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Voyant Domestic

Comprehensive Analysis

Hanger, Inc. (HGR – $32.16)

June 20, 2014

Hanger, Inc. (HGR) provides orthotic and prosthetic (O&P) patient care services, distributes O&P devices and components, manages O&P networks, and provides therapeutic solutions to the post-acute market. The Company operates under two segments: (1) Patient Care and (2) Products & Services. The Company's customers and sources of reimbursement include individuals, insurance companies, HMOs, PPOs, hospitals, workers' compensation programs, Medicare, Medicaid, and the US Department of Veterans Affairs. The Company is headquartered in Austin, TX and its fiscal year ends on 12/31.

Thesis Summary

We are concerned about a surge in receivables given (1) a recent increase in CMS audit activity, (2) delays in Medicare appeals, and (3) deterioration in receivables aging. In addition, we believe the Company may not be adequately reserved for potential unfavorable CMS audit decisions. Our concerns are heightened given a recent SEC investigation into the Company's receivables and bad debt expense levels, a previous overstatement of receivables, potential evidence of manual control processes, and a systems upgrade that we believe may be a catalyst for a potential financial restatement. In addition, we are concerned about a surge in inventory given (1) a valuation methodology that requires significant estimation and physical inventory counts, (2) two consecutive years of inventory internal control weaknesses, (3) evidence of recent material (in our view) inventory misstatements, and (4) the existence of six SEC correspondence letters focused on inventory valuation over the past eighteen months. Our concerns are heightened in light of negative cash from operations, a surge in capex and prepaid expenses, a high level of soft assets with negative tangible book value, the recent announcement of the departure of the CFO and COO, and significant insider divestitures. **We are initiating coverage of HGR on *The Short List*.**

Catalysts and Timing

- FY 14 guidance reduction.
- Q4 14 physical inventory count results in discovery of inventory overstatement.
- New Janus billing system integration results in discovery of accounts receivable and/or reserve irregularities.
- SEC and/or auditor compelled restatement of prior period results.
- Unfavorable Medicare appeals results in receivable write-downs.

Company Data

Country/Exchange	US/NYSE
Shares Outstanding (mil)	35.2
Float (mil)	34.0
Short Interest (mil)	1.9
% of Float Short	5.6%
Avg. Volume	258,377
52 Week Range	$28.47 - $40.71
Dividend Yield	0.0%
Market Cap (bil)	$1.1
Net Debt (mil)	$506.3
TTM Rev (mil)/Rev Growth	$1,052.7/6.8%
TTM EBITDA (mil)	$165.6
TTM Gross Margin %/Change	69.7%/(10 bps)
TTM Op. Margin %/Change	12.1% /(110bps)

Historical EPS

	Actual	Expected	Surprise
Q1 14	$0.19	$0.24	(20.8%)
Q4 13	$0.54	$0.68	(20.6%)
Q3 13	$0.62	$0.58	6.9%

Estimate Drift

	Est.	1M Ago	6M Ago	1Yr Ago
Q2 14 Rev	$286.5	$286.5	$286.0	--
FY 14 Rev	$1,102.4	$1,102.4	$1,113.2	$1,135.3
FY 15 Rev	$1,171.2	$1,171.2	$1,179.4	$1,214.8
Q2 14 EPS	$0.53	$0.54	$0.66	--
FY 14 EPS	$2.03	$2.06	$2.44	$2.34
FY 15 EPS	$2.38	$2.42	$2.75	$2.70

Peers Mentioned In This Piece

- AmSurg Corp. (AMSG)
- HealthSouth Corporation (HLS)
- Surgical Care Affiliates, Inc. (SCAI)
- Universal Health Services, Inc. (UHS)

Please refer to the end of this report for an updated version of *The Short List*.

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Background and Bull Story

Company Background

Company description: Hanger, Inc. (HGR) provides orthotic and prosthetic (O&P) patient care services, distributes O&P devices and components, manages O&P networks, and provides therapeutic solutions to the broader post-acute market. The Company operates under two segments: (1) Patient Care and (2) Products & Services. The Company's customers and sources of reimbursement include individuals, insurance companies, HMOs, PPOs, hospitals, workers' compensation programs, Medicare, Medicaid, and the US Department of Veterans Affairs. The Company is headquartered in Austin, TX and its fiscal year ends on 12/31.

Background on segments: The Company operates the Patient Care and Products & Services segments. As of 12/31/13, the Patient Care segment provided O&P services to 749 patient care clinics in 45 states. In the orthotics market, the Company designs, fabricates, and fits custom-made braces and other devices (i.e. spinal knee and sports-medicine braces) that provide external support to patients. In the prosthetics market, the Company designs, fabricates, and fits custom-made artificial limbs for patients. Patients are referred to the Company's clinics by an attending physician. Customers and sources of reimbursement include commercial and individual patients, Medicare, Medicaid, and the US Department of Veterans Affairs. The Company enters into contracts with third-party payors that allow it to perform O&P services with a one to three year term.

The Products & Services segment consists primarily of the Company's distribution business, which distributes over 26,000 O&P SKUs to independent customers and its own clinics. The Products & Services segment also (1) leases rehabilitation equipment to rehabilitation centers and (2) consists of a product development business focused on commercializing emerging O&P products. In FY 13, the Company generated 83.4% (16.6%) and 73.6% (26.4%) of revenue and operating income from the Patient Care segment (Products & Services segment), respectively. Further, the Company generated 60.1%, 28.3%, 6.3%, and 5.2% of revenue from commercial and other, Medicare, Veterans Affairs, and Medicaid customers.

FY 13 Segment Analysis	Revenue	Operating Income[1]	FY 13 Revenue by Customer Type	% of Revenue	Patient Care Clinics by State	% of Total
Patient Care	83.4%	73.6%	Commercial & Other	60.1%	California	10.8%
Products & Services	16.6%	26.4%	Medicare	28.3%	Florida	7.3%
--	--	--	Veterans Affairs	6.3%	Texas	5.7%
--	--	--	Medicaid	5.2%	Arizona	5.5%
--	--	--	--	--	Ohio	4.9%
Total	100.0%	100.0%	Total	100.0%	Subtotal	34.2%

Background on exposure to Medicare audits: In its FY 13 10K, the Company disclosed it was subject to various Medicare audits including (1) Recover Audit Contractor (RAC) audits, (2) Comprehensive/Error Rate Testing (CERT) audits, and (3) Medicare Administrative Contractor (MAC) prepayment audits. Recover Audit Contractors (RACs) are private organizations that identify and correct improper and/or overpayment of Medicare claims. The CERT program was implemented by the Centers for Medicare & Medicaid Services (CMS) to measure improper payments in the Medicare Fee-for-Service program. Medicare Administrative Contractors (MACs) are private organizations that have the authority to conduct prepayment reviews (i.e. an audit before payment has been made to ensure proper submission of Medicare claims).

[1] Excludes unallocated corporate expenses.

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The Bull Story: Historical Growth, Market Share, Economies of Scale

Strong historical revenue growth and margin expansion: In FY 13, revenue increased 7.4% to 1,046.4 million. In addition, since FY 09, revenue has increased by 8.6% annually. Over the same time period, the Company has expanded its EBITDA margin from 14.2% to 16.4%. Certain market participants believe the Company's strong growth and margin expansion is attributable to its dominant O&P market position and economies of scale from operating the largest US network of O&P clinics (as discussed next).

Revenue Growth Analysis ($ in millions)	FY 13	FY 12	FY 11	FY 10
Revenue	$1,046.4	$974.4	$907.8	$808.8
Change	*7.4%*	*7.3%*	*12.2%*	*7.4%*
EBITDA Margin	16.4%	16.8%	16.2%	12.3%
Change in bps	*(50)*	*60*	*390*	*(190)*

Largest market share position in the O&P market provides scale and cost advantages: In its FY 13 10K, the Company represented the O&P industry is highly fragmented and is characterized by local, independent O&P businesses that only operate one facility. Further, in a November 2013 Investor Presentation, the Company represented it is the only national and regional O&P provider. The Company represented it holds a 20.0% market share position in its addressable O&P market of $4.3 billion. In the same presentation, the Company expressed its belief that none of its competitors hold a market share higher than 2.0%.

The Company's O&P network consists of 1,150 clinics, composed of Company-owned clinics and 400 independent providers. The Company currently operates 749 O&P patient care centers in 45 states, employing over 1,300 certified and licensed clinicians. The Company also operates a contract and management network dedicated to serving the O&P market for national and regional insurance companies. The Company partners with healthcare insurance companies as a preferred provider or manager of the O&P network. As a result of (1) the Company's large position and status as the only national O&P clinic provider and (2) its economies of scale from operating the largest US O&P network, certain market participants believe the Company is well positioned to deliver strong shareholder returns.

Valuation: We compared to the Company's valuation to healthcare peers operating surgical facilities, outpatient centers, and rehabilitation centers. As of the date of publication, the Company's shares trade at a slight premium (3.2%) relative to our peer group based on enterprise value-to-trailing twelve month EBITDA.[2]

Valuation Analysis	EV/EBITDA
Hanger, Inc. (HGR)	9.7
AmSurg Corp. (AMSG)	7.4
HealthSouth Corporation (HLS)	9.1
Surgical Care Affiliates, Inc. (SCAI)	11.4
Universal Health Services, Inc. (UHS)	9.9
Peer average	9.4
HGR above (below) peer average	*3.2%*

[2] We utilized enterprise value-to-EBITDA as the comparable valuation metric (instead of price-to-earnings) due to higher relative debt levels at the Company compared to its peers.

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Voyant's Earnings Risk Assessment

We are concerned about a surge in receivables given (1) a recent increase in CMS audit activity, (2) delays in Medicare appeals, and (3) deterioration in receivables aging. In addition, we believe the Company may not be adequately reserved for potential unfavorable CMS audit decisions. Our concerns are heightened given a recent SEC investigation into the Company's receivables and bad debt expense levels, a previous overstatement of receivables, potential evidence of manual control processes, and a systems upgrade that we believe may be a catalyst for a potential financial restatement. In addition, we are concerned about a surge in inventory given (1) a valuation methodology that requires significant estimation and physical inventory counts, (2) two consecutive years of inventory internal control weaknesses, (3) evidence of recent material (in our view) inventory misstatements, and (4) the existence of six SEC correspondence letters focused on inventory valuation over the past eighteen months. Our concerns are heightened in light of negative cash from operations, a surge in capex and prepaid expenses, a high level of soft assets with negative tangible book value, the recent announcement of the departure of the CFO and COO, and significant insider divestitures. We are initiating coverage of HGR on *The Short List*.

Weaker-than-Expected Q1 14 Results, FY 14 Guidance Reduction

Q1 14 results: On 05/05/14, the Company reported Q1 14 revenue (earnings) of $235.6 million ($0.19), 3.7% (20.8%) below the consensus estimate of $244.7 million ($0.24). In addition, operating margin declined 300 basis points year-over-year to 7.1%, 60 basis points below the consensus estimate. On its Q1 14 Conference Call on 05/06/14, the Company attributed its results to (1) significant weather conditions that resulted in 1,000 closed clinic days and (2) costs associated with its delayed FY 13 10K filing (discussed in more detail later).[3]

> **Q1 was a difficult quarter given the weather conditions that impacted much of the country resulting in a significant number of lost days compared to 2013**. My specific comments on the quarter are as follows. Adjusted diluted EPS was $0.19 compared to $0.27 in the prior year. **The shortfall was driven by the impact of severe weather as Vinit mentioned earlier and the costs associated with the delayed filing of our 10-K.** The combination of lower than expected sales and increased costs negatively impacted our adjusted operating margins, which were down from 10.1% in 2013 to 7.1% this year. (CFO Mr. George E. McHenry, Q1 14 Conference Call, 05/06/14) [emphasis added]

Q1 14 Results Analysis ($ in millions, except earnings)	Reported	Consensus Estimate	*Difference*
Revenue	$235.6	$244.7	*(3.7%)*
Operating margin	7.1%	7.8%	*(60 bps)*
Earnings	$0.19	$0.24	*(20.8%)*

FY 14 guidance reduction: In its Q1 14 Earnings Release on 05/05/14, the Company reduced its FY 14 revenue (non-GAAP earnings) guidance by 0.9% (4.2%) to $1,110.0 million ($2.06), 0.7% (4.6%) below the consensus estimate of $1,117.9 million ($2.16). In addition, the Company reduced its FY 14 same center sales growth (free cash flow) guidance by 100 basis points (20.0%) to 3.0% ($40.0 million). On its Q1 14 Conference Call, the Company represented the $0.09 reduction to its FY 14 non-GAAP earnings guidance was due to (1) the $0.04 unfavorable Q1 14 weather impact and (2) $0.05 in additional back office costs. We note the Company did not provide updated guidance for its prior guidance of a "slight decline" in FY 14 Products & Services revenue.

[3] On 03/03/14, the Company filed a Form 12b-25 (Notification of Late Filing) for its FY 13 10K. The Company represented that additional time was required to test and assess its internal controls and procedures implemented in response to a material internal control weakness identified in its FY 12 10K. The Company subsequently filed its FY 13 10K on 04/04/14.

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FY 14 Guidance Analysis ($ in millions, except earnings)	05/05/14 Guidance	Consensus Estimate	*Difference*	02/12/14 Guidance	*Difference*
Same center sales growth	3.0%	--	--	4.0%	*(100 bps)*
Revenue	$1,110.0	$1,117.9	*(0.7%)*	$1,220.0	*(0.9%)*
Products & Services revenue	--	--	--	Slight Decline	--
Non-GAAP earnings	$2.06	$2.16	*(4.6%)*	$2.15	*(4.2%)*
Janus ERP costs	--	--	--	$0.05	--
Back office investments	$0.24	--	--	$0.19	*26.3%*
Cash from operations	$85.0	--	--	$95.0	*(10.5%)*
Capex	$45.0	--	--	$45.0	*0.0%*
FCF	$40.0	--	--	$50.0	*(20.0%)*
Acquired annualized revenue	$40.0	--	--	$40.0	--

We have the following observations about Q1 14 results and FY 14 guidance:

1. **We believe the Company accelerated its acquisition strategy in response to weak revenue performance:** In its Q1 14 Earnings Release, the Company reaffirmed its prior guidance of acquiring $40.0 million (at midpoint) of annualized net O&P revenue in FY 14. However, on its Q1 14 Conference Call, the Company disclosed it acquired $20.0 million of revenue in Q1 14 and implied (in our view) that it could exceed its $40.0 million guidance for FY 14. **We believe the Company potentially accelerated its acquisition strategy due to weaker-than-expected revenue performance.**

   Analyst: So then it sounds like maybe the $35 million to $45 million of acquired revenue if you're including the initial $20 million or so in that, I mean maybe there is a reasonable chance you can exceed that as you finish up the year?

   CEO Mr. Vinit K. Asar: Yes, anything's possible, but we want to re-affirm the guidance of $35 million to $45 million, because remember, typically in a year if we have $20 million in revenue, say if you do $5 million in the first half and $15 million in the second. There's still some in the first half that do occur, so we're – at this point, I just want to reiterate our guidance is $35 million to $45 million in acquisitions. (Q1 14 Conference Call)

2. **We believe the Company guided for a 26.3% increase in additional back office investments:** In its Q4 13 Earnings Release on 02/12/14, the Company guided for $11.0 million ($0.19) of "back office investments" (which was included in its non-GAAP earnings guidance). Based on our understanding of representations made by the Company on its Q1 14 Conference Call, we believe the Company guided for additional back office investments of (1) $0.04 in additional resources to remedy its internal control weakness and (2) $0.01 in increased legal printing and labor costs. **Accordingly, we believe the Company guided for a 26.3% ($0.05) increase in back office investments.** Given our concerns regarding revenue sustainability (as discussed next), we believe a ramp in back office expenses may result in continued margin pressure.

   I believe filing costs were approximately $0.01 hit to EPS that was due to increased legal printing and labor cost. And given the outcome of the delayed filing, we will be adding additional resources to assist in remediation of our control weaknesses in the [ph] bulk (10:19) internal controls and investment will cost us approximately $0.04 per share. Those three components make up 9% change in our guidance range. (CFO Mr. George E. McHenry, Q1 14 Conference Call)

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Surge in Receivables, Potentially Inadequate Reserves, Revenue Sustainability Concerns

Background on revenue recognition: Revenue in the Patient Care segment is generated from the sale of O&P devices and from the maintenance and repair of existing devices. Revenue from maintenance and repairs is recognized when the service is rendered. Revenue from the sale of devices is recognized upon patient acceptance and is recorded net of known and estimated future contractual adjustments and discounts. The Products & Services segment generates revenue from the distribution of O&P devices and leasing rehabilitation technology. Distribution revenue is recorded upon shipment. Leasing revenue is recognized based on the contractual terms of the agreements (which contain pricing and service levels with terms of one to five years).

Background on contractual adjustments and discounts, allowance for doubtful accounts, and accounts receivable: The Company reports accounts receivable net of (1) contractual adjustments and discounts (CAD) and (2) allowances for doubtful accounts (ADA). Based upon our understanding of the Company's SEC filings, CAD represents receivables not expected to be collected due to differences in the interpretation of Medicare and Medicaid laws. CAD charges are recorded as contra-revenue (i.e. a reduction to revenue) and represent a reduction to accounts receivable on the balance sheet.[4] We believe CAD relates to commercial and government customers.

The Company also estimates an ADA for uncollectible patient accounts based on historical collections from individual patients. The Company reports an expense for doubtful accounts in the "other operating expenses" line item on the income statement. In its SEC filings, the Company discloses the aging of gross accounts receivable by customer type (i.e. commercial insurance, private pay, Medicaid, Medicare, Veterans Affairs (VA), and the Products & Services segment). In addition, in its Earnings Releases the Company discloses revenue by customer type (i.e. commercial and other, Medicare, Medicaid, and VA).

Background on accounting change for CAD: In its Q3 13 10Q, the Company disclosed that during Q3 13, it corrected an error in the classification of certain components of bad debt expense. Based on our understanding of disclosures, prior to Q3 13 the Company's bad debt expense included charges for both the ADA and CAD reserves. Effective Q3 13, the Company began accounting for CAD charges as a reduction to revenue. Based on its assessment, the Company concluded the change was not material to prior periods. The impact of the adjustment reduced revenue and other operating expenses (i.e. bad debt expense) by equal and offsetting amounts.

Surge in accounts receivable: In Q1 14, gross accounts receivable increased 8.8% year-over-year to $193.9 million, while revenue increased 2.7% to $235.6 million. Accordingly, gross accounts receivable-to-revenue increased 6.0% y/y (to 0.823) from an elevated base period. The receivables build was primarily related to Medicare, Medicaid, and VA receivables, which increased 27.0%, 14.7%, and 13.3% relative to revenue, respectively. On its Q1 14 Conference Call, the Company represented the increase in receivables was primarily due to CMS audits.

[4] The Company previously reported contractual adjustments and discounts as an increase in ADA.

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Accounts Receivable Analysis ($ in millions)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13
Total accounts receivable	$193.9	$195.8	$185.0	$196.1	$178.1
Total revenue	$235.6	$272.3	$271.1	$273.7	$229.4
Total accounts receivables-to-revenue	0.823	0.719	0.683	0.716	0.777
Year-over-year change	*6.0%*	*8.8%*	*(0.7%)*	*8.0%*	*9.0%*
Medicare receivables-to-revenue	0.941	0.785	0.696	0.688	0.741
Year-over-year change	*27.0%*	*37.0%*	*20.1%*	*29.8%*	*38.7%*
Medicaid receivables-to-revenue	1.854	1.699	1.494	1.382	1.617
Year-over-year change	*14.7%*	*36.8%*	*7.1%*	*9.3%*	*9.9%*
Veteran's Affairs receivables-to-revenue	0.247	0.221	0.176	0.217	0.218
Year-over-year change	*13.3%*	*17.4%*	*(19.0%)*	*23.5%*	*11.5%*

We have the following observations about accounts receivable:

1. **Receivable collections slow due to CMS audit activity:** As mentioned, the Company attributed the receivables build primarily to CMS audits. On its Q1 14 Conference Call, the Company represented that while there was a slowdown in RAC audits, **it experienced an increase in Medicare prepayment audits in all regions.** The Company represented the increase in prepayment audit activity resulted in longer times to receive initial payment from claim submissions. Further, the Company represented that prepayment audits have been targeted at high dollar claims, which exacerbated the build in receivables.

   Given an increase in Medicare prepayment audits targeted at high dollar claims, **we are concerned about (1) potential adverse audit decisions that could result in reduced payments and/or (2) write downs of accounts receivable and reductions to revenue.** Our concerns about the increase in CMS audit activity are heightened given a new FY 13 10K risk factor disclosure regarding an increase in Medicare audits.

   > We continue to see Medicare audit activity increase. While the volume of RAC audits has slowed down for the time being, we have experienced an increase in the number of Medicare prepayment audits across all Medicare regions. With the increased prepayment audit activity, the time from claim submission to the initial payment is often significantly increased. I should also mention that pre-payment audits target high dollar claims, which affect our AR more than we have seen in the past. (CEO Mr. Vinit K. Asar, Q1 14 Conference Call)

   > In recent years we have seen a significant increase in Medicare audits, including Recover Audit Contractor or RAC audits, Comprehensive/Error Rate Testing or CERT audits and Medicare Administrative Contractor (MAC) prepayment audits. (FY 13 10K)

2. **Medicare receivables subject to audit surge:** Since Q3 13, the Company has disclosed the amount of accounts receivable subject to audit in its SEC filings. In Q1 14, Medicare receivables subject to audit increased 12.5% sequentially to $17.1 million. Accordingly, the percentage of Medicare receivables subject to audit increased 230 basis points sequentially to 28.3%. We note the percentage of Medicare receivables subject to audit has increased substantially from 9.3% in Q4 12 to 28.3% in Q1 14. **Accordingly, we are concerned about (1) a potential overstatement of receivables, (2) potential revenue headwinds if adverse CMS audit decisions increase, and (3) a slowdown in CMS payments and the potential negative impact on cash collections.**

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Medicare Receivables Subject to Audit Analysis ($ in millions)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13	Q4 12
Medicare receivables subject to audit	$17.1	$15.2	$13.9	$11.4	--	$3.9
Sequential change	*12.5%*	*9.4%*	*21.9%*	--	--	--
Year-over-year change	--	*289.7%*	--	--	--	--
% of Medicare receivables subject to audit	28.3%	25.9%	25.9%	20.8%	--	9.3%
Sequential change in bps	*230*	*10*	*510*	--	--	--

3. **Surge in Medicare appeals may result in additional receivables growth, in our view:** Once an initial Medicare claim determination has been made, service providers have a right to appeal the decision. The Medicare appeals process has five levels: (1) a Medicare Administrative Contractor (MAC) redetermination, (2) a Qualified independent Contractor (QIC) reconsideration, (3) an Administrative Law Judge (ALJ) hearing, (4) a review by the Medicare Appeals Council, and (5) a review by the United States District Court. Under the third appeals level, an ALJ will independently review the facts of the appeal, question witnesses, and make a new impartial decision in accordance with applicable law.

   In government fiscal year (GFY) 13, the average processing time for ALJ appeals increased 64.1% year-over-year to 220.7 days.[5] **Further, the year-to-date GFY 14 average processing time has increased sequentially every month to 418.7 days in April.** We note the average time to process has increased significantly from 94.9 days in GFY 09. According to the Office of Medicare Hearings and Appeals (OMHA) website, which handles the ALJ appeals process, **it has experienced "a record number of Medicare appeals" which has resulted in a 20 – 24 week delay in entering new requests into its case processing system.**

   If the OMHA continues to delay new requests and/or if the days to process appeals continues to increase, we believe the Company's receivables may continue to grow. Our concerns are heightened given Q1 14 Conference Call commentary that the appeals process for RAC claims has resulted in longer payment times and a "draw out" of accounts receivable.

   > Although OMHA is processing a record number of Medicare appeals, we continue to receive more requests for hearing than our Administrative Law Judges can adjudicate in a timely manner….**Due to record receipt levels, we are currently projecting an 20 - 24 week delay in entering ("docketing") new requests into our case processing system.** If 22 weeks have not lapsed since you submitted your Request for Hearing, do not resubmit your request. (Office of Medicare Hearings and Appeals Website) [emphasis added]
   >
   > Most significantly the time to final adjudication of all Medicare audits has increased with the recent moratorium on ALJ case assignment. With the appeals process for RAC claims being stretched to several years in some cases, time of payment averages continue to draw out our accounts receivable. (CEO Mr. Vinit K. Asar, Q1 14 Conference Call)

Medicare Appeals Days to Process Analysis	GFY 14	GFY 13	GFY 12	GFY 11	GFY 10	GFY 09
Days to Process	366.9	220.7	134.5	121.3	109.6	94.9
Year-over-year change	--	*64.1%*	*10.9%*	*10.7%*	*15.5%*	--

[5] The US government's fiscal year ends on 9/30. The US government is currently in its 2014 fiscal year ending on 09/30/14.

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GFY 14 Medicare Appeals Days to Process Analysis	Apr.	Mar.	Feb.	Jan.	Dec.	Nov.	Oct.
Days to Process	418.7	402.4	383.4	371.0	343.7	325.7	301.3
Month/month change	*4.1%*	*5.0%*	*3.3%*	*7.9%*	*5.5%*	*8.1%*	--

4. **Appeals delay concerns are heightened given a significant decline in favorable outcomes:** According to the OMAH website, **the percentage of fully favorable (partially favorable) Medicare appeals declined from 50.9% (6.1%) in GFY 12 to 34.4% (2.8%) as of April 2014 for GFY 14. Further, the percentage of dismissed appeals increased from 12.0% to 32.6%.** We believe the decline in favorable appeals may be due, in part, to the substantial increase in appeal filings and potential deterioration in case quality. **We are concerned the substantial decline in favorable outcomes may indicate increased regulatory scrutiny in approving Medicare appeals.**

Medicare Appeals Outcome Analysis	GFY 14 (YTD)	GFY 13	GFY 12
Fully favorable	34.4%	34.1%	50.9%
Partially favorable	2.8%	4.0%	6.1%
Unfavorable	27.6%	19.6%	26.7%
Remanded	2.2%	23.0%	4.1%
Dismissed	32.6%	19.2%	12.0%
Other	0.4%	0.1%	0.2%
Total	100.0%	100.0%	100.0%

5. **Receivables aging deteriorates:** In its SEC filings, the Company discloses the aging of accounts receivable in three categories: (1) 0 – 60 days, (2) 61 – 120 days, and (3) over 120 days. In Q1 14, the percentage of total gross accounts receivable aged over 120 days increased 890 basis points year-over-year to 33.6%, the fifth consecutive increase. **We note that in Q1 14, accounts receivable aged over 120 days increased for all customer categories.** On its Q1 14 Conference Call, the Company attributed the increase in over 120 days aged receivables to CMS audits. In addition, the Company represented it experienced an increase in pre-authorization (of payments) for commercial customers.

   Given an increase in over 120 days aged accounts receivable, we are concerned about (1) a potential overstatement of receivables, (2) potential revenue headwinds if adverse CMS audit decisions increase, and (3) a slowdown in CMS payments and the potential negative impact on cash collections. **Our concerns are heightened given the Company's Q1 14 Conference Call commentary that a slowdown in payments due to CMS audits has not "significantly influenced" its accounts receivable reserve calculations.**

   > The CMS audits have been a contributing factor, but we have also seen **a general slowdown in payments, which have not yet set significantly influenced our reserve calculations.** But we're watching this very closely. (CFO Mr. George E. McHenry, Q1 14 Conference Call) [emphasis added]

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Over 120 Days Aged Gross Receivables Analysis (% of Subcategory Total)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13
Commercial insurance receivables	25.9%	18.2%	19.3%	17.9%	19.6%
Year-over-year change in bps	*630*	*180*	*(150)*	*(330)*	*(40)*
Private pay receivables	46.9%	43.7%	49.0%	45.2%	38.2%
Year-over-year change in bps	*870*	*700*	*350*	*(380)*	*(1,550)*
Medicaid receivables	30.6%	24.8%	23.6%	20.8%	21.9%
Year-over-year change in bps	*870*	*710*	*230*	*150*	*(140)*
Medicare receivables	42.7%	35.7%	33.9%	28.7%	28.2%
Year-over-year change in bps	*1,450*	*1,420*	*1,560*	*1,270*	*1,270*
Veteran's Affairs receivables	17.9%	12.8%	12.5%	9.8%	17.4%
Year-over-year change in bps	*50*	*190*	*250*	*50*	*730*
Products & Services segment receivables	30.0%	24.1%	20.9%	23.7%	24.7%
Year-over-year change in bps	*530*	*340*	*(10)*	*300*	*350*
Total accounts receivable	33.6%	26.4%	26.3%	24.3%	24.7%
Year-over-year change in bps	*890*	*630*	*370*	*200*	*160*

6. **Potentially inadequate reserve levels, in our view:** As previously mentioned, effective Q3 13, the Company changed its method of presenting CAD charges as a reduction of revenue from the prior policy of including it in "other operating expense." While the Company implicitly disclosed the CAD balance for FY 12, FY 11, and FY 10, it did not disclose the balance for the quarterly periods prior to the change.[6]

   In its Q3 13 10Q, the Company represented that CAD related to "older accounts receivable balances due from commercial and government payors." Hence, we compared the CAD balance to over 120 days aged government and commercial customers (aged receivables hereinafter) in the Patient Care segment.[7] In Q1 14, CAD increased 10.1% sequentially to $22.7 million, while aged receivables increased 24.2% to $51.8 million. Accordingly, CAD-to-aged receivables declined 12.4% sequentially to 0.438. In addition, we note the Q1 14 CAD-to-aged receivable ratio of 0.438 is 26.1% below the three-year average of 0.593. Given a low CAD balance relative to aged receivables, **we are concerned the Company may be under-reserved for potential adverse CMS audits. Accordingly, we are concerned about the sustainability of revenue and earnings.**

CAD Analysis ($ in millions)	Q1 14	Q4 13	Q4 12	Q4 11	Q4 10
Contractual adjustments and discounts (CAD)	$22.7	$20.6	$13.9	$14.8	$11.5
Aged receivables	$51.8	$41.7	$24.8	$20.5	$12.6
CAD-to-aged receivables	0.438	0.500	0.558	0.721	0.912
Sequential change	*(12.4%)*	--	--	--	--
Year-over-year change	--	*(10.3%)*	*(22.6%)*	*(21.0%)*	--

[6] In its Q3 13 10Q, the Company disclosed the revised and previously reported ADA balance for FY 12, FY 11, and FY 10 after correcting the previously mentioned error. We calculated the CAD balance by taking the difference between the previously reported and revised ADA balances.

[7] We compared CAD to over 120 days aged government and commercial receivables given our view that these receivables represent the greatest risk for potential write-off.

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7. **Deletion of accounts receivable collectability disclosure heightens our concerns about restatement risk:** In its Q3 13 10Q and FY 12 and FY 11 10K filings, the Company disclosed that **a company-wide evaluation of the collectability of receivables older than 180 days is performed at least semi-annually,** and the results of which are incorporated in its allowance analysis. **We note the Company did not disclose a similar policy in its FY 13 10K.** Given an increase in over 120 days aged accounts receivable from all customer types, **we are concerned that the removal of this disclosure suggests the Company may have changed its methodology in evaluating significantly aged receivables.** Accordingly, our concerns about the adequacy of CAD reserves and potential restatement risk are heightened.

   > On a quarterly basis, the Company evaluates cash collections, accounts receivable balances and write-off activity to assess the adequacy of the allowance for doubtful accounts. **Additionally, a company-wide evaluation of collectability of receivable balances older than 180 days is performed at least semi-annually,** the results of which are used in the next allowance analysis. In these detailed reviews, the account's net realizable value is estimated after considering the customer's payment history, past efforts to collect on the balance and the outstanding balance, and a specific reserve is recorded if needed…In the cases when valid accounts receivable cannot be collected the uncollectible account is written off to bad debt expense. (FY 12 10K) [emphasis added]

8. **SEC investigation into receivables and bad debt expense heightens our concerns:** In a 07/31/13 8K, the Company disclosed that on 05/20/13, the Staff of the SEC's Division of Enforcement informed the Company it was conducting an investigation and requested documents and information concerning the calculation of bad debt expense and ADA. On 05/05/14, the Company released an 8K announcing the SEC had concluded its investigation and did not intend to recommend an enforcement action. While the SEC investigation did not result in an enforcement action, we remain concerned about the adequacy of ADA and CAD reserves given (1) a decline in CAD relative to aged receivables and (2) the potential change in methodology for evaluating significantly aged receivables (as previously discussed).

9. **Janus system roll-out and back office investments heighten concerns about potential improper billings, potential receivables overstatement, and earning sustainability:** On its Q2 13 Conference Call on 08/01/13, the Company announced it would implement its Janus next generation clinical management and billing system.[8] Further, on its Q4 13 Conference Call on 02/13/14, the Company represented it would invest in a revenue cycle management system (which we believe is a reference to Janus) to (1) redirect all cash receipts to central lockboxes, (2) convert payers to electronic invoicing and payment, (3) automate posting of receipts, and (4) provide insight into its relationships with payors to improve claims realization. In addition, the Company represented it would invest $11.0 million ($0.19) into back office operations including the centralization of billing and processing activities and improvements in finance, accounting, and information functions.

   Based on the Company's Q4 13 Conference Call commentary, **we believe its prior billing and management system was decentralized and included significant manual processes.** In our view, billing and management systems that are not performed electronically are subject to greater error rates for improper and/or duplicate billings. **Accordingly, we are concerned the Company may be currently utilizing an outdated billing system (which increases risk of potential improper billings and/or financial misstatements, in our view).**

   Further, on its Q1 14 Conference Call, the Company guided for additional back office investments of (1) $0.04 in additional resources to remedy its internal control weakness (discussed in more detail later) and (2) $0.01 in increased legal printing and labor costs, **which represented a 26.3% ($0.05) increase in back office investments from the Company's previous guidance.** Hence, we are concerned about potential margin pressure as the Company attempts to strengthen its accounting systems and back office functions.

   > The earnings growth includes an $11 million, or $0.19 per diluted share investment we are making in our back office operations, including centralization of our billing and processing activities and improvements in our finance, accounting and information technology functions. The most significant investment is in a

[8] In its FY 13 10K, the Company represented the rollout of the Janus would continue through FY 16.

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project called revenue cycle management, **which will redirect all cash to central lockboxes, convert our payers to electronic invoicing and payment, automate posting of receipts and give us much more ability** to analyze our relationship with payers and improve our realization on claims…We are also making investments in our financial reporting group, embedding the finance group in our clinics and have allocated funds in 2014 to develop an ERP strategy for the company. Finally, we are investing in our IT infrastructure and software to support our growth. (CFO Mr. George E. McHenry, Q4 13 Conference Call, 02/13/14) [emphasis added]

10. **Previous financial restatement heightens our concerns:** On 09/15/04, the Company filed an amended 10K to restate errors in its FY 03 10K. The Company disclosed that it discovered an error that led to the overstatement of accounts receivable and an equal understatement of bad debt expense, which resulted in an understatement of selling, general, and administrative (SG&A) expense. Accordingly, the Company restated its balance sheet for the years ended 12/31/03 and 12/31/02 and its income statement for the years ended 12/31/03, 12/31/02, and 12/31/01.

FY 03 Restatement Analysis ($ in millions)	FY 03	FY 02	FY 01
Accounts receivable (previously reported)	$116.5	$107.6	--
Accounts receivable (restated)	$112.9	$105.1	--
Overstatement	*3.1%*	*2.4%*	--
SG&A (previously reported)	$194.5	$184.1	$178.6
SG&A (restated)	$195.5	$185.1	$180.1
Understatement	*0.5%*	*0.5%*	*0.8%*
Earnings (previously reported)	$0.39	$0.86	($0.73)
Earnings (restated)	$0.37	$0.83	($0.77)
Overstatement	*5.4%*	*3.6%*	*5.2%*

In its FY 03 Amended 10K, the Company represented the accounting restatement was discovered during the preparation of its 06/30/04 financial statements. In addition, the Company represented the final rollout of its (at that point in time) new billing and cash collection system aided in the discovery of the discrepancy. Given the significant (in our view) abnormalities in recent receivable and reserve levels, the upcoming rollout of the new Janus system, and our belief that the Company's current billing system may be decentralized and may include significant manual processes, **we are concerned that the new system rollout may (once again) result in the discovery of accounting irregularities and/or a material financial misstatement.**[9]

Inventory Surge, Internal Control Deficiencies, and Additional SEC Scrutiny

Background on Patient Care segment inventory valuation: The Company values its Patient Care segment inventory based on the gross profit method, **which requires the Company to conduct an annual physical inventory count.** Based on our understanding of the Company's representations in SEC Correspondence Letters, we believe the Company expenses all inventory purchases. When the Company conducts its annual physical inventory count (at all of its 149 Patient Care segment clinics) on October 31st of each year, an adjustment is recorded for the difference between the inventory value recorded on its books with the physical count. The adjustment results in an increase/decrease in inventory with a corresponding decrease/increase in cost of materials (i.e. COGS).

[9] We note the Company's CFO (who recently announced he would resign from the firm), Mr. George E. McHenry, presided over the FY 03 financial restatement.

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The increase or decrease in inventory since the last physical count is added or subtracted to purchases for the twelve-months ended 10/31 to compute the materials usage rate for that period. The materials used are divided by net sales for the corresponding period to establish the current materials rate (i.e. gross margin). During interim periods, the gross profit rate is established based on the physical count and is updated to reflect changes in reimbursement rates, sales, mix, and material costs and is utilized to estimate COGS and inventory.

Surge in inventory levels: In Q1 14, inventory increased 16.2% year-over-year to $154.0 million, while revenue increased 2.7% to $235.6 million. Accordingly, inventory-to-revenue increased 13.1% y/y to 0.653. Further, DSI increased 14.4% to 197.4 days. The Company did not discuss the increase in inventory on its Q1 14 Conference Call or in its Q1 14 10Q.

Inventory Analysis ($ in millions)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13
Inventory	$154.0	$141.5	$144.4	$137.6	$132.5
Revenue	$235.6	$272.3	$271.1	$273.7	$229.4
Inventory-to-revenue	0.653	0.520	0.533	0.503	0.578
Year-over-year change	*13.1%*	*7.0%*	*1.8%*	*1.4%*	*4.6%*
DSI	197.4	142.2	163.3	154.7	172.6
Year-over-year change	*14.4%*	*1.5%*	*3.1%*	*1.0%*	*7.8%*

We have the following observations about the increase in inventory:

1. **We believe the gross profit method provides the Company with significant discretion in its estimate of cost of materials:** We believe the Company's method of accounting for inventory allows significant discretion in determining changes in the materials usage (i.e. gross profit) for its estimate of gross margin and inventory. In a 02/20/13 SEC Correspondence Letter, the Company represented it believed its method of inventory valuation was accurate given a history of immaterial book to physical count adjustments. Nevertheless, we believe the Company's reliance on physical inventory counts exposes it to significant risk of incorrectly valuing inventory. **Our concerns are heightened given (1) six SEC Correspondence letters over the last year and a half specifically questioning inventory valuation practices, (2) two consecutive years of internal control deficiencies related to inventory valuation, and (3) a history of errors and restatements related to inventory and accounts receivable.**

   > "We believe our present accounting model accurately reflects the activity within our balance sheet and income statement as demonstrated by our history of immaterial book to physical adjustments. Further, we believe the cost to implement and maintain such systems would far exceed these small book to physical adjustments we have experienced in the past." (SEC Correspondence Letter, 02/20/13)

2. **Our concerns about inventory are heightened given consistent internal control weaknesses and the Company's inability to file timely 10Ks:** For the past two fiscal years, the Company (1) has not filed its 10K within 90 days of year-end in accordance with SEC rules and (2) identified material internal control weaknesses related to inventory[10]:

   - **FY 13 10K internal control weakness:** In its FY 13 10K, the Company represented that as of 12/31/13, it identified several internal control weaknesses over financial reporting. The Company represented it did

[10] On 03/03/14, the Company filed a Form 12b-25 (Notification of Late Filing) for its FY 13 10K. The Company represented that additional time was required to test and assess its internal controls and procedures implemented in response to a material internal control weakness identified in its FY 12 10K. The Company subsequently filed its FY 13 10K on 04/04/14. On 03/04/13, the Company filed a Form 12b-25 for its FY 12 10K. The Company represented it was unable to file its FY 12 10K given that additional time was required to answer questions related to inventory from the SEC.

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not design and/or maintain effective controls over (1) raw materials to ensure items are priced using FIFO accounting due to the identification of inaccurate prices utilized in the valuation of inventory quantities on-hand based physical counts; (2) the accuracy of the stage of completion in valuing WIP inventory due to the identification of data input errors from physical inventory counts used; and (3) certain key assumptions used in the valuation of WIP inventory due to the identification of inaccurate or imprecise data used in the development of these assumptions.

- **FY 12 10K internal control weakness:** In its FY 12 10K, the Company represented that as of 12/31/12, it did not maintain effective internal controls over the valuation of WIP inventory. The Company represented it did not appropriately account for the effect of sales volume changes in the determination of the valuation of WIP inventory, resulting in misstatements of inventory, material costs, personnel costs, other operating expenses, and income taxes for Q1 12, FY 11, and FY 10. In addition, the Company represented the internal control deficiency resulted in an audit adjustment for FY 12.

3. **Our concerns are elevated given a Q4 12 inventory overstatement:** In its FY 12 10K, the Company disclosed that during Q4 12, **it determined that its work-in-process (WIP) inventory balance at 12/31/11 and 12/31/10 was overstated and required corrective adjustments.** The Company assessed the errors on previously reported periods and concluded the impact was not material to prior annual financial statements. However, the Company determined the impact was material to the consolidated financial statements for the Q1 12 and Q1 11 periods. We note that in its explanatory footnote, the Company did not discuss the cause of the inventory overstatement.

Q4 12 Inventory Error Analysis ($ in millions)	FY 11	FY 10
Inventory (previously reported)	$114.1	$98.3
Inventory (revised)	$112.3	$97.4
Overstatement	*1.6%*	*0.9%*
Material costs (previously reported)	$267.7	$247.6
Material costs (revised)	$270.2	$248.7
Understatement	*0.9%*	*0.4%*
Earnings (previously reported)	$1.61	$0.65
Earnings (revised)	$1.59	$0.64
Overstatement	*1.3%*	*1.6%*

4. **Additional inventory valuation irregularity for Dosteon business disclosed in Q4 13:** On 01/30/14, the Company pre-announced Q4 13 non-GAAP earnings (at midpoint) of $0.53, which was significantly below its prior guidance (at midpoint) and the consensus estimate of $0.68. The Company represented the lower-than-expected earnings was due to "operational issues isolated to a small non-clinic unit within the Patient Care segment" (later disclosed as its Dosteon business).

   On its Q4 13 Conference Call, the Company represented a book to physical inventory count adjustment at its Dosteon business (which is included in the Patient Care segment) resulted in a 160 basis point ($4.6 million) increase in its cost of materials rate. The Company represented it discovered the discrepancy when it completed its physical inventory valuation in January. The Company attributed the discrepancy to (1) poor collections on sales, which effectively increased the cost of materials rate, (2) issues in the billing process, and (3) a sales mix shift. The Company expressed its belief that it could reverse the adverse sales mix impact, improve collections, and correct the issues discovered in the billing process.

   We note the Company began disclosing inventory for each of its businesses within the Patient Care segment in Q4 13. In Q1 14, the Company disclosed the Dosteon business held $8.8 million of inventory at quarter-end.

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Based on the Company's prior representation of a $4.6 million book to physical inventory adjustment during the quarter, we believe the Dosteon inventory balance may have been overstated by 34.1% prior to the adjustment. As Dosteon inventories only represented 7.3% of the Patient Care segment total inventory balance as of Q1 14, we believe that any potential inventory adjustments in the Hanger clinic business could have a significant impact on financial results. In light of multiple inventory valuation errors and the Company's previous representation to the SEC that its inventory valuation was appropriate given a lack of historical discrepancies, we believe the Company could be subject to additional SEC scrutiny regarding this issue.

> Our com rate of 33.2% was 220 basis points or $6.1 million higher than last year…Our Dosteon business had a book-to-physical adjustment and a higher com rate in the fourth quarter that combined had a $4.6 million or 160 basis point impact. We discovered this increase when we completed the valuation of the 12/31/13 physical inventory in the third week of January. Prior to this discovery the com rate for both 2011 and 2012 had remained very consistent at just under 30%. **We have determined that the principal reasons for the variance were a combination of the impact of poor collections on sales, which effectively increased the com rate, and efficiencies in the billing process and a change in the sales mix.** We believe that we can reverse the change in the mix of sales, improve collections and correct the issues we have discovered in the billing process. These issues occurred principally at two of the five Dosteon locations, and a number of fixes are already in place. But it goes without saying that we will watch the performance of this business very closely. (CFO Mr. George E. McHenry, Q4 13 Conference Call, 02/13/14) [emphasis added]

Given the recent abnormal inventory build, two consecutive years of inventory internal control weaknesses, and multiple instances of accounting errors for inventory valuation, we are concerned the Company's inventory balance may be inaccurate (i.e. overstated). Our concerns are heightened given the recently announced departure of the Company's CFO (discussed next).

5. **Departure of CFO heightens our concerns regarding potential latent accounting irregularities:** On 04/07/14, the Company announced its CFO Mr. George E. McHenry would retire effective 12/31/14. The Company has not yet announced Mr. McHenry's successor. In our experience, CFO turnover in conjunction with a history of restatements, internal control deficiencies, and SEC inquiries heightens the risk of potential latent accounting irregularities.

Cash Flow Deteriorates, Surge in CapEx and Prepaid Expenses May Pressure Margins

In Q1 14, cash from operations (CFO) declined $12.2 million year-over-year to negative $10.0 million, while net income declined $3.5 million to $6.0 million. Accordingly, operating accruals increased $8.7 million to $16.0 million. We note that in Q1 14, inventory consumed $10.6 million of cash and accounts receivable provided $5.7 million less cash year-over-year. Given a build in both accounts receivable and inventory, we are concerned about the sustainability of revenue and earnings.

Cash Flow Analysis ($ in millions)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13
Cash from operations (CFO)	($10.0)	$17.7	$40.9	$25.5	$2.2
Net income	$6.0	$18.4	$21.7	$14.1	$9.5
Operating accruals	$16.0	$0.6	($19.2)	($11.4)	$7.3

Surge in capex may pressure margins, in our view: In Q1 14, capital expenditures (capex) increased 64.2% year-over-year to $8.9 million, while depreciation expense increased 9.8% to $10.2 million. Accordingly, capex-to-depreciation increased 49.4% to 0.869. On its Q1 14 Conference Call, the Company represented the capex increase was related to the rollout of its billing and scheduling system (Janus). If the Company is unable to achieve expected efficiencies from the Janus rollout, we believe earnings may be pressured as the capital expenditures are depreciated.

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Capex-to-Depreciation Analysis ($ in millions)	Q1 14	Q4 13	Q3 13	Q2 13	Q1 13
Capital expenditures (capex)	$8.9	$11.0	$9.4	$12.6	$5.4
Depreciation	$10.2	$9.5	$9.2	$9.5	$9.3
Capex-to-depreciation	0.869	1.159	1.022	1.330	0.581
Year-over-year change	*49.4%*	*29.0%*	*(0.1%)*	*5.3%*	*(9.4%)*

Additional potential concern – surge in prepaid expenses and other assets: We note that in Q1 14, prepaid expenses, other current assets, and income tax receivable increased 40.0% year-over-year to $27.7 million. The Company does not provide a breakdown of the specific components within this line item. To the extent the increase is attributable to depreciable expenses, we would be concerned about potentially aggressive cost capitalization and/or incremental risk of margin compression.

Debt-Fueled Acquisitive Strategy Yields Negative Tangible BV, Goodwill Impairment Risk

From FY 09 to FY 13, the Company made $260.4 million in acquisitions of smaller O&P clinics and other businesses. As a result, goodwill and intangible assets (soft assets hereinafter) increased 50.4% from $491.9 million in FY 09 to $739.6 million in FY 13. The Company's acquisitions have historically been funded with cash on hand and debt. We note that a substantial portion of the Company's acquisitions occurred prior to FY 12. Accordingly, we believe the Company may have acquired a significant amount of clinics before the substantial increase in CMS audits in recent years (i.e. potentially acquired them with peak earnings/valuations).

As of Q1 14 (FY 13), soft assets accounted for 55.8% (58.2%) of the Company's total assets. In light of the high level of soft assets and debt ($561.9 million as of Q1 14), **the Company's net tangible book value was negative $173.3 million as of Q1 14.** Given our concerns about (1) CMS audits, (2) a potential overstatement of accounts receivable and/or inventory levels, and (3) weak results in recent periods, we believe the Company may be subject to material impairment charges for soft assets.

Soft Asset Analysis ($ in millions)	Q1 14	FY 13	FY 12	FY 11	FY 10	FY 09
Goodwill and Intangible Assets	$763.8	$739.6	$739.1	$664.4	$647.1	$491.9
Year-over-year change	3.4%	0.1%	11.2%	2.7%	31.5%	3.5%
Total assets	$1,369.7	$1,271.7	$1,237.3	$1,126.7	$1,060.6	$875.0
Soft assets as % of total assets	55.8%	58.2%	59.7%	59.0%	61.0%	56.2%
Total debt	$561.9	$468.3	$520.6	$508.0	$508.7	$410.5
Year-over-year change	8.4%	(10.1%)	2.5%	(0.1%)	23.9%	(2.8%)
Acquisitions (net of cash acquired)	$19.2	$9.3	$62.5	$14.8	$162.3	$11.5

Material Insider Selling and Recent Executive Departures Heighten Our Concerns

Since the beginning of 2014, the Company's Chairman Mr. Thomas P. Cooper, CFO Mr. George E. McHenry, COO of Hanger Prosthetics Mr. Richmond L. Taylor, and COO of Southern Prosthetic Supply Mr. Kenneth Wilson have collectively sold 59,742 shares, representing 62.8% of their beneficial ownership. Further, we note that in addition to Mr. McHenry's retirement as CFO (as previously discussed), on 05/12/14, Mr. Taylor also announced his intention to retire effective 12/31/14. The Company announced that Samuel M. Liang, currently SVP of the Radiology & International medical device business unit of Bayer Healthcare, would be Mr. Taylor's successor.

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Given recent material (in our view) share divestures and executive turnover, our concerns about earnings sustainability and potential accounting irregularities are heightened.

Insider Sales Analysis	Shares Sold	% of B/O Sold
Chairman Mr. Thomas P. Cooper	16,500	64.5%
CFO Mr. George E. McHenry	29,737	62.1%
COO Hanger Prosthetics Mr. Richmond L. Taylor	9,345	68.0%
COO Southern Prosthetic Supply Mr. Kenneth Wilson	4,160	52.4%

Risks to Our Thesis and Conclusion

Risks to our thesis: The following developments could present challenges to our thesis:

- The ALJ Medicare appeals backlog delays begin to improve.
- The Company continues to receive favorable CMS audit appeals.
- New Janus billing system does not uncover billing irregularities.
- Q4 14 physical inventory count does not require significant adjustments.
- The Company is able to remedy its internal control deficiencies.

Conclusion: We are concerned about a surge in receivables given (1) a recent increase in CMS audit activity, (2) delays in Medicare appeals, and (3) deterioration in receivables aging. In addition, we believe the Company may not be adequately reserved for potential unfavorable CMS audit decisions. Our concerns are heightened given a recent SEC investigation into the Company's receivables and bad debt expense levels, a previous overstatement of receivables, potential evidence of manual control processes, and a systems upgrade that we believe may be a catalyst for a potential financial restatement. In addition, we are concerned about a surge in inventory given (1) a valuation methodology that requires significant estimation and physical inventory counts, (2) two consecutive years of inventory internal control weaknesses, (3) evidence of recent material (in our view) inventory misstatements, and (4) the existence of six SEC correspondence letters focused on inventory valuation over the past eighteen months. Our concerns are heightened in light of negative cash from operations, a surge in capex and prepaid expenses, a high level of soft assets with negative tangible book value, the recent announcement of the departure of the CFO and COO, and significant insider divestitures. We are initiating coverage of HGR on *The Short List*.

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