

SUNLINK HEALTH SYSTEMS INC  
Form 10-Q  
February 18, 2015

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended December 31, 2014**

**OR**

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

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

**Commission File Number 1-12607**

**SUNLINK HEALTH SYSTEMS, INC.**

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

**Ohio** **31-0621189**  
**(State or other jurisdiction of** **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**900 Circle 75 Parkway, Suite 1120, Atlanta, Georgia 30339**  
**(Address of principal executive offices) (Zip Code)**  
**(770) 933-7000**  
**(Registrant's telephone number, including area code)**

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of Common Shares, without par value, outstanding as of February 17, 2015 was 9,443,408.

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

|  | <b>December 31,<br/>2014<br/>(unaudited)</b> | <b>June 30,<br/>2014</b> |
|--|--|--------------------------|
| <b>ASSETS</b>                              |  |                          |
| Current Assets:                            |  |                          |
| Cash and cash equivalents                  | \$ 3,971                                     | \$ 3,587                 |
| Receivables net                            | 11,115                                       | 9,850                    |
| Inventory                                  | 4,047  | 3,757                    |
| Deferred income tax asset                  | 2,319  | 2,978                    |
| Due from third party payors                | 2,672  | 2,786                    |
| Current assets held for sale               | 0  | 270                      |
| Prepaid expense and other assets           | 3,536  | 2,547                    |
| Total current assets                       | 27,660                                       | 25,775                   |
| Property, plant and equipment, at cost     | 54,307                                       | 53,466                   |
| Less accumulated depreciation              | 31,484                                       | 30,389                   |
| Property, plant and equipment net          | 22,823                                       | 23,077                   |
| Noncurrent Assets:                         |  |                          |
| Intangible assets net                      | 2,908  | 2,979                    |
| Goodwill                                   | 461  | 461                      |
| Deferred income tax asset                  | 4,436  | 4,432                    |
| Noncurrent assets held for sale            | 0  | 6,111                    |
| Other noncurrent assets                    | 1,550  | 1,012                    |
| Total noncurrent assets                    | 9,355  | 14,995                   |
| <b>TOTAL ASSETS</b>                        | <b>\$ 59,838</b>                             | <b>\$ 63,847</b>         |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b> |  |                          |
| Current liabilities:                       |  |                          |
| Accounts payable                           | \$ 5,433                                     | \$ 4,530                 |
| Current maturities of long-term debt       | 866  | 561                      |
| Accrued payroll and related taxes          | 4,097  | 4,186                    |
| Income tax payable                         | 139  | 73                       |
| Current liabilities held for sale          | 0  | 4,842                    |
| Other accrued expenses                     | 2,072  | 2,314                    |

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|  |                  |                  |
|--|------------------|------------------|
| Total current liabilities  | 12,607           | 16,506           |
| <b>Long-Term Liabilities</b>   |                  |                  |
| Long-term debt   | 11,579           | 11,948           |
| Noncurrent liability for professional liability risks                          | 964              | 1,268            |
| Other noncurrent liabilities   | 786              | 807              |
| <b>Total long-term liabilities</b>   | <b>13,329</b>    | <b>14,023</b>    |
| <b>Commitment and Contingencies</b>  |                  |                  |
| <b>Shareholders' Equity</b>  |                  |                  |
| Preferred Shares, authorized and unissued, 2,000 shares                        | 0                | 0                |
| <b>Common Shares, without par value:</b>                                       |                  |                  |
| Issued and outstanding, 9,444 shares at December 31, 2014 and at June 30, 2014 | 4,722            | 4,722            |
| Additional paid-in capital   | 13,464           | 13,444           |
| Retained earnings  | 16,050           | 15,486           |
| Accumulated other comprehensive loss   | (334)            | (334)            |
| <b>Total Shareholders' Equity</b>  | <b>33,902</b>    | <b>33,318</b>    |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                              | <b>\$ 59,838</b> | <b>\$ 63,847</b> |

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

(in thousands, except per share amounts)

(unaudited)

|  | <b>Three Months</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------|-------------|-------------------------|-------------|
|  | <b>Ended</b>        |             | <b>December 31,</b>     |             |
|  | <b>December 31,</b> | <b>2013</b> | <b>2014</b>             | <b>2013</b> |
|  | <b>2014</b>         | <b>2013</b> | <b>2014</b>             | <b>2013</b> |
| Operating revenues (net of contractual allowances)             | \$ 25,108           | \$ 26,111   | \$ 49,717               | \$ 50,197   |
| Less provision for bad debts of Healthcare Facilities Segment  | 1,982               | 2,231       | 4,215                   | 4,288       |
| Net revenues   | 23,126              | 23,880      | 45,502                  | 45,909      |
| Costs and Expenses   |                     |             |                         |             |
| Cost of goods sold   | 5,456               | 6,485       | 10,072                  | 10,760      |
| Salaries, wages and benefits                                   | 10,589              | 10,722      | 21,406                  | 21,514      |
| Provision for bad debts of Specialty Pharmacy Segment          | 123                 | 42          | 123                     | 95          |
| Supplies   | 2,034               | 2,054       | 4,140                   | 3,982       |
| Purchased services   | 1,025               | 1,350       | 2,202                   | 2,595       |
| Other operating expenses                                       | 1,968               | 3,030       | 4,340                   | 5,973       |
| Rent and lease expense   | 329                 | 358         | 677                     | 713         |
| Insurance settlement   | (1,000)             | 0           | (1,000)                 | 0           |
| EHR incentive payments   | 0                   | (1,215)     | 0                       | (1,215)     |
| Depreciation and amortization                                  | 580                 | 763         | 1,215                   | 1,537       |
| Operating Profit (Loss)  | 2,022               | 291         | 2,327                   | (45)        |
| Other Expense:   |                     |             |                         |             |
| Interest expense net   | (234)               | (238)       | (464)                   | (480)       |
| Earnings (Loss) from Continuing Operations before income taxes | 1,788               | 53          | 1,863                   | (525)       |
| Income Tax Expense (Benefit)                                   | 799                 | (297)       | 985                     | (95)        |
| Earnings (Loss) from Continuing Operations                     | 989                 | 350         | 878                     | (430)       |
| Loss from Discontinued Operations, net of tax                  | (12)                | (123)       | (314)                   | (501)       |
| Net Earnings (Loss)  | 977                 | 227         | 564                     | (931)       |
| Other comprehensive income                                     | 0                   | 0           | 0                       | 0           |
| Comprehensive Earnings (Loss)                                  | \$ 977              | \$ 227      | \$ 564                  | \$ (931)    |
| Earnings (Loss) Per Share:                                     |                     |             |                         |             |
| Continuing Operations:   |                     |             |                         |             |
| Basic  | \$ 0.10             | \$ 0.04     | \$ 0.09                 | \$ (0.05)   |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Diluted  | \$ 0.10   | \$ 0.04   | \$ 0.09   | \$ (0.05) |
| <b>Discontinued Operations:</b>                    |           |           |           |           |
| Basic  | \$ (0.00) | \$ (0.01) | \$ (0.03) | \$ (0.05) |
| Diluted  | \$ (0.00) | \$ (0.01) | \$ (0.03) | \$ (0.05) |
| <b>Net Earnings (Loss):</b>                        |           |           |           |           |
| Basic  | \$ 0.10   | \$ 0.02   | \$ 0.06   | \$ (0.10) |
| Diluted  | \$ 0.10   | \$ 0.02   | \$ 0.06   | \$ (0.10) |
| <b>Weighted-Average Common Shares Outstanding:</b> |           |           |           |           |
| Basic  | 9,443     | 9,443     | 9,443     | 9,443     |
| Diluted  | 9,497     | 9,446     | 9,478     | 9,443     |

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

(in thousands)

(unaudited)

|  | <b>Six Months Ended</b> |             |
|--|-------------------------|-------------|
|  | <b>December 31,</b>     |             |
|  | <b>2014</b>             | <b>2013</b> |
| Net Cash Provided by (Used in) Operating Activities                    | \$ (52)                 | \$ 3,545    |
| Cash Flows from Investing Activities:                                  |                         |             |
| Proceeds from sale of Fulton   | 6,090                   |             |
| Net change in cash in escrow   |                         | (160)       |
| Expenditures for property, plant and equipment continuing operations   | (737)                   | (768)       |
| Expenditures for property, plant and equipment discontinued operations | (11)                    | (83)        |
| Net Cash Provided by (Used in) Investing Activities                    | 5,342                   | (1,011)     |
| Cash Flows from Financing Activities:                                  |                         |             |
| Payments on long-term debt continuing operation                        | (239)                   | (409)       |
| Payments on long-term debt discontinued operations                     | (4,842)                 | (61)        |
| Proceeds from long-term debt   | 175                     |             |
| Net Cash Used in Financing Activities                                  | (4,906)                 | (470)       |
| Net increase in Cash and Cash Equivalents                              | 384                     | 2,064       |
| Cash and Cash Equivalents Beginning of Period                          | 3,587                   | 2,497       |
| Cash and Cash Equivalents End of Period                                | \$ 3,971                | \$ 4,561    |
| Supplement Disclosure of Cash Flow Information:                        |                         |             |
| Cash Paid (Received) for:  |                         |             |
| Interest   | \$ 562                  | \$ 575      |
| Income taxes   | \$ 29                   | \$ (1,629)  |

See notes to condensed consolidated financial statements.

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**SUNLINK HEALTH SYSTEMS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**THREE AND SIX MONTHS ENDED DECEMBER 31, 2014**

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

**(unaudited)**

**Note 1. Basis of Presentation**

The accompanying unaudited Condensed Consolidated Financial Statements as of December 31, 2014 and for the three and six month periods ended December 31, 2014 and 2013 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission ( SEC ) and, as such, do not include all information required by accounting principles generally accepted in the United States of America ( GAAP ). The condensed consolidated June 30, 2014 balance sheet included in this interim filing has been derived from the audited financial statements at that date but does not include all of the information and related notes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. ( SunLink , we , our , ours , u the Company ) Annual Report on Form 10-K for the fiscal year ended June 30, 2014, filed with the SEC on September 26, 2014. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three and six month periods ended December 31, 2014 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

**Note 2. Business Operations**

Business Operations

SunLink Health Systems, Inc., through subsidiaries, owns businesses which are providers of healthcare services in certain markets in the United States. SunLink s business is composed of the ownership of two business segments:

The Healthcare Facilities Segment is composed of three operational areas:

Three community hospital subsidiaries in two states with a total of 183 licensed beds;

Two nursing homes with a total of 166 licensed beds, each of which is located adjacent to, or in close proximity with a corresponding SunLink community hospital; and

A healthcare facility which is currently vacant except for two medical offices which are rented.

The Specialty Pharmacy Segment is composed of four operational areas:

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

Institutional pharmacy services;

Specialty pharmacy services; and

Durable medical equipment.

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

**Note 3. Discontinued Operations**

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

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

|   | Three Months Ended<br>December 31, |                 | Six Months Ended<br>December 31, |                 |
|---|------------------------------------|-----------------|----------------------------------|-----------------|
|   | 2014                               | 2013            | 2014                             | 2013            |
| <b>Net Revenues:</b>                        |                                    |                 |                                  |                 |
| Fulton Hospital                             | \$ 3,321                           | \$ 3,184        | \$ 6,730                         | \$ 6,733        |
| Dexter Hospital                             | 90                                 | 418             | 131                              | 513             |
| Memorial of Adel                            | 69                                 | 2               | 53                               | (4)             |
|   | \$ 3,480                           | \$ 3,604        | \$ 6,914                         | \$ 7,242        |
| <b>Earnings (loss) before income taxes:</b> |                                    |                 |                                  |                 |
| Fulton Hospital                             | \$ (449)                           | \$ (549)        | \$ (897)                         | \$ (1,147)      |
| Dexter Hospital                             | 532                                | 410             | 570                              | 482             |
| Memorial of Adel                            | 56                                 | (1)             | 32                               | (12)            |
| Life sciences and engineering               | (30)                               | (40)            | (64)                             | (79)            |
| <b>Earnings (Loss) before income taxes</b>  | <b>109</b>                         | <b>(180)</b>    | <b>(359)</b>                     | <b>(756)</b>    |
| <b>Loss on Sale</b>                         |                                    |                 |                                  |                 |
| Fulton Hospital                             | (191)                              |                 | (191)                            |                 |
| Loss on Sale                                | (191)                              |                 | (191)                            |                 |
| <b>Income tax expense (benefit)</b>         | <b>(70)</b>                        | <b>(57)</b>     | <b>(236)</b>                     | <b>(255)</b>    |
| <b>Loss from discontinued operations</b>    | <b>\$ (12)</b>                     | <b>\$ (123)</b> | <b>\$ (314)</b>                  | <b>\$ (501)</b> |

**Fulton Hospital** On December 31, 2014, the Company's subsidiary, HealthMont of Missouri sold substantially all the assets of its Callaway Community Hospital ( Fulton ) and related clinics in Fulton, Missouri for approximately \$6,090. Fulton's results have been reclassified as discontinued operations in our condensed consolidated financial statements as of December 31, 2014 and June 30, 2014 and for the three and six month periods ended December 31, 2014 and 2013. Fulton retained accounts receivable and certain other assets, including the right to Medicare and Medicaid incentive payments ( EHR Funds ) for meaningful use of electronic health record technology, and substantially all liabilities of the hospital as of the sale closing date. At closing, Fulton repaid the outstanding balance of its RDA Loan of \$4,745. A loss of \$191 resulted from the sale of the Fulton assets, which includes \$237 early repayment penalty resulting from the repayment of the RDA loan.

Fulton RDA Loan SunLink, Fulton and HealthMont LLC ( HLLC ), the direct parent of HOM closed on a \$5,000 Loan Agreement dated as of March 16, 2012 (the Fulton RDA Loan ) with a bank. The Fulton RDA Loan was repaid in full on December 31, 2014 concurrent with the sale of Fulton.

**Dexter Hospital** On December 31, 2012, the Company completed the sale of substantially all the assets and the leasehold interest of its subsidiary, Dexter Hospital, LLC ( Dexter ), to Southeast Health Center of Stoddard County, LLC, an indirect subsidiary of Southeast Missouri Hospital Association ( SoutheastHEALTH ). The assets of Dexter consisted of a leased 50-bed acute care hospital and related clinics, equipment, and home health services in Dexter, Missouri. Subsequent to the sale, Dexter managed the hospital and related businesses for Southeast Health Center of

Stoddard County, LLC through a transition period ended June 30, 2013. Dexter retained accounts receivable and certain other assets, including the right to Medicare and Medicaid incentive payments ( EHR Funds ) for meaningful use of electronic health record technology and substantially all liabilities of the hospital as of December 31, 2012. Dexter s operations have been classified as discontinued operations in our condensed consolidated financial statements for the three and six month periods ended December 31, 2014 and 2013.

***Memorial Hospital of Adel*** On July 2, 2012, the Company and its HealthMont of Georgia, Inc. subsidiary completed the sale of substantially all the assets of the Company s Memorial Hospital of Adel and Memorial Convalescent Center (collectively Memorial ) to the Hospital Authority of Tift County, Georgia ( Tift ) for approximately \$8,350. Memorial s operations have been classified as discontinued operations in our condensed consolidated financial statements for the three and six month periods ended December 31, 2014 and 2013.

***Life Sciences and Engineering Segment*** SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when the segment was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Pension expense

and related tax benefit or expense is reflected in the results of operations for this segment for the three and six months ended December 31, 2014 and 2013. The components of pension expense for the three and six months ended December 31, 2014 and 2013, respectively, were as follows:

|                                    | Three Months Ended<br>December 31, |       | Six Months Ended<br>December 31, |       |
|------------------------------------|------------------------------------|-------|----------------------------------|-------|
|                                    | 2014                               | 2013  | 2013                             |       |
| Interest Cost                      | \$ 16                              | \$ 15 | \$ 33                            | \$ 30 |
| Expected return on assets          | (7)                                | (7)   | (15)                             | (14)  |
| Amortization of prior service cost | 23                                 | 32    | 48                               | 63    |
| Net pension expense                | \$ 32                              | \$ 40 | \$ 66                            | \$ 79 |

SunLink contributed \$56 to the plan in the three and six months ended December 31, 2014.

#### Note 4. Shareholders Equity

##### *Stock-Based Compensation*

For the three months ended December 31, 2014 and 2013, the Company recognized \$48 and \$15, respectively, in stock based compensation for options issued to employees and directors of the Company. For the six months ended December 31, 2014 and 2013, the Company recognized \$21 and \$31, respectively, in stock based compensation for options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model. There were 90,000 and 0 share options granted under the 2005 Equity Incentive Plan during the six months ended December 31, 2014 and 2013, respectively. There were 0 and 21,000 share options granted under the 2011 Director Stock Option Plan during the six months ended December 31, 2014 and 2013, respectively.

#### Note 5. Revenue Recognition and Accounts Receivables

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

Revenues before provision for doubtful accounts by payor were as follows for the three and six months ended December 31, 2014 and 2013:

|   | <b>Three Months<br/>Ended<br/>December 31,</b> |             | <b>Six Months Ended<br/>December 31,</b> |             |
|---|--|-------------|--|-------------|
|   | <b>2014</b>                                    | <b>2013</b> | <b>2014</b>                              | <b>2013</b> |
| <b>Healthcare Facilities Segment:</b>           |  |             |  |             |
| Medicare  | \$ 6,685                                       | \$ 6,516    | \$ 13,963                                | \$ 13,623   |
| Medicaid  | 3,602  | 3,524       | 6,971                                    | 6,844       |
| Self-pay  | 2,002  | 2,453       | 3,990                                    | 4,705       |
| Managed Care & Other Insurance                  | 4,189  | 4,156       | 8,514                                    | 8,572       |
| Other   | 43   | 45          | 96                                       | 98          |
| Revenues before provision for doubtful accounts | 16,521   | 16,694      | 33,534                                   | 33,842      |
| Provision for doubtful accounts                 | (1,982)  | (2,231)     | (4,215)                                  | (4,288)     |
| Healthcare Facilities Segment Net Revenues      | 14,539   | 14,463      | 29,319                                   | 29,554      |
| Specialty Pharmacy Segment Net Revenues         | 8,430  | 9,326       | 15,884                                   | 16,168      |
| Other Revenues                                  | 157  | 91          | 299                                      | 187         |
| Total Net Revenues                              | \$ 23,126                                      | \$ 23,880   | \$ 45,502                                | \$ 45,909   |

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

Summary information for accounts receivable is as follows:

|   | <b>December 31,<br/>2014</b> | <b>June 30,<br/>2014</b> |
|---|------------------------------|--------------------------|
| Accounts receivable (net of contractual allowances) | \$ 18,394                    | \$ 16,753                |
| Less allowance for doubtful accounts                | (7,279)                      | (6,903)                  |
| Patient accounts receivable net                     | \$ 11,115                    | \$ 9,850                 |

The following is a summary of the activity in the allowance for doubtful accounts for the Healthcare Facilities Segment and the Specialty Pharmacy Segment for the three and six months ended December 31, 2014:

| <b>Three Months Ended December 31, 2014:</b>    | <b>Healthcare<br/>Facilities</b> | <b>Specialty<br/>Pharmacy</b> | <b>Total</b> |
|---|----------------------------------|-------------------------------|--------------|
| Balance at October 1, 2014                      | \$ 7,117                         | \$ 213                        | \$ 7,330     |
| Additions recognized as a reduction to revenues | 3,016                            | 80                            | 3,096        |
| Accounts written off, net of recoveries         | (3,078)                          | (69)                          | (3,147)      |

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Balance at December 31, 2014 \$ 7,055 \$ 224 \$ 7,279

|   | <b>Healthcare<br/>Facilities</b> | <b>Specialty<br/>Pharmacy</b> | <b>Total</b> |
|---|----------------------------------|-------------------------------|--------------|
| <b>Six Months Ended December 31, 2014:</b>      |                                  |                               |              |
| Balance at July 1, 2014                         | \$ 6,649                         | \$ 254                        | \$ 6,903     |
| Additions recognized as a reduction to revenues | 6,251                            | 80                            | 6,331        |
| Accounts written off, net of recoveries         | (5,845)                          | (110)                         | (5,955)      |
| Balance at December 31, 2014                    | \$ 7,055                         | \$ 224                        | \$ 7,279     |

| <b>Three Months Ended December 31, 2013:</b>    | <b>Healthcare<br/>Facilities</b> | <b>Specialty<br/>Pharmacy</b> | <b>Total</b> |
|---|----------------------------------|-------------------------------|--------------|
| Balance at October 1, 2013                      | \$ 7,317                         | \$ 482                        | \$ 7,799     |
| Additions recognized as a reduction to revenues | 2,899                            | 42                            | 2,941        |
| Accounts written off, net of recoveries         | (3,456)                          | (45)                          | (3,501)      |
| Balance at December 31, 2013                    | \$ 6,760                         | \$ 479                        | \$ 7,239     |

| <b>Six Months Ended December 31, 2013:</b>      | <b>Healthcare<br/>Facilities</b> | <b>Specialty<br/>Pharmacy</b> | <b>Total</b> |
|---|----------------------------------|-------------------------------|--------------|
| Balance at July 1, 2013                         | \$ 7,286                         | \$ 475                        | \$ 7,761     |
| Additions recognized as a reduction to revenues | 5,617                            | 95                            | 5,712        |
| Accounts written off, net of recoveries         | (6,143)                          | (91)                          | (6,234)      |
| Balance at December 31, 2013                    | \$ 6,760                         | \$ 479                        | \$ 7,239     |

Net revenues included increase (decrease) of (\$297) and \$302 for the three months ended December 31, 2014 and 2013, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included net increase (decrease) of (\$297) and \$506 for the six months ended December 31, 2014 and 2013, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

#### **Note 6. Medicare and Medicaid Electronic Health Records Incentives Deferred Gain Medicare Electronic Health Records Incentives**

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

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

For the three and six months ended December 31, 2014, the Company reported no EHR incentive payments. For the three and six months ended December 31, 2013, the Company reported a net \$1,215 gain for Medicare and Medicaid EHR incentive payments which were for successful Medicaid attestation by the three hospitals and also adjustments calculated at the time of filing Medicare cost reports for the preceding fiscal year.



**Note 7. Goodwill and Intangible Assets**

SunLink's Specialty Pharmacy Segment has goodwill and intangible assets related to its Carmichael acquisition.

Goodwill consists of the following:

|                            | <b>December 31,<br/>2014</b> | <b>June 30,<br/>2014</b> |
|----------------------------|------------------------------|--------------------------|
| Specialty Pharmacy Segment | \$ 461                       | \$ 461                   |

Intangibles consist of the following, net of amortization:

|                            | <b>December 31,<br/>2014</b> | <b>June 30,<br/>2014</b> |
|----------------------------|------------------------------|--------------------------|
| Specialty Pharmacy Segment |                              |                          |
| Trade Name                 | 2,000                        | 2,000                    |
| Customer Relationships     | 1,089                        | 1,089                    |
| Medicare License           | 769                          | 769                      |
|                            | 3,858                        | 3,858                    |
| Accumulated Amortization   | (950)                        | (879)                    |
| Total                      | \$ 2,908                     | \$ 2,979                 |

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

Amortization expense was \$36 and \$35 for both the three months ended December 31, 2014 and 2013, respectively, and \$71 and \$70 for the six months ended December 31, 2014 and 2013, respectively.

**Note 8. Long-Term Debt**

Long-term debt consisted of the following:

|                         | <b>December 31,<br/>2014</b> | <b>June 30,<br/>2014</b> |
|-------------------------|------------------------------|--------------------------|
| Trace RDA Loan          | \$ 8,405                     | \$ 8,624                 |
| SHPP RDA Loan           | 2,013                        | 2,033                    |
| Carmichael Notes        | 1,852                        | 1,852                    |
| Other                   | 175                          |                          |
| Total                   | 12,445                       | 12,509                   |
| Less current maturities | (866)                        | (561)                    |
|                         | \$ 11,579                    | \$ 11,948                |

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

The Trace RDA Loan has a term of 15 years with monthly payments of principal and interest until repaid. The Trace RDA Loan bears a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 1.5%, or (ii) 6% (6.0% at December 31, 2014). The Trace RDA Loan is collateralized by Trace's real estate and equipment and is partially guaranteed under the U.S. Department of Agriculture, Rural Development Business and Industry Program. Approximately \$8,500 of the Trace RDA Loan proceeds were used to repay a portion of the Company's senior debt under the Term Loan under the then outstanding Credit Facility. Approximately \$850 of the Trace RDA Loan proceeds were used for improvements to the hospital and its medical office building with the remainder of the loan proceeds used for working capital and closing costs.

The Trace Working Capital Loan as amended provides for a revolving line of credit to SHCH equal to the lesser of (i) a Borrowing Base equal to eighty percent (80%) of Eligible Accounts Receivable (as defined in the Working Capital Loan Agreement dated July 5, 2012) or (ii) (a) for the quarter ending December 31, 2014, \$875; (b) for the quarter ended March 31, 2015, \$750; (c) for the quarter ending June 30, 2015, \$625; and (d) thereafter, \$500. The Trace Working Capital Loan expires July 2, 2015. It is subject to annual renewal at the discretion of the lender. At December 31, 2014, there were no outstanding borrowings under the Trace Working Capital Loan.

The Trace RDA Loan contains various terms and conditions, including financial restrictions and limitations, and affirmative and negative covenants. The covenants include financial covenants measured on a quarterly basis which require our SHCH subsidiary to comply with a ratio of current assets to current liabilities, debt service coverage, fixed charge coverage, and funded debt to EBITDA, all as defined in the Trace RDA Loan. If SHCH is unable to remain in compliance with the financial covenants, SHCH would cease to have a right to draw on the revolving working capital loan (of which \$0 was drawn at December 31, 2014 and June 30, 2014).

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

The SHPP RDA Loan has a term of 25 years with monthly payments of principal and interest until repaid. The SHPP RDA Loan bears interest at a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 2.0%, or (ii) 5% (5.25% at December 31, 2014). The SHPP RDA Loan is collateralized by SHPP's real estate, equipment and leases and is partially guaranteed under the U.S. Department of Agriculture, Rural Development Business and Industry Program. Of the SHPP RDA Loan proceeds, \$1,800 was used by SHC Ellijay to acquire a medical office building in Ellijay, Georgia which was then sold to SHPP, with the remainder of the SHPP RDA Loan proceeds used by SHPP for working capital and closing costs. The SHPP RDA Loan contains certain financial covenants with respect to the ratio of current assets to current liabilities and debt service coverage, all as defined in the SHPP RDA Loan Agreement, which SHPP must maintain and that are measured at the end of each fiscal year. The SHPP RDA Loan is guaranteed by the Company and MedCare.

**Carmichael Notes** On April 22, 2008, SunLink Scripts Rx, LLC issued a \$3,000 promissory note with an interest rate of 8% to the former owners of Carmichael as part of the acquisition purchase price (the Carmichael Purchase Note). On April 12, 2012, an amendment to the Carmichael Purchase Note was entered into under which SunLink has the option to issue promissory notes to the former owners of Carmichael in payment of up to two semi-annual payments of principal and interest due under the Carmichael Purchase Note (the PIK Notes). The PIK Notes bear an interest rate of 8% and were to be due on April 22, 2015. A PIK Note for \$247 was issued on April 22, 2012 for the principal and interest payment that would have been due on April 22, 2012. A PIK Note for \$252 was issued on October 22, 2012 for the principal and interest payment that would have been due on October 22, 2012. The Carmichael Purchase Note and the PIK Notes were combined into one note (the Carmichael Note dated April 22, 2014 for the remaining balance payable of \$1,852. The Carmichael Note is payable in one interest only payment of \$75 due on October 22, 2014 and five semi-annual installments of \$185 of principal and accrued interest commencing on April 22, 2015, with the

remaining balance of the Carmichael Note of \$1,255 due October 22, 2017. Interest is payable in arrears semi-annually on the six and twelve-month anniversary of the issuance of the note. The Carmichael Note is guaranteed by the Company.

**Note 9. Insurance settlement**

In January 2015, the Company received a \$1,000 settlement on a claim made under its insurance policy covering, among other things, employee theft relating to misappropriation of funds by two now former employees over an eight year period beginning in 2006. Income of \$1,000 was recognized in the three and six months ended December 31, 2014 for this settlement.

**Note 10. Income Taxes**

Income tax expense of \$799 (\$643 federal tax expense and \$156 state tax expense) and income tax benefit of \$297 (\$328 federal tax expense and \$31 state tax expense) was recorded for the three months ended December 31, 2014 and 2013, respectively. Income tax expense of \$985 (\$863 federal tax expense and \$122 state tax expense) and income tax benefit of \$95 (\$78 federal tax benefit and \$17 state tax benefit) was recorded for the six months ended December 31, 2014 and 2013, respectively.

At December 31, 2014, the Company had \$5,190 of estimated net operating loss carry-forwards for federal income tax purposes available for use in future years subject to the limitations of the provisions of Internal Revenue Code Section 382. At December 31, 2014, we have provided a partial valuation allowance against the deferred tax asset so that the net tax asset was \$6,755. Based upon management's assessment that it was more likely than not that a portion of its deferred tax asset (primarily its net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the tax asset which management estimates will not be utilized.

**Note 11. Commitments and Contingencies**

**Litigation** A settlement was reached on November 3, 2014 relating to litigation as a result of sellers failure to close on the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia purchased by a subsidiary of the Company. In satisfaction of the Company's claims against the sellers, a five year promissory note in the principal amount of \$600 was issued to Castlemark Properties, LLC, ( Castlemark ) one of the Company's subsidiaries. The note is secured by a mortgage on the real property. Castlemark will have a right to immediate payment of the note if the property is sold prior to maturity. If the owner does not sell the property prior to maturity and does not pay the note in full at maturity or deed the property to Castlemark, then Castlemark will have a right to foreclose the mortgage and take title to the property. The litigation was dismissed by joint stipulation on or about November 12, 2014. As a result of this settlement the Company recorded pre-tax income of \$500, the estimated fair value of the real property, which is the most probable value of the judgment in the quarter ended December 31, 2014. The promissory note is included in long-term assets in the December 31, 2014 balance sheet.

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

**Sale of Hospital Facilities** The Company has sold three hospital facilities since June 30, 2012 and in connection with the sales has retained certain assets and substantial liabilities. See Note 3 Discontinued Operations.

**Office of Inspector General Investigation** In March 2013, SunLink received a document subpoena from the United States Department of Health and Human Services Office of Inspector General ( OIG ) in connection with an investigation of possible improper claims submitted to Medicare and Medicaid. The subpoena was directed to SunLink's indirect subsidiary Southern Health Corporation of Dahlenega, Inc. ( SHCD ), which owns and operates Chestatee Regional Hospital in Dahlenega, Georgia, and requested documents concerning possible false or fraudulent

claims made for intensive outpatient psychiatric services provided by and billed for a third-party outpatient psychiatric service provider. The subpoena also sought information about SHCD's relationship with the

outpatient psychiatric service provider, including financial arrangements. SHCD is continuing to cooperate with the government with respect to an ongoing document production, as well as conducting a joint medical necessity review of a sampling of medical records. We cannot at this time estimate what, if any, impact these matters and any results from these matters could have on our business, financial position, operating results or cash flows.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases and interest on outstanding debt from continuing operations at December 31, 2014 were as follows:

| <b>Payments due in:</b> | <b>Long-Term<br/>Debt</b> | <b>Operating<br/>Leases</b> | <b>Interest<br/>on<br/>Outstanding<br/>Debt</b> |
|-------------------------|---------------------------|-----------------------------|---|
| 1 year                  | \$ 866                    | \$ 858                      | \$ 712  |
| 2 years                 | 775                       | 333                         | 708   |
| 3 years                 | 1,951                     | 200                         | 650   |
| 4 years                 | 601                       | 74                          | 508   |
| 5+ years                | 8,252                     | 22                          | 3,104   |
|                         | \$ 12,445                 | \$ 1,487                    | \$ 5,682  |

At December 31, 2014, SunLink had a guarantee agreement with one physician. A physician with whom a guarantee agreement is made generally agrees to maintain his or her practice within a hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician's liability for any guarantee repayment due to non-compliance with the provisions of a guarantee agreement generally is collateralized by the physician's patient accounts receivable and/or a promissory note from the physician. All potential payments payable under this one guarantee have been paid as of December 31, 2014. SunLink expensed \$16 and \$33 on physician guarantees and recruiting for the three months ended December 31, 2014 and 2013, respectively. SunLink expensed \$31 and \$67 on physician guarantees and recruiting for the six months ended December 31, 2014 and 2013, respectively.

**Note 12. Related Party Transactions**

A director of the Company and the Company's secretary are members of two different law firms, each of which provides services to SunLink. The Company has expensed an aggregate of \$91 and \$159 for legal services to these law firms in the three months ended December 31, 2014 and 2013, respectively. The Company has expensed an aggregate of \$190 and \$319 for legal services to these law firms in the six months ended December 31, 2014 and 2013, respectively. Included in the Company's condensed consolidated balance sheets at December 31, 2014 and June 30, 2014 is \$113 and \$115, respectively, of amounts payable to these law firms.

**Note 13. Financial Information by Segment**

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



We evaluate performance of our operating segments based on revenue and operating profit (loss). Segment information as of December 31, 2014 and 2013 and for the three and six months then ended is as follows:

|  | Healthcare<br>Facilities | Specialty<br>Pharmacy | Corporate<br>and<br>Other | Total     |
|--|--------------------------|-----------------------|---------------------------|-----------|
| <b><u>Three months ended December 31, 2014</u></b> |                          |                       |                           |           |
| Net revenues from external customers               | \$ 14,539                | \$ 8,430              | \$ 158                    | \$ 23,126 |
| Operating profit (loss)                            | 2,596                    | 80                    | (654)                     | 2,022     |
| Depreciation and amortization                      | 360                      | 177                   | 43                        | 580       |
| Assets   | 33,843                   | 12,165                | 13,830                    | 59,838    |
| Expenditures for property, plant and equipment     | 48                       | 271                   | 0                         | 319       |
| <b><u>Six months ended December 31, 2014</u></b>   |                          |                       |                           |           |
| Net revenues from external customers               | \$ 29,319                | \$ 15,884             | \$ 299                    | \$ 45,502 |
| Operating profit (loss)                            | 3,374                    | 219                   | (1,266)                   | 2,327     |
| Depreciation and amortization                      | 720                      | 345                   | 150                       | 1,215     |
| Assets   | 33,843                   | 12,165                | 13,830                    | 59,838    |
| Expenditures for property, plant and equipment     | 132                      | 574                   | 31                        | 737       |
| <b><u>Three months ended December 31, 2013</u></b> |                          |                       |                           |           |
| Net revenues from external customers               | \$ 14,463                | \$ 9,326              | \$ 91                     | \$ 23,880 |
| Operating profit (loss)                            | 1,287                    | 229                   | (1,225)                   | 291       |
| Depreciation and amortization                      | 370                      | 171                   | 222                       | 763       |
| Assets   | 38,225                   | 11,517                | 18,782                    | 68,524    |
| Expenditures for property, plant and equipment     | 161                      | 104                   | 141                       | 406       |
| <b><u>Six months ended December 31, 2013</u></b>   |                          |                       |                           |           |
| Net revenues from external customers               | \$ 29,554                | \$ 16,168             | \$ 187                    | \$ 45,909 |
| Operating profit (loss)                            | 2,116                    | 135                   | (2,296)                   | (45)      |
| Depreciation and amortization                      | 769                      | 337                   | 431                       | 1,537     |
| Assets   | 38,225                   | 11,517                | 18,782                    | 68,524    |
| Expenditures for property, plant and equipment     | 294                      | 283                   | 191                       | 768       |

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

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

### Forward-Looking Statements

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

#### *General Business Conditions*

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

increases in uninsured and/or underinsured patients due to unemployment or other conditions, higher deductibles and co-insurance, terms of health insurance coverage resulting in higher bad debt amounts;

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

demographic changes in areas where we operate;

the availability of cash or borrowings to fund working capital, renovations, replacements, expansions and capital improvements at existing healthcare and specialty pharmacy facilities and for acquisitions and replacement of such facilities;

changes in accounting principles generally accepted in the U.S.; and,

fluctuations in the market value of equity securities including SunLink common shares;

#### *Operational Factors*

inability to operate profitably in one or more segments of the healthcare business;

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the availability of, and our ability to attract and retain, sufficient qualified staff physicians, management, nurses, pharmacists and staff personnel for our operations;

timeliness and amount of reimbursement payments received under government programs;

the ability or inability to obtain external financing for working capital included under lending agreements;

changes in interest rates under debt agreements

the ability or inability to refinance former or existing indebtedness and potential defaults under existing indebtedness;

restrictions imposed by existing or future debt agreements;

the cost and availability of insurance coverage including professional liability (e.g., medical malpractice) and general liability insurance;

the efforts of insurers, healthcare providers, government payors and others to contain healthcare costs;

the impact on hospital services of the treatment of patients in lower acuity healthcare settings, whether with drug therapy or in alternative healthcare settings, such as surgery centers or urgent care centers;

changes in medical and other technology;

risks of changes in estimates of self insurance claims and reserves;

changes in prices of materials and services utilized in our Healthcare Facilities and Specialty Pharmacy Segments;

changes in wages as a result of inflation or competition for management, physician, nursing, pharmacy and staff positions;

changes in the amount and risk of collectability of accounts receivable, including deductibles and co-pay amounts;

the functionality or costs with respect to our information systems for our Healthcare Facilities and Specialty Pharmacy Segments and our corporate office, including both software and hardware; and



the availability of and competition from alternative drugs or treatments provided by our Specialty Pharmacy Segment;

*Liabilities, Claims, Obligations and Other Matters*

claims under leases, guarantees and other obligations relating to discontinued operations, including sold facilities, retained or acquired subsidiaries and former subsidiaries;

potential adverse consequences of known and unknown government investigations;

claims for product and environmental liabilities from continuing and discontinued operations;

professional, general and other claims which may be asserted against us; and,

natural disasters and weather-related events such as earthquakes, hurricanes, flooding, snow, ice and wind damage and population evacuations affecting areas in which we operate.

*Regulation and Governmental Activity*

existing and proposed governmental budgetary constraints;

Federal and state insurance exchanges and their rules on reimbursement terms;

the decision by states in which we operate hospitals (Georgia, Mississippi, Missouri) to not expand Medicaid;

the regulatory environment for our businesses, including state certificate of need laws and regulations, pharmacy licensing laws and regulations, rules and judicial cases relating thereto;

anticipated adverse changes in the levels and terms of government (including Medicare, Medicaid and other programs) and private reimbursement for SunLink's healthcare services including the payment arrangements and terms of managed care agreements; EHR reimbursement and indigent care reimbursements (Medicare Upper Payment Limit UPL and Disproportionate Share Hospital DSH adjustments);

changes in or failure to comply with Federal, state or local laws and regulations affecting our Healthcare Facilities and Specialty Pharmacy Segments; and,

the possible enactment of additional Federal healthcare reform laws or reform laws in states where our subsidiaries operate hospital and pharmacy facilities (including Medicaid waivers, bundled payments, accountable care and similar organizations, competitive bidding, and other reforms).

*Dispositions, Acquisitions, and Renovation Related Matters*

the ability to dispose of underperforming facilities;

the availability and terms of capital to fund acquisitions, improvements, renovations or replacement facilities; and

competition in the market for acquisitions of hospitals and healthcare businesses.

The foregoing are significant factors we think could cause our actual results to differ materially from expected results. However, there could be additional factors besides those listed herein that also could affect SunLink in an adverse manner.

You should read this Quarterly Report completely and with the understanding that actual future results may be materially different from what we expect. You are cautioned not to unduly rely on forward-looking statements when evaluating the information presented in this Quarterly Report or our other disclosures because current plans, anticipated actions, and future financial conditions and results may differ from those expressed in any forward-looking statements made by or on behalf of SunLink.

We have not undertaken any obligation to publicly update or revise any forward-looking statements. All of our forward-looking statements speak only as of the date of the document in which they are made or, if a date is specified, as of such date. Subject to an mandatory requirements of applicable law, we disclaim any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in our expectations or any changes in events, conditions, circumstances or information on which the forward-looking statement is based. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the foregoing factors and the risk factors set forth elsewhere in this report and in our Annual Report on Form 10-K.

### **Business Strategy: Operations, Dispositions and Acquisitions**

SunLink's business strategy is to focus its efforts on improving internal operations of its existing healthcare facilities and its pharmacy business. We also consider from time to time potential healthcare facility acquisitions, development and dispositions, including but not limited to hospitals, physician clinics, ambulatory surgery centers, nursing, long-term care and assisted living homes, medical office buildings and pharmacy businesses. We consider dispositions of facilities or operations based on a variety of factors including asset values, return on investments, competition from existing and potential competitors, capital improvement needs, corporate strategy and other corporate objectives.

Our efforts over the last two years have been more focused on the disposition of hospital facilities than on acquisitions due to our financial position and need to reduce our leverage and interest expense, the changing nature of certain of our subsidiary hospital markets resulting in, among other things, substantial additional competition, and pressure from Federal and state programs (e.g., Medicare and Medicaid) and private payors to reduce reimbursement for medical services. In July 2012, we sold our Adel, Georgia hospital and its related nursing home; in December 2012, we sold our Dexter, Missouri hospital and its related home health agency; and in December 2014, we sold our Fulton, Missouri hospital. We currently have engaged advisors to advise us on and to assist us with the possible sale of one other hospital facility. As a result of the sale of these three hospitals and the improved operations of the remaining three hospitals and the Specialty Pharmacy Segment, the Company has reduced its debt from \$29,021 at June 30, 2012 to \$12,445 at December 31, 2014, and has increased its working capital by approximately \$16,000 over the same two and a half year period.

Even though the Company's financial position has improved, we believe our ability to compete for acquisitions is still limited. However, during the last fiscal year, we have evaluated certain rural and exurban hospitals, pharmacy operations and healthcare facilities and businesses which were for sale, monitored other selected acquisition targets which we believed might become available for sale, and considered the feasibility of developing healthcare facilities on property we own as well as on property that may be for sale. Although we have no current plans to do so, from time to time we may consider the acquisition of other complementary based healthcare businesses, outside of our existing business segments, which are or may become available for acquisition.

At its Board of Directors meeting on February 9, 2015, the Board discussed extensively the Company's future and strategic alternatives. No action was taken on future and strategic alternatives other than the Board determined that the Company should not pursue its previously announced going private strategy at this time.

### **Critical Accounting Estimates**

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect reported amounts and related disclosures. We consider an accounting estimate to be critical if:

it requires assumptions to be made that were uncertain at the time the estimate was made; and

changes in the estimate or different estimates that could have been made could have a material impact on our consolidated results of operations or financial condition. Our critical accounting estimates are more fully described in our 2014 Annual Report on Form 10-K and continue to include the following areas:

Receivables net and provision for doubtful accounts;

Revenue recognition / Net Patient Service Revenues;

Goodwill, intangible assets and accounting for business combinations;

Professional and general liability claims

Accounting for income taxes; and

Electronic Health Record incentives

**Financial Summary**

The results of continuing operations shown in the financial summary below are for our two business segments, Healthcare Facilities and Specialty Pharmacy.

|   | Three Months Ended<br>December 31, |           |          | Six Months Ended<br>December 31, |           |          |
|---|------------------------------------|-----------|----------|----------------------------------|-----------|----------|
|   | 2014                               | 2013      | % Change | 2014                             | 2013      | % Change |
| Net Revenues - Healthcare Facilities                          | \$ 14,539                          | \$ 14,463 | 0.5%     | \$ 29,319                        | \$ 29,554 | (0.8)%   |
| Net Revenues - Specialty Pharmacy                             | 8,430                              | 9,326     | (9.6)%   | 15,884                           | 16,168    | (1.8)%   |
| Other Revenues  | 157                                | 91        | 72.5%    | 299                              | 187       | 59.9%    |
| Total Net Revenues  | 23,126                             | 23,880    | 3.2%     | 45,502                           | 45,909    | (0.9)%   |
| Costs and expenses  | (21,104)                           | (23,589)  | 10.5%    | (43,175)                         | (45,954)  | (6.0)%   |
| Operating profit (loss)                                       | 2,022                              | 291       | 594.8%   | 2,327                            | (45)      | NA       |
| Interest expense - net  | (234)                              | (238)     | (1.7)%   | (464)                            | (480)     | (3.3)%   |
| Earning (Loss) from continuing operations before income taxes | \$ 1,788                           | \$ 53     | 3273.6%  | \$ 1,863                         | \$ (525)  | NA       |
| <b>Healthcare Facilities Segment:</b>                         |                                    |           |          |                                  |           |          |
| Admissions  | 660                                | 646       | 2%       | 1,292                            | 1,233     | 5%       |
| Equivalent admissions   | 1,787                              | 1,958     | (9)%     | 3,736                            | 4,013     | (7)%     |
| Surgeries   | 410                                | 418       | (2)%     | 828                              | 859       | (4)%     |

|                                  |          |          |     |          |          |    |
|----------------------------------|----------|----------|-----|----------|----------|----|
| Revenue per equivalent admission | \$ 8,135 | \$ 7,387 | 10% | \$ 7,848 | \$ 7,318 | 7% |
|----------------------------------|----------|----------|-----|----------|----------|----|

*Equivalent admissions* Equivalent admissions is used by management (and certain investors) as a general measure of combined inpatient and outpatient volume for our hospital operations. Equivalent admissions are computed by multiplying admissions (inpatient volume) by the sum of gross inpatient revenues and gross outpatient revenues and dividing the result by gross inpatient revenues. The equivalent admissions computation is intended to relate outpatient revenues to the volume measure (admissions) used to measure inpatient volume to result in a general approximation of combined inpatient and outpatient volume (equivalent admissions).

**Results of Operations****Healthcare Facilities Segment Net Revenues**

The following table sets forth the percentage of net patient revenues from major payors for the Healthcare Facilities Segment for the periods indicated:

|                                | Three Months Ended   |                      | Six Months Ended     |                      |
|--------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                | December 31,<br>2014 | December 31,<br>2013 | December 31,<br>2014 | December 31,<br>2013 |
| <b>Source:</b>                 |                      |                      |                      |                      |
| Medicare                       | 40.5%                | 39.0%                | 41.8%                | 41.3%                |
| Medicaid                       | 21.8%                | 21.1%                | 20.8%                | 19.9%                |
| Managed Care Insurance & Other | 25.4%                | 24.9%                | 25.5%                | 24.7%                |
| Self-pay                       | 12.3%                | 15.0%                | 11.9%                | 14.1%                |
|                                | 100.0%               | 100.0%               | 100.0%               | 100.0%               |

Healthcare Facilities net revenues included increase (decrease) of (\$297) and \$302 for the three months ended December 31, 2014 and 2013, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included net increase (decrease) of (\$297) and \$506 for the six months ended December 31, 2014 and 2013, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

Medicare and Medicaid net revenues as a percentage of net revenues were up slightly for the three and six months ended December 31, 2014 compared to the prior year periods. Self-pay net revenues decreased primarily due to the closing of the emergency room in one of our hospitals in September 2014.

**Specialty Pharmacy Segment Net Revenues**

Specialty Pharmacy net revenues for the three months ended December 31, 2014 were \$8,430 a decrease of \$896, or 9.6%, from \$9,326 for the three months ended December 31, 2013. Specialty Pharmacy net revenues for the six months ended December 31, 2014 were \$15,884, a decrease of \$284, or 1.8%, from \$16,168 for the six months ended December 31, 2013. The decrease was a result of decreased Louisiana Medicaid revenues including sales of one product which is primarily sold to patients with Louisiana Medicaid coverage. Medicaid has restricted both the number of eligible customers and the number of approved purchases of this drug. Durable medical equipment and related products sales increased during the quarter ended December 31, 2014 compared to the prior year.

**Healthcare Facilities Segment Cost and Expenses**

Costs and expenses for our Healthcare Facilities Segment, including depreciation and amortization, were \$11,953 and \$13,176 for the three months ended December 31, 2014 and 2013, respectively. Costs and expenses for our Healthcare Facilities Segment, including depreciation and amortization, were \$25,945 and \$27,438 for the six months ended December 31, 2014 and 2013, respectively.

|                                       | <b>Cost and Expenses</b>      |             |                         |             |
|---------------------------------------|-------------------------------|-------------|-------------------------|-------------|
|                                       | <b>as a % of Net Revenues</b> |             |                         |             |
|                                       | <b>Three Months Ended</b>     |             | <b>Six Months Ended</b> |             |
|                                       | <b>December 31,</b>           |             | <b>December 31,</b>     |             |
|                                       | <b>2014</b>                   | <b>2013</b> | <b>2014</b>             | <b>2013</b> |
| Salaries, wages and benefits          | 56.5%                         | 59.9%       | 57.1%                   | 58.4%       |
| Supplies                              | 12.8%                         | 13.8%       | 12.9%                   | 13.1%       |
| Purchased services                    | 8.2%                          | 9.6%        | 8.4%                    | 9.2%        |
| EHR incentive payments                | 0%                            | -8.4%       | 0%                      | -4.1%       |
| Other operating expenses              | 12.9%                         | 15.1%       | 12.5%                   | 14.9%       |
| Rent and lease expense                | 2.3%                          | 2.4%        | 2.3%                    | 2.4%        |
| Depreciation and amortization expense | 2.2%                          | 2.3%        | 2.2%                    | 2.6%        |

Salaries, wages and benefits decreased as a percentage of net revenue in the three and six months ended December 31, 2014 due to decreased employee medical claims incurred as compared to the three and six months ended December 31, 2013.

For the three and six months ended December 31, 2014, the Company reported no EHR incentive payments. For the three and six months ended December 31, 2013, the Company reported a net \$1,215 gain for Medicare and Medicaid EHR incentive payments which were for successful Medicaid attestation by the three hospitals and also adjustments calculated at the time of filing Medicare cost reports for the preceding fiscal year.

Other operating expenses decreased as a percentage of net revenues for the three and six months ended December 31, 2014 compared to the comparable prior year periods due to decreased insurance expense as a result of lower professional and general liability claims incurred in the three and six months ended December 31, 2014.

#### Specialty Pharmacy Segment Cost and Expenses

Cost and expenses for our Specialty Pharmacy Segment, including depreciation and amortization, were \$8,350 and \$9,097 for the three months ended December 31, 2014 and 2013, respectively. Cost and expenses for our Specialty Pharmacy Segment, including depreciation and amortization, were \$15,665 and \$16,033 for the six months ended December 31, 2014 and 2013, respectively.

|                                       | <b>Cost and Expenses</b>      |             |                         |             |
|---------------------------------------|-------------------------------|-------------|-------------------------|-------------|
|                                       | <b>as a % of Net Revenues</b> |             |                         |             |
|                                       | <b>Three Months Ended</b>     |             | <b>Six Months Ended</b> |             |
|                                       | <b>December 31,</b>           |             | <b>December 31,</b>     |             |
|                                       | <b>2014</b>                   | <b>2013</b> | <b>2014</b>             | <b>2013</b> |
| Cost of goods sold                    | 64.7%                         | 69.5%       | 63.4%                   | 66.6%       |
| Salaries, wages and benefits          | 22.8%                         | 17.9%       | 23.4%                   | 21.1%       |
| Provision for bad debts               | 0.9%                          | 0.5%        | 0.5%                    | 0.6%        |
| Supplies                              | 0.4%                          | 0.6%        | 0.4%                    | 0.6%        |
| Purchased services                    | 3.7%                          | 3.7%        | 4.1%                    | 3.9%        |
| Other operating expenses              | 3.7%                          | 2.9%        | 3.8%                    | 3.4%        |
| Rent and lease expense                | 0.8%                          | 0.8%        | 0.9%                    | 0.9%        |
| Depreciation and amortization expense | 2.1%                          | 1.9%        | 2.2%                    | 2.1%        |

Cost of goods sold as a percent of net revenues decreased in the three and six month periods ended December 31, 2014 as compared to the comparable periods of the prior year due to the current period sales product mix. Sales of one high sales volume product with a higher than average cost of goods sold decreased approximately 40%, based on units

sold for the three and six months compared to the comparable periods last year.

Salaries, wages and benefits as a percent of net revenues increased in the six month period ended December 31, 2014 as compared to the comparable period of the prior year due to the increased staffing requirements related to the net growth in the institutional pharmacy business as seven new institutional supply contracts have been added this fiscal year.

Insurance settlement

In January 2015, the Company received a \$1,000 settlement on a claim made under its insurance policy covering, among other things, misappropriation of funds by two now former employees over an eight year period beginning in 2006. Income of \$1,000 was recognized in the three and six months ended December 31, 2014 for this settlement.

Operating Profit and Loss

SunLink had an operating profit of \$2,022 and \$291 for the three months ended December 31, 2014 and 2013, respectively. SunLink had an operating profit of \$2,327 for the six months ended December 31, 2014 and an operating loss of \$45 for the six months ended December 31, 2013. The increased operating profit for the three and six months ended December 31, 2014 compared to the prior year period resulted from the decrease in professional and general liability claims, reduced provision for bad debts and the \$1,000 insurance settlement, somewhat offset by negative cost reports settlements in the current year compared to positive cost report settlements last year.

Interest Expense

Interest expense was \$234 and \$238 for the three months ended December 31, 2014 and 2013, respectively and \$464 and \$480 for the six months ended December 31, 2014 and 2013, respectively.

Income Taxes

Income tax expense of \$799 (\$643 federal tax expense and \$156 state tax expense) and income tax benefit of \$297 (\$328 federal tax expense and \$31 state tax expense) was recorded for the three months ended December 31, 2014 and 2013, respectively. Income tax expense of \$985 (\$863 federal tax expense and \$122 state tax expense) and income tax benefit of \$95 (\$78 federal tax benefit and \$17 state tax benefit) was recorded for the six months ended December 31, 2014 and 2013, respectively.

At December 31, 2014, the Company had \$5,190 of estimated net operating loss carry-forwards for federal income tax purposes available for use in future years subject to the limitations of the provisions of Internal Revenue Code Section 382. At December 31, 2014, we have provided a partial valuation allowance against the deferred tax asset so that the net tax asset was \$6,755. Based upon management's assessment that it was more likely than not that a portion of its deferred tax asset (primarily its net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the tax asset which management estimates will not be utilized.

Earnings (Loss) After Taxes

Earnings from continuing operations were \$989 (\$0.10 per fully diluted share) for the three months ended December 31, 2014 compared to earnings from continuing operations of \$350 (\$0.04 per fully diluted share) for the three months ended December 31, 2013. Earnings from continuing operations were \$878 (\$0.08 per fully diluted share) for the six months ended December 31, 2014 compared to a loss from continuing operations of \$430 (\$0.05 loss per fully diluted share) for the six months ended December 31, 2013. The increased earnings for the three and six months ended December 31, 2014 resulted from the increased operating profit as compared to the comparable prior year period.

Loss from discontinued operations of \$12 for the three months ended December 31, 2014 resulted from pre-tax earnings from businesses sold in prior years of \$558 (primarily recognition of Medicare EHR incentive payments received for the fiscal year ended June 30, 2014), offset by the loss from operations of \$449 of Fulton and the loss on sale of Fulton of \$191. Tax benefit for discontinued operations for the three months ended December 31, 2014 was \$70. The loss from discontinued operations for the six months ended December 31, 2014 of \$314 resulted from a

pre-tax earnings from businesses sold in prior years of \$538, offset by the loss from operations of \$897 for Fulton and the loss on sale of Fulton of \$191. Tax benefit for discontinued operations for the six months ended December 31, 2013 was \$236.

Loss from discontinued operations of \$123 for the three months ended December 31, 2013 resulted from earnings from businesses sold in prior years, offset by the loss from operations of \$549 for Fulton. Tax benefit for discontinued operations for the three months ended December 31, 2013 was \$57. The loss from discontinued operations for the six months ended December 31, 2013 of \$501 resulted from a pre-tax earnings from businesses sold in prior fiscal years of \$391, offset by the Fulton loss from operations of \$1,147. Tax benefit for discontinued operations for the six months ended December 31, 2013 was \$255.

Net earnings for the three months ended December 31, 2014 were \$977 (\$0.10 earnings per fully diluted share) compared to net earnings of \$227 (\$0.02 earnings per fully diluted share) for the three months ended December 31, 2013. Net earnings for the six months ended December 31, 2014 were \$564 (\$0.06 loss per fully diluted share) compared to a net loss of \$931 (\$0.10 loss per fully diluted share) for the six months ended December 31, 2013.

### **Adjusted earnings before income taxes, interest, depreciation and amortization**

Earnings before income taxes, interest, depreciation and amortization ( EBITDA ) represent the sum of income before income taxes, interest, depreciation and amortization. We understand that certain industry analysts and investors generally consider EBITDA to be one measure of the liquidity of a company, and it is presented to assist analysts and investors in analyzing the ability of a company to generate cash, service debt and meet capital requirements. We believe increased EBITDA is an indicator of improved ability to service existing debt and to satisfy capital requirements. EBITDA, however, is not a measure of financial performance under accounting principles generally accepted in the United States of America and should not be considered an alternative to net income as a measure of operating performance or to cash liquidity. Because EBITDA is not a measure determined in accordance with accounting principles generally accepted in the United States of America and is thus susceptible to varying calculations, EBITDA, as presented, may not be comparable to other similarly titled measures of other corporations. Where we adjust EBITDA for non-cash charges we refer to such measurement as Adjusted EBITDA , which we report on a company wide basis. Non-cash adjustments in Adjusted EBITDA are not intended to be identified or characterized in any respect as non-recurring, infrequent or unusual, if we believe such charge is reasonably likely to recur within two years, or if there was a similar charge (or gain) within the prior two years. Where we report Adjusted EBITDA, we typically also report Healthcare Facilities Segment Adjusted EBITDA and Specialty Pharmacy Segment Adjusted EBITDA which is the EBITDA for the applicable segments without any allocation of corporate overhead, which we report as a separate line item, without gains on sales of businesses and without any allocation of the non-cash adjustments, which we also report as a separate line item in Adjusted EBITDA. Net cash used in operations for the three and six months ended December 31, 2014 and 2013, respectively, is shown below.

|  | <b>Three Months Ended<br/>December 31,</b> |             | <b>Six Months Ended<br/>December 31,</b> |             |
|--|--|-------------|--|-------------|
|  | <b>2014</b>                                | <b>2013</b> | <b>2014</b>                              | <b>2013</b> |
| Healthcare Facilities Adjusted EBITDA                                      | \$ 2,956                                   | \$ 1,657    | \$ 4,094                                 | \$ 2,885    |
| Specialty Pharmacy Adjusted EBITDA   | 257  | 400         | 564                                      | 472         |
| Corporate overhead costs   | (611)                                      | (1,003)     | (1,116)                                  | (1,865)     |
| Taxes and interest expense   | (1,033)                                    | 59          | (1,449)                                  | (575)       |
| Other non-cash expenses and net change in operating assets and liabilities | (576)                                      | 46          | (2,145)                                  | 2,628       |
| Net cash provided by (Used in) operations                                  | \$ 993                                     | \$ 1,159    | \$ (52)                                  | \$ 3,545    |

### **Liquidity and Capital Resources**

*Overview*

Our primary sources of liquidity are cash on hand and one facility-based revolving loan facility of \$750, which has limited availability due to facility cash on hand restrictions. Currently, the Company's ability to raise capital (debt or equity) in the public or private markets on what it considers acceptable terms is uncertain. We are nevertheless actively seeking options to obtain financing for the Company's liquidity needs.

Although two of the Company's subsidiaries have been able to borrow money through facility based mortgages, each of which is guaranteed by the Company, utilizing USDA Rural Development Authority guaranties, (individually, an RDA Loan and collectively, the RDA Loans), and, in the case of our Trace hospital subsidiary, obtain a working revolving capital loan facility of \$750, the Company and its subsidiaries currently are funding its working capital needs primarily from cash from operations and from the sale of additional assets. See *Subsidiary Loans* below.

Although operations of the Company's Healthcare Facilities and Specialty Pharmacy segments have improved in fiscal 2015, the Company believes its hospital facilities and its specialty pharmacy business continue to underperform. The Company has incurred losses from continuing operations in five of the last ten fiscal quarters through the quarter ending December 31, 2014.

In light of the current underperformance of the Company's hospital facilities and its specialty pharmacy business, the Company has engaged advisors to evaluate and conduct the possible sale of one hospital facility. There can be no assurance that the sale will occur or that, if a sale occurs, it will be at a price that results in a gain or net proceeds after transaction costs, taxes and outstanding debt. The Company may need to use a portion of the net proceeds, if any, from future asset sales to fund its working capital needs if its remaining hospitals and its specialty pharmacy segment are not, at that time, providing sufficient cash flow to fund working capital.

Subject to the risks and uncertainties discussed herein, we believe we have adequate financing and liquidity to support our current level of operations through the next twelve months.

#### Subsidiary Loans

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

The Trace RDA Loan has a term of 15 years with monthly payments of principal and interest until repaid. The Trace RDA Loan bears a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 1.5%, or (ii) 6% (6.0% at December 31, 2014). The Trace RDA Loan is collateralized by Trace's real estate and equipment and is partially guaranteed under the U.S. Department of Agriculture, Rural Development Business and Industry Program. Approximately \$8,500 of the Trace RDA Loan proceeds were used to repay a portion of the Company's senior debt under the Term Loan under the then outstanding Credit Facility. Approximately \$850 of the Trace RDA Loan proceeds were used for improvements to the hospital and its medical office building with the remainder of the loan proceeds used for working capital and closing costs.

The Trace Working Capital Loan as amended provides for a revolving line of credit to SHCH equal to the lesser of (i) a Borrowing Base equal to eighty percent (80%) of Eligible Accounts Receivable (as defined in the Working Capital Loan Agreement dated July 5, 2012) or (ii) (a) for the quarter ending December 31, 2014, \$875; (b) for the quarter ended March 31, 2015, \$750; (c) for the quarter ending June 30, 2015, \$625; and (d) thereafter, \$500. The Trace Working Capital Loan expires July 2, 2015. It is subject to annual renewal at the discretion of the lender. At December 31, 2014, there were no outstanding borrowings under the Trace Working Capital Loan.

The Trace RDA Loan contains various terms and conditions, including financial restrictions and limitations, and affirmative and negative covenants. The covenants include financial covenants measured on a quarterly basis which require our SHCH subsidiary to comply with a ratio of current assets to current liabilities, debt service coverage, fixed charge coverage, and funded debt to EBITDA, all as defined in the Trace RDA Loan. If SHCH is unable to remain in

compliance with the financial covenants, SHCH would cease to have a right to draw on the revolving working capital loan (of which \$0 was drawn at December 31, 2014 and June 30, 2014).

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

The SHPP RDA Loan has a term of 25 years with monthly payments of principal and interest until repaid. The SHPP RDA Loan bears interest at a floating rate of interest equal to the greater of (i) the prime rate (as published in The Wall Street Journal) plus 2.0%, or (ii) 5% (5.25% at December 31, 2014). The SHPP RDA Loan is collateralized by SHPP's real estate, equipment and leases and is partially guaranteed under the U.S. Department of Agriculture, Rural Development Business and Industry Program. Of the SHPP RDA Loan proceeds, \$1,800 was used by SHC Ellijay to acquire a medical office building in Ellijay, Georgia which was then sold to SHPP, with the remainder of the SHPP RDA Loan proceeds used by SHPP for working capital and closing costs. The SHPP RDA Loan contains certain financial covenants with respect to the ratio of current assets to current liabilities and debt service coverage, all as defined in the SHPP RDA Loan Agreement, which SHPP must maintain and that are measured at the end of each fiscal year. The SHPP RDA Loan is guaranteed by the Company and MedCare.

### **Contractual Obligations, Commitments and Contingencies**

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases and interest on outstanding debt from continuing operations at December 31, 2014 were as follows:

| <b>Payments<br/>due in:</b> | <b>Long-Term<br/>Debt</b> | <b>Operating<br/>Leases</b> | <b>Interest<br/>on<br/>Outstanding<br/>Debt</b> |
|-----------------------------|---------------------------|-----------------------------|---|
| 1 year                      | \$ 866                    | \$ 858                      | \$ 712  |
| 2 years                     | 775                       | 333                         | 708   |
| 3 years                     | 1,951                     | 200                         | 650   |
| 4 years                     | 601                       | 74                          | 508   |
| 5+ years                    | 8,252                     | 22                          | 3,104   |
|                             | \$ 12,445                 | \$ 1,487                    | \$ 5,682  |

At December 31, 2014, SunLink had a guarantee agreement with one physician. A physician with whom a guarantee agreement is made generally agrees to maintain his or her practice within a hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician's liability for any guarantee repayment due to non-compliance with the provisions of a guarantee agreement generally is collateralized by the physician's patient accounts receivable and/or a promissory note from the physician. All potential payments payable under this one guarantee have been paid as of December 31, 2014. SunLink expensed \$16 and \$33 on physician guarantees and recruiting for the three months ended December 31, 2014 and 2013, respectively. SunLink expensed \$31 and \$67 on physician guarantees and recruiting for the six months ended December 31, 2014 and 2013, respectively.

At December 31, 2014, we had outstanding long-term debt of \$12,444 of which \$8,405 was incurred under the Trace RDA Loan, \$2,013 was incurred under the SHPP RDA Loan, \$1,851 was incurred under the Carmichael Notes, and \$175 was related to other debt.

### **Discontinued Operations**

**Fulton Hospital** On December 31, 2014, the Company's subsidiary, HealthMont of Missouri sold substantially all the assets of its Callaway Community Hospital ( Fulton ) and related clinics in Fulton, Missouri for approximately \$6,090. Fulton's results have been reclassified as discontinued operations in our condensed consolidated financial statements as of December 31, 2014 and June 30, 2014 and for the three and six month periods ended December 31, 2014 and 2013.

Fulton retained accounts receivable and certain other assets, including the right to Medicare and Medicaid incentive payments ( EHR Funds ) for meaningful use of electronic health record technology, and substantially all liabilities of the hospital as of the sale closing date. At closing, Fulton repaid the outstanding balance of its RDA Loan of \$4,745. Loss of \$191 resulted from the sale of the Fulton assets, which includes \$237 early repayment penalty resulting from the repayment of the RDA loan.

***Dexter Hospital*** - On December 31, 2012, the Company completed the sale of substantially all the assets and the leasehold interest of its subsidiary, Dexter Hospital, LLC ( Dexter ), to Southeast Health Center of Stoddard County, LLC, an indirect subsidiary of Southeast Missouri Hospital Association ( SoutheastHEALTH ). The assets of Dexter consisted of a leased 50-bed acute care hospital and related clinics, equipment, and home health services in Dexter, Missouri. Subsequent to the sale, Dexter managed the hospital and related businesses for Southeast Health Center of Stoddard County, LLC through a transition period ended June 30, 2013. Dexter retained accounts receivable and certain other assets, including the right to Medicare and Medicaid incentive payments ( EHR Funds ) for meaningful use of electronic health record technology and substantially all liabilities of the hospital as of December 31, 2012. Dexter s operations have been classified as discontinued operations in our condensed consolidated financial statements for the three and six month periods ended December 31, 2014 and 2013.

***Memorial Hospital of Adel*** On July 2, 2012, the Company and its HealthMont of Georgia, Inc. subsidiary completed the sale of substantially of all the assets of the Company s Memorial Hospital of Adel and Memorial Convalescent Center (collectively Memorial ) to the Hospital Authority of Tift County, Georgia ( Tift ) for approximately \$8,350. Memorial s operations have been classified as discontinued operations in our condensed consolidated financial statements for the three and six month periods ended December 31, 2014 and 2013.

### **Related Party Transactions**

A director of the Company and the Company s secretary are members of two different law firms, each of which provides services to SunLink. The Company has expensed an aggregate of \$91 and \$159 for legal services to these law firms in the three months ended December 31, 2014 and 2013, respectively. The Company has expensed an aggregate of \$190 and \$319 for legal services to these law firms in the six months ended December 31, 2014 and 2013, respectively. Included in the Company s condensed consolidated balance sheets at December 31, 2014 and June 30, 2014 is \$113 and \$115, respectively, of amounts payable to these law firms.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We have not entered into any transactions using derivative financial instruments or derivative commodity instruments and believe that our exposure to market risk associated with other financial instruments (such as investments and borrowings) and interest rate risk is not material.

### **ITEM 4. CONTROLS AND PROCEDURES**

We maintain controls and procedures designed to ensure that we are able to collect the information we are required to disclose in the reports we file with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules of the SEC.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the *Exchange Act* )) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer initially concluded that, as of the end of such period, our disclosure controls and procedures were effective in providing reasonable assurances that information required to be disclosed by the Company in the reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported in a timely manner. However, subsequent to such quarter end and evaluation, our management in response to correspondence from the SEC with respect to our annual report for the year ended June 30, 2014 re-examined the effectiveness of our disclosure controls and procedures and concluded that our controls during the quarter ended December 31, 2014 were not effective as of December 31, 2014 based on management's failure to include a complete report on internal controls over financial reporting as required under Item 308(a) of Regulation S-K in prior filings with the SEC. Accordingly, subsequent to the end of the period covered by this report, the Company implemented procedures in the preparation and filing of its periodic reports which it believes will remediate for future periods such material weakness in internal controls.

Except for the changes subsequent to the end of the quarter as described above, there were no changes during the quarter ended June 30, 2014, or in the other periods referred to above, in our internal control over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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## PART II. OTHER INFORMATION

Items required under Part II not specifically shown below are not applicable.

### ITEM 1. LEGAL PROCEEDINGS

#### Office of Inspector General Investigation

In March 2013, SunLink received a document subpoena from the United States Department of Health and Human Services Office of Inspector General (OIG) in connection with an investigation of possible improper claims submitted to Medicare and Medicaid. The subpoena was directed to SunLink's indirect subsidiary Southern Health Corporation of Dahlonega, Inc. (SHCD), which owns and operates Chestatee Regional Hospital in Dahlonega, Georgia, and requested documents concerning possible false or fraudulent claims made for intensive outpatient psychiatric services provided by and billed for a third-party outpatient psychiatric service provider. The subpoena also sought information about SHCD's relationship with the outpatient psychiatric service provider, including financial arrangements. SHCD is continuing to cooperate with the government with respect to an ongoing document production, as well as conducting a joint medical necessity review of a sampling of medical records. We cannot at this time estimate what, if any, impact these matters and any results from these matters could have on our business, financial position, operating results or cash flows.

### ITEM 1A. RISK FACTORS

#### Risk Factors Relating to an Investment in SunLink

Information regarding risk factors appears in MD&A Forward-Looking Statements, in Part I Item 2 of this Form 10-Q and in MD&A -Risks Factors Relating to an Investment in SunLink in Part I Item 1A of the Company's Annual Report on Form 10-K for the year ended June 30, 2013. While we believe there have been no material changes from the risk factors previously disclosed in such Annual Report except as set forth herein, you should carefully consider, in addition to the other information set forth in this report, the risk factors discussed in our Annual Report which could materially affect our business, financial condition or future results. Such risk factors are expressly incorporated herein by reference. The risks described in our Annual Report are not the only risks facing our Company. In addition to risks and uncertainties inherent in forward looking statements contained in this Report on Form 10-Q, additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. Whenever we refer to SunLink, Company, we, our, us in this Item 1A, we mean SunLink Health Systems, Inc. and its subsidiaries, unless the context suggests otherwise.

### ITEM 6. EXHIBITS

#### Exhibits:

- 31.1 Chief Executive Officer's Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 31.2 Chief Financial Officer's Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- 32.1 Chief Executive Officer's Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2

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Chief Financial Officer's Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 The following materials from the Company's quarterly report on Form 10-Q for the three months ended December 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of December 31, 2014 (unaudited) and June 30, 2014, (ii) Condensed Consolidated Statements of Operations for the three months ended December 31, 2014 and 2013 (unaudited), (iii) Condensed Consolidated Statements of Cash Flows, for the three months ended December 31, 2014 and 2013 (unaudited), and (iv) Notes to Condensed Consolidated Financial Statements (unaudited), tagged as blocks of text.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, SunLink Health Systems, Inc. has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SunLink Health Systems, Inc.

By: /s/ Mark J. Stockslager  
Mark J. Stockslager  
Chief Financial Officer

Dated: February 18, 2015