3D ADVISORS

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

Behavior Raises Questions About New Strategy
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

- **Insider Trading:** Number of Section 16 filers still limited, and still selling
- **Governance:** In rare disclosure, LNCR can buy shares directly from insiders
- **Governance:** Repurchase activity that directly benefits insiders suddenly slows
- **Accounting:** Goodwill impairment issues loom
- **Accounting:** Acquisitions and revenue growth slow dramatically
- **Accounting:** Credit facility looks very expensive

Discussion of 3DAdvisors Findings

Wall Street interpreted the passage of last year's Medicare Prescription Drug, Improvement, and Modernization Act of 2003 in November as a Draconian scenario for Lincare Holdings (LNCR), as the shares promptly fell 30%. One of the reasons investors reacted negatively is that the Bill calls for reimbursement cuts for inhalation drug therapies, reducing payments from 95% of the average wholesale price to just 80%. The implications of the Medicare reimbursement scenario are well followed and the Company seems to have been rather forthright in objectively presenting them. Management's stated strategy to regain growth and pick up market share was to selectively acquire smaller companies not strong enough to weather the coming storm, which seemed logical. But is this alone an effective strategy to deal with the changes imposed on the Company by the new legislation?

Lincare's disclosure policies can be tricky, and executive behavior in this area appears to suggest much more is going on than what we are told. The Company seems to disclose only what it must and refrains from conducting earnings conference calls or making statements about its governance practices or principles. Lincare also chooses not to disclose an ethics policy and furthermore, does not disclose to shareholders its board and committee meeting attendance. In situations such as this where disclosure is so limited, we are more interested in what Lincare management has *done* since November as opposed to what they have *said* in public. The changes forced on the Company by the new legislation are like a dreadnought bearing down on it, and certain behaviors raise questions about whether there is an effective strategy in place to get out of the way.

Insider Trading: Number of Section 16 filers still limited, and still selling

Soon after the passage of the new Medicare bill, and the subsequent stock drop, three key company executives sold at the lows in the $30 to $32 range (see our first report on LNCR dated 01/16/2004). We had noted, among the sellers, CFO **Paul Gabos**, who had cleared out of 23% of his actionable holdings at the time. At the time of our earlier report we had also noted, with significant interest, how Lincare had designated only three executive officers (outside of directors, all of who must file) as Section 16 filers. In over 22 years of following insider trading behavior we have not seen a company, of any size even close to this, who has designated so many of its executives as exempt from the Section 16 filing process. Consequently upon seeing all three selling at the lows, after the passage of the Bill, we have to wonder how many other executives, ones that are not Section 16 filers, could have been selling as well.

Figure 1. Lincare Holdings, Inc. Stock Chart, November 3, 2003 to June 14, 2004. Blue diamond is the date of our first LNCR Report; Shaded blue area is where recent insider selling took place. Source: Reuters and Vickers.

As you can see from the chart above, the shares have yet to fully recover from that November drop, but have worked their way a bit higher recently. On the move however, three more insiders (one executive officer and two directors) surfaced to sell, this time with two of them unloading big chunks of their holdings in the process. We found the recent re-emergence of CEO **John Byrnes** to be interesting in that he seems to have filed a 10b5-1 plan between his December selling (of 10,000 shares) and his more recent larger sales and post-10b5-1, his sales have increased dramatically. The most telling thing about the selling is that the insiders involved do not seem to want to wait around for any further rebound in the shares.

- **John Byrnes (45)** – Chairman, CEO. Since we last highlighted Byrnes' 10,000-share sale in December just after the stock's precipitous drop to $30, he has adopted a 10b5-1 trading plan. These 10b5-1 plans are meant to imply that the insiders involved are diversifying their portfolios in a fashion that would insulate them from securities claims. This said because the insider is supposed to have filed the trading plan while not in the possession of inside information. We are more than intrigued however, at the fact that, after selling only 85,000 shares in total between 2001 and 2003, he has chosen the after-Medicare Bill time frame to file a plan that covers for the selling of what appears to be 50,000 shares per month. In all, he has sold 150,000 shares between April 26th and June 1st with the issue trading around $34. He exercised long-vested options, which were set to expire in 2005. Much of Byrnes' ownership is tied up in options as he holds less than 13,000 shares of common stock. He continues to hold a sizeable position.

- **William Miller III (54)** – Director. Since joining the board in 1997, Miller's only prior transaction was a 48,000-share sale in December 2000 when four insiders converged to sell 1.1 million shares. But even more interesting than his rare selling is that on March 23rd he exercised all of his vested options and sold the 72,000 newly acquired shares at $31.09. **The sale trimmed his actionable position by 88%** and left him with only 10,000 shares of common stock. The option series he exercised had been vested for nearly four years and wasn't set to expire until December 2005. We should also point out that Miller sits on the boards at two other companies – HMS Holding Corp. (NASDAQ: HMSY) and AMN Healthcare Services (NYSE: AHS). He last purchased 6,000 shares of HMSY for his two children in August 2003, but hasn't bought or sold shares of AHS in the past few years.

- **Chester Black (58)** – Director. Between 1996 and 2000 Black sold 116,000 shares at increasing prices. He too was a seller in the December 2000 round that both Miller and Byrnes participated in. Like Miller, he was inactive until he surfaced to sell 72,000 shares on March 19th, which he acquired from exercising a non-expiring option series (expire 12/05). A board member since 1991, Black exercised all of his vested options and **reduced his holdings by 96%**. He now holds only 3,184 shares of common stock, a meager ownership stake for a board veteran of nearly fourteen years.

<u>Governance: In rare disclosure, LNCR can buy shares directly from insiders</u>

Lincare's option plans make it clear that it has the ability to buy optioned-for shares from plan participants. The discrete disclosures show that the option committee has the authority to determine when optioned-for shares are to be repurchased by the Company. The disclosures also reveal that, in these situations, the Company has the “right of first refusal” with regards to whether it will repurchase the shares or not. This is the first time we have seen such a disclosure in a company of this size. Our checks with compensation experts tell us that this sort of provision is more common in private companies that anticipate an IPO in the future. They have these provisions in order to control where the shares are going. This is not common for a Company such as Lincare. Due to the absence of any follow-up disclosure (what we found appeared only in various option plan documents) it is impossible to tell whether the Company has actually bought shares from insiders during its repurchase campaigns. What we do know however is that the disclosures leave the door open for the Company to be able to buy shares from its insiders.

Governance: Repurchase activity that directly benefits insiders suddenly slows

After repurchasing no shares in 2001, Lincare began its repurchase program anew in 2002, spending $86 million on shares, and then another $264 million in 2003. We have always found these repurchases intriguing since top Lincare management has 50% of its bonus structure tied to EPS growth as opposed to net income. In February of 2003, the Company adopted a $100 million share repurchase program only to increase it to $225 million just four months later. In F/Y 2003, the Company bought 6.7 million shares, spending double what it had for acquisitions during the period (see slowing acquisitions below). The net effect of the repurchases was to juice EPS by about $0.14 per share during the period. In other words, EPS growth, which came in at 28% for the year, allowed for Lincare executives to receive EPS-related cash bonuses approximating 90% of their base salaries. Without the stock repurchases, the bonus payments would have been only 50% of base salaries. While another portion of the executive bonus structure is tied to EBITDA growth, it’s a fair statement that repurchase-aided EPS growth is largely responsible for the fact that Company executives, all down the line, received 2003 bonuses that totaled approximately 145% of base salary. This makes 2003 a banner year for management and the first year their bonus’s exceeded their base salaries. Remember too that shareholders took a hit in fiscal 2003 when the stock dropped 30% following passage of the new legislation.

So intent management seemed to be on repurchasing shares, the Company amended its $200 million credit revolver in June of 2003 in order to raise the amount of potential repurchases it could make from $250 million to $450 million. All systems seem poised to continue the repurchasing process, and thus continuing the collateral windfall of EPS-related bonus compensation for management. But the Company had all but exhausted the June 2003 repurchase authorization by the end of F/Y 2003 and ceased repurchasing shares in Q1 of 2004. So far, there has been no announcement of a new authorization. We think this could be directly correlated with the fact that the Net Worth Covenant tied to the $200 million Credit Facility was treading close enough to the line by year-end to cause them to hold off. Based on the formula, this covenant requires net worth to be at about $765 million as of Y/E 2003. With net worth at $848 million at 12//31/03, the $83 million cushion would seem to be adequate. Maybe not enough of a cushion, however, if you are carrying $942 million of Goodwill on the books representing about 66% of total assets. With this taken into account, Lincare is basically a Goodwill impairment charge away from being in violation of its Net Worth Covenant.

Accounting: Goodwill impairment issues loom

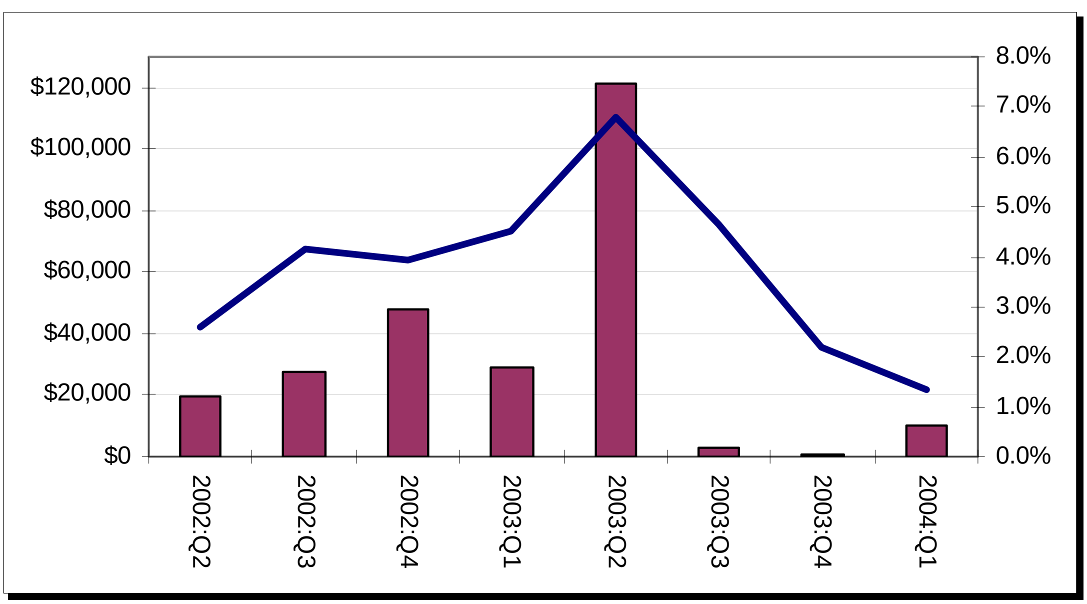
In past years, Lincare has relied heavily on acquisitions to boost revenues. In 2002, the Company spent $120 million in 28 separate acquisitions, allocating $113 million of the purchase prices to Goodwill. In 2003, Lincare spent another $154 million on 13 acquisitions and allocated $141 million of the prices to Goodwill. In other words, Lincare has essentially been trading cash for Goodwill in its quest for revenue growth. Indeed, actual revenues increased by $186.5 million, or 19.5% in 2003. By the Company's own admission, acquisitions accounted for 8.9% of that 19.5%. In other words, acquisitions accounted for 46% of revenue growth in 2003. Ditto for 2002 where acquisitions accounted for just less than 47% of revenue growth.

Since nearly half of Lincare's revenue growth is coming from acquisitions and cash is still being traded essentially for goodwill, cash generation by acquired companies is extremely important, both to support continued acquisitions and, more importantly, to avoid impairment of goodwill. The latter point is paramount since discounting the expected revenue stream of the acquired businesses is a key element in testing for goodwill impairment.

Accounting: Acquisitions and revenue growth slow dramatically

Lincare states that it plans to grow market share, through this difficult time, by acquiring weaker companies struggling with the Medicare problem. Yet, in spite of these plans, it is evident that acquisitions have slowed significantly of late and, no surprise to us, so has revenue growth.

Figure 2. Acquisitions by Quarter (red bars; left scale in Thousands $), and Quarterly Growth in Revenue (blue line, right scale in % change). Source: LNCR SEC Filings



Another interesting aspect to Lincare's revenue growth is that it is regularly outpaced by Net Income Growth. Net income growth of 21.8% (2003 over 2002) was recorded with revenue growth for the period of just 19%. The same stands for 2002 over 2001 where Net Income growth of 41% was achieved during a period while Revenue grew by just 18%. Although this phenomenon held during Q1 of 2004, the effect seemed to have been smaller, with Net Income growth of 19% on revenues of 15.7%. It is interesting that, without the acquisitions, Lincare's growth model seems to deteriorate.

In the same vein as the phenomenon for earnings outpacing revenues, we continue to be intrigued as to how margins do not budge, and haven't done so since 2002. As a percentage of revenues, Cost of Goods & Services (and net income) have all remained within a 100 basis point range since Y/E 2002. This becomes especially interesting when one considers that the Company has made over 39 acquisitions during the period. As we said in our earlier report, we continue to be led to assume that the operating expenses for the acquired companies all track the same as Lincare's.

Accounting: Credit facility looks very expensive

Possibly reflecting the condition of Lincare's prospects and balance sheet, the current $200 million revolving credit facility is rather costly to the Company. Lincare paid a $1.7 million origination fee plus it pays commitment fees on the unused portion of .300%. Most interesting however, is the fact that interest on the outstanding principal balance is payable monthly, not quarterly as is typically the case. Another point worth mentioning is that the revolver is secured by a pledge of the stock of the wholly owned subsidiaries of Lincare Holdings. Although somewhat unusual, this pledge is not that much different from any other assets - property, plant and equipment, securities, receivables - which are owned by the shareholders as well. It could be that the lenders thought the stocks of the subsidiaries were the only worthwhile asset they could claim in the event of problems with so little by the way of fixed assets and most of the asset base consisting of goodwill, not much else was available. We find it interesting, however, that the lenders did not attempt to tie up receivables.