Strategic Report for Tenet Healthcare

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Executive Summary

Throughout its history, Tenet Healthcare has been burdened by legal troubles that have clouded otherwise solid fundamentals. Tenet is currently the second largest publicly traded hospital company in the United States, owning and operating 69 acute care hospitals and related healthcare facilities serving urban and rural communities in 13 states. The industry to which Tenet belongs is defined as for-profit operators of acute care hospitals. Composed predominantly of small independent hospitals, the acute care industry is characterized by intense competition in both price and quality of healthcare services. As healthcare is not a service that varies significantly from hospital to hospital, reputation plays a major role in generating hospital admissions.

Macroeconomic factors have had a negative effect on the hospital industry as a whole in recent years. Lingering effects of the economic downturn in 2001 and 2002 have dampened demand for healthcare services and reduced the profitability of those services. Predominant among these factors are an increase in the number of uninsured and self-pay patients and a decline in the number of employer-sponsored healthcare plans. Tenet's legal issues have compounded its financial difficulties as the company's damaged reputation has contributed to a decline in market share and a sharp fall in its share price.

To address these problems, the company has brought in a new management team and divested unprofitable hospitals. Tenet is narrowing the focus of its resources and is working diligently to settle its legal disputes.

In this report, Pandora Group focuses attention on the macroeconomic factors afflicting the Managed Healthcare Industry and considers its economic outlook. We also address Tenet's company-specific problems.

Pandora Group believes the business of for-profit operators of acute care hospitals is economically inefficient. With a cost structure unaided by economies of scale and with close substitutes for its services, Tenet would best serve its shareholders by leaving the industry. As it is unlikely management would take such a step, we alternatively suggest that Tenet seek to invest in specialty hospitals in regions where the company is not currently operating.

It is Pandora Group's firm belief that the primary factor driving Tenet's current decline in share price is its legal troubles. As such, the company must work to settle its cases in a timely manner to quell uncertainty regarding the economic impact of potential

settlements. With a new management team in place, the company must increase oversight of its medical staff and allow for more transparency in its accounting methods to see that highly questionable practices are not repeated. To further efforts to restore its reputation, we also recommend Tenet pursue a public ad campaign and publish a code of ethics to help portray the company as a community leader.

Company Background

Headquartered in Dallas, Tenet Healthcare Corporation operates in one line of business – the provision of health care services, primarily through the operation of general hospitals and related health care facilities. All of Tenet's operations are conducted through its subsidiaries. As the second largest publicly traded hospital company in the United States, the company owns and operates 69 general hospitals, serving primarily urban communities in 13 states. They offer a variety of services including acute care, operating and recovery rooms, radiology, and intensive care.

Tenet and its subsidiaries also own or lease various health related facilities, including two rehabilitation hospitals, one specialty hospital, four skilled nursing facilities and 85 medical office buildings (at December 31, 2004), each of which is located near one of the general hospitals. Tenet's subsidiaries also own or lease physician practices, captive

insurance companies and various other health care businesses, including outpatient surgery centers, and occupational and rural health care clinics.

Recent legal and financial troubles that have seen Tenet shares fall from over $50 a share in late 2002 to $8 a share today are just the latest in a series of scandals over the past decade. Tenet, formerly known as National Medical Enterprises, was originally based in Santa Barbara. The company changed its name in 1995, following a series of scandals just a few years earlier. Its problems began in the early 1990's, when the firm was accused of holding some patients in its psychiatric hospitals against their will and treating them until their insurance benefits ran out.[i] More than 100 patients sued the company, as did several insurers. In 1993, federal agents raided company offices in 17 states as part of the investigation. No charges were filed, however, and NME eventually settled lawsuits involving the claims. In 1994, the company pled guilty to seven federal charges of paying kickbacks and bribes to doctors for referrals and was fined $382.7 million. By the time Tenet settled its lawsuits, sold its psychiatric hospitals and refocused on acute care hospitals, the company's founders had all either resigned or been forced out, as had several top executives.

This left Jeffrey Barbakow, who joined Tenet's board in 1990 and became chief executive in 1993, in charge of engineering the company's return to prominence in the late 1990's. For six years, the company grew, buying hospitals around the country. Tenet went from a $425 million loss in 1994 to a $302 million profit in 2000 and was applauded by Wall Street for its strong recovery.

However, in late 2002, the company's shares began to precipitously tumble amid new claims of doctor misdeeds and insurance fraud. Allegations surfaced that two physicians at a hospital in Redding performed hundreds of unnecessary heart surgeries, and that physicians at a hospital in San Diego paid to recruit patients. The hospitals were raided and the doctors investigated with regard to these events. The company itself also faced a federal probe into whether its aggressive pricing policies improperly triggered supplementary Medicare payments for care. The Justice Department ultimately sued Tenet for $323 million for allegedly overbilling Medicare to inflate its revenues from 1992 to 1998. Barbakow took responsibility for the firm's diminished credibility in the marketplace, contending he should have inspected more closely when company profits began to grow so unexpectedly.

Facing large settlements and declining profitability, Tenet began to scale back its operations, selling a number of hospitals in several states. This divestiture reduced Tenet's holdings from roughly 100 hospitals to a core group of 69. From March 2003 to February 2004, Tenet organized its general hospitals and related healthcare facilities into two divisions with five underlying regions. In February 2004, it began streamlining its operational structure by eliminating the two divisions and having the five regions report directly to the firm's newly appointed chief operating officer. In July 2004, Tenet further consolidated from five to four operating regions, which include California; Central Northeast-Southern States; Florida-Alabama; and Texas-Gulf Coast, all of which report to the COO. The core group of 69 hospitals remaining after the consolidations and divestitures generated 96% of Tenet's operating revenues for all periods presented its consolidated financial statements.[ii]

In early 2006, Tenet announced it will have to restate financial results over a 5-year period, the result of an internal investigation by the SEC. As part of this restatement, the company is expected to add approximately $22 million to its fiscal 2000 results and $17 million to its 2001 results. Net income will be $15 million lower than previously stated in fiscal 2002 and the restatement will widen the 2003 net loss by an additional $55 million. Fiscal 2004 results will be restated to take an income charge of $47 million.[iii]

Competitive Analysis

Tenet Healthcare Corporation provides health care services, primarily through the operation of general hospitals and related health care facilities. Though the company also owns other facilities including a specialty hospital and several skilled nursing facilities, such facilities are also operated by its competitors and do not account for a major portion of Tenet's revenues. As such, our analysis will focus primarily on for-profit hospital systems, not including psychiatric hospitals. Tenet's competitors include HCA, Health Management Associates, Community Health Systems, Lifepoint Hospitals, Triad Hospitals, and Universal Health Services. A geographic market definition is not useful here, as these firms operate nationwide. Key operating statistics from these companies are included below.[iv]

Table 1

KEY OPERATING STATISTICS OF FOR-PROFIT HOSPITAL SYSTEMS
(Quarter ended June 30, 2004, except as noted)

	HCA INC.	HEALTH MANAGEMENT ASSOCIATES	COMMUNITY HEALTH SYSTEMS	LIFEPOINT HOSPITALS	TENET* HEALTHCARE	TRIAD HOSPITALS	UNIVERSAL† HEALTH SERVICES	AVERAGE
Number of hospitals	183‡	57	67	48	69	47	24	71
Licensed beds	42,013	8,310	7,575	5,051	17,897	8,112	5,552	13,501
Average length of stay (days)	4.9	4.5	4.1	4.1	5.1	4.7	4.5	4.6
Total admissions								
(% chg. from previous year)	(0.7)	10.7	8.8	78.3	(0.8)	1.0	3.9	14.5
Same-store comparison								
(% chg. from previous year)								
Admissions	(0.3)	2.3	0.3	3.2	(1.4)	1.7	2.6	1.2
Revenues per admission	3.1	5.1	9.3	6.1	(2.5)	5.8	3.9	4.4
As % of revenues								
Salaries and benefits	40.6	38.1	39.7	40.0	46.0	41.5	41.2	41.0
Supplies	17.2	15.5	12.0	13.0	18.5	16.7	12.7	15.1
Bad debt	8.9	11.3	10.0	8.8	6.3	7.7	9.6	8.9
Outpatient services	37.5	49.8	48.4	50.8	29.8	54.0	28.1	42.6
Consolidated EBITDA margin (%)	18.1	17.6	15.3	22.3	6.9	14.4	11.2	15.1

EBITDA-Earnings before interest, taxes, depreciation, and amortization. *Inpatient only. †Acute care hospitals only. ‡Excludes ambulatory surgical centers, and 7 joint-venture facilities.
Source: Company reports.

Internal Rivalry

The For-Profit Managed Healthcare Industry is one characterized by very strong competition. Though hospitals today increasingly belong to chains, the vast majority of hospitals are small and independently owned. It is not clear that market share is important to profitability in the industry as there do not appear to be significant economies of scale in the operation of hospitals. Nevertheless, this is a very competitive industry with large operators fighting for market share. Due to the nature of the service provided, each individual hospital, whether it belongs to a chain or not, faces competition from other local hospitals. Though price elasticities of demand have increased as insurance companies have increasingly steered patients to the lowest-priced hospitals, medical care is still a needed service. Patients generally use those hospitals closest to them unless prevented by their insurance provider.

While firms in the industry compete fiercely with each other, players have become increasingly focused on challenges posed by external economic factors on the industry in recent years. Demand and profitability in the nation's hospital industry have been affected by several variables outside the direct control of the participating firms. Lingering effects of the U.S. economic downturn in 2001 and 2002 have hurt volume and profit for the industry in recent years.[v] Though overall profit margins have risen recently, the industry is still troubled by sluggish volume from lower admittance, rising co-payments and deductibles, and a rising proportion of self-pay and uninsured patients, whose accounts are relatively more difficult to collect than those of the insured. At the end of 2004, the U.S. Census Bureau estimated the uninsured population in the United States at approximately 15.7% of the population, the highest ever and more than 15% above the same measure in 2000.

There are two primary factors that may likely affect the growth rate of the uninsured population moving forward. Continued job growth is important in slowing increases in the uninsured population and may also curtail the recent rise in self-pay revenue.[vi] Self-pay revenue is revenue the hospital earns that patients must pay themselves rather than being covered by insurance; this includes deductibles and co-payments made by

insured patients as well as remittances by uninsured patients. The unemployment rate has fallen from 6.0% to 5.5% to 5.0% at the end of 2003, 2004, and 2005 respectively. Standard & Poor's claims that lower unemployment rates and rising payrolls will positively affect bad debt expense (recorded revenues that are never realized) for hospital operators in 2006.

Though employment and payrolls have strengthened in recent years, a comparably powerful factor that has negatively affected the rise of the uninsured and hospital profitability is the decline in employer-sponsored health plans. A continued rise in insurance premiums is forcing many employers, especially smaller businesses, to scale back or drop health coverage for their employees. Despite this negative trend, lower unemployment rates combined with a growing senior population may be able to sustain demand for hospital services in the near future. An important question is the profitability of the care that stems from that demand.

Entry

For a firm seeking to enter the managed healthcare industry, there are several barriers to opening a new hospital. Hospitals are capital intensive, making it very expensive to enter the industry with one facility, let alone develop a chain. Additionally, a new hospital would need to establish an identity for itself, to attract both doctors (whose

reputations are reflected in that of the hospital and vice versa) and patients (who may be unwilling to trust their health to an unknown entity). A new hospital would also need access to the medical staff that admits and cares for patients, which may be difficult to come by in a tight market for nurses. Even then, the firm may have difficulty finding a favorable location, as existing companies would tend to already occupy those large, convenient locations.

Barriers to entry are large, but not overwhelming. Though analysts do not generally expect the state of the industry to change much in the next few years, given there is no short-term solution to the continued growth in the uninsured population, the industry does have room for growth with the constant demand for hospital services. Innovations in medicine have made it possible to specialize and open smaller, cost-competitive inpatient facilities (known as specialty hospitals) that focus on specific treatments such as heart or orthopedic surgery or burn treatment. Such hospitals would not require the same level of capital or physicians for successful entry. These specialty hospitals, which may be a significant source of competition for general hospitals in the next few years, are discussed more below.

Substitutes and Compliments

Specialty hospitals, while not new, have been growing in number and popularity. They present traditional acute care providers, such as Tenet, with a strong competitive challenge. Such hospitals include heart, orthopedic, cancer, and surgical hospitals, as well as ambulatory surgery centers, or ASC's. The building of new specialty hospitals had been suspended in early 2004 under an 18-month moratorium placed by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), but has restarted since the MMA expired in early 2006.

Critics of specialty hospitals, which include the American Hospital Association (AHA), argue that they are bad for both the managed healthcare industry and for consumers. These hospitals specialize in and focus on procedures that are more profitable, and they tend to serve only patients with the best insurance coverage, leaving the less lucrative services and patients to the general acute care hospitals. According to the AHA, this trend will have severe consequences for the nation's healthcare system. By undermining overall industry support for these less profitable services, access to such services for all patients becomes more limited. Additionally, because the procedures they focus on are more profitable, specialty hospitals draw specialty physicians and their support staff from general acute care hospitals, compounding the preexisting labor shortage problems in those hospitals and jeopardizing critical care. Finally, as many

physicians have some financial stake, possibly ownership interest, in these smaller specialty hospitals, they have an incentive to refer their patients to these facilities. Supporting their position, the AHA notes that Medicare patients of physicians who referred them to specialty centers where the physician had some financial interest received 34% more laboratory services than patients in the general Medicare population, though this may or may not be suggestive of the possible overuse of services that the AHA claims. These patients also received imaging exams more than four times more often and received 40-45% more physical therapy.

Supporters of specialty hospitals argue that these hospitals are able to provide higher quality care and in a more efficient manner through their specialization. In a study released in April 2005, for example, the Federated Ambulatory Surgery Association, a group representing ambulatory surgery centers, found that the ASC's Medicare claims averaged $320 less than outpatient departments of general hospitals for similar procedures. This would have saved Medicare $1.5 billion in 2005.

Congress and the Centers for Medicare and Medicaid Services (CMS) are currently studying the industry effects of specialty hospitals and are examining loopholes in existing laws concerned with physicians holding ownership interests in hospitals.

Though it is too early to determine the outcome of the government studies, Standard & Poor's believes that the government is likely to encourage competition within the healthcare industry, particularly as healthcare costs continue to rise. This would make life more difficult for Tenet and other acute care hospital firms, giving them an additional competitive challenge.

Supplier Power

Primary suppliers to hospitals include labor (nurses, lab technicians, etc.), medical equipment companies, and drug manufacturers. Also included are hospital-based doctors such as radiologists, anesthesiologists, and pathologists (RAP physicians).[vii] Admitting physicians will be considered buyers rather than suppliers as they help determine which hospitals patients will purchase services from.

These suppliers all have some indirect power, but not enough so to take the upper hand in the buyer-seller relationship. Nurses have been in relatively short supply in recent years, driving up their wages. The prices of drugs and other medical supplies have also risen in recent years, though this trend may be discontinued from pricing pressure being considered by Congress regarding the import of less expensive drugs from abroad. As both hospitals and their suppliers make few relationship-specific investments, neither party can significantly affect the transaction costs of the other.

Aside from a degree of human asset specificity, there is little preventing hospitals from abandoning their current relationships with suppliers to form new ones through the market.

Hospital personnel learn to work in teams, but seem to adjust quickly to new work settings and thus can usually be replaced at the market wage. Some hospitals routinely use nursing pools and make use of on-call doctors to handle short-term needs. Hospitals are constantly recruiting doctors, making RAP physicians relatively easy to replace by use of the national recruiting market. As no firm in the medical supplies industry has monopoly power, medical suppliers cannot credibly threaten to hold up hospitals to obtain higher prices for their products. Though the markets for some drugs are somewhat narrow, generic drugs have become increasingly popular over the years and have challenged pricing of pharmaceutical companies. In the absence of strong union movement from RAP physicians or new drug legislation passed by Congress, the magnitude of supplier power does not look to change much over time.

Buyer Power

Buyers include patients, the physicians who refer those patients, and insurers, who collectively decide how hospitals will be paid and which will receive business. Patients and their physicians have not wielded purchase power in the past and generally do not

today.[viii] There are exceptions however, particularly those highly skilled and charismatic doctors who can attract patients regardless of where they practice. Such doctors may cause hospitals to engage in bidding wars with the result of driving up their wages and extracting a significant percentage of the profits their services generate from the winning hospitals. Such physicians are not common, however, and their buyer power does not affect hospitals on a national scale.

Insurers, who had little buyer power 20 years ago, wield substantial buyer power today. These powerful insurers include private health providers such as Blue Shield and United Healthcare as well as the two major government insurers, Medicare (which insures the elderly and disabled) and Medicaid (which insures the poor). These providers use their size to negotiate significant price discounts with hospitals. Medicare has forced all hospitals to accept fixed-price contracts, so that hospitals must bear the risks of excessive treatment costs. Furthermore, the size of Medicare and Medicaid payments are directly affected by Congressional budget decisions, which have tended to reduce payments in recent years. Whatever the political climate may be, the Managed Healthcare industry is one with strong buyer power.

Recent Financial Performance

Over the past few years, Tenet Healthcare's economic health has been slowly deteriorating. A number of indicators have been on the decline as Tenet faces both internal and external challenges. Internally, the company has been host to several investigations by the Department of Justice and the Securities and Exchange Commission regarding highly questionable medical and pricing/billing strategies. As a result of these investigations, a handful of key managers have been replaced including Tenet's former CEO, Jeffrey Barbakow. Externally, rising healthcare costs to consumers have dampened demand for managed healthcare and resulted in lower admittance levels for Tenet and other hospitals. Demand is also lower from lingering effects of the decline in the U.S. economy in 2001 and 2002.

The following table of activity ratios reflects the manner in which Tenet has used its assets from 2002 through 2005. We first note the improvement in receivables turnover and associated increase in the average number of days receivables are outstanding.

Table 2

Activity Ratios	2002	2003	2004	2005
Receivables Turnover (Times)	2.33	4.02	4.82	5.98
Days Receivables Outstanding (Days)	156.46	90.87	75.65	61.07
Total Asset Turnover (Times)	0.43	0.77	0.89	0.97

The changes in these two measures suggest that management is using the company's assets more efficiently. The same trend is visible in the total asset turnover ratio as well. The improvement in the receivables ratios likely reflects Tenet's divestiture of its less profitable hospitals. The company announced its intention to divest 27 general hospitals in January 2004 and as of December 31, 2005 had successfully divested 25 of the 27 facilities. This decision was reached after an announcement in March 2003 that only 14 such hospitals would be divested. The remaining 69 hospital core on which Tenet plans to focus its financial management and resources generated more than 96% of the company's net operating revenues over the 2002-2005 time period.[ix]

Like other hospital operators, Tenet utilizes large amounts of debt in its financing. The following table presents several measures of the company's solvency:

Table 3

Solvency Ratios	2002	2003	2004	2005
Debt to Equity	0.67	0.94	2.67	4.83
Assets to Equity	2.38	2.54	3.68	7.31
Debt to Total Capital	40%	48%	73%	83%
Times Interest Earned (Times)	6.00	-3.74	-3.87	-0.53

Capital Expenditure Ratio (Times)	2.55	0.85	0.58	1.24

It is clear by the first four measures that Tenet has been steadily increasing its level of debt since 2002 in accordance with its financing needs. Ryan Beck & Co. find the average (cap weighted) level of debt to capital in the Managed Healthcare Industry to be approximately 58% in 2004, compared to Tenet's 73% debt to capital for the same year.[x]

Tenet currently faces numerous temporary expenses that have increased the firm's need for cash, while suffering from lower levels of admittance and a less aggressive pricing strategy. With many holdings in the Gulf region, Tenet took a large hit from Hurricanes Katrina and Wilma in late 2005. Though the cost to repair or construct new facilities in the region has not been fully determined and is partially covered by insurance, borrowings will likely be needed to make the necessary repairs. The company has also accumulated hundreds of millions of dollars in fees and settlements in its numerous legal proceedings.[xi] Tenet emphasizes that its existing unrestricted cash and cash equivalents on hand, future cash flows form operations, and other borrowings (depending on capital market conditions) should be adequate to meet its interest obligations, finance planned capital expenditures, and other presently known operating

needs. However, management concedes that, given its rising level of debt, its cash needs and ability to satisfy those needs could be materially affected by a continued deterioration in the firm's results of operations and legal proceedings.

With its rising leverage ratios, the losses on operations Tenet endured from 2003 to 2005 were magnified to produce highly negative returns on equity. In 2002, Tenet Healthcare offered investors a respectable 7.35% after-tax ROE.

Table 4

Profitability Ratios	2002	2003	2004	2005
Gross Margin	27.13%	20.73%	16.56%	13.20%
Operating Margin	15.31%	-11.00%	-13.32%	-3.73%
Profit Margin	7.13%	-11.14%	-19.27%	-6.46%
Pretax ROA	6.20%	-8.40%	-11.53%	-2.17%
Pretax ROE	12.28%	-27.07%	-53.45%	-52.06%
After-tax ROE	7.35%	-21.75%	-62.87%	-45.66%

Note: Measures of net income used for calculating these ratios exclude income from discontinued operations as they do not affect the company's cash flows moving forward

However, the previously discussed macroeconomic factors have contributed to the company's eroding operating and profit margins. While its peers have struggled with many of the same external economic and political factors Tenet has, the company's legal

troubles have brought additional problems. In addition to the settlement costs and lawyers' fees the company is straddled with, Tenet holds a damaged reputation in the eyes of many physicians who admit patients to its hospitals. Given the level of competition in the industry and the availability of substitutes, this weakened relationship with doctors has caused Tenet to lose many patients and market share to competitors. The company did show some improvement in its ratios in 2005, suggesting that the new management team may keep its promise of restoring demand for Tenet services both among doctors and patients.

The table below applies a three-component DuPont analysis to Tenet's return on equity.

Table 4

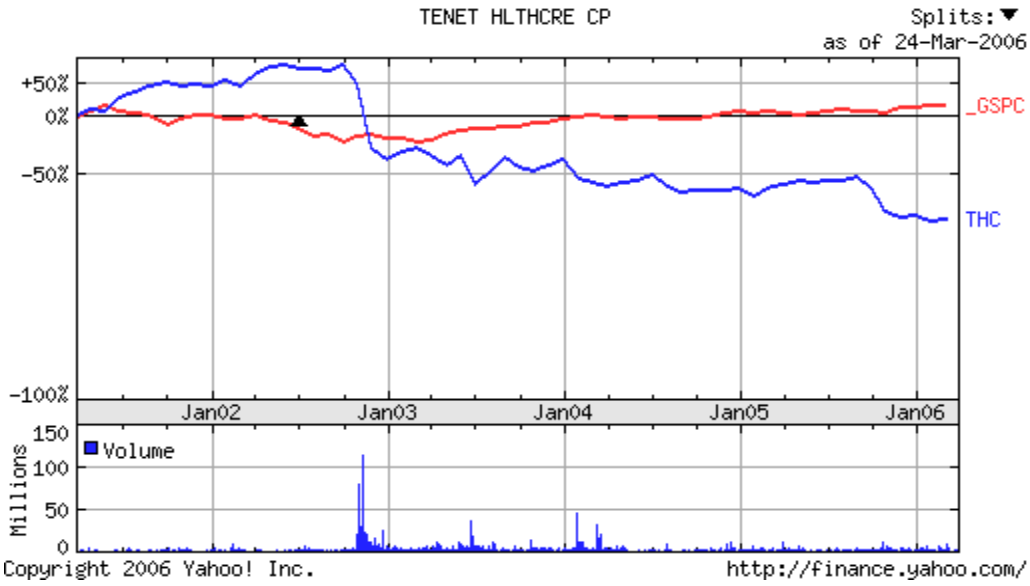
DuPont Analysis	2002	2003	2004	2005
Profit Margin	7.13%	-11.14%	-19.27%	-6.46%
Total Asset Turnover (Times)	0.43	0.77	0.89	0.97
Assets to Equity	2.38	2.54	3.68	7.31
After-Tax ROE	7.35%	-21.75%	-62.87%	-45.66%

ROE = Net Income/ Sales x Sales/Avg. Total Assets x Avg Total Assets/Avg. Common Equity

From this table, it appears that Tenet's difficulties lie with its profit margins. As Tenet becomes more highly leveraged with its growing levels of debt, a potential cause for

concern among investors, these negative profit margins are magnified to produce very poor after-tax ROE.

The company's economic health during this 4-year span is reflected in the fluctuations of its share price, illustrated below:



For the greater part of 2002, Tenet outperformed the market. However, amid investigations into questionable physician conduct and suspect billing and pricing strategies, worries arose that Tenet had yet to clean up its act. The stock share price began a sharp freefall in late 2002 that saw 50% gains evaporate into losses of greater than 50% in less than one year. As the company's reputation was damaged and external economic factors took their toll on the hospital industry as a whole, the stock continued to gradually decline to its current level of $8.71/share (as of April 12, 2006).

Problems and Solutions

As a healthcare provider, there is little Tenet can do with regard to the aforementioned macroeconomic challenges other than to endure them until they fade. One factor that may lessen these challenges as the economy improves is continued job growth. Job growth is important in reducing the proportion of the population that is uninsured and may stimulate growth in employee health plans. The decline in employer-sponsored health plans due to higher premiums in recent years has been a significant cause of the rise in the uninsured population and in the growth of self-pay revenue as well. Standard & Poor's claims that the trend will continue in 2006, partially offsetting the benefits of lower unemployment rates and rising payrolls.[xii] Additionally, job growth may contribute to the supply of nurses, a source of rising costs for Tenet in recent years. Favorable demographics, which include a growing senior population thanks to aging baby boomers, may also stimulate demand for hospital services.

Regardless of the macroeconomic factors troubling Tenet, the company's strategy for the near future should nevertheless be the same. It is important that Tenet take back some of the market share it has lost to competitors in recent years, as well as improving its profitability. Tenet has taken a step in the right direction by divesting its

unprofitable hospitals rather than continuing to divert valuable resources to operate them. But, there are two things Tenet must do to increase its admittance levels. The company should lower its prices to more competitive levels, giving self-pay patients and those who have not met their deductibles a greater incentive to choose Tenet. Tenet should also offer doctors greater fees as a percentage of revenue generated to induce them to admit more patients to Tenet hospitals than those of its competitors.

Pandora group believes that once Tenet has restored confidence in its business, the company should shift its focus to specialty hospitals. Specialty hospitals are able to provide higher quality care than acute care hospitals and in a more efficient manner through their specialization. Specialty hospitals also do not face the same level of competition from nonprofit hospitals, a source of strong competitive pressure for Tenet and other for-profit acute care hospital operators. The higher quality care and focus on more profitable, complex procedures at specialty hospitals make nonprofit hospitals a less close substitute. To avoid cannibalizing its general hospitals, Tenet must look to acquire or build specialty hospitals in regions it does not currently operate. The company should gradually divest more of its less profitable acute care hospitals and shift its business focus to specialty hospitals.

It is Pandora's firm belief that the most significant problem at Tenet is the poor reputation it has acquired in the eyes of doctors and investors. Tenet's legal troubles make patients less likely to choose its services over those of a comparable local hospital and doctors less likely to admit patients to its hospitals. This in turn leads to lower bed occupancy and lower profitability for the company on a hospital-by-hospital basis. More than anything else, Tenet needs time to show it has cleaned up its act. The company has replaced its management team and refocused its resources on its 69 core hospitals. It is now in a position to rebuild its reputation within the medical community and trust with investors.

An important step to convincing investors the company's troubles are in the past is to resolve legal troubles. The sooner Tenet can reach settlement on the various lawsuits and investigations it is playing host to, the sooner the economic costs to the company will become known and the investor uncertainty can die down. Tenet should also restore its reputation through a public ad campaign that includes a code of ethics. Lastly, to ensure that the company continues to operate legitimately, it is important that Tenet increases oversight of its physicians' operations. Administrators at individual hospitals must be held more accountable for the actions of their hospitals' physicians.

We believe these actions will collectively enable Tenet to restore and maintain confidence among doctors and investors.

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