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

Top 3 Insiders Sell on 30% Drop in Shares
Lincare Holdings Inc. (NASDAQ: LNCR)

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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

- **Insider Trading:** Top 3 insiders sell on 30% drop in shares
- **Governance:** Insiders benefit from aggressive repurchases and option vesting
- **Accounting:** Acquisition related accounting raises questions
- **Accounting:** Tightened debt covenants close to being tested

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Discussion of 3DAdvisors Findings

The recent passage of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 has caused much concern about Lincare Holdings. The Bill implies cuts to Lincare’s reimbursement levels for inhalation drugs will drop from 95% to 80% in 2004, with even worse longer-term effects. Exacerbating the matter is the fact that Lincare receives about 67% of its revenues from the federal government under Medicare, Medicaid and other funded programs.

Company management has voiced its related concerns but steadfastly maintains its confidence that the implied cuts in Medicare reimbursement levels, although difficult, will not result in the Draconian scenario envisioned by some. The actions of certain insiders, though, tell a different story. Lincare shares fell over 30% in late November, from $44 to $30, when the legislation passed in its current form. *After* the drop, the Company CFO sold aggressively at prices just above $30. Two other key insiders sold at the same time.

To counter the Medicare risks, the Company's plans are to expand market share, during this uncertain time, by acquiring small competitors that are struggling with the new order. This seems to have settled the concerns of some analysts. The actions of the insiders, however, again speak louder to us about the risks facing the Company, going forward, than any other analysis of the situation that we've seen.

Further investigation reveals a less-than-robust balance sheet, tight restrictive debt covenants, and a potential earnings management betrayed by earnings growth having outpaced revenue growth for the past three years and certain references to unbilled receivables (whose existence is discretely disclosed without explanation of size or origin). Lincare is also extraordinarily tight-lipped, choosing not to hold earnings conference calls and profiling just three executive officers in its SEC filings and on its website.

Insider Trading: Top 3 insiders sell on 30% drop in shares

The first thing to understand, with regards to analyzing Lincare's insider behavior, is that there are only three operating executives listed in the Company Proxy and on the Lincare website with no mention of anyone else. The investor relations contact is listed on the website. He's CFO Paul Gabos, one of the three named officers. **In fact, we were astonished to see that, outside of directors, the only other Section 16 filers at Lincare are the same three named officers.** We can assure you that, in our 22 years of following insiders, we have never seen a company of this size with such little insider disclosure (read: so few filers) on the Section 16 front. With that said, we viewed the emergence of insider selling by all three, after LNCR shares had already dropped, to be a truly significant event.

With only three executives filing Form 4's at the Company, the fact that all three sold after the shares dropped hit the middle of our radar screens. We can only wonder what the picture looks like among the other Company employees. We'll have a better handle on this once the 2003 10K is released. For now, here's the detail on the three:

- **Paul Gabos (age not disclosed)** – CFO. Gabos, CFO since 1997, had not sold a share since June of 2001 prior to unloading 23% of his actionable holdings on December 15th and 16th. To do so, he exercised long-vested options for 310,000 shares and sold them for prices in the $32 range. The options were not going to expire soon as the expiration dates ranged from 12/05 to 12/07.

- **Shawn Schabel (age not disclosed)** – COO. Schabel reduced his actionable holdings by 7% with sales of 80,000 shares, on December 17th, for $31 each. These were his first sales since February of 2001.

- **John Byrnes (44)** – President, CEO and Chairman. Byrnes sold 10,000 shares on December 18th, for $30.50 each. Although the sale was not material to his holdings, we note it because he rounds out the group of the only three Section 16 filing insiders, all of whom sold on a 30% drop in the stock.

Governance: Insiders benefit from aggressive repurchases and option vesting

Although Lincare has a history of repurchasing shares, the practice has become quite aggressive of late. In February of 2003, the Company adopted a $100 million share repurchase program only to increase it to $225 million just four months later. Through the first three quarters of 2003, LNCR has bought 6.35 million shares under these authorizations plus another 1.1 million under an older authorization, burning $251 million in cash in the process, which is $118 million more than it spent for acquisitions during the period. The $251 million in repurchases thus far in 2003 have dwarfed those from prior years: $87 million in 2002, none in 2001, $60 million in 2000, $118 million in 1999, and $1.7 million in 1998.

With the escalation of the repurchase program, Lincare is quite dependent upon the ability to keep rolling over debt to avoid paying out large amounts of cash and depleting working capital. Management has not made clear its strategy for justifying using such a large percentage of cash flow from operations to buy back stock while, at the same time, using significant amounts of borrowed funds to acquire businesses. One explanation, although management would be unlikely to admit it, is that the repurchases inure to the benefit of the three named executives. The fortunes of the three seem fairly closely intertwined as they all signed employment agreements on the same day, 12/5/2001. A review of the agreements reveals that their bonuses are tied 50% to diluted EPS growth (not income), the other 50% tied to EBITA Growth. CEO Byrnes received a salary of $753,630 in F/Y 2002 and a bonus of $717,250. The others made out similarly well. It will be interesting to see how their 2003 package, aided by the attendant ramp-up in repurchases will look like. According to our calculations, had LNCR not repurchased the 7.5 million shares so far this year, EPS for the period (through Q3) would have been reduced by 12 cents per share, or about 8%.

At this juncture, it's interesting to note that Lincare's Compensation Committee reports justify executive bonus payments, in each of the last three fiscal years, by stating that the Company achieved growth in net revenues that were exceeded by growth in EPS. The explanation (for the greater EPS growth) for 2002, however, was stated as being "as a result of strong management of operating and administrative expenses." A look at the Compensation Committee's 2000 report, however, tells a different story. In that year, a year where repurchases ($60 million vs. $87 million in 2002) were smaller than in 2002, the wording justifying the CEO's bonus payout was more revealing: "Earnings per share grew at a faster pace than net revenues in 2000 as a result of strong cost controls and execution of the Company's share repurchase program." Interesting how, in the post Sarbanes-Oxley era, management ceases to point out the contribution of the repurchase program to EPS growth, which of course has personally benefited the named executives.

The Compensation Committee has also been generous with option vesting schedules, generally allowing for vesting of 50% of a grant within a year of the grant date with the balance to vest 12 months later. Rarely do we see such lenient application of vesting schedules.

Accounting: Acquisition related accounting raises questions

During F/Y 2002 (year-end 12/31) Lincare made 28 acquisitions totaling $119 million ($94.7 million cash). The Company allocated $113 of the total to Goodwill. Through Q3 of 2003, Lincare has done eleven deals, investing $153 million ($133 million cash), allocating $141 million of the acquisitions to Goodwill. So, over 93% of the deals of the past seven quarters have been allocated to Goodwill. This strategy has propelled Lincare's Goodwill number from $685 million (Y/E 2002) to $941 million as of the end of Q3 (F/Y 2003). At this time, Goodwill represents 67% of total Company assets and tangible net worth is negative, having crossed over into the red in Q2 of 2003.

The Company's continuing success is largely dependent upon the ability of those acquired companies not only to remain profitable but also to experience margin contributions similar to the parent. The strategy needs to work as Lincare has essentially been trading cash for Goodwill in the form of expected earnings. Lincare has built up Goodwill to the point where it is nearly the largest line item on the balance sheet. Certainly, any significant amount of Goodwill impairment could be seriously damaging to the balance sheet and income statement. Exacerbating this risk, the looming Medicare issue does not bode well for the balance sheet's ability to support a protracted period of low earnings or losses.

Margins, however, do behave, and from our perspective almost too well. In fact, they have barely budged since Y/E 2002. As a percentage of revenues, Cost of Goods & Services, Operating Expenses, SG&A (not to mention Net Income) have all remained within a 100 basis point range since Y/E 2002. This becomes rather interesting when you consider that LNCR has made 39 acquisitions since then. It would seem that we are left to assume that the operating expenses for the acquired companies all track the same as Lincare's.

Accounting: Tightened debt covenants close to being tested

The Company points to its $147 million revolving bank credit facility as being, along with internally generated funds, a prime factor in assuring investors that it can meet its anticipated capital requirements. It is interesting to note that covenants under this facility tightened up noticeably in the last round.

When the facility was initially entered into, in November of 1997, the associated restrictive covenants required (among other things) a Consolidated Fixed Charge Coverage Ratio (as defined in the agreement) of at least 2.50 to 1.00. In addition, the Consolidated Leverage Ratio (as defined) could not exceed 2.00 to 1.00. These covenants tightened up noticeably in the first revision of the revolver, entered into in April of 2002. In this version of the deal, the Consolidated Fixed Charge Coverage ratio tightened to 2.75 to 1.00, as did the Leverage Ratio, from 2.00 to 1.00 to 2.50 to 1.00. Not only did these tightened covenants catch our eye but so did the new one to enter the picture: The current agreement, which does not expire until 2007, contains a "Consolidated Net Worth" covenant which, thanks to the heavy 2003 repurchases, seems to be on the cusp of being violated. Working through the formula provided in the Credit Agreement document, it is apparent that Lincare's consolidated net worth had to be at least $734.5 million as of 9/31/03 (the end of Q3). Actual consolidated net worth did not exceed this threshold by much, coming in at just $786 million. The culprit is clearly the stock repurchase activity, which has drained over $251 million in cash this year and weakened the balance sheet accordingly.

Going forward, Lincare must maintain a Consolidated Net Worth of about $734.5 million plus 50% of Consolidated Net Income for each successive quarter in order to stay in compliance with this covenant. Fortunately for Lincare, the Covenant is not based on Tangible Net Worth as the $941 million Goodwill figure makes up such a huge component of the Company's total assets. As Lincare's business model shifts, as a result of the new Medicare legislation, any accompanying Goodwill impairment could put the current agreement, and with it much of Lincare's access to liquidity, in jeopardy. Needless to say, it will also be difficult for the Company to continue its current repurchase pace.

Then there's the matter of restricted cash. Lincare currently has $10.5 million in restricted cash on the balance sheet. There is simply no explanation as to what has caused it to be escrowed. Although the Company did not have any such balance in 2002, there was a restricted cash balance recorded in F/Y 2001 as well, this time for $8.3 million. Again, absolutely no explanation as to what required this. The absence of a Company explanation as to the nature of this is interesting as we are accustomed to seeing such explanations from other companies who have been required to post restricted cash. Our bet is that it has something to do with the debt picture. Any significant downturn in the Company's business would most likely bring the bankers into the picture quickly, we would think.