INTEROFFICE MEMORANDUM

TO: TRAVIS HUGHES, HUGHES & COMPANY
FROM: JOHN MCCARTHY
SUBJECT: TWENTY GOOD QUESTIONS
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1. **You invest around the intersection of healthcare+software+market leaders. What events or forces in your background and career has brought you to this intersection?**

Professionally, I was fortunate to work in venture, buyout, and growth equity before starting Hughes & Company. This gave me an appreciation for different investing styles and underwriting various types of risk. My experience also spanned generalist firms and specialist firms. The contrast illuminated the significant information advantage gained from sector specialization.

As I studied different industries during the early years of my career, the healthcare market stood out given its size, fragmentation, inefficiency, and macro-demographic trends. The healthcare market possessed long-term potential for differentiated investment returns.

Investing across different industries also exposed me to a wide range of business models. I found the high-margin, recurring revenue models in software and technology far superior to any other model.

On a personal level, my parents and grandparents taught me common sense, good decision-making skills, and how to treat people fairly. My parents ran their own small businesses, and one set of grandparents ran a farm. They were all entrepreneurs. Observing my family and how they worked exposed me to many valuable lessons about the entrepreneurial mindset and the realities of running businesses.

A combination of these influences led me to where I am today. I am fundamentally drawn to scalable, recurring revenue business models in large, inefficient markets. Healthcare is a complex, exciting market with many

opportunities to build interesting companies. We continue to see outsize potential where technology and healthcare intersect.

2. **For a relatively new firm, and a relatively small firm, you have assembled a team with a great deal of experience. Why did you take this approach and how did you do it?**

   My approach with people and teambuilding is simple. Work with people who care and share common values. Work with people who are curious and relentless. And then create opportunities and an environment for people to do their best work.

3. **You have some experience in venture capital, but you no longer participate in VC. Why did you make this decision?**

   Venture capital is the most difficult style of investing, in my opinion. Nonetheless, it is appealing and receives significant attention for good reason. There is potential for high returns, and, importantly, venture capital helps fuel innovation, a core driver of growth in our economy.

   A significant challenge with venture investing is underwriting undefined and unproven business models. With an early-stage startup, it is hard to assess the viability of the business model, even if the value proposition appears obvious. Will customers pay, and will the model scale and be profitable?

   Growth equity investing captures the best elements of venture capital and private equity. Our sweet spot is finding companies with proven business models and demonstrable product-market fit and where there is substantial growth potential. As private equity has become more mature, growth is where the greatest opportunity exists to generate outsize returns on a risk-adjusted basis. If we pick our spots correctly, the primary risk we are underwriting is execution. We can influence execution. It is much more challenging to influence market readiness and business model adoption.

4. You invest around the intersection of healthcare and technology. Do one of these tend to lead the other?

Not necessarily, which is why we continue to see extraordinary inefficiency in healthcare.

It took the HITECH Act of 2009 to force electronic health record (EHR) adoption. In 2008, only 9 percent of hospitals and 17 percent of office-based physicians utilized an EHR. By 2015, 96 percent of hospitals and 78 percent of office-based physicians utilized an EHR.

One would think that technology was advanced enough prior to 2008 to see adoption rates greater than 9 to 17 percent. One would also think that hospitals and physicians would see the opportunities to drive efficiency with technology and be quicker to adopt. Neither happened on its own.

It is a market with inherent adoption barriers due to sheer complexity.

Fax use is still widespread in healthcare. Data sharing and interoperability remains an issue despite the now widespread adoption of EHRs.

Technology adoption is much better than ten years ago, but still has a long way to go. As technology continues to take hold and gain deeper adoption over the next ten years, we will begin seeing a market that behaves more like more mature industry verticals like financial services.

5. You do work with various business founders or business builders. Any few traits that you admire the most?

Several important traits that immediately come to mind are grit, resiliency, curiosity, and a bias to action.

Another very important characteristic the best leaders possess is optimism grounded in reality. Strong leaders need to articulate a vision and inspire the team to follow. But great leaders must also be able to articulate the realities of the challenge. When things get difficult – and they almost always do – the team must be prepared with the appropriate tools, resources, and attitude to fight for the win. They cannot lose motivation or become discouraged.

Leaders who understand and promote realistic optimism create the most enduring, high-performance organizations.

6. **Do you have any favorite due diligence habits that you tend to employ over and over?**

   A habitually curious mindset trumps process. Question every assumption, continuously refine and test the investment thesis, do not stop on a question until you are satisfied with the answer, never underwrite heroics, and, most importantly, don't believe your own BS. When we tune our minds to habitual curiosity and intellectual honesty, our diligence will be comprehensive and exhaustive every time.

7. **What kind of things would make you walk away from an investment where you have exclusivity?**

   Reflecting on situations where we would walk away late in a process, it is almost always a question of integrity. When we start questioning the integrity of the numbers or the people, we know there is a problem. The way it manifests is typically subtle and part of a pattern only discernible with the benefit of time.

   For example, an inflated pipeline, chronically delayed bookings, or a pattern of not disclosing information management deems 'not material.' Five immaterial non-disclosures may or may not add up to something material. However, it can indicate either a lack of transparency or a lack of judgment – neither a good fact heading into a new partnership. In this instance, it is almost always best to take the cues and walk away.

8. Any common problems or obstacles to growth among your type of companies?

All bootstrapped growth companies, especially small-cap (<$20m in revenue) businesses, are fundamentally resource-constrained.

Common themes we see prior to our involvement are 1) no strategic finance leadership 2) limited sales resources 3) underinvestment in a scalable product organization.

This is not to suggest the companies are doing a bad job in these functional areas. In fact, they are typically doing an admirable job. These are scrappy organizations that figured out how to grow despite limited resources.

When we make an investment, we do not try to solve everything at once. We prioritize and judiciously focus resources to eliminate bottlenecks in a logical and systematic fashion.

9. Software-as-a Service: more product or more service in your view?

It is more product, although I would argue the service itself is part of the product and inherently embedded in the delivery mechanism. With SaaS, the end user is "consuming" a product. With any SaaS software solution, the customer typically receives something persistent that can be used over and over, as opposed to receiving a one-time service.

10. Among the investments you already have, what are some common characteristics that combine to make a large opportunity?

There is a saying that you need to think small to get big.

A common characteristic we see in successful growth companies is focus. Companies need to do one thing extremely well. And they need to say no to everything else. Say no to non-core products, non-core markets, and non-core clients.

Young companies often get criticized for pursuing a narrow market. Narrow does not necessarily mean small. What is defined as a narrow

market may be a sub-vertical of a larger market. If a company masters one sub-vertical, they earn the right to move into other related sub-verticals. The best companies learn to avoid temptation while remaining laser-focused on delivering valuable solutions better than anyone else.

11. You have experience as a minority and a majority investor. As a minority investor, how do you add value?

We do not distinguish in our approach between minority and majority investments. We believe in the importance of earning the right to an opinion irrespective of ownership stake. Earned trust establishes the basis for working with management teams to create value.

Everyone talks about alignment. Real alignment is quite challenging to achieve, and it is easy to fall into a false sense of alignment. Alignment does not mean we need to agree on the how; we need to agree on the what. Whether it is a minority or majority investment, we want to establish alignment on strategic direction and resource allocation – people, capital, and prioritization. Once that happens, we can execute a value creation plan around our four primary pillars: foundation-building, product, sales, and talent.

12. For executives, after general traits such as integrity, hard work ethic, etc., are there any traits that are particularly valuable in the intersection of technology and healthcare?

Leaders who are steadfast and persuasive are the most effective changemakers in healthcare technology. Convincing people to adopt new technology and processes in healthcare requires the ability to overcome deeply entrenched biases. Additionally, since patients and caregivers are the ultimate consumers of healthcare, executives with an empathetic yet highly disciplined style will win the confidence of customers, employees, and partners.

13. In your space, is change revolutionary or evolutionary?

It is evolutionary, in a glacial sense. The continued prevalence of CDs and faxes in healthcare is remarkable and indicative of the slow pace of change. A 2021 survey, for example, found that 80 percent of healthcare organizations still shared medical images using CDs. The challenges in healthcare are very complex and will take years to solve.

14. Also in your space, what are some attractive business model attributes?

We look for strong fundamental characteristics such as recurring revenue, high gross margins as an indicator of scalability, and high customer retention rates.

We also look for companies that are solving discrete problems in the healthcare value chain. Companies that effectively address cost, quality, productivity, and outcomes tend to be durable, defensible investments.

Beyond the financial metrics, the characteristics we desire are often manifested in high customer and employee satisfaction ratings.

15. It seems we are moving toward "value-based care", where health outcomes per unit of cost are measured. Is this a good thing for patients, physicians, and payors?

We strongly believe in the principles underpinning value-based care ("VBC"). The market talks about the triple aim in healthcare: reducing cost, improving care for individuals, and improving care for populations. When the triple aim is married with risk-based models that promote accountability, the result is value-based care.

Patients are the biggest winners. Quality of care is higher, and cost is lower. Employers are also significant winners, given their role as health plan sponsors. VBC arrangements are helping stem spiraling healthcare costs, and the models are still evolving.

There are a range of models that constitute value-based care, starting with one-sided shared saving programs to full population-based risk models, sometimes called capitation. Technology plays a vital role in enabling VBC, and we expect these models to mature and improve in the years ahead.

16. It seems increased resources are devoted to "revenue cycle management" or healthcare providers actually getting paid by payors. Will we be devoting the same amount of time and attention to this in the future or is this need going away?

Revenue cycle is a substantial administrative burden for the entire healthcare industry. The complexity in revenue cycle is unnecessarily high. The structural conflict inherent in the relationship between payers and providers complicates matters. Payers generally want to pay for less, while providers generally want to deliver more care, all of which gets manifested in the revenue cycle.

As a contrast, consider the speed and efficiency of a banking or credit card transaction. A complex array of data exchanges, authorizations, transaction routing, security verifications, and settlements occur in an instant. Why shouldn't healthcare revenue cycle function in the same manner?

We are optimistic that healthcare revenue cycle will eventually become more efficient given market, regulatory and technological forces.

17. Will technology lower healthcare costs? (This seems to be slow in coming.)

Yes, technology will continue to lower healthcare costs through efficiency and productivity gains.

Revenue cycle, from the prior question, is a good example. Components of revenue cycle, including transcription, coding, reconciliations, prior authorizations, and credentialing, are benefiting from the application of technologies such as rules-based automation and artificial intelligence.

In the care delivery environment, technology helps deliver better outcomes by putting increasingly rich information at physicians' fingertips. Doctors

can more effectively manage their patient populations with tools that allow them to identify gaps in care, employ preventative measures such as immunizations and recommended screenings, prescribe appropriate medications, and manage complex and high-risk populations.

Zooming out, it is easy to be skeptical about the impact of technology in healthcare. Healthcare is still challenging to navigate and overly complicated. But we are seeing progress at the ground level, and it will continue to improve in the years ahead.

18. The longer- term trend toward Urgent Care settings. Will this continue and is there an investment theme for investors?

The primary care model is undergoing a shift, and urgent care is part of that shift.

Think of primary care as the "front door" for medical care. However, a typical primary care doctor is not available on-demand, meaning patients must schedule an appointment and potentially wait for days. Historically, if a person required immediate care, they went to the emergency room.

Urgent care fills an important gap. If you develop an eye or ear infection over the weekend, for instance, you can now go to urgent care rather than an expensive visit to the ER.

From an investment perspective, there will likely be continued interest from investors in alternate primary care models. No one has yet figured out the ideal model. However, investors must recognize they will be competing with some well-capitalized companies. Amazon, Optum, large regional health systems, and many others are experimenting with alternative primary and urgent care models.

19. Did the pandemic bring into question the all-weather nature of healthcare? In other words, is there more elective, or consumer discretion in demand for healthcare services?

Yes, at the outset of pandemic, there was a question as to the durability of healthcare discretionary spending. Surgical procedures, both elective and non-elective, serves as a good proxy. The number of surgical procedures dropped precipitously – almost 50 percent – at the outset of the pandemic. Interestingly, by early 2021, surgical procedures, including elective procedures, quickly rebounded to pre-pandemic levels and largely made up for the one-time shock of the pandemic shutdown.

20. Many investors say selling well is harder than buying well. How do you decide when to sell?

Knowing when to sell is a difficult question, particularly for growth companies. We consider a variety of factors, including market conditions and company specific considerations including scale, momentum, and performance against our underwriting plan.

We also consider what is right for the business and leadership team. Often, as a company scales and a market vertical evolves, a company's long-term potential is best realized as part of another organization. As vertically-focused investors, we are able to closely monitor themes, trends, and competitive dynamics that may influence the timing of a sale.