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

Insider Selling is The Tip of The Iceberg
Omnicare, Inc. (NYSE:OCR)

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Omnicare, Incorporated is a provider of pharmacy services to long-term care institutions such as skilled nursing facilities (SNFs), assisted living facilities (ALFs) and other institutional healthcare facilities. The Company also provides comprehensive clinical research for the pharmaceutical and biotechnology industries. The Company operates in two business segments. The largest segment, Pharmacy Services, provides distribution of pharmaceuticals, related pharmacy consulting, data management services and medical supplies to long-term care facilities. The Company's other business segment is contract research organization services (CRO Services). CRO Services is an international provider of comprehensive product development and research services to client companies in the pharmaceutical, biotechnology, medical device and diagnostics industries.

Summary of 3DAdvisors Findings for OCR

- **Insider Trading:** Chairman leads rare round of selling by key insiders
- **Accounting:** Inventory accounting offers opportunity to manage results
- **Accounting:** Stretching out payables significantly boosts cash flow
- **Governance:** Management behavior and board structure worrisome combination

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Discussion of 3DAdvisors Findings

Insider Trading: Chairman leads rare round of selling by key insiders

A significant round of insider selling at Omnicare hit the middle of our radar screens recently. No surprise to us, the Company dismissed the selling by implying the trading window for insiders had been closed because of the $460 million takeover of rival NCS Healthcare. The NCS deal was completed in January of 2003. Insider sales however, did not accelerate until August. Clearly, Omnicare shares broke out of their early-2003 trading range in June, settling into a new trading range they continue in today. It is interesting to us that insiders began selling en-masse in early August; right around the time Chairman Edward Hutton began selling. Later that month, Hutton filed a

10b5-1 trading plan. Coincident with this event, Omnicare insider selling shifted into high gear.

Make no mistake about it; insider sales at Omnicare are significant. They are the first from the Company in years. Omnicare would like us to believe that the sales mean nothing: In a seemingly orchestrated fashion, each seller has retained a small amount of shares exercised for. We say "orchestrated" because in our previous life, we would tell anyone that would listen that it is not particularly significant when insiders exercise options and sell only some of the underlying shares. We regularly voiced our opinion on this to practically every major news organization. As a result, it became common for investor relations types to emphasize the point when insiders would exercise and retain some of the shares. In Omnicare's case however, the sellers are clearing out of much more than they would have been required in order to cover the cost of the exercises and the associated withholding taxes.

Most of the sellers are clearing out of historically large amounts. At least four key operating individuals, including CFO David Froesel, have dropped about one-third of their actionable positions (common stock plus exercisable options). To us, there is more in this action than Company explanations would imply.

All of the sellers are doing so at their highest paces in the past five years. All holdings figures are "actionable holdings" which include any common shares held plus vested exercisable options. We have carefully calculated the holdings reductions by taking into account any options that have vested recently:

- **Edward Hutton (83)** – Company Chairman. To us, it was very interesting to see Hutton's stock sales leading the way for the other insiders. We say this because, according to our sources, Hutton has a history of making it tough on employees and insiders who wanted to sell their Chemed shares in the pre-Omnicare spin off days. Consequently, it didn't surprise us to see his recent selling become a trail-blazing event, as it seemed to cause others to come out of the woodwork. Hutton cleared out of 156,704 shares, between August and early October, at prices in the $34 to $36 range. His sales trimmed his actionable holdings (common stock plus exercisable holdings) by 12%.

- **David W. Froesel (51)** – CFO and Director. Once Hutton began selling, Froesel soon followed, clearing out 185,482 shares at prices in the $34 range. Most interestingly, Froesel had dropped 32% of his actionable holdings in the process. Froesel's last sales were in November of 2001 and much smaller than these sales. They occurred, however, during the same period that Edward Hutton had sold his last time as well. In Froesel's case, the shares currently sold significantly exceed the 3,100 sold back in November of 2001.

- **Timothy Bien (69)** – Senior V.P., Professional Services and Purchasing. Bien exercised across a wide variety of options, in August, reducing options in six separate option series held by him (he completely cleared out of three). Making matters more interesting is the fact that he cleared out of his entire inventory of $26.22 options (for 24,000 shares), which were not set to expire until March of 2006. He also dropped all that were exercisable of his $27.02 options (for 18,000 shares), which were not set to expire until 2012. Exercising high-priced options, trading close to market price, that have plenty of time before expiration is quite unusual. When this occurs, we are of the impression that the individual involved is concerned that the options run the risk of losing their premium, consequently forcing action at this time. In all, Bien unloaded 118,438 shares (at prices in the $34 range) or about one-third of his actionable holdings.

- **Patrick E. Keefe (57)** – Executive V.P., Operations and Director. Like Froesel, Keefe sold about one-third of his actionable position in August, once Hutton made his move. Keefe dropped 230,250 shares during the month at prices around $33 - $34 each. Like Froesel, Keefe was last seen selling back in November of 2001 where he had sold just 6,500 shares.

- **Cheryl Hodges (51)** – Sr. V.P., Secretary (Investor Relations) and Director. In selling 197,888 shares, in August, Hodges dropped her actionable holdings by about 31%.

- **Sandra Laney (59)** – Director. Like Bien (above), Laney also exercised her entire position (for 3,050 shares) of high-priced ($26.22) options, which were not set to expire until March of 2006. In all, she sold 27,569 shares, in August, at prices in the $33 to $34 range. It appears that her husband, who works for Omnicare (see below), sold 8,440 of these. These sales trimmed her actionable holdings by 13%.

- **Joel Gemunder (63)** – CEO and Director. Though Gemunder did not reduce his holdings as significantly as the others, his 280,000 share August sale (in the $34 range) is the largest of the group. He was last seen selling back in November of 2001, the same time that Hutton and CFO Froesel had done so.

- **Peter Laterza (45)** – General Counsel. Laterza sold his highest-ever amount in August, liquidating 32,078 shares.

It is extremely rare to see as many as four key insiders dropping their holdings by over 30% as we have here. It has been our experience however, that surges of insider distribution of this nature are seldom followed by bad news in the near term. Those involved would be putting themselves in too much jeopardy should something negative emerge on the heels of their selling. Instead, in these cases is it wise to keep a sharp eye out a few quarters down the road.

Accounting: Inventory accounting offers opportunity to manage results

Unlike industry peers, Omnicare chooses to maintain a *periodic* inventory system that relies on physical counts. According to the Company “Physical inventories are typically performed on a monthly basis at all pharmacy sites, and in all cases at least once a quarter”. The Company goes on to explain that “Cost of goods sold is recorded based on actual results of the physical inventory counts, and is estimated during those circumstances when a physical inventory is not performed in a particular month.”

Industry peers do not use this type of inventory system, choosing instead, the more typical *perpetual* inventory system. Our curiosity with Omnicare inventories, however, goes beyond whether counts are accurate using one system versus the other. Instead, we wonder whether the ***valuations*** of inventories are suspect.

We say this because of the fact that Cost of Goods Sold (COGS), as a percentage of Gross Sales had not wavered by as much as one half of one percent for the past three years (see Figure 1 below).

Figure 1. Cost of Goods Sold (Before Reimbursement-Related Expenses) as a Percentage of Gross Sales (Before Reimbursements). Source: OCR SEC Filings

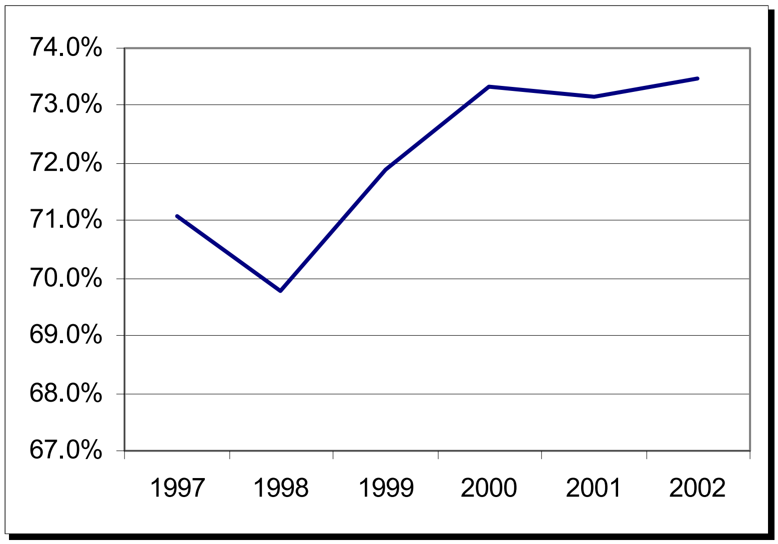
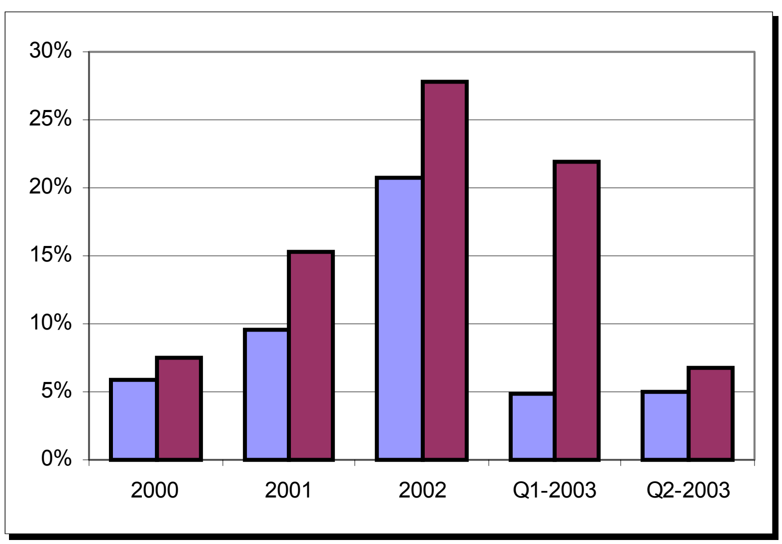


Figure 2. Percent Growth in Sales (Blue) Versus Percent Growth in Inventory (Red) Source: OCR SEC Filings



It is evident that margins, for the past three years, calculated before reimbursements related to the CRO Services (Contract Research Organization) segment, may have been governed by inventory valuations, which, under the periodic inventory system used by Omnicare, determine the Cost of Goods Sold. We have backed out CRO-related reimbursements, as they are non-core and do not relate to the pharmacy segment and associated inventories. Upon doing this, you can see that these core Omnicare margins seem too steady for what mere coincidence would dictate.

Granted, it is not possible to determine the direct effect from any possible distortion in inventory valuations that could be occurring. Given the straight lining of the margins however, our curiosity has become piqued. One more thought here: Inventory Growth has been consistently outpacing sales growth. Figure 2 above shows the growth comparisons for the past three years plus the past two quarters (Q1 and Q2 of 2003).

It becomes clear that, on a regular basis, inventory grows more than sales. Since inventory levels are the determinate of Omnicare's Cost of Goods Sold, it is interesting to see the constancy of this relationship. It would seem that higher inventory valuations could be helping keep those margins in line by lowering Cost of Goods Sold. Whether or not these are caused by adjustments made at headquarters is difficult to prove. The fact stands, however, that inventory valuations seem to be an important component for the maintenance of some key financial ratios dealing with profitability.

Accounting: Stretching out payables significantly boosts cash flow

Omnicare's accounts payables took a significant jump in Q2 (quarter ended June 30). Payables (and associated days payables outstanding), which have been on a steady rise for the past six years, jumped noticeably in Q2 of 2003. Consequently, days payables, which had been averaging 21.3 days for six years, jumped to 28.3 days for the quarter. Checking back sequentially by quarter, accounts payable jumps of this magnitude have not occurred so the recent move looks like a true anomaly, not just something seasonal.

The jump in payables added $40.4 million to Cash from Operations for the quarter, or about 34% of the $120 million total for the period. In the conference call, management was quick to point out how cash flow was strong. Indeed, CFO Froesel prominently featured cash flow in the management presentation as "my most favorite subject" and citing "tight working capital management" as being a prime contributor. Our forays into various message boards have uncovered rumblings about Omnicare's holding back payments to non-essential contractors to 30 days. Without that boost from payables, Cash from Operations for the first six months would have been about $70.9 million, or behind its levels the year before.

We were surprised that no one picked up on this during the Q2 earnings conference call.

Governance: Management behavior and board structure worrisome combination

The insider trading and accounting behaviors we have observed take on added significance for us when you factor in that this is the same management team that engaged in some scandalous behavior in the past that got them in trouble with the U.S. Justice Department and the State of Illinois. Combine some of this history with a board that is packed with business associates and friends and you have, from our perspective, a company that should be very carefully monitored.

Its no secret that, back in April of 1998, Home Pharmacy Services, Inc., a wholly-owned Omnicare subsidiary, entered into a settlement agreement with the U.S. Department of Justice and the State of Illinois regarding, according to Omnicare, "certain practices involving refunds for returned drugs." More specifically, the lawsuit and government charged that the Omnicare subsidiary routinely recycled the unused drugs of dead nursing home patients and re-sold them to Medicaid for other nursing home patients.

Under the Settlement Agreement, Home paid $5.3 million in fines and restitution to the United States and Illinois, and Omnicare and Home agreed to a corporate integrity program for four years, which includes annual reporting obligations. The terms of the corporate integrity agreement expired in April 2002 and same Omnicare management now maintains its own compliance program.

Then there's the board, which seems to be a throwback to the pre-Enron days. Spun off from Chemed (now Roto-Rooter) in 1981, Omnicare continues to sport Edward Hutton (83) as its Chairman (a position he's held since the spin-off). Although he has no formal operating responsibilities, he remains one of the highest-compensated individuals in the company, receiving $549,625 in salary and bonus in 2002 ($231,000 was incentive bonus). This fact prompts our strategic partners, Governance Metric International, to rate Hutton as an "executive" director as opposed to "independent". In all, five out of Omnicare's ten board members are classified as "executive". This group also includes CFO David Froesel. But there's much more to this picture.

Hutton is also Chairman of Roto-Rooter (Chemed) where he had also been CEO until 2001. There are a number of interesting links between individuals, and the two firms. Perhaps the most interesting is that of current Omnicare director, Sandra Lacey. Lacey is a long-time friend of Hutton. They frequently travel together and their families own adjacent properties in Indiana. She has worked with Chemed since its inception. Her most recent Chemed position was Chief Administration Officer. Lacey was forced out in 2001, after Hutton was eased out of the Chemed CEO position. Her severance package, which totaled $3.6 million, towered over her Salary and Bonus package, which had averaged $410,000 annually in her final three years.

Not only is Lacey a member of Omnicare's board, she's on its Audit Committee. Not only is her independence (from Hutton's influence) suspect, so is her finance background. While Chief Administration Officer at Chemed, a significant 15% shareholder (Select Equity Advisors) had argued for Laney's ouster, as it "couldn't figure out what her job was". But there's more to the Lacey story. Lacey's husband continues to work for Omnicare as V.P. Management Information Systems. The initial disclosure of this related party dealing is particularly interesting. It is the sole reason for a 10K amendment for the 2001 period. Clearly, there had been no initial intent to disclose this relationship, until most likely forced by the independent auditors.

Independence of Omnicare's audit committee becomes more suspect when one examines Hutton's pedigree. Chemed (which spun-off Omnicare) had also been a spin off at its inception. In the early '60's it was spawned from W.R. Grace. Long time Hutton friend and ally, Charles Erhart, former W.R. Grace president, is also a member of both Roto Rooter's (read: Chemed) board and Omnicare. Most importantly, he is the Chairman of Omnicare's Audit Committee.

We have yet a third member of Omnicare's Audit Committee whose independence could be questioned. He is John Timoney, a retired executive of Applied Bioscience International. His Hutton connections were sown earlier in his career when held executive positions at both Chemed and W.R. Grace.

The only apparently true independent member of the Omnicare Audit Committee is Andrea Lindell who, interestingly, does not appear to have a financial background. She is Dean and Professor in the College of Nursing at the University of Cincinnati, making it hard to imagine she can effectively provide independent financial oversight of a management team that has exhibited the types of behavior described above.