

TRANSCEND SERVICES

Moderator: Larry Gerdes
November 7, 2011
11:00 a.m. ET

Operator: Good morning. My name is (Darla), and I will be your conference operator today. At this time, I would like to welcome everyone to the Transcend Services Third Quarter 2011 Earnings call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Mr. Gerdes, you may begin your conference.

Larry Gerdes: Thank you, (Darla). Good morning. I'm Larry Gerdes, Chairman of the Board and Chief Executive Officer of Transcend Services Inc.

Joining me today for this conference call is Susan McGrogan, our President and Chief Operating Officer; and Lance Cornell, our Chief Financial Officer. This call is regarding Transcend's operating results for the quarter ended September 30th, 2011.

Lance, could you begin by stating our disclaimer?

Lance Cornell: Good morning. We'd like to ensure that everyone understands that our commentary and responses during this conference call may contain forward-looking statements dealing with topics such as our business strategy, our

anticipated future results, our service offerings, our relationships with other companies or customers and our ultimate role in the market.

The rest of the forward-looking statements or predictions may differ materially from the results because of factors such as Company decisions, market conditions, business relationships and/or performance of various third parties associated with Transcend, including but not limited to their access to capital and their financial condition. Please realize we will not necessarily provide updates to any such statements other than as required by law.

Finally, more information about potential risk factors is included in the third-quarter press release and the periodic reports that the Company files from time to time with the Securities and Exchange Commission, including the Company's Form 10-K for the year ended December 31 2010.

Larry Gerdes: Thanks, Lance. Many of you have followed our growth for several years, and you know that we often have relatively simple quarters where there aren't too many moving parts. But, from time to time, we have a quarter that has more complexity to it, and the third quarter was certainly one of those.

From a high level, we're very pleased with our results, especially if we take unusual nonrecurring items into account. Our revenue growth in gross margins were solid and we are very excited to have another strong sales quarter.

On the other hand, we did lose three customers and the impact of foreign currency fluctuations on the quarter was significant for the first time since we acquired Heartland last year. It was also a quarter in which we made some key operational decisions to improve long-term profitability.

Lance will now provide you with the financial overview of the quarter, after which we will discuss our operations in more detail. We'll close with a question-and-answer period. Lance?

Lance Cornell: Thanks, Larry.

Revenue for the third quarter of 2011 increased 41 percent to \$32.2 million compared to \$22.9 million for the third quarter of last year. The \$9.3 million increase included \$7.6 million of revenue contributed by the Heartland DTS, and Salar acquisitions, which have all occurred in the past 12 months. Excluding the impact of these three acquisitions, our organic revenue growth rate was 7 percent.

Gross profit for the third quarter of 2011 increased 44 percent to \$12.4 million, or 39 percent of revenue, compared to \$8.7 million or 38 percent of revenue for the third quarter of 2010. The acquisition of DTS had a slight negative impact on the gross margin for the third quarter but the impact was less than 1 percent.

We had two unusual nonrecurring items in our direct costs. First, we won a multi-hospital outsourcing contract in the second quarter and we hired over 50 transcriptionists from several hospitals. In order to bring them onboard and ease the transition to Transcend, we incurred \$236,000 of incremental compensation costs in the third quarter, above and beyond what this group would have made under our normal pay plans.

As of September 16, they were back to our standard production-based pay structure. We also incurred \$110,000 of restructuring costs in India as we continue to work to streamline and improve operations in our centers there. Excluding these two items, non-GAAP gross profit was \$12.8 million or 40 percent of revenue in the third quarter of 2011.

Operating income for the third quarter of 2011 increased 27 percent to \$5.4 million, or 17 percent of revenue, compared to \$4.3 million or 19 percent of revenue for the third quarter of 2010. In addition to the two nonrecurring items that impacted direct costs, we also incurred \$103,000 of expense related to the Salar acquisition. Excluding these three items which total \$449,000, non-GAAP operating income increased 38 percent to \$5.9 million, or 18 percent revenue for the third quarter of 2011 compared to the same quarter of last year.

I should also point out that depreciation and amortization expense was 3 percent of revenue in the third quarter of this year compared to 2.1 percent in the third quarter of last year due in large part to increased amortization of intangibles from our acquisitions. We expect this to increase to somewhere in the general range of 3.5 percent of revenue next year due to depreciation on our newly developed software.

The impact of changes in foreign currency exchange rates was negative \$380,000 included in other expense during the quarter, or approximately negative 2 cents per diluted share. This was approximately offset by a lower effective income tax rate for the third quarter of 2011 of 34 percent compared to 38 percent in the third quarter of 2010. The decrease in the effective tax rate was due primarily to the favorable resolution of tax contingencies in India.

Net income for the third quarter of 2011 increased 28 percent to \$3.3 million compared to \$2.6 million for the third quarter of 2010. Excluding the three unusual expenses described previously, non-GAAP net income for the third quarter of 2011 increased 38 percent to \$3.6 million compared to the third quarter of 2010.

Our non-GAAP diluted earnings per share, excluding the \$449,000 of unusual items, increased to 33 percent for the third quarter of 2011 compared to GAAP diluted earnings per share of 24 cents for the third quarter of 2010.

The results for this past third quarter – that doesn't include the add-back of about 2 cents for the foreign exchange currency impact. Including these – the three unusual expenses, GAAP diluted earnings per share was 30 cents for the third quarter of 2011. The Salar acquisition had no impact on earnings per share due to transaction costs and the timing of sales and the associated revenue.

Let me switch over to the balance sheet for just a minute. As of September 30, the Company had \$12.3 million of cash, cash equivalents, and short-term investments on hand, \$22.2 million of working capital and no debt

outstanding. We also have approximately \$16 million of federal net operating loss carry-forwards available to offset future taxable income.

During the third quarter of 2011, we acquired Salar for \$11 million. We also invested \$1.5 million in capital expenditures and capitalized software development costs during the third quarter, which included \$1 million related to development of our new Encore transcription platform. With our healthy balance sheet and our access to capital, we continue to be well-positioned to make acquisitions as opportunities arise.

Now I'd like to turn the call over to Sue to lead off a discussion of our operations.

Susan McGrogan: For the second quarter in a row, our sales were very strong. We sold new business that we expect will generate between \$3.8 million and \$4.7 million once it's fully implanted. We also had a good-sized sale that closed a couple of days after quarter end. For the first three quarters of the whole, we've sold between \$11.5 million and \$14.3 million. That's a record pace for us.

Please note that it does not include over \$2 million of increased annual revenue within our existing customer base as we add on new departments and clinics. I cannot be prouder of our sales and field op teams who continue to grow their customer base through strong customer service.

One thing I find really exciting is that about 55 percent of the revenue from our sales this year is from hospitals outsourcing their in-house transcriptionists to us. In the past years, I'd guess that this averaged more like 20 percent or so of our sales. We think this could be the beginning of a real trend in the industry and I think we've developed a great reputation for how we treat our new employees once they come onboard.

From the hospital point of view, they're looking to save money of course, but they're still very concerned about displacing their long-term employees. With our track record, we can get them very comfortable that we're going to take care of their people. Once they've come over to us, our retention rates have been fantastic, over 90 percent. I'm very proud of our team for what we've accomplished in that area.

In addition to the 50 new employees from this outsourcing trend in the third quarter that Lance mentioned a minute ago, so far we have hired over 20 employees from other new customers that charting in the fourth quarter. Our motto says that "it's better here" and our employees, both new and old, (continue) that it is better here.

Unfortunately, we lost three customers during the quarter that totaled about \$3 million of annual revenue. These three contributed only about \$100,000 of revenue in the quarter, which is \$650,000 less than their normal contribution, or about 0.015 cents to 2 cents per share.

As you know, our customer retention rate has been in the range from 94 percent to 99 percent over the last five years. We expect to finish 2011 within that range, but probably quote closer to 95 percent or so. The loss of one large customer that came to us from Heartland will make the difference between an OK year and a great year for customer retention.

The other two customer losses were not customer satisfaction-related due to pricing consolidation of our clients to one vendor. I am not concerned about a trend or a pattern of attrition that will stay at this level. Now of course many companies would love to have retention rates that have averaged in the mid 90s for so long. Again, I do want to say that I don't find this a trend or some problem with our customer satisfaction levels as a whole.

The customer loss from Heartland was the largest customer that I have ever lost in my career. We are still trying to get them back and are speaking with them currently. Although it's tough to lose customers, I am still very proud of our retention rates given the competitive nature of this market.

Larry Gerdes: Before Sue leaves this topic of revenue, I'd like to jump in just for a second and say a word about our top line growth. Excluding the impact of acquisitions, our organic growth was 7 percent in the third quarter. As you know, our goal is at least 10 percent. What we're seeing is the impact of lower sales in the fourth quarter of 2010 and also in the first quarter of 2011 working their way into the Q3 results as they've been implemented. Going

forward, we expect to see the impact of the much stronger sales in the second and third quarters of this year.

A rough rule of thumb is that, at our current size, it takes new sales of at least \$4 million per quarter to drive a 10 percent organic growth rate. We've exceeded that level for the past two quarters. I'm sorry, Sue.

Susan McGrogan: That's OK. Thanks, Larry.

Let me switch gears a little bit and talk about our operational initiatives that are driving our higher gross profit margins. We use speech recognition technology to edit 83 percent of the volume on our BeyondTXT platform and 90 percent of our Gemstar platform volume in the third quarter. We're very pleased with those results, but we'd like to try and increase the total on both platforms to at least 90 percent.

This improves margins because we save about 40 percent on direct labor costs when we edit reports compared to typing them from scratch without the use of speech recognition. The savings are partially offset by technology costs to produce the draft document, but the impact on gross margins is still – on gross profit is still significant.

We can also improve margins by sending more work offshore. We are comfortable with our current mix of approximately 37 percent offshore and 63 percent domestic production and expect to increase the offshore mix gradually but not dramatically over time. Our strategy is to provide a blended approach to our customers where our offshore transcriptionists primarily staff the night shift in the U.S. to improve turnaround time.

We also expect inflation and wage pressure in India to result in less meaningful (market) expansion opportunities there in the long-term. So we don't want to put all our eggs in one basket.

We do believe we still have opportunities to improve efficiency and reduce the cost per line at our three centers in India. Our restructuring charge during the third quarter resulted from efforts we've taken in that direction.

We've done a good job improving productivity of our transcriptionists in India since we acquired Heartland, raising their production from 100 – from on average 125 lines per hour to 167 lines per hour currently with a short-term goal of 200 lines per hour. But they still don't come close to our U.S. standards. So we have ongoing training and coaching programs in place to help them become more proficient with the tools we provide for them.

It's also important for us to maximize capacity in the centers to leverage our fixed facilities costs. Bangalore in particular still has excess capacity during India's dayshift, so we will continue to work on that. As we work to right-size our costs in India, we are also looking to decrease the size of our Delhi center in the first half of next year.

Lance Cornell: Sue just talked about three areas where we can improve our gross profit margins – improved speech recognition throughput, increasing the offshore mix, and improving efficiency in India.

These are all important initiatives. But really our single largest opportunity for gross margin improvement is to migrate as much of our transcription revenue that's processed on a variety of third-party platforms over onto our new Encore platform as quickly as we can. We still have 38 percent of our transcription revenue on these other platforms.

The opportunity is significant because migrating them allows us to utilize speech recognition technology to improve margins and in some cases eliminate fees that we are paying to use some of the third-party platforms.

The challenge is that customers have to be engaged in the process and agree to the migration, so it's hard for us to precisely control the pace of the migration. I am pleased to say that we do have several important migrations scheduled over the next several months, but this is going to be an ongoing effort for us.

Susan McGrogan: Lance is absolutely right. Thanks for that, Lance.

Over the last quarter, we've made customer migrations a very strong focus. We plan to migrate 10 hospitals before the end of the year with a few large

ones in the beginning of January. This will account for approximate \$7 million of revenue moving from other platforms to our own.

Let me mention one last thing related to gross profit margins and then I'll turn the call back over to Larry. As Larry mentioned, we brought over 50 transcriptionists onboard back in late Q2 and Q3 from several hospitals under one large contract that we sold in Quarter two. We agreed to a transitional compensation package that ended up costing us \$236,000 more in Quarter three than we would've paid if these new employees had been paid on a production basis only from day one.

We look at this as an investment, a little like a mini-acquisition. We invested \$236,000 (inaudible) business that should generate close to \$2 million of revenue per year for us. We feel that this is a win-win for not only the employees but the hospital and Transcend both in the short-term and the long-term.

We want Transcend to be known as the safe place for a hospital to outsource their people, but I also think this level of investment wasn't typical. Other recent outsourcing sales and those in our pipeline have much lower or no transitional requirement.

Lastly, I'd like to mention the teams that have been working extremely hard this quarter and past quarters. Everyone for our HR team to training, to implementation and definitely the field management team are a group of folks that I definitely couldn't live without. We have the best group of people in the industry and everyone either knows or is starting to know that it's better here.

OK, that's all I have. Over to Larry.

Larry Gerdes: Thanks, Sue.

Let me take a minute to comment on the industry and our position in it. As most of you know, our customers are facing two major issues that impact the area of clinical documentation.

The first is achieving meaningful use of electronic health records. The second is adopting the new ICD-10 clinical diagnostic coding system that's mandatory in 2013. As a result of both of these major external demands, hospitals have an increased sense of urgency about producing more of their clinical documentation in an electronic format as well as improving the content of that documentation.

Transcend is well-positioned to help by offering all three primary modes for capturing clinical documentation – traditional transcription, which we've done for years, dictation-based self-documentation solutions for physicians which is now available, and with our recent Salar acquisition, advanced clinical documentation using our TeamNotes solution.

We plan to add significant value by helping physicians produce ICD-10 compliant documentation on the front end in order to improve coding accuracy and ultimately reimbursement on the back end. We believe that a closer link between clinical documentation improvement and revenue cycle management is becoming increasingly important to our customers.

In addition to our clinical documentation solutions, we now offer Salar's TAP Charge Capture solution which enables physicians to capture charges at the point of care. We're excited about how we are positioned to help hospitals address these changes in the industry.

Finally, I want to thank our employees for their dedication and hard work this past quarter. We took several important steps to invest in our future this past quarter, and I'm excited about how we are positioned.

But our top priority will continue to be the day-to-day blocking and tackling of providing excellent service to our customers and a great place to work for our employees. It is our customer-centric operating model and passionate dedication to service excellence that continues and really differentiates Transcend from our competition.

Now, we'd like to open up the lines for your questions. Operator?

Operator: Thank you. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. Once again, to ask a question, please press star then the number one your telephone keypad. We'll pause for just amoment to compile the Q&A roster.

And your first question comes from the line of Ryan Daniels with William Blair.

Andy O'Hara: It's Andy O'Hara in for Ryan today.

Larry Gerdes: Hi, Andy.

Susan McGrogan: Hi.

Andy O'Hara: Just a couple of follow-ups on the customer losses. Can you let us know who won those three contracts that you guys lost?

Susan McGrogan: Yes. One was a small local vendor. One was a big competitor, a national competitor that had a platform. They had in-house employees and the platform – the production of the in – they did not want to outsource in the production of the in-house employees, made overflow. It was an overflow customer for us. The other one was due to, again, in-house to a large national vendor on their platform.

There was only one that was due to customer dissatisfaction. The rest was a matter of either consolidating vendors or keeping it in-house.

Andy O'Hara: Which one was that large Heartland customer?

Susan McGrogan: The name?

Larry Gerdes: That was to a regional firm.

Andy O'Hara: That was to a regional firm, a small firm, yes.

Andy O'Hara: Got you. OK, great. Then where did retention come out to for the quarter, percentage-wise?

Susan McGrogan: (75) percent annualized (inaudible) ...

Andy O'Hara: Yes, perfect. OK. There have been a couple of HMA announcements recently. The acquisition of Tenova which was seven hospitals and then the potential for a joint venture in Oklahoma with five hospitals.

Susan McGrogan: Yes. Correct.

Andy O'Hara: I was wondering if any of the Tenova hospitals were included in the sales figures or revenue yet?

Susan McGrogan: Yes. The Tenova hospital were included in the sales revenues, but Oklahoma obviously are not, even though we'll get those hospitals.

Andy O'Hara: And then how much do they account for, do you know?

Susan McGrogan: \$1.3 million.

Larry Gerdes: The first group of seven we realized in the third quarter \$1.3 million. We have not yet sized the recent announcement that you heard about in Oklahoma.

Andy O'Hara: Thanks a lot guys.

Larry Gerdes: Thank you.

Operator: Your next question comes from the line of Brad Hoover with Sidoti & Co.

Brad Hoover: Hi. Good morning.

Susan McGrogan: Hi, Brad.

Larry Gerdes: Good morning, Brad.

Lance Cornell: Hi, Brad.

Brad Hoover: I think it was the \$7.6 million from acquisitions revenue, could you break that up between each of the acquisitions?

Lance Cornell: I can give you the Salar peace. Salar was about \$600,000 with nothing significant in terms of license fee revenue. DTS would have – was very close to \$1 million, probably just shy of that. Then the balance would be Heartland.

Brad Hoover: On Salar, I guess can you maybe talk about kind of as you look out here the next couple of quarters, kind of revenue contribution as far as maybe talking about either pipeline or types of customers, or deal size, or anything of that nature as you have a kind of better sense of Salar's prospects and how to model that going over the next two to three quarters.

Lance Cornell: Sure. I think I just misspoke on DTS. DTS, the \$1 million would be for a month, so multiply that by three.

Brad Hoover: Three. OK, thanks.

Lance Cornell: Regarding the Salar pipeline, we've got a number of prospects in the pipeline that – a couple of which we hope to close before the end of the year. They will – most of the pipeline prospects are subscription license fee-based as opposed to upfront perpetual license, which is probably better in the long haul for our model, even though sometimes, like any software company, it's tempting to take that one-time license revenue.

Really, they sell both ways. It depends on what the customer wants. Their transactions can range all the way from \$0.5 million or so in one year, the first year of revenue, all the way up to potentially \$2 million or \$3 million if they're sold as a perpetual license.

So some good opportunities. It is a tough, long sales process with a lot of demos to physicians and the clinical folks at the hospital, but some good prospects.

I think one thing that we haven't done yet that I think is a good cross-selling opportunity for us is to get their guys more plugged into selling the Charge Capture solution, (cap) Charge Capture into the hospitals for the physicians who need to Charge Capture solution. It's basically capturing charges at the point of care.

Larry Gerdes: I might add a couple of things to that because I think your questions are very appropriate. When we made the Salar acquisition, we mentioned to the marketplace that we knew that the operating contributions could be lumpy because of the timing of the sales because they just don't happen to fall on an even keel during the whole year.

In addition to that, though, we did encourage that they consider subscription pricing which does extend out some of that new revenue. So what could be a 2 cents to 3 cents per-quarter contribution can be somewhat mitigated by that.

But what I am particularly excited about is also the fact that our two development teams have gotten together to start investigating ways in which we can embed and integrate our dictation with their front-end template and tools so that we can offer that physician the front-end choice of how he wants to enter his data. So we're very excited about it, but the contributions will be inconsistent from quarter to quarter.

Brad Hoover: Larry, at this point, you're still – so you're working right now in putting multimodal speech rec into Salar's template? Is that what you said?

Larry Gerdes: Not – what we're really trying to do is take our dictation – our front-end dictation capture tools and allow that physician to use dictation in parts of that templating process if he would like to. And so it's not necessarily multi-modal tools. It's more the integration of our workflow platform with theirs.

Brad Hoover: Got it.

Susan McGrogan: We've also found, in talking with our customers, that it's not a matter of cannibalizing our existing business. It's more additive to it, some of the things that they'd like to do with the Charge Capture and with the progress notes and things like that. It's additive.

Larry Gerdes: Yes, good point.

Brad Hoover: OK, thanks for all that color. Then on the gross margin, as we look out into the fourth quarter, is there anything, I guess as you said in the release, unusual or one-time in cost of goods sold that should be in there? Secondly, how do

we stay with that margin going forward when kind of balance out the fact that you're still doing some work as far as improving India operations?

Lance Cornell: I don't think that the India impact will be a significant impact; it should be almost unnoticeable in the fourth quarter. I'm sure we'll do a couple of things, but nothing that's going to require calling out separately. At least at this point I don't see that.

Generally speaking, I think the way we look at it, the margins are certainly on an upward trend for the short-term, both because we won't have the recurring – or the nonrecurring items in the fourth quarter as well as some of the things that Sue talked about.

If we can migrate \$7 million of business over to our platform, it's easy to get a 10-point improvement on that base of business once we're up and running on speech rec, which would be about probably about 0.5 point of margin and would represent 1 cent per quarter of earnings improvement if we can do that.

So I think short-term, we're looking at margins that kind of head back into the area that we saw earlier in the year. Exactly where that settles remains to be seen, but in that general range.

Susan McGrogan: I think it's important to know as well it's the way we've always run the Company. We've leave the things that are good for everyone long-term. We knew take some of the things we were going to do when we saw the Quarter 1 margins and how great they were, we also knew that at the same time we had to invest in India. We also know that we knew that doing this with transcriptions from one of the large deals, we'd take a hit, but we knew take it was the right thing to do for the Company.

So again when you look at – when I look at our margins and these one-time items, it doesn't really – there's no reason in my mind why we can't go back to where we were but do it the right way. In the first quarter, we had some issues in India that we had to take care of and we did. The third quarter was just a blip with our – the acquisition of all those employees.

So again, I see it that I don't find any problems with where we are that we can't get back to where we were. I do think though we have to make healthy investments in the Company.

Larry Gerdes: Thanks, Sue.

Brad Hoover: Thanks, Sue. Lastly, could you just remind me, as we go forward and you start to move your existing BeyondTXT customers to Encore, what sort of resources are required on the hospital's end?

Lance Cornell: Yes. That's a good question. Actually, the way that we're modeling that is we've got some – did you say on the hospital side?

Brad Hoover: Yes, well I guess on both ...

Lance Cornell: Yes.

Brad Hoover: Yes, in the hospital as far – I mean there's a lot going on. It's just one more thing they have to do, so I'm just kind of curious what kind of personnel or time they need on their end for you to go from BeyondTXT to Encore?

Susan McGrogan: Well, it's just we try to make it as seamless as possible for the hospital. We definitely require one interface resource. We're trying to work with our team to make it so they don't even need one interface resource. But we try to – we give them a compelling story. We try to make it the least invasive for them because they are very busy. There is one thing. We always have to tell them and give them the benefit of why we want to switch.

Now sometimes the benefits are compelling. It's going from an old tired platform to Encore, that's easy. If they're going to something like BeyondTXT or Gemstar, which they like, that's a tougher sell. So we always want to have the customer buy in, and we've been working hard with our R&D teams and our implementation teams try and make it less and less time-consuming for the hospital. But it is, I would say we need one interface professional for sure.

Larry Gerdes: But to put it into perspective, (we know) we need a week of testing by one person on the hospital side, but these hospitals have enough activity going on with all of these other initiatives that it's asking them to do something for us that doesn't bring obvious early benefits to them. Ultimately being on our Encore platforms will benefit them, but it's not obvious at the front end. So we still have to get them convinced to cooperate.

But I'm really happy. I met with our team on Friday and I'm really happy with some of the momentum we're gaining again in implementing some of these larger customers from – or migrating them from these other platforms.

Brad Hoover: Thanks for all the comments this morning.

Larry Gerdes: Thanks.

Operator: Your next question comes from the line of Steve Unger with Lazard Capital Markets.

Steve Unger: Hi, good morning.

Larry Gerdes: Good morning.

Susan McGrogan: Good morning.

Larry Gerdes: Hello?

Lance Cornell: Steve, are you there?

Operator: Steve, your line is open. Do you have your phone muted? He may have withdrew his question.

Your next question comes from the line of Leo Carpio with Caris & Co.

Leo Carpio: Good morning. I have actually a couple of questions. First up, regarding the sales trend you saw this quarter, correct me if I'm wrong, it's the second quarter in a row that you're seeing about \$3 million to \$4 million in quarterly sales. How sustainable is this going into the – coming into the second – in to

fourth quarter and into 2012? Is the driver being this increased awful outsourcing trend that you noticed?

Larry Gerdes: First of all, looking to answer, Leo, and then I'll let Sue chime in; I look at our sales this quarter at ranging between maybe \$3.8 million and \$4.7 million. That's without same-store in house sales. So that's why I said earlier in my comments that, from my standpoint, the last two quarters have exceeded what is required ultimately to drive 10 percent organic growth.

Our goal has all along been to sell \$20 million in total for the year. When you include the over \$2 million of same-store sales we've had year-to-date, we're probably be in the neighborhood of \$16 million to \$17 million already.

We've seen some early large system sales, one large system sale and then also the HMA announcement early in this fourth quarter. So I think that, in my mind, we ought to exceed the \$20 million we're looking for in our plan, and we feel very good about that. So that's why we said that, in our mind, the momentum has continued.

Sue, is there anything you'd add to that?

Susan McGrogan: No. I feel very good about the momentum we have in the sales team and also the synergies we've seen with the Salar team and our sales team, and it's just getting better and better. So ...

Lance Cornell: We're up to a total of nine salespeople, including six of – six reps out in the field, plus two from Salar as well as a VP of Sales. So we've got a little broader coverage than we've had in the past, although it's still a small team.

Leo Carpio: Then turning to the competitive landscape, can you provide us an update in terms of is this landscape – are you still picking up opportunities from the smaller mom-and-pop local vendors, and then how you're doing against the other players in the space?

Susan McGrogan: I feel that the small mom-and-pops are finding it hard to compete in this landscape, and we're finding them, especially in the bigger deals, less and less able to compete, although our model is based off of a small mom-and-pop, our

regional operations model, we feel we give the best of both world worlds, a small mom-and-pop deal with a large company powered by Transcend.

We do see a lot of – our two main competitors, very formidable competitors which would be MedQuist and Nuance. We see them a lot, and like I said, we're all – they're formidable competitors. So we just have to work very, very hard to compete with them. We also have to make sure that we play on a field.

I also think, like I said, the most exciting thing for me is the fact that if you look at our market, whatever the number, whatever you read – I believe I said it was 50 percent – 40 percent to 50 percent of hospitals are still – Lance is saying 55 percent – 55 percent of hospitals are still in-house.

So if you look at the possibility of in-house to outsource, you don't have to slug it out with your competitors so much because they're less price-sensitive, and we do keep their employees. So I do think there's a large opportunity for all of us in this market; it's a very big market. I'm real excited about where we're going.

Leo Carpio: Then looking at the second – third-quarter expenses here on sales and R&D, for modeling purposes, is that kind of a good sense of run rate for going forward for trending that, or are there other factors I'm overlooking here?

Lance Cornell: With the exception of the transaction costs in G&A, which we carved out separately, the sales is – we generally like to look at it as somewhere in the neighborhood of 2.5 percent to 3 percent revenue. R&D is approximately the same, so those two combined end up being somewhere in the neighborhood of 6 percent of revenue. That's usually a pretty big – pretty good ballpark range for forecasting purposes.

On the G&A, the challenge there is about 40 percent of our G&A is benefits, and so it's more variable in nature and grows as we grow. And then the other 60 percent we get from leverage as we grow because we're not adding as much back-office staff and that sort of thing.

Leo Carpio: Then the last question, you mentioned ICD-10 as being an opportunity. How much is that in terms of the potential sales leads you've had so far? How much has that been a factor in terms of clients or customers indicating that's their motivation for updating systems and reaching out, or are we still early in the beginning of that opportunity?

Larry Gerdes: We're in the beginning of that. We're all concerned about it, but a very small minority of the hospitals have started attacking it. So none of the decisions we've had year-to-date have been driven by ICD-10, but I can tell you that a lot of our customers are asking us to consider how we could help them, because they look at us as a partner. So in the next, oh, I'd say year, they've got to address it. But it hasn't driven any specific sales even though we've had a lot of discussions with our customers.

Lance Cornell: Yes, we see it as a good – if you look at our M&A opportunities, I think they fall into three primary buckets. We've got transactions in the pipeline for all of these that are anywhere from very early stage. It's just ongoing discussions. They include transcription companies first.

In the area of ICD-10, computer-assisted coding is an area that we're particularly interested in and could end up with a partnership in that space, if not someday an acquisition opportunity.

Then the third would be just in the general category of data analytics and improving the quality of clinical documentation. There are a number of companies that do that either on the clinical side or more on the financial revenue cycle side. We think that would be – with the richness of the data that we collect, there's some good opportunities there as well.

Leo Carpio: All right. Thank you.

Larry Gerdes: Thank you.

Lance Cornell: Thanks, Leo.

Operator: Your next question comes from the line of Lenny Dunn with Freedom Investors Corporation.

Lenny Dunn: Good morning.

Larry Gerdes: Good morning, Lenny.

Lenny Dunn: Decent quarter, not a great one but decent, a little harder to read than usual, but I've been able to read it. Just a couple of questions. The NOL, where does that come from? Because I didn't even realize we had one still to use.

Lance Cornell: Yes we do. It comes from a combination of the Heartland and DTS acquisitions. Of course, we had limitations due to change of control, and so that number is after applying the limitation, but that's still realizable for us. It's going to – it is limited in terms of what we can use each year. So that \$16 million gets spread out over – I don't know what it is – 10, 15 years. It's way out into the future.

Lenny Dunn: (Inaudible) asset that can't hurt.

Lance Cornell: Yes, absolutely.

Lenny Dunn: The other thing is ...

Lance Cornell: It certainly helps cash flow.

Lenny Dunn: Yes. That's the second question, the cash flow. In the past, and of course you will on the Q, we've had some cash flow information. I didn't see any on this particular import. How was the cash flow in the quarter?

Lance Cornell: Yes, cash flow I don't typically report or I haven't for a long time on these calls. We'll be filing the Q in a couple of days, and actually I don't even have it right here in front of me, although I did speak to some of the financial items.

Larry Gerdes: We ended the quarter at \$12.3 million, as Lance mentioned. That's of course after accounting for payment for Salar. So cash flow has continued to be very healthy. Lance, did you just pull –

Lance Cornell: Yes, it's roughly \$9 million from operations less a net of – this is the nine months, sorry. I don't have the quarter here in front of me. For the nine

months, we're at about \$9 million from operations, \$5.5 million investing activities, and positive \$800,000 in financing activities.

Larry Gerdes: Yes, the way I look at it, we generate net free cash of in the neighborhood of \$4 million to \$5 million a quarter. I actually think our fourth quarter may be a little stronger than typical because we've got some account receivable reversals that our days in outstanding – even though they're probably the lowest in the industry, they popped up slightly at the end of the third quarter because we went on some new systems to maybe 44, 45 days.

We intend to get them back down in the neighborhood of 40 to 41 days like we typically have. So fourth quarter ought to be that relatively strong, so my guess, Lance, would be that we'll end the year in something in the neighborhood of \$17 million to \$18 million, maybe a little more in cash.

Lenny Dunn: Those are good numbers. Wouldn't hurt to have them in the release. It does sound, going forward, you could generate as much as \$20 million a year in free cash flow, assuming you weren't doing any more acquisitions, which is probably not the case, but still those are good numbers.

Larry Gerdes: Yes, I agree.

Lance Cornell: Generating significant cash flow, you're right.

Lenny Dunn: OK. That's all I have. Looking forward to a very strong fourth quarter.

Larry Gerdes: Thanks, Lenny, appreciate it.

Lance Cornell: Thank you.

Operator: Again, if you would like to ask a question, please press star then the number one on your telephone keypad.

And we do have Steve Unger with Lazard Capital Markets back in queue at this time. Steve, your line is open.

Steve Unger: Hi, thanks. Can you hear me?

Lance Cornell: Yes.

Susan McGrogan: Yes.

Lance Cornell: We can.

Steve Unger: Great. Just in terms of the overall impact of the customer losses, is that pretty much – you have felt that impact already in the third quarter, and you're saying that maybe there is a lingering \$100,000 in the fourth?

Lance Cornell: No. In the third quarter, we felt the vast majority of those three customers. They normally would've done about \$750,000 of revenue. They only did \$100,000 in the third quarter. So for all intents and purposes, they were pretty much gone in the third quarter.

Steve Unger: Excellent, OK. Then as far as – are you experiencing I guess implementation delays at all in new customer wins? Has that been an issue for you?

Susan McGrogan: This is Sue. I'll say yes and no. We have a new implementation scheme. We've had some delays with a large customer systems that did not implement as it should have in the first quarter, so it's pushing some things back. We also have a new implementation team, so we push back a little bit for training.

Again, those are some of the intangible things that you do because it's good for the Company, maybe not so much good for quarter-to-quarter earnings. So we did have a – we had our implementations in in August to really come through a lot of training and things like that. Our implementations did get pushed back on August, but nothing – I wouldn't say that they're pushed back in general. So the answer would be a yes and a no.

Do you want to talk to that any more, Lance?

Lance Cornell: Yes, I mean that was just that one particular customer and it's –

Susan McGrogan: Yes.

Lance Cornell: We haven't really had anything pushed out outside of the normal – you try to get it in a particular month and it pushes back 30 days typically because the

customer is not ready. So in a nutshell, we haven't had anything that's systemic or dramatic, just more of the 30-day kind of pushes here and there.

Susan McGrogan: Yes, it was the same customer, so the same customer, same interface, et cetera, so we decided to push them back a little bit. But it's like Lance said, the team is an awesome team.

Steve Unger: Good. Then just I didn't quite understand the conversion disclosure. As far as – so you have 38 percent that are on third-party platforms. Does that include Gemstar, and how many are on Encore at the moment?

Lance Cornell: Two questions – first, the 38 percent did not include Gemstar. Gemstar would be included in the 62 percent as our platform along with BeyondTXT and now a little bit of Encore. So within that 38 percent, you've got a wide variety of platforms, including eScription, a platform called BayScribe that we acquired that we're on as a result of the acquisition of MDI Maryland, ChartScript. There's a long list.

Susan McGrogan: eScription, I can give you some data. BayScribe is 9.2 percent of our revenue. We hope to be off that relatively soon. As I said, we've got about 14 accounts – I believe I said 14 – between now and Q1 of next year. We also have a platform called (DataWorks) which we're moving.

We have a platform called WebMT which we're moving. So there are some customers that are easier to move than others. There's also some customers that cost us money, so we have to move them. It just makes a lot of sense. So those are the ones that make more financial sense first.

Lance Cornell: Then I think the other part of your question was customers on Encore. I believe we're up to about ten or so, although several of those are very small, but the total is about ten.

Susan McGrogan: Yes, right.

Lance Cornell: Just really getting started there.

Steve Unger: Good. So then this is the last question then. As far as the tax rate for next quarter, you're expecting 40 percent again? Is that correct?

Lance Cornell: Yes. The only thing that – in the U.S., the tax rate is pretty stable and predictable. In India, we've got these discrete items that can come in from time to time related to our transfer pricing contingencies, which in the U.S. we put up as uncertain tax positions FIN 48, uncertain tax position.

And so those – the net of all of those we hope is our favorable adjustments over the next few years. But when they come in is completely unpredictable. It's just going to – when we get the rulings, we get the rulings.

Steve Unger: Got you.

Larry Gerdes: Did you say 40 percent, Lance, or is it 38 percent?

Lance Cornell: Yes, well, we forecast around 39 percent and then – between 39 percent and 40 percent really – and then those discrete items would be – could lead to a favorable impact on top of that.

Steve Unger: Perfect. OK. Great job. Thanks, guys.

Larry Gerdes: Thank you.

Susan McGrogan: Thank you.

Operator: And again, to ask a question, please press star then the number one on your telephone keypad.

At this time, there are no further questions.

Larry Gerdes: Thank you. Well, in closing, we are very excited about where Transcend is headed and how we've positioned the Company. I can't emphasize enough this trend we're seeing with hospitals willing to allow us to employ their people.

As Sue said, for the last several years, we've always told investors that about 20 percent of our sales came from that area, but now it's over 50 percent. The

reason it's particularly good is something Sue alluded to, but when we take on customers that are willing to give us their staff, not only do we get their business and the people, but we get the capacity that goes with those folks.

So interestingly enough, the one with 50 employees that we mentioned to you a minute ago, once those employees came on our platforms and we started applying our technology, their productivity went up to the point that we could move some of those people to other forms of Transcend business. So there are a lot of subtle pickups that go with that trend. I think that's a recognition by the healthcare industry that they've got to cut costs but they've also got confidence in our company.

So, as usual, I'd like to thank our investors for the support you've given our Company. We're very excited about what we've gotten accomplished. We look at this as a very positive quarter and one in which we did a good job of positioning the Company, as Sue, mentioned, is always our priority. We are very happy to answer any additional questions you might have in the interim.

So until we talk to you next, thanks for your support.

Susan McGrogan: Thank you.

Operator: This concludes Transcend Services' Third Quarter 2011 Earnings conference call. You may now disconnect.

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