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Catasys (CATS): The Numbers Speak for Themselves

Catasys (CATS) failed to respond to our initial report on Thursday afternoon's conference call (other than an incoherent claim of doctored documents). Nor did Catasys answer any of the seven key questions we posed, besides offering what appeared to be a rambling admission that Anthem did in fact walk away from Catasys. Instead, the Company opted for the lame deflection that "the numbers speak for themselves, and it's not necessary to address anything about [the report]." We commend Chairman and CEO Peizer for his commitment to avoiding uncomfortable subjects, but let's look at the numbers.

Our original report criticized the apparent ways in which the Company inflates member retention rate, which we believe is less than the claimed 80%. Yesterday's call only cast further doubt on these figures, as Peizer stated:

> "Throughout the first quarter, we also saw a decrease in dis-enrollments, month to month, with March **hitting lows of 9.4%,** and in April, coming in even lower at 8.9%. Both March and April were below our trailing twelve month number of about 10.8% monthly."

This 9.4% figure seems to blatantly contradict the Company's March 25 press release, which claimed that "the **halving of disenrollment rates to 4.9%** have in part been driven by the COVID-19 pandemic." By the Company's own admission, disenrollment rates did not halve in March, but were only flat to slightly down. Catasys offered no explanation for this massive disparity on Thursday's call, adding yet another conflicting, slapdash statement by Peizer to the long list we laid out in our original report.

We also questioned Catasys's historical ability to retain insurance customers, as we found at least 6 logos that we believe are not offering Catasys, despite once being touted by the Company. In addition, we questioned the Company's disclosures regarding its HCSC relationship, which we believe was placed in runoff 9 months ago. Instead of addressing these concerns head-on, the Company's only response was to remove two more logos from its updated presentation: HCSC and Humana are now gone. The Company offered no detail as to the nature of its current relationship with either insurer or why the logos have been removed:

April 2020:

May 2020:

The numbers speak for themselves. In the past 14 months alone, Catasys has now removed 8 insurance company logos from its investor presentation.

Similarly, we expressed concerns about the Company's apparent pass-through contract structure with Aetna, which we believe to be its largest customer. Catasys again declined to address how it actually gets paid from Aetna, and the economic benefits, if any, that it accrues through this relationship.

Indeed, we view Catasys as uninterested in engaging with shareholders apart from spewing out substance-light promotional garbage. To that end, management's promises have turned once again to the prospect of a national rollout with UnitedHealth. At the same time, Catasys failed to deny that, even though UnitedHealth featured prominently through the Company's investor presentations through January 2020, UnitedHealth has never paid the Company a dime. Nevertheless, Catasys touts a UnitedHealth contract signing in the next 2 weeks and a launch by July 1:

> "Now, given that it's going to launch in – we believe it'll launch in the beginning of the third quarter, and given how everything is always sloping, the numbers will contribute a lot more next year …
>
> I can say with respect to that national plan, we're in the final week, or two, of getting that deal signed and announced …
>
> Now to fast forward we are currently engaged with both Optum and most importantly for us, United and we're cautiously optimistic that something will result from that in the not too distant future."

<u>In how many quarterly conference calls has Catasys made similar claims to be contracted with UnitedHealth or on the brink of a national plan rollout? We count at least 7:</u>

(1) May 2017: "As we pointed out, just the launch of UnitedHealth – remember, UnitedHealth is a major revenue generator for us."

(2) August 2017: "For what it's worth, we think we're at the end of the lake, at the end of the tunnel and I think it's ready for launch and hopefully over the next 30 to no more than 60 days we hope we can announce that we've launched with United HealthCare Optum."

(3) November 2017: "We were prepared for launch. Most of the preparation for the launch is behind us. So once we get the visibility and a launch date, we should be able to move very quickly.

(4) March 2018: "Cigna joins, in alphabetical order, Aetna, Centene, Coventry, HCSC, Health Alliance Medical Plans or HAMP, Humana and United HealthCare, and we expect to sign another very soon."

(5) May 2018: "In January of this year, Catasys signed an agreement with Cigna, making us the only company in our space to be contracted with six of the eight largest health plans in the country. In addition to Cigna, those would be Aetna, Centene, HCSC, Humana and UnitedHealthcare."

(6) August 2018: "Catasys is now contracted with seven of the top eight insurers nationwide."

(7) March 2019: "We are getting close to launching with United and we are getting closer with Optum. But it's not done until it's done. But we're getting closer. We're very close."

Perhaps the eighth time is the charm for Catasys, but in light of the Company's past claims and continued preference to sweep shareholder concerns under the rug, we have tremendous difficulty putting much faith behind these promises.

We also note that CATS's $90 million revenue guide, which analysts now cling to, includes a still-unsigned UnitedHealth launch: by management's admission, "[UnitedHealth] is a significant part of our numbers." By our reckoning, this is a departure from the Company's historic guidance, which did not include expected launches. See, for example, this statement from the Q4 2018 call:

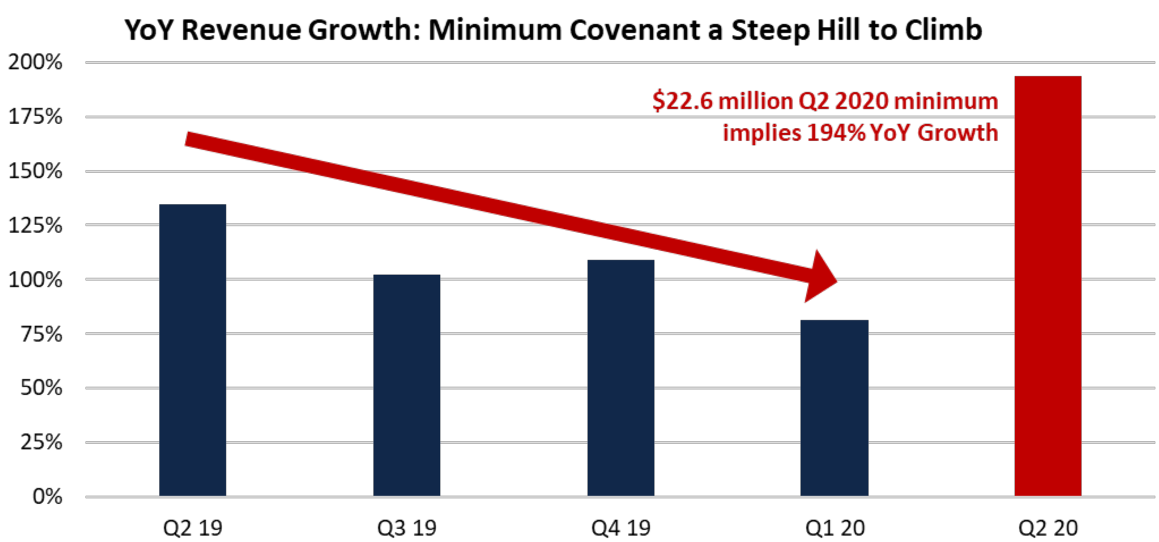
> "We know of several plans that we believe, again, it's not in our guidance. It's not what we know. It's what we expect. But there are several plans that we do expect to press the button, expand nationally … Most companies when they give guidance, they give you what they expect. I'm just giving you what I know."

We suspect that Catasys now includes UnitedHealth in its guidance not out of confidence, but desperation, as it recognizes that lenders are watching closely. The revenue covenant on the Goldman debt specifies that Catasys must generate minimum LTM consolidated recurring revenue of $55.5 million in Q2 2020, $78 million in Q3 2020, and $90 million by year-end:

Fiscal Quarter End Date	Consolidated Recurring Revenue
September 30, 2019	$26,750,000
December 31, 2019	$31,750,000
March 31, 2020	$40,500,000
June 30, 2020	$55,500,000
September 30, 2020	$78,000,000
December 31, 2020 until the Maturity Date	$90,000,000

With this in mind, the aggressive nature of Catasys's guidance makes more sense; they have no choice under their credit agreement. If Catasys were to miss its 2020 revenue guidance – say, by failing to sign or scale UnitedHealth – then it would be in default of its debt. Thus, without meaningful contributions from UnitedHealth, we believe that the Company is set to breach its debt covenants by year-end, if not sooner.

Even in the very near term, given that Catasys has generated $32.9 million in revenues in the last 9 months, the Company must generate $22.6 million in Q2 2020 revenues, or 194% YoY growth, just to avoid default in Q2. We believe this will be challenging against the backdrop of decelerating growth:

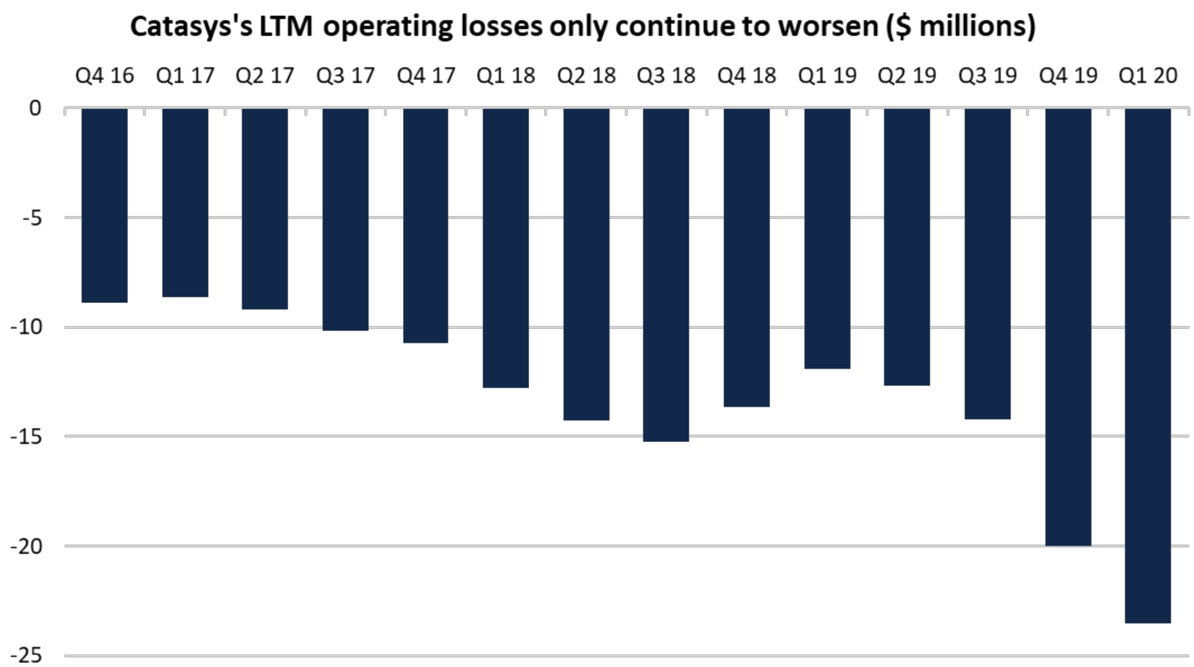


<u>The numbers speak for themselves. We believe Catasys is in a highly distressed position.</u> Analysts have hoisted up the Goldman Sachs nameplate as an authority, while Peizer pontificated that "I have never seen such exhaustive due diligence in any transaction I have ever been a part of directly or indirectly." We have no doubt that Goldman Sachs's specialty lending group – effectively acting as a distressed lender – "did their due diligence" on the deal. **<u>Indeed, the fact that the group (a) lent Catasys money at a highly punitive 15.75% rate; (b) demanded warrants on the deal; and (c) imposed the steep covenants outlined above ought to be an indication of the degree to which Catasys had to beg for cash.</u>**

On the matter of the Company's profitability, we reiterate our view that Catasys is structurally unprofitable. The Company has claimed 50% EBITDA margins at scale, which, as of over a year ago, was "in the not too distant future" and "shortly":

> March 12, 2019: "We do expect to be **<u>significantly EBITDA positive next year</u>** based on the numbers we're seeing today … At scale, which we believe we'll achieve in the not too distant future, we will be somewhere around a 50% gross margin, which again goes pretty well to an EBITDA type of gross margin."
>
> March 20, 2019: "We have about 50% EBITDA contribution margin at scale. We'll get to scale shortly."

Instead, in the most recent quarter, gross margins declined to 41%, while operating losses ballooned to $6.0 million, a negative 49% margin:



We believe that with no visibility to eventual profitability, a customer base that continues to distance itself from Catasys, and intensifying revenue pressure necessary to avoid a default on its debt, CATS shares remain worthless.