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Metropolitan Health Networks (ASE/MDF)

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BUY Q1 Earnings surprise sets stage for 2010; Raising Price Target

Metropolitan Health provides Medicare HMO medical services

Investment Highlights

1) Metropolitan Health reported very strong earnings for their Q1/2010 this morning, earning \$0.18 per share versus \$0.09 one year ago on revenues of \$93.0 million, up 3% year-over-year. Revenue growth was split evenly between an increase in total customer months of 1.1% (concurrent with an increase of 1.4% in Medicare Advantage customers under coverage) and a similar 1.7% increase in average premium per member, as improved risk scores countered Medicare reimbursement rate decreases. Our estimates had been revenues of \$87.0 million (representing a 4% decrease year-over-year) and earnings per share of \$0.05. The main difference in actual and projected results, however, came from a large drop in the medical expense ratio in Q1/2010, to 81.7% from 87.9% in the prior year period and 84.9% in the prior quarter, fueled by a decrease in average per member medical costs to \$713 from \$754. These costs fell due to a number of factors, including improved utilization, a decrease in certain plan benefits allowed by Humana, and an elimination of certain types of expensive medical plans. The drop in medical costs more than offset increases in other costs, including administrative payroll, marketing and general and administrative expenses, although some of these increased costs were a result of planned infrastructure put in place to support the new Patient-Centered Medical Home model. Combined with a lower share count and slightly lower effective tax rates, net income and earnings per share were able to significantly exceed last year's totals and our estimates for this year. Membership under contract fell slightly to 35,400 from 35,500 at the start of 2010.

2) Again Metropolitan management did not provide specific financial guidance for the upcoming year, although they did mention in the press release that although first quarter does not make a trend, the Company is well positioned for the rest of this year and even into next, before the 4-year phase-in of the next round of Medicare HMO rate cuts is set to begin in 2012. Keeping in mind the better-than-expected results for Q1/2010, we are thus increasing our estimates for Metropolitan to

Current Price \$3.26

Price Target \$5.00

Estimates	F2008A	F2009A	F2010E
Sales (\$mil)	\$317.2	\$354.4	\$367.0
1Q	76.0	90.4	93.0 A
2Q	82.2	87.1	90.0 E
3Q	78.9	88.1	91.5 E
4Q	80.0	88.8	92.5 E
Prev. Rev. Estimate (\$ mil.)			\$352.2

EPS(ProForma)	\$0.20	\$0.31	\$0.40
1Q	(0.01)	0.09	0.17 A
2Q	0.07	0.07	0.07 E
3Q	0.08	0.05	0.07 E
4Q	0.05	0.11	0.09 E
Previous EPS Estimate			\$0.25
P/E (x)	16.5	10.4	8.2

EBITDA/Share	\$0.25	\$0.50	\$0.97
EV/EBITDA (x)	10.1	5.0	2.6

Stock Data	
52-Week Range	\$1.65-\$3.95
Shares Outstanding (mil.)	39.8
Market Capitalization (mil.)	\$129.7
Enterprise Value (mil.)	\$99.4
Debt to Capital (3/10)	1.5%
Book Value/Share (3/10)	\$1.17
Price/Book	2.8 x
Average Trading Volume (10-Day)	150,000
Insider Ownership	31.2%
Institutional Ownership	30.6%
Short interest (Million)	1.22
Dividend / Yield	\$0.00/0.0%



Price target and ratings changes over the past 3 years:
Initiated - August 25, 2009 – Target \$3.25
Price Target increased on May 4, 2010 to \$5.00

revenues of \$367.0 million for 2010, up 4% from 2009, and earnings per share to \$0.40, representing a nice jump from EPS of \$0.31 for 2009. Our estimates had been revenues of \$352.5 million, essentially flat year-over-year, and earnings of \$0.25 per share. Wild cards for the remainder of this year for Metropolitan include additional share buybacks (the Company has over 5 million shares remaining under their current authorization) and potential acquisitions, an area where Metropolitan has been quiet since the 2008 presidential election.

3) Cash flow from operations was positive for Metropolitan for the quarter, coming in at an estimated \$7.5-\$8 million, although much of this amount was used to repurchase shares or remains a receivable due from Humana, which historically distributes cash after the second quarter of the year following a mid-year Medicare risk adjustment analysis. At the end of March, Metropolitan had \$30.3 million in cash on hand, plus an additional \$4.7 million held in restricted reserves, offset by less than \$1 million in long-term debt. We estimate that the Company could finish its share re-purchase program in 2010 using its operating cash flow estimated for the remainder of the year plus the receivable amount due from Humana. Alternatively, Metropolitan could once again delve into the acquisition arena, especially targeting physician-owned or managed care plans or network providers.

Conclusion/Stock Valuation

Metropolitan Health can be compared with a large group of other managed care companies, including some large national and some smaller regional players. These include large national HMOs with some operations in Florida such as Humana, United Healthcare, WellCare, Coventry Health; other larger HMOs including WellPoint (NYSE/WLP/NR), Healthnet (NYSE/HNT/NR) and HealthSpring; Medicaid-oriented HMOs such as Amerigroup (NYSE/AGP/NR), Centene (NYSE/CNC/NR), and Molina Healthcare (NYSE/MOH/NR); and several other managed care service providers including CorVel (Nasdaq/CRVL/NR), HMS Holding (Nasdaq/HMSY/NR) and Continucare (ASE/CNU/NR). Perhaps due to its smaller size or only recent simplification to a pure network service provider, MetCare's shares currently trade at a discount to our list of thirteen comparable managed care firms, ranging from 30% to 50%, based on price/earnings ratios for 2009 actual and 2010 estimated and price/revenues ratio for 2010 estimated. What's more, average valuation multiples for those firms which do not contract directly with State and Federal programs but rather with private HMOs such as CorVel, HMS Holding and Continucare, are generally much higher than those of the larger, more mature HMOs. While shares of MDF have gained over the past twelve months, especially with the recent removal of the double whammy of uncertain management progression and murky reimbursement environment, share prices of similar healthcare service firms have rebounded as well, maintaining Metropolitan's discount. Therefore, we are maintaining our BUY rating on MDF shares and increasing our 12-18 month price target from the original \$3.25 to \$5.00, still just 13x this year's estimated earnings, believing that value-oriented investors will continue to be rewarded by shares in this company with a strong balance sheet, innovative services, and solid earnings track record.

Risk Factors

We believe an investment in Metropolitan Health Networks involves the following risks:

- **Concentration of revenues** – With the 2008 sale of its HMO division, Metropolitan now derives nearly all of its revenues from Humana. Metropolitan has a long-standing relationship with Humana, however, and recently signed a number of new service agreements with the Florida division of the Louisville-based firm. These include ones with new subsidiary CarePlus, the recently divested former AdvantageCare members, and new geographic areas in Florida to help with Humana's new MD Medicare Choice members, among other purposes. Therefore, we believe that Humana is more likely to expand its relationship with the Company in the future than to decrease it, thus ensuring continuing growth for Metropolitan.

- **Reliance on government funding** — Metropolitan derives a majority of its revenues from Federal (CMS) reimbursement of the costs of providing services to Humana's HMO membership. While Federal Medicare reimbursement for HMO members has been steadily rising in recent years, anticipated decreases in federal spending for Medicare programs this year of 4%-5% could squeeze margins for medical service providers such as Metropolitan. In recent years, payments under the Medicare Risk Adjustment (MRA) system have become increasingly important to earnings growth, and these are difficult to predict on a quarterly basis (leading to quarterly EPS fluctuations) and this program is scheduled to be phased out in 2011.

Metropolitan Health Networks
Consolidated Statements of Operations
 (in \$000, except EPS)

Robert M. Wasserman

Calendar Year	2002	2003	2004	2005	2006	2007	2008	1Q09 (March)	2Q09 (June)	3Q09 (Sept)	4Q09 (Dec)	2009	1Q10 (March)	2Q10E (June)	3Q10E (Sept)	4Q10E (Dec)	2010E
Revenues	140,064	143,874	158,070	183,765	228,216	277,577	317,212	90,441	87,076	88,138	88,752	354,407	93,042	90,000	91,500	92,500	367,042
Operating expenses:																	
Medical claims expense	133,587	121,010	129,179	154,784	194,839	229,427	267,983	75,921	74,625	76,929	71,565	299,040	72,048	75,600	77,300	76,800	301,748
Payroll expenses	7,699	7,847															
Medical center costs	1,913	2,127															
Other medical costs			8,577	10,346	10,601	11,269	12,807	3,585	3,554	3,582	3,791	14,512	3,984	3,960	3,930	3,980	15,854
Depreciation and amort	946	655															
Admin payroll			4,394	6,867	11,511	13,068	12,537	2,709	2,452	2,252	3,873	11,287	3,779	3,690	3,750	3,790	15,009
Marketing and advertising			139	2,754	3,710	3,959	1,865	39	45	119	156	359	137	160	185	210	692
General and admin	6,816	5,024	4,112	5,781	7,789	11,199	9,754	1,826	1,742	1,864	2,132	7,564	1,959	2,250	2,290	2,310	8,809
Total	150,962	136,663	146,402	180,533	228,449	268,922	304,946	84,080	82,417	84,747	81,517	332,761	81,906	85,660	87,455	87,090	342,111
Income before other	(10,898)	7,211	11,668	3,232	(233)	8,655	12,266	6,361	4,659	3,392	7,235	21,646	11,136	4,340	4,045	5,410	24,931
Other income (expense)	(2,968)	(1,350)	(183)	617	1,058	1,369	78	235	30	80	22	367	193	200	210	220	823
Disc Oper & restructuring	(3,215)	(1,460)	(42)	1	0	(583)	4,275	0	445	366	525	1,336	62	0	0	0	62
Pre-tax income	(17,081)	4,402	11,442	3,850	826	9,441	16,619	6,596	5,134	3,838	7,782	23,349	11,391	4,540	4,255	5,630	25,816
Income taxes	0	0	(7,380)	1,468	353	3,527	6,414	2,561	1,982	1,412	2,945	8,900	4,262	1,730	1,620	2,140	9,752
Net income	(17,081)	4,402	18,823	2,382	473	5,914	10,205	4,034	3,152	2,426	4,837	14,449	7,129	2,810	2,635	3,490	16,064
EPS	(\$0.56)	\$0.13	\$0.42	\$0.05	\$0.01	\$0.11	\$0.20	\$0.09	\$0.07	\$0.05	\$0.11	\$0.31	\$0.17	\$0.07	\$0.07	\$0.09	\$0.40
Shares outstanding	30,375	34,750	44,919	51,007	51,696	52,127	51,587	47,116	47,600	45,500	43,600	45,954	40,800	39,800	40,000	40,200	40,200
Key Ratios:																	
Sales growth	9.3%	2.7%	9.9%	16.3%	24.2%	21.6%	14.3%	19.0%	5.9%	11.6%	10.9%	11.7%	2.9%	3.4%	3.8%	4.2%	3.6%
Direct medical/revenues	95.4%	84.1%	81.7%	84.2%	85.4%	82.7%	84.5%	83.9%	85.7%	87.3%	80.6%	84.4%	77.4%	84.0%	84.5%	83.0%	86.5%
Other medical/revenues			5.4%	5.6%	4.6%	4.1%	4.0%	4.0%	4.1%	4.1%	4.3%	4.1%	4.3%	4.4%	4.3%	4.3%	4.3%
Admin payroll/revenues			2.8%	3.7%	5.0%	4.7%	4.0%	3.0%	2.8%	2.6%	4.4%	3.2%	4.1%	4.1%	4.1%	4.1%	4.1%
Gen & admin/revenues	4.9%	3.5%	2.6%	3.1%	3.4%	4.0%	3.1%	2.0%	2.0%	2.1%	2.4%	2.1%	2.1%	2.5%	2.5%	2.5%	2.4%
Tax Rate	0.0%	0.0%	0.0%	38.1%	42.8%	37.4%	38.6%	38.8%	38.6%	36.8%	37.8%	38.1%	37.4%	38.0%	38.0%	38.0%	37.8%
Cash Flow/Share	-\$0.43	\$0.19	\$0.26	\$0.05	\$0.01	\$0.13	\$0.15	\$0.09	\$0.06	\$0.05	\$0.11	\$0.31	\$0.18	\$0.08	\$0.07	\$0.10	\$0.43
EBITDA/Share	-\$0.33	\$0.23	\$0.59	\$0.08	\$0.02	\$0.17	\$0.25	\$0.14	\$0.10	\$0.08	\$0.17	\$0.50	\$0.36	\$0.20	\$0.19	\$0.22	\$0.97

Quarterly Comparisons

Balance Sheets (in \$000s)	Quarterly Comparisons							
	12/31/09	3/31/10	(March)	June	(Sept)	(Dec)	Total	
Assets:			Revenues (in \$millions)					
Cash and investments	\$33,831	\$30,298	2002	\$34.4	\$36.2	\$34.6	\$34.8	\$140.1
Accounts receivable	517	8,179	2003	36.9	35.9	35.7	35.5	143.9
Inventory	216	243	2004	38.5	38.6	40.1	40.9	158.1
Other current	1,150	1,472	2005	45.5	46.2	45.0	47.1	183.8
Total current	35,715	40,192	2006	54.8	56.9	60.8	55.7	228.2
Property & equip, net	1,910	1,903	2007	68.1	69.9	69.6	69.9	277.6
Restricted cash	6,445	4,664	2008	76.0	82.2	78.9	80.0	317.2
Goodwill & other	7,263	7,121	2009	90.4	87.1	88.1	88.8	354.4
TOTAL ASSETS	51,332	53,880	2010E	93.0	90.0	91.5	92.5	367.0
Liabilities:			Earnings per Share					
Accounts payable	455	181	2002	\$0.01	(\$0.07)	(\$0.06)	(\$0.43)	(\$0.56)
Accrued expenses	7,235	6,326	2003	0.02	0.03	0.03	0.04	0.13
Other current	0	0	2004	0.03	0.08	0.08	0.21	0.42
Current portion of LTD	318	318	2005	0.02	0.03	0.01	(0.01)	0.05
Total current	8,009	6,826	2006	0.01	0.01	0.05	(0.05)	0.01
Long-term debt	398	398	2007	0.00	0.03	0.03	0.05	0.11
Stockholders' equity	42,926	46,657	2008	(0.01)	0.07	0.08	0.05	0.20
TOTAL LIAB. & EQ	51,332	53,880	2009	0.09	0.07	0.05	0.11	0.31
			2010E	0.17	0.07	0.07	0.09	0.40

Revenues by Segment (In \$millions)	2003	2004	2005	2006	2007	2008	2009	2010E
Revenues by Segment								
Provider Service Network	\$143.9	\$158.1	\$180.9	\$198.3	\$222.5	\$240.0	\$260.0	\$270.0
PSN membership (year-end)			26,200	25,600	25,400	33,000	35,500	36,000
HMO/New Humana	0.0	0.0	2.9	29.9	55.1	78.2	94.4	97.0
HMO membership (year-end)			1,400	3,800	6,200	0	0	0
Laboratory	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	\$143.9	\$158.1	\$183.8	\$228.2	\$277.6	\$318.2	\$354.4	\$367.0

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

Initiated - August 25, 2009 – Target \$3.25

Price Target increased on May 4, 2010 to \$5.00

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	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Buy	12	86%	6	50%
Neutral	2	14%	2	100%
Sell	0	0%	0	0%
Total	14	100%	8	57%

Information about valuation methods and risks can be found in the “CONCLUSION/STOCK VALUATION” and “RISKS” sections of this report.

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