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Change Healthcare, Inc.

After Completing Its Corporate Transition, the Company Copes With COVID-19

Executive Summary

May 13, 2020

Change Healthcare Inc. (CHNG, Change Inc., Change or Inc.) is a new public company formed in 2016 as a joint venture between McKesson Corporation (MCK) and an investor group led by The Blackstone Group. Over the past four years, the joint venture partners have combined their healthcare IT businesses and raised capital through an IPO and unit offering. In March, McKesson completed the distribution of its interests in the joint venture to its existing shareholders through an exchange offer.

With the onset of the COVID-19 pandemic, CHNG's stock has fallen sharply and now trades at a very wide discount to its peer group. As activity in the healthcare system returns to normal, the stock should have rebound potential to its pre-COVID levels of \$15-\$17. If the company then demonstrates progress toward its revenue growth, operating cost and leverage goals, its stock should have upside beyond \$17 per share, as it shrinks its discount to its peer group.

For those equity investors seeking to limit some of their downside risk, Change's 6.00% Tangible Equity Units (TEUs) provide a current yield of 7.1%, until they convert to common stock on June 30, 2022. The quarterly distribution of \$0.75 per unit reduces the breakeven share price upon the conversion of the TEUs into common on June 30, 2022 to \$9.23 per share.

Change's 5.75% Senior Notes due March 1, 2025 recently traded at 98.41 which equates to a 6.13% yield-to-maturity and a spread over Treasuries of 570 basis points. The Notes are rated Caa1/B-; but their yield is consistent with Ba/BB-rated notes.

Common Stock Performance Rating: 1; Safety Rating: C-**S&P 500: 2820.00**

Amt Outst (\$m)	CUSIP/Symbol	Type	Recent Price	Coupon	Maturity	YTW	Spread	Call Date	Call Price	Credit Ratings
1,325.0	15911NAA3	Senior Notes	98.41	5.750%	3/1/25	6.13%	570 bp	3/1/21	101.44	Caa1/B-
287.5	15912K209	Tangible Equity Units	42.24	6.000%	6/30/22	7.10%	N/A	N/A	N/A	N/A

YTW=Yield to Worst. Prices, yields and spreads as of May 13, 2020.

Shares Outst. (mil.)	Common Stock	5/13/20 Price	Div. Per Share	Div. Yield	Book Val.	Proj. '20 EPS	2020 P/E	Proj. '21 EPS	2021 P/E
303.4	Change Healthcare, Inc. (N:CHNG)	\$10.40	N/A	N/A	\$15.72	\$0.51	20.4	N/A	N/A

Book value per share is a Lark Research estimated, as are projected fiscal 2020 GAAP and Non-GAAP earnings and P/E multiples. Projected 2020 Adjusted EPS as estimated by Lark Research is \$1.49, which equates to a P/E multiple of 7.0 times. Stock price as of May 13, 2020.

Early Years. Although formed in June 2016, the joint venture, Change Healthcare LLC (Change LLC or LLC) did not begin operations until March 2017 when both parties contributed their healthcare technology businesses in exchange for joint venture interests. Change Healthcare Inc., formerly known as Emdeon, was originally acquired by Blackstone for \$3 billion in 2011. Its investors at the time of the formation of the joint venture included Blackstone, Hellman & Friedman, and Neil de Crescenzo, Change's CEO. (Change Healthcare Inc.'s pre-joint venture operations are known as "Legacy CHC.")

McKesson (MCK), which is ranked seventh in the Fortune 500, is a leading distributor of pharmaceuticals and medical-surgical supplies and offers a range of management and technology services to providers and other healthcare businesses. Up until the formation of the joint venture, MCK had acquired and operated various healthcare IT businesses that comprised its McKesson Technology Solutions (MTS) business segment. The businesses that MCK contributed to the joint venture are known as "Core MTS."

Under the terms of the original transactions, the Change Inc. investor group received \$1.8 billion in cash, stock in the eRx Network (Legacy CHC's pharmacy claims switching and prescription routing business), and certain tax concessions. For Core MTS, McKesson received \$1.3 billion in cash and certain tax concessions.

5.75% Senior Notes due 2025. To fund a portion of the payouts, Change LLC issued in a February 2017 private placement \$1.0 billion of 5.75% Senior Notes due March 1, 2025. The Notes were rated B- by Standard & Poor's. In late April, Change LLC (and Change Healthcare Finance, Inc., its financing subsidiary) issued a \$325 million follow-on offering of the 5.75% Senior Notes. In March, Moody's rated the Notes Caa1. According to Trace data, the Notes traded on May 8, 2020 at 99.00, which translates into a yield-to-maturity of 5.99% and a spread of 570 basis points (bp) over the comparable maturity U.S. Treasury note. Although the notes are rated Caa1/B-, they trade at spreads that are on par with Ba/BB rated debt instruments.

I do not have access to the rating agencies' rationale for Change LLC's low credit rating. Change's debt service coverage of around 2.8 times (EBITDA/interest expense) is consistent with BB-rated credits. The rating agencies may have given Change LLC a lower credit rating because of the fierce competition in the healthcare technology sector and ongoing consolidation among payers and providers, both of which raise the risk that its business may be disrupted. In addition, in its current form the company has a limited operating history and a highly leveraged capital structure, following the \$3.1 billion of cash payouts to the Blackstone investors and McKesson.

Change's IPO. In June 2019, Change Healthcare Inc., which held the joint venture interests of the Legacy CHC investors, issued 49.3 million shares of common stock at a price of \$13.00 per share for net proceeds, after underwriting discounts, of \$608.7 million. It also issued 5.75 million of its 6% Tangible Equity Units (TEUs) at \$50.00 each for \$278.9 million. Total net proceeds of \$887.6 million were used to pay down the Term Loan Facility of the joint venture. CHNG's stock price would later serve as a reference point for setting the terms of the exchange of McKesson's joint venture interests in March 2020.

6% Tangible Equity Units (CHNGU). Each TEU consists of a stock purchase contract and a senior amortizing note with an original principal amount of \$8.2378. The stock purchase contract will settle automatically on June 30, 2022. At that time, TEU investors will receive between 3.2051 and 3.8461 shares of CHNG, depending upon CHNG's share price at the time of settlement. Under the formula, they will received 3.8461 shares, if CHNG's share price is at or below the "reference price" of \$13.00 ($\$50/3.8461$) or 3.2051 shares, if its share price is at or above the "threshold appreciation price" of \$15.60 ($\$50/3.2051$), or between 3.8461 and 3.2051 shares, if the share price is between the reference price and the threshold appreciation price. Under certain limited circumstances, the purchase contract settlement could be postponed.

The senior amortizing note bears interest at a rate of 5.50% per annum. TEU investors are currently receiving quarterly payments of interest and principal of \$0.75 per unit, which are designed to repay the note completely on the final installment payment date of June 30, 2022. The quarterly payment, which is \$3.00 on annualized basis, provides TEU investors with an annualized yield of 6.00% on their original \$50 investment.

With the \$3 annual distribution and assuming that CHNG does not initiate a dividend, I calculate that at the 5/13/20 prices of \$10.47 for CHNG and \$42.24 for the TEUs, investors would be indifferent to either security if they believe that the 6/30/22 price of CHNG will be \$14.34. At that future price, the internal rates of return on both investments is 15.9%. Consequently, an investor who thinks that CHNG's share price will exceed \$14.34 at 6/30/22 would realize a higher relative return by buying CHNG common stock today; but if that investor thought that CHNG's future price would be less than \$14.34, he/she would earn a higher relative return on the TEUs. At a future price of \$9.23 on CHNG common, the TEUs would breakeven (i.e. earn a 0% IRR), which is well below the current (May 13) CHNG share price of \$10.47. At the current low price for CHNG, the income provided by the TEUs reduces the risk of owning CHNG outright, but the conversion rate formula limits the relative upside potential return on the TEUs (above \$14.34). Consequently, investor seeking to reduce the risk of owning CHNG common shares, should consider the TEUs.

Exchange of Joint Venture Interests for McKesson Shares. The IPO and TEU issuance provided CHNG with \$887.6 million of equity capital which was used to reduce debt. The CHNG IPO also established a valuation basis for the distribution of Change Healthcare LLC shares that were held by McKesson.

McKesson completed the distribution of its joint venture interests on March 10, 2020. This was accomplished through an exchange offer of its CHNG shares for shares of MCK. Under the exchange offer formula, McKesson had planned to distribute \$107.53 worth of CHNG for every \$100.00 of MCK shares that it accepted, which equates to a 7% discount on the CHNG shares, subject to a cap of 11.4086 shares of CHNG for every share of MCK.

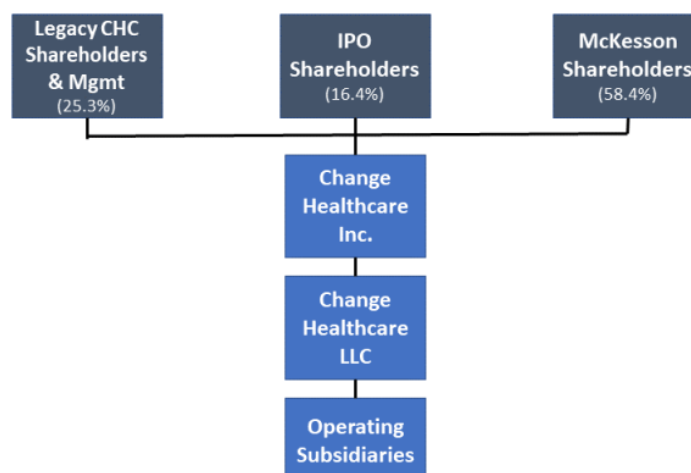
The exchange offer was oversubscribed by more than 6-to-1. McKesson accepted 15,426,537 of its shares in exchange for all its 175,992,192 CHNG shareholdings. That equates to an exchange ratio of 11.4084, essentially equal to the exchange cap. The prices for CHNG and MCK that determined the final exchange ratio were based upon their volume-weighted share price averages over three trading days in March prior to the exchange offer deadline. By my calculations, because the number of CHNG shares distributed per MCK share was limited by the

cap, MCK investors whose shares were accepted in the exchange offer received \$106.20 worth of CHNG for each \$100.00 of MCK stock that they owned.

Through the merger between Change Inc. and PF2 SpinCo, Inc., a subsidiary of McKesson, McKesson traded its interests in the LLC joint venture for Change Inc. stock. McKesson then swapped the CHNG shares for its own shares through the exchange offer, reducing total MCK shares outstanding. I estimate that the exchanging McKesson shareholders now own 58.4% of Change, while the original Legacy CHC investors, management and IPO shareholders own the remaining 41.7%. When the TEUs are converted into CHNG common on June 30, 2022, the stake of the original McKesson shareholders will decline to 54.4%.

Change Healthcare Inc.

Organization Chart and Share Ownership at March 10, 2020



Thus, the “float” on CHNG is now equal to 74.8% of the total outstanding shares (at March 10, 2020). Legacy CHC shareholders, management and members of the Board of Directors hold 25.3%. I estimate that Blackstone holds 19.8% and Hellman & Friedman about 5% of the currently outstanding shares.

Business. Change Healthcare Inc. operates an independent healthcare technology platform that offers data and analytics primarily to payers and providers within the U.S. healthcare system. Its comprehensive suite of solutions helps customers improve clinical decision-making, administrative efficiency and patient satisfaction. The company offers both discrete (or functional) and enterprise-wide solutions. Change serves 30,000 customers, of which none accounts for more than 4% of its revenues. 40% of its business comes from payers; 60% from providers. About one-third of Change’s business is indexed to transaction volume in the health care system; one-third is driven by its customers’ transaction dollar volume and the remaining one-third is subscription-based. Its key products and services include:

CHNG’s *Intelligent Healthcare Platform (IHP)* is the backbone upon which customers access its comprehensive set of solutions. Through its extensive customer connections, the IHP is at the

center of the U.S. healthcare system. In fiscal 2018 (ended March 31), the network facilitated 14 billion transactions and approximately \$1 trillion of adjudicated claims, representing about one-third of all U.S. healthcare expenditures. The platform serves 900,000 physicians (or about 80% of the U.S. total, according to statista.com), 118,000 dentists (60% of the total, according to Wikipedia), 33,000 pharmacies (about half, according to Wikipedia), 5,500 hospitals (nearly 100%, according to the American Hospital Association) and 600 laboratories. It also maintains 2,200 government and commercial payer connections. With the insights gained from the high volume of transactions, Change has developed its portfolio of applications and analytics that add value to its customers and thus to the platform.

InterQual is a widely used clinical decision support solution that provides payers and providers with actionable, evidence-based clinical practices and procedures that are consistent with standards of appropriate care. As such, its clinical delivery options help lower administrative costs by streamlining the medical review process and reduce claims rejections by payers.

- [*InterQual AutoReview*](#) pulls data from electronic health records and matches them with InterQual's evidence-based clinical criteria to facilitate medical reviews and ready clinical decisions for approval. Accordingly, it helps to reduce the administrative burden and errors associated with manual reviews, promoting more efficient, (primarily exception-based) utilization management (UM).
- [*InterQual Connect*](#) is a cloud-based service that automates the submission of medical review-based treatment plans to payers for prior authorization. It therefore helps to reduce the possibility of a rejection of claims by submitting treatment plans that are consistent with standard medical practices and payer authorization guidelines. In this way, it reduces the administrative burden associated with the medical review process.

Together, InterQual AutoReview and InterQual Connect are key components of an exception-based utilization management/care management system. They help reduce administrative costs and ensure fewer denials of claims, allowing clinicians to focus more on patient care.

[*End-to-End Payment Accuracy Solution*](#). Change offers several solutions, such as *Coding Advisor* and *ClaimsXten*, that help payers streamline and improve the accuracy of the payments process. These solutions address all aspects of payments, including standardized claims and exceptions, to ensure that they are processed efficiently and conform to payer requirements. For example, they identify abnormal billings, handle out-of-network claims, correct claims submissions and identify and recover inappropriate payments.

[*Revenue Cycle Management \(RCM\)*](#). Change's solutions also run end-to-end through the patient revenue cycle to assist providers in optimizing their workflows and improving staff efficiency to deliver a better patient experience. Its RCM solutions automate pre-authorizations (and avert denials), accelerate reimbursement and avoid bad debts. On the front end of the revenue cycle, its partnership with [*Epic Systems*](#), a large, privately-held provider of electronic healthcare records (EHR) software, has served to expand Change's customer reach.

[*Value-Based Care*](#). Simply put, value-based care is delivering the highest quality medical services at the lowest possible cost to patients (and payers). Change has developed software and services that use insights gleaned from its existing suite of (primarily fee-based)

applications to help payers and providers work collaboratively toward the objectives of value-based care.

Change's [HealthQx](#) solution is a cloud-based episode analytics platform that allows payers to analyze care delivery practices for specific medical problems and conditions. It therefore facilitates discussions between payers and providers on costs, utilization and treatment standards for specific medical conditions. Through this process, HealthQx helps payers identify bundled payment opportunities, a key component of value-based care programs.

[Enterprise Medical Imaging](#). A key priority, Change is repositioning the business: moving it to the cloud, beefing it up with AI technology (with the aid of its partner, Google Health) and widening the scope of its services. Its vendor-agnostic radiology and cardiac imaging management solutions help improve diagnoses, manage equipment utilization, speed radiologist turnaround times, manage staffing levels and meet record keeping and other regulatory requirements. *Enterprise Viewer* provides care teams with a unified view of a patient's imaging history. Change also offers consulting services for enterprise imaging, with analytics that include customizable key performance indicators and industry benchmarking.

[Patient Engagement](#). Change has solutions that help increase patient acquisition and retention through personalized communications that raise patients' level of engagement and protect providers from financial loss. Its applications, including *Shop Book and Pay*, help patients compare pricing of clinical services, assess out-of-pocket costs, schedule appointments, and pay bills. Change also offers outsourced call center services and financial counseling for patients.

[Other Solutions](#). Change has many solutions: some discrete, others are part of suites. Its eligibility and enrollment services have consistently received high ratings from third party reviewers in recent years. Other leading applications include *Quality Performance Advisor*, a payer quality analytics tool, *ANSOS* for nurse and staff scheduling and *True View*, which delivers cost information, quality reviews and alerts on prescriptions and medical services to health plan members.

Solutions are continually upgraded and new solutions emerge frequently in response to technology improvements and population health trends. Recently, for example, there has been a rush by Change and other healthcare IT providers to provide [COVID-19- related solutions](#), including the rapid expansion of telehealth services.

Understanding Change's relative competitive positions across its wide scope of solutions and services is obviously important to assessing its prospects. However, I do not have sufficient knowledge in that regard; so such an assessment is beyond the scope of this report. While I hope to learn more about the various healthcare technology solutions and services over time, interested investors might get a better handle now on Change's competitive position from research providers, like [KLAS Research](#) and [Gartner](#), that evaluate and rate the individual products and services of healthcare technology companies.

From what I have gleaned from its financial disclosures, conference calls and other independent sources, Change is among the leaders in most of the major categories in which it competes. However, some of the company's solutions may have been (or are at risk of being) surpassed by competitors. In addition, with the creation of large healthcare systems from the

ongoing consolidation among regional health care providers, more of Change's customers are gaining sufficient operating scale to justify bringing their IT solutions and services in house. Change has disclosed in its regulatory filings that part of its strategy includes "repositioning certain underperforming solutions to better address end market dynamics," which presumably include competition and consolidation.

Over the past few years, much of Change's attention has been focused on integrating the operations that were combined in the joint venture. The company also spends less as a percent of sales on research and development than most of its competitors; while it relies more on partnerships and acquisitions. Even so, its competitive position may have eroded in certain product lines in recent years. With most of the integration now behind it, the two original organizations are increasingly functioning as one and management is turning most of its attention now to optimizing its portfolio of solutions and services and driving revenue growth.

Competition. Change is among the largest Healthcare IT providers in an industry that is fragmented and competitive. The wide scope of its solutions and services puts it up against a diverse set of competitors, including healthcare transaction processors, information system vendors, IT and healthcare consultants, insurance companies, pharmacy benefit managers and payments providers as well as companies that specialize in healthcare eligibility and enrollment services, payment accuracy and customer engagement.

Among these are publicly traded healthcare IT companies, such as Allscripts (MDRX), Cerner Corporation (CERN), Health Catalyst Inc. (HCAT), HMS Holdings (HMSY), Inovalon (INOV), NantHealth (NANT) and NextGen Healthcare (NG). Change competes against IT software and services firms such as IBM and Oracle (ORCL), medical equipment manufacturers who also offer digital solutions, such as GE Healthcare, and service providers such as Accenture (ACN) and Deloitte Consulting, who help large healthcare organizations develop proprietary IT solutions. Numerous smaller companies, both public and private, compete against Change in narrower segments of the market. Change also competes with non-profit service providers, including the state and regional healthcare information exchanges.

Although Change does face formidable competition, it has also partnered with leading technology companies, like Google Health, Amazon Web Services, Microsoft and Adobe, to support its innovation efforts. Such partnerships should help Change sustain or build upon its competitive advantages.

Industry Trends. Although the application of information technology is not new to healthcare, there is still growth potential in the healthcare IT industry. Key emerging trends in healthcare management (such as value-based care and the interoperability of electronic health records (EHR)), in science (such as personalized medicine), and in the application of advanced technologies (like high performance computing, big data, artificial intelligence and machine learning) to improve population health, hold promise for the future. Yet, many applications are early in their development and institutional and political barriers exist that are limiting their deployment in the near-term. Identifying the likely winners and losers in this dynamic environment is not an easy task.

Probably the most important trend that is shaping technology deployment is the drive to control healthcare spending. In the U.S., the Patient Protection and Affordable Care Act (ACA), which

was an attempt to broaden coverage and promote efficiency, has been in limbo since the election of President Trump.

Though well-intentioned, the ACA has its flaws – most notably its expansion of coverage to previously uninsured people and its mandate of coverage for pre-existing conditions. Those costly provisions were supposed to be offset partially by additional revenues from younger, healthier citizens who would pay a penalty if they failed to maintain health insurance coverage; but the Trump administration eliminated the penalty in 2017 (effective January 1, 2019).

Besides the federally-supported expansion of Medicaid, the cost of insuring the uninsured and covering pre-existing conditions has been covered mostly through increases in health insurance rates and deductibles for consumers. Despite a federal government subsidy that has made health insurance affordable for many lower income households, on average consumers are paying more today for less insurance coverage.

The ACA was also supposed to restrain health insurance cost increases by speeding the transition from fee-for-service to value-based care, but the shift has been slow so far. The law also anticipated that greater transparency in health care costs would empower consumers and thus bring down the overall cost of care over time, but by and large costs remain opaque and consumers who have insurance coverage (and even those who have high deductibles) do not show much interest in trying to control costs.

Many states and insurers have adapted to ACA-mandated changes and support its proposed shift to value-based care. Although the ACA remains a hot political issue, many stakeholders favor fixing rather than repealing it. Given the partisan rancor (and now with the all-consuming effort to combat COVID-19), Congress has so far avoided any reconsideration of the terms and provisions of the ACA. Still, the COVID-19 pandemic has placed great strains on the economy and the [health care system](#), raising the urgency for a fix. Congress may have no choice but to tackle the issue after the presidential election.

Even so, given President Trump's expressed preferences for handling COVID-19-related issues, responsibility for finding a permanent fix for healthcare insurance may be passed on to the individual states, if he is elected to a second term. Currently, 13 states have established their own [healthcare insurance exchanges](#) and 6 states have exchanges that are based upon the Federal platform. The rest rely on [healthcare.gov](#), the Federal government's healthcare insurance exchange.

Most states have also established their own [healthcare information exchanges](#), which they either run directly, contract out or manage in partnership with other organizations. The Federal government's Office of the National Coordinator seems to be focused primarily on [reducing the regulatory burden](#) of EHRs and other healthcare technology initiatives and not on developing a comprehensive federal solution.

The Promise of Technology . . . Against these formidable economic and political hurdles, emerging and cutting-edge technologies – like [personalized medicine](#) – are becoming available. Adapting these technologies to clinical settings will be costly and take time, but they could eventually deliver a step change improvement in quality and cost effectiveness of health care.

... and Its Limits. Even though technology promises to improve outcomes while at the same time reducing costs, there are significant political and institutional barriers that are limiting its deployment. [Some experts charge](#) that healthcare institutions and suppliers whose business models are at risk have taken steps to avoid the full implementation of EHRs and other technologies that would facilitate the transition to value-based care.

Yet, while the transition may be delayed, perhaps even for years to come, [it cannot be avoided indefinitely](#). The high cost of healthcare, currently [around 18% of GDP](#), is the “tapeworm” of American economic competitiveness, according to Warren Buffet. There will be a limit eventually to the healthcare system’s ability to adjust to steadily rising costs without undertaking structural reforms. Although it is difficult to predict what exactly will happen when that limit is reached, a true shift to value-based care, aided by the realization of the full benefits of technology implementation, is one of the possible (and probably the better) solutions. In the meantime, healthcare technology companies will focus on where demand currently exists – for example in solutions that help providers avoid rejected claims and bad debts, enhance patient engagement, and improve clinical outcomes. Judging by the average valuations placed on healthcare technology stocks, investors still see good earnings growth potential in many of these companies.

Change’s Financial Reporting. It is a challenge to evaluate Change Inc.’s financial results prior to its merger with SpinCo because it accounts for its 41.6% minority interest in the joint venture (Change LLC) under the equity method. Accordingly, Change Inc. has no revenues and its earnings reflect primarily its share of the net earnings of the joint venture. Inc. also has a small amount of administrative costs, which are offset mostly by management fee income earned from the joint venture. Finally, since the joint venture issued TEUs to Inc. that mirror the terms of the publicly traded TEUs, Inc. records the profit or loss associated with changes in the fair market value of the TEUs in its own financial statements.

In its earnings releases and conference calls, management skips over the results of Change Inc. and focuses instead on the results of Change LLC, the joint venture, which holds the operating business. Since management’s guidance covers only a couple metrics – primarily revenues and adjusted EBITDA – the guidance works for both Change Inc. (post the PF2 SpinCo merger) and Change LLC. For fiscal 2020, which ended on March 31, its guidance applies only to LLC. For fiscal 2021, the guidance applies to Inc.

For fiscal 2020 and beyond, sell-side earnings projections, as reflected in consensus estimates, are apparently based on the results of Change LLC and do not incorporate the purchase accounting adjustments from the SpinCo merger. Analysts currently show that Change will post positive GAAP earnings for the next few years; but Inc.’s GAAP earnings will be negative because of the purchase accounting adjustments (unless its non-GAAP adjustments decline significantly).

Change Inc. will account for the merger with SpinCo as an acquisition in its fiscal 2020 financial statements. Since the merger will result in Inc. consolidating the results of LLC for the first time, I believe that Inc.’s fiscal 2020 financial statements will (or at least should) be separated into two periods: the first, from April 1, 2019 to March 9, 2020, using the equity method of accounting for its interest in the joint venture; and the second from March 10, 2020 to March 31, 2020, with fully consolidated results including Change LLC.

For fiscal 2021, Change Inc.'s quarterly financial statements will include fully consolidated results for the current period and equity method results for the prior year period. Ideally, in order to facilitate meaningful performance comparisons, the company should provide supplemental disclosures that reflect pro forma fully consolidated results for the prior year periods; but it may choose to provide Change LLC's results as a proxy instead.

I waded into the nitty gritty of Change Inc.'s financial reporting simply to point out that gaining a useful perspective on its fully consolidated results will continue to be a difficult task (until the one-year anniversary of the merger), given the changes in the bases of accounting that have accompanied its transition from a private joint venture to a standalone publicly-traded company. In my mind, the company could have done a better job of presenting its financial results to make it easier for investors to evaluate its financial performance during this transition period. Consequently, investors who try to be thorough in their decision-making and who do not rely exclusively on sell-side analyst recommendations may have decided to avoid CHNG because of the complexity of Change's financial reporting. The difficulty in evaluating Change's financial performance may therefore be a contributing factor in CHNG's low relative valuation vs. its peer group.

Projected Fiscal 2020 Fourth Quarter and 2021 Results and the Impact of COVID-

19. Complex financial reporting is one, but certainly not the only factor affecting CHNG's relative valuation vs. peers. Another is the potential impact of the COVID-19 pandemic on its fiscal 2021 financial performance. Since the start of the pandemic, revenues for healthcare providers have been squeezed, primarily because of the need to suspend all elective procedures at hospitals. Likewise, physicians have cancelled in-person appointments with patients in order to enforce social distancing guidelines. While most doctors are still communicating with patients by telephone, video chat or telehealth services, the volume of activity has declined substantially. In May, the prohibition against in-person visits has begun to be lifted, but it remains to be seen how long it will take for activity to return to pre-COVID-19 levels and whether there will be structural changes to the health care system as a result of the dislocations caused by COVID-19.

In an April 8 fireside chat with investors (sponsored by Bank of America Merrill Lynch), Change CEO Neil de Crescenzo said that revenues for the fiscal 2020 fourth quarter would be roughly in line with management's guidance (given or confirmed on February 13), as the company was able to close on most work that was in progress before the nationwide lockdowns began. However, he did say that the company anticipated that some installations that it planned to complete during the fiscal 2020 first quarter would be delayed into the second quarter.

Still, a substantial portion (roughly two-thirds) of Change's business, as noted above, is generated from both the number and dollar volume of transactions across its network. Since healthcare activity has been down sharply, it seems likely that Change's earnings will also be down sharply at least in the fiscal 2020 first quarter. Mr. de Crescenzo said in early April that network transactions were down 25%-35%. Network volume will probably bounce back a bit in the second quarter, but it will still be down compared to the prior year. The network should then experience steady sequential improvement in the third and fourth quarters, as long as a second wave of COVID-19 does not force another lockdown. It is difficult, however, to gauge what the pace of the recovery in transaction volumes will be and whether they will recover fully.

With this change in the operating environment, it seems likely that Change Inc. will report 2019 fourth quarter and full year results that are roughly consistent with its earlier guidance; but it will either have to revise its fiscal 2021 guidance down significantly or it may choose to withdraw its guidance entirely, as many other companies have done, until it gets better visibility into its future performance.

For the record, consensus estimates, according to Standard & Poor's Global Market Intelligence (SPGMI), anticipate (non-GAAP) adjusted EPS of \$0.38 for the fiscal 2020 fourth quarter and \$1.46 for the full year. My projections, which are based upon Change's pro forma results and management's guidance and definitions, call for adjusted EPS of \$0.37 for the fourth quarter and \$1.49 for all of fiscal 2020.

For fiscal 2021, management's preliminary guidance, given in February, anticipated revenue growth of 4%-6% and adjusted EBITDA growth of 6%-8%. As noted, that guidance seems almost certain to be either revised downward or withdrawn.

Valuation. So far this year (through midday trading on May 13), nearly all healthcare technology stocks are down, but CHNG is down more than most. The average year-to-date decline for a group of 11 healthcare technology stocks that I have been tracking is 15.5%; but CHNG is down 36.5%. By comparison, the S&P 400 MidCap Information Technology sector, for which CHNG qualifies, is down 16.8% year-to-date; and the S&P 600 SmallCap Information Technology sector, for which nearly all of its peer group qualifies, is down 20.5%. With this year's share price decline, CHNG trades at an even wider discount to most of its peers. By my estimates and using data from S&P Global Market Intelligence, I calculate that Change trades at 8.1 times anticipated fiscal 2020 adjusted EBITDA. By comparison, several of its high-flying peers (Cerner (CERN), HMS Holdings (HNSY) and Inovalon (INOV)) trade at around 18 times trailing 12 month EBITDA; while a couple of low-flying peers (Allscripts (MDRX) and NextGen (NXGN) trade at trailing EBITDA multiples that are comparable to CHNG.

Similarly, CHNG trades at 7.1 times anticipated fiscal 2020 adjusted EPS, while the three high-flying peers have P/E multiples well into the 20s and those low-flying peers that have positive earnings have P/E multiples comparable to CHNG.

(Most of the adjustments that Change makes in its determination of (non-GAAP) adjusted EPS are not unusual for a company that is undergoing a significant transformation, even though they may be temporary. Accordingly, I believe that such adjustments should not be excluded from an evaluation of the company's historical performance, but they may be excluded in assessing its future performance, if indeed such expenses are not likely to be repeated. In Change's case, while management has said that the company is near the end of its integration period, it has not offered specific guidance about future unusual costs that it may classify as non-GAAP adjustments. For that reason, I prefer to exclude only the amortization expense resulting from acquisition-method adjustments, which is non-cash. Doing so results in fiscal 2020 anticipated EPS of \$0.91, well below the consensus estimate of \$1.46. Using my alternate definition for fiscal 2020 adjusted EPS implies a P/E multiple of 11.4 at the current quote for CHNG, which is still well below the average of 25+ for the high-flying peers.)

The primary performance differences between the high flyers and the low flyers are on revenue and earnings growth rates, and to a lesser extent, leverage. The high flyers are growing

revenues by mid- to high-single digit percentages and earnings by low-double digit percentages. By comparison, the low flyers have low single-digit revenue growth and low- to mid-single-digit earnings growth.

Thus, the market rewards the faster growing healthcare technology companies with above-market valuation multiples – multiples that are consistent with those of other general information technology companies. The slower growing companies have multiples that are well below the market averages. By implication, those low valuation multiples reflect concerns about the sustainability of revenues and earnings, which may be due to product obsolescence or loss of competitive advantage.

Change's Forward Growth and Leverage Targets. Change is targeting revenue growth in the mid-single digits and EBITDA growth in the high-single digits for fiscal 2021 and beyond. Both are well above the company's recent historical averages.

To achieve its growth goals, Change is pulling all available levers. The company is pursuing growth through internal development, entering or expanding partnerships and acquisitions. It is using its broad portfolio of solutions, technological expertise and deep domain knowledge to identify new opportunities. It is taking advantage of its extensive customer network to cross sell solutions and services. Change is also repositioning or exiting solutions that have lost their competitive edge.

Within its three business segments, Change expects to achieve mid-single digit growth in fiscal 2021 and beyond in **Software & Analytics** and **Network Solutions**, while repositioning **Technology-enabled Services** for future growth.

Recent Developments. In its fiscal 2019 third quarter, Software & Analytics revenue increased 5.3% on the strength of its Payment Accuracy and Decision Support solutions, despite the headwinds from "optimizing" the Connected Analytics business and the transition to the cloud-based Enterprise Imaging Solution.

Network Solutions achieved 5.0% revenue growth from customer additions to its B2B payments, data solutions and dental network businesses and increased volume in its medical network. The company sees more opportunities for growth in Network Solutions from market expansion and new solutions, like its *Shop Book and Pay* healthcare member app.

The growth in Software & Analytics and Network Solutions was offset partially by a 3.7% decline in Technology-enabled Services (TES) due primarily to the continuing retrenchment in Revenue Cycle Management. As it repositions RCM and other businesses, TES has suffered a loss of revenue – \$41 million year-to-date – through planned customer attrition, including the loss of its largest RCM customer who transitioned to an in-house platform. (TES will still provide certain value-added business to that customer; but on a net basis it continues to lose revenue on this and similar transitions.) The losses in RCM were partially offset by customer wins in growth areas, such as health systems (which helps providers address inefficiencies that are a barrier to the transition to value-based care) and the aggregator segment (firms that funnel patients from abroad to healthcare providers). Excluding the planned attritions, TES's revenue growth was 2.4%, which when combined with the revenue growth in the other two segments would allow Change to achieve its overall revenue growth objective of 4%-6%.

On May 4, Change announced the sale of its Connected Analytics business to Kaufman Hall, a leader in enterprise performance management software and solutions, for an undisclosed price. (I think of Connected Analytics as a business intelligence dashboard that aggregates key performance metrics and data from various parts of an enterprise into one screen or console for monitoring and analysis.) Connected Analytics had been a drag on the performance of the Software & Analytics segment. The company had been seeking to optimize the business, but apparently found a qualified buyer at an acceptable price.

Also on May 4, Change announced that it had executed its option to acquire eRx Network, a provider of data-driven solutions for pharmacies, from the Blackstone investor group for \$212.9 million plus cash on the balance sheet. eRx was left out of the initial combination of the Legacy CHC and Core MTS business, probably out of anti-trust concerns, because McKesson originally controlled 70% of Change LLC. With the distribution of its stake in Change Inc., MCK is no longer in the picture.

eRx generated about \$30 million in EBITDA on \$67 million of revenues for the 12 months ended February 29, 2020. The purchase price was therefore a reasonable 7.1 times EBITDA. Management sees good growth potential in the business, which improves operational efficiency and optimizes reimbursement for pharmacies.

The eRx acquisition was funded from the proceeds of the \$325 million follow-on offering of its 5.75% Senior Notes due 2025 that was completed on April 21.

How Bad Will It Get (Short Term and Long Term)? As noted, management reported in early April that transaction volumes across its network were down 25%-35%. I suspect that the company probably saw even greater declines later in the month. Volumes are probably in the process of bottoming at this time and should begin to show sequential improvement; but the return of activity to pre-COVID levels will probably take time. With two-thirds of its revenues tied to transaction and dollar volume, Change's revenues could fall 20% or more in the fiscal 2020 quarter.

Although management is confident that the declines will be temporary, the company drew down \$250 million from its revolving credit facility to have additional liquidity given the uncertain business environment (and also in anticipation of purchasing the eRx Network). That raised its total liquidity on hand to \$450 million.

The revolver drawdown occurred a few weeks before the company completed the \$325 million Senior Note follow-on offering; so it is not clear whether Change has since paid down its revolver or continues to hold what should now be in excess of \$550 million in cash on its balance sheet. Either way, the probability that Change will experience a financial squeeze over the next few months should be low.

Management has been working proactively to respond to the challenges presented by the COVID-19 lockdown. It has instituted a hiring freeze across most of its businesses (except those that are strategic growth priorities) and reduced its use of contractors. It has conducted scenario planning to gauge the impact of lower volumes on its financial performance in various scenarios. (To aid its planning process, it has been using insights from changes in transaction volumes at each step in its customers' revenue cycles to see how their business activity has

been changing. This has informed its view of where it needs to cut costs or where there may be opportunities to generate new revenues that can offset some of the temporary declines.) Change has also reviewed its capital spending and R&D budgets to identify expenditures that can be deferred. Finally, it has entered into fixed rate interest rate swaps to lock in low interest costs through 2024.

Management is applying the same diligence to anticipate longer-term changes in its business. While it has described the lost RCM revenues as “planned” contract eliminations, it is undoubtedly true that the company would rather have planned differently to avoid the loss of revenues, if that had been possible. What seems to have happened here was that its customer informed Change perhaps a year or more in advance that it would be transitioning to a different (in-house) RCM platform. That advance planning was done for practical reasons – the customer cannot suddenly flip a switch to make such consequential IT system changes – but it also speaks to the strength of the relationships that Change has with many of its larger customers, many of whom have been using Changes solutions and services for years and rely upon Change for advice on in technology and workflow matters. Because of the strength of these relationships, Change has often been able to compensate for part of the planned losses by convincing its customer to sign up for other solutions, even though the end result is a net loss of revenues for Change.

With its large customer base, relationships that in many instances have been in place for a decade or more and the significant volume of traffic that moves across its networks, Change has a well-focused eye on industry trends. This should help it anticipate changes in its business. Change also has the ability to innovate through internal development, entering into technology partnerships or acquiring companies that are well positioned in growth niches. If it can maintain that finger on the pulse of the industry, it should have a better chance of adapting to changing conditions over the long-term.

That assertion comes with a few caveats, however. First, the pace of change in healthcare must be evolutionary rather than revolutionary. Sudden changes can cause disruptions that may be difficult to adjust to quickly. Along with this, stakeholders in the healthcare system must be willing and able to make the changes necessary to bring healthcare costs as a percent of GDP down over time (otherwise, change may be forced upon the industry when the structural supports collapse).

Change also needs to be able to take the steps necessary to reposition its business embrace trends that are inevitable – such as interoperability and value-based care – that may over time render parts of its business obsolete. The company needs to reduce its leverage as quickly as possible to gain greater financial flexibility to respond to changing market dynamics.

Summary and Conclusion. Although Change’s financial performance will likely suffer a sharp decline for at least a quarter or two, the company appears to have sufficient liquidity to fund its operations in an extended industry downturn. Its current valuation is well below both the broader market and its peer group’s average. Closing that gap will probably require that Change lift its sustainable revenue growth toward the peer group average in the mid- to high-single digits and its profit growth to the high-single digits.

While CHNG's share price could conceivably go lower, its current valuation already discounts a significant erosion in its profitability. As health care volumes begin to recover to pre-COVID-19 levels and as long as healthcare payers and providers do not suffer any major setbacks from the recent disruption in their businesses, the stock has near-term rebound potential to \$15-\$17, which is where it traded before the pandemic began. Upside beyond that level will most likely require that the company demonstrate progress toward achieving its 2021 growth targets of 4%-6% in revenues and 6%-8% in EBITDA.

For those investors seeking to limit some of their downside risk, the TEUs provide a current yield of 7.1%, until they convert to common stock on June 30, 2022. The quarterly distribution of \$0.75 per unit reduces the breakeven share price upon the conversion of the TEUs into common on June 30, 2022 to \$9.23 per share.

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