Evolent Health, Inc.
Form 10-Q
November 10, 2016

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, 2016
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: 001-37415

Evolent Health, Inc.
(Exact name of registrant as specified in its charter)

Delaware	32-0454912
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
800 N. Glebe Road, Suite 500, Arlington, Virginia	22203
(Address of principal executive offices)	(Zip Code)

(571) 389-6000
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed 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 (Do not check if a smaller reporting company) 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

As of November 7, 2016, there were 52,576,422 shares of the registrant's Class A common stock outstanding and 15,346,981 shares of the registrant's Class B common stock outstanding.

Evolent Health, Inc.
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Explanatory Note

In this Quarterly Report on Form 10-Q, unless the context otherwise requires, "Evolent," the "Company," "we," "our" and "us" refer to (1) prior to the completion of the Offering Reorganization described in "Part I - Item 1. Business - Initial Public Offering and Organizational Transactions - the Offering Reorganization in our Annual Report on Form 10-K for the year ended December 31, 2015, as amended, filed with the SEC on February 29, 2016 ("2015 Form 10-K"), Evolent Health Holdings, Inc., our predecessor, (including its operating subsidiary, Evolent Health LLC), and (2) after giving effect to such reorganization, Evolent Health, Inc. and its consolidated subsidiaries. Evolent Health LLC, a subsidiary of Evolent Health, Inc. through which we conduct our operations, has owned all of our operating assets and substantially all of our business since inception. Evolent Health, Inc. is a holding company and its principal asset is all of the Class A common units of Evolent Health LLC. As described below under "Part I - Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations," the financial statements of Evolent Health, Inc. for the nine months ended September 30, 2015, do not reflect a complete view of the operational results for that period. Evolent Health, Inc.'s results reflect only the investment of Evolent Health, Inc.'s predecessor in its equity method investee, Evolent Health LLC, for the period from January 1, 2015, through June 3, 2015.

For more information about the Offering Reorganization, refer to "Part I - Item 1. Business - Initial Public Offering and Organizational Transactions" in our 2015 Form 10-K.

FORWARD-LOOKING STATEMENTS - CAUTIONARY LANGUAGE

Certain statements made in this report and in other written or oral statements made by us or on our behalf are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). A forward-looking statement is a statement that is not a historical fact and, without limitation, includes any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain words like: "believe," "anticipate," "expect," "estimate," "aim," "predict," "potential," "continue," "plan," "project," "will," "should," "might" and other words or phrases with similar meaning in connection with a discussion of future operating or financial performance. In particular, these include statements relating to future actions, trends in our businesses, prospective services, future performance or financial results and the outcome of contingencies, such as legal proceedings. We claim the protection afforded by the safe harbor for forward-looking statements provided by the PSLRA.
These statements are only predictions based on our current expectations and projections about future events. Forward-looking statements involve risks and uncertainties that may cause actual results, level of activity, performance or achievements to differ materially from the results contained in the forward-looking statements. Risks and uncertainties that may cause actual results to vary materially, some of which are described within the forward-looking statements, include, among others:

- certain risks and uncertainties associated with the acquisition of Valence Health, Inc., excluding its contracts serving certain state insurance cooperatives ("Valence Health"), including:
  - revenues of Valence Health before and after the merger may be less than expected, and expected results of Evolent may not be impacted as anticipated;
  - our ability to implement integration plans for the merger and to recognize the anticipated growth, benefits, cost savings and synergies of the merger;
  - the risks that the merger and the other transactions contemplated by the merger agreement disrupt current plans and operations and the potential difficulties in retention of any members of senior management of Valence Health and any other key employees that Evolent is interested in retaining after the closing of the merger;
  - the effect of the merger on Evolent's and Valence Health's business relationships, customers, suppliers, other partners, standing with regulators, operating results and businesses generally;
  - the amount of any costs, fees, expenses, impairments and charges related to the merger; and

the market price for our Class A common stock potentially being affected, following the merger, by factors that historically have not affected the market price for our Class A common stock;

- the structural change in the market for healthcare in the United States;
- our ability to effectively manage our growth;
- the significant portion of revenue we derive from our largest partners;
- our ability to offer new and innovative products and services;
- the growth and success of our partners, which is difficult to predict and is subject to factors outside of our control, including premium pricing reductions and the ability to control and, if necessary, reduce health care costs;
- our ability to attract new partners;
- our ability to recover the significant upfront costs in our partner relationships;
- our ability to estimate the size of our target market;
- our ability to maintain and enhance our reputation and brand recognition;
- consolidation in the healthcare industry;
- competition which could limit our ability to maintain or expand market share within our industry;
- our ability to partner with providers due to exclusivity provisions in our contracts;
- uncertainty in the healthcare regulatory framework;

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- restrictions and penalties as a result of privacy and data protection laws;
- adequate protection of our intellectual property;
- any alleged infringement, misappropriation or violation of third-party proprietary rights;
- our use of “open source” software;
- our ability to protect the confidentiality of our trade secrets, know-how and other proprietary information;
- our reliance on third parties;
- our ability to use, disclose, de-identify or license data and to integrate third-party technologies;
- data loss or corruption due to failures or errors in our systems and service disruptions at our data centers;
- breaches or failures of our security measures;
- our reliance on Internet infrastructure, bandwidth providers, data center providers, other third parties and our own systems for providing services to our users;
- our dependency on our key personnel, and our ability to attract, hire, integrate and retain key personnel;
- risks related to acquisitions, investments and alliances;
- the risk of potential future goodwill impairment on our results of operations;
- our future indebtedness and our ability to obtain additional financing;
- our ability to achieve profitability in the future;
- the requirements of being a public company;
- our adjusted results may not be representative of our future performance;
- the risk of potential future litigation;
- our ability to remediate the material weakness in our internal control over financial reporting;
- our holding company structure and dependence on distributions from Evolent Health LLC;
- our obligations to make payments to certain of our pre-IPO investors for certain tax benefits we may claim in the future;
- our ability to utilize benefits under the tax receivables agreement;
- our ability to realize all or a portion of the tax benefits that we currently expect to result from past and future exchanges of Class B common units of Evolent Health LLC for our Class A common stock, and to utilize certain tax attributes of Evolent Health Holdings and an affiliate of TPG;
- distributions that Evolent Health LLC will be required to make to us and to the other members of Evolent Health LLC;
- our obligations to make payments under the tax receivables agreement that may be accelerated or may exceed the tax benefits we realize;
- different interests among our pre-IPO investors, or between us and our pre-IPO investors;
- the terms of agreements between us and certain of our pre-IPO investors;
- our exemption from certain corporate governance requirements due to our previous status as a “controlled company” within the meaning of the New York Stock Exchange rules;
- the potential volatility of our Class A common stock price;
- the potential decline of our Class A common stock price if a substantial number of shares become available for sale or if a large number of Class B common units is exchanged for shares of Class A common stock;
- provisions in our amended and restated certificate of incorporation and amended and restated by-laws and provisions of Delaware law that discourage or prevent strategic transactions, including a takeover of us;
- the ability of certain of our investors to compete with us without restrictions;
- provisions in our certificate of incorporation which could limit our stockholders’ ability to obtain a favorable judicial forum for disputes with us or our directors, officers or employees;
- our intention not to pay cash dividends on our Class A common stock; and
- our status as an “emerging growth company.”

The risks included here are not exhaustive. Although we believe the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, level of activity, performance or achievements. Our 2015 Form 10-K and other documents filed with the SEC include additional factors that could affect our businesses and financial performance. Moreover, we operate in a rapidly changing and competitive environment. New risk factors emerge from time to time, and it is not possible for management to predict all such risk factors.

Further, it is not possible to assess the effect of all risk factors on our businesses or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. In addition, we disclaim any obligation to update any forward-looking statements to reflect events or circumstances that occur after the date of this report.

PART I – FINANCIAL INFORMATION
Item 1. Financial Statements
EVOLENT HEALTH, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited, in thousands, except share data)

	As of September 30, 2016	As of December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 109,777	$ 145,726
Restricted cash	4,990	4,703
Accounts receivable, net (amounts related to affiliates: 2016 - $5,768; 2015 - $10,185)	21,986	20,381
Prepaid expenses and other current assets (amounts related to affiliates: 2016 - $37; 2015 - $1,220)	4,983	4,208
Investments, at amortized cost	49,693	9,445
Total current assets	191,429	184,463
Restricted cash	1,580	1,582
Investments, at amortized cost	—	44,618
Investments in and advances to affiliates	2,538	—
Property and equipment, net	21,123	12,796
Prepaid expenses and other non-current assets	12,118	—
Intangible assets, net	162,789	163,152
Goodwill	459,703	608,903
Total assets	$ 851,280	$ 1,015,514
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Liabilities		
Current liabilities:		
Accounts payable (amounts related to affiliates: 2016 - $11,506; 2015 - $13,311)	$ 14,486	$ 16,699
Accrued liabilities (amounts related to affiliates: 2016 - $629; 2015 - $828)	11,839	6,047
Accrued compensation and employee benefits	21,287	21,925
Deferred revenue	17,717	14,835
Total current liabilities	65,329	59,506
Other long-term liabilities	7,997	111
Deferred tax liabilities, net	18,097	21,318
Total liabilities	91,423	80,935
Commitments and Contingencies (See Note 8)		
Shareholders' Equity (Deficit)		
Class A common stock - $0.01 par value; 750,000,000 shares authorized; 45,028,807 and 41,491,498 shares issued and outstanding as of September 30, 2016, and December 31, 2015, respectively	448	415
Class B common stock - $0.01 par value; 100,000,000 shares authorized; 15,346,981 and 17,524,596 shares issued and outstanding as of September 30, 2016, and December 31, 2015, respectively	153	175

Additional paid-in-capital	397,603	342,063
Retained earnings (accumulated deficit)	164,024	306,688
Total shareholders' equity (deficit) attributable to Evolent Health, Inc.	562,228	649,341
Non-controlling interests	197,629	285,238
Total equity (deficit)	759,857	934,579
Total liabilities and shareholders' equity (deficit)	$ 851,280	$ 1,015,514

See accompanying Notes to Consolidated Financial Statements

EVOLENT HEALTH, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited, in thousands, except per share data)

	For the Three Months Ended September 30, 2016	For the Three Months Ended September 30, 2015	For the Nine Months Ended September 30, 2016	For the Nine Months Ended September 30, 2015
Revenue				
Transformation [1]	$7,757	$6,783	$26,259	$9,486
Platform and operations [1]	52,453	33,623	139,918	41,334
Total revenue	60,210	40,406	166,177	50,820
Expenses				
Cost of revenue (exclusive of depreciation and amortization expenses presented separately below) [1]	33,905	24,762	95,294	32,649
Selling, general and administrative expenses [1]	38,398	29,834	103,101	42,916
Depreciation and amortization expenses	3,746	3,056	10,728	4,040
Goodwill impairment	—	—	160,600	—
Total operating expenses	76,049	57,652	369,723	79,605
Operating income (loss)	(15,839)	(17,246)	(203,546)	(28,785)
Interest income (expense), net	255	54	805	67
Gain on consolidation	—	—	—	414,133
Income (loss) from affiliates	(448)	—	(462)	(28,165)
Other income (expense), net	1	—	4	—
Income (loss) before income taxes and non-controlling interests	(16,031)	(17,192)	(203,199)	357,250
Provision (benefit) for income taxes	(256)	(104)	(1,614)	29,169
Net income (loss)	(15,775)	(17,088)	(201,585)	328,081
Net income (loss) attributable to non-controlling interests	(4,567)	(5,108)	(59,250)	(8,532)
Net income (loss) attributable to Evolent Health, Inc.	$(11,208)	$(11,980)	$(142,335)	$336,613
Earnings (Loss) Available for Common Shareholders				
Basic	$(11,208)	$(11,980)	$(142,335)	$334,429
Diluted	(11,208)	(11,980)	(142,335)	328,081
Earnings (Loss) per Common Share				
Basic	$(0.26)	$(0.29)	$(3.34)	$17.05
Diluted	(0.26)	(0.29)	(3.34)	7.93
Weighted-Average Common Shares Outstanding				
Basic	43,110	41,468	42,632	19,618
Diluted	43,110	41,468	42,632	41,398

(1) Amounts related to affiliates included above are as follows (see Note 15):

Revenue				
Transformation	$67	$485	$169	$534
Platform and operations	8,636	10,732	24,342	14,660

Expenses				
Cost of revenue (exclusive of depreciation and amortization)	$3,723	$6,470	$14,209	$8,303
Selling, general and administrative expenses	531	689	1,298	940

See accompanying Notes to Consolidated Financial Statements

EVOLENT HEALTH, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	For the Nine Months Ended September 30,	
	2016	2015
Cash Flows from Operating Activities		
Net income (loss)	$(201,585)	$328,081
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on consolidation	—	(414,133)
(Income) loss from affiliates	462	28,165
Depreciation and amortization expenses	10,728	4,040
Goodwill impairment	160,600	—
Stock-based compensation expense	13,844	10,536
Deferred tax provision (benefit)	(1,614)	29,169
Other	443	93
Changes in assets and liabilities:		
Accounts receivables, net	(1,605)	3,663
Prepaid expenses and other current assets	(112)	(1,348)
Accounts payable	(3,692)	1,073
Accrued liabilities	6,165	(6,384)
Accrued compensation and employee benefits	(638)	6,322
Deferred revenue	2,882	(1,434)
Other long-term liabilities	117	—
Net cash provided by (used in) operating activities	(14,005)	(12,157)
Cash Flows from Investing Activities		
Cash acquired upon consolidation of affiliate	—	13,065
Cash paid for asset acquisition or business combination	(14,000)	—
Purchases of investments	—	(2,023)
Investments in and advances to affiliates	(3,000)	—
Maturities and sales of investments	4,099	4,000
Purchases of property and equipment	(11,116)	(3,907)
Change in restricted cash	1,194	—
Net cash provided by (used in) investing activities	(22,823)	11,135
Cash Flows from Financing Activities		
Proceeds from initial public offering, net of offering costs	—	209,087
Proceeds from stock option exercises	1,244	92
Taxes withheld for vesting of restricted stock units	(365)	—
Net cash provided by (used in) financing activities	879	209,179
Net increase (decrease) in cash and cash equivalents	(35,949)	208,157
Cash and cash equivalents as of beginning-of-period	145,726	—
Cash and cash equivalents as of end-of-period	$109,777	$208,157
Supplemental Disclosure of Non-cash Investing and Financing Activities		

Non-cash contribution of common stock to Evolent Health LLC prior to the Offering Reorganization	$ —	$21,810
Unsettled investment purchases	—	22,048
Accrued property and equipment purchases	374	53
Stock issued in connection with business combinations	10,534	—
Effects of the Offering Reorganization:		
Reclassification of deferred offering costs acquired to additional paid-in capital	—	3,154
Conversion of existing equity as part of the Offering Reorganization	—	39,014
Issuance of Class B common stock	—	196
Assumption of non-controlling interest as a result of merger with TPG affiliate	—	34,875
Effects of the Secondary Offering		
Decrease in non-controlling interests as a result of the Exchange	28,220	—

See accompanying Notes to Consolidated Financial Statements

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EVOLENT HEALTH, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS’ EQUITY (DEFICIT) AND REDEEMABLE PREFERRED STOCK
(unaudited, in thousands)

	Series A Redeemable Preferred Stock		Series B Redeemable Preferred Stock		Series B-1 Redeemable Preferred Stock		Series A Preferred Stock		Class A Common Stock		Class B Common Stock		Additional Paid-in
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Capital
Balance as of December 31, 2014	7,900	$12,847	6,468	$24,833	360	$1,593	7,400	$2	4,048	$1	—	$—	$23,733
Non-cash issuance of common stock to Evolent Health LLC	—	—	—	—	—	—	—	—	—	—	—	—	21,810
Net income (loss) prior to the Offering Reorganization	—	—	—	—	—	—	—	—	—	—	—	—	—
Effects of the Offering Reorganization:													
Conversion of existing equity	(7,900)	(12,847)	(6,468)	(24,833)	(360)	(1,593)	(7,400)	(2)	22,128	261	—	—	39,014
Issuance of Class B common stock	—	—	—	—	—	—	—	—	—	—	19,576	196	(196)
Merger with TPG affiliate	—	—	—	—	—	—	—	—	2,051	21	(2,051)	(21)	34,875
Issuance of Class A common stock sold in initial public offering, net of offering costs	—	—	—	—	—	—	—	—	13,225	132	—	—	205,801
Tax effect of Offering Reorganization	—	—	—	—	—	—	—	—	—	—	—	—	2,144
Stock-based compensation expense subsequent to the Offering Reorganization	—	—	—	—	—	—	—	—	—	—	—	—	14,730

Exercise of stock options	—	—	—	—	—	—	—	—	39	—	—	—	152
Net income (loss) subsequent to the Offering Reorganization	—	—	—	—	—	—	—	—	—	—	—	—	—
Balance as of December 31, 2015	—	—	—	—	—	—	—	—	41,491	415	17,525	175	342,063
Cumulative-effect adjustment from adoption of new accounting principle	—	—	—	—	—	—	—	—	—	—	—	—	468
Stock-based compensation expense	—	—	—	—	—	—	—	—	—	—	—	—	13,844
Exercise of stock options	—	—	—	—	—	—	—	—	217	—	—	—	1,244
Restricted stock units vested, net of shares withheld for taxes	—	—	—	—	—	—	—	—	76	—	—	—	(365)
Exchange of Class B common stock	—	—	—	—	—	—	—	—	2,178	22	(2,178)	(22)	28,220
Tax impact of Class B common stock exchange	—	—	—	—	—	—	—	—	—	—	—	—	1,606
Issuance of common stock for business combination	—	—	—	—	—	—	—	—	1,067	11	—	—	10,523
Net income (loss)	—	—	—	—	—	—	—	—	—	—	—	—	—
Balance as of September 30, 2016	—	$—	—	$—	—	$—	—	$—	45,029	$448	15,347	$153	$397,603

See accompanying Notes to Consolidated Financial Statements

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EVOLENT HEALTH, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization

Evolent Health, Inc. was incorporated in December 2014 in the state of Delaware, and is a managed services firm that supports leading health systems and physician organizations in their migration toward value-based care and population health management. The Company’s services include providing our customers, which we refer to as partners, with a population management platform, integrated data and analytics capabilities, pharmacy benefit management (“PBM”) services and comprehensive health plan administration services. Together these services enable health systems to manage patient health in a more cost-effective manner. The Company’s contracts are structured as a combination of advisory fees, monthly member service fees, percentage of plan premiums and shared medical savings arrangements. The Company’s headquarters is located in Arlington, Virginia.

Our predecessor, Evolent Health Holdings, Inc. (“Evolent Health Holdings”), merged with and into Evolent Health, Inc. in connection with the Offering Reorganization. As a result, the consolidated financial statements of Evolent Health, Inc. reflect the historical accounting of Evolent Health Holdings.

Prior to the organizational transactions noted below, due to certain participating rights granted to our investor, TPG Global, LLC and certain of its affiliates (“TPG”), Evolent Health Holdings did not control Evolent Health LLC, our operating subsidiary company, but was able to exert significant influence and, accordingly, accounted for its investment in Evolent Health LLC using the equity method of accounting through June 3, 2015. Subsequent to the Offering Reorganization (as defined below), initial public offering (“IPO”) and secondary offering described below, as of September 30, 2016, Evolent Health, Inc. owns 74.6% of Evolent Health LLC, holds 100% of the voting rights, is the sole managing member and, therefore, controls its operations. Accordingly, the financial results of Evolent Health LLC are consolidated in the financial statements of Evolent Health, Inc. subsequent to the Offering Reorganization.

Initial Public Offering

In June 2015, we completed an IPO of 13.2 million shares of our Class A common stock at a public offering price of $17.00 per share. We received $209.1 million in proceeds, net of underwriting discounts and commissions. Offering expenses incurred were $3.2 million which were recorded as a reduction of proceeds from the offering. We used the net proceeds to purchase newly-issued Class A common units from Evolent Health LLC, our consolidated subsidiary. Evolent Health LLC will use the net proceeds for working capital and other general corporate and strategic purposes. See Note 4 for further details surrounding the IPO and related transactions.

Organizational Transactions

In connection with the IPO, we completed the following organizational transactions (the “Offering Reorganization”) as further described in Note 4:

- We amended and restated our certificate of incorporation to, among other things, authorize two classes of common stock - Class A common stock and Class B exchangeable common stock. Both classes of stock will vote together as a single class.
- We acquired, by merger, an affiliate of a member of Evolent Health LLC, for which we issued 2.1 million shares of Class A common stock.
- We issued shares of our Class B exchangeable common stock to certain existing members of Evolent Health LLC.

Secondary Offering

In September 2016, the Company completed a secondary offering of 8.6 million shares of its Class A common stock at a price to the public of $22.50 per share. The shares sold in the offering were sold by certain affiliates of TPG Global, LLC, The Advisory Board Company, UPMC, Ptolemy Capital, LLC (together, the “Investor Stockholders”) and certain management selling stockholders (together with the Investor Stockholders, the “Selling Stockholders”). The Company did not receive any proceeds from the sale of the shares.

The shares sold in the offering consisted of 6.4 million existing shares of the Company’s Class A common stock owned and held by the Selling Stockholders and 2.2 million newly-issued shares of the Company’s Class A common stock received by certain Investor Stockholders pursuant to the exercise of an existing exchange right.

The newly-issued shares of the Company’s Class A common stock were issued to certain Investor Stockholders in exchange (the “Exchange”) for an equal number of shares of the Company’s Class B common stock (which were subsequently canceled) and an equal number of Evolent Health LLC’s Class B common units (“Class B units”). Class B units received by the Company from relevant Investor Stockholders were simultaneously exchanged for an equivalent number of Class A units of Evolent Health LLC, and Evolent Health LLC canceled the Class B units it received in the Exchange.

As a result of the Exchange and Evolent Health LLC's cancellation of the Class B units, the Company's economic interest in Evolent Health LLC increased from 71.0% to 74.6% and, accordingly, we reclassified a portion of our non-controlling interests into shareholders' equity attributable to Evolent Health, Inc. The Company's economic interest in Evolent Health LLC will increase if further exchanges occur.

Since its inception, the Company has incurred losses from operations. As of September 30, 2016, the Company had cash and cash equivalents of $109.8 million. The Company believes it has sufficient liquidity for the next twelve months as of September 30, 2016.

2. Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

In our opinion, the accompanying unaudited interim consolidated financial statements include all adjustments, consisting of normal recurring adjustments, which are necessary to fairly state our financial position, results of operations, and cash flows. The consolidated balance sheet at December 31, 2015, has been derived from audited financial statements as of that date. The interim consolidated results of operations are not necessarily indicative of the results that may occur for the full fiscal year. Certain footnote disclosure normally included in financial statements prepared in accordance with United States of America generally accepted accounting principles ("GAAP") has been omitted pursuant to instructions, rules, and regulations prescribed by the United States Securities and Exchange Commission ("SEC"). The disclosures provided herein should be read in conjunction with the audited financial statements and notes thereto included in our 2015 Form 10-K.

As discussed in Note 4, amounts for the nine months ended September 30, 2015, presented in our unaudited consolidated financial statements and notes to unaudited consolidated financial statements for that period, include the historical operations of our predecessor entity, Evolent Health Holdings, which did not consolidate the operations of Evolent Health LLC for the entire nine month period. The amounts as of and for the three and nine months ended September 30, 2016, reflect our operations, which consolidate the operations of Evolent Health LLC.

All inter-company accounts and transactions have been eliminated in consolidation.

Summary of Significant Accounting Policies

Certain GAAP policies, which significantly affect the determination of our financial position, results of operations and cash flows, are summarized in our 2015 Form 10-K unless otherwise updated below.

Restricted Cash

Restricted cash is carried at cost, which approximates fair value, and includes cash used to collateralize various contractual obligations as follows (in thousands):

	As of September 30, 2016	As of December 31, 2015
Letters of credit for facility leases	$ 2,516	$ 3,710

Pharmacy benefit management services	3,902	2,479
Other	152	96
Total restricted cash	6,570	6,285
Non-current restricted cash	1,580	1,582
Current restricted cash	$ 4,990	$ 4,703

Change in Accounting Principle

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes,

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forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. The Company elected to early adopt ASU 2016-09 during the second quarter of 2016.

ASU 2016-09 requires that certain amendments resulting from the adoption of the new pronouncement be applied using a modified-retrospective transition method by means of a cumulative-effect adjustment to retained earnings as of the beginning of the period in which the guidance is adopted. Thus, the Company decreased beginning retained earnings by approximately ($0.5) million on January 1, 2016, for amendments related to an accounting policy election to recognize share-based award forfeitures as they occur rather than applying an estimated forfeiture rate. For the three months ended March 31, 2016, our net loss decreased by $0.1 million due to a reduction in stock compensation expense as a result of accounting for forfeitures as they occur, instead of using an estimated forfeiture rate. Therefore, the net impact to retained earnings as of March 31, 2016, was approximately ($0.4) million.

The following table summarizes the impact of the change in accounting principle to the Company's consolidated statement of operations for the three months ended March 31, 2016 (in thousands):

	As Reported	Adjustments	As Adjusted
Cost of revenue (exclusive of depreciation and amortization expenses)	$28,562	$ 48	$28,610
Selling, general and administrative expenses	32,095	(149)	31,946
Total operating expenses	224,628	(101)	224,527
Operating income (loss)	(175,179)	101	(175,078)
Income (loss) before income taxes and non-controlling interests	(174,900)	101	(174,799)
Net income (loss)	(173,912)	101	(173,811)
Net income (loss) attributable to non-controlling interests	(51,100)	29	(51,071)
Net income (loss) attributable to Evolent Health, Inc.	(122,812)	72	(122,740)

The following table summarizes the impact of the change in accounting principle to the Company's consolidated balance sheets, including the net amount charged to retained earnings as of March 31, 2016 (in thousands):

	As Reported	Adjustments (1)	As Adjusted
Additional paid-in capital	$357,047	$ 367	$357,414
Retained earnings (accumulated deficit)	183,876	(257)	183,619
Total shareholders' equity (deficit) attributable to Evolent Health, Inc.	541,524	(257)	541,267
Non-controlling interests	234,138	(110)	234,028

(1) The adjustments are a result of a cumulative-effect adjustment to beginning retained earnings of $(0.5) million, partially offset by an adjustment of $0.1 million to net income (loss) for the three months ended March 31, 2016, related to the policy election to recognize share-based award forfeitures as they occur, as opposed to applying an estimated forfeiture rate. Approximately $(0.3) million of the net adjustment was allocated to Evolent Health, Inc. and approximately $(0.1) million of the net adjustment was allocated to non-controlling interests.

In addition, the adoption of ASU 2016-09 changed how the Company recognizes excess tax benefits ("windfalls") or deficiencies ("shortfalls") related to share-based compensation. Prior to the adoption of ASU 2016-09, these windfalls and shortfalls were credited or charged, respectively, to additional paid-in capital in the Company's consolidated balance sheets. Under the revised standard, these windfalls and shortfalls are recognized prospectively as discrete tax benefit or discrete tax expense, respectively, in the Company's consolidated statement of operations. For the nine months ended September 30, 2016, the Company recognized a discrete tax benefit related to net windfall tax benefits from share-based compensation, which increased the net operating loss ("NOL") deferred tax asset and our valuation allowance.

3. Recently Issued Accounting Standards

Adoption of New Accounting Standards

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting. The update simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. This standard is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted for any interim or annual period. The Company elected to early adopt this ASU during the second quarter of 2016, as described in Note 2 above.

Future Adoption of New Accounting Standards

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments. This ASU provides updated guidance on eight specific cash flow issues to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. We intend to adopt the requirements of this standard effective January 1, 2018 and are currently evaluating the impact of the adoption on our statement of cash flows.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments. With respect to assets measured at amortized cost, such as held-to-maturity assets, the update requires presentation of the amortized cost net of a credit loss allowance. The update eliminates the probable initial recognition threshold that was previously required prior to recognizing a credit loss on financial instruments. The credit loss estimate can now reflect an entity's current estimate of all future expected credit losses as opposed to the previous standard, when an entity only considered past events and current conditions. With respect to available for sale debt securities, the update requires that credit losses be presented as an allowance rather than as a write-down. The update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We intend to adopt the requirements of this standard effective January 1, 2020 and are currently evaluating the impact of the adoption on our financial condition and results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases, in order to establish the principles to report transparent and economically neutral information about the assets and liabilities that arise from leases. This update introduces a new standard on accounting for leases, including a lessee model that brings most leases on the balance sheet. The new standard also aligns many of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those related to evaluating when profit can be recognized). The standard also requires lessors to increase the transparency of their exposure to changes in value of their residual assets and how they manage that exposure. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. We intend to adopt the requirements of this standard effective January 1, 2019, and are currently evaluating the impact of the adoption on our financial condition and results of operations.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, in order to clarify the principles of recognizing revenue. This standard establishes the core principle of recognizing revenue to depict the transfer of promised goods or services in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services. The FASB defines a five-step process that systematically identifies the various components of the revenue recognition process, culminating with the recognition of revenue upon satisfaction of an entity's performance obligation. By completing all five steps of the process, the core principles of revenue recognition will be achieved. In March 2016, the FASB issued an update to the new revenue standard (ASU 2014-09) in the form of ASU 2016-08, which amended the principal-versus-agent implementation guidance and illustrations in the new revenue guidance. The update clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued another update to the new revenue standard in the form of ASU 2016-10, which amended the guidance on identifying performance obligations and the implementation guidance on licensing. These ASUs were followed by two further updates issued during May 2016, including ASU 2016-11, which rescinds certain SEC guidance, such as the adoption of ASUs 2014-09 and 2014-16, including accounting for consideration given by a vendor to a customer, and ASU 2016-12, which is intended to clarify the objective of the collectability criterion while identifying the contract(s) with a customer. The new revenue standard (including updates) will be effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted only as of annual reporting periods beginning after December 15, 2016. We intend to adopt the requirements of this standard effective January 1, 2018, and, while we are evaluating the impact to our financial condition and results of operations, we expect the adoption of this ASU to require the inclusion of additional disclosures surrounding the nature and timing of our revenue.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern: Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern. This standard requires management to assess an entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards by requiring an assessment for a period of one year after the date that the financial statements are issued. Further, based on certain conditions and circumstances, additional disclosures may be required. This standard is effective beginning with the first annual period ending after December 15, 2016, and for all annual and interim periods thereafter. Early application is permitted. The Company does not expect this standard to have an impact on the Company’s financial statements or related disclosures.

We have evaluated all other issued and unadopted ASUs and believe the adoption of these standards will not have a material impact on our results of operations, financial position, or cash flows.

4. Acquisitions and Business Combinations

Business Combinations

Passport

On February 1, 2016, the Company entered into a strategic alliance with University Health Care d/b/a Passport Health Plan (“Passport”), a nonprofit community-based and provider-sponsored health plan administering Kentucky Medicaid and federal Medicare Advantage benefits to over 280,000 Kentucky Medicaid and Medicare Advantage beneficiaries. As part of the transaction, we issued 1.1 million Class A common shares to acquire capabilities and assets from Passport to enable us to build out a Medicaid Center of Excellence based in Louisville, Kentucky. Additional equity consideration of up to $10.0 million may be earned by Passport should we obtain new third party Medicaid businesses in future periods. This transaction also includes a 10-year arrangement under which we will provide various health plan management and managed care services to Passport. The Company has accounted for the transactions with Passport as a business combination using purchase accounting.

The fair value of the total consideration transferred in connection with the close of the transaction was $18.2 million, of which the Class A common shares were valued at $10.5 million and the contingent equity consideration was valued at $7.8 million. The contingent consideration is recorded within “Other long-term liabilities” on our consolidated balance sheets. The fair value of the shares issued was determined based on the closing price of the Company’s Class A common stock on the NYSE as of February 1, 2016, and the quantity of shares issued was determined under a pricing collar set forth in the purchase agreement. The fair value of the contingent equity consideration was estimated based on the real options approach, a form of the income approach, which estimated the probability of the Company achieving future revenues under the agreement. Key assumptions include the discount rate and the probability-adjusted recurring revenue forecast. A further discussion of the fair value measurement of the contingent consideration is provided in Note 14.

The purchase price was allocated to the assets acquired based on their estimated fair values as of February 1, 2016, as follows (in thousands):

Purchase price	$18,200
Less amount allocated to prepaid asset	6,900
Goodwill	$11,300

The prepaid asset is related to an acquired facility license agreement as the Company was provided with leased facilities which house the acquired Passport employees at no future cost. The fair value of the acquired facility license agreement was determined by comparing the current market value of similar lease spaces to the facilities occupied by the acquired Passport personnel to obtain a market value of the occupied space, with the present value of the determined market value of the occupied space classified as the acquired facility license agreement prepaid asset. The goodwill is attributable partially to the acquired assembled workforce. The transaction was a taxable event for the Company and the amount of goodwill determined for tax purposes is deductible upon the beginning of the amortization period for tax purposes.

Results for the three and nine months ended September 30, 2016, include revenues and related expenses from our services agreement with Passport and amortization of the acquired intangibles for the period February 1, 2016, through September 30, 2016. The consolidated statements of operations include $15.0 million and $31.1 million of revenues and $(3.0) million and $(4.4) million of net income (loss) attributable to Passport for the three and nine months ended September 30, 2016, respectively.

The Offering Reorganization

Evolent Health, Inc. was incorporated as a Delaware corporation on December 12, 2014, for the purpose of pursuing the Company's IPO. Immediately prior to the completion of the IPO in June 2015, we amended and restated our certificate of incorporation to, among other things, authorize two classes of common stock, Class A common stock and Class B common stock. Each share of our Class A common stock and Class B common stock entitles its holder to one vote on all matters to be voted on by stockholders, and holders of Class A common stock and holders of Class B common stock vote together as a single class on all matters presented to stockholders for their vote or approval (except as otherwise required by law). Pursuant to the Offering Reorganization:

- Evolent Health Holdings merged with and into Evolent Health, Inc. and the surviving corporation of the merger was Evolent Health, Inc.;
- An affiliate of TPG merged with and into Evolent Health, Inc. and the surviving corporation of the merger was Evolent Health, Inc.;

- Each of the then-existing stockholders of Evolent Health Holdings received four shares of our Class A common stock and the right to certain payments under the Tax Receivables Agreement ("TRA") in exchange for each share of Class A common stock held in Evolent Health Holdings;
- TPG received 2.1 million shares of Class A common stock of Evolent Health, Inc., together with the right to certain payments under the TRA in exchange for 100% of the equity that it held in its affiliate that was merged with Evolent Health, Inc.; and
- We issued shares of our Class B common stock and the right to certain payments under the TRA to The Advisory Board Company ("The Advisory Board"), TPG and another investor, each of which was a member of Evolent Health LLC prior to the Offering Reorganization.

The existing shareholders of Evolent Health Holdings held the same economic and voting interest before and after the merger of Evolent Health Holdings with and into Evolent Health, Inc., which represents a transaction among entities with a high degree of common ownership. As such, the merger is viewed as non-substantive and the consolidated financial statements of Evolent Health, Inc. reflect the historical accounting of Evolent Health Holdings except that the legal capital reflects the capital of Evolent Health, Inc.

In addition, in connection with the Offering Reorganization, Evolent Health LLC amended and restated its operating agreement to establish two classes of equity (voting Class A common units and non-voting Class B common units); after the amendment, the pre-reorganization members of Evolent Health LLC (other than Evolent Health, Inc.) hold 100% of the Class B common units and Evolent Health, Inc. holds the Class A voting common units. Evolent Health LLC's Class B common units can be exchanged (together with a corresponding number of shares of our Class B common stock) for one share of our Class A common stock.

As of September 30, 2016, the Company owns 74.6% of the economic interests and 100% of the voting rights in Evolent Health LLC. Our operations will continue to be conducted through Evolent Health LLC and subsequent to the Offering Reorganization the financial results of Evolent Health LLC are consolidated in the financial statements of Evolent Health, Inc. Evolent Health, Inc. is a holding company whose principal asset is all of the Class A common units it holds in Evolent Health LLC, and its only business is to act as sole managing member of Evolent Health LLC.

Pro Forma Financial Information (Unaudited)

The unaudited pro forma statement of operations data presented below gives effect to (1) the Passport transaction as if it had occurred on January 1, 2015, and (2) the consolidation of Evolent Health LLC as if it had occurred on January 1, 2014. The following pro forma information includes adjustments to:

- Remove transaction costs related to the Passport transaction of $0.3 million recorded during the nine months ended September 30, 2016, and reclassify said amounts to the nine months ended September 30, 2015;
- Remove transaction costs related to the Passport transaction of $0.2 million recorded in the fourth quarter of 2015 and reclassify said amounts to the nine months ended September 30, 2015;
- Remove the gain recognized upon the consolidation of the previously held equity method investment in 2015 and reclassify said amount to 2014;
- Remove transaction costs related to the Offering Reorganization of $1.2 million in 2015 and reclassify said amount to 2014;
- Record amortization expenses related to intangible assets beginning January 1, 2014, for intangibles related to the Offering Reorganization;
- Record rent expense related to Passport prepaid lease beginning January 1, 2015; and
- Record adjustments of income taxes associated with these pro forma adjustments.

This pro forma data is presented for informational purposes only and does not purport to be indicative of the results of future operations or of the results that would have occurred had the transactions described above occurred in the specified prior periods. The pro forma adjustments were based on available information and assumptions that the Company believes are reasonable to reflect the impact of these transactions on the Company's historical financial information on a pro forma basis (in thousands).

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$60,210	$55,363	$169,370	$145,189
Net income (loss)	(15,717)	(12,015)	(198,198)	(57,637)
Net income (loss) attributable to non-controlling interests	(4,567)	(3,505)	(57,984)	(21,494)
Net income (loss) attributable to Evolent Health, Inc.	(11,150)	(8,510)	(140,214)	(36,143)