

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**Form 10-Q**

---

(Mark One)

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

**For the quarterly period ended September 30, 2019**

or

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

**Commission file number: 001-37576**

**Surgery Partners, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**47-3620923**

(I.R.S. Employer  
Identification No.)

**310 Seven Springs Way, Suite 500**

**Brentwood, Tennessee 37027**

(Address of principal executive offices and zip code)

**(615) 234-5900**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Trading Symbol(s)</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$0.01 per share	SGRY	The Nasdaq Global Select Market

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 filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

Large accelerated filer

Non-accelerated filer

Accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of November 1, 2019, there were 49,506,287 shares of the registrant's common stock outstanding.

---

---

**SURGERY PARTNERS, INC.**  
**FORM 10-Q**  
**TABLE OF CONTENTS**

	<u>Page</u>
<b>PART I - FINANCIAL INFORMATION</b>	
Item 1.	Financial Statements <span style="float:right"><a href="#"><u>1</u></a></span>
	Condensed Consolidated Balance Sheets (Unaudited) <span style="float:right"><a href="#"><u>1</u></a></span>
	Condensed Consolidated Statements of Operations (Unaudited) <span style="float:right"><a href="#"><u>2</u></a></span>
	Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited) <span style="float:right"><a href="#"><u>3</u></a></span>
	Condensed Consolidated Statements of Stockholders' Equity (Unaudited) <span style="float:right"><a href="#"><u>4</u></a></span>
	Condensed Consolidated Statements of Cash Flows (Unaudited) <span style="float:right"><a href="#"><u>6</u></a></span>
	Notes to Condensed Consolidated Financial Statements (Unaudited) <span style="float:right"><a href="#"><u>7</u></a></span>
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations <span style="float:right"><a href="#"><u>23</u></a></span>
Item 3.	Quantitative and Qualitative Disclosures About Market Risk <span style="float:right"><a href="#"><u>32</u></a></span>
Item 4.	Controls and Procedures <span style="float:right"><a href="#"><u>32</u></a></span>
<b>PART II - OTHER INFORMATION</b>	
Item 1.	Legal Proceedings <span style="float:right"><a href="#"><u>34</u></a></span>
Item 1A.	Risk Factors <span style="float:right"><a href="#"><u>34</u></a></span>
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds <span style="float:right"><a href="#"><u>35</u></a></span>
Item 3.	Defaults Upon Senior Securities <span style="float:right"><a href="#"><u>35</u></a></span>
Item 4.	Mine Safety Disclosures <span style="float:right"><a href="#"><u>35</u></a></span>
Item 5.	Other Information <span style="float:right"><a href="#"><u>35</u></a></span>
Item 6.	Exhibits <span style="float:right"><a href="#"><u>36</u></a></span>

---

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

SURGERY PARTNERS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited, dollars in millions, except per share amounts)

	September 30, 2019	December 31, 2018
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 111.3	\$ 184.3
Accounts receivable	303.1	307.6
Inventories	44.4	43.4
Prepaid expenses and other current assets	59.1	53.0
Total current assets	517.9	588.3
Property and equipment, net of accumulated depreciation of \$97.9 and \$56.1, respectively	408.2	426.3
Intangible assets, net	52.6	54.3
Goodwill	3,405.6	3,382.8
Investments in and advances to affiliates	93.0	78.5
Long-term deferred tax assets	96.1	109.2
Other long-term assets	344.1	36.9
Total assets	\$ 4,917.5	\$ 4,676.3
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 85.1	\$ 83.3
Accrued payroll and benefits	45.9	55.2
Other current liabilities	199.2	155.2
Current maturities of long-term debt	51.3	55.6
Total current liabilities	381.5	349.3
Long-term debt, less current maturities	2,403.0	2,270.9
Other long-term liabilities	426.3	271.3
Non-controlling interests—redeemable	314.5	326.6
Redeemable preferred stock - Series A; shares authorized, issued and outstanding - 310,000; redemption value - \$385.7 and \$359.3, respectively	385.7	359.3
Stockholders' equity:		
Preferred stock, \$0.01 par value; shares authorized - 20,000,000; shares issued or outstanding - none	—	—
Common stock, \$0.01 par value; shares authorized - 300,000,000; shares issued and outstanding - 49,506,287 and 48,869,204, respectively	0.5	0.5
Additional paid-in capital	670.3	673.5
Accumulated other comprehensive loss	(57.5)	(22.4)
Retained deficit	(284.6)	(247.0)
Total Surgery Partners, Inc. stockholders' equity	328.7	404.6
Non-controlling interests—non-redeemable	677.8	694.3
Total stockholders' equity	1,006.5	1,098.9
Total liabilities and stockholders' equity	\$ 4,917.5	\$ 4,676.3

See notes to unaudited condensed consolidated financial statements.

**SURGERY PARTNERS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
*(Unaudited, dollars in millions, except per share amounts, shares in thousands)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Revenues	\$ 452.0	\$ 432.4	\$ 1,314.2	\$ 1,280.3
Operating expenses:				
Salaries and benefits	139.3	131.4	401.2	395.2
Supplies	126.2	120.1	364.6	355.7
Professional and medical fees	38.5	34.9	110.0	107.3
Lease expense	21.4	21.7	63.0	64.9
Other operating expenses	27.7	26.2	80.8	78.6
Cost of revenues	353.1	334.3	1,019.6	1,001.7
General and administrative expenses	19.9	19.4	64.9	69.7
Depreciation and amortization	18.4	17.0	56.3	49.4
Income from equity investments	(2.4)	(1.9)	(6.6)	(6.3)
Loss (gain) on disposals and deconsolidations, net	0.6	12.6	(7.0)	15.9
Transaction and integration costs	3.4	7.1	11.6	23.8
Loss on debt extinguishment	—	—	11.7	—
Other income	—	(1.1)	(0.4)	(3.6)
Total operating expenses	393.0	387.4	1,150.1	1,150.6
Operating income	59.0	45.0	164.1	129.7
Tax receivable agreement expense	—	—	(2.4)	—
Interest expense, net	(45.7)	(37.2)	(134.1)	(107.3)
Income before income taxes	13.3	7.8	27.6	22.4
Income tax expense	2.4	5.8	5.1	10.9
Net income	10.9	2.0	22.5	11.5
Less: Net income attributable to non-controlling interests	(26.6)	(23.0)	(78.1)	(69.5)
Net loss attributable to Surgery Partners, Inc.	(15.7)	(21.0)	(55.6)	(58.0)
Less: Amounts attributable to participating securities	(9.1)	(8.2)	(26.4)	(23.9)
Net loss attributable to common stockholders	\$ (24.8)	\$ (29.2)	\$ (82.0)	\$ (81.9)
Net loss per share attributable to common stockholders				
Basic	\$ (0.51)	\$ (0.61)	\$ (1.70)	\$ (1.71)
Diluted <sup>(1)</sup>	\$ (0.51)	\$ (0.61)	\$ (1.70)	\$ (1.71)
Weighted average common shares outstanding				
Basic	48,310	48,038	48,265	48,020
Diluted <sup>(1)</sup>	48,310	48,038	48,265	48,020

<sup>(1)</sup> The impact of potentially dilutive securities for all periods presented was not considered because the effect would be anti-dilutive in those periods.

See notes to unaudited condensed consolidated financial statements.

**SURGERY PARTNERS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
*(Unaudited, dollars in millions)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Net income	\$ 10.9	\$ 2.0	\$ 22.5	\$ 11.5
Other comprehensive income, net of tax:				
Derivative activity	(6.8)	(1.4)	(35.1)	(1.4)
Comprehensive income (loss)	4.1	0.6	(12.6)	10.1
Less: Comprehensive income attributable to non-controlling interests	(26.6)	(23.0)	(78.1)	(69.5)
Comprehensive loss attributable to Surgery Partners, Inc.	<u>\$ (22.5)</u>	<u>\$ (22.4)</u>	<u>\$ (90.7)</u>	<u>\$ (59.4)</u>

See notes to unaudited condensed consolidated financial statements.

**SURGERY PARTNERS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
*(Unaudited, dollars in millions, shares in thousands)*

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Deficit	Non-Controlling Interests— Non-Redeemable	Total
	Shares	Amount					
Balance at December 31, 2018	48,869	\$ 0.5	\$ 673.5	\$ (22.4)	\$ (247.0)	\$ 694.3	\$ 1,098.9
Net (loss) income	—	—	—	—	(20.1)	16.0	(4.1)
Equity-based compensation	517	—	0.9	—	—	—	0.9
Preferred dividends	—	—	(8.5)	—	—	—	(8.5)
Other comprehensive loss	—	—	—	(11.5)	—	—	(11.5)
Net effect of adoption of new accounting standard (see Note 1)	—	—	—	—	18.0	—	18.0
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	8.0	—	—	6.1	14.1
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(23.5)	(23.5)
Balance at March 31, 2019	49,386	0.5	673.9	(33.9)	(249.1)	692.9	1,084.3
Net (loss) income	—	—	—	—	(19.8)	18.7	(1.1)
Equity-based compensation	117	—	3.1	—	—	—	3.1
Preferred dividends	—	—	(8.8)	—	—	—	(8.8)
Other comprehensive loss	—	—	—	(16.8)	—	—	(16.8)
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	9.6	—	—	(7.6)	2.0
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(17.7)	(17.7)
Balance at June 30, 2019	49,503	0.5	677.8	(50.7)	(268.9)	686.3	1,045.0
Net (loss) income	—	—	—	—	(15.7)	19.3	3.6
Equity-based compensation	3	—	2.7	—	—	—	2.7
Preferred dividends	—	—	(9.1)	—	—	—	(9.1)
Other comprehensive loss	—	—	—	(6.8)	—	—	(6.8)
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	(1.1)	—	—	(7.9)	(9.0)
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(19.9)	(19.9)
Balance at September 30, 2019	49,506	\$ 0.5	\$ 670.3	\$ (57.5)	\$ (284.6)	\$ 677.8	\$ 1,006.5

<sup>(1)</sup> Includes post acquisition date adjustments.

See notes to unaudited condensed consolidated financial statements.

**SURGERY PARTNERS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
*(Unaudited, dollars in millions, shares in thousands)*

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Deficit	Non-Controlling Interests— Non-Redeemable	Total
	Shares	Amount					
Balance at December 31, 2017	48,687	\$ 0.5	\$ 695.5	\$ —	\$ (41.3)	\$ 681.9	\$ 1,336.6
Net (loss) income	—	—	—	—	(17.5)	15.9	(1.6)
Equity-based compensation	368	—	1.3	—	—	—	1.3
Preferred dividends	—	—	(7.8)	—	—	—	(7.8)
Repurchase of shares	(157)	—	(2.0)	—	—	—	(2.0)
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	2.0	—	—	(1.2)	0.8
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(22.5)	(22.5)
Balance at March 31, 2018	48,898	0.5	689.0	—	(58.8)	674.1	1,304.8
Net (loss) income	—	—	—	—	(19.5)	16.6	(2.9)
Equity-based compensation	4	—	2.5	—	—	—	2.5
Preferred dividends	—	—	(7.9)	—	—	—	(7.9)
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	(7.7)	—	—	(17.5)	(25.2)
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(16.8)	(16.8)
Balance at June 30, 2018	48,902	0.5	675.9	—	(78.3)	656.4	1,254.5
Net (loss) income	—	—	—	—	(21.0)	16.4	(4.6)
Equity-based compensation	(10)	—	1.4	—	—	—	1.4
Preferred dividends	—	—	(8.3)	—	—	—	(8.3)
Other comprehensive loss	—	—	—	(1.4)	—	—	(1.4)
Acquisition and disposal of shares of non-controlling interests, net <sup>(1)</sup>	—	—	2.3	—	—	3.1	5.4
Distributions to non-controlling interests—non-redeemable holders	—	—	—	—	—	(18.2)	(18.2)
Balance at September 30, 2018	48,892	\$ 0.5	\$ 671.3	\$ (1.4)	\$ (99.3)	\$ 657.7	\$ 1,228.8

<sup>(1)</sup> Includes post acquisition date adjustments.

See notes to unaudited condensed consolidated financial statements.

**SURGERY PARTNERS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(Unaudited, dollars in millions)*

	Nine Months Ended September 30,	
	2019	2018
<b>Cash flows from operating activities:</b>		
Net income	\$ 22.5	\$ 11.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	56.3	49.4
Non-cash interest expense (income), net	0.6	(1.0)
Equity-based compensation expense	7.6	6.3
(Gain) loss on disposals and deconsolidations, net	(7.0)	15.9
Loss on debt extinguishment	11.7	—
Deferred income taxes	4.1	9.5
Income from equity investments, net of distributions received	0.5	(0.2)
Amortization of right-of-use operating lease assets	28.8	—
Changes in operating assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	7.7	2.1
Other operating assets and liabilities	(28.7)	5.6
Net cash provided by operating activities	<u>104.1</u>	<u>99.1</u>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(50.2)	(26.6)
Payments for acquisitions, net of cash acquired	(13.8)	(55.2)
Proceeds from disposals of facilities and other assets	17.6	18.0
Purchases of equity investments	(15.2)	—
Other investing activities	(0.2)	(2.8)
Net cash used in investing activities	<u>(61.8)</u>	<u>(66.6)</u>
<b>Cash flows from financing activities:</b>		
Principal payments on long-term debt	(436.1)	(94.9)
Borrowings of long-term debt	442.5	62.8
Payments of debt issuance costs	(8.8)	—
Payment of premium on debt extinguishment	(17.8)	—
Payments of preferred dividends	—	(7.8)
Distributions to non-controlling interest holders	(89.5)	(80.1)
Payments related to ownership transactions with non-controlling interest holders	(4.6)	(0.5)
Repurchase of shares	—	(2.0)
Other financing activities	(1.0)	(5.8)
Net cash used in financing activities	<u>(115.3)</u>	<u>(128.3)</u>
Net decrease in cash, cash equivalents and restricted cash	(73.0)	(95.8)
Cash, cash equivalents and restricted cash at beginning of period	184.6	175.2
Cash, cash equivalents and restricted cash at end of period	<u>\$ 111.6</u>	<u>\$ 79.4</u>

See notes to unaudited condensed consolidated financial statements.



**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

**1. Organization and Summary of Accounting Policies**

**Organization**

Surgery Partners, Inc., a Delaware corporation, acting through its subsidiaries, owns and operates a national network of surgical facilities and ancillary services. The surgical facilities, which include ambulatory surgery centers ("ASCs") and surgical hospitals, primarily provide non-emergency surgical procedures across many specialties, including, among others, gastroenterology, general surgery, ophthalmology, orthopedics and pain management. The Company's surgical hospitals also provide services such as diagnostic imaging, laboratory, obstetrics, oncology, pharmacy, physical therapy and wound care. Ancillary services are comprised of a diagnostic laboratory, multi-specialty physician practices, urgent care facilities, anesthesia services and optical services. Unless the context otherwise indicates, Surgery Partners, Inc. and its subsidiaries are referred to herein as "Surgery Partners," "we," "us," "our" or the "Company."

As of September 30, 2019, the Company owned or operated a portfolio of 128 surgical facilities, comprised of 113 ASCs and 15 surgical hospitals in 31 states. The Company owns these facilities in partnership with physicians and, in some cases, healthcare systems in the markets and communities it serves. The Company owned a majority interest in 86 of the surgical facilities and consolidated 107 of these facilities for financial reporting purposes.

**Basis of Presentation**

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation of the Company's financial position and results of operations have been included. The Company's fiscal year ends on December 31 and interim results are not necessarily indicative of results for a full year or any other interim period. The information contained in these condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, as well as interests in partnerships and limited liability companies controlled by the Company through its ownership of a majority voting interest or other rights granted to the Company by contract to manage and control the affiliate's business. All significant intercompany balances and transactions are eliminated in consolidation.

**Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and footnotes. Examples include, but are not limited to, estimates of accounts receivable allowances, professional and general liabilities and the estimate of deferred tax assets or liabilities. Actual results could differ from those estimates.

**Variable Interest Entities**

The condensed consolidated financial statements include the accounts of variable interest entities ("VIE") in which the Company is the primary beneficiary under the provisions of the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification 810, Consolidation. The Company has the power to direct the activities that most significantly impact a VIEs economic performance. Additionally, the Company would absorb the majority of the expected losses from any of these entities should such expected losses occur. As of September 30, 2019, the consolidated VIEs include four surgical facilities, three anesthesia practices and three physician practices.

The total assets (excluding goodwill and intangible assets, net) of the consolidated VIEs included in the accompanying condensed consolidated balance sheets as of September 30, 2019 and December 31, 2018, were \$31.5 million and \$11.2 million, respectively, and the total liabilities of the consolidated VIEs were \$23.4 million and \$3.6 million, respectively.

**Fair Value of Financial Instruments**

The fair value of a financial instrument is the amount at which the instrument could be exchanged in an orderly transaction between market participants to sell the asset or transfer the liability. The Company uses fair value measurements based on quoted prices in active markets for identical assets or liabilities (Level 1), inputs other than quoted prices in active markets that are either directly or indirectly observable (Level 2), or unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions (Level 3), depending on the nature of the item being valued.

The carrying amounts reported in the condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, restricted invested assets and accounts payable approximate their fair values under Level 3 calculations.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

A summary of the carrying amounts and estimated fair values of the Company's long-term debt follows (in millions):

	Carrying Amount		Fair Value	
	September 30, 2019	December 31, 2018	September 30, 2019	December 31, 2018
Senior secured term loan	\$ 1,437.2	\$ 1,447.9	\$ 1,401.3	\$ 1,382.8
8.875% senior unsecured notes due 2021	\$ —	\$ 406.7	\$ —	\$ 407.2
6.750% senior unsecured notes due 2025	\$ 370.0	\$ 370.0	\$ 333.5	\$ 320.5
10.000% senior unsecured notes due 2027	\$ 430.0	\$ —	\$ 436.5	\$ —

The fair values in the table above were based on a Level 2 inputs using quoted prices for identical liabilities in inactive markets. The carrying amounts related to the Company's other long-term debt obligations, including finance lease obligations, approximate their fair values under Level 3 calculations.

The Company has entered into certain interest rate swap agreements (see Note 6. "Derivatives and Hedging Activities"). The fair value of these derivative instruments was \$57.5 million and \$22.4 million at September 30, 2019 and December 31, 2018, respectively, and was included in other long-term liabilities in the condensed consolidated balance sheets. The fair value of these derivative financial instruments was based on a quoted market price, or a Level 2 computation.

**Revenues**

The Company's revenues generally relate to contracts with patients in which the performance obligations are to provide healthcare services. The Company recognizes revenues in the period in which our obligations to provide health care services are satisfied and reports the amount that reflects the consideration the Company expects to be entitled to. The contractual relationships with patients, in most cases, also involve a third-party payor (e.g., Medicare, Medicaid, managed care health plans, employers and commercial insurance companies, including plans offered through the health insurance exchanges) and the transaction prices for the services provided are dependent upon the terms provided by or negotiated with the third-party payors. The payment arrangements with third-party payors for the services provided to the related patients typically specify payments at amounts less than the Company's standard charges. The Company continually reviews the contractual estimation process to consider and incorporate updates to laws and regulations and the frequent changes in managed care contractual terms resulting from contract renegotiations and renewals.

A summary of revenues by service type as a percentage of total revenues follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
<b>Patient service revenues:</b>				
Surgical facilities revenues	93.9%	93.2%	94.0%	93.2%
Ancillary services revenues	4.4%	4.7%	4.6%	4.8%
	98.3%	97.9%	98.6%	98.0%
<b>Other service revenues:</b>				
Optical services revenues	0.2%	0.6%	0.2%	0.6%
Other revenues	1.5%	1.5%	1.2%	1.4%
	1.7%	2.1%	1.4%	2.0%
<b>Total revenues</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

*Patient service revenues.* This revenue is related to charging facility fees in exchange for providing patient care. The fee charged for healthcare procedures performed in surgical facilities varies depending on the type of service provided, but usually includes all charges for usage of an operating room, a recovery room, special equipment, medical supplies, nursing staff and medications. The fee does not normally include professional fees charged by the patient's surgeon, anesthesiologist or other attending physician, which are billed directly by such physicians to the patient or third-party payor. However, in several surgical facilities, the Company charges for anesthesia services. Ancillary service revenues include fees for patient visits to the Company's physician practices, pharmacy services and diagnostic tests ordered by physicians.

Patient service revenues are recognized as performance obligations are satisfied. Performance obligations are based on the nature of services provided. Typically, the Company recognizes revenue at a point in time in which services are rendered and the Company has no obligation to provide further patient services. As the Company primarily performs outpatient procedures, performance obligations are generally satisfied same day and revenue is recognized on the date of service.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

The Company determines the transaction price based on gross charges for services provided, net of estimated contractual adjustments and discounts from third-party payors. The Company estimates its contractual adjustments and discounts based on contractual agreements, its discount policies and historical experience. Changes in estimated contractual adjustments and discounts are recorded in the period of change.

*Other service revenues.* Optical service revenues consist of handling charges billed to the members of the Company's optical products purchasing organization. The Company's optical products purchasing organization negotiates volume buying discounts with optical products manufacturers. The buying discounts and any handling charges billed to the members of the buying group represent the revenue recognized for financial reporting purposes. The Company satisfies the performance obligation and recognizes revenue when the orders are shipped to members. The Company bases its estimates for sales returns and discounts on historical experience and has not experienced significant fluctuations between estimated and actual return activity and discounts given.

Other revenues include management and administrative service fees derived from the non-consolidated facilities that the Company accounts for under the equity method, management of surgical facilities in which it does not own an interest, and management services provided to physician practices for which the Company is not required to provide capital or additional assets. These agreements typically require the Company to provide recurring management services over a multi-year period which are billed and collected on a monthly basis. The fees derived from these management arrangements are based on a predetermined percentage of the revenues of each facility or practice and are recognized in the period in which management services are rendered and billed.

The following table sets forth patient service revenues by type of payor and as a percentage of total patient service revenues for the Company's consolidated surgical facilities (dollars in millions):

	Three Months Ended September 30,			
	2019		2018	
	Amount	%	Amount	%
<b>Patient service revenues:</b>				
Private insurance	\$ 236.3	53.2%	\$ 224.5	53.1%
Government	175.4	39.5%	162.4	38.4%
Self-pay	11.8	2.7%	12.4	2.9%
Other <sup>(1)</sup>	21.0	4.6%	23.8	5.6%
Total patient service revenues	444.5	100.0%	423.1	100.0%
<b>Other service revenues:</b>				
Optical services revenues	0.9		2.7	
Other revenues	6.6		6.6	
Total revenues	\$ 452.0		\$ 432.4	

	Nine Months Ended September 30,			
	2019		2018	
	Amount	%	Amount	%
<b>Patient service revenues:</b>				
Private insurance	\$ 682.1	52.7%	\$ 668.7	53.3%
Government	518.4	40.0%	483.4	38.6%
Self-pay	32.1	2.5%	38.3	3.1%
Other <sup>(1)</sup>	62.2	4.8%	62.7	5.0%
Total patient service revenues	1,294.8	100.0%	1,253.1	100.0%
<b>Other service revenues:</b>				
Optical services revenues	3.0		8.5	
Other revenues	16.4		18.7	
Total revenues	\$ 1,314.2		\$ 1,280.3	

(1) Other is comprised of anesthesia service agreements, automobile liability, letters of protection and other payor types.

**Cash, Cash Equivalents and Restricted Cash**

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company maintains its cash and cash equivalent balances at high credit quality financial institutions.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

Cash, cash equivalents and restricted cash reported within the consolidated statement of cash flows includes \$0.3 million of restricted investments, which are reflected in other long-term assets in the consolidated balance sheet at both September 30, 2019 and December 31, 2018. These restricted investments represent restricted cash held in accordance with the provisions of a long-term operating lease agreement held as security for performance under the Company's covenants and obligations within the agreement through January 2024.

#### **Accounts Receivable and Allowances for Contractual Adjustments and Doubtful Accounts**

Accounts receivable from third-party payors are recorded net of estimated implicit price concessions, which are estimated based on the historical trend of the Company's surgical facilities' cash collections and contractual write-offs, established fee schedules, relationships with payors and procedure statistics. While changes in estimated reimbursement from third-party payors remain a possibility, the Company expects that any such changes would be minimal and, therefore, would not have a material effect on its financial condition or results of operations.

Accounts receivable consists of receivables from federal and state agencies (under the Medicare and Medicaid programs), managed care health plans, commercial insurance companies, employers and patients. Management recognizes that revenues and receivables from government agencies are significant to the Company's operations, but it does not believe that there is significant credit risk associated with these government agencies. Concentration of credit risk with respect to other payors is limited because of the large number of such payors. As of September 30, 2019 and December 31, 2018, the Company had a net third-party Medicaid settlements liability of \$7.9 million and \$4.8 million, respectively, included in other current liabilities in the condensed consolidated balance sheets.

The Company recognizes that final reimbursement of accounts receivable is subject to final approval by each third-party payor. However, because the Company has contracts with its third-party payors and also verifies insurance coverage of the patient before medical services are rendered, the amounts that are pending approval from third-party payors are not considered significant. Amounts are classified outside of self-pay if the Company has an agreement with the third-party payor or has verified a patient's coverage prior to services rendered. The Company's policy is to collect co-payments and deductibles prior to providing medical services. Patient services of the Company are primarily non-emergency, which allows the surgical facilities to control the procedures for which third-party reimbursement is sought and obtained. The Company does not require collateral from self-pay patients.

The Company's collection policies and procedures are based on the type of payor, size of claim and estimated collection percentage for each patient account. The operating systems used to manage patient accounts provide for an aging schedule in 30-day increments, by payor, physician and patient. The Company analyzes accounts receivable at each of its surgical facilities to ensure the proper collection and aged category. The operating systems generate reports that assist in the collection efforts by prioritizing patient accounts. Collection efforts include direct contact with third-party payors or patients, written correspondence and the use of legal or collection agency assistance, as required.

The receivables related to the Company's optical products purchasing organization are recognized separately from patient accounts receivable, as discussed above, and are included in other current assets in the condensed consolidated balance sheets. Such receivables were \$9.2 million and \$8.5 million at September 30, 2019 and December 31, 2018, respectively.

#### **Goodwill**

Goodwill represents the fair value of the consideration provided in an acquisition over the fair value of net assets acquired and is not amortized. Additions to goodwill include amounts resulting from new business combinations and incremental ownership purchases in the Company's subsidiaries. A summary of the Company's acquisitions for the nine months ended September 30, 2019 is included in Note 2. "Acquisitions."

A summary of activity related to goodwill for the nine months ended September 30, 2019 is as follows (in millions):

Balance at December 31, 2018	\$	3,382.8
Acquisitions, including post acquisition adjustments		22.8
Balance at September 30, 2019	\$	<u>3,405.6</u>

#### **Derivative Instruments and Hedging Activities**

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

**Non-Controlling Interests—Redeemable**

Each partnership and limited liability company through which the Company owns and operates its surgical facilities is governed by a partnership or operating agreement, respectively. In certain circumstances, the applicable partnership or operating agreements for the Company's surgical facilities provide that the facilities will purchase all of the physician limited partners' or physician minority members', as applicable, ownership if certain adverse regulatory events occur, such as it becoming illegal for the physician(s) to own an interest in a surgical facility, refer patients to a surgical facility or receive cash distributions from a surgical facility. The non-controlling interests—redeemable are reported outside of stockholders' equity in the condensed consolidated balance sheets.

A summary of activity related to the non-controlling interests—redeemable is as follows (in millions):

Balance at December 31, 2018	\$	326.6
Net income attributable to non-controlling interests—redeemable		24.1
Acquisition and disposal of shares of non-controlling interests, net—redeemable <sup>(1)</sup>		(7.8)
Distributions to non-controlling interest—redeemable holders		(28.4)
Balance at September 30, 2019	\$	<u>314.5</u>

(1) Includes post acquisition date adjustments.

**Income Taxes**

The Company uses the asset and liability method to account for income taxes. Under this method, deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. If a carryforward exists, the Company makes a determination as to whether the carryforward will be utilized in the future. A valuation allowance is established for certain carryforwards when their recoverability is deemed to be uncertain. The carrying value of the net deferred tax assets assumes that the Company will be able to generate sufficient future taxable income in certain tax jurisdictions, based on estimates and assumptions. If our expectations for future operating results on a consolidated basis or at the state jurisdiction level vary from actual results due to changes in healthcare regulations, general economic conditions, or other factors, we may need to adjust the valuation allowance, for all or a portion of our deferred tax assets. Our income tax expense in future periods will be reduced or increased to the extent of offsetting decreases or increases, respectively, in our valuation allowance in the period when the change in circumstances occurs. These changes could have a significant impact on our future earnings.

The Company and certain of its subsidiaries file a consolidated federal income tax return. The partnerships, limited liability companies, and certain non-consolidated physician practice corporations also file separate income tax returns. The Company's allocable portion of each partnership's and limited liability company's income or loss is included in taxable income of the Company. The remaining income or loss of each partnership and limited liability company is allocated to the other owners.

**Recent Accounting Pronouncements**

In February 2016, the FASB issued ASU 2016-02, "Leases," (the "Lease Accounting Standard"). The core principal of the Lease Accounting Standard is to increase transparency and comparability among organizations by requiring the recognition of right-of-use lease assets and liabilities on the balance sheet and disclosing key information. The most prominent among the changes from this ASU is the recognition of right-of-use assets and lease liabilities by lessees for those leases classified as operating leases. The Company's accounting for finance leases remained substantially unchanged from its prior accounting for capital leases. The disclosure objective is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

The Company adopted the Lease Accounting Standard effective January 1, 2019, using a modified retrospective transition approach. Under this approach, the Company elected to recognize and measure leases under the new standard in the period of adoption, with a cumulative-effect adjustment recorded to equity on its condensed consolidated balance sheets, along with the application of certain available practical expedients including an exclusion for short-term leases and accounting for leases at the portfolio level where appropriate. The cumulative effect of the accounting change recognized upon adoption was \$18.0 million reflected as an adjustment to retained deficit in our condensed consolidated balance sheets.

The Company has implemented internal controls and key system functionality to establish governance and oversight over the implementation, and to ensure the Company's financial statements and related footnotes are complete and accurate and are adequately reviewed by members of management. The newly implemented internal control changes related to leases include new systems and software implementation, updated accounting and disclosure policies, and redesigned financial reporting internal controls over governance, oversight and reviews. Additionally, the Company has expanded data gathering procedures to comply with the additional disclosure requirements and ongoing contract review requirements.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

In June 2016, the FASB issued ASU2016-13, which introduced a new model for recognizing credit losses on financial instruments based on an estimate of the current expected credit losses. The new current expected credit losses (“CECL”) model generally calls for the immediate recognition of all expected credit losses and applies to financial instruments and other assets, including accounts receivable and other financial assets measured at amortized cost, debt securities and other financial assets. This guidance replaces the current incurred loss model for measuring expected credit losses, requires expected losses on available-for-sale debt securities to be recognized through an allowance for credit losses rather than as reductions in the amortized cost of the securities, and provides for additional disclosure requirements. This ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact that adoption of this ASU will have on its consolidated financial position and results of operations.

## 2. Acquisitions

During the nine months ended September 30, 2019, the Company acquired a controlling interest in one surgical facility, a clinic that was merged into an existing facility and a physician practice for total aggregate consideration of \$26.7 million, including cash consideration of \$20.1 million, net of cash acquired. The remainder of the consideration related to the forgiveness of certain amounts due to the Company from the acquired clinic. The cash consideration was funded through cash from operations. The total consideration was allocated to the assets acquired and liabilities assumed based upon the respective acquisition date fair values. The aggregate amounts preliminarily recognized for each major class of assets acquired and liabilities assumed for the acquisitions are as follows (in millions):

Total consideration <sup>(1)</sup>	\$	26.7
Fair value of non-controlling interests		8.3
Aggregate acquisition date fair value	<u>\$</u>	<u>35.0</u>
Net assets acquired:		
Current assets	\$	5.0
Property and equipment		1.8
Goodwill		22.8
Other long-term assets <sup>(2)</sup>		37.7
Current liabilities		(3.9)
Long-term debt, less current maturities		(0.2)
Other long-term liabilities		(28.2)
Aggregate acquisition date fair value	<u>\$</u>	<u>35.0</u>

(1) In connection with the clinic acquisition, the Company acquired the remaining non-controlling interests in one of its existing consolidated surgical facilities. As such, \$6.3 million of the cash consideration for the clinic acquisition was classified as a financing activity and presented in payments related to ownership transactions with non-controlling interest holders in the Condensed Consolidated Statements of Cash Flows.

(2) The assets acquired includes the fair value of a non-controlling investment held by the acquired clinic in one of the Company's consolidated surgical facilities \$8.8 million. This investment asset was subsequently eliminated in consolidation.

The fair values assigned to certain assets acquired and liabilities assumed by the Company have been estimated on a preliminary basis and are subject to change as new facts and circumstances emerge that were present at the date of acquisition. During the nine months ended September 30, 2019, no significant changes were made to the purchase price allocation of assets and liabilities, existing at the date of acquisition, related to individual acquisitions completed in 2018. The goodwill acquired was primarily allocated to the Company's reportable segments as follows: \$14.3 million to surgical facility services and \$8.5 million to ancillary services. The results of operations of the acquisitions were included in the Company's results of operations beginning on the dates of acquisition and were not considered significant for the nine months ended September 30, 2019.

### Other Acquisitions and Dispositions

During the nine months ended September 30, 2019, the Company acquired a non-controlling interest in four surgical facilities for a cash investment of \$14.0 million. The non-controlling interest was accounted for as an equity method investment and recorded as a component of investments in and advances to affiliates in the accompanying condensed consolidated balance sheets.

During the nine months ended September 30, 2019, the Company disposed of previously owned real property associated with one of its existing non-consolidated surgical facilities. In connection with the sale, the Company recognized a \$10.9 million pretax gain included in loss (gain) on disposals and deconsolidations, net in the accompanying condensed consolidated statements of operations. The sale did not impact the Company's investment in the surgical facility, which continues to be accounted for as an equity method investment.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

**3. Long-Term Debt**

A summary of long-term debt is as follows (in millions):

	September 30, 2019	December 31, 2018
Senior secured term loan <sup>(1)</sup>	\$ 1,437.2	\$ 1,447.9
Senior secured revolving credit facility	—	—
8.875% senior unsecured notes due 2021 <sup>(2)</sup>	—	406.7
6.750% senior unsecured notes due 2025	370.0	370.0
10.000% senior unsecured notes due 2027	430.0	—
Notes payable and other secured loans	74.4	79.4
Finance lease obligations <sup>(3)</sup>	153.5	25.4
Less: unamortized debt issuance costs	(10.8)	(2.9)
<b>Total debt</b>	<b>2,454.3</b>	<b>2,326.5</b>
Less: Current maturities	51.3	55.6
<b>Total long-term debt</b>	<b>\$ 2,403.0</b>	<b>\$ 2,270.9</b>

(1) Includes unamortized fair value discount of \$2 million and \$5.5 million as of September 30, 2019 and December 31, 2018, respectively.

(2) Includes unamortized fair value premium of \$6.7 million as of December 31, 2018. The premium was written-off upon redemption as discussed below.

(3) In connection with the adoption of the Lease Accounting Standard, the Company's capital lease obligations that existed as of December 31, 2018 were derecognized and included as a component of the finance lease obligations included in the table shown above. See Note 4. "Leases" for further discussion on the adoption of the Lease Accounting Standard. The increase in finance lease obligations upon adoption of the Lease Accounting Standard is due to the inclusion of certain financing obligations that were previously recognized as a component of other current and long-term liabilities as discussed further in Note 8. "Other Assets and Liabilities."

*10.000% Senior Unsecured Notes due 2027*

Effective April 11, 2019, the Company issued an aggregate principal amount of \$430.0 million of senior unsecured notes due April 15, 2027 (the "2027 Unsecured Notes"). The 2027 Unsecured Notes bear interest at the rate of 10.000% per annum, payable semi-annually on April 15 and October 15 of each year, beginning on October 15, 2019. The 2027 Unsecured Notes are a senior unsecured obligation of Surgery Center Holdings, Inc. and are guaranteed on a senior unsecured basis by each of Surgery Center Holdings, Inc.'s existing and future domestic wholly-owned restricted subsidiaries that guarantees the existing senior secured term loan and revolving credit facility (subject to certain exceptions).

The Company may redeem up to 40% of the aggregate principal amount of the 2027 Unsecured Notes at any time prior to April 15, 2022, with the net cash proceeds of certain equity issuances at a redemption price equal to 110.000% of the principal amount of notes to be redeemed, plus accrued and unpaid interest to, but excluding, the date of redemption.

The Company may redeem the 2027 Unsecured Notes, in whole or in part, at any time prior to April 15, 2022, at a redemption price equal to 100% of the principal amount of notes to be redeemed plus the applicable premium, plus accrued and unpaid interest, if any, to, but excluding, the date of redemption. The Company may redeem the 2027 Unsecured Notes, in whole or in part, at any time on or after April 15, 2022, at the redemption prices set forth below (expressed as a percentage of the principal amount of notes to be redeemed), plus accrued and unpaid interest, if any, to, but excluding, the date of redemption:

April 15, 2022 to April 14, 2023	105.000%
April 15, 2023 to April 14, 2024	102.500%
April 15, 2024 and thereafter	100.000%

If Surgery Center Holdings, Inc. experiences a change of control under certain circumstances, it must offer to purchase the 2027 Unsecured Notes at a purchase price equal to 101.000% of the aggregate principal amount of notes, plus accrued and unpaid interest, if any, to, but excluding, the date of repurchase.

The indenture governing the 2027 Unsecured Notes contains customary affirmative and negative covenants, which, among other things, limit the Company's ability to incur additional debt, pay dividends, create or assume liens, effect transactions with its affiliates, guarantee payment of certain debt securities, sell assets, merge, consolidate, enter into acquisitions and effect sale and leaseback transactions.

In connection with the offering of the 2027 Unsecured Notes, the Company recorded debt issuance costs of \$8.8 million.

SURGERY PARTNERS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

*8.875% Senior Unsecured Notes due 2021*

In connection with issuance of the 2027 Unsecured Notes as discussed above, the Company redeemed all of the then existing senior unsecured notes due 2021 ("2021 Unsecured Notes"). The redemption price was equal to 104.438% of the outstanding principal amount plus accrued and unpaid interest. In connection with the redemption, the Company recorded a debt extinguishment loss of \$11.7 million, included in loss on debt extinguishment in the condensed consolidated statements of operations for the nine months ended September 30, 2019. The loss includes the redemption premium paid partially offset by the write-off of the unamortized fair value premium as of the redemption date.

*Senior Secured Revolving Credit Facility*

In connection with the completion of the issuance of the 2027 Unsecured Notes, the outstanding commitments under the Company's senior secured revolving credit facility ("Revolver") were increased by \$45.0 million pursuant to an incremental amendment to the credit agreement governing its revolving credit facility. As of both September 30, 2019 and December 31, 2018, the Company had no outstanding borrowing on the Revolver. As of September 30, 2019, the Company's availability on the Revolver was \$115.2 million (including outstanding letters of credit of \$4.8 million).

**4. Leases**

On January 1, 2019, the Company adopted the Lease Accounting Standard using the modified retrospective transition approach by applying the new standard to all leases existing at that date. Results and disclosure requirements for reporting periods beginning after January 1, 2019 are presented under the new guidance, while prior period amounts have not been adjusted.

The Company elected the package of practical expedients permitted under the transition guidance, which allowed the Company to carryforward its historical lease identification, lease classification and initial direct costs for any leases that existed prior to January 1, 2019. The Company also elected the accounting policy practical expedient to exclude leases with an initial term of twelve months or less from the balance sheet. Additionally, for certain leases, the Company applied a portfolio approach to effectively account for the operating lease right-of-use assets and liabilities.

The Company determines if an arrangement is a lease at inception. Right-of-use assets and liabilities are recognized at commencement date based on the present value of remaining lease payments over the lease term. For this purpose, the Company considers only payments that are fixed and determinable at the time of commencement. Variable components of lease payments fluctuating with a future index or rate, as well as those related to common area maintenance costs, are not included in determining lease payments and are expensed as incurred. As most leases do not provide an implicit rate, the Company uses an incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The incremental borrowing rate is a hypothetical rate based on the Company's understanding of what its credit rating would be. The right-of-use asset also includes any lease payments made prior to commencement and is recorded net of any lease incentives received. Lease terms may include options to extend or terminate the lease when it is reasonably certain that the Company will exercise such options.

The Company's operating leases are primarily for real estate, including medical office buildings, and corporate and other administrative offices. The Company's finance leases are primarily for medical equipment and information technology and telecommunications assets. Real estate lease agreements typically have initial terms of ten years and may include one or more options to renew. Certain leases also include options to purchase the leased property. The useful life of assets and leasehold improvements are limited by the expected lease term, unless there is a transfer of title or purchase option reasonably certain of exercise. The majority of the Company's medical equipment leases have a bargain purchase option that is reasonably certain of exercise, so these assets are depreciated over their useful life, typically ranging from five to seven years.



**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

The following table presents the components of the Company's right-of-use assets and liabilities related to leases, their classification in the condensed consolidated balance sheets, the weighted-average lease terms and discount rates at September 30, 2019 (in millions):

Classification in Condensed Consolidated Balance Sheets		September 30, 2019
<b>Assets:</b>		
Operating lease assets	Other long-term assets	\$ 311.7
Finance lease assets	Property and equipment, net of accumulated depreciation	147.2
Total leased assets		<u>\$ 458.9</u>
<b>Liabilities:</b>		
Operating lease liabilities:		
Current	Other current liabilities	\$ 35.8
Long-term	Other long-term liabilities	281.4
Total operating lease liabilities		<u>317.2</u>
Finance lease liabilities:		
Current	Current maturities of long-term debt	13.9
Long-term	Long-term debt, less current maturities	139.6
Total finance lease liabilities		<u>153.5</u>
Total lease liabilities		<u>\$ 470.7</u>
Weighted-average remaining lease term:		
Operating leases		8.9 years
Finance leases		12.7 years
Weighted-average discount rate:		
Operating leases		10.4%
Finance leases		10.2%

The following table presents the components of the Company's lease expense and their classification in the condensed consolidated statement of operations for the nine months ended September 30, 2019 (in millions):

Classification in Condensed Consolidated Statement of Operations		Nine Months Ended September 30, 2019
Operating lease costs	Lease expense and general and administrative expenses	\$ 50.8
Finance lease costs:		
Amortization of leased assets	Depreciation and amortization	15.3
Interest on lease liabilities	Interest expense, net	10.9
Total finance lease costs		<u>26.2</u>
Variable and short-term lease costs	Lease expense and general and administrative expenses	10.6
Total lease costs		<u>\$ 87.6</u>

During the nine months ended September 30, 2019, the Company incurred lease costs of \$15.1 million under operating lease agreements with physician investors who are related parties. During the nine months ended September 30, 2019, the Company paid rent of \$4.8 million under a finance lease agreement with a lessor who is a related party. One of the Company's surgical facilities has a non-controlling ownership interest in the lessor. Payments are allocated to principal adjustments of the finance lease liability and interest expense.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

The following table presents supplemental cash flow information for the nine months ended September 30, 2019 (dollars in millions):

	<b>Nine Months Ended September 30, 2019</b>	
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash outflows from operating leases	\$	48.7
Operating cash outflows from finance leases	\$	10.9
Financing cash outflows from finance leases	\$	9.4
Right-of-use assets obtained in exchange for lease obligations:		
Operating leases	\$	48.0
Finance leases	\$	9.1

Future maturities of lease liabilities at September 30, 2019 are presented in the following table (in millions):

	<b>Operating Leases</b>		<b>Finance Leases</b>	
2019	\$	21.9	\$	9.4
2020		65.1		27.8
2021		59.9		25.7
2022		54.9		22.6
2023		51.7		20.1
Thereafter		246.6		194.6
Total lease payments		500.1		300.2
Less: imputed interest		(182.9)		(146.7)
Total lease obligations	\$	317.2	\$	153.5

Future maturities of lease liabilities at December 31, 2018, prior to the adoption of the Lease Accounting Standard, are presented in the following table (in millions):

	<b>Operating Leases <sup>(1)</sup></b>		<b>Capital Leases</b>	
2019	\$	81.5	\$	8.8
2020		75.6		6.7
2021		66.7		4.7
2022		61.3		2.9
2023		57.2		1.5
Thereafter		470.2		4.3
Total lease payments	\$	812.5		28.9
Less: imputed interest				(3.5)
Capital lease obligations			\$	25.4

(1) Includes financing obligations payable to the lessors of certain land, buildings and improvements that arose due to the Company's continued involvement with the leased assets under the sale-leaseback guidance in effect prior to the adoption of the Lease Accounting Standard. As of December 31, 2018, the current portion of the financing obligations was \$7.0 million and was included in other current liabilities in the consolidated balance sheets. The long-term portion of the finance obligations was \$149.8 million and was included as other long-term liabilities in the consolidated balance sheets.

**5. Redeemable Preferred Stock**

On August 31, 2017, the Company issued 310,000 shares of Series A Preferred Stock to Bain at a purchase price of \$1,000 per share for an aggregate purchase price of \$310.0 million.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

A summary of activity related to the Series A Preferred Stock follows (in millions):

Balance at December 31, 2018	\$	359.3
Dividends accrued (there were no cash dividends declared)		26.4
Balance at September 30, 2019	\$	<u>385.7</u>

There were no unpaid cash dividends declared at both September 30, 2019 and December 31, 2018. The aggregate and per share amounts of unpaid cumulative preferred dividends as of September 30, 2019 was \$60.1 million and \$194.00, respectively.

## 6. Derivatives and Hedging Activities

### *Cash Flow Hedges of Interest Rate Risk*

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. During 2019, such derivatives have been used to hedge the variable cash flows associated with existing variable-rate debt.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings, as documented at hedge inception in accordance with the Company's accounting policy election. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Company's variable-rate debt. Over the next 12 months, the Company estimates that an additional \$14.2 million will be reclassified as an increase to interest expense.

As of September 30, 2019, the Company had four interest rate swaps with a current notional amount of \$1.2 billion and a termination date of November 30, 2023. The derivatives are recorded at fair value (see Note 1. "Organization and Summary of Accounting Policies") and classified as a long-term liability included in other long-term liabilities in the condensed consolidated balance sheets.

The following table presents the pre-tax effect of the interest rate swaps on the Company's accumulated other comprehensive income ("OCI") and statement of operations for the three and nine months ended September 30, 2019 (dollars in millions):

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>
<b>Derivatives in cash flow hedging relationships</b>				
Loss recognized in OCI (effective portion)	\$ 8.5	\$ 1.4	\$ 39.6	\$ 1.4
Loss reclassified from accumulated OCI to interest expense (effective portion)	\$ 1.7	\$ —	\$ 4.5	\$ —

## 7. Earnings Per Share

Basic and diluted earnings per share are calculated based on the weighted-average number of shares outstanding in each period and dilutive stock options, unvested shares and warrants, to the extent such securities exist and have a dilutive effect on earnings per share. The Company computes basic and diluted earnings per share using the two-class method. The two-class method of computing earnings per share is an earnings allocation method that determines earnings per share for common shares and participating securities according to their participation rights in dividends and undistributed earnings.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

A reconciliation of the numerator and denominator of basic and diluted earnings per share follows (dollars in millions, except per share amounts; shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
<b>Numerator:</b>				
Net loss attributable to Surgery Partners, Inc.	\$ (15.7)	\$ (21.0)	\$ (55.6)	\$ (58.0)
Less: amounts allocated to participating securities <sup>(1)</sup>	(9.1)	(8.2)	(26.4)	(23.9)
Net loss attributable to common stockholders	<u>\$ (24.8)</u>	<u>\$ (29.2)</u>	<u>\$ (82.0)</u>	<u>\$ (81.9)</u>
<b>Denominator:</b>				
Weighted average shares outstanding- basic and diluted <sup>(2)</sup>	48,310	48,038	48,265	48,020
<b>Loss per share:</b>				
Basic and diluted <sup>(2)</sup>	\$ (0.51)	\$ (0.61)	\$ (1.70)	\$ (1.71)
<b>Dilutive securities outstanding not included in the computation of loss per share as their effect is antidilutive:</b>				
Stock options	—	145	—	154
Restricted shares	10	134	24	141
Convertible preferred stock	N/A	N/A	N/A	N/A

(1) Includes dividends accrued during all periods for the Series A Preferred Stock. The Series A Preferred Stock does not participate in undistributed losses.

(2) The impact of potentially dilutive securities for all periods presented was not considered because the effect would be anti-dilutive in each period.

#### Share Repurchase Transactions

On December 15, 2017, the Company's Board of Directors authorized a share repurchase program of up to \$50.0 million of the Company's issued and outstanding common stock from time to time. The timing and size of repurchases will be determined based on market conditions and other factors. The authorization does not obligate the repurchase of any shares and the Company may repurchase shares of common stock at any time without prior notice. The share repurchases will be made in accordance with applicable securities laws in open market or privately negotiated transactions. The authorization does not have a specified expiration date, and the share repurchase program may be suspended, recommenced or discontinued at any time or from time to time without prior notice.

There were no share repurchases under the share repurchase program during the nine months ended September 30, 2019. During the nine months ended September 30, 2018, the Company repurchased 156.8 thousand shares of its common stock at an average price of \$12.64 per share through market purchases. At September 30, 2019, the Company had \$46.0 million of repurchase authorization available under the December 2017 authorization.

## 8. Other Assets and Liabilities

### Other Long-Term Assets

A summary of other long-term assets is as follows (in millions):

	September 30, 2019	December 31, 2018
Right-of-use operating lease assets	\$ 311.7	\$ —
Other	32.4	36.9
Total	<u>\$ 344.1</u>	<u>\$ 36.9</u>

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

**Other Current Liabilities**

A summary of other current liabilities is as follows (in millions):

	September 30, 2019	December 31, 2018
Accrued legal settlement	\$ 42.3	\$ 42.3
Right-of-use operating lease liabilities	35.8	—
Interest payable	26.6	20.8
Amounts due to patients and payors	18.0	20.0
Accrued expenses and other	76.5	72.1
Total	<u>\$ 199.2</u>	<u>\$ 155.2</u>

**Other Long-Term Liabilities**

A summary of other long-term liabilities is as follows (in millions):

	September 30, 2019	December 31, 2018
Right-of-use operating lease liabilities	\$ 281.4	\$ —
Facility lease obligations	—	149.8
Other	144.9	121.5
Total	<u>\$ 426.3</u>	<u>\$ 271.3</u>

At December 31, 2018, the Company had financing obligations payable to the lessors of certain land, buildings and improvements that arose due to the Company's continued involvement with the leased assets under the sale-leaseback guidance in effect prior to the adoption of the Lease Accounting Standard. These obligations were included as facility lease obligations in other long-term liabilities at December 31, 2018 in the table above. Upon adoption of the Lease Accounting Standard on January 1, 2019, the Company reevaluated the classification of these financing arrangements utilizing the new accounting requirements for sale-leasebacks, and concluded that each of these financing arrangements continue to not qualify for sale treatment and therefore should continue to be recognized on the balance sheet as finance leases under the new guidance. Further, the Company has an ongoing development agreement to construct a new hospital, which costs were recognized as incurred as a deferred financing obligation included in facility lease obligations at December 31, 2018. Upon reevaluation, the Company concluded that it does not control the assets under construction and therefore the obligation and related asset were derecognized from the balance sheets upon adoption of the Lease Accounting Standard. The lease related to this new hospital is expected to commence in late 2019 when construction is completed.

**9. Commitments and Contingencies****Professional, General and Workers' Compensation Liability Risks**

The Company is subject to claims and legal actions in the ordinary course of business, including claims relating to patient treatment, employment practices and personal injuries. The Company maintains general liability and professional liability insurance in excess of self-insured retentions, on a claims-made basis through third party commercial insurance carriers. Although management believes the coverage is sufficient for the Company's operations, some claims may potentially exceed the scope of coverage in effect. The Company also maintains workers' compensation insurance, subject to a deductible. Plaintiffs in these matters may request punitive or other damages that may not be covered by insurance. The Company is not aware of any such proceedings that are reasonably possible to have a material adverse effect on the Company's business, financial position, results of operations or liquidity.

*Insurance Reserves*

The Company expenses the costs under the self-insured retention exposure for general and professional liability and workers' compensation claims which relate to (i) claims made during the policy period, which are offset by insurance recoveries and (ii) an estimate of claims incurred but not yet reported that are expected to be reported after the policy period expires. Reserves and provisions are based upon periodic actuarially determined estimates. The reserves are estimated using individual case-basis valuations and actuarial analysis. Reserves for professional, general and workers' compensation claim liabilities are determined with no regard for expected insurance recoveries and are presented gross on the condensed consolidated balance sheets. Total professional, general and workers' compensation claim liabilities as of September 30, 2019 and December 31, 2018 were \$19.5 million and \$18.2 million, respectively. The balances include expected insurance recoveries of \$11.8 million and \$12.0 million as of September 30, 2019 and December 31, 2018, respectively.

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

***Laws and Regulations***

Laws and regulations governing the Company's business, including those relating to the Medicare and Medicaid programs, are complex and subject to interpretation. These laws and regulations govern every aspect of how the Company's surgical facilities conduct their operations, from licensing requirements to how and whether the Company's facilities may receive payments pursuant to the Medicare and Medicaid programs. Compliance with such laws and regulations can be subject to future government agency review and interpretation as well as legislative changes to such laws. Noncompliance with such laws and regulations may subject the Company to significant regulatory action including fines, penalties, and exclusion from the Medicare, Medicaid and other federal healthcare programs. From time to time, governmental regulatory agencies will conduct inquiries of the Company's practices, including, but not limited to, the Company's compliance with federal and state fraud and abuse laws, billing practices and relationships with physicians.

On October 23, 2017, the Company received several civil investigative demands ("CIDs") from the federal government under the False Claims Act ("FCA") for documents and information dating back to January 1, 2010 relating to the medical necessity of certain drug tests conducted by the Company's physicians and submitted to laboratories owned and operated by the Company. In addition, the Company has been informed by the Centers for Medicare and Medicaid Services ("CMS") that payments to its diagnostic laboratory, Logan Laboratories, have been suspended pending further investigation by CMS.

The Company has been providing information to the government in response to the CIDs and currently has a non-binding agreement in principle with the DOJ on the financial terms of a settlement with the goal of resolving these matters. Based on those discussions, which are still ongoing, the Company recorded a litigation-related charge of \$46.0 million relating to these matters on the consolidated statements of operations for the year ended December 31, 2018. The Company believes that this reserve is sufficient to cover a potential resolution with the government relating to these matters, including legal expenses relating to the settlement that have not previously been recorded in operating expenses. The ultimate timing, amount and/or final terms of any such resolution may differ materially from those anticipated or the Company may not be able to reach a resolution at all. It is reasonably possible that the Company will incur additional losses above the amount reserved, but the Company is not able to estimate such amounts at this time. See Item 1A "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 under the heading "Risk Factors - Risks Related to Government Regulation - Companies within the healthcare industry, including us, continue to be the subject of federal and state audits and investigations, including actions for false and other improper claims."

***Acquired Facilities***

The Company, through its wholly-owned subsidiaries or controlled partnerships and limited liability companies, has acquired and will continue to acquire surgical facilities with prior operating histories. Such facilities may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, such as billing and reimbursement, fraud and abuse and similar anti-referral laws. Although the Company attempts to assure that no such liabilities exist, obtain indemnification from prospective sellers covering such matters and institute policies designed to conform centers to its standards following completion of acquisitions, there can be no assurance that the Company will not become liable for past activities that may later be asserted to be improper by private plaintiffs or government agencies. There can be no assurance that any such matter will be covered by indemnification or, if covered, that the liability sustained will not exceed contractual limits or the financial capacity of the indemnifying party.

The Company cannot predict whether federal or state statutory or regulatory provisions will be enacted that would prohibit or otherwise regulate relationships which the Company has established or may establish with other healthcare providers or have materially adverse effects on its business or revenues arising from such future actions. Management believes, however, that it will be able to adjust the Company's operations so as to be in compliance with any statutory or regulatory provision as may be applicable.

***Potential Physician Investor Liability***

A majority of the physician investors in the partnerships and limited liability companies which operate the Company's surgical facilities carry general and professional liability insurance on a claims-made basis. Each partnership or limited liability company may, however, be liable for damages to persons or property arising from occurrences at the surgical facilities. Although the various physician investors and other surgeons generally are required to obtain general and professional liability insurance with tail coverage that extends beyond the period of any claims-made policies, such individuals may not be able to obtain coverage in amounts sufficient to cover all potential liability. Since most insurance policies contain exclusions, the physician investors will not be insured against all possible occurrences. In the event of an uninsured or underinsured loss, the value of an investment in the partnership interests or limited liability company membership units and the amount of distributions could be adversely affected.

***Tax Receivable Agreement***

On May 9, 2017, the Company entered into an agreement to amend that certain Income Tax Receivable Agreement, dated September 30, 2015 (as amended, the "TRA"), by and between the Company, and the other parties referred to therein, which amendment became effective on August 31, 2017. Pursuant to the amendment to the TRA, the Company agreed to make payments to H.I.G., the Company's former controlling shareholder, in its capacity as the stockholders representative pursuant to a fixed payment schedule. The amounts payable under the TRA are calculated as the product of (i) an annual base amount and (ii) the maximum corporate federal income tax rate for the applicable year plus three percent. The amounts payable under the TRA are related to the Company's projected realized tax savings over the next six years and are not dependent on the Company's actual tax savings over such period. The calculation of amounts payable pursuant to the TRA is thus dependent on the maximum corporate federal income tax rate. To the extent that the Company is unable to make payments under the TRA and such

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

inability is a result of the terms of credit agreements and other debt documents that are materially more restrictive than those existing as of September 30, 2015, such payments will be deferred and will accrue interest at a rate of LIBOR plus 500 basis points until paid. If the terms of such credit agreements and other debt documents cause the Company to be unable to make payments under the TRA and such terms are not materially more restrictive than those existing as of September 30, 2015, such payments will be deferred and will accrue interest at a rate of LIBOR plus 300 basis points until paid.

Assuming the Company's effective tax rate is 24%, calculated as the maximum corporate federal tax rate plus three percent, throughout the remaining term of the TRA, the Company estimates that the total remaining amounts payable under the TRA was approximately \$68.2 million and \$64.6 million as of September 30, 2019 and December 31, 2018, respectively. As a result of the amendment to the TRA, the Company was required to value the liability under the TRA by discounting the fixed payment schedule using the Company's incremental borrowing rate. The carrying value of the liability under the TRA, reflecting the discount, was \$55.3 million and \$48.5 million as of September 30, 2019 and December 31, 2018, respectively. The current portion of the liability was \$8.0 million and \$7.6 million as of September 30, 2019 and December 31, 2018, respectively, and was included as a component of other current liabilities in the condensed consolidated balance sheet. The long-term portion was included as a component of other long-term liabilities in the condensed consolidated balance sheets.

## 10. Segment Reporting

The Company operates in three major lines of business that are also the Company's reportable operating segments - the operation of surgical facilities, the operation of ancillary services and the operation of optical services. The surgical facility services segment consists of the operation of ASCs and surgical hospitals and includes anesthesia services. The ancillary services segment consists of a diagnostic laboratory and multi-specialty physician practices. The optical services segment consists of an optical products group purchasing organization. "All other" primarily consists of the Company's corporate general and administrative functions.

The following tables present financial information for each reportable segment (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
<b>Revenues:</b>				
Surgical facility services	\$ 431.1	\$ 410.2	\$ 1,250.9	\$ 1,211.5
Ancillary services	20.0	19.6	60.3	60.4
Optical services	0.9	2.6	3.0	8.4
Total	\$ 452.0	\$ 432.4	\$ 1,314.2	\$ 1,280.3
<b>Adjusted EBITDA:</b>				
Surgical facility services	\$ 77.1	\$ 74.5	\$ 223.9	\$ 216.5
Ancillary services	0.9	0.9	3.5	2.9
Optical services	0.4	0.6	1.3	2.1
All other	(16.2)	(17.0)	(54.5)	(60.1)
Total	\$ 62.2	\$ 59.0	\$ 174.2	\$ 161.4
<b>Adjusted EBITDA:</b>	\$ 62.2	\$ 59.0	\$ 174.2	\$ 161.4
Net income attributable to non-controlling interests	26.6	23.0	78.1	69.5
Depreciation and amortization	(18.4)	(17.0)	(56.3)	(49.4)
Interest expense, net	(45.7)	(37.2)	(134.1)	(107.3)
Equity-based compensation expense	(2.7)	(1.5)	(7.6)	(6.3)
Transaction, integration and acquisition costs <sup>(1)</sup>	(5.3)	(7.5)	(16.8)	(25.4)
(Loss) gain on disposals and deconsolidations, net	(0.6)	(12.6)	7.0	(15.9)
Litigation costs	(2.8)	—	(2.8)	—
Loss on debt extinguishment	—	—	(11.7)	—
Tax receivable agreement expense	—	—	(2.4)	—
Contingent acquisition compensation expense	—	(0.5)	—	(1.5)
Reserve adjustments <sup>(2)</sup>	—	2.1	—	(2.7)
Income before income taxes	\$ 13.3	\$ 7.8	\$ 27.6	\$ 22.4

**SURGERY PARTNERS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited)*

- (1) For the three months ended September 30, 2019 and 2018, this amount includes transaction and integration costs of \$3.4 million and \$7.1 million, respectively, and acquisition costs of \$0.5 million and \$0.4 million, respectively. This amount further includes start-up costs related to a de novo surgical hospital of \$1.4 million for the three months ended September 30, 2019, with no comparable costs in the 2018 period. For the nine months ended September 30, 2019 and 2018, this amount includes transaction and integration costs of \$11.6 million and \$23.8 million, respectively, and acquisition costs of \$2.0 million and \$1.6 million, respectively. This amount further includes start-up costs related to a de novo surgical hospital of \$3.2 million for the nine months ended September 30, 2019, with no comparable costs in the 2018 period.
- (2) This amount represents adjustments to revenue in connection with applying consistent policies across the combined company as a result of the integration of Surgery Partners and a previously acquired entity.

	September 30, 2019	December 31, 2018
<b>Assets:</b>		
Surgical facility services	\$ 4,505.4	\$ 4,204.3
Ancillary services	80.2	52.7
Optical services	21.2	20.1
All other	310.7	399.2
Total assets	<u>\$ 4,917.5</u>	<u>\$ 4,676.3</u>

	Nine Months Ended September 30,	
	2019	2018
<b>Cash purchases of property and equipment, net:</b>		
Surgical facility services	\$ 42.8	\$ 21.6
Ancillary services	0.5	0.3
All other	6.9	4.7
Total cash purchases of property and equipment, net	<u>\$ 50.2</u>	<u>\$ 26.6</u>



## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this report and included in our Annual Report on Form 10-K for the year ended December 31, 2018. Unless the context otherwise indicates, the terms "Surgery Partners," "we," "us," "our" or the "Company," as used herein, refer to Surgery Partners, Inc. and its subsidiaries. Unless the context implies otherwise, the term "affiliates" means direct and indirect subsidiaries of Surgery Partners, Inc., and partnerships and joint ventures in which such subsidiaries are partners. The terms "facilities" or "hospitals" refer to entities owned and operated by affiliates of Surgery Partners, Inc. and the term "employees" refers to employees of affiliates of Surgery Partners, Inc.

### **Cautionary Note Regarding Forward-Looking Statements**

This report contains forward-looking statements, which are based on our current expectations, estimates and assumptions about future events. All statements other than statements of current or historical fact contained in this report are forward-looking statements. These statements include, but are not limited to, statements regarding our future financial position, business strategy, budgets, effective tax rate, projected costs and plans and objectives of management for future operations. The words "projections," "believe," "continue," "drive," "estimate," "expect," "intend," "may," "plan," "will," "could," "would" and similar expressions are generally intended to identify forward-looking statements. These statements involve risks, uncertainties and other factors that may cause actual results to differ from the expectations expressed in the statements. Many of these factors are beyond our ability to control or predict. These factors include, without limitation, our ability to execute on our operational and strategic initiatives; the timing and impact of our portfolio optimization efforts; our ability to continue to improve same-facility volume and revenue growth on the timeline anticipated, if at all; our ability to successfully integrate acquisitions; the anticipated impact and timing of our ongoing efficiency efforts, including insurance consolidations and completed headcount actions, as well as our ongoing procurement and revenue cycle efforts; the impact of adverse weather conditions and other events outside of our control; whether or not a settlement is reached with the government relating to the previously disclosed investigation, the terms of any such settlement and the ongoing cost of complying with the terms of any such settlement; and the risks and uncertainties set forth under the heading "Risk Factors" in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2019 and discussed from time to time in our reports filed with the SEC.

Considering these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur, and actual results could differ materially from those anticipated or implied in the forward-looking statements. When you consider these forward-looking statements, you should keep in mind these risk factors and other cautionary statements in this report.

These forward-looking statements speak only as of the date made. Other than as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether because of new information, future events or otherwise.

### **Executive Overview**

Total revenues for the third quarter of 2019 increased 4.5% to \$452.0 million from \$432.4 million for the third quarter of 2018. The implementation of a recent accounting standard on revenue recognition lowered total revenues in the third quarter of 2019 and 2018 by \$6.3 million and \$11.6 million, respectively. Same-facility revenues for the third quarter of 2019 increased 9.7% from the same period last year, with a 6.7% increase in revenue per case and a 2.8% increase in same-facility cases. As a result of our targeted net revenue improvement initiatives, the three months ended September 30, 2019 represented the fifth consecutive quarter of same-facility case volume growth. For the third quarter of 2019, the net loss attributable to common stockholders was \$24.8 million compared to \$29.2 million for the same period last year. For the third quarter of 2019, Adjusted EBITDA increased 5.4% to \$62.2 million compared to \$59.0 million for the same period last year. A reconciliation of non-GAAP financial measures appears below under "Certain Non-GAAP Metrics."

We had cash and cash equivalents of \$111.3 million and \$115.2 million of borrowing capacity under our revolving credit facility at September 30, 2019. Net operating cash inflows, including operating cash flows less distributions to non-controlling interests, were \$28.3 million for the third quarter of 2019.

We continue to focus on improving our same-facility performance, selectively acquiring established facilities and developing new facilities. During the nine months ended September 30, 2019, we completed the acquisitions of a surgical facility, a clinic that was merged into an existing facility and a physician practice for an aggregate cash investment of \$20.8 million. Additionally, during the nine months ended September 30, 2019, we acquired a non-controlling interest in four surgical facilities for a cash investment of \$14.0 million. The non-controlling interest was accounted for as an equity method investment and recorded as a component of investments in and advances to affiliates in the accompanying condensed consolidated balance sheets.

### **Regulatory Developments**

On October 8, 2019, CMS and the Office of the Inspector General of the U.S. Department of Health and Human Services issued proposed rules that would modify the federal physician referral statute, or Stark Law, regulations and the federal anti-kickback and civil monetary penalty for beneficiary inducement statutes and regulations. The intent of the proposed rules is to reduce over-burdensome and unnecessary regulatory barriers to value-based compensation models and accelerate the transformation of the health care system into one that better promotes the coordination of care among providers. Among other things, the proposed rules would create new anti-kickback and beneficiary inducement

statute safe harbors and Stark Law exceptions for certain value based arrangements and arrangements that involve the donation of cybersecurity technology. In addition, the proposed rules would also provide additional guidance on several key requirements, including fair market value and commercial reasonableness, that must be met in order for physicians and health care providers to comply with the Stark Law. We cannot predict the final form of the rules that may be adopted, or if the proposed rules will be adopted at all, nor can we predict the impact that the final rules would have on our surgery centers and hospitals.

**Revenues**

Our revenues consist of patient service revenues and other service revenues. Patient service revenues consist of revenue from our surgical facility services and ancillary services segments. Specifically, patient service revenues include fees for surgical or diagnostic procedures performed at surgical facilities that we consolidate for financial reporting purposes, as well as for patient visits to our physician practices, anesthesia services, pharmacy services and diagnostic screens ordered by our physicians. Other service revenues consist of discounts and handling charges billed to the members of our optical products purchasing organization. Other service revenues also include management and administrative service fees derived from our non-consolidated facilities that we account for under the equity method, management of surgical facilities and physician practices in which we do not own an interest and management services we provide to physician practices for which we are not required to provide capital or additional assets.

The following table summarizes our revenues by service type as a percentage of total revenues for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
<b>Patient service revenues:</b>				
Surgical facilities revenues	93.9%	93.2%	94.0%	93.2%
Ancillary services revenues	4.4%	4.7%	4.6%	4.8%
	<u>98.3%</u>	<u>97.9%</u>	<u>98.6%</u>	<u>98.0%</u>
<b>Other service revenues:</b>				
Optical services revenues	0.2%	0.6%	0.2%	0.6%
Other	1.5%	1.5%	1.2%	1.4%
	<u>1.7%</u>	<u>2.1%</u>	<u>1.4%</u>	<u>2.0%</u>
<b>Total revenues</b>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>

**Payor Mix**

The following table sets forth by type of payor the percentage of our patient service revenues generated at the surgical facilities which we consolidate for financial reporting purposes in the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Private insurance payors	53.2%	53.1%	52.7%	53.3%
Government payors	39.5%	38.4%	40.0%	38.6%
Self-pay payors	2.7%	2.9%	2.5%	3.1%
Other payors <sup>(1)</sup>	4.6%	5.6%	4.8%	5.0%
<b>Total</b>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>	<u><u>100.0%</u></u>

(1) Other is comprised of anesthesia service agreements, automobile liability, letters of protection and other payor types.

**Surgical Case Mix**

We primarily operate multi-specialty surgical facilities where physicians perform a variety of procedures in various specialties. We believe this diversification helps to protect us from adverse pricing and utilization trends in any individual procedure type and results in greater consistency in our case volume.

[Table of Contents](#)

The following table sets forth the percentage of cases in each specialty performed at the surgical facilities which we consolidate for financial reporting purposes for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Gastrointestinal	20.9%	22.0%	21.0%	21.6%
General surgery	2.9%	2.9%	2.9%	3.0%
Ophthalmology	25.5%	25.4%	24.7%	25.7%
Orthopedic and pain management	36.7%	37.6%	37.1%	37.4%
Other	14.0%	12.1%	14.3%	12.3%
Total	100.0%	100.0%	100.0%	100.0%

**Case Growth**

*Same-facility Information*

Same-facility information includes cases and revenues from our consolidated and non-consolidated surgical facilities (excluding facilities acquired in new markets or divested during the current and prior period).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Cases	138,414	134,620	410,473	401,626
Case growth	2.8%	N/A	2.2%	N/A
Revenue per case	\$ 3,268	\$ 3,064	\$ 3,205	\$ 3,045
Revenue per case growth	6.7%	N/A	5.3%	N/A
Number of work days in the period	64	63	191	191
Case growth (days adjusted)	1.2%	N/A	2.2%	N/A
Revenue growth (days adjusted)	7.9%	N/A	7.6%	N/A
Number of facilities	110	110	109	109

**Accounts Receivable**

Our patient service revenues and other receivables from third-party payors are recorded net of estimated implicit price concessions which are estimated based on the historical trend of our surgical facilities' cash collections and contractual write-offs, established fee schedules, relationships with payors and procedure statistics. While changes in estimated reimbursement from third-party payors remain a possibility, we expect that any such changes would be minimal and, therefore, would not have a material effect on our financial condition or results of operations.

Our collection policies and procedures are based on the type of payor, size of claim and estimated collection percentage for each patient account. The operating systems used to manage our patient accounts provide for an aging schedule in 30-day increments, by payor, physician and patient. We analyze accounts receivable at each of our surgical facilities to ensure the proper collection and aged category. The operating systems generate reports that assist in the collection efforts by prioritizing patient accounts. Collection efforts include direct contact with insurance carriers or patients, written correspondence and the use of legal or collection agency assistance, as required. Our days sales outstanding were 62 days for the nine months ended September 30, 2019 and 63 days for the year ended December 31, 2018.

**Critical Accounting Policies**

A summary of significant accounting policies is disclosed in our 2018 Annual Report on Form 10-K under the caption "Critical Accounting Policies" in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no material changes in the nature of our critical accounting policies or the application of those policies since December 31, 2018.

## Results of Operations

### Three Months Ended September 30, 2019 Compared to Three Months Ended September 30, 2018

The following table summarizes certain results from the statements of operations for the three months ended September 30, 2019 and 2018 (dollars in millions):

	Three Months Ended September 30,	
	2019	2018
Revenues	\$ 452.0	\$ 432.4
Operating expenses:		
Cost of revenues	353.1	334.3
General and administrative expenses	19.9	19.4
Depreciation and amortization	18.4	17.0
Income from equity investments	(2.4)	(1.9)
Loss on disposals and deconsolidations, net	0.6	12.6
Transaction and integration costs	3.4	7.1
Other income	—	(1.1)
Total operating expenses	393.0	387.4
Operating income	59.0	45.0
Interest expense, net	(45.7)	(37.2)
Income before income taxes	13.3	7.8
Income tax expense	2.4	5.8
Net income	10.9	2.0
Less: Net income attributable to non-controlling interests	(26.6)	(23.0)
Net loss attributable to Surgery Partners, Inc.	\$ (15.7)	\$ (21.0)

*Overview.* During the three months ended September 30, 2019, our revenues increased 4.5% to \$452.0 million compared to \$432.4 million for the three months ended September 30, 2018. We incurred a net loss attributable to Surgery Partners, Inc. of \$15.7 million for the 2019 period, compared to \$21.0 million for the 2018 period.

*Revenues.* Revenues for the three months ended September 30, 2019 compared to the three months ended September 30, 2018 were as follows (dollars in millions):

	Three Months Ended September 30,	
	2019	2018
Patient service revenues	\$ 444.5	\$ 423.1
Optical service revenues	0.9	2.7
Other service revenues	6.6	6.6
Total revenues	\$ 452.0	\$ 432.4

Patient service revenues increased 5.1% to \$444.5 million for the three months ended September 30, 2019 compared to \$423.1 million for the three months ended September 30, 2018. The growth of 5.1% was primarily driven by same-facility case growth of 2.8% and revenue per case growth of 6.7% due to targeted net revenue per case improvement initiatives. The 2018 period includes patient service revenues associated with disposed facilities that are not included in the 2019 period.

*Cost of Revenues.* Cost of revenues were \$353.1 million for the three months ended September 30, 2019 compared to \$334.3 million for the three months ended September 30, 2018. The increase in costs were primarily attributable to our 2019 and 2018 acquisitions and an increase in supply costs associated with higher acuity surgical case volume. As a percentage of revenues, cost of revenues increased to 78.1% for the 2019 period compared to 77.3% for the 2018 period.

*General and Administrative Expenses.* General and administrative expenses were \$19.9 million for the three months ended September 30, 2019 compared to \$19.4 million for the three months ended September 30, 2018. As a percentage of revenues, general and administrative expenses decreased to 4.4% for the 2019 period compared to 4.5% for the 2018 period. The decrease is primarily due to reduced costs as we complete our planned investment in our corporate infrastructure and integration of corporate office functions related to acquisitions we completed in 2017.

*Depreciation and Amortization.* Depreciation and amortization was \$18.4 million and \$17.0 million for the three months ended September 30, 2019 and 2018, respectively. As a percentage of revenues, depreciation and amortization expenses was 4.1% for the 2019 period compared to 3.9% for the 2018 period. The increase is primarily due to increased capital investments and integration of acquisitions we completed in 2018.

*Loss on Disposals and Deconsolidations, Net.* The net loss on disposals and deconsolidations was \$0.6 million for the 2019 period related to disposals of other long-lived assets. The net loss on disposals and deconsolidations was \$12.6 million for the 2018 period, including a net loss of \$8.0 million on the sale of surgical facilities and \$4.6 million on disposals of other long-lived assets.

*Transaction and Integration Costs.* We incurred \$3.4 million of transaction and integration costs for the three months ended September 30, 2019 compared to \$7.1 million for the three months ended September 30, 2018. The decrease primarily relates to reduced reorganization costs as we complete our planned investment in our infrastructure and the integration of acquisitions we completed in 2017.

*Interest Expense, Net.* Interest expense, net, increased 22.8%, to \$45.7 million for the three months ended September 30, 2019 compared to \$37.2 million for the three months ended September 30, 2018. The increase primarily relates to the \$180.0 million senior secured incremental term loan, which was fully funded on October 23, 2018 and the issuance of \$430.0 million in senior unsecured notes effective April 11, 2019. As a percentage of revenues, interest expense, net was 10.1% for the 2019 period compared to 8.6% for the 2018 period.

*Income Tax Expense.* The income tax expense was \$2.4 million and \$5.8 million for the three months ended September 30, 2019 and 2018, respectively. The effective tax rate was 18.0% for the three months ended September 30, 2019 compared to 74.3% for the three months ended September 30, 2018. The higher effective tax rate for the 2018 period was primarily due to additional tax expense recorded as discrete items related to (a) gain on various divestitures and (b) revaluing certain deferred tax assets and liabilities as a result of enacted legislation changes that reduced corporate income tax rates. As a result of the Tax Cuts and Jobs Act of 2017 (the "Tax Act"), effective January 1, 2018, the Company's effective tax rate for both 2019 and 2018 is impacted by limitations on the amount of interest expense the Company can ultimately realize. The interest expense limitation results in a deferred tax asset for which the Company maintains a valuation allowance to report the related deferred tax asset at its net realizable value. Based upon the application of interim accounting guidance, the tax rate as a percentage of net income after income attributable to non-controlling interests will vary based upon the relative net income from period to period.

*Net Income Attributable to Non-Controlling Interests.* Net income attributable to non-controlling interests was \$26.6 million for the three months ended September 30, 2019 compared to \$23.0 million for the three months ended September 30, 2018. As a percentage of revenues, net income attributable to non-controlling interests was 5.9% in the 2019 period and 5.3% for the 2018 period.

**Nine Months Ended September 30, 2019 Compared to Nine Months Ended September 30, 2018**

The following table summarizes certain results from the statements of operations for the nine months ended September 30, 2019 and 2018 (dollars in millions):

	Nine Months Ended September 30,	
	2019	2018
Revenues	\$ 1,314.2	\$ 1,280.3
Operating expenses:		
Cost of revenues	1,019.6	1,001.7
General and administrative expenses	64.9	69.7
Depreciation and amortization	56.3	49.4
Income from equity investments	(6.6)	(6.3)
(Gain) loss on disposals and deconsolidations, net	(7.0)	15.9
Transaction and integration costs	11.6	23.8
Loss on debt extinguishment	11.7	—
Other income	(0.4)	(3.6)
Total operating expenses	1,150.1	1,150.6
Operating income	164.1	129.7
Tax receivable agreement expense	(2.4)	—
Interest expense, net	(134.1)	(107.3)
Income before income taxes	27.6	22.4
Income tax expense	5.1	10.9
Net income	22.5	11.5
Less: Net income attributable to non-controlling interests	(78.1)	(69.5)
Net loss attributable to Surgery Partners, Inc.	\$ (55.6)	\$ (58.0)

*Overview.* During the nine months ended September 30, 2019, our revenues increased 2.6% to \$1,314.2 million compared to \$1,280.3 million for the nine months ended September 30, 2018. We incurred a net loss attributable to Surgery Partners, Inc. of \$55.6 million for the 2019 period, compared to \$58.0 million for the 2018 period.

*Revenues.* Revenues for the nine months ended September 30, 2019 compared to the nine months ended September 30, 2018 were as follows (dollars in millions):

	Nine Months Ended September 30,	
	2019	2018
Patient service revenues	\$ 1,294.8	\$ 1,253.1
Optical service revenues	3.0	8.5
Other service revenues	16.4	18.7
Total revenues	\$ 1,314.2	\$ 1,280.3

Patient service revenues increased 3.3% to \$1,294.8 million for the nine months ended September 30, 2019 compared to \$1,253.1 million for the nine months ended September 30, 2018. The three months ended September 30, 2019 represented the fifth consecutive quarter of same-facility case volume growth, which has resulted in 2.2% same-facility case growth for the nine months ended September 30, 2019. Additionally, our targeted net revenue improvement initiatives have resulted in 5.3% same-facility revenue per case growth for the same nine month period. The 2018 period includes patient service revenues associated with disposed facilities that are not included in the 2019 period.

*Cost of Revenues.* Cost of revenues were \$1,019.6 million for the nine months ended September 30, 2019 compared to \$1,001.7 million for the nine months ended September 30, 2018. The increase in costs were primarily attributable to our 2019 and 2018 acquisitions and an increase in supply costs associated with higher acuity surgical case volume. As a percentage of revenues, cost of revenues were 77.6% for the 2019 period and 78.2% for the 2018 period.

*General and Administrative Expenses.* General and administrative expenses were \$64.9 million for the nine months ended September 30, 2019 compared to \$69.7 million for the nine months ended September 30, 2018. The decrease is primarily due to reduced costs as we complete our planned investment in our corporate infrastructure and integration of corporate office functions related to acquisitions we

completed in 2017. As a percentage of revenues, general and administrative expenses decreased to 4.9% for the 2019 period compared to 5.4% for the 2018 period.

*Depreciation and Amortization.* Depreciation and amortization was \$56.3 million and \$49.4 million for the nine months ended September 30, 2019 and 2018, respectively. As a percentage of revenues, depreciation and amortization expenses was 4.3% for the 2019 period compared to 3.9% for the 2018 period. The increase is primarily due to increased capital investments and integration of acquisitions we completed in 2018.

*(Gain) Loss on Disposals and Deconsolidations, Net.* The net gain on disposals and deconsolidations was \$7.0 million for the 2019 period, including a \$10.9 million gain on the sale of previously owned real property associated with one of our non-consolidated surgical facility equity method investments, offset by a loss of \$3.9 million on disposals of other long-lived assets. The net loss on disposals and deconsolidations was \$15.9 million for the 2018 period, including a net loss of \$9.5 million on the sale of surgical and other facilities and \$7.5 million on disposals of other long-lived assets, offset by a net gain of \$1.1 million on the deconsolidation of a surgical facility.

*Transaction and Integration Costs.* We incurred \$11.6 million of transaction and integration costs for the nine months ended September 30, 2019 compared to \$23.8 million for the nine months ended September 30, 2018. The decrease primarily relates to reduced reorganization costs as we complete our planned investment in our infrastructure and the integration of acquisitions we completed in 2017.

*Loss on Debt Extinguishment.* During the nine months ended September 30, 2019, we incurred a debt extinguishment loss of \$11.7 million in connection with issuance of the 2027 Unsecured Notes. The loss includes the redemption premium paid to redeem the 2021 Unsecured Notes partially offset by the write-off of the unamortized fair value premium as of the redemption date.

*Interest Expense, Net.* Interest expense, net, increased 25.0%, to \$134.1 million for the nine months ended September 30, 2019 compared to \$107.3 million for the nine months ended September 30, 2018. The increase primarily relates to the \$180.0 million senior secured incremental term loan, which was fully funded on October 23, 2018 and the issuance of \$430.0 million in senior unsecured notes effective April 11, 2019. As a percentage of revenues, interest expense, net increased to 10.2% for the 2019 period compared to 8.4% for the 2018 period.

*Income Tax Expense.* The income tax expense was \$5.1 million and \$10.9 million for the nine months ended September 30, 2019 and 2018, respectively. The effective tax rate was 18.5% for the nine months ended September 30, 2019 compared to 48.6% for the nine months ended September 30, 2018. The higher effective tax rate for the 2018 period was primarily due to additional tax expense recorded as discrete items related to (a) gain on various divestitures and (b) revaluing certain deferred tax assets and liabilities as a result of enacted legislation changes that reduced corporate income tax rates. As a result of the Tax Act, effective January 1, 2018, the Company's effective tax rate for both 2019 and 2018 is impacted by limitations on the amount of interest expense the Company can ultimately realize. The interest expense limitation results in a deferred tax asset for which the Company maintains a valuation allowance to report the related deferred tax asset at its net realizable value. Based upon the application of interim accounting guidance, the tax rate as a percentage of net income after income attributable to non-controlling interests will vary based upon the relative net income from period to period.

*Net Income Attributable to Non-Controlling Interests.* Net income attributable to non-controlling interests was \$78.1 million for the nine months ended September 30, 2019 compared to \$69.5 million for the nine months ended September 30, 2018. As a percentage of revenues, net income attributable to non-controlling interests was 5.9% in the 2019 period and 5.4% for the 2018 period.

## **Liquidity and Capital Resources**

### ***Operating Activities***

The primary source of our operating cash flow is the collection of accounts receivable from federal and state agencies (under the Medicare and Medicaid programs), managed care health plans, commercial insurance companies and individuals. During the nine months ended September 30, 2019, our cash flow provided by operating activities was \$104.1 million compared to \$99.1 million in the nine months ended September 30, 2018 primarily due to the timing of certain payroll and trade payable payments.

### ***Investing Activities***

Net cash used in investing activities during the nine months ended September 30, 2019 was \$61.8 million, which included \$50.2 million related to purchases of property and equipment. We paid an additional \$13.8 million in cash for acquisitions (net of cash acquired), which primarily included a surgical facility, a clinic that was merged into an existing facility and a physician practice. Further, we paid \$15.2 million in cash for a non-controlling interest in four surgical facilities accounted for as equity method investments and we received cash proceeds of \$17.6 million related to the sale of previously owned real property associated with one of our non-consolidated equity method investments.

Net cash used in investing activities during the nine months ended September 30, 2018 was \$66.6 million, which included \$26.6 million related to purchases of property and equipment. We paid approximately \$55.2 million (net of cash acquired) related to acquisitions, which primarily included four surgical facilities, one of which was merged into an existing facility and multiple physician practices. Further, we sold our controlling interests in four surgical facilities, retaining a non-controlling interest in one, and our optical laboratory for cash proceeds of \$18.0 million.

## **Financing Activities**

Net cash used in financing activities during the nine months ended September 30, 2019 was \$115.3 million. During this period, we made distributions to non-controlling interest holders of \$89.5 million and payments related to ownership transactions with consolidated affiliates of \$4.6 million. Further, we made repayments on our long-term debt of \$436.1 million, which was offset by borrowings of \$442.5 million. In connection with the issuance of the 2027 Unsecured Notes and redemption of the existing 2021 Unsecured Notes, we paid debt issuance costs of \$8.8 million and paid a redemption premium of \$17.8 million.

Net cash used in financing activities during the nine months ended September 30, 2018 was \$128.3 million. During this period, we made distributions to non-controlling interest holders of \$80.1 million and payments related to ownership transactions with consolidated affiliates of \$0.5 million. Further, we made repayments on our long-term debt of \$94.9 million offset by borrowings of \$62.8 million. In addition, we made preferred dividend payments of \$7.8 million and repurchased \$2.0 million of our common stock pursuant to our \$50 million repurchase program announced on December 15, 2017.

## **Debt**

As of September 30, 2019, the carrying value of our total indebtedness was \$2.454 billion, which includes unamortized fair value discount of \$5.2 million and unamortized deferred financing costs of \$10.8 million.

### *Term Loan and Revolving Credit Facility*

We had term loan borrowings with a carrying value of \$1.437 billion, consisting of outstanding aggregate principal of \$1.442 billion and unamortized fair value discount of \$5.2 million (the "Term Loan") as of September 30, 2019. The Term Loan matures on August 31, 2024. The Term Loan amortizes in equal quarterly installments of 0.25% of the aggregate original principal amount of the Term Loan.

We have a revolving credit facility providing for revolving borrowings of up to \$120.0 million (the "Revolver" and, together with the Term Loan, the "2017 Senior Secured Credit Facilities"). The Revolver will mature on August 31, 2022. As of September 30, 2019, our availability on the Revolver was \$115.2 million (including outstanding letters of credit of \$4.8 million).

The Revolver may be utilized for working capital, capital expenditures and general corporate purposes. Subject to certain conditions and requirements set forth in the credit agreement, we may request one or more additional incremental term loan facilities or one or more increases in the commitments on the Revolver.

The 2017 Senior Secured Credit Facilities bear interest at a rate per annum equal to (x) LIBOR plus a margin ranging from 3.00% to 3.25% per annum, depending on our first lien net leverage ratio or (y) an alternate base rate (which will be the highest of (i) the prime rate, (ii) 0.5% per annum above the federal funds effective rate and (iii) one-month LIBOR plus 1.00% per annum (solely with respect to the Term Loan, the alternate base rate shall not be less than 2.00% per annum)) plus a margin ranging from 2.00% to 2.25% per annum. In addition, we are required to pay a commitment fee of 0.50% per annum in respect of unused commitments on the Revolver.

### *Senior Unsecured Notes*

On April 11, 2019, we completed the issuance and sale of \$430.0 million in gross proceeds of 2027 Unsecured Notes. The 2027 Unsecured Notes bear interest at the rate of 10.000% per year, payable semi-annually on April 15 and October 15 of each year, beginning on October 15, 2019. In connection with issuance of the 2027 Unsecured Notes, we redeemed in whole the then existing 2021 Unsecured Notes. The redemption price was equal to 104.438% of the outstanding principal amount plus accrued and unpaid interest. Refer to Note 3. "Long-Term Debt" to the Condensed Consolidated Financial Statements elsewhere in this report for further discussion.

We have \$370.0 million aggregate principal amount of senior unsecured notes due July 1, 2025 outstanding (the "2025 Unsecured Notes"). The 2025 Unsecured Notes bear interest at the rate of 6.750% per year, payable semi-annually on January 1 and July 1 of each year.

### *Other Debt*

We and certain of our subsidiaries have other debt consisting of outstanding bank indebtedness of \$74.4 million, which is collateralized by the real estate and equipment owned by the surgical facilities to which the loans were made, and right-of-use finance lease obligations of \$153.5 million for which we are liable to various vendors for several property and equipment leases classified as finance leases.

### *Summary*

Based on our current level of operations, we believe cash flow from operations and available cash, together with available borrowings on the Revolver, will be adequate to meet our short-term (i.e., 12 months) liquidity needs.

## **Certain Non-GAAP Metrics**

Adjusted EBITDA is not a measurement of financial performance under GAAP and should not be considered in isolation or as a substitute for net income, operating income or any other measure calculated in accordance with GAAP. The items excluded from this non-GAAP metric are significant components in understanding and evaluating our financial performance. We believe such adjustments are appropriate, as the magnitude and frequency of such items can vary significantly and are not related to the assessment of normal operating performance. Our calculation of Adjusted EBITDA may not be comparable to similarly titled measures reported by other companies.



When we use the term "Adjusted EBITDA," we are referring to income before income taxes, adjusted for net income attributable to non-controlling interests, depreciation and amortization, interest expense, net, equity-based compensation expense, contingent acquisition compensation expense, transaction, integration and acquisition costs, certain litigation costs, reserve adjustments, net loss (gain) on disposals and deconsolidations, loss on debt extinguishment and tax receivable agreement expense. We use Adjusted EBITDA as a measure of financial performance. Adjusted EBITDA is a key measure used by our management to assess operating performance, make business decisions and allocate resources.

The following table reconciles Adjusted EBITDA to income before income taxes, the most directly comparable GAAP financial measure (in millions and unaudited):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
<b>Condensed Consolidated Statements of Operations Data:</b>				
<b>Income before income taxes</b>	\$ 13.3	\$ 7.8	\$ 27.6	\$ 22.4
<i>Plus (minus):</i>				
Net income attributable to non-controlling interests	(26.6)	(23.0)	(78.1)	(69.5)
Depreciation and amortization	18.4	17.0	56.3	49.4
Interest expense, net	45.7	37.2	134.1	107.3
Equity-based compensation expense	2.7	1.5	7.6	6.3
Transaction, integration and acquisition costs <sup>(1)</sup>	5.3	7.5	16.8	25.4
Loss (gain) on disposals and deconsolidations, net	0.6	12.6	(7.0)	15.9
Litigation costs	2.8	—	2.8	—
Loss on debt extinguishment	—	—	11.7	—
Tax receivable agreement expense	—	—	2.4	—
Contingent acquisition compensation expense	—	0.5	—	1.5
Reserve adjustments <sup>(2)</sup>	—	(2.1)	—	2.7
<b>Adjusted EBITDA</b>	<b>\$ 62.2</b>	<b>\$ 59.0</b>	<b>\$ 174.2</b>	<b>\$ 161.4</b>

(1) For the three months ended September 30, 2019 and 2018, this amount includes transaction and integration costs of \$3.4 million and \$7.1 million, respectively, and acquisition costs of \$0.5 million and \$0.4 million, respectively. This amount further includes start-up costs related to a de novo surgical hospital of \$1.4 million for the three months ended September 30, 2019, with no comparable costs in the 2018 period. For the nine months ended September 30, 2019 and 2018, this amount includes transaction and integration costs of \$11.6 million and \$23.8 million, respectively, and acquisition costs of \$2.0 million and \$1.6 million, respectively. This amount further includes start-up costs related to a de novo surgical hospital of \$3.2 million for the nine months ended September 30, 2019, with no comparable costs in the 2018 period.

(2) This amount represents adjustments to revenue in order to apply consistent policies to businesses acquired by Surgery Partners in prior periods.

We use Credit Agreement EBITDA as a measure of liquidity and to determine our compliance under certain covenants pursuant to our credit facilities. Credit Agreement EBITDA is determined on a trailing twelve-month basis. We have included it because we believe that it provides investors with additional information about our ability to incur and service debt and make capital expenditures. Credit Agreement EBITDA is not a measurement of liquidity under GAAP and should not be considered in isolation or as a substitute for any other measure calculated in accordance with GAAP. The items excluded from Credit Agreement EBITDA are significant components in understanding and evaluating our liquidity. Our calculation of Credit Agreement EBITDA may not be comparable to similarly titled measures reported by other companies.

When we use the term "Credit Agreement EBITDA," we are referring to Adjusted EBITDA, as defined above, further adjusted for other items related to our historical financial performance during the trailing twelve month period, including loss on litigation settlement. Also included are adjustments for acquisitions, which do not relate to our historical financial performance and instead relate to estimates compiled by our management and calculated in conformance with the definition of "Consolidated EBITDA" used in the credit agreements governing our credit facilities.

[Table of Contents](#)

The following table reconciles Credit Agreement EBITDA to cash flows from operating activities, the most directly comparable GAAP financial measure (in millions and unaudited):

	<b>Twelve Months Ended September 30, 2019</b>
<b>Cash flows from operating activities</b>	<b>\$ 149.6</b>
<i>Plus (minus):</i>	
Non-cash interest income, net	(0.2)
Non-cash lease expense	(28.8)
Deferred income taxes	(19.9)
Income from equity investments, net of distributions received	(0.9)
Changes in operating assets and liabilities, net of acquisitions and divestitures	(4.5)
Income tax expense	20.7
Net income attributable to non-controlling interests	(118.7)
Interest expense, net	173.8
Transaction, integration and acquisition costs	25.3
Litigation costs	2.8
Loss on litigation settlement	46.0
Tax receivable agreement expense	2.4
Acquisitions <sup>(1)</sup>	43.0
<b>Credit Agreement EBITDA</b>	<b>\$ 290.6</b>

(1) This includes revenue synergies from other business initiatives and an adjustment for the effects of adopting the new lease accounting standard, as defined in the credit agreement.

#### Recent Accounting Pronouncements

Please refer to Note 1. "Organization and Summary of Accounting Policies" to our condensed consolidated financial statements included elsewhere in this report for a discussion of the impact of the adoption of recently issued accounting standards.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk primarily from exposure to changes in interest rates based on our financing, investing and cash management activities. We utilize a balanced mix of maturities along with both fixed rate and variable rate debt to manage our exposures to changes in interest rates. Additionally, we periodically enter into interest rate swap agreements to manage our exposure to interest rate fluctuations. Our interest rate swap agreements involve the exchange of fixed and variable rate interest payments between two parties, based on common notional principal amounts and maturity dates. The notional amounts of the swap agreements represent balances used to calculate the exchange of cash flows and are not our assets or liabilities. Our credit risk related to these agreements is considered low because the swap agreements are with creditworthy financial institutions. The interest payments under these agreements are settled on a net basis. These derivatives have been recognized in the financial statements at their respective fair values. Changes in the fair value of these derivatives, which are designated as cash flow hedges, are included in other comprehensive income.

Our variable rate debt instruments are primarily indexed to the prime rate or LIBOR. Interest rate changes would result in gains or losses in the market value of our fixed rate debt portfolio due to differences in market interest rates and the rates at the inception of the debt agreements. Based on our indebtedness and the effect of our interest rate swap agreements at September 30, 2019, a 100 basis point interest rate change would impact our net earnings and cash flow by approximately \$2.5 million annually. Although there can be no assurances that interest rates will not change significantly, we do not expect changes in interest rates to have a material effect on our net earnings or cash flows in 2019 based on our indebtedness at September 30, 2019.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

An evaluation was performed under the supervision and with the participation of our management, including the chief executive officer and the chief financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, as amended) as of September 30, 2019. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective.

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2019 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1. *Legal Proceedings*

*Stockholder Litigation.* On December 4, 2017, a purported Company stockholder filed an action in the Delaware Court of Chancery (the “Delaware Action”). That action is captioned *Klein v. H.I.G. Capital, L.L.C., et al.*, C.A. No. 2017-0862. The plaintiff in the Delaware Action asserted claims against (i) certain current and former members of the Company’s Board of Directors (together, the “Directors”); (ii) H.I.G. Capital, LLC and certain of its affiliates (collectively, “H.I.G.”); and (iii) Bain Capital Private Equity, L.P. and certain of its affiliates (collectively, “Bain Capital” and, together with the Directors and H.I.G., the “Defendants”). The plaintiff asserted derivative claims on behalf of the Company, which is a nominal defendant in the Delaware Action, as well as putatively direct claims on behalf of a purported class of Company stockholders. The plaintiff in the Delaware Action asserted that the Defendants breached their fiduciary duties in connection with the transactions in which (i) the Company acquired National Surgical Healthcare; (ii) Bain Capital acquired preferred equity in the Company; and (iii) Bain Capital acquired H.I.G.’s equity stake in the Company, and that, in the alternative, Bain Capital aided and abetted those purported breaches. The plaintiff also asserted an unjust enrichment claim against Bain Capital.

On January 2, 2018, the Defendants moved to dismiss the plaintiff’s complaint. On December 19, 2018, the Court of Chancery issued a decision on that motion. Following that decision, all of the Directors have been dismissed from the Delaware Action. The Court did not dismiss the plaintiff’s breach of fiduciary duty claim against H.I.G. or the aiding and abetting claim asserted against Bain Capital. However, the Court dismissed the plaintiff’s breach of fiduciary duty and unjust enrichment claims against Bain Capital. In addition, the Court dismissed all of the plaintiff’s claims that were asserted on behalf of a putative class of Company stockholders. Accordingly, all of the plaintiff’s remaining claims in the Delaware Action are asserted derivatively on the Company’s behalf.

*Government Investigation.* On October 23, 2017, the Company received several civil investigative demands (“CIDs”) from the federal government under the False Claims Act (“FCA”) for documents and information dating back to January 1, 2010 relating to the medical necessity of certain drug tests conducted by the Company’s physicians and submitted to laboratories owned and operated by the Company. In addition, the Company has been informed by CMS that payments to its diagnostic laboratory, Logan Laboratories, have been suspended pending further investigation by CMS.

The Company has been providing information to the government in response to the CIDs and currently has a non-binding agreement in principle with the DOJ on the financial terms of a settlement with the goal of resolving these matters. Based on those discussions, which are still ongoing, we recorded a litigation-related charge of \$46.0 million relating to these matters on the consolidated statements of operations for the year ended December 31, 2018. We believe that this reserve is sufficient to cover a potential resolution with the government relating to these matters, including legal expenses relating to the settlement that have not previously been recorded in our operating expenses. The ultimate timing, amount and/or final terms of any such resolution may differ materially from those anticipated or we may not be able to reach a resolution at all. It is reasonably possible that we will incur additional losses above the amount reserved, but we are not able to estimate such amounts at this time. See Item 1A “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2018 under the heading “Risk Factors - Risks Related to Government Regulation - *Companies within the healthcare industry, including us, continue to be the subject of federal and state audits and investigations, including actions for false and other improper claims.*”

*Other Litigation.* In addition, we are, from time to time, subject to claims and suits, or threats of claims or suits, relating to our business, including claims for damages for personal injuries, breach of management contracts and employment related claims. In certain of these actions, plaintiffs request payment for damages, including punitive damages, which may not be covered by insurance or may otherwise have a material adverse effect on our business or results of operations.

See Note 9. “Commitments and Contingencies” for additional information regarding pending legal proceedings, which information is incorporated herein by reference.

### Item 1A. *Risk Factors*

There have been no material changes with respect to the risk factors discussed in the Annual Report on Form 10-K for the year ended December 31, 2018.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table presents information related to our repurchases of common stock for the periods indicated:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs (2)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
<i>(dollars in millions, except per share amounts)</i>				
July 1, 2019 to July 31, 2019	26,013	\$ 7.98	—	\$ 46.0
August 1, 2019 to August 31, 2019	16,291	\$ 6.97	—	\$ 46.0
September 1, 2019 to September 30, 2019	2,027	\$ 7.40	—	\$ 46.0
Total	<u>44,331</u>	\$ 7.58	<u>—</u>	\$ 46.0

(1) Shares delivered to or withheld by us in connection with employee payroll tax withholding upon exercise or vesting of stock awards.

(2) Made pursuant to the \$50 million share repurchase program authorized by our Board of Directors on December 15, 2017. The authorization does not have a specified expiration date, and the share repurchase program may be suspended, recommenced or discontinued at any time or from time to time without prior notice.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

No.	Description
31.1	<a href="#">Certification of Principal Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
31.2	<a href="#">Certification of Principal Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
32.1	<a href="#">Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

**SIGNATURES**

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

SURGERY PARTNERS, INC.

By: /s/ Thomas F. Cowhey  
Thomas F. Cowhey  
*Executive Vice President and Chief Financial Officer*  
*(Principal Financial and Accounting Officer)*

Date: November 6, 2019

## CERTIFICATIONS

I, Wayne S. DeVeydt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Surgery Partners, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Wayne S. DeVeydt  
Wayne S. DeVeydt  
*Chief Executive Officer*

Date: November 6, 2019



## CERTIFICATIONS

I, Thomas F. Cowhey, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Surgery Partners, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Thomas F. Cowhey  
Thomas F. Cowhey  
*Executive Vice President and Chief Financial Officer*

Date: November 6, 2019

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report of Surgery Partners, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2019, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned certifies, pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company for the periods presented therein.

By: /s/ Wayne S. DeVeydt  
Wayne S. DeVeydt  
*Chief Executive Officer*

Date: November 6, 2019

By: /s/ Thomas F. Cowhey  
Thomas F. Cowhey  
*Executive Vice President and Chief Financial Officer*

Date: November 6, 2019