April 24th, 2018

H·SOURCE

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# Right Time, Right Strategic Assets

## Special points of interest:

- Health care spending and political risk are now creating industry wide change
- Defensive growth investing is NOT an oxymoron
- Excessive liquidity is shifting opportunity to early stage investing
- Successful early stage investing is driven by unconventional financial metrics
- Limited competition in a large marketplace
- Mgmt. is a student of history and understands you have to create both a distribution and supply-side model

## Business Description

H-Source Holdings Ltd. is a healthcare technology company. Their platform is an innovative resource for member healthcare providers to privately buy and sell products and equipment directly with each other. Their cloud-based platform combines a user-friendly web-based marketplace with robust accounting, reporting, and data visualization tools with existing hospital systems. The H-Source system improves facility efficiency by reducing waste on the sell-side and decreases cost of product procurement on the buy side.


## Select Fundamental Data

| |
|---|
| OTC Ticker: HSCHF |
| Stock Price: $0.0802 |
| Blended Price Target (2019): $0.31 |
| Market Cap: $8.47 mln |
| Price/Sales (2019): 1.26 |
| Trailing P/E: N.M. |
| Forward P/E (2019): 4.1x |
| Net Debt/Cap: 0.0% |

## Industry Overview

Health care spending has been growing as a percent of total GDP and is now forecasted to represent 19.7 percent of GDP by 2026. For context, in 1960 healthcare spending was only 5 percent of GDP. This dramatic increase has been driven by both rising costs and an increase in utilization. The primary driver of this increase was the introduction of both Medicare and Medicaid in 1965, which materially increased utilization. The government's inability to use its size to control pricing has led to high utilization and rising costs.

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Over the next decade utilization will continue to increase as the Baby Boomer generation ages. The only way to control spending over this period will be price. Companies that can lower pricing (e.g. generic drugs, bio-similar, software platforms, etc.) are going to see increasing demand.

This unsustainable trend is now being addressed by some of the most powerful and innovative companies in the U.S. In the last six months both Apple (e.g. AC Wellness) and Amazon, Berkshire and JP Morgan have announced plans to offer their own healthcare networks (not yet named). Given the size and innovative prowess of these companies, lower pricing may become the industry standard. Companies that provide real healthcare savings will be in high demand under this new paradigm.

Under this new model of care, hospitals and physician practices will be under heightened pressure to increase their efficiency. It has been well documented that most hospitals lack efficiency given legacy software and systems that are not fully integrated across the network. The lack of integration often creates waste because the front-end of the hospital is not effectively communicating with accounting and inventory management. As a result, there are numerous cases where a physician prefers a particular medical device, supplies and/or pharmaceutical regimen that is mothballed if the physician changes his preference or shifts his practice to another hospital. Additionally, instrument trays and many other surgical supplies are provided to cover all physician preferences, whereby unused supplies are discarded post-surgery. Due to the lack of systems integration these excess/unwanted supplies build-up in hospital warehouses until they are completely obsolete and sent to the dump. Correcting these inefficiencies is critical and represents some of the lowest hanging fruit for hospitals to address.

**Why H-Source?**

H-Source's business model is simple but very compelling. It provides a cloud-based exchange platform and inventory management system allowing hospitals to collaborate and communicate to drive down supply chain costs thru the purchase and sale of medical supplies, capital equipment and non-controlled pharmaceuticals. The system is also used by other continuum of care providers (e.g. long-term care facilities, rehab hospitals, pharmacies, etc.). Having a wide spectrum of providers is critical to its model as often a slightly used piece of equipment (e.g. MRI or CT system, hospital bed) is useful to another mem-

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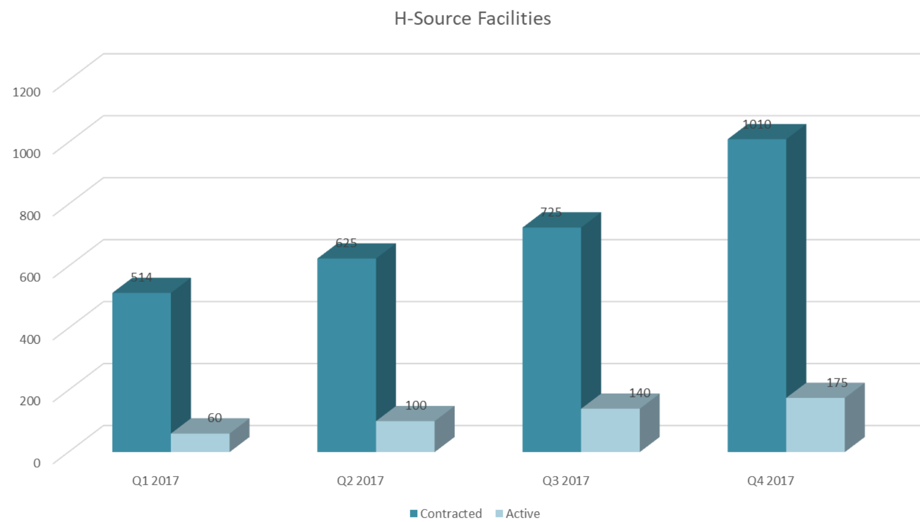
ber facility.

The company was formed in 2014 and has refined its model over the last few years. Initially, the company worked on refining its product platform and building relationships with companies across the spectrum of care. It has since evolved from having less than 500 contracted hospitals at the end of 2016 to over 1,000 as of the 4th quarter of 2017 (depicted below).




H-Source has a first-to-market advantage and has made great progress over the past year, as depicted above, but they have barely scratched the surface of the huge marketplace.

H-Source can significantly grow revenue by simply converting their 1000+ Contracted users into Active users. They can also add more Contracted users from the 10,000+ Hospitals and Surgery Centers in the US and the 30,000+ Global Hospitals and Surgery Centers. H-Source has an opportunity to become the platform of choice and create a network effect as more users create higher value for existing users.

Management has publicly indicated that they have had discussions with numerous industry players Group Purchasing Organizations (GPO's), Integrated Delivery Networks (IDN's), and others, that could integrate their platform across their service offering. The GPO space is very large. As depicted below the four largest GPO's in the U.S. represent more than $180 billion in annual purchases:

| | Annual Purchases (billions) | |
|---|---|---|
| Vizient | $ | 100 |
| Premier | $ | 50 |
| HealthTrust | $ | 30 |
| Intalere | $ | 9 |
| Total | $ | 189 |

Most industry research indicates that the typical hospital has 5 to 7 percent in excess waste. Dr. Corinna Zygourakis, recently conducted a study for UCSF Hospital which tracked medical waste in 58 neurosurgeries. When the doctors were incentivized to lower

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their supply waste, median surgical supply costs decreased by 6.5 percent. Using the lower end of this range, if the H-Source platform was utilized by even the fourth largest GPO (Intalere), H-Source sales would be approximately $67.5 million annually.

| | | |
|---|---|---|
| Intalere Revenue | $ | 9,000,000,000 |
| Client Transaction Value (5 Percent) | $ | 450,000,000 |
| H-Source Revenue Opportunity (15 Percent Fee)) | $ | 67,500,000 |

The opportunities in the space are clear and the H-Source management team is prepared to deliver. Both the CEO and President have extensive industry experience. John Kupice, CEO, spent over 10 years with Ernst & Young, LLP as director of Lawson practice providing program management and implementation assistance for clients in multiple industries including healthcare in North America. Murray Walden, President, has been in the medical industry for over 20 years working with hospitals, GPOs and medical device companies. The company also has a deep bench of experienced industry veterans on their board of directors. Follow the attached link http://h-source.com/investors/ for complete biographies on the management team and board of directors.

**Catalysts to Drive Growth**

1) Given H-Source's unique competitive position, the company is likely to sign additional strategic partnerships and royalty agreements over the next few quarters/years.

2) Contracted and Active user growth should continue/accelerate as revenue growth supports adding sales staff.

3) Revenue per Active user should increase as members become more comfortable with the platform and cost savings fortify increased use.

4) Company has had discussions with multiple Original Equipment Manufacturer (OEM) suppliers and is likely to begin providing new product on their platform at some point in 2018. These revenues will initially be small and scale over time. More importantly this lays the groundwork to become a one-stop online purchasing platform for their customers.

5) Given rising costs and shrinking operating margins consolidation will continue in the healthcare industry. This could lead to potential M&A going forward.

**Competitive Landscape**

H-Source has no U.S. publicly traded competition. There are only a few competitors in the space, which don't compete directly with the company:

Scientific Equipment Liquidators

The company buys used equipment from hospitals, primarily in liquidation and then resells the product on its website. This model dramatically increases the capital requirements to bring buyers and seller together. Additionally, the cost to carry inventory dramat-

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ically reduces the company's ability to scale going forward.

Alternup Medical

This is a French company that purchases new and used equipment for resale. They face the same high fixed cost business model that will impede rapid growth going forward. Alternup Medical also lacks customer transparency vis-à-vis their antiquated quote based platform. Under this business model customers can search for product on their website and then must request a quote from the company. This used car buying experience is not what healthcare facilities are demanding.

Uni-med Healthcare LTD

This company is based in Singapore and faces numerous competitive disadvantages. They do not provide an on-line marketplace and are at an inherent disadvantage procuring product outside of the United States. Not having a CE mark for international approval or FDA clearance limits its ability to re-distribute product in the developed world. Conversely, all of H-Source product are CE marked or FDA approved, allowing for a global marketplace for their customers.

BidMed

This U.S.-based company originally focused on hospital liquidations. Over the last few years they have developed data analytics software and management and planning services. The company is trying to offer a lower working capital model but is still very reliant on its legacy business.  H-Source signed a partnership with BidMed in early 2017.

Relink Medical

This U.S.-based company was founded in 2014. It focuses on improving the disposition process for hospitals and health systems. The collaboration of Relink and H-Source could create some positive synergies.

Lumere

Another interesting non-direct competitor is Procure, which recently changed its name to Lumere. Lumere provides data analytics software that allows clinicians to purchase both devices and drugs based on clinical outcomes. This innovative model allows physicians to use products that drive positive clinical outcomes versus making their decisions based on personal preference and/or kick-backs/consulting fees from the manufacturer. Although this is a very thoughtful platform that will bring frictional costs out of the system it does not address the waste that is created when practitioners move from one product to another, thus mothballing legacy inventory. As Lumere and other companies move physicians from being sold product to utilizing those products that have the best clinical outcomes, there will be more demand for inventory redeployment solutions. Lumere could be a good partner or acquirer of H-Source over the next few years.

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## H-Source Revenue and Profitability Prospects

As depicted in the Income Statement below, the company has gone from having no revenue this time last year to an estimated $270, 000 for fiscal 2017. The potential revenue opportunity in fiscal 2018 is currently forecasted at over $3 million. This dramatic increase in revenue will be driven by a continued acceleration in contracted hospitals and more importantly, increasing Active hospital users. Active users have been growing at a faster rate (almost 200 percent) versus Contracted hospitals (almost 100 percent).

We expect this trend to continue throughout 2018 and will be a material driver to revenue growth. The management team has spent the last few years building relationships with strategic partners (independent hospitals, GPOs, IDNs, etc.) and can now focus on increasing Active user activity, which will drive top-line sales.

Additionally, the company has been in active negotiations with multiple strategic partners for their white-label business. Their white-label business involves licensing the platform to larger industry players, whereby they receive an annual subscription in addition to ongoing transactional revenue. The transactional business under this model is at a lower percentage, but still very attractive when combining both the transactional revenue and recurring royalty payments. It is also anticipated that organizations that invest in a white-label agreement will have higher utilization rates. Our model does not include any large partnership and/or white-label business. The white label business would increase the Enhanced Service revenues going forward.

## Understanding the Income Statement

| | Full Year 2016 | Q1, 2017 | Q2, 2017 | Q3, 2017 | Q4, 2017 | Full Year 2017 | Full Year 2018 | Full Year 2019 | Full Year Long-term |
|---|---|---|---|---|---|---|---|---|---|
| Platform | | | $ - | $ 50,000 | $ 55,000 | $ 105,000 | $ 1,150,000 | $ 2,500,000 | $ 5,000,000 |
| Distribution | | | $ 7,439 | $ 78,408 | $ 80,000 | $ 165,847 | $ 1,600,000 | $ 3,200,000 | $ 7,000,000 |
| Enhanced Services | | | | $ - | $ - | $ - | $ 550,000 | $ 1,000,000 | $ 2,000,000 |
| Total Revenue | $ - | $ - | $ 7,439 | $ 128,408 | $ 135,000 | $ 270,847 | $ 3,300,000 | $ 6,700,000 | $ 14,000,000 |
| *growth (yoy)* | | | | | | | *1118.4%* | *103.0%* | *109.0%* |
| Cost of Goods Sold | | | $ - | $ 28,633 | $ 30,000 | $ 58,000 | $ 510,000 | $ 1,030,000 | $ 2,000,000 |
| Gross Profit | | | $ - | $ 99,775 | $ 105,000 | $ 212,847 | $ 2,790,000 | $ 5,670,000 | $ 12,000,000 |
| *gross profit margin* | | | *0.0%* | *77.7%* | *77.8%* | *78.6%* | *84.5%* | *84.6%* | *85.7%* |
| SG&A | $ (2,224,546) | $ (504,786) | $ (578,358) | $ (545,986) | $ (560,000) | $ (2,189,130) | $ (2,600,000) | $ (3,000,000) | $ (3,500,000) |
| Other -one time charges | $ (69,933) | $ 16,328 | $ 20,935 | $ 68,648 | $ - | $ 105,911 | $ - | $ - | $ - |
| Other - share based comp | $ (221,690) | $ - | $ - | $ - | -200000 | $ (200,000) | $ (250,000) | $ (300,000) | $ (350,000) |
| Total Expenses | $ (2,516,169) | $ (488,458) | $ (557,423) | $ (477,338) | $ (760,000) | $ (2,283,219) | $ (2,850,000) | $ (3,300,000) | $ (3,850,000) |
| Other Interest Income/Expense | $ (98,573) | $ 681 | $ 5,402 | $ 2,860 | $ 1,000 | $ 9,943 | $ 10,000 | $ - | $ - |
| Net Income/Loss | $ (2,614,742) | $ (487,777) | $ (552,021) | $ (374,703) | $ (624,000) | $ (2,273,276) | $ (50,000) | $ 2,370,000 | $ 8,150,000 |
| EPS (fully diluted) | $ (0.04) | $ (0.01) | $ (0.01) | $ (0.00) | $ (0.01) | $ (0.02) | $ (0.00) | $ 0.02 | $ 0.08 |
| Diluted Shares Out (000's) | 63,650.82 | 75,716.00 | 87,978.51 | 88,366.76 | 105,924.71 | 89,496.49 | 106,000.00 | 107,000.00 | 108,000.00 |
| Price Target (25 x Forecasted EPS) | | | | | | | | $ 0.55 | $ 1.89 |

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The income statement on the previous page, does not include any large partnership(s) and/or white-label business. The gradual revenue growth is based on individual customer acquisitions over the next three years. Any large partnership would dramatically change both revenue and margin assumptions going forward. COGS margin will decrease over time as revenues ramp. SG&A will increase with sales, but decrease as a percentage of sales as revenues accelerate. Diluted Shares Outstanding should hold relatively stable over the next few years as profitability should fund future growth.

**Valuation Analysis:**

Price/Earnings Valuation

As shown on the previous page, using a 25-x multiple of earnings the stock should be worth $0.55 in 24 months and $1.89 in 3 years. This is a conservative assumption as most growth stocks trade at approximately 1-x their growth rate. We currently forecast approximately 100 percent revenue growth over the foreseeable future.

Traditional Valuation:

Diagram 1., below, shows current valuations for publicly traded healthcare medical technology companies. Diagram 2., on the next page, shows the Enterprise Value of the business if the company achieves our revenue targets. The valuation assumptions are conservative given the industry average price/sales is 3.22x and sales growth for the group is below 9 percent. We assign a 5x sales multiple next year (above the industry average) given the company's sales growth will materially surpass industry growth. The 5x multiple is difficult to determine because the company is working off a very low base level of sales. As the business model and sales become more meaningful the multiple will become more understandable and reliable moving forward. With that said, we assign a conservative 3x multiple in 2019 and beyond, despite revenue growth that is likely to far surpass industry growth.

**Diagram 1., Industry Valuations, April 24, 2018**

| Company Name | Ticker Symbol | Market Cap (mls) | | Price/Sales* | Forecasted Revenue Growth (Zacks) |
|---|---|---|---|---|---|
| H-Source | HSCHF | $ | 8.47 | 2.57 | 100%+ |
| Allscripts Health | MDRX | $ | 2,176.36 | 1.2 | 16.54% |
| Cerner Corp | CERN | $ | 19,426.45 | 3.78 | 7.21% |
| AthenaHealth | ATHN | $ | 5,744.01 | 4.71 | 12.69% |
| Omnicell | OMCL | $ | 1,701.97 | 2.38 | 3.40% |
| Medidata Solutions | MDSO | $ | 4,292.45 | 7.56 | 17.73% |
| Quality Systems | QSII | $ | 899.00 | 1.7 | 3.48% |
| HMS Holdings | HMSY | $ | 1,495.28 | 2.86 | 5.08% |
| Computer Programs | CPSI | $ | 425.40 | 1.54 | 3.61% |
| Industry Average (excluding H-Source) | | $ | 4,520.12 | 3.22 | 8.72% |

**H-Source Sales are based on forecasted 2018 revenue*

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**Diagram 2., Forward Price/Sales (estimate)**

| Company Metrics | 2018 Enterprise Value | 2019 Enterprise Value | LT Enterprise Value |
|---|---|---|---|
| 2018 Price/Sales Estimate (5 x Sales) | $ 16,500,000 | | |
| 2019 Price/Sales Estimate (3 x Sales) | | $ 20,100,000 | |
| LT Price/Sales Estimate (3 x Sales) | | | $ 42,000,000.00 |
| | | | |
| Projected Diluted Shares Out | 106,000,000 | 107,000,000 | 108,000,000 |
| | | | |
| 2018 Price Target | $ 0.16 | | |
| 2019 Price Target | | $ 0.19 | |
| LT Price Target | | | $ 0.39 |
| | | | |
| Projected Return | 55.7% | 87.9% | 288.9% |

<u>Private Equity Valuation:</u>

As mentioned in the Competitive Landscape description, Lumere is an innovative company that could be a synergistic acquirer or partner for H-Source. It is an interesting company because they have recently raised $10 million in Series B fundraising from a prestigious group of investors. The Series B round was led by Heritage Group, a venture capital firm backed by some of the country's largest healthcare companies. HCA subsidiary Health Insight Capital also participated. This fundraise shows the heightened level of interest in driving costs out of the system and bodes well for H-Source moving to the next level of capital raises to finance their growth. In today's financing world the lion's share of profits are made when companies move from local financing (e.g friends and family, crowd funding, etc.) to established venture capital backing. Given H-Source's forecasted revenue growth and partnering opportunities it makes sense to own the stock before this next phase of financing revalues the business. The diagram below shows H-Source is being valued at half the valuation of Lumere.

| | | Lumere | H-Source |
|---|---|---|---|
| Capital Raises | | | |
| | 2014 | $ 4,000,000 | $ 168,000 |
| | 2015 | $ - | $ 2,264,294 |
| | 2016 | $ 10,000,000 | $ 2,812,971 |
| | 2017 | $ - | $ 3,220,200 |
| | 2018 | $ - | $ 1,750,000 |
| Total | | $ 14,000,000 | $ 10,215,465 |
| | | | |
| Most Recently Reported Hospitals Under Contract | | 450 | 1,010 |

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## Blended 2019 Price Target

| | | |
|---|---|---|
| Price/Earnings | $ | 0.55 |
| Traditional Valuation (price/sales) | $ | 0.19 |
| Private Equity | $ | 0.20 |
| Blended Average | $ | 0.31 |

## Defensive Growth Investing is NOT an Oxymoron

Valuations in the stock market are high (approximately 20 x GAAP Earnings) and the IPO marketplace has been extraordinarily slow. This is atypical as high stock market valuations have historically fueled a torrid issuance of IPOs. This phenomena is a result of even higher valuations paid for private equity and venture capital deals. This type of investing environment supports finding early stage companies with great growth opportunities. Most of the easy money is being made in the early venture capital stages of financing. Although H-Source is publicly traded its business prospects are more representative of a venture capital backed business. Given today's investment climate finding individual growth companies in their early stage is a more defensible strategy than over-paying for a low growth stock market.

## Summary

H-Source is at the forefront of addressing our healthcare waste and sustainability issues. Given uncontrollable demographics/utilization trends, companies will need to control costs going forward. Eliminating waste is the elephant in the operating room. As H-Source educates and penetrates the marketplace, revenues are likely to accelerate at a rapid rate. This revenue growth could go parabolic if the company signs a strategic partnership with a large GPO and/or IDN. Additionally, the company could partner or be acquired by a handful of industry disruptors (e.g. AC Wellness, Amazon/Berkshire/J.P. Morgan group, etc.). Without a material partnership the company is still well positioned to grow organically. Our model assumes gradual organic growth and the company doing $14 million in sales over the next three years. Our 2019 blended price target is $0.31, which is conservative and will be surpassed if the company lands a large partnership. We will update our model as the company makes progress throughout the year.

## Risks

Liquidity Risk - H-Source is a small publicly traded company that is thinly traded. The stock trades on the OTC Bulletin Board and TSX exchanges. If the company becomes insolvent or experiences any unforeseen problems it could be difficult to exit/sell the stock.

Regulatory Risk - H-Source operates in the health care sector where regulatory requirements are constantly changing. Any unforeseen regulatory change could pose risk to their business model.

Financing Risk - H-Source has been building their platform and customer relationships since the inception of the firm. If the company is not able to reach their revenue targets, it

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could be forced to raise additional capital, diluting the value to current shareholder's. Additionally, if the company is extraordinarily successful it could need additional capital to facilitate future revenue growth.

Management Risk - The CEO and Founder have been instrumental in building the business. Additionally, recent board member additions have built confidence and relationships with both investors and customers. Loss of any of these members could create perceived and/or realistic risk to the business going forward.

**Disclosures**

H-Source has compensated the writers of this research report. This could influence their unbiased view of both the company and industry prospects. Additionally, one of the contributors owns stock in the company and will benefit if the stock price increases. For more information regarding the writers compensation and stock ownership please contact H-Source directly.