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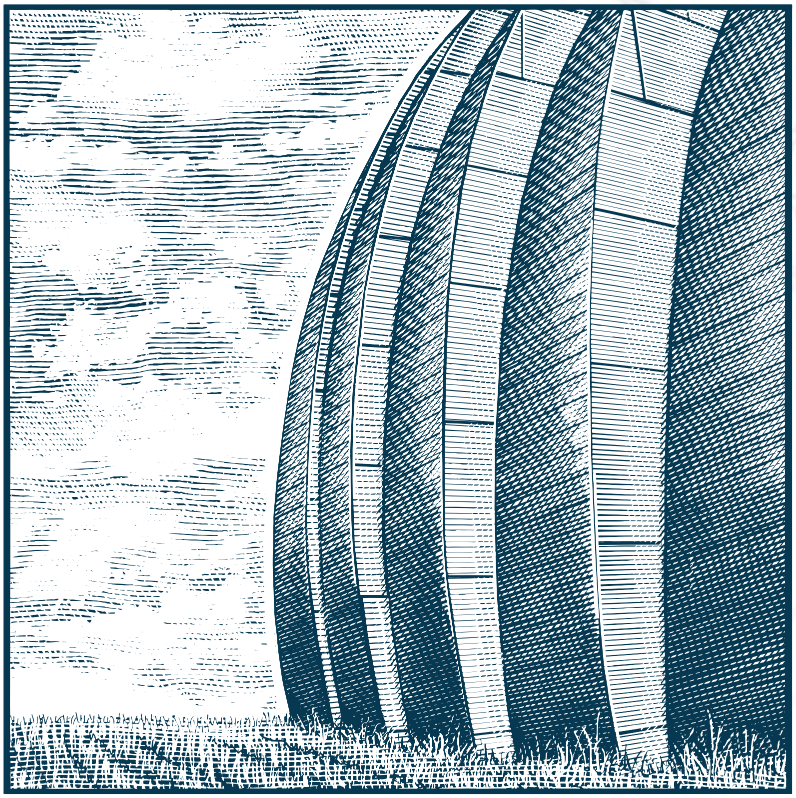
Crossroads Capital LLC

2017 Annual Letter | January 2018



Dear Friends,

We're happy to report that accounts managed by Crossroads Capital put up solid results in our first full year of operation, with the Crossroads equity composite returning 16.54% in 2017 and 31.8% since inception on June 6, 2016. Note that performance figures are calculated as of January 1, 2018 and are net of our 1.5% quarterly management fee and a 20% annual incentive fee.

Our annualized IRR to date of 19% is above our partnership's 15% hurdle rate for 3- to 5-year intervals. Moreover, we generated those returns while maintaining substantial cash balances, generally between 10% and 20% of our invested capital. As always, your own results and the composition of your individual holdings will differ somewhat, depending on when you joined the Crossroads Capital family.

Keep in mind that our relatively high cash level since inception isn't necessarily a reflection of bearishness on our part or a near-term call on the markets per se, as much a byproduct of our longstanding preference towards high levels of liquidity to help better manage risk as well as prepare for times of greater opportunity.

In short, so far so good.

But before we dive into the body of today's letter, we'd like to remind you that from our perspective evaluating investment performance over anything less than a multi-year timeframe is a relatively pointless endeavor. This is particularly true with a fundamental value strategy like ours, where "longterm" means at least 3 years, not 6 to 12 months. Moreover, because our strategy is highly concentrated, periods of significant volatility are par for the course. We advise limited partners to view our performance from a long-term perspective, just as we do. Quarterly – or even annual – returns may have little to no bearing on our performance over a full cycle.

Finally, as you all know, 2017 was an eventful year for us. We formally opened Crossroads to new investors, and we began registration processes with the State of Missouri, which we hope to have wrapped up by the end of Q2. We are immensely grateful for your trust and support through the early days of our fund. Managing your hard-earned money is a responsibility we will never take lightly.

R1 RCM Case Study (Updated Feb 22)

Given our mandate and focused approach, we can aggressively pursue compelling investment opportunities whenever and wherever they arrive. It's with this in mind that we'd like to introduce you to R1 RCM, or just "R1" for short – a resilient, non-cyclical, high-quality business that's been undergoing a value-unlocking transformation since we initiated our position in the low $2's in late 2016.

R1 is a leading provider of revenue cycle management services to hospital networks. That means it handles their front- and back-office needs, aiming to streamline operations, cut out unnecessary costs, and reduce billing errors, all in a bid to maximize revenues and profits. With hospitals facing tight 1-to-2 percent margins, R1 can make a big contribution, often doubling or even tripling their profitability over time.

To deliver those extra profits, R1 plugs directly into its clients' operations, tying its own differentiated IT and systems into hospital networks and working hand-in-hand with employees to eliminate margin-sapping inefficiency. With R1 on the scene, hospitals label patient visits more accurately, find more insurance options, and make sure everything gets properly billed. Moreover, by rationalizing vendors, moving hospitals to an offshore shared service platform (to benefit from labor arbitrage), and taking other cost-cutting measures, R1 is in a prime position to enhance its partners' – and its own – bottom line.

While it's a solid business today, R1 has a complicated history. In fact, R1 wasn't even always called R1 – it was originally known as Accretive Health, a spinoff of Ascension Health, the second-largest hospital system in the US. As Accretive, its troubles included:

+ being charged with abusive billing practices by the state of Minnesota,
+ being charged with failing to protect consumers' personal information by the FTC, and
+ a full-blown SEC investigation into aggressive revenue recognition from 2011 through 2013.

To make matters worse, in 2014 Accretive was delisted from the NYSE and banished to the OTC netherworld after missing a deadline to restate 2011-2013 results. Of course, problems like these did pretty much what one would expect for the share price: From above $30 in 2011, it crashed to below $10 in 2012, slumped below $5 in 2015, and even dipped below $2 for part of 2016. Then Ascension, the company's largest customer, smelled blood in the water – ultimately making a lowball bid to reacquire Accretive at roughly 50% below market value, threatening to pull its business if Accretive didn't fall in line.

Yet while the stock was tanking, the company itself was healing. First, in 2012, Accretive settled with the state of Minnesota while admitting no wrongdoing. Then, in 2013, it settled with the FTC and leadership changes were enacted, including the CEO and Chairman. Next, at the end of 2014, it filed restated earnings for the 2011-2013 period. Finally, in early 2016, it concluded a new agreement with Ascension that killed the take-under bid. Instead, Ascension bought $200 million worth of 8% convertible preferred shares in Accretive and got warrants for another 60 million in common shares. In exchange, it gave Accretive a new 10-year exclusive service contract and an enormous amount of new business. It was this new symbiotic arrangement that sparked our initial interest in a name that, at the time, was nothing short of despised. We pulled the trigger.

Fast forward to the start of 2017, and the company took further steps to dissociate itself from its difficult past, changing its name to R1 RCM and up-listing to the Nasdaq. Of course, we invested well ahead of these value-unlocking events in order to profit as R1's respectability rose phoenix-like from its own ashes. And that respectability recently reached new heights as management nailed down another highly accretive deal with another highly reputable client: Intermountain Healthcare.

R1's deal with Intermountain resembled the one with Ascension: Intermountain bought $20 million worth of R1 shares north of $4, with warrants for 1.5 million additional shares at $6 thrown in. In exchange, R1 got a 10-year exclusive service renewal and contract extension, plus rights to serve hospitals Intermountain might acquire later on. And by this point, the Ascension deal had been modified to grant R1 similar rights to serve hospitals Ascension might itself acquire down the road.

So where does all this leave R1 today?

The Ascension and Intermountain deals suggest that R1 has moved far beyond its days as scandalridden Accretive. They also mean that R1's two biggest revenue and cash flow streams will get materially bigger as R1 continues to onboard new hospitals over the next several years. Of course, to get a sense of what that's worth, we need to consider the normalized cash flow generation of the net patient revenue ("NPR") that R1 has under contract. And to do that, we can look to the company itself: Management recently estimated that for every $1 billion in NPR, R1 should earn about $45 million in recurring revenue. That means R1's annual revenue stands to grow several-fold from here…even if it never wins another client.

Where is all this NPR coming from? First, let's look at the Ascension deal. R1 already had $6 billion of Ascension's NPR under contract. The deal, in its final form, added $8 billion. And in Q1 2017, Ascension voluntarily added healthcare facilities representing another $1.5 billion in NPR into the mix. That move not only brought total incremental NPR from the deal to $9.5 billion, it was also a huge vote of confidence from Ascension, providing strong evidence that R1 is delivering the goods.

With all that NPR locked in, R1's annual revenue stands to almost triple to roughly $850 million solely from new business with Ascension as it exists today. And as Ascension acquires more hospitals with more NPR, more revenue to R1 should roll in. In fact, the first such deal is already underway: On February 15, Ascension reached a definitive agreement to acquire Chicago-based Presence Health, and its $2.2 billion in annual NPR. Naturally, given R1's contractual rights, Presence announced that it planned to use R1's services the very next day.

To us, the Presence deal looks like just the first in an eventual series of similar Ascension takeovers. For example, the Wall Street Journal reported last December that Ascension is in talks to acquire another hospital system, Providence St. Joseph (PSJ) in 2018, a deal that would result in R1 eventually onboarding PSJ's $17 billion of NPR, effectively doubling the size of R1's business overnight.

Keep in mind as well that, thus far, we've only looked at new NPR flowing from the Ascension deal. But the Intermountain deal was another big win for R1, putting over $4.6 billion in additional business under contract. And that figure represents less than 25% of Intermountain's total NPR, leaving plenty of incremental business for R1 to win as it proves its worth.

By 2021, all new Ascension- and Intermountain-related NPR should be fully onboarded, plausibly bringing R1's normalized annual revenue to $1.25 billion. Note that this estimate doesn't include likely additional contract wins from unrelated hospital networks. Furthermore, as the industry consolidates, with existing customers acquiring less-efficient peers, R1 should see significant revenue growth above and beyond what it gets from these initially-acquired chunks of NPR.

Now while embedded revenue growth is good to have, what we really care about is the bottom line. With that in mind, we should mention that all of R1's recent deals are based on its higher-margin "operating partner" model. That means R1 assumes direct responsibility for the cost of revenue cycle management in exchange for a base fee and incentive payments for hitting agreed-upon targets. Under such agreements, R1's margins start out below where they would be under a co-managed model, but end up higher as the company puts its people and systems in place and everything starts running more smoothly. This dynamic translates into EBITDA margins at maturity of roughly 25%, versus 18 to 20% under the old "co-managed" model.

With a 25% margin, we calculate that the Ascension deal alone should result in roughly $120 million in annual EBITDA for R1, once new NPR is fully onboarded. Tack on another $100 million or so from the Intermountain and Presence deals and existing NPR, and R1's annual normalized earnings capacity [EBITDA], assuming no further growth, comes to about $250 million.

Again, this figure includes nothing from the potential PSJ deal, which would layer on another ~$150 million in incremental EBITDA in one fell swoop. And while we hesitate to say the PSJ deal is a slam dunk, the industrial logic of the combination is compelling and the potential merger has been widely covered by the press. So we think it's more of a "when" than an "if" scenario. To put it another way, we believe the net present value ("NPV") from the PSJ deal alone will be larger than what investors can purchase R1's entire business for today.

Critically, we've sanity checked our numbers by cross-referencing management's estimates with figures for other players in the space. Pure play hospital RCM comps are hard to come by, and even then may have inferior services and less scale. Still, we take comfort in the fact that the RCM business segment of unlisted Conifer Health Systems enjoys EBITDA margins of around 18%, despite the company's much higher labor costs. Few Conifer employees are offshore, and with labor representing about 75% of its operating expenses, that extra cost has a big impact. By comparison, over 50% of R1's workforce is based in India, at a significantly lower cost per worker. With labor costs low, a 20% margin four years out (the low end of company guidance) seems quite conservative to us. As another reference point, the RCM segment of MedAssets (MDAS) was generating EBITDA margins of roughly 24% when Pamplona Capital acquired it in November 2015.

Given our revenue outlook and assuming 20% margins, R1 should post 2021 EBITDA of $250 million. Putting enterprise value at 13x EBITDA (reasonable to us on an absolute basis and given where private market multiples for revenue cycle management firms are more generally), gives us an EV of $3.24 billion four years out. Then subtract out Ascension's preferred shares, add back R1's cash and interim free cash flow, and you get an implied 2020 market cap of $3.52 billion. With 256 million shares outstanding (factoring in dilution from warrants and stock options), R1's fair value share price would be $13.70. That's almost three times where it trades today, resulting in an annualized IRR approaching 40%.

Why hasn't the market already given R1 full credit for its growth potential? We can think of many reasons but a few of the most likely include:

+ Some investors may still associate R1 with its past scandals as Accretive, despite the company's change in management and the fundamental transformation of its business model.

+ Until the beginning of last year, R1's revenue recognition policies, ironically adopted to avoid the problems of 2011-2013, were extremely confusing. Revenue was booked at the very end of a contract, when a hospital's savings had been realized (and, hence, R1's fees could be calculated). That meant R1's GAAP-based financials were a poor representation of its actual business activity, making its progress hard for a casual investor to see.

+ Fidelity sold off its own large position in R1 over several months in mid-2017, putting temporary downward pressure on the share price.

+ R1 is almost entirely uncovered by sell-side analysts at this point. Only Cowen seems to put out research at present, so the stock has not been on the institutional radar screen for a while.

In sum, we think the market will soon give R1 its due. CEO Joe Flanagan has a real owner-operator mentality and fills employees and investors with confidence. He's set an extensive series of quantitative, time-sensitive KPIs on the Ascension contract and seems to be meeting them. And management has spoken openly about progress on further M&A activity, which could result in more sell-side research coverage.

At any rate, it's not as though the market is completely ignoring R1. Its share price has more than doubled since we built our initial stake. But we believe the market hasn't fully recognized the dramatic rise in value per share since that time. Luckily, we think R1 is just getting started, and that's why it's one of our largest positions.

Housekeeping

As we've discussed, making our annual letters publicly available requires us to balance the desire to share our thoughts with the need to keep mum about opportunities we might want to exploit further.

Even so, our dedication to transparency and frequent communication with you will never change. You will always have direct access to discuss our investments as thoroughly as you wish; so if this annual letter - or any of our communications for that matter - leaves you with questions, just pick up the phone.

We want to reiterate as well that our letters will continue to include examples of the deep, fundamental due diligence at the heart of the Crossroads Capital investment process. And they'll still provide select commentary on recently initiated or exited investments, plus a summary of our outlook for the portfolio as a whole when merited. None of that is going anywhere.

Last but not least, we hope these letters will continue to show why we think Crossroads is uniquely advantaged in today's index-fueled world, where the secular megatrend of passive investing is causing significant distortions in equity markets. Indeed, upwards of a trillion dollars has been poured into passive strategies – and therefore, into a relatively small number of securities both large and liquid enough to readily absorb such huge inflows of capital. The result of this large-scale abandonment of active management, in our view, is that less attention is being paid to stocks outside the "indexing vortex", leaving many of them significantly undervalued. This phenomenon represents a wonderful opportunity for long-term value investors like us. Smaller, closely held, less liquid names are our bread and butter.

As always, we appreciate your confidence in us, and we look forward to updating you again on the fund's progress in early 2019. We will continue to do our absolute best to protect and grow your investment over time.

With our best regards,

Ryan O'Connor
Founder and Portfolio Manager
Crossroads Capital, LLC

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

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