Ram Fund

# athenahealth, INC. (NASDAQ: ATHN)

Healthcare Sector
Healthcare Technology Industry
http://www.athenahealth.com/
Justin Bosscher and Brittany DeLano

## Recommendation - Buy
## Price Target $187.19

- Legislation will require healthcare technology advances
- Financial incentives for the use of Electronic Healthcare Records
- Healthcare internet technologies will be used to bend the cost curve of healthcare expenditures
- Expands their client base and service offerings through acquisitions

## Company Overview

Founded in 1997 and incorporated in Delaware, athenahealth, INC. is currently headquartered in Watertown, Massachusetts. Its customers include 69,762 U.S. physicians and 95,377 U.S. healthcare providers. athenahealth is a provider of cloud-based services across 4 business segments: Electronic Health Records (EHRs), practice management, patient communication and care coordination. All services provided by athenahealth are consumed through one application named athenaNet, which is available on both smartphones and tablets. Their combination of cloud-based services, information infrastructure knowledge and office services help medical practices achieve greater efficiencies and, more importantly, greater patient outcomes.

| Key Statistics | |
|---|---|
| Price (4/16/14) | $147.87 |
| Market Cap | $5.53B |
| 52 Week Range | $82.01 - 206.70 |
| EPS (ttm) | 0.07 |
| Beta | 1.08 |

| Price Multiples | |
|---|---|
| P/E (ttm) | 2,059 |
| P/E (fwd) | 136.92 |
| P/B | 13.7 |
| P/S | 8.79 |

| Key Ratios | ATHN | Industry |
|---|---|---|
| Gross Profit Margin (ttm) | 62.9% | 47.3% |
| Operating Margin (ttm) | 2.1% | -14% |
| Return on Assets (ttm) | 0.4% | 0.2% |
| Current Ratio | 1.19 | |

## Recent Developments:

- **4/10/14 -** Phoebe Physician Group selected athenahealth for use across its network of physicians. Phoebe Physician Group is comprised of 260 multi-specialty providers. The group will also leverage athenahealth's population health management and analytics services to support its transition from volume- to value-based care.

- **3/31/14 -** Senate delays ICD-10 until October 2015 (the 10th revision of the International Statistical Classification of Diseases and Related Health Problems)

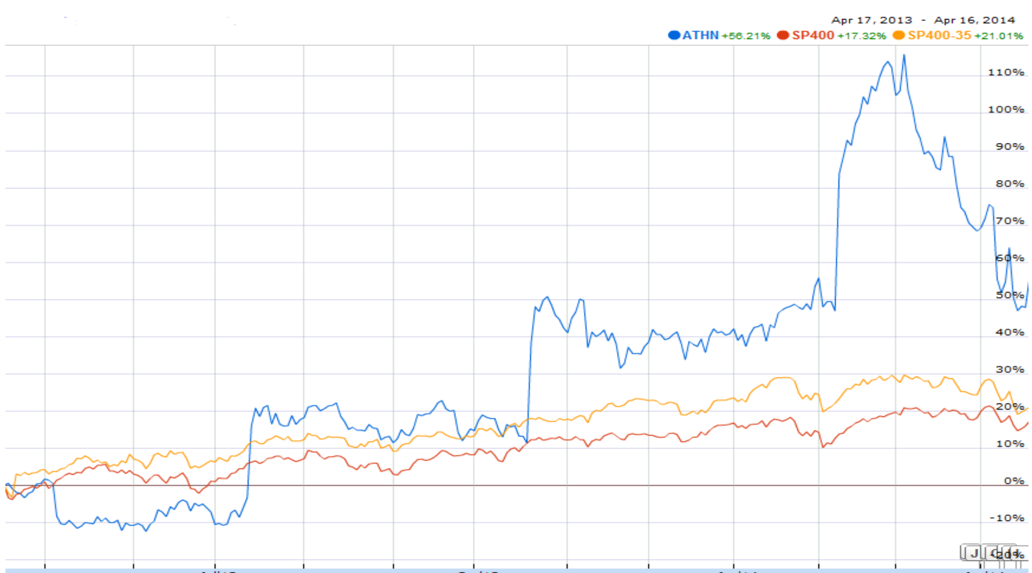
- **3/18/14 –** Saint Peter's Healthcare System selects athenahealth's suit of services, athenaOne, for its multi-specialty physician practices comprised of 176 physicians

## Industry Overview

It is estimated that with the passage of the Affordable Care Act, 30 million people will enter the healthcare system thereby increasing total healthcare expenditures. In addition, the aging of the population will increase healthcare expenditures. Healthcare expenditures are estimated to equal 20% of GDP by the year 2021 by the Kaiser Family Foundation.

Health Internet Technologies will bend the cost curve of these rising healthcare expenditures by creating greater efficiencies. Interweaving technologies such as online data analysis, electronic health records, communications services, back office services, and health identification, will reduce costs and increase patient outcomes. This cost cutting ability will be a source of demand among health providers, as well as, the end users of the healthcare system, namely the patients.

In addition to the market demand for these goods and services, the U.S. government has created the legislative requirement for healthcare providers to build the health IT infrastructure to their practices. Recently delayed, the 10th revision of the International Statistical Classification of Diseases and Related Health Problems list published by World Health Organization, will code diseases, symptoms, circumstances, etc… ICD-10, as it is known, will, in all likelihood, become a required system of classification for the U.S. healthcare system. However, it cannot become a reality unless the IT infrastructure is in place. Also, passed in 2009, the American Reinvestment and Recovery Act created an incentive program involving the roll-out of the health IT infrastructure by healthcare providers known as Meaningful Use. These pieces of legislation, as well as, the market demand for lower costs, create demand for the services provided by the health IT industry.



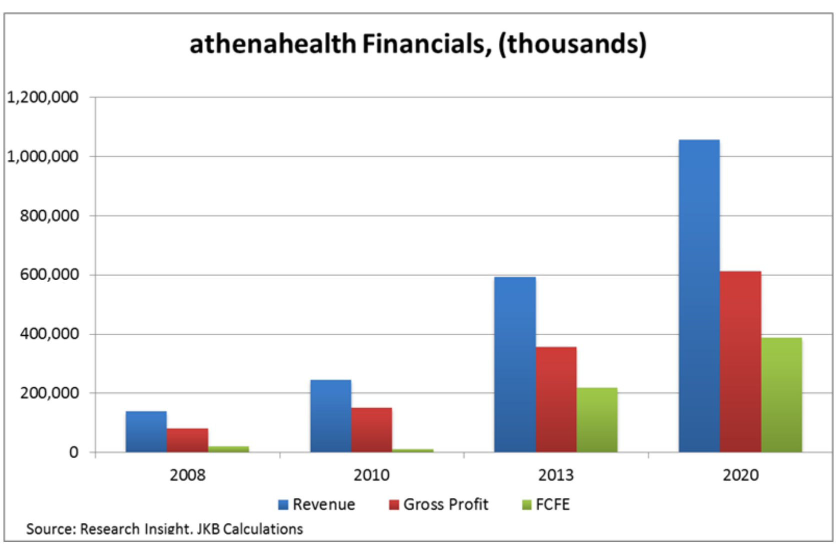

The chart above compares athenahealth to the S&P 400 and the S&P 400 Healthcare Sector over the last year.

## Company Outlook

athenahealth, Inc. will continue to grow its installed user base in two primary ways. First, it will continue to sign up individual practitioners, as well as, small groups to use one or all of its services. This includes the strategic use of its most recent acquisition, Epocrates, which is the number 1 mobile device application among US physicians for clinical content, practice tools and health industry engagement. The second is the use of its ambulatory services as the firm seeks to target patients with the roll-out of health identification that can be used in the case of emergencies, as well as, the entirety of the healthcare experience.

Additionally, athenahealth will continue with its visionary plans to build a healthcare technology hub at a 37 acre site in Watertown, MA known as Arsenal on the Charles. With the use of certain tax advantages and the collection of rents, athenahealth will create a community of great intellectual depth at a profit.

CEO, Jonathan Bush, will take a brief sabbatical in 2014. While a source of concern for many, his plans include taking his kids to school every day, learning how to fly an airplane, and, more importantly, learning how to lead and manage groups of people up to 4,000 while embedded with the U.S. Army. athenahealth currently stands at approximately 3,000 strong. This, no doubt, not only confirms his plans to return to the company, but, also, his belief that the company will continue to experience a high rate of growth. This experience will allow Mr. Bush to return as an even greater asset to athenahealth, as well as, the healthcare sector. Under his leadership, athenahealth will continue to increase its services organically, as well as, through carefully targeted acquisitions that bring value to the firm in the same well-executed manners in which Epocrates and Arsenal on the Charles were acquired.



## Appendix A: Supernormal Growth Rate Model

Increased demand for healthcare will create a larger burden for the U.S. economy. Taxes, alone, cannot offset the increase in projected healthcare expenditures as the population ages. This creates the need for cost cutting measures and Health IT will be one of the major components of any reduction of future per capita healthcare costs. For this reason, the health IT industry, including athenahealth, will see greater than normal demand for its goods and services resulting in high growth for a number of years.

The supernormal growth rate model first inflates 2012 total revenue of all small and mid-cap healthcare companies. The model then, deflates those revenues to arrive at the health IT industry aggregate revenue. That revenue is, also deflated to reach the projected 2020 athenahealth revenue. Using the proportion of free cash flow to equity and revenue, the projected 2020 free cash flow to equity for athenahealth is achieved. The percentage change from 2013 FCFE to 2020 FCFE on an annual basis over a period of 7 years results in a supernormal annual growth rate of 12 percent.

The supernormal growth rate period of 7 years was chosen for a number of reasons. First, the aging of the population will not peak until well beyond 2020. Second, it should not take 7 years for the health IT infrastructure to be put in place. Third, after the implementation of ICD-10 and Meaningful Use, other technologies will be added to the health IT infrastructure (EG: Big Data analysis tools, telehealth). These technologies will add to the revenue stream of the health IT firms that successfully implement of such technologies. Seven years is a compromise between the prolonged growth of the 65+ cohort, the roll-out of the health IT infrastructure, and the expectation of new technologies entering the marketplace. It is expected that the supernormal growth period will be much longer.

Data from the Centers for Medicare & Medicaid Services provides the proportions of total healthcare expenditures that were incurred by the 64 and under and the 65 and older cohorts from the year 2004. Using this ratio, healthcare expenditures (small and midcap revenues by proxy) for both cohorts are found for the year 2013. These two expenditures are inflated over a period of 7 years using the projected rates of change in the two demographics through 2020, 3.3 and 24.8 percent, respectively (Regional Economic Models). Additionally, the Congressional Budget Office Medicare projected growth rate through 2023 of 3 percent is used as an inflator. The result is a projection of 2020 healthcare sector (small and midcap) revenue of nearly 381.6 billion.

The resulting healthcare sector revenue figure is, then, deflated using a ratio of 2013 health IT industry revenue to 2013 healthcare sector revenue figure of 2 percent. It is assumed, that because the health IT industry will see faster than normal growth, it will increase as a proportion of the healthcare sector as a whole. For this reason, it is inflated using an assumption of 8 percent which allows for faster growth than the actual change in proportion seen from 2011 to 2012 of 5.1 percent over 7 years to arrive at a projected 2020 health IT industry revenue of approximately 12.1 billion.

The projected 2020 health IT industry revenue is, then, deflated using the proportion of 2013 athenahealth revenue to the 2013 health IT industry revenue, approximately 9 percent, to arrive at the projected 2020 athenahealth revenue figure of nearly 1.1 billion.

Free cash flow to equity for athenahealth is found by multiplying the firm's projected 2020 revenue by the proportion of 2013 athenahealth FCFE to 2013 athenahealth revenue resulting in a projected 2020 FCFE figure of roughly 400 million.

It is important to note that given the multitude of possible effects on future revenue, it is best to remain conservative. It is for this reason that the supernormal growth period is no longer than 7 years, and that lagged data have been chosen over more recent data in order to project growth in a more conservative manner.

| | | |
|---|---|---|
| **2020 Healthcare Sector Revenue** | **240,000 - 295,000** | |
| 2004 CMS 65+ Proportion of Expenditures | | 40% |
| 2013-2020 % Change 65+ Cohort | | 25% |
| 2004 CMS ≤ 64 Proportion of Expenditures | | 60% |
| 2013-2020 % Change ≤ 64 Cohort | | 3.3% |
| CBO CMS growth through 2023 | | 3.0% |
| Supernormal Growth Rate Period | | 7 |
| **2020 Health IT Industry Revenue** | **12,250 - 15,000** | |
| 2013 Industry as % Sector Growth | | 7.6% |
| **2020 ATHN Revenue** | **1,100 -1,400** | |
| | | |
| **2020 ATHN FCFE** | **410 - 500** | |
| 2013 FCFE to Revenue | | 37% |
| **ATHN Supernormal Growth Rate** | **12%** | |

Source: CMS, CBO, Regional Economic Models, JKB Calculations
(in millions)

## Appendix B: Discounted Cash Flow Results and Sensitivity

**Athenahealth, Inc. (ATHN)**

| | |
|---|---|
| Net Income | 2,594 |
| Cap. Expenditures | 38,260 |
| Depreciation & Amortization | 43,575 |
| Change NWC | -36,101 |
| New Debt | 173,750 |
| **FCFE** | **$217,760** |

| | |
|---|---|
| Beta | 1.08 |
| Rf | 2.82% |
| RM | 7.71% |
| **CAPM $K_e$** | 8.10% |

| | |
|---|---|
| **Supernormal Growth** | 12% |
| **Constant Growth** | 3% |

| **Year** | **1** | **2** | **3** | **4** | **5** | **6** | **7** |
|---|---|---|---|---|---|---|---|
| **FCFE Supernormal Growth** | 243,891 | 273,158 | 305,937 | 342,650 | 383,768 | 429,820 | 481,398 |
| **FCFE Terminal** | | | | | | | 9,212,931 |
| **FCFE Total** | 243,891 | 273,158 | 305,937 | 342,650 | 383,768 | 429,820 | 9,694,329 |
| **Discount Factor** | 1.08 | 1.17 | 1.27 | 1.38 | 1.50 | 1.62 | 1.76 |
| **PV FCFE** | 225,029 | 232,541 | 240,304 | 248,326 | 256,615 | 265,182 | 5,518,456 |
| **Intrinsic Value** | 6,986,453 | | | | | | |
| **Value of Equity Per Share** | **$187.19** | | | | | | |

**Sensitivity Analysis**

| | | **Supernormal Growth** | | | |
|---|---|---|---|---|---|
| | **$187.19** | 11% | 12% | 13% | 14% |
| **Constant Growth** | 1% | 139.33 | 147.13 | 155.34 | 163.96 |
| | 2% | 155.19 | 164.03 | 173.31 | 183.08 |
| | 3% | 176.95 | **187.19** | 197.97 | 209.30 |
| | 4% | 208.64 | 220.94 | 233.88 | 247.49 |

| | |
|---|---|
| **Current Price** | $147.87 |

# Appendix C: Gray & Carlisle Financial Strength

| | |
|---|---|
| **FS_ROA** | 1 |
| **FS_FCFTA** | 1 |
| **FS_ACCRUAL** | 1 |
| **ΔLEVER** | 0 |
| **ΔLIQUID** | 0 |
| **ΔNEQUISS** | 0 |
| **ΔROA** | 0 |
| **ΔFCFTA** | 1 |
| **ΔMARGIN** | 0 |
| **ΔTURN** | 1 |
| **Financial Strength** | **5** |


| **2012** | |
|---|---|
| Net Income | 18,732 |
| Cap. Expenditures | 23,904 |
| Depreciation & Amortization | 25,641 |
| Change NWC | 52,379 |
| New Debt | 0 |
| | |
| **FCFE** | -31,910 |

| | |
|---|---|
| Net Income before Extraordinary items | 5,853 |
| Total Assets | 796,396 |
| Total Assets 2012 | 428,452 |
| Total Assets 2011 | 348,786 |
| Net Income | 2,594 |
| Depreciation & Amortization | 43,575 |
| Long Term Debt | 173,750 |
| Current Assets | 178,657 |
| Current Liabilities | 149,756 |
| Gross Profit | 356,331 |
| Gross Profit 2012 | 255,385 |
| Sales | 595,003 |
| Sales 2012 | 422,271 |
| FCF 2013 | 217760 |
| FCF 2012 | |
| | |
| 2013 LEVER | 0.22 |
| 2012 LEVER | 0 |
| | |
| 2013 Current Ratio | 1.19 |
| 2012 Current Ratio | 4.10 |
| | |
| 2013 ROA | 0 |
| 2012 ROA | 0.10 |
| | |
| 2013 MARGIN | 0.60 |
| 2012 MARGIN | 0.60 |
| | |
| FCFTA 2012 | -0.09 |
| | |
| TURN 2013 | 1.39 |
| TURN 2012 | 1.21 |