

MANAGEMENT'S DISCUSSION
AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF
OPERATIONS FOR
ASCENSION

AS OF AND FOR THE
YEAR ENDED
JUNE 30, 2014 AND 2013

The following information should be read in conjunction with Ascension's consolidated financial statements and related notes to the consolidated financial statements.

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Management's Discussion and Analysis of Financial Condition
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Introduction to Management's Discussion and Analysis

The purpose of Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), is to provide a narrative explanation of the financial statements of Ascension Health Alliance, d/b/a Ascension (the System), that enables users of the System's financial statements to better understand the System's operations, to enhance the System's overall financial disclosures, to provide the context within which the System's financial information may be analyzed, and to provide the System's financial condition, results of operations and cash flows. Unless otherwise indicated, all financial and statistical information included herein relates to continuing operations. MD&A, which should be read in conjunction with the accompanying Consolidated Financial Statements and Supplementary Information, includes the following sections:

- Strategic Direction
- Organizational Developments
- Results of Operations - Consolidated
- Liquidity and Capital Resources
- Results of Operations – Same Facility

Strategic Direction

The System continues to create a sustainable person-centric healthcare company to serve individuals throughout their lifetime. The System continues to focus on centralization, standardization, optimization and collaboration to provide value-based care to patients and the communities in which the System serves. The System is focused on high quality patient outcomes and quality of care for those served.

Across the System, Health Ministries are engaging in population health management pilot programs such as accountable care organizations (ACOs), participating in state health exchanges and leading and participating in emerging healthcare projects across the country. Some

of these projects include partnering with the Centers for Medicare and Medicaid Services (CMS) as part of the Pioneer ACO program, Medicare Shared Savings Program, the Center for Medicare & Medicaid Innovation and the Center for Medicare and Medicaid Partnership for Patients, operating a Medicaid Health Maintenance Organization (HMO), and participating in commercial ACOs.

Organizational Developments

Healthcare Operations

The System continues to broaden its healthcare delivery platform, as shown through a significant business combination last fiscal year. Effective April 1, 2013, three regional health systems that formerly comprised Marian Health System, Inc. joined Ascension Health, a direct subsidiary of the System. The three health systems are as follows: Via Christi Health, Inc. (Via Christi Health), based in Wichita, Kansas; Ministry Health Care, Inc. (Ministry Health Care), based in Milwaukee, Wisconsin; and St. John Health System, Inc. (St. John Health), based in Tulsa, Oklahoma (collectively, the Marian Systems). Prior to this transaction, Ascension Health had a 50% interest in Via Christi Health, which was accounted for under the equity method of accounting.

In total, the addition of the Marian Systems into Ascension Health added 32 hospitals and more than 250 clinics to the System in the states of Wisconsin, Minnesota, Oklahoma and Kansas. As of April 1, 2013 this transaction resulted in a contribution from business combinations of \$2.0 billion, net of the 50% interest in Via Christi Health, with increases to total assets of \$4.9 billion, total liabilities of \$2.7 billion and restricted net assets of \$0.2 billion, including the contribution of unrestricted net assets – non-controlling interests. Prior to this combination, the Marian Systems recognized \$3.9 billion in total revenue for the fiscal year ended September 30, 2012. For the year ended June 30, 2014, the Marian Systems recognized \$4.3 billion in total

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Organizational Developments (continued)

revenue, which is included in the System's consolidated financial statements for the year ended June 30, 2014.

The Marian Systems offer two care management programs in addition to those mentioned previously. The first is Network Health Plan (NHP) which contracts with various healthcare facilities to provide covered medical services and supplies to NHP participants for a fixed monthly premium. NHP is a fully consolidated entity of Ministry Health Care. The other program is a 50% owned joint venture, CommunityCare Managed HealthCare Plans of Oklahoma, Inc. (CommunityCare). CommunityCare contracts to provide primarily medical services to subscribing participants and St. John Health receives premium revenue from CommunityCare for its participation. CommunityCare is accounted for under the equity method of accounting by St. John Health.

Carondelet Health (Kansas City, Missouri)

Carondelet Health in Kansas City, Missouri, a subsidiary of Ascension Health, has signed a Letter of Intent with Prime Healthcare Services Inc. for the acquisition of the majority of the facilities of Carondelet Health. The transaction would include St. Joseph Medical Center in Kansas City and St. Mary's Medical Center in Blue Springs, Missouri, and most of their subsidiaries and affiliated facilities.

As part of this transaction, the three Carondelet Health long-term care facilities - Carondelet Manor, Villa Saint Joseph and St. Mary's Manor- and the two hospitals' charitable foundations would remain part of Ascension Health. Carondelet Health and Prime Healthcare Services Inc. have started the due diligence process. The organizations anticipate reaching a definitive agreement by the fall of 2014.

Mount St. Mary's Hospital and Health Center (Lewiston, New York)

Catholic Health of Buffalo ("Catholic Health"), a health system serving western New York, and Mount St. Mary's Hospital and Health Center, a subsidiary of Ascension Health, have agreed in principle to formalize

a comprehensive agreement to have Mount St. Mary's become a full member of Catholic Health. Mount St. Mary's will join Catholic Health's other regional hospitals; however, Our Lady of Peace Nursing Care Residence will remain part of Ascension Health. The transition will require corporate, religious and governmental approvals. The entire approval process is expected to be completed later next year.

Carondelet Health Network (Tucson, Arizona)

Carondelet Health Network (Carondelet), a subsidiary of Ascension Health, has entered into a Letter of Intent to create a joint venture with Tenet Healthcare Corp. ("Tenet") and Dignity Health to own and operate the operating assets of Carondelet in Tucson, Arizona. The organizations have started exclusive negotiations anticipated to result in a definitive agreement in the fall of 2014.

Under the anticipated agreement, Tenet would be the majority partner in the joint venture and have management responsibility for the operations of Carondelet's health system assets, including St. Joseph's and St. Mary's Hospitals in Tucson, Arizona, Holy Cross Hospital in Nogales, Arizona, Carondelet Medical Group, Carondelet Specialist Group, as well as all of Carondelet's ancillary businesses.

Health City Cayman Islands

The System has entered into a partnership with Narayana Health (NH) based in India, to bring innovative healthcare services to the Cayman Islands. NH is led by a world-renowned cardiovascular surgeon with extensive experience in providing high-quality/low-cost healthcare at medical facilities in India. Health City Cayman Islands (Health City), includes a 104 bed hospital, specializing in cardiac and orthopedic services. The multi-specialty hospital will provide services not widely available in the region. Health City opened in March 2014 and the first procedures were performed in April 2014.

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Organizational Developments (continued)

Ascension Investment Management

Effective October 1, 2013, Catholic Healthcare Investment Management Company (CHIMCO) began doing business as Ascension Investment Management. Effective January 1, 2014, all business activities were transferred to a new entity, Ascension Investment Management, LLC (AIM). AIM is a wholly owned subsidiary of Ascension whose purpose is to provide investment advisory services to the System, as well as to other clients. AIM, a federally registered investment advisor, offers expertise in the areas of asset allocation, manager selection and risk management and seeks to provide its clients with benefits such as access to a variety investment strategies, access to quality investment managers, administrative ease, cost economies and socially responsible investment choices.

AIM manages the Ascension Alpha Fund, LLC (Alpha Fund), in which the assets of the System, as well as those of other clients, are invested. The majority of the System's long-term investments are held in the Alpha Fund.

Total net investments under management by AIM are \$29.6 billion and \$25.9 billion at June 30, 2014 and 2013, respectively. Of the total net investments under AIM management, \$14.0 billion and \$12.8 billion are included in the total consolidated net assets of the System at June 30, 2014 and 2013, respectively.

The Resource Group

Ascension Health Resource and Supply Management Group, LLC (The Resource Group) is a contracting, operations, logistics and change management organization that continuously implements non-labor expense reductions in collaboration with the Health Ministries, physicians and associates, while ensuring that a high level of quality is maintained for end users. The Resource Group maintains status as a Group Purchasing Organization (GPO), having received this designation from the Office of the Inspector General. As a wholly owned GPO, The Resource Group negotiates and manages contracts for its participants, which include the

Health Ministries as well as other healthcare entities and educational institutions, with the goal of effectively managing all participants' expenses while supporting quality patient care and other services.

For the year ended June 30, 2014, supplies expense as a percentage of net patient service revenue was 16.3% (16.1% on a same facility basis), compared to 16.0% for the year ended June 30, 2013. The slight increase for the year ended June 30, 2014 was primarily due to the 19.1% increase in total surgeries (a 2.3% decrease on a same facility basis), particularly higher cost implant procedures, as well as increased pharmacy costs due in part to modifications made to the discounts available under Health Resources and Services Administration's (HRSA) 340B Drug Pricing Program.

Ascension Clinical Holdings

Ascension Clinical Holdings (Clinical Holdings) provides a standard suite of capabilities and services to enable physician practices to operate more efficiently, and to facilitate the transition to emerging fee-for-value payment models and risk-based contracting arrangements. Clinical Holdings near term efforts are primarily focused on deploying a core set of capabilities and common practice management software platform to the System's Health Ministries' employed physician base. This common platform was successfully implemented for approximately 1,700 providers, representing 30% of total System providers for the year ended June 30, 2014.

Symphony and Ministry Service Center

Symphony is an enterprise resource planning initiative of Ascension. Symphony is designed to facilitate efficiency, focus resources, and provide analytic capabilities that will improve operational and clinical decisions, both at the local Health Ministry and System-wide levels. Symphony will provide a single, centralized source of information with a shared database, allowing for immediate information access and retrieval and reducing or eliminating data inaccuracy and duplication.

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Organizational Developments (continued)

Through Symphony, the System is implementing new operational practices in finance, human resources, and supply chain, enabled by information technology. As of June 30, 2014, this initiative has been successfully deployed at seventeen Health Ministries with more than 90,000 users. In addition, Symphony was successfully deployed at three additional Health Ministries on September 1, 2014. Symphony is expected to be fully implemented in fiscal year 2016.

The Ministry Service Center (MSC), a critical and permanent component of Symphony, provides shared services in the areas of finance, human resources, and supply chain to the Health Ministries of the System. Through process transformation, the MSC delivers value by providing services more efficiently, enabling new insights, and facilitating Health Ministry consistency in day to day practices.

Results of Operations – Consolidated

The addition of the Marian Systems to Ascension had a significant impact on the consolidated financial results for the year ended June 30, 2014. On a consolidated basis, the System experienced a 14.3% increase in equivalent discharges and a 19.9% increase in outpatient visits as compared to the same period in the prior year. Additionally, net patient service revenue per equivalent discharge increased 3.1% on a consolidated basis as compared to the year ended June 30, 2013, with case mix index increasing from 1.51 for the year ended June 30, 2013 to 1.54 for the year ended June 30, 2014. With the addition of the Marian Systems, total operating expense per equivalent discharge (net of NHP's insurance claims) increased 3.5% for the year ended June 30, 2014, as compared to the prior period.

On a consolidated basis, recurring operating margin was 4.1% for the year ended June 30, 2014, as compared to 3.4% for the year ended June 30, 2013. The primary drivers for the increase in the recurring operating margin for the year ended June 30, 2014, as compared to the same period in the prior year include:

- An increase in the intensity of services provided,
- Focused efforts to right size the labor force and increase productivity as evidenced by the decrease in FTE's per adjusted occupied bed from 4.8 for the year ended June 30, 2013 compared to 4.5 for the year ended June 30, 2014, a decrease of 6.3%,
- Decreased employee healthcare costs and modifications to employee benefit programs, including the addition of care management and wellness programs along with the transition to defined contribution retirement plans.

The costs of care of persons living in poverty and other community benefit programs increased \$334 million for the year ended June 30, 2014, an increase of 22.5%, as compared to the same period in the prior year. The most significant increase was in the unpaid cost of public programs for persons living in poverty, which increased \$153 million, or 31.3%, for the year ended June 30, 2014, as compared to the same period in the prior year, primarily due to expansion of Medicaid in certain states, improved efforts to identify patients qualifying for state and local programs as well as reduced Medicaid funding and increased state sponsored provider taxes.

In addition to the increased unpaid cost of public programs for persons living in poverty, the cost of charity care provided increased \$56 million, or 10.7%, and the cost of other community benefit programs increased \$97 million, or 25.4%, primarily due to the addition of the Marian Systems. The cost of other community benefit programs also increased due to reduced funding to cover the increased costs of graduate medical education and trauma programs.

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The following table reflects certain patient volume information and key performance indicators, on a consolidated basis, for the year ended June 30, 2014 and 2013.

	Year Ended June 30,	
	2014	2013
<u>Volume Trends</u>		
Equivalent Discharges	1,515,509	1,325,844
Total Admissions	759,693	681,551
Case Mix Index	1.54	1.51
Acute Average Length of Stay (days)	4.50	4.48
Observation Days	290,689	227,858
Emergency Room Visits	2,818,762	2,454,029
Surgical Visits (IP & OP)	607,353	509,965
Physician Office Visits	9,153,681	7,448,351
Home Health Visits	752,064	590,578
<u>Key Performance Indicators</u>		
Recurring Operating Margin	4.1%	3.4%
Recurring Operating EBITDA Margin	9.6%	8.7%
Operating Margin	3.0%	2.7%
Operating EBITDA Margin	8.5%	8.1%

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Liquidity and Capital Resources

The System had net unrestricted cash and investments of \$13.0 billion at June 30, 2014, compared to \$12.0 billion at June 30, 2013. This increase is primarily due to favorable investment returns and cash generated from operations partially offset by capital purchases and net debt repayments for the year ended June 30, 2014.

Days cash on hand increased 16 days from June 30, 2013 to June 30, 2014 primarily due to favorable investment income and strong expense management with daily operating expenses increasing only 1.2%

from the prior fiscal year despite the increase in case mix index as previously mentioned. Net days in accounts receivable have increased from 47 to 48 from June 30, 2013 to June 30, 2014, primarily due to implementation of new billing systems and procedures and preparation for the transition to use ICD-10 code sets for medical billing.

Cash-to-senior debt and cash-to-debt continue to remain strong at 224.6% and 201.5%, respectively, at June 30, 2014, representing increases from June 30, 2013. Debt to capitalization has also shown improvement, decreasing from 30.2% at June 30, 2013 to 27.6% at June 30, 2014.

Balance Sheet Ratios		
	June 30,	
	2014	2013
Days Cash on Hand	256	240
Net Days in Accounts Receivable	48	47
Cash-to-Senior Debt	224.6%	204.1%
Cash-to-Debt (Senior and Subordinated)	201.5%	183.2%
Senior Debt to Capitalization	25.5%	28.0%
Total Debt to Capitalization	27.6%	30.2%

Results of Operations – Same Facility¹

The remainder of this document discusses results of operations on a same facility basis, which is the System excluding primarily the Marian Systems for the period from July 1, 2013 through March 31, 2014, and certain other facilities which do not have comparable operation periods in the prior year.

Volume Trends and Net Patient Service Revenue

For the year ended June 30, 2014, equivalent discharges decreased 2.1% as compared to prior year, a reflection of the national trend toward declining utilization rates in healthcare delivery systems. Inpatient surgeries decreased 0.5% and observation days increased 7.6% as compared to the same period in the prior year. The increase in

observation days is primarily due to increasing limitations on the admission of Medicare and Medicaid patients, such as the “2-Midnight Rule.”

Contrary to the trend in inpatient volumes, outpatient volumes continue to grow. Outpatient visits increased 1.1% for the year ended June 30, 2014 as compared to the same period in the prior year due primarily to a 0.7% increase in physician office visits, consistent with the transition to deliver healthcare services in the outpatient setting.

Net patient service revenue per equivalent discharge increased 3.8% compared to the same period in the prior year due to the increase in volume of outpatient surgical cases, mix of services provided, and favorable rate negotiations in certain markets. Revenue realization improved despite the previously

¹ Amounts are on a same facility which is the System primarily excluding the Marian Systems for the period July 1, 2013 through March 31, 2014 and certain other facilities which do not have comparable operation periods in the prior year.

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**Results of Operations – Same Facility¹
(continued)**

mentioned continued increases in uncompensated care - a result of high unemployment, Medicaid expansion in certain states and trends toward high-deductible health plans, which shift greater financial responsibility to the patient. Additionally, case mix increased to 1.54 for the year ended June 30, 2014 as compared to 1.51 for the same period in the prior year, with more substantial increases in case mix index at certain facilities.

Uncompensated Care

Charity care costs decreased \$7.4 million, or 1.4%, for the year ended June 30, 2014 as compared to the same period in the prior year. This decrease is primarily attributable to the expansion of Medicaid in certain states and improved processes for identifying patients qualifying for financial assistance. As compared to the same period in the prior year, bad debt expense decreased 6.9% due to successful collection efforts at certain health ministries and the previously mentioned improved processes for identifying patients qualifying for financial assistance.

The unpaid cost of public programs for persons living in poverty increased \$99.6 million, or 20.4%, for the year ended June 30, 2014 as compared to the year ended June 30, 2013. This increase is primarily attributable to a decrease in reimbursement at certain health ministries and the previously mentioned expansion of Medicaid in certain states, improved processes for identifying patients qualifying for financial assistance, and increased state sponsored provider taxes in Illinois and Indiana.

The cost for other programs for persons living in poverty and other vulnerable persons increased \$18.0 million, or 20.0%, for the year ended June 30, 2014 as compared to the same period in the prior year, primarily due to new programs and initiatives to improve community health at certain health ministries.

Recurring Operations

For the year ended June 30, 2014:

Net patient service revenue, less provision for doubtful accounts, increased \$245.9 million, or 1.6% as compared to the same period in the prior year. In addition to growth in net patient service revenue, other operating revenues have increased \$77.1 million, or 5.8%, primarily due to the 29.4% increase in new customer growth at certain Ascension subsidiaries and slightly increased levels of American Recovery and Reinvestment Act (ARRA) meaningful use incentive revenue, both federal and state.

Total operating expenses increased \$236.5 million, or 1.5%, as compared to the same period in the prior year primarily due to the following:

- Salaries, wages and employee benefits decreased \$85.8 million, or 1.0%, compared to the year ended June 30, 2013, due primarily to focused efforts to right size the labor force and increase productivity, decreased employee healthcare costs and modifications to employee retirement programs.
- Purchased services expense increased \$36.9 million, or 3.9%, as compared to the same period in the prior year primarily due to the System's biomedical engineering company's growth in new customers and the additional maintenance expense incurred to serve those customers. In addition, purchased services increased as a result of the ongoing transition to a third-party contractor to provide dietary and housekeeping services at a reduced rate across the System, which has shifted and reduced salaries and wages.
- Professional fees increased \$70.5 million, or 6.5%, as compared to the same period in the prior year due primarily to management's continued efforts to identify process improvements and further streamline operational processes across the System.

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Results of Operations – Same Facility¹
(continued)

- Supplies expense increased only \$55.3 million, or 2.4%, as compared to the same period in the prior year due to management's continued focus on centralized contracts, leading to reduced pricing and additional rebates, despite the increased level of acuity evidenced by the 2.0% increase in total case mix index.
- Other expenses increased \$144.7 million, or 6.8%, as compared to the same period in the prior year primarily due to the previously mentioned \$31.8 million increase in state sponsored provider tax expense primarily in Illinois and Indiana. Additionally, maintenance and repairs expense increased \$21.2 million, primarily due to the growth in new customers in the System's biomedical engineering company. Utilities increased \$9.7 million, or 4.0%, from prior year.

Impairment, Restructuring and Nonrecurring Losses

Net impairment, restructuring and nonrecurring losses were \$222.0 million for the year ended June 30, 2014 as compared to a loss of \$103.3 million during the year ended June 30, 2013. Losses for the year ended June 30, 2014, were primarily due to \$163.3 million in Symphony expenses, one-time termination and other restructuring expenses of \$28.8 million, impairment expenses of \$22.1 million, and other nonrecurring expenses of \$7.8 million. Losses for the year ended June 30, 2013 were primarily due to \$113.3 million in Symphony expenses, one-time termination and other restructuring expenses of \$57.5 million, and other nonrecurring expenses of \$4.8 million, partially offset by pension curtailment gains of \$72.3 million

recorded at Ministry Health Care and St. John Health.

Investment Return

For the year ended June 30, 2014, the long-term investments held in the Alpha Fund, excluding non-controlling interests and long-term investments held by the self-insurance programs, earned a return of 11.8%, compared to a return of 8.7% for the year ended June 30, 2013. The System's cash and investments are invested in a broadly diversified portfolio that is managed by AIM, a wholly owned subsidiary of Ascension, as previously discussed.

Nonoperating Gains, Net

For the year ended June 30, 2014, nonoperating gains, net were \$1.3 billion compared to \$2.7 billion for the year ended June 30, 2013. The decrease is due to the contributions from the business combination of the Marian Systems of \$2.0 billion during the year ended June 30, 2013, partially offset by increased investment return of \$636.0 million previously discussed in the Investment Return section.

Excess of Revenues and Gains over Expenses and Losses

The excess of revenues and gains over expenses and losses was \$1.8 billion and \$3.2 billion for the years ended June 30, 2014 and 2013, respectively. The decrease is primarily driven by the previously mentioned decrease in the contributions from business combinations of the Marian Systems during the year ended June 30, 2013, offset by favorable investment returns and an increased recurring operating margin in comparison to the same period in the prior year.

¹ Amounts are on a same facility which is the System primarily excluding the Marian Systems for the period July 1, 2013 through March 31, 2014 and certain other facilities which do not have comparable operation periods in the prior year.