

Investment Process Case Study: Eclipsys Corp. (ECLP)

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Eclipsys Corporation is a long-time Emerging Franchise holding in both the Thornburg Value Fund and the Core Growth Fund. Eclipsys is a health care information technology company that provides software and services which help hospitals to improve their clinical and business results. Although each stock in our portfolio has different characteristics, each is selected using the same steps, which we will describe below.

1. Identify stocks with potential undervaluation.

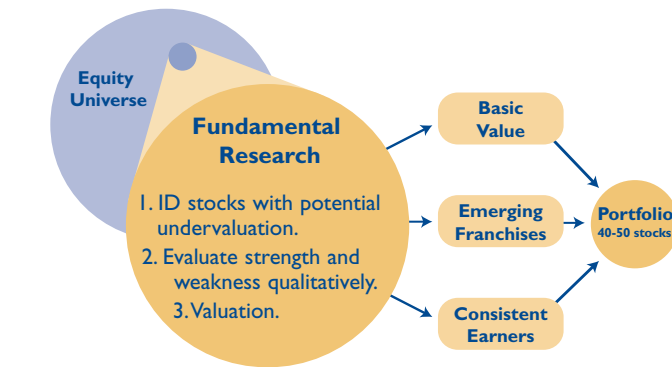
Most stocks are initially identified using quantitative screening, which reduces the investment universe of over 5,000 names to a manageable list of perhaps 100 to 150. We have a variety of screens customized to identify stocks with certain Emerging Franchise characteristics, such as growth potential, attractive profitability, and a low valuation. The table above shows some key attributes of Eclipsys Corp. that caught our attention during mid-2003

Eclipsys as of Mid-2003

Industry opportunity – Health care IT is a multi-billion dollar industry, expected to grow 7%/yr.; clinical IT to grow much faster than overall market

Profitability – High gross margins and an attractive stream of recurring revenue

Share price – Down significantly from the \$20s to below \$10; also, stock price only moderately exceeds net cash



when we first identified the company as a worthwhile candidate for further research.

In an Emerging Franchise we are looking for value-priced companies in the process of establishing a leading position in a product, service, or market that is expected to grow at an above-average rate. Based on the attributes noted above, Eclipsys appeared to offer promise at a discount, but the bulk of our research was still to come. The next step was to evaluate the company on a variety of characteristics that are not easily quantified, but which are critical for long-term success. As part of this process we often speak directly with the company and its competitors,

visit the company’s website, examine its financial results, and read research on the company and its operating environment.

2. Evaluating the company’s strengths and weaknesses in areas not easily quantifiable.

We have a comprehensive approach to value. Characteristics such as management quality, market share, proprietary technologies, financial strength, brand value, and growth prospects are more important to us than current or historical earnings because they provide more insight into future results. The market is very efficient at pricing in near-term earnings prospects but we believe it is less efficient at pricing in characteristics that are not easily quantified. We believe long-term growth in value is driven by the non-quantifiable elements like those listed above. Here is our view of how Eclipsys compares on some of the important characteristics:

The investment philosophy of the Thornburg Value Fund is to buy promising companies with sound business fundamentals at a discount to their intrinsic value. This theme is the foundation of our comprehensive approach to value investing. As an added layer of risk control each stock added to the portfolio is assigned one of three proprietary baskets: Basic Value, Consistent Earner, and Emerging Franchise. Although the stocks that populate these baskets have different characteristics, each are selected using the same process.

Basic Value: Stocks of financially sound companies with well established businesses that are selling at low valuations relative to the company’s net assets or potential earning power.

Consistent Earners: Growing companies with steady earnings and dividend growth that are selling at attractive values and are priced below historical norms.

Emerging Franchises: Value-priced emerging companies in the process of establishing a leading position in a product, service or market that is expected to grow at an above average rate.

Competitive Position and Market Share.

A sustainable competitive advantage is a particularly important element for success when evaluating an Emerging Franchise. In order for a company to maintain its leadership position in an industry, its products or services must be differentiated from its competitors in a durable manner. For Eclipsys’ software and IT solutions, product differentia-

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Notable Eclipsys Customers

- The Cleveland Clinic – Eastern Region
- Boston Medical Center
- Yale New Haven Medical Center
- Brigham & Women’s Hospital
- The National Institutes of Health
- Johns Hopkins Hospital and Health System

tion is created by superior business process knowledge (BPK). BPK is an understanding of the discrete steps required to complete a particular unit of work – for example, treating a sick patient – within an industry. Eclipsys acquired its initial core clinical BPK in 1996 through its purchase of the intellectual property of the Brigham Integrated Computer System from Brigham & Women’s and Massachusetts General Hospital. In the late 1990s the Company completed other acquisitions to build on this base of intellectual property and BPK. So today, Eclipsys and its predecessor companies have several decades experience building BPK and the tailored functionality used by its customers to deliver better health care. As a result, Eclipsys enjoys a leading position in its industry and is the market share leader in the clinical software segment.

Purchase of a core clinical IT system represents a large, resource-intensive commitment for any health care organization. The purchasing decision is typically made over a period of one to three years, and credible reference accounts are an essential part of the process. So, we were encouraged to learn that the company’s products are already in use by some of the most prestigious health care institutions in the country.

We were able to verify the competitive position of Eclipsys

through several channels, including conversations with physicians, interviews with health care industry consultants, and the research of a number of third party industry participants. For example, Frost & Sullivan, The Leapfrog Group, and KLAS (a market research firm) all attest to the leadership position of Eclipsys’ core clinical software solutions. There are however several competitors that we studied and which together comprise a vibrant, competitive health care IT industry.

Financial Strength.

Eclipsys Corporation has always been a conservatively financed company with no debt and a healthy amount of cash on hand. This is particularly important because the company has not yet achieved sustained profitability. However we believe the business continues to evolve favorably and that Eclipsys will achieve attractive profits and predictable, growing free cash flow.

Growth Prospects.

We believe Eclipsys is well-positioned in the market for clinical IT systems which improve the health care delivery process. Specifically, these systems have been shown to improve patient safety and operating efficiency (i.e., financial results). A 1999 study by the Institute of Medicine highlighted the extent of medical errors in our society. It estimated that between 50,000 and 100,000 people die annually in U.S. hospitals due to medical errors. The Leapfrog Group, a non-profit consortium of large U.S. companies, has estimated that over one million serious medication errors occur in U.S. hospitals per year, and that each error adds approximately \$2,000 on average to the cost of hospitalization, excluding the impact on insurance costs and employee pro-

ductivity. The Leapfrog Group has supported significant research in this area and has concluded that clinical software systems “can be remarkably effective at reducing the rate of serious medication errors.”¹

Eclipsys’ products are in high demand by health care organizations. For example, the Health Care Information and Management Systems Society’s 2003 Leadership Survey indicated that health care executives increasingly believe that IT must be implemented to reduce medical errors and promote patient safety. Sixty-three percent of these executives viewed reduction of medical errors as the health care industry’s most critical business priority for the next two years, and 64% of these executives considered core clinical software systems as the most important IT application over the next two years. But, industry adoption of clinical software systems is still less than 10%, indicating that the vast majority of the thousands of health care organizations in the U.S. have not yet made the investment.

Management Competence and Motivation.

An Emerging Franchise often does not have a well-established economic history. So we must evaluate management qualitatively. Eclipsys was founded in 1995 and went through several years as a rapidly growing but

Key Competitors – Specialized Clinical Software

- Cerner Corporation
- IDX Systems Corporation
- Epic Systems

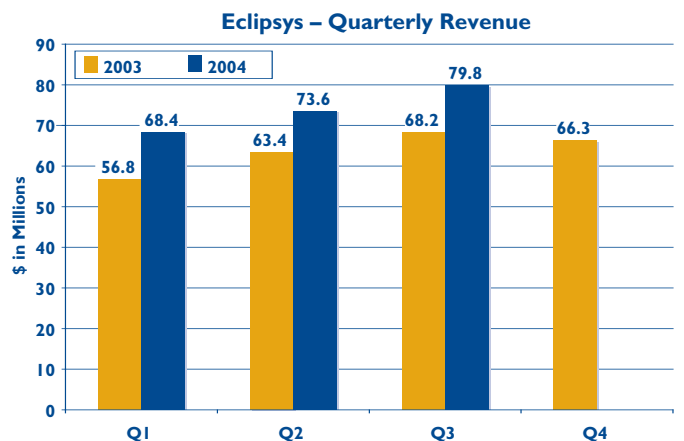
Broader Health Care IT Cos.

- General Electric Corp
- Siemens AG
- McKesson Corp

unprofitable start-up enterprise. As the business has grown, however, the company now has the resources to hire seasoned, professional management. In early 2002 the company hired as CEO an experienced executive from a leading IT systems integration firm; he has, in turn, built a first-class senior management team. Importantly, officers and directors of the company own a significant amount of common stock, and they have been adding to their holdings since 2002.

3. Valuation: The Case for a Discounted Cash Flow

After examining all of the qualitative factors to ensure that the company has promise, the final step in our process is to ensure that the valuation is attractive. In our screening process we looked at valuation multiples and earnings growth rates. At this stage we used more sophisticated valuation



¹ Computer Physician Order Entry Fact Sheet, The Leapfrog Group, revision 4/18/03.

techniques such as discounted cash flows (DCF) and/or dividend discount models. The output of a model is only as good as the inputs, so we work hard to estimate the likely growth rates and the appropriate discount rates.

A stock is worth the present value of its future free cash flow. Pricing metrics such as price-to-sales or price-to-book are sometimes misused, as their validity depends upon the assumptions underlying a discounted cash flow calculation. For Eclipsys Corporation, our discounted cash flow analysis focuses on the timing, size, and risks to these future free cash flows. We ask ourselves “How will new business bookings develop? What are the realistic profit margins? How risky is the business?” Using our assumptions we can build a financial model for the company to estimate the intrinsic value of the common stock. Checking our valuation against historical norms and current market conditions provides further assurance. We also “stress test” the valuation using a variety of assumptions regarding growth and earnings to determine the margin of safety the investment has.

We always ask ourselves why a prospective investment is out of favor. The timing of business development can be critical in determining the timing of appreciation in the share price. An investment whose problems appear permanent may be no bargain. In the case of Eclipsys, we believe the discount to intrinsic value is prevalent for a variety of reasons, including a misunderstanding among the investment community of the company’s accounting policies, and a lack of appreciation for the company’s competitive strengths and long-term growth prospects.

Many value managers tend to prefer companies within the same industry that trade at relatively lower multiples of earnings and cash flow. We believe that Eclipsys warrants a premium valuation to its peer group, and that historical pricing metrics (e.g., price-to-sales) are not a good indication of the DCF-derived intrinsic value of the company.

This article is not intended as an endorsement of Eclipsys Corporation, but rather to help understand our process for selecting Emerging Franchises and, in fact, every investment we make. Compared to other value managers we are probably more willing to pay for companies that have those unquantifiable characteristics that lead to stronger long-term growth. We differ from growth-oriented managers in that our investment time horizon is longer and we are more focused on fundamentals.



The views expressed by the portfolio managers and/or associate portfolio managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

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