

**INTRODUCTION**

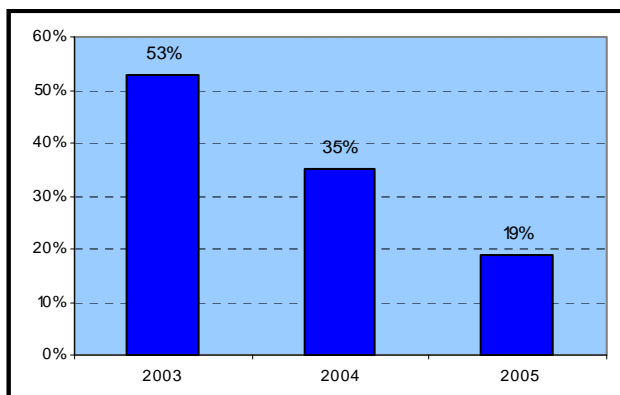
The medical software industry is undergoing rapid growth as the health community realizes the benefits of information technology. Coupled with expected cost savings, operations integration and current regulatory awareness on the rise, we view the outlook in the next twelve months for the medical software industry to be very positive.

**INDUSTRY OVERVIEW**

The medical software industry is currently experiencing rapid growth as industry leaders are realizing the benefits from implementing cost-efficient technological tools such as automated order entry, practice management software and bar-coding systems. In a recent telephone poll we conducted comprised of several industry experts, there was an overwhelming indication that many believe the market is continuing to expand at a rapid rate. One respondent states that this industry is not only growing rapidly, but that the growth is occurring at the highest rate in the last 50 years. Mark Spates, president of Final Support, Inc., a Dallas-based private company, also believes this growth can be attributed to both a favorable regulatory environment and the enhanced efficiency that the various software tools offer.

A survey conducted by PricewaterhouseCoopers reports that physician acceptance towards medical software has increased. In 2005, only 19% of executives polled said physician acceptance was a barrier to IT – down from 53% in 2003 and 35% in 2004.

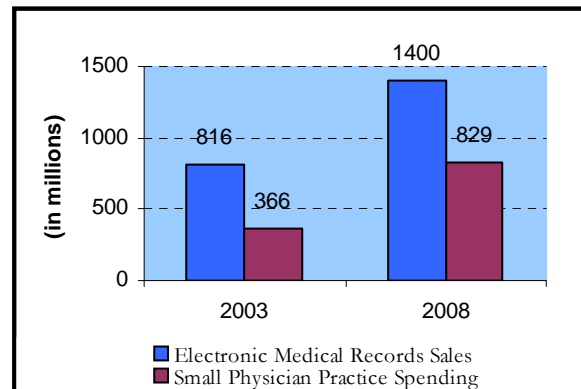
**Physician Acceptance Being a Barrier to Implementing Medical Software**



Source: PricewaterhouseCoopers

Forrester Research predicts Electronic Medical Records (EMR) sales in physician practices will increase from \$816 million in 2003 to \$1.4 billion (11.4% CAGR) by 2008. Forrester Research also forecasts that spending among small physician practices is expected to double in the same time period, from \$366 million to \$829 million, which will affect opportunities for many software companies and VARS that operate downstream.

**Forecasts of EMR Revenues and Expenditures**



Source: Forrester Research

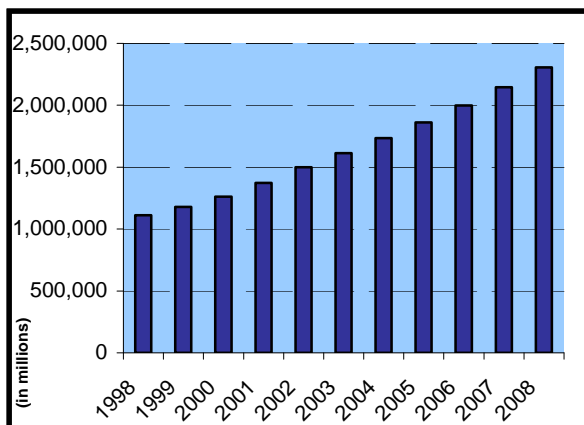
A study conducted by the Centers for Disease Control and Prevention (CDC) reports that the majority of ambulatory care in this country is provided in physicians' offices but less than one in five doctors are using electronic medical records. Due to the fact that most practices are not utilizing the current technology, we view this growth to be not only sustainable, but will intensify as an increasing number of physicians begin realizing the practical benefit of practice management systems.

We view this market as an attractive long-term investment due to many industry-specific factors. First, practice management systems provide effective decision-making capabilities and cost efficient approaches that will improve patient-client relationships. Second, in order to bring health care into the information age, President Bush recently called for the majority of Americans to have electronic health records within 10 years, while a decade may seem like a long time, the undertaking to create open standards and connectivity creates tremendous revenue opportunities. This mandate should increase the exposure towards practice management systems as practices seek ways to fulfill this requirement. Third, in regards to regulation, practice management systems offer a platform that facilitates and helps streamline HIPAA-compliance.

## **RISK FACTORS**

Although optimistic conditions are expected in the medical software market, there are fundamental risks that are prevalent within the industry. *First, even though the current regulatory environment may be stable, this may not be reflective of future conditions.* Integration and automation of client records and information may lead to further control systems and standards being implemented. If this occurs, practice management systems may need to update their software, in order to comply with the new regulations. Risk may also occur through the transferability of client information. If client records cannot be reciprocated from one system to the next, this will create a lack of congruence in the health care community, resulting in conflicting attitudes toward practice management systems and add huge overall technology costs to healthcare practices. A problem facing the industry focuses on replicating the information from paper script to electronic format. Information could be potentially lost during the transfer or worse; errors can be made in misreading medication information. Finally, client confidentiality faces a new threat as profiles and financial information are being frequently uploaded into doctor's databases electronically. This new vulnerability creates a demand for protocols that securely store or transfer client information without the threat of intruders.

### **National Health Service & Supplies Expenditures**



Source: CMS

## **INDUSTRY REGULATION**

The Health Insurance Portability and Accountability Act (HIPAA) has assisted in the exposure and growth of practice management systems. To review, HIPAA was established in order to reduce the costs of healthcare administration, protect individual privacy, and secure health care information. These provisions can be broken down into four defined classes: electronic transactions & code sets, privacy, security, and unique identifiers. Practice management systems, by design, perform two of the four

parameters regulated by HIPAA: electronic transactions & code sets and security. In seeking HIPAA compliance, healthcare providers see the benefit of using practice management systems as the crux of their practice administration infrastructure. The key will be determining which practice management systems provide the greatest value proposition relative to their cost.

The deadline to conform to the electronic transactions & code set standards was pushed back due to industry-wide difficulties from October 16, 2003 to July 01, 2004. In addition, the deadline for full compliance of the security standard was April 20, 2005. Healthcare Information and Management Systems Society (HIMSS) recently conducted a HIPAA compliance survey in January 2005, polling a total of 400 industry representatives. Their results indicate that only 73% of the providers and 70% of the payers conform to the HIPAA electronic transactions & code set standards. Further, only 30% of providers and 18% of payers indicate that they are currently compliant with the HIPAA security regulation. This represents an immediate short to intermediate term opportunity for software providers as pressure continues to build as practices attempt to conform to HIPAA standards.

## **RECENT TRENDS IN THE MEDICAL SOFTWARE M&A MARKET**

The industry is very fragmented with many large national and regional practice management system providers. Victory Partners believes that growth in the industry will continue to rise, as increased competition will lead to rapid consolidation over the short term with a handful of well-capitalized companies emerging as clear leaders. For example, in July 2005, Omnicare recently acquired many of their key rivals including: NeighborCare, ExcelleRX Inc, and RX Crossroads. In addition, UnitedHealth Group Inc. purchased Pacific Healthcare for \$ 8.1 billion dollars in July 2005. Finally, in May 2005, Fresenius Medical Care has entered into an agreement to purchase Renal Care Group. Based on the past 3 months, the transaction acquisition price has been in the range of 0.5-2.6X revenue. The relatively high trailing EBITDA multiple (13-15X) signals an expectation for higher growth in the future performance in the industry. Furthermore, other major healthcare IT providers such as Cerner and NDCHealth have recently acquired key competitors or reorganized critical strategic business units in an attempt to capitalize on the expected growth in the industry.

Victory Partners, LLC is actively involved in analyzing and representing companies in the medical software industry, having provided financial advisory services, performed recapitalizations, and completed M&A transactions for middle market companies.

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