OFFICE OF THE ATTORNEY GENERAL
STATE OF GEORGIA

IN THE MATTER OF THE AFFILIATION OF DEKALB REGIONAL HEALTH SYSTEM, INC. WITH EMORY HEALTHCARE, INC.	* * * * * *	NO. AG 2018-02

REPORT OF FINDINGS

I.

BACKGROUND

DeKalb Regional Health System, Inc. ("DRHS"), a Georgia nonprofit corporation, serves as the parent company of an integrated system of nonprofit healthcare organizations including DeKalb Medical at North Decatur and DeKalb Medical at Hillandale. Through Decatur Health Resources, DRHS also operates DeKalb Medical at Downtown Decatur, a long term acute care hospital and other related healthcare and ancillary medical facilities and service entities ("DRHS Affiliates") (collectively referred to as the "Hospitals").[1] DRHS has a total of 627 licensed acute care beds, as well as 814 employed or affiliated physicians covering 49 specialties. DRHS offers emergency and trauma medicine, radiology and medical imaging, and laboratory, surgical, cancer care, and obstetrical services. DRHS also operates five Centers of Excellence: the Joint Solutions Center, Orthopedic Care, Bariatric Surgery, Maternity Care, and DeKalb Medical Heart and Vascular Services.

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[1] "DRHS Affiliates" includes: (i) DeKalb Medical Center, Inc.; (ii) DeKalb Health Resources, Inc.; (iii) DeKalb Medical Hospitalists, LLC; (iv) DRHS Ventures, Inc.; (v) DeKalb Medical Occupational Medicine Group, LLC; (vi) Dekalb Medical Specialty Care Group, LLC; (vii) DeKalb Medical Primary Care Group, LLC; and (viii) DeKalb Medical Auxiliary, Inc. Pursuant to the Hospital Acquisition Act, however, the Attorney General's review is limited to the sale of nonprofit hospitals. Therefore, the Attorney General has limited his review to the transfer of control of DeKalb Medical at North Decatur, DeKalb Medical at Hillandale, and DeKalb Medical at Downtown Decatur.

DRHS leases certain real property, including DeKalb Medical at North Decatur and DeKalb Medical at Hillandale from the DeKalb County Hospital Authority (the "Authority").

DRHS is a large community-based hospital system that provides a wide range of inpatient and outpatient healthcare services. DRHS serves an eight-county area in northern Georgia. The primary service area includes DeKalb and portions of Gwinnett counties. The secondary service area includes Fulton, Clayton, Henry, Rockdale, Newton, and Walton counties.

THE DISPOSITION PROCESS

DRHS engaged Cain Brothers to request proposals from organizations interested in an affiliation. DRHS worked with Cain Brothers to evaluate potential partners based on the following objectives: (1) ensuring that DRHS remained a viable, high-quality health care system which could continue to serve the community; (2) accessing sufficient capital to meet current and future capital needs, including infrastructure and strategic investments; (3) developing wider ambulatory network for increased patient touch points; (4) expanding clinical service line offerings; (5) growing the medical staff, both employed and independent practices; (6) gaining access to clinical, financial, and operational best practices; (7) developing a strong leadership team; (8) expanding community outreach; and (9) preserving a community-oriented culture.

DRHS identified a mix of potential partners consisting of local, regional, and national nonprofit and for-profit organizations. Cain Brothers contacted seventeen (17) potential strategic partners. Twelve (12) potential partners executed a nondisclosure agreement and received a Request for Proposal ("RFP") and Confidential Information Presentation. In response to the RFP, DRHS received six (6) proposals from potential partners, including (3) three local not-for-profit entities, one (1) regional nonprofit entity, and two (2) national for-profit entities. Of the initial six (6) bidders that submitted proposals, one (1) of the organizations failed to meet the basic financial commitment requirements and was eliminated from consideration, and three (3) of the organizations withdrew from the bidding process. As a result, the search was narrowed to two (2) prospective partners for the DRHS Board of Directors to consider.

After extensive discussion, DRHS's Board chose to pursue an affiliation with Emory Healthcare, Inc. ("Emory") because DHRS determined that it was best suited to meet DRHS' objectives. David Jollay, Chairman of the Board for DRHS, testified that Emory was selected because it allowed the Hospitals to keep their main service lines and to remain a full-service hospital system which would be "strategically used in Emory's system."

THE PROPOSED TRANSACTION

DRHS leases certain real property, including DeKalb Medical at North Decatur and DeKalb Medical at Hillandale from the Authority. DRHS proposes to enter into a Definitive Agreement with Emory whereby DRHS will amend its articles of incorporation and bylaws to appoint Emory as the sole controlling member of DRHS. As a result, the operations of DRHS, including the Hospitals, will be controlled by Emory, which intends to integrate such operations into the Emory system.

Under the proposed transaction, the Authority will continue to hold title to the real property used in connection with the operation of the North Decatur and Hillandale campuses. Additionally, the lease between DRHS and the Authority will be amended to, among other provisions: (1) reflect Emory's status as the sole and controlling member of DRHS; (2) extend the term of the leases; and (3) provide the Authority with a right of first refusal.

The proposed transaction is structured as a member substitution, and therefore, there is no acquisition price. The proposed affiliation will provide significant consideration and other financial and operational benefits to the communities served by DRHS. Emory has made a number of commitments related to the proposed transaction, however, including a commitment to: (1) provide $239 million in post-transaction capital investments in the facilities currently operated by DRHS over a seven year period, which can be extended up to ten (10) years under limited circumstances; (2) assume or repay around $168 million of DRHS's outstanding bond debt; and (3) continue to provide indigent and charity care services and community benefit programs. The proposed Definitive Agreement also includes a provision that Emory intends, but is not obligated, to deploy $135 million in strategic capital investments in DeKalb and Gwinnett counties to facilitate network development and ambulatory growth.

Emory's plan for DRHS is structured to ensure that the residents of the communities served by DRHS continue to have access to locally managed, high-value, and easily accessible care.

VALUATION ANALYSIS

Pershing Yoakley & Associates, P.C. ("PYA") was retained by DRHS to assist it with the Attorney General's review of the Proposed Transaction pursuant to the Hospital Acquisition Act. The scope of PYA's engagement included a fair market analysis to calculate the value of DRHS and an independent assessment of the estimated community benefit to be derived from the Proposed Transaction between DRHS and Emory. In its report, PYA concluded that the fair market value ("FMV") of DRHS on a stand-alone basis without an affiliation was $266 million. Further, PYA also concluded that the Proposed Transaction would yield $389.1 million in community benefits based on its analysis of capital commitments, debt defeasance, commitments to charity and indigent care, and the improvement of the overall quality, scope, and access to healthcare services for residents in the DRHS service area. Katherine Morris, on behalf of PYA, testified at the public hearing held on July 11, 2018.

Typically, there are three (3) traditional approaches that are considered in a valuation of a business. The three approaches are: (1) the Income Approach; (2) the Market Approach, and (3) the Cost Approach (Net Asset Value). In developing its FMV for DRHS, PYA considered the three (3) traditional approaches to value but ultimately relied on the Net Asset Value method in its analysis of DRHS, noting that it was not feasible to use the other approaches due to the anticipated future operating losses and negative cash flow.

PYA received budget estimates from DRHS Management as of October 31, 2018, which reflected operating significant losses for fiscal year 2018. Management indicated that underutilization of facilities and an unfavorable payer mix resulted in a level or revenues that could not adequately cover operating expenses or support capital investments needed to generate operating efficiencies. PYA noted poor financial performance and lack of forecast data, significant differences between DRHS and publicly traded companies, and transaction data that was not sufficiently reliable made the Income and Market approaches not feasible. Due to these circumstances, PYA utilized and relied solely on the Net Asset Value ("NAV") method in valuation of DRHS.

The application of the NAV method typically involves performing discrete valuations of the individual assets and liabilities, and then summing all values to reach a conclusion. However, in applying the NAV method, PYA used the book values of the assets and liabilities as a proxy for FMV based on DRHS' un-audited consolidated balance sheet as of October 31, 2017. Under the NAV method, PYA estimated the total value ("net asset value") for DRHS at approximately $98.7 million. PYA noted that they did not believe any substantial intangible value or goodwill existed based on DRHS' substantial negative cash flow and history of operating losses. PYA next added $168.8 million for the value of interest-bearing debt that will transfer in the transaction to calculate the total invested capital ("TIC") value of $267.5 million. Finally, in reaching its FMV conclusion for DRHS, PYA subtracted $1.5 million representing cash to be transferred from DRHS to the Foundation for enforcement of Emory's commitments to reach a FMV of $266.0 million.

In its analysis of the estimated economic benefit the community will receive as a result of the Proposed Transaction, PYA identified a number of qualitative and quantitative community benefits. PYA noted that the Proposed Transaction will improve the overall quality, scope and access to healthcare services for residents of the DRHS service area and that the enhanced ability to recruit physicians, develop services and decrease operating costs can provide a pathway for positive cash flows to improve the long-term financial viability of the system.

In addition to the qualitative benefits, PYA analyzed three (3) specific quantifiable benefits using present value techniques: (1) core capital commitment of $239.0 million over the seven year period after the closing of the Proposed Transaction; (2) debt defeasance of $168.7 million immediately after the closing; and (3) the commitment to reimburse $3.5 million of DRHS's transaction costs. Based on its analysis of the quantifiable benefits identified, PYA estimated the value of the community benefits at $389.1 million.

Ernst & Young, LLP ("EY"), in accordance with O.C.G.A. § 31-7-405(b), was retained as an independent financial advisory consultant by the Attorney General to assist in the review of the Proposed Transaction between DRHS and Emory. The Attorney General engaged EY to provide valuation advisory services, but not to provide a separate valuation or fairness opinion. Bridget Bourgeois, a partner at EY specializing in healthcare valuations, testified at the hearing. As part of this engagement, EY held discussions with representatives of all of the parties involved in the Proposed Transaction and performed independent research and analyses to review the conclusions contained in PYA's assessment of the value of DRHS and community benefit to be derived from the Proposed Transaction.

In the course of its engagement, EY focused its analyses in the following principle areas: (1) analysis of PYA's NAV method to test the impact to PYA's concluded value for DRHS; (2) sensitivity analyses of PYA's valuation of the community benefit varying certain assumptions to test the impact to PYA's concluded value for the community benefit; and (3) limited market research of valuation multiples observed for hospital transactions and for publicly-traded hospital operators.

With respect to PYA's FMV analysis of DRHS, EY reasoned that, given the historical and expected operating losses of DRHS, PYA's decision to rely on the NAV method to determine FMV was reasonable. EY analyzed PYA's NAV method and held discussions with PYA to understand the potential variance that may exist between the FMV of the net assets and the book value relied upon by PYA in its valuation of DRHS. PYA indicated that they believed economic obsolescence exists in the assets and that the FMV of DRHS is likely to be no more than the net book value. According to PYA's report, approximately half of the total value for DRHS ($266 million) was comprised of cash and investments ($136 million), and the most significant liability was bond debt ($168.8 million). Given that most of the value comprises financial assets and liabilities, EY determined that it is unlikely that the book value of these items is substantially divergent from the FMV. Ultimately, EY's analysis of PYA's NAV method yielded results similar to PYA's concluded FMV of $266.0 for DRHS.

With respect to PYA's community benefit analysis, EY noted that PYA considered and used relevant valuation approaches and methods that one would expect to see in an analysis of community benefits. However, EY identified certain assumptions in PYA's report related to the core capital commitment that could be debated. EY performed a sensitivity analysis by varying the amounts and timing of the capital expenditure commitment over the seven year period using information provided by DRHS management, and replaced PYA's after-tax discount rate with pre-tax discount rates to match the pre-tax basis of the capital commitment obligations. EY's sensitivity analysis of PYA's valuation of the community benefit resulted in a value of $384.1 million, which EY noted is very similar to PYA's concluded amount of $389.1 million for the community benefits.

EY also conducted independent market research of valuation multiples for comparable hospital transactions and compared them to the valuation multiples implied by PYA's valuation of DRHS. Based on EY's market research, EY observed that the valuation multiples implied from PYA's FMV for DRHS falls towards the low end of the range of valuation multiples paid in similar transactions, which was consistent with the financial performance of DRHS. Therefore, EY ultimately concluded that PYA used relevant valuation approaches and methods in its valuation of DRHS and in its analysis of the community benefits.

PUBLIC COMMENT

The public hearing was held on July 11, 2018, at 5:00 p.m. in the Hall Theater at DeKalb Medical at North Decatur, 2701 N. Decatur Road, Decatur, Georgia 30033. Six (6) persons made comments at the public hearing and all were in favor of the Proposed Transaction.

Following the public hearing, the record was held open until the close of business on July 17, 2018, at 5:00 p.m., for any further public comment. This Office did not receive any written public comments after the public hearing. Counsel for the parties were requested to inform this Office in writing before the record closed, as to whether their respective clients intended to proceed with the Proposed Transaction as structured or modify the Proposed Transaction in some respect. Counsel for the DRHS, the Authority, and Emory have written a joint letter stating that their clients wish to proceed with the transaction as proposed.

II.

FINDINGS

The Hospital Acquisition Act (the "Act") involves a public interest determination in the Attorney General's review of a proposed disposition and acquisition of hospital assets. *See* O.C.G.A. § 31-7-400 *et seq.*; *Sparks v. Hospital Authority of City of Bremen and County of Haralson*, 241 Ga. App. 485 (1999) (physical precedent only). The Act requires a written notice filing and a public hearing "regarding the Proposed Transaction in the county in which the main campus of the hospital is located." O.C.G.A. §§ 31-7-401, 31-7-405(a). The purpose of the public hearing is "to ensure that the public's interest is protected when the assets of a nonprofit hospital are acquired by an acquiring entity by requiring full disclosure of the purpose and terms of the transaction and providing an opportunity for local public input." O.C.G.A. § 31-7-406.

Under the Act, disclosure is linked to whether "appropriate steps have been taken to ensure that the transaction is authorized, to safeguard the value of charitable assets, and to ensure that any proceeds of the transaction are used for appropriate charitable health care purposes." O.C.G.A. § 31-7-406. The Act identifies thirteen (13) factors that are key considerations in determining whether the appropriate steps have been taken by the parties. *Id.* The thirteen (13) factors are listed in Appendix A to this report.

The thirteen (13) factors set forth in O.C.G.A. § 31-7-406 can be grouped into four (4) categories relating to (a) the exercise of due diligence by the seller (factors number 1, 2, 3, 4 and 8), (b) conflicts of interest (factors number 5 and 13), (c) valuation of the hospital assets (factors number 6, 7 and 10), and (d) the charitable purpose of the Proposed Transaction (factors number 9, 11 and 12).

The Exercise of Due Diligence by the Seller

The disposition of DRHS is authorized by applicable law as provided in factor number 1, and DRHS has taken the appropriate actions to sell the Hospitals. O.C.G.A. §§ 14-3-302, 31-7-400 *et seq.* With regard to factor number 2, Article 2.4 of the Definitive Agreement between the parties provides that the "Contemplated Transaction shall be consistent with, and [Emory] shall honor, the directives of all previous donors to the DRHS Entities, including all gifts, donations, and memorials." Therefore, it appears that the proposed disposition is consistent with the directives of any major donors who have contributed over $100,000.00.

The due diligence factors number 3 and 4 necessitate review of the process and procedures employed by the seller "in deciding to dispose of hospital assets, selecting the acquiring entity, and negotiating the terms and conditions of the disposition." O.C.G.A. § 31-7-406(3). As discussed in detail above, DRHS exercised appropriate due diligence in its selection process because the evidence shows that an extensive and deliberative process was conducted by it with the assistance of professional consultants. A formal RFP was conducted. DRHS received and considered six (6) proposals from potential partners. Of the initial six bidders that submitted proposals, there were two (2) prospective partners for the DRHS Board of Directors to consider. After extensive discussion, DRHS's Board chose to pursue an affiliation with Emory. The deliberative process employed by DRHS in selecting the proposal of Emory demonstrates the exercise of due diligence, consistent with factors number 3 and 4.

Since there is no separate management or services contract negotiated in conjunction with the Proposed Transaction, factor number 8 is not applicable to the determination of the Seller's exercise of due diligence.

Conflicts of Interest

The disclosure of any conflict of interest involving the Sellers, the Chief Executive Officer of the Hospital System and its expert consultant is to be considered under factor number 5. Conflict of interest certifications as required by the Act and the notice filing requirements of the Attorney General have been filed by all of the members of DRHS's Board of Directors, members of the Board of Directors of the Authority, the CEO, and PYA (DRHS's financial consultant). Although some exceptions were noted on the certifications, such certifications do not disclose any impermissible or significant conflicting financial interest in the Proposed Transaction. With regard to factor number 13, health care providers will not be offered an opportunity to invest or own an interest in the Hospital System. Therefore, factor number 13 is not applicable.

Valuation of the Hospital Assets

The value of the Hospital System and the amount of consideration to be paid in the Proposed Transaction must be weighed under factors number 6, 7 and 10. In a sale of hospital assets from one nonprofit corporation to another nonprofit corporation, the nonprofit seller should receive an enforceable commitment for fair and reasonable community benefits for its assets. *See* O.C.G.A. § 31-7-406(6). Based on the record, including the analysis conducted by PYA on behalf of DRHS, and the review by Ernst & Young at the request of the Attorney General as described herein, DRHS and the Authority will receive an enforceable commitment for fair and reasonable community benefits in exchange for its assets as required by the Act.

Since the Seller is not financing any portion of the Proposed Transaction, factor number 7 is not applicable. Factor number 10 requires that a meaningful right of first refusal has been retained, should the successor nonprofit corporation subsequently propose to sell, lease, or transfer the Hospital System to another entity. The Authority will continue to own the land and buildings that comprise DeKalb Medical Center at North Decatur and DeKalb Medical at Hillandale, which will be leased to Emory. Under Section 4.16 of the Proposed Lease Amendment, the Authority is granted a right of first refusal which it may exercise if Emory receives a written offer for an asset sale or change of control transaction from a third party related to DeKalb Medical Center at North Decatur and DeKalb Medical at Hillandale. In addition, pursuant to 5.7.3 of the Definitive Agreement, the DeKalb Medical Center Foundation, Inc. is granted a right of first refusal if Emory receives a written offer for an asset sale or change of control transaction from a third party related to the LTACH. Therefore, the proposed Agreement is consistent with the purposes of factor number 10.

Charitable Purpose of the Proposed Transaction

With respect to the charitable purpose of the Proposed Transaction, factor number 9 requires that the disposition of proceeds be used for charitable health care purposes consistent with the nonprofit's original purpose. Although DRHS will not generate any monetary proceeds with the proposed affiliation, Emory will make certain investments in the Hospitals, including $239,000,000.00 in capital commitments. In addition, Emory will satisfy $168 million of DRHS's outstanding bond debt.

The other two charitable purpose factors, factor numbers 11 and 12, concern the purchaser's commitment to provide (a) continued access to affordable care, (b) the range of services historically provided by the seller, (c) health care to the disadvantaged, the uninsured and the underinsured and (d) benefits to the community to promote improved health care. The notice filing and the testimony provided at the public hearing indicate that the emergency room will remain open 24 hours a day, seven days a week. After completion of the transaction, the Hospitals will continue in existence as part of Emory, a Georgia nonprofit corporation. Emory has committed to following DRHS's commitment to providing care to disadvantaged, uninsured, and underinsured patients, and is obligated to maintain policies and procedures that are at least as favorable to the indigent and uninsured as DRHS's existing policies and procedures. Emory has also committed to continue to provide care through community-based health programs, including cooperation with local organizations that sponsor healthcare initiatives to address identified community needs and improve the health status of the elderly, poor, and other at-risk populations. The evidence, taken as a whole, demonstrates an enforceable commitment to improve health care in the community and to assure continued access to affordable care.

III.

CONCLUSION

Upon review of the public record and in accordance with the Hospital Acquisition Act, the Hearing Officer finds that the public record in this matter discloses that the parties have taken appropriate steps to ensure (a) that the Proposed Transaction is authorized, (b) that the value of the charitable assets is safeguarded and (c) that any proceeds of the Proposed Transaction are used for appropriate charitable health purposes.

This 9TH day of August, 2018.

JULIE ADAMS JACOBS
Senior Assistant Attorney General
Hearing Officer

APPENDIX A

(1) Whether the disposition is permitted under Chapter 3 of Title 14, the Georgia Nonprofit Corporation Code,' and other laws of Georgia governing nonprofit entities, trusts, or charities;

(2) Whether the disposition is consistent with the directives of major donors who have contributed over $100,000.00;

(3) Whether the governing body of the nonprofit corporation exercised due diligence in deciding to dispose of hospital assets, selecting the acquiring entity, and negotiating the terms and conditions of the disposition;

(4) The procedures used by the nonprofit corporation in making its decision to dispose of its assets, including whether appropriate expert assistance was used;

(5) Whether any conflict of interest was disclosed, including, but not limited to, conflicts of interest related to directors or officers of the nonprofit corporation and experts retained by the parties to the transaction;

(6) Whether the seller or lessor will receive fair value for its assets, including an appropriate control premium for any relinquishment of control or, in the case of a proposed disposition to a not-for-profit entity, will receive an enforceable commitment for fair and reasonable community benefits for its assets;

(7) Whether charitable assets are placed at unreasonable risk if the transaction is financed in part by the seller or lessor;

(8) Whether the terms of any management or services contract negotiated in conjunction with the transaction are reasonable;

(9) Whether any disposition proceeds will be used for appropriate charitable health care purposes consistent with the nonprofit corporation's original purpose or for the support and promotion of health care in the affected community;

(10) Whether a meaningful right of first refusal to repurchase the assets by a successor nonprofit corporation or foundation has been retained if the acquiring entity subsequently proposes to sell, lease, or transfer the hospital to yet another entity;

(11) Whether sufficient safeguards are included to assure the affected community continued access to affordable care and to the range of services historically provided by the nonprofit corporation;

(12) Whether the acquiring entity has made an enforceable commitment to provide health care to the disadvantaged, the uninsured, and the underinsured and to provide benefits to the affected community to promote improved health care; and

(13) Whether health care providers will be offered the opportunity to invest or own an interest in the acquiring entity or a related party, and whether procedures or safeguards are in place to avoid conflicts of interest in patient referrals.