



Quarterly Report

As of and for the Second Quarter
Ended February 28, 2017

Northwestern Memorial HealthCare and Subsidiaries



**NORTHWESTERN MEMORIAL HEALTHCARE
AND SUBSIDIARIES**
Unaudited Condensed Consolidated Financial Statements
As of and for the Second Quarter Ended February 28, 2017

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Forward-Looking Information:

Certain statements included or incorporated by reference in this report constitute "forward-looking statements." Such statements are generally identifiable by the terminology used such as "plan," "expect," "estimate," "budget" or similar words. The achievement of certain results or other expectations contained in such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Northwestern Memorial HealthCare and Subsidiaries do not plan to issue any updates or revisions to those forward-looking statements if or when changes to its expectations, or events, conditions or circumstances on which such statements are based, occur.

Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Balance Sheets
(Dollars in thousands)

	February 28, 2017	August 31, 2016
	(Unaudited)	Note A
Assets		
Current Assets:		
Cash and cash equivalents	\$ 178,254	\$ 218,163
Short-term investments	36,209	10,474
Current portion of investments, including assets limited as to use	142,782	296,029
Patient accounts receivable, net of estimated allowances for uncollectible accounts of \$179,475 at February 28, 2017 and \$174,234 at August 31, 2016	689,850	599,772
Current portion of pledges and grants receivable, net	20,964	20,121
Current portion of insurance recoverable	27,608	11,716
Inventories	60,318	60,338
Other current assets	137,354	139,159
Total current assets	1,293,339	1,355,772
Investments, including assets limited as to use, less current portion	5,198,253	4,843,924
Property and equipment, at cost:		
Land	347,006	348,841
Buildings	3,379,481	3,339,542
Equipment and furniture	1,070,849	1,017,617
Construction in progress	495,833	349,738
	5,293,169	5,055,738
Less accumulated depreciation	1,944,228	1,821,853
	3,348,941	3,233,885
Prepaid pension cost	54,029	43,488
Insurance recoverable, less current portion	62,081	64,339
Other assets, net	183,064	170,778
Total assets	\$ 10,139,707	\$ 9,712,186

Continued on next page.

Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Balance Sheets (continued)
(Dollars in thousands)

	February 28, 2017	August 31, 2016
	(Unaudited)	Note A
Liabilities and net assets:		
Current Liabilities		
Accounts payable	\$ 198,054	\$ 237,282
Accrued salaries and benefits	262,494	304,521
Grants and academic support payable, current portion	53,816	50,753
Accrued expenses and other current liabilities	96,996	164,279
Due to third-party payors	384,386	406,123
Current accrued liabilities under self-insurance programs	95,625	89,789
Current maturities of long-term debt	43,284	29,565
Short-term debt	87,252	—
Long-term debt subject to short-term remarketing agreements	—	318,795
Total current liabilities	<u>1,221,907</u>	<u>1,601,107</u>
Long-term debt, less current maturities	1,343,755	1,077,180
Accrued liabilities under self-insurance programs, less current portion	496,492	495,352
Grants and academic support payable, less current portion	98,626	98,937
Interest rate swaps	105,061	150,107
Other liabilities	138,993	139,910
Total liabilities	<u>3,404,834</u>	<u>3,562,593</u>
Net assets:		
Unrestricted:		
Undesignated	6,125,957	5,556,407
Board-designated	225,860	221,750
Non-controlling interest in consolidated venture	(2,829)	(2,244)
Total unrestricted	<u>6,348,988</u>	<u>5,775,913</u>
Temporarily restricted	218,103	211,769
Permanently restricted	167,782	161,911
Total net assets	<u>6,734,873</u>	<u>6,149,593</u>
Total liabilities and net assets	<u>\$ 10,139,707</u>	<u>\$ 9,712,186</u>

Note A: The August 31, 2016 financial statement information was derived from and should be read in conjunction with the Northwestern Memorial HealthCare and Subsidiaries 2016 audited consolidated financial statements.

See accompanying notes to the interim condensed consolidated financial statements.

Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Statements of Operations and Changes in Net Assets
(Unaudited)
(Dollars in thousands)

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Revenue				
Net patient service revenue	\$ 1,187,973	\$ 1,107,567	\$ 2,352,138	\$ 2,077,309
Provision for uncollectible accounts	48,074	44,832	85,615	92,901
Net patient service revenue after provision for uncollectible accounts	1,139,899	1,062,735	2,266,523	1,984,408
Rental and other revenue	65,818	48,376	128,684	92,104
Net assets released from donor restrictions and federal and state grants	6,398	4,864	11,309	9,014
Total revenue	1,212,115	1,115,975	2,406,516	2,085,526
Expenses				
Salaries	480,121	439,342	963,322	844,975
Employee benefits	76,261	78,917	155,021	138,437
Supplies	215,721	194,133	418,753	361,672
Purchased services	124,386	112,314	235,882	197,898
Depreciation and amortization	67,354	74,867	135,140	145,280
Insurance	19,282	22,924	50,402	50,064
Rent and utilities	23,670	21,103	46,110	38,814
Repairs and maintenance	16,695	18,694	34,338	31,012
Interest	11,683	13,485	23,421	27,600
Illinois Hospital Assessment	25,316	20,997	52,109	40,914
Other	34,541	34,602	63,935	64,771
Total expenses	1,095,030	1,031,378	2,178,433	1,941,437
Operating income	117,085	84,597	228,083	144,089
Nonoperating gains (losses)				
Investment return	262,740	(247,064)	297,041	(250,129)
Change in fair value of interest rate swaps	6,413	(19,227)	45,045	(23,951)
Contribution of KishHealth unrestricted net assets	—	323,067	—	323,067
Loss on extinguishment of long term debt	—	(4,030)	(82)	(4,030)
Grants and academic support provided	(7,375)	(6,460)	(10,812)	(8,788)
Other	4,910	(5,430)	6,953	(5,641)
Total nonoperating gains, net	266,688	40,856	338,145	30,528
Excess of revenue over expenses	383,773	125,453	566,228	174,617
Net (loss) gain attributable to non-controlling interest in subsidiaries	(287)	526	(564)	420
Excess of revenue over expenses attributable to NMHC and Subsidiaries	\$ 384,060	\$ 124,927	\$ 566,792	\$ 174,197

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Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Statements of Operations and Changes in Net Assets (continued)
(Unaudited)
(Dollars in thousands)

	Three Months Ended					
	February 28, 2017			February 29, 2016		
	Total	Controlling	Non-controlling	Total	Controlling	Non-controlling
Unrestricted net assets						
Excess (deficiency) of revenue over expenses	\$ 383,773	\$ 384,060	\$ (287)	\$ 125,453	\$ 124,927	\$ 526
Net assets released from restrictions used for property and equipment additions	3,215	3,215	—	6,373	6,373	—
Postretirement-benefit-related changes other than net periodic pension cost	1,352	1,352	—	116	116	—
Initial value of noncontrolling interests in acquired companies	—	—	—	1,141	—	1,141
Distribution to non-controlling interest	(377)	—	(377)	(431)	(34)	(397)
Other	502	464	38	(347)	(347)	—
Increase (decrease) in unrestricted net assets	388,465	389,091	(626)	132,305	131,035	1,270
Temporarily restricted net assets						
Contributions	20,216	20,216	—	5,807	5,807	—
Investment return	4,127	4,127	—	2,502	2,502	—
Net assets released from restrictions used for:						
Operating expenses, charity care, research and education	(10,146)	(10,146)	—	(4,174)	(4,174)	—
Property and equipment additions	(3,215)	(3,215)	—	(6,373)	(6,373)	—
Change in fair value of split-interest agreements	207	207	—	(144)	(144)	—
Contribution of KishHealth restricted net assets	—	—	—	788	788	—
Other	(4,490)	(4,490)	—	(404)	(404)	—
Increase (decrease) in temporarily restricted net assets	6,699	6,699	—	(1,998)	(1,998)	—
Permanently restricted net assets						
Contributions	2,576	2,576	—	1,134	1,134	—
Change in fair value of split-interest agreements	174	174	—	(610)	(610)	—
Contribution of KishHealth restricted net assets	—	—	—	601	601	—
Other	2,888	2,888	—	—	—	—
Increase in permanently restricted net assets	5,638	5,638	—	1,125	1,125	—
Change in net assets	400,802	401,428	(626)	131,432	130,162	1,270
Net assets, beginning of period	6,334,071	6,336,274	(2,203)	5,539,295	5,541,990	(2,695)
Net assets, end of period	\$ 6,734,873	\$ 6,737,702	\$ (2,829)	\$ 5,670,727	\$ 5,672,152	\$ (1,425)

Continued on next page.

Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Statements of Operations and Changes in Net Assets
(Unaudited)
(Dollars in thousands)

	Six Months Ended					
	February 28, 2017			February 29, 2016		
	Total	Controlling	Non-controlling	Total	Controlling	Non-controlling
Unrestricted net assets						
Excess (deficiency) of revenue over expenses	\$ 566,228	\$ 566,792	\$ (564)	\$ 174,617	\$ 174,197	\$ 420
Net assets released from restrictions used for property and equipment additions	4,604	4,604	—	8,665	8,665	—
Postretirement benefit-related changes other than net periodic pension cost	2,703	2,703	—	231	231	—
Initial value of non-controlling interests in acquired companies	—	—	—	1,141	—	1,141
Distribution to non-controlling interest	(539)	—	(539)	(1,449)	(34)	(1,415)
Other	79	(439)	518	(347)	(347)	—
Increase (decrease) in unrestricted net assets	573,075	573,660	(585)	182,858	182,712	146
Temporarily restricted net assets						
Contributions	25,089	25,089	—	14,473	14,473	—
Investment return	7,519	7,519	—	5,823	5,823	—
Net assets released from restrictions used for:						
Operating expenses, charity care, research and education	(17,177)	(17,177)	—	(9,831)	(9,831)	—
Property and equipment additions	(4,604)	(4,604)	—	(8,665)	(8,665)	—
Change in fair value of split-interest agreements	207	207	—	(32)	(32)	—
Contribution of KishHealth restricted net assets	—	—	—	788	788	—
Other	(4,700)	(4,700)	—	(457)	(457)	—
Increase in temporarily restricted net assets	6,334	6,334	—	2,099	2,099	—
Permanently restricted net assets						
Contributions	2,915	2,915	—	1,182	1,182	—
Change in fair value of split-interest agreements	68	68	—	(1,063)	(1,063)	—
Contribution of KishHealth restricted net assets	—	—	—	601	601	—
Other	2,888	2,888	—	—	—	—
Increase in permanently restricted net assets	5,871	5,871	—	720	720	—
Change in net assets	585,280	585,865	(585)	185,677	185,531	146
Net assets, beginning of period	6,149,593	6,151,837	(2,244)	5,485,050	5,486,621	(1,571)
Net assets, end of period	<u>\$ 6,734,873</u>	<u>\$ 6,737,702</u>	<u>\$ (2,829)</u>	<u>\$ 5,670,727</u>	<u>\$ 5,672,152</u>	<u>\$ (1,425)</u>

Northwestern Memorial HealthCare and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Six Months Ended	
	February 28, 2017	February 29, 2016
Operating activities		
Change in net assets	\$ 585,280	\$ 185,677
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Postretirement benefit-related changes other than net periodic pension cost	(2,703)	(231)
Change in fair value of interest rate swaps	(45,045)	23,951
Loss on extinguishment of long-term debt	82	4,030
Net unrestricted realized investment return and net change in unrestricted and restricted unrealized investment gains/losses	(298,484)	249,973
Restricted contributions, change in fair value of split interest agreements, and realized investment return	(34,147)	(20,158)
Contribution of KishHealth net assets less non-controlling interest	—	(325,597)
Depreciation and amortization	135,140	145,280
Provision for uncollectible accounts	85,615	92,899
Changes in operating assets and liabilities:		
Patient accounts receivable	(175,693)	(153,219)
Due to third-party payors	(21,767)	(8,340)
Grants and academic support payable	2,752	27
Other operating assets and liabilities	(110,895)	(54,791)
Net cash provided by operating activities	120,135	139,501
Investing activities		
Purchase of trading securities	(1,422,815)	(736,462)
Sale of trading securities	1,414,584	615,029
Cash received from contribution of KishHealth	—	40,535
Net unrestricted realized investment return	79,895	53,217
Capital expenditures, net	(255,075)	(210,191)
Net cash used in investing activities	(183,411)	(237,872)
Financing activities		
Proceeds from line of credit	45,000	59,750
Proceeds from commercial paper	87,252	—
Proceeds from issuance of long-term debt	—	80
Payments of line of credit	(104,750)	—
Payments of long-term debt	(38,282)	(71,859)
Restricted contributions, change in fair value of split interest agreements, and realized investment return	34,147	20,158
Net cash provided by financing activities	23,367	8,129
Net decrease in cash and cash equivalents	(39,909)	(90,242)
Cash and cash equivalents, beginning of period	218,163	258,313
Cash and cash equivalents, end of the period	\$ 178,254	\$ 168,071

See accompanying notes to the interim condensed consolidated financial statements.

As of and for the Second Quarter Ended

February 28, 2017

1. Organization and Basis of Presentation

Northwestern Memorial HealthCare (NMHC) is the parent of an integrated nonprofit health care organization, anchored by Northwestern Memorial Hospital (NMH) and Northwestern Medical Group (NMG), that provides health care services to communities in northern Illinois. NMHC partners with Northwestern University's Feinberg School of Medicine (FSM) to form an academic medical center, branded as Northwestern Medicine, that is shaping the future of medicine through outstanding patient care, research and training of resident physicians.

The accompanying condensed consolidated financial statements include the accounts of NMHC and its subsidiaries (collectively referred to herein as Northwestern Memorial). All significant intercompany transactions and balances have been eliminated in consolidation.

These interim financial statements have not been audited; however, in the opinion of management, they include all adjustments necessary for their fair presentation in conformity with U.S. generally accepted accounting principles (U.S. GAAP). These interim statements have been prepared on a basis that is substantially consistent with the accounting principles applied in the audited consolidated financial statements of Northwestern Memorial for the year ended August 31, 2016.

Interim results are not necessarily indicative of results for a full year or any future periods. The information included in these interim financial statements should be read in conjunction with the audited consolidated financial statements for the year ended August 31, 2016, which are available on the Electronic Municipal Market Access ("EMMA") website of the Municipal Securities Rulemaking Board.

2. Reclassifications and Change in Accounting Estimates

Certain reclassifications have been made to the 2016 condensed consolidated financial statements to conform with classifications used in 2017. The reclassifications had no effect on the changes in net assets previously reported.

In 2016, NMHC extended the useful lives of certain assets based on an independent assessment. This resulted in a reduction of depreciation expense of \$35,898 for the three months and year ended August 31, 2016, as compared to the depreciation expense computed using former lives. Management estimated that this extension of the useful lives reduced depreciation expenses by approximately \$9,000 and \$18,000 in the three and six month periods ended February 29, 2017, respectively, compared to the similar periods in fiscal year 2016.

3. Adoption of Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 requires an entity to recognize revenue for the transfer of promised goods or services to customers in an amount

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services and disclose sufficient information to enable the financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU 2015-14, which defers the effective date to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. This ASU allows two alternative methods for application: either retrospectively to each reporting period presented or a modified retrospective approach with a cumulative effect adjustment to net assets at the date of initial application. Northwestern Memorial is evaluating the effect this guidance will have on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which will require lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to existing accounting standards. The guidance also eliminates current real estate-specific provisions for all entities. This new guidance is effective for Northwestern Memorial for the fiscal years and interim periods within those fiscal years beginning after December 15, 2018, with early adoption permitted. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited. Northwestern Memorial is currently evaluating the effect this guidance will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. ASU 2016-14 will change certain financial statement requirements for not-for-profit (NFP) entities in the scope of Topic 958 in an effort to make the information more meaningful to users and make reporting less complex. NFP entities will no longer be required to distinguish between resources with temporary and permanent restrictions on the face of the financial statements. Additionally, NFP entities will be required to present expenses by their natural and functional classification and present investment returns net of external and direct internal investment expenses. This new guidance is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. This guidance is to be applied retrospectively and early adoption is permitted. Northwestern Memorial is currently evaluating the effect this guidance will have on its consolidated financial statements.

4. Acquisitions

Affiliation with KishHealth

On December 1, 2015, KishHealth System (KishHealth) became a wholly owned subsidiary of NMHC pursuant to an affiliation agreement between NMHC and KishHealth. This affiliation positions Northwestern Memorial, under the Northwestern Medicine brand, to expand its integrated academic health delivery system to DeKalb County, offering patients access to leading-edge care closer to where they live and work.

The affiliation was effected through a membership substitution with no consideration paid. For accounting purposes, this transaction is considered an acquisition under Accounting Standards Codification (ASC) 958-805, *Not-for-Profit Entities: Business Combinations*, and a contribution was recorded for the fair value of assets, net of liabilities of KishHealth. No goodwill has been recorded as a result of this transaction.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The acquisition-date fair value of identifiable assets and liabilities of KishHealth at December 1, 2015, consisted of the following:

Fair Value of identifiable net assets:	
Cash and cash equivalents	\$ 40,535
Other current assets	210,407
Property and equipment	166,399
Other long-term assets	83,812
Current liabilities	(66,218)
Long-term debt	(74,025)
Other long-term liabilities	(11,377)
Noncontrolling interested in unrestricted net assets	(1,141)
Temporarily restricted net assets	(788)
Permanently restricted net assets	(601)
Contribution of unrestricted net assets	<u>\$ 347,003</u>

The valuation of property and equipment; other current and long-term assets, including identifiable intangible assets and current and long-term liabilities has been completed. In valuing these assets and liabilities, fair values were based on, but not limited to, independent appraisals, discounted cash flows, replacement costs and actuarially determined values.

The contribution recorded in the statement of operations and changes in net assets for the three and six month periods ended February 28, 2016 of \$323,067 was based on a provisional amount of net assets acquired. The final valuation procedures during the measurement period resulted in an increase in total net assets acquired of \$23,936 with a corresponding adjustment to the contribution during the second half of fiscal 2016 resulting in a final contribution amount of \$347,003 for the year ended August 31, 2016.

Affiliation with Marianjoy

On March 1, 2016, Marianjoy, Inc. (Marianjoy) became a wholly owned subsidiary of NMHC pursuant to a Member Substitution Agreement and Real Estate Purchase Agreement (collectively, the acquisition) between NMHC and Marianjoy's corporate parent, Wheaton Franciscan Services, Inc. (WFSI). This acquisition expands the offerings of Northwestern Memorial, under the Northwestern Medicine brand, to include physical medicine and rehabilitation care in DuPage County and surrounding areas.

Under these agreements, NMHC transferred \$35,412 to WFSI in exchange for Marianjoy's unrestricted net assets at the time of closing less Marianjoy's debt and cash, which were not acquired, and land purchased from WFSI. For accounting purposes, this transaction is considered an acquisition under ASC 958-805.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The acquisition-date fair value of identifiable assets and liabilities of Marianjoy at March 1, 2016, consisted of the following:

Fair Value of identifiable net assets:	
Other current assets	\$ 13,385
Property and equipment	68,996
Other long-term assets	3,921
Current liabilities	(4,561)
Temporarily restricted net assets	<u>(3,365)</u>
	78,376
Less consideration paid	<u>(35,412)</u>
Contribution of unrestricted net assets	<u><u>\$ 42,964</u></u>

The valuation of property and equipment, other current and long-term assets, including identifiable intangible assets, current and long-term liabilities and non-controlling interest has been completed. In valuing these assets and liabilities acquired, fair values were based on, but not limited to independent appraisals, discounted cash flows, replacement costs and actuarially determined values.

Following are the unaudited operating results and changes in net assets attributable to KishHealth and Marianjoy for the three and six month period ended February 28, 2017 included in the accompanying condensed consolidated statements of operations and changes in net assets:

	<u>Three Months</u>	<u>Six Months</u>
Total operating revenue	\$ 91,185	\$ 184,098
Excess of revenue over expenses	11,856	20,963
Change in unrestricted net assets	11,937	20,562
Change in temporarily restricted net assets	561	778

Following are the unaudited supplemental pro forma operating results of Northwestern Memorial for the three and six month period ended February 29, 2016 as if the KishHealth and Marianjoy affiliations had occurred on September 1, 2015:

	<u>Three Months</u>	<u>Six Months</u>
Total operating revenue	\$ 1,138,433	\$ 2,198,342
Operating income	84,791	150,583
Excess of revenue over expenses attributable to NMHC and subsidiaries	124,940	176,495

The pro forma information provided should not be construed to be indicative of Northwestern Memorial's results of operations had the acquisition been consummated on September 1, 2015, and is not intended to project Northwestern Memorial's results of operations for any future period.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

5. Investments and Other Financial Instruments

The composition of investments, including assets limited as to use, and cash and cash equivalents and short-term investments, is as follows:

	February 28, 2017	August 31, 2016
Measured at fair value:		
Cash and short-term investments	\$ 276,214	\$ 351,099
Mutual funds	265,188	415,364
Corporate bonds	271,067	143,740
U.S. government and agency issues	269,470	264,074
Equity securities	212,898	234,344
Other fixed income	15,781	202
	<u>1,310,618</u>	<u>1,408,823</u>
Measured at net asset value as practical expedient:		
Common collective trusts and commingled funds	602,076	703,072
Interest in 103-12 investment entities	261,720	232,998
	<u>863,796</u>	<u>936,070</u>
Accounted for under the equity method:		
Alternative investments	3,381,084	3,023,697
	<u>\$ 5,555,498</u>	<u>\$ 5,368,590</u>

Investments, including assets limited as to use, and cash and cash equivalents and short-term investments, consist of the following:

	February 28, 2017	August 31, 2016
Assets limited as to use:		
Trustee-held funds	\$ 67,475	\$ 90,473
Self-insurance programs	590,781	572,661
Board-designated funds	180,436	176,268
Total assets limited as to use	<u>838,692</u>	<u>839,402</u>
Donor-restricted funds	326,806	319,544
Unrestricted, undesignated funds	4,175,537	3,981,007
Total investments, excluding short-term investments	<u>5,341,035</u>	<u>5,139,953</u>
Other financial instruments:		
Cash and cash equivalents and short-term investments	214,463	228,637
	<u>\$ 5,555,498</u>	<u>\$ 5,368,590</u>

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The composition and presentation of investment returns are as follows:

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Interest and dividend income	\$ 5,490	\$ 17,406	\$ 11,351	\$ 23,361
Investment expenses	(978)	(1,061)	(2,333)	(1,855)
Realized gains on alternative investments, net	23,886	6,220	52,422	31,189
Realized gains on other investments, net	6,947	2,918	23,745	4,797
Unrealized gains/(losses) on alternative investments	157,762	(152,426)	157,107	(208,421)
Unrealized gains/(losses) on other investments	73,291	(118,731)	61,484	(94,501)
Change in value of joint ventures	624	925	785	1,391
	<u>\$ 267,022</u>	<u>\$ (244,749)</u>	<u>\$ 304,561</u>	<u>\$ (244,039)</u>
Reported as:				
Rental and other revenue	\$ 155	\$ (187)	\$ 1	\$ 267
Nonoperating investment return	262,740	(247,064)	297,041	(250,129)
Temporarily restricted - investment return	4,127	2,502	7,519	5,823
	<u>\$ 267,022</u>	<u>\$ (244,749)</u>	<u>\$ 304,561</u>	<u>\$ (244,039)</u>

Northwestern Memorial's investments measured at fair value include mutual funds; common equities; corporate and US government debt issues; state, municipal and foreign government debt issues; commingled funds; common collective trusts; and 103-12 entities.

Commingled investments, common collective trusts and 103-12 entities are commingled funds formed from the pooling of investments under common management. Unlike a mutual fund, these investments are not registered investment companies and, therefore, are exempt from registering with the Securities and Exchange Commission.

The investment strategy for the mutual funds, commingled funds, common collective trusts and 103-12 entities involves maximizing the overall long-term return by investing in a wide variety of assets, including domestic large cap equities, domestic small cap equities, international developed equities, blended equities, (i.e. a mix of domestic and international equities), natural resources and private investment limited partnerships (LPs).

Northwestern Memorial's non-pension plan investments measured under the equity method of accounting include absolute return hedge funds, equity long/short hedge funds, real estate, natural resources and LPs, collectively referred to as alternative investments. Alternative investments in the pension plan assets are measured at fair value.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

Absolute return hedge funds include funds with the ability to opportunistically allocate capital among several strategies. Generally, these funds diversify across strategies in an effort to deliver consistently positive returns regardless of the movement within global markets, exhibit relatively low volatility and are redeemable quarterly with a 60-day notice period. Equity long/short hedge funds include hedge funds that invest both long and short in U.S. and international equities. These funds typically focus on diversifying or hedging across particular sectors, regions or market capitalizations and are generally redeemable quarterly with a 60-day notice period. Absolute return and equity long/short managers are redeemable quarterly or annually with a 45- to 90-day notice period.

Real estate includes LPs that invest in land and buildings and seek to improve property level operations by increasing lease rates, recapitalizing properties, rehabilitating aging/distressed properties, and repositioning properties to maximize revenue. Real estate LPs typically use moderate leverage. Natural resources include a diverse set of LPs that invest in oil and natural gas-related companies, commodity-oriented companies, and timberland. Private equity includes LPs formed to make equity and debt investments in operating companies that are not publicly traded. These LPs typically seek to influence decision-making within the operating companies. Investment strategies in this category may include venture capital, buyouts and distressed debt. These three categories of investments cannot be redeemed with the funds. Distributions from each fund will be received as the underlying assets of the fund are expected to be liquidated periodically over the lives of the LPs, which generally run 10 to 12 years.

Because of the timing of the preparation and delivery of financial statements for limited partnership investments, the use of the most recently available financial statements provided by the general partners results in a quarter delay in the inclusion of the limited partnership results in Northwestern Memorial's statements of operations and changes in net assets. Due to this delay, these financial statements do not yet reflect the market conditions experiences in the last two months of the first quarter of fiscal 2017 for the limited partnerships.

As of February 28, 2017, \$2,404,603 of alternative investments is subject to various redemption limits and lockup provisions, of which \$1,832,873 expires within one year and \$571,730 expires after one year from the balance sheet date.

At February 28, 2017, Northwestern Memorial had commitments to fund approximately an additional \$843,000 to alternative investment entities. This funding is expected to occur over the next 12 years.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

6. Fair Value Measurements

Northwestern Memorial follows the requirements of ASC 820, *Fair Value Measurement*, in regards to measuring the fair value of certain assets and liabilities as well as disclosures about fair value measurements. ASC 820 defines fair value as the price that would be received for an asset or paid for a transfer of a liability in an orderly transaction on the measurement date.

The methodologies used to determine the fair value of assets and liabilities reflect market participant objectives and are based on the application of a three-level valuation hierarchy that prioritizes observable market inputs over unobservable inputs. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Examples of level 2 inputs are quoted prices for similar assets or liabilities in inactive markets or pricing models with inputs that are observable for substantially the full term of the asset or liability.
- Level 3 – Inputs to the valuation methodology are significant to the fair value of the asset or the liability and less observable. These inputs reflect the assumptions market participants would use in the estimation of the fair value of the asset or liability.

Fair Values

A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The following table presents the financial instruments measured at fair value on a recurring basis at February 28, 2017:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 178,254	\$ —	\$ —	\$ 178,254
Investments:				
Short-term investments:				
Currency	27	—	—	27
Fixed Income	36,182	—	—	36,182
Total short-term investments	36,209	—	—	36,209
Mutual funds:				
Fixed income	91,003	—	—	91,003
U.S. equities	174,185	—	—	174,185
Total mutual funds	265,188	—	—	265,188
Other fixed income	—	15,781	—	15,781
Bonds:				
Corporate bonds	—	271,067	—	271,067
U.S. government and agencies' issues	—	269,470	—	269,470
Total bonds	—	540,537	—	540,537
Equity securities	212,424	474	—	212,898
Cash equivalents in investment accounts	61,751	—	—	61,751
Total investments	575,572	556,792	—	1,132,364
Beneficial interest in trusts	—	13,556	—	13,556
Total assets	<u>\$ 753,826</u>	<u>\$ 570,348</u>	<u>\$ —</u>	<u>\$ 1,324,174</u>
Investments recorded at fair value based on NAV				863,796
Total assets measured at fair value				<u>\$ 2,187,970</u>
Liabilities:				
Interest rate swaps	\$ —	\$ 105,061	\$ —	\$ 105,061

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The following table presents the financial instruments measured at fair value on a recurring basis at August 31, 2016:

	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	\$ 218,163	\$ —	\$ —	\$ 218,163
Investments:				
Short-term investments:				
Currency	27	—	—	27
Fixed Income	10,447	—	—	10,447
Total short-term investments	10,474	—	—	10,474
Mutual funds:				
Fixed income	212,714	—	—	212,714
International equities	9,431	—	—	9,431
U.S. equities	193,219	—	—	193,219
Total mutual funds	415,364	—	—	415,364
Other fixed income	—	202	—	202
Bonds:				
Corporate bonds	—	143,740	—	143,740
U.S. government and agencies' issues	—	264,074	—	264,074
Total bonds	—	407,814	—	407,814
Equity securities	233,927	417	—	234,344
Cash equivalents in investment accounts	122,462	—	—	122,462
Total investments	782,227	408,433	—	1,190,660
Beneficial interest in trusts	—	13,181	—	13,181
Total assets	<u>\$ 1,000,390</u>	<u>\$ 421,614</u>	<u>\$ —</u>	<u>\$ 1,422,004</u>
Investments recorded at fair value based on NAV				936,070
Total assets measured at fair value				<u>\$ 2,358,074</u>
Liabilities:				
Interest rate swaps	\$ —	\$ 150,107	\$ —	\$ 150,107

There were no transfers into or out of Level 1 or Level 2 during the six months ended February 28, 2017 or the year ended August 31, 2016.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

Reconciliation to the Condensed Consolidated Balance Sheets

A reconciliation of the fair value of financial assets to the condensed consolidated balance sheets at February 28, 2017 and August 31, 2016 is as follows:

	February 28, 2017	August 31, 2016
Short-term investments measured at fair value	\$ 36,209	\$ 10,474
Investments, including assets limited as to use measured at fair value	1,959,951	2,116,256
Total investments at fair value	1,996,160	2,126,730
Alternative investments accounted for under equity method included in investments, including assets limited as to use	3,381,084	3,023,697
Total investments	<u>\$ 5,377,244</u>	<u>\$ 5,150,427</u>
Other long-term assets:		
Beneficial interests in trusts at fair value	\$ 13,556	\$ 13,181
Other long-term assets, net	169,508	157,597
Total other long-term assets, net	<u>\$ 183,064</u>	<u>\$ 170,778</u>

Valuation Techniques and Inputs

Beneficial Interests in Trusts - The fair value of beneficial interests in trusts is based on Northwestern Memorial Foundation's (the Foundation) percentage of the fair value of the trusts' assets adjusted for any outstanding liabilities (discounted using a rate per Internal Revenue Service (IRS) regulations), based on each trust arrangement.

Interest Rate Swaps - The fair value of interest rate swaps is based on generally accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative and quoted prices from dealer counterparties and other independent market sources. The valuation incorporates observable interest rates and yield curves for the full term of the swaps. The valuation is also adjusted to incorporate nonperformance risk for NMHC or the respective counterparty. The adjustment is based on the credit spread for entities with similar credit characteristics as NMHC or market-related data for the respective counterparty. Northwestern Memorial pays various fixed rates and receives cash flows based on rates equal to a percentage of the London Interbank Offered Rate (LIBOR) plus a spread for certain interest rate swaps.

Investments - The fair value of Level 1 investments, which consist of equity securities and mutual funds, is based on quoted market prices that are valued on a daily basis. Level 2 investments consist of U.S. government securities, corporate bonds, commingled funds, common collective trusts, interest in 103-12 entities and fixed income instruments issued by municipalities and foreign government agencies. The fair value of the U.S. government and agency securities and corporate bonds is established based on values obtained from nationally recognized pricing services that value the investments based on similar securities and matrix pricing of similar quality and maturity securities.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

The fair values of commingled funds, common collective trusts and 103-12 entities are based on the ownership interest in the net asset value (NAV) per share or its equivalent, of the respective fund.

Northwestern Memorial's investments are exposed to various kinds and levels of risk. Equity securities and equity mutual funds expose Northwestern Memorial to market risk, performance risk and liquidity risk. Market risk is the risk associated with major movements of the equity markets. Performance risk is that risk associated with a company's operating performance. Fixed income securities and fixed income mutual funds expose Northwestern Memorial to interest rate risk, credit risk and liquidity risk. As interest rates change, the value of many fixed income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell particular securities. Liquidity risk tends to be higher for equities related to small capitalization companies and certain alternative investments. Due to the volatility in the capital markets, there is a reasonable possibility of subsequent changes in fair value, resulting in additional gains and losses in the near term.

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other current liabilities and short-term borrowings are reasonable estimates of their fair values due to their short-term nature.

The fair value of the long-term debt portfolio, including the current portion, was \$1,446,689 at February 28, 2017 and \$1,527,365 at August 31, 2016. The fair value of this Level 2 liability is based on quoted market prices for the same or similar issues and the relationship of those bond yields with various market indices. The market data used to determine yield and calculate fair value represents Aa/AA-rated tax-exempt municipal health care bonds. The effect of third-party credit valuation adjustments, if any, is immaterial.

The fair value of pledges receivable, a Level 2 asset, is based on discounted cash flow analysis and approximates the carrying value of \$44,583 and \$40,343 at February 28, 2017 and August 31, 2016, respectively.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

7. Long-Term Debt

Long-term debt consists of the following:

	February 28, 2017	August 31, 2016
Revenue Bonds, Series 2015A and 2015B (KishHealth System), payable in monthly installments through March 1, 2035 (fixed coupon rate of 2.80% through March 1, 2020)	\$ 11,403	\$ 11,642
Revenue Bonds, Series 2013 (NMHC), payable in annual installments beginning August 15, 2031 through August 15, 2043 (fixed coupon rates from 4.00% to 5.00%)	111,235	111,235
Revenue Bonds, Series 2011A and 2011B (CDH), with interest at a variable rate payable in annual installments through November 1, 2038, (weighted average interest rate of 0.83% and 0.61% for the six months ended February 28, 2017 and February 29, 2016, respectively)	116,300	117,950
Revenue Bonds, Series 2011C (Delnor), with interest at a variable rate payable in annual installments through November 1, 2038, (weighted average interest rate of 0.78% and 0.71% for the six months ended February 28, 2017 and February 29, 2016, respectively)	56,595	57,070
Revenue Bonds, Series 2009A (NMH), payable in annual installments through August 15, 2039 (fixed coupon rates range from 5.00% to 6.00%)	299,220	299,220
Revenue Bonds, Series 2009B (NMH), payable in annual installments through August 15, 2030 (fixed coupon rates range from 5.00% to 5.75%)	39,930	39,930
Revenue Bonds, Series 2009 (CDH) payable in annual installments through November 1, 2039 (fixed coupon rates range from 5.00% to 5.25%)	84,165	86,255
Revenue Bonds, Series 2009B (CDH) payable in annual installments through November 1, 2039 (fixed coupon rates range from 3.30% to 5.75%)	215,330	221,565
Variable Rate Demand Revenue Bonds, Series 2008A (NMH), payable in annual installments beginning August 15, 2017 through August 15, 2038 (weighted average interest rate of 0.58% and 0.01% for the six months ended February 28, 2017 and February 29, 2016, respectively)	78,775	78,775
Variable Rate Demand Revenue Bonds, Series 2007A (NMH), payable in annual installments through August 15, 2042 (weighted average interest rate of 0.66% and 0.01% for the six months ended February 28, 2017 and February 29, 2016, respectively)	206,000	206,000

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

	February 28, 2017	August 31, 2016
Revenue Bonds, Series 2003A–Series 2003C (Delnor) payable in annual installments through November 1, 2033 (fixed coupon rates range from 5.00% - 5.25%)	22,350	22,350
Variable Rate Demand Revenue Bonds, Series 2002C (NMH), payable in annual installments beginning August 15, 2026 through August 15, 2031 (weighted average interest rate was 0.01% for the six months ended February 29, 2016)	—	27,450
Revenue Bonds, Series 2002B–Series 2002D (Delnor) payable in annual installments beginning May 1, 2022 through May 1, 2032 (fixed coupon rate of 5.25%)	35,000	35,000
Delnor medical office building loan, interest fixed at 6.34%, matures September 1, 2017	13,416	13,548
NMHC variable rate note dated October 4, 2016 to a bank, matures October 4, 2019 (weighted average interest rate of 1.11% and 0.86% for the six months ended February 28, 2017 and February 29, 2016, respectively)	105,000	105,000
The Midland Surgical Center, LLC line of credit due July 10, 2017, interest payments required monthly at a variable rate not less than 3.75%, and loan with maturity date of December 10, 2018, payable in monthly installments of \$2 including interest at a rate of 3.75%	439	449
NMHC line of credit (weighted average interest rate of 1.26% for the six months ended February 28, 2017 and 1.08% for the three months ended February 29, 2016)	—	59,750
NMHC commercial paper (weighted average interest rate of 0.80% for the six months ended February 28, 2017)	87,299	—
	1,482,457	1,493,189
Less:		
Unamortized discount, net and debt issuance costs	8,166	7,899
Current maturities	43,284	29,565
Long-term debt subject to short-term remarketing agreements	—	318,795
Line of credit, included in Accrued expenses and other current liabilities	—	59,750
Commercial paper, included in Short-term debt	87,252	—
	\$ 1,343,755	\$ 1,077,180

Per the Amended and Restated Master Trust Indenture dated as of May 1, 2004, as supplemented and amended (the NMHC Master Indenture), the Obligated Group includes NMHC, NMH, Northwestern Lake Forest Hospital (NLFH), Central DuPage Hospital (CDH), Cadence, Delnor-

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

Community Hospital (Delnor) and Cadence Physician Group (CPG), the Foundation, Northwestern Medical Faculty Foundation d/b/a Northwestern Medical Group (NMG), Northwestern Foundation for Research and Education d/b/a Northwestern Medical Group Management Services (NMGMS), Lake Forest Health and Fitness Institute (HFI), and Wells Fargo Bank, N.A., as master trustee. Supplemental Master Trust Indentures were issued so that all the debt as of November 30, 2014, is either secured or guaranteed by the NMHC Obligated Group.

Effective December 18, 2015, KishHealth, Kishwaukee Community Hospital, Valley West Community Hospital and Kishwaukee Physician Group, Inc. became members of the Obligated Group created under the NMHC Master Indenture. The Series 2015A and Series 2015B Bonds were restructured and secured by direct note obligations within the NMHC Obligated Group. The KishHealth system's Illinois Finance Authority Hospital Revenue Refunding Bonds, Series 2008, were legally defeased by placing sufficient assets in escrow funded by a debt reserve fund and a draw of \$59,750 on a Northwestern Memorial line of credit, resulting in a loss on extinguishment of \$4,030 for the year ended August 31, 2016.

Effective May 31, 2016, Marianjoy Inc., Marianjoy Rehabilitation Hospital & Clinic, Inc., Rehabilitation Medicine Clinic, Inc. and Marianjoy Foundation, Inc. became members of the Obligated Group created under the NMHC Master Indenture.

Northwestern Memorial had lines of credit of \$50,000 and \$80,000 that were to expire in May 2019 and September 2018, respectively. At August 31, 2016, Northwestern Memorial had drawn \$59,750 on the \$80,000 line of credit and restricted \$467 of the \$50,000 line to secure a letter of credit. The remaining amounts were available for operations. In October 2016, the lines of credit in the amounts of \$50,000 and \$80,000 were replaced with two \$65,000 lines of credit. At February 28, 2017, Northwestern Memorial had restricted \$1,556 of the \$65,000 line of credit to secure a letter of credit. Northwestern Memorial has the option to borrow at various rates expressed as an adjustment to LIBOR, prime rate or other bank-offered rates. At February 28, 2017, no amounts were borrowed under the lines of credit.

Northwestern Memorial has standby bond purchase agreements (SBPAs) with multiple banks that cover all of its variable rate demand revenue bonds (VRDBs). The short-term credit rating for each series of VRDBs is based on the respective bank's short-term credit rating. The long-term credit rating for each series of VRDBs is based on Northwestern Memorial's long-term credit rating. Changes in credit ratings may impact the interest paid on or remarketing of the VRDBs. As of February 28, 2017, the banks provided liquidity support in the event of a failed remarketing as follows:

	<u>Par Value</u>	<u>Expiration date</u>
Subseries 2007A-1, 2007A-3	\$ 103,000	October 2020
Series 2008A	78,775	October 2020
Subseries 2007A-2, 2007A-4	103,000	October 2019

The SBPAs include reporting and financial requirements and other covenants. If an SBPA is not

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

renewed or replaced prior to its expiration, or if some portion, or all, of the related VRDBs are not successfully remarketed (failed remarketing) during the term of the SBPAs, the related VRDBs convert to a term loan at the earlier of the expiration date of the related SBPA or after 90 consecutive days of failed remarketing. The principal payment on the term loan would then be payable over a three-year term. The earliest principal payment on any term loan associated with the bonds is 367 days from the initial failed remarketing date. Therefore the VRDBs, all SBPAs with maturities greater than one year less any current portion, are classified as long-term debt in the accompanying condensed consolidated balance sheets.

In October 2016, the SBPAs for the \$103,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-1 and Subseries 2007A-3 (NMH) and for the \$78,775 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2008A (NMH) were each extended for four years. The SBPAs for the \$103,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-2 and Subseries 2007A-4 was replaced by a new standby bond purchase agreement provider. At August 31, 2016, the expiration date for these SBPAs was less than one year from the balance sheet date and as such the related debt was classified as short-term.

In October 2016, the Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2011A, 2011B, and 2011C (CDH-Delnor Health System) in the aggregate amount of \$175,020 were purchased by different banks at variable rates for a period of seven years, five years, and three years, respectively. At August 31, 2016, the expiration date for the SBPAs then in effect was less than one year from the balance sheet date and as such the related debt was classified as short-term.

In October 2016, the existing \$105,000 CDH-Delnor Health System variable rate note was replaced with a \$105,000 NMHC variable rate note with a different lender and extended to 2019.

In October 2016, NMHC issued commercial paper in the aggregate amount of \$87,299. Proceeds were used to redeem all outstanding \$27,450 NMH Series 2002C Bonds and pay down a \$59,750 NMHC line of credit.

8. Derivatives

Northwestern Memorial's only derivative financial instruments are interest rate swaps approximately equal to its Series 2007A and Series 2011A-C variable rate bonds for the sole purpose of risk management. These bonds expose Northwestern Memorial to variability in interest payments due to changes in interest rates. To manage fluctuations in cash flows resulting from interest rate risk, Northwestern Memorial entered into various interest rate swap agreements. These swaps limit the variable-rate cash flow exposure on the variable rate bonds to synthetically fixed cash flows. By using interest rate swaps to manage the risk of changes in interest rates, Northwestern Memorial exposes itself to credit risk and market risk. Credit risk is the risk that a counterparty will fail to perform under the terms of a derivative contract. When the fair value of a swap is positive, the counterparty owes Northwestern Memorial, which creates credit risk for Northwestern Memorial. When the fair value of a swap is zero or negative, the counterparty does not owe Northwestern Memorial. Northwestern Memorial minimizes the credit risk in its swap contracts by entering into transactions that either require the counterparty to post collateral for

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

the benefit of Northwestern Memorial based on the credit rating of the counterparty and the fair value of the swap contract or whose cash flows are insured by a third party. For certain interest rate swaps, Northwestern Memorial is required to post collateral for the benefit of the counterparty when the negative fair value of the swap exceeds a defined threshold. The aggregate fair value liability of the swaps on the condensed consolidated balance sheets reflect a reduction of \$4,510 and \$4,707 for non-performance risk at February 28, 2017 and August 31, 2016, respectively. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. Management also mitigates risk through periodic reviews of its swap positions in the context of their total blended cost of capital.

The following is a summary of the outstanding positions under existing interest rate swap agreements:

Notional Amount		Maturity Date	Rate Paid	Rate Received
February 28, 2017	August 31, 2016			
\$ 103,000	\$ 103,000	August 2042	3.89%	63% of 1-Month LIBOR + 28 bps
103,000	103,000	August 2042	3.89%	63% of 1-Month LIBOR + 28 bps
61,650	62,175	November 2038	3.82%	67% of 3-Month LIBOR
61,650	62,175	November 2038	3.52%	67% of 3-Month LIBOR
35,000	35,000	May 2032	4.18%	67% of 1-Month LIBOR
22,350	22,350	May 2033	2.89%	67% of 1-Month LIBOR
<u>\$ 386,650</u>	<u>\$ 387,700</u>			

The fair value of derivative instruments is as follows:

	Derivatives Liabilities		
	Balance Sheet Location	February 28, 2017	August 31, 2016
Derivatives not designated as hedging instruments:			
Interest rate contracts	Interest rate swap liabilities	\$ 105,061	\$ 150,107

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

The effects of derivative instruments on the condensed consolidated statements of operations and changes in net assets are as follows:

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Derivatives not designated as hedging instruments:				
Operating expense - interest	\$ (2,026)	\$ (2,672)	\$ (3,340)	\$ (4,454)
Nonoperating - change in fair value of interest rate swaps	6,413	(19,227)	45,045	(23,951)

Northwestern Memorial's derivative instruments contain provisions that require its debt to remain above certain credit ratings from Standard & Poor's and Moody's. If Northwestern Memorial's debt were to fall below those levels, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. Northwestern Memorial has posted collateral of \$0 and \$24,203 as of February 28, 2017 and August 31, 2016, respectively. If the credit-risk-related contingent features underlying these agreements were triggered to the fullest extent on February 28, 2017, Northwestern Memorial would be required to post \$109,571 of additional collateral to its counterparties.

In October 2016, three interest rate swaps were novated under the same notional amounts and contract terms to a new counterparty except for the one swap that was subject to a collateral requirement. As a result of this transaction, none of these novated swaps require collateral.

9. Endowments

Northwestern Memorial's endowment consists of individual donor-restricted funds established for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the donor-imposed restrictions.

Northwestern Memorial has interpreted the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA), as adopted by the State of Illinois (State), as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment fund absent explicit donor stipulation to the contrary. As a result of this interpretation, Northwestern Memorial classifies as permanently restricted net assets the original value of gifts donated to the permanent endowment, the original value of subsequent gifts to the permanent endowment, and accumulations to the permanent endowment made in accordance with the applicable donor gift instrument. The remaining portion of the donor-restricted endowment fund that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure consistent with donor intent or, where silent, the standard of prudence prescribed by UPMIFA.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements *(continued)*
(Unaudited and in thousands)

In accordance with UPMIFA, Northwestern Memorial considers the following factors in making a determination to appropriate or accumulate donor-restricted funds:

- The duration and preservation of the fund
- The purposes of Northwestern Memorial and the endowment fund
- General economic conditions
- The possible effects of inflation and deflation
- The expected total return from investment income
- Other resources of Northwestern Memorial
- The investment policies of Northwestern Memorial.

Northwestern Memorial has adopted investment and spending policies for endowment assets designed to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity or for a donor-specified period. Under this policy, endowment assets are allocated a fixed annual return, which is currently set at 6%.

Northwestern Memorial has a policy that limits annual spending from endowment funds to 4% of the endowment fund balance at the midpoint of the preceding fiscal year. In establishing this policy, Northwestern Memorial considered the long-term expected return on its endowment. Accordingly, over the long term, Northwestern Memorial expects the spending policy to allow its endowment to grow at an average annual rate of 2%. This is consistent with its objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specific term, as well as to provide additional real growth through new gifts and investment return.

Northwestern Memorial HealthCare
Notes to Interim Condensed Consolidated Financial Statements (continued)
(Unaudited and in thousands)

The changes in endowment net assets for the six months ended February 28, 2017 and 2016 are summarized below:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, September 1, 2015	\$ 55,431	\$ 160,775	\$ 216,206
Contribution of KishHealth restricted net assets	—	601	601
Contributions	225	1,330	1,555
Change in value of trusts	(23)	(778)	(801)
Investment return	7,812	—	7,812
Appropriation for expenditure	(5,989)	—	(5,989)
Other	(140)	(17)	(157)
Endowment net assets, August 31, 2016	57,316	161,911	219,227
Contributions	149	2,915	3,064
Change in value of trusts	—	68	68
Investment return	3,915	—	3,915
Appropriation for expenditure	(2,043)	—	(2,043)
Other	(399)	2,888	2,489
Endowment net assets, February 28, 2017	<u>\$ 58,938</u>	<u>\$ 167,782</u>	<u>\$ 226,720</u>

10. Self-Insurance Programs and Related Insurance Recoverable

Northwestern Memorial's self-insurance liabilities and the related amount recoverable from reinsurers are reported in the condensed consolidated balance sheets at present value based on a discount rate of 1.5% as of February 28, 2017 and August 31, 2016. Provisions for the professional and general liability risks are based on an actuarial estimate of losses using actual loss data adjusted for industry trends and current conditions and an evaluation of claims by Northwestern Memorial's legal counsel. The provision for estimated self-insured claims includes estimates of ultimate costs for both reported claims and claims incurred but not reported.

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11. Net Patient Service Revenue

Northwestern Memorial recognizes net patient service revenue associated with services provided to patients who have third-party payment coverage with Medicare, Medicaid, Blue Cross, other managed care programs and other third-party payors on the basis of the contractual rates for the services rendered at the time services are provided. Payment arrangements with those payors include prospectively determined rates per admission or visit, reimbursed costs, discounted charges and per diem rates. Reported costs and/or services provided under certain of the arrangements are subject to retroactive audit and adjustment. Net patient service revenue increased by \$9,920 and \$4,937 in the three months ended February 28, 2017 and February 29, 2016, respectively, and increased \$11,569 and \$5,664 in the six months ended February 28, 2017 and February 29, 2016, as a result of changes in estimates due to settlements of prior fiscal years' cost reports and the disposition of other payor audits and settlements. Changes in Medicare and Medicaid programs and reduction in funding levels could have an adverse effect on Northwestern Memorial.

Northwestern Memorial also provides care to self-pay patients. Under its Financial Assistance Policy (the Policy), Northwestern Memorial provides medically necessary care to patients in its community with inadequate financial resources at discounts of up to 100% of charges using a sliding scale that is based on patient household income as a percentage (up to 600%) of the federal poverty level guidelines. The Policy also contains a catastrophic financial assistance provision that limits a patient's total financial responsibility to Northwestern Memorial. Since Northwestern Memorial does not pursue collection of these amounts, they are not reported as net patient service revenue. Northwestern Memorial implemented presumptive eligibility screening procedures for free care in fiscal year 2014. Northwestern Memorial recognizes net patient service revenue on services provided to these patients at the discounted rate at the time services are rendered.

Net patient service revenue, net of contractual allowances and discounts, is reduced by the provision for uncollectible accounts, and net patient accounts receivable are reduced by an allowance for uncollectible accounts. These amounts are based primarily on management's assessment of historical and expected write-offs and net collections, along with the aging status for each major payor source. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. Based on historical experience, a portion of Northwestern Memorial's self-pay patients who do not qualify for charity care will be unable or unwilling to pay for the services provided. Thus, a provision is recorded for uncollectible accounts in the period services are provided related to these patients. After all reasonable collection efforts have been exhausted in accordance with Northwestern Memorial's policies, accounts receivable are written off and charged against the allowance for uncollectible accounts.

For receivables associated with self-pay patients, Northwestern Memorial records an allowance for uncollectible accounts in the period of service on the basis of past experience. These adjustments are accrued on an estimated basis and are adjusted as needed in future periods.

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Net patient service revenue (including patient co-pays and deductibles), net of contractual allowances and discounts (but before the provision for uncollectible accounts) by primary payor source was as follows:

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Third-party payors	\$ 1,161,405	\$ 1,083,000	\$ 2,313,716	\$ 2,031,356
Self-pay	26,568	24,567	38,422	45,953
	\$ 1,187,973	\$ 1,107,567	\$ 2,352,138	\$ 2,077,309

Northwestern Memorial grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. At February 28, 2017 and August 31, 2016, patient accounts receivable, including patient co-pays and deductibles by major primary payor source, before deducting estimated uncollectibles, were as follows:

	February 28, 2017	August 31, 2016
Medicare	16%	15%
Medicaid	11	9
Blue Cross	18	16
Other managed care	32	33
Other third-party payors	9	11
Patients	14	16
	100%	100%

The allowance for uncollectible accounts was \$179,475 and \$174,234, or 20.6% and 22.4% of the related patient accounts receivable, net of contractual adjustments as of February 28, 2017 and August 31, 2016, respectively.

Hospital Assessment Program

In December 2008, the Illinois Hospital Assessment Program was approved by the Federal Centers for Medicare and Medicaid Services (CMS) for the period from July 1, 2008 through June 30, 2013. In July 2012, this program was extended to December 31, 2014, as part of the Save Medicaid Access and Resources Together (SMART) Act. In June 2014, this program was extended to June 30, 2018 as part of the Omnibus Medicaid Bill Senate Bill 741. In October 2013, the Enhanced Illinois Hospital Assessment Program as authorized under Illinois Public Act 97-688 was approved by CMS retroactive to June 10, 2012. Together, these two programs are referred to herein as (HAP). Under HAP, the state receives additional federal Medicaid funds for the State's healthcare system, administered by the Illinois Department of Healthcare and Family Services. HAP includes payments to NMHC hospitals from the state and assessments against NMHC hospitals, which are paid to the state in the same year.

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In June 2014, Omnibus Medicaid Bill Senate Bill 741 authorized a new supplemental program (Access Program) to cover new Medicaid beneficiaries under the Affordable Care Act (ACA), which was approved by CMS in January 2015. In May 2016 the State of Illinois passed HB 4678 (Expanded Access Program) which implemented a framework to increase ACA access funds to Illinois hospitals. The new ACA access funds are attributable to the ACA adults enrolled in managed care products. In September 2016 the Illinois Department of Family and Healthcare Services submitted its certification of the new Medicaid managed care organization rates to CMS. After agreements between managed care organizations and providers were executed, payments for this new program and an adjustment to the assessments began in November 2016 and were retroactive to January 1, 2016.

A summary of the amounts recognized for the HAP and Access programs is as follows:

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Net patient service revenue				
HAP	\$ 28,204	\$ 27,489	\$ 56,414	\$ 52,943
Access Program	4,952	5,169	9,486	10,997
Expanded Access Program	6,277	—	29,834	—
	<u>39,433</u>	<u>32,658</u>	<u>95,734</u>	<u>63,940</u>
Illinois Hospital Assessment	25,316	20,997	52,109	40,914
Net excess of HAP and ACA revenue over Illinois assessment	<u>\$ 14,117</u>	<u>\$ 11,661</u>	<u>\$ 43,625</u>	<u>\$ 23,026</u>

The Expanded Access Program Revenue and Illinois Hospital Assessment expense for the six months ended February 29, 2016 includes retroactive portions from January 1, 2016 through August 31, 2016 of \$16,728 and \$2,004, respectively.

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12. Employee Benefit Obligations

Northwestern Memorial's non-contributory, defined-benefit pension plans (Plans) cover certain Northwestern Memorial employees employed prior to January 1, 2013 in NMHC, NMH and NLFH. The Plans were hard frozen as of December 31, 2012, such that no participant will earn any additional or new benefits under the Plans on or after January 1, 2013.

Net periodic pension benefit cost included in employee benefits expense in the accompanying condensed consolidated statements of operations and changes in net assets is comprised of the following:

	Three Months Ended		Six Months Ended	
	February 28,	February 29,	February 28,	February 29,
	2017	2016	2017	2016
Plan expenses	\$ 352	\$ 421	704	842
Interest cost on projected benefit obligation	4,783	6,504	9,566	13,008
Expected return on the Plans' assets	(11,583)	(11,630)	(23,166)	(23,260)
Amortization of net loss	941	346	1,882	692
	<u>\$ (5,507)</u>	<u>\$ (4,359)</u>	<u>\$ (11,014)</u>	<u>\$ (8,718)</u>

Northwestern Memorial made no contributions for the three and six month periods ended February 28, 2017 and has no current plans to contribute to the Plans during the fiscal year ending August 31, 2017.

At August 31, 2016, Northwestern Memorial changed the discount rate method used to measure the service and interest cost starting in fiscal 2017 to the spot rate approach from the yield curve methodology used historically. This change had no impact on three and six month periods ended February 28, 2017 projected benefit obligation. This method does not apply to the service cost as both plans have been frozen, but results in different discount rates utilized for purposes of measuring the interest cost of the two plans. Northwestern Memorial has made this change to provide a more precise measurement of interest costs by improving the correlation between projected benefit cash flows to the corresponding spot yield curve rates. The future impact of this change is expected to be nominal.

13. Commitments and Contingencies

Academic, Programs and Other Support

Consistent with its mission, Northwestern Memorial provides academic, program and other support to other not-for-profit entities. The present value of the total remaining commitments related to this support is \$152,442 and \$149,690 at February 28, 2017 and August 31, 2016, respectively, which is reported as Grants and academic support payable, current portion and

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Grants and academic support payable, less current portion in the accompanying condensed consolidated balance sheets.

Northwestern Memorial will provide continuing funding to Northwestern University in support of the research and education mission of the FSM. This continuing funding is based on the average net patient service revenue and operating results of Northwestern Memorial. The expense incurred of \$19,043 and \$15,706 for the three months ended February 28, 2017 and February 29, 2016, respectively and \$37,867 and \$30,457 for the six months ended February 28, 2017 and February 29, 2016, respectively is recorded in Other expense in the accompanying condensed consolidated statements of operations and changes in net assets; and a related liability of \$1,544 and \$52 is reported in Accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets as of February 28, 2017 and August 31, 2016, respectively.

Capital Projects

Various capital projects are currently being constructed and are expected to be placed in service over the next three years. The total estimated cost of these projects is approximately \$1,448,000. As of February 28, 2017, project commitments totaled \$1,027,000, of which \$787,612 has been incurred. These commitments include the construction of a replacement hospital on the Lake Forest Campus as agreed to in the 2010 affiliation agreement with Lake Forest Hospital. All governmental reviews, approvals and building permits have been received. Construction began in February 2015. Building occupancy and hospital opening are planned for the spring of 2018.

Regulatory

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a reasonable possibility that recorded amounts will change by a material amount in the near term. During the last few years, as a result of nationwide investigations by governmental agencies, various healthcare organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and potential exclusion from the Medicare and Medicaid programs.

In addition, an increasing number of the operations and practices of not-for-profit healthcare providers has been challenged or questioned to determine if they are consistent with the regulatory requirements for nonprofit tax-exempt organizations. These challenges are broader than concerns about compliance with federal and state statutes and regulations of core business practices of the health care organizations. The laws and regulations regarding these practices are also subject to interpretation and challenge. Areas that have come under examination have included pricing practices, billing and collection practices, charity care, community benefit, executive compensation, exemption of property from real property taxation and others. Northwestern Memorial expects that the level of review and audit to which it and other health care providers are subject will increase. There can be no assurance that regulatory authorities will not challenge Northwestern Memorial's compliance with these laws and regulations or that the laws and

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regulations themselves will not be subject to challenge, and it is not possible to determine the impact, if any, such claims, penalties or challenges would have on Northwestern Memorial.

Northwestern Memorial is aware of, has investigated, and made disclosure to the United States Department of Health and Human Services Office for Civil Rights (OCR) certain privacy breaches. OCR has requested information for these breaches. NMHC has responded to OCR's requests for information with respect to one breach related to the theft of a password-protected, unencrypted laptop that contained patient identifiable health information. OCR has also requested information on a separate matter relating to whether a NMHC affiliate had a Business Associate Agreement with a vendor that has been implicated in privacy breaches not involving NMHC records. OCR has been taking a more aggressive enforcement position relating to similar privacy matters by comparable health care organizations, including multiple seven-figure settlements against the disclosing party. NMHC is unable to determine which, if any, fines might be imposed by OCR or other actions that might be taken as result of any privacy breaches or OCR investigations.

Litigation

Northwestern Memorial is a defendant in various other lawsuits arising in the ordinary course of business. Although the outcome of these lawsuits cannot be predicted with certainty, management believes the ultimate disposition of such matters will not have a material effect on Northwestern Memorial's financial condition or operations.

In March 2016, a settlement was reached with various vendors and insurance companies over costs incurred and to be incurred to remediate certain facility issues. Costs incurred related to these issues have been expensed as incurred in operating expenses. The settlement amount of \$50,000 is recorded in Rental and other revenue in the condensed consolidated statements of operations and changes in net assets for the three months ended May 31, 2016 and the year ended August 31, 2016.

14. Centegra Letter of Intent

In April 2016, NMHC and Centegra Health System (Centegra) executed a non-binding letter of intent that provides for a period of exclusive discussions regarding a potential affiliation between NMHC and Centegra. NMHC cannot predict whether these discussions will result in an agreement between the two organizations. Any definitive agreement would be subject to both parties' governing bodies and applicable regulatory approvals.

15. Subsequent Events

Northwestern Memorial evaluated events and transactions occurring subsequent to February 28, 2017 through April 14, 2017, the date of issuance of these financial statements. There were no recognized subsequent events and no unrecognized subsequent events requiring disclosure.