

SUNLINK HEALTH SYSTEMS INC

Form 10-Q

November 14, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended September 30, 2017**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 1-12607**

**SUNLINK HEALTH SYSTEMS, INC.**

**(Exact name of registrant as specified in its charter)**

**Ohio**  
**(State or other jurisdiction of**  
**incorporation or organization)**  
**900 Circle 75 Parkway, Suite 1120, Atlanta, Georgia 30339**  
**(Address of principal executive offices)**  
**(Zip Code)**  
**(770) 933-7000**  
**(Registrant's telephone number, including area code)**

**31-0621189**  
**(I.R.S. Employer**  
**Identification No.)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filings requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter during the preceding 12 months (of for such shorter period that the registrant was required to submit and post such files). Yes No

Large accelerated filer Accelerated filer  
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company  
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of Common Shares, without par value, outstanding as of November 14, 2017 was 9,162,608.

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)**

|                                                                  | <b>September 30,<br/>2017<br/>(unaudited)</b> | <b>June 30,<br/>2017</b> |
|------------------------------------------------------------------|-----------------------------------------------|--------------------------|
| <b>ASSETS</b>                                                    |                                               |                          |
| Current Assets:                                                  |                                               |                          |
| Cash and cash equivalents                                        | \$ 9,909                                      | \$ 10,494                |
| Restricted cash                                                  | 1,000                                         | 1,000                    |
| Receivables - net                                                | 5,989                                         | 5,906                    |
| Inventory                                                        | 2,207                                         | 2,159                    |
| Prepaid expense and other assets                                 | 3,411                                         | 3,062                    |
| Total current assets                                             | 22,516                                        | 22,621                   |
| Property, plant and equipment, at cost                           | 29,285                                        | 28,609                   |
| Less accumulated depreciation                                    | 18,714                                        | 18,319                   |
| Property, plant and equipment - net                              | 10,571                                        | 10,290                   |
| Noncurrent Assets:                                               |                                               |                          |
| Intangible assets - net                                          | 1,558                                         | 1,587                    |
| Other noncurrent assets                                          | 757                                           | 838                      |
| Total noncurrent assets                                          | 2,315                                         | 2,425                    |
| <b>TOTAL ASSETS</b>                                              | <b>\$ 35,402</b>                              | <b>\$ 35,336</b>         |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                       |                                               |                          |
| Current liabilities:                                             |                                               |                          |
| Accounts payable                                                 | \$ 1,897                                      | \$ 1,571                 |
| Current maturities of long-term debt, net of debt issuance costs | 6,589                                         | 6,710                    |
| Accrued payroll and related taxes                                | 2,278                                         | 2,098                    |
| Due to third party payors                                        | 645                                           | 658                      |
| Other accrued expenses                                           | 1,249                                         | 1,277                    |
| Total current liabilities                                        | 12,658                                        | 12,314                   |
| Long-Term Liabilities                                            |                                               |                          |
| Long-term debt, net of debt issuance costs                       | 0                                             | 0                        |
| Noncurrent liability for professional liability risks            | 1,001                                         | 1,040                    |
| Other noncurrent liabilities                                     | 321                                           | 289                      |

|                                                                                 |                  |                  |
|---------------------------------------------------------------------------------|------------------|------------------|
| Total long-term liabilities                                                     | 1,322            | 1,329            |
| Commitment and Contingencies                                                    |                  |                  |
| Shareholders' Equity                                                            |                  |                  |
| Preferred Shares, authorized and unissued, 2,000 shares                         | 0                | 0                |
| Common Shares, without par value:                                               |                  |                  |
| Issued and outstanding, 9,163 shares at September 30, 2017 and at June 30, 2017 | 4,581            | 4,581            |
| Additional paid-in capital                                                      | 13,109           | 13,103           |
| Retained earnings                                                               | 4,059            | 4,336            |
| Accumulated other comprehensive loss                                            | (327)            | (327)            |
| Total Shareholders' Equity                                                      | 21,422           | 21,693           |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                               | <b>\$ 35,402</b> | <b>\$ 35,336</b> |

See notes to condensed consolidated financial statements.

**SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE EARNINGS (LOSS)**

(In thousands, except per share amounts)

(unaudited)

|                                                               | <b>Three Months<br/>Ended<br/>September 30,</b> |             |
|---------------------------------------------------------------|-------------------------------------------------|-------------|
|                                                               | <b>2017</b>                                     | <b>2016</b> |
| Operating revenues (net of contractual allowances)            | \$ 13,433                                       | \$ 13,079   |
| Less provision for bad debts of Healthcare Facilities Segment | 70                                              | 33          |
| Net revenues                                                  | 13,363                                          | 13,046      |
| Costs and Expenses                                            |                                                 |             |
| Cost of goods sold                                            | 4,458                                           | 4,636       |
| Salaries, wages and benefits                                  | 5,764                                           | 5,845       |
| Provision for bad debts of Specialty Pharmacy Segment         | 120                                             | 91          |
| Supplies                                                      | 425                                             | 436         |
| Purchased services                                            | 687                                             | 708         |
| Other operating expenses                                      | 1,442                                           | 1,710       |
| Rent and lease expense                                        | 154                                             | 129         |
| EHR incentive payments                                        | (17)                                            | 0           |
| Depreciation and amortization                                 | 429                                             | 444         |
| Operating Loss                                                | (99)                                            | (953)       |
| Other Income (Expense):                                       |                                                 |             |
| Gain on sale of assets                                        | 2                                               | 22          |
| Gain on extinguishment of debt                                | 0                                               | 46          |
| Interest expense - net                                        | (127)                                           | (221)       |
| Loss from Continuing Operations before income taxes           | (224)                                           | (1,106)     |
| Income Tax Expense                                            | 0                                               | 144         |
| Loss from Continuing Operations                               | (224)                                           | (1,250)     |
| Earnings (Loss) from Discontinued Operations, net of tax      | (53)                                            | 4,273       |
| Net Earnings (Loss)                                           | (277)                                           | 3,023       |
| Other comprehensive income                                    | 0                                               | 0           |
| Comprehensive Earnings (Loss)                                 | \$ (277)                                        | \$ 3,023    |
| Earnings (Loss) Per Share:                                    |                                                 |             |
| Continuing Operations:                                        |                                                 |             |

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|                                             |           |           |
|---------------------------------------------|-----------|-----------|
| Basic                                       | \$ (0.02) | \$ (0.13) |
| Diluted                                     | \$ (0.02) | \$ (0.13) |
| Discontinued Operations:                    |           |           |
| Basic                                       | \$ (0.01) | \$ 0.45   |
| Diluted                                     | \$ (0.01) | \$ 0.45   |
| Net Earnings (Loss):                        |           |           |
| Basic                                       | \$ (0.03) | \$ 0.32   |
| Diluted                                     | \$ (0.03) | \$ 0.32   |
| Weighted-Average Common Shares Outstanding: |           |           |
| Basic                                       | 9,163     | 9,443     |
| Diluted                                     | 9,163     | 9,443     |

See notes to condensed consolidated financial statements.

**SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

|                                                                        | <b>Three Months<br/>Ended<br/>September 30,</b> |             |
|------------------------------------------------------------------------|-------------------------------------------------|-------------|
|                                                                        | <b>2017</b>                                     | <b>2016</b> |
| Net Cash Provided by (Used in) Operating Activities                    | \$ 233                                          | \$ (3,190)  |
| Cash Flows Provided by (Used in) Investing Activities:                 |                                                 |             |
| Expenditures for property, plant and equipment - continuing operations | (684)                                           | (244)       |
| Proceeds from sale of other assets                                     | 2                                               | 0           |
| Proceeds from sale of Chestatee                                        | 0                                               | 14,620      |
| Net Cash Provided by (Used in) Investing Activities                    | (682)                                           | 14,376      |
| Cash Flows Used in Financing Activities:                               |                                                 |             |
| Payments on long-term debt - continuing operation                      | (136)                                           | (1,646)     |
| Net Cash Used in Financing Activities                                  | (136)                                           | (1,646)     |
| Net increase (decrease) in Cash and Cash Equivalents                   | (585)                                           | 9,540       |
| Cash and Cash Equivalents Beginning of Period                          | 10,494                                          | 3,261       |
| Cash and Cash Equivalents End of Period                                | \$ 9,909                                        | \$ 12,801   |
| Supplement Disclosure of Cash Flow Information:                        |                                                 |             |
| Cash Paid for:                                                         |                                                 |             |
| Interest                                                               | \$ 111                                          | \$ 206      |
| Income taxes                                                           | \$ 0                                            | \$ 33       |

See notes to condensed consolidated financial statements.

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**SUNLINK HEALTH SYSTEMS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**THREE MONTHS ENDED SEPTEMBER 30, 2017**

**(all dollar amounts in thousands except per share amounts)**

**(unaudited)**

**Note 1. Basis of Presentation**

The accompanying unaudited Condensed Consolidated Financial Statements as of September 30, 2017 and for the three month periods ended September 30, 2017 and 2016 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission ( SEC ) and, as such, do not include all information required by accounting principles generally accepted in the United States of America ( GAAP ). The condensed consolidated June 30, 2017 balance sheet included in this interim filing has been derived from the audited financial statements at that date but does not include all of the information and related notes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. ( SunLink , we , our , ours , u the Company ) Annual Report on Form 10-K for the fiscal year ended June 30, 2017, filed with the SEC on September 28, 2017. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three month periods ended September 30, 2017 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

**Note 2. Business Operations**

Business Operations

SunLink Health Systems, Inc., through subsidiaries, owns businesses which provide healthcare services in certain markets in the southeastern United States. Our business is composed of two business segments, the Healthcare Services segment and the Pharmacy segment. Our Healthcare Services segment subsidiaries own and operate an 84-bed community hospital and a 66- bed nursing home in Mississippi, a 100- bed nursing home in Georgia, an IT service company based in Georgia, and healthcare facilities, which are leased to third parties. Our Pharmacy segment subsidiary operates a pharmacy business in Louisiana with four service lines.

The business strategy of SunLink is to focus its efforts on expanding and improving operations of and growing its existing Healthcare Services and Pharmacy businesses. The Company is investing in upgrades and improvements to certain of its Healthcare Services and Pharmacy businesses, while seeking to sell certain of its subsidiaries underperforming assets.

The Company has used a portion of the cash proceeds from recent dispositions of assets to pay down debt and certain other liabilities, and to repurchase common shares in a tender offer completed in February 2017. The Company may also use existing cash, as well as any net proceeds from future dispositions, if any, to improve its existing businesses, make acquisitions of Healthcare Services and Pharmacy businesses, prepay debts, return capital to shareholders including through potential public or private purchases of shares, and for other general corporate purposes. There is no assurance that any further dispositions, will be authorized by the Company s Board of Directors or, if authorized, that any such transactions will be completed or, if completed, will result in net cash proceeds to the Company on a before

or after tax basis.

The Company considers the disposition of business segments, facilities and operations based on a variety of factors in addition to under-performance, including asset values, return on investments and competition from existing and potential competitors, capital improvement needs, the prevailing reimbursement environment under various Federal and state programs (e.g., Medicare and Medicaid) and by private payors, corporate strategy, and other corporate objectives. The Company believes certain facilities in its Healthcare Services segment as well as its Pharmacy segment continue to under-perform, and the Company has engaged advisors to assist it in evaluating the possible sale of its Pharmacy business lines.

Throughout these notes to the consolidated financial statements, all references to SunLink, we, our, ours, us and Company refer to SunLink Health Systems, Inc. and our consolidated subsidiaries. References to our specific operations refer to operations conducted through our subsidiaries and references to we, our, ours, and us in such context refer to the operations.

**Note 3. Discontinued Operations**

All of the businesses discussed in the note below are reported as discontinued operations and the condensed consolidated financial statements for all prior periods have been adjusted to reflect this presentation.

Results for all of the businesses included in discontinued operations are presented in the following table:

|                                              | <b>Three Months Ended<br/>September 30,</b> |             |
|----------------------------------------------|---------------------------------------------|-------------|
|                                              | <b>2017</b>                                 | <b>2016</b> |
| <b>Net Revenues:</b>                         |                                             |             |
| Chestatee Hospital                           | \$ 0                                        | \$ 2,101    |
| Other Sold Hospitals                         | (12)                                        | (234)       |
|                                              | \$ (12)                                     | \$ 1,867    |
| <b>Earnings (Loss) before income taxes:</b>  |                                             |             |
| Chestatee Hospital                           | \$ (1)                                      | \$ (64)     |
| Other Sold Hospitals                         | (16)                                        | (238)       |
| Life sciences and engineering                | (36)                                        | (37)        |
| Gain on sale of Chestatee Hospital           | 0                                           | 7,246       |
| Earnings (Loss) before income taxes          | (53)                                        | 6,907       |
| Income tax expense                           | 0                                           | 2,634       |
| Earnings (Loss) from discontinued operations | \$ (53)                                     | \$ 4,273    |

**Chestatee Hospital** On August 19, 2016, Southern Health Corporation of Dahlonega, Inc., ( Chestatee ), a wholly owned subsidiary of the Company, sold substantially all of the assets and certain liabilities of Chestatee Regional Hospital in Dahlonega, Georgia through an asset purchase agreement for \$15,000 subject to adjustment for the book value of certain assets and certain liabilities assumed at the sale date. The pre-tax gain on sale of \$7,246 is subject to adjustment for various purchase price adjustments. Chestatee retained certain liabilities, including for employee related liabilities and certain Medicare and Medicaid liabilities, relating to the period it owned and operated the hospital. A portion of the net proceeds were used for the repayment of debt.

**Other Sold Hospitals** Subsidiaries of the Company have sold substantially all of the assets of three hospitals ( Other Sold Hospitals ) during the period July 2, 2012 to December 31, 2014. The loss before income taxes of the Other Sold Hospitals results primarily from negative prior year Medicare and Medicaid cost report settlements.

**Life Sciences and Engineering Segment** SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when the segment was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Pension expense and related tax benefit or expense is reflected in the results of operations for this segment for the three months ended September 30, 2017 and 2016.

The components of pension expense for the three months ended September 30, 2017 and 2016, respectively, were as follows:

|                                    | <b>Three Months Ended</b> |             |
|------------------------------------|---------------------------|-------------|
|                                    | <b>September 30,</b>      |             |
|                                    | <b>2017</b>               | <b>2016</b> |
| Interest Cost                      | \$ 14                     | \$ 13       |
| Expected return on assets          | (9)                       | (8)         |
| Amortization of prior service cost | 31                        | 32          |
| Net pension expense                | \$ 36                     | \$ 37       |

SunLink contributed \$35 to the plan in the three months ended September 30, 2017 and expects to contribute an additional \$105 during the last three fiscal quarters of the fiscal year ending June 30, 2018.

#### Note 4. Restricted Cash

Under the Fourth Amendment to the Trace RDA Loan (see Note 8. Long-Term Debt) a deposit of \$1,000 into an interest bearing blocked account was made with the lender and certain financial covenants were modified. The deposit, which was made on January 13, 2017, is currently required to remain in the blocked account until compliance is achieved with respect to financial covenants in effect prior to the Amendment or until November 15, 2017, when the modified financial covenants will revert back to the pre-modification amounts. At September 30, 2017 and June 30, 2017, Trace was not in compliance with either the modified covenants or the prior covenants.

#### Note 5. Shareholders Equity

##### *Stock-Based Compensation*

For the three months ended September 30, 2017 and 2016, the Company recognized \$5 and \$49, respectively, in stock based compensation for options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model. There were 0 and 72,000 share options granted under the 2011 Director Stock Option Plan during the three months ended September 30, 2017 and 2016, respectively.

#### Note 6. Revenue Recognition and Accounts Receivables

The Company's subsidiaries recognize revenues in the period in which services are provided. Accounts receivable primarily consist of amounts due from third-party payors and patients. The Company's subsidiaries' ability to collect outstanding receivables is critical to their results of operations and cash flows. Amounts the Company's subsidiaries receive for treatment of patients covered by governmental programs such as Medicare and Medicaid and other third-party payors such as health maintenance organizations ( HMOs ), preferred provider organizations ( PPOs ) and other private insurers are generally less than the Company's subsidiaries' established billing rates. Additionally, to provide for accounts receivable that could become uncollectible in the future an allowance for doubtful accounts is established to reduce the carrying value of such receivables to their estimated net realizable value. Accordingly, the revenues and accounts receivable reported in the accompanying unaudited condensed consolidated financial statements are recorded at the net amount expected to be received.

Revenues by payor were as follows for the three months ended September 30, 2017 and 2016:

|                                                 | <b>Three Months<br/>Ended<br/>September 30,<br/>2017      2016</b> |          |
|-------------------------------------------------|--------------------------------------------------------------------|----------|
| Healthcare Facilities Segment:                  |                                                                    |          |
| Medicare                                        | \$ 2,296                                                           | \$ 2,033 |
| Medicaid                                        | 2,135                                                              | 2,496    |
| Self-pay                                        | 172                                                                | 119      |
| Managed Care & Other Insurance                  | 714                                                                | 720      |
| Other                                           | 407                                                                | 370      |
| Revenues before provision for doubtful accounts | 5,724                                                              | 5,738    |

|                                 |      |      |
|---------------------------------|------|------|
| Provision for doubtful accounts | (70) | (33) |
|---------------------------------|------|------|

Healthcare Facilities Segment Net Revenues