Management CV

Update Note:
athenahealth, Inc. (ATHN)
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ATHN: A Lack of Discipline

When we first profiled athenahealth's CEO Jonathan Bush (45) the report title was "Good Vision with Sloppy Execution". That assessment still applies. Even though CEO Bush has delivered 30% annual sales growth at ATHN, the team has repeatedly missed guidance. Right place, right time, effects have made ATHN a momentum play in Healthcare despite frequent big EPS misses, the result of expenses rising much faster than revenues. CFO Tim Adams is leaving ATHN at the end of this month after just 4 years in the role, and we worry operating costs will continue to escalate. Karl Stubelis (48) was appointed acting CFO in May, replacing Adams (who is leaving to become CFO of Demandware). We remind investors that Adams was hired to clean up an accounting mess at ATHN. Due to his lack of prior CFO experience (he was the Controller at Sapient previously), lack of industry experience and short time with the firm, we don't think Stubelis is likely to be the permanent CFO (and it would be a further negative if he were). We don't expect much change under acting CFO Stubelis. We think CEO Bush shows little interest in cost discipline and operates virtually unchecked by a complacent Board. The inexperienced CFO exacerbates the ongoing concerns we have with this CEO and his team and the situation may worsen this year since Bush says he plans to spend aggressively on Sales and Marketing concurrent with increased R&D expenses.

Dominant CEO Takes Most of the Rewards Co-founder Bush continues to hold the triple titles of Chairman, CEO & President and collects the lion's share of management's incentive pay (62%), signaling a one man show. His outsized option grants are finally drawing complaints from investors and he garnered unwanted attention from David Einhorn at Monday's Sohn investment conference. Poor cost discipline and misaligned pay for performance are the reasons we rank Bush and the ATHN team poorly in our 4th quintile. The outsized equity pay of Bush has drawn the ire of outside investors, as reflected in only a 52% approval of ATHN's executive compensation plan last year. Such poor Say on Pay vote results are increasingly an anomaly at reputable firms. Generous serial option awards have nearly doubled CEO Bush's pay in just the last 3 years. In response to complaints from investors, the Board modified a 245k option grant to the CEO 2 years ago by making 50% of it subject to performance vesting, but then awarded Bush another 182k options last year. In the past 5 years, Bush has received cumulative grants totaling 885k shares representing about 2.4% of shares outstanding. Option based share dilution is a concern because the large option awards to Bush have resulted in a relatively high equity burn rate averaging 4% over the last 3 years. Notably, Bush is also the only officer awarded options. Grants to other executives are made in performance-based restricted stock units targeted at 4x salary for COO Park and 2.2x salary for other senior managers.

Generous Cash Pay and Poor Benchmarking The bonus metrics for management's annual incentives are client satisfaction (weighted 10%), bookings (weighted 30%), revenue (weighted 30%) and net income (weighted 30%). Target awards are 100% of salary for CEO Bush, 80% for COO Park and 60% for others. We think it shows poor alignment between pay and performance that annual incentives were paid at 91% to Bush and 95%-96% to other senior executives despite the senior team missing on their revenue and net income goals last year. The Board notes that CEO Bush's compensation package declined 11% last year to $8 million, but that was still 2x his 2011 pay. We also think the Board uses a poor benchmark for peer compensation as it is almost entirely comprised of software firms unconnected to the Healthcare industry and targets the CEO's cash compensation at the 75th percentile of that group. CEO Bush received a $540k salary, $491k annual incentive and options worth $7 million. Pay for departing CFO Adams was 4% lower than last year at $1.4 million, but 21% higher than 2 years ago. He was paid a $347k salary, $197k annual incentive and $800k of stock. CMO Cosinuke received a $1.2 million package, which was down 11% from last year and consisted of $300k in salary, a $169k annual incentive and stock valued at $746k. Group President Kahane's pay was $1.3 million, down 7% from last year and 81% from 2 years ago when

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he received a $5.4 million sign-on equity grant. COO Park's pay was down 26% from last year to $2 million but 19% higher than 2 years ago.

Big Insider Stakes but Recent Sustained Selling Directors' and Officers' equity skin-in-the-game is good at over 1.3 million shares and CEO Bush beneficially owns over 826k shares (a 2.16% stake). He holds stock worth about 7x his annual pay and has about 351k vested options. The CEO's options are deeply in the money at a $49 weighted average strike price. Other senior managers are also well-aligned with investors by their equity stakes. Departing CFO Adams has stock worth $5.3 million and 18k vested options which we think will represent a small overhang in the coming months. Group President Kahane has $11 million in stock (8.6x annual pay), COO Park has stock worth $6.4 million (3.2x annual pay) and 7k options, and CMO Cosinuke has $6.2 million in stock (5.1x annual pay) and 104k options. Insiders have been material net sellers in the last 6 months and there have been consistent and sizable sales by executives in the last 18 months. Adams sold 60k shares (52% of his beneficial stake) in prior months and Park and Cosinuke have each sold roughly one-third of their beneficial holdings. CEO Bush sold 150k shares (about 16% of his beneficial stake) but his significant option grants continue to vest. We like the Board's share ownership guidelines which are: 5x salary for the CEO, 3x for the CFO and 2x for other officers.

Aggressive SG&A Spending Management has used its cash flow primarily for organic growth and M&A. We think CFO Adams and COO Park have done a poor job in containing costs and growth in operating expenses has consistently exceeded sales growth. As a percentage of revenues, total operating expenses have jumped from 89.9% three years ago to 99% last year. CEO Bush says he is not concerned with the rising expense trend and said plans to spend on additional sales & marketing and significant R&D investment is needed this year. Management's M&A spending has generally been modest, focused on bolt-on deals like Proxsys and Healthcare Data Services to grow the cloud-based business, but management stepped up its game last year by closing its biggest transaction ever. The team paid $293 million and a 22% stock price premium to acquire Epocrates and its popular mobile app used by more than 338k physicians to check drug interactions. We think this deal was a smart move that gives ATHN an immediate footprint in a previously untapped physician market. Epocrates has major name recognition among physicians, 90% versus only 30% recognition of Athena's name. Prior cash expenditures have been questionable and, we think, unrelated to the firm's core business. Most notably, the Board approved the 2011 cash purchase of a $7 million waterfront estate on 396 acres in Maine for use as a conference and retreat facility. Management has plenty of capacity for more M&A with $65 million of cash and $90 million available on its bank lines of credit. Long-term debt is easily manageable at $188 million and only 2.8x annual EBITDA.

Other Fiduciary Issues We found no material conflicts or related party transactions. Readers of our prior reports on ATHN know that Jon Bush is the first cousin of former President George W. Bush. We think this Board needs an independent Chairman. Current Lead Director Brandon Hull has been on this Board since 1999, too long for us to have confidence in his independent thinking. Notably, Hull only owns about 27k shares despite his long tenure and annual grants worth $175k a year. Likewise, David Robinson's former role as COO makes his independence from the CEO questionable in our minds. We note the Board's positive changes to provisions for management severance in the event of a Change-in-Control (C-in-C) which have been improved by the addition of a prudent double-trigger. Due to his large option holdings, a C-in-C would trigger accelerated vesting worth about $25 million to CEO Bush. *End*

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