

Performant Financial Corp
Form 10-Q
November 14, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 001-35628

PERFORMANT FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

20-0484934
(I.R.S. Employer
Identification No.)

Performant Financial Corporation

333 North Canyons Parkway

Livermore, CA 94551

(925) 960-4800

(Address, including zip code and telephone number, including area code of registrant's principal executive offices)

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

The number of shares of Common Stock outstanding as of November 12, 2012 was 45,320,606.

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PERFORMANT FINANCIAL CORPORATION
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2012

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Consolidated Balance Sheets

(In thousands)

(Unaudited)

	December 31, 2011 (Restated)	September 30, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$ 20,004	\$ 32,204
Trade accounts receivable, net of allowance for doubtful accounts of \$77 and \$64, respectively and estimated allowance for appeals of \$484 and \$1,112, respectively	19,398	24,132
Deferred income taxes	5,348	5,132
Prepaid expenses and other current assets	3,292	2,451
Income tax receivable		800
Debt issuance costs, current portion	595	1,140
Total current assets	48,637	65,859
Property, equipment, and leasehold improvements, net	14,915	18,237
Identifiable intangible assets, net	36,516	37,177
Goodwill	81,572	81,572
Debt issuance costs		4,112
Other assets	659	671
Total assets	\$ 182,299	\$ 207,628
Liabilities, Redeemable Preferred Stock and Stockholders (Deficit) Equity		
Liabilities:		
Current liabilities:		
Current maturities of notes payable	\$ 8,134	\$ 11,040
Accrued salaries and benefits	7,138	6,344
Accounts payable	60	1,578
Other current liabilities	8,475	8,213
Income taxes payable	470	
Deferred revenue	2,214	2,499
Estimated liability for appeals	450	3,655
Total current liabilities	26,941	33,329
Notes payable, net of current portion	87,051	139,489
Line of credit, drawn	8,198	
Deferred compensation	1,761	
Deferred income taxes	14,647	14,604
Other liabilities	1,158	2,890
Total liabilities	139,756	190,312
Commitments and contingencies		
Redeemable preferred stock		58,248

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Series A convertible preferred stock, \$0.0001 par value. Authorized, 18,000 and zero shares; issued and outstanding, 5,296 and zero shares at December 31, 2011 and September 30, 2012, respectively

Stockholders' (deficit) equity:

Due from stockholders	(2,266)	
Common stock, \$0.0001 par value. Authorized, 60,000 and 500,000 shares at December 31, 2011 and September 30, 2012, respectively; issued and outstanding 37,667 and 45,321 shares at December 31, 2011 and September 30, 2012, respectively	4	4
Additional paid-in capital	19,371	35,186
Accumulated deficit	(32,814)	(17,874)
Total stockholders' (deficit) equity	(15,705)	17,316
Total liabilities, redeemable preferred stock, and stockholders' (deficit) equity	\$ 182,299	\$ 207,628

The number of Series A convertible preferred shares outstanding, Series A Convertible Preferred Stock, the number of common shares outstanding, Common stock, and Additional paid-in capital have been restated to give effect to the two-for-one split. See Note 1 for additional information.

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Operations

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Revenues	\$ 42,009	\$ 53,400	\$ 120,333	\$ 154,099
Operating expenses:				
Salaries and benefits	16,456	21,003	50,437	59,426
Other operating expenses	13,613	18,240	35,193	53,053
Total operating expenses	30,069	39,243	85,630	112,479
Income from operations	11,940	14,157	34,703	41,620
Debt extinguishment costs				(3,679)
Interest expense	(3,366)	(3,175)	(10,213)	(9,329)
Interest income	31	2	94	64
Income before provision for income taxes	8,605	10,984	24,584	28,676
Provision for income taxes	3,439	4,601	9,839	11,698
Net income	\$ 5,166	\$ 6,383	\$ 14,745	\$ 16,978
Accrual for preferred stock dividends	1,660		4,785	2,038
Net income available to common shareholders	\$ 3,506	\$ 6,383	\$ 9,960	\$ 14,940
Net income per share attributable to common shareholders (see Note 1)				
Basic	\$ 0.08	\$ 0.14	\$ 0.23	\$ 0.34
Diluted	\$ 0.08	\$ 0.13	\$ 0.22	\$ 0.32
Weighted average shares (see Note 1)				
Basic	42,962	44,337	42,962	43,519
Diluted	45,024	47,811	44,646	47,164

Net income per share attributable to common shareholders and weighted average shares outstanding have been restated to give effect to the two-for-one split. See Note 1 for additional information

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Changes in Redeemable Preferred Stock and Stockholders' (Deficit) Equity

For the Nine Months Ended September 30, 2012

(In thousands)

(Unaudited)

	Redeemable Preferred Stock					Additional				
	Series A Convertible Preferred Stock		Series A Convertible Preferred Stock		Due From Stockholders	Common Stock		Paid-In Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount		Shares	Amount			
Balance, December 31, 2011 (as Reported)		\$	5,296	\$ 58,248	\$ (2,266)	37,667	\$ 4	\$ 19,371	\$ (32,814)	\$ 42,543
Adjustment	5,296	58,248	(5,296)	(58,248)						(58,248)
Balance, December 31, 2011 (as Restated)	5,296	\$ 58,248		\$	\$ (2,266)	37,667	\$ 4	\$ 19,371	\$ (32,814)	\$ (15,705)
Increase in redemption value of Series A preferred stock		2,038							(2,038)	(2,038)
Conversion of Series A Preferred Stock to Series B Preferred Stock which was immediately redeemed for cash		(60,286)								
Conversion of Series B Preferred Stock to common stock	(5,296)					5,296				
Exercise of stock options						213		137		137
Issuance of stock						2,243		15,640		15,640
Purchase of treasury stock						(98)		(1,225)		(1,225)
Interest on notes receivable from stockholders					(57)					(57)
Repayment of note receivable from stockholders					2,323					2,323
Stock-based compensation expense								883		883
Income tax benefit from employee stock options								380		380
Net income									16,978	16,978
Balance, September 30, 2012		\$		\$	\$	45,321	\$ 4	\$ 35,186	\$ (17,874)	\$ 17,316

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The number of Series A convertible preferred shares outstanding, Series A convertible preferred stock, the number of common shares outstanding, Common stock, and Additional paid-in capital have been restated to give effect to the two-for-one stock split. See Note 1 for additional information.

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2011	2012
Cash flows from operating activities:		
Net income	\$ 14,745	\$ 16,978
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposal of asset		52
Depreciation and amortization	5,712	7,002
Write-off of unamortized debt issuance costs		335
Deferred income taxes		173
Stock-based compensation	83	883
Interest expense from debt issuance costs and amortization of discount note payable	947	946
Interest income on notes receivable from stockholders	(80)	(57)
Changes in operating assets and liabilities:		
Trade accounts receivable	(3,216)	(4,734)
Prepaid expenses and other current assets	1,937	841
Income tax receivable		(800)
Other assets	30	(12)
Accrued salaries and benefits	1,141	(794)
Accounts payable	363	1,518
Other current liabilities	4,434	(1,262)
Income taxes payable		(90)
Deferred revenue		285
Estimated liability for appeals		3,205
Other liabilities	(91)	306
Net cash provided by operating activities	26,005	24,775
Cash flows from investing activities:		
Purchase of property, equipment, and leasehold improvements	(4,237)	(7,355)
Purchase of perpetual software license and computer equipment		(837)
Net cash used in investing activities	(4,237)	(8,192)
Cash flows from financing activities:		
Borrowing under notes payable		156,000
Borrowing under line of credit		4,500
Redemption of preferred stock		(60,286)
Repayment of notes payable	(11,074)	(100,656)
Repayment of line of credit		(12,698)
Debt issuance costs paid		(3,061)
Proceeds from exercise of stock options		137
Proceeds from issuance of stock		12,844
Receipt from stockholders		2,323
Payment to stockholders		(1,761)
Purchase of treasury stock		(1,225)
Payment of purchase obligation		(500)

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Net cash used in financing activities	(11,074)	(4,383)
Net increase in cash and cash equivalents	10,694	12,200
Cash and cash equivalents at beginning of year	11,078	20,004
Cash and cash equivalents at end of year	\$ 21,772	\$ 32,204
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	\$ 9,425	\$ 12,415
Cash paid for interest	8,489	8,358
Cash paid as debt extinguishment		3,344
Supplemental disclosure of non-cash investing and financing activities:		
Obligation to sellers of perpetual license	\$	\$ 3,250
Issuance of common stock as part of debt issuance costs		2,796

See accompanying notes to consolidated financial statements.

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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Notes To Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2011 and 2012

(Unaudited)

1. Organization and Description of Business

(a) Basis of Presentation and Organization

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles, or U.S. GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In the opinion of management, the unaudited interim financial statements furnished herein include all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of our and our subsidiaries' financial position at September 30, 2012, the results of our operations for the three and nine months ended September 30, 2011 and 2012 and cash flows for the nine months ended September 30, 2011 and 2012. Interim financial statements are prepared on a basis consistent with our annual financial statements. The financial statements included herein should be read in conjunction with the consolidated financial statements for the years ended December 31, 2009, 2010 and 2011 and notes included in our Registration Statement on Form S-1, which is referred to as our Registration Statement.

We are a leading provider of technology-enabled recovery and analytics services in the United States. Our services help identify, restructure and recover delinquent or defaulted assets and improper payments for both government and private clients in a broad range of markets. Our clients typically operate in complex and regulated environments and outsource their recovery needs in order to reduce losses on billions of dollars of defaulted student loans, improper healthcare payments and delinquent state tax and federal treasury receivables. We generally provide our services on an outsourced basis, where we handle many or all aspects of the clients' recovery processes.

Our consolidated financial statements include the operations of Performant Financial Corporation (PFC), its wholly owned subsidiary Performant Business Services, Inc., and its wholly owned subsidiaries Performant Recovery, Inc. (Recovery), and Performant Technologies, Inc. Effective August 13, 2012, we changed the name of our wholly owned subsidiary from DCS Business Services, Inc. (DCSBS) to Performant Business Services, Inc., and DCSBS' wholly owned subsidiaries from Diversified Collection Services, Inc. (DCS), and Vista Financial, Inc. (VFI), to Performant Recovery, Inc., and Performant Technologies, Inc., respectively. PFC is a Delaware corporation headquartered in California and was formed in 2003. Performant Business Services, Inc. is a Nevada corporation founded in 1997. Recovery is a California corporation founded in 1976. Performant Technologies, Inc. is a California corporation that was formed in 2004. All significant intercompany balances and transactions have been eliminated in consolidation.

We are managed and operated as one business, with a single management team that reports to the Chief Executive Officer.

The preparation of the consolidated financial statements in conformity with U.S. GAAP, requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, primarily accounts receivable, intangible assets, estimated liability for appeals, accrued expenses, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Our actual results could differ from those estimates.

As more fully described in Note 1 to the financial statements included in our Registration Statement, the accompanying financial statements have been restated to correct an error in the balance sheet presentation of the Company's Series A Convertible Preferred Stock. The purpose of the restatement is to classify the balances outside of permanent equity, as they are redeemable at the option of the holders. The following financial statement line items were affected (in thousands):

December 31, 2011	As originally reported	As adjusted	Effect of the change
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Redeemable preferred stock	\$	\$ 58,248	\$ 58,248
Total stockholders equity/deficit	42,543	(58,248)	(15,705)

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On July 26, 2012, the Company effected a two-for-one stock split of the Company's shares of Common Stock. Accordingly, all per share amounts, average shares outstanding, shares outstanding, and equity based compensation presented in the consolidated financial statements and notes have been adjusted retroactively to reflect the stock split. Shareholders' deficit has been retroactively adjusted to give effect to the stock split for all periods presented by reclassifying the par value of the additional shares issued in connection with the stock split to additional paid-in capital. Concurrently with the stock split, the authorized Common Stock was increased from 25,000,000 shares to 60,000,000 shares. On August 15, 2012, the authorized Common Stock was increased to 500,000,000 shares and the authorized preferred stock was increased to 50,000,000 shares.

(c) Revenues, Accounts Receivable, and Estimated Liability for Appeals

Revenue is recognized upon the collection of defaulted loan and debt payments. Loan rehabilitation revenue is recognized when the rehabilitated loans are sold (funded) by clients. Incentive revenue is recognized upon receipt of official notification of incentive award from customers. Under the Company's RAC contract with CMS, the Company recognizes revenues when the healthcare provider has paid CMS for a given claim or offset. Providers have the right to appeal a claim and may pursue additional appeals if the initial appeal is found in favor of CMS. The Company accrues an estimated liability for appeals based on the amount of commissions received which are subject to appeal and which the Company estimates are probable of being returned to providers following successful appeal. At December 31, 2011, a total of \$0.9 million was presented as an allowance against accounts receivable, representing the Company's estimate of claims that may be overturned. Of this amount, \$0.5 million was related to amounts in accounts receivable and \$0.5 million was related to commissions which had already been received. The Company has changed the presentation in its financial statements of its estimated liability with respect to commissions which have been received, from an allowance against accounts receivable to a liability captioned "estimated liability for appeals" at December 31, 2011. The \$0.5 million balance at December 31, 2011, and the \$3.7 million balance as of September 30, 2012, represents the Company's best estimate of the probable amount of losses related to appeals of claims for which commissions were previously collected and recognized as revenues at such dates. In addition to the \$3.7 million amount accrued at September 30, 2012, the Company estimates that it is reasonably possible that it could be required to pay an additional amount up to approximately \$1.5 million as a result of potentially successful appeals. To the extent that required payments by the Company exceed the amount accrued, revenues in the applicable period would be reduced by the amount of the excess.

2. Acquisition

In February 2012, we purchased a perpetual software license and computer equipment from HOPS, a non-public Florida company, in a transaction valued at \$3.7 million. The purchase agreement calls for a total of \$4.0 million in cash payments to be made over an approximate 3 year period, beginning with an initial payment of \$0.8 million which was made in February 2012, followed by quarterly payments of \$0.3 million. As part of the transaction valuation, these payments were discounted to a present value using an estimate of our incremental borrowing rate. The purchase is being treated as a business combination for accounting purposes; the following table summarizes the estimated fair values of the assets acquired at the acquisition date (in thousands):

	February 1, 2012
Computer equipment	\$ 280
Identifiable intangible assets	3,400
Total identifiable assets acquired	\$ 3,680

The following table summarizes the fair values of the intangible assets acquired from HOPS (in thousands):

	February 1, 2012
Perpetual license	\$ 3,250
Customer relationships	150

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Total	\$ 3,400
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The acquired intangible assets will be amortized over their estimated useful lives, which are 5 and 4 years for the perpetual license and customer relationships, respectively.

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The following represents our pro forma Consolidated Statements of Income as if HOPS had been included in our consolidated results for the three and nine months ending September 30, 2011 (in thousands, except per share data):

(unaudited)	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 30, 2011
Total revenue	\$ 42,323	\$ 121,275
Net income available to common shareholders	\$ 3,174	\$ 8,964
Earnings per share attributable to common shareholders		
Basic	\$ 0.07	\$ 0.21
Diluted	\$ 0.07	\$ 0.20

3. Property, Equipment, and Leasehold Improvements

Property, equipment, and leasehold improvements consist of the following at December 31, 2011 and September 30, 2012 (in thousands):

	December 31, 2011	September 30, 2012
Land	\$ 1,767	\$ 1,767
Building and leasehold improvements	4,797	5,019
Furniture, equipment, and automobile	3,612	4,125
Computer hardware and software	31,197	37,803
Total	41,373	48,714
Less accumulated depreciation and amortization	(26,458)	(30,477)
Total	\$ 14,915	\$ 18,237

Depreciation and amortization expense of property, equipment and leasehold improvements was \$1.2 million and \$1.5 million for the three months ended September 30, 2011 and 2012, respectively, and \$3.4 million and \$4.3 million for the nine months ended September 30, 2011 and 2012, respectively.

4. Identifiable Intangible Assets

Identifiable intangible assets consist of the following at December 31, 2011 and September 30, 2012 (in thousands):

December 31, 2011	Gross Amounts	Accumulated Amortization	Net
Amortizable intangibles:			
Customer contracts and related relationships	\$ 62,046	\$ (25,530)	\$ 36,516
Covenants not to compete	3,600	(3,600)	
Total intangible assets	\$ 65,646	\$ (29,130)	\$ 36,516

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September 30, 2012	Gross Amounts	Accumulated Amortization	Net
Amortizable intangibles:			
Customer contracts and related relationships	\$ 62,198	\$ (27,838)	\$ 34,360
Covenants not to compete	3,600	(3,600)	
Perpetual license	3,250	(433)	2,817
Total intangible assets	\$ 69,048	\$ (31,871)	\$ 37,177

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For the three and nine months ended September 30, 2011, amortization expense related to intangible assets amounted to \$0.8 million and \$2.3 million respectively. For the three and nine months ended September 30, 2012, amortization expense related to intangible assets amounted to \$0.9 million and \$2.7 million, respectively.

The estimated aggregate amortization expense for each of the five following fiscal years is as follows (in thousands):

Year Ending December 31,	Amount
Remainder of 2012	\$ 933
2013	3,731
2014	3,731
2015	3,731
2016	3,696
Thereafter	21,355
Total	\$ 37,177

5. Credit Agreement

On March 19, 2012 we recapitalized, entering into a credit agreement (the Agreement) consisting of a Term A Loan of \$57.0 million, a Term B Loan of \$79.5 million, and a revolving credit facility of \$11.0 million. In connection with the recapitalization, our old credit facility, scheduled to mature in 2012, was extinguished, and our indebtedness on the old facility was paid in full. On June 28, 2012, the Agreement was amended to increase the Term B Loan to \$99 million. Payments under the Agreement are as follows (in thousands):

Year Ending December 31,	Amount
Remainder of 2012	\$ 2,760
2013	11,040
2014	11,040
2015	11,040
2016	11,040
Thereafter	103,609
Total	\$ 150,529

Proceeds from the new Term A, Term B, and revolving credit facility borrowings were used along with \$14.5 million of our cash to repay our old notes payable and line of credit in the amount of \$103.4 million and to redeem 3,897,000 shares of Series A Convertible Preferred Stock plus accrued dividends for a total of \$44.0 million. Fees paid in conjunction with the credit agreement totaled \$6.5 million, including an agency fee for \$1.5 million to an entity associated with our majority stockholder, and an agreement to grant 215,000 shares of Common Stock valued at approximately \$2.8 million to an investment bank acting as advisor.

Proceeds from the additional Term B borrowings were used to redeem the remaining 1,399,000 shares of Series A Convertible Preferred Stock outstanding plus accrued dividends for a total of \$16.3 million. Fees paid in conjunction with the credit agreement totaled \$0.8 million, including an agency fee for \$0.2 million to an entity associated with our majority stockholder. Remaining proceeds of \$2.3 million were used along with existing cash to pay off the line of credit balance of \$4.5 million.

The Term A Loan is charged interest either at Prime (subject to a 2.50% floor) +4.25% or LIBOR (subject to a 1.50% floor) +5.25%, which was 6.75% at September 30, 2012. The Term A loan requires quarterly payments of \$2.5 million beginning in June 2012, with the remaining outstanding principal balance due March 19, 2017.

The Term B loan is charged interest at Prime +4.75% (subject to a 2.50% floor) or LIBOR (subject to a 1.50% floor) +5.75% which was 7.25% at September 30, 2012. The Term B loan requires quarterly payments of \$0.2 million beginning in June 2012, with the outstanding principal

balance due March 19, 2018.

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We have a line of credit under the Agreement which allows for borrowings of up to \$11 million. Borrowings accrue interest at Prime + 4.25% or LIBOR + 5.25%, which was 7.5% at September 30, 2012. Both the Prime and the LIBOR alternatives are subject to minimum rate floors. There were no outstanding borrowings under this line of credit at September 30, 2012, and a letter of credit outstanding in the amount of \$1.4 million, leaving remaining borrowing capacity under the line of credit of \$9.6 million at September 30, 2012. The line of credit expires in March 19, 2017.

The Agreement contains certain restrictive financial covenants, which require, among other things, that we meet a minimum fixed charge coverage ratio and maximum total debt to EBITDA ratio.

During our March 19, 2012 recapitalization, debt issuance costs of \$5.0 million were capitalized, including \$1.5 million of agent fees paid to an entity associated with our majority stockholder, and \$0.8 million paid to third parties for legal and other services and a grant of 215,044 shares of Common Stock issued as compensation to an investment bank acting as financial advisor valued at approximately \$2.8 million, based upon a price of \$13 per share. These costs are being amortized to expense over the life of the new loans.

We capitalized an additional \$0.8 million related to our June 28, 2012 amendment to the Agreement, which included \$0.2 million of agent fees paid to an entity associated with our majority stockholders, and \$0.04 million paid to third parties for legal and other services. Debt issuance costs are being amortized to interest expense over the life of the new loans. Accumulated amortization of debt issuance costs amounted to \$0.6 million at September 30, 2012.

Debt extinguishment costs of \$3.7 million were expensed, including \$3.3 million of fees paid to lenders, and \$0.3 million of unamortized debt issuance costs associated with the old credit facility.

6. Commitments under Operating Leases

We lease office facilities and certain equipment. In January 2012, we renewed two of our facilities leases and entered into a new lease agreement for approximately 6,000 square feet in Livermore, California.

Future minimum rental commitments under non-cancelable leases as of September 30, 2012 are as follows (in thousands):

Year Ending December 31,	Amount
Remainder of 2012	\$ 413
2013	1,620
2014	1,643
2015	1,272
2016	838
Thereafter	628
Total	\$ 6,414

Lease expense was \$0.5 million and \$1.5 million respectively, for the three and nine months ended September 30, 2011, and \$0.6 million and \$1.9 million for the three and nine months ended September 30, 2012, respectively.

7. Capital Stock

(a) Redemption of Series A Preferred Stock

On March 19, 2012, we recapitalized. As part of the recapitalization, 3,897,000 shares of Series A Convertible Preferred Stock were converted into conversion units, which consisted of one share of Series B Preferred Stock and one share of Common Stock. The Series B Preferred shares plus accrued dividends were redeemed for cash of \$44 million, and 3,897,000 shares of Common Stock were issued to the holders of the redeemed Series A Convertible Preferred Stock.

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In June 2012, the remaining 1,399,000 shares of Series A Convertible Preferred Stock were converted into conversion units of one share of Series B Preferred Stock and one share of Common Stock. The shares Series B Preferred Stock plus accrued dividends were redeemed for cash of \$16.3 million and 1,399,000 shares of Common Stock were issued to the holders of the redeemed Series A Convertible Preferred Stock.

Table of Contents**(b) Issuance of Shares of Common Stock as Compensation**

As part of the March 19, 2012 recapitalization, the Company issued to its financial advisor as compensation in connection with the debt portion of the recapitalization 215,044 shares of Common Stock valued at approximately \$2.8 million based upon a price of \$13 per share. This amount represents debt issuance costs and is being amortized to expense over the 5 to 6 year life of the loans described in Note 5.

(c) Initial Public Offering

In August 2012, we completed our initial public offering (IPO) in which we issued and sold 1,924,000 shares of Common Stock at a public offering price of \$9.00 per share. We received net proceeds of \$12.8 million after deducting underwriter discounts and commissions of \$1.0 million and other offering expenses of approximately \$3.4 million. In addition, a financial advisor to the Company was paid \$0.9 million through the issuance of 103,500 shares of Common Stock valued at \$9.00 per share.

8. Stock-based Compensation

Total stock-based compensation expense charged as salaries and benefits expense in the consolidated statements of operations was \$0.03 million and \$0.08 million, respectively, for the three and nine months ended September 30, 2011 and \$0.8 million and \$0.9 million, respectively for the three and nine months ended September 30, 2012.

Options have been granted, exercised, and canceled as follows:

	Outstanding Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Life
Outstanding at December 31, 2011	5,664,750	\$ 0.80	5.2
Granted	2,464,109	10.40	
Forfeited	(2,700)	1.31	
Exercised	(213,440)	0.64	
Outstanding at September 30, 2012	7,912,719	\$ 3.79	6.1
Exercisable at September 30, 2012	4,791,943	\$ 0.61	4.0

The Company's board of directors and stockholders approved the 2012 Stock Incentive Plan, or the 2012 Plan, in July 2012. The 2012 Plan became effective immediately prior to the Company's August 9, 2012 effective date, and will expire on July 19, 2022, unless extended by approval of the Company's board of directors and stockholders. The 2012 Plan provides for the granting of incentive stock options within the meaning of Section 422 of the Code to employees and the granting of nonstatutory stock options, restricted stock, stock appreciation rights, stock unit awards and cash-based awards to employees, non-employee directors and consultants. The Company has reserved 4,300,000 shares of common stock under the 2012 Plan.

On August 10, 2012, the Company's board of directors awarded a total of 2,364,000 options to employees. We estimated the fair value of the August 10, 2012 grant to be \$11.4 million using a Black-Scholes option pricing model, and the following assumptions:

Expected dividend yield	
Risk-free interest rate	1.01%
Expected volatility	48.3%
Expected life	6.5

The estimated value of the August 10, 2012 grant is being amortized to salaries and benefits expense over a five year period.

9. Income Taxes

Our effective income tax rate changed slightly from 40.0% for the nine months ended September 30, 2011 to 40.8% for the nine months ended September 30, 2012.

We file income tax returns with the U.S. federal government and various state jurisdictions. We are no longer subject to U.S. federal income tax examinations for years before 2008. We operate in a number of state and local jurisdictions, most of which have never audited our records. Accordingly, we are subject to state and local income tax examinations based upon the various statutes of limitations in each jurisdiction. We are currently being examined by the IRS and California.

10. Earnings per Share

Basic income per share is calculated by dividing net income available to holders of Common Stock by the sum of the weighted average number of shares of Common Stock outstanding during the period plus the weighted average number of shares of Series A Convertible Preferred Stock outstanding during the period. The shares of Series A Convertible Preferred Stock are included in the basic denominator because they can be converted into shares of Common Stock for no cash consideration, and are thus considered outstanding shares of Common Stock in computing basic earnings per share. Diluted income per share is calculated by dividing net income available to common shareholders by the weighted average number of shares of Common Stock and dilutive common share equivalents outstanding during the period. Common share equivalents consist of stock options and restricted stock units. The Company excluded from the calculation of diluted earnings per share for the three months and nine months ended September 30, 2012 options to purchase 2,364,000 shares whose combined exercise price, unamortized fair value and excess tax benefits were greater in each of those periods than the average price for the Company's common stock because their effect would be anti-dilutive.

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The following table reconciles the basic to diluted weighted average shares outstanding using the treasury stock method (shares in thousands):

	Nine Months			
	Three Months		Ended September 30,	
	Ended September 30, 2011	2012	2011	2012
Weighted average shares outstanding - basic	42,962	44,337	42,962	43,519
Diluted effect of stock options	2,062	3,474	1,684	3,645
Weighted average shares outstanding - diluted	45,024	47,811	44,646	47,164

11. Related Party Transactions

Our notes payable, both before and after the recapitalization of March 19, 2012, are held by a number of lenders, some of whom also invested in our stock. As a result, these entities are considered related parties. Interest expense under these arrangements totaled \$3.4 million and \$10.2 million for the three and nine months ended September 30, 2011, respectively, and \$3.1 million and \$9.2 million for the three and nine months ended September 30, 2012, respectively, and debt extinguishment expense associated with the recapitalization totaled \$3.7 million for the nine months ended September 30, 2012.

In an agreement dated April 13, 2012, the Company and an affiliate of Parthenon Capital Partners terminated an existing advisory services agreement, which called for quarterly payments of \$0.1 million. As part of the April 13, 2012 termination agreement, the Company agreed to pay Parthenon Capital \$1.3 million in equal quarterly installments of \$0.1 million beginning in April 2012, provided that the remaining balance will become due and payable immediately upon the closing of an IPO or the sale of the Company. The Company paid two quarterly installments of \$0.1 million and paid the remaining balance of \$1.1 million on August 15, 2012, the date the IPO closed. The Company accrued expense of \$1.3 million in the second quarter of 2012 to account for the termination agreement. In addition, the agreement specifies that the affiliate will be due a fee equal to 1% of the aggregate gross proceeds of an IPO offering or 1% of the aggregate consideration paid in connection with the sale of the Company, as applicable. The Company expensed and paid \$0.9 million to Parthenon Capital Partners in August 2012 upon successful closing of the IPO.

12. Subsequent Events

We have evaluated subsequent events through the date these consolidated financial statements were issued and there are no other events that have occurred that would require adjustments or disclosure to our consolidated financial statements.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion in conjunction with our condensed consolidated financial statements (unaudited) and related notes included elsewhere in this report. This report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The words believe, may, will, estimate, continue, anticipate, design, intend, expect and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and trends that we believe may affect our financial condition, results of operations, strategy, short-term and long-term business operations and objectives, and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Risk Factors under Item 1A of Part II of this report. In light of these risks, uncertainties and assumptions, the forward-looking events and trends discussed in this report may not occur, and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements. Forward-looking statements include, but are not limited to, statements about: our opportunities and expectations for growth in the student lending, healthcare and other markets; anticipated trends and challenges in our business and competition in the markets in which we operate; our client relationships and future growth opportunities; the adaptability of our technology platform to new markets and processes; our ability to invest in and utilize our data and analytics capabilities to expand our capabilities; our belief that we benefit from a significant degree of revenue visibility; our growth strategy of expanding in our existing markets and considering strategic alliances or acquisitions; our ability to meet our liquidity and working capital needs; maintaining, protecting and enhancing our intellectual property; our expectations regarding future expenses; expected future financial performance; and our ability to comply with and adapt to industry regulations and compliance demands. The forward-looking statements in this report speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Overview

We provide technology-enabled recovery and related analytics services in the United States. Our services help identify and recover delinquent or defaulted assets and improper payments for both government and private clients in a broad range of markets. Our clients typically operate in complex and regulated environments and outsource their recovery needs in order to reduce losses on billions of dollars of defaulted student loans, improper healthcare payments and delinquent state tax and federal treasury and other receivables. We generally provide our services on an outsourced basis, where we handle many or all aspects of our clients' recovery processes.

Our revenue model is generally success-based as we earn fees on the aggregate amount of funds that we enable our clients to recover. Our services do not require any significant upfront investments by our clients and offer our clients the opportunity to recover significant funds otherwise lost. Because our model is based upon the success of our efforts and the dollars we enable our clients to recover, our business objectives are aligned with those of our clients and we are generally not reliant on their spending budgets. Furthermore, our business model does not require significant capital expenditures and we do not purchase loans or obligations. We believe we benefit from a significant degree of revenue visibility due to predictable recovery outcomes in a substantial portion of our business.

Recent Developments

On November 13, 2012, we announced that we received notification that, due to the effects of Hurricane Sandy, we must temporarily suspend certain Medicare audit and recovery activities in three of the twelve states where we are the prime Medicare audit contractor. We will be unable to submit requests for medical records from healthcare providers in the states of New York, New Jersey and Connecticut and will not be permitted to submit claims to providers in these states for at least 30 days. Providers located within designated Federal disaster areas will receive this relief for a period of at least 60 days. We do not believe the temporary suspension of audit and recovery activities will have a material impact on our expected fourth quarter and 2012 full year results due to our understanding that claims made prior to November 7, 2012 will continue to be processed. However, we also expect that there may be a delay in the recognition of some revenues that would have otherwise been recorded during the first quarter of 2013.

This report corrects an error in our earnings press release dated on November 5, 2012 with respect to the number of diluted common shares outstanding for the three months and nine months ended September 30, 2012. The actual number of diluted common shares for the three months and nine months ended September 30, 2012 are 47,811 thousand and 47,164 thousand, respectively rather than 48,674 thousand and 47,133 thousand, respectively. This error did not impact any other amounts in the unaudited consolidated financial statements reported in the earnings press release.

Sources of Revenues

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We derive our revenues from services for clients in a variety of different markets. These markets include our two largest markets, student lending and healthcare, as well as our other markets which include but are not limited to delinquent state taxes and federal Treasury and other receivables.

	2009	Year Ended December 31,		Nine Months Ended September 30,	
		2010	2011	2011	2012
			(in thousands)		
Student Lending	\$ 84,056	\$ 103,672	\$ 122,253	\$ 91,578	\$ 98,232
Healthcare		1,821	21,549	14,406	39,093
Other	25,776	18,026	19,172	14,349	16,774
Total Revenues	\$ 109,832	\$ 123,519	\$ 162,974	\$ 120,333	\$ 154,099

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Student Lending

We derive the majority of our revenues from the recovery of student loans. These revenues are contract-based and consist primarily of contingency fees based on a specified percentage of the amount we enable our clients to recover. Our contingency fee percentage for a particular recovery depends on the type of recovery facilitated. We also receive incremental performance incentives based upon our performance as compared to other contractors with the Department of Education, which are comprised of additional inventory allocation volumes and incentive fees.

We believe the size and the composition of our student loan inventory at any point provides us with a significant degree of revenue visibility for our student loan revenues. Based on data compiled from over two decades of experience with the recovery of defaulted student loans, at the time we receive a placement of student loans, we are able to make a reasonably accurate estimate of the recovery outcomes likely to be derived from such placement and the revenues we are likely able to generate based on the anticipated recovery outcomes.

There are five potential outcomes to the student loan recovery process from which we generate revenues. These outcomes include: full repayment, recurring payments, rehabilitation, loan restructuring and wage garnishment. Of these five potential outcomes, our ability to rehabilitate defaulted student loans is the most significant component of our revenues in this market. Generally, a loan is considered successfully rehabilitated after the student loan borrower has made nine consecutive qualifying monthly payments and our client has notified us that it is recalling the loan. Once we have structured and implemented a repayment program for a defaulted borrower, we (i) earn a percentage of each periodic payment collected up to and including the final periodic payment prior to the loan being considered rehabilitated by our clients, and (ii) if the loan is rehabilitated, then we are paid a one-time percentage of the total amount of the remaining unpaid balance. The fees we are paid vary by recovery outcome as well as by contract. For non-government-supported student loans we are generally only paid contingency fees on two outcomes: full repayment or recurring repayments. The table below describes our typical fee structure for each of these five outcomes.

Student Loan Recovery Outcomes

Full Repayment	Recurring Payments	Rehabilitation	Loan Restructuring	Wage Garnishment
Repayment in full of the loan	Regular structured payments, typically according to a renegotiated payment plan	After a defaulted borrower has made nine consecutive recurring payments, the loan is eligible for rehabilitation	Restructure and consolidate a number of outstanding loans into a single loan, typically with one monthly payment and an extended maturity	If we are unable to obtain voluntary repayment, payments may be obtained through wage garnishment after certain administrative requirements are met
We are paid a percentage of the full payment that is made	We are paid a percentage of each payment	We are paid based on a percentage of the overall value of the rehabilitated loan	We are paid based on a percentage of overall value of the restructured loan	We are paid a percentage of each payment

For certain guaranty agency, or GA, clients, we have entered into Master Service Agreements, or MSAs. Under these agreements, clients provide their entire inventory of outsourced loans or receivables to us for recovery on an exclusive basis, rather than just a portion, as with traditional contracts that are split among various service providers. In certain circumstances, we engage subcontractors to assist in the recovery of a portion of the client's portfolio. We also receive success fees for the recovery of loans under MSAs and our revenues under MSA arrangements include fees earned by the activities of our subcontractors. As of September 30, 2012, we had four MSA clients in the student loan market.

Healthcare

We derive revenues from the healthcare market primarily from our Recovery Audit Contractor, or RAC, contract, under which we are the prime contractor responsible for detecting improperly paid Part A and Part B Medicare claims in 12 states in the Northeastern United States. Revenues earned under the RAC contract are driven by the identification of improperly paid Medicare claims through both automated and manual review of such claims. We are paid contingency fees by the Centers for Medicare and Medicaid Services, or CMS, based on a percentage of the dollar amount of claims recovered by CMS as a result of our efforts. We recognize revenue when the provider pays CMS or incurs an offset against future Medicare claims. The revenues we recognize are net of our estimate of claims that will be overturned by appeal following payment by the provider.

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To accelerate our ability to provide Medicare audit and recovery services across our region following our award of the RAC contract, we outsourced certain aspects of our healthcare recovery process to three different subcontractors. Two of these subcontractors provide a specific service to us in connection with our claims recovery process, and one subcontractor is engaged to provide all of the audit and recovery services for claims within a portion of our region. According to CMS, the geographic area allocated to this subcontractor represented approximately 17% of the total Medicare spending in our region in 2009. We recognize all of the revenues generated by the claims recovered through these subcontractor relationships, and we recognize the fees that we pay to these subcontractors in our expenses.

Other

We also derive revenues from the recovery of delinquent state taxes, and federal Treasury and other receivables, default aversion services for certain clients including financial institutions and the licensing of hosted technology solutions to certain clients. For our hosted technology services, we license our system and integrate our technology into our clients' operations, for which we are paid a licensing fee. Our revenues for these services include contingency fees, fees based on dedicated headcount to our clients and hosted technology licensing fees.

Operating Metrics

We monitor a number of operating metrics in order to evaluate our business and make decisions regarding our corporate strategy. These key metrics include Placement Volume, Placement Revenue as a Percentage of Placement Volume, Net Claim Recovery Volume and Claim Recovery Fee Rate.

	2009	Year Ended December 31, 2010	2011	Nine Months Ended September 30, 2011	2012
	(dollars in thousands)				
Student Lending:					
Placement Volume	\$ 4,920,506	\$ 5,294,971	\$ 6,241,483	\$ 4,747,518	\$ 3,600,495
Placement Revenue as a percentage of Placement Volume	1.71%	1.96%	1.96%	1.93%	2.73%
Healthcare:					
Net Claim Recovery Volume	\$	\$ 15,494	\$ 188,573	\$ 125,689	\$ 343,794
Claim Recovery Fee Rate		11.76%	11.43%	11.46%	11.37%

Placement Volume. Our Placement Volume represents the dollar volume of defaulted student loans first placed with us during the specified period by public and private clients for recovery. Placement Volume allows us to measure and track trends in the amount of inventory our clients in the student lending market are placing with us during any period. The revenues associated with the recovery of a portion of these loans may be recognized in subsequent accounting periods, which assists management in estimating future revenues and in allocating resources necessary to address current Placement Volumes.

Placement Revenue as a Percentage of Placement Volume. Placement Revenue as a Percentage of Placement Volume is calculated by dividing revenues recognized during the specified period by Placement Volume first placed with us during that same period. This metric is subject to some level of variation from period to period based upon certain timing differences including, but not limited to, the timing of placements received by us within a period and the fact that a significant portion of revenues recognized in a current period is often generated from the Placement Volume received in prior periods. However, we believe that this metric provides a useful indication of the revenues we are generating from Placement Volumes on an ongoing basis and provides management with an indication of the relative efficiency of our recovery operations from period to period.

Net Claim Recovery Volume. Our Net Claim Recovery Volume measures the dollar volume of improper Medicare claims that we have recovered for CMS during the applicable period net of any amount that we have reserved to cover appeals by healthcare providers. We are paid recovery fees as a percentage of this recovered claim volume. We calculate this metric by dividing our claim recovery revenues by our Claim Recovery Fee Rate. This metric shows trends in the volume of improper payments within our region and allows management to measure our success in finding these improper payments, over time.

Claim Recovery Fee Rate. Our Claim Recovery Fee Rate represents the weighted-average percentage of our fees compared to amounts recovered by CMS. This percentage primarily depends on the method of recovery and, in some cases, the type of improper payment that we identify. This metric helps management measure the amount of revenues we generate from Net Claim Recovery Volume.

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Costs and Expenses

We generally report two categories of operating expenses: salaries and benefits and other operating expense. Salaries and benefits expenses consist primarily of salaries and performance incentives paid and benefits provided to our employees. Other operating expense includes expenses related to our use of subcontractors, other production related expenses, including costs associated with data processing, retrieval of medical records, printing and mailing services, amortization and other outside services, as well as general corporate and administrative expenses. In addition to our main components of operating expenses, in 2011 we incurred a \$13.4 million impairment expense to write off the carrying amount of the trade name intangible asset due to our plan to retire our Diversified Collection Services, Inc. trade name, which we report as impairment of trade name. We expect a significant portion of our expenses to increase as we grow our business. However, we expect certain expenses, including our corporate and general administrative expenses, to grow at a slower rate than our revenues. As a result, and over the long term, we expect our overall expenses to modestly decline as a percentage of revenues.

We also expect to incur additional professional fees and other expenses resulting from future expansion and the compliance requirements of operating as a public company, including increased audit and legal expenses, investor relations expenses, increased insurance expenses, particularly for directors and officers liability insurance, and the costs of complying with Section 404 of the Sarbanes-Oxley Act. While these costs may initially increase as a percentage of our revenues, we expect that in the future these expenses will increase at a slower rate than our overall business volume, and that they will eventually represent a smaller percentage of our revenues.

Factors Affecting Our Operating Results

Our results of operations are influenced by a number of factors, including allocation of placement volume, claim recovery volume, contingency fees, regulatory matters, effects of client concentration and macroeconomic factors.

Allocation of Placement Volume

Our clients have the right to unilaterally set and increase or reduce the volume of defaulted student loans or other receivables that we service at any given time. In addition, many of our recovery contracts for student loans and other receivables are not exclusive, with our clients retaining multiple service providers to service portions of their portfolios. Accordingly, the number of delinquent student loans or other receivables that are placed with us may vary from time to time, which may have a significant effect on the amount and timing of our revenues. We believe the major factors that influence the number of placements we receive from our clients in the student loan market include our performance under our existing contracts and our ability to perform well against competitors for a particular client. To the extent that we perform well under our existing contracts and differentiate our services from those of our competitors, we may receive a relatively greater number of placements under these existing contracts and may improve our ability to obtain future contracts from these clients and other potential clients. Further, delays in placement volume, as well as acceleration of placement volume, from any of our large clients may cause our revenues and operating results to vary from quarter to quarter.

Typically we are able to anticipate with reasonable accuracy the timing and volume of placements of defaulted student loans and other receivables based on historical patterns and regular communication with our clients. Occasionally, however, placements are delayed due to factors outside of our control. For example, a technology system upgrade at the Department of Education, which began in September 2011, has significantly decreased the volume of student loan placements by the Department of Education to all recovery vendors, including us, since that time. As a result, the dollar amount of placements that we received from the Department of Education in the nine months ended September 30, 2012 was 45% lower than in the comparable nine months ended September 30, 2011. While it is expected that we and the other Department of Education recovery vendors will receive substantially larger than normal placements once this situation is resolved, the large majority of the revenues from these placements will be delayed because we do not begin to earn rehabilitation revenues from a given placement until at least nine months after receipt of the placement. In addition, since September 2011, the Department of Education has not been able to process a portion of rehabilitated student loans and accordingly we have not been able to recognize a significant amount of the revenues associated with rehabilitation of loans for this client. However, the Department of Education has continued to pay us based on invoices submitted and we have recorded these cash receipts as deferred revenues on our balance sheet. This has led to deferred revenues of \$2.5 million as of September 30, 2012. The Department of Education started processing a portion of rehabilitated student loans beginning in April 2012, and we recognized \$2.8 million in deferred revenues during the three months ended September 30, 2012 related to loans that were rehabilitated during the current and prior periods.

The amount of placement volume that we receive is also dependent on the client relationships that we maintain. We analyze the profitability of each of our student lending clients, and sometimes determine that our resources servicing a specific client should be allocated elsewhere. As a result of this process, we decided to terminate an unprofitable contract with a commercial bank, which we do not expect will have a significant effect on revenues or net income in future periods. Our decision to terminate this contract, together with the decrease in placements from the Department of Education, as discussed above, account for substantially all of the 24% decrease in Placement Volume in the nine months ended

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September 30, 2012 compared to the prior year period.

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Claim Recovery Volume

While we are entitled to review Medicare records for all Part A and Part B claims in our region, we are not permitted to identify an improper claim unless that particular type of claim has been pre-approved by CMS to ensure compliance with applicable Medicare payment policies, as well as national and local coverage determinations. The growth of our revenues is determined primarily by the aggregate volume of Medicare claims in our region and our ability to identify improper payments within these claims. However, the long-term growth of these revenues will also be affected by the scope of the issues pre-approved by CMS.

Further, our claim recovery volume is currently impacted by a system adjustment that is being implemented by CMS for its Periodic Interim Payment providers, or PIP providers. PIP providers are reimbursed for Medicare claims through different processes than other healthcare providers, and CMS is in the process of making certain system adjustments in order to allow these claims to be processed. Prior to April 2012, we were not permitted to audit Medicare claims for these PIP providers, which we estimated to account for approximately 20% of Medicare claims in our region. Since April 2012, we have identified improper payments to PIP providers, but these payments have not yet been processed by CMS. As a result, we have not recognized any revenues from identified improper payments to PIP providers, but we have incurred expenses related to these claims. We estimate that this delayed our recognition of more than \$2 million in revenues in the three months ended September 30, 2012. CMS remains in the process of implementing the necessary changes to its systems that would allow these claims to be processed. While we believe that this delay in processing is temporary, we are uncertain of when processing will begin and the failure of CMS to process these claims will adversely affect our revenues until this is resolved.

Contingency Fees

Our revenues consist primarily of contract-based contingency fees. The contingency fee percentages that we earn are set by our clients or agreed upon during the bid process, and may change from time to time either under the terms of existing contracts or pursuant to the terms of contract renewals. For example, we have been advised that our contractual arrangement with the Department of Education may be modified as a result of the Department of Education's decision to have its recovery vendors promote income based repayment, or IBR, to defaulted student loans. The IBR program provides flexibility on the required monthly payment for student loan borrowers at an amount intended to be affordable based on a borrower's income and family size. As a result of the increased application of the IBR program to defaulted student loans, we expect that there will be an increase in the number of loans that become eligible for rehabilitation because more defaulted student loan borrowers will be able to make qualifying payments. In this connection, we have been advised that the Department of Education may make certain changes to its contractual arrangements with its recovery vendors, although the nature of the changes remains uncertain. Any changes in the contingency fee percentages or other compensation terms that we are paid under existing and future contracts could have a significant impact on our revenues.

Regulatory Matters

Each of the markets which we serve is highly regulated. Accordingly, changes in regulations that affect the types of loans, receivables and claims that we are able to service or the manner in which any such delinquent loans, receivables and claims can be recovered will affect our revenues and results of operations. For example, the passage of the Student Aid and Fiscal Responsibility Act, or SAFRA, in 2010 had the effect of transferring the origination of all government-supported student loans to the Department of Education, thereby ending all student loan originations guaranteed by the GAs. Loans guaranteed by the GAs represented approximately 70% of government-supported student loans originated in 2009. While the GAs will continue to service existing outstanding student loans for years to come, this legislation will over time shift the portfolio of student loans that we manage toward the Department of Education, and further concentrate our sources of revenues and increase our reliance on our relationship with the Department of Education. In addition, our entry into the healthcare market was facilitated by passage of the Tax Relief and Health Care Act of 2006, which mandated CMS to contract with private firms to audit Medicare claims in an effort to increase the recovery of improper Medicare payments. Any changes to the regulations that affect the student loan industry or the recovery of defaulted student loans or the Medicare program generally or the audit and recovery of Medicare claims could have a significant impact on our revenues and results of operations.

Client Concentration

Our revenues from the student loan market depend on our ability to maintain our contracts with some of the largest providers of student loans. In 2011, four providers of student loans each accounted for more than 10% of our revenues during such period and they collectively accounted for 61% of our total revenues during this period. Our contracts with these clients entitle them to unilaterally terminate their contractual relationship with us at any time without penalty. If we lose one of our significant clients, including if one of our significant clients is consolidated by an entity that does not use our services, if the terms of compensation for our services change or if there is a reduction in the level of placements provided by any of these clients, our revenues could decline.

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Our contract with CMS for the recovery of improper Medicare payments began generating significant revenues during 2011 and represented 25% of our total revenues in the three months ended September 30, 2012. This contract expires

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in 2014 and we expect that CMS will issue a request for proposals for the new RAC contract prior to December 31, 2012. We expect that this process will be competitive, and we believe that CMS will announce the award of new RAC contracts in early 2013. While we believe our performance under the existing agreement and the experience we have gained in performing this contract position us well to renew the agreement, failure to renew the agreement or renewal on substantially less favorable terms could significantly harm our revenues and results of operations.

Macroeconomic Factors

Certain macroeconomic factors influence our business and results of operations. These include the increasing volume of student loan originations in the U.S. as a result of increased tuition costs and student enrollment, the default rate of student loan borrowers, the growth in Medicare expenditures resulting from increasing healthcare costs, as well as the fiscal budget tightening of federal, state and local governments as a result of general economic weakness and lower tax revenues.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. We believe that the accounting policies discussed below are critical to understanding our historical and future performance, as these policies relate to the more significant areas involving management's judgments and estimates.

Revenue Recognition

The majority of our contracts are contingency fee based. We recognize revenues on these contingency fee based contracts when third-party payors remit payments to our clients or remit payments to us on behalf of our clients, and, consequently, the contingency is deemed to have been satisfied. Under our RAC contract with CMS, we recognize revenues when the healthcare provider has paid CMS for a given claim or incurs an offset against future Medicare claims. Providers have the right to appeal a claim and may pursue additional appeals if the initial appeal is found in favor of CMS. We accrue an estimated liability for appeals based on the amount of commissions received which are subject to appeal and which we estimate may be returned to providers following successful appeal. This estimated liability for appeals is an offset to revenues on our income statement. Our estimates are based on our historical experience with appeals activity under our CMS contract since January 2010. During the three months ended September 30, 2012, we reserved an amount equal to 15% of gross revenues from our CMS contract, and for the nine months ended September 30, 2012, we reserved an amount equal to 13% of gross revenues from our CMS contract. We have increased our estimated liability for appeal in 2012 due to recent trends in our historical data related to the likelihood of successful appeals. Commencing on December 31, 2011, we established a separate line item in the current liabilities section of our balance sheet entitled "Estimated liability for appeals" to reflect our estimate of this liability. The \$3.7 million balance as of September 30, 2012, represents our best estimate of the probable amount of losses related to appeals of claims for which commissions were previously collected and recognized as revenues. We estimate that it is reasonably possible that we could be required to pay up to an additional approximately \$1.5 million as a result of potentially successful appeals. To the extent that required payments by us related to successful appeals exceed the amount accrued, revenues in the applicable period would be reduced by the amount of the excess. We similarly accrue an allowance against accounts receivable related to commissions yet to be collected, based on the same estimates used to establish the estimated liability for appeals of commissions received. Our inability to correctly estimate the estimated liabilities and allowance against accounts receivable could adversely affect our revenues in future periods.

Goodwill

We periodically review the carrying value of intangible assets not subject to amortization, including goodwill, to determine whether an impairment may exist. GAAP requires that goodwill and certain intangible assets not subject to amortization be assessed annually for impairment using fair value measurement techniques.

Specifically, goodwill impairment is determined using a two-step test. The first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of a reporting unit with its book value, including goodwill. If the fair value of the reporting unit exceeds its book value, goodwill is considered not impaired and the second step of the impairment test is unnecessary. If the book value of the reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The

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second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the book value of that goodwill. If the book value of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of

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goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. In September 2011, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. This ASU permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it need not perform the two-step impairment test. The ASU permits early adoption, and based on our qualitative assessment we concluded that we are not required to perform the two-step impairment test at December 31, 2011.

Impairments of Depreciable Intangible Assets

We evaluate depreciable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Depreciable intangible assets consist of client contracts and related relationships, and are being amortized over their estimated useful life, which is generally 20 years. We evaluate the client contracts intangible at the individual contract level. The recoverability of such assets is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If the assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. There was no impairment expense for depreciable intangible assets in 2010 or 2011. In 2009, an impairment charge of \$2.6 million was recognized to account for our decision to discontinue a relationship with a client.

Results of Operations**Three Months Ended September 30, 2011 compared to the Three Months Ended September 30, 2012**

The following table represents our historical operating results for the periods presented:

	Three Months Ended	
	September 30, 2011	2012
	(in thousands)	
Consolidated Statement of Operations Data:		
Revenues	\$ 42,009	\$ 53,400
Operating expenses:		
Salaries and benefits	16,456	21,003
Other operating expense	13,613	18,240
Total operating expenses	30,069	39,243
Income from operations	11,940	14,157
Interest expense	(3,366)	(3,175)
Interest income	31	2
Income before provision for income taxes	8,605	10,984
Provision for income taxes	3,439	4,601
Net income	\$ 5,166	\$ 6,383
Accrual for preferred stock dividends	1,660	
Net income available to common shareholders	\$ 3,506	\$ 6,383

Revenues

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Total revenues were \$53.4 million for the three months ended September 30, 2012, an increase of \$11.4 million or 27.1%, compared to total revenues of \$42.0 million for the three months ended September 30, 2011. This increase in revenues is primarily due to an increase of \$8.4 million in revenues received from CMS under our RAC contract as a result of higher claim recovery volumes and an increase of \$2.0 million generated from a new default-aversion service contract in the other markets that we serve. Revenues from student lending increased by 2.5% during the quarter to \$33.0 million from \$32.2 million in the prior year period.

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Salaries and Benefits

Salaries and benefits expense was \$21.0 million for the three months ended September 30, 2012, an increase of \$4.5 million, or 27.6%, compared to salaries and benefits expense of \$16.4 million for the three months ended September 30, 2011. This increase is primarily due to hiring of new employees to provide services under our RAC contract with CMS, an increase in expenses associated with the engagement of additional software engineers to assist in the integration of a newly acquired software license and an increase in expenses associated with the hiring of additional administrative employees.

Other Operating Expense

Other operating expense was \$18.2 million for the three months ended September 30, 2012, an increase of \$4.6 million, or 34.0%, compared to other operating expense of \$13.6 million for the three months ended September 30, 2011. This increase is primarily due to (i) an additional \$2.8 million of subcontractor fees incurred in connection with increased services provided under the RAC contract and MSA contracts and (ii) \$0.9 million paid to an affiliate of Parthenon Capital Partners (such entity and its affiliates individually and collectively referred to as Parthenon Capital Partners) at the closing of our initial public offering in connection with the termination of an advisory services agreement. In addition, we incurred \$0.3 million in additional payments to healthcare providers for the retrieval of medical records in accordance with the RAC contract due to an increase in the amount of Medicare claims we audited during the three months ended September 30, 2012. Payments to healthcare providers for the retrieval of medical records are incurred in the ordinary course of business under the RAC contract in order to complete our audit process and are directly correlated to the amount of Medicare claims we audit. We expect these payments for the retrieval of medical records to increase over time as the amount of Medicare claims we audit under the RAC contract increases.

Income from Operations

As a result of the factors described above, income from operations was \$14.2 million for the three months ended September 30, 2012, compared to \$12.0 million for the three months ended September 30, 2011, representing an increase of \$2.2 million, or 18.6%.

Interest Expense

Interest expense was \$3.2 million for the three months ended September 30, 2012 compared to \$3.4 million for the three months ended September 30, 2011, representing a decrease of 5.7% due to lower interest rates under the new credit agreement as compared to the interest rates under our old credit agreement.

Income Taxes

Income tax expense was \$4.6 million for the three months ended September 30, 2012 compared to \$3.4 million for the three months ended September 30, 2011, representing an increase of 38.8% consistent with the increase in income before provision for income taxes. Our effective income tax increased to 41.9% for the three months ended September 30, 2012 from 40.0% for the three months ended September 30, 2011.

Net Income

As a result of the factors described above, net income was \$6.4 million for the three months ended September 30, 2012, which represented an increase of \$1.2 million compared to net income of \$5.2 million for the three months ended September 30, 2011.

Table of Contents***Nine Months Ended September 30, 2011 compared to the Nine Months Ended September, 2012***

The following table represents our historical operating results for the periods presented:

	Nine Months Ended September 30,	
	2011	2012
	(in thousands)	
Consolidated Statement of Operations Data:		
Revenues	\$ 120,333	\$ 154,099
Operating expenses:		
Salaries and benefits	50,437	59,426
Other operating expense	35,193	53,053
Total operating expenses	85,630	112,479
Income from operations	34,703	41,620
Debt extinguishment costs		(3,679)
Interest expense	(10,213)	(9,329)
Interest income	94	64
Income before provision for income taxes	24,584	28,676
Provision for income taxes	9,839	11,698
Net income	\$ 14,745	\$ 16,978
Accrual for preferred stock dividends	4,785	2,038
Net income available to common shareholders	\$ 9,960	\$ 14,940

Revenues

Total revenues were \$154.1 million for the nine months ended September 30, 2012, an increase of \$33.8 million, or 28.1%, compared to total revenues of \$120.3 million for the nine months ended September 30, 2011. This increase in revenues is primarily due to an increase of \$24.7 million in revenues received from CMS under our RAC contract as a result of higher claim recovery volumes and an increase of \$2.5 million generated from a new default-aversion service contract in the other markets we serve. Revenues from student lending increased by \$ 6.4 million, or 6.9%, to \$98.2 million from \$91.8 million in the comparable prior year period.

Salaries and Benefits

Salaries and benefits expense was \$59.4 million for the nine months ended September 30, 2012, an increase of \$9.0 million, or 17.8%, compared to salaries and benefits expense of \$50.4 million for the nine months ended September 30, 2011. This increase is primarily due to hiring of new employees to provide services under our RAC contract with CMS, an increase in expenses associated with the engagement of additional software engineers to assist in the integration of a newly acquired software license and an increase in expenses associated with the hiring of additional administrative employees.

Other Operating Expense

Other operating expense was \$53.0 million for the nine months ended September 30, 2012, an increase of \$17.9 million, or 51.0%, compared to other operating expense of \$35.2 million for the nine months ended September 30, 2011. This increase is primarily due to (i) an additional \$9.6 million of subcontractor fees incurred in connection with increased services provided under the RAC contract and MSA contracts and (ii) a \$1.3 million expense incurred as the result of the termination of an advisory services agreement with Parthenon Capital Partners, and an additional \$0.9 million paid to Parthenon Capital Partners at the closing of our initial public offering also as a result of the termination of the advisory services agreement. In addition, the Company incurred an increase of \$1.6 million in payments to healthcare providers for the retrieval of medical records in accordance with the RAC contract due to an increase in the amount of Medicare claims we audited during the nine months

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ended September 30, 2012.

Income from Operations

As a result of the factors described above, income from operations was \$41.6 million for the nine months ended September 30, 2012, compared to \$34.7 million for the nine months ended September 30, 2011, representing an increase of \$6.9 million, or 20.0%.

Debt Extinguishment Costs

As a result of the entry into our new credit facility and the repayment of all amounts owed under our then existing credit facility in March 2012, we incurred debt extinguishment costs of \$3.7 million, comprised of approximately \$3.3 million in fees paid to the lenders in connection with our new credit facility and approximately \$0.3 million of unamortized debt issuance costs associated with our old credit facility.

Interest Expense

Interest expense was \$9.3 million for the nine months ended September 30, 2012 compared to \$10.2 million for the nine months ended September 30, 2011 representing a decrease of 8.7% due to lower interest rates under the new credit agreement as compared to the interest rates under our old credit agreement.

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Income Taxes

Income tax expense was \$11.7 million for the nine months ended September 30, 2012 compared to \$9.8 million for the nine months ended September 30, 2011 representing an increase of 18.9% consistent with the increase in income before provision for income taxes. Our effective income tax increased to 40.8% for the nine months ended September 30, 2012 from 40.0% for the nine months ended September 30, 2011.

Net Income

As a result of the factors described above, net income was \$17.0 million for the nine months ended September 30, 2012, which represented an increase of \$2.2 million compared to net income of \$14.7 million for the nine months ended September 30, 2011. Excluding the debt extinguishment costs incurred in March 2012, net income would have been \$20.7 million for the nine months ended September 30, 2012.

Adjusted EBITDA and Adjusted Net Income

To provide investors with additional information regarding our financial results, we have disclosed in the table below and in this report adjusted EBITDA and adjusted net income, both of which are non-GAAP financial measures. We have provided a reconciliation below of adjusted EBITDA to net income and adjusted net income to net income, the most directly comparable GAAP financial measure to these non-GAAP financial measures.

We have included adjusted EBITDA and adjusted net income in this report because they are key measures used by our management and board of directors to understand and evaluate our core operating performance and trends and to prepare and approve our annual budget. Accordingly, we believe that adjusted EBITDA and adjusted net income provide useful information to investors and analysts in understanding and evaluating our operating results in the same manner as our management and board of directors.

Our use of adjusted EBITDA and adjusted net income has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements;

adjusted EBITDA does not reflect interest expense on our indebtedness;

adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

adjusted EBITDA does not reflect tax payments;

adjusted EBITDA and adjusted net income do not reflect the potentially dilutive impact of equity-based compensation;

adjusted EBITDA and adjusted net income do not reflect the impact of certain non-operating expenses resulting from matters we do not consider to be indicative of our core operating performance; and

other companies may calculate adjusted EBITDA and adjusted net income differently than we do, which reduces its usefulness as a comparative measure.

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Because of these limitations, you should consider adjusted EBITDA and adjusted net income alongside other financial performance measures, including net income and our other GAAP results. The following tables present a reconciliation of adjusted EBITDA and adjusted net income for each of the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2012	2011	2012
Reconciliation of Adjusted EBITDA:				
Net income	\$ 5,166	\$ 6,383	\$ 14,745	\$ 16,978
Provision for income taxes	3,439	4,601	9,839	11,698
Interest expense	3,366	3,175	10,213	9,329
Interest income	(31)	(2)	(94)	(64)
Debt extinguishment costs ⁽¹⁾				3,679
Depreciation and amortization	1,953	2,445	5,712	7,002
Non-core operating expenses ⁽³⁾	1,856		2,438	47
Advisory fee ⁽⁴⁾	109	932	326	2,641
Stock based compensation	28	734	83	883
Adjusted EBITDA	\$ 15,886	\$ 18,268	\$ 43,262	\$ 52,193

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Reconciliation of Adjusted Net Income:				
Net income	\$ 5,166	\$ 6,383	\$ 14,745	\$ 16,978
Debt extinguishment costs ⁽¹⁾				3,679
Non-core operating expenses ⁽²⁾	1,856		2,438	47
Advisory fee ⁽³⁾	109	931	327	2,640
Stock based compensation	28	734	83	883
Amortization of intangibles ⁽⁴⁾	760	932	2,282	2,741
Deferred financing amortization costs ⁽⁵⁾	307	344	946	865
Tax adjustments ⁽⁶⁾	(1,224)	(1,177)	(2,430)	(4,341)
Adjusted net income	\$ 7,002	\$ 8,147	\$ 18,391	\$ 23,492

- (1) Represents debt extinguishment costs comprised of approximately \$3.3 million of fees paid to lenders in connection with our new credit facility and approximately \$0.3 million of unamortized debt issuance costs in connection with our old credit facility.
- (2) Represents professional fees and settlement costs related to strategic corporate development activities and a \$1.2 million legal settlement in 2011.
- (3) Represents expenses incurred under an advisory services agreement with Parthenon Capital Partners, which was terminated in April 2012. See Note 11 Related Party Transactions.
- (4) Represents amortization of capitalized expenses related to the acquisition of Performant by an affiliate of Parthenon Capital Partners in 2004, the impairment expense to reduce the carrying amount of the intangible asset due to our decision to terminate a client contract in 2009 and an acquisition in the first quarter of 2012 to enhance our analytics capabilities.
- (5) Represents amortization of capitalized financing costs related to debt offerings conducted in 2009, 2010 and 2012.
- (6) Represents tax adjustments assuming a marginal tax rate of 40%.

Liquidity and Capital Resources

Our principal sources of liquidity are cash flows from operations, term loans, and the proceeds received from our recent initial public offering, or IPO. Cash and cash equivalents, which totaled \$32.2 million as of September 30, 2012, consist primarily of cash on deposit with banks. We expect that operating cash flows will conti