From: Jackson, Scott
Sent: Saturday, September 13, 2014 9:56 AM
To: Ilhardt, Benjamin; Wingkun, Lauren-Nicole
Subject: Fwd: Paladin - DCHS Final Bid Letter
Attachments: Paladin - DCHS Final Round Bid Letter 09-12-14.docx; ATT00001.htm

Scott Jackson
HOULIHAN LOKEY
312-456-4729 **Direct**
312-730-5713 **Mobile**
SJackson@HL.com

Begin forwarded message:

From: Joel Freedman <jfreedman@pldn.com>
Date: September 13, 2014 at 11:34:37 CDT
To: "Turnbull, Andrew" <ATurnbull@hl.com>
Cc: "Jackson, Scott" <SJackson@hl.com>, Eric Klein <eklein@sheppardmullin.com>, Garrett Fletcher <gfletcher@midcapfinancial.com>, Nick Orzano <norzano@pldn.com>, "James MacPherson" <jmacpherson@pldn.com>
Subject: Paladin - DCHS Final Bid Letter

Andrew,

At the beginning of the transaction process, following a detailed review of the CIM which was provided to us by Houlihan Lokey, we had a discussion with Geoff Ligabel in which we suggested that, based on market comps, the enterprise value of the DCHS business was approximately $170,000 per bed or $285mm based on 1,679 total beds across the system, which was just enough to retire the senior debt (which was stated at $263mm in the CIM) and cover transaction expenses. I suggested that the assumption of pension liabilities would mean that a buyer is grossly overpaying, but he rightfully reminded me of the QAF receivables as an equalizer, which was a legitimate position under those circumstances. For a tax-exempt buyer, the QAF income would cover the pension liabilities; but for a for-profit buyer, QAF income is taxable, and therefore, the net after-tax value of such income would equal only about half of the pension obligations. We were fortunate to have been studying the ESOP model which allows a corporation to have an effective tax rate of zero percent. Instead of a direct purchase by Paladin, we contemplated a transaction in which we would become a financial and management resource to enable the current employees of DCHS to participate in the transaction (through an ESOP) on a basis in which they would have no personal downside risk and significant upside opportunity.

Experience has proven to us that, when dealing with underperforming assets, in the absence of an overzealous strategic buyer, deals that are not economically sound do not get done, and buyers who attempt to overpay for such assets do not receive financing. The for-profit model falls into this category and we therefore consider it “dead on arrival”; but the ESOP model works, and based on the information contained in the CIM, it was working well. Accordingly, we proposed a deal structure that Paladin and Apollo/MidCap were fully prepared to support (along with several other prospective capital partners); and if conditions were the same today, we would be prepared to follow through on the deal as originally proposed. However, there are two material differences between the information presented in the CIM and today’s reality. First, with the deal dragging on longer than expected and the

Company continuing to burn more than $20mm per month (therefore necessitating bridge financing), senior debt at closing is estimated to be approximately $100mm higher than anticipated. Furthermore, with the monetization of the pooled investments, elimination of $40mm cash reserve, and use of pre-closing QAF, the asset values at Closing have fallen by more than $200mm (based on our original perceptions). These dynamics became clear to us a couple of weeks ago after you clarified our list of assets which would be included in the transaction, along with the projected cash flow which was posted to the data room.

Other challenges evolved by virtue of your client's proposed deal structure such as no indemnity, a full release, and exposure to known and unknown, on- and off-balance sheet contingent liabilities (many of which are uninsurable). Most problematic, however, was the request that the buyer be responsible for satisfying all liabilities regardless of the closing date, including cash at closing to retire all senior debt and cover all transactions costs. This creates a dynamic in which the buyer is responsible for any losses incurred pre-closing, with approximately $20mm of additional capital needed for every month of delay beyond a targeted closing date. Thus, the purchase price and capital requirements became a moving target, which is extremely difficult to underwrite.

The aggregate of these issues undermined our original underwriting thesis, and we had to go back to the drawing board, but with the hope that we could keep the core components of the deal structure in place. Despite the advantages of a tax free structure, we have fallen short. However, we are in a position to present a deal structure that has significant merit given the reality of the situation, and which provides a tangible pathway for all creditors to be made whole over time. In the end, we believe that most if not all of the seller's objectives will have been met, but we simply cannot get there on day one (i.e., at closing). Despite this reality, and having been an advisor in many comparable transactions, rather than simply withdrawing from the process, we believe your preference would be that we propose a deal that we are prepared to close; a deal that may prove to be the best outcome in an otherwise difficult situation. We do believe that our proposal is clearly a better solution than an underfunded reorganization or liquidation, and we expect that creditors will see it that way as well. But if there is a better deal on the table which offers certainty of closing, then we fully expect that you will pursue such an alternative.

With that rationale in mind, you will find attached a proposed revised bid letter. It does not include much of the minutiae that we have worked through together with our respective counsel over several prior discussions, but is focused on the core business points. If we end up proceeding, the prior correspondence will have not gone to waste, as we have been making considerable progress on the definitive agreements and have been sensitive to many of the points you have made. To that end, we are prepared to provide a revised comprehensive asset purchase agreement in short order following a positive response to this submission.

Here are some highlights of the proposed deal structure:

1. We are proposing to buy substantially all of the assets of DCHS, excluding the retained assets we have previously discussed (e.g., IP, church-related grants).

2. We cannot underwrite a purchase price that varies based on an unknown closing date, so we are offering a fixed purchase price in exchange for a fixed amount of assets and liabilities.

3. As is typical of most asset purchases, we will only assume specified liabilities, including the pension obligations, but not including all known and unknown, on- and off-balance sheet liabilities.

4. We will arrange for cash at closing calculated to satisfy all senior debt and transaction costs based on information provided to-date, which is estimated to be $384mm ($385mm in total senior debt, less $26mm cash reserve, plus $25mm in transaction costs), less $100mm, for a total amount of cash at closing of $284mm.

5. Given the $100mm shortfall, we will arrange for a $100mm junior secured note that will sit behind an OpCo A/R revolver and be well-secured by QAF receivables. The junior secured note will sweep a sufficient percentage of current QAF payments as received by OpCo to achieve a

zero balance by the end of the current round of QAF financing (end of 2016). Prior to its repayment, the note will receive a yield of 12-15% that is appropriate for subordinated debt.

6. We will provide two contingent notes which provide tangible opportunities for the accounts payable which are left behind to be fully paid over time. The first note will be for $30mm and will be paid in full on the 24 month anniversary of the closing, but this note will act as an indemnity and be subject to offset rights. The second note will be for $60mm and will be paid out of a percentage of subsequent rounds of QAF (post-2016), which are deemed highly likely to continue. Both notes will earn interest prior to being repaid.

7. Other than excluding certain liabilities, the balance of the proposed deal structure is substantially similar to that which we have previously discussed such as treatment of employees, pension obligations, and contractual obligations, including collective bargaining agreements.

The proposed transaction structure will not significantly impair the unpaid senior creditors of DCHS as their remaining position will be comparable, if not superior, to that of the senior debt that resides on the current balance sheet. The debt owed to DCHS will be secured by a tangible asset and receive a strong market-based yield. Yet, it will be payable by a business that has the same tax advantages as DCHS and that is managed by a very strong and capable management team who has skin in the game, along with the benefits of fresh-start balance sheets.

Our financial projections, which we believe are realistic if not conservative (having had the benefit of turning around several comparable hospitals in comparable markets), fully support the proposed capital structure, while ensuring that the business has reasonable liquidity to operate through a transition that will be complicated but achievable. The model and transition plan hold up very well.

We believe the seller note is a viable solution. However, both Apollo/MidCap and Paladin have ideas as to prospective capital partners who may have interest in replacing the seller in the junior secured position, thereby enabling all senior debt to be retired at closing. We didn't have time to make such connections prior to the deadline, but are prepared to pursue such alternatives in earnest. That said, the junior secured note is an attractive security (potentially including warrants if long term in nature; an option with an ESOP vs. a 501(C)3), and one or more of the Company's incumbent lenders may have interest.

Accounts payable, although left behind, will have a legitimate path to recovery that we believe is substantially more viable than taking their chances in an involuntary bankruptcy, which we think could lead to an air ball for senior creditors and nothing for unsecured creditors or pensions, with potential hospital closures which would ripple across the community.

We would have preferred to make this an easy transaction in which all of the seller's objectives were met, but the fundamentals don't support that outcome. Nonetheless, we believe that our current proposal is worthy of consideration in the absence of a better viable alternative, and we appreciate your ongoing time and consideration.

Best regards,

Joel Freedman
President
Paladin Healthcare Capital, LLC
2121 Rosecrans Avenue, Suite 2320
El Segundo, CA 90245
[redacted]