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RESEARCH NOTE

DATE:	September 6, 2013
TO:	Catalyst Investors
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SUBJECT:	**Physician Practice Update Note**

As a quick update, we still believe in that the following long term market trends that drove our interest in healthcare in November 2011:

Health Care Trends:

- **Quality of Care** – Reduction of reimbursement rates from pay for service to bundle payments is requiring focus on cost efficiency. Hospitals, physician practices, medical device and life science companies will face lower reimbursements and greater scrutiny regarding the value delivered to patients as Accountable Care Organizations (ACO) will have to meet quality thresholds.
- **Legislative Incentives** – The enactment of the HITECH ACT providing financial incentives for hospitals and physicians (including dentists, optometrists, podiatrist and chiropractors) to demonstrate "meaningful use" of electronic health records has catalyzed the adoption of IT, as 85% of eligible hospitals and 75% of physicians have registered to receive more than $35 billion of government provided incentives, $14.6 billion which have been administered as of April 2013.
- **Aging US Population** increasing patient volumes – 20% of the population will be over the age of 65 by 2050, creating further demand as baby boomers require greater medical care.

Boarder Technology Trends Applicable to HCIT:

- **Cloud and Mobile "Native" –** Companies that have cloud and mobile in their "DNA" and are able to execute better, quicker and cheaper than larger, more risk adverse companies. As the overall HCIT ecosystem becomes more comfortable with cloud and mobile, we believe that large strategic acquires will play "catch-up" leading to more acquisitions like Allscripts acquiring dbMotion.

- **Increased Data** – Healthcare data is expected to increase 50x to more than 25,000 petabytes annually, creating an even greater need to manage, store and gain insight from the data across the healthcare enterprise.
- **Patient Engagement and Consumerization of IT** – Customer behavior trends have changed due to emerging technology. With the convergence of electronic health records (EHR), personal health records, cloud computing, health kiosks, mobile apps and home-based monitoring, consumer will expect and demand personalized real-time access to health services.[1] Players like Wal-Mart, Walgreens, and tech/social media companies are already entering the healthcare value chain. Consumers, especially tech-savvy Millennials are expecting more interaction with their physician as well as the ability to track their progress and their family's medical records online.

As we've evaluated physician practice management companies (EMR, PM, RCM) over the two years, we have noted the following observations.

Evaluation Observations:

- **Market Opportunity**: The market is extremely large if you count all physicians ($3+ billion: 510K physicians, $500/month ARPU); and the market is even larger when you include the RCM opportunity as a percentage of total office collections. Although vertical markets may be much smaller, there is an opportunity to increase total addressable marketing to through adding additional features such as marketing related services.
- **SaaS metrics**: We can look at the HCIT landscape similar to that of other SaaS companies, especially for EHR & practice management software systems. Several of these companies measure ARPU/Churn and Cost to Acquire a Customer (CAC) already and are adding customers profitably. RCM metrics are similar to the other types of transaction processing revenue re-occurring vs. recurring revenue. This revenue line item typically represents 50% or more of total revenues and can cause the client to be very sticky. RCM gross margins are generally lower than as EHR/PM gross margins (sub 50% versus ~70%, but with scale and automation, market leaders can reach 60+%.
- **Mix of software and services business models**: Some companies give EMR away for free or charge a minimal amount however can charge for it if the doctors make more on an annual basis and/or the vertical is certified for meaningful use and the offices will receive monetary incentives for implementing and EMR. The RCM component tends to be more lucrative for

[1] Oliver Wyman. The Volume to Value Revolution: Rebuilding the DNA of Health from the Patient In.

the companies as they can act as the outsourced billings/collection support for a physician office and charge between 4.0% and 7.5% of collections.

- **Increasing complexity is driving adoption**: As coding and referrals rules are increasingly more complex, it's becoming harder for clinics to manage internally so we are seeing a trend towards outsourced services. Frost and Sullivan estimating that next generation RCM solutions to grow 62% from 2012 to 2017 to $3.1 billion.
- **Vertical products need to not only serve vertical but designed to fit workflow:** To compete and win against established players, the product must fit not only have all of the features of the vertical but designed to fit the workflow of patients. Seemly great UI / UX solutions often have poor reviews from users as the setup doesn't match actual offline workflow and often creates double work for users.