

When federal agents raided HealthSouth's corporate headquarters to investigate allegations of massive accounting fraud, many predicted the healthcare giant would implode under the weight of the colossal scandal. Management was in turmoil. An avalanche of negative publicity ensued. The stock plunged, while major note payments loomed. Insolvency, it seemed, was inevitable. The troubling prognosis set the stage for the recovery of a lifetime. Not only did HealthSouth defy expectations of almost certain bankruptcy, it achieved exponential increases in enterprise value during a remarkable turnaround executed by Alvarez & Marsal.

A HEALTHCARE GIANT IN CRITICAL CONDITION

In March of 2003, the Federal Bureau of Investigation raided HealthSouth's Birmingham, Alabama headquarters and the Securities & Exchange Commission announced formal charges against the company, alleging in a press release that: "since 1999, at the insistence of founder and chief executive officer Richard Scrushy, HealthSouth systematically overstated its earnings by at least \$1.4 billion in order to meet or exceed Wall Street earnings expectations. The false increases in earnings were matched by false increases in HealthSouth's assets. By the third quarter of 2002, HealthSouth's assets were overstated by at least \$800 million, or approximately 10 percent." Later assessments would estimate the fraud at over \$4 billion.

Trading of shares was suspended in the wake of the news. Management began fleeing – either by choice or under duress. HealthSouth appeared to be on the brink of disaster.

Within days of the SEC's charges, HealthSouth's board of directors placed Scrushy – who was later indicted on 85 criminal counts – and chief financial officer William Owens – who later pleaded guilty to criminal charges – on administrative leave. Bob May, a veteran business executive who had been recently recruited as a company director, was named acting chief executive officer. Joel Gordon, a widely respected, successful healthcare industry entrepreneur who had previously sold his company to HealthSouth, became interim board chairman. Recognizing that swift and decisive action would be critical to the company's chance for survival, the board hired Alvarez & Marsal to reverse an increasingly grim prognosis.

TRouBLING PRoGNOSIS

Alvarez & Marsal co-founder Bryan Marsal assumed the role of chief restructuring officer. His team of more than 20 senior professionals, including Guy Sansone, an Alvarez & Marsal managing director who served as HealthSouth's acting chief financial officer, faced a daunting situation. Following the SEC charges and additional probes by the Department of Justice and Centers for Medicare and Medicaid Services (CMS), most of HealthSouth's financial officers, accountants and treasurers stopped coming to work. Several pleaded guilty and began cooperating with investigators. Their departures left no "institutional memory" to help navigate the company's finances – a tangled web that included fictitious bank accounts and reports of nonexistent money.

While much of HealthSouth's financial picture and the extent of the accounting chicanery remained unclear, a few facts were certain. The company had \$3.3 billion in debt and no access to capital. Banks had cut off a \$1.2 billion line of credit. HealthSouth was about to default on interest payments on senior bonds and bank debt and principal payments on a \$344 million convertible bond issue. Cash flow was in jeopardy, with speculation that financial fraud had led to Medicare fraud. Creditors were clamoring. Employees were anxious and confused. And joint venture partners and doctors were threatening to flee.

INTENSIVE OPERATIONS

Addressing liquidity was the first priority. Books and records indicated the company had \$674 million in cash. Through financial modeling exercises, Alvarez & Marsal found HealthSouth had only \$117 million. There was no balance sheet. No one knew what receivables the company was owed. No one knew what assets were real. To evaluate potential earnings power, Alvarez & Marsal had to determine how many procedures HealthSouth performed and multiply the figures by standard industry costs.

Draconian cash-management policies were implemented. Non-patient-related and non-essential payments were halted. Expenses were cut by more than \$110 million. To build cash in hopes of paying all current obligations, the team executed non-strategic asset sales, including aircraft and land plots, producing about \$260 million. At the same time, Alvarez & Marsal sought to improve operations and protect value by concentrating resources in the five divisions.

The team also worked with HealthSouth to cooperate with federal investigators – giving them open access to records and files to build credibility – and maintained constant communications with stakeholders. They sought to restore crucial trust among patients, vendors and suppliers and to boost employee morale. Through personal visits and phone calls, the team worked tirelessly to keep doctors and joint venture partners, who feared HealthSouth's crisis threatened their reputations and practices, from bolting. They knew their departure would have irreparably crippled the company.

In addition, Alvarez & Marsal spearheaded lease renegotiations or buyouts from numerous facilities, under the leadership of the firm's Real Estate Advisory Services group, and eliminated under-performing units. Unfavorable equipment leases and contracts were renegotiated, while purchasing systems were standardized. Substantial upgrades were made to billing, accounting and receiving technologies – overhauling a seriously outmoded system. Formalized accounting policies and a new compliance program were implemented. Marketing was refocused on core operations.

Within months, it was clear HealthSouth was a viable business. Yet the threat of bankruptcy continued to cast a pall over progress. HealthSouth had failed to make the \$344 million bond payment. That meant creditors could force a filing at any time.

Alvarez & Marsal decided to use HealthSouth's cash to make interest payments to creditors, totaling about \$60 million. The strategy, exceptionally rare in restructuring situations, sent a message to creditors that the underlying business was sound. It also bought more time.

HealthSouth continued to build cash on its road to recovery. At a July stakeholders conference, the company announced it had significant earnings power – estimating EBITDA at \$650 million – and could sustain current debt service.

In October – just seven months after A&M arrived – The Wall Street Journal reported: “HealthSouth has so far defied the doomsayers. While it could still stumble, it has managed to survive by owning up to its problems and tackling them head-on. Its board slashed costs, wooed shocked surgeons into staying with the group and convinced the Department of Justice that HealthSouth would cooperate with a federal probe.”

By November, HealthSouth had \$519 million cash on hand. Debt began trading up. Equity price per share grew from \$0.10 in March of 2003 to \$4.72 in December 2003. Senior notes rose from \$0.43 to \$0.89 and subordinated notes increased from \$0.14 to \$0.80 over the same period.

But the \$344 million obligation remained a roadblock. If HealthSouth did nothing, creditors likely would force bankruptcy. Negotiating would have been expensive, with debt holders using leverage for major concessions. George Varughese, head of Alvarez & Marsal's Corporate Finance Services, had another idea: raise money and pay off the creditors. It was an unprecedented – almost unthinkable – option.

While companies undergoing restructurings rarely can raise money, HealthSouth's situation was further complicated by the lack of financial statements, massive fraud, government investigations and absence of permanent management. In its favor, HealthSouth was rebounding and anticipating revenue of \$3.99 billion for 2003 and a profit by 2005. And the high-yield market was hot.

Varughese approached Credit Suisse First Boston, seeking a loan for the entire amount needed to cover the defaulted obligation. While CSFB had witnessed the turnaround first-hand as HealthSouth's financial advisor, Varughese faced unenviable odds since the bank risked losing the entire investment in the event of bankruptcy. Varughese mapped out a scenario under which HealthSouth would repay the loan. Underscoring the substantial credibility Alvarez & Marsal brought to the table, CSFB agreed to the deal.

The transaction, announced in January 2004, enabled HealthSouth to refinance the \$344 million debt from the proceeds of a \$355 million loan. Alvarez & Marsal later reached agreements with remaining bondholders, bringing the company into compliance on all of its \$2.6 billion in public debt.

REMARKABLE RECOVERY

Today, HealthSouth has new life surging through its veins. Through the efforts of Alvarez & Marsal, in partnership with HealthSouth's interim and new leadership, the company averted disaster, rebounded financially, improved operationally, and restored vital relationships with employees, physicians, vendors and stakeholders. Once devoid of crucial permanent management and viewed as “radioactive” by potential recruits, HealthSouth has attracted a stellar management team, evidence of the outstanding turnaround and growing confidence in the company's future.

Jay Grinney, the former president of the Eastern Group of HCA, became the company's new chief executive in May of 2004. By his side is a new, world-class team of management including a chief operating officer, chief

financial officer, chief compliance officer, general counsel, controller, senior vice president of internal audit and several other managers for corporate compliance, finance and internal audit.

An independent forensic review of accounting irregularities has been completed. New, more disciplined financial and accounting policies, procedures and controls have been implemented. Corporate governance now reflects best practices. Four new board members have been added. Strong internal controls including technology-based solutions are a reality. The company's corporate culture has become one of honesty and accountability. Having restated growth initiatives, HealthSouth is looking to the future.

Alvarez & Marsal's greatest achievements, however, are perhaps best seen outside of Birmingham, in cities and towns across the United States where HealthSouth facilities, once shamed by scandal, have reclaimed their pride. Like politics, as a former House speaker once asserted, all healthcare delivery is local – even with a national brand.

Alvarez & Marsal's strategy of feeding divisions, while starving certain corporate operations, has been a linchpin in the recovery. Even during this extraordinarily difficult time, HealthSouth maintained its extensive network of referral sources and strong relationships with doctors. It is the nation's largest healthcare services provider and its clinical reputation has been unscathed. Patient satisfaction scores for the inpatient division, for example, are

above the national average. And demand for services is extremely high.

While most restructurings involve a complete change in financial structure and ownership, HealthSouth's journey has centered on improving operations – the least expensive way to achieve a turnaround.

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Bob May, former acting Chief Executive Officer, HealthSouth

HealthSouth has new management, a new board, a market leading business, more efficient operations, new compliance and control procedures, a reduced cost structure and has resolved issues with defaulted bondholders. Moreover, its enterprise value increased by more than \$4 billion during the turnaround. The stage for long-term success has been set.

Before handing over the reins to the new CEO, May reportedly told the Birmingham Business Journal that HealthSouth's accomplishments "wouldn't have been possible without Alvarez & Marsal. A lot of it is Bryan's credibility, backed up by their organization. He has some terrific folks on his team." Jay Grinney echoed his predecessor's appreciation of Alvarez & Marsal a few months later, telling the publication: "Bryan Marsal and Bob May... worked tirelessly to get this company on a level trajectory. I can't tell you how appreciative I am of their efforts."

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