SUNLINK HEALTH SYSTEMS INC
Form 10-Q
May 15, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2013

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	**31-0621189**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

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)

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 x 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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

The number of Common Shares, without par value, outstanding as of May 15, 2013 was 9,443,408.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	March 31, 2013 (unaudited)	June 30, 2012
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,559	$ 2,057
Cash in escrow	635	0
Receivables - net	13,724	13,228
Inventory	3,842	3,884
Income tax receivable	585	198
Deferred income tax asset	6,170	5,174
Prepaid expense and other	3,948	4,231
EHR incentive reimbursement receivable	485	0
Net current assets held for sale	0	1,846
Total current assets	31,948	30,618
Property, plant and equipment, at cost	63,749	63,856
Less accumulated depreciation	33,272	33,774
Property, plant and equipment - net	30,477	30,082
Noncurrent Assets:		
Intangible assets - net	3,212	3,320
Goodwill	461	461
Deferred income tax asset	4,041	5,891
Other noncurrent assets	1,721	894
Net noncurrent assets held for sale	0	7,906
Total noncurrent assets	9,435	18,472
TOTAL ASSETS	$ 71,860	$ 79,172
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,409	$ 6,934
Revolving advances	0	5,931
Current maturities of long-term debt	924	9,350
Accrued payroll and related taxes	3,986	4,584
Due to third party payors	603	0
Deferred Gain - Medicare EHR incentive reimbursement	5,257	0
Other accrued expenses	2,503	2,566
Current liabilities held for sale	0	2,449
Total current liabilities	19,682	31,814
Long-Term Liabilities		
Long-term debt	17,688	13,740
Noncurrent liability for professional liability risks	2,215	3,191

Other noncurrent liabilities	796	907
Noncurrent liabilities held for sale	0	229
Total long-term liabilities	20,699	18,067
Commitment and Contingencies		
Shareholders Equity		
Preferred Shares, authorized and unissued, 2,000 shares	0	0
Common Shares, without par value:		
Issued and outstanding, 9,443 shares at March 31, 2013 and 9,447 shares at June 30, 2012	4,722	4,724
Additional paid-in capital	13,386	13,521
Retained earnings	13,868	11,543
Accumulated other comprehensive loss	(497)	(497)
Total Shareholders Equity	31,479	29,291
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 71,860	$ 79,172

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE EARNINGS AND LOSS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2013	**2012**	**2013**	**2012**
Operating revenues (net of contractual allowances)	$ 32,106	$ 33,317	$ 91,663	$ 94,274
Less provision for bad debts of Healthcare Facilities Segment	2,866	1,963	8,883	7,718
Net revenues	29,240	31,354	82,780	86,556
Costs and Expenses				
Cost of goods sold	7,319	8,418	18,085	21,159
Salaries, wages and benefits	13,287	13,261	39,894	39,613
Provision for bad debts of Specialty Pharmacy Segment	129	201	386	510
Supplies	2,213	2,157	6,913	6,417
Purchased services	1,777	1,961	5,629	5,884
Other operating expenses	3,218	3,823	11,299	11,934
Rent and lease expense	450	526	1,454	1,653
Impairment of property, plant and equipment	0	0	789	0
Impairment of goodwill	0	931	0	931
Depreciation and amortization	1,022	1,130	2,995	3,349
EHR incentive payments	93	0	(931)	(1,272)
Operating Loss	(268)	(1,054)	(3,733)	(3,622)
Other Income (Expense):				
Interest expense	(301)	(1,071)	(1,507)	(3,405)
Interest income	1	8	1	10
Loss from Continuing Operations before income taxes	(568)	(2,117)	(5,239)	(7,017)
Income Tax Benefit	(371)	(433)	(2,025)	(2,193)
Loss from Continuing Operations	(197)	(1,684)	(3,214)	(4,824)
Earnings from Discontinued Operations	11	141	5,539	791
Net Earnings (loss)	(186)	(1,543)	2,325	(4,033)
Other comprehensive income	0	0	0	0
Comprehensive income (loss)	$ (186)	$ (1,543)	$ 2,325	$ (4,033)
Earnings (Loss) Per Share:				
Continuing Operations:				
Basic	$ (0.02)	$ (0.18)	$ (0.34)	$ (0.52)
Diluted	$ (0.02)	$ (0.18)	$ (0.34)	$ (0.52)
Discontinued Operations:				
Basic	$ 0.00	$ 0.01	$ 0.59	$ 0.08

Diluted	$	0.00	$	0.01	$	0.59	$	0.08
Net Earnings (loss):								
Basic	$	(0.02)	$	(0.16)	$	0.25	$	(0.43)
Diluted	$	(0.02)	$	(0.16)	$	0.25	$	(0.43)
Weighted-Average Common Shares Outstanding:								
Basic		9,446		9,448		9,446		9,317
Diluted		9,446		9,448		9,446		9,317

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended March 31, 2013	Nine Months Ended March 31, 2012
Net Cash Used in Operating Activities	$ (4,347)	$ (656)
Cash Flows from Investing Activities:		
Proceeds from sale of Memorial	8,350	0
Proceeds from sale of Dexter	9,930	0
Net change in cash in escrow	(635)	0
Expenditures for property, plant and equipment - continuing operations	(2,164)	(617)
Expenditures for property, plant and equipment - discontinued operations	(41)	(118)
Net Cash Provided by (Used in) Investing Activities	15,440	(735)
Cash Flows from Financing Activities:		
Revolving advances - net	(5,931)	1,331
Proceeds of long-term debt	12,698	4,000
Payments on long-term debt	(17,176)	(12,656)
Repurchase of common stock	(182)	0
Net proceeds from issuance of common shares	0	2,345
Net Cash Used in Financing Activities	(10,591)	(4,980)
Net increase (decrease) in Cash and Cash Equivalents	502	(6,371)
Cash and Cash Equivalents Beginning of Period	2,057	7,250
Cash and Cash Equivalents End of Period	$ 2,559	$ 879
Supplement Disclosure of Cash Flow Information:		
Cash Paid (Received) for:		
Interest	$ 1,485	$ 3,393
Income taxes	$ 2,116	$ (2,514)
Non-cash investing and financing activities:		
Assets acquired under capital lease obligation - continuing operations	$ 0	$ 80
Assets acquired under capital lease obligation - discontinued operations	0	316
	$ 0	$ 396

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE AND NINE MONTHS ENDED MARCH 31, 2013

(all dollar amounts in thousands except per share amounts)

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements as of March 31, 2013 and for the three and nine month periods ended March 31, 2013 and 2012 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, 2012 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 , us or the Company) Annual Report on Form 10-K for t fiscal year ended June 30, 2012, filed with the SEC on September 20, 2012. 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 and nine month periods ended March 31, 2013 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. subsidiaries provide healthcare services in certain rural and exurban markets in the United States. SunLink s business is composed of the ownership of subsidiaries which operate two business segments:

- Healthcare Facilities, which consist of
  - Our four community hospitals which have a total of 232 licensed beds;
  - Our two nursing homes, which have a total of 166 licensed beds, each of which is located adjacent to a corresponding SunLink community hospital; and
  - One hospital facility and related equipment formerly leased to a third party hospital operator.
- Specialty Pharmacy, which consists of
  - Specialty pharmacy services;
  - Durable medical equipment;

Institutional pharmacy services; and

Retail pharmacy products and services, all of which are conducted in rural markets.

SunLink subsidiaries have conducted the healthcare facilities business since 2001 and the specialty pharmacy business since April 2008. The Specialty Pharmacy Segment currently is operated through Carmichael s Cashway Pharmacy, Inc. (Carmichael), a subsidiary of SunLink ScriptsRx, LLC subsidiary, and is composed of a specialty pharmacy business acquired in April 2008 with four service lines.

SunLink s Board and management have determined to focus the Company s strategic investments on enhancing the existing hospital portfolio, including the selective disposal of underperforming and non-strategic subsidiaries. The Company believes certain of its four remaining hospital facilities (exclusive of its specialty pharmacy business) are presently underperforming and currently is evaluating the possible sale of one or more of these hospital facilities. There is no assurance any sale will occur or that, if a sale occurs, it will be at a price that results in a gain or net proceeds after transaction costs, taxes and outstanding debt. The Company expects to use a portion of the net proceeds, if any, from future asset sales to fund its working capital needs and for other corporate purposes.

On February 5, 2013, the Company announced the commencement of a tender offer to purchase at the price of $1.50 per share in cash all of its common shares held by holders of 99 or fewer shares (odd lots) who owned such shares as of the close of business on January 31, 2013 (Odd Lot Tender Offer). In addition to the $1.50 per share price, the Company offered each eligible tendering holder a bonus of $100 upon completion of the Odd Lot Tender Offer for the tender of all shares beneficially owned by such holder which were received and not withdrawn prior to the date of expiration of the Odd Lot Tender Offer, which was March 26, 2013. In accordance with the terms and conditions of the Offer, SunLink accepted for purchase a total of 2,631 common shares of SunLink tendered by 68 holders pursuant to the Offer. As a result of the completion of the Offer, immediately following payment for the tendered shares, the Company has approximately 9,443,334 common shares issued and outstanding and held by approximately 480 stockholders of record. The shares repurchased were retired immediately. The aggregate cash cost of the Odd Lot Tender Offer was $195 and was recorded in equity. Included in the cash cost are purchase price for the odd lot shares of $4, aggregate bonus payments of $7 and fees and expenses of $184.

The primary purpose of the Odd Lot Tender Offer was to reduce the number of holders of record of the Company s common shares in order to permit the Company to deregister the common shares with the SEC. The Company s Board and management each believes that deregistering the Company s common shares will result in significant cost savings. Since the Offer failed to accomplish the objective of reducing the number of record holders to fewer than 300, SunLink anticipates that it will take further actions to reduce the number of holders of record of the Company s common shares in order to permit the Company to deregister the common shares with the SEC. As previously disclosed in the Company s offer to purchase, the Board will likely consider other alternatives to achieve that result, including a further tender offer, a reverse stock split or cash out merger (in which a new corporation is formed to merge with the Company and holders of a limited number of Company shares are cashed out), so long as the Board continues to believe that deregistration remains in the Company s best interests.

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:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2013	2012	2013	2012
Net Revenues:				
Dexter Hospital	$ 264	$ 5,396	$ 9,772	$ 15,412
Memorial of Adel	54	3,516	59	10,772
	$ 318	$ 8,912	$ 9,831	$ 26,184
Earnings (loss) before income taxes:				
Dexter Hospital	$ (38)	$ 746	$ 717	$ 2,028
Memorial of Adel	28	(514)	(86)	(693)
Life sciences and engineering	(34)	(22)	(102)	(66)
Earnings (loss) before income taxes	(44)	210	529	1,269
Gain on Sale				
Dexter Hospital	65	0	8,457	0
Memorial of Adel	0	0	1,161	0
Gain on Sale	65	0	9,618	0
Income tax expense	10	69	4,608	478
Earnings from discontinued operations	$ 11	$ 141	$ 5,539	$ 791

Dexter Hospital On December 31, 2012, the Company completed the sale of substantially all the assets and the leasehold interest of its subsidiary, Dexter Hospital, LLC (Dexter), to Southeast Health Center of Stoddard County, LLC, an indirect subsidiary of Southeast Missouri Hospital Association (SoutheastHEALTH). The assets

6

of Dexter consisted of a leased 50-bed acute care hospital and related clinics, equipment, and home health services in Dexter, Missouri. Subsequent to the sale, Dexter has managed the hospital and related businesses for Southeast Health Center of Stoddard County, LLC and will do so through a transition period ending June 30, 2013. Dexter retained accounts receivable and certain other assets, including the right to Medicare and Medicaid incentive payments (EHR Funds) for meaningful use of electronic health record technology and substantially all liabilities of the hospital as of December 31, 2012. The sale of the assets, including the right to EHR Funds, and leasehold interest of Dexter for approximately $9,800, less sale expenses and taxes, resulted in net proceeds of approximately $7,400. Approximately $5,200 of the net proceeds was used to pay off the outstanding balance of the Company s senior credit facility under the Company s then outstanding Credit Facility. Dexter s operations have been reclassified as discontinued operations in our condensed consolidated financial statements for the three and nine month periods ended March 31, 2013 and 2012.

Memorial Hospital of Adel On July 2, 2012, the Company and its HealthMont of Georgia, Inc. subsidiary completed the sale of substantially of all the assets of the Company s Memorial Hospital of Adel and Memorial Convalescent Center (collectively Memorial) to the Hospital Authority of Tift County, Georgia (Tift) for approximately $8,350. Excluded assets included accounts receivable as of the March 31, 2012 (Cutoff Date) and all EHR Funds and all receivables, claims and settlements made pursuant to the Indigent Care Trust Fund of the State of Georgia (ICTF) paid with respect to the State of Georgia s fiscal year ended June 30, 2012. Retained liabilities consist of liabilities incurred prior to July 2, 2012. Approximately $7,500 of the net proceeds from the sale were used to repay a portion of the Company s senior credit facility under the Company s then outstanding Credit Facility. Memorial s operations have been reclassified as discontinued operations in our condensed consolidated financial statements for the three and nine month periods ended March 31, 2013 and 2012 and as of June 30, 2012.

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 and nine months ended March 31, 2013 and 2012. The components of pension expense for the three and nine months ended March 31, 2013 and 2012, respectively, were as follows:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2013	2012	2013	2012
Interest Cost	$ 17	$ 18	$ 51	$ 36
Expected return on assets	(10)	(10)	(30)	(20)
Amortization of prior service cost	27	14	81	28
Net pension expense	$ 34	$ 22	$ 102	$ 44

SunLink contributed $43 to the plan in the nine months ended March 31, 2013.

Note 4. Shareholders Equity

Stock-Based Compensation

For the three months ended March 31, 2013 and 2012, the Company recognized $24 and $29, respectively, in stock based compensation for options issued to employees and directors of the Company. For the nine months ended March 31, 2013 and 2012, the Company recognized $76 and $34, 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 120,000 and 180,000 share options granted under the 2005 Equity Incentive Plan during the nine months ended March 31, 2013 and 2012, respectively. There were 140,000 share options granted under the 2012 Director s Stock Option Plan during the nine months ended March 31, 2013.

Private Placement of Shares

In July, 2011, SunLink sold in a private placement approximately 1,329,000 common shares at a price equal to the average closing price for the shares over the ten trading days prior to the applicable closing, which price was approximately $1.90 per share. The net proceeds of the private placement of approximately $2,500 were used, together with the Company s operating funds, to make an $8,000 pre-payment on the Term Loan under the Company s then outstanding Credit Facility. Concurrent with and conditioned upon the Term Loan pre-payment, the Company s lenders modified the Credit Facility to reduce the interest rate, revise certain financial and other covenants and extend the maturity date of the Credit Facility until January 1, 2013 (see Note 9, Long-Term Debt).

Note 5. Revenue Recognition and Accounts Receivables

The Company recognizes revenues in the period in which services are performed. Accounts receivable primarily consist of amounts due from third-party payors and patients. The Company s ability to collect outstanding receivables is critical to its results of operations and cash flows. Amounts the Company receives 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 established billing rates. Additionally, to provide for accounts receivable that could become uncollectible in the future, the Company establishes an allowance for doubtful accounts to reduce the carrying value of such receivables to their estimated net realizable value. Accordingly, the revenues and accounts receivable reported in the Company s accompanying unaudited condensed consolidated financial statements are recorded at the net amount expected to be received.

The Company s revenues before provision for doubtful accounts by payor were as follows for the three and nine months ended March 31, 2013 and 2012:

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012	Nine Months Ended March 31, 2013	Nine Months Ended March 31, 2012
Healthcare Facilities Segment:				
Medicare	$ 8,607	$ 9,414	$ 27,302	$ 27,409
Medicaid	2,857	3,576	8,758	9,579
Self-pay	3,662	1,858	9,885	7,787
Managed Care & Other Insurance	6,418	6,979	19,128	19,354
Other	146	(51)	185	177
Revenues before provision for doubtful accounts	21,690	21,776	65,258	64,306
Provision for doubtful accounts	(2,866)	(1,963)	(8,883)	(7,718)
Healthcare Facilities Segment Net Revenues	18,824	19,813	56,375	56,588
Specialty Pharmacy Segment Net Revenues	10,416	11,541	26,405	29,968
Total Net Revenues	$ 29,240	$ 31,354	$ 82,780	$ 86,556

The net revenues of the Specialty Pharmacy Segment are presented net of contractual adjustments. The provision for bad debts of the Specialty Pharmacy Segment is presented as a component of operating expenses in the Condensed Consolidated Statements of Operations and Comprehensive Earnings and Loss.

Summary information for account receivable is as follows:

	March 31, 2013	June 30, 2012
Accounts receivable (net of contractual allowances)	$ 23,755	$ 22,349
Less allowance for doubtful accounts	(10,031)	(9,121)
Receivables - net	$ 13,724	$ 13,228

The following is a summary of the Company s activity in the allowance for doubtful accounts for the Healthcare Facilities Segment and the Specialty Pharmacy Segment for the three and nine months ended March 31, 2013:

Three Months Ended March 31, 2013:	**Healthcare Facilities**	**Specialty Pharmacy**	**Total**
Balance at January 1, 2013	$ 9,986	$ 460	$ 10,446
Additions recognized as a reduction to operating profit	2,866	129	2,995
Accounts written off, net of recoveries	(3,296)	(114)	(3,410)
Balance at March 31, 2013	$ 9,556	$ 475	$ 10,031

Nine Months Ended March 31, 2013:	**Healthcare Facilities**	**Specialty Pharmacy**	**Total**
Balance at July 1, 2012	$ 8,714	$ 407	$ 9,121
Additions recognized as a reduction to operating profit	8,883	386	9,269
Accounts written off, net of recoveries	(8,041)	(318)	(8,359)
Balance at March 31, 2013	$ 9,556	$ 475	$ 10,031

Net revenues included increases of $176 and $496 for the three months ended March 31, 2013 and 2012, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included increases of $176 and $547 for the nine months ended March 31, 2013 and 2012, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

Note 6. Medicare and Medicaid Electronic Health Records Incentives

Deferred Gain Medicare Electronic Health Records Incentives

Electronic Health Records (EHR) payments are incentive reimbursements received under the Health Information Technology for Economic and Clinical Health Act (the HITECH Act) which was enacted into law on February 17, 2009 as part of the American Recovery and Reinvestment Act of 2009 (ARRA). The HITECH Act includes provisions designed to increase the use of EHR by both physicians and hospitals. Beginning with federal fiscal year 2012 (federal fiscal year is October 1 through September 30) and extending through federal fiscal year 2016, eligible hospitals and critical access hospitals (CAH) participating in the Medicare and Medicaid programs are eligible for reimbursement incentives based on successfully demonstrating meaningful use of their certified EHR technology. Conversely, those hospitals that do not successfully demonstrate meaningful use of EHR technology are subject to payment penalties or downward adjustments to their Medicare payments beginning in federal fiscal year 2015.

The Company accounts for EHR incentive payments in accordance with ASC 450-30, Gain Contingencies , (ASC 450-30). In accordance with ASC 450-30, the Company recognizes a gain for Medicare and Medicaid EHR incentive payments when its eligible hospitals have demonstrated meaningful use of certified EHR technology for the applicable period and when the cost report information needed for the full cost report year used for the final calculation of the EHR incentive reimbursement payment is available. The demonstration of meaningful use is based on meeting a series of objectives and varies among hospitals, between the Medicare and Medicaid programs and within the Medicaid program from state to state. Additionally, meeting the series of objectives in order to demonstrate meaningful use becomes progressively more stringent as its implementation is phased in through stages as outlined by the Centers for Medicare and Medicaid Services.

SunLink s four operating hospital subsidiaries and Dexter (see Note 3, Discontinued Operations) successfully attested for the Medicare EHR program for the fiscal year which will end June 30, 2013. Medicare EHR incentive payments for all four operating hospital subsidiaries and Dexter totaling $5,257 were received during the nine months ended March 31, 2013. As Medicare EHR incentive payments cannot be recognized until the cost report information utilized to determine the final amount of reimbursement is known, the hospital subsidiaries recorded the $5,257 as deferred gain to be recognized as of June 30, 2013. SunLink s four operating hospital subsidiaries and Dexter successfully attested for the Medicaid EHR program and recognized Medicaid EHR incentive payments in the nine months ended March 31, 2013 in the amount of $1,319. Medicaid incentive payments were received for three hospitals during the nine months ended March 31, 2013 in the amount of $835. Medicaid EHR incentive payments for the two Missouri hospitals (which include Dexter) were not received as of March 31, 2013 and are recorded as a receivable on the balance sheet in the amount of $485 at March 31, 2013.

Note 7. Goodwill and Intangible Assets

SunLink has goodwill and intangible assets related to its Healthcare Facilities and Specialty Pharmacy Segments.

Intangibles consist of the following, net of amortization:

	March 31, 2013	June 30, 2012
Healthcare Facilities Segment		
Certficates of Need	$ 80	$ 80
Accumulated Amortization	(25)	(23)
	55	57
Specialty Pharmacy Segment		
Trade Name	2,000	2,000
Customer Relationships	1,089	1,089
Medicare License	769	769
	3,858	3,858
Accumulated Amortization	(701)	(595)
	3,157	3,263
Total	$ 3,212	$ 3,320

The trade name intangible asset under the Specialty Pharmacy Segment is a non-amortizing intangible asset.

Amortization expense was $36 and $42 for the three months ended March 31, 2013 and 2012, respectively. Amortization expense was $108 and $85 for the nine months ended March 31, 2013 and 2012, respectively.

Goodwill consists of the following:

	March 31, 2013	June 30, 2012
Specialty Pharmacy Segment	$ 461	$ 461

Note 8. Impairment of Assets

Impairment of Long-Lived Assets Central Alabama Medical Associates, LLC (CAMA), an indirect subsidiary of the Company owns a hospital facility and related equipment in Clanton, Alabama, which it formerly leased to a third party hospital operator. The lessee/operator held a Certificate of Need and other required hospital operating licenses. On October 29, 2012, the Alabama Department of Public Health issued an emergency order to suspend the operating license of the former lease/operator and for the cessation of all operations in an orderly manner due to the former lease/operator s inability to meet its financial obligations and failure to have an effective governing authority.

Due to the changes in circumstances regarding the hospital and equipment in Clanton, Alabama, the carrying amount of these assets are not likely to be fully recoverable. The net realizable value of the hospital and equipment was evaluated and it was determined that an impairment of the net value of the leased property, plant and equipment had occurred. An impairment charge of $789 was recognized in the nine months ended March 31, 2013.

As the property, plant and equipment is currently not in use due the former lease/operator s suspended operating license, the plant, property and equipment of CAMA is considered temporarily idle as of March 31, 2013. Temporarily idle assets included in the balances of property, plant and equipment in the condensed consolidated balance sheet are comprised of the following (after the impairment charge):

	March 31, 2013
Property, plant and equipment, at cost	$ 3,086
Less accumulated depreciation	1,522
Property, plant and equipment - net	$ 1,564

On December 6, 2012, CAMA entered into an option agreement with the Chilton County (Alabama) Hospital Board (CCHB) under which CCHB had the option through March 15, 2013 to acquire CAMA s real and personal property relating to Chilton Medical Center in Clanton, Alabama, for $1,500. CCHB and CAMA applied jointly for a receiver which has taken over operations of the third-party operator. However, the option period expired without CCHB exercising the option and CAMA plans to have the receivership terminated. The operating license for use of the property as a hospital has been revoked and CAMA has terminated the leases with the third-party operator. CAMA is currently investigating alternative uses of the property but no definitive use plan has been finalized.

Impairment of Goodwill and Intangible Assets The Company performed an interim impairment testing of the goodwill and certain intangible assets of its subsidiaries as March 31, 2012. The Company concluded that the carrying value of the subsidiary exceeded its fair value, and as a result, recognized a goodwill impairment charge of $931 for its Healthmont, LLC subsidiary, part of the Healthcare Facilities Segment, during the quarter ended March 31, 2012.

Note 9. Long-Term Debt

Long-term debt consisted of the following:

	March 31, 2013	June 30, 2012
Callaway RDA Loan	$ 4,934	$ 4,376
Trace RDA Loan	9,182	0
SHPP RDA Loan	2,083	0
Carmichael Notes	2,302	2,452
Term Loan	0	16,086
Capital lease obligations	111	176
Total	18,612	23,090
Less current maturities	(924)	(9,350)
	$ 17,688	$ 13,740

Callaway RDA Loan SunLink, HealthMont of Missouri, LLC (HOM) and HealthMont LLC (HLLC), the direct parent of HOM closed on a $5,000 Loan Agreement dated as of March 16, 2012 (the Callaway RDA Loan) with a bank. HealthMont of Missouri, LLC owns and operates Callaway Community Hospital (Callaway) in Fulton, Missouri. The Loan Agreement consists of a $4,000 term loan and $1,000 construction loan. The $4,000 term loan was drawn in its entirety at closing. As of March 31, 2013, $1,000 has been drawn on the $1,000 construction loan in connection with the construction and improvement projects described below.

The Callaway RDA Loan has a term of 25 years with monthly payments of principal and interest. The Callaway RDA Loan bears interest at a floating interest rate computed as the prime rate (as published in The Wall Street Journal) plus 2% (5.25% at March 31, 2013). The Callaway RDA Loan is collateralized by Callaway s real estate and equipment and is partially guaranteed under the U.S. Department of Agriculture, Rural Development

Business and Industry Program. Of the Callaway RDA Loan proceeds, $3,250 was applied as payment against the Company s then outstanding Credit Facility. Approximately $1,000 of the Callaway RDA Loan proceeds were used to finance improvements, including to provide an inpatient geriatric psychiatry unit and an emergency department upgrade, with the remainder of the Callaway RDA Loan proceeds used for working capital and closing costs. Drawn but unused loan proceeds of $254 are included on the balance sheet at March 31, 2013 as cash in escrow. The Callaway RDA Loan contains certain financial covenants with respect to the ratio of current assets to current liabilities and debt service coverage, all as defined in the Callaway RDA Loan Agreement and measured at the end of each fiscal year. The Callaway RDA Loan is guaranteed by HLLC and the Company.

Trace RDA Loan and Trace Working Capital Loan On July 11, 2012, SunLink, MedCare South, LLC (formerly known as SunLink Healthcare, LLC) (MedCare) and Southern Health Corporation of Houston, Inc. (SHCH), an indirect wholly-owned subsidiary of the Company, closed on a $9,975 Mortgage Loan Agreement dated as of July 5, 2012 (Trace RDA Loan) and up to a $1,000 Working Capital Loan Agreement dated as of July 5, 2012 (Trace Working Capital Loan) with a bank. SHCH owns and operates Trace Regional Hospital Trace) in Houston, Mississippi.

The Trace RDA Loan has a term of 15 years with monthly payments of principal and interest until repaid. The Trace RDA Loan bears a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 1.5%, or (ii) 6% (6.0% at March 31, 2013). The Trace RDA Loan is collateralized by Trace s real estate and equipment and is partially guaranteed under the U.S. Department of Agriculture, Rural Development Business and Industry Program. Approximately $8,500 of the Trace RDA Loan proceeds was used to repay a portion of the Company s senior debt under the Term Loan under the then outstanding Credit Facility. Approximately $850 of the Trace RDA Loan proceeds are being used for improvements to the hospital and its medical office building with the remainder of the loan proceeds used for working capital and closing costs. Drawn but unused loan proceeds of $381 are included on the balance sheet at March 31, 2013 as cash in escrow.

The Trace Working Capital Loan provides for a revolving line of credit to SHCH equal to the lesser of (i) a Borrowing Base equal to eighty percent (80%) of Eligible Accounts Receivable (as defined in the Working Capital Loan Agreement) or (ii) $1,000. At March 31, 2013, there were no outstanding borrowings under the Trace Working Capital Loan. Both the Trace RDA Loan and the Trace Working Capital Loan are guaranteed by the Company and SunLink Healthcare LLC (SHL), a wholly-owned intermediate holding company.

The Trace RDA Loan contains various terms and conditions, including financial restrictions and limitations, and affirmative and negative covenants. The covenants include financial covenants measured on a quarterly basis which require SHCH to meet a ratio of current assets to current liabilities, debt service coverage, fixed charge coverage, and funded debt to EBITDA, all as defined in the Trace RDA Loan. At December 31, 2012, SHCH was not in compliance with the debt service coverage ratio. On May 14, 2013, the non-compliance was waived as part of the Amendment and Waiver to Loan Agreement between SHCH and the lender (Amendments) for each of the Trace RDA and Working Capital Loans. The Amendments also permanently modified certain financial covenants of the Loans. No action was taken by the lender as a result of this non-compliance under the Loans prior to the waiver being issued. At March 31, 2013, SHCH was in compliance with all the financial covenants of the loan. The ability of SHCH and the Company, respectively, to make the required debt service under the Trace RDA Loan or the guarantee depends on, among other things, the respective ability of SHCH and the Company to generate sufficient cash flows, including from operating activities. If SHCH or the Company are unable to generate sufficient cash flow from operations to meet debt service or other financial covenants on the Trace RDA loan or the guarantee, including in the event the lender were to declare an event of default and accelerate the maturity of the indebtedness, such failure could have material adverse effects on the Company.

SHPP RDA Loan On November 6, 2012, SunLink Healthcare Professional Property, LLC, a subsidiary of the Company, entered into and closed on a $2,100 term loan dated as of October 31, 2012 (the SHPP RDA Loan) with a bank. SHPP owns and leases a medical office building to Southern Health Corporation of Ellijay, Inc. (SHC Ellijay). SHC Ellijay owns and operates North Georgia Medical Center (North Georgia), located in Ellijay, Georgia.

The SHPP RDA Loan has a term of 25 years with monthly payments of principal and interest until repaid. The SHPP RDA Loan bears interest at a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 2.0%, or (ii) 5% (5.25% at March 31, 2013). The SHPP RDA Loan is collateralized by SHPP s real estate, equipment and leases and is partially guaranteed under the U.S. Department of

Agriculture, Rural Development Business and Industry Program. Of the SHPP RDA Loan proceeds, $1,800 was used by SHC Ellijay to acquire a medical office building in Ellijay, Georgia which was then sold to SHPP, with the remainder of the SHPP RDA Loan proceeds used by SHPP for working capital and closing costs. The SHPP RDA Loan contains certain financial covenants with respect to the ratio of current assets to current liabilities and debt service coverage, all as defined in the SHPP RDA Loan Agreement, which SHPP must maintain and that are measured at the end of each fiscal year. The SHPP RDA Loan is guaranteed by the Company and MedCare.

Carmichael Notes On April 22, 2008, SunLink Scripts Rx, LLC (formerly known as SunLink Homecare Services, LLC) entered into a $3,000 promissory note agreement with an interest rate of 8% with the former owners of Carmichael as part of the acquisition purchase price (the Carmichael Purchase Note). On April 12, 2012, an amendment to the Carmichael Purchase Note was entered into under which SunLink has the option to issue promissory notes to the former owners of Carmichael in payment of up to two semi-annual payments of principal and interest due under the Carmichael Purchase Note (the PIK Notes). The PIK Notes bear an interest rate of 8% and are due on April 22, 2015. A PIK Note for $247 was issued on April 22, 2012 for the principal and interest payment that would have been due on April 22, 2012. A PIK Note for $252 was issued on October 22, 2012 for the principal and interest payment that would have been due on October 22, 2012. The Carmichael Purchase Note is payable in semi-annual installments of $150, which began on April 22, 2009, with the remaining balance of the Carmichael Purchase Note and the PIK Notes of $1,702 due April 22, 2015. Interest is payable in arrears semi-annually on the six and twelve-month anniversary of the issuance of the note. The Carmichael Purchase Note is guaranteed by the Company.

Termination and Repayment of Credit Facility On April 23, 2008, SunLink and substantially all of its subsidiaries entered into a $47,000 seven-year senior secured credit facility (Credit Facility) initially comprised of a revolving line of credit of up to $12,000 (the Revolving Loan) and a $35,000 term loan (the Term Loan). The Credit Facility was subsequently amended by eight modification agreements as a result of which the Revolving Loan commitment was reduced to $9,000 as of September 20, 2012 and the termination date of the Credit Facility was established as January 1, 2013. As of December 31, 2012, the Company paid all outstanding amounts under the Revolving Loan and the Term Loan and the Credit Facility was terminated.

Financing costs and expenses related to the Credit Facility of $2,710 were amortized over the modified life of the Credit Facility. Amortization expense was approximately $0 and $42, respectively, for the three months ended March 31, 2013 and 2012 and $188 and $126, respectively, for the nine months ended March 31, 2013 and 2012.

Note 10. Income Taxes

Income tax benefit of $371 ($369 federal tax benefit and $2 state tax benefit) and income tax benefit of $433 ($434 federal tax benefit and $1 state tax expense) was recorded for the three months ended March 31, 2013 and 2012, respectively.

Income tax benefit of $2,025 ($1,735 federal tax benefit and $290 state tax benefit) and income tax benefit of $2,193 ($1,822 federal tax benefit and $371 state tax benefit) was recorded for the nine months ended March 31, 2013 and 2012, respectively.

At March 31, 2013, the Company had $2,418 of estimated net operating loss carry-forward for federal income tax purposes available for use in future years subject to the limitations of the provisions of Internal Revenue Code Section 382. At March 31, 2013, we have provided a partial valuation allowance against the deferred tax asset so that the net tax asset was $10,211. Based upon management s assessment that it was more likely than not that a portion of its deferred tax asset (primarily its net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the tax asset which management estimates will not be utilized.

The Company accounts for uncertainty in income taxes for a change in judgment related to prior years tax positions in the quarter of such change. Activity in the unrecognized tax benefit liability account was as follows from July 1, 2010 through March 31, 2013:

Balance at July 1, 2010	$ 71
Reduction for tax positions of prior years	(34)
Balance at June 30, 2011	37
Reduction for tax positions of prior years	(18)
Balance at June 30, 2012	19
Reduction for tax positions of prior years	(8)
Balance at March 31, 2013	$ 11

Note 11. Commitments and Contingencies

Legal Proceedings

In 2007, Southern Health Corporation of Ellijay, Inc. (SHC-Ellijay) filed a Complaint against James P. Garrett and Roberta Mundy, both individually and as Fiduciary of the Estate of Randy Mundy (collectively, Defendants), seeking specific performance of an Option Agreement (the Option Agreement) dated April 17, 2007, between SHC-Ellijay, Mr. Garrett, and Ms. Mundy as Executrix of the Estate of Randy Mundy for the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia, and recovery of SHC-Ellijay s damages suffered as a result of Defendants failure to close the transaction in accordance with the Option Agreement. SHC-Ellijay also stated alternative claims for breach of the Option Agreement and fraud, along with claims to recover attorney s fees and punitive damages and the defendants filed counterclaims against SHC-Ellijay.

On April 11, 2012, the Court granted SHC-Ellijay s motion for partial summary judgment and denied Defendants motions for summary judgment. In April 2012, Defendants filed a notice of appeal to the Georgia Court of Appeals. On March 8, 2013, the Georgia Court of Appeals issued an opinion affirming in part and reversing in part the summary judgment entered for the Company. The appellate court rejected all of the Sellers various contract-law defenses. The appellate court also held that the Sellers intentionally breached the Option Agreement by failing to close the transaction and satisfy their other obligations. The appellate court reversed, however, on the question of whether Sellers breach was also willful, reasoning that willfulness carries with it an aspect of bad faith. The case has been remanded to the Superior Court for trial on the willfulness/bad faith issue and damages. A trial has not yet been scheduled but could occur as early as summer 2013.

SunLink denies that it has any liability to Defendants and intends to vigorously defend the claims asserted against SunLink by the Defendants and to vigorously pursue its claims against the Defendants. While the ultimate outcome and materiality of the litigation cannot be determined, in management s opinion the litigation should not have a material adverse effect on SunLink s financial condition or results of operations.

SunLink and its subsidiaries are a party to various medical malpractice and other claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to but could have a material adverse effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

Office of Inspector General Investigation

In March 2013, one of the Company s hospital subsidiaries received a document subpoena from the United States Department of Health and Human Services Office of Inspector General (OIG) in connection with an investigation of possible improper claims submitted to Medicare and Medicaid. The subpoena requests documents concerning possible false or fraudulent claims made for services provided by a third-party service provider and billed by the subsidiary. The subpoena also seeks information about the subsidiary s relationship with the service provider, including financial arrangements. The subsidiary is continuing to cooperate with the government with respect to ongoing document production, as well as conducting a joint medical necessity review of a sampling of medical records. The Company cannot at this time estimate what, if any, impact these matters and any results from these matters could have on our business, financial position, operating results or cash flows.

production, as well as conducting a joint medical necessity review of a sampling of medical records. We cannot at this time estimate what, if any, impact these matters and any results from these matters could have on our business, financial position, operating results or cash flows.

Internal Revenue Service

The Company is subject to examination of its income tax returns by the Internal Revenue Service (IRS) and other tax authorities. The Company s U.S. Federal income tax returns filed for the tax years ended June 30, 2009 through June 30, 2011 are under examination by the IRS. In May 2013, the Company received from the IRS a Notice of Proposed Adjustment (NOPA) primarily related to bad debts claimed by the Company in the tax year ended June 30, 2011. If the IRS were to prevail on all matters in dispute, the Company would be liable for potential federal income tax liabilities of up to $434, plus interest and penalties, if any. The Company believes that its positions with respect to the deductions are supported by, and consistent with, applicable tax law. The Company is challenging the proposed adjustment and will file a formal protest with the Office of Appeals Division within the IRS. See Note 10, Income Taxes, for further disclosures on the Company s income taxes.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees and interest on outstanding debt from continuing operations at March 31, 2013 were as follows:

Payments due in:	Long-Term Debt	Operating Leases	Physician Guarantees	Interest on Outstanding Debt
1 year	$ 924	$ 846	$ 27	$ 1,065
2 years	907	435	20	1,005
3 years	2,343	107	0	890
4 years	675	61	0	782
5+ years	13,763	17	0	6,891
	$ 18,612	$ 1,466	$ 47	$ 10,633

At March 31, 2013, SunLink had a guarantee agreement with one physician. A physician with whom a guarantee agreement is made generally agrees to maintain his or her practice within a hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician s liability for any guarantee repayment due to non-compliance with the provisions of a guarantee agreement generally is collateralized by the physician s patient accounts receivable and/or a promissory note from the physician. Included in the Company s condensed consolidated balance sheet at March 31, 2013 is a liability of $47 for one physician guarantee. SunLink expensed $45 and $57 on physician guarantees and recruiting for the three months ended March 31, 2013 and 2012, respectively. SunLink expensed $96 and $311 on physician guarantees and recruiting for the nine months ended March 31, 2013 and 2012, respectively. The table above shows non-cancelable commitments under physician guarantee contracts as of March 31, 2013.

Note 12. Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of $268 and $239 for legal services to these law firms in the three months ended March 31, 2013 and 2012, respectively, and $796 and $743 for legal services to these law firms in the nine months ended March 31, 2013 and 2012, respectively. Included in the Company s condensed consolidated balance sheet at March 31, 2013 and June 30, 2012 is $281 and $644, respectively, of amounts payable to these law firms.

Note 13. Financial Information by Segment

Under ASC Topic No. 280, Segment Reporting, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-making group is composed of SunLink s chief executive officer and other members of SunLink s senior management. Our two reportable operating segments are Healthcare Facilities and Specialty Pharmacy.

15

We evaluate performance of our operating segments based on revenue and operating income (loss). Segment information as of March 31, 2013 and 2012 and for the three and nine months then ended March 31, 2013 and 2012 is as follows:

	Healthcare Facilities	Specialty Pharmacy	Corporate and Other	Total
As of for the three months ended March 31, 2013				
Net revenues from external customers	$ 18,824	$ 10,416	$ 0	$ 29,240
Operating profit (loss)	689	406	(1,363)	(268)
Depreciation and amortization	657	183	182	1,022
Assets	42,217	11,828	17,653	71,698
Expenditures for property, plant and equipment	902	127	0	1,029
As of for the nine months ended March 31, 2013				
Net revenues from external customers	$ 56,375	$ 26,405	$ 0	$ 82,780
Operating profit (loss)	(394)	272	(3,611)	(3,733)
Depreciation and amortization	2,017	521	457	2,995
Assets	42,217	11,828	17,653	71,698
Expenditures for property, plant and equipment	1,725	416	23	2,164
As of and for the three months ended March 31, 2012				
Net revenues from external customers	$ 19,813	$ 11,541	$ 0	$ 31,354
Operating profit (loss)	135	63	(1,252)	(1,054)
Depreciation and amortization	753	240	137	1,130
Assets	53,064	11,885	17,806	82,755
Expenditures for property, plant and equipment	84	109	11	204
As of and for the nine months ended March 31, 2012				
Net revenues from external customers	$ 56,588	$ 29,968	$ 0	$ 86,556
Operating profit (loss)	290	(160)	(3,752)	(3,622)
Depreciation and amortization	2,238	703	408	3,349
Assets	53,064	11,885	17,806	82,755
Expenditures for property, plant and equipment	247	320	50	617

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(dollars in thousands, except per share and admissions data)

Forward-Looking Statements

This Quarterly Report and the documents that are incorporated by reference in this Quarterly Report contain certain forward-looking statements within the meaning of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that do not relate solely to historical or current facts and may be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are ba plans and expectations and are subject to a number of risks, uncertainties and other factors which could significantly affect current plans and expectations and our future financial condition and results. These factors, which could cause actual results, performance and achievements to differ materially from those anticipated, include, but are not limited to:

General Business Conditions

general economic and business conditions in the U.S., both nationwide and in the states in which we operate;

increases in uninsured and/or underinsured patients due to unemployment or other conditions resulting in higher bad debt amounts;

the competitive nature of the U.S. community hospital, nursing home, homecare and specialty pharmacy business