

March 21, 2014

Houlihan Lokey
c/o Geoffrey Ligibel and Scott Jackson

SENT ELECTRONICALLY

Preliminary Proposal by El Camino Hospital

El Camino Hospital (“ECH”) submits this non-binding letter of interest subject to the Confidentiality Agreement signed by the parties effective February 10, 2014, which prohibits any public disclosure of this document or related discussions without prior consent by ECH.

This preliminary proposal is being sent to you following the instructions received on the evening of March 4 relative to the Daughters of Charity Health System. Under those instructions, this preliminary proposal is a non-binding indication of interest, and is not a commitment to complete any agreement, and is conditioned upon completion of due diligence, legal review and documentation that is satisfactory to El Camino Hospital.

- 1. *Description of Potential Acquirer*** El Camino Hospital is a 501(c)(3) corporation, whose sole corporate member is El Camino Healthcare District. El Camino Hospital operates under a single license on two campuses – one in Mountain View (12 miles west of O’Connor Hospital) with an average daily census of approximately 215, and the other in Los Gatos (8 miles south of O’Connor) with an average daily census of approximately 40. In addition to providing acute care services, the organization has a history of serving the community by providing inpatient psych services, by providing EAP services on a global basis to major employers, by operating a patient centered medical home near its Mountain View campus, and by making cash grants to school districts and clinics that serve the poor. El Camino Hospital operates profitably, with an operating margin of approximately 8% and strong credit ratings of A1/A+ from Moody’s and S&P respectively. ECH has accumulated cash balances of around \$600 million and has a debt/capitalization ratio of 13% (despite having opened a new hospital building in Mountain View in 2009). El Camino Hospital’s strategy is to be “a locally controlled leader in optimizing the health and wellness of our communities in Silicon Valley, differentiated by innovative continuum of care developed in partnership with physicians, businesses and payers.”
- 2. *Assets to be Acquired*** ECH is primarily interested in acquiring the Northern California portion of the DCHS Medical Foundation (“Medical Foundation”), as a vehicle to expand its reach across the continuum of care, delivering “value” by reducing unnecessary hospitalization. Because the Medical Foundation is closely linked to O’Connor and Saint Louise, we would propose one of two alternative approaches:

- a.** In collaboration with other providers like Santa Clara Valley Medical Center (SCVMC) and Santa Clara County Independent Physician Association (SCCIPA), ECH could come up with an innovative plan to own and operate O'Connor Hospital and Saint Louise Hospital in a coordinated fashion with the Northern California portion of the DCHS Medical Foundation. Since you have advised ECH that we do not have permission to talk with SCVMC or SCCIPA until you have evaluated first round proposals, it is difficult to describe exactly what that collaboration might look like – but perhaps it would mean SCVMC purchasing and operating the two hospitals, while ECH would purchase the Medical Foundation and work with SCCIPA to find additional ways to contract with payors and employers on a “value” basis.
 - b.** If collaboration does not prove feasible, El Camino Hospital would be prepared to purchase the assets of O'Connor Hospital (with or without Saint Louise). El Camino Hospital had a similar experience in 2009, when ECH acquired the buildings which housed the former Los Gatos Community Hospital. The hospital temporarily closed for facility upgrading and opened as a 2nd campus on ECH's license..
- 3. *Treatment of the Medical Foundation*** As indicated above, ECH's principal interest is in acquiring the Medical Foundation – but only the Northern California portion, which would likely require a restructuring into two 1206(l) foundations and ECH's formation of a not-for-profit subsidiary 501(c)(3) corporation. ECH would plan to maintain the Medical Foundation clinics as they currently operate and renew professional service agreements with the physician groups. ECH would hope to expand the Medical Foundation by encouraging other physicians on staff at our Mountain View and Los Gatos campuses to participate, and to expand the Medical foundation's Contracts with payors by partnering with SCCIPA.
- 4. *Amount and Form of Consideration*** From the information provided, it is difficult to assess the value of services provided by the Medical Foundation which incurred cash losses of \$19 million in the most recent year, especially without detailed information as to the amount of such losses attributable to Northern California. We understand that DCHS spent \$9 million to acquire San Jose Medical Group and another \$5 million for other physician groups, and the sum of those amounts may reflect a reasonable value. Depending on additional information obtained during the due diligence period and the possibility of collaborative ventures with other organizations, the value may be higher. ECH has no interest in owning the medical office buildings separately from the purchase of the hospitals, and would not purchase the hospitals without the medical office buildings. We would plan for the consideration to be cash at the time of closing.

If collaboration with other providers does not prove feasible, we would plan to purchase the assets of O'Connor with or without Saint Louise. Without additional due diligence, it is difficult to place a value on hospitals having operating losses of \$25 million and \$15 million respectively. ECH believes the net book value of the physical assets is \$58 million and \$28 million respectively and, despite the deferred maintenance and seismic work required, may reflect a reasonable value. Again, we would plan for the consideration to be cash at the time of closing, or an

assumption of debt liabilities in an equal amount, whichever is preferable to DCHS. ECH would not assume the debt or the pension obligations associated with the hospitals.

5. **Working Capital Assumption** We are flexible regarding working capital. Our preference would be for DCHS to retain the patient receivables and other non-fixed assets, though ECH would be willing to purchase the inventory at book value.
6. **CBA Agreements and Non-Union Employee Retention** El Camino Hospital has a good working relationship with its nursing union (PRN), its engineers (Local 39), and SEIU for many of its other employees. Our preference would be to buy only the hospitals fixed assets and none of the existing employee obligations or their collective bargaining agreements. In such a case, we would plan to have DCHS close the hospitals and ECH would reopen with new employees (many of whom would be former DCHS employees rehired) and would assume that the employees would vote to be represented through collective bargaining agreements. ECH is willing to discuss the possibility of maintaining the existing work force and their collective bargaining agreements.
7. **Post-Retirement Obligations** We are not interested in assuming the post-retirement obligations.
8. **Treatment of Other Agreements** ECH prefers to have a sale of assets under which specific agreements could be transferred to ECH at its discretion after due diligence review.
9. **Sources of Capital** El Camino Hospital has sufficient liquid assets to finance any purchase. If the transaction involved the purchase of the hospital(s), ECH might choose to obtain financing through the issuance of tax-exempt bonds, but would not delay closing for the issuance of such bonds.
10. **Anticipated Operating Plan and Capital Commitments** El Camino Hospital will need to conduct further due diligence and research the most efficient way to integrate and align the Medical Foundation and the two DCHS hospitals and to develop synergies with our existing facilities. An operating plan will develop out of this analysis that identifies how the expanded system could best meet the evolving needs of the surrounding communities. We anticipate that such a plan would likely suggest that we invest sufficient capital to address the near-term deferred maintenance items highlighted in the confidential information (pages 110 and 131). At the O'Connor site, we would need to address whether the 1953 building should be renovated to meet seismic standards or whether it should be demolished. We would evaluate the longer-term needs for the O'Connor campus by considering what the community needs for the combined resources of O'Connor, Santa Clara Valley Medical Center, El Camino Hospital – Los Gatos and Good Samaritan Hospital; if El Camino Hospital is the sole acquirer, it is possible that we would conclude that some services should be consolidated between the O'Connor and Los

Gatos campuses. The possible participation of the SCVMC or the County in a joint proposal for the assets would also be a factor.

- 11. Community Service and Charity Care** El Camino Hospital has a strong history of providing charity care to those who need it and, going beyond that to make cash grants to organizations that are improving the health of the community or operating clinics for the underserved. For example, in our fiscal year ended June 30, 2103, we made grants of \$1,400,000 to Valley Medical Center Foundation for a clinic they operate in Sunnyvale. We subsidized a RotaCare Clinic on our own campus by \$765,000, and we made grants of \$520,000 to school districts for school nurse and other programs.
- 12. Process and Timing** We would propose 90-days of due diligence and up to 120-days of contract drafting and negotiation.
- 13. Due Diligence** Extensive due diligence will be required to get a better understanding of the losses that have been occurring at the DCHS facilities as well as where synergies and value can be extracted between the organizations. If the DCHS hospitals are acquired, a range of data that would be examined will include organization and business information, market information, operating data, information systems, financial data, payor data, physician contracts, insurance contracts, risk management policies, property and real estate inspections, labor and employee contracts, and general material contracts. A detailed list of initial due diligence requests is attached as Appendix A.

If only the Medical Foundation is acquired, the due diligence will examine the performance of physicians, physician contracts, ongoing operations, referral patterns, finances of the MSO, and other related areas.

- 14. Specific Contingencies to Closure** Any final binding contract would require approval of the El Camino Hospital Board and the El Camino Healthcare District Board. ECH's Board has a history of quick action, as evidenced by the rapid closure on the acquisition of the Los Gatos campus. The ECH Board meets monthly and the District Board meets quarterly, but special meetings can be called if necessary. ECH would need to notify the Local Agency Formation Commission of Santa Clara County ("LAFCO"), since the assets being acquired would be outside the El Camino Healthcare District boundaries – but this is notification only, and ECH does not need to seek LAFCO approval.

In addition, regulatory approvals would be required from the Attorney General of California and any associated licensure approvals for the hospital's licensure and certification process. Depending on the scope of the transaction, it may also be subject to Hart-Scott-Rodino review by the Federal Trade Commission. Creation of a new 501(c)(3) corporation for the Medical Foundation and/or securing a determination letter from the IRS would extend the time table for closing.

15. Other Parties As indicated above, ECH seeks to collaborate with other parties such as Santa Clara Valley Medical Center (SVCMC) and Santa Clara County Independent Physician Association (SCCIPA) in the proposed transaction.

16. Contact Information Prior to April 14, the El Camino Hospital contact is Ned Borgstrom, Interim CFO [REDACTED] after April 14, Iftikhar Hussain, CFO [REDACTED]; same phone number)