Change Healthcare Holdings, Inc.
Form 10-Q
November 10, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

Commission file number 1-34435

CHANGE HEALTHCARE HOLDINGS, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**20-5799664**
(State or Other Jurisdiction of	**(I.R.S. Employer**

Incorporation or Organization)	Identification No.)

3055 Lebanon Pike, Suite 1000

Nashville, TN	**37214**
(Address of Principal Executive Offices)	**(Zip Code)**

(615) 932-3000

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ¨ No x*

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

Class	Outstanding as of November 10, 2016
Common Stock, $0.01 par value	**100**

* The registrant is a voluntary filer of certain reports required to be filed by companies under Section 13 or 15(d) of the Securities and Exchange Act of 1934 and has filed all reports that would have been required to have been filed by the registrant during the preceding 12 months had it been subject to such filing requirements during the entirety of such period.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Change Healthcare Holdings, Inc.

Condensed Consolidated Balance Sheets

(unaudited and amounts in thousands, except share and per share amounts)

	September 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 92,449	$ 66,655
Accounts receivable, net of allowance for doubtful accounts of $3,610 and $3,379 at September 30, 2016 and December 31, 2015, respectively	276,378	280,858
Prepaid expenses and other current assets	42,559	35,413
Total current assets	411,386	382,926
Property and equipment, net	227,670	244,145
Goodwill	2,229,228	2,230,100
Intangible assets, net	1,638,654	1,707,863
Other assets, net	9,776	8,500
Total assets	$ 4,516,714	$ 4,573,534
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 26,316	$ 27,950
Accrued expenses	177,796	167,169
Deferred revenues	18,189	12,943
Current portion of long-term debt	30,163	32,775
Total current liabilities	252,464	240,837
Long-term debt, excluding current portion	2,740,554	2,741,178
Deferred income tax liabilities	370,233	430,383
Tax receivable agreement obligations to related parties	184,139	173,493
Other long-term liabilities	16,173	11,954
Commitments and contingencies		
Equity:		
Common stock (par value, $.01), 100 shares authorized and outstanding at September 30, 2016 and December 31, 2015, respectively		
Additional paid-in capital	1,325,585	1,319,754
Accumulated other comprehensive income (loss)	(4,719)	(2,656)
Accumulated deficit	(367,715)	(341,409)
Total equity	953,151	975,689
Total liabilities and equity	$ 4,516,714	$ 4,573,534

See accompanying notes to unaudited condensed consolidated financial statements.

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Change Healthcare Holdings, Inc.

Condensed Consolidated Statements of Operations

(unaudited and amounts in thousands)

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Revenue:				
Solutions revenue	$ 307,586	$ 287,946	$ 942,362	$ 810,162
Postage revenue	73,880	89,839	234,205	268,119
Total revenue	381,466	377,785	1,176,567	1,078,281
Costs and expenses:				
Cost of operations (exclusive of depreciation and amortization below)	138,685	129,385	430,216	371,859
Development and engineering	16,494	11,651	46,015	32,600
Sales, marketing, general and administrative	69,513	56,719	210,377	151,955
Customer postage	73,880	89,839	234,205	268,119
Depreciation and amortization	65,899	85,817	188,882	183,446
Accretion	1,721	6,458	10,645	15,254
Impairment of long-lived assets	20	219	251	1,180
Operating income (loss)	15,254	(2,303)	55,976	53,868
Interest expense, net	46,534	45,541	139,720	121,685
Contingent consideration		(4,660)		(4,825)
Income (loss) before income tax provision (benefit)	(31,280)	(43,184)	(83,744)	(62,992)
Income tax provision (benefit)	(33,765)	(10,278)	(57,438)	(32,264)
Net income (loss)	$ 2,485	$ (32,906)	$ (26,306)	$ (30,728)

See accompanying notes to unaudited condensed consolidated financial statements.

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Change Healthcare Holdings, Inc.

Condensed Consolidated Statements of Comprehensive Income (Loss)

(unaudited and amounts in thousands)

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Net income (loss)	$ 2,485	$ (32,906)	$ (26,306)	$ (30,728)
Other comprehensive income (loss):				
Changes in fair value of interest rate swap, net of taxes	330	6	(2,303)	(445)
Foreign currency translation adjustment	(70)	(347)	240	(531)
Other comprehensive income (loss)	260	(341)	(2,063)	(976)
Total comprehensive income (loss)	$ 2,745	$ (33,247)	$ (28,369)	$ (31,704)

See accompanying notes to unaudited condensed consolidated financial statements.

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Change Healthcare Holdings, Inc.

Condensed Consolidated Statements of Equity

(unaudited and amounts in thousands, except share amounts)

	Common Stock		Additional Paid-in	Accumulated	Accumulated Other Comprehensive Income	Total
	Shares	Amount	Capital	Deficit	(Loss)	Equity
Balance at January 1, 2015	100	$	$ 1,149,360	$ (245,340)	$ (1,955)	$ 902,065
Equity compensation expense			6,814			6,814
Issuance of shares in connection with equity compensation plans, net of taxes			305			305
Repurchase of Parent common stock			(4,351)			(4,351)
Capital contribution from Parent			166,576			166,576
Net income (loss)				(30,728)		(30,728)
Foreign currency translation adjustment					(531)	(531)
Change in fair value of interest rate swap, net of taxes					(445)	(445)
Balance at September 30, 2015	100	$	$ 1,318,704	$ (276,068)	$ (2,931)	$ 1,039,705
Balance at January 1, 2016	100	$	$ 1,319,754	$ (341,409)	$ (2,656)	$ 975,689
Equity compensation expense			8,089			8,089
Repurchase of Parent common stock			(2,258)			(2,258)
Net income (loss)				(26,306)		(26,306)
Foreign currency translation adjustment					240	240
Change in fair value of interest rate swap, net of taxes					(2,303)	(2,303)
Balance at September 30, 2016	100	$	$ 1,325,585	$ (367,715)	$ (4,719)	$ 953,151

See accompanying notes to unaudited condensed consolidated financial statements.

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Change Healthcare Holdings, Inc.

Condensed Consolidated Statements of Cash Flows

(unaudited and amounts in thousands)

	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Operating activities		
Net income (loss)	$ (26,306)	$ (30,728)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	188,882	183,446
Accretion	10,645	15,254
Equity compensation	8,089	6,814
Deferred income tax expense (benefit)	(57,713)	(28,837)
Amortization of debt discount and issuance costs	10,224	7,441
Contingent consideration		(4,825)
Impairment of long-lived assets	251	1,180
Other	(1,417)	(1,474)
Changes in operating assets and liabilities:		
Accounts receivable	3,489	6,147
Prepaid expenses and other	(8,344)	(11,674)
Accounts payable	(3,839)	10,517
Accrued expenses, deferred revenue and other liabilities	21,051	(918)
Net cash provided by (used in) operating activities	145,012	152,343
Investing activities		
Purchases of property and equipment	(53,830)	(39,175)
Payments for acquisitions, net of cash acquired	1,502	(717,669)
Purchases of technology-based intangible assets	(43,495)	(3,676)
Net cash provided by (used in) investing activities	(95,823)	(760,520)
Financing activities		
Proceeds from Term Loan Facility		385,411
Proceeds from Senior Notes		243,453
Proceeds from Revolving Facility		60,000
Payments on Revolving Facility		(60,000)
Payments on Term Loan Facility	(13,890)	(11,870)
Payment of debt assumed from acquisition		(154,469)
Payments of deferred financing obligations	(7,621)	(6,173)
Repurchase of Parent common stock	(1,884)	(4,351)
Capital contribution from Investor Group and management		166,881
Payment of contingent consideration		(5,553)
Other		(2,500)
Net cash provided by (used in) financing activities	(23,395)	610,829
Net increase (decrease) in cash and cash equivalents	25,794	2,652
Cash and cash equivalents at beginning of period	66,655	82,306

Cash and cash equivalents at end of period	$	92,449	$	84,958

See accompanying notes to unaudited condensed consolidated financial statements.

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Change Healthcare Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited and amounts in thousands, except share and per share amounts)

1. Nature of Business and Organization

Nature of Business

Change Healthcare Holdings, Inc. (the Company), through its subsidiaries, is a provider of software and analytics, network solutions and technology-enabled services that optimize communications, payments and actionable insights designed to enable smarter healthcare. The Company s integrated capabilities enable its customers to exchange mission critical information, optimize revenue opportunities, control costs, increase cash flows and efficiently manage complex work flows.

Organization

The Company was formed as a Delaware limited liability company in September 2006 and converted into a Delaware corporation in September 2008 in anticipation of the Company s August 2009 initial public offering (the IPO). On November 2, 2011, pursuant to an Agreement and Plan of Merger among the Company, Change Healthcare, Inc. (Parent) and Beagle Acquisition Corp. (Merger Sub), Merger Sub merged with and into the Company with the Company surviving the merger (the 2011 Merger). Subsequent to the 2011 Merger, the Company became an indirect wholly-owned subsidiary of Parent, which is controlled by affiliates of The Blackstone Group L.P. (Blackstone).

Proposed Business Combination Transaction

On June 28, 2016, Parent and its controlling stockholders affiliates of Blackstone and Hellman & Friedman (H&F) entered into an Agreement of Contribution and Sale (the Contribution Agreement) with McKesson Corporation (McKesson). Under the terms of the Contribution Agreement, Parent stockholders and McKesson have agreed to form a joint venture (NewCo) that combines the majority of the McKesson Technology Solutions businesses (MTS) with Parent s businesses, including substantially all of the assets and operations of the Company, but excluding the Company s pharmacy claims switching and prescription routing businesses (the MTS Transaction). McKesson will retain its Enterprise Information Solutions business and its RelayHealth Pharmacy Network and the Company s pharmacy claims switching and prescription routing businesses will be retained by Parent stockholders.

Pursuant to the terms of the Contribution Agreement, (i) Parent stockholders will, directly and indirectly, transfer ownership of Parent to NewCo in consideration of (a) the payment at the closing of the MTS Transaction by NewCo to Parent stockholders and certain participants in the Change Healthcare Amended and Restated 2009 Equity Incentive Plan (the Parent Equity Plan) of approximately $1.75 billion and (b) the issuance to Parent stockholders of membership interests representing approximately 30% of NewCo s equity interests; and (ii) McKesson will cause MTS to be transferred to NewCo in consideration of (a) NewCo s assumption, and subsequent repayment to McKesson at the closing of the MTS Transaction, of a promissory note in the aggregate principal amount of approximately $1.25 billion, (b) the issuance of membership interests in NewCo representing approximately 70% of NewCo s equity interests and (c) a tax receivable agreement from NewCo. Actual cash payment and equity amounts are subject to certain adjustments in accordance with the Contribution Agreement.

In connection with the MTS Transaction, NewCo has entered into a commitment letter with Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Goldman Sachs Bank USA, Barclays Bank PLC and Citigroup Global Markets Inc. pursuant to which subsidiaries of NewCo have obtained debt financing commitments for $6.1 billion in long-term funded debt and a $500 million revolving credit facility. The proceeds of the committed debt financing will be used to make all payments to Parent stockholders and McKesson described above, to refinance certain of the Company s existing indebtedness and to pay fees and expenses incurred in connection with the MTS Transaction. The revolving credit commitments also will be available for ongoing working capital and other general corporate purposes of subsidiaries of NewCo following completion of the MTS Transaction.

The Company has incurred and expects to continue to incur significant other expenses related to the MTS Transaction, a portion of which may be shared with McKesson or reimbursed by Newco upon completion of the MTS transaction. Specific amounts to be shared or reimbursed by Newco are subject to further refinement based upon specific agreement among the parties to the MTS Transaction. As a result, initial estimates could differ materially from final determined amounts. For the nine months ended September 30, 2016, the Company has recognized approximately $15,786 of expense related to such costs, net of expected reimbursements.

Upon closing of the MTS Transaction, the Company also expects to incur a significant charge related to the accelerated vesting of a portion of outstanding stock-based awards under the Parent Equity Plan and other incentive awards. Additionally, because the MTS Transaction will qualify as a covered change in control under certain of the Company s tax receivable agreements, the Company could be required to make payments in the future that significantly exceed its actual cash tax savings from the tax benefits giving rise to such payments.

Change Healthcare Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

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The MTS Transaction is subject to various closing conditions, including the expiration or termination of the waiting period under applicable antitrust laws, the completion of the committed debt financing described above, the delivery of audited financial statements for MTS, the separation of the Company s pharmacy claims switching and prescription routing businesses and other customary closing conditions. The Contribution Agreement may be terminated by McKesson and/or Parent under certain circumstances, including if the MTS Transaction is not consummated by June 28, 2017, or if there is a change in tax law or certain relevant facts such that a party s respective tax advisor will be unable to render a favorable tax opinion at the closing of the MTS Transaction as to the tax-free nature of certain elements of the MTS Transaction affecting such party.

On August 31, 2016, McKesson received a request for additional information and documentary materials from the U.S. Department of Justice pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The Company continues to anticipate that the MTS Transaction will be completed in the first half of calendar year 2017.

2. Basis of Presentation

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (SEC) Guidelines, Rules and Regulations (Regulation S-X) and, in the opinion of management, reflect all normal recurring adjustments necessary for a fair presentation of results for the unaudited interim periods presented. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The results of operations for the interim period are not necessarily indicative of the results to be obtained for the full fiscal year. All material intercompany accounts and transactions have been eliminated in the unaudited condensed consolidated financial statements.

Reclassifications

Certain reclassifications have been made to the prior period financial statements to conform to the current period presentation.

Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company bases its estimates on historical experience, current business factors and various other assumptions that the Company believes are necessary to consider in order to form a basis for making judgments about the carrying values of assets and liabilities, the recorded amounts of revenue and expenses and disclosure of contingent assets and liabilities. The Company is subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in the Company s business environment; therefore, actual results could differ materially from these estimates. Accordingly, the accounting estimates used in the preparation of the Company s financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as the Company s operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in the reported results of operations; and if material, the effects of changes in estimates are disclosed in the notes to the consolidated financial statements. Estimates and assumptions by management affect: the allowance for doubtful accounts; the fair value assigned to assets acquired and liabilities assumed in business combinations; tax receivable agreement obligations; the fair value of interest rate swap obligations; contingent consideration; loss accruals; the carrying value of long-lived assets (including goodwill and intangible assets); the amortization period of long-lived assets (excluding goodwill); the carrying value, capitalization and amortization of software development costs; the provision and benefit for income taxes and related deferred tax accounts; certain accrued expenses; revenue recognition; contingencies; and the value attributed to equity awards.

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Change Healthcare Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited and amounts in thousands, except share and per share amounts)

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, which replaces most prior general and industry specific revenue recognition guidance with a principles-based comprehensive revenue recognition framework. Under this revised framework, a company will recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. This update is effective for fiscal years and interim periods beginning in those years after December 15, 2017. Early adoption is permitted in years beginning after December 15, 2016. Upon adoption, a company may elect to either retrospectively restate each prior reporting period or reflect the cumulative effect of initially applying the update with an adjustment to retained earnings at the date of adoption. While the Company cannot yet determine the transition method or the effect the adoption of this update will have on its financial statements, the Company believes that significant changes to its accounting policies, estimation processes, internal controls and information systems, as well as significant implementation costs prior to adoption, will be necessary to comply with this update. Such changes are expected to be necessary to accumulate information and data required to estimate the transaction prices in our contracts, and to allocate such transaction prices to the specific performance obligations in our contracts, as a result of variability from volume-based pricing, price increases, contingent fees, service level agreements and other arrangements.

In January 2016, the Company adopted FASB ASU No. 2014-12, which clarifies, in the context of share-based payment awards, that a performance target that affects vesting and could be achieved after the requisite service period has been rendered should be treated as a performance condition. Prior to this update, because there was no explicit guidance, there was diversity in practice among companies. The adoption of this update had no material effect on the Company s consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, which generally requires that all lease obligations be recognized on the balance sheet at the present value of the remaining lease payments with a corresponding lease asset. This update is scheduled to be effective for fiscal years and interim periods beginning in those years after December 15, 2018. The Company is currently assessing the potential effects this update may have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, which generally requires that all income tax effects of share-based payment awards be recognized in the statement of operations when the awards vest or are settled. It also will allow an employer to repurchase more of an employee s shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. This update is scheduled to be effective for fiscal years and interim periods beginning in those years after December 15, 2016, with early adoption permitted. The Company is currently assessing the potential effects this update may have on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, which requires that a financial asset (or group of financial assets) measured at amortized cost be presented at the net amount expected to be collected based on relevant information about past events, including historical experience, current conditions and reasonable and supportable forecasts that affect the collectability of the reported amount. This update is scheduled to be effective for fiscal years and interim periods beginning in those years after December 15, 2019, with early adoption permitted beginning with fiscal years beginning after December 15, 2018. The Company is currently assessing the potential effects this update may have on its consolidated financial statements.

In August 2016, the Company adopted FASB ASU No. 2016-15, which specifies the treatment within the statement of cash flows of eight specific matters including the treatment of debt prepayment or debt extinguishment costs and contingent consideration payments made after a business combination, among other matters. The adoption of this update had no material effect on the Company s consolidated financial statements.

3. Concentration of Credit Risk

The Company s revenue is primarily generated in the United States. Changes in economic conditions, government regulations or demographic trends, among other matters, in the United States could adversely affect the Company s revenue and results of operations.

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Notes to Condensed Consolidated Financial Statements

(unaudited and amounts in thousands, except share and per share amounts)

The Company maintains its cash and cash equivalent balances in either insured depository accounts or money market mutual funds. The money market mutual funds are limited to investments in low-risk securities such as United States or government agency obligations, or repurchase agreements secured by such securities.

4. Long-Term Debt

The Company s long-term indebtedness is comprised of a senior secured term loan facility (as amended, the Term Loan Facility), a revolving credit facility (the Revolving Facility ; together with the Term Loan Facility, the Senior Credit Facilities), 11% senior notes due 2019 (the 2019 Notes), 11.25% senior notes due 2020 (the 2020 Notes) and 6% senior notes due 2021 (the 2021 Notes ; together with the 2019 Notes and 2020 Notes, the Senior Notes).

Long-term debt as of September 30, 2016 and December 31, 2015 consisted of the following:

	September 30, 2016	December 31, 2015
Senior Credit Facilities		
$1,696 million Senior Secured Term Loan facility, due November 2, 2018, net of unamortized discount of $17,494 and $23,511 at September 30, 2016 and December 31, 2015, respectively (effective interest rate of 4.29%)	$ 1,615,308	$ 1,621,981
$160 million Senior Secured Term Loan facility, due November 2, 2018, net of unamortized discount of $2,483 and $3,334 at September 30, 2016 and December 31, 2015, respectively (effective interest rate of 4.54%)	154,317	154,666
$125 million Senior Secured Revolving Credit facility, $28.4 million expiring on November 2, 2016 and $96.6 million expiring on August 3, 2018, and bearing interest at a variable base rate plus a spread rate		
Senior Notes		
$375 million 11% Senior Notes due December 31, 2019, net of unamortized discount of $5,327 and $6,299 at September 30, 2016 and December 31, 2015, respectively (effective interest rate of 11.53%)	369,673	368,701
$375 million 11.25% Senior Notes due December 31, 2020, net of unamortized discount of $7,496 and $8,471 at September 30, 2016 and December 31, 2015, respectively (effective interest rate of 11.85%)	367,504	366,529
$250 million 6% Senior Notes due February 15, 2021, net of unamortized discount of $5,382 and $6,161 at September 30, 2016 and December 31, 2015, respectively (effective interest rate of 6.57%)	244,618	243,839
Obligation under data sublicense agreement	10,810	10,810
Other	8,487	7,427
Less current portion	(30,163)	(32,775)
Long-term debt	$ 2,740,554	$ 2,741,178

Senior Credit Facilities

The credit agreement governing the Senior Credit Facilities (the Senior Credit Agreement) provides that, subject to certain conditions, the Company may request additional tranches of term loans, increase commitments under the Revolving Facility or the Term Loan Facility or add one or more incremental revolving credit facility tranches (provided that the revolving credit commitments outstanding at any time have no more than three different maturity dates) in an aggregate amount not to exceed (a) $300,000 plus (b) an unlimited amount at any time, subject to compliance on a pro forma basis with a first lien net leverage ratio of no greater than 4.00 to 1.00. Availability of such additional tranches of term loans or revolving credit facilities and/or increased commitments is subject to, among other conditions, the absence of any default under the Senior Credit Agreement and the receipt of commitments by existing or additional financial institutions. Proceeds of the Revolving Facility, including up to $30,000 in the form of borrowings on same-day notice, referred to as swingline loans, and up to $50,000 in the form of letters of credits ($2,985 outstanding as of September 30, 2016), are available to provide financing for working capital and general corporate purposes.

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Change Healthcare Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited and amounts in thousands, except share and per share amounts)

Borrowings under the Senior Credit Facilities bear interest at an annual rate equal to an applicable margin plus, at the Company s option, either (a) a base rate determined by reference to the highest of (i) the applicable prime rate, (ii) the federal funds rate plus 0.50% and (iii) a LIBOR rate determined by reference to the costs of funds for United States dollar deposits for an interest period of one month, adjusted for certain additional costs, plus 1.00%, which base rate, in the case of the Term Loan Facility only, shall be no less than 2.25%, or (b) a LIBOR rate determined by reference to the costs of funds for United States dollar deposits for the interest period relevant to such borrowing, adjusted for certain additional costs, which, in the case of the Term Loan Facility only, shall be no less than 1.25%.

The interest rate on both the Term Loan Facility and Revolving Facility is LIBOR plus 2.50%. The Term Loan Facility is subject to a LIBOR floor of 1.25%, and there is no LIBOR floor on the Revolving Facility.

In August 2015, through an amendment to the Senior Credit Agreement, the Company borrowed an additional $395,000 under incremental term loan facilities on identical terms and having the same rights and obligations as the existing term loans under the Senior Credit Agreement.

In September 2016, through an amendment to the Senior Credit Agreement, the Company extended the maturity date in respect of $96.6 million of the Revolving Facility to August 2018. The remaining $28.4 million of the Revolving Facility that was available as of September 30, 2016, subsequently expired on November 2, 2016.

In addition to paying interest on outstanding principal under the Senior Credit Facilities, the Company is required to pay customary agency fees, letter of credit fees and a 0.50% commitment fee in respect of the unutilized commitments under the Revolving Facility.

The Senior Credit Agreement requires that the Company prepay outstanding loans under the Term Loan Facility, subject to certain exceptions, with (a) 100% of the net cash proceeds of any incurrence of debt other than debt permitted under the Senior Credit Agreement, (b) 50% (which percentage will be reduced to 25% and 0% based on the Company s first lien net leverage ratio) of the Company s annual excess cash flow and (c) 100% of the net cash proceeds of certain asset sales and casualty and condemnation events, subject to reinvestment rights and certain other exceptions.

The Company generally may voluntarily prepay outstanding loans under the Senior Credit Facilities at any time without premium or penalty other than breakage costs with respect to LIBOR loans.

The Company is required to make quarterly payments equal to 0.25% of the aggregate principal amount of the loans under the Term Loan Facility, with the balance due and payable on November 2, 2018. Any principal amount outstanding under the Revolving Facility is due and payable on August 3, 2018.

Certain of the Company s United States wholly-owned restricted subsidiaries, together with the Company, are co-borrowers and jointly and severally liable for all obligations under the Senior Credit Facilities. Such obligations of the co-borrowers are unconditionally guaranteed by Change Healthcare Intermediate Holdings, Inc. (a direct wholly-owned subsidiary of Parent), the Company and each of its existing and future United States wholly-owned restricted subsidiaries (with certain exceptions including immaterial subsidiaries). These obligations are secured by a perfected security interest in substantially all of the assets of the co-borrowers and guarantors now owned or later acquired, including a pledge of all of the capital stock of the Company and its United States wholly-owned restricted subsidiaries and 65% of the capital stock of its foreign restricted subsidiaries, subject in each case to the exclusion of certain assets and additional exceptions.

The Senior Credit Agreement requires the Company to comply with a maximum first lien net leverage ratio financial maintenance covenant at 5.35 to 1.00 for the remaining term of the Senior Credit Facilities, to be tested on the last day of each fiscal quarter. A breach of the first lien net leverage ratio covenant is subject to certain equity cure rights. In addition, the Senior Credit Facilities contain a number of negative covenants that, among other things and subject to certain exceptions, restrict the Company s ability and the ability of its subsidiaries to:

incur additional indebtedness or guarantees;

incur liens;

make investments, loans and acquisitions;

consolidate or merge;

sell assets, including capital stock of subsidiaries;

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Change Healthcare Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited and amounts in thousands, except share and per share amounts)

pay dividends on capital stock or redeem, repurchase or retire capital stock of the Company or any restricted subsidiary;

alter the business of the Company;

amend, prepay, redeem or purchase subordinated debt;

engage in transactions with affiliates; and

enter into agreements limiting dividends and distributions of certain subsidiaries.

The Senior Credit Agreement also contains certain customary representations and warranties, affirmative covenants and provisions relating to events of default (including upon change of control).

As of September 30, 2016, the Company believes it was in compliance with all of the applicable debt covenants under the Senior Credit Agreement.

Senior Notes

The 2019 Notes bear interest at an annual rate of 11.00% with interest payable semi-annually on June 30 and December 31 of each year. The 2019 Notes mature on December 31, 2019. The 2020 Notes bear interest at an annual rate of 11.25% with interest payable quarterly on March 31, June 30, September 30 and December 31 of each year. The 2020 Notes mature on December 31, 2020. The 2021 Notes bear interest at an annual rate of 6.00% with interest payable semi-annually on April 15 and October 15 of each year. The 2021 Notes mature on February 15, 2021.

The Company may redeem the 2019 Notes, the 2020 Notes or both, in whole or in part, at any time on or after December 31, 2015 at the applicable redemption price, plus accrued and unpaid interest.

The Company may redeem the 2021 Notes, in whole or in part, at any time on or after August 15, 2017 at the applicable redemption price, plus accrued and unpaid interest. At any time prior to August 15, 2017, the Company may, at its option and on one or more occasions, redeem up to 40% of the aggregate principal amount of the 2021 Notes at a redemption price equal to 100% of the aggregate principal amount, plus a premium and accrued and unpaid interest with the net cash proceeds of certain equity offerings. At any time prior to August 15, 2017, the Company may redeem the 2021 Notes, in whole or in part, at its option and on one or more occasions, at a redemption price equal to 100% of the principal amount, plus a make-whole premium and accrued and unpaid interest.

If the Company experiences specific kinds of changes in control, it must offer to purchase the Senior Notes at a purchase price equal to 101% of the principal amount, plus accrued and unpaid interest.

The Senior Notes are senior unsecured obligations and rank equally in right of payment with all of the Company s existing and future indebtedness and senior in right of payment to all of its existing and future subordinated indebtedness. The Company s obligations under the Senior Notes are guaranteed on a senior basis by all of its existing and subsequently acquired or organized wholly-owned United States restricted subsidiaries that guarantee the Senior Credit Facilities or its other indebtedness or indebtedness of any affiliate guarantor. The Senior Notes and the related guarantees are effectively subordinated to the Company s existing and future secured obligations and that of its affiliate guarantors to the extent of the value of the collateral securing such obligations, and are structurally subordinated to all existing and future indebtedness and other liabilities of any of the Company s subsidiaries that do not guarantee the Senior Notes.

The indentures governing the Senior Notes (the Indentures) contain customary covenants that restrict the ability of the Company and its restricted subsidiaries to:

pay dividends on capital stock or redeem, repurchase or retire capital stock of the Company, subject to customary exceptions, including compliance with a fixed charge coverage ratio and subject to limitation based on net income generated during the term of the Indentures;

incur additional indebtedness or issue certain capital stock;

incur certain liens;

make investments, loans, advances and acquisitions;

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consolidate, merge or transfer all or substantially all of their assets and the assets of their subsidiaries;

prepay subordinated debt;

engage in certain transactions with affiliates; and

enter into agreements restricting the subsidiaries ability to pay dividends.

The Indentures also contain certain customary affirmative covenants and events of default.

As of September 30, 2016, the Company believes it was in compliance with all of the applicable debt covenants under the Senior Notes.

Obligation Under Data Sublicense Agreement

In 2009 and 2010, the Company acquired certain additional rights to specified uses of its data from the former owner of the Company s business in order to broaden the Company s ability to pursue business intelligence and data analytics solutions for payers and providers. The Company previously licensed exclusive rights to this data to the former owner of the Company s business. In connection with these data rights acquisitions, the Company recorded amortizable intangible assets and corresponding obligations at inception based on the present value of the scheduled annual payments through 2018, which totaled $65,000 in the aggregate (approximately $12,700 remained payable at September 30, 2016). In connection with the 2011 Merger, the Company was required to adjust this obligation to its fair value.

Other

From time to time, the Company enters into deferred financing arrangements with certain vendors. The obligations under such arrangements are generally recorded at the present value of the scheduled payments. Such future payments totaled approximately $8,500 at September 30, 2016.

5. Interest Rate Swap

Risk Management Objective of Using Derivative Financial Instruments

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources and duration of its debt funding and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company s derivative financial instruments are used to manage differences in the amount, timing and duration of the Company s known or expected cash receipts and its known or expected cash payments principally related to the Company s borrowings.

Cash Flow Hedges of Interest Rate Risk

The Company s objectives in using interest rate derivative financial instruments are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swap and cap agreements as part of its interest rate risk management strategy. During the three months ended September 30, 2016, such derivative financial instruments were used to hedge the variable cash flows associated with existing variable-rate debt pursuant to the Term Loan Facility.

In January 2012, the Company executed three interest rate swap agreements with an aggregate notional amount of $640,000 to reduce the variability of interest payments associated with the Term Loan Facility. The interest rate swap agreements expire in February 2017. In March 2016, the Company executed two annuitized interest rate cap agreements with a combined notional amount of $650,000 to limit the exposure of the variable component of interest rates under the Term Loan Facility or future variable rate indebtedness to a maximum of 1.25%, beginning in March 2017 and expiring in March 2020. As of September 30, 2016, the Company s outstanding interest rate swap agreements and interest rate cap agreements were designated as cash flow hedges of interest rate risk and determined to be highly effective.

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The effective portion of changes in the fair value of derivative financial instruments designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivative financial instruments is recognized directly in earnings. Amounts reported in accumulated other comprehensive income related to derivative financial instruments will be reclassified to interest expense as interest payments are made on the Company s variable-rate debt. During the next twelve months, the Company estimates that an additional $1,427 will be reclassified as an increase to interest expense.

The following table summarizes the fair value of the Company s derivative financial instruments at September 30, 2016 and December 31, 2015:

Fair Values of Derivative Financial Instruments

	Balance Sheet Location	Asset (Liability) September 30, 2016	December 31, 2015
Derivative financial instruments designated as hedging instruments:			
Interest rate swap and cap agreements	Accrued expenses	$ (2,527)	$ (1,870)
Interest rate swap and cap agreements	Other long-term liabilities	(3,897)	(556)
		$ (6,424)	$ (2,426)

Tabular Disclosure of the Effect of Derivative Financial Instruments on the Statement of Operations

The effect of the derivative financial instruments on the accompanying unaudited condensed consolidated statements of operations for the three and nine months ended September 30, 2016 and 2015, respectively, is summarized in the following table:

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Derivative financial instruments in cash flow hedging relationships:				
Gain/ (loss) related to effective portion of derivative financial instruments recognized in other comprehensive loss	$ (71)	$ (645)	$ (5,867)	$ (2,695)
Gain/ (loss) related to effective portion of derivative financial instruments reclassified from accumulated other comprehensive loss to interest expense	$ (652)	$ (652)	$ (1,942)	$ (1,935)
Gain/ (loss) related to ineffective portion of derivative financial instruments recognized in interest expense	$ 30	$	$ (71)	$

Credit Risk-related Contingent Features

The Company has agreements with each of its derivative financial instrument counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company also could be declared in default on its derivative financial instrument obligations.

As of September 30, 2016, the termination value of the Company s derivative financial instruments in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was $7,341. If the Company had breached any of these provisions at September 30, 2016, the Company could have been required to settle its obligations under the agreements at this termination value. The Company does not offset any derivative financial instruments, and the derivative financial instruments are not subject to collateral posting requirements.

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6. Fair Value Measurements

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company s assets and liabilities that are measured at fair value on a recurring basis consist of the Company s derivative financial instruments and contingent consideration associated with business combinations. The table below summarizes these items as of September 30, 2016, aggregated by the level in the fair value hierarchy within which those measurements fall.

Description	Balance at September 30, 2016	Quoted in Markets Identical (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest rate swap and cap agreements	$ (6,424)	$	$ (6,424)	$
Contingent consideration obligations				
Total	$ (6,424)	$	$ (6,424)	$

The valuation of the Company s derivative financial instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivative financial instrument, including the period to maturity, and uses observable market-based inputs, including interest rate curves. The fair value of the interest rate swap and cap agreements are determined using the market standard methodology of netting the discounted future fixed cash payments (or receipts) and the discounted expected variable cash receipts (or payments) using the overnight index swap rate as the discount rate.

The Company incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty s nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative financial instrument contracts for the effect of nonperformance risk, the Company has considered the impact of netting and any applicable credit enhancements and measures the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

Although the Company has determined that the majority of the inputs used to value its derivative financial instruments fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivative financial instruments utilize Level 3 inputs to evaluate the likelihood of default by itself and by its counterparties. As of September 30, 2016, the Company determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, the Company determined that its derivative financial instrument valuations in their entirety are classified in Level 2 of the fair value hierarchy.

The valuation of the Company s contingent consideration obligations is estimated as the present value of total expected contingent consideration payments which are determined using a Monte Carlo simulation. This analysis reflects the contractual terms of the purchase agreements and utilizes assumptions with regard to future sales, probabilities of achieving such future sales, the likelihood and timing of expected payments and a discount rate. Significant increases with respect to assumptions as to future sales and probabilities of achieving such future sales would result in a higher fair value measurement, while an increase in the discount rate would result in a lower fair value measurement.

The table below presents a reconciliation of the fair value of the liabilities that use significant unobservable inputs (Level 3).

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Balance at beginning of period	$ (4,650)	$ (9,310)	$ (4,650)	$ (17,486)
Adjustment of provisional amounts				(50)
Settlement of contingent consideration				8,061
Gain/ (loss) included in contingent consideration		4,660		4,825
Transfers out of Level 3 fair value measurements	4,650		4,650	
Balance at end of period	$	$ (4,650)	$	$ (4,650)

During April 2015, the Company exercised its option to terminate all future obligations under the Vieosoft, Inc. (Vieosoft) stock purchase agreement in exchange for a cash payment of $4,650 to the former stockholders of Vieosoft. This termination payment was not accepted, and the former stockholders of Vieosoft have filed a lawsuit against the Company.

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Because this amount no longer represents a fair value measurement, the Company has transferred this obligation out of fair value measurements. The Company currently does not believe this lawsuit will result in additional liability that will have a material adverse effect on its business, financial condition or results of operations.

Assets and Liabilities Measured at Fair Value upon Initial Recognition

The carrying amount and the estimated fair value of financial instruments held by the Company as of September 30, 2016 were:

	Carrying Amount	Fair Value
Cash and cash equivalents	$ 92,449	$ 92,449
Accounts receivable	$ 276,378	$ 276,378
Senior Credit Facilities (Level 1)	$ 1,769,625	$ 1,791,643
Senior Notes (Level 2)	$ 981,795	$ 1,062,969

The carrying amounts of cash equivalents and accounts receivable approximate fair value because of their short-term maturities. The fair value of long-term debt is based upon market quotes and trades by investors in partial interests of these instruments.

7. Legal Proceedings

In the normal course of business, the Company is involved in various claims and legal proceedings. While the ultimate resolution of these matters has yet to be determined, the Company does not believe that their outcomes will have a material adverse effect on the Company s consolidated financial position, results of operations or liquidity.

8. Income Taxes

Income taxes have been affected by both routine changes in apportionment following the filing of the Company s tax returns each year, as well as certain discrete events.

In May 2015, the state of Tennessee enacted the Tennessee Revenue Modernization Act, which changed the manner in which the Company s Tennessee apportionment is determined.

In December 2015, the Company simplified its legal organizational structure for which the primary economic effect was to enable it to realize deferred tax assets for state income tax purposes that it previously had concluded were not likely to be realized. In July 2016, the Company further simplified its legal organizational structure which affected apportionment of state income taxes.

During the nine months ended September 30, 2016, the Company incurred transaction expenses in connection with the proposed MTS Transaction for which no income tax deduction is anticipated.

After giving effect to these events, income taxes for the nine months ended September 30, 2016 amounted to an income tax benefit of $57,438 and an effective tax rate of 68.6%. The income tax benefit for the nine months ended September 30, 2015 was $32,264 and resulted in an effective tax rate of 51.2%.

9. Tax Receivable Agreement Obligation to Related Parties

The Company is a party to tax receivable agreements which obligate it to make payments to certain of its current and former owners, including affiliates of Blackstone, Hellman & Friedman and certain members of management (collectively, the TRA Members), equal to 85% of the applicable cash savings that the Company realizes as a result of tax attributes arising from certain previous transactions, including the 2011 Merger. The Company will retain the benefit of the remaining 15% of these tax savings. The Company expects cumulative remaining payments under the tax receivable agreements of approximately $355,244. $185,125 of this amount, which reflected the initial fair value of the tax receivable agreement obligations plus recognized accretion, was reflected as an obligation on the accompanying unaudited condensed consolidated balance sheet at September 30, 2016.

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10. Segment Reporting

Management views the Company s operating results in three reportable segments: (a) software and analytics, (b) network solutions and (c) technology-enabled services. Listed below are the results of operations for each of the reportable segments. This information is reflected in the manner utilized by management to make operating decisions, assess performance and allocate resources. Such amounts include allocations of corporate shared services functions that are essential to the core operations of the reportable segments such as information technology, operations and product development functions. Segment assets and related depreciation expenses are not presented to management for purposes of operational decision making, and therefore are not included in the accompanying tables. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies in the notes to the Company s audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the SEC.

Software and Analytics

The software and analytics segment provides revenue cycle technology, revenue optimization, payment integrity, electronic payment, risk adjustment, quality reporting, data and analytics and engagement solutions.

Network Solutions

The network solutions segment provides financial and administrative information exchange solutions for medical, pharmacy and dental claims management and other standardized healthcare transactions, including clinical information exchange capabilities.

Technology-enabled Services

The technology-enabled services segment provides communication and payment, eligibility and enrollment, healthcare consulting, payment automation and pharmacy benefits administration solutions.

Corporate and Eliminations

Inter-segment revenue and expenses primarily represent claims management and communication and payment solutions provided between segments.

Corporate and eliminations includes pass-through postage costs, management, administrative and certain other shared corporate services functions such as legal, finance, human resources and marketing, as well as eliminations to remove inter-segment revenue and expenses. These administrative costs are excluded from the adjusted EBITDA measure for each respective operating segment.

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The revenue and adjusted EBITDA for the operating segments are as follows:

	Three Months Ended September 30, 2016				
	Software and Analytics	Network Solutions	Technology-enabled Services	Corporate and Eliminations	Consolidated
Revenue from external customers:					
Solutions revenue	$ 125,082	$ 93,814	$ 96,455	$ (7,765)	$ 307,586
Postage revenue				73,880	73,880
Inter-segment revenue		198	1,513	(1,711)	
Net revenue	$ 125,082	$ 94,012	$ 97,968	$ 64,404	$ 381,466
Income (loss) before income taxes	$ 39,804	$ 50,911	$ 30,052	$ (152,047)	$ (31,280)
Interest expense				46,534	46,534
Depreciation and amortization				65,899	65,899
EBITDA	39,804	50,911	30,052	(39,614)	81,153
Equity compensation	951	204	162	1,718	3,035
Acquisition accounting adjustments	106		116		222
Acquisition-related costs	362	22	39	466	889
MTS transaction-related costs				6,818	6,818
Monitoring fees and related costs				1,525	1,525
Strategic initiatives, duplicative and transition costs	2,318	532	582	2,509	5,941
Severance costs	1,589	174	213	2,429	4,405
Accretion				1,721	1,721
Impairment of long-lived assets				20	20
Other non-routine, net	1,180	4	14	(603)	595
EBITDA Adjustments	6,506	936	1,126	16,603	25,171
Adjusted EBITDA	$ 46,310	$ 51,847	$ 31,178	$ (23,011)	$ 106,324

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	Three Months Ended September 30, 2015				
	Software and Analytics	Network Solutions	Technology-enabled Services	Corporate and Eliminations	Consolidated
Revenue from external customers:					
Solutions revenue	$ 97,766	$ 93,415	$ 103,720	$ (6,955)	$ 287,946
Postage revenue				89,839	89,839
Inter-segment revenue		146	1,111	(1,257)	
Net revenue	$ 97,766	$ 93,561	$ 104,831	$ 81,627	$ 377,785
Income (loss) before income taxes	$ 36,407	$ 49,733	$ 35,523	$ (164,847	