# Second Quarter 2017

**Management's Discussion and Analysis**
*For the Periods ended August 31, 2016 and 2015*

Convalo Health International, Corp.

*The following Management's Discussion and Analysis ("MD&A") of the financial condition and results of operations of Convalo Health International, Corp. ("Convalo" or the "Company"), prepared as of October 28th, 2016, should be read in conjunction with the consolidated financial statements for the months ended August 31, 2016 and August 31, 2015, including the notes therein. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"). Unless otherwise specified, all financial data is presented in Canadian dollars. The words "we", "our", "us", "Company", and "Convalo" refer to Convalo Health International, Corp and/or the management and employees of the Company.*

*Additional information relevant to the Company is available for review on SEDAR at www.sedar.com.*

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## CAUTION REGARDING FORWARD-LOOKING STATEMENTS

Information included or incorporated by reference in this report may contain forward-looking statements. This information may involve known and unknown risks, uncertainties, and other factors which may cause our actual results, performance, or achievements to be materially different from the future results, performance, or achievements expressed or implied by any forward-looking statements. Forward-looking statements, which involve assumptions and describe our future plans, strategies, and expectations, are generally identifiable by use of the words "may," "will," "should," "expect," "anticipate," "estimate," "believe," "plan," "intend" or "project" or the negative of these words or other variations on these words or comparable terminology. Readers are cautioned regarding statements discussing profitability; growth strategies; anticipated trends in our industry; our future financing plans; and our anticipated needs for working capital. Actual events or results may differ materially from those discussed in forward-looking statements. There can be no assurance that the forward-looking statements contained in this report will in fact occur. The Company bases its forward-looking statements on information currently available to it, and assumes no obligation to update them.

THE FORWARD-LOOKING INFORMATION CONTAINED IN THIS MD&A PRESENTS THE EXPECTATIONS OF THE COMPANY AS OF THE DATE OF THIS MD&A AND, ACCORDINGLY, IS SUBJECT TO CHANGE AFTER SUCH DATE. READERS SHOULD NOT PLACE UNDUE IMPORTANCE ON FORWARD-LOOKING INFORMATION AND SHOULD NOT RELY UPON THIS INFORMATION AS OF ANY OTHER DATE. WHILE THE COMPANY MAY ELECT TO, THE COMPANY DOES NOT UNDERTAKE TO UPDATE THIS INFORMATION AT ANY PARTICULAR TIME EXCEPT AS REQUIRED BY APPLICABLE SECURITIES LEGISLATION.

(Expressed in Canadian dollars in thousands)

## HIGHLIGHTS FOR THE THREE AND SIX MONTHS ENDED AUGUST 31, 2016

- Finished build-out of five BLVD branded facilities in the quarter, with an investment in facilities and expenses of over $5 million: San Diego outpatient facility, Portland outpatient facility, Greater Los Angeles detox facility, Central Los Angeles detox facility, and an internal laboratory.
- Cash balance remained near neutral for the quarter, with cash on hand of $12,215,000 as compared to $12,712,000 at the end previous quarter.
- Revenue of $7,434,000 for the quarter compared to $5,674,000 for the quarter ended Aug 31, 2015 an increase of 31% year over year.
- Narrowed enterprise net loss before stock based compensation to $1,918,000 from $3,410,000 in the previous quarter as upfront investments and expenses associated with launching five facilities draws to a conclusion.

2016 Facility Build-Out Details:

| Facility | **Month Launched** |
|---|---|
| San Diego IOP | April |
| Portland IOP | April |
| Corona Detox Facility | May |
| Los Angeles Detox Facility | May |
| Internal Laboratory | May |

## SELECTED FINANCIAL INFORMATION

| | **Three months ended August 31, 2016** | **Three months ended August 31, 2015** | **Six months ended August 31, 2016** | **Six months ended August 31, 2015** |
|---|---|---|---|---|
| Revenue | $7,434 | $5,674 | $14,722 | $7,993 |
| Gross Profit | $4,483 | $3,648 | $8,342 | $5,256 |
| Gross margin | 60% | 64% | 57% | 66% |
| Adjusted EBITDA[(1)] | ($39) | $1,974 | $898 | $2,427 |

[(1)] Throughout this document, "EBITDA" and "Adjusted EBITDA' are used as profitability measures. Please refer to the "Non-IFRS Measures" section of this MD&A for further discussion on these measures.

(Expressed in Canadian dollars in thousands)

**Summary of Quarterly Results**

The Company's revenues, net income/loss and net income/loss per share for each of the nine most recently completed quarters is as follows:

| | Three Months Ended August 31, 2014 | Three Months Ended November 30, 2014 | Three Months Ended February 28, 2015 | Three Months Ended May 31, 2015 | Three Months Ended August 31, 2015 | Three Months Ended November 30, 2015 | Three Months Ended February 29, 2016 | Three Months Ended May 31, 2016 | Three Months Ended August 31, 2016 |
|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | $ 348 | $ 345 | $ 1,201 | $ 2,318 | $ 5,674 | $ 8,072 | $ 6,422 | $ 7,288 | $ 7,434 |
| **Expenses** | 1,305 | 1,038 | 1,364 | 2,316 | 6,145 | 7,941 | 8,560 | 11,256 | 10,024 |
| **Net income (loss)** | $ (957) | $ (693) | $ (163) | $ 2 | $ (471) | $ 131 | $ (2,138) | $ (3,968) | $ (2,590) |
| **Net income (loss) per share** | (0.002) | (0.014) | (0.002) | (0.000) | (0.002) | 0.001 | (0.04) | (0.02) | (0.01) |

## Historical Revenue and Capacity Information Since Start-up:

*Build Phase I (Start-up):* May 2014 to February 2015.
Total reported revenues for the phase (10 month period): $1,894,000.
Fully mature centers: 1; centers being built during phase: 3
*Revenue Growth Phase I:* March 2015 to February 2016.
Total reported revenues for the phase (12 month period): $22,476,000.
Fully mature centers: 4; centers being built during phase: 0

*Current Build Phase II:* March 2016 to (projected) April 2017.
Total reported revenues for the phase (March 2016 to August 2016, 6 months): $14,722,000.
Fully mature centers: 4; centers being built during phase: 5
*Revenue Growth Phase II:* Projected May 2017 to July 2018.
Projected matures centers: 9; projected centers being built during phase: 0

**ABOUT OUR BUSINESS**

**Convalo business summary**

Convalo is a public Canadian company focused on the United States inpatient (detox and residential) and outpatient rehabilitation market and serves clients with addictive and co-occurring disorders. The Company's treatment philosophy, through its BLVD brand, emphasizes mindfulness, meditation, trauma work, giving back, creative self-expression and community. All of these philosophies are set to achieve a deeply soulful and sustainable recovery. In conjunction with the 12-Step approach, the Company also offers additional insurance-reimbursed services catered to a variety of communities: gender specific, creatively-oriented, meditation/mindfulness and LGBT affirmative. The Company offers access to a wide range of services helpful to the recovery process of clients.

Convalo's business operations are dedicated to the treatment of insurance-reimbursed and private pay clients in the United States, who suffer from alcohol abuse, drug abuse, process addiction and other addictions. The employees of the Company work with each individual client to develop a schedule that promotes their recovery, which may include group therapy, case management, individual therapy, wellness and life skills mentoring, 12-Step integration, staff support, random drug and alcohol screenings, and five-star amenities.

The Company offers programs designed as either:

(a) the first or second phase in a long-term comprehensive program; or
(b) Community fellowship and extra-support for individuals in need.

The Company's treatment facilities are located in Los Angeles County, Orange County, San Diego County in California, Phoenix, Arizona and Portland, Oregon.

**Amalgamation and private placement**

On February 11, 2015 Convalo and Valiant Minerals Ltd. ("Valiant"), a corporation incorporated under the BCBCA and listed on the NEX trading board of the TSX Venture Exchange (the "Exchange"), completed a triangular amalgamation (the "Amalgamation"), whereby Valiant amalgamated with a wholly owned subsidiary of Convalo, 0986282 B.C. Ltd. (the "Amalgamation Entity"), to form an amalgamated corporation (named Convalo Health Corp.). As a result of the Amalgamation all of the property and assets of Valiant and the Amalgamation Entity became the property and assets of Convalo Health Corp., and all of the liabilities and obligations of Valiant and the Amalgamation Entity became liabilities of Convalo Health Corp. Following the Amalgamation Convalo obtained the listing status of Valiant and Valiant ceased to be a reporting issuer on the Exchange. Convalo trades under the trading symbol "CXV".

The Amalgamation provided for the issuance of 5,900,000 Convalo shares to the Valiant shareholders at a rate of one Convalo share issued in exchange for every two Valiant shares issued and outstanding. Convalo Health Corp. issued to Convalo one fully paid issued and outstanding share in the capital of the Convalo Health Corp. in exchange for each one Convalo Sub share held and subsequently Convalo Health Corp. became a wholly owned subsidiary of Convalo.

In conjunction with the Amalgamation, Valiant completed a non-brokered private placement of 58,140,000 subscription receipts for gross proceeds of $2,907. Each subscription receipt entitled the holder, prior to the Amalgamation, to acquire one share in the capital of Valiant and one warrant. These subscription receipts were automatically exchanged for 29,070,000 Convalo shares and warrants exercisable for 29,070,000 Convalo shares. Broker warrants issued in connection with the private placement were automatically exchanged for warrants exercisable for 1,989,400 Convalo shares.

**Key performance drivers**

Our inpatient and outpatient service revenues are based on the enrollment of clients that suffer from addiction requiring them to get inpatient and outpatient care for recovery. Overall capacity and occupancy rates are, therefore, key drivers of profitability.

The Company's treatment facilities are responsible for supporting the clients that enroll in recovery programs. Operational effectiveness of these facilities is a key to achieving industry-leading client success rates and maintaining insurance reimbursement. Convalo is committed to compliance with all applicable regulations, the delivery of quality service, and ensuring the highest level of care for our clients.

The growing demand for inpatient and outpatient services nationally provides significant opportunity to garner market share. The Company's operational efficiency and marketing strategy are key going forward to driving more client business to Convalo, thus increasing revenues and gross profits.

**Future outlook**

Organic growth: Top priorities continue to be organic growth, the generation of net profit, positive cash flow, and positive EBITDA. Our niche approach supplements the 12-step program and our other client focused initiatives provide high-touch client care. Organic growth is driven by the expansion of services in our existing markets and by leveraging our core competencies and existing business platform to enter into new markets.

Going forward, we seek to find ways to continue to grow our client base. We strive to penetrate the market in order to streamline our operational platform and generate positive cash flow and operational profits. We will continue to improve on operational efficiencies and management as they are key execution points in order to achieve healthy gross margins while growing revenues via the cross selling of services to existing and new clients.

Expansion through acquisitions of new markets: The Company is focused on two types of acquisition opportunities. The first are small tuck-in acquisitions to acquire local referral sources and the necessary licenses to expedite the launch process in new markets. The second types of acquisition targets are companies with significant revenue and clients that can achieve additional post-acquisition growth by transitioning into a larger BLVD branded facility. As we continue to grow and achieve scale, the anticipated increase in cash generated from operations can be used for future acquisitions which we will pursue to augment our organic growth strategy.

## OPERATING RESULTS

### Accounting policies and estimates

The consolidated financial statements for the period ended August 31, 2016 are prepared under International Financial Reporting Standards ("IFRS") issued by the governing body of the International Accounting Standards Board ("IASB'). The preparation of financial statements, in conformity with IFRS, requires management to make estimates and assumptions. These estimates and assumptions affect; the reported amounts of assets and liabilities, disclosers of contingent assets and liabilities, and the reported amounts of revenues and expenses for the period of consolidated financial statements. The Company's critical accounting estimates are described under Accounting and Disclosure Matters below.

### Non-IFRS measures

Throughout this MD&A, references are made to a number of measures which are believed to be meaningful in the assessment of the Company's performance. All of these metrics are non-standard measures under IFRS, and may not be identical to similarly titled measures reported by other companies. Also, in the future, we may disclose different non-IFRS financial measures in order to help our investors more meaningfully evaluate and compare our future results of operations to our previously reported results of operations. Readers are cautioned that the disclosure of these items is meant to add to, and not replace, the discussion of financial results as determined in accordance with IFRS. The primary purpose of these non-IFRS measures is to provide supplemental information that may prove useful to investors who wish to consider the impact of certain non-cash or uncontrollable items on the Company's operating performance and who wish to separate revenues and related costs associated with start-up activities that may not be ongoing.

### EBITDA and adjusted EBITDA

In calculating EBITDA and adjusted EBITDA, certain items are excluded from net loss including interest, taxes, amortization and non-cash share-based payments. Set forth below are descriptions of the financial items that have been excluded from net loss to calculate EBITDA and adjusted EBITDA and the material limitations associated with using this non-IFRS financial measure as compared to net loss.

- Depreciation and amortization expense may be useful for investors to consider as they generally represent the wear and tear on our property, as well as the equipment used in our operations. However, we do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating costs.

- The amount of interest expense we incur or interest income we generate may be useful for investors to consider and may result in current cash inflows or outflows. However, we do not consider the amount of interest expense or interest income to be a representative component of the day-to-day operating performance of our business.

- Income tax expense may be useful for investors to consider as it generally represents the taxes. The taxes may be payable for the period, which will change deferred income taxes and may reduce the amount of funds otherwise available for use. However, we do not consider the amount of income tax expense to be a representative component of the day-to-day operating performance of our business.

- Stock based compensation may be useful for investors to consider because it is an estimate of the non-cash component of compensation received by the Company's directors, officers, employees, vendors and consultants for services rendered. However, stock-based compensation is being excluded from the Company's operating expenses because the decisions which gave rise to these expenses were not made to increase revenue in a particular period, but were made for the Company's long- term benefit over multiple periods. While strategic decisions, such as those to issue share-based payments are made to further the Company's long-term strategic objectives and do impact the Company's earnings under IFRS, these items affect multiple periods and management is not able to change or affect these items within any particular period.

- One-time non-recurring cost may be useful for investors to consider as these are costs are associated with work force rationalizations, short term consulting projects, and other one-time legal cost associated to billing audits. These costs are not expected to be recurring in the current run-rate operations.

- New facility start-up costs may be useful for investors to consider because they represent costs directly related to new facilities that have yet to be have their grand opening. New facility start-up costs include: pre-opening rent expense, non-capitalized building expense, permit fees, pre-opening training costs, and compensation costs of employees hired to work at the new facilities. We view new facility start-up costs as investments that enable expansion and growth, but do not necessarily consider them a representative component of the day-to-day operating performance of our business.

**(Expressed in Canadian dollars in thousands)**

Management uses both IFRS and non-IFRS measures when planning, monitoring, and evaluating the Company's performance.

The following table shows our Non-IFRS measures reconciled to our net loss for the indicated periods:

| | Three months ended August 31, 2016 | Three months ended August 31, 2015 | Six months ended August 31, 2016 | Six months ended August 31, 2015 |
|---|---|---|---|---|
| **Net income (loss)** | **($2,590)** | **$470** | **($6,558)** | **$467** |
| Add back: | | | | |
| Depreciation and amortization | 428 | 44 | 801 | 53 |
| Interest expense/(interest income) | (23) | (11) | (22) | (17) |
| Provision for income taxes | - | - | - | - |
| **EBITDA** | **($2,185)** | **$503** | **($5,779)** | **$503** |
| Add back: | | | | |
| Stock based compensation | 672 | 1,319 | 1,230 | 1,518 |
| One-time non-recurring cost and facility start up cost | 1,474 | 152 | 4,506 | 409 |
| Reserve for disputed pricing | - | - | 947 | - |
| **Adjusted EBITDA** | **($39)** | **$1,974** | **$904** | **$2,430** |

## Consolidated operating results

| Consolidated statement of operations | Three months ended August 31, 2016 | Three months ended August 31, 2015 | Six months ended August 31, 2016 | Six months ended August 31, 2015 |
|---|---|---|---|---|
| **Revenue** | **$7,434** | **$ 5,674** | **$14,722** | **$ 7,993** |
| Cost of services | 2,951 | 2,026 | 6,380 | 2,737 |
| **Gross margin** | **$4,483** | **$3,648** | **$8,342** | **$5,256** |
| *Gross margin %* | *60%* | *64%* | *57%* | *66%* |
| Facilities | 969 | 469 | 1,702 | 699 |
| Sales and marketing | 1,265 | 514 | 2,578 | 845 |
| Insurance | 249 | 63 | 434 | 85 |
| General and administrative | 788 | 826 | 1160 | 837 |
| Billing and other outside services | 943 | 710 | 1,727 | 1,262 |
| Depreciation and amortization | 428 | 44 | 801 | 53 |
| Interest expense/(income) | (23) | (11) | (22) | (17) |
| New facility start-up costs and nonerecurring cost | 930 | 152 | 3,491 | 409 |
| Reserve for disputed pricing and bad debt | 852 | - | 1,799 | - |
| Transaction Costs | - | 32 | - | 32 |
| **Net loss before other items and stock based compensation** | **($1,918)** | **$849** | **($5,328)** | **$1,051** |
| Stock based compensation | 672 | 1,319 | 1,230 | 1,518 |
| Realized foreign exchange | - | - | 7 | - |
| **Net income/ (loss)** | **($2,590)** | **$470** | **($6,558)** | **$467** |
| **Basic and diluted loss per share** | **($0.011)** | **($0.002)** | **($0.029)** | **($0.003)** |

*Revenue*

For the three months ended August 31, 2016 and August 31, 2015, revenue totaled $7,434 and $5,674, respectively. The increase in revenue reflects higher client occupancy at the Company's BLVD treatment center in Hollywood, West Los Angeles, and San Diego California and Portland Oregon. It also includes the additional residential and outpatient centers in Orange County and Los Angeles, which were brought on through both launch and acquisition. Favorable US dollar exchange rates benefited revenue by approximately $120 for the three months ended August 31, 2016, compared to the same period in the prior year.

*Cost of revenue and gross margin*

Cost of revenue is comprised primarily of wages paid to clinical directors, clinicians, and group facilitators; along with program supplies, testing supplies and other expenses directly related to treating clients.

For the three months ended August 31, 2016 and August 31, 2015, cost of revenue was $2,951 and $2,026, respectively, and gross margin was 60% and 64%, respectively. The increase in cost of sales is directly related to an increase in revenue. The decrease in gross margin percentage in fiscal year 2017 is due partially to variable insurance rates. In addition, Inpatient facilities typically have lower gross margins when capacity utilization is lower than out-patient facilities due to the high fixed costs to operate them. Higher US dollar exchange rates increased cost of sales by approximately $47 in the three months ended August 31, 2016.

*Facilities*

Facilities expense includes all expenses related to renting and maintaining our physical corporate and operating locations, but excludes facility costs related to new operating facilities which have yet to be opened.

For the three months ended August 31, 2016 and August 31, 2015, facilities expense totaled $969 and $469, respectively. The increase in facilities expense is due primarily to having more facilities from acquisitions and openings. Higher US dollar exchange rates increased facilities expense by approximately $73 in the three months ended August 31, 2016.

*Sales and marketing*

Sales and marketing costs are comprised primarily of salaries, commissions and related expenses for sales personal and other expenses incurred to acquire new clients and get them enrolled in our service, salaries and related expenses for marketing personal, and costs related to advertising.

For the three months ended August 31, 2016 and August 31, 2015, sales and marketing expenses totaled $1,265 and $514, respectively. The increase in sales and marketing expenses is due to the increased internet marketing for new facilities, higher sales commissions associated with the increase in revenues, higher sales and internet and marketing headcount. Higher US dollar exchange rates increased sales and marketing costs by approximately $96 in the three months ended August 31, 2016.

*General and Administrative*

General and administrative expenses are comprised primarily of salaries and related expenses for finance, IT, accounting, management, and human resource personnel. In addition, there are new facility start-up costs, professional and legal services and other general overhead.

For the three months ended August 31, 2016 and August 31, 2015, general and administrative expenses were $788 and $826 respectively. The increase is as a result of building out the Company's corporate infrastructure, including staffing and a corporate office, as well as higher billing and consulting services. In addition, new facility start-up costs (which includes pre-opening rent expense, non-capitalized building, permit fees and pre-opening training and compensation costs of employees hired to work at the new operating facilities). The increase relates to certain costs for the outpatient center opened in San Diego, California and Portland, Oregon, and costs associated with a new inpatient facility in Hollywood, California, expected to open in summer 2016. Higher US dollar exchange rates increased general and administrative expenses by $65 in the three months ended August 31, 2016.

*Stock based compensation*

Stock based compensation represents the amortization of the fair value of options and warrants issued to the Company's directors, officers, employees, vendors and consultants for services rendered. For the three months ended August 31, 2016 and August 31, 2015, stock based compensation costs were $672 and $1,319, respectively.

Net Income/Loss

For the three months ended August 31, 2016 and August 31, 2015, the Company incurred a net loss of $2,590 and $470, respectively.

Comprehensive Income/Loss

For the three months ended August 31, 2016 and August 31, 2015, the Company incurred comprehensive income/ (loss) of ($2,491) and $1,364, respectively.

The difference between net loss and comprehensive income/ (loss) for the respective periods relates to foreign currency translation adjustments which record exchange differences arising on translation of the assets and liabilities of foreign controlled subsidiaries and loans between the members of the group. The comprehensive loss in the three months ended August 31, 2016, are a result of the strengthening of the Canadian dollar versus the U.S. dollar over the first quarter.

**(Expressed in Canadian dollars in thousands)**

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**Consolidated Statements of Financial Position**

| | | **August 31, 2016** | | February 29, 2016 |
|---|---|---|---|---|
| Cash | **$** | **11,625** | **$** | **19,417** |
| Restricted cash | | **590** | | **371** |
| Accounts receivable | | **7,841** | | **6,439** |
| Prepaid expenses | | **746** | | **710** |
| Other current assets | | **341** | | **25** |
| Property and equipment | | **6,778** | | **4,172** |
| Deposits and other non-current assets | | **353** | | **323** |
| Goodwill | | **9,938** | | **10,265** |
| Intangible assets | | **2,565** | | **3,288** |
| Deferred Tax Asset | | **532** | | **544** |
| **Total assets** | **$** | **41,309** | **$** | **45,554** |
| Accounts payable and other current liabilities | | **3,696** | | **3,426** |
| Long-term debt | | **2,265** | | **73** |
| Deferred Tax Liabilities | | **140** | | **138** |
| **Total liabilities** | **$** | **6,101** | **$** | **3,637** |
| Share capital and contributed surplus | | **43,802** | | **42,565** |
| Deficit | | **(11,139)** | | **(4,581)** |
| Accumulated other comprehensive gain | | **2,545** | | **3,933** |
| **Shareholders' equity** | **$** | **35,208** | **$** | **41,917** |

**Liquidity**

As of August 31, 2016, the Company had cash and restricted cash on hand of $12,215. Management considers liquid assets to consist of cash and cash equivalents, restricted cash, accounts receivable, inventory, prepaid expenses and other current assets. According to this definition, the company's liquid assets equal the current assets totaling $21,143. While working capital is traditionally used as a measure of a company's liquidity, management believes that a more accurate view of the Company's liquidity is liquid assets less current liabilities. The Company's liquid assets less current liabilities equal $17,447. Although the Company's cash flows from operations were negative in the three months ended August 31, 2016, the Company has experienced rapid growth and as a result working capital requirements (consisting primarily of receivables) have increased over the period; furthermore, the Company has been investing in sales and marketing, corporate infrastructure and new facility expansion. The Company has sufficient cash on hand to continue to support its expansion plans and meet its contractual obligations, and expects to generate positive operating cash flow in the second half of fiscal 2017. The Company has the ability to slow its expansion rate should the need arise. In addition, the Company has access to public markets and can access debt facilities to supplement its cash needs.

*Contractual obligations*

| | Payments due by period | | | | | |
|---|---|---|---|---|---|---|
| **Contractual obligations**<br>At August 31, 2016 | | **Total** | | **Less than 1 year** | | **Over 1 year** |
| Operating leases | $ | 7,569 | $ | 2,071 | $ | 5,498 |
| Capital leases | | 545 | | 166 | | 545 |
| **Total contractual obligations** | $ | **8,114** | **$** | **2,237** | **$** | **6,043** |

*Operating Leases*

The Company leases certain facilities under the terms of non-cancelable operating leases. For the three and six months ended August 31, 2016 the amounts included in facilities expense totaled $960 and $1,398, respectively.

In March 2016, the Company entered into a five-year master lease agreement with a Real Estate Investment Fund (the "RE Fund" or "Lessor"). The agreement covers the next eight inpatient pods, potentially including up to 16 properties, that the Company desires to utilize for inpatient services as part of its expansion plans. Subject to certain limitations, the agreement requires the RE Fund, as lessor, to purchase properties identified by the Company and to lease those properties to the Company for a period of five years, after which, the Company has the option to extend each lease for an additional five years, acquire all the properties at a guaranteed return to the RE Fund or let the leases lapse. The leases also contain an early termination right for the Company, which the Company may exercise after one year, provided the Company acquires the leased property from the RE Fund. As part of securing this agreement, the Company will issue 8,700,000 shares to the RE Fund. The agreement allows the Company to support its expansion plans without having to utilize its own cash or access outside financing.

*Capital leases*

The company has capital lease obligations related to vehicles and laboratory equipment with terms of two to three years and fixed interest rates between 2.9% and 7.0%.

*Other contractual obligations*

The Company has an advisory agreement as described in the related party information below.

**Capital Management**

The Company considers its capital to be shareholders' equity, which is comprised of share capital, contributed surplus, deficit and accumulated other comprehensive income and deficit, which totaled $35,208 at August 31, 2016, as well as long-term debt, which totaled $2265 at August 31, 2016.

The Company plans to raise capital and/or debt, as necessary, to meet its needs and take advantage of perceived opportunities and, therefore, does not have a numeric target for its capital structure. Funds are primarily secured through equity capital raised by way of private placements and convertible notes. There can be no assurance that the Company will be able to continue raising capital in this manner.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable.

The Company invests all capital that is surplus to its immediate operational needs in short-term, liquid and highly rated financial instruments, such as cash and short-term guarantee deposits, held with major Canadian and US financial institutions.

**Financing**

On April 22, 2015 (the "Closing), the Company closed on a bought deal private placement of 43,125,000 units. Each Unit consists of one common share in the capital of Convalo issued at $0.40 per common share, and one warrant of Convalo. Each Warrant entitles the holder thereof to acquire one common share for an exercise price of $0.50 per common share for a period of 36 months following the closing of the offering. The expiry date of the Warrants may be accelerated by Convalo at any time following the six-month anniversary of the Closing and prior to the expiry date of the Warrants if the volume-weighted average trading price of the Company's common shares is greater than $0.60 for any 20 consecutive trading days. The Company received gross proceeds of $17,250 and incurred cash share issuance costs of $1,467 for total net proceeds of $15,783. In addition, the Company issued 2,156,250 broker warrants to the underwriters.

During the six months ended August 31, 2016, a total of 66,500 warrants and were exercised at a weighted average exercise price of $0.10 per share for total net proceeds of $7.

(Expressed in Canadian dollars in thousands)

## Share Capital

| | ***August 31, 2016*** | *February 29, 2015* |
|---|---|---|
| *Authorized* | | |
| Unlimited voting common shares without par value | | |
| *Issued* | | |
| 228,032,550 voting common shares (2015 – 227,966,050) | **$40,242** | $40,235 |

***Changes to share capital:***

| | ***Number of shares*** | ***Amount*** |
|---|---|---|
| **Balance at November 30, 2013** | **37,534,300** | **37,534,300** |
| Shares issued through private placement, net of costs | 3,100,250 | 3,100,250 |
| Shares issued to third parties in exchange for services | 12,600,000 | 12,600,000 |
| Subscription receipts for shares in escrow, net of costs | 17,855,000 | 17,855,000 |
| **Balance at November 30, 2014** | **71,089,550** | **71,089,550** |
| Shares issued to Valiant shareholders (Amalgamation) | 5,900,000 | 5,900,000 |
| Shares issued through Valiant private placement, net of costs | 29,070,000 | 29,070,000 |
| Shares issued through bought deal private placement | 43,125,000 | 43,125,000 |
| Exercise of Options | 2,000,000 | 2,000,000 |
| Exercise of warrants | 64,781,500 | 64,781,500 |
| Shares issued for Purchase of Harmony Hollywood and ARTS | 12,000,000 | 12,000,000 |
| **As at February 29, 2016** | **227,966,05** | **227,966,050** |
| Exercise of warrants | 66,500 | 66,500 |
| **August 31, 2016** | **228,032,550** | **228,032,550** |

As of the date of this report 228,032,550 shares are outstanding.

## Off Balance Sheet Arrangements

The Company has no material undisclosed off-balance sheet arrangements that have or are reasonably likely to have, a current or future effect on its results of operations or financial condition.

## ACCOUNTING AND DISCLOSURE MATTERS

## Financial Reporting Controls

The Company is not required to certify the design and evaluation of its disclosure controls and procedures and internal controls over financial reporting and has not completed such an evaluation.

There were no substantive changes in the Company's disclosure controls and procedures and internal controls over financial reporting during the period ended August 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's disclosure controls and procedures and internal controls over financial reporting.

## Critical Accounting Estimates

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in the consolidated financial statements. We constantly evaluate these estimates and assumptions.

We base our estimates and assumptions on past experience and other factors that are deemed reasonable under the circumstances. This involves varying degrees of judgment and uncertainty, thus the amounts currently reported in the consolidated financial statements could prove to be inaccurate in the future.

We consider the estimates and assumptions described in this section to be an important part in understanding the consolidated financial statements. These estimates and assumptions are subject to change, as they rely heavily on management's judgment and are based on factors that are inherently uncertain.

Recognition of revenues

The majority of the Company's revenues are reimbursable by commercial payors, at out-of-network rates, with the remaining revenues payable directly by our clients. The Company bills commercial payors, once insurance has been verified and services have been performed, based on usual and customary rates for each service. Revenues from commercial payors are recognized based on expected realizable rates using historical collections rates by payor for each service provided. If no collections data is available for a payor (for example where the payor is new to the Company), the Company uses the Company-wide average reimbursement rate for that particular service. If commercial payors change their reimbursement rates for services already provided but not yet reimbursed, or a new payor rate is different from the estimated rate used, revenue is adjusted to account for the new rates. Because of continuing changes in the health care industry and third party reimbursement, it is possible that our estimates could change, which could have a material impact on the Company's recorded revenues and consequently, reported earnings.

Valuation of accounts receivable

The Company records bad debt expense based on the Company's historical experience of denials from commercial insurers. While the Company has controls in place to minimize the occurrence of denials, the underlying client insurance policy and deductible status is not always available at the time services are provided. Denials can be as a result of termed policies, client deductibles not met, client max benefits met, medical necessity not met, etc. In addition, management reviews accounts receivable in detail at each reporting period and provides for specific accounts that are deemed to not be collectible. Because of continuing changes in the health care industry and third party reimbursement, it is possible that our estimates could change, which could have a material impact on our operations and cash flows. If circumstances related to certain customers change or actual results differ from expectations, the Company's estimate of the recoverability of receivables could fluctuate from that provided for in the consolidated financial statements. A change in estimate could impact bad debt expense and accounts receivable.

Stock based Compensation

The Company uses the Black-Scholes option pricing model to determine the fair value of the Company's issued stock options and warrants as prescribed by IFRS 2. The Black-Scholes option pricing model requires management to make various estimates about certain inputs into the model, including the expected option life, expected volatility, risk-free interest rate and expected dividend yield. The company uses the following methodologies to estimate each of these inputs:

| Black-Scholes Input | Assumption | Methodology |
|---|---|---|
| Expected option/warrant life | 5 years/2 years | The life of the option or warrant is used |
| Expected volatility | 51% | The trading volatility of similar companies as well as its own trading volatility for the previous 52 week period |
| Risk-free interest rate | 0.99% | The Canadian Treasury rate on government bonds with similar duration |
| Dividend yield | Nil | The Company's expected dividend yield over the life of the underlying instrument |

A change in any of these estimates at the time the underlying options or warrants were issued would have impacted the Company's equity and ongoing stock-based compensation expense.

**Changes in accounting policies including initial adoption**

There were no accounting policy changes or adoption of new accounting policies in the three months ended August 31, 2016.

## FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

### Financial instrument risk exposure

The Company's activities expose it to a variety of financial risks: market risk (including price risk, currency risk and interest rate risk), credit risk and liquidity risk. These risks arise from the normal course of operations and all transactions are undertaken to support the Company's ability to continue as a going concern. The Company's financial risk management goals are to ensure that the outcome of activities involving elements of risk are consistent with the Company's objectives and risk tolerance, while maintaining an appropriate risk/reward balance and protecting the Company's consolidated balance sheet from events that have the potential to materially impair its financial strength. Balancing risk and reward is achieved through identifying risk appropriately, aligning risk with overall business strategy, diversifying risk, pricing appropriately for risk, mitigation through preventative controls, and transferring risk to third parties.

Market risk

*Foreign Currency Risk*

A significant portion of the Company's revenues are transacted in U.S. dollars and as a result, fluctuations in the rate of exchange between the U.S. dollar and Canadian dollar can have a significant impact on the Company's cash flows and reported results. As a majority of the Company's operating expenses are also in United States dollars, operational foreign currency risk is limited.

The functional currency for all of the Company's foreign operations is the US dollar which is the local currency. The Company translates the assets and liabilities of its US dollar functional currency subsidiaries into Canadian dollars using exchange rates in effect at the end of each period. Revenue and expenses for these subsidiaries are translated using average exchange rates that approximate those in effect during the period. The Company is affected by the fluctuations in the value of the US dollar. Significant fluctuations of exchange rates could adversely affect the Company's financial condition and results of operations. At the present, the Company maintains cash balances in both US and Canadian dollars, but does not purchase any securities or financial instruments to speculate on or hedge against a rise or fall in the value of the US Dollar.

Credit Risk

Credit risk is the potential that clients or a counterparty to a financial instrument fail to meet their obligation to the Company. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable as the Company's revenues are concentrated in California. The Company had many customers during the period and believes that there is minimal risk associated with collection of these amounts. The Company manages its credit risk by evaluating the eligibility of its clients for insurance or other coverage prior to admittance.

As of August 31, 2016 one commercial payors individually represented 20% of outstanding accounts receivable. No other customer represented more than 10% of outstanding receivables. The Company's customers are generally large, financially stable, commercial insurers and accordingly credit risk associated with each of them is considered low. Credit risk is generally limited to the risk that the estimated amount of revenue that can be collected is not accurate.

Provision for doubtful accounts recorded during the three months ended August 31, 2016 and August 31, 2015 was $852 and $nil, respectively.

Liquidity Risk

Liquidity risk is the risk the Company will encounter difficulties in meeting its financial liability obligations as they become due. The Company manages its liquidity risk through cash management. In managing liquidity risk, the Company maintains access to equity markets, the availability of which is dependent on market conditions. The Company monitors its requirements through the use of rolling future net cash flow projections and budgets and believes it has sufficient funding through its current cash position to continue operating for the foreseeable future. All financial liabilities, except for $379 related to capital lease obligations which are due in the next three years, are current and due within the next twelve months.

## RISK FACTORS

***Due to the nature of* Convalo's *business, the legal and economic climate in which* Convalo *operates and the present stage of development of its business,* Convalo *may be subject to significant risks.* Convalo*'s future development and actual operating results may be very different from those expected as at the date of this* MD&A. *There can be no certainty that* Convalo *will be able to implement successfully the strategy set out herein. No representation is or can be made as to the future performance of* Convalo *and there can be no assurance that* Convalo *will achieve its objectives. In addition to the other information in this* MD&A*, an investor should carefully consider each of, and the cumulative effect of, the following* factors.**

An investment in Convalo's shares should be considered highly speculative due to the nature of Convalo's business and the present stage of its development. In evaluating Convalo and its business, shareholders should carefully consider the following risk factors. These risk factors are not a definitive list of all risk factors associated with Convalo or in connection with their operations. It is believed that these are the factors that could cause actual results to be different from expected and historical results. You should not rely upon forward-looking statements as a prediction of future results. Additional risks and uncertainties that Convalo is unaware of, or that Convalo currently deems to be immaterial, may also become important factors that affect Convalo. If any of the risks actually occur, the business, financial condition or results of operations could be materially adversely affected, with the result that the trading price of Convalo or Convalo's shares, as applicable, could decline and the shareholder could lose all or part of his or her investment.

***Ability to Manage Growth***

Recent rapid growth in all areas of Convalo's business has placed, and is expected to continue to place, a significant strain on its managerial, operational and technical resources. Convalo expects operating expenses and staffing levels to increase in the future. To manage such growth, Convalo must expand its operational and technical capabilities and manage its employee base while effectively administering multiple relationships with various third parties. There can be no assurance that Convalo will be able to manage its expanding operations effectively. Any failure to implement cohesive management and operating systems, to add resources on a cost-effective basis or to properly manage Convalo's expansion could have a material adverse effect on its business and results of operations.

***Capital Investment***

The timing and amount of capital expenditures by Convalo will be dependent upon Convalo's ability to utilize credit facilities, raise new debt, generate cash from operations, meet working capital requirements and sell additional shares in order to accommodate these items. There can be no assurance that sufficient capital will be available on acceptable terms to Convalo for necessary or desirable capital expenditures or that the amount required will be the same as currently estimated. Lack of these funds could limit the future growth of Convalo and its subsidiaries and their respective cash flows.

***Competition***

Convalo will participate in a highly competitive market, which may become more competitive as new players enter. Certain competitors will be subsidiaries or divisions of larger, much better capitalized companies. Certain competitors will have vertically integrated services sectors of the market. Convalo will have less capital and may encounter greater operational challenges in serving the market.

***Dependence upon Management***

Although Convalo is expected to have experienced senior management and personnel, Convalo will be substantially dependent upon the services of a few key personnel for the successful operation of its business. The loss of the services of any of these personnel could have a material adverse effect on the business of Convalo. Convalo may not be able to attract and retain personnel on acceptable terms given the intense competition for such personnel among competitors. If it loses any of these persons, or is unable to attract and retain qualified personnel, its business, financial condition and results of operations may be materially and adversely affected.

***Inability to Implement the Business Strategy***

The growth and expansion of Convalo's business is heavily dependent upon the successful implementation of Convalo's business strategy. There can be no assurance that Convalo will be successful in the implementation of its business strategy.

***Issuance of Debt***

From time to time, Convalo may enter into transactions to acquire assets or the shares of other corporations. These transactions may be financed partially or wholly with debt, which may increase Convalo's debt levels above industry standards. The level of Convalo's indebtedness from time to time could impair Convalo's ability to obtain additional financing in the future on a timely basis to take advantage of business opportunities that may arise.

***Conflicts of Interest***

Certain of the directors of Convalo are also directors and officers of other companies, some of which may be in the healthcare sector, and conflicts of interest may arise between their duties as directors of Convalo and as officers and directors of such other companies. Such conflicts must be disclosed in accordance with, and are subject to such other procedures and remedies as apply under the applicable corporate statute.

***Dilution and Future Issuances of* Convalo *Shares***

Convalo may issue additional shares in the future, which may dilute a shareholder's holdings in Convalo.

***Future Sales of* Convalo *Shares by Directors and Officers***

Subject to compliance with applicable securities laws, directors and officers and their affiliates may sell some or all of their securities in Convalo in the future. No prediction can be made as to the effect, if any, such future sales will have on the market price of Convalo's securities prevailing from time to time. However, the future sale of a substantial number of securities by Convalo's directors and officers and their controlled entities, or the perception that such sales could occur, could adversely affect prevailing market prices for Convalo's securities.

***Reimbursement Rates May Decline***

Reimbursement for services to be provided by Convalo come primarily from private health insurance companies. The reimbursement rates offered are out-of-network and therefore outside the control of Convalo. Reimbursement rates in the United States, and much of the United States healthcare market in general, have been subject to continual reductions as health insurers and governmental entities attempt to control healthcare costs. The extent and timing of any reduction in reimbursement rates cannot be predicted by Convalo.

Reductions in reimbursement rates can have a material impact on the profitability of Convalo's operations. A reduction in reimbursement may be unrelated to any concurrent decline in the cost of operations, thereby resulting in reduced profitability. Convalo's costs of operations could increase, but the cost increases may not be passed on to customers because reimbursement rates are set without regard to the cost of service.

***Requirement for Permits and Licenses in a Highly Regulated Business***

Some operations of Convalo require certain licenses and permits from the authorities in the United States. The ability of Convalo to obtain, sustain or renew any such licenses and permits on acceptable terms is subject to changes in regulations and policies and to the discretion of the applicable authorities or other governmental agencies. There is no guarantee that Convalo will be able to obtain such licenses and permits.

Convalo will be subject to regulation from both United States federal and state authorities. Regulatory action could disrupt Convalo's ability to provide services. Such regulatory action could come in the form of actions based upon Convalo's operation. Regulatory action could prevent or delay reimbursement for certain services. There could also be legislative action that could adversely affect Convalo's business model, including a decision by the United States government, to become the exclusive provider of healthcare services at some time in the future Amendments to current laws and regulations could have a substantial adverse impact on Convalo.

***Privacy Legislation***

The *Health Insurance Portability and Accountability Act of 1996* ("**HIPAA**") required the United States Department of Health and Human Services to adopt standards to protect the privacy and security of individually identifiable health-related information. The department released regulations containing privacy standards in December 2000 and published revisions to the final regulations in August 2002. The privacy regulations extensively regulate the use and disclosure of individually identifiable health related information. The regulations also provide patients with significant new rights related to the understanding and controlling how their health information is used or disclosed. The security regulations require healthcare providers to implement administrative, physical and technical practices to protect the security of identifiable health information that is maintained or transmitted electronically.

In addition to HIPAA, there are numerous federal and state laws and regulations addressing patient and consumer privacy concerns, including unauthorized access or theft of personal information. State statutes and regulations vary from state to state. Lawsuits, including class actions and action by state attorneys general, directed at companies that have experienced a privacy or security breach can also occur.

Convalo believes that the cost of compliance with HIPAA and other federal and state privacy laws will not have a material adverse effect on its business, financial condition, results of operations or cash flows. However, there can be no assurance that a breach of privacy or security will not occur. If there is a breach, Convalo may be subject to various penalties and damages and may be required to incur costs to mitigate the impact of the breach on affected individuals.

***Strategic Relationships with Third Parties***

Convalo anticipates that it will continue to depend on the relationships with various third parties, including hospitals, long-term care facilities and physicians to grow its business. Identifying, negotiating and documenting relationships with third parties requires significant time and resources. Convalo's competitors may be effective in providing incentives to their parties to favour their solutions or may prevent Convalo from developing strategic relationships with these parties. In addition, these third parties may not perform as expected under any agreement with them and Convalo may have disagreements or disputes with these parties, which could negatively affect Convalo's brand and reputation. It is possible that these third parties may not be able to devote the resources that Convalo expects from the relationship. If Convalo is unsuccessful in establishing or maintaining its relationship with these third parties, Convalo's ability to compete in the marketplace or to grow its revenue could be impaired, and operating results would suffer. Even if Convalo is successful, these relationships may not result in improved operating results.

***Referrals***

The success of Convalo is primarily dependent upon physician referrals of patients for assessment and rehabilitation procedures. These referrals come through preferred provider and other service agreements established through competitive tendering processes. If Convalo's physician relationships were to decline in number, the business, financial condition and results of operations of Convalo could be adversely affected. Further there is a risk concerning changes in the United States Anti-Kickback Statute and Stark Law and/or similar state laws, rules and regulations.

***Information Technology Systems***

Convalo's business depends, in part, on the continued and uninterrupted performance of its information technology systems. Sustained system failures or interruptions could disrupt Convalo's ability to operate effectively, which in turn could adversely affect its business, results of operations and financial condition. Convalo's computer systems may be vulnerable to damage from a variety of sources, including physical or electronic break-ins, computer viruses and similar disruptive problems. Despite precautions taken and the extensive mitigation strategies put in place by Convalo, unanticipated problems affecting the information technology systems could cause interruptions for which Convalo's insurance policies may not provide adequate compensation.

***Insurance and Uninsured Risks***

Convalo's business will be subject to a number of risks and hazards generally, including general liability. Such occurrences could result in damage to facilities, personal injury or death, damage to the properties of Convalo, or the properties of others, monetary losses and possible legal liability.

Although Convalo will maintain insurance to protect against certain risks in such amounts as it considers to be reasonable, its insurance will not cover all potential risks associated with its operations. Convalo may also be unable to maintain insurance to cover these risks at economically feasible premiums. Insurance coverage may not continue to be available or may not be adequate to cover any resulting liability. Convalo might also become subject to liability which may not be insured against or which Convalo may elect not to insure against because of premium costs or other reasons. Losses from these events may cause Convalo to incur significant costs that could have a material adverse effect upon its financial performance and results of operations.

***General Litigation Risk***

Disputes are common in the United States healthcare industry and as such, in the normal course of business, Convalo might be involved in various legal actions and proceedings which arise from time to time, some of which may be substantial. There is no assurance that Convalo's insurance arrangements will be sufficient to cover any particular claim or claims that may arise in the future. Furthermore, Convalo is subject to the risk of claims and legal actions for various commercial and contractual matters in respect of which insurance is not available.

***Exchange Rate Fluctuations***

Exchange rate fluctuations may affect the costs that Convalo incurs in its operations. The appreciation of non-United States dollar currencies against the United States dollar can increase the cost of operations in United States dollar terms.

***Holding Corporation***

Convalo is considered a holding corporation and a substantial portion of its assets is the capital stock of its subsidiaries. As a result, the holders of Convalo shares are subject to risks attributable to its subsidiaries. As a holding corporation, Convalo conducts substantially all of its business through its subsidiaries, which generate substantially all of its revenue. Consequently,

Convalo's cash flows and ability to complete current or desirable future enhancement opportunities are dependent on the earnings of its subsidiaries and the distribution of those earnings to Convalo. The ability of the subsidiaries of Convalo to pay dividends and other distributions depend on their operating results and is subject to applicable laws and regulations which require that solvency and capital standards be maintained by such companies and contractual restrictions contained in ten instruments governing their debt. In the event of bankruptcy, liquidation or reorganization of any of Convalo's subsidiaries, holders of indebtedness and trade creditors will generally be entitled to payment of their claims from the assets of those subsidiaries before any assets are made available for distribution to Convalo.

***Internal Control over Financial Reporting and Disclosure Controls and Procedures***

Convalo may face risks if there are deficiencies in its internal controls over financial reporting and disclosure controls and procedures. Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external reporting purposes. Management is responsible for establishing and maintaining adequate internal controls over financial reporting appropriate to the nature and size of Convalo. The board of directors, in conjunction with its Audit Committee, is responsible for assessing the progress and sufficiency of internal controls over financial reporting and disclosure controls and procedures and will make adjustments as necessary. However, these initiatives may not be effective at remedying any deficiencies in internal control over financial reporting and disclosure controls and procedures. Any deficiencies, if uncorrected, could result in Convalo's financial statements being inaccurate and in future adjustments or restatements of its financial statements, which could adversely affect the price of Convalo shares and Convalo's business, financial condition and results of operations.

***Key Credentialed Employees***

Convalo will rely on a number of key employees and licensed providers with specialized training in the delivery of Convalo's services. Convalo's operations will be adversely affected if any of the key employees cease their employment with Convalo or if Convalo is unable to recruit and retain qualified staff.

***Ability to Implement Acquisition Strategy***

Convalo may not be able to effectively implement its acquisition strategy. There is the possibility that Convalo will not be able to reduce costs, improve profits or roll out additional rehabilitation facilities fast enough to meet its objectives.

***Uninsured and Underinsured Clients and Collection Risks***

An increase in uninsured and underinsured clients or the deterioration in the collectability of the accounts of such clients could have a material adverse effect on Convalo's business, financial condition and results of operations. Collection of receivables from third-party payors and clients is critical to Convalo's operating performance. The primary collection risks are (i) the risk of overestimating Convalo's net revenues at the time of billing that may result in Convalo receiving less than the recorded receivable, (ii) the risk of non- payment as a result of commercial insurance companies denying claims, (iii) the risk that clients will fail to remit insurance payments to Convalo when the commercial insurance company pays out-of-network claims directly to the client, (iv) resource and capacity constraints that may prevent Convalo from handling the volume of billing and collection issues in a timely manner, (v) the risk that clients do not pay Convalo for their self-pay balance (including co-pays, deductibles and any portion of the claim not covered by insurance, and (vi) the risk of non-payment from uninsured clients. Significant changes in business office operations, payor mix or economic conditions, including changes resulting from implementation of the *Affordable Care Act*, could affect Convalo's collection of accounts receivable, cash flows and results of operations.

***Increased State and Federal Investigation of Healthcare Providers***

Both federal and state government agencies have heightened and coordinated their civil and criminal enforcement efforts as part of numerous ongoing investigations of healthcare companies and various segments of the healthcare industry. These investigations relate to a wide variety of topics, including relationships with physicians, billing practices and use of controlled substances. The PPACA included an additional $350 million of federal funding over 10 years to fight healthcare fraud, waste and abuse, including $40 million for federal fiscal year 2014. From time to time, the Office of Inspector General and the Department of Justice have established national enforcement initiatives that focus on specific billing practices or other suspected areas of abuse. In addition, increased government enforcement activities, even if not directed towards our treatment facilities, also increase the risk that Convalo's facilities, physicians and other clinicians furnishing services in Convalo's facilities, or Convalo's executives and directors, could become named as defendants in private litigation such as state or federal false claims act cases or consumer protection cases, or could become the subject of complaints at the various state and federal agencies that have jurisdiction over Convalo's operations. Any governmental investigations involving any of Convalo's facilities, executives or directors, even if Convalo ultimately prevails, could result in significant expense and could adversely affect Convalo's reputation.

***Uncertainties Regarding the PPACA***

The PPACA provides for increased access to coverage for healthcare and seeks to reduce healthcare-related expenses. Overall, the expansion of health insurance coverage under the PPACA, most of which went into effect on January 1, 2014, is expected to be beneficial to the substance abuse treatment industry. Beginning January 1, 2014, health insurers are prohibited from denying coverage to individuals because of preexisting conditions. Further, all new small group and individual market health plans are required to cover ten essential health benefit categories, which include substance abuse addiction and mental health disorder services. Likewise, as of January 1, 2014, small group and individual market plans are required to comply with the requirements of the MHPAEA of 2008. According to the U.S. Department of Health and Human Services estimates published in February 2013, these changes are expected to expand coverage for substance abuse addiction treatment and mental health disorders treatment for another 62.5 million Americans. The expansion of commercial insurance for substance abuse treatment services under the PPACA may result in a higher demand for services from all providers. This may bring new competitors to the market, some of which may be better capitalized and have greater market penetration than Convalo. Further, Convalo expects increased demand for substance abuse treatment services to also increase the demand for case managers, therapists, medical technicians and others with clinical expertise in substance abuse treatment, which may make it both more difficult to adequately staff Convalo's substance abuse treatment facilities and could significantly increase its costs in delivering treatment, which may adversely affect both its operations and profitability. One of the many impacts of the PPACA has been a dramatic increase in payment reform efforts by federal and state government payors as well as commercial payors. These efforts take many forms including the growth of accountable care organizations, pay-for-performance bonus arrangements, partial capitation arrangements and the bundling of services into a single payment. The end result of these efforts is that more risk of the overall cost of care is being transferred to providers. As institutional providers and their affiliated physicians assume more risk for the cost of care, Convalo expects more services to be furnished within provider networks formed to accept these types of payment reform.

Convalo's ability to compete and retain traditional sources of clients may be adversely affected by Convalo's exclusion from such networks or its inability to be included in such networks. Convalo cannot predict the impact the implementation of the PPACA and related rulemaking and regulations may have on Convalo's business, results of operations, cash flow, capital resources and liquidity or whether Convalo will be able to adapt successfully to the changes required by the PPACA.

***Changes to Federal, State and Local Regulations***

Because Convalo's treatment programs and operations are regulated at federal, state and local levels, Convalo could be affected by different regulatory changes in different regional markets. Increases in the costs of regulatory compliance and the risks of noncompliance may increase Convalo's operating costs, and Convalo may not be able to recover these increased costs, which may adversely affect Convalo's results of operations and profitability. Also, because many of the current laws and regulations are relatively new, Convalo does not always have the benefit of significant regulatory or judicial interpretation of these laws and regulations. In the future, different interpretations or enforcement of these laws and regulations could subject Convalo's current or past practices to allegations of impropriety or illegality or could require Convalo to make changes to its treatment facilities, equipment, personnel, services or capital expenditure programs. A determination that Convalo has violated these laws, or the public announcement that Convalo is being investigated for possible violations of these laws, could adversely affect Convalo's business, operating results and overall reputation in the marketplace. In addition, federal, state and local regulations may be enacted that impose additional requirements on Convalo's facilities, such as the 2013 changes to the HIPAA privacy and security regulations. Adoption of legislation or the creation of new regulations affecting Convalo's facilities could increase its operating costs, restrain its growth, limit it from taking advantage of opportunities presented and could have a material adverse effect on its business, financial condition and results of operations. Adverse changes in existing comprehensive zoning plans or zoning regulations that impose additional restrictions on the use or requirements with respect to its facilities may affect Convalo's ability to operate its existing facilities or acquire new facilities, which may adversely affect its results of operations and profitability.

***Estimates of reimbursement amounts for services performed***

Convalo recognizes revenues from commercial payers at the time services are provided based on estimates of the amount that payors will pay the Company for the services performed. Management estimates the net realizable value of revenues by adjusting gross client charges using expected realization rates and applying this discount to gross client charges. Expected realization is determined by management after taking into account historical collections received from commercial payors in the prior six month period by facility, by type of service and by payer. Estimates of net realizable value are subject to significant judgment and approximation by management. It is possible that actual results could differ from the historical estimates management has used to help determine the net realizable value of revenues. If actual collections either exceed or are less than the net realizable value estimates, the Company will record a revenue adjustment, either positive or negative, for the difference between our estimate of the receivable and the amount actually collected in the reporting period in which the collection occurred. A significant negative revenue adjustment could have a material adverse effect on our revenues, profitability and cash flows in the reporting period in which such adjustment is recorded. In addition, if we record a significant revenue adjustment, either positive or negative, in any given reporting period, it may lead to significant shifts in our results from operations from quarter to quarter, which may limit our ability to make accurate long-term predictions about our future performance.