ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Selling by Finance Executives Suggests Greater Risk Triad Hospitals Inc. (NYSE:TRI)

May 3, 2005

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Triad Hospitals, Inc. (Triad) through its affiliates owns and manages hospitals and ambulatory surgery centers in small cities and selected larger urban markets primarily in the southern, midwestern and western United States. Triad has 52 hospitals (including one under construction) and 14 ambulatory surgery centers in 15 states with approximately 8,340 licensed beds. Triad's general acute care hospitals provide a range of services in hospitals, such as internal medicine, general surgery, cardiology, oncology, neurosurgery, orthopedics, obstetrics, diagnostic and emergency services. These hospitals also provide outpatient and ancillary healthcare services, such as outpatient surgery, laboratory, radiology, respiratory therapy, cardiology and physical therapy. Through its subsidiary Quorum Health Resources, LLC (QHR), Triad provides hospital management, consulting and advisory services to independent general acute care hospitals throughout the United States.

Summary of 3DAdvisors Findings for TRI

- **Insider Trading:** Heavy selling and holdings reductions by finance executives
- **Accounting:** Is well known receivables risk greater than disclosure suggests?
- **Accounting:** Stretching amortization of acquired management contracts
- **Accounting:** Aggressive amortization of physician income guarantees
- **Governance:** Abrupt departure of General Counsel

Discussion of 3DAdvisors Findings

Our interest in the actions of insiders at Triad has accelerated significantly in the days following our initial coverage of the Company in the *Insider Research Bulletin* of 04/22/05. We cannot remember a time, in our almost 24 years of analyzing insider behavior, when so many executives in key financial positions at a company, have converged to liquidate the vast majority of their holdings in a very short period of time. It also happens that this group has very few new options set to vest downstream, making the holdings reductions stand out even more.

In addition to these key financial personnel, other insider sales have occurred during the same time period. These sales have also significantly depleted the holdings of those involved. In our eyes, there is simply no denying the significance of the activity which, in spite of the existence of certain 10b5-1 plans, has eclipsed the insider holdings effect of any prior selling activity by TRI insiders in past years.

While reviewing executive accounting and governance behavior, we were struck with the impression that Triad management wants us to believe it has laid all its risk cards on the table. Indeed, the Company goes to great lengths to disclose, in great detail, the significant A/R exposure related to both uninsured patients and those skipping on their co-payment obligations. We recognize that these A/R related risks are widely known and do not warrant extensive coverage on our part. At the same time, however, the rush to the exits by key TRI insiders implies that, all disclosure aside, the risk picture may very well be significantly understated by management and, consequently not fully discounted in the current price of Triad shares. Surely the convergence of decisions by key financial executives to liquidate the majority of their holdings cannot be separated from their unique insight into the Company's prospects and their evaluation of possible adverse changes in its financial condition. It would seem to us that they have very little confidence in the stock price holding at its present levels. In light of this, we find ourselves compelled to bring the following observations to the attention of our clients.

Insider Trading: Heavy selling and holdings reductions by finance executives

Perhaps it's just serendipitous, but the fact that three of Triad's top financial executives chose to punch out the vast majority of their actionable holdings (common stock plus exercisable options) following a run up in the shares earlier in the year after HCA raised guidance and immediately following the departure of their Company CFO, for active duty in Iraq, is not lost on us. Be advised, we are not affixing significance to the fact that **Burke Whitman (49)**, a Lieutenant Colonel in the U.S. Marine Corps Reserves, was called to temporary active duty in March. Indeed, we commend his loyalty to the Corps and wish him only the best of luck and a speedy and safe return. What hit us, however, is the fact that immediately after TRI's February 10th announcement of his impending departure, three prominent members of his financial team, certainly an integral part of the team expected to carry the load, began their unprecedented flight to cash, dropping between 70% and 100% of their holdings in the process:

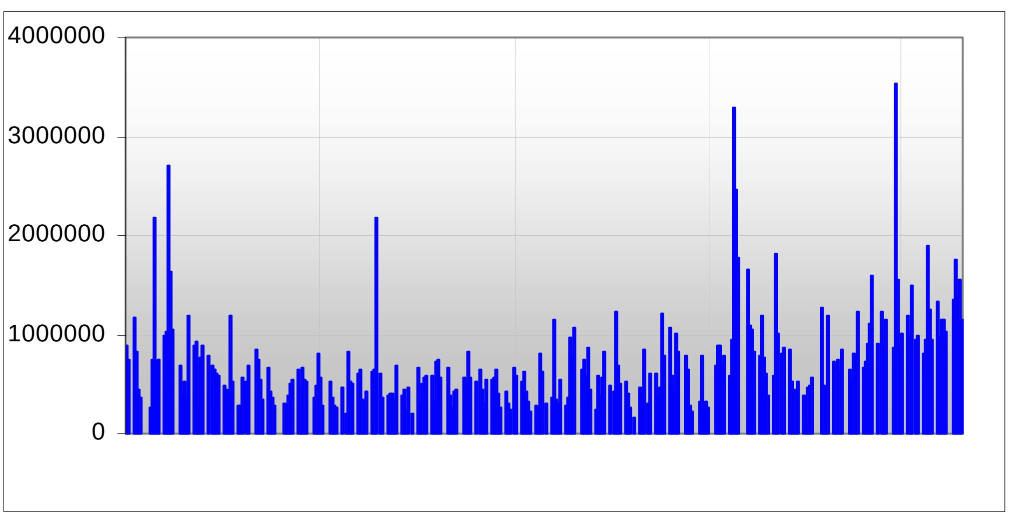
- **William Huston (50)** – Senior V.P. Finance. Huston has responsibility for materials management, business office operations, operations improvement and revenue analysis. He has sold only two times since 1999, both proving to be prescient decisions. After the announcement of Whitman's departure, Huston exercised four of his long-vested options series, none of them set to expire until May 2009 at the earliest. In selling the underlying 127,128 shares, **he monetized 76% of his actionable position.** What's more, his next options vesting date is February of 2006 when he will have options for only 22,750 shares become exercisable.

- **James Bedenbaugh (56)** – Senior V.P. Treasurer. Bedenbaugh **monetized 90% of his actionable position** in March, exercising four series of mostly long-vested non-expiring options (expiration dates between 4/11 and 2/14), selling the 65,500 shares exercised for. This was his first activity since joining TRI in 2001 (from Magellan

Health Services) and left him with only the 175 shares in his ESOP and 8,750 options that vested in the final week of April. He will have another 26,750 options vest in February of 2006.

- **W. Stephen Love (53)** – Senior V.P., Controller (acting CFO). Between January 13th and February 25th, Love exercised most of his vested options (the earliest expiration date being March of 2010) and sold the underlying 101,382 shares. The majority of the shares (60,000) were sold after the announcement that CFO Whitman was leaving for active duty. **The moves slashed his actionable holdings by 69%.** More importantly, he will see just 22,750 shares vest next February, and he won't see any more vest until February of 2007.

Figure 1. TRI Daily Closing Price (Top) and Daily Trading Volume (Bottom). Blue shaded area is date range where all the selling in this report took place, beginning one day after a 10% run up in the shares and heavy volume caused by HCA raising guidance in early January. Source: Reuters and TRI SEC Filings.



What also seems to have motivated some additional sellers is the 10% move the stock made on March 26th following the announcement of quarterly earnings. Several Divisional Heads joined the finance executives and took the stock's upward momentum as an opportunity to unload the majority of their actionable positions during the same time frame:

- **Nicholas Marzocco (50)** – Divisional President with responsibility for hospitals in Texas, Arkansas and Alabama. Marzocco's selling began in early February and between then and April 27th, he managed to unload 106,382 shares he acquired through the exercise of long-vested options, none of which were expiring until 2009 at the earliest. **This move cut his holdings by 69%.** He will not see new options vest until February of 2006 (for 21,500 shares).

- **William Anderson (55)** – Division President with responsibility for hospitals in Indiana, Ohio, Arkansas and Texas. Acting seemingly in unison with the others, Anderson exercised options for, and disposed of, 60,000 shares between March and April. Like the others, the options exercised for were far from any expiration threat (earliest being 2011). He has **slashed his holdings by 80%** with no more new options other than 22,750 vesting in February of 2006, with the next vesting date being February of 2007.

- **Marsha Powers (51)** – Division President with responsibility for hospitals in New Mexico, Texas, Mississippi, South Carolina and West Virginia. Powers executed her largest-ever sale on March 4th, clearing out the majority of three options series, none expiring until 2011. In doing so, she **trimmed her holdings by 87%** with no new options vesting until February of 2006 (for 21,500 shares).

But there's more. Selling by COO **Michael Parsons**, who went outside of his 10b5-1 plan to sell a larger-than-plan amount of 50,000 shares and director **Donald Halverstadt**, who reduced his holdings by 50% with his 50,000 share sale, among others, adds to the consensus of insiders unloading at this time.

We cannot emphasize enough how rare it is to see so many, at one company, cashing in so much of their holdings at the same time, even taking into consideration the evident price momentum. We should also add that the resulting holdings reductions are unprecedented for the Company. Putting this in context is the fact that new options to be vested will be at a very slow pace for the next few years at best. Also, there have been no significant restricted stock awards to fill in the gaps. All this suggests that these insiders are cashing in with the knowledge that their holdings are not going to be replenished by significant new grants or the vesting of existing options. The behavior strongly suggests a risk picture that is not factored into the current price of the shares.

<u>Accounting: Is well known receivables risk greater than disclosure suggests?</u>

It certainly is no secret that Triad, along with other healthcare companies who operate hospitals and/or outpatient surgical centers, face growing threats from bad A/R's as the amount of bad receivables related to noninsured patients and uncollected co-payments continues to rise exponentially. As mentioned earlier, it is not necessary for us to itemize the extent of the problem except to cite some relevant examples as to how the situation has affected Triad:

- In the recent Q1 conference call, company management cited bad debt expense as "the single biggest risk to our financial performance near-term".

- Triad's allowance for Doubtful A/R's is running at about 10.8% of revenues, above the Company's already-high target of 9 to 9.5%.

- In 2004, the Company increased its A/R allowance by $69 million and this after an increase of $87 million in 2003. Uninsured receivables were up by $105 million during the 2004 period.

- For the three-year period ended December 31, 2004, the Company wrote off just under $1.1 billion in bad debts. We acknowledge that this is a pervasive problem for the industry, as certain industry peers are experiencing write-offs of similar magnitude. That being said, however, the total is not an insignificant amount to be recognizing as revenue with little or no likelihood of collection.

- The Company carries an extra $15 million in its allowance for doubtful A/R's, beyond what their A/R look-back model requires "to reflect the potential for further deterioration in historical write-offs". On the surface, this could be interpreted as conservative management. Indeed, some analysts view this as a possible downstream positive surprise should the extra allowance be reversed in a future period. We suspect, however, that there is a reasonable possibility that the insider picture implies that the opposite is true and that the extra allowance amounts to an admission that the elaborate statistical exercise the Company goes through does not come up with enough allowance to fill the bill.

<u>Accounting: Stretching amortization of acquired management contracts</u>

Our clients are probably aware that, through its acquisition of Quorum Health Group in 2001, Triad is now one of the largest players in the contract management (read: hospital management) area. It is interesting to note how Triad is amortizing its management contracts acquired from Quorum. Triad indicates that the average length of its hospital management contracts ranges from between three and five years. To this, we find it curious that the Company chooses to amortize these acquired contracts, using the straight-line method, over a period of 15 years. It seems that Triad has received independent auditor approval on the extended amortization schedule by using the argument that these contracts renew at the rate of 79%.

Looking back into Quorum's financials before the acquisition, however, sheds some interesting light on this practice. At that time, Quorum disclosed the same average contract lengths (three to five years) but added **that almost 11% of its contracts terminated prior to reaching their full term**. We found it curious that Triad chooses to avoid disclosure of this metric, all the while implying that its average contract renews between three and five times, making the basket of contracts amortizable over a much longer 15 year period than they would had their actual individual 3 to 5 year contract lengths been taken into account.

Accounting: Aggressive amortizing of physician income guarantees

Triad enters into “Physician Recruiting Agreements” whereby the Company “supplements physician income to a minimum amount over a period of time, typically one year, while the physicians establish themselves in the community.” The physician is required to stay in the community (as part of the agreement) for three years.

We find the practice curious that Triad records the payments to the physicians as an “Other Asset” then amortizes that asset “over the remaining period of the agreement”. We have raised the issue of this practice with certain health care consultants who concur with us that this treatment, albeit compliant with GAAP, is an aggressive one.

Governance: Abrupt departure of General Counsel

We thought the terse disclosure of the retirement of the Company’s General Counsel, **Donald Fay (61)**, was curious and worth mentioning. The disclosure took place during the Company’s Q1 conference call. There was no press release or other corporate announcement, just the following statement in the opening remarks by Triad Chairman and CEO, **Denny Shelton** [bolding is ours for emphasis]: **“With us, as we always have had since we started the company, is Don Fay, our General Counsel. And Don has announced his retirement. This will be his last call. He will be hanging it up at the end of May.”**

Shelton certainly didn’t offer any praises or best wishes to his outgoing general counsel, who is leaving on what appears to be one-month’s notice. Not a lot of time for a company embroiled in the complex legal and regulatory challenges that Triad deals with which include multiple False Claims Act litigation inherited with the Quorum Health Group acquisition, not to mention numerous HCA-related governmental investigations which could involve Triad.

Even though Triad has been indemnified, to a certain extent, by HCA, concerning various claims the Company is still required to take the position that settlement of certain issues may still result in material payments by Triad, and that Triad could still stand to be materially affected as a result of the many investigations and that there could be a material and adverse effect on Triad’s results of operations or financial position. We are led to wonder whether the various risks on Triad’s legal front may not only have been a cause for some of the insider holdings reductions but also the apparent early retirement of the Company’s General Counsel.