Citron RESEARCH

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Chemed: Game Over

Citron details the breaking news defining the looming regulatory and litigation threat the analysts won't identify. Citron provides links to the pivotal case documents.

Background

Chemed (NYSE:CHE) is the nation's largest for-profit provider of outpatient hospice services, accounting for 74% of its appx $1.45 billion annual revenues. Medicare is responsible the payer for over 90% of the company's hospice services revenue.

On May 2, the US Department of Justice filed a false claims act lawsuit alleging fraudulent billing in Chemed's VITAS business units in appx. 20 states. **[LINK to DoJ case complaint]** The stock reacted by shedding a quick 20 points, then bounced back, as the analysts loudly defended.

Breaking News

Completely unmentioned by the analyst community, is a **2nd suit about VITAS billing practices that is equally if not more damaging to the company.** **Unsealed on May 6th** is the Gonzales vs VITAS suit.
[LINK to Gonzales Qui Tam case].

What makes this immediately newsworthy is that it is a qui tam suit, filed in Los Angeles, which is VITAS 's largest base of operations, is now **joined** by Department of Justice. This government action, taken in only 18% of such filed cases, means the US Government takes over prosecution, and shares any financial recoveries with the plaintiff. Here is the order as filed:

IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION

UNITED STATES OF AMERICA,)
ex rel. CHARLES GONZALES,)

Plaintiffs,)
v.)

Case No. 13-0344-CV-W-BP
FILED UNDER SEAL

VITAS HEALTHCARE CORPORATION,)
a Florida corporation; and)
VITAS HEALTHCARE CORPORATION)
OF CALIFORNIA, a California corporation,)
Defendants.)

ORDER REGARDING THE UNITED STATES OF AMERICA'S NOTICE OF ELECTION TO INTERVENE

The United States of America having intervened in this action pursuant to the False Claims Act, 31 U.S.C. § 3730(b)(4), the Court hereby orders as follows:

1. The relator's Complaint(s), the United States America's Notice of Election to Intervene, and this Order shall be unsealed;

2. All other documents previously filed with the Court in this case shall remain under seal and not be made public or served upon the defendants, except as previously ordered by this Court; and

3. Documents filed in this case after the date of this Order shall not be sealed.

IT IS SO ORDERED.
This 6th day of May, 2013.

/s/ Beth Phillips
BETH PHILLIPS
United States District Judge
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What is significant here is twofold: The scope of the revealed misdeeds of the company, and the fact that the US Government, having already progressed in its investigation of its own suit, quickly and decisively steps into the driver's seat.

Overview of the US Government Suit

The Department of Justice suit alleges that Chemed's VITAS division (which provides the hospice care) has been systematically defrauding Medicare for years. **Two** primary systemic fraudulent acts, alleged to be orchestrated at the corporate level, stand out clearly in the suit claims and plentiful supporting details.

1. Enrolling patients in hospice who are not in fact at end-of-life, then billing and collecting for services not provided, or services provided to patients who don't need them and don't qualify for them … while encouraging employees to lie about the patient's condition, and failing to train employees in proper patient qualifications for enrollment in hospice care.

2. Enrolling hospice patients in "critical care" categories, allowing them to bill dramatically larger daily amounts (up to 8 hours of daily in-home nursing care, meant for extreme medical crises) This windfall revenue is based on falsified patient categorizations, pushed by corporate demands that management maintain quotas of such patient statuses.

In the government case, point 2, the overuse of "critical care" status, is detailed first. This billing category contributes appx 14% of Chemed's gross margin. The over-enrollment issue, which is the primary driver of the company's topline revenue, is further down.

The heart of the matter is that to qualify for hospice benefits, the patient is required to be medically certified to be diagnosed as terminal within six months. Hospice care benefits are designed for not for pain management or other chronic care conditions; they are **specifically** reserved for the dying.

The Gonzales Suit

Meanwhile, a whistleblower suit filed by Dr. Charles Gonzales, a physician employed by VITAS from 2004 to 2011, vs VITAS and VITAS California, in Los Angeles is brought to readers' urgent attention. This suit has been under seal, and was only made public by virtue of government order on May 6th, upon the government Election to Intervene.

Here are some critical passages from the Gonzales suit:

> "Over the past decade, VITAS Los Angeles has submitted thousands of false certifications of hospice eligibility to Medicare for patients in Los Angeles"
>
> "If a patient no longer qualifies for hospice, the team managers would fabricate a rationale for keeping the patient on hospice or instruct the team doctors to do so."
>
> "As a result of these practices, many of VITAS Los Angeles patients remain on hospice for years, with little or no decline in health and requiring little in resources from VITAS ."

So what Gonzales vs VITAS exposes is:

- The prevalence of issue 2. from the Department of Justice case: overenrolling hospice from 2004 to 2011, a span in which VITAS billed Medicare for **several billions** for hospice services.

- Evidence of complicity of top management in VITAS largest operating unit in a pattern of overenrollment. Despite hospice care having been intended to provide for care during the last six months of life, the average of the patients detailed in the Gonzales case is two years seven months.

The US Government election to Intervene in Gonzales vs VITAS is **highly material to Chemed**, and should have been immediately disclosed by the company in an 8-K filing.   What is newsworthy here is that it is Citron publishing this information, rather than appropriate company disclosure.

The Lessons of History

Citron is very familiar with the effects of systemic Medicare fraud on a publicly traded company. In August 2008, Citron described a pervasive and systemic Medicare overbilling scheme at Amedisys (NASDAQ:AMED).

Of course the company denied and the same Oppenheimer analyst vigorously defended the company and his $75 price target. (The stock was over 50 at the time.) Citron reported again in October 2009 on increasing scrutiny in Medicare reimbursement for home health care workers. But it wasn't until 2010 that the Dept of Justice moved on Amedisys, and the stock took its ride from 60 to the 20's where the company "defended it" by loudly proclaiming stock buybacks. Today it trades around 10. Citron now examines the consequences of Government regulators removing the punchbowl in a highly comparable scenario.

It is just part of the way Wall Street works that it falls to Citron to provide this type of information. The analyst community is systematically incapable of being a reliable source of real disclosure.

Impacts on Chemed

Citron is quite confident that in days to come, investors will hear that this lawsuit and the claims against the company are "materially insignificant". The Oppenheimer analyst has already dismissed the Department of Justice suit with a few company-provided hospice enrollment statistics. But, following the path of Amedisys, here is what will happen:

The increased scrutiny will force the company to carefully certify each hospice enrollee, which will **reduce** its intake rates and therefore **reduce its revenues**.

VITAS will be forced to systematically review every hospice enrollment, and promptly discharge every improper enrollee, **reducing revenues**.   It is Citron's opinion that this process is already underway.   And if it is not, it should be!

VITAS will be forced to modify its compensation policies to **reduce and/or eliminate incentive compensation and bonuses for soliciting patients with targeted lengths of stay**. It will be forced to consent to ceasing to compensate nursing homes based on volume and exclusivity.

The regulatory scrutiny and an open investigation will chill the enthusiasm of its referral network of physicians, nursing homes, and other health care providers. There is simply no reason to refer patients to an agency under the dark cloud of a Department of Justice investigation – especially if any questionable inducements for enrollment have been offered.

The elimination of improper enrollees, plus the reduction in the percentage of enrollees who receive critical care services, will reduce the **company's operating margins**.

The fact is, this investigation is the "tip of the spear" of the US Government acting to curb Medicare fraud in the hospice industry specifically. The following articles are just two of many, detailing the system-wide effects of increased regulatory scrutiny.

"In the wake of an ongoing federal audit and an internal investigation, the nonprofit hospice's patient load has dropped by hundreds as it targets its services more tightly to only those within the six-month window.

Across the country, hospices with generous admissions policies may find themselves on life support too. Medicare, which heavily funds hospice programs, is cracking down on the industry's growing habit of embracing those whose deaths aren't imminent.."

'"We're facing a time of much more extraordinary focus on guidelines and regulations," said Kathleen Pacurar, president and CEO of San Diego Hospice, who's had to cut her staff by about 30 percent.'

http://www.kaiserhealthnews.org/Stories/2013/January/16/san-diego-hospice.aspx

From Forbes:

" Medicare is focusing on abuses. And make no mistake, those concerns are real when it comes to the $14 billion hospice business. Providers have figured out clever ways to game Medicare, which pays for 84 percent of all hospice care. One big one: enrolling patients who are not terminally ill, or at least not likely to die within the six-month window Medicare requires."

http://www.forbes.com/sites/howardgleckman/2013/01/18/learning-the-right-lessons-from-hospice/

In fact, the Department of Justice is in the midst of a major initiative to curb this type of fraud. The Government may move slowly, but when it moves it moves decisively, and the industry is forced to

adapt. See this OIG report from 2011, "Medicare Hospices That Focus on Nursing Facility Residents" (note the report's special emphasis on for-profit agencies delivering a high percentage of services into nursing homes :

" The Office of Inspector General (OIG) has recently raised a number of concerns about Medicare hospice care for nursing facility residents. OIG found that 31 percent of Medicare hospice beneficiaries resided in nursing facilities in 2006 and that 82 percent of hospice claims for these beneficiaries did not meet Medicare coverage requirements."

"Some hospices may be seeking out beneficiaries with particular characteristics, including those with conditions associated with longer but less complex care. Such beneficiaries are often found in nursing facilities. By serving these beneficiaries for longer periods, the hospices receive more Medicare payments per beneficiary, which can contribute to higher profits. "

"As the growth in Medicare spending on hospice care for nursing facility residents continues, special attention should be paid to hospices that depend heavily on nursing facility residents. OIG plans to look at the marketing practices of these hospices and their relationships with nursing facilities."

So the Office of Inspector General has told you exactly what the US Government investigators were going to do, and now they're doing it. And their poster child is Chemed's VITAS unit.

What do the Analysts Do?

Oppenheimer wrote a note defending the stock from the DoJ suit. He admits the likelihood of a "settlement forced on the company", and claims to project that the cost won't dent the company's coffers. But just a few things he leaves out:

- **He fails to mention the suit not only claims overenrollment in crisis-care, but the far more financially impactful overenrollment in hospice care itself.**
- **He fails to mention the Gonzales case, or the US Government qui tam Intervention in the case.**
- **He fails to mention that False Claims Act cases carry the sanction of treble damages for all amounts billed to the Government fraudulently.**
- **He fails to mention that the impacts of this litigation within the context of the OIG bringing hospice care billing practices within a more careful regulatory scheme, which will dramatically and negatively impact <u>both</u> gross revenues and margins at Chemed.**

Where is this Stock Going?

The analysts targets 91 targets are predicated on a 16x EPS for this stock and revenue growth projecting into the future. The reality is that as margins compress, this stock, would be headed towards a 10x EPS to align with every other player in the home health services cohort. But that is without considering the litigation risk.

The nature of the False Claims Act, under which these suits are filed, allows the US Government to collect **treble damages** for all fraudulently and improperly billed amounts to the US Government. This law includes the qui tam provision under which the Gonzales case has been consolidated.

Left for Government prosecutors is to assess how widely the systemic abuses detailed in Los Angeles and San Antonio by VITAS personnel appear nationwide. This will create enormous pressure on Chemed to settle under onerous circumstances. The "tens of millions" quote from the Oppenheimer Analyst may well turn out to have been wildly optimistic. The fact is, given both the timespan of the fraud, and their systemic nature, the actual liability here could easily be calculated into the hundreds of millions.

Balance Sheet Imbalance

Chemed's balance sheet is not a sign of encouragement. The company has 177 million of long term debt, and another 38 million of "deferred compensation liabilities". It posts $465 million of "Goodwill", which will be highly impaired by the removal of the punchbowl in the for-profit hospice business.

Chemed operates only one other business besides VITAS which is Roto Rooter, responsible for appx 26% of the company's revenue. This company is riddled with its own problems, including class action suits alleging fraudulent sales activities, misrepresentations to consumers, plumbing services provided by unlicensed personnel, and a variety of compensation abuses against its licensees. The management of Roto Rooter only tends to confirm management's approach to operations. In brief, Chemed is primarily exposed in the VITAS litigation and regulation initiative, and Roto Rooter will not prevent the stock from going down the drain.

Conclusion

It is Citron's opinion that Chemed is unavoidably headed for the teens. In every way, from the discovery of Medicare billing fraud, to the need to systemically reform its corporate management and billing practices, to the draining of margins in its mainline business, and the systemic changes in the industry, its diagnosis is terminal.

Citron will continue to monitor breaking developments in this story.