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QSII - Q2 2016 Quality Systems Inc Earnings Call

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OVERVIEW:

Co. reported 2Q16 total revenue of \$125.4m and GAAP fully diluted EPS of \$0.14.



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PRESENTATION

Operator

Ladies and gentlemen, this is the operator. Today's conference is scheduled to begin momentarily. Welcome to the Quality Systems Incorporated FY16 second-quarter results conference call. Hosting the call today from Quality Systems is Dan Morefield, Chief Operating Officer and Rusty Frantz, President & Chief Executive Officer. Today's call is being recorded. At this time all participants have been placed in a listen only mode and the floor will be opened for your questions following the presentation.

(Operator Instructions)

It is now my pleasure to turn the floor over to Dan Morefield, Chief Operating Officer.

Dan Morefield - *Quality Systems, Inc. - COO*

Good afternoon and welcome. Before turning things over to Rusty, I remind everyone that the comments made on this call may include statements that are forward-looking within the meaning of security laws, including without limitation, statements related to industry trends, the company's plans, products, perspectives, and strategies, preliminarily and projected and capital equity initiatives to the implementation of potential impacts of legal, regulatory or accounting principles.



Rusty Frantz - *Quality Systems, Inc. - President & COO*

Good afternoon everyone, Rusty Frantz here. And thank you for joining us today for Quality Systems FY16 second-quarter results conference call. To begin, I will provide you with an overview of our focus during the quarter, as well as our emerging business strategy and then I will turn the call over to John Stumpf, interim CFO, to review the financial results and performance in the second quarter. Following the financial overview, our Chief Operating Officer Dan Morefield will update you on our business operations.

I want to start today by emphasizing the fact that we are further positioning the company to center around our strong core market, our ambulatory client base. The strength of our company lies in our large installed client base. Our platform is very solid and we are confident in our ability to leverage the existing leadership position we have built over the years and use it as a springboard for future growth. This focus on our ambulatory core competency is reflected in the divestiture of our acute care hospital solutions division, which we sold to QuadraMed Affinity Corporation, part of the Harris Operating Group of Constellation Software Inc. We believe this will be a great addition to their organization. We thank our inpatient team for their great efforts and wish all parties the best as they move forward with the transition process. This transaction helps to clear the path to allow us to focus on our ambulatory clients.

I would also like to briefly address our focus on capital management. As we move forward through the remainder of the year we will be focused on cost containment initiatives. The benefits of these initiatives will manifest themselves late in the financial year and accelerate in the next year. To this end, some of these initiatives include: the aforementioned divestiture of the hospital solutions division, focus on expense control across the organization, and continued simplification and restructuring of the organization to enable more aligned and efficient performance. We are pleased with the efforts made so far as we concentrate on these tighter cost controls and simplification to streamline expenses. We see these efforts as key to ensuring our ability to invest in both organic and inorganic initiatives as we continue to evolve our strategy.

The next priority here in the success of the business going forward is the client experience that I have been referring to since joining. As I mentioned previously on the call last quarter, ensuring a top notch experience for every QSI NextGen client relationship is absolutely essential. We are committed to providing clients a low total cost of ownership in terms of products and services as well as a great support experience. To this end, we continue to assist our clients to achieve both a lower total cost of ownership of our solutions as well as the services necessary to enable a seamless migration to value-based health care and the provision of tools to help them operate amid changing and new reimbursement models.

For example, our commitment to a low total cost of ownership will be expanded when we outline the expansion of our managed service and hosting capabilities at our user group meeting in November. By offloading many of the management and upgrade tasks from our clients we can ensure the best possible experience, as well as reducing their labor and technology cost structure when using our flagship NextGen ambulatory platform. Our continuing investment in a great support experience can be evidenced by our recent proactive service and support in our clients' shift and transition to ICD-10. Dan Morefield will cover this in more detail later in the call.

Also during the quarter, we continued to leverage our best in class, our revenue cycle management side expertise to continue to drive growth. This is certainly an area in which we expect to see increasing demand for the type of competitive advantage and expertise we bring to the table as ICD-10 and valued-based reimbursement takes further hold.

I want to turn now to ways in which we are listening to our clients and directly incorporating their feedback. Since we implemented our voice of client initiative back in 2013, a program whereby we continuously monitor client feedback and take action accordingly based on their input, we have seen significant benefits in this program. It continues to bring invaluable real-time insight into how we can improve the client experience. Based on client feedback, this quarter we made additional headway in enhancing that experience. We have been investing and improving our quality assurance processes and our software, bolstering account management, ramping targeted development within our flagship NextGen ambulatory platform to enhance provider efficiency, as well as reorganizing and refining our customer-based support function.

Turning to solution development. On the heels of the announcement of the transition in technology leadership early in quarter, I have been evaluating our current progress, both in our flagship NextGen ambulatory platform as well as our NG Now platform.

During Dan Morefield's interim leadership of our technology and product organizations, he has done a great job of increasing investment, alignment and focus on the flagship platform, better serving the needs of our existing client base. In addition, subsequent to the resignation of our prior CTO,

Dan and I have inspected the NG Now program. We see the initial delivery of a cloud-based EHR/EPM system on our NG Now platform happening in calendar year 2017. I am certainly not satisfied with this timeline and am aggressively evaluating ways to accelerate delivery of this capability to market.

In addition I am moving quickly through our CTO search as I see that role as key to our future. In summary, we continue to align and focus this organization by capitalizing on the previous successes we have achieved in the ambulatory space to ensure that our infrastructure is built to support both organic growth as well as the integration of future acquisition opportunities. In addition we remain nimble and developing tools that aid our clients in their approach to navigating reimbursement models and succeeding in today's rapidly changing healthcare landscape.

I will now turn the call over to John to provide color for the quarter.

John Stumpf - *Quality Systems, Inc. - Interim CFO*

Thanks, Rusty. This is John Stumpf. I am pleased to announce QSI's second quarter FY16 financial performance on today's call.

Our total revenue for the quarter of \$125.4 million reflects a 4% growth rate over the year ago quarter, led by gains of 28% in recurring subscription services, 19% in our revenue cycle management business, and at 9% in our electronic data interchange services. Dampening the overall growth rate were relatively flat software license sales and maintenance revenue, and a decline in professional services revenues; the latter mostly reflecting the fact that the year ago quarter was very robust for such services.

On a sequential basis, total revenues increased 3%, benefiting from a substantial rebound from the particularly low level of system sales that we experienced in our first quarter. As we mentioned in our first-quarter earnings call, Q1 appears to have been impacted by the timing of bookings in light of our strong FY15 end-of-year performance as well as overall chopiness in the end market.

Our sequential growth also derives from incremental gains in our RCM, subscriptions, EDI and professional services revenues. Mitigating our substantial growth rate is a decline in reported maintenance revenue. The sequential decline reflects a reduction in certain revenues that are recognized on a cash collections basis, and unfavorable impact due to changes in sales returns reserves, and the timing of sales credit. Normalizing the current and prior quarters for such items, maintenance revenues are flat on a sequential basis and continue to reflect an up trend over the prior year period.

Total contract bookings for the quarter were \$60 million, reflecting a sequential improvement of over 55%, a substantial growth in sequential bookings derives from a higher volume of both add-on and new customer arrangement principally relating to software license sales and RCM deals. As mentioned on our first quarter earnings call, the low bookings number for Q1 was believed to be somewhat anomalous, reflecting a decline of over 40% from the fourth quarter of FY15 due mostly to the timing of deal closures.

Gross profit grew a solid 8% or \$5 million versus the year ago period. Our consolidated gross profit margin this quarter expanded to 55% versus 53% a year ago. This improvement both in dollars and in margin expansion was broad-based. Limiting the overall margin improvement was an increase in maintenance and support personnel costs relating to initiatives aimed at increasing customer satisfaction. Though such expenditures weigh on near-term profitability, we continue to believe our various voice of the client initiatives will yield longer-term benefits.

On a sequential basis gross profit grew by 4%, reflecting the significantly higher level of system sales in Q2 and the resulting mix shift in favor of software-related revenue. Similar to the year-over-year gross margin trend, our growth in maintenance and support costs slowed the overall rate of margin expansion. We anticipate continuing to add targeted resources in support of the customer facing initiatives.

SG&A, excluding amortization of intangible assets, decreased over 3% from the year ago period. A portion of this trend reflects our ongoing effort to manage our expenses but we also did derive some benefit from the normal inter-quarter timing of costs. On a sequential basis, SG&A decreased due to the incurrence of \$900,000 in Q1 for CEO transition-related costs and net favorable timing across a number of other expense categories. Total [growth in the] investment increased 2% sequentially and 3% from the year ago period. We capitalized \$3.1 million in development costs this quarter, representing a 15% capitalization rate. By comparison, our capitalization rate was 18% for Q1 of this year, and 17% a year ago. Net



R&D operating expense increased to \$18 million this quarter versus \$16.9 million a year ago, reflecting the higher level of gross investment and slightly lower capitalization rate. Our net R&D expense as a percentage of total revenue for the quarter was 14%, flat with the year ago period and sequentially.

Our GAAP effective tax rate for the current quarter was 33% compared to 35% a year ago. This decrease in rate is primarily due to certain deductions that benefited from year-over-year growth in our taxable income. The current quarter GAAP rate would have been even lower absent certain discrete items recorded during the period. Our non-GAAP effective tax rate for the current quarter is 30.5% as compared to 35% in the year ago period. As noted in our first-quarter 2016 earnings release, we anticipate utilizing a static non-GAAP tax rate of 30.5% for each of the quarters in the FY16 period to provide increased consistency of our inter-quarter results and to better reflect our longer-term normalized outlook.

On a GAAP basis, fully diluted earnings per share for the second quarter of FY16 was \$0.14, an increase from \$0.08 per share reported in the year ago quarter. On a non-GAAP basis, fully diluted earnings per share for the second quarter of FY16 was \$0.21 compared to \$0.13 for the second quarter of FY15. Our year-over-year increase in both GAAP and non-GAAP earnings per share was driven by increased revenue and expanded margins, both gross and operating, and a favorable trend in our tax rate relative to the year ago period. Sequentially, fully diluted earnings per share on a GAAP and non-GAAP basis each increased largely from growth in revenue and the related expansion of gross profit as well as the reduction in total operating expenses.

With regard to the balance sheet, we made further progress on our DSO improvement initiative. Our turnover of receivables decreased to 72 days this quarter, an improvement of three days sequentially and nine days from the year ago period. Our cash and cash equivalents plus marketable securities ended the quarter at \$111 million. This balance represents a net decline of \$6 million from the start of the current quarter, principally due to the timing of tax installment payments. Specifically, our second-quarter cash flows reflect required installment payments totaling approximately 50% of all federal and state taxes due for the full fiscal year.

Moving on to revenue trends by business unit. Our ambulatory unit for the second quarter had revenues of \$95.0 million, a 2% increase from \$93.1 million a year ago. Our dental business unit had revenues of \$4.7 million, a 0% change year over year. Our hospital business unit had revenues of \$3.2 million, a 23% decline from \$4.2 million a year ago, and our RCM business unit had revenues of \$22.5 million, a 21% increase over \$18.6 million a year ago, and again, on a consolidated basis our revenues for the quarter, \$125.4 million, a 4% increase over \$120.5 million a year ago.

I will now move on to a recap of select non-cash expenses for the quarter, as follows. Amortization of capitalized software, \$2.5 million, amortization of intangible assets, \$1.8 million, depreciation expense, \$2.2 million, stock compensation expense, \$0.9 million and bad debt expense, \$0.4 million. Our investing activities for the quarter were as follows. Internally generated capitalized software, \$3.1 million, and investments in fixed assets, \$2.7 million. This concludes my review of financial performance for the quarter.

With respect to our outlook for the second half of FY16 year I am limiting my comments primarily to directional and qualitative measures. Before consideration of the divestiture of our inpatient business unit, which was reported this afternoon, we anticipate our second-half organic revenues to reflect continued but limited growth over our first half of 2016. In light of our record performance in Q4 of FY15 however, our year-over-year growth rate in the second half of FY16 is likely to be more muted than the 4% year-over-year growth rate we achieved in the first half of this year. Based upon the divestiture date of our inpatient business unit, we expect the sale to impact revenue by \$4 million to \$6 million in the second half of this fiscal year. We will not be recasting previously reported numbers relating to our in-patient business unit in our published financials.

From an earnings standpoint, I want to reiterate a couple comments that I made in context of our Q2 performance. Specifically we derived a timing benefit favorable SG&A expenses in the current quarter, we feel that a normalized rate of 32% of revenues reflect a reasonable basis for near-term expectations. Further, we continue to anticipate our net R&D expense to grow to as much as 15% of revenue, consistent with what we communicated at the onset of FY16. After normalizing our SG&A run rate and factoring in our intent to ramp our investment in R&D, we would expect a somewhat lower non-GAAP EPS margin in our second-half before consideration of our divestiture of our in-patient business unit. For the second half of 2016 we anticipate this divestiture would add \$0.02 to \$0.04 to our non-GAAP EPS.

I want to thank all of you for being on our call and your interest in our company. I will now turn things over to Dan Morefield, EVP and COO of Quality Systems.



Dan Morefield - *Quality Systems, Inc. - COO*

Thanks, John, and hello everyone. As John said, for the second quarter the ambulatory division's revenue increased roughly 2% when compared with the same period in FY15. One highlight of the year-over-year increase is the performance of EDI which was up 9% over the prior year. When compared to Q1 of this fiscal year, total revenue is up roughly 4%. Software, hardware and related revenue increased 13% quarter over quarter. Consulting revenue was a highlight in the service line item as this category increased 25% over the prior quarter. I will highlight some of the sales that drove the software increase later in the commentary.

As the transition date for ICD-10 loomed, our service teams were highly engaged with our clients to assist with preparations. I am pleased to report that our ICD-10 transition went very well. We believe it was a successful outcome due to the combined effort of our clients and our teams working together. The services that we offered as part of the ICD-10 transition are examples of a move toward a more proactive service approach that we believe will lead to increased client satisfaction.

A strategic highlight for the quarter was the announcement of the partnership with Mass Hlway. Through this particular partnership, providers utilizing NextGen share can exchange crucial patient information with over 350 organizations connected to the Mass Hlway, the statewide health information exchange that facilitates the transmission of healthcare data and information amongst providers, hospitals, and other healthcare entities throughout Massachusetts. This is just one example of our strength and interoperability and connecting practices in meaningful ways. We remain committed to creating ways that our clients can connect within their communities.

Sales nicely rebounded in Q2 as expected when we spoke in July. It was evident that the success of the quarter was a result of a very balanced performance across all of our major revenue drivers. Mirth, RCM Services, EDI professional consulting services, hosting, and system sales. Industry conversations around interoperability continue to grow and as a result, our Mirth product sales continue to grow. We posted another solid quarter with a mix of revenue from both the NextGen client base and non-NextGen clients. Our teams continued to work well on cross-selling opportunities, educating our client based on the value that the Mirth products can bring, and the problems that the Mirth products can solve. The near term opportunity remains a solid mix of public and private HIEs, core interoperability products, new population health and analytics.

Of particular note in Q2 we landed the third regional HIE in Southern California, with the Los Angeles area HIE. Premise Health, a long time NextGen client and progressive provider of work site healthcare, purchased the Mirth HIE stack to serve as the backbone for their interoperability and data aggregation across their diverse nationwide enterprise. Sonic Labs purchased an HIE enterprise license to serve a patient population of over 15 million lives, which demonstrates the scale and scope of the Mirth stack in this lab specific use case. Blackstone Valley Community Health Center, a premier New England federally qualified health center and long time NextGen client purchased Mirth as part of their private HIE interoperability strategy.

We drove a solid mix of RCM services, net new system sales and sales into the existing client base. A number of NextGen ambulatory enterprise clients continue to consolidate practices in their market space; excuse me, as the number of NextGen ambulatory enterprise clients continue to consolidate, we benefit greatly from their growth and continue to benefit. Clients such as Accelerated Rehab, Amsearch, Jackson Community Medical Record, Dermatology Associates of Wisconsin, to name a few, all contributed to the growth story within the NextGen client base. We believe that this is a trend that will continue as these type of organizations continue to acquire providers and drive consolidation.

Also worth noting in Q2 was the success of our professional consulting services and managed cloud services sales. Our client are seeing the value of moving their NextGen applications to our hosting offering for a number of reasons, including a significant ROI over on-premise solutions, excellent performance and to allow NextGen to manage the maintenance of their applications to provide a much improved support experience. RCM service revenue for the first quarter was up slightly over last quarter at \$22.5 million and 21% better than the same quarter a year ago. A large portion of the quarter was spent preparing for the ICD-10 implementation on October 1 so we concentrated our efforts on making sure our technology was ready, training our staff and educating and support our customers for their ICD-10 readiness with tools, training and webinars.

RCM services had solid sales last quarter that included family care services, [waitly] health services and in university orthopedic center. We also successfully began the rollout of our credentialing services offering that we believe will provide additional value and further differentiate us as the

high touch leader in this space. We look forward to aggressively expanding our RCM service model in the coming quarters with many unique products and services to aid our clients in the transition from a volume to a value-based marketplace.

Up next is our annual user group meeting in Las Vegas where once again thousands of our clients, along with industry experts, dozens of NextGen partner firms and prospects will gather together for an extraordinarily learning experience and, quite honestly, just a lot of fun. Rusty and the team will be hosting our general session to talk about our strategic focus, product updates, and what's in store for the future. We are currently in the process of modifying our overall sales process and looking at the various predictive analytics we used to forecast sales. While we will not be providing pipeline information this quarter, we believe that the future sales and revenue opportunities remain materially the same as those represented in last quarter's pipeline number. We will provide a greater degree of insight and perspectives into our sales prospects in future calls.

Wrapping up our call this morning, I would like to report that the company executed 61 new arrangements on a consolidated basis versus 68 in the prior quarter. 57% of the arrangements were greenfield, 43 were replacements. Discounting did not materially change in the quarter and as of September 30 there were 114 quota carrying sales and management positions. There was no material increase in the sales staff over Q1 FY16.

And with that I'd like to thank you for your time and continued interest. Operator, I'd like to turn it over to you for questions at this point.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jamie Stockton, Wells Fargo.

Jamie Stockton - Wells Fargo Securities - Analyst

Good evening thanks for taking my question. I guess maybe the first one I don't know if this is to Rusty or John but I think in Rusty's comments you talked about cost containment initiatives. Obviously, getting the hospital business off the books is going to help from a profitability standpoint. Is there any way you can quantify for us what you think the opportunity is within the rest of the cost base, maybe over the next year, as far as some of the initiatives you're looking at?

Rusty Frantz - Quality Systems, Inc. - President & COO

Hey Jamie, I appreciate the question. This is Rusty and then I will pass it over to John. I would say we are early in the journey on that. We brought in external help to help us better understand the structure of the organization as well as some of the areas where we can become more efficient. Certainly as we move forward through the next couple quarters we will be a little more crisp on identifying those, but at this point we are really on the front end of that journey. Today mainly focus is just making sure the no regret steps, like making sure we are only traveling when we really need to, and we are continuing to be careful stewards of the operating expense line. John, anything to add to that?

John Stumpf - Quality Systems, Inc. - Interim CFO

I agree with Rusty's comments, it would be premature to get quantitative but we are taking a holistic approach. We are looking at benchmarking, best practices, and those types of things about organizational efficiency and that's about as far as we can go on today's call.



Jamie Stockton - Wells Fargo Securities - Analyst

Okay that's great. Maybe one other question. On ICD-10, obviously, a big focus on it during the quarter. Can you give us any sense for whether that had an impact on deal flow? I think Dan said that of the number of deals was down you know maybe 10% roughly sequentially even though you did see a nice improvement in average deal size. Just any color around what impact ICD-10 might have had during the quarter, and what you expect over the next quarter or two, if there was an impact?

Dan Morefield - Quality Systems, Inc. - COO

Thanks. This is Dan. The impact of ICD-10 I think we've talked about that a little in the past. We started talking that ICD-10 might be a little headwind in the current sales environment. And I think we saw a little bit of that.

With that being said, our expectation with ICD-10 mostly behind us, although we still have a couple cycles to go through, payment reimbursements to make sure, that we are seeing greater opportunities in the marketplace based upon clients and prospects beginning to take away focus from their internal operations. I don't think there's any way to quantify that but I think from a trend line we like what we see.

Jamie Stockton - Wells Fargo Securities - Analyst

Okay. Thank you.

Operator

Mike Cherny, Evercore ISI.

Michael Cherny - Evercore ISI - Analyst

Afternoon guys, nice job on the bottom line performance sure here. I want to dive in a little bit relative to the refocusing. Obviously, by divesting in the hospital business, clearly hasn't lived up to the expectations that had previously been set when you bought the business, now that you're getting rid of that distraction, you're thinking about refocusing. Are there any areas in terms of R&D development you want to refocus around? Taking some of those resources that were working in the hospital division and putting them in something else, areas around RCM services or analytics. I guess as you've refocused where will the priorities shift relative to those resources?

Dan Morefield - Quality Systems, Inc. - COO

Thanks. This is Dan again. Let me give you a little bit of color associated with that. The resources, and it's not just the resources specifically from hospital, but as we take a look at the overall resource pool, it really applies to everything.

Clearly, we have said that the current satisfaction level of our clients is of immanent importance and being able to focus on improving that on things like providing better hosting solutions, better upgrade experiences, better bug fixes, and enhancements, while continuing to invest in the core premier ambulatory platform. And so, it's a combination of focus and redirection of resources, while at the same time, continuing to invest in our future and provide us or make sure we have the ability to not only continue to grow aggressively organically but also have the ability to grow inorganically as we see potential opportunities.

Michael Cherny - Evercore ISI - Analyst

Got it. And I apologize if I missed this before, do you have any updates especially on attrition rates, or any feedback in terms of guys that may have been questioning long-term strategy and now with Rusty in place say -- Hey, I like this guy -- and give him another shot?

Dan Morefield - *Quality Systems, Inc. - COO*

We have no statistic on that, have not reported any metrics surrounding our overall attrition and we continued to see growth in our overall ambulatory portfolio and continue to take the efforts to make sure not only we can retain our existing clients but have the ability to aggressively compete in the marketplace as it is today and as it's being developed in the future.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Let me just add in a little bit of that. Certainly as we come to our user group meeting, my intention is to be front and center in the user group meeting and to give the keynote speech to the client base.

I have already spent a good bit of time going around the country, meeting the clients, giving them a sense as to who I am, to the energy and focus that I bring to the table as I lead this organization. My expectation is, is that time in November with our users will be a very important opportunity to continue to solidify our clients' optimism in the future of our organization.

Michael Cherny - *Evercore ISI - Analyst*

Perfect. Thanks guys.

Operator

Charles Rhyee, Cowen and Company.

Charles Rhyee - *Cowen and Company - Analyst*

Thanks, guys. You declined to give a pipeline figure this quarter. Can you go into a little more why it wasn't a useful metric for you to provide this quarter, but it sounds like you plan to give it next quarter; did I understand that correctly?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

As I've come into the organization, and I've looked at the way we go to market, we have a real opportunity with the breadth of solution we have to truly bring an enterprise message to our client base, to a much more solution-oriented message, that's also driving a change in the sales process and how we actually go to client.

Naturally, as that sales process takes hold, that creates a different optic around what the future looks like and so to that end as we are changing the sales process the way that we used to view opportunity will now morph to more reflect this new process, this new level of inspection and a new level of enterprise solution messaging to our clients. Does that help?

Charles Rhyee - *Cowen and Company - Analyst*

Yes it does, but the other comment you made was that you thought the number of opportunities, et cetera, was the same as last quarter. Is that just the way you'll report the metric -- reflects the new sales process but it's not to say the number of opportunities has materially changed?

Dan Morefield - *Quality Systems, Inc. - COO*

This is Dan. That's absolutely correct. My purpose for actually stating that directly is I did not want this group to walk away with the understanding that by not providing that particular pipeline information we were in any way previewing that we thought our future sales and revenue opportunities had decreased.

Charles Rhyee - *Cowen and Company - Analyst*

Okay. Thank you, appreciate that. Obviously, we are exiting the hospital business but we're still in the population health business. You feel that not being also a hospital provider hurts you, when you see some of the your competitors in the space they are also a hospital systems under plus a population health system, and is going to ease us on to an install basis that way? How do you view that market going forward as you exit hospitals?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

First of all, we see that market to be very large. And segmented in many ways. And so from that perspective, we think there are many ways to look at the opportunities and what we have said that the opportunity associated with the combination of our core ambulatory capabilities with small, principally rural hospitals, are not as strong as our ability to focus on population health management and ambulatory solutions centered around the larger doctor practices. It's just an understanding that the market is very large and which areas do we think we can compete at and aggressively compete at and win.

John Stumpf - *Quality Systems, Inc. - Interim CFO*

And I'd also add to that that's where our Mirth solution set comes in so strongly. I just had the privilege to attend a both EHR company and provider conference with the class group in Utah, where we were specifically talking about interoperability within the industry and how do we as an industry continue to improve the ability to interchange data between various EHRs. Because of that, that I see, is another tailwind -- having that great interoperability capability allows us to meet the needs of the ambulatory client base but also allow them to interoperate with in their own groups but with all the critical care facilities that they also serve.

Charles Rhyee - *Cowen and Company - Analyst*

Great. Thank you.

Operator

Greg Bolan, Avondale and Partners

Greg Bolan - *Avondale Partners - Analyst*

Congrats on the improvement in the topline. Wanted to ask a little bit about the activity within the revenue cycle management area, this has obviously been a right spot for you guys for some time especially as you kind of anniversaried the hospital client loss. Are you seeing, what kind of activity are you seeing? Is it mostly greenfield activity? Are you displacing maybe some of your peers? Maybe if you could give characterization of the revenue cycle management backdrop that would be great.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Thanks, Greg. As we've reported previously, the RCM activity is well-balanced. We see opportunities and actual successes and replacing existing national RCM vendors. We see replacement of regional players, we see greenfield opportunities, and we see them both as they cross sell within

our client rates where they already have our NextGen ambulatory software as well as a combined new sale for new clients that are installing both our software and our RCM services.

What we continue to see is just a number of wins across all fronts, versus specializing in one particular area. And the one thing I would add on top of that, as we continue to expand services such as we announced today, the credentialing service and as we continue to add more services to drive our ability to support our clients moving toward value-based reimbursements.

Operator

Dave Francis, RBC Capital Markets

David Francis - *RBC Capital Markets - Analyst*

Afternoon, guys. Did you give out any information on the hospital divestiture in terms of size of transaction or anticipated closing date?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

We did not give out any information on the size of transaction

Dan Morefield - *Quality Systems, Inc. - COO*

And the closing date was today.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

It was a simultaneous sign and close.

David Francis - *RBC Capital Markets - Analyst*

Any reason why you aren't talking about the size of the impact transaction on the balance sheet?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

Immaterial consideration. This is John.

David Francis - *RBC Capital Markets - Analyst*

Okay. If I could ask, changing gears, the ICD-10 question a little bit differently.

You talked about people -- you are three weeks into the shift now and you saw some kind of impact on near-term sales activity in the last quarter. Can you talk a little bit more about how you've seen your clients thinking about ICD-10 as it rolls forward?

Is there a tale to how long they are kind of focusing on the issue as something they need to be worried about relative to cash flow or when do they kind of believe that from your perspective we are back to kind of operations as usual?

Dan Morefield - *Quality Systems, Inc. - COO*

Dave, Dan here. In response to your question what we are seeing is a very mixed response from our clients. Much of it comes from the size and sophistication of the client and how well prepared the client was for the transition. Some of our clients that really did an exceptional job in preparation for the ICD-10 transition had hit it really in stride in our reporting that much of that is behind them, especially after they're seeing the first few cycles of reimbursements.

Others I think our a little bit more problematic as they had not prepared nearly as well. But again, those tend to be different depending on size, sophistication, and preparedness of the clients. So I don't think we are seeing anything I could see across all of our client base, with the exception of, that the overall process seems to be well-accepted and well down the path of being behind them.

David Francis - *RBC Capital Markets - Analyst*

Okay, if I could sneak in one more quickie. John, you ran through very quickly some puts and takes on normalizing the downward shift in the maintenance revenue sequentially, but I didn't quite track the ups and downs there that got you to what you said was a constant basis. Can you run through that real quick again for us?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

Sure. In a given quarter, we could have cash based collection revenues, we can have sales credits to greater or lesser degree, we could have movement in our sales return reserves. Our maintenance is fairly flat, frankly quarter to quarter.

You get year-over-year changes largely from the software sales bookings, the CCPI increases, and the attrition come into play. Sequentially there's really not that much movement. This quarter to quarter movement you've seen from Q1 to Q2, Q1 benefited a bit from sales return movement. This quarter it went the other way.

You can pretty much normalize Q1 and Q2 together versus the first half of last year to get a flatter more meaningful trend. We think when we get to our third quarter, all things equal, you'd see a more normalized number reflected closer to Q1 probably.

David Francis - *RBC Capital Markets - Analyst*

Okay that's helpful. Thank you.

Operator

David Larsen, Leerink.

David Larsen - *Leerink Partners - Analyst*

Hi, can you talk a little bit more about the Mirth solution itself? I think on your analyst day you mentioned you would be investing into it so that the financial and capitation oriented capabilities of Mirth would be created or enhanced. Can you just give a little color on that?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

David, good to hear from you. We talked a lot about that Mirth would continue to be integrated into our overall solution architecture and greater degree within our product. Some of the things you talked about are examples of the components that we are looking at on things such as the

population health management tools that have a number of the Mirth stacks within them. Mirth analytics is a good example about that, that the next generation of Mirth analytics will come out later this year. And the current view on that is it will not only support the Mirth branded stack but will also be implemented and used within the NextGen ambulatory stack.

Everything continues to be sort of process for lack of better term but we are comfortable that the interoperability capabilities and the nature of the technology solution will continue to prepare us to be much more aggressive in the population health management world as well as the overall world of value-based reimbursement.

David Larsen - *Leerink Partners - Analyst*

Okay. So, if you had a large physician group that wanted to enter into a profitable arrangement with a commercial plan, would Mirth basically be able to bring them through that process?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Mirth, I believe, would be able to bring them that process. Those, as you know, are very custom in nature, and one of the great values of our Mirth stack and Mirth results are things that we can and do customize those especially on the large end for these kind of opportunities.

David Larsen - *Leerink Partners - Analyst*

Great. Thank you very much.

Operator

Ricky Goldwater, Morgan Stanley.

Zack Sopcak - *Morgan Stanley - Analyst*

This is Zack Sopcak for Ricky. I just want to ask a question on the delay in the cloud-based HER, and ask if any of the increase in R&D ramp is related to that project, and also if it's had any impact on your discussion with clients?

Dan Morefield - *Quality Systems, Inc. - COO*

This is Dan. Thanks for the response. There are two parts to that question.

The first part having to do with the ramp associated with the technology spent. The most recent ramps associated with our technology spend I don't think were related to that. I think they were much more related to issues surrounding putting more investments into our core premium NextGen ambulatory product line. Enhancing client satisfaction, upgrade capabilities, bug fixes, enhancement and all of the things we talked about not only from that perspective but all the processes around that as well. We have had some conversations with our clients concerning the timing of the EHR coming to market but quite honestly, our clients have expressed less of an interest of a specific products and more of an interest in understanding what our strategy is going to the cloud.

But what do we think and how are we going to do that? Those conversations tend to be second to, what are you doing for me on the application I'm using today? What are you doing to reduce the overall cost of ownership of the application I have today?

These are things that first come out and the long-term strategic conversation always centers around, what is your plan for the cloud; talk to us about architecture designs, features like that. And it's much less of a discussion of when will you have a small doctor practice ready to be commercialized and go to market.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

And this is Rusty, let me chime in a little bit here. The first commitment to our clients is to make sure that they are getting a great experience with the solution they own today. It is also our commitment is to make sure as our strategy evolves it has an understanding evolves it is transparent with our clients. As I stated in the call right now that timeline has us delivering a cloud-based capability on the EHR/EPM side in calendar year 2017.

As I said I'm not satisfied with that date. Frankly, technology development is well within my wheelhouse and is an area I'm looking to drive very aggressively as I continue to take the reins of the organization. What I would say is more to come on this conversation as we move through the next couple of quarters. But certainly it's an area we feel is important, but maybe secondarily important to giving a great experience on the highly capable, highly customizable enterprise solution set we deliver today.

Zack Sopcak - *Morgan Stanley - Analyst*

Great. Thank you.

Operator

Jeff Garro, William Blair and Company

Jeff Garro - *William Blair & Company - Analyst*

Good afternoon guys, and thanks for taking the question. I wanted to ask if you could quantify the opportunity for hosting, and will pushing hosting services help you set up an upgrade for NextGen when it is ready for market?

Dan Morefield - *Quality Systems, Inc. - COO*

Jeff, Dan Morefield here, thanks for your question. Can I quantify the hosting opportunities? What I can say is I believe that less than a quarter of our existing clients take advantage of our hosting opportunities, so I think that there is a significant ramp there. And as we have focused our time and attention on delivering a much better quality product, as we've seen the results associated with that, and our customers and internal surveys reflect that the quality they are receiving has gone up, we think that opportunity to bring more clients on board is a good size one.

So as far as quantifying it, other than outlining that I think we're probably have got a long way to go from our existing client base. The discussions we had about the value of our hosting environment is less centered around the ability to migrate them over to some new platform in the future, but the ability to provide significantly better service and significantly better experience with their existing stack. That we can help take away some of the complexity of the upgrades. And it's not just the upgrades in the software but it's the complexity of the overall HIT stack and the interrelationships between not only our software but other softwares that the client is using.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

I think also as I look at it we will continue to deliver capabilities in the cloud as we already have. And having on premise hosting versus being able to host the NextGen ambulatory footprint, that NextGen footprint in the hosted offering allows us to much more easily migrate piecewise certain capabilities that are in the NG regulatory footprint today, but might be for example better positioned in a multi-tenant cloud offering.



I would say it creates a little more frictionless optionality for us as we continue to release some of these new cloud-based capabilities regardless of whether they are EHR/EPM or other population health orientated capabilities.

Jeff Garro - *William Blair & Company - Analyst*

That's great guys. Just a quick follow-up there just trying to fully understanding the value that hosted services are bringing to your clients. Could you talk a little more about where the revenue opportunity lies, just in terms of and if average increase of maintenance type revenue or revenue that is hitting other segment lines?

Dan Morefield - *Quality Systems, Inc. - COO*

That's a tough question to answer off the top of our heads. I think that the revenue lines as part of the service lines

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Let me just chime in here. What I would say is the core value to us is the improvement and client satisfaction and the ability to continue to move clients towards a more consistent footprint. Which of course does have a lots of goodness both from a client satisfaction standpoint also it helps us better utilize our service resources to continue to provide that better customer experience. We are not really in a position to comment on what that might mean on a per customer basis from a revenue standpoint.

John Stumpf - *Quality Systems, Inc. - Interim CFO*

This is John and furthermore I want to say we're in exploratory phase of this we have not baked those into that forward-looking information that I described for the second half of this year.

Jeff Garro - *William Blair & Company - Analyst*

Great. Thanks for taking my questions guys.

Operator

Donald Hooker, KeyBanc

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Good afternoon. So the interest in the quiet part of your business in my opinion, the EDI revenue line, which continues to impress with some nice growth. Is there a way for us as we think about this revenue line going forward, realizing you don't provide guidance, that maybe you can help kind of give us perspective here, kind of think about the components of the EDI business and where your penetration rates are. I assume this is a claims management patient's statements. It sounds like basic things but it's been a great performer and how long can we expect this to continue? What are the greenfields within your client base and outside of your client base?

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Donald, thanks for your question. Certainly the areas you talked about are important, also things like messaging are included. The key way to think about this is these are auxiliary products that are part of our core set of products that we offer to our ambulatory clients. They're as a general basis

included in the overall workflow of the client's operations with a lot of different touch points. One of the reasons that we continue to have good success in that line item is that we continued to enhance and increase the number of relatively small but important features and products that are all built within this EDI nomenclature. They all tend to roll up over time. Their strategic to our clients because they enhance workflow capabilities and increase the overall experience as well as increase the financial viability of a small practice a medium practice and a large practice. One of the reasons it keeps going is we do have a lot of greenfield opportunity within our client base and outside of our client base. We are beginning to have much more connections and involvements with payers in this environment. As payers have EDI kind of needs and request for data. If we expand EDI to talk about data monetization a little bit and the opportunities are there. So I think the key is, it's a bundle of services that are interrelated and an important part of the operations of almost all of our customers. And it's one that we have, with the exception over the last couple of years, not had a lot of conversations with them and as we have more conversations we find there's more opportunities.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Okay and then maybe one last one. I guess we are running out of time here. When I look at the bookings in the quarter the \$60 million, were there any large deals that skewed in and out of the quarter is there anything we can think about there, how does that compare compositionally versus prior quarters?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

This is John. There was no individually large deals that skewed that number upward from Q1, Q1 was particularly low, relative to prior quarters. I think that was just timing; bad luck if you will, for Q1 this quarter's more normalized.

Donald Hooker - *KeyBanc Capital Markets - Analyst*

Thank you.

Operator

Mohan Naidu with Oppenheimer

Unidentified Analyst

This is actually Mike [Ott] on for Mohan. Wanted to inquire how the new CMS proposal around MU2 and MU3 from earlier this month might impact you guys, if at all, around 90 day [activation] periods and that sort of thing.

Dan Morefield - *Quality Systems, Inc. - COO*

This is Dan again. We have spent as many others have much of the last couple weeks studying the reams of paper that came out of that.

What I think it does is provide a greater degree of flexibility for our clients and that provides opportunity for us. At the end of the day it's a greater degree of opportunity and it also provides in some cases the ability to have more time and more flexibility from our side to provide the right levels of solutions to support it.

Unidentified Analyst

And if I could just ask a quick follow on. I don't know if you can -- but obviously more going on in the last two months, Rusty, but if you could update us on the search for the full-time CFO position?



Rusty Frantz - *Quality Systems, Inc. - President & COO*

I continue to look internally and externally and evaluate our path forward there. It's certainly something I'm focused on but that's the only update I have right now.

Unidentified Analyst

Okay thanks.

Operator

Gene Mannheimer, Topeka Capital.

Gene Mannheimer - *Topeka Capital Markets - Analyst*

Good afternoon and congrats on the improvements you are making in the business Rusty. The question came up earlier about the delay in NextGen Now. I just want to drill down because as we sit here today that was running at least a year behind.

What was it in your inspection of that business that led you to estimate a timeline of 2017 now and can you talk about how that could get expedited as you drill down on that? Thanks.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Thanks Gene, appreciate the question. Certainly for those of you that have heard from me in the past you are aware of the fact that I have a good deal of experience in delivering, frankly, net new solutions from my experience at Pyxis. I really got in and examined where we were in the software development lifecycle, got a better understanding of where we are from a requirement standpoint and then really worked hard between Dan and myself and some external consultants to really help the team come to what we felt was a truly actionable project plan, program plan. That's where the date came out.

My job is to be transparent with my clients and my investors and so that's where we set today is 2017. That being said, I am right now for example, aggressively looking for a CTO that has the ability to really drive this program forward. I am starting to bring in external resources to look at how we can accelerate that timeline and then I'm also looking across the marketplace to make sure we have a full exhaustive understanding of the capabilities that might be out there. And so I'd say there's a number of levers that I am looking to pull, more granularity as we move down the path here. But I'm a believer in transparent processes, rigorous discipline, and client focused execution. So I think you will see all of those things start to really come to the table as we move forward through the next couple of quarters together.

Operator

George Hill, Deutsche Bank

George Hill - *Deutsche Bank - Analyst*

Good evening guys. Thanks for taking my question. I guess if I think about the little bit of guidance you guys provided, it looks like you had a nice step up in system sales this quarter. But it looks like it will revert closer to that \$16 million run rate in the back half of the year. I guess Don asked my question I'm going to ask it another way.



Was there any revenue concentration in the quarter and the software licenses and hardware line that kind of came through this quarter? Like, was there anything that popped in that was unexpected. And in my thinking about the back half of the year that \$16 millionish run rate seems to be the right way to think about how the business is trending?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

This is John. With regard to the current quarter we had good deal flow. There was no single deal that skewed this quarter particularly high; again, Q1 was low. With regard to subdividing some of the commentary I made regarding the second half into the individual revenue streams, that's more granular than we are prepared to get on this call.

George Hill - *Deutsche Bank - Analyst*

How about not asking revenue streams but can you talk about product strength? So is EMR product stronger than practice management, and is practice management stronger because ICD-10, is MIRTH stronger because is Mirth? Exchange functionality is one of the hot topics right now, can you talk about where you're seeing product stream?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

Between EHR and EPM we never get that granular when we talk about revenue streams. With regard to Mirth products that is one of the components of our subscription revenues so you can see the trend in that number year over year and sequentially.

George Hill - *Deutsche Bank - Analyst*

Fair enough, and Rusty, one quick last one for you. As we think about when the (inaudible) comes to market in 2017, will the plan be to try to migrate some of the smaller practices or some of the install software client people up to NG now? Or is the thought there that we are just going to go to new clients with that product? I'm trying to think about how much of the strategy is preserve and defend the base versus how much is going to be to migrate to new platform? Thanks.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

That's going to be a little bit of an evolving discussion as we move forward. Certainly today we are delivering great value to our clients through our core flagship platform but as we bring a cloud-based capability to the table that's more of a multi-tenant capability, I would think we would be attempting to do both.

We feel like first of all, there is a lot of greenfield in the smaller physician practice space and certainly a cloud-based product with a lower cost of operation is something that is attractive to that client base. And so that would certainly be an area of focus but we also feel like we can continue to provide more and more value and lower total cost of ownership not just through our hosting operations but in migrating some of our larger clients to this cloud based offering. So George, I would say it's probably a little of both.

Operator

Garen Sarafian, Citi Research.



Garen Sarafian - *Citi Research - Analyst*

Thanks for taking my questions. Couple follow up quick questions at this point. One was, last quarter you had indicated you weren't seeing as robust of a replacement market for the [core MER] (inaudible) management solution but obviously this quarter was 43% in improvement. How are you viewing the pipeline mixes? Has your view changed or is it still for the next few quarters more likely weighed towards greenfield opportunities?

John Stumpf - *Quality Systems, Inc. - Interim CFO*

This is John. As I mentioned our bookings this quarter had greenfield, we had opportunities and assistance sales, RCM, we also had sales to existing clientele. Pretty broad-based. I think that the dramatic uptick in bookings again from Q1 was the anomaly. This quarter was more what you would expect. Dan, do you want to add anything to that?

Dan Morefield - *Quality Systems, Inc. - COO*

The only thing I would add to that is that we have seen relatively the same mix quarter over quarter. Some adjustments that vary by quarter but again we haven't seen that overall mix change materially in a while.

Garen Sarafian - *Citi Research - Analyst*

Okay and then just as a follow-up. In Interoperability, you guys seem pretty comfortable with where you stand in interoperability. It's interesting that you aren't part of the [common alliance] that some of your peers promote. I'm just curious, how do you view this alliance and what advantage does not joining give you in the market are perhaps product development? Just tried to get a better idea of how you're thinking in this area.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

This is Rusty. Look I look at interoperability as a great boost not just for us but for the industry and the provider base, and the patient base as a whole. There's a number of different standards out there. Different organizations go after it, honestly I think they work that we did with all the other EHR vendors as well as the provider in Utah, where we are really looking rather than looking at any individual body really stepping back and saying -- how do we as a community work to create interoperability, not just to exchange data, but interoperability that's actually used inpatient care? And how do we measure that as an industry and make sure that we are challenging each other and our provider partners to effectively bring that information frictionlessly across into a provider patient interaction. We will continue to look at different bodies and different standards as we sit there today. We are comfortable that through our vendor agnostic open source Mirth capabilities that we are already significantly contributing to the conversation and the realities of interoperability.

Operator

This concludes the Q&A portion of our conference. I will now hand it back to Rusty for any closing comments or remarks.

Rusty Frantz - *Quality Systems, Inc. - President & COO*

Thank you and we really appreciate both the attendance and the questions today. As we look forward to continuing our journey on this path of further aligning our employees and our culture with the Company's future goals and objectives, we will continue to deliver increased value to our ambulatory clients.

We will continue to bring solutions to the market that allows these clients to quickly and easily adapt to evolving healthcare models. With healthcare continually changing at such a rapid pace our employee culture is an incredibly important boost to our ability to remain flexible and to enable our clients to thrive.



I am grateful to our employee base who has been very receptive of me as the CEO and really excited about some of the cohesive culture that I am seeing emerging in the organization. I look forward to continuing the conversation with you our investors, our clients, and our employees. So thank you for your participation today we look forward to keeping you apprised of our developments as we move forward in this exciting time. Bye now.

Operator

This concludes today's teleconference. If you would like to listen to a replay of today's conference please dial 800 585 8367 and refer to the conference ID number 58999378. A webcast archive of this call can also be found at www.qsii.com. Please disconnect your lines at this time and have a wonderful day.

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