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THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Providence Service Corporation (PRSC)

FLETCHER JAY MCCUSKER has served as Providence Service Corporation's Chairman of the Board of Directors and Chief Executive Officer since the company was founded in December 1996. Prior to founding the company, Mr. McCusker served as Executive Vice President of Youth Services International, Inc., a NASDAQ-listed company that provided private institutional care for at-risk youth, from July 1995 until December 1996. From September 1992 until July 1995, he served as Chief Executive Officer of Introspect Healthcare Corporation, a closely held multi-state behavioral health provider. In 1983, Mr. McCusker co-founded a mental healthcare company, Century healthcare, which was sold to New York Stock Exchange-listed Columbia Healthcare in 1992.

(TAC213) TWST: What's gone on over the past year at Providence that investors should focus on?

Mr. McCusker: It's a story of remarkable growth. We just filed our year-end and fourth quarter results, where we saw 80% growth in quarter over quarter revenue and 112% growth in profitability. The company has found itself in the right place at the right time, particularly as it relates to government initiatives.

TWST: What was the key to the strong growth last year?

Mr. McCusker: Client census is what drives our revenue; it's what drives profitability. Our census a year ago when we spoke was a little under 14,000 clients, and at year-end 2004, it's almost 30,000 clients. So we had nearly a 120% increase just in our daily census. That's really what's driven the company's growth. And correspondingly now, we have nearly 3,600 employees, which is more than twice as many as we had a year ago.

TWST: Where are these clients coming from? Is it in the expansion of services on your part?

Mr. McCusker: Much of it is pure organic growth. We currently have 312 government contracts and the majority of those all increased their business with us. We are eight years old now and still have never lost a government contract. So for the most part, our business has been 100% recurring and each year, when our contracts are renewed, we are asked to take on additional client population. We have done three acquisitions since our IPO in August 2003, which account for the remainder of our growth. But for the most part, it's just us trying to keep pace with the demand that is placed on our business model.

TWST: Is it that the government is expanding programs or are you gaining share, or both?

Mr. McCusker: Some of both. We still can't even measure our market share. We're in a $100 billion space and we represent maybe $250 million of that combined with our managed entities. So our share is still miniscule in terms of the total market, but we clearly have been the beneficiary of states rethinking how they spend their government dollars. A lot of our funds had not been newly allocated to us, but have been reallocated away from the institutional providers. Most states are still looking at those programs as expensive and not very successful and, for the most part, we've been the proven alternative to that kind of care. We've had some outcome studies released recently that really demonstrate not only the economic value of what we do, but the efficacy of our programs. We've seen continued interest in our home-based models, primarily from states that are suffering from a recessionary economy, while, at the same time, their enrollment of government beneficiaries has never been higher. So that's the combination of forces that really spearheaded our growth.

TWST: What's likely to happen as the economy recovers?

Mr. McCusker: It's been very interesting. A year ago when we spoke, we would not have been surprised to see some leveling off of the kind of benchmarks that drive our business. To the contrary, Medicaid enrollment has never been higher; it's now 49 million people, up from 42 million people just a year ago. In the President's budget released a few weeks ago, it was estimated that Medicaid enrollment will grow to over 50 million. Looking at levels of poverty in the US — approximately 13% of the American population lives below the federal guidelines for poverty and these are people who are categorically eligible for our services. In order to be eligible for our services in America, basically all you have to do is be poor and that population continues to grow. In spite of economic recovery, child protective service referrals have never been higher, adults on probation and parole have never been higher. So the demographics don't seem to be slowing down or leveling off to any degree.

That's particularly true in the Sun Belt and the in-migration states, states like California, Arizona, Florida, Texas and New Mexico, where a lot of people are migrating, and they're bringing their Medicaid eligibility and their problems with them. So the influx of these beneficiaries into the Sun Belt states have really driven their eligibility numbers up at a time when the dollars aren't necessarily following the clients. So a lot of the demands we've had and a lot of the growth that we've had has been in-migration in Sun Belt locations.

TWST: So even with the general decline we're seeing in the prison population, it hasn't hurt you?

Mr. McCusker: No, because the numbers are up in probation and parole and the correctional organizations are responsible for this population in their community. That number has grown to 4.8 million people now. Last year, it was 4.5 million. So you are seeing, as you suggested, a flattening of the institutionalized component of corrections, the incarcerated inmates, but you've seen an increase in the number that are in that community and of course, that's the business model that we enjoy. We've had ever increased demand in our correctional contracts to serve the people who are in community probation.

TWST: You mentioned the staff has doubled over the past year. Where are you getting qualified people?

Mr. McCusker: We still enjoy an employer's market in that regard. We get about 10 applicants for every job that we post. The majority of our staff is young. We require a Bachelor's level degree only to be an entry-level caseworker and a lot of our current staff recruits friends and colleagues. We're known for being an innovative company to work for. Our benefit package is pretty competitive, but moreover, we've been very generous with stock options. We've issued over 700,000 shares of options to our non-executive employees. We might be the only place in America where a social worker can help create financial security by being part of an emerging public company. So that's really allowed us to attract the cream of the crop in terms of the population and our turnover has also been very low. Last year, it was only 18% and we had 0% turnover at the executive and management level. So we are not constantly turning people over, and we do seem to have a steady influx of applicants.

TWST: Are you going to be able to continue with this? Do you have a stock program, given the accounting changes?

Mr. McCusker: We're expensing it now. In our forecast for 2005, we've got approximately $600,000 of expense identified as the cost of these options, and our Board has seen the wisdom to continue the program. Having hundreds of owners, who think like owners and are concerned about the company's performance and know that a lot of their financial security is tied up in their equity participation, has really made for a very productive company. So I think we'd be foolish to try to shave a few dollars off of our expenses by altering the option program. So certainly through 2005, we expect to continue to issue options to primarily our line and middle management staff.

TWST: If we look out over the next two years, what are the goals that you've set for the company?

Mr. McCusker: We're headed to double the business. We've grown remarkably. Our revenue, when we went public, was just over $50 million and it's now almost $100 million. Our managed side of our business has grown even more aggressively than that, to over $120 million for 2004. So we're looking at, in 2005, approaching $300 million of government-sponsored social services under our auspices, and we're fully anticipating we'll continue to grow. Our forecast is for about 35% growth next year in revenue. So we're dealing with the infrastructure support to handle our future growth.

We've just gone through our Sarbanes-Oxley Section 404 internal control assessment, which was an incredible process for a company our size. The good news is that we don't have any material weaknesses to report, even as decentralized as we are and as young as we are. So we are pretty comfortable with the systems, the infrastructure and the personnel to grow the business. Our targets are clearly within our sights, and I think it's what motivates us to respond to counties that have become our payor base.

TWST: What's the risk here? Can the government reverse what they are doing?

Mr. McCusker: Sure. The government's fickle, it's famous for changing its mind. We have built a company without any bricks and mortar expense because we always anticipated that the government would go one way this year and another way the next year. In our experience, if you have a lot of building expense and depreciation and amortization expense, when the government changes its mind, you're stuck with a white elephant facility. If you look at the psychiatric hospitals and the prisons, there are a lot of those littering the landscape that lost a contract and now they're stuck with a $6 million office building. So we're prepared to be as light-footed as need be.

The good news is we continue to be right in their sights as part of the solution to these issues — as opposed to part of the problem. But, if the federal government were to dismantle the program, it would take some catastrophic event to really harm our business model; some Congressional act or the discontinuance of Medicaid. One of the reasons we don't contract with the federal government and we're not a Medicare contractor is because Medicare has a history of policy change and providers have to react to a single bureaucratic change. We have 300 plus county contracts and we like that diversity. It's unlikely that all of our counties are going to simultaneous change their thinking in terms of how they view their delivery system. So we're not at risk for some single stroke of the pen to really harm the business. In the near term, certainly, through 2005, we don't see anything that would radically upset our business. But clearly, we are a government contractor and we really encourage our investor base to watch the trends, read the news, read the President's budget, and make sure that they understand how this service on behalf of this indigent population is going to play out in a time when the government is supporting both a war and a tax decrease.

So even though the country may be enjoying an economic recovery, the federal obligations and the population that we serve have never been bigger and, of course, the states are paying their fair share of that. So Medicaid is clearly a topical item. State governors have braced to argue with the President about his view of Medicaid's future and the role of the federal government.

There clearly are a number of trends that can affect our business, and we've designed the company to allow ourselves to adjust if they change — knock on wood. So far, we've been in the right place at the right time.

TWST: Given the success that you've had in this tremendous growth, what's to keep competition at bay?

Mr. McCusker: I don't think too many people are attracted to our margins. This is a 12% operating income business. It means you must be a lean corporation. If you look at the traditional healthcare providers, they spend an equivalent amount just supporting their corporate offices. So you can not look at our business like a 20% or 25% business model. You must run lean. In fact, our corporate office is seven people. You can't be a big corporation and really be attracted to this business. It's unlikely established companies would be interested in the margin aspects of what we do. Clearly, our incumbency is our biggest advantage. We have an eight-year track record of delivering social services. When we bid on a new proposal, we're able to use the experience other competitors don't have. Also remember, we're dealing with a very difficult population in their own home in very difficult communities — places like DC, South Chicago, South Phoenix, Richmond, Virginia, and rural Oklahoma, environments where a lot of providers have no interest in doing home-based care. So we still seem to have prime mover advantage in that regard and a competitive edge and at least our willingness to work at these reduced margins and our willingness to encounter a very difficult population in their own environment.

TWST: Given the growth rate, do you have the management depth that you need?

Mr. McCusker: We're pretty good there. Craig Norris was promoted last year to our Chief Operating Officer. He's young, in his late 30s. He's been with the company since we started. He's run a site. He's run a region. He ran our Eastern Division. Each state has its own state director. So we have 21 states now, each with its own executive and we've had zero turnover in that population. We really live or die by the talent of those operating people, as decentralized as we are, and we really view them as the president of their state. They have to be part contractor, part marketer, a clinician, a motivator, and everything that goes along with running your own business. So these are very entrepreneurial people, who like being part of a bigger effort. The model's working. We don't have a shortage of talent, although we have to add some people in the accounting side of our business to help deal with Sarbanes-Oxley compliance. We also have a full-time attorney on our staff now. We've made the decisions that we needed to a year ago, anticipating some of the regulatory changes, the accounting rules, just the complexities that it requires now to run a public company. So no, we are not really lacking for management or executive help anywhere.

TWST: As you grow this rapidly, how do you go about maintaining a consistent culture in the company?

Mr. McCusker: Most of that is done with a peer process. We rely on our state directors to influence the culture more than probably anybody; the monitoring we do from state to state is through this peer process. We'll have staff from Illinois go to Virginia, staff from Virginia go to Florida. Any time we start up a de novo project, we start it up with relocated or transferred staff. So when we opened in West Virginia last year, and we opened in Michigan, the people who opened those states were tenured employees with us. So they are really driving the culture. We really believe that there's very little a corporate office can do to influence a company culture. It really is a grassroots phenomenon. So we've gotten out of their way and allowed them to develop a best practice model where they're cross training each other in state-of-the-art social services through a peer review process that is a little competitive and encourages states to really work with one another on developing their model. It is incredible to watch. I have never been in an environment where there is so little corporate influence.

But remember, Sarbanes-Oxley is a fine-toothed comb. There are huge companies out there that are not compliant with Section 404 of Sarbanes-Oxley, that struggle with this and here we are operating in 150 locations, 21 distinctively different states, yet we have systems in place that provide that our internal controls are effective in accordance with Sarbanes-Oxley, which is just a remarkable thing when you think about it. I think our investors have always been concerned that we were just held together by a common name, and I think we've indicated that there are systems and oversight in place, and there are controls that would be required to meet the most onerous of public company requirements. We are thrilled that the model's working as well as it is.

TWST: Do you have the financial resources you need to support the growth?

Mr. McCusker: We do. We still have cash from our two offerings, our IPO in August 2003 and a follow on in May 2004. We also have significant credit facilities that had zero drawn on them at year end. So we've got a strong balance sheet. So we don't see any need for us to be back in the market with an equity proposition any time soon. The company plan and what we've announced publicly is that most of that cash goes toward our acquisition strategy, and we could leverage the company using the available credit to us before we'd see ourselves back in the market, providing us with flexibility. So we have a long way to go before we would need any additional capital. We are generating approximately $2 million a quarter in free cash flow too. Really, the only need for that cash is to support growth, particularly for the acquisition side of our business.

TWST: What are you looking for in terms of acquisitions?

Mr. McCusker: The three that we've done and the targets that we currently are in conversation with are typically small, they're $5 million kinds of businesses. We can buy them usually at 4 to 6 times trailing EBITDA, and the three that we've done since the IPO have been right at the high end of that range, right at 6 times trailing. The good news is we've been able to go into all three of those and expand them dramatically and we see wonderful opportunities for future expansion, making them very attractive financially for Providence. We have found ourselves targeting new geography; that's how we got into Indiana and how we got into Pennsylvania, that's how we got into California, acquiring an incumbent company and then leveraging off of their basic business into our expanded model. We've been very successful doing that. There are not a lot of companies with scale out there, so we are not going to show up with a $50 million book of business or $25 million book of business, but there are hundreds, literally, of these $2 million to $5 million operations that fit very nicely with us strategically. That's been our target.

TWST: Are these small acquisitions difficult to fit in?

Mr. McCusker: Not really. I have always told Craig that he has the veto over our acquisition activity as head of operations. If he tells me that we are having trouble integrating anything, then obviously we would slow down. But to the contrary, we have found them incredibly easy to integrate. They thrive in our culture, they have been for the most part very parochial, given their base of business, and we encourage them to expand into other services, into other counties, into other cities within their state. We have not lost a single executive who joined us through an acquisition, which is unheard of in my experience. Normally, you have a conqueror and conqueree kind of environment and somebody usually resigns or gets fired or leaves in that process, and we've had nothing like that. We've kept nearly every executive who we acquired and they seem to thrive in our environment. They're all capable of growing their businesses. We typically retire the seller, which is usually a proprietor, a psychologist or a social worker, and we are looking to their next-in-command to run the business, and that's really worked very well for us.

TWST: Is the market fairly valuing you at this point?

Mr. McCusker: We feel very comfortable with our valuation. Our current p/e is about 22 times to 25 times. There are some other companies in our space that enjoy a higher multiple. There are others that enjoy lower multiples. Generally the market does seem to be valuing us fairly. We really can't argue with the way investors look at the company or how they value the stock. That's the one thing they tell me I can't control, so I try not to worry about it, although I must confess it's sitting in there now on my computer screen. We've also picked up analyst coverage in the last year. We now have five analysts that follow us. We are very pleased with the analyst coverage that we have, the investment banking relationships that we have, and generally the investors that we have. If you look at who owns our stock, 90% of it is owned by quality institutions, and they continue to be interested in increasing their positions. So we've got a loyal, long-term group of holders, who really seem to value what we are doing. Some of them have taken almost million share positions in a very small, generally illiquid company, which I think is just incredible.

TWST: If you were talking to some potential investors at this point, what are the two or three reasons you'd give them to take a look at the company?

Mr. McCusker: One is what we do. We are a social services company; we are making a difference in the lives of challenged Americans every day. There are not too many Wall Street investments that you can actually appreciate the value of the organization. We are socially responsible, we are indeed part of the chemistry in this country that's making a difference. It's not a charity, we are also doing that while we're making a little money. So here is an opportunity to participate in a socially responsible company that is making a difference and it's making money and it's created incredible value for its shareholders. We are interested in people who take a long-term view and appreciate the company's philosophy and understand that our margins aren't going to get much better. Our company is not designed to get to 15% or 18% or 20% margins; we continue to educate people that we won't get there, not with the government payor base we have and the tolerance the government has for privatized providers. We could probably do that for as long as two quarters. But if you look at the history of privatization, that's been the legacy of these providers — that they have a really good year and the stock goes up and then the payors see what these companies are making and decide to do something about it. The public equity markets are littered with those kinds of companies that have abused the government payor in the short term, only to have a high flying stock that was a flash in the pan. So we've tended to take a much longer-term view of our business and it seems like most of our supporters agree.

TWST: Thank you.

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