UCSF Medical Center/Stanford Health Services
Proposed Merger of Clinical Enterprises
Third Party Review
November 8, 1996 Regents Report

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UCSF Medical Center/Stanford Health Services
Proposed Merger of Clinical Enterprises
Third Party Review
Executive Summary

The overall goal of the third party review process was to render an objective and independent opinion on the following three questions:

1.) Is this a sound business decision for the University of California?

2.) Has the analysis to date been sufficient to determine the business viability of the merger?

3.) What, if any, further analysis should be conducted?

It is the opinion of the third party review team that the proposed merger of clinical services is a sound business decision for the University of California.

The following summarizes our opinion:

- The Northern California healthcare market is one of the most competitive in the nation and is expected to continue to place significant economic pressures on healthcare providers through price declines, utilization reductions and diminishing state and federal funds available for the support of teaching and research.

- While UCSF Medical Center has successfully navigated through these challenges to date, their performance was facilitated by significant non-operating income sources to support operations. These are the same funding sources that are expected to decline in the future, placing UCSF Medical Center's clinical and academic mission in jeopardy.

- The proposed Newco merger offers UCSF Medical Center stronger financial prospects. This improved financial health enables the continued support for the UCSF School of Medicine, ensures the ability to maintain the care provided for indigent patients, and offers the opportunity to grow its clinical volume and therefore support more healthcare workers relative to UCSF Medical Center on a standalone basis.

- In addition to the proposed merger providing UCSF Medical Center with important short term benefits, it also provides UCSF with a longer term

source of competitive advantage through the coordination of clinical and academic activities with Stanford Health Services and Stanford School of Medicine. This might include such areas as coordinating departments and faculty chair recruitment packages, sharing in program investments, and coordinating teaching programs. While the magnitude of these longer term benefits has not been quantified, we believe the potential is significant.

In the charge to the third party review team, the Regents asked if the analysis to date had been sufficient to determine the business viability of the merger, and if not, what further analysis should be conducted.

It is the opinion of the third party review team that, in fact, additional analysis was required to understand the soundness of the business aspects of the decision for the University of California. The review team carried out the additional analysis required and considered the findings in the overall opinion expressed to the University of California Regents. At this point, we do not considered there to be additional analyses required to determine the viability of the proposed merger.

UCSF Medical Center/Stanford Health Services
Proposed Merger of Clinical Enterprises
Third Party Review
November 8, 1996 Regents Report

I. Context for Third Party Review: Why are we here today?

II. Description of Regents Charge: What have we been asked to do?

III. Role of Clinical Enterprises for the University of California System: Why is UC in the hospital business?

IV. Environmental Context: What is the environment in which UCSF Medical Center is operating?

V. UCSF Medical Center's Business Prospects: How healthy is a standalone UCSF Medical Center today and in the future? How does this compare with Newco's business prospects?

VI. Risks of Merging: What are the uncertainties associated with merging?

VII. Risks of Not Merging: What are the risks associated with not merging?

VIII. Proposed Merger Structure: School of Medicine Support, Dissolution Provision, Governance Structure, and Equity Split

IX. Third Party Review Team Recommendation: Is this a sound business decision?

X. Additional Analysis: Is any additional analysis required to make a decision?

XI. Importance of Timely Decision: Why do it now?

Appendices

A. Third Party Review Team Members

B. Environmental Context

C. Financial Analysis: UCSF Medical Center versus Stanford Health Services and Lucile Packard Children's Hospital

D. Merger Business Plan: Key Assumptions

E. UCSF Medical Center Performance: Standalone versus Merged Scenarios

F. Cost Position Comparison

G. Impact on Labor Force

H. Impact on Indigent Care: Patient Mix Comparison

I. Newco Board of Directors: Proposed Composition

J. Measures of Equity Contribution: UCSF Medical Center versus SHS/LPCHS

UCSF Medical Center/Stanford Health Services
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Third Party Review
November 8, 1996 Regents Report

I. Context for the Third Party Review

In the fall of 1995, the University of California, San Francisco Medical Center (UCSF Medical Center) began discussions with Stanford Health Services (SHS) regarding a possible merger of clinical enterprises (excluding the Schools of Medicine). The rationale for this merger was to create one of the country's premier medical centers for highly specialized services that would have improved clinical and financial performance and strengthened academic capabilities. This proposed merger was in response to the continued pressure the Northern California market places on both entities and the recognition that as the marketplace continues to consolidate both entities must adapt to remain competitive. In addition, both organizations considered each other the best specialty care partner, due to their commonality of academic mission.

These initial discussions led to a merger evaluation process which was begun in early 1996. This evaluation process was comprised of joint UCSF Medical Center/Stanford Health Services teams meeting weekly to identify opportunities for merger-related synergies – cost reduction opportunities, revenue enhancement opportunities, avoided capital investments and the cost to achieve these synergies. The result of these joint working group sessions was a business plan for "Newco" (the interim name representing the merged clinical enterprises of UCSF and SHS). In July, the Regents took their first action to proceed with further discussions regarding the proposed merger. Shortly thereafter, Stanford Health Services announced that Lucile Packard Children's Hospital would be merged into SHS, changing the strategic and financial contribution of Stanford University to Newco.

In August, the Regents requested an independent and objective financial and business analysis of the proposed merger, including the Lucile Packard Children's Hospital. President Richard Atkinson asked Warren Hellman to serve as chairman for a third party review of the proposed merger of clinical services. Mr. Hellman chose John McArthur and Dr. Samuel Thier as the additional members of the third party review team. In addition, Warren Hellman retained Bain & Company, a management consulting firm, to provide analytic support to the review team. (See Appendix A, pages 29-31, for review team biographies).

II. Regents' Charge to the Third Party Review Team

The overall goal of the third party review process was to render an objective and independent opinion on the following three questions:

1.) Is this a sound business decision for the University of California?

2.) Has the analysis to date been sufficient to determine the business viability of the merger?

3.) What, if any, further analysis should be conducted?

The team's approach has been data-driven. We have reviewed the facts of the situation, understood the issues that have been raised and gathered data to support an objective opinion on the charge described above.

The Office of the President has made available to us the information and analyses that have been produced by a variety of consultants on behalf of both the University of California and Stanford. We have reviewed this information and we have performed additional analysis on our own. Specifically, we have:

- analyzed the healthcare environment generally, as well as specific to the Bay Area to understand better the marketplace dynamics

- analyzed the historical and current fiscal and academic health of UCSF Medical Center, SHS and Lucile Packard Children's Hospital (LPCHS), (specifically, the ability to permit the School of Medicine to continue to achieve its academic mission)

- analyzed the financial prospects for UCSF Medical Center and SHS/LPCHS going forward on a standalone basis

- analyzed the potential benefits and risks of consolidation – both from the standpoints of academic missions and fiscal viabilities

- analyzed governance and administrative structures on a consolidated basis

- analyzed the equity structure of the proposed merger

As part of this analysis, we or our representatives have met with over 35 people associated with the medical centers, medical schools and universities.

In addition to the above specified issues, there are other concerns that various constituencies have raised with respect to the proposed merger that are not within the scope of this third party review. For example, the legal authority of the Regents to create this proposed entity is not within our scope. A more comprehensive list of these areas is outlined on page 21 of this report.

III. Role of Clinical Enterprises for the UC System

The University of California provides clinical services to support its academic mission. Specifically, UC must have a critical mass of clinical activities to educate medical and graduate students, to train residents and clinical fellows, to support faculty clinicians, and to support medical and biological sciences research at the School of Medicine and the University at large.

In addition to providing this critical mass of clinical activities for the faculty and the School of Medicine, the UCSF Medical Center also provides financial support for the academic mission. Specifically, UCSF Medical Center contributes approximately $20MM in financial support to the School of Medicine every year. This includes medical direction, recruitment/new program development and primary care support. UCSF Medical Center's ability to continue to fund the School of Medicine in these areas is highly dependent upon its continued financial health. A healthy UCSF Medical Center can continue to support the School of Medicine. A financially strapped UCSF Medical Center will not be able to support its School of Medicine funding over time.

It is within this context that the University of California and the Third Party Review must approach its charge. Specifically, to answer the question of which path holds the more financially viable and academically healthy future for the UCSF Medical Center: standalone or merged with Stanford's clinical enterprises?

IV. Environmental Context

UCSF Medical Center is in an environment that is experiencing significant economic pressures (See Appendix B, pages 32-39, for supporting analysis):

- **The growth in managed care, specifically HMOs' share of the market, is steadily increasing in California.**

- HMO payment rates to providers are significantly below that of other insurers and have fallen at a predictable rate.
- This growth in HMOs is causing a significant decline in the use of hospital services.
  - HMOs enforce lower levels of utilization of high cost services through primary care gatekeepers and other utilization review mechanisms.
- Consequently, there is significant over-capacity in the Bay Area market for inpatient beds, putting even more downward pressure on price.
- Funds historically available for the support of teaching and research are diminishing.
  - Substantial reductions in Federal funding are proposed for Medicare and Medi-Cal, and these reductions are disproportionately focused on the special payments teaching hospitals have received.
  - Children's services are particularly affected because of their greater reliance on Medi-Cal, which the state plans to convert to a managed care program, resulting in decreased utilization by this patient population.
- Bay area employers and insurers are cooperating to increase leverage and continue to negotiate price concessions from providers.
  - e.g., large group purchasing of health plans from groups like CalPERS and Pacific Business Group on Health (PBGH)
- Hospitals and physicians are consolidating into larger healthcare systems to provide more cost effective care for their patients (by reducing administrative and practice costs), broaden their geographic reach, and assume greater risk for providing cost effective care for their enrolled populations.

This highly challenging environment forces academic medical centers and specifically UCSF Medical Center to strive to achieve the following strategic imperatives:

1. Gain access to an adequate and appropriate patient flow to meet the academic and economic requirements;
2. Demonstrate to employers, insurers, and consumers their high quality of medical care for patients;
3. Ensure a comparable position on cost and customer service relative to their competitors.

UCSF Medical Center's strategy must encompass initiatives for its *local* market (e.g., San Francisco proper), *regional* market (e.g., Northern California market) and *broader* market (e.g., the rest of the United States and other countries). For example, recent initiatives in UCSF's *local* market strategy include its acquisition of Mt. Zion Medical Center, the building of UCSF's primary care physician base

and the creation of Brown & Toland Medical Group - the affiliation of UCSF physicians and California Pacific Medical Group physicians. Each of these initiatives is aimed at gaining access to patients in the local, San Francisco marketplace.

UCSF Medical Center also has a series of strategic initiatives aimed at their *regional* and *broader* markets – markets that typically comprise high acuity, specialty patient care. The proposed merger of clinical enterprises between UCSF and SHS/LPCHS is aimed at improving UCSF's position in these *regional* and *broader* markets. This proposed merger is by no means considered a "silver bullet" or single solution for UCSF Medical Center. It is considered one in a series of initiatives that are collectively expected to improve UCSF Medical Center's financial prospects. The proposed merger is, however, unique in that Stanford is the only other academic medical center in the Bay Area and therefore poses the only potential merger of this type for UCSF. In addition, both UCSF and Stanford enjoy world class reputations as academic medical centers.

V. UCSF Medical Center's Business Prospects: Standalone versus Merged

The Regent's have asked the third party review team to analyze whether or not the proposed Newco merger is a sound business decision for the University of California. Based upon business and financial analysis, it is the opinion of the third party review team that the proposed Newco merger is a sound business decision for the following reasons that will be further discussed throughout the remainder of this report:

1. UCSF Medical Center is in a stronger financial position in Newco than on a standalone basis.
    - UCSF Medical Center's standalone financial forecasts reflect weak operating performance, with significant reliance on non-operating income sources.
    - Newco offers potential for a stronger financial position due to merger-related benefits of revenue enhancement and cost reductions.
    - Even if the merger-related benefits are half of those forecasted, UCSF Medical Center is still financially stronger under a merged scenario.

2. The risks associated with the merger can be managed.

3. UCSF may not have the option to negotiate as favorable a position in this merger in the future as UCSF Medical Center's financial position declines.

4. The leadership and professionals most directly involved, whose careers and livelihoods are on the line, strongly support the proposed merger.

Measure of Operating Profitability:

The third party review team considers the appropriate measure of the "vitality" of each business to be "operating profit". Operating profit is defined as the income from operations before non-operating income (net investment income, gifts, and clinical teaching support), before one-time charges, and before the benefit of an over-funded pension. Non-operating income sources are removed as they are neither guaranteed nor indicative of the underlying performance of the operation. One-time charges are adjusted as well, since they are not indicative of the underlying performance of the operation. And the benefit of an over-funded pension is removed as it is not a sustainable occurrence. We examined each entity using this measure, operating profitability, to create a comparable and meaningful representation of the underlying financial health of each operation.

This measure is different from the publicly reported profitability measure of "revenues over expenses". Revenue over expenses includes non-operating income, one-time charges, and the benefit of an over-funded pension. The third party review team does not believe this measure is appropriate for understanding the "vitality" of each entity.

We also recognize that the above defined measure of operating profitability is not a good indication of each medical center management team's performance. Clearly, management may have run their respective medical centers differently if they had not received these non-operating "subsidies".

UCSF Medical Center's Standalone Performance:

Using this measure of operating profitability, UCSF Medical Center's standalone financial forecasts reflect weak operating performance (See Appendix C, page 45). Specifically, the operating *deficit* is forecasted to be 3.4% of revenues by the year 2000. UCSF Medical Center relies heavily on "non-operating" income sources to subsidize operations. With these subsidies, UCSF Medical Center forecasts a *total* profit margin of 2.3% of revenues. This is a very thin margin on forecasted operating revenues of $553MM.

UCSF Medical Center's Performance versus Stanford Health Services:

We have also analyzed the financial health of Stanford Health Services (SHS) and Lucile Packard Children's Hospital at Stanford (LPCHS). It is the opinion of the third party review team that SHS's and LPCHS's operations are at least as financially healthy as UCSF Medical Center. Using the above defined measure of operating profit and comparing cumulative operating profit from fiscal year 1991 to fiscal year 1996, we found that SHS/LPCHS outperformed UCSF Medical Center by $67MM. SHS/LPCHS realized $25MM in cumulative operating profit over this time period, and UCSF Medical Center realized a cumulative operating deficit of $42MM. (See Appendix C, page 46, for UCSF detail).

Benefits of the Proposed Merger:

The proposed merger scope encompasses the clinical enterprises of UCSF and Stanford, including the medical centers and the clinical activities associated with UCSF, Stanford Health Services (SHS) and Lucile Packard Children's Hospital at Stanford (LPCHS). The proposed merger excludes the Schools of Medicine. The Schools of Medicine will be represented on the Newco board and will interface with the Newco management team regarding future operating decisions that impact both entities. The medical centers will utilize the faculty from the Schools of Medicine for clinical services. The services to be provided by the faculty to the Medical Centers are defined in the Professional Services Agreement.

The rationale for the proposed merger is as follows:

To continue to thrive as a premier academic medical center in the highly competitive Bay Area marketplace, UCSF Medical Center is pursuing a merger with Stanford's clinical enterprises to become increasingly cost competitive, to share in expensive investments required to maintain each institution's leading edge clinical care, and to improve its ability to assume risk for defined patient populations in order to attract and retain managed care contracts and access to the specialty referral market.

In the spring of this year, representatives of both the UCSF Medical Center and Stanford Health Services engaged in a joint working group process to develop the Newco business plan. Over a three month period, these representatives met to discuss the expected merger benefits and costs, identify the sources of those benefits and costs, and quantify their expected magnitude and timing. This Newco business plan created by both UCSF Medical Center and Stanford Health Services forecasts the following merger benefits and related costs:

Merger-Related Benefits:

- additional specialty care revenues of $100MM by 1998 (an additional 3000 specialty cases)
- cumulative operating expense reductions of $152MM by 2000
- avoided capital of $7.8MM over four years (1997-2000)

Merger-Related Costs:

- professional service fees of $9.5MM and severance costs of $4MM
- annual pension/retiree health benefits of roughly $21MM per year due to Newco not benefiting from the University of California's over-funded pension

Appendix D (pages 64, 67, and 68) outlines each of these key assumptions.

For each of these merger-related benefits and costs, the third party review team analyzed the assumptions underlying these numbers, assessed the reasonableness of the magnitude of the expected benefits and assessed the sensitivity of Newco's performance to the realization of these benefits.

Regarding the **expected revenue enhancements**, the third party review team agreed with the underlying rationale for the benefit but felt the $100MM revenue increase was too aggressive and considered a $50MM target (50% of the original business plan's assumed increase) more reasonable.

The expected increase in specialty case volume is driven by the benefits of improved market share relative to competition. Today, UCSF Medical Center currently has a specialty care market leadership position in 6 of 26 medical diagnostic categories. SHS/LPCHS currently leads in 6 categories as well. The combination of UCSF Medical Center and SHS/LPCHS specialty volume creates a market leadership position in 8 additional medical diagnostic categories. In other words, Newco will be the market leader in 20 out of 26 medical diagnostic categories (refer to Appendix D, pages 60-63, for details).

This improved market share position benefits Newco in two ways. First, the merged entity will have an improved cost position and therefore should allow for the possibility of lower prices for specialty care which should make Newco more attractive than alternative referral centers. Second, a merged entity has the potential to provide improved customer service by being able to offer a broader geographic coverage and service line representation. This includes more location choices for patients and more specialist choices for referring physicians.

The third party review team considered the magnitude of the increase in specialty referrals to be aggressive given the implied growth rate and given the expected growth of the market overall. The increase in specialty care cases implied a 22% increase in the combined Newco specialty care volume over a two year period. This would be an aggressive growth goal even in a moderate growth market. However, specialty care is a flat to declining market, implying a significant share gain to achieve this volume increase.

Consequently, the third party review team considered a $50MM revenue increase over two years (50% of the original business plan's assumed increase) to be a more realistic goal for Newco. A $50MM target increase over two years is reflective of roughly 5% growth in specialty care volume each year for two years.

With respect to the **cost reductions**, the third party review team felt the identified operating expense reductions of roughly $44MM annually were reasonable *given the scope of the planned consolidation*. This amounts to 3.5% of the combined fiscal year 1996 operating expenses. The team reviewed the specific cost reduction opportunities identified and the level of specificity associated with these assumptions and considered them to be reasonable.

With regards to the **net avoided capital**, the third party review team considered the $7.8MM avoided capital goal (over four years) to be conservative. The goal amounts to a 3% reduction in the forecasted capital budget and is limited in scope to primarily information systems and non-clinical programs. However, specific adjustments were not made due to a lack of a detailed merger-related capital plan particularly with respect to the clinical departments.

The third party review team also reviewed and agreed with the transaction cost assumptions and the incurred pension/health benefit expenses.

It is important to note the level of commitment that both UCSF and SHS Medical Centers share in these assumptions. It was clear in our discussions with representatives of both entities that the level of commitment to realize these targets is quite high. There has been a significant amount of time, effort and thoughtfulness put into these assumptions.

It was also important for us to have evidence that both organizations possessed the capabilities required to implement these targeted cost reduction initiatives. What we found was that each entity has demonstrated its ability to realize significant operating cost reductions at their respective campuses. UCSF Medical Center has realized $53MM in cumulative cost reductions over the past four years (1993-1996) while Stanford Health Services has realized $74MM over this same time period. In addition, UCSF Medical Center has demonstrated its

ability to successfully integrate another facility into its operations in its integration of Mt. Zion Medical Center, which represented a five year cumulative cost reduction of $29MM.

The above mentioned Newco business plan and the analysis of merger-related benefits was limited in scope to primarily the clinical services and medical centers. There are additional areas of potential future benefits that have not been quantified or included in this analysis. These areas could include coordinating departments and faculty chair recruitment packages, sharing in program investments, and coordinating teaching efforts. The third party review team considers these areas, currently outside the scope of the proposed plan, to have significant potential value for Newco and to provide an important additional rationale for the proposed merger.

UCSF Medical Center Performance: Standalone versus Merged Future:

The third party review team compared UCSF Medical Center's expected future performance under a standalone scenario and under a merged, Newco scenario. We found that UCSF Medical Center is expected to be in a stronger economic position on a merged basis than on a standalone basis. By the year 2000, UCSF Medical Center's operating *deficit* is expected to be 3.4% of revenues on a standalone basis (losses of $19MM) versus a 3.9% operating profit as part of Newco (assuming the third party review team's probable case forecast). Even if the merger-related benefits are half of those forecasted, UCSF Medical Center is still expected to be financially stronger under a merged scenario. (See Appendix E, pages 70-73, for analysis).

VI. Risks Associated with Merging

In any merger analysis, it is important to assess the expected benefits as well as the expected risks associated with the merger. The third party review team has identified five areas of risk or uncertainty that we felt merited analysis. These five areas are as follows:

- management risks
- financial risks
- strategic risks
- impact on labor force
- impact on indigent care

The following discusses each of these merger-related risks. *It is the opinion of the third party review team that none of these risks poses an insurmountable obstacle to the proposed Newco merger. If the Newco merger is approved, we would highly recommend aggressive management and monitoring of each of these risk.*

Management Risks:

There are two areas of uncertainty regarding the management of Newco. First, who will lead Newco? And second, can the cultural differences between public and private entities be overcome?

As the leadership of Newco will not be determined until after a merger decision is made, there is uncertainty regarding the specific capabilities of the Newco management team and the Newco board members. After in-depth meetings with both UCSF Medical Center and SHS Medical Center management, we feel there are several outstanding individuals to choose from for the Newco management team. We believe the leadership risks associated with the proposed merger are controllable if those competent individuals are selected.

With respect to the Newco board, we believe the proposed board composition is reasonable and would stress the importance of the careful selection of the outside directors. We recommend seeking outstanding individuals from the business leadership community that have successfully demonstrated the ability to navigate a complex business through a difficult industry transition. An in-depth understanding of the current, challenging healthcare environment will be required for all board members.

The second management risk pertains to the cultural differences between the UCSF Medical Center and the Stanford Health Services. The third party review team considers the differences between these two entities to be far outweighed by their similarities. Both entities are leading academic medical centers with common missions of teaching, research and clinical care. In addition, both UCSF Medical Center and Stanford Health Services have a high degree of mutual respect and a strong sense of commitment to make the merger work.

Financial Risks:

The financial health of Stanford Health Services and Lucile Packard Children's Hospital is of obvious importance when considering the financial risks associated with this proposed merger. Specifically:

- Is UCSF Medical Center merging with an operation of comparable financial performance?
    - Is the overall profitability comparable to UCSF Medical Center's? (refer to Section 5 on page 10 and Appendix C, pages 41-46, for analysis)
    - Is the departmental profitability comparable to UCSF Medical Center's?
    - Is the cost position comparable to UCSF Medical Center's?

- Can Newco realize the cost reductions, avoided capital and revenue enhancements that have been targeted?

Departmental Profitability:

Departmental profitability is an indicator of the financial health of each clinical department within the respective entities. We would expect a mixture of profitability across departments with some areas being very profitable, some marginally profitable and some losing money on a standalone basis. This is a common profile across academic medical centers and is often a reflection of the reimbursement level (payor mix) and severity of patients in that department's patient population. In addition, some departments provide referral volume to other departments (e.g., primary care and general medicine serve as feeders for surgery and specialty care services) and consequently should not be viewed solely on a standalone basis.

The third party review team has compared UCSF Medical Center's and Stanford Health Services/Lucile Packard Children's Hospital's departmental profitability for their inpatient departments (outpatient profitability was not available at either entity on a departmental basis). What we found was consistent at both Medical Centers. In addition, the profitability profiles we found are fully consistent with the experience of other academic medical centers. The majority of departments are profitable, with some more profitable than others and some unprofitable on a standalone basis. The third party review team has reviewed the information and feels comfortable that the profitability by department is comparable between UCSF Medical Center and Stanford Health Services/Lucile Packard Children's Hospital.

Cost Position:

The second area of financial comparison involved each entities' cost position. It is difficult to accurately compare cost position due to the differences in the severity of each entities' patient population. However, there are several organizations that track and report a "severity-adjusted" cost per inpatient day

for hospitals (e.g., Medicare cost reports). The third party review team used this measure to assess the relative cost position of UCSF Medical Center and Stanford Health Services, adjusting for the most recent cost reductions achieved by both entities and excluding non-operating expenses. (The findings of the cost comparison analysis are for closed session only).

While we recognize the limitations in this analysis, we believe the measure of relative cost position is directionally correct. We believe this difference in costs is acceptable for two reasons. First, Stanford Health Services expects to take out differentially more costs than UCSF Medical Center over the next three years (as per their standalone forecasts), which will continue to reduce SHS's costs and close the gap. And second, cost per day is only part of the profitability equation and as such is less meaningful than the analysis of aggregate profitability, which takes into account pricing differences and outpatient contributions for each entity. Comparing cumulative operating profitability from 1991 to 1996, Stanford Health Services has been able to sustain greater operating profitability than UCSF Medical Center over this time period (operating *profit* of $46MM versus an operating *deficit* of $42MM, respectively).

Realizing the Targeted Merger Benefits:

In addition to the financial health of the proposed merger partner, one must also consider the risks associated with achieving the targeted cost reductions, revenue enhancements and avoided capital expenditures. This is the risk or uncertainty of successfully *implementing* the proposed merger plan, given that the plan is reasonable (refer to the above section on merger benefits for assessment of plan reasonableness).

Based upon the experience of the third party review team, we believe that merger implementation success is driven by the following:

- the capabilities of the leadership team
- the sense of urgency to realize these goals
- the clarity of the implementation plan
- the commitment of the people driving the plan
- the challenges that the external environment poses

As discussed above, we consider there to be several outstanding individuals to choose from for the Newco management team that seem to possess the necessary capabilities for implementing this proposed merger. We believe the sense of urgency associated with achieving these merger benefits should be high due to the significant marketplace challenges that both entities face. The implementation plan is reasonably detailed with a high degree of commitment

from the respective management teams. While we cannot predict what future environmental challenges the merged entity will face, we do believe that each entity will be better able to confront these challenges together than apart.

Strategic Risks:

In addition to the above financial risks, there are also two important strategic uncertainties to consider:

- Can Newco be competitive in the Bay Area marketplace?
- Will each entity's local market strategy support their local market needs?

Competitiveness

The Bay Area marketplace is among the most competitive and rapidly changing healthcare markets in the nation. Newco's ability to be competitive in the Bay Area depends on a number of factors including the evolution of the marketplace dynamics, future changes in traditional funding sources (e.g., Medicare and Medi-Cal funding for medical education), customer receptiveness to Newco and competitor reaction to Newco. While we do not know now how successful Newco will be, we do believe that UCSF Medical Center is in a better competitive position in the Newco entity than on a standalone basis.

The short term sources of competitive advantage in this undertaking are the opportunities for cost reduction and revenue enhancement. Based upon the savings identified to date, the benefit is forecasted to be an additional 3-4% reduction in operating expenses and is highly consistent with UCSF Medical Center's continued battle to find ways to remain cost competitive with other Bay Area medical centers considered as alternatives for specialty care.

We feel there are longer term sources of competitive advantage related to the coordination of clinical and academic activities with Stanford Health Services and Stanford School of Medicine that have not been explored to date. This might include such areas as coordinating departments and faculty chair recruitment packages, sharing in program investments and coordinating teaching programs. While the magnitude of these longer term benefits has not been quantified, we believe that the potential is significant. Without the merger, UCSF Medical Center will not have the option to pursue these longer term opportunities. If the merger is approved, the Newco board and the schools of medicine would collectively decide whether or not to pursue these additional sources of competitive advantage over time.

Local Market Strategies

As discussed above, both entities must have strong local market positions to remain strategically and financially competitive. Both UCSF Medical Center and Stanford Health Services/Lucile Packard Children's Hospital have multi-pronged local market strategies with specific initiatives underway to achieve access to their respective local markets. The formation of Newco does not preclude Newco from pursuing the local market strategies at both locations. These local market initiatives appear reasonable to the third party review team. However, we are not endorsing the ability of either entity to successfully implement these strategies.

Impact on Labor Force:

The third party review team assessed the impact the merger is expected to have on UCSF Medical Center's labor force. The proposed merger impacts the labor force in two ways: 1.) cost initiatives reducing employee headcount, and 2.) revenue enhancements increasing employee headcount. Most of these employee additions are expected to come in the clinical care area due to the increased specialty care volume related to the merger.

Under the original business plan assumptions, the net effect of these two opposing forces is estimated to be positive, depending upon the merger-related revenue enhancements realized. These numbers will be discussed in closed session.

In addition to the impact Newco is expected to have on employee headcount, the third party review team has also discussed with University of California labor negotiators the expected impact on retirement benefits.

Impact on Indigent Care:

The final merger-related risk assessed by the third party review team is the potential impact on indigent care. The UCSF School of Medicine trains medical students and residents at the San Francisco General Hospital and the Veteran's Administration Hospital, San Francisco. In addition, UCSF Medical Center currently serves a broad spectrum of patients, including the indigent and uninsured populations. Serving this patient population is an important element of UCSF's academic mission.

With regard to UCSF's training programs, the proposed merger agreement does not change the existing relationships that UCSF has with the San Francisco General Hospital and the Veteran's Administration Hospital, San Francisco. In

fact, the contracts associated with the teaching programs are with the University of California for the benefit of the UCSF School of Medicine.

With regard to UCSF Medical Center, the third party review team compared the payor mix of UCSF Medical Center with both Stanford Health Services and Lucile Packard Children's Hospital to assess the portion of each entity's patient care that was indigent care. We found a similar proportion of indigent patient care at each entity: 26% of discharges at UCSF Medical Center and 20% of discharges at Stanford Health Services and Lucile Packard Children's Hospital combined. (See Appendix H, pages 84-86, for analysis).

In addition to this similar indigent care mix, the respective mechanisms for approving patients for admission are not expected to change as a result of the proposed merger. Consequently, we do not believe that the Newco merger will adversely impact current levels of indigent care at the UCSF Medical Center.

Other Risks Outside the Scope of the Third Party Review:

In addition to the above described risks, there are also considerations associated with legal and legislative issues that are outside the scope of the third party review. For example, what is the legal authority of the Regents to create this proposed entity? Who is responsible for the liabilities of UCSF Medical Center prior to the closing date of the transaction? What financial impact would the passage of Proposition 216 have on this proposed merger? What level of clinical teaching support (CTS) can Newco and/or the UCSF School of Medicine expect to receive in the future? How might this merger impact CTS funding to the University of California system as a whole? What is the potential impact of the two complaints recently issued by the Public Employment Relations Board (PERB) regarding the proposed Newco merger?

The third party review team did not consider itself qualified to provide an opinion on these areas as we are neither legal nor legislative experts. We did discuss each of these issues with University of California legal and legislative representatives, but do not consider our third party review team qualified to give an opinion on these areas.

It should be noted that the third party review team's financial analysis of Newco's operating profitability excludes clinical teaching support (CTS) payments and is therefore independent of this particular legislative outcome.

VII. Risks Associated with Not Merging

In addition to describing the risks associated with the merger, one must also consider the risks associated with **not** proceeding with the merger. Specifically, there are organizational and competitive implications to consider.

After interviewing over 35 people from the hospitals, the faculty and the medical schools at both universities, we found that many of the people interviewed are highly supportive of this merger. People share virtually the same perceptions with one another of the downside associated with not seizing this opportunity, and of the risks, difficulties and potential rewards connected to the merger.

In addition to these organizational risks, there are also competitive risks to consider; specifically, the risks associated with competing head on in clinical medicine, education and research with the only other major academic medical center in the Bay Area.

VIII. Proposed Merger Structure

There are several legal documents that form the basis of the proposed Newco merger agreement, including the Affiliation Agreement, the Articles of Incorporation, the Bylaws, and the Professional Services Agreement. Within these documents, we considered there to be four elements of the proposed merger structure that were important to consider in the review team's evaluation, namely: the intended support for the Schools of Medicine; the proposed governance structure; the proposed equity split between The University of California and Stanford University; and the dissolution provision.

1.) Support for the Schools of Medicine

As specified in the Affiliation Agreement, Newco will target historical funding levels to both UCSF School of Medicine and Stanford's School of Medicine. For UCSF, this support was roughly $20MM in 1995, including medical direction, recruitment and new program development, and primary care support. Any proposed reduction in Newco's support to either school below its historical levels would require a full exploration of alternative expense reductions prior to reducing funding to the respective schools.

In addition to this historical level of support, the affiliation agreement requires Newco to make an *incremental* annual "academic contribution" (specified as a range between $1.25MM and $2.5MM for each school of medicine in year one), and to create a reserve fund of 5%-7% of adjusted operating profit annually to

support each school of medicine's academic mission. Beyond year one, the Newco board of directors will determine the amount of Newco's "academic contribution", in the context of its annual budget-setting process and overall financial plan.

If either party is not satisfied with Newco's support to the Schools of Medicine, dispute resolution procedures have been clearly outlined. If the dispute can not be resolved to the satisfaction of either party, dissolution of the merger can be sought (see "Dissolution Provision" section below).

In addition to this financial support, Newco is also legally bound to provide an atmosphere conducive to the achievement of the collective academic missions. This includes providing an environment conducive to training of future health professionals, promoting basic and clinical research activities, and delivering high-quality, cost-effective healthcare services to the community. This applies to the School of Medicine as well as to the Schools of Pharmacy, Nursing and Dentistry.

It is the opinion of the third party review team that the specified support for the Schools of Medicines appears reasonable – it strives to maintain historical funding levels while recognizing the financial uncertainty of the future.

2.) Dissolution Provision

As specified in the principles of the Newco bylaws and the articles of incorporation, there are two situations that can lead to the dissolution of the merged entity. The first is the unsatisfactory support of the Schools of Medicine (discussed above) and the second is extraordinary losses incurred by Newco.

In general, the third party review team believes that the incentive should be for both parties to come to a reasonable consensus on the dispute at hand, rather than turning to an "out-clause" on the relationship. In addition, it seems that this dissolution provision would be difficult to implement in practice after the passage of only a short period of time. Too much will have changed.

However, if the Regent's consider the dissolution provision to be a necessary component of the merger agreement, we would suggest that Newco's dissolution not be tied to a specific dollar value of losses incurred or a specific dollar value for support to the respective Schools of Medicine. We consider the specification of a dollar value that would legally trigger dissolution of Newco to be highly inflexible and therefore potentially undesirable for both entities. It is

also unclear what the ramifications to Newco's credit rating would be should a specific dollar value be set.

It should be noted that our recommendation is different from the action taken by the Regents in July. In July, the dissolution provision language called for specific dollar amounts and time periods for both the school of medicine funding support and the losses incurred, to be determined and included into the articles of incorporation.

3.) Governance Structure

The current governance structure is comprised of a board of seventeen directors and a single Newco management team. The board composition, as detailed in Appendix I (page 88), proposes 35% University of California members (6 directors), 35% Stanford members (6 directors), 18% outside members (3 directors), and 12% Newco management (2 directors). This arrangement achieves balance between the two merging entities while still allowing for adequate representation of outside business advisors and Newco management.

While the board members have not yet been selected, we can recommend broad criteria for consideration. For the outside directors, we would recommend that they are highly successful business people from the Bay Area community with a proven track record of operating businesses that have successfully negotiated through turbulent times (e.g., industry consolidation, price declines, turnarounds) and have been involved in merger integration. For the University of California Regents and Stanford Trustees selected for board seats, we would recommend they have significant familiarity of the healthcare marketplace or relevant business expertise to offer to Newco.

The Newco management team has not yet been chosen; however, we would offer several points to consider in the selection and the structure of the Newco management team. First, we would caution Newco against the use of "interim" leadership positions at the CEO or Chief Medical Officer (CMO) level. Newco should fill these positions with the intended leaders immediately after Newco formation, to minimize any lag in implementing the Newco business plan. In addition, we would recommend that the Newco management team have a single point person for the senior management team (e.g., one CEO, one CMO, one CFO). Dual management positions have the potential to complicate implementation and send a "non-unified" signal to the rest of the organization.

It is the opinion of the third party review team that the proposed board of directors can provide a reasonable structure and adequate balance of

backgrounds for governing Newco. Because the directors and management team have not yet been chosen, we cannot comment on the merits of the specific individuals. However, we have been impressed by the management teams currently at both UCSF Medical Center and Stanford Health Services, and consider there to be several outstanding individuals to chose from for the Newco management team.

4.) Equity Split

The proposed equity and ownership split for Newco is 50%/50% between the University of California and Stanford University. The third party review team assessed the "fairness" of this 50%/50% proposed structure for both entities using measures of income and assets. For income, we assessed the total revenue and total profits of each entity. For assets, we analyzed contribution along three dimensions: funds balance (assets net of liabilities), facility "throughput" (inpatient discharges, occupied beds, and outpatient visits), and facility "capacity" (staffed beds, faculty).

The analysis is included in Appendix J (page 90). The following summarizes the overall findings:

- Income: total revenue and total profit measures were found to be relatively comparable (SHS/LPCHS has slightly greater contribution)
- Funds Balance: funds balances were found to be comparable
- Facility "Throughput": facility throughput was found to be comparable
- Facility "Capacity": UCSF Medical Center has more "capacity"

While there was some variation in the equity measures analyzed, the variation was not consistently in favor of a greater split for either entity. Overall, it is the opinion of the third party review team that the proposed 50/50 split in ownership is fair to both entities and is most consistent with the intended partnership arrangement.

IX. Objective and Independent Opinion to the Regents: Is this a sound business decision?

The Regent's have asked the third party review team to analyze whether or not the proposed Newco merger is a sound business decision for the University of California. Based upon our business and financial analysis, it is the opinion of the third party review team that the proposed Newco merger is a sound business decision for the following reasons that were discussed throughout this report:

1. UCSF Medical Center is in a stronger financial and business position in Newco than on a standalone basis
   - UCSF Medical Center's standalone financial forecasts reflect weak operating performance, with significant reliance on non-operating income sources;
   - Newco offers potential for a stronger financial position due to merger-related benefits of revenue enhancement and cost reductions;
   - Even if the merger-related benefits are half of those forecasted, UCSF Medical Center is still financially stronger under a merged scenario;
   - Longer term strategic options are greater in a merged context.

2. The risks and uncertainties associated with the merger can be managed.

3. The University of California may not have the option to negotiate as favorable a position in this merger in the future as UCSF Medical Center's financial position continues to decline.

4. The leadership and professionals most directly involved, whose careers and livelihoods are on the line, strongly support the proposed merger. This is a tremendous asset.

X. Additional Analysis Required Prior to Decision

In the charge to the third party review team, the Regents asked if the analysis to date had been sufficient to determine the business viability of the merger, and if not, what further analysis should be conducted.

It was the opinion of the third party review team that, in fact, additional analysis was required to understand the soundness of the business decision for the University of California. The following additional analysis, which was carried out by the review team, was considered necessary for us to form this opinion:

- definition of the appropriate measure of operating performance
- financial analysis on the historical operating performance of UCSF Medical Center, Stanford Health Services, and Lucile Packard Children's Hospital
- comparison of standalone and merged financial forecasts
- analysis of funding support to respective schools of medicine
- analysis of labor impact
- assessment of Newco's combined specialty market share relative to competitors

- assessment of payor mix and indigent care
- comparison of clinical department profitability
- comparison of cost positions
- analysis of equity contribution and ownership split
- assessment of the reasonableness of the proposed affiliation principles, specifically: support to the Schools of Medicine, dissolution, and governance structure

The findings from the above analyses were considered in the overall opinion expressed to the University of California Regents and are reflected throughout the text and the appendices of this report. At this point, we do not consider there to be additional analyses required to determine the business and financial viability of the proposed merger.

XI. *Importance of a Timely Decision*

It is very important for the University of California Regents to make a timely decision, for or against, this proposed merger. There has been over one year of merger discussions between the campus leaders, over six months of intense joint working group sessions among the management teams and other professionals, and over two months of third party review. At this stage in the process, we believe there is more than adequate data and analysis to make an informed decision on the merger. The time to decide has arrived. We recognize that there is significant uncertainty regarding the future. However, this uncertainty exists with or without a merger. We recommend that the decision not be postponed any further.

It is important to recognize the cost associated with continuing to prolong the proposed merger decision. It puts both entities in a state of "hold" with respect to important operating decisions such as specialty care capital investments and employee retention efforts.

Finally, some may advocate waiting until UCSF Medical Center "is really in financial trouble" before deciding on this merger. We would not support such a position. We believe there is significant merit in taking such actions while UCSF is still financially strong and while so many of those involved are so enthusiastic. This allows UCSF Medical Center to be proactive, rather than reactive to the increasingly difficult challenges posed by the Northern California and national environments for healthcare, medical education and research.

Appendices

Appendix A: Third Party Review Team Members

APPENDIX A: Third Party Review Team Members

Warren Hellman personally selected the individuals that served on the review team. Collectively, this team is knowledgeable about mergers and acquisitions, highly respected in the field of academic medicine, and independent of the consultants involved in the process to date. The following is a brief introduction to the third party review members:

John McArthur, D.B.A.: John McArthur served as the Dean of the Harvard University Graduate School of Business Administration from 1980 to 1995. A member of the Harvard Business School faculty since 1962, he has taught courses in corporate finance in the MBA and doctoral programs as well as several executive programs while engaging in research and course development in Europe and North America. At the Harvard Business School, John completed the MBA degree in 1959 and the doctorate in business administration in 1963.

John has held numerous corporate directorships, committee memberships and consulting posts in business and government settings over the years. He has held leadership roles in several large industrial reorganizations and bankruptcies over the years in Canada, Europe and the United States. He served as chairman of the Brigham and Women's Hospital for many years, and was closely involved in the activities leading to the coming together of that institution with the Massachusetts General Hospital in 1994. Until July, he served as Co-chair, Board of Trustees of Partners HealthCare System.

Dr. Samuel Thier: Dr. Thier is chief executive officer of Partners HealthCare System, Inc., president of The Massachusetts General Hospital and Professor of Medicine at Harvard Medical School. Prior to joining MGH in 1994, Dr. Thier served as Brandeis' sixth president, as president of the Institute of Medicine, National Academy of Sciences, and served for 11 years as chairman of the Department of Internal Medicine at Yale University School of Medicine. Dr. Thier is a nationally-known, widely published authority on internal medicine and kidney disease and is equally well known for his expertise in the areas of national health policy, medical education and biomedical research.

Warren Hellman: Warren Hellman is serving as the chairman of the Third Party Review Team. Warren is co-founder of San Francisco-based Hellman and Friedman, a firm engaged primarily in the investment of its own capital. Since January, 1982, he has been a General Partner of Matrix Partners, with offices in Menlo Park, California and in Boston, Massachusetts. From 1977 to 1989, he was General Partner of Hellman, Ferri Investment Associates in Boston. From 1962

to 1977, he was a Partner of Lehman Brothers in New York, where he served as head of Lehman's Investment Banking Division, President and Director of Lehman Brothers, Inc., and Chairman of Lehman Corporation. Warren serves as a director of many companies, including APL Limited, Il Fornaio (America) Corp., and Williams-Sonoma, Inc. In addition, Warren is involved in numerous civic activities in the Bay Area.

Warren Hellman chose Bain & Company to provide analytic support to this process.

Charles Farkas: Chuck is a Director in the Boston office of Bain & Company. Chuck is a leader in the healthcare practice, and has over 15 years business experience working with clients in such areas as growth, strategy, leadership, change and restructuring. He is the author of the best-selling book Maximum Leadership (1996) and numerous articles in the Harvard Business Review, Fortune, and other publications. Chuck earned an MBA from Harvard Business School and currently serves as a Director of The Brigham Medical Center.

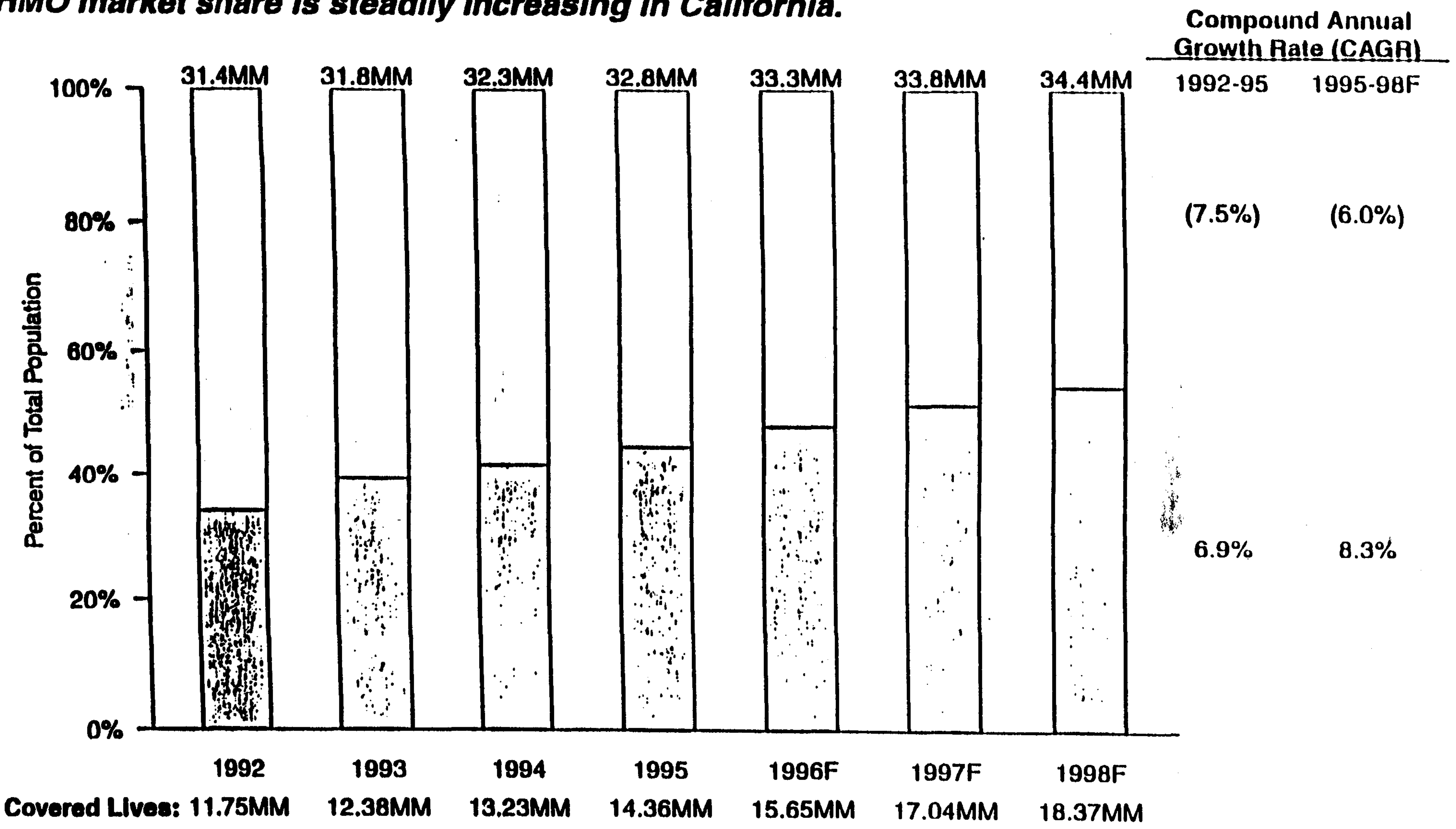
Kristine Miller: Kris is a senior manager in the San Francisco office of Bain & Company and has worked extensively in the healthcare industry. She has experience working with clients in areas such as strategy, mergers, restructuring and new business development. Kris received an M.B.A. from Stanford Graduate School of Business. Kris's husband is currently a junior faculty member on staff at UCSF's Medical Group. The faculty status of Ms. Miller's husband was disclosed to the University of California at the beginning of the third party review process and was determined by the University not to constitute a conflict of interest.

Bain & Company has worked with both UCSF and Stanford University in the past but has not been involved in the merger negotiations between UCSF and Stanford prior to the third party review.

Appendix B: Environmental Context

California HMO Market Share

HMO market share is steadily increasing in California.



Notes: HMO penetration is HMO and risk bearing PPOs

Sources: Bernstein; Interstudy; State Filings; California Hospital Association

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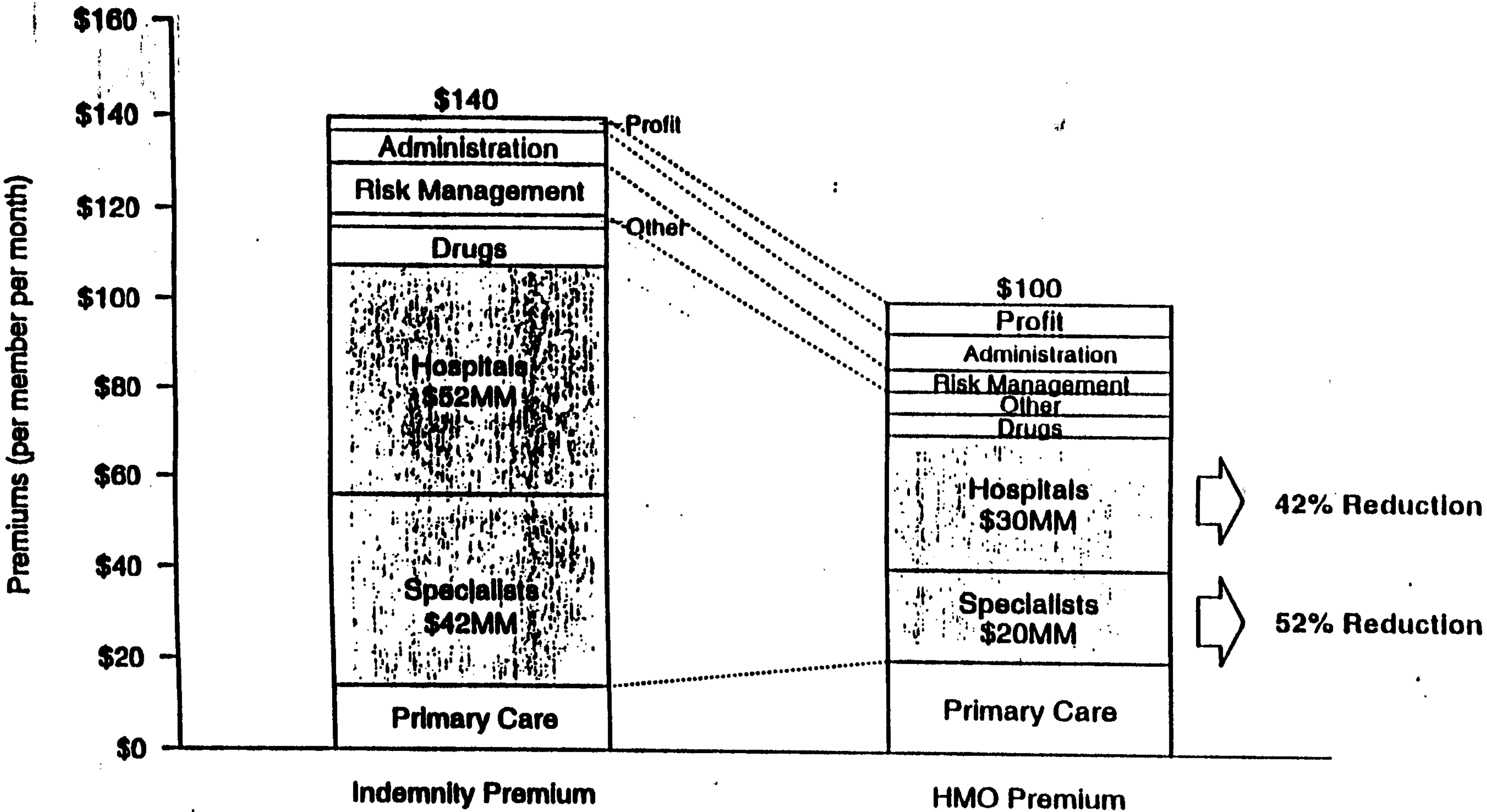
HMO Rates

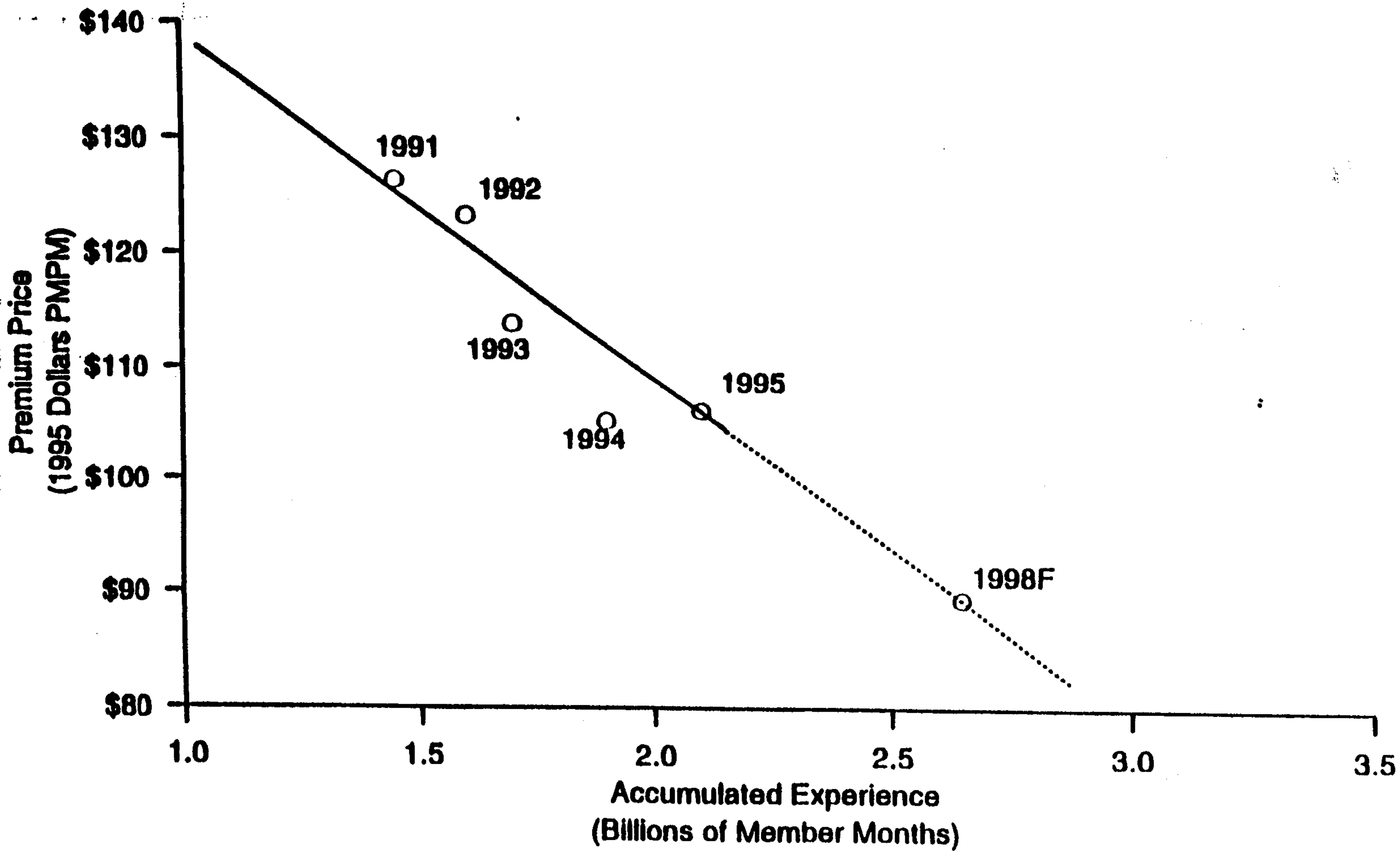
HMO payment rates to providers are significantly below that of Indemnity plans.



Sources: Advanced Health Plans and Bernstein Research (1995)

California Market Price Experience Curve (HMO Only)

California's HMO premium prices have fallen at a predictable rate.

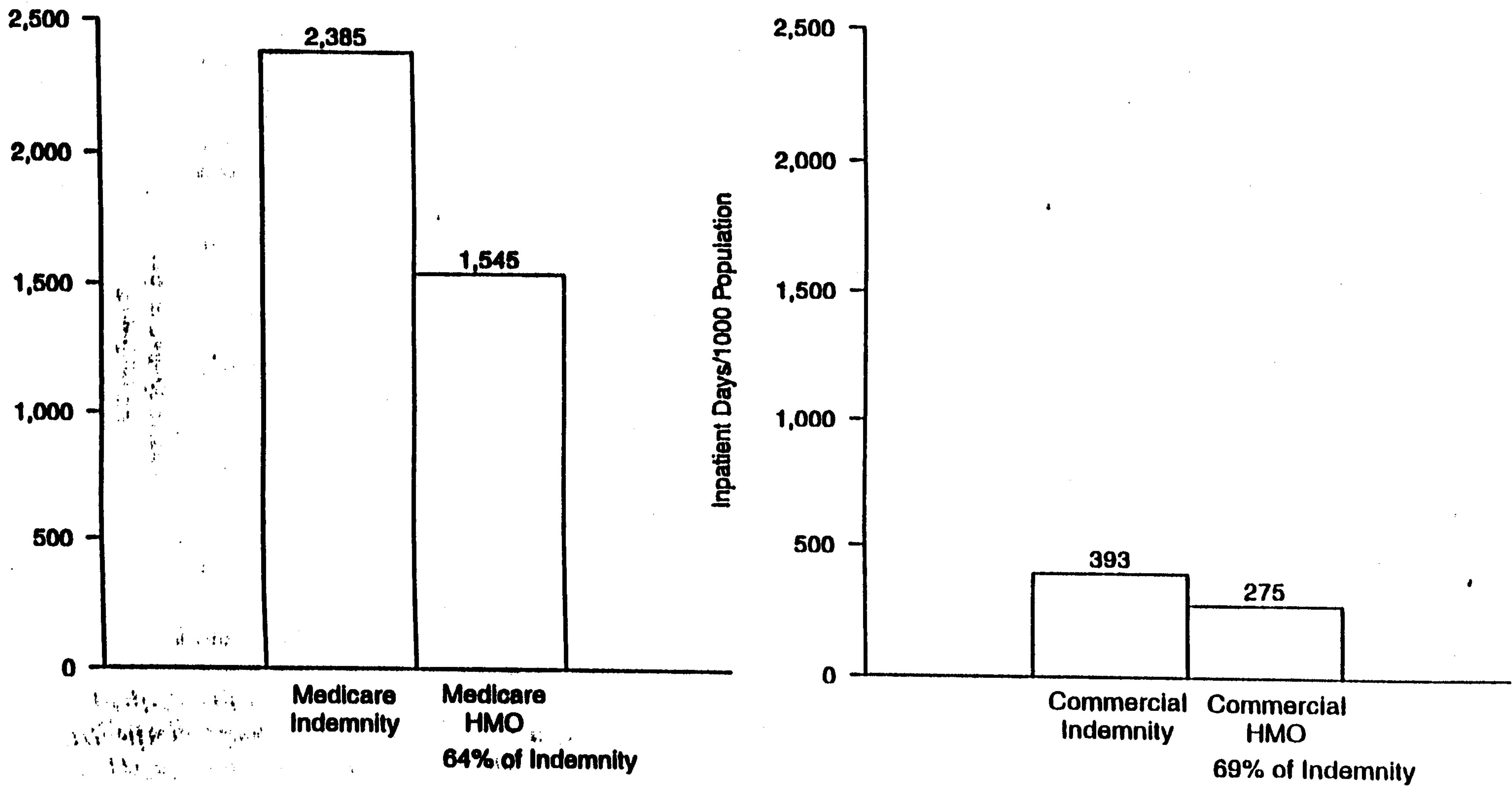


Notes: Straight averages used for prices

Sources: Interstudy; Bernstein; State Filings

Impact on Utilization

The growth of HMOs is causing a significant decline in the use of hospital services.



Sources: Milliman & Robertson 1995 Survey; phone interview

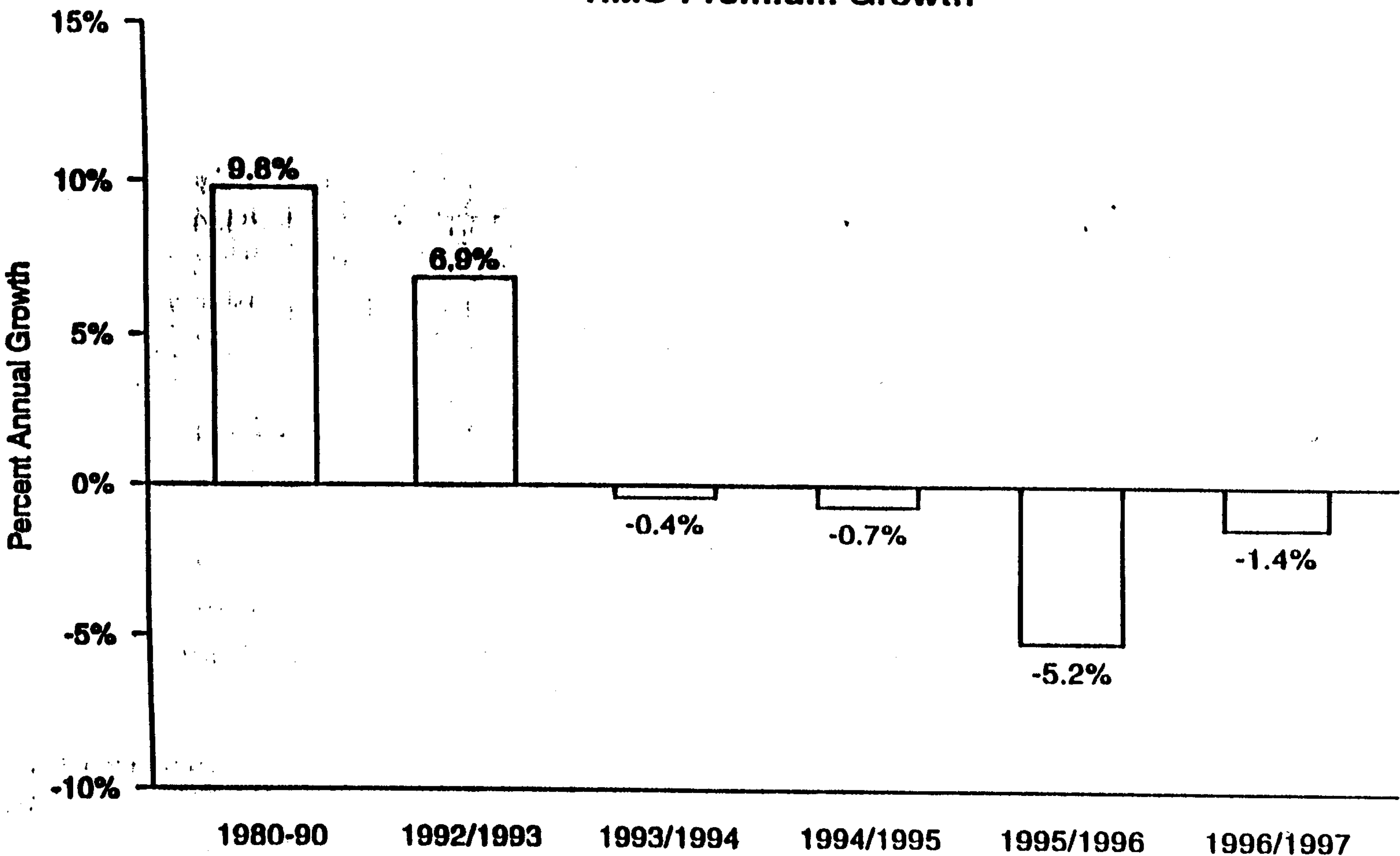
California Purchasing Pools

California employers are banding together to increase purchasing power.

- California Public Employees' Retirement System (CalPERS)
  - provides health insurance for more than 981,000 state workers, retirees and dependents
- Pacific Business Group on Health (PBGH)
  - represents 29 employers and 2.5MM employees
- Health Insurance Plan of California
  - state-run purchasing cooperative for small business
  - represents 88,000 employees and dependents from nearly 4,800 businesses

Customer Power

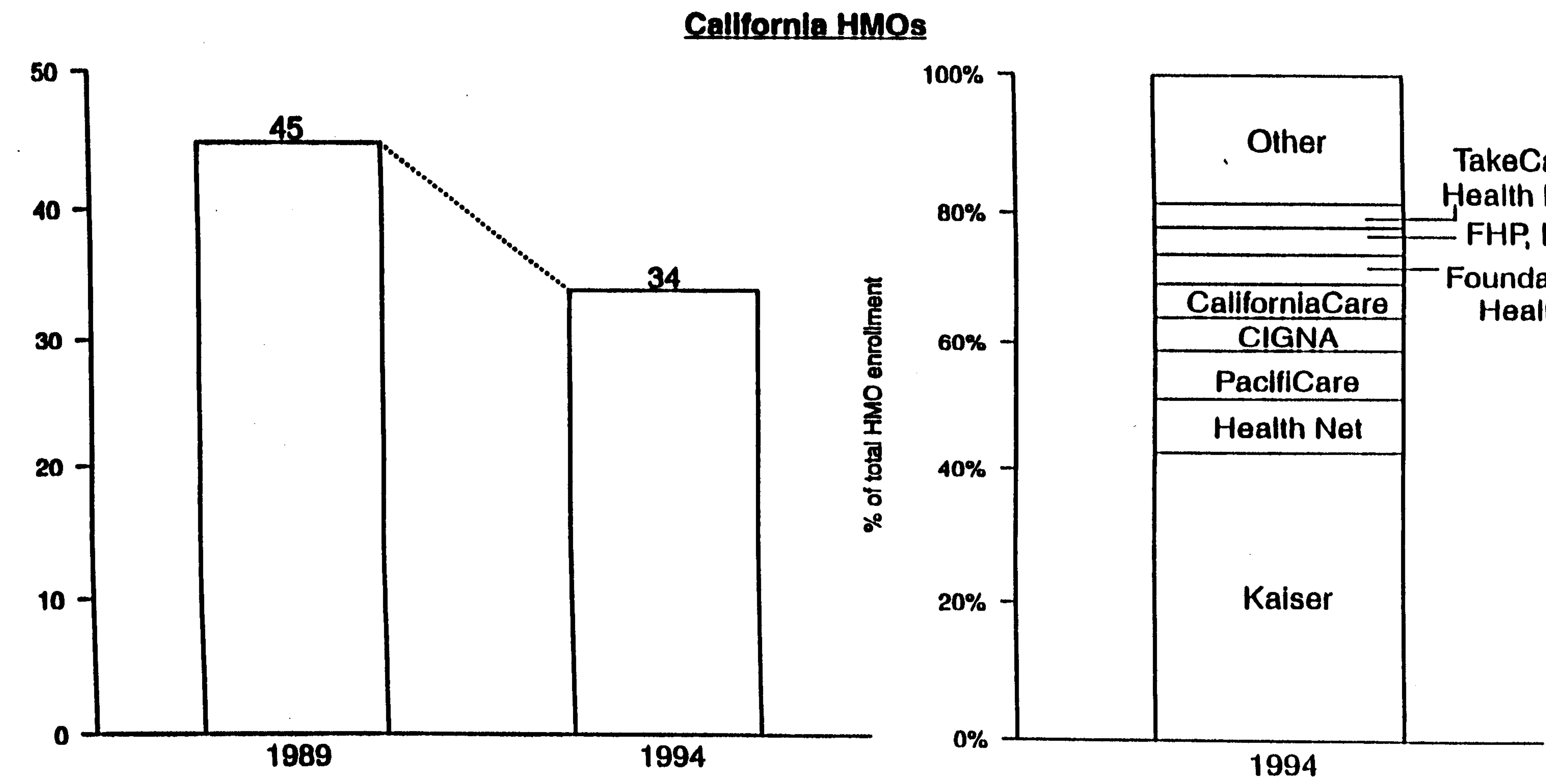
CalPERS exemplifies the increasing pressure that will be put on payor and provider pricing.



Sources: CalPERS

HMO Consolidation

California HMOs are consolidating and the top eight HMOs account for over 80% of the total enrollment.

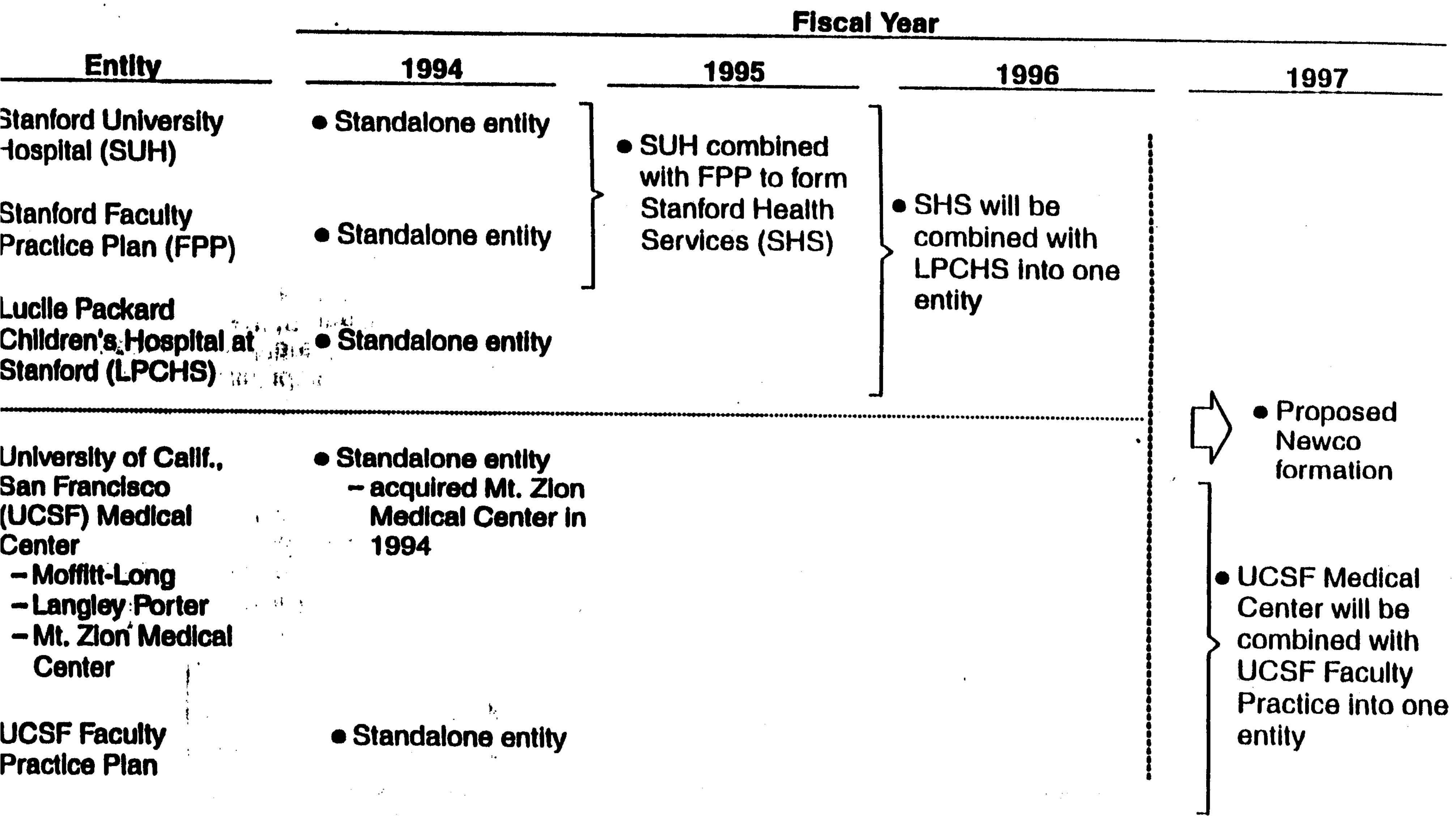


Notes: Some HMOs may have multiple plans

Sources: 1989 and 1994 National Directory of HMOs published by GHAA

Appendix C: Financial Analysis: UCSF Medical Center versus Stanford Health Services and Lucile Packard Children's Hospital

History of Entities



Financial Performance (Definitions)

Operating Profit

Operating Revenue:

- Excludes
  - investment income
  - gifts
  - Clinical Teaching Support (UCSF)

Operating Expenses:

- Excludes
  - interest expense
  - SHS one time charges
    - bad debt write-off
    - write down of primary care practices
    - restructuring related to FPP incorporation
  - UCSF benefit from overfunded pension

Total Profit

Total Revenue:

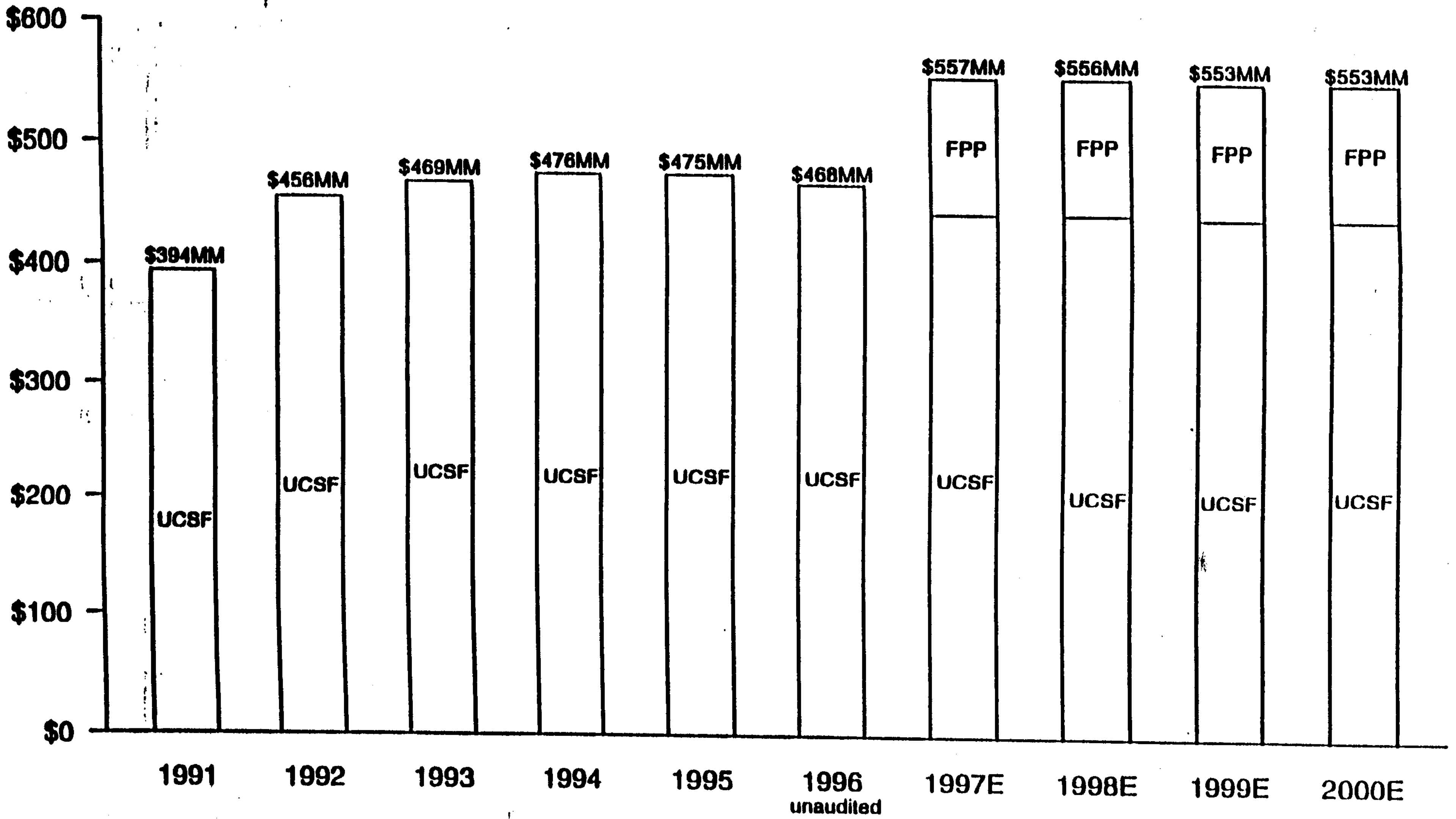
- Includes
  - investment income
  - gifts
  - Clinical Teaching Support (UCSF)

Total Expenses:

- Includes
  - interest expense
  - SHS one time charges
    - bad debt write-off
    - write down of primary care practices
    - restructuring related to FPP incorporation
  - UCSF benefit from overfunded pension

Although in the past UCSF has grown, its operating revenues are forecasted to decline after 1995.

UCSF
(Operating Revenue[1])



Notes: [1]Revenue excludes investment income, CTS, gifts, and other non-operating revenue

Sources: Auditor's reports, internal financial forecasts, and Bain analysis

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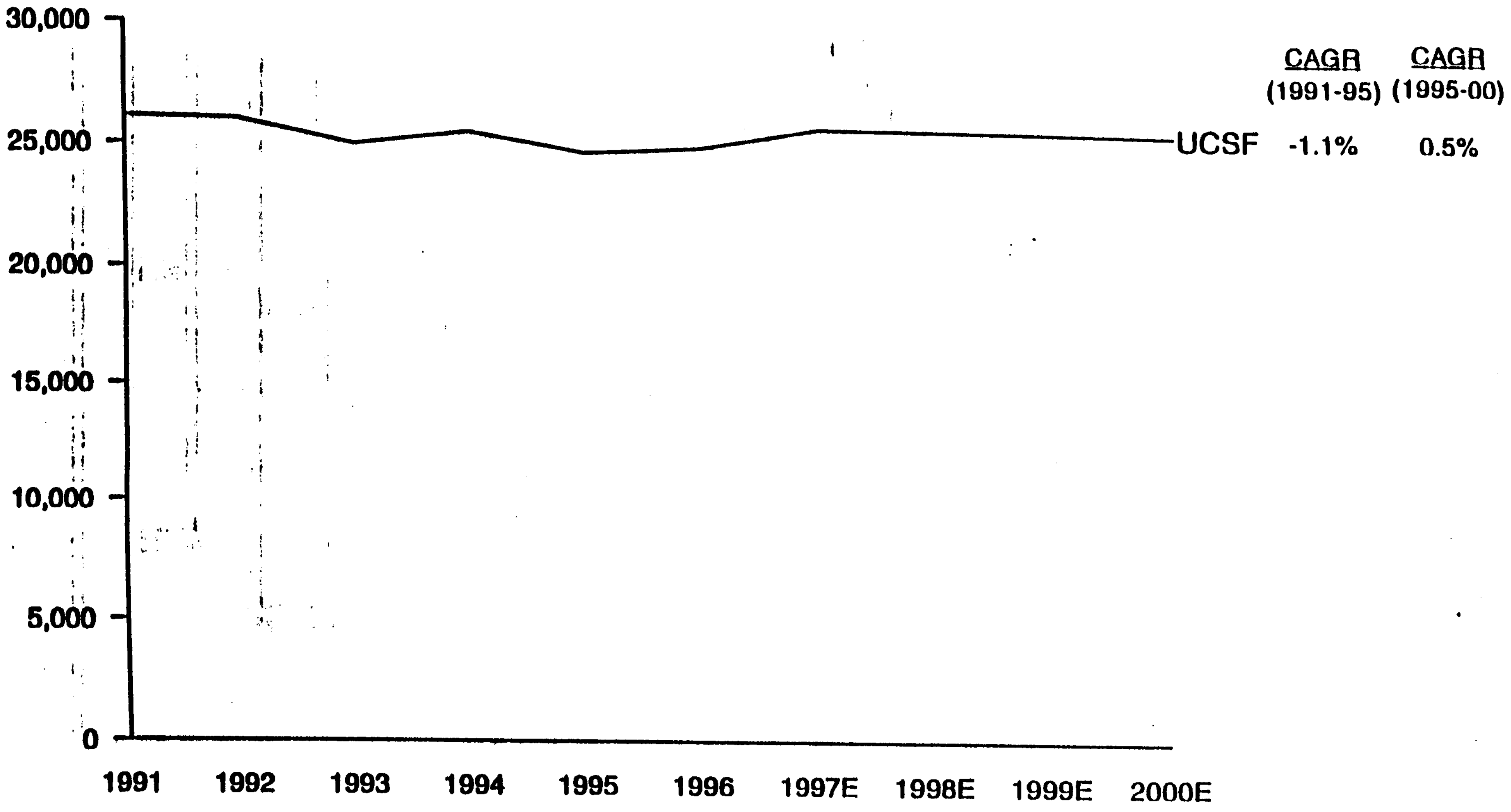
UCSF Inpatient Discharges

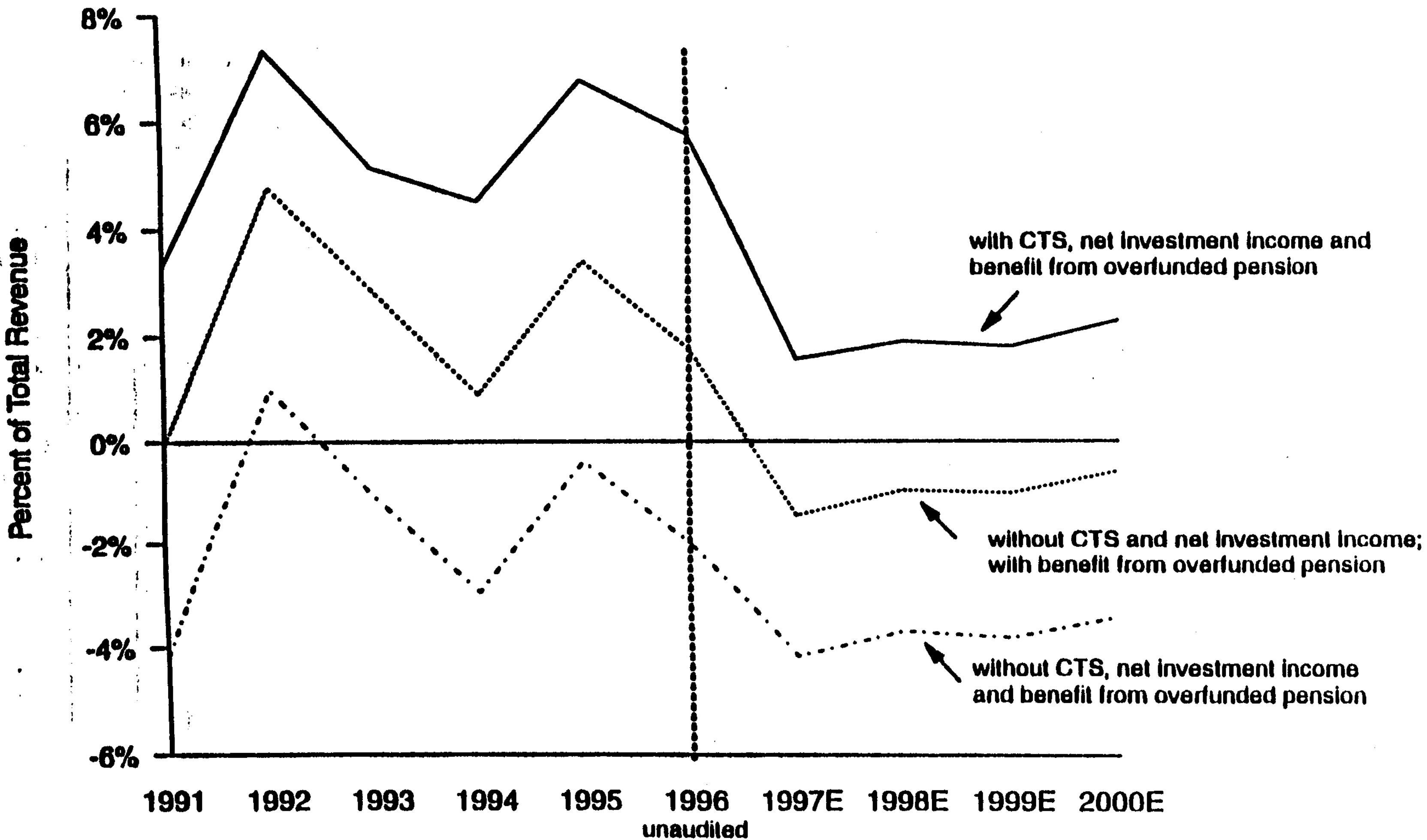
UCSF Medical Center's inpatient discharges have declined slightly over the past five years and are forecasted to remain level.



Sources: UCSF Medical Center finance departments

Standalone Performance

UCSF's profit margin is heavily influenced by non-operating sources of income (e.g. Clinical Teaching Support, benefit of overfunded pension, and net investment income).

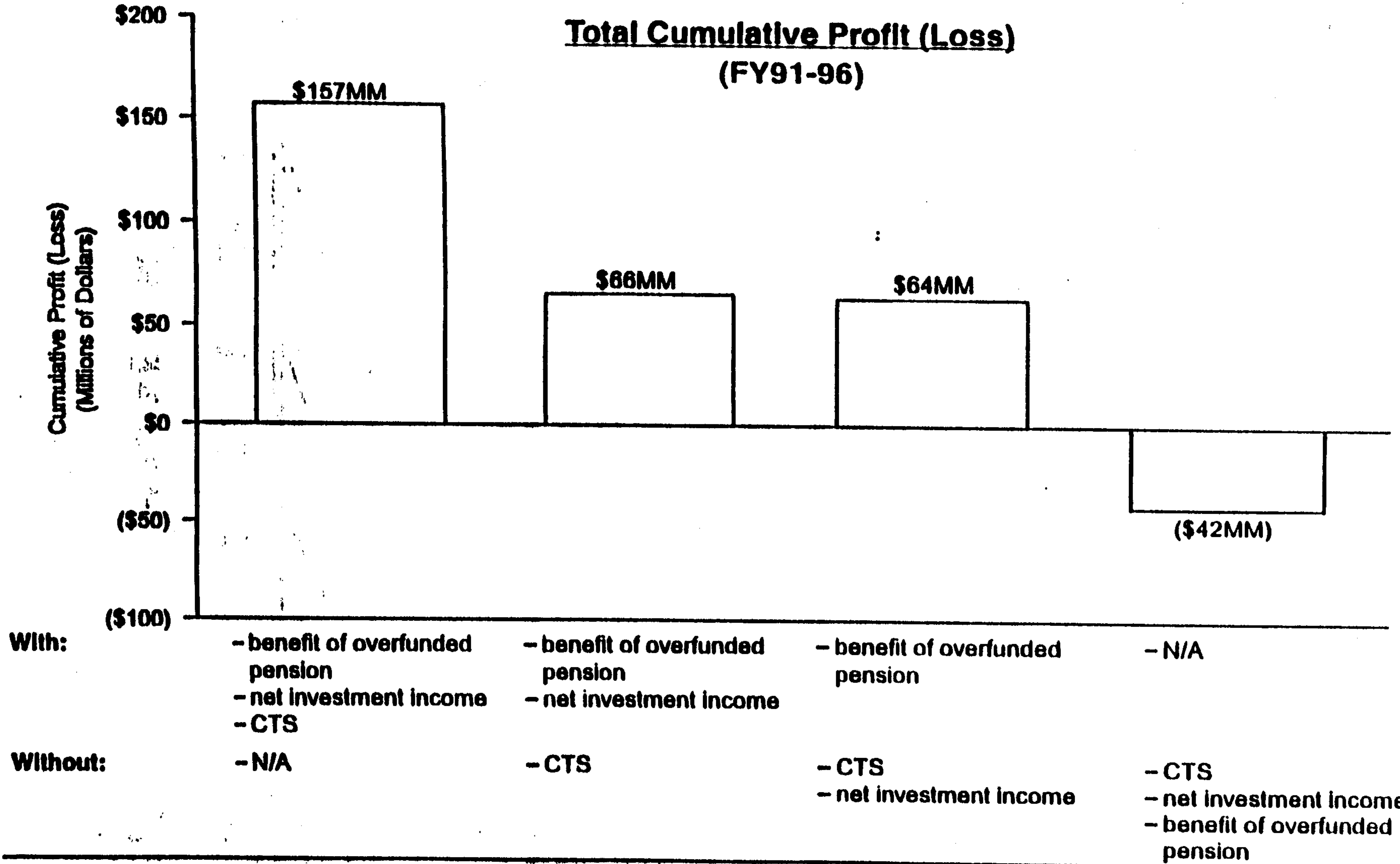


Notes: Pension expense assumes 7.5% of salaries

Sources: Auditor's reports, internal financial forecasts, and Bain analysis

UCSF Medical Center Cumulative Profit (Loss) (FY91-96)

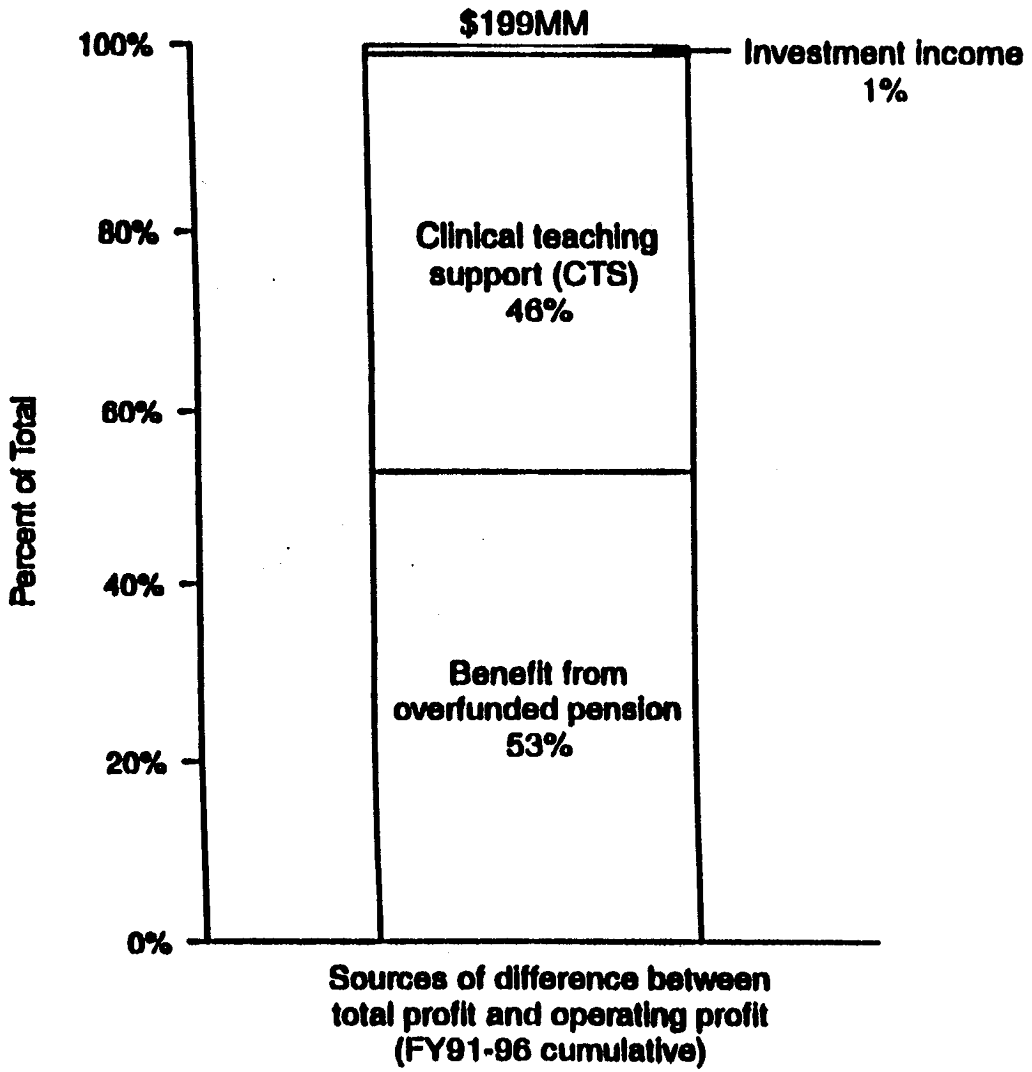
UCSF's cumulative profit (loss) is heavily influenced by non-operating sources of income.



Notes: FY96 data is unaudited; CTS denotes Clinical Teaching Support

Sources: Auditor's Statements; Internal Finance Department; Bain Analysis

UCSF Other Income Sources



Comments

- Conservative investment strategy
- Subject to state and UC discretion
  - "subsidy" for teaching/education programs
- If standalone, UCSF Medical Center expected to continue to benefit over next five years
- If merger occurs, benefit from overfunded pension stays within UC system

Notes: 1996 values based on unaudited reports

Sources: Auditor's reports; Bain analysis

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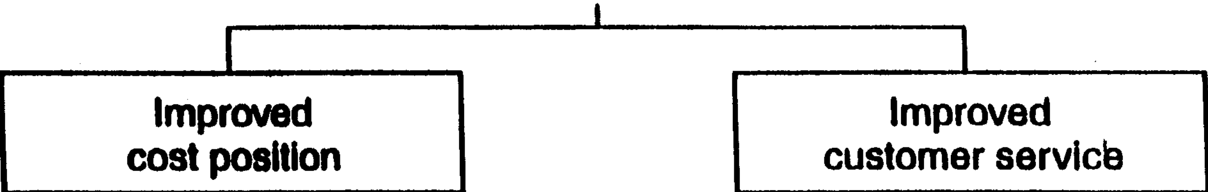
Appendix D: Merger Business Plan: Key Assumptions

Rationale for Increased Specialty Volume

How would the proposed merger result in additional specialty cases? Answer: through the benefits of improved relative marketshare(RMS).



Supporting Logic:

Improved cost position

- Merged entity able to reduce costs and therefore lower prices for specialty care
- Lower prices will make NEWCO more attractive than alternative referral centers

Improved customer service

- Merged entity provides broader geographic coverage and service line representation
  - more locations
  - more physicians to choose from

Issues to Consider:

Improved cost position

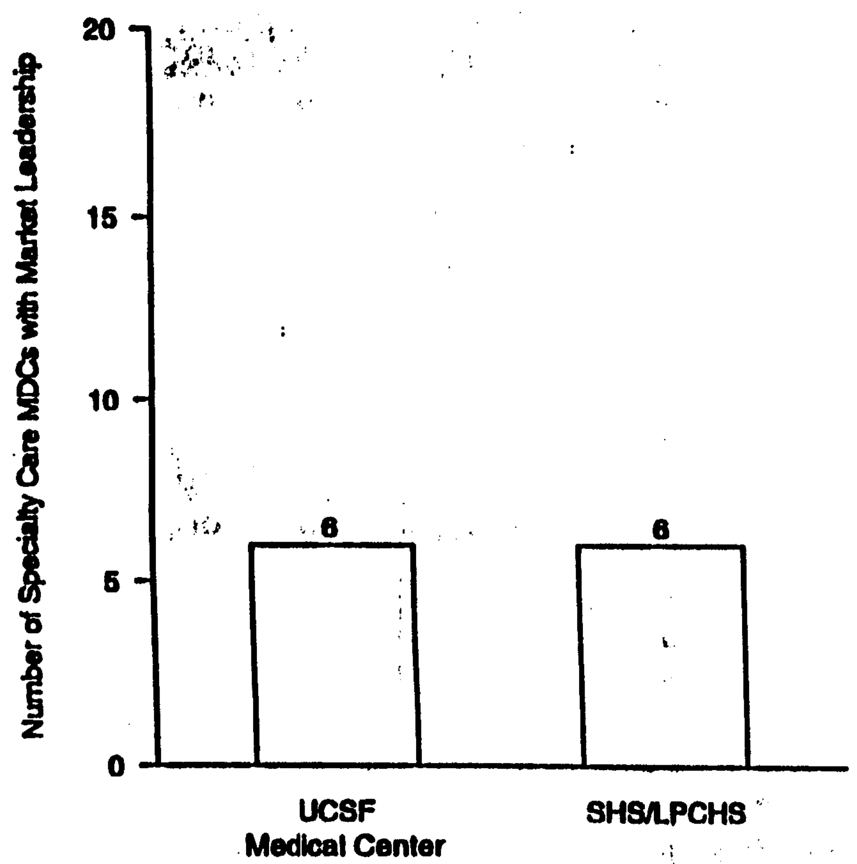
- Is the intended price reduction enough to support a 22% volume increase?
- Will (lower cost) competitors respond with an equal or greater price reduction?

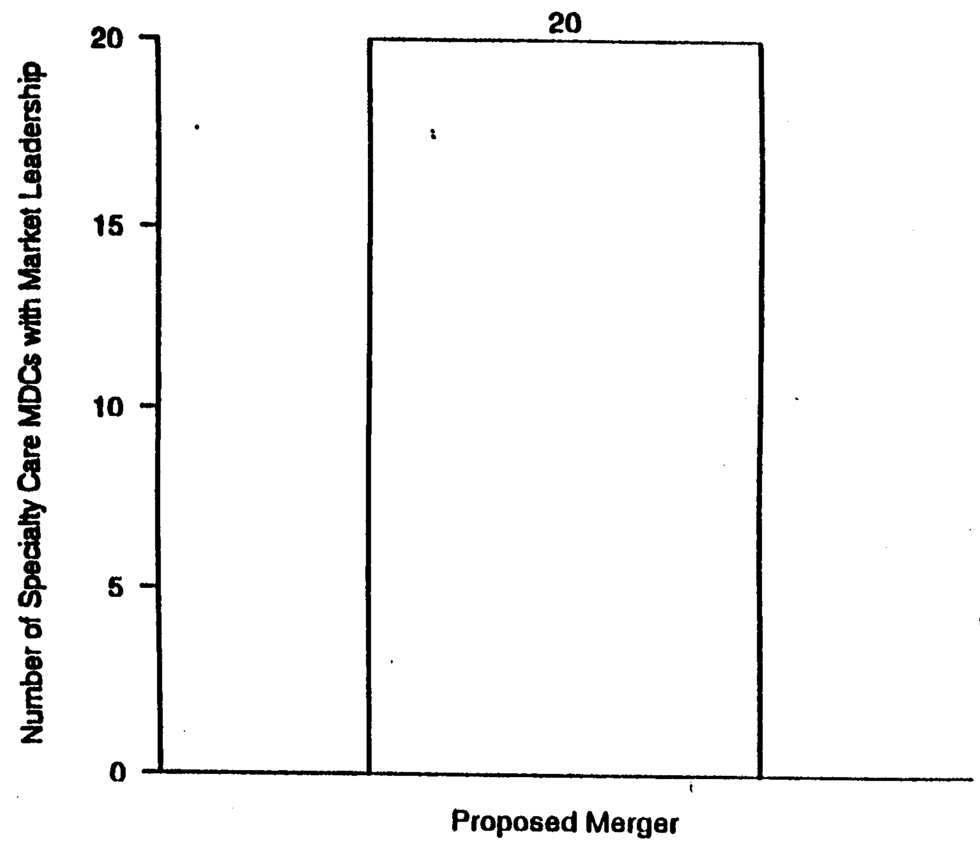
Improved customer service

- Will customers significantly change referral / contracting patterns for this benefit?

Major Diagnostic Category (MDC) Market Leadership (1994)

The proposed merger allows UCSF to achieve a market leadership position in eight additional specialty care MDCs*.





Note: *Specialty care cases defined as having a severity weighting in the top two of four categories

Sources: OSHPD—Market includes the eleven counties around Bay Area

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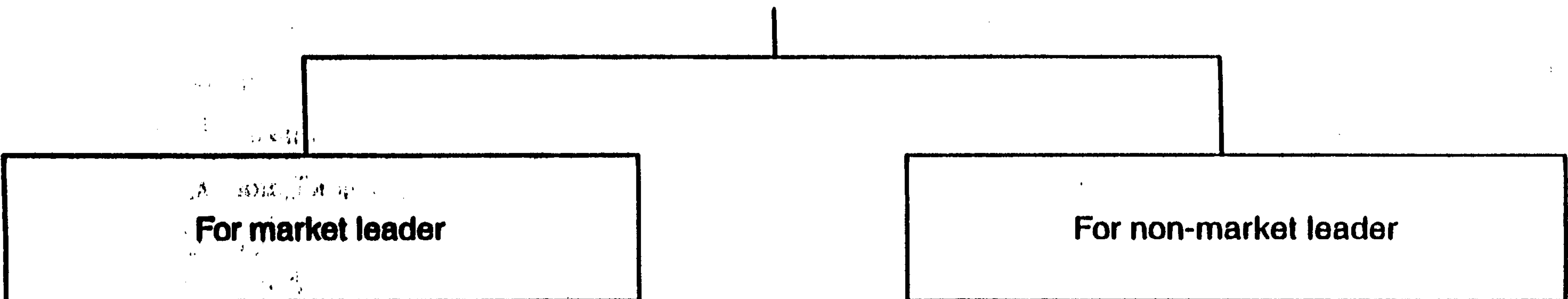
RMS Calculation

Relative marketshare (RMS) is calculated in one of two ways, depending on a company's market position.



- RMS equals market leader divided by next largest competitor (RMS is always greater than or equal to 1.0 for the market leader)
- RMS equals non-market leader divided by market leader (RMS is always less than one for non-market leader)

Relative Marketshare by Major Diagnostic Categories (1 of 2)

MDC Name (#)	UCSF RMS (1994)	SHS RMS (1994)	Proposed Merger RMS
Eye(2)	1.60	0.25	2.00
Kidney(11)	1.52	0.65	2.51
Hepatobiliary(7)	1.40	0.53	2.14
Other (0)	1.25	0.80	4.55
Nervous(1)	1.19	0.79	2.12
Endocrine(10)	1.14	0.88	2.25
Musculoskeletal(8)	0.99	0.91	1.90
Myeloproliferative(17)	0.93	1.07	4.16
Digestive(6)	0.90	1.11	2.45
Ear, Nose, Mouth & Throat(3)	0.88	1.01	1.90
Respiratory(4)	0.74	0.92	1.66
Female Reproductive(13)	0.68	1.11	1.86
Circulatory(5)	0.66	0.72	1.39

Notes: SHS includes LPCHS

Sources: CY 94 DATIS Northern California Database

Relative Marketshare by Major Diagnostic Categories (2 of 2)

MDC Name (#)	UCSF RMS (1994)	SHS RMS (1994)	Proposed Merger RMS
Skin and Breast(9)	0.66	0.61	1.27
Male Reproductive(12)	0.63	0.86	1.49
Blood(16)	0.61	0.59	1.19
Poison(21)	0.60	0.66	1.27
HIV(25)	0.59	0.14	0.74
Infectious and Parasitic(18)	0.55	1.03	1.59
Mental(19)	0.49	0.54	1.03
Newborns(15)	0.48	1.19	1.76
Alcohol/Drug Use(20)	0.36	0.32	0.68
Factors(23)	0.27	0.22	0.49
Pregnancy(14)	0.26	0.44	0.71
Burns(22)	0.06	0.01	0.07
Trauma(24)	0.01	0.18	0.19

Notes: SHS Includes LPCHS
Sources: CY 94 DATIS Northern California Database

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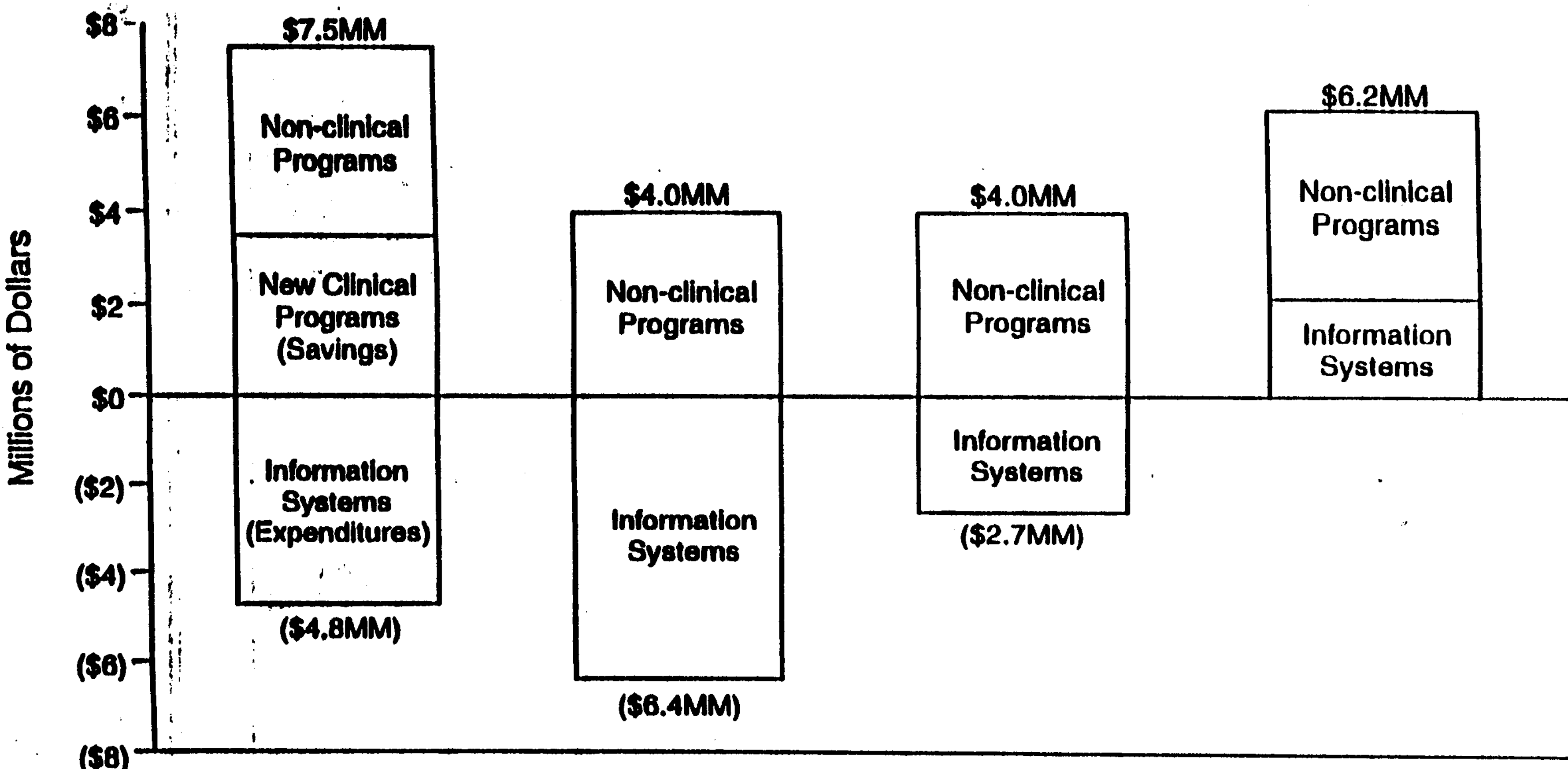
Increased Specialty Volume (Opinion)

- The proposed merger offers several real and important benefits that increase specialty referrals:
  - improved cost position
  - improved customer service
- However, a 22% targeted increase in specialty referrals is an aggressive goal, particularly given the slow growth in the market overall

More realistic target: 1,500 new specialty cases (11% increase over current)

Capital Expenditures/Avoidance

Merger-related net capital avoidance of $7-8MM (3% of total) over four years is conservative.



Sources: E & Y business plan; Bain Analysis

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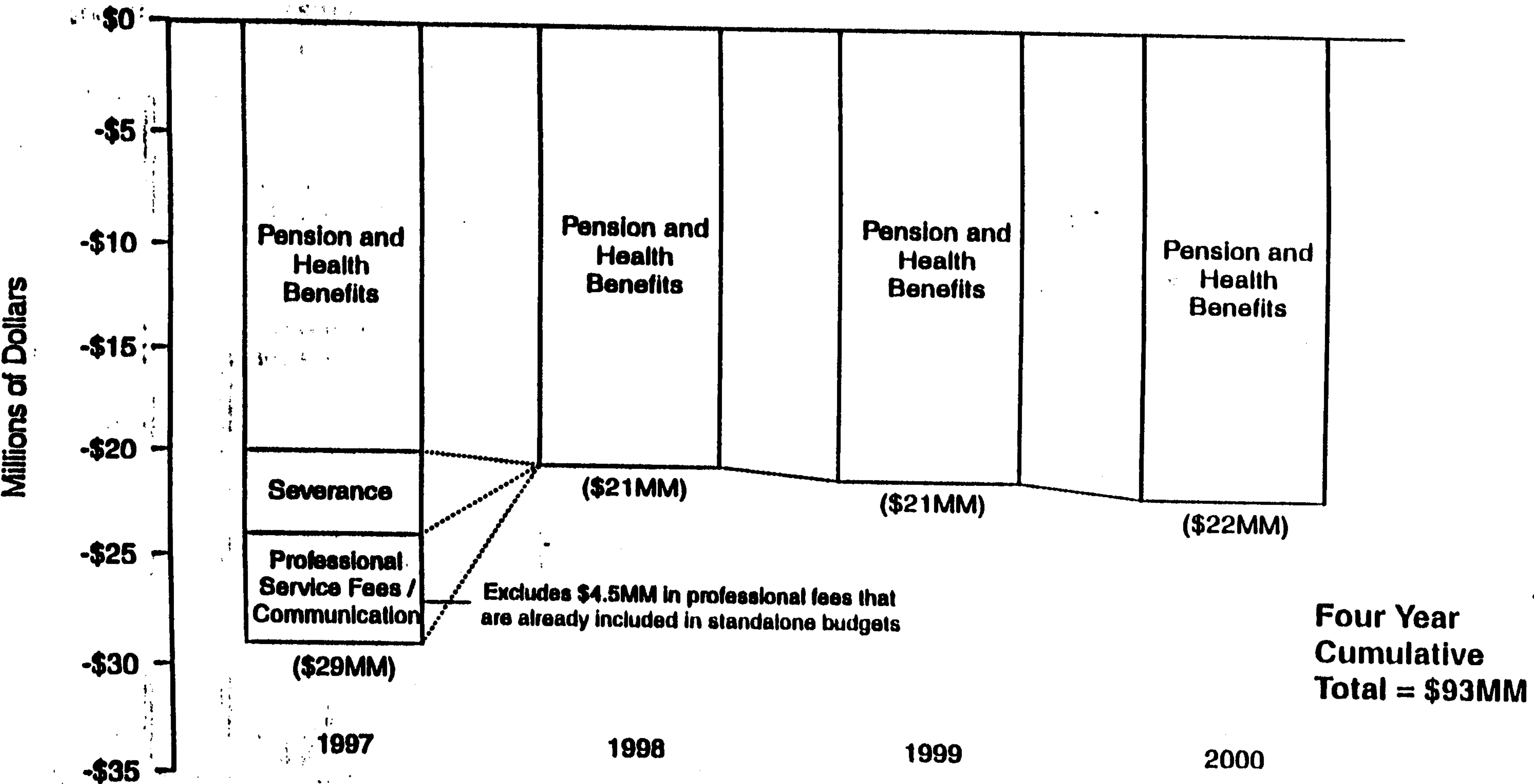
Merger Costs

Pension and health benefit costs account for the bulk of the projected merger costs.

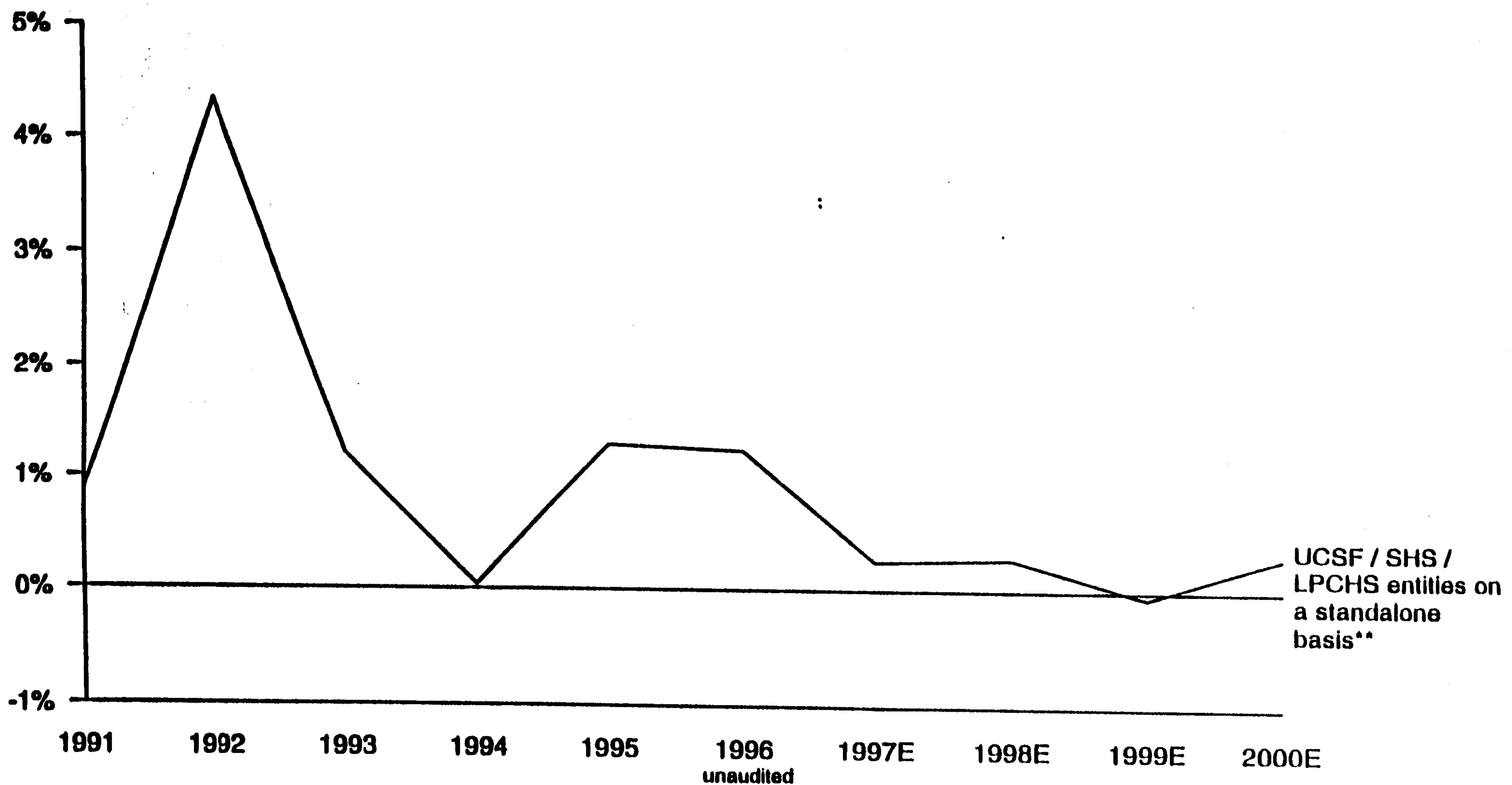


Sources: E&Y business plan; Internal finance departments

Appendix E: UCSF Medical Center Performance: Standalone versus Merged Scenarios

Standalone Entities Combined (Operating Profit*)

The combined entity without merger related synergies will provide limited profitability on an operational level.



Notes: *Operating profit excludes investment income, gifts, CTS, non-operating revenue, one-time adjustments, but includes UCSF's benefit from the overfunded pension

**Graph combines entities on an additive basis, excluding merger related synergies

Sources: Auditors' reports, internal financial forecasts, and Bain analysis

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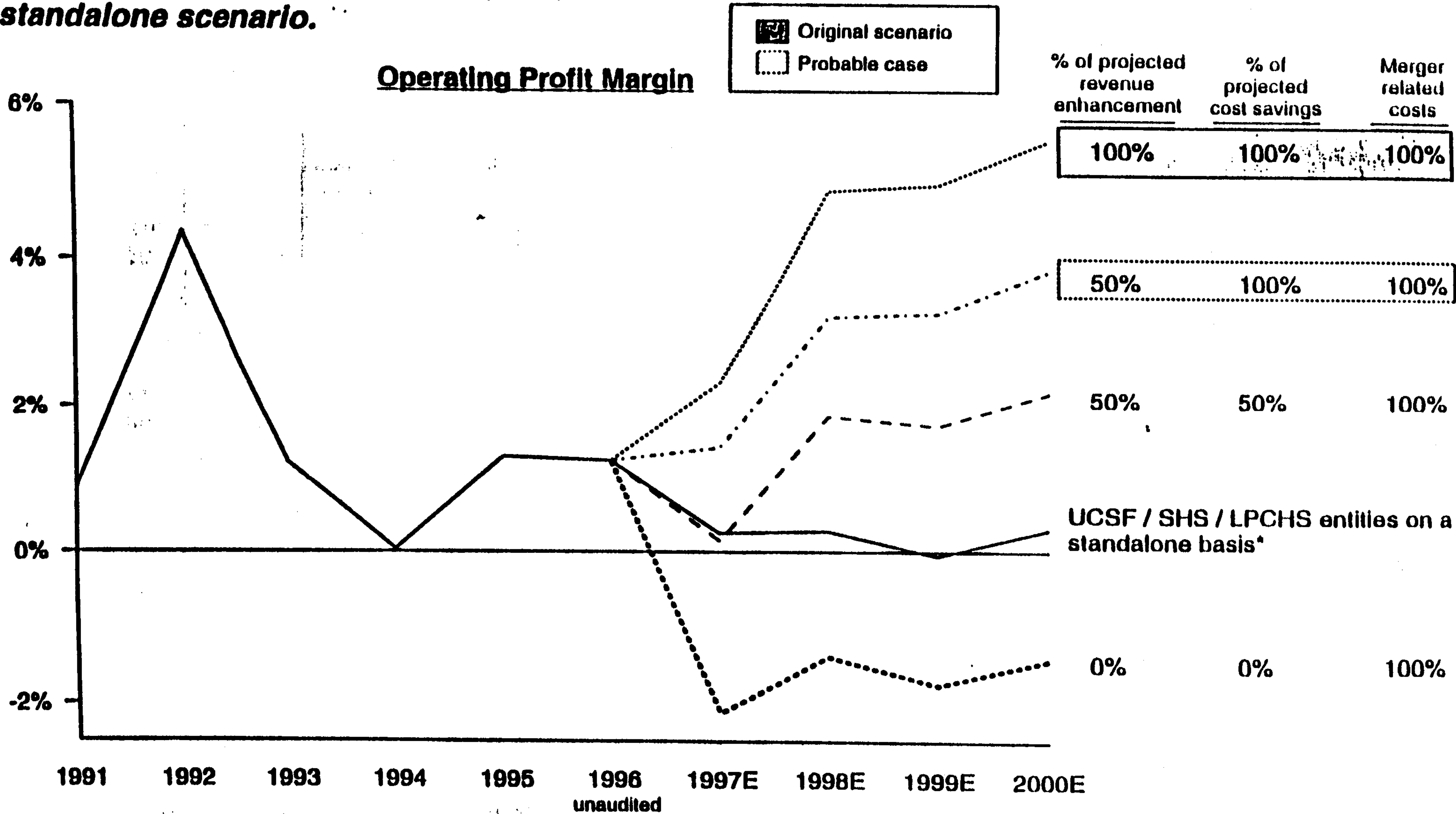
Merged Entity

The most probable merger scenario is more favorable from an operating profit margin perspective than the standalone scenario.



Notes: *Operating profit excludes investment income, gifts, CTS, other non-operating revenue, but includes UCSF's benefit from the overfunded pension

Sources: Auditors' reports, internal financial forecasts, and Bain analysis

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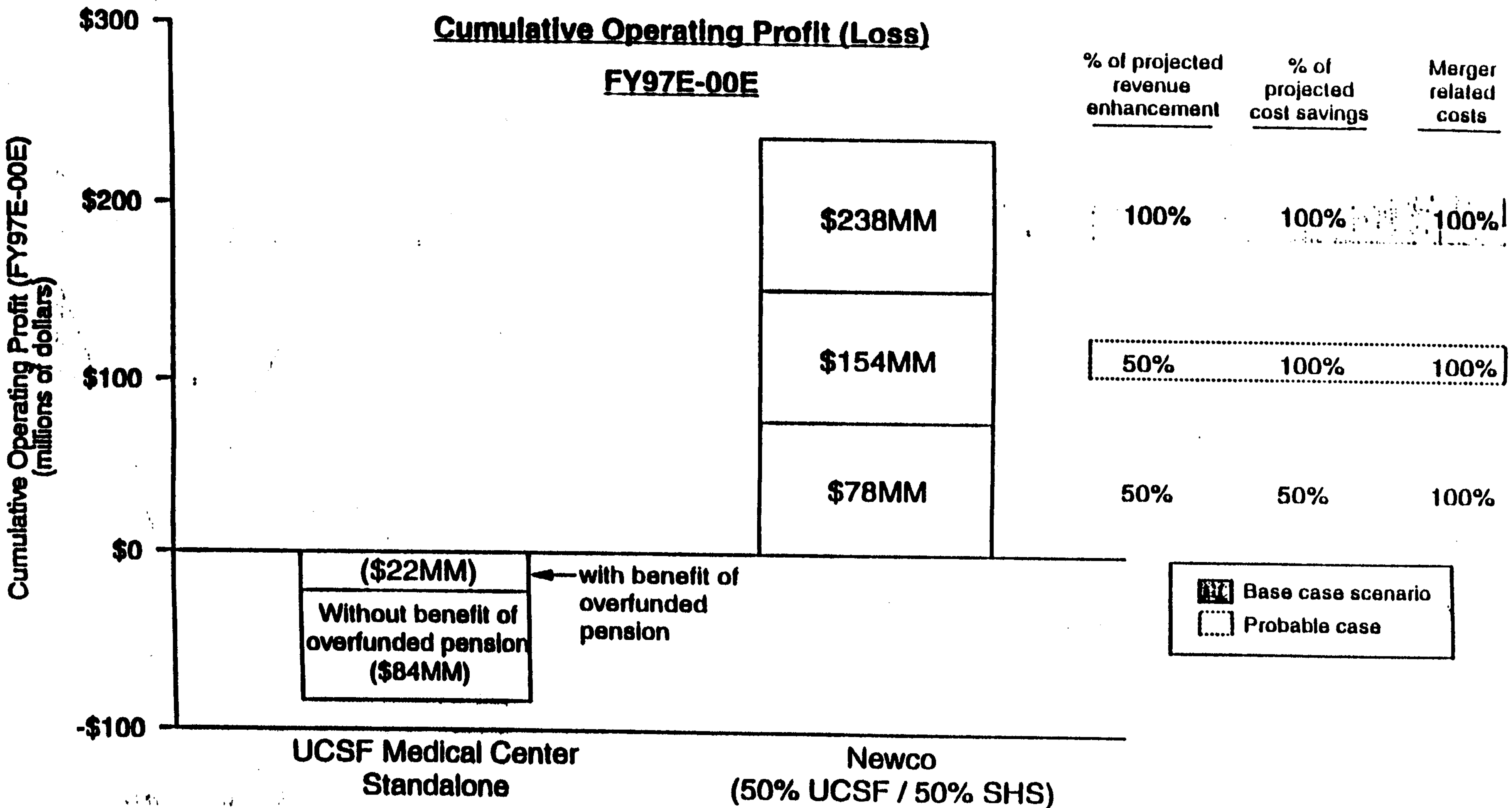
Cumulative Operating Profit (Loss) Comparison

Cumulative forecasted operating profit for Newco is significantly higher than UCSF standalone.

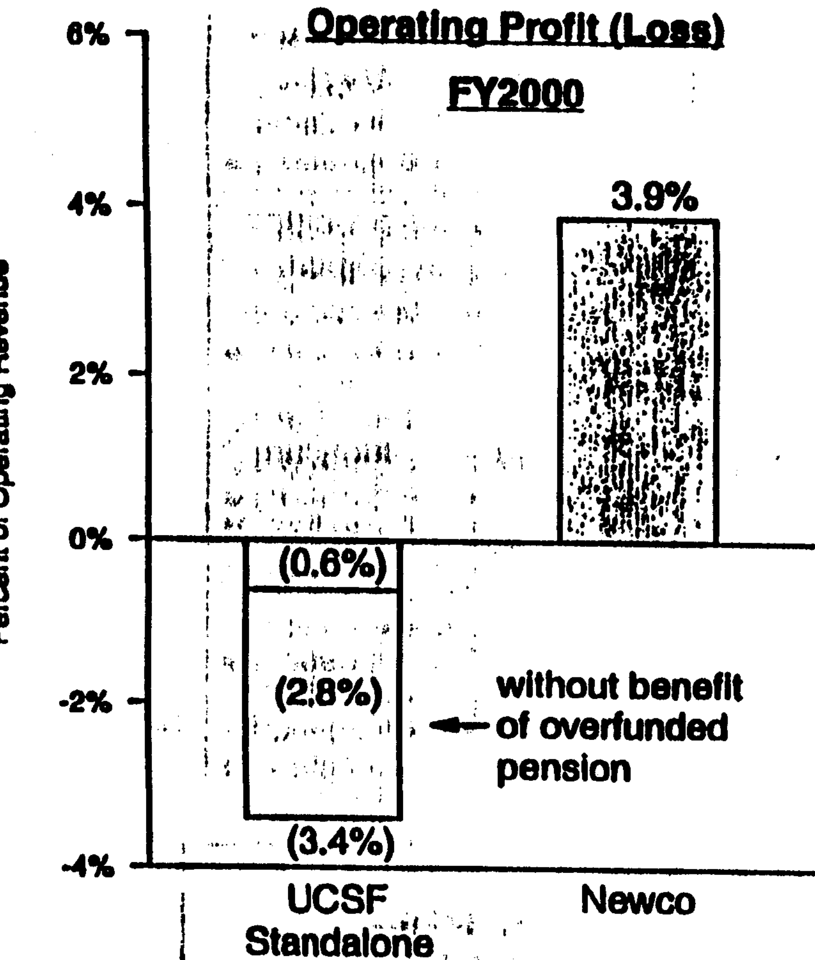


Notes: Operating profit excludes investment income, gifts, CTS, and other non-operating revenue

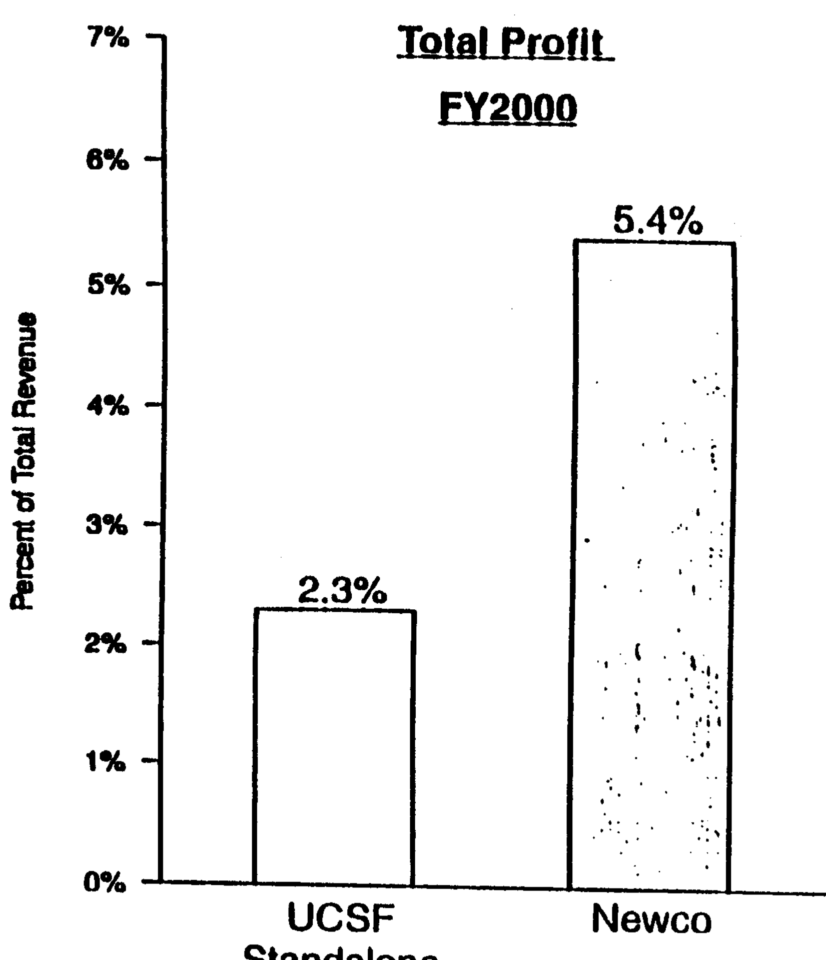
Sources: Auditors' reports, internal financial forecasts, and Bain analysis

Standalone UCSF and Merged Entity Comparison

The operating and total profit of Newco are both estimated to be well above UCSF's standalone forecasts.



Operating profit excludes investment income, gifts, CTS, and other non-operating revenue



Total profit includes investment income, gifts, CTS, and other non-operating revenue

Notes: Merged Entity profitability assumes "Probable Case" scenario

Sources: Auditors' reports, internal financial forecasts, and Bain analysis

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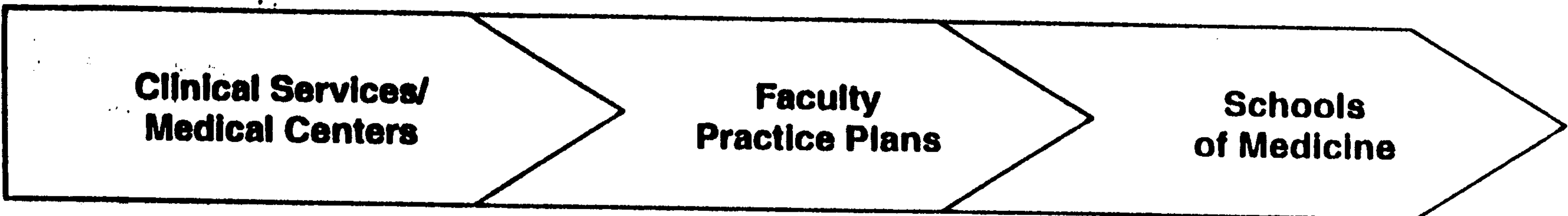
Scope of Consolidation

[i] Included in initial NEWCO merger analysis



Potential Benefits:	Clinical Services/ Medical Centers	Faculty Practice Plans	Schools of Medicine
	• Jointly contract with physicians and payors • Consolidate administrative functions • Pool purchasing volume • Centralize clinical support functions – e.g. clinical labs • Avoid duplicate capital investments, e.g., – medical technology – information systems • Consolidate clinical care facilities – tertiary – routine	• Jointly contract with physicians and payors • Coordinate chair recruitment packages • Share program investments • Consolidate administrative functions • Integrate support functions – e.g. billing • Rationalize faculty	• Coordinate clinical and basic sciences research efforts, e.g. – administration – grants – labs • Coordinate teaching efforts, e.g., – programs – investments – administration • Consolidate underfunded departments

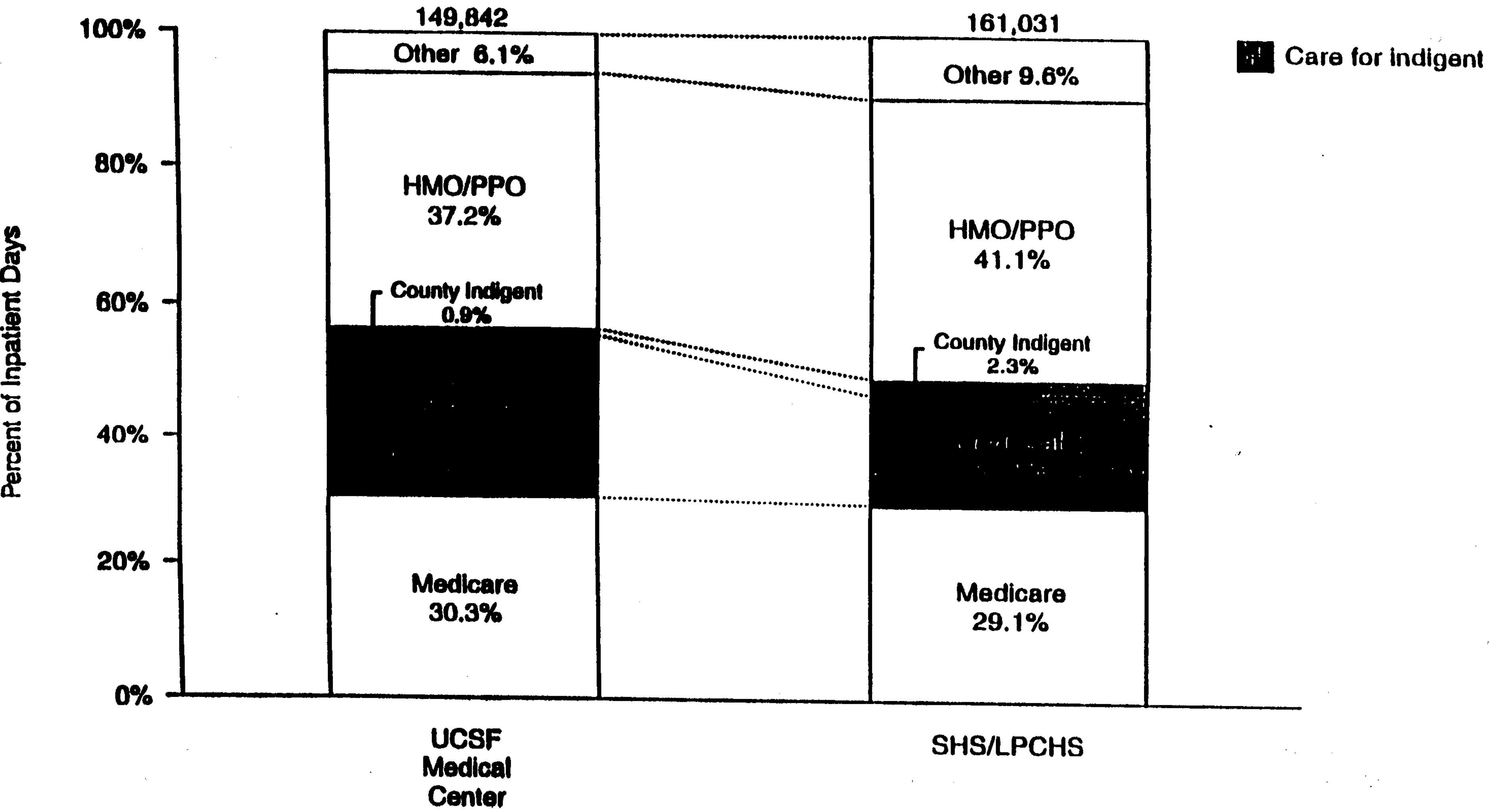
Appendix F: Cost Position Comparison

Appendix G: Impact on Labor Force

Appendix H: Impact on Indigent Care: Patient Mix Comparison

Indigent Care (1996)

UCSF Medical Center has a slightly higher percentage of indigent care as a percentage of inpatient days, relative to SHS/LPCHS.



Notes: Medi-Cal percent of inpatient days (SHS = 13%; LPCHS = 30%)

Sources: Internal Finance Department

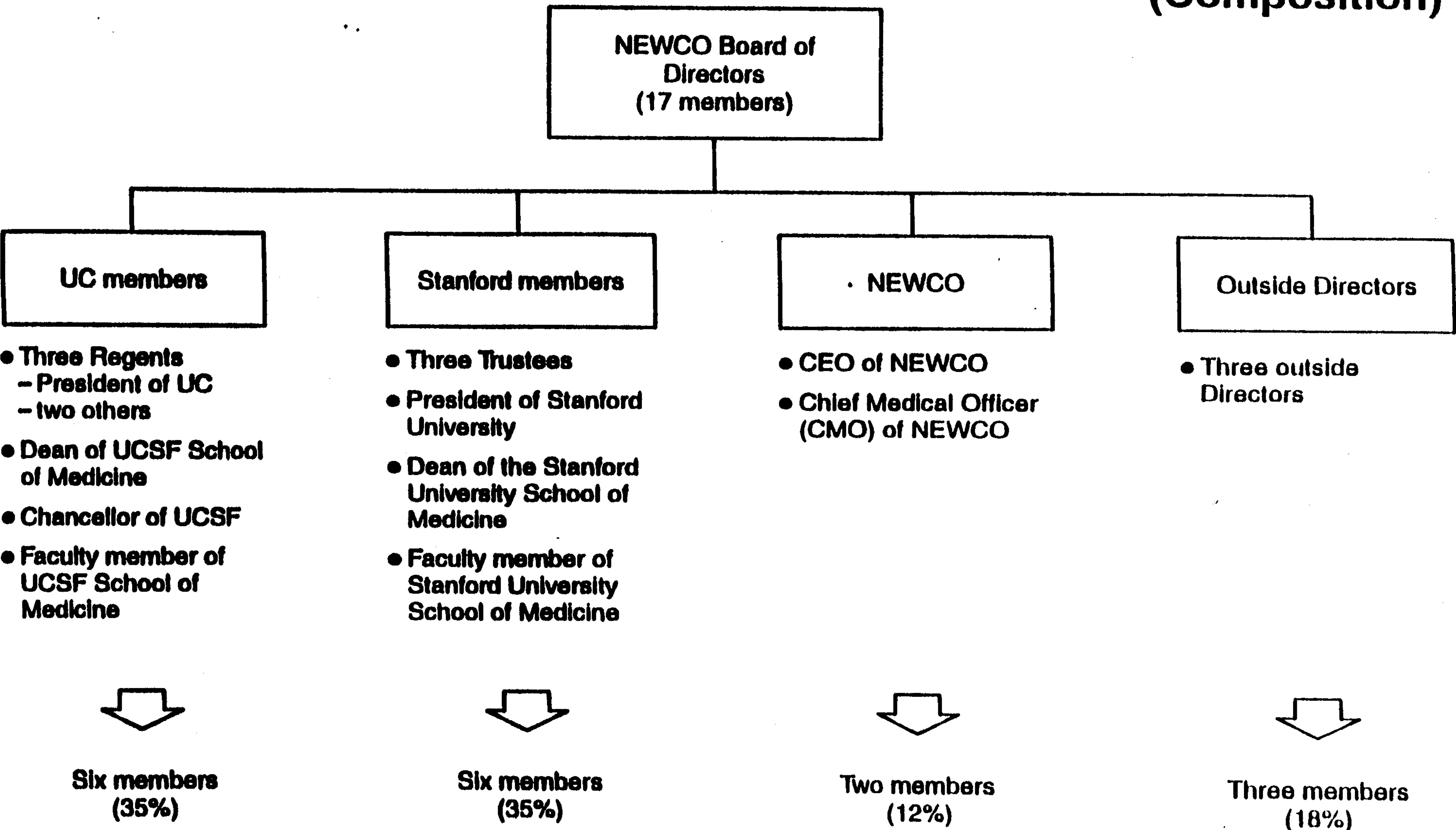
Indigent Care Summary

- UCSF and SHS/LPCHS Medical Centers have similar proportions of indigent patient care today
- Their respective mechanisms for approving patients for admission is not expected to change as a result of the proposed merger
- If the merger realizes its forecast, both entities should be able to maintain their fair share of care for indigent patients as a result of becoming financially stronger

NEWCO formation should not significantly impact current levels of indigent care

Appendix I: Newco Board of Directors: Proposed Composition

Board of Directors (Composition)



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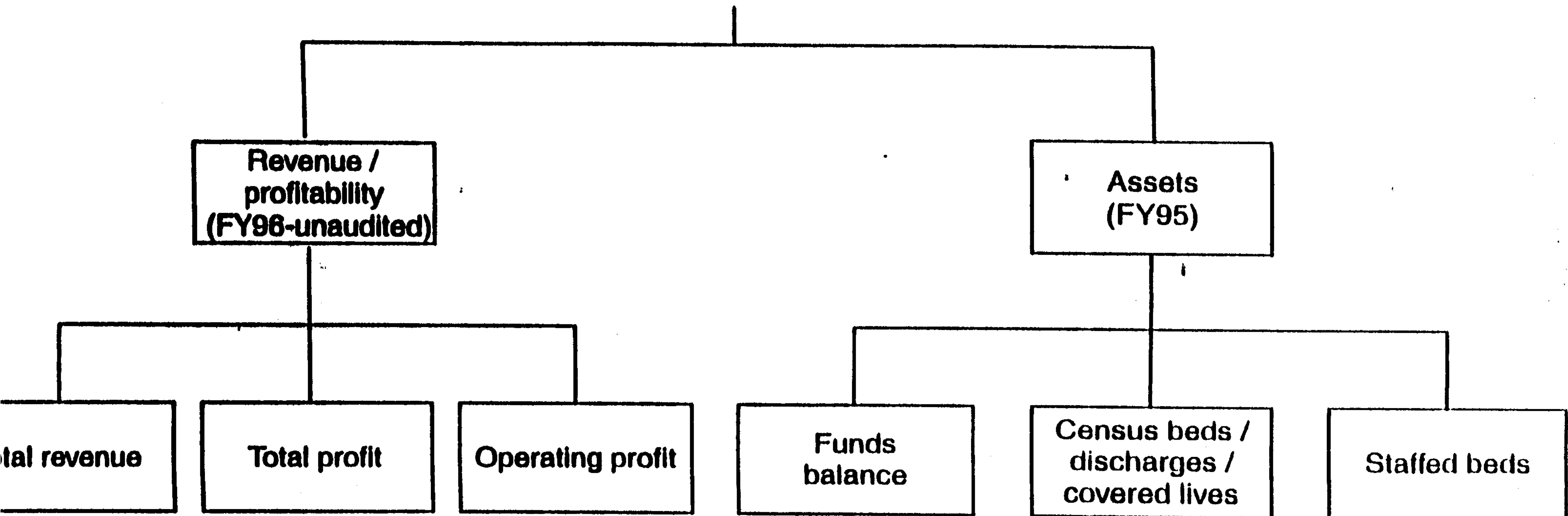
Appendix J: Measures of Equity Contribution: UCSF Medical Center versus SHS/LPCHS

Measures of Value



Notes: total revenue includes FPP for both SHS ($84MM) and UCSF ($112MM); Census beds equals occupied beds; discharges equal inpatient discharges; Revenue / profitability data from FY96 (unaudited); Asset data from FY95

Sources: Internal finance departments; Auditors' reports; Bain analysis

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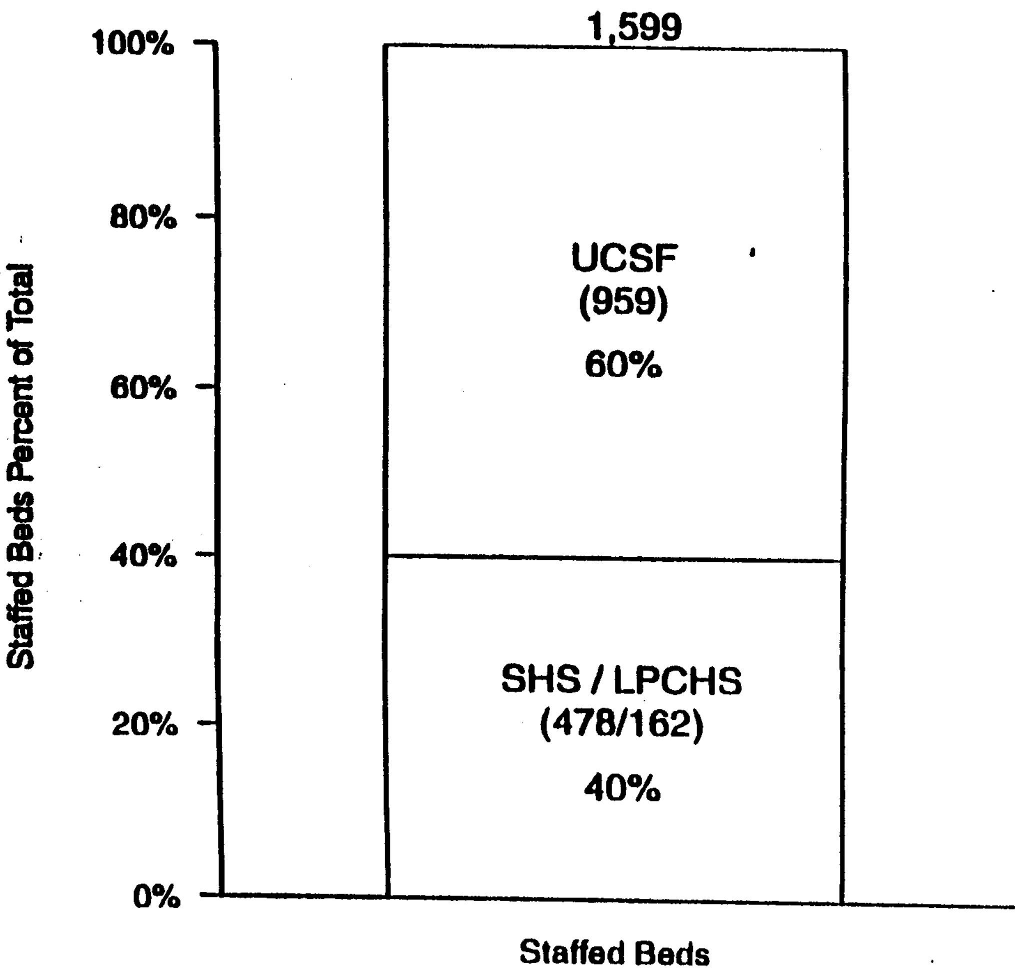
Capacity Comparison (FY95)

UCSF Medical Center has more staffed beds than SHS/LPCHS.



Sources: Internal finance departments

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