Duff & Phelps

Industry Insights July 2012

Healthcare Services: Healthcare IT Services Insights

Curve Benders — Healthcare IT, Shared Financial Risk and M&A

Before it became codified in the 2010 Patient Protection and Affordable Care Act ("PPACA"), healthcare reform had two major objectives—to expand healthcare coverage and to reduce, or "bend the curve" of, healthcare cost increases. The Supreme Court's June decision on the constitutionality of PPACA now prescribes the path forward to expand coverage, although the number of new lives to be covered is in question as the Court struck that portion of the law that would have effectively forced states to expand Medicaid eligibility to up to 30 million people. Some states may now decide to forgo expansion, reducing the number of new Medicaid enrollees. Nonetheless, implementation of PPACA will result in a large increase in the number of individuals with healthcare benefits, fulfilling half of the reform's promise. However, but for a few provisions at the margin, PPACA itself will do very little to slow healthcare costs and, by virtue of setting minimum standards for insurance coverage, could very well increase US healthcare costs instead.

The increase in healthcare costs has moderated in recent years. According to the Centers for Medicare and Medicaid Services ("CMS"), in 2009, 2010 and 2011 US healthcare spending grew at the lowest rates on record—3.8%, 3.9% and 3.9%, respectively. (By comparison, spending still outpaced US GDP, which grew at an annual average of just 1.9% over this period.) Despite being a necessity, even healthcare spending was impacted by the recession as

> "If something cannot go on forever, it will stop."
>
> –Herbert Stein's Law

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consumers cut back on elective procedures and other discretionary healthcare expenses. CMS is projecting continued moderation in expense growth in 2012 and 2013, in part because of the questionable assumption that the 30.9% Medicare physician payment rate cut mandated under the Sustainable Growth Rate ("SGR") formula will be implemented in full (even though since 2003, Congress has regularly prevented the full cuts required by the SGR from going into effect). In 2014, the year in which many of the provisions of PPACA go live, CMS projects a cost increase of 7.4% (as compared to a projected increase of 2% for the consumer price index). A return to healthcare spending outpacing inflation and GDP growth by several percentage points is not sustainable. Per the late economist Herbert Stein's Law, it must stop as there simply is not enough money in the US economy to support healthcare cost increases in excess of GDP growth ad infinitum.

Information technology and managed care-like risk-sharing models, applied in heavy doses, will play important roles in moderating cost increases. Two recently announced deals make the point:

- On July 2, private equity group One Equity Partners announced a $1.1 billion deal to acquire **M*Modal** (NASD:MODL), a provider of speech and language recognition technology and services used in clinical transcription and coding. This technology is critical in accelerating the adoption of technology by physicians, improving the workflow of clinical and administrative data and enabling the transition from ICD-9 to ICD-10 coding.
- On May 20, kidney dialysis services company DaVita, Inc. (NYSE:DVA) announced a $4.4 billion deal to acquire privately-held independent physician association operator HealthCare Partners, an endorsement of the role that risk sharing models will play in reducing healthcare costs and replacing the fee for service ("FFS") payment model that is a large contributor to rising costs and is prevalent in Medicare and private payor reimbursement.

FFS provides reimbursement based on the volume, rather than the quality, of care provided. Managed care, where providers take on risk by receiving a capitated payment to manage the care of a pool of lives, is an example of a risk-sharing alternative to FFS. Successful managed care models emphasize higher levels of patient interface with primary care physicians (vs. specialists), treatment in lower cost venues (i.e., not the Emergency Room) and careful management of pharmaceuticals in order to reduce overall costs while improving outcomes. Another

"We look forward to working with DaVita to extend our patient-focused and physician-led integrated care model to serve the needs of patients, physicians, and payors in new markets and in new ways. DaVita's vision 'to build the greatest healthcare community the world has ever seen' and HealthCare Partners' aspiration to lead the transformation of American healthcare to higher quality, efficiency, and value are absolutely complementary to each other."

– Robert Margolis, MD, Chairman and CEO of HealthCare Partners in announcing its sale to DaVita on May 21, 2012.

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risk-sharing model that private insurers are piloting is bundling payments, whereby a provider is paid a fixed amount, representing the expected cost of a standard treatment regimen, to manage care for a specific condition. Accountable Care Organizations ("ACOs"), enabled under PPACA, are additional examples of evolving models that involve the sharing of financial risk by payors, primary care physicians, specialists and hospitals.

A very real example of risk sharing that has the attention of hospital operators is the PPACA provision that will penalize hospitals for the readmission, within 30 days, of patients treated for one of three conditions—congestive heart failure, heart attacks and pneumonia. Beginning in October 2012 (federal fiscal year 2013), hospitals with excessive readmission rates (the bottom quartile relative to other hospitals) for these conditions will be subject to a penalty equal to 1% percent of their total Medicare billings, increasing to 2% in fiscal 2014 and 3% in fiscal 2015. Because readmissions are so costly to the system, CMS may eventually expand the penalty to include other conditions as well.

Readmissions present a useful case study to highlight the important role that healthcare IT must play in order to stem healthcare costs. In the brave new world of readmission penalties the hospital now bears financial risk for the patient post-discharge. Traditional discharge plans, even when coupled with disease management, are insufficient to manage this new fiscal exposure. The hospital must become an active participant in designing the care plan and in monitoring and adjusting it, as necessary, post-discharge.

This requires close coordination with a series of constituents—including the pharmacy, rehabilitation providers, skilled nursing facilities, home health providers and family members—who often work in silos to care for the patient.

To manage its financial risk, the hospital needs to analyze clinical and financial data which typically reside in separate databases. Clinical decision support, a predictive analytical technique used to predict the risk of patients developing certain illnesses, is a start. By adding an overlay of financial data and analysis of the large, complex and often unstructured data sets (so-called "Big Data"), healthcare IT can enable the integration of care, case management and wellness enabling treatment plans with predictable costs and outcomes. We envision several potential winners resulting from this integration—analytics, coding and consulting—to name a few.

On the surface, the large, incumbent RCM and HCIT companies appear to be well positioned to lead in this area. Their balance sheets are flush with profits from selling RCM and EMR solutions which touch the financial and clinical data that needs to be integrated. However, we have seen creative applications developed by healthcare technology entrepreneurs that may prove to be emerging leaders in the industry. An example is Cerecons (www.cerecons.com), a privately-held company based in California that has developed a cloud-based care management platform for risk-bearing parties—payors and providers—to extract and integrate clinical and financial data for use across the care chain—from physicians at the point of care to administrators developing and implementing care guidelines and protocols—allowing greater insight and control over the cost and quality of care. This is a very different model than FFS.

> "… the window of opportunity to realize the potential of these incredible opportunities is short and there are significant risks. Delaying such execution is not really a choice. We need to leverage numerous avenues to capitalize on new business opportunities and to move with as much agility as possible…"
>
> – Vern Davenport, Chairman and Chief Executive Officer of M*Modal, in announcing its sale to One Equity Partners on July 3, 2012.

The market has been anticipating reform since 2009. Healthcare enterprises and investors did not wait for the Supreme Court to rule in June—deals were made at a healthy pace in 2011 and into the first six months of this year. Of course many uncertainties linger—the results of the November elections in particular. However, with the uncertainty of PPACA's constitutionality now lifted, and the continued certainty of Stein's Law, deal activity can be expected to increase. 2014 is just around the corner.

2012 YTD M&A Activity

M&A volume in the Healthcare IT ("HCIT") sector was strong in the first half of 2012, with 112 announced transactions. Transaction activity increased by 17.9% in the first six months of 2012 versus the same period in 2011. Sector activity greatly outpaced overall US M&A activity, which grew by just 3.2% in the first half of 2012. Strategic acquirers, including portfolio companies of financial investors, continue to dominate, representing 94% of activity during this period. New platform acquisitions by financial investors represented the remaining 6% of announced deals.

M&A activity throughout the HCIT spectrum. Significant acquisitions were announced in business process outsourcing (Omega Healthcare), EMR/EHR (MediConnect Global), billing (Marina Medical Billing Service), practice management (Matrix Management Solutions), healthcare analytics (Truven Health Analytics) and other sub-sectors.

Healthcare reform. The Supreme Court's ruling on PPACA has provided greater clarity for corporations and investors, paving the way for additional sector M&A activity. Additionally, the HCIT sector is expected to experience strong growth as healthcare providers and payors endeavor to improve outcomes and reduce costs through technology implementation.

Strategic investors continued to bolster their platforms. Strategic acquirers, including 3M, Genpact, McKesson and Epicor, made acquisitions to build more robust product and service offerings.

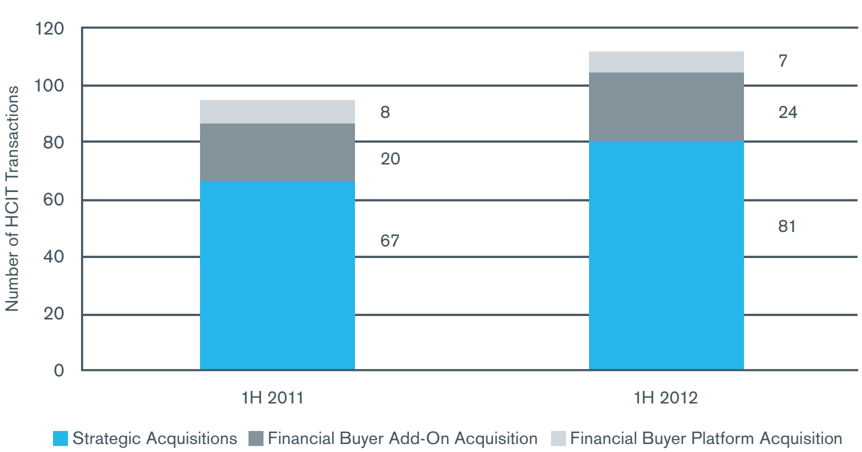
CodeRyte, Inc., a natural language processing and computer-assisted coding company, was acquired by 3M Co. (NYSE:MMM) in April 2012 from a consortium of financial investors. 3M will embed CodeRyte's technology in its 360 Encompass System, a coding and document improvement application. 3M's decisive move bolsters the company's coding platform ahead of the deadline for conversion to ICD-10 (currently October 1, 2013, but subject to extension).

In March 2012, Nuance Communications, Inc. (NasdaqGS:NUAN) acquired Transcend Services, Inc., a transcription and clinical documentation services company, for an implied enterprise value of $315.6 million (12.2x EV/EBITDA). The acquisition is expected to help Nuance provide hospitals with clinical documentation and workflow efficiencies and enhance its medical transcription capabilities with small- to mid-sized hospitals.

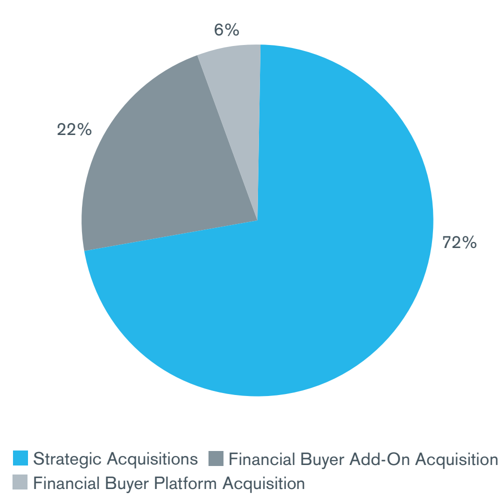
Financial buyers continue to be active. Notable examples of financial buyer activity include:

- TA Associates, which is reported to be in discussions to acquire a majority interest in Omega Healthcare Management Services, a business process outsourcing company, from HealthEdge Holdings and other investors for $93 million. Omega

Number of Healthcare IT Transactions



1H 2012 Transactions by Acquiror Type



Source: Capital IQ

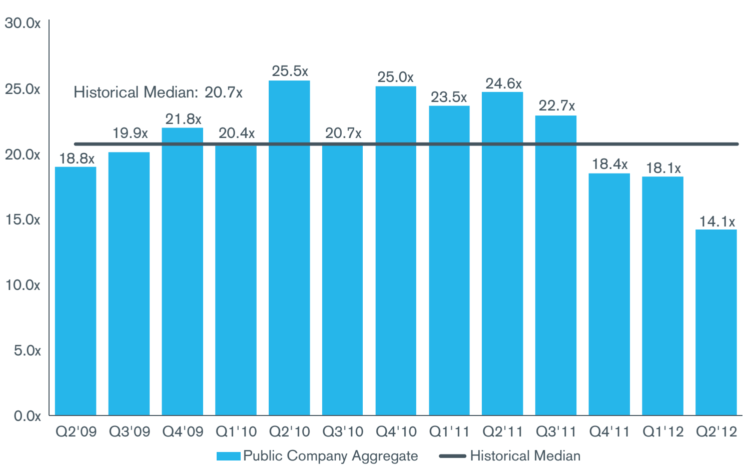
2012 YTD M&A Activity

provides outsourced coding and claims processing services through its facilities in Bangalore and Chennai, India. This underscores the important role that offshore outsourcing plays in reducing healthcare costs, as discussed in previous Duff & Phelps reports.

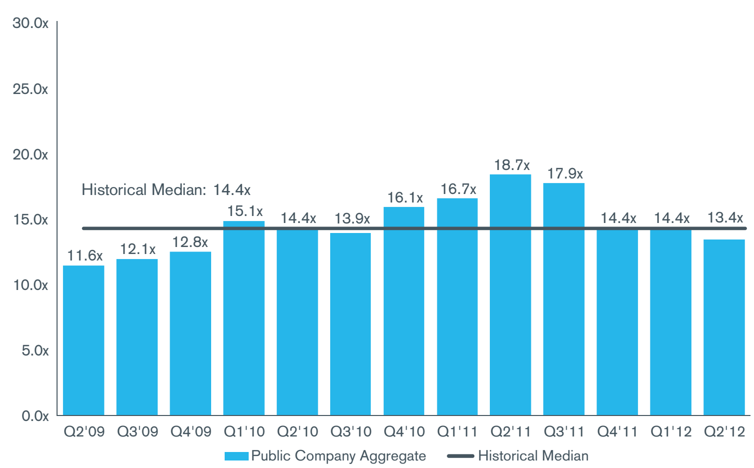
- Veritas Capital's acquisition of Truven Health Analytics, formerly Thomson Reuters' healthcare division, for $1.2 billion in April 2012. Truven provides business analytics tools to hospitals, government agencies, employers, health plans, clinicians and pharmaceutical companies. As mentioned elsewhere in this report, new risk sharing models being adopted require payors and providers to process and analyze organized data from EHR/RCM platforms and complex, unstructured data in order to lower costs and improve quality.
- The acquisition by T-System, Inc., a portfolio company of Francisco Partners, of Marina Medical Billing Service from American Capital in June 2012. T-System's add-on acquisition of the coding and RCM outsourced services company was its third acquisition of 2012, following its acquisitions of Clinical Coding Solutions, Inc. (February 2012) and Practice Management Associates, LLC (January 2012).
- The acquisition by Emdeon, a portfolio company of Hellman & Friedman and The Blackstone Group, of TC³ Health, Inc. from JMI Equity and other investors in May 2012. The add-on acquisition of the claims management company was the latest in a series of acquisitions by Emdeon and the first under its current ownership. This acquisition expands Emdeon's Payment Integrity solutions to include new claims analytics tools.

Other sector deals announced include Cardon Healthcare Network's (Serent Capital) acquisition of Outreach Services, Inc., Adreima's (Waud Capital) acquisition of Armds, Inc., iMedX's (RFE Investment Partners) acquisitions of Accumedscript LLP and The Inner Office Ltd., and Santa Rosa Consulting's (Century Capital Management) acquisition of InfoPartners, Inc.

Revenue Cycle Management Index Quarterly LTM EBITDA Multiples (Q2 2009 - Q2 2012)



Information Services Index Quarterly LTM EBITDA Multiples (Q2 2009 - Q2 2012)



* Multiples calculated based on the average daily LTM EBITDA multiple for the preceding fiscal quarter.

Source: Capital IQ

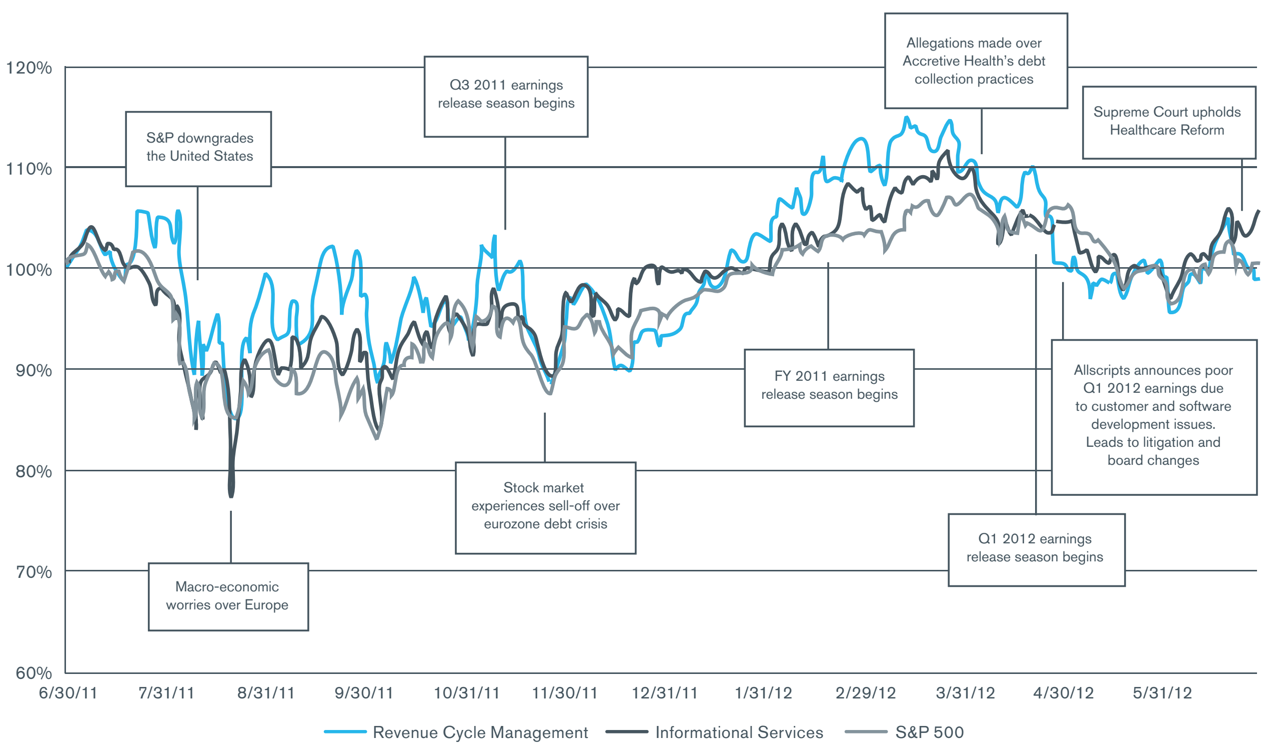
Selected Publicly Traded HCIT Companies

Volatility in Stock Prices. In the first six months of 2012, publicly-traded HCIT companies experienced significant stock price volatility. The best performing stock in the RCM sector, athenahealth (NASD: ATHN) increased 61% in the first six months while the poorest performer, Accretive Health (NYSE: AH), declined by 52%. The median price change for the group was an increase of 34%. The best performing stock in the Information Services sector, Medidata (NYSE: MDSO), increased 50% in the first six months while the poorest performer, WebMD Health (NASD: WBMD), declined by 45%. The median price change for the group was an increase of 15%. The large negative changes in stock prices were primarily a result of company-specific events such as litigation (Accretive Health) and earnings misses (Allscripts (NASD: MDRX) and WebMD) rather than industry-wide trends. The large positive changes in prices were primarily a result of strong financial performance and future growth expectations.

Strong Revenue and EBITDA Growth. Financial performance of public HCIT companies remained strong in 2012. Revenue increased in the first half for all but one company in the index (WebMD) and EBITDA increased for 70% of the companies in the index.

Valuation Multiples Impacted. The median EV/EBITDA multiples for our selected RCM companies declined from 16.6x at 12/31/2011 to 11.9x at to 6/30/12. EV/Revenue multiples for RCM companies as of 6/30/2012 ranged from 1.0x to 7.8x, with their median multiple increasing slightly from 2.8x to 2.9x between 12/31/11 and 6/30/12. Sector EV/EBITDA multiples for Information Services companies as of 6/30/2012 ranged from 5.6x to 48.3x while the median EV/EBITDA multiple of the selected public companies increased from 12.8x to 14.9x between 12/31/11 and 6/30/12. EV/Revenue multiples for these companies ranged from 0.8x to 8.0x, with their median increasing from 3.0x to 3.4x between 12/31/11 and 6/30/12. The large swings in valuation multiples were predominantly due to the previously mentioned company-specific events rather than underlying industry events.

Stock Price Index
June 30, 2011-June 30, 2012



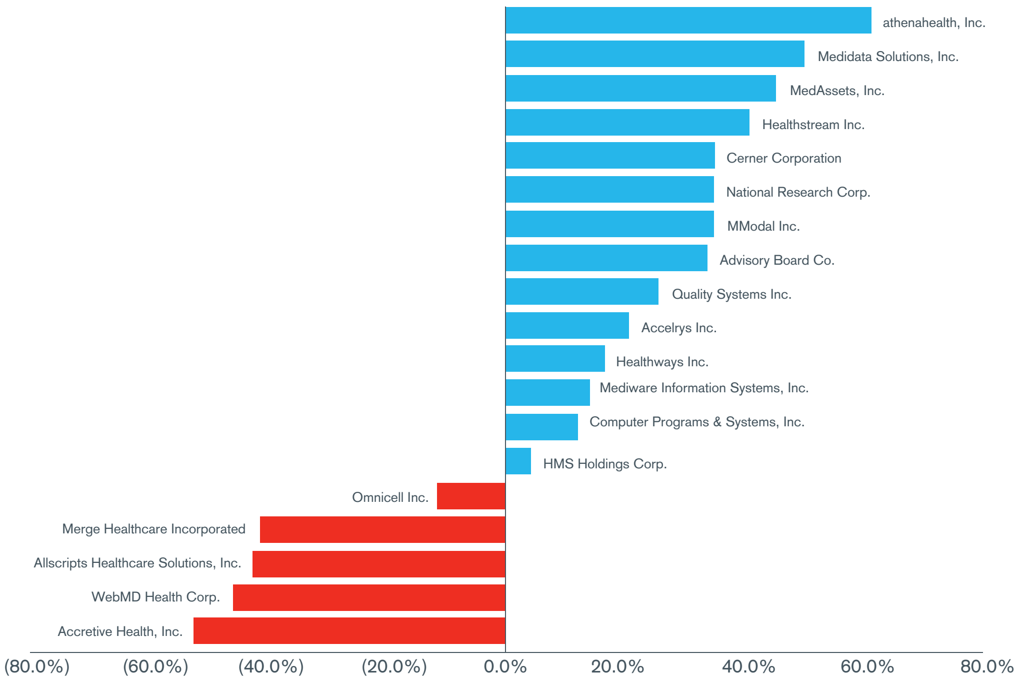
Source: Capital IQ

Selected Publicly Traded HCIT Companies

Company Name	Ticker	Price 6/30/12	% Change 12/31/11	LTM Multiples (as of 6/30/2012) Rev	EBITDA	LTM Mulitples (as of 12/31/2011) Rev	EBITDA	Change in Multiples Rev	EBITDA
Revenue Cycle Management									
Accretive Health, Inc.	AH	$ 10.96	(52.3%)	1.0x	14.9x	2.8x	48.1x	(66.1%)	(69.1%)
Advisory Board Co.	ABCO	49.59	33.6%	4.4x	28.7x	3.6x	25.5x	22.8%	12.7%
Allscripts Healthcare Solutions, Inc.	MDRX	10.93	(42.3%)	1.5x	9.1x	2.8x	15.8x	(46.2%)	(42.0%)
athenahealth, Inc.	ATHN	79.17	61.2%	7.8x	51.5x	5.4x	31.4x	44.4%	64.2%
MedAssets, Inc.	MDAS	13.45	45.4%	2.9x	9.7x	2.7x	10.0x	9.5%	(3.9%)
MModal Inc.	MODL	12.98	34.9%	2.2x	8.7x	1.8x	7.4x	21.7%	18.8%
Quality Systems Inc.	QSII	27.51	(25.6%)	3.5x	11.9x	5.2x	16.6x	(32.7%)	(28.8%)
Mean			7.8%	3.3x	19.2x	3.5x	22.1x	(6.6%)	(6.9%)
Median			33.6%	2.9x	11.9x	2.8x	16.6x	9.5%	(3.9%)
Index Weighted			11.2%	4.0x	24.3x	3.6x	24.6x	9.5%	(1.3%)
Information Services									
Accelrys Inc.	ACCL	$ 8.09	20.4%	2.0x	19.4x	1.8x	136.1x	12.7%	NM
Cerner Corporation	CERN	82.66	35.0%	5.8x	21.2x	4.7x	17.5x	23.3%	20.9%
Computer Programs & Systems Inc.	CPSI	57.22	12.0%	3.4x	13.6x	3.1x	12.5x	10.8%	9.2%
Greenway Medical Technologies, Inc.	GWAY	16.31	NM	3.7x	48.3x	NA	NA	NA	NA
Healthstream Inc.	HSTM	26.00	40.9%	6.8x	34.8x	5.6x	29.3x	20.9%	18.9%
Healthways Inc.	HWAY	7.98	16.3%	0.8x	5.6x	0.7x	3.8x	13.9%	48.2%
HMS Holdings Corp.	HMSY	33.31	4.2%	8.0x	26.5x	7.3x	25.5x	8.7%	3.8%
Medidata Solutions, Inc.	MDSO	32.67	50.2%	3.7x	17.7x	2.4x	10.9x	55.5%	62.3%
Mediware Information Systems Inc.	MEDW	14.60	13.9%	1.3x	6.6x	1.2x	6.1x	8.6%	9.2%
Merge Healthcare Incorporated	MRGE	2.86	(41.0%)	2.0x	8.8x	3.0x	13.2x	(34.4%)	(33.3%)
National Research Corp.	NRCI	52.35	34.9%	4.6x	14.9x	3.7x	12.3x	23.9%	21.4%
Omnicell Inc.	OMCL	14.64	(11.4%)	1.1x	11.0x	1.5x	18.4x	(25.8%)	(40.4%)
WebMD Health Corp.	WBMD	20.51	(45.4%)	1.5x	8.3x	3.1x	12.2x	(52.1%)	(31.6%)
Mean			10.8%	3.4x	18.2x	3.2x	24.8x	5.5%	8.1%
Median			15.1%	3.4x	14.9x	3.0x	12.8x	11.7%	9.2%
Index Weighted			17.5%	5.4x	21.1x	4.5x	20.0x	18.3%	5.4%

Source: Capital IQ

Stock Price Change
December 31, 2011 - June 30, 2012



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Contact

Jim Hesburgh
Managing Director
+1 212 871 5970
jim.hesburgh@duffandphelps.com

Brooks Dexter
Managing Director
+1 424 249 1646
brooks.dexter@duffandphelps.com

Tim Meyer
Managing Director
+1 212 871 3030
timothy.meyer@duffandphelps.com

Brad Hileman
Director
+1 424 249 1644
brad.hileman@duffandphelps.com