

Phase One Report

Overview of the Engagement

Cain Brothers & Co. LLC (“Cain Brothers”) has been engaged by Citizens Medical Center (“CMC” or the “Hospital”) to assist in a strategic analysis of the Hospital’s potential value and future ownership and partnering alternatives.

- Specifically, the scope of Cain Brothers’ engagement includes:
 1. Identifying the objectives of the Board regarding the future ownership of CMC
 2. Determining which strategic alternatives, consistent with the Board’s objectives, are available to CMC in the current market
 3. Developing a fair market value range for CMC
 4. Developing a list of prospective strategic partners and buyers consistent with the objectives established by the Board
 5. Developing a strategy for conducting a potential transaction process to achieve the Board’s objectives
 6. Assisting the Board in evaluating the options potentially available to CMC

We request that, to the fullest extent permitted by law, this report, which contains evaluation approaches, intellectual content, and other information that Cain Brothers considers proprietary, be kept confidential and not disseminated beyond those on a “need-to-know” basis. In addition, the disclosure of the content of this report could give competitors of CMC and Cain Brothers competitive advantages. Further, should the contents of this document be disclosed publicly, and should CMC pursue a sale or lease transaction in the future, the ultimate value received by CMC could be negatively impacted by such disclosure.

In developing this evaluation, Cain Brothers relied upon certain information relating to CMC regarding the operations and financial performance of the Hospital and the market as provided to us by CMC Management and the Board

- Audited financial statements from the fiscal years ended June 30, 2007 - 2011
- Unaudited financial statements from the fiscal year ended June 30, 2012
- Management's projected budget for fiscal year ending June 30, 2013
- Management's projected capital budget for fiscal years 2013 - 2015
- Utilization statistics from fiscal years 2007 - 2012 and projections for 2013
- Payor mix analysis for fiscal years 2008 - 2012
- A summary of all CMC physicians classified by department
- Other financial and operational information and analysis relating to CMC
- Interviews with the Board and management pertaining to: their objectives for the Hospital, the Hospital's business prospects, historical operating and financial performance, corporate strategy, the physician and managed care market, market share trends, demographic statistics, general economic trends, competition, provider relationships, and payor relationships.

We also relied upon publicly available information:

- Publicly available information considered includes:
 - Financial, operating and descriptive information for certain publicly traded health care services companies that we deemed to be relevant to the analysis;
 - Stock price information for publicly traded health care services companies and related stock market indices; and
 - Valuation information for acquisitions of publicly traded and privately owned companies that we deemed to be relevant to the analysis.
- Cain Brothers assumed to be reliable the information furnished by others. We have not independently verified any such information, and we have relied on it being complete, accurate, and current in all material respects.
- In addition, Cain Brothers has not undertaken an independent appraisal or physical inspection of the assets or liabilities, and our analyses are not, and do not purport to be, appraisals of the assets, liabilities or business of CMC or any other entity.
- Cain Brothers makes no representations as to the legal, tax, or accounting effects of entering into and consummating a future transaction.
- The preliminary valuation range is based upon generally accepted valuation techniques, reflects financial market conditions and other industry factors as of the date of this report, and does not purport to take into consideration any information or events arising subsequent to such date as described herein.
- This report is intended solely for discussion purposes with CMC's Board.

Identifying, evaluating, and executing on strategic options is predicated on establishing key organizational objectives. Based on interviews with Board members, we have assumed the following as key objectives of the CMC Board:

- Focus should be on high quality health care
- Balance quality with need to produce a margin
- Prefer a choice of providers in the market
- Provide care for the indigent of the community
- Maintain critical service lines within the community (cancer center, heart center)

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Situational Analysis – National Trends

Evolving Health Care Economics

- Reduction in Medicaid and Medicare reimbursement rates can no longer be offset by commercial payor rates
- Providers are increasingly becoming price takers
- Shift from pay-for-service to risk-bearing payments is converting hospitals into cost centers
- Sector is increasingly becoming commoditized

Physician Shortages

- Physician shortages are challenging providers and their referral base
- Integration of physician groups with hospital systems is becoming increasingly important
- Recruitment and retention costs will continue to increase as the competitive environment intensifies

Capital Markets Trends

- Significant capital is needed to fund necessary IT infrastructure and acquire physician practices
- IT and physician costs cannot be financed with tax-exempt debt
- Increased focus on providers' credit profile and performance trends
- Continuing favorable interest rate environment and institutional appetite for tax-exempt debt

Increasing Consolidation

- Providers are increasingly seeking strategic partnerships to achieve the economies of scale necessary to operate in the low reimbursement, high cost infrastructure environment
- Need for access to capital also driving high rate of consolidation
- In-market consolidation has come under increased scrutiny by the FTC

**Local
Economy**

- Victoria's economy continues to outperform similar-sized metropolitan areas with relatively low unemployment
- Texas and the local economy are facing increasing Medicaid enrollment and continued Medicaid cost containment measures into the foreseeable future
- Residential housing market is strong due to Caterpillar and Eagle Ford Shale activities

**Victoria
Demographics**

- Aging population results in fewer young people to fill employment demands
- Aging population is driving increasing percentage of hospital volume through Medicare
- Population base continues to grow
- Region's population is expected to grow moderately and median income is expected to outpace the national average between 2011 and 2016

**Market
Position**

- Based on AHD's inpatient discharge data for 2011, CMC captures a market share of 54% and 62% in the area's two largest zip codes
- Market size may not adequately support two providers in certain service lines in the long term
- Geographic location and property ownership are positives

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Situational Analysis - Internal Environment

Financial Trends

- Total Operating Revenue decrease from \$183 million in 2008 to FY 2013 Budget of \$155 million (before Bad Debt expense, but including rural upper payment limit (UPL) reimbursement)
- EBIDA (earnings before interest, depreciation, and amortization) decrease from \$30.1 million in 2008 to FY 2013 Budget of (\$1.3) million
- Physician support (call coverage, income guaranties) impacting bottom line
- Significant levels of bad debt (approximately 20% of net patient revenue)

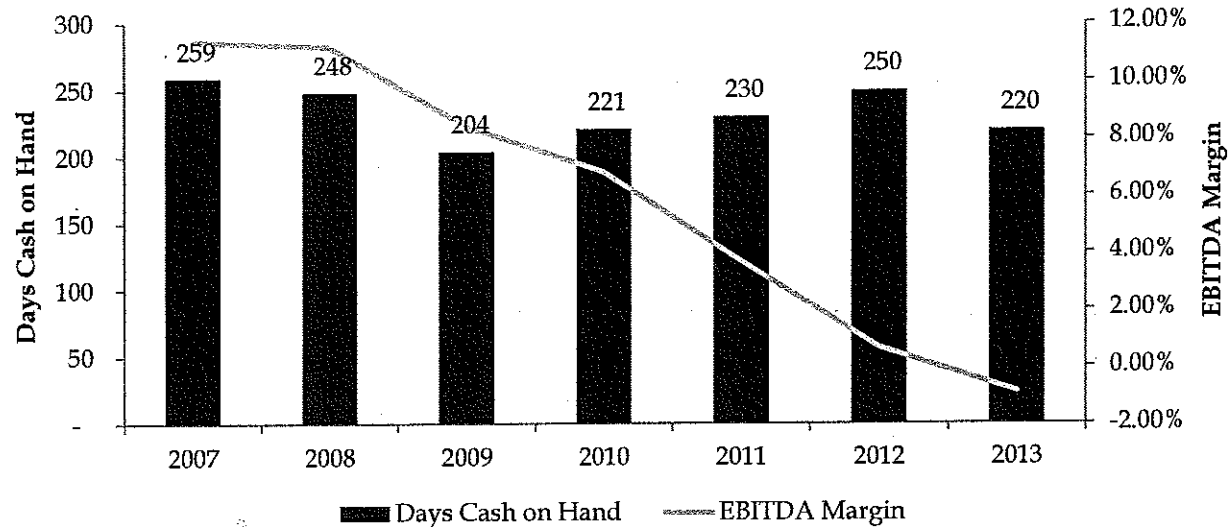
Operational Issues

- Increase in Blue Cross component of payor mix
- Inpatient reimbursement from Blue Cross significantly impacting earnings
- Significant volume drop-off over last 5 years (both inpatient and outpatient)
- No expense reduction initiatives to-date
- HealthPlex wellness facility has been reasonably successful, but adjacent medical office building is underutilized

Capital Markets

- Strong cash position, lack of long-term debt, and favorable capital markets provide opportunity to access long-term debt financing
- No pressing need to borrow for deferred maintenance or capital equipment items

CMC's liquidity remains strong, however with continually declining cash flow, cash balances will begin to fall ⁽¹⁾



- Continued poor operating performance could result in lower capital expenditure levels, which could further compound the problem of weak operating results
- Current financial performance is not being impacted by underinvestment, but rather driven largely by external market forces, therefore, leveraging the balance sheet or utilizing cash will not necessarily result in any material operating improvements (i.e., it is unlikely that CMC can “invest its way out” of the financial situation)

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Summary of Preliminary Observations Regarding CMC's Outlook

Despite positive balance sheet indicators (strong days cash on hand and no debt), earnings improvements as a standalone hospital facility are unlikely to be easily attained, significantly hindering the Hospital's ability to remain competitive.

Summary of Future Positives

- Victoria economy remains vibrant and housing market is strong
- HealthPlex MOB provides room for growth on north side of Victoria
- Days Cash on Hand and lack of debt provide financial resilience
- Community opinion of quality is believed to be high
- Cost cutting measures have not yet been attempted

Summary of On-going Challenges

- Admissions have dropped in every department since 2007
- Payor mix has transitioned to heavy reliance on government pay and Blue Cross
- Standalone facility status results in low leverage with Blue Cross
- Relatively small pie being split two ways for certain service lines
- Bad debt levels are well above typical norms
- Inability to meaningfully impact top line revenue (through volume increases or reimbursement improvement) means future earnings can only be achieved with significant cost reduction initiatives (primarily labor force reductions)

Bottom Line

- To remain viable, CMC should seek strategic alternatives that improve top-line revenues (through improved contracts, volume increases, and increased bad debt collection) or reduce expenses (labor force reduction, consolidate service lines).

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Preliminary Valuation Summary

The following summarizes the results of our analysis. We have concluded that the estimated fair market enterprise value range of CMC is million to nillion

- The range of enterprise values assumes a fully engaged auction process with multiple bidders
- The valuation range implies an LTM revenue multiple range of , an LTM EBITDA multiple range of and a \$ per bed multiple range of
- As in all transaction processes, there is a chance that a bidder(s) will not emerge or will submit an offer(s) substantially lower or higher than the estimated range of fair market enterprise values

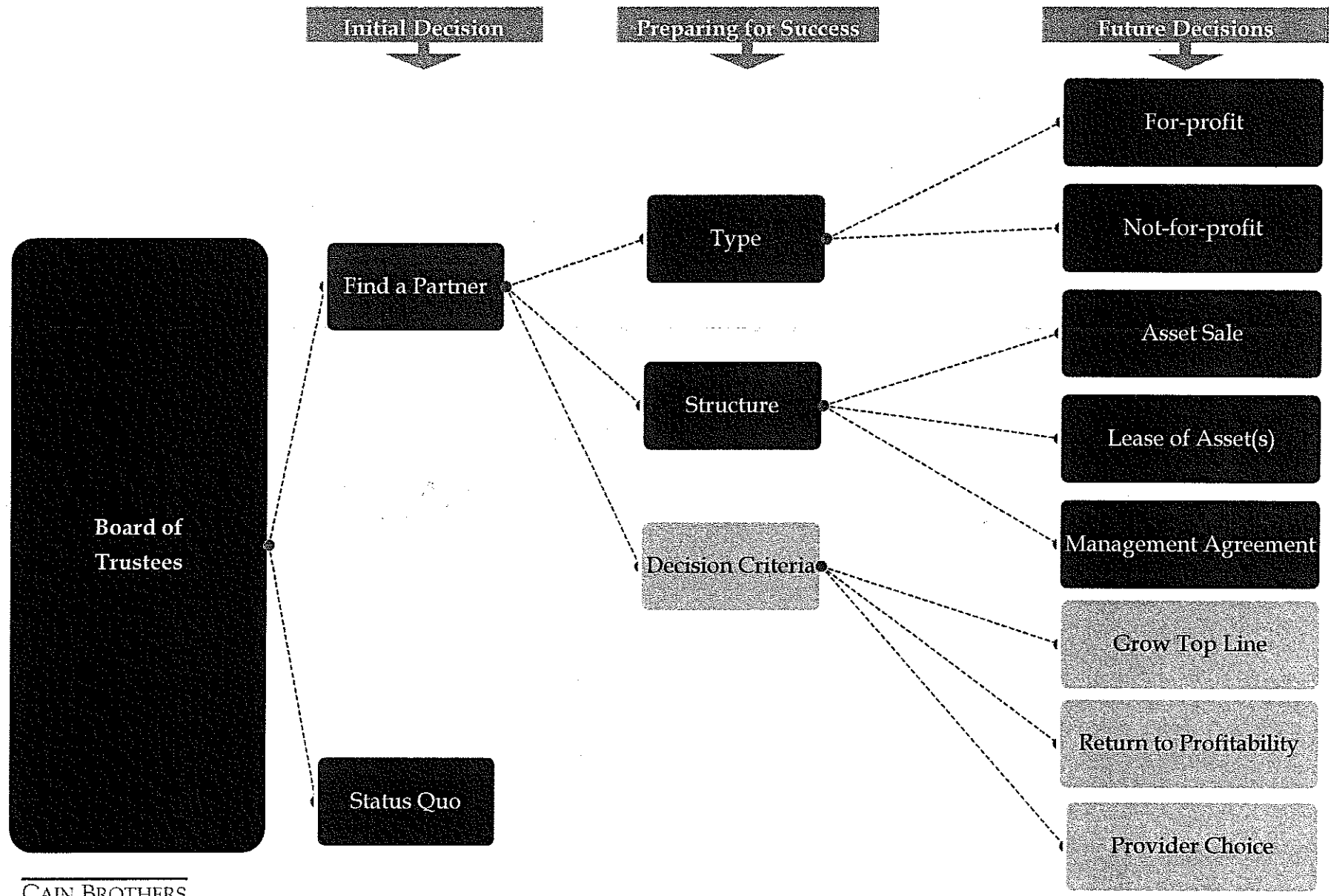
(\$ in thousands)

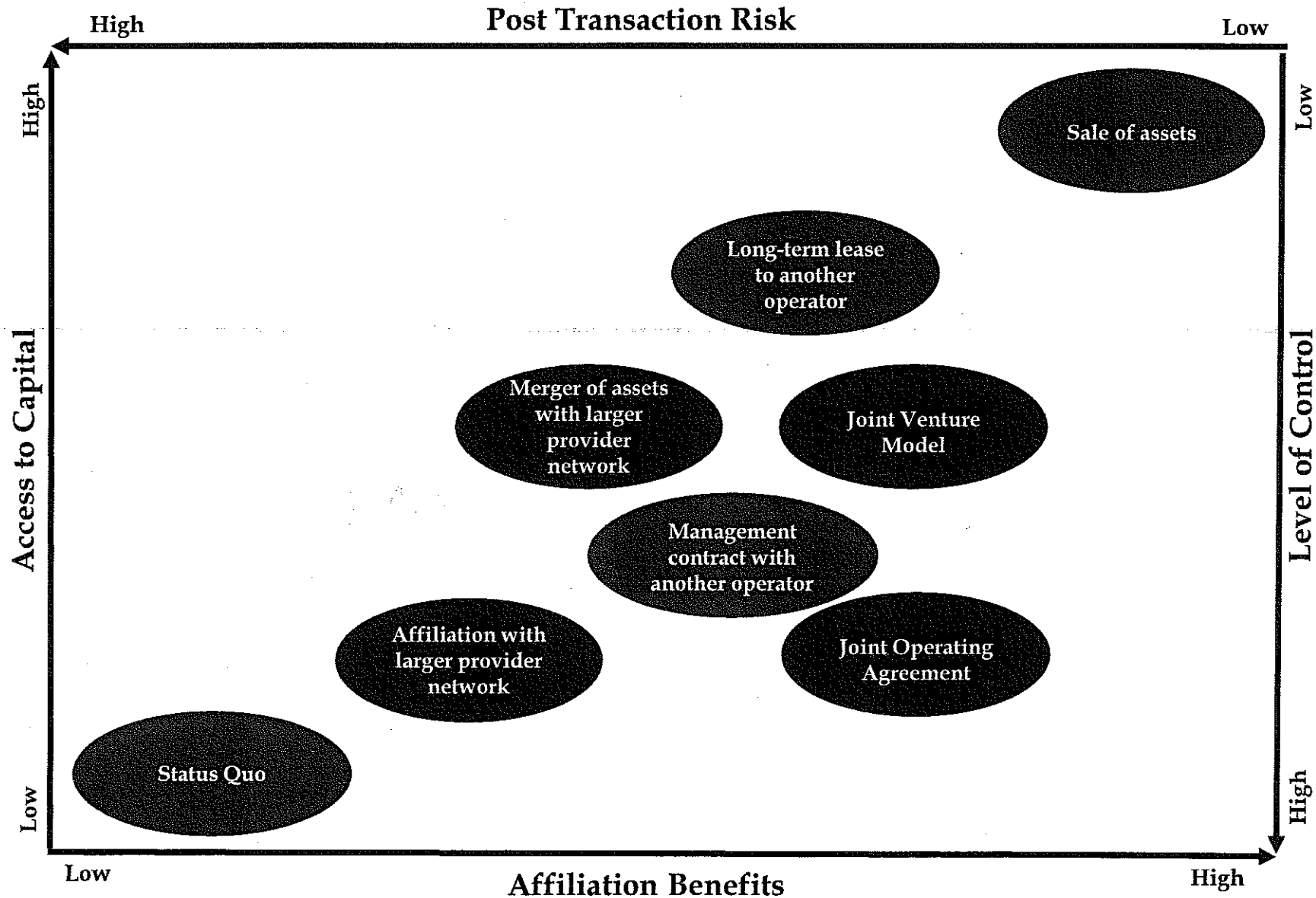
Preliminary Enterprise Valuation Summary

	Comparable Company LTM Revenue	Comparable Company FY 2011 Revenue	Comparable Company LTM EBITDA	Comparable Company FY 2011 EBITDA	Comparable Transactions LTM Revenue	Comparable Transactions LTM EBITDA	Comparable Transactions \$ Per Bed
Market Median							
Market Mean							

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Potential Decision Tree for the Board





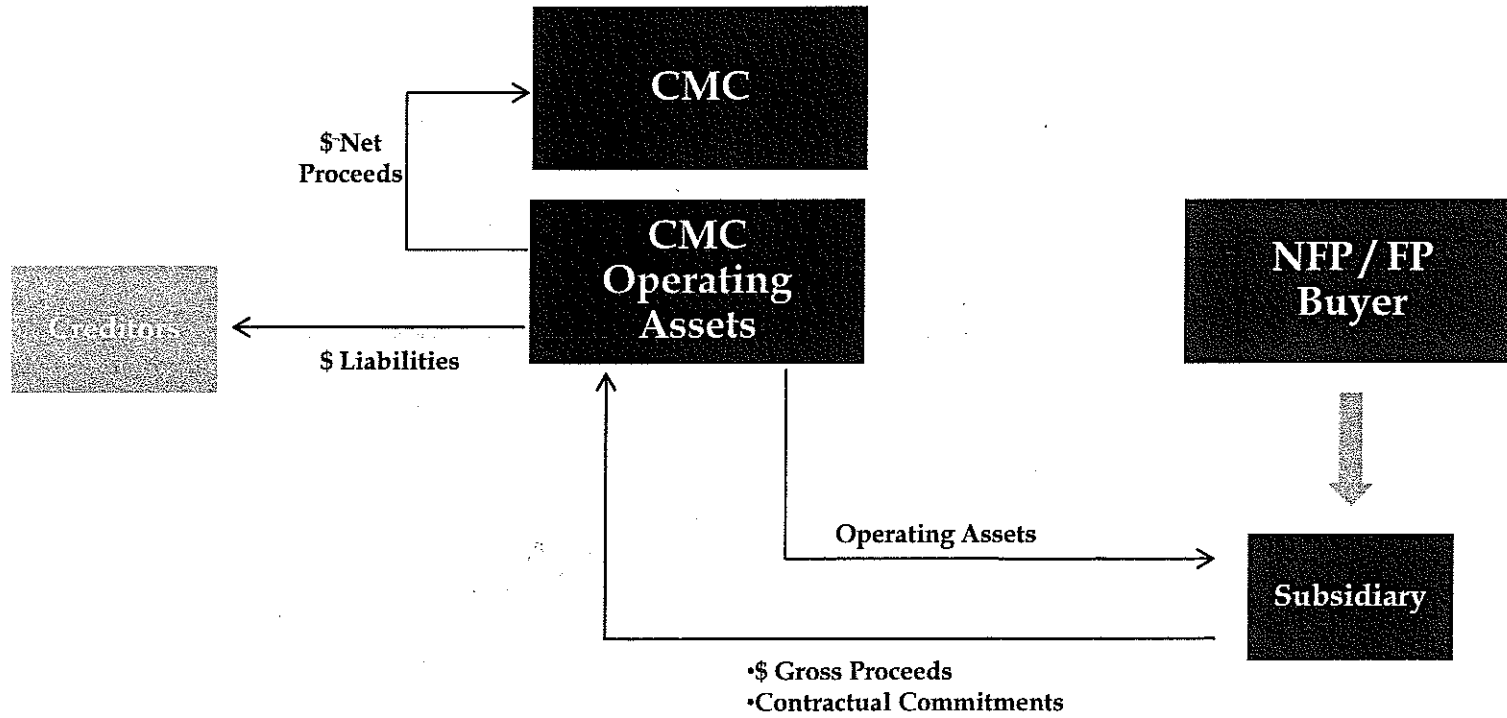
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Strategic Alternatives

	Pros	Cons
Remain Independent	<ul style="list-style-type: none"> ▪ Implement potential action plan to fend off challenges associated with operating a status quo strategy ▪ Retain governance and management control 	<ul style="list-style-type: none"> ▪ Need to implement cost saving reductions and focus on efficiencies ▪ Need capital to be competitive in physician recruiting and marketing programs ▪ Competitive position will continue to be a significant challenge
Management Service Agreement	<ul style="list-style-type: none"> ▪ Retain facility ownership and governance control ▪ Contract for professional management services ▪ Access best practice protocols and procedures ▪ Potential for clinical service line affiliation agreements with other provider(s) 	<ul style="list-style-type: none"> ▪ May not provide access to managed care contracts that improve top line reimbursement ▪ Cost associated with management services could further erode bottom line ▪ Cost cutting measures likely ▪ No upfront consideration
Lease	<ul style="list-style-type: none"> ▪ Retain ownership of the facility ▪ Enterprise value received over the life of the lease via annual lease payments ▪ Can specify service line maintenance (could negatively impact value) 	<ul style="list-style-type: none"> ▪ Loss of control during lease term ▪ Risk that capital improvements and maintenance are lacking and facility quality deteriorates over time
FP/NFP Sale	<ul style="list-style-type: none"> ▪ Strategic acquiror may be in a better position to address increased competitive risks ▪ Strategic partners can bring significant operational experience, capital and other resources ▪ Potential to maintain service lines (could negatively impact value) ▪ County tax rolls could benefit if FP buyer 	<ul style="list-style-type: none"> ▪ Loss of operational and governance control ▪ Potential not-for-profit status may not continue going forward ▪ Service lines could be cut/consolidated ▪ Expense reduction programs could result in layoffs

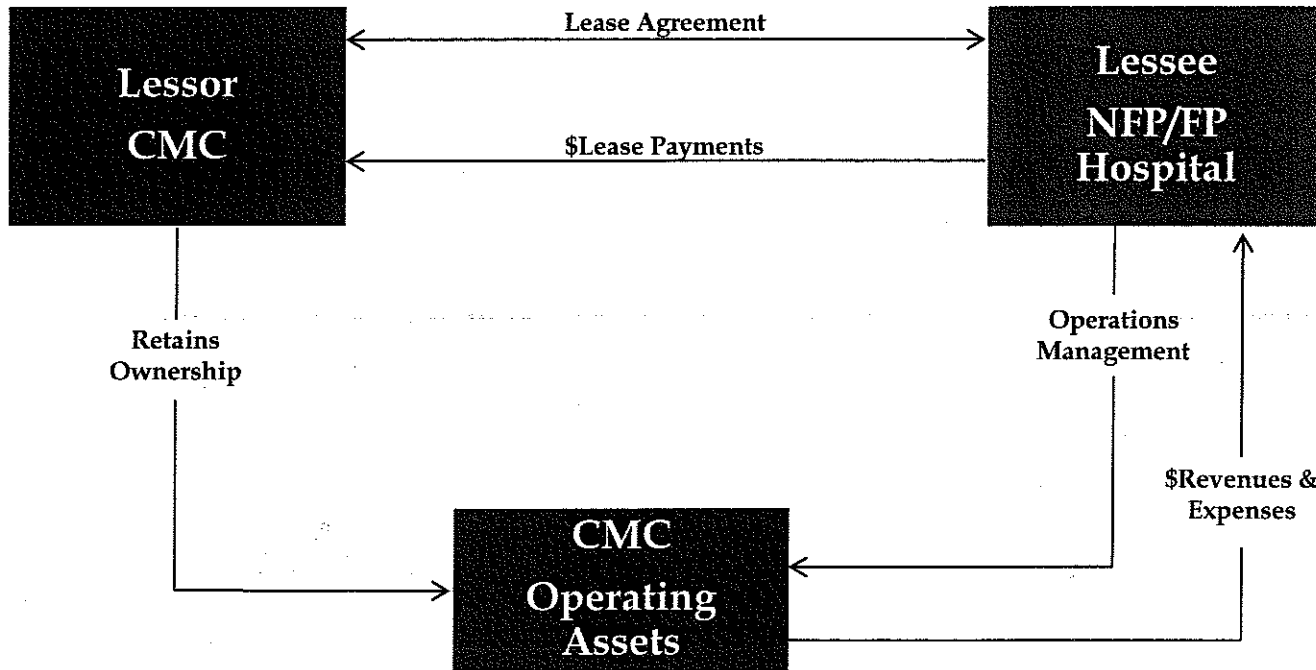
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Asset Sale Structure



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Long-Term Lease Structure



Cain Brothers views the following hospital providers as prospective partners/buyers for CMC:

▪ Not-for-Profits

- Scott & White (Temple, Central Texas)
- Seton/Ascension (Austin, Central Texas)
- CHRISTUS (San Antonio, Houston, Corpus Christi)
- Memorial Hermann (Houston)
- St. Luke's Episcopal (Houston)
- Methodist (Houston)

▪ For-Profits

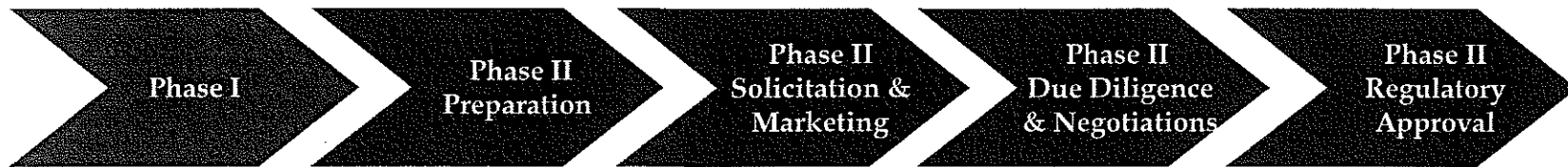
- Vanguard Health Systems
- HCA
- Community Health Systems
- Tenet
- LifePoint
- HMA
- LHP
- Universal
- IASIS
- Prospect Medical
- Capella
- RegionalCare
- Ardent Health Services
- Prime Healthcare Services

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Transaction Timeline

An efficient sales process takes four to six months to produce a definitive agreement

September							October							November							December							January							February												
S	M	T	W	T	F	S	S	M	T	W	T	F	S	S	M	T	W	T	F	S	S	M	T	W	T	F	S	S	M	T	W	T	F	S	S	M	T	W	T	F	S						
						1	1	2	3	4	5	6							1	2	3							1							1	2	3	4	5							1	2
2	3	4	5	6	7	8	7	8	9	10	11	12	13	4	5	6	7	8	9	10	2	3	4	5	6	7	8	6	7	8	9	10	11	12	3	4	5	6	7	8	9						
9	10	11	12	13	14	15	14	15	16	17	18	19	20	11	12	13	14	15	16	17	9	10	11	12	13	14	15	13	14	15	16	17	18	19	10	11	12	13	14	15	16						
16	17	18	19	20	21	22	21	22	23	24	25	26	27	18	19	20	21	22	23	24	16	17	18	19	20	21	22	20	21	22	23	24	25	26	17	18	19	20	21	22	23						
23	24	25	26	27	28	29	28	29	30	31	25	26	27	28	29	30	23	24	25	26	27	28	29	27	28	29	30	31	24	25	26	27	28														
30																				30	31																										



Weeks:	<u>1-4 (Aug./Sep.)</u>	<u>5-7 (Sep.)</u>	<u>8-12 (Oct.)</u>	<u>13-18 (Nov./Dec.)</u>	<u>19-25 (Jan./Feb.)</u>
	<ul style="list-style-type: none"> Organizational meeting to determine process objectives Internal due diligence Strategic alternatives assessment Valuation range estimate Discuss options Pursue Phase II or continue status quo 	<ul style="list-style-type: none"> Prepare data room Prepare confidential information memorandum ("CIM") and other marketing materials Prepare potential buyer list 	<ul style="list-style-type: none"> Contact potential buyers Disseminate CIM and bidding procedures Follow up with parties to respond to questions Prepare management presentation Preliminary indications of interest due Evaluate Proposals / select Round II finalist(s) 	<ul style="list-style-type: none"> Conduct management presentations Detailed bidder due diligence Draft and negotiate terms of definitive agreement with Phase II candidate(s) Evaluate final proposal(s) Execute definitive agreement / announce transaction 	<ul style="list-style-type: none"> Finalist confirmatory due diligence Regulatory and other approvals Closing