



#### This 3DAdvisors Report Covers:

- ✓ **Insider Trading:** Insider Trading Behavior
- ✓ **Accounting:** Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

## Light Disclosure and Heavy Insider Selling Continue Lincare Holdings, Inc. (NASDAQ:LNCR) Update

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Lincare Holdings Inc., together with its subsidiaries, is a provider of oxygen and other respiratory therapy services to patients in the home. The Company's customers typically suffer from chronic obstructive pulmonary disease, such as emphysema, chronic bronchitis or asthma, and require supplemental oxygen or other respiratory therapy services in order to alleviate the symptoms and discomfort of respiratory dysfunction. Lincare serves over 400,000 customers in 47 states through 642 operating centers. The Company also provides a variety of durable medical equipment and home infusion therapies in certain geographic markets.

### Summary of 3DAdvisors Findings for LNCR

- ▶ **Governance:** Disclosure behaviors should be of major concern to investors
- ▶ **Governance:** Compensation plans seem exorbitant and self-serving
- ▶ **Insider Trading:** Selling continues despite depressed stock price
- ▶ **Accounting:** Cash flow issues may be limiting Company strategies
- ▶ **Accounting:** Goodwill impairment risks significant if revenue slows

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### Discussion of 3DAdvisors Findings

As we have mentioned in our two previous reports on Lincare (01/15/04 and 06/15/04), the Company's proclivity for extremely limited disclosure, combined with certain questionable governance practices of its board and management, should give investors a reason for pause even if there were no draconian Medicare issues looming. Not only does the Company refrain from holding earnings conference calls, disclosure in its key SEC filings is absolute bare bones. Indeed, even in instances when significant government investigations have surfaced, Lincare generally chooses not to disclose or comment on them, leaving such matters up to the press instead.

The self-serving nature of management's compensation plans is unquestionable and one gets the distinct impression that top management is focused on getting as much out of the Company as it can while the getting is good. Persistent stock sales by management continually reinforce this impression, as there has been a steady stream of selling underway ever since the 30% price drop late last year that was induced by

passage of the new Medicare legislation. The extremely stingy nature of disclosure at the Company, combined with certain other behaviors of management, give us the impression that, should some truly negative events be brewing, investors should expect to receive little or no warning as to their approach.

#### Governance: Disclosure behaviors should be of major concern to investors

There is, perhaps, no better way to enter into a discussion describing Lincare's disclosure policies than to recount certain events of early 2003 when a Lincare Missouri subsidiary, Med 4 Home, failed to perform a complete recall of an inhalant drug that had been contaminated. Not only was it alleged, by Missouri regulators, that the Lincare subsidiary did just a partial recall but also that Company employees did not warn patients that they had potentially contaminated products, saying instead that the problem was one of "quality assurance". In addition, a state inspector was blocked from entering a Lincare facility. Citing "a serious public health issue", the Missouri regulators brought an injunction barring the subsidiary (Med 4 Home) from compounding and dispensing drugs until the situation was cleared up.

When word got out about the problem, on January 30 of 2003, Lincare's stock dropped 11% on eight times its normal volume. The Company, when asked about the stock action, would only issue a press release saying "We are not aware of the reasons for the unusual movement in the stock price today. To our knowledge, there have been no adverse developments in the business or any inquiries by any regulatory agencies other than in the ordinary course of business. Lincare will not comment on rumors." Rumors? Three months later, on April 11<sup>th</sup>, Lincare and Missouri regulators signed a consent agreement allowing state regulators access to inspect the facility and its records. Lincare had to wait 30 more days before resuming its compounding of drugs at Med 4 Home.

Lincare never issued an 8-K relating to this situation. In fact the matter went completely undisclosed by the Company. This was just one example of a long line of probes into Company dealings, most of which were never disclosed. Back in June of 2000, Lincare shares fell 27%, in one day, when it was revealed that several of its employees were being investigated by a federal grand jury concerning violation of health care laws. In June of 1998, the U.S. Attorney's office in Sacramento, CA initiated a probe relating to the provision of home oxygen therapy to beneficiaries of certain federally funded health care programs in the state. This resulted in a \$4.15 million settlement with the government plus another \$1.2 million in legal fees. Only upon the settlement of this matter, with its attendant fees, did the Company offer disclosure of this situation. In March of 1999, the Department of Health and Human Services' Office of The Inspector General subpoenaed Medicare billing records for patients in the Tampa Bay, Florida area. In addition, there have been at least three whistle-blower complaints involving the Company that have been made public, but not by Lincare.

Instead of revealing details of contingencies relating to its potentially embarrassing (or worse) problems, Lincare provides only a boiler plate disclosure in its financials which basically says that they are "involved in certain claims and legal matters arising in the ordinary course of business", and that "we have concluded that accrued liabilities related to contingencies are appropriate and in accordance with generally

accepted accounting principles.” Based on the disclosure behavior we’ve observed, we doubt these statements inspire a great deal of investor confidence.

True to form, Lincare does not conduct conference calls when releasing earnings. In addition, the Company designates just three executive officers (other than directors) as Section 16 filers. In our 23 years of monitoring insider activity, this is the smallest number of designated filers we’ve seen. The average company of this size has 6 to 10 such filing executives whose stock moves would require full disclosure.

#### Corporate Governance: Compensation plans seem exorbitant and self-serving

Each year, the top three Lincare executives, Chairman and CEO **John Byrnes** (2003 salary and bonus - \$1.9 million), CFO **Paul Gabos** (2003 salary and bonus - \$945 thousand) and President and COO **Shawn Schabel** (2003 salary and bonus - \$945 thousand) find themselves among the ranks of the highest-paid executives in the state of Florida according to several published reports. In addition to the above salaries, Byrnes received options for 300,000 shares in 2003 while Gabos and Schabel received 150,000 each. The trio had extended their employment agreements together in 2001, pushing through hefty cash signing bonuses for themselves in the process. Byrnes got \$2.4 million; Gabos and Schabel received \$1.1 million each.

Inspection of their cash incentive bonus criteria, however, reveals sleight of hand and creativity at its best. The performance criteria are divided into two segments, both open-ended, but take a look at the criteria: Half the bonus is based on Earnings Per Share, the other half on EBIDA. They are actually paying the bonuses twice on the same performance! In other words, incentive bonuses are not based on one or the other, but both. This is akin to paying a bonus for bringing receivables down then paying another one for lowering DSO’s as well. In addition, the Board of Directors has the discretion to adjust the Bonus “equitably” for extraordinary charges, “unusual” non-recurring items or changes in accounting principles. This virtually gives the board the license to increase the bonuses for any reason or, at the very least, pay them out under almost any circumstance.

The newly approved 2004 Stock Plan also plays directly into the hands of the three executives. When pushing the program through the shareholder vote, the Company noted that the plan covered 7,500 eligible employees, making it, on the surface anyway, appear as a broad-based plan. Further inspection of the Plan, however, reveals that it seems designed to make very large awards to very few persons. We say this because the plan can grant a total of common stock and/or restricted stock awards totaling 4 million shares in aggregate, however, such awards under the plan can be as high as 800,000 shares to any one person in a fiscal year. Indeed, Lincare management has already moved to get a large portion of these awards into their hands early in the game: So far in 2004, Lincare has awarded a total of 260,000 shares of restricted stock under the plan, all of it to the three executives named above (Byrnes – 120,000 shares, Schabel – 80,000 shares, Gabos – 60,000 shares). In addition to the restricted shares, Lincare also granted options to the three at the same pace, or more, as they did in 2003 (Byrnes – 300,000 shares, Schabel – 200,000 shares, Gabos – 150,000 shares). So in the first six months of the new “broad based” Lincare Stock Plan, Lincare’s top three executives have managed to grab 23% of the available shares.

Making this giveaway even more interesting is that the new Stock Plan does not provide detail as to the performance criteria to be met in order for the restricted stock award component to vest; the plan leaves such things up to the discretion of the board. It would seem, however, that a significant portion of the criteria might be simple “service-based vesting conditions” (this phrase appearing on the related Form 4 filings disclosing the awards). We are left to assume that this probably means that vesting occurs as long as these individuals stick around long enough. But given the compensation giveaways inuring to their benefit, why would they leave, especially if all they need to do is stay in the job?

One more interesting practice continues in the new Stock Plan that has also been in place in prior versions. The Company continues to reserve the right to repurchase shares issued under the plan directly from the executives. This repurchase provision appears consistently through the plan document. Though the Company has never disclosed having actually repurchased shares from its insiders, the existence of these disclosures strongly implies that this may be occurring. Disclosure of direct repurchases from insiders is extremely rare.

#### Insider Trading: Selling continues despite depressed stock price

Insider selling has been suspiciously consistent in Lincare shares ever since they lost 30% of their value on the Medicare reimbursement concerns. Since that drop, five insiders have sold a total of 974,000 shares between the prices of \$30.51 and \$34.71, far outpacing the 335,000 shares that Company insiders sold in *total* for the years 2001 and 2002 combined. Also, in spite of the fact that the shares have drifted steadily lower (by 15%) since our June 15<sup>th</sup> report, insider selling has persisted. From July 1<sup>st</sup> through

**Figure 1.** LNCR Daily Closing Prices, October 1, 2003 Through September 28, 2004. Blue diamond is the date of our first report (01/15/04); Green diamond is the date of our most recent update (06/15/04). Shaded blue area is where insiders sold 280,000 shares. Sources: Reuters, LNCR SEC Filings and 3DAdvisors, LLC.



September 3<sup>rd</sup> three insiders sold 280,000 shares between \$31.53 and \$33.28.

Making this particular insider picture all that much more interesting is the fact that was mentioned above: Lincare designates just three executive officers (other than board members) as Section 16 filing officers. To us, this is nothing other than pure obfuscation and is behavior consistent with this Company's practice of providing as little disclosure as possible. If there were more executives filing evidence of their trading, we would not be surprised if much more selling were evident.

- **William Miller (54)** – Director. We last reported a March 2004 sale covering 72,000 shares by Miller that wiped out all of his vested options and left him with only 10,000 shares of common stock. Curiously, Miller, who has been on the board since 1997, recently sold his last 10,000 shares on July 26<sup>th</sup> at \$33.28. Not only is Miller out of both common stock and vested options, he is out of unvested options as well. Directors aren't granted options annually, but are allowed to participate in the Company's stock option plan. As of September 29<sup>th</sup>, Miller hasn't received any options in 2004. Since Lincare's board members are elected annually, it is unclear if he'll stand for re-election at the 2005 shareholder's meeting but we haven't found any information that would lead us to believe he won't be.
- **Shawn Schabel (age not disclosed)** – President, COO. Schabel has been an infrequent seller since first filing as a Section 16 insider back in 1998. His first transaction was a 160,000-share sale in February 2001 at \$29 and he didn't resurface until he sold 80,000 shares in December 2003 immediately after the stock dropped from \$43 to \$30 on the Medicare news. More recently Schabel exercised 120,000 options in a series not set to expire until December 2008 and sold the underlying shares at \$31.58. Following this transaction Schabel holds 88,000 shares of common stock and over one million vested options.
- **John Byrnes (45)** – Chairman, CEO. After having sold a modest 85,000 shares over the past three years, Byrnes entered into a 10b5-1 trading plan in April, announcing his intention to sell 765,000 shares by September 2005. He promptly began selling following the announcement and has routinely sold 50,000 shares per month since April at gradually declining prices. Between July 1<sup>st</sup> and September 1<sup>st</sup> he disposed of 150,000 shares at roughly \$32, driving his year-to-date sales to 300,000 shares. Following these distributions, Byrnes has an actionable position in excess of 3 million shares and vested stock options.

#### Accounting: Cash flow issues may be limiting Company strategies

In our earlier reports, we had noted how Lincare management had aggressively increased its share repurchase strategy, spending \$264 million in F/Y 2003 vs. just \$87 million the year prior (none in 2001). So intent had management been to repurchase shares, the Company amended its \$200 million credit revolver in 2003 in order to raise the amount of potential repurchases it could make from \$250 million to \$450 million. Given the fact that the bonus structures of top management are so aligned to both EPS and EBIDA, we were quite interested (but not surprised) to note management's increasing focus on share repurchases. They had adopted a strategy for justifying large

chunks of cash flow from operations to buy back stock while, at the same time, using significant amounts of borrowed funds to acquire businesses.

And acquire they must, according to their stated strategy following the passage of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003: Lincare's answer to the Medicare reimbursement problem has been that they plan to grow market share, through this period of uncertainty, by acquiring weaker competitors who are also struggling with the same Medicare issues.

Things seem to have changed, with regards to both of the above strategies. There have been no repurchases of Company stock through the first two quarters of F/Y 2004. The Company has exhausted its previous \$225 million repurchase authorization and has thus far made no efforts to institute a new one. Acquisitions continue to move along at a trickle. Through June 30<sup>th</sup>, Lincare has made a total of 34 acquisitions for about \$34 million in cash (plus an additional \$8 million in assumed obligations) vs. F/Y 2003 when the Company spent \$131 million in cash (plus another \$23 million in assumed obligations). It would hardly seem, at this time, that their stated acquisition strategy is running full steam ahead.

While there was more cash on hand at end of June than at the same time last year, the increase has come about solely through the curtailment of two of the Company's key announced strategies, namely share repurchases and acquisitions. Cash on hand stood at \$135 million as of 6/30/04 vs. just \$49 million the same time last year. However, Lincare spent \$130 million to repurchase shares in 2003, plus \$86 million on acquisitions during the year (over what has been spent in 2004 so far). Obviously, growth and EPS will suffer as a result of the curtailments.

#### Accounting: Goodwill impairment risks significant if revenue slows

Though acquisition pace has slowed recently, there can be little doubt that, with over \$982 million in Goodwill representing 62% of assets, potential impairment risks could spell big trouble should they materialize in any significant fashion. It is clear that the Company has relied heavily on acquisitions to boost revenues, making Goodwill the largest asset on its balance sheet. There's no question the Company has been aggressive at trading cash for Goodwill in its quest for revenue growth. By its own admission, acquisitions accounted for 46% of Lincare's revenue growth in 2003 and 47% in 2002. This all makes cash generation, from acquired entities, extremely important, not only to support continued acquisitions but, increasingly importantly, to avoid impairment charges. The present value of future expected revenue streams from acquired companies remains a key factor in the test for goodwill impairment. Lost revenues from lower Medicare reimbursements will affect this calculation in a major way, it appears.

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