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New Rec: Matria Healthcare (MATR: $39.00) March 12, 2006

Position: Sell **Target: $22.00**

$000	1Q06e	2Q06e	3Q06e	4Q06e	2006e	2007e
Revenue	80,320	90,796	92,697	93,815	357,627	402,721
EPS*	0.18	0.27	0.25	0.23	0.94	1.11
Y/Y Gro	n/a	n/a	n/a	n/a	364%**	19%
PE	n/a	n/a	n/a	n/a	42	35
PSR	n/a	n/a	n/a	n/a	2.4	2.1
Consen*	0.17	0.28	0.35	0.42	1.20	1.79

*Includes stock-based compensation
**Versus reclassified EPS excluding discontinued operations

Shares Out: 22M **Market Cap: $858M** **FYE: Dec.**

Summary: Matria is a "health enhancement" company providing disease management/wellness maternity management programs to employers and health plans. The company is in the process of remaking itself into a nearly pure-play disease

management company. In January, it acquired CorSolutions, a privately-held disease management (DM) company with revenue 1.6x greater than its own DM revenue, and is looking for a buyer of its non-core assets to fund part of the $445M purchase price. With $457M in debt, the company's debt to total capital ratio stands at a hefty 64%.

Investors initially responded well to Matria's new look, driving shares up 20% since the deal was announced. However, the disclosure last week that its CFO resigned (following the departure of two other key executives in 2005) sent shares down 10% as investors became more cautious about integration issues. We think investors are right to worry about the future of MATR, and expect the company to fall short of "street" revenue and EPS estimates in 2006 and beyond.

About 70% of the "new" MATR's 2006 revenue is expected to come from DM. DM has been a darling of Wall Street for several years, with the only publicly traded comp, Healthways (HWAY) trading at 34x 2006 and 28x 2007 EPS. The "street" expects the market to grow at 30%-35% per year for the next few years, with significant growth coming from expansion into the Medicare fee-for-service population. MATR is not yet a participant in this part of the market, but bulls still expect MATR's 2006 pro forma DM growth to be 39%, ahead of market growth, and well ahead of the 24% revenue growth expected for HWAY's ex-Medicare business in 2006. We model MATR's DM business to grow about 24% in 2006 and 15% in 2007.

Bulls are also excited about the margin expansion opportunities offered by Cor and the growth of MATR's own DM business. Cor reportedly had operating margins of 27% in 2005, surprisingly high as compared to market leader HWAY's 19% operating margins. MATR says that Cor's margins can expand even further, and that its own DM business can realize expanding margins, as well. As we discuss, there are many reasons to doubt that MATR will manage to achieve its lofty margin guidance. Without detailed pro formas, however, for the time being we are conservatively modeling 20% operating margins for MATR in 2006 and 2007, slightly below the 21% expected by the "street."

The remaining 30% of MATR's 2006 revenue is expected to come from its maternity management programs, which provide screening and case management services for high-risk pregnancies. This business has been growing slowly, and the company has guided to about 7% growth in 2006. Operating margins have deteriorated in recent quarters, and are now only about 7% before allocation of corporate expenses. We expect revenue growth of 5% in 2006 and 7% in 2007.

In its enthusiasm for MATR's new DM focus, the "street" is ignoring many problems the company has acquired along with Cor's book of business. Cor has been in turmoil for a number of years, and has lost at least two contracts, most recently Premera BC/BS to HWAY in 2005. In 2004, Cor was also accused by an employee of making

fraudulent claims about its outcomes data, and just before being acquired settled a suit for an undisclosed payment plus attorney's fees.

MATR's DM business, too, is not without problems. Ex-employees have told us that several significant accounts, including BellSouth and IBM, are up for re-bid in 2006. Also, they have said its strategy of contracting directly with employers means its model cannot be leveraged as much as that of companies contracting with health plans since 1) it must customize many more, smaller programs, 2) it must integrate claims data from an employer's multiple health plans, and 3) measuring and proving ROIs on a smaller base of claims is more difficult. Moreover, we have concerns about the company's revenue recognition policies. Despite signing contracts with performance guarantees that put revenue at risk if goals are not met, the company does not maintain a liability on its balance sheet where revenue is held until results can be measured. This is much different than the accounting at HWAY, where revenue is held in an account called "Billings in Excess of Earned Revenue" until performance against goals is known. This aggressive revenue recognition policy could mean trouble in future periods.

Industry sources tell us that the overall dynamics of the DM business are weakening in several ways. Contract lengths are shortening, with the average now about three years from five years a few years ago. This increases the risk of losing business or accepting lower revenue to keep business. The DM market is also becoming rapidly commoditized, with benefits managers increasingly seeing DM programs as interchangeable. ROIs still cannot be reliably measured or compared, leading to continuing skepticism about the actual value of DM as a cost saving tool. Wellness programs, while allowing DM companies to reach many more patients, are not something employers are willing to pay much for, and so are not a source of much revenue growth. Finally, industry insiders tell us that RFPs are becoming increasingly price driven, as benefits consultants seek to save clients money.

A look back at MATR's deal making history makes us wonder about the level of due diligence that went into the Cor acquisition. One early acquisition by the company, a fertility clinic chain, went belly-up two years after it was purchased. A mail order diabetes supply business bought in 1999 was hit by a *qui tam* lawsuit in 2002 which alleged that the company defrauded Medicare of at least $45M by shipping diabetes supplies to dead people. MATR just settled this suit with a $10M payment.

Finally, we note that much of management's rationale for taking on $445M in debt to buy Cor depends on the successful sale of its Facet lancet distribution business and its German diabetes service business. Management even wants investors to ignore the full interest expense on the debt in its pro-forma numbers, giving itself credit for the debt reduction associated with the sale even before a buyer and price are established. We think "street" expectations for proceeds from the sale, at about $250M, are about $100M

too high. Growth in the businesses is slowing. Also, the Facet business relies on an exclusive distribution agreement with a Japanese supplier that expired in December 2005. We think the business could have little value if Facet fails to re-sign the agreement.

We are apparently not the only ones worried about MATR's new direction. The company has lost its Executive VP of Disease Management, its COO, and its CFO within the past few months. If MATR really is entering a bright new chapter in its history, we wonder why these executives did not stay around to participate.

We do not expect the Cor acquisition to live up to expectations. We project total revenue of $358M for 2006 and $403M for 2007 versus "street" estimates of $376M and $453M. We estimate 2006 EPS will be $0.94 versus consensus of $1.20. For 2007, we expect EPS to be $1.11 versus consensus of $1.79. Our target of $22 is 23x our 2006 and 20x 2007 EPS.

Background:

Matria was founded in 1996 with the merger of two maternity management companies. The company has evolved into a self-described "health enhancement" company, providing disease management/wellness maternity management programs to employers and health plans.

Since its inception, the company has undertaken a series of acquisitions and divestitures as management has sought growth opportunities. In 1996, it acquired a fertility clinic chain for $14M (which it wrote-down in full in 1998). In 1998 it acquired a cardiac diagnostic company for $17M, which it sold in 2001 for $18.1M. In 1999, the company acquired diabetes disease management companies Gainor (MATR sued the founder following the acquisition, but lost all claims and paid attorney's fees) and Diabetes Management Services for about $136M. In October 2002, it acquired a cancer disease management company, Quality Oncology, for $40.2M ($19.7M plus a $20.5M earn-out payment made in 2004). This price was about 4x expected 2002 sales of $10M, and the company was growing at about 100% y-y. In 2004, it divested its pharmacy and supplies business for $101M.

In January 2006, MATR acquired CorSolutions, a DM company with about $125M in 2005 revenue, for $445M, or 3.6x sales. This looks like a much higher relative price than paid for Quality Oncology, since growth is expected to be only 20% in 2006 for Cor, and the full payment was made upfront, financed with debt. The Cor DM business is larger than MATR's existing DM business, which had $77M in revenue in 2005. Coincident with the Cor acquisition, management announced it will sell its diabetes supply business (Facet) and German diabetes service business (Dia Real) to fund the acquisition, and to position itself as a "pure play" disease management company.

Although no buyers have been found for the discontinued businesses, and little is known about private CorSolutions' business, Wall Street responded favorably, rewarding MATR with a disease management multiple of 33x 2006 and 22x 2007 estimated EPS, compared to its non-pure play multiple of 26x 2006 before the Cor acquisition was announced. Note that competitor HWAY trades at 34x 2006 and 28x 2007 EPS. Both sets of estimates include stock option expenses.

Disease Management and Wellness Services

The disease management market has been growing rapidly. Companies such as Healthways (HWAY) and Health Dialog have realized top line growth of 40% plus as health plans and employers have embraced disease management as a way to try to control health care spending. "Street" analysts estimate total industry revenue at about $900M in 2004, and expect 30%-35% growth through 2007. A significant piece of this growth comes from expansion into the Medicare population through CMS' pilot DM projects launched in 2005. Notably, MATR/Cor is not a participant in these pilots.

MATR's disease management programs target patients with chronic conditions such as diabetes, cardiac conditions, and respiratory illness. The company analyzes health plan claim data to identify patients who are at risk of becoming intensive users of health care services. Using telephone calls from nurse educators and mailings, the company tries to change patient behavior (e.g., increase compliance with medication, diet) to avoid or reduce hospitalizations and the development of concomitant conditions. Companies tout their results by calculating ROIs showing the savings their programs generate.

ROI measures are a sore point between DM companies and purchasers of the services. Despite nearly 10 years of experience in designing these programs and measuring the results, no one has been able to agree on a standard method of calculating ROI. Some DM companies argue that a high ROI is a negative result, since it suggests the DM program is not aggressive enough in enrolling all patients that can benefit from DM services. As a result, confusion reigns in efforts to measure the impact of DM, and there is no meaningful way to compare the results of one DM program to another.

MATR and other disease management companies have recently added "wellness" services to their disease management portfolios. These services target a broad group of participants in a health plan or at an employer customer (e.g., overweight patients, smokers). The stated goal is to change behavior before individuals develop chronic illness by impacting lifestyle, diet, and exercise choices.

Our industry contacts tell us that the development of "wellness" services has been driven primarily by employers, who have been pushing for these services. As employers

are asking employees to pay higher premiums and take more control of their health through consumer-directed health care initiatives, they have sought ways to make people feel more empowered. Wellness programs seem to be an easy way to fill this need.

While employers are asking for these programs, they are not willing to pay much for them. Our industry contacts tell us that wellness programs must be very low cost to work for the DM companies. They are typically layered on top of DM programs for little incremental revenue. Since the programs must reach many more participants than a targeted chronic care disease management program yet cost very little, they are typically internet-based offerings with little human interaction. As such, they are easily copied. We are told by industry insiders that benefits consultants and employers see these plans as pretty much the same.

While buyers are not willing to pay much for wellness, they are also not demanding much in the way of ROI. Industry insiders tell us that benefits managers realize the savings generated by such programs cannot accurately be quantified. This may take the pressure off DM companies' statistics departments, but it will also keep a lid on revenue that can be generated from wellness services.

Women's and Children's Health (WCH)

Matria's WCH services provide screening and management for high risk pregnancies. In its 2003 10-K, it says it has an 85% market share for these services. Women identified by their physicians as high risk are referred to Matria, which works with the physicians to prolong the pregnancy and keep the patient at home as long as possible. This sometimes involves at-home uterine activity monitors and calls to a nurse educator. Matria also educates patients on the use of at-home drug infusion pumps that administer agents (e.g., terbutaline) that slow contractions and prolong pregnancy. While there is some evidence these drugs can prolong pregnancy, their use is controversial. Thus, coverage of these services by health plans is spotty and can change as new guidelines are published. For example, in the Michigan market, BC/BS does not cover the use of the drug infusion pump, which limits Matria's ability to serve customers in that market.

Pro Forma Revenue and "Street" Estimates

With the acquisition of Cor and the divestment of Facet and Dia Real, Matria will be closer to a DM pure play. The table below presents pro forma revenue and operating margin estimates for the newly combined business for 2005 and "street" estimates 2006:

2005 Pro Forma Revenue and 2006 "Street" Estimates

	Pro Forma 2005	"Street" Pro Forma 2006 Estimates	Y-Y change
CorSolutions Rev	$120M	$144M	20%
Matria DM Rev	$77M	$126M	64%
Combined DM Rev	$197M	$270M	37%
WCH Rev	$102M	$107M	5%
Total	$299M	$377M	26%

Sources: Matria press releases, "Street" reports, OWS Estimates

The "street" is expecting MATR's combined DM business to grow 37% from $197M to $270M. We suppose this enthusiastic estimate comes from MATR's guidance for total revenue of $370M-$380M for 2006, and the fact that the growth is not likely to come from WCH, which grew only 5% y-y in 4Q05. With no information on how Cor's business grew in 2005, and evidence that contracts were lost in 2004 and 2005, we see a great deal of risk to the company's DM revenue estimate, as we discuss in more detail below. We expect MATR to generate revenue of $358M in 2006 and $403M in 2007 versus "street" estimates of $376M in 2006 and $453M in 2007.

The "street" is very bullish about MATR's operating expansion opportunities for 2006. In the table below, we present pro forma 2005 operating income for the combined business. Note that the operating income estimate for Matria's DM and WCH businesses comes from the company's filings and its 4Q05 earnings release. The forward estimates are based on consensus "street" operating income of $81M, management guidance that the MATR DM business can operate at 26% margins, and its statement that the Cor operating margin will expand faster than revenue as the company realizes operating synergies. Below we assume that in 2005 Cor had about $10M in corporate expenses on top of MATR's $11M, and that "street" estimates put the combined entity at $10M in corporate overhead for 2006. For illustration purposes, we include $5M of overhead in Cor's operating income, and $5M MATR's operating income.

2005 Pro Forma Operating Income/Margins and 2006 "Street" Estimates

	Pro Forma 2005	"Street" Pro Forma 2006
CorSolutions Segment Op Inc	$42M	$51M
CorSolutions Corp OH	($10M)	($5M)
CorSolutions Op Inc	$32M	$46M
CorSolutions Op Margin	27%	32%
Matria DM Segment Op Inc	$12M	$33M
WCH Segment Op Inc	$7M	$7M
MATR Corp Op Exp	($11M)	($5M)
MATR Op Inc	$8M	$35M
Matria Op Margin	5%	15%
Combined Op Income	$40M	$81M
Combined Op Margin	13%	21%

Sources: Matria press releases, "Street" reports, OWS Estimates

We think “street” margin expansion expectations are overly optimistic. Industry executives with whom we have spoken agree, as we discuss in more detail below.

Discussion:

1. “Street” revenue growth expectations too high

“Street” analysts have followed company guidance, and are expecting $377M in revenue for 2006, a 26% increase over pro forma 2005 revenue. The company has assured investors that this growth is achievable, saying on its 4Q05 earnings call that is already has $320M in 2006 revenue in hand, including revenue from 10 new MATR/Cor contracts announced in February. Management says it need only win $53M in new business to meet its revenue guidance.

We are skeptical for a number of reasons. The $320M in revenue is equivalent to MATR’s 4Q05 pre-acquisition revenue run rate ($194M) plus $125M in revenue from Cor. It is also in line with a run rate off of the company’s 1Q06 revenue guidance of $80M-$82M. We wonder why there is no sequential growth in the run rate from 4Q05 to 1Q06. Could it be that Cor’s 2005 revenue of over $120M (we hear it was $125M from ex-employees and a private round investor) will not be so high in 2006? Lost contracts for MATR or Cor could mean that significantly more than $53M in new business will be needed to meet guidance. The $53M needed is actually over $75M in new “annual” business, since it starts in Q2 or later.

We know that Cor lost a contract with Premera Blue Cross/Blue Shield in 2005, and that HWAY took over these lives in December 2005. An article in 2004 quoted a Premera executive as saying 27,000 of its members benefited from disease management programs. At $18 PMPM (comparable to HWAY’s rate in 2004), the contract would have been worth $5.8M, or about 5% of Cor’s revenue. Cor lost its Highmark BC/BS contract to Health Dialog (a large privately-held DM company) in 2004. We wonder what awaits investors in 2006.

We are also told by former MATR employees that several big MATR contracts are up for re-bid in 2006, including BellSouth and IBM. With significant layoffs at both MATR and Cor (we hear 50-75 on each side), we wonder if MATR will be able to convince clients to stay while it undertakes this sizable acquisition.

To put expectations for MATR into context, the “street” expects HWAY to grow its revenue $102M from CY2005-CY2006, but $20M of that revenue is to come from Medicare contracts. Excluding this revenue, bulls are looking for $82M in new revenue for HWAY, or 24% growth versus the 39% DM revenue growth expected for MATR.

Finally, we note that MATR's contracts tend to be with employers. These customers each have a smaller number of potential lives than would a large health plan. Thus, the company must sign many contracts to generate $53M. We think the turmoil likely caused by the Cor acquisition will distract its salespeople, and make closing a large number of contracts difficult.

2. Margin expansion expectations may be too bullish

Bulls expect MATR to realize 21% operating margins in 2006, expanding to 23% in 2007. This is huge expansion from the 5% operating income MATR had after divesting Facet/Dia Real but before the Cor acquisition. Without financials, it is difficult to understand how this will occur. Thus, until the 8-K comes out at the end of March, we are modeling operating margins of 20% in 2006 and 2007, though we have significant doubts such margin levels can be realized.

The expansion relies on several questionable factors:

<u>Cor must expand already high margins</u>: Cor had 27% operating margins and 32% EBITDA margins in 2005. We estimate operating margins must expand to 32% in 2006 to meet "street" estimates. The expansion of the margins would come from synergies in corporate expenses resulting from the combination with MATR. But industry sources with whom we have spoken are very surprised at Cor's 27% operating margins, and think they are unsustainable. Our contacts speculate that Cor's margins may be inflated due to the timing of payments versus expenses (e.g., recognition of revenue from 2004 may have been delayed until 2005 while program performance was proven/evaluated), or an unsustainable lack of investment in the business as the company positioned itself for sale. For comparison, note that HWAY's operating margin runs at 18%-19% and EBITDA margins are 25%.

<u>MATR must expand its own DM margins</u>: While profitability in MATR's existing DM business is improving, it is still well below Cor's. As shown in the table below, if we allocate half of MATR's corporate overhead expense to the DM business (to make an apples-to-apples comparison to pure plays HWAY and Cor), margins were about 15% in 2H06.

MATR DM Pre-Acquisition Operating Margin Analysis

	1Q05	2Q05	3Q05	4Q05e
Matria DM Rev	15,564	18,333	19,974	23,300
Matria DM Op Inc	2,112	2,895	4,908	4,525
1/2 Corp OH	(1,357)	(1,214)	(1,454)	(1,750)*
Adj DM Op Inc	756	1,681	3,454	3,375
Matria DM Op Margin	5%	9%	17%	14%

Source: MATR SEC Filings

*Assumes $3.5M in corporate overhead versus $2.7M average, with extra expense due to merger preparation.

To meet "street" operating margin projections, we estimate that MATR's DM business must reach 24% operating margins in 2006. Our discussions with an ex-Matria executive suggest this will be difficult. He explains that MATR's costs are higher than its peers HWAY and Health Dialog due to its strategy of targeting employers rather than health plans. This is because 1) employers demand customization, with each contract serving fewer customers than a big health plan contract, increasing product development costs, 2) larger employers typically have 3-5 health plans, requiring MATR to gather and integrate claims data from multiple sources, increasing data processing and analysis costs, and 3) ROIs on a smaller amount of claims data are difficult to put together and prove, meaning MATR has a harder time backing up its performance and demanding higher fees.

In addition, we note that putting MATR and Cor's IT departments and outcomes analysis groups together will be difficult, since each has developed an independent methodology for analyzing claims data. Thus, we think it is likely that MATR will have to maintain both systems for the foreseeable future.

<u>Deterioration in WCH Operating Margins Must Stabilize</u>: While MATR succeeded in growing its Women's and Children's Health business in 2005, increasing revenue 10% y-y versus a 2% decline in 2004 and 4% decline in 2005, top line growth came at the expense of operating margins. As shown in the table below, WCH operating margins deteriorated markedly in 3Q05, meaning the company generated less operating income despite 12% revenue growth.

Women's and Children's Health Revenue and Op Margins

	3Q04	4Q04	1Q05	2Q05	3Q05
WCH Revenue	23,423	24,100	24,114	26,234	26,140
WCH Op Income	2,227	1,740	1,826	2,083	1,777
WCH Op Margin	9.5%	7.2%	7.6%	7.9%	6.8%

Source: MATR SEC Filings

3. DM market for employers may be reaching saturation, MATR not a participant in Medicare DM pilots

Matria was relatively late to the DM game. In 2003, it had only $23M in DM revenue, while HWAY had $192M. With most major health plans already aligned with a DM company and/or maintaining in-house DM programs, MATR had to target employers in order to win business. While this approach won it top line growth in 2004 and 2005, our analysis suggests saturation of this segment is close to being reached.

A recent study by Forrester Research of 226 US benefits executives says 45% of employers offer disease management benefits to their employees. Only 22% of the remaining employers plan to offer DM to their employees, while 33% have no plan to offer DM. By company size, penetration is even higher with large employers, where 67% of those with 10,000 or more employees already offer DM, with 33% planning to offer it. Only employers with 250 or fewer employees have low penetration, at 32%. But only 15% of these employers plan to offer DM in the future.

We used data from the US Census Bureau to try to quantify this penetration with employee counts. As shown below, extrapolating from the Forrester survey, about 52.3M American employees work for companies that offer DM benefits present. Another 24.1M work for companies that will offer DM, if benefits managers follow their current plans. Assuming half of these employees get DM in 2006 and half in 2007, growth in the number of employees offered DM benefits would be 23% in 2006 and 18% in 2007. Thus, to achieve "street" pro forma DM revenue growth expectations of 37% in 2006 and 30% in 2007, MATR will have to grow much faster than the overall market, which means it will have to gain market share.

Employees Offered DM/Will be Offered DM/No Plans to Offer DM

Employees in Companies with:	Employees (M)	% Offer DM	Employees w DM (M)	Plan to Offer	Employees will get DM (M)	No Plan to Offer	Empolyees No DM
1-500 employees*	55.6	32%	17.8	15%	8.3	53%	29.5
500-1K employees*	5.7	56%	3.2	33%	1.9	12%	0.7
1K-5K employees	13.5	58%	7.8	15%	2.0	27%	3.6
5K-10K employees	6.1	58%	3.5	33%	2.0	8%	0.5
10K+ employees	29.7	67%	19.9	33%	9.8	0%	0.0
	110.6		52.3		24.1		34.3

Sources: Forrester Research, US Census Bureau

*Note: Forrester breaks its figures into 250 or fewer and 251-1000 employees

Bulls argue that the market for DM is more than just employers, since it is expanding into Medicare with pilot programs launched in 2005. This expansion is supposed to drive continued DM growth for years to come. However, Matria and Cor are not participants in these pilots, making growth expectations even harder to achieve. We know that both organizations bid on these pilots, but neither won. Cor is involved in a different Medicare demonstration project that began in February 2004, but as it enrolled patients in the New Orleans/Shrevesport area, we cannot imagine it is going very well.

This project is three years in length, and so will be complete in early 2007. If the project failed, even for hurricane related reasons, we think it is unlikely that CMS will provide further funding.

4. Industry dynamics weakening for DM companies

Our industry contacts have told us that industry dynamics for DM companies are weakening in several areas:

Contract lengths shortening: In the past, DM companies were able to sign up health plans and employers for contracts five years in length or longer. Benefits consultants are increasingly resisting such contracts, since they are able to generate more fees by managing more frequent RFPs. The average contract length, we are told, is now three years.

DM/Wellness is becoming a commodity: Industry executives with whom we have spoken acknowledge that there is increasingly little differentiation between the services offered by DM companies. One industry insider, who has marketing experience across a number of industries, commented that this is the fastest move to commoditization in a service market that he has ever seen.

Benefits Consultants Increasingly Aggressive on Price: Benefits consultants like Hewitt, Towers Perrin and Mercer are increasingly pitting one plan against the other to save clients money. With no ROIs that can be accurately compared, and little difference between programs, it is easy for consultants to convince buyers to choose based on price.

5. CorSolutions acquisition has a lot of problems

In 2004, CorSolutions' VP of Informatics and Outcomes Management submitted a detailed report to Cor's board detailing data manipulation and fraud by senior management to make Cor's patient and physician satisfaction results look better than they were. This employee subsequently quit Cor, and went to work for competitor Alere. Cor sued the employee for breaching non-compete and confidentiality agreements, and the employee countersued.

This suit was settled in early December 2005 with Cor paying all attorney fees and making an undisclosed settlement. We wonder if this settlement was a precondition to MATR's acquisition, since it would not like to have this issue outstanding at the time of the acquisition. But in the meantime, Cor lost its contract with Premera BC/BS, and has failed to announce any new contracts. Cor's competitors, including Matria, must have had a field day using the outcomes scandal against it in contract negotiations. We wonder how Matria's salespeople will now be able to go into accounts and pitch Cor's

services and outcomes data, having so recently used the fraud allegations as a competitive tool.

We have also heard from industry contacts that, in an effort to grow its top line to position itself for sale, Cor competed especially aggressively for contracts in 2005. An ex-Matria employee tells us that Matria walked away from some of these negotiations because terms became unfavorable. Now Matria owns these contracts, and must deal with the consequences.

Top management at Cor appears to have been in disarray during most of 2005, as the company sought to deal with the ramifications of the outcomes scandal. The CEO resigned in August, and was replaced by a board member. Its Chief Medical Officer was replaced in August as well. The former CMO is now the medical director of a laser hair removal center in North Carolina. The chaos seems to have continued after the acquisition, with many top employees gone from the company.

6. MATR CEO reportedly pursued acquisition at all costs. Spotty track record

We spoke with an ex-employee of Matria who told us that the acquisition of Cor was driven almost exclusively by MATR's CEO with little input from MATR's vice presidents. At 64 years of age, we wonder if the CEO was making this huge acquisition to cement his legacy before retirement.

While MATR's CEO has a lot of deal making experience, his record on due diligence seems less than perfect. A fertility clinic purchased in 1996 went belly-up two years later. A mail-order diabetes supply business purchased in 1999 was hit with a *qui tam* lawsuit in 2002, The suit alleged that the company had 65,000 customers it its database, but that another 15,000 who had died were still being sent supplies, defrauding Medicare of at least $45M. The subsidiary was sold to CCS Medical in 2004, but Matria retained the *qui tam* liability. Verbal settlement of the suit for $10M was announced by Matria in February 2006. Interestingly, it seems that the cash needed to make the settlement is being wrapped into the company's debt to buy Cor, since the company is paying $445M for Cor, but is borrowing $455M. Paying the $10M settlement would have been tough without the debt, since Cor had only $28M in cash on the balance sheet in September 2005.

We wonder how much MATR really knows about Cor's business. On conference calls, MATR's CEO has repeatedly said that his access to Cor's contracts and financials was limited prior to the acquisition due to anti-trust concerns. Given the outcomes scandal and the questionably high margins Cor reportedly has, we think investors should be concerned that there are surprises in store once MATR gets a closer look at Cor's books and contracts.

7. MATR revenue recognition policy may be more risky than HWAY

In its 2004 10-K, MATR discloses the following:

> "Many of our existing disease management agreements contain savings or other guarantees, which typically provide that we will repay all or some of our fees if the payor's cost savings as a result of our disease management programs do not meet expectations or if other quality performance measures are not met. Some contracts also provide that we will receive bonus compensation by meeting certain performance criteria. There is no guarantee that we will accurately forecast cost savings and clinical outcome improvements under our disease management agreements or meet the performance criteria necessary to receive the designated bonus compensation or to avoid repayment of fees under the agreements."

This language is familiar to investors in competitor HWAY, who have become used to seeing the company keep sizable revenue on the balance sheet as a liability called "Billings in Excess of Earned Revenue." HWAY has typically held performance-based revenue on the balance sheet until it has generated enough data over 6-9 months to prove to itself and its auditors that it will not have to give the money back. Even after it has recognized the revenue, HWAY informs investors of the percentage that was performance-based and subject to potential return upon final reconciliation if HWAY and its clients do not agree that targets have been met. This amount was 10% of revenue for HWAY in its most recent quarter, the same percentage of DM revenue that MATR disclosed was subject to final reconciliation in the nine months ended September 2005.

What is curious to us is that, while MATR employs a performance-based revenue model that is strikingly similar to HWAY's, it does not have a "Billings in Excess" or any comparable liability on its balance sheet. This suggests to us that it has convinced itself and its auditors that it is in no danger of missing performance targets, and so immediately recognizes its DM revenue as it comes in the door. This may be risky. If, as HWAY experience with its Oxford Health Plan contract, a client does not agree that MATR has met performance goals, recognized revenue may have to be returned. In HWAY's case, this revenue had not been recognized, and only the balance sheet took a hit. MATR, it appears, may not take such an equally conservative stance.

8. Current strategy depends on selling Facet and German diabetes business, expectations too high

Bulls have been very generous in their expectations for the price MATR's German diabetes and Facet businesses will fetch from buyers. One "street" analyst projects that the combined businesses will generate $165M-$170M in revenue in 2006, and should get 1-2x sales from a buyer, or a midpoint of about $250M in proceeds. This would go a

long way toward paying down the company's $455M in debt taken on to buy Cor and pay the *qui tam* lawsuit settlement.

We think expectations about proceeds are too high. The combined businesses generated only $152M in revenue in 2005, up 2% y-y. We think 1x sales is the best MATR can hope for, meaning the sale could come up short by $100M versus expectations.

Growth in the German diabetes business has been slowing, from 20% y-y in 2004 to 10% in 2005. One "street" analyst projects $75M in revenue for 2006, or 7% y-y. We think getting more than 1x sales for such a low growth business will be difficult.

MATR's Facet Technologies division distributes private label lancing devices, lancets, and pressure bandages primarily to companies with diabetes testing products. Over 92% of the divisions' revenue in 2004 came from five customers: Roche, J&J, Becton Dickinson, Abbott, and Bayer.

Virtually all of the components in Facet's products are purchased from Nipro Corporation, a Japanese company, under an exclusive supply agreement. But this supply agreement expired in December 2005. We have spoken with a Nipro executive who tells us that an extension of the agreement is currently under negotiation, but has yet to be signed. The lack of an agreement will likely complicate sale of Facet, since without it the company could be worthless. We think Facet's customers would be very unhappy if Facet tried to change its component supplier, since that may impact the quality of a crucial component in their products.

Something seems to be amiss at Facet, with sales down 12% y-y in 3Q05 and 13% y-y in 4Q05. The company has blamed the weakness on inventory adjustments at its customers. But these are not the kind of results a company on the block should be putting up to get the best price.

10. Guidance on Interest Expense confusing, accounting questionable

On its 4Q05 earnings call, management told investors to expect about $25M in interest expense in 1Q06 on its $455M in debt. This works out to about 5.6% annual interest, which confused "street" analysts since MATR's new debt has interest rates that range from 7%-11%. At an average 9% interest rate, interest expense on the $455M in debt would be $41M. The CFO explained that some of the interest on the debt will be included in discontinued operations, representing the amount the company hopes to eliminate when it sells the Facet and German diabetes businesses.

This strikes us as aggressive accounting. With no buyer yet found, and no price set, who is to say how much interest savings MATR will realize from the sale, and when this will happen? Moreover, management has repeatedly reminded investors that, even though the Facet/German businesses will be sold, MATR will still have access to its cash flow. So management wants to have its cake and eat it too. It wants us to ignore the interest expense associated with having not yet sold the discontinued operations, but continue to value the company by including the cash flow these businesses contribute.

11. Executive departures raise questions

MATR has seen a spate of executive departures over the last several months. In September 2005, its Executive VP of Disease Management left to become CEO of Green Ribbon Health, a joint venture between Pfizer and Humana that won a Medicare Demonstration Project contract in Florida. In October, its COO left to run NovaMed, and ambulatory surgery center. Most recently, in March, its CFO left for a position at MedSolutions, a radiology service management firm. In our view, this top level instability, coupled with similar instability at Cor, significantly increases the risk that MATR will fail in its attempts to integrate Cor and execute its large number of new contracts.

12. Financial Assumptions

As MATR plans to report Cor and MATR DM revenue as one entity, we assume no growth for Cor, and in fact lower revenue by about $5M in 2006 to account for loss of the Premera BC/BS contract. We assume MATR's DM business grows 70% y-y in 2006 on new contracts. This puts pro forma growth for the combined DM business at 24%, in line with our market growth estimates for MATR's employer DM model. In 2007, we expect the total MATR DM business to grow 15% as disarray at the company causes it to lose share. We project total revenue of $358M for 2006 and $403M for 2007 versus "street" estimates of $376M and $453M.

We assume operating margins of 20% versus the "street's" 21%. We think our estimate is high, but will wait for detailed pro formas on Cor and MATR's 10-K to fine tune our estimates. With no 8-K for the Cor acquisition, we cannot yet tell how COGS and SG&A will break out, but follow the consensus view for now.

We assume interest expense of $25M in 2006 and $24M in 2007. This follows company statements that interest on the portion of the $455M in debt expected to be paid down after the sale of Facet/German operations will be included in discontinued operations. We do not agree with this aggressive treatment, but in order to make our estimates comparable to the "street's," we follow this approach.

Our tax rate of 40.6% is in line with "street" estimates. Our EPS estimates include after tax stock option expenses of $1.68M per quarter, in line with guidance. We estimate 2006 EPS will be $0.94 versus consensus of $1.20. For 2007, we expect EPS to be $1.11 versus consensus of $1.79.

13. Financials:

$000	2005a	Reclassified 2004	Reclassified 2005	2006e	2007e
Cor DM	0	0	0	119,750	137,713
MATR DM	77,171	52,389	77,171	131,000	150,650
German Diabetes	69,933	17,600	--	--	--
Facet	82,014	19,749	--	--	--
Health Enhancement	229,699	52,389	77,171	250,750	288,363
WCH Revenue	101,788	92,768	101,788	106,877	114,359
Total Revenue	331,515	234,894	256,131	357,627	402,721
Cost of Health Enhance	n/a	n/a	n/a	120,360	141,298
Cost of WCH Rev	n/a	n/a	n/a	50,232	53,749
Total Cost of Revenue	n/a	64,938	72,972	170,592	195,046
Selling/Administration	n/a	79,309	94,656	111,000	125,000
Doubtful Accounts	n/a	2,412	3,493	3,634	3,888
Total Operating Expense	293,599	146,659	171,121	285,226	323,934
Operating Income	37,916	-1,572	8,110	72,401	78,787
EBITDA	43,238	n/a	n/a	80,001	86,387
Interest, Net	-1,589	-9,629	-1,589	-26,000	-24,000
Other, Net	226	681	226	0	0
Net Inc Before Taxes	36,553	-33,406	6,747	46,401	54,787
Provision for Inc Taxes	14,800	-13,329	2,733	18,839	22,243
Net Income After Taxes	21,753	-20,077	4,014	27,562	32,543
Dilution Adjustment	1,165	0	0	0	0
Diluted Net Income	22,918	-20,077	4,014	27,562	32,543
EPS contin ops ex options	1.06	-1.29	0.20	1.24	1.40
S/O	21,629	15,520	19,874	22,250	23,200
Options Exp Net Tax	0	0	0	6,720	6,720
EPS Incl Option Exp	1.06	-1.29	0.20	0.94	1.11

Y-Y chng	2005a	Reclassified 2004	Reclassified 2005	2006e	2007e
Cor DM	n/a	n/a	n/a	n/a	15%
MATR DM	47%	80%	47%	70%	15%
German Diabetes	10%	n/a	n/a	n/a	n/a
Facet	-4%	n/a	n/a	n/a	n/a
Health Enhance Revenue	14%	80%	47%	225%	15%
WCH Revenue	10%	-2%	10%	5%	7%
Total Revenue	13%	90%	9%	40%	13%
Total Cost of Revenue	n/a	n/a	12%	134%	14%
Selling/Administration	n/a	n/a	19%	17%	13%
Total Operating Expense	10%	n/a	17%	67%	14%
Operating Income	43%	n/a	n/a	793%	9%
EBITDA	35%	n/a	n/a	n/a	8%
Interest, Net	-83%	n/a	n/a	n/a	-8%
Pre-Tax Income	101%	n/a	n/a	588%	18%
Income Taxes	120%	n/a	n/a	589%	18%
Diluted Net Income	89%	n/a	n/a	587%	18%
EPS excl stock options	61%	n/a	n/a	513%	13%
EPS incl stock options	61%	n/a	n/a	364%	19%

% Total	2005a	Reclassified 2004	Reclassified 2005	2006e	2007e
Cor DM	0%	0%	0%	33%	34%
MATR DM	23%	22%	30%	37%	37%
German Diabetes	21%	7%	0%	0%	0%
Facet	25%	8%	0%	0%	0%
Health Enhance Rev	69%	22%	30%	70%	72%
WCH Revenue	31%	39%	40%	30%	28%
Total Revenue	100%	100%	100%	100%	100%
Cost of Health Enhan Rev	n/a	n/a	n/a	48%	49%
Cost of WCH Rev	n/a	n/a	n/a	47%	47%
Total Cost of Revenue	n/a	28%	28%	48%	48%
Selling/Administration	n/a	34%	37%	31%	31%
Total Operating Expense	89%	62%	67%	80%	80%
Operating Income	11%	-1%	3%	20%	20%
EBITDA	13%	n/a	n/a	22%	21%
Interest, Net	0%	-4%	-1%	-7%	-6%
Pretax Income	11%	-14%	3%	13%	14%
Income Taxes	4%	-6%	1%	5%	6%
Diluted Net Income	7%	-9%	2%	8%	8%

$000	1Q05a	2Q05a	3Q05a	4Q05a	Reclass -ified 4Q05	1Q06e	2Q06e	3Q06e	4Q06e
Cor DM	--	--	--	--	--	26,000	31,250	31,250	31,250
MATR DM	15,564	18,333	19,974	23,300	23,300	29,000	32,000	34,000	36,000
German Diabetes	17,054	17,654	17,625	17,600	--	--	--	--	--
Facet	20,997	21,506	19,762	19,749	--	--	--	--	--
Health Enhancement	53,432	57,754	57,884	60,629	23,300	55,000	63,250	65,250	67,250
WCH Revenue	24,114	26,234	26,140	25,300	25,300	25,320	27,546	27,447	26,565
Total Revenue	77,574	83,988	84,024	85,929	48,580	80,320	90,796	92,697	93,815
Cost of Health Enhance	31,481	33,245	32,027	n/a	n/a	26,400	30,360	31,320	32,280
Cost of WCH Rev	11,406	12,460	12,954	n/a	n/a	11,900	12,946	12,900	12,486
Total Cost of Revenue	42,885	45,705	44,982	n/a	19,947	38,300	43,306	44,220	44,766
Selling/Administration	26,116	27,988	27,570	n/a	25,326	25,000	27,000	29,000	30,000
Doubtful Accounts	879	891	965	n/a	872	861	937	933	903
Total Operating Expense	69,880	74,584	73,517	75,618	46,145	64,161	71,243	74,153	75,669
Operating Income	7,694	9,404	10,507	10,311	2,435	16,159	19,553	18,544	18,146
EBITDA	9,360	11,280	12,287	10,311	4,335	18,059	21,453	20,444	20,046
Interest, Net	-1,048	-672	38	93	14	-6,500	-6,500	-6,500	-6,500
Other, Net	52	203	283	-312	89	0	0	0	0
Net Inc Before Taxes	6,698	8,935	10,828	10,092	2,538	9,659	13,053	12,044	11,646
Provision for Inc Taxes	2,696	3,617	4,400	4,087	1,028	3,921	5,299	4,890	4,728
Net Income After Taxes	4,002	5,318	6,428	6,005	1,510	5,737	7,753	7,154	6,918
Dilution Adjustment	665	500	0	0	0	0	0	0	0
Diluted Net Income	4,667	5,818	6,428	6,005	1,510	5,737	7,753	7,154	6,918
EPS cont ops ex options	0.22	0.27	0.30	0.28	0.07	0.26	0.35	0.32	0.31
S/O	21,409	21,477	21,728	21,769	21,769	22,100	22,100	22,300	22,500
Options Exp Net Tax	0	0	0	0	0	1,680	1,680	1,680	1,680
EPS Incl Option Exp	0.22	0.27	0.30	0.28	0.07	0.18	0.27	0.25	0.23

Y-Y chng	1Q05a	2Q05a	3Q05a	4Q05a	Reclass -ified 4Q05	1Q06e	2Q06e	3Q06e	4Q06e
Cor DM					n/a	n/a	n/a	n/a	n/a
MATR DM	56%	38%	38%	62%	62%	86%	75%	70%	55%
German Diabetes	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Facet	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Health Enhanc Revenue	19%	18%	10%	10%	62%	253%	245%	227%	189%
WCH Revenue	7%	15%	12%	5%	5%	5%	5%	5%	5%
Total Revenue	15%	17%	11%	8%	26%	4%	8%	10%	93%
Total Cost of Revenue	6%	12%	4%	n/a	19%	-11%	-5%	-2%	124%
Selling/Administration	13%	25%	15%	n/a	19%	-4%	-4%	5%	18%
Total Operating Expense	10%	17%	8%	4%	19%	-8%	-4%	1%	64%
Operating Income	106%	17%	32%	53%	n/a	110%	108%	76%	645%
EBITDA	82%	20%	32%	26%	n/a	93%	90%	66%	362%
Interest, Net	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Pre-Tax Income	1310%	96%	60%	58%	n/a	44%	46%	11%	359%
Income Taxes	1255%	107%	71%	84%	n/a	45%	47%	11%	360%
Diluted Net Income	402%	106%	53%	45%	n/a	23%	33%	11%	358%
EPS excl stock options	282%	48%	45%	40%	n/a	19%	30%	8%	343%
EPS incl stock options	282%	48%	45%	40%	n/a	n/a	n/a	n/a	n/a

% Total	1Q05a	2Q05a	3Q05a	4Q05a	4Q05	1Q06e	2Q06e	3Q06e	4Q06e
Cor DM	0%	0%	0%	0%	0%	32%	34%	34%	33%
MATR DM	20%	22%	24%	27%	48%	36%	35%	37%	38%
German Diabetes	22%	21%	21%	20%	0%	0%	0%	0%	0%
Facet	27%	26%	24%	23%	0%	0%	0%	0%	0%
Health Enhance Rev	69%	69%	69%	71%	48%	68%	70%	70%	72%
WCH Revenue	31%	31%	31%	29%	52%	32%	30%	30%	28%
Total Revenue	100%	100%	100%	100%	100%	100%	100%	100%	100%
Cost of Health Enhance	59%	58%	55%	n/a	0%	48%	48%	48%	48%
Cost of WCH Rev	47%	47%	50%	n/a	0%	47%	47%	47%	47%
Total Cost of Revenue	55%	54%	54%	n/a	41%	48%	48%	48%	48%
Selling/Administration	34%	33%	33%	n/a	52%	31%	30%	31%	32%
Total Operating Expense	90%	89%	87%	88%	95%	80%	78%	80%	81%
Operating Income	10%	11%	13%	12%	5%	20%	22%	20%	19%
EBITDA	12%	13%	15%	12%	9%	22%	24%	22%	21%
Interest, Net	-1%	-1%	0%	0%	0%	-8%	-7%	-7%	-7%
Net Income Before Taxes	9%	11%	13%	12%	5%	12%	14%	13%	12%
Income Taxes	3%	4%	5%	5%	2%	5%	6%	5%	5%
Diluted Net Income	6%	7%	8%	7%	3%	7%	9%	8%	7%