Accretive Health (ACHI) – The Definition of “Special”

Date: July 10, 2014

Accretive Health (ACHI) is the definition of “special”. “Special” is in quotes because in this case, special is not a good thing. Actually, the Company is a complete mess. Just take a look at what’s happened over the past three years:

- In July 2011 – just a couple months after going public – an employee lost a laptop containing unencrypted health data on 23,500 Minnesota patients.
- This incident triggered a broader investigation of Accretive's business practices and in January 2012 – just 8 months after going public – Minnesota’s Attorney General filed a complaint against Accretive for aggressive collection practices (here).
- In July 2012, Accretive bit the stick and settled with the MN AG, paying $2.5MM and agreeing not to operate in the state for a period of 2 – 6 years (here).
- In March 2013, the Company announced that their revenue recognition practices weren’t correct and restatements were necessary (here).
- In April 2013, Mary Tolan – the 2010 E&Y Entrepreneur of the Year; the woman who built the company – was forced out of the CEO role, replaced by Stephen Schuckenbrock from Dell (here). Mary remained Chair of the Board.
- In November 2013, Mary Tolan resigned as Chairwoman of the Board (here).
- In mid-March 2014, the NYSE delisted the Company for failing to file restated financials on time (here).
- In late April 2014 Stephen Schuckenbrock, the CEO of Accretive Health, tendered his resignation, effective Oct-14 (here).
- Despite telling the Street that they would have restated financials by 1Q14, the Company still hasn’t filed them. In their most recent update, the Company said this: “the restatement is substantially complete, it has taken longer than anticipated and more time is needed. […] The Company is currently in the process of working with its auditors to complete the audits as soon as possible” (source).

So to recap: We have a company with a lameduck CEO, no financials, trading over the counter. Now can you understand why I call this company “special”?

After reading all this, you might think the business is permanently impaired. You’d be wrong.

Incredulously, ACHI has managed to keep a pretty darn good business and **still grow its cash pile!**

Before digging into the numbers, a brief overview of the business:

ACHI is in the revenue cycle management business. It partners with large hospitals and infuses its technology and processes into the back office, helping hospitals boost revenue collection. Michael Zimmerman put it best:

> Accretive moves fast, calling patients before they arrive at the hospital to discuss their insurance coverage. "Most (outside firms) start the collection process 30 days after patient discharge," says Michael Zimmerman, a Milwaukee-based industry consultant who is exploring a joint venture with Accretive to commercialize its approach for smaller hospitals (source).

For their efforts, Accretive charges nothing upfront but shares the cost savings with the hospital and retains a portion of the revenue lift. Customers easily understand the value ACHI brings:

> "We went from a nightmare to making money," says Susan Field, former executive at St. John, an affiliate of St. Louis-based Ascension Health, the nation's largest non-profit hospital chain (source).

In addition to revenue cycle management, ACHI helps hospital partners do care coordination (monitor in-clinic activities and coordinate patient treatments) and perform compliance auditing services.

Boiled down, ACHI is a healthcare IT company. And healthcare IT companies like CERN, MCK and ATHN are awarded outrageous multiples in this market. But because of its myriad issues, ACHI is trading at a 40% - 50% discount to its peer group. **The market is telling us that the Company is completely untouchable.**

Or is it?

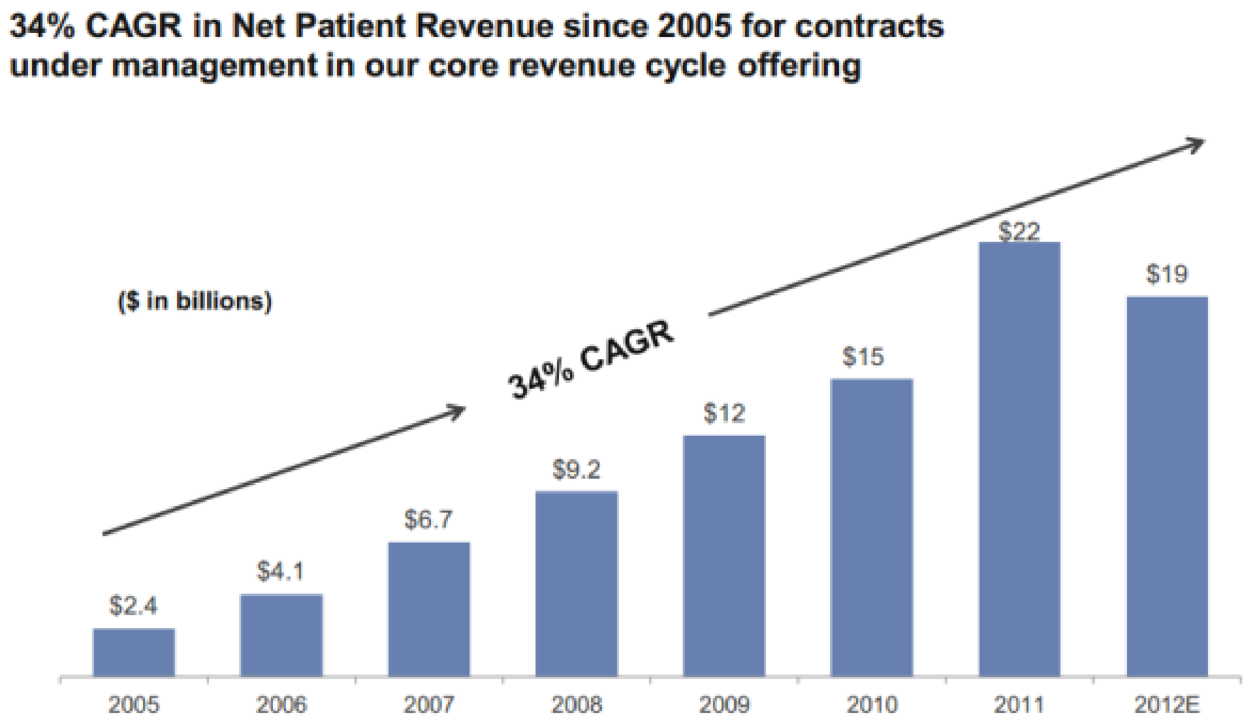
Let’s peel the onion back – some questions are worth considering:

1. Why did ACHI pay only $2.5MM to settle the Minnesota lawsuit? If there was serious wrongdoing, wouldn’t the monetary fine have been much greater? After all, ACHI received approx. $100MM in revenue from Fairview in MN in 2011 (source), making the cash settlement almost de minimis.
2. Why would Ernst & Young approve their revenue recognition practices, stating in the Company’s S-1, “the consolidated results of its operations and its cash flows […] (are) in conformity with U.S. generally accepted accounting principles” only to reverse course a few years later (source)?
3. Why would very reputable healthcare consultants / professionals join Mary Tolan as partners in a new PE firm if they thought she was the mastermind of a fraud? Why would LPs give her hundreds of millions of dollars (source)?

When you ask the right questions, you arrive at a much more sanguine view of Mary Tolan and Accretive Health. Here’s my take:

Mary Tolan was an aggressive founder. She moved very fast and broke many things. And the Company suffered because of it, so she had to go. But she built a pretty darn good business. So good, in fact, that in spite of all the negative PR and internal issues, the only real revenue

ACHI lost is the forfeiture of their Minnesota business due to the 2012 AG settlement – Fairview represented 12% of their 2011 revenues (source) – and some business canceled as a result of clients getting acquired. Overall, the impact of these very public issues has been a decrease in contracted net patient revenue from $22BN in 2011 to $18BN as YE13 (source). Here's a longer historical view of NPR (note: 2013 is cut off here, but the NPR at year end was $18BN, per the Company's most recent conference call):



Source, slide 69: https://www.dropbox.com/s/of4gn20gxm46qho/ACHI%20Investor%20Day%20-%20Dec%202012.pdf

To me, this is remarkable. Despite all the mud-slinging from the Minnesota AG and all the internal turmoil, ACHI has lost less than 20% of their NPR (>12% was "forced" due to the AG settlement; some other % was "forced" due to hospital acquisitions). This speaks to the primary point I want to make about ACHI's business:

Once embedded, this business is damn near impossible to rip out.

So at the core, you have a darn good business that is in the process of fixing the mistakes it's made. Management has stabilized the workforce ("we've had significant reductions in employee attrition in the US and in India" – source), reorganized their collection efforts, solidified their client relationships, and are accelerating their investment in technology (e.g., real time analytics is a top priority). Does this sound like a business that is permanently impaired? Not to me.

Oh yeah, and they announced a $50MM share buyback which will be initiated at the end of their restatement process (source). Hmmm….

So what about the accounting issues?

ACHI has spent the past 5 quarters pouring over every detail of their hospital contracts. I can't express how laborious this process is; they have to go through each contractual detail for the past 5 years and study the manner in which they recognized revenue. Then they have to verify the accounting treatment with their auditors / attorneys, then they have to change their systems to reflect the re-classification, then it gets reflected in their financials. Not only is this laborious, it's expensive. Last year, the Company incurred more than $20MM in cash costs related to this restatement effort ($15MM in restatement costs + $5MM in legal costs).

After over a year of effort, here's what ACHI has said publicly about their restatement:

- The issue is the timing of revenue recognition for certain revenue cycle management contracts.
- Some GAAP revenues will be shifted to later periods (lower reported net income in earlier periods; higher net income in later periods).
- **Importantly, they expect NO change to historical cash flows.**
- There is NO change in the economic relationship between a hospital and ACHI.

My understanding is that some of the restatement also has to do with how the Company defines revenue. Previously, a hospital would turn over its collections staff to Accretive and instead of paying the staff directly, the hospital would pay Accretive who would then pay the staff. This would mean ACHI reported higher revenues because of the no-margin employee cost. I suspect this cost may shift back to the hospital once the restatement is completed (which decreases revenues but leaves EBITDA unchanged).

So we have a situation where margin percentages will likely change, but cash flow won't. This is critical. After 5 quarters of financial tedium, ACHI expects **no change to operating cash flows**. So the single most important part of accounting – the part of accounting you can take to the bank – isn't changing on the re-file.

So I ask you now, would you consider ACHI completely untouchable?

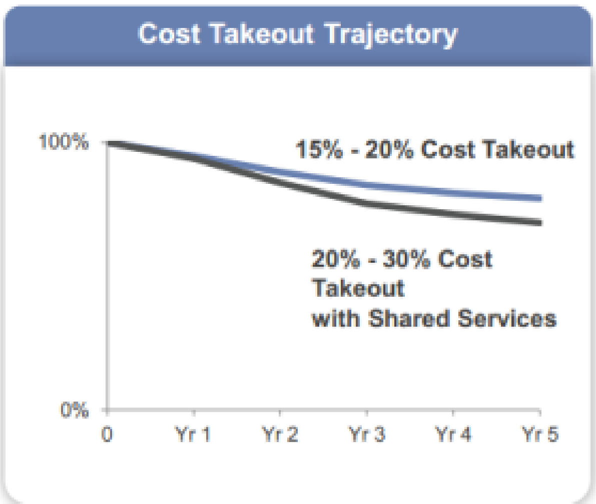
With 100MM diluted shares and $228MM in cash (source), the market is valuing ACHI at $600MM.

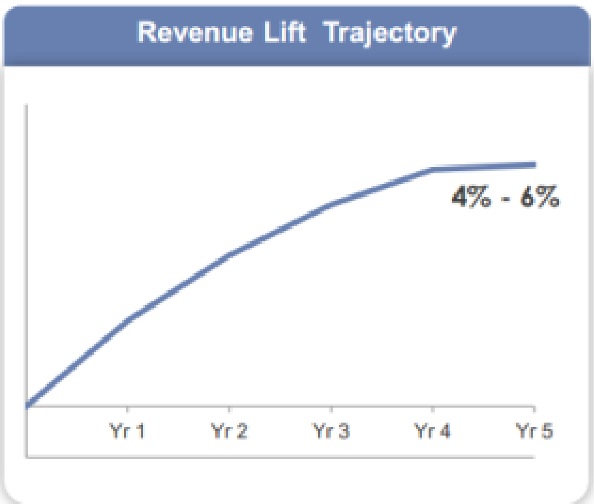
As noted above, with the restatement, margin percentages will likely change but absolute dollars shouldn't. So you can look at EBITDA and ballpark how much money the company is making today. Here's the history we have:

	2007	2008	2009	2010	2011
	Year Ended December 31, (In thousands)				
Net income	$ 774	$ 1,243	$ 14,590	$ 12,618	$ 29,164
Net interest (income) expense(a)	(1,710)	(710)	9	(29)	(22)
Provision for income taxes	456	2,264	2,966	9,729	18,913
Depreciation and amortization expense	1,307	2,540	3,921	6,157	8,312
EBITDA	$ 827	$ 5,337	$ 21,486	$ 28,475	$ 56,367
Stock compensation expense(b)	934	3,551	6,917	16,549	25,196
Stock warrant expense(b)	5,081	3,332	4,509	—	—
Adjusted EBITDA	$ 6,842	$ 12,220	$ 32,912	$ 45,024	$ 81,563

Source, page 39: http://secfilings.nasdaq.com/filingFrameset.asp?FileName=0001193125-12-139929%2Etxt&FilePath=%5C2012%5C03%5C29%5C&CoName=ACCRETIVE+HEALTH%2C+INC%2E&FormType=10-K%2FA&RcvdDate=3%2F29%2F2012&pdf=

One nuance you have to understand about ACHI's model is that their contracts typically have a multi-year ramp up period before hitting their sustained contribution level. So arriving at revenue is not as simple as multiplying (Net Patient Revenue) x (Savings) x (X% to ACHI). What you have to consider is the ramp – which you can clearly see here:





Source, slide 71: https://www.dropbox.com/s/of4gn20gxm46qho/ACHI%20Investor%20Day%20-%20Dec%202012.pdf

Without any recent filings, one way to estimate EBITDA is to take historical EBITDA and divide it by NPR – this will give you their operating profit as a percent of NPR (neither of those numbers should change on the re-file, so they can help us triage to the answer). Once you have that, you then have to make some adjustment for the ramp-up; this will give you a pretty good idea of EBITDA. Here's my stab at it (note: EBITDA through 2011 are actuals; 2012/13 are estimates):

	2007	2008	2009	2010	2011	2012	2013
EBITDA	$827	$5,337	$21,486	$28,475	$56,367	$45,600	$41,400
EBITDA, adj for stock options	$6,842	$12,220	$32,912	$45,024	$81,563	$62,700	$57,600
Net Patient Revenue	$6,700,000	$9,200,000	$12,000,000	$15,000,000	$22,000,000	$19,000,000	$18,000,000
EBITDA / NPR	0.01%	0.06%	0.18%	0.19%	0.26%	0.24%	0.23%
Adj EBITDA / NPR	0.10%	0.13%	0.27%	0.30%	0.37%	0.33%	0.32%

My guess is that ACHI is doing somewhere around $55MM in EBITDA adjusted for stock options expense (my assumption here is that their rather generous stock option grants in 2010 and 2011 are more one-time items related to the IPO than recurring expenses going forward). $55MM on a $600M EV company means ACHI is trading at 11x EV / EBITDA. **Compared with its healthcare IT peers, this implies that ACHI is a screaming buy.**

One more time: is ACHI completely untouchable?

Investors that read this will generally fall into one of two camps:

1. Too many cockroaches: not touching it at any price.
2. Solid business, issues are getting fixed, clear catalyst: buy.

I fall squarely in the second camp. To me, where ACHI has been is not nearly as important as where ACHI is going. And I see a near-term future where investors get more clarity and visibility into Accretive's business than at any point in the past 5 quarters. **And that is unquestionably bullish.**