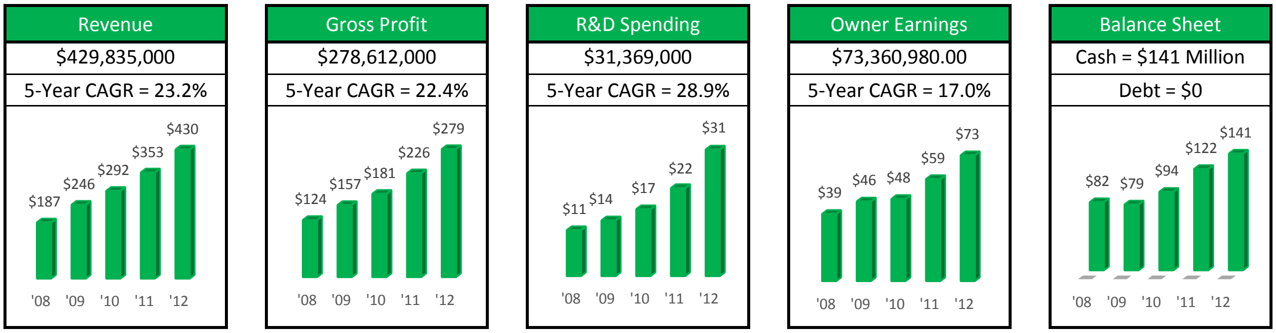
SELECTIVE
WEALTH MANAGEMENT

Quality Systems
April 22, 2014

General Overview

Quality Systems (QSII) sells software to hospitals and dental practices that helps organize patient medical records and perform administrative functions. The company's products help bring efficiency to medical practices around the United States and consistently receive the highest reviews for customer satisfaction. In recent years the Obama administration has mandated all health care companies move to electronic health records (EHR) and the mandate has created a strong tailwind for QSII's high quality products.



Purchase Logic

Quality Systems Inc. (QSII) is a software firm that specializes in creating and implementing solutions specific to hospitals and dental practices. In the last 10 years QSII has grown income from $7 million to more than $70 million. The firm was able to rapidly compound income as the majority of health practices switched from archaic paper systems to more modern electronic based systems. As QSII captured a large portion of this new market the company locked in profits for years to come due to the 'sticky' nature of electronic health record solutions. Typically when a health practice implements a solution they stick with that solution for many years (sometimes decades). This creates highly predictable and strong recurring revenue for QSII as the solutions provider.

The market conditions in which QSII operates today are drastically different than those of the preceding 10 years. The majority of the largest health providers have implemented electronic solutions and the number of 'greenfield' opportunities have diminished. In order for QSII to grow they will need to gain market share from incumbents – a much more difficult task. However, the Affordable Health Care (AHC) act has forced changes on the industry that may provide an opportunity for QSII to continue growth at a healthy pace. The AHC act mandates all electronic health care providers (like QSII) to be compliant with ICD-10 by October 2015 and the majority of the providers are non-compliant (and likely too small to afford compliance). There is a very high probability that the EHR industry will continue to consolidate and firms such as QSII will gain additional market share.

While the implementation of ICD-10 creates a potential opportunity for QSII to gain market share it has also placed substantial short-term pressure on earnings. Increased spending on R&D will reduced reported income for the next few years. Once the short-term pressure subsidies from ICD-10 implementation we anticipate QSII to earn more than $70 million per year for an effective purchase price of approximately 13x earnings.

Key Metrics

The key metrics for QSII are Revenue, Gross Profit, R&D Spending, and Owner Earnings. The business factors that impact each key metric are described below in greater detail.

Revenue

QSII derives revenue by installing electronic systems for medical practices and then charging an annual fee to maintain those electronic systems. Once software is installed medical practices typically utilize the same software for many years. Hospitals and dental practices are reluctant to switch software platforms, even at a lower cost, once a solution is implemented. The resistance to change stems from the costs associated with retraining the entire medical staff on the new system – often an expense that is extremely costly in man-hours lost and complaints from employees. These high switching costs make QSII recurring revenue base extremely stable and steadily increasing. Additional revenue is added each year by increasing the maintenance fees for existing clients and adding a few additional practices each year.

Gross Profit

As a software firm QSII commands unusually high gross profit margins. The firm typically installs a solution and then charges maintenance fees annually that require very little work relative to the fees charged. This has allowed QSII to maintain gross profit margins in excess of 60% for the last 10 years. The company has pricing power on these recurring fees due the high switching costs of replacing a software system. This has allowed gross profits to climb every year without exception for more than a decade.

R&D Spending

The research and development (R&D) for QSII has historically been between 6% and 8% of overall revenues. The R&D is paid to software programmers that build new solutions to cross-sell into the existing customer base. This R&D spend is a source of future revenue growth and allows QSII to continuously expand the business and solve new problems for clients. In recent years R&D spending has been focused on adding new products as well as becoming compliant with the Affordable Health Care act.

Owner Earnings

After subtracting all expenses, including taxes, we arrive at QSII owner earnings. The firm has historically posted owner earnings that are approximately 17% of revenues. This exceptional profitability is due to the outstanding margins on recurring maintenance contracts. The owner earnings historically have been paid out primarily as dividends or retained for acquisitions. We anticipate QSII to continue to pay the majority of earnings (50% or more) as dividends each year.

Historical Performance of Key Metrics

Year	'08	'09	'10	'11	'12
Total Revenue	$186,500,000	$245,515,000	$291,811,000	$353,363,000	$429,835,000
Gross Profit	$123,999,000	$156,625,000	$181,004,000	$225,881,000	$278,612,000
Research & Development	$11,350,000	$13,777,000	$16,546,000	$21,797,000	$31,369,000
Owner Earnings	$39,091,500	$46,371,780	$47,848,500	$59,443,650	$73,360,980
Dividends	$20,455,000	$30,763,000	$34,275,000	$34,716,000	$40,989,000
Cash	$81,670,000	$78,878,000	$94,108,000	$121,524,000	$141,393,000
Debt	$0	$0	$0	$0	$0

<u>Revenue</u>

In the last 5 years QSII has compounded revenue at a rate of 23.2%. The rapid growth in revenue can be attributed to the dramatic shift from paper based client records to electronic. Today the vast majority of the industry is digital and the opportunity for growth is less than in the preceding decade. However, QSII has the potential to continue to increase revenue by capturing additional market share from incumbent EHR solutions and offering new solutions to existing clients. The Affordable Care Act mandates that by October 2014 all software utilized in the industry must be ICD-10 compliant, which will be very difficult for smaller providers to accomplish. There is a strong possibility that larger software providers, such as QSII, will capture additional market share during this transition. We anticipate QSII to continue to grow revenues at a rate between 3% and 15% per year with a 5-year average of 8%.

<u>Gross Profit</u>

The gross profit for QSII has moved in tandem with revenue during the last 5 years compounding at a rate of 22.4%. However, without top line growth the ability for QSII to increase gross profits are very limited. We anticipate gross profits to increase at a slightly lower rate than revenue during the next 5 years. The reason for the slower growth rate is due to the gross profit margins on future products, such as revenue cycle management (RCM), which has lower overall margins than the existing business. We anticipate QSII to grow gross profit at a rate between 3% and 12% per year with a 5-year average of 6%.

<u>R&D Spending</u>

Historically R&D spending has been relatively stable as a percentage of revenue at approximately 6% of revenue. The implementation of ICD-10 requires significant work that will increase the R&D spending as a percentage of revenue to more than 9% for the next few years. This increase in R&D spending will temporarily compress owner earnings (with no impact on revenue or gross profit). We believe that this temporary increase in R&D is a major reason for the decrease in QSII stock price leading up to our purchase. It is our expectation that R&D will be maintained at approximately 9% of revenue for the next few years as changes are implemented from the Affordable Health Care Act and then decline to historical levels of 6%.

Year	'08	'09	'10	'11	'12
Total Revenue	$186,500,000	$245,515,000	$291,811,000	$353,363,000	$429,835,000
Research & Development	$11,350,000	$13,777,000	$16,546,000	$21,797,000	$31,369,000
R&D % of Revenue	6.1%	5.6%	5.7%	6.2%	7.3%

Owner Earnings

The owner earnings for the business has grown at a rate of 17.0% during the last 5 years. The majority of all earnings are paid out as dividends to the owners. At our time purchase the dividend yield was more than 4.5% - an extremely attractive rate in such a low interest rate environment. However, it is our expectation that owner earnings will be slightly depressed during the next 2 to 3 years as QSII maintains an unusually high R&D budget. This unusually high R&D allowed us to purchase into the company at an attractive valuation. It is our expectation that owner earnings will be relatively flat for 2 to 3 years and then quickly increase to roughly 15-17% of overall revenue when the R&D spending subsides. Additionally, we fully anticipate the dividend to be maintained during this time period.

Summary of Key Metrics

Metric	Expectations
Revenue	Annual growth between 3% and 15% 5-year average of 8%
Gross Profit	Annual growth between 3% and 12% 5-year average of 6%
R&D Spending	9% of Revenue for 2 to 3 years 6% of Revenue beyond
Owner Earnings	Flat for 2 to 3 years 15%-17% of Revenue beyond

The Moat Around The Metrics

The primary moat surrounding QSII's future revenue is the high switching cost associated with software in the medical industry. It is exceedingly rare that a medical practice will switch EHR software voluntarily. The lost man hours associated with retraining staff and potential errors is too high to risk change. QSII has retention rates near 100% for the 300+ hospitals utilizing the company's software. This 'sticky' relationship makes QSII recurring revenue extremely predictable.

In addition to a naturally sticky industry QSII benefits from having superior products. In the event that a hospital must change EHR software, like when a previous vendor goes out of business, QSII's excellent reputation and high quality products allow the company to win additional business. The Affordable Health Care Act mandates all software vendors become ICD-10 compliant by October 2014. This mandate will be extremely expensive for smaller software providers and many will not be able to implement the changes in time. The fallout of existing EHR providers could be a catalyst for consolidation in the industry and allow QSII to gain additional market share.

Risks

In the last 10 years the stability of QSII's recurring revenue has been prolific without almost no lost clients. Despite the extreme stability of QSII's business model there are a few risks that we have assumed as owners of the business.

Short-Term Risks

- Increased R&D Spending. This risk is all but certain. In the short-term QSII will be required to increase R&D spending to implement all the required changes for ICD-10. However, we believe these elevated costs will subside in due time and profitability return to historic levels.
    - Low Risk

- Industry shift to SaaS. QSII has benefited from selling perpetual software licenses to new hospitals. The hospitals typically pay large cash payments upfront for these licenses. After the initial sale QSII continues to generate revenue through maintenance contracts creating strong recurring revenue with outstanding profits. As the industry shifts to SaaS the upfront payments for perpetual licenses will diminish and impact the profitability of QSII in the short-term. The majority of earnings would be from recurring subscriptions to the company's software platform. We believe this shift is extremely likely to occur and will temporarily reduce QSII's ability to grow.
  - Moderate Risk

Long-Term Risks

- Regulatory Changes. The biggest risk, by far, are regulatory changes implemented by the Obama Administration. Health care has been a very hot topic of late and the potential for new legislation to pass that impacts QSII's business model is possible. We are unsure what type of changes may occur and how they would impact QSII's business. We must evaluate any potential changes if / when they arrive.
  - High Risk

Conclusion

QSII is a dominant business that provides software to medical practices around the United States. The company experienced rapid growth in the last 10 years due to the secular shift from paper health records to electronic. This large shift is near complete and future growth will be much more difficult. However, even with moderate growth it is extremely likely that QSII will prove to a very lucrative investment for us. The company benefits tremendously from a strong economic moat related to the high switching costs of medical software.

We were able to purchase our stake in QSII at approximately 13x TTM earnings with a 4.5% dividend yield. The low purchase price was due to the changes being implemented by the Affordable Care Act that will increase R&D expenses in the short-term. We believe that when these changes are complete QSII will be able to win additional market share and return to historical levels of profitability.

Works Cited

1) *QSII Annual Report - SEC Filing 10-K.* EDGAR, 2013.

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