

Salem Partners – Healthcare Industry Review

Introduction

Q3 2009

Dear Friends,

We are pleased to share Salem Partners' Healthcare Industry Review with you for the third quarter of 2009. The third and fourth quarters are proving to be very opportunistic for those with available cash, but many challenges still exist for those companies trying to manage growth through internal drug development and/ or business expansion.

During the past quarter, segments that provide products and services which add to the efficient delivery of healthcare, such as healthcare IT and diagnostics, have enjoyed increased transactional activity. The investment thesis is simple: improve results, reduce costs. Conversely, those with closer exposure to reimbursement, such as physician related services, are experiencing an intensified level of scrutiny thanks to the murky outlook provided by the federal government as it tackles healthcare reform.

Overall, M&A activity remains resilient in healthcare and life sciences with several high profile transactions announced across the various sub-sectors. A continuing rally in the equity markets and several IPOs signify that capital is becoming more readily available to finance growth and development. Nonetheless, capital remains constrained compared to 2006-2008 levels and companies must analyze all options when searching for growth and venture capital.

Salem Partners is also pleased to announce the closing of a \$29 million financing for Neos Therapeutics, a specialty pharma company based in Dallas and Chicago. Salem Partners was the exclusive placement agent for Neos and arranged a syndicate of investors which included leading institutions and industry veteran executives who participated in the financing individually. We welcome the opportunity to speak to you about our firm and the services we provide to our clients.

Sincerely,



John Dyett
Managing Director



Sean Walker
Managing Director

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HIGHLIGHTS

❖ *Struggling for Consensus*

❖ *The Issues are Apparent, But the Solutions are Unknown*

The Issues for Reform



For years, the United States healthcare system has been under pressure for transformation. The current system has obvious problems: high cost, complexity, uneven quality, the uninsured and the underinsured, but the solutions remain more ambiguous. Proposed solutions are abundant but often come from varying political parties and are accompanied with very little agreement. The predicted outcome is largely unknown which could create new avenues of success for the opportunistic.

As the economic crisis subsides, the administration has been spending more time focusing on healthcare reform. President Obama has recently made significant efforts to help work out a solution. No one is quite sure how Obamacare will change things, but the areas of focus are well known:

Insurance Coverage – A nationalized insurance system seems highly unlikely at this point, however, the administration has indicated that a government sponsored insurance health insurance program could be a viable option for those without coverage. Uncertainty remains on how an added government program might change the current payer system, but we are likely to see the creation of new regulations and requirements on existing insurance providers to provide or subsidize a more economical coverage plan.

Healthcare Information Technology – Creating a standardized and adequate healthcare IT infrastructure should provide significant benefits in both reduced costs and improved quality. The primary effort in this area is creating electronic medical records in order to increase administrative efficiency and to avoid duplicate tests, improper treatments and medical errors. A \$20 billion stimulus package for healthcare IT was signed into affect this year, showcasing the opportunity for new development in the space.

Primary Care & Prevention - Preventable and uncontrolled chronic diseases are key drivers of healthcare costs and can be stopped with efficient and proactive primary care. Primary care physicians helping their patients to stop smoking, control their weight, and live healthy lives are an important element in reducing the future incidence of chronic disease.

Cost Reduction - Price cuts are the quickest way to reduce costs, but the savings are often temporary. Hospitals often cut prices through staff reduction, health plans reduce plan benefits, and pharmaceutical companies could cut R&D. These actions may have detrimental long-term effects if too much attention is paid to short-term cost reduction. The real opportunities exist in services and technologies that enable organizations to be more efficient and cost effective on a sustainable level.

Tort Reform - Malpractice liability continues to be a significant concern for healthcare providers. This issue appears to be more about posturing and less about actions. The lobbyist power in favor of current malpractice methods may prove to be too strong for a significant change. In dollar amounts, malpractice proves to be a liability to providers, but accounts than for just over 1% of national healthcare spending according to the CBO.

HIGHLIGHTS



Access to Capital

The Numbers

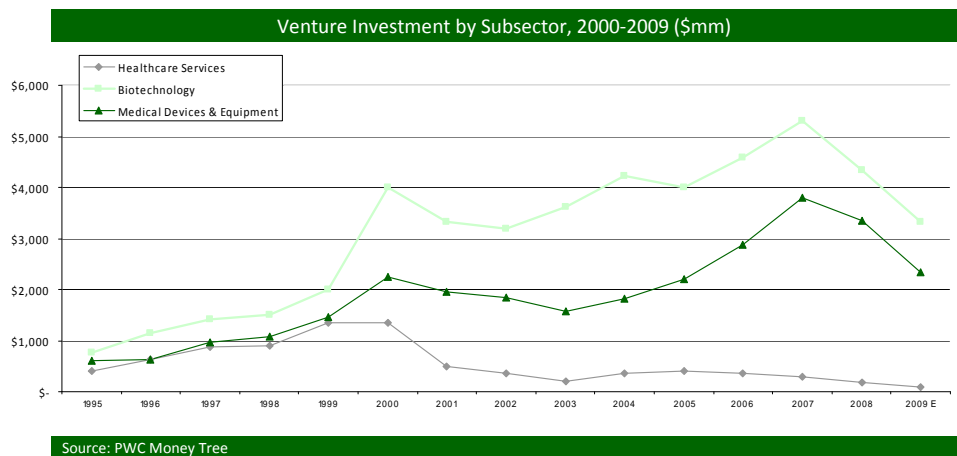
Venture capital totaled \$4.8 billion invested in 637 deals in the third quarter of 2009 (PWC Money Tree). That number increased when compared to the second quarter of the year when \$4.1 billion was invested in 657 deals. The current run-rate estimates a total 2009 invested amount to be roughly 58% of 2008 invested total. Healthcare and Life Sciences venture investing remains steadfast but is still estimated to decline by roughly 27% compared to 2008 levels.

Life Sciences continues to be the largest grossing industry sector for venture capital investment, the preferred way for emerging companies to raise capital. Both this past year and historically, biotechnology garners the most investment compared to other sectors. Since 1995, biotechnology has received over \$45 billion in fresh capital.

❖ *Venture Capitalists Show Activity*

❖ *2009 Venture Investing Dips to 2005 Levels*

❖ *IPO Market Shows Signs of Life*



Later Stage Investing

As firms seek to de-risk their portfolios, many venture capitalists are transitioning focus towards later stage investments. Companies with revenue and break-even bottom lines are gaining even more attention from the typical early-stage investor. This shift is causing the line between venture capital and growth equity to become increasingly blurry.

Cumberland Pharmaceuticals Raises Capital in Successful IPO

Cumberland Pharmaceuticals (CPIX) IPO was the first by a pharmaceutical company in nearly two years. On August 10th, the company offered 5 million shares of common stock, initially priced at \$17 per share, raising \$85 million. This was below earlier projections of \$19 to \$21 a share cited in the SEC filing.

Nashville-based Cumberland is a specialty pharmaceutical company. It markets Acetadote, an injectable compound for the treatment of acetaminophen poisoning. Acetaminophen is the pain-relieving, fever-reducing ingredient in Tylenol and other prescription and over-the-counter medications. Total sales of Acetadote in 2008 were \$25.4 million, of which, \$24.3 million were to hospitals, according to the prospectus.



Growth in Ambulatory

HIGHLIGHTS

- ❖ *Strong Growth in ASCs*

- ❖ *Better Care for Less*

- ❖ *More Bang for the Tax Payer Buck*

- ❖ *Growth in Pain Management Due to Newly Approved Services*

The number of Medicare-certified ambulatory surgical centers (ASC) has grown at a CAGR of 7.3% from 2000-2007, with Medicare payments to ASCs increasing by an average of 11.4%. During that same period, hospital outpatient departments (HOPD) grew by 6.9% on average in terms of Medicare spending (MedPAC, 2008). The large growth rates shown in ASCs have alarmed those in charge of budgeting for Medicare spending. This has resulted in an administrative focus on ASCs and decreased reimbursement rates. Despite this scrutiny, overall growth continues.

Cheaper, Better, Faster

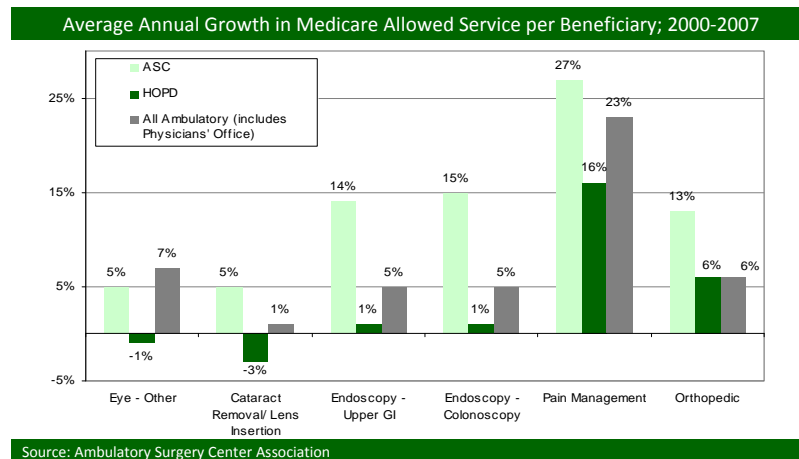
Increased use of ASCs could benefit both patients and providers. According to MedPAC, ASCs often offer more convenient locations, shorter waiting times, and easier scheduling for patients. Beneficiary coinsurance amounts are lower for services provided in ASCs as compared to HOPDs as are Medicare program payments for the same services. Consequently, with better care to the patient at a lower cost to the provider, surgical volume should continue the transition to ASCs from HOPDs as the procedures continue to be less expensive while providing better care.

Changes in Reimbursement

Moving volume to ASCs from HOPDs will result in future saving to the Medicare program as reimbursement for ASC procedures are lower than that of HOPD procedures. In 2008, Centers for Medicare and Medicaid Services (CMS) revised its Medicare payment system for ASCs. The new system reduced payments for many high volume ASC services, while increasing payments for other services. This change resulted in about 800 more procedures being covered in ASCs. According to MedPAC, the new payment system and other changes are expected to result in ASCs receiving an average of 59% of HOPD payment rates in 2009, a significant reduction from prior levels.

Cost Savings to Drive Volume

These changes in ASC payment rates should continue to drive volume growth to ASCs and lead to overall growth in ASC revenue. Conversely, as ASCs outpace HOPD in volume of procedures, it will lead to decreased spending by Medicare and Medicaid by at least 40% per procedure.



HIGHLIGHTS

- ❖ *Outsourcing the Supply Chain Provides Flexibility and Efficiency*
- ❖ *Contract Manufacturers Can Act Quickly to Change*
- ❖ *Large Sales & Distribution Partners Can Penetrate the Market Quickly*



Life Sciences: Managing the Supply Chain



The life science sector is not typically known for its supply chain management. Pharmaceutical and medical device companies tend to focus on more apparent growth factors, such as product development and market share. However, it has become even more of a challenge for a start-up company to fund a full size manufacturing scale up, build a sales force and form a distribution channel in order to fully integrate the supply chain. The capital requirements have become exponentially more difficult to obtain in the current economic climatic. This results in an even greater reliance on building a competent outsourced supply chain that can handle the demands needed of emerging pharmaceutical and medical device companies.

Getting the Most from a Contract Manufacturer

In order to fully manage the product lifecycle, a contract manufacturer must be able to react quickly to significant variables in demand. The latest supply chain management programs from companies like SAP and Oracle provide a fully integrated model to better equip each party to respond timely to changes in demand. An efficient contract manufacturer relationship must go beyond the traditional practice and become a fully integrated relationship with the drug or device company. This can be achieved through various techniques such as rapid technology transfers, engineering change processes, increased quality management and conforming knowledge with all aspects of supply chain.

The Benefits of a Distribution Partner

The benefits from having a larger partner to handle sales and distribution are twofold. Outsourcing sales and distribution provides significant cost reduction in forming a national or worldwide sales force; which would require new staffing, training and significant costs that all occur pre-revenue. A broad reach distribution partner can also provide rapid deployment and market penetration. The distribution partner receives a fresh technology to help stimulate sales in return, and new product enables each salesman to enter every hospital and doctors' office with a purpose to help sell the existing suite of products.

The effects of properly outsourcing the supply chain of a new product for an early stage company can severely alter overall performance. A competent contract manufacturer and distribution partner not only result in immediate pre-revenue cost savings, but also bring a well of knowledge to increase the speed and success of new product commercialization.

Salem Partners Transaction Highlight

Neos Therapeutics Raises \$29 Million – Neos Therapeutics is a specialty pharmaceutical company focused on the development, manufacture and sale of FDA-approved drug products. Neos will use the newly raised capital to fund development and clinical trials for sustained release liquid drugs using its proprietary DTRS™ technology.

Salem Partners worked closely with the company as the exclusive financial advisor and placement agent. The investor syndicate in Neos includes leading institutional investors as well as pharma industry veterans who participated in the financing individually.

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HIGHLIGHTS

❖ *Brand Drugs Coming Off-Patent*

❖ *\$60 billion of Brand Revenue will be Taken Generic*

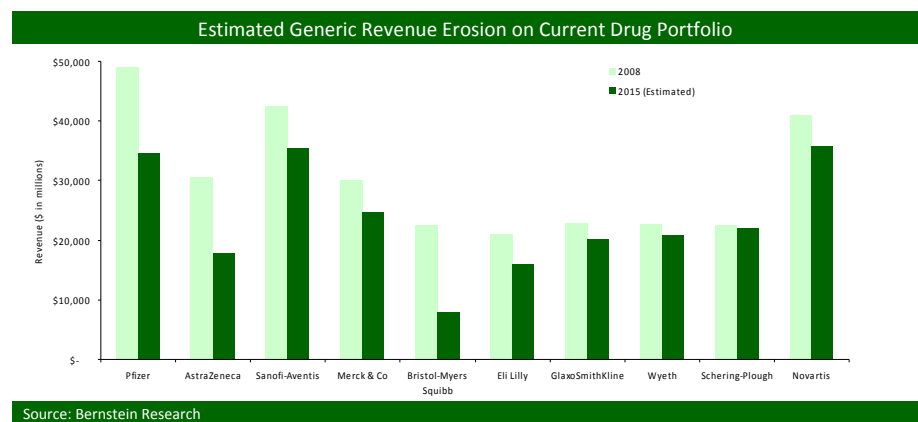
❖ *Large Pharma is Turning to M&A to Stock Pipeline*

The Pipeline Problem



Big Pharma Faces Generics

In the coming years, big pharma will continue to face an uphill battle. The growth of newly approved drugs has slowed drastically and current drugs are continually coming off patent. The effect is a steady decrease in revenue as newly approved drugs fail to account for losses in big name brand drugs. More than \$60 billion of brand name drugs will go off patent over the next decade, enabling growth to accelerate in the generic market. The chart below illustrates the decline in future revenue on current drug portfolios for some of the top companies in the industry.



The Late Stage Pipeline Problem

While there has been steady and encouraging growth in preclinical drug candidates, the near term outlook on Phase III drugs is alarming. While pharmaceutical R&D must be long-term in its nature, there is an inevitable need for short term successes to maintain at least a steady revenue level.

In order to achieve the necessary short-term results, cash-rich pharma companies have turned to M&A in order to stock their pipeline with promising late-stage drug candidates. The average top 20 pharma company has access to \$7.5 billion in cash; Pfizer has \$25 billion (Datamonitor). Big pharma has been very active in the past year, acquiring companies with promising therapeutics and devices across a breadth of therapy areas. Mergers, acquisitions and licensing deals have long been prominent within life sciences, but with liquidity issues for emerging companies and pipeline troubles for big pharma, deal volume is likely to keep increasing.

Eli Lilly acquired ImClone for \$6.5 billion, getting three late-stage oncology programs and the blockbuster cancer drug Erbitux.

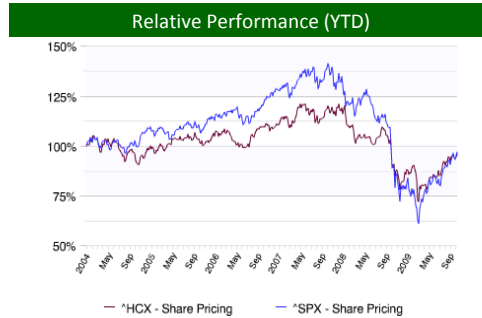
Bristol-Myers Squibb bought Kosan Biosciences for \$191 million which provided a valuable pipeline of anticancer compounds.

Pfizer acquired Encysive Pharmaceuticals for \$200 million, receiving the pulmonary arterial hypertension drug Thelin, which is still awaiting approval by the FDA.

HIGHLIGHTS

- ❖ The S&P Healthcare Index continues to trade in line with the broader market index.

Capital Markets

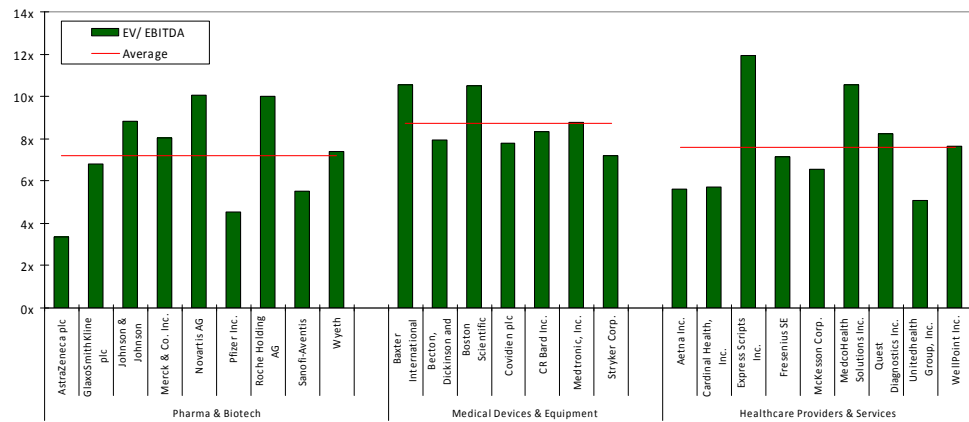


Source: Analyst Research



Source: Analyst Research

Enterprise Value by Subsector



Source: Analyst Research

Select Healthcare/ Life Sciences M&A Activity

Announced/ Filing Date	Status	Target	Acquirer	Transaction Value (\$mm)	Implied Enterprise Value (\$mm)	EV/ Revenue	EV/ EBITDA
9/26/2009	Pending	Solvay Pharmaceuticals S.A.	Abbott Laboratories (NYSE:ABT)	\$5,200	\$5,200	1.9x	-
9/3/2009	Pending	Sepracor, Inc. (NasdaqGS:SEPR)	Dainippon Sumitomo Pharma Co., Ltd.	2,857	2,354	1.8x	7.7x
8/24/2009	Pending	Procter & Gamble, Global Pharmaceuticals	Warner Chilcott plc (NasdaqGS:WCRX)	3,100	3,100	1.3x	1.3x
7/29/2009	Closed	Merial Limited	Sanofi-Aventis (ENXTPA:SAN)	4,000	8,000	2.9x	-
7/22/2009	Closed	Medarex, Inc. (NasdaqGM:MEDX)	Bristol-Myers Squibb Co. (NYSE:BMJ)	2,325	2,031	NM	-
6/17/2009	Pending	HLTH Corporation (NasdaqGS:HLTH)	WebMD Health Corp. (NasdaqGS:WBMD)	1,958	1,406	3.6x	34.8x
6/16/2009	Pending	Arrow Group Ltd.	Watson Pharmaceuticals Inc. (NYSE:WPI)	1,944	1,944	3.0x	-
5/7/2009	Closed	Vnus Medical Technologies Inc.	Covidien plc (NYSE:COV)	470	396	3.7x	21.8x
4/20/2009	Closed	Stiefel Laboratories, Inc.	GlaxoSmithKline plc (LSE:GSK)	3,600	3,600	4.0x	-
4/15/2009	Closed	BiPar Sciences, Inc.	Sanofi-Aventis (ENXTPA:SAN)	500	500	-	-
3/8/2009	Pending	Schering-Plough Corporation (NYSE:SGP)	Merck & Co. Inc. (NYSE:MRK)	50,744	47,366	2.6x	9.9x
2/20/2009	Closed	Ventor Technologies, Ltd.	Medtronic, Inc. (NYSE:MDT)	325	325	-	-
1/25/2009	Pending	Wyeth (NYSE:WYE)	Pfizer Inc. (NYSE:PFE)	78,564	64,019	2.8x	8.1x
1/12/2009	Closed	Ablation Frontiers, Inc.	Medtronic, Inc. (NYSE:MDT)	235	235	-	-
1/11/2009	Closed	Advanced Medical Optics Inc.	Abbott Laboratories (NYSE:ABT)	2,770	2,719	2.3x	10.1x

Source: Analyst Research

*Figures as of 9/30/09



John Dyett
Managing Director
(310) 806 – 4206
jdyett@salempartners.com



Sean Walker
Managing Director
(310) 806 – 4215
swalker@salempartners.com



Caleb Smith
Associate
(310) 806 – 4205
csmith@salempartners.com



Erik Einwalter
Analyst
(310) 806 – 4211
eeinwalter@salempartners.com

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