

OPTION CARE INC/DE
Form 10-K
March 16, 2005

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

or

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

Commission File No. 0-19878

OPTION CARE, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

485 Half Day Road, Suite 300

Buffalo Grove, IL

(Address of principal executive offices)

36-3791193

(I.R.S. Employer Identification No.)

60089

(Zip Code)

Registrant's telephone number, including area code **(847) 465-2100**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.01 Par Value per Share

(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

The aggregate market value of voting stock held by non-affiliates of the registrant as of June 30, 2004 was approximately \$211,651,000 (based on closing sale price on June 30, 2004 of \$15.26 per share as reported on the NASDAQ National Market). Solely for purposes of the foregoing calculation of aggregate market value of voting stock held by non-affiliates, the registrant has assumed that all directors and executive officers of the registrant are affiliates of the registrant. Such assumption shall not be deemed a determination by the registrant that such persons are affiliates of the registrant for any purposes.

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The number of shares of Common Stock outstanding as of March 1, 2005 was 21,326,755.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for its 2005 annual stockholders' meeting are incorporated by reference in Part III of this Report.

OPTION CARE, INC.
ANNUAL REPORT ON FORM 10-K
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The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. Certain information included or incorporated by reference in this Annual Report on Form 10-K, including information in "Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations" and other materials filed or to be filed by us with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by us) contain, or may contain, statements that are or will be forward-looking, such as statements relating to acquisitions and other business development activities, future capital expenditures and the anticipated or potential effects of future regulation and competition. Such forward-looking information involves important risks and uncertainties that could significantly affect anticipated results in the future and, accordingly, such results may differ from those expressed in any forward-looking statements made by us, or on our behalf. These risks and uncertainties include, but are not limited to, uncertainties affecting our businesses and our franchisees relating to acquisitions and divestitures (including continuing obligations with respect to completed transactions), sales and renewals of franchises, government and regulatory policies (including federal, state and local efforts to reform the delivery of and payment for healthcare services), general economic conditions (including economic conditions affecting the healthcare industry in particular), the pricing and availability of goods and services, technological developments and changes in the competitive environment in which we operate. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or circumstances occurring after the date of this Annual Report or to reflect the occurrence of unanticipated events.

PART I

Item 1. BUSINESS

BUSINESS

Option Care is a leading integrated provider of home infusion pharmacy services and specialty pharmacy services to patients with acute or chronic conditions that can be treated at home, at one of our local ambulatory infusion centers or in a physician's office. We provide these services to patients on behalf of managed care organizations, government healthcare programs and biopharmaceutical manufacturers through two central high volume distribution facilities, 39 company-owned locations and 83 franchised locations. Our services include the distribution and administration of infused and injectable medications, patient care coordination, clinical and compliance management and reimbursement support. For the years ended December 31, 2004 and 2003, we generated net revenue of \$414.4 million and \$355.4 million, respectively, and net income of \$18.9 million and \$8.7 million, respectively.

We are a leading provider to managed care organizations and other third party payors, patients, physicians and pharmaceutical manufacturers with a cost-effective solution for both home infusion pharmacy services and specialty pharmacy services nationwide. Our combination of national and local distribution capabilities, sales and marketing resources, clinical staff and information systems support our customers as follows:

- **Payors** We provide payors with a comprehensive approach to meeting their pharmacy services needs. Our home infusion pharmacy services offer a lower cost alternative to providing these therapies in a hospital setting. We offer the flexibility of providing home infusion pharmacy services at the patient's home or at one of our local ambulatory infusion centers. Our specialty pharmacy services offer payors a cost effective solution for the distribution of specialty pharmaceuticals directly to patients for self-administration. We also provide the direct distribution of biotech pharmaceuticals to physicians' offices for in-office administration. This provides payors with a cost-effective alternative to direct billing of biotech pharmaceuticals by physicians. We also provide payors with utilization and outcomes data to evaluate therapy effectiveness.
- **Patients** We improve patients' quality of life by allowing them to remain at home while receiving necessary medications, supplies and services or visit one of our ambulatory infusion centers to receive care. In addition, we help manage patients' conditions through counseling and education regarding their treatment and by providing ongoing monitoring to encourage patient compliance with the prescribed therapy. We also provide services to help patients receive reimbursement benefits.
- **Physicians** We assist physicians with time-intensive patient support by providing care management related to their patients' pharmacy needs and improving compliance with therapy protocols. We eliminate the need for physicians to carry inventories of high cost prescriptions by distributing the medications directly to patients' homes or, if required, to the physicians' offices. Additionally, we either bill the payor directly or assist the patient in the submission of claims to the payor.
- **Pharmaceutical Manufacturers** We provide pharmaceutical manufacturers with a broad distribution channel for their existing pharmaceuticals and their new product launches. Our team of approximately 100 salespeople helps pharmaceutical manufacturers increase the visibility of their products to prescribing physicians. We implement patient monitoring programs that encourage compliance with the prescribed therapy. We also provide valuable clinical information in the form of outcomes and compliance data to support manufacturer research initiatives and reporting requirements.

Our company was founded in 1979 and was a pioneer in the delivery of home infusion services. The industry was formed when the technology emerged allowing for the safe and cost-effective administration of infused medications in a home environment. In addition, Medicare reimbursement changes in 1984 encouraged hospitals to reduce length of stays creating increased discharges to alternate site settings. During the 1980 s, we expanded our services nationally with a franchise model targeting markets with populations of fewer than 300,000. We completed our initial public offering on April 23, 1992 and embarked on transitioning the company from a franchise organization to a healthcare services provider through an acquisition program targeting franchised and non-affiliated operations.

During the 1990 s, we focused on building a leadership position in the home infusion industry and began to leverage our local pharmacy capabilities to distribute niche high cost therapies targeting chronic conditions. Due to the robust biotech pharmaceutical product pipeline, we have seen a significant increase in the distribution of these high cost injectible medications. As a result, we have created a specialized service offering that meets the needs of patients, product manufacturers and managed care organizations.

Our common stock is traded on the NASDAQ National Market under the symbol OPTN. We are engaged in one reportable industry segment containing three service lines: specialty pharmacy; infusion and related healthcare services; and other.

We have one reportable segment with three distinct service lines specialty pharmacy, infusion and related healthcare services and other. The following table presents summarized information about our revenue by service line for each of the three years ended December 31, 2004 (amounts in thousands):

	Years Ended December 31, 2004		2003		2002	
	Amounts	% of Total	Amounts	% of Total	Amounts	% of Total
Revenue:						
Specialty pharmacy	\$ 249,697	60.2 %	\$ 208,557	58.7 %	\$ 181,049	56.5 %
Infusion and related healthcare services	153,302	37.0 %	136,192	38.3 %	129,146	40.3 %
Other	11,431	2.8 %	10,691	3.0 %	10,301	3.2 %
Total revenue	\$ 414,430	100.0 %	\$ 355,440	100.0 %	\$ 320,496	100.0 %

INDUSTRY OVERVIEW

Healthcare related expenditures constitute a large and growing segment of the US economy. According to estimates by the Centers for Medicare & Medicaid Services, national health expenditures reached an estimated \$1.7 trillion in 2003 and are expected to increase to \$3.4 trillion by 2013. In 2002, prescription drug expenditures were \$162 billion, representing 10% of national healthcare expenditures for that year. Prescription drugs remain among the fastest-growing categories of healthcare expenditure, increasing by 15.3% in 2002. We believe the recently enacted Medicare Prescription, Drug, Improvement, and Modernization Act of 2003 (MPDIMA) should support the viability of Option Care s specialty pharmacy business. Reimbursement for drugs furnished in connection with durable medical equipment (DME) continues for 2004 and 2005 and does not appear to be adversely impacted. Two important trends that impact our business have emerged in relation to healthcare spending. These trends are positively impacting the growth of many services we provide:

- Government programs, private insurance companies, managed care organizations and self-insured employers have implemented various cost-containment measures to limit the growth of healthcare expenditures. These cost-containment measures, together with technological advances, have resulted in a shift in the delivery of many healthcare services away from traditional hospital settings to more cost-effective settings, including patients homes.

- As a result of the proliferation of biotech research and development, biotech companies and pharmaceuticals manufacturers have developed a variety of high cost biotech pharmaceuticals. These biotech pharmaceuticals are most often used in the treatment of chronic conditions such as multiple sclerosis, growth hormone disorders, hemophilia, cancer and immune deficiency disorders. These biotech pharmaceuticals, which in many cases cost over \$10,000 per patient per year, are typically used on a recurring basis for extended periods of time and require special inventory handling, administration and patient compliance monitoring. Historically, traditional pharmacy distribution channels have not been designed to handle the additional services required by many of these medications.

Home Infusion Pharmacy Services

Home infusion pharmacy services primarily involve the intravenous administration of medications treating a wide range of acute and chronic health conditions. Home infusion pharmacy services are primarily administered to treat infections, dehydration, cancer, pain and nutritional deficiencies. Patients are generally referred to home infusion pharmacy services providers by physicians, hospital discharge planners and case managers. The medications are mixed and dispensed under the supervision of a registered pharmacist and the therapy is typically delivered in the home of the patient by a registered nurse or trained caregiver. Depending on the preferences of the patient and/or the payor, these services may also be provided at a local ambulatory infusion center. According to the National Home Infusion Association, the size of the home infusion pharmacy services industry is currently between \$4 and \$5 billion. We believe that several factors will contribute to the continuing growth in non-hospital based infusion therapy services, including the following:

- Healthcare cost containment pressures;
- Increased number of therapies that can be safely administered in patients' homes;
- Patient preference for at-home treatment;
- Increased acceptance of home infusion by the medical community and by managed care organizations and other payors;
- Technological innovations such as implantable injection ports, vascular access devices and portable infusion control devices;
- Increase utilization of home infusion therapies due to demographic trends, in particular increasing life expectancies.

Specialty Pharmacy Services

Specialty pharmacy services involve the distribution of injectable and infused pharmaceuticals, as well as related support services, for patients with chronic health conditions. These pharmaceuticals can be directly distributed to the patient or to the patient's physician for in-office administration and in many cases cost over \$10,000 per patient per year. These pharmaceuticals may require refrigeration during shipping as well as special handling to prevent potency degradation. Patients receiving treatment usually require special counseling and education regarding their condition and treatment programs. The specialty pharmacy services industry primarily treats conditions such as multiple sclerosis, growth hormone disorders, hemophilia, cancer, immune deficiency disorders, asthma and other chronic conditions. Retail pharmacies and other traditional distributors generally are designed to carry inventories of low cost, high volume products and therefore are not equipped to handle the high cost, low volume specialty pharmaceuticals that have specialized requirements. As a result, these pharmaceuticals are generally provided by pharmacies that focus primarily on filling, labeling and delivering specialty pharmaceuticals

and related support services. Depending on therapy, specialty pharmaceuticals may be administered at the patient's home, a physician's office or at an ambulatory infusion center.

The U.S. market for specialty pharmaceuticals is estimated to be approximately \$25 billion and is growing rapidly. We expect several factors to contribute to the continuing growth of the specialty pharmacy services industry, including the following:

- Healthcare cost containment pressures;
- Development of new pharmaceuticals;
- Direct to consumer advertising;
- Increased acceptance of mail-order distribution; and
- Growing emphasis on care management and compliance monitoring to improve outcomes for these high-cost, chronic diseases.

OUR STRATEGY

We leverage our 25 years of clinical experience, the wide geographical coverage of our two central high volume distribution facilities and 39 company-owned locations and 83 franchise locations, as well as our flexible distribution model which includes the delivery of our services to patients' homes, physicians' offices or our local ambulatory infusion centers, to make us an attractive provider to managed care organizations, insurance companies and other third party payors and referral sources seeking a single source for infusion pharmacy services and specialty pharmacy services. We intend to increase our revenue and profitability by implementing the following strategies:

- ***Infusion Pharmacy Growth Strategy***

We intend to strengthen our position as the leading national provider of infusion therapy by investing in sales execution to new and existing referral sources and through selective acquisitions and start-ups that expand our geographic coverage into new markets and consolidate providers in existing markets that we serve.

- ***Specialty Pharmacy Growth Strategies***

We have two strategies to providing specialty pharmacy services:

- ***Manufacturer Strategy***

We intend to expand our relationships with biotech and other pharmaceutical manufacturers in order to acquire distribution rights to existing and new products by providing centralized distribution, patient compliance programs, patient reimbursement support and clinical data. To support our operations and enhance the services provided under our relationships with pharmaceutical manufacturers, we maintain a national Specialty Care Pharmacy in Ann Arbor, Michigan to provide a central distribution channel for certain specialty pharmaceuticals.

- ***Managed Care Strategy***

We currently have contracts with most major managed care organizations, which cover approximately 75 million lives. We are actively implementing contracts for additional services with existing payors as well as new managed care relationships. We intend to expand existing relationships and enter into new relationships with managed care organizations to lower the cost of physician office-based biotech pharmaceuticals and provide utilization and outcomes data. Our specialty pharmacy in Miramar, Florida serves as a central management and distribution point for delivery of biotech pharmaceuticals to physician offices.

- ***Acquisition Strategy***

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The home infusion industry is highly fragmented with the majority of service providers operating primarily in local or regional markets. Currently, there are approximately 3,000 home infusion

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providers operating in the United States 80% are small, mom and pop operations while the remaining 20% include a variety of local and national providers that are either independent pharmacies or hospital affiliated. We believe that few competitors possess the scale and resources to consolidate the industry and that our financial resources and operating strength give us an advantage in this area. Additionally, our franchise network provides us with a built-in pipeline of potential acquisition opportunities. Our typical franchise agreement provides us with a right of first refusal for the potential acquisition of an existing franchise.

OUR CORPORATE INFORMATION

We were incorporated in Delaware in July 1991. Our principal executive offices are located at 485 Half Day Road, Suite 300, Buffalo Grove, Illinois 60089, and our telephone number is (847) 465-2100. We maintain an Internet website at <http://www.optioncare.com>.

OUR SERVICES

Home Infusion Pharmacy and Related Healthcare Services

As of December 31, 2004, our home infusion pharmacy services are provided through our local pharmacy network of 39 company-owned pharmacies. Our services are most typically provided in the patient's home, but may also be provided at clinics, the physician's office or at one of our ambulatory infusion centers. We offer patients and physicians the following products and services:

- Medication and supplies for administration and use at home or within one of our ambulatory infusion centers;
- Consultation and education regarding the patient's condition and the prescribed medication;
- Clinical monitoring and assistance in monitoring potential side effects; and
- Assistance in obtaining reimbursement.

We provide the following home infusion therapies:

- **Total Parenteral Nutrition:** intravenous therapy providing required nutrients to patients with digestive or gastro-intestinal problems, most of whom have chronic conditions requiring treatment for life;
- **Anti-infective Therapy:** intravenous therapy providing medication for infections related to diseases such as osteomyelitis and urinary tract infections;
- **Pain Management:** intravenous or continuous injection therapy, delivered by a pump, providing analgesic pharmaceuticals to reduce pain;
- **Enteral Nutrition:** providing nutritional formula by tube directly into the stomach or colon;
- **Chemotherapy:** intravenous therapy providing prescription medications to treat cancer; and
- **Other therapies:** treating a wide range of medical conditions.

Some of our company-owned pharmacies also provide home health nursing services, respiratory therapy services and home medical equipment sales and rentals. We also have one location that provides home hospice services.

Specialty Pharmacy Services

As of December 31, 2004, we provide specialty pharmacy services through our two central high volume distribution facilities and our 39 company-owned local pharmacies. We purchase specialty

pharmaceuticals from manufacturers and wholesale distributors, fill prescriptions provided by physicians, and label, package and deliver the pharmaceuticals to patients' homes or physicians' offices, either ourselves or through contract couriers. Depending on therapy, we may also administer the specialty pharmaceuticals to the patient at one of our ambulatory infusion centers. Our approach to delivering specialty pharmacy services includes a manufacturer strategy and managed care strategy to meet the unique needs of each customer segment. For selected drugs, we also supply clinical efficacy and outcomes data to the manufacturers.

We provide specialty pharmacy services to treat the following chronic high cost diseases:

- **Growth Hormone Deficiency:** a condition that prevents normal growth patterns in children, generally caused by disorders of the pituitary gland or kidneys. Therapy consists of daily injections of growth hormone and usually lasts seven to nine years.
- **Respiratory Syncytial Virus (RSV) Prevention:** RSV is a major cause of respiratory disease in young children and infants. Treatment is directed toward high-risk pediatric patients, typically from infant to age two. The most common treatment consists of monthly injections throughout the RSV season which lasts from approximately October through April.
- **Hepatitis C Virus:** a viral infection which results in the inflammation of the liver. Left untreated, hepatitis C virus can cause serious liver damage. Treatment includes injections of interferon alfa products, which are proteins that boost the body's immune system. Treatment can last up to 24 months.
- **Multiple Sclerosis:** a chronic, incurable, progressive disease of the central nervous system. The goal of treatment is to decrease the severity, intensity and duration of outbreaks and to slow the progression of the disease. Treatment regimens involve pharmaceutical injections, and products vary widely.
- **Hemophilia:** an inherited bleeding disorder that is caused by a blood clotting deficiency that results in a longer bleeding time. Hemophilia is one of the most costly diseases to treat. The treatment goal is to raise the level of the deficient clotting factor and maintain it in order to stop the bleeding. Treatments include infusion of the clotting factor products. The length of treatment depends on the severity of the bleeding episode, and the need for treatment continues throughout the life of the patient.
- **Immune Deficiency:** immune deficiencies are disorders which reduce the patient's ability to identify and destroy substances which do not belong in the human body and are characterized by reduced levels of antibodies. Intravenous immune globulins, which are infused to treat the immune deficiencies, are concentrated antibodies that have been purified from large numbers of human blood donors.
- **Cancer:** includes a wide spectrum of tumors, abnormal growths and cellular abnormalities. Treatment includes radiation, chemotherapy and/or surgery. As a result of these treatments, patients may require therapies that combat anemia and increase white blood cell counts. Our specialty pharmacy programs provide chemotherapy and related products to physicians' offices for in-office administration and to patients' homes.
- **Asthma:** an inflammatory condition of the bronchial airways, most commonly caused by allergies. The inflammation leads to airway obstruction, chest tightness, coughing and wheezing. Treatment focuses on controlling symptoms and typically consists of inhaled corticosteroids. Our specialty pharmacy program provides patients with an injectable drug, Xolair®, designed for adults and adolescents with moderate to severe allergic asthma that is inadequately controlled by the use of inhaled corticosteroids.

Seasonality of Specialty Pharmacy Services

Our results of operations are partially affected by seasonal factors. One of the specialty pharmaceuticals that we distribute, Synagis®, is a preventive drug used to protect high-risk pediatric patients against respiratory syncytial virus (RSV). Treatments typically consist of monthly Synagis® injections during the RSV season, which lasts from approximately October through April.

Our quarterly revenue from sales of Synagis® in 2004 and 2003 was as follows (amounts in thousands):

	2004				2003			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Synagis® revenue	\$ 9,455	\$ 571	\$ 3,955	\$ 14,251	\$ 8,867	\$ 435	\$ 3,958	\$ 11,998
Percent of total revenue	8.4	% 0.6	% 4.0	% 13.8	% 9.3	% 0.5	% 4.7	% 13.0

Other Revenue Sources:

- **Franchise Royalties and Related Fees:**

We generate royalty revenue and related fees from our network of Option Care franchised locations. As of December 31, 2004, we have a network of 83 franchise locations operating under 64 separate franchise agreements throughout the United States.

- **Software License, Rental and Support:**

Our subsidiary, Management by Information, Inc. (MBI), licenses, sells and supports proprietary software products created and designed for the home infusion pharmacy industry. Their products include an older, DOS-based product, as well as a new, browser-based product named iEmphysys .

- **Vendor Rebates and Administration Fees:**

Through the combined purchasing power of our company-owned and franchised locations, we are able to sign pharmaceutical purchase contracts with manufacturers and other vendors that provide us the opportunity to earn volume purchase rebates and vendor administration fees. Such fees are recorded as revenue to the extent that they are earned based on the purchase volume of our franchised locations.

BILLING & SIGNIFICANT PAYORS

We derive most of our revenue from contracts with third party payors, such as managed care organizations, insurance companies, self-insured employers and Medicare and Medicaid programs. Where permissible, we bill patients for any amounts not reimbursed by third party payors. For the most part, our infusion pharmacy revenue consists of reimbursement for both the cost of the pharmaceuticals sold and the cost of services provided. Pharmaceuticals are typically reimbursed on a percentage discount from the published average wholesale price (AWP) of each drug, while certain nursing and other patient support services and ancillary medical supplies are reimbursed separately or on a per diem basis, where applicable. Specialty pharmaceuticals are typically pre-packaged drugs that are self-injected by the patient or a trained in-home caregiver. Therefore, minimal service is provided and no per diem revenue is generated.

Our principal managed care contract is with Blue Cross and Blue Shield of Florida, Inc. (BC/BS of Florida). We provide infusion pharmacy and specialty pharmacy services to BC/BS of Florida members throughout the state of Florida. This contract renews annually each September for an additional one-year term, if not terminated by either party upon 90 days notice. For the year 2004, our contract with BC/BS of Florida produced \$64.1 million in revenue. In 2004, 2003 and 2002, respectively, approximately 15%, 17% and 20% of our total revenue was related to this contract. As of December 31, 2004 and 2003, approximately 7% and 9% of Option Care's accounts receivable were from BC/BS of Florida.

We also provide services that are reimbursable through government healthcare programs such as Medicare and state Medicaid programs. For the twelve months ended December 31, 2004, 2003 and 2002, respectively, approximately 18%, 18% and 15% of our revenue came from government healthcare programs such as Medicare and Medicaid. The accounts receivable related to these programs represented approximately 18% and 20% of our total accounts receivable, respectively, as of December 31, 2004 and 2003.

We bill payors and track all of our accounts receivable through computerized billing systems. The majority of our company-owned pharmacies utilize software that was developed by our subsidiary, Management by Information, Inc. (MBI). This software allows our billing staff the flexibility to review and edit claims in the system before they are submitted to payors. Claims are submitted to payors either electronically or through the mail. We utilize electronic claim submission whenever possible to expedite claim review and payment, and to minimize errors and omissions.

The net revenue that we report is based on usual and customary billing rates for the products and services we provide, less applicable contractual adjustments. In most cases, our computerized billing systems generate contractual adjustments based on the fee schedules of the underlying insurance contracts when the claims are billed. If our computerized billing systems cannot automatically generate the contractual adjustment for a given claim, we calculate the contractual adjustment manually and key the adjustment into our billing system when the claim is billed. For revenue that is not yet billed, we manually estimate the contractual adjustments using a claim-by-claim analysis of the unbilled charges, by applying historic contractual adjustment percentages, or a combination of the two methods.

We generate accounts receivable aging reports from our MBI software and all the other billing systems that we use. We utilize these reports to help us monitor the condition of our outstanding receivables and evaluate the performance of our billing and reimbursement staff. We also utilize these aging reports, combined with historic write-off statistics generated from our billing systems, to determine our required level of bad debt reserves.

Our financial performance is highly dependent upon effective billing and collection practices at each of our company-owned pharmacies. The process begins with an accurate and complete patient admission process, in which all critical information about the patient, the patient's insurance and their care needs is gathered. A critical part of this process is verification of insurance coverage and authorization from insurance to provide the required care, which typically takes place before we initiate services. The only exception occurs when a patient referral is received outside of normal business hours, but we have an existing contractual relationship with the patient's insurance carrier. In such cases, we provide the patient with sufficient drugs and services to last until the next business day, when the patient's insurance coverage can be verified.

FRANCHISE PROGRAM

Our franchise program was developed to increase our geographical presence and to provide a national network of pharmacies to service the needs of our managed care customers without requiring extensive capital expenditures. In marketing our franchise program, we target independent infusion pharmacies that would benefit from participating in our national and regional managed care and manufacturer contracts as well as in our marketing programs. Our franchised locations are given a license to operate an Option Care branded pharmacy in a defined territory to provide infusion therapy and related products and services.

We receive a start-up fee upon execution of the franchise agreement with subsequent royalties based on a percentage of gross receipts of the franchised location. Each franchisee is required to maintain a licensed pharmacy equipped to compound medications in a sterile environment as prescribed by physicians. In the program that we are currently marketing, the franchisee must use our proprietary software and obtain specified liability insurance protecting the franchise owner and us against claims

arising from the operation of the franchised business. The franchisees may participate in our managed care and manufacturer contracts. Our franchisees may also purchase pharmaceuticals and supplies from a preferred list of vendors under contract with us. This frequently allows us and the franchisee to obtain volume discount pricing. Most of our franchise agreements also provide us with a right of first refusal for the potential acquisition of the franchise. However, none of our current agreements grants us the option to purchase the franchise at our will.

As of December 31, 2004, we had 83 franchised pharmacy locations operating under 64 separate franchise agreements. Approximately 58% of our franchise agreements come up for renewal in the four-year period from 2006 through 2009. As franchise agreements near expiration, we expect to propose new agreements to maintain the network. If we cannot reach agreement with the franchisee and the franchise expires, the franchisee is required to cease using the Option Care trademark and will not be able to access our managed care agreements or purchasing contracts. We would then be free to re-franchise the territory or to service the territory with a company-owned facility.

The following table summarizes the termination dates of our franchise agreements, by year, and presents the percentage of our 2004 royalty revenue attributable to franchises terminating in each year:

Year ended December 31,	Number of franchise Agreements expiring	Percent of 2004 Royalty Revenue
2005	6	9.4 %
2006	9	12.4 %
2007(1)	10	24.8 %
2008	9	12.8 %
2009	9	14.1 %
2010	5	6.0 %
2011	7	10.5 %
2012-2017	9	10.0 %
	64	100.0 %

(1) Includes St. Cloud, MN franchise, which we acquired on February 4, 2005.

To facilitate our specialty pharmacy services, we have entered into participation agreements with 55 of our 83 franchised pharmacy locations. Of the franchisees that have signed participation agreements, 35 are actively providing specialty pharmacy services. The participation agreements provide that we will pay a fee to the franchisee if we sell selected specialty pharmacy services in that franchisee's territory, and also provide for a reduced royalty rate on related sales of specialty pharmaceuticals made by the franchisee. We continue to offer participation agreements to selected franchisees. The franchise program that we are currently marketing specifically provides for specialty pharmacy sales and related services by us in the franchised territory.

PROPRIETARY DATA MANAGEMENT SYSTEM

Our wholly owned subsidiary, Management by Information, Inc. (MBI), has developed proprietary software systems designed to manage the intake, dispensing, clinical, billing and collection processes for home infusion pharmacies. These products also contain a component for managing the clinical, billing, and inventory tracking functions for respiratory therapy/durable medical equipment (RT/DME) businesses. We license and service our software systems to non-affiliated home infusion pharmacy and durable medical equipment companies, and to several of our franchisees. We also use MBI's systems internally to manage the operations of the majority of our company-owned local pharmacies and RT/DME businesses.

MBI has completed development of the next generation of its software product a scalable, browser-based system named iEmphsys and began marketing the software to third-party customers in 2003. As

of December 31, 2004, we are utilizing iEmphsys in seven of our company-owned pharmacies and are planning to install iEmphsys in all of our company-owned pharmacies. This software is currently being marketed as a stand-alone product to be utilized on a local area network. We are continuing to enhance the product to improve upon its capabilities.

SALES AND MARKETING

Our sales and marketing efforts focus on three primary objectives: (1) building new relationships and expanding existing contracts with managed care organizations; (2) establishing, maintaining and strengthening relationships with local and regional patient referral sources; and (3) maintaining existing and developing new relationships with biotech drug manufacturers to gain distribution access as they release new products. Our national and regional sales directors focus primarily on establishing and expanding our contracts with managed care organizations, while our local account managers focus on pull-through from these contracts by developing and maintaining relationships with local and regional referral sources, such as physicians, hospital discharge planners and case managers. In addition, we have a sales force focused on maintaining and expanding our relationships with biotech drug manufacturers to establish our position as a participating provider when they release new products.

Most new patients are referred to us by physicians, medical groups, hospital discharge planners, case managers employed by Health Maintenance Organizations (HMOs), Preferred Provider Organizations (PPOs) or other managed care organizations, insurance companies and home care agencies. Our sales force is responsible for establishing and maintaining these referral relationships.

Our sales structure allows us to take advantage of our national managed care relationships to provide sales and contract pull-through by our local field-based sales personnel. Additionally, the existence of our contracts with national managed care organizations provides our local sales personnel with more flexibility and leverage for sales in local markets. This cross-utility enables us to market our services to numerous sources of patient referrals, including physicians, hospital discharge planners, hospital personnel, HMOs, PPOs or other managed care organizations, and insurance companies. Local marketing focuses on our infusion pharmacy business and our care management programs, with an emphasis on certain key therapies.

COMPETITION

Our pharmacies compete in the large and highly fragmented home infusion and specialty pharmacy markets. We compete for contracts with managed care organizations and other third party payors and compete to receive referrals from physicians, case managers and hospital discharge planners. Competition in the home infusion market is based on quality of care, cost of service and reputation. Competition in the specialty pharmacy market is based on price, reliability of service and reputation. Some of our existing and potential competitors in the home infusion market include integrated home healthcare providers such as Apria Healthcare Group Inc. and Coram Healthcare Corporation, and local providers of alternate site healthcare services such as hospitals, local home health agencies and other local providers. In the specialty pharmacy market, our existing and potential competitors include specialty pharmacy providers such as Accredo Health Inc., Caremark Rx, Priority Healthcare Corporation and others, specialized retail pharmacies such as PharmaCare, a division of CVS Corporation, pharmacy benefit management companies, wholesalers and retail pharmacies. In each market, some of these current competitors have, and our potential future competitors may have, greater financial, operational, sales and marketing resources than us. However, we believe that our reputation for providing quality services, the strength of our growing national presence and our ability to effectively market our services at national, regional and local levels places us in a strong position against existing and potential competitors. We also believe that our dual presence in the local infusion pharmacy market and the national specialty pharmacy market

provide synergies and make us more appealing to the managed care community than the majority of our competitors.

GOVERNMENTAL REGULATION

The healthcare industry is subject to extensive regulation by a number of governmental entities at the federal, state and local level. The industry is also subject to frequent regulatory change. Laws and regulations in the healthcare industry are extremely complex and, in many instances, the industry does not have the benefit of significant regulatory or judicial interpretation. Moreover, our business is impacted not only by those laws and regulations that are directly applicable to us but also by certain laws and regulations that are applicable to our managed care and other clients. If we fail to comply with the laws and regulations directly applicable to our business, we could suffer civil and/or criminal penalties, and we could be excluded from participating in Medicare, Medicaid and other federal and state healthcare programs, which would have an adverse impact on our business.

If our franchisees fail to comply with the laws and regulations applicable to their businesses, they could suffer civil and/or criminal penalties and/or be excluded from participating in Medicare, Medicaid and other federal and state healthcare programs, which could have an adverse impact on our business.

The healthcare industry is undergoing significant change as third party payors, such as Medicare and Medicaid, health maintenance organizations and other health insurance carriers increase efforts to control the cost, utilization and delivery of healthcare services. Reductions in reimbursement by Medicare and Medicaid and other third party payors may be implemented from time to time. These cost control efforts may result in a decline in the prices for which we are able to sell our products and services, which would have an adverse effect on our gross profit margins and overall profitability.

Professional Licensure. Nurses, pharmacists and certain other healthcare professionals employed by us are required to be individually licensed or certified under applicable state law. We perform criminal and other background checks on employees and take steps to ensure that our employees possess all necessary licenses and certifications, and we believe that our employees comply in all material respects with applicable licensure laws.

Each of our franchisees is responsible for ensuring the licensing or certification of its employees in accordance with applicable law, performing any criminal or other background checks required by state law, and ensuring that all employees perform only those tasks which fall within their authorized scope of practice. While each franchisee is responsible for any failure or non-compliance with respect to these licensure and scope of practice issues, any such failure or non-compliance by a franchisee that impacts such franchisee's operations could have an adverse effect on our business.

Pharmacy Licensing and Registration. State laws require that each of our pharmacy locations be licensed as an in-state pharmacy to dispense pharmaceuticals in that state. Certain states also require that our pharmacy locations be licensed as an out-of-state pharmacy if we deliver prescription pharmaceuticals into those states from locations outside of the state. We believe that we substantially comply with all state licensing laws applicable to our business. If we are unable to maintain our licenses or if states place burdensome restrictions or limitations on non-resident pharmacies, our ability to operate in some states would be limited, which could have an adverse impact on our business.

Laws enforced by the Drug Enforcement Administration, as well as some similar state agencies, require our pharmacy locations to individually register in order to handle controlled substances, including prescription pharmaceuticals. A separate registration is required at each principal place of business where we dispense controlled substances. Federal and state laws also require that we follow specific labeling, reporting and record-keeping requirements for controlled substances. We maintain federal and state controlled substance registrations for each of our facilities that require such registration and follow

procedures intended to comply with all applicable federal and state requirements regarding controlled substances.

Many states in which we operate also require home infusion companies to be licensed as home health agencies. We believe we are in compliance with these laws as applicable.

Food, Drug and Cosmetic Act. Certain provisions of the federal Food, Drug and Cosmetic Act govern the handling and distribution of pharmaceutical products. This law exempts many pharmaceuticals and medical devices from federal labeling and packaging requirements as long as they are not adulterated or misbranded and are dispensed in accordance with and pursuant to a valid prescription. To the extent that this law applies to us, we believe that we comply with all applicable requirements.

Fraud and Abuse Laws Anti-Kickback Statute. The federal Anti-Kickback Statute prohibits individuals and entities from knowingly and willfully paying, offering, receiving, or soliciting money or anything else of value in order to induce the referral of patients or to induce a person to purchase, lease, order, arrange for, or recommend services or goods covered by Medicare, Medicaid, or other government healthcare programs. The federal courts have held that an arrangement violates the Anti-Kickback Statute if any one purpose of the remuneration is to induce the referral of patients covered by the Medicare or Medicaid programs, even if another purpose of the payment is to compensate an individual for rendered services. The Anti-Kickback Statute is extremely broad and potentially covers many standard business arrangements. Violations can lead to significant penalties, including criminal fines of up to \$25,000 per violation and/or five years imprisonment, civil monetary penalties of up to \$50,000 per violation plus treble damages, and/or exclusion from participation in Medicare, Medicaid, and other federal government healthcare programs. In an effort to clarify the conduct prohibited by the Anti-Kickback Statute, the Office of the Inspector General (OIG) of the United States Department of Health and Human Services has published regulations that identify a limited number of safe harbors. Business arrangements that satisfy all of the elements of a safe harbor are immune from criminal enforcement or civil administrative actions. The Anti-Kickback Statute is an intent based statute and the failure of a business relationship to satisfy all of the elements of a safe harbor does not in and of itself mean that the business relationship violates the Anti-Kickback Statute. The OIG, in its commentary to the safe harbor regulations, has recognized that many business arrangements that do not satisfy a safe harbor nonetheless operate without the type of abuses the Anti-Kickback Statute is designed to prevent. We attempt to structure our business relationships to satisfy an applicable safe harbor. However, in those situations where a business relationship does not fully satisfy the elements of a safe harbor, or where no safe harbor exists, we attempt to satisfy as many elements of an applicable safe harbor as possible. The OIG is authorized to issue advisory opinions regarding the interpretation and applicability of the Anti-Kickback Statute, including whether an activity constitutes grounds for the imposition of civil or criminal sanctions. We have not, however, sought any opinions regarding our business relationships.

A number of states have in place statutes and regulations that prohibit the same general types of conduct as those prohibited by the Anti-Kickback Statute described above. Some state anti-fraud and anti-kickback laws apply only to goods and services covered by Medicaid. Other state anti-fraud and anti-kickback laws apply to all healthcare goods and services, regardless of whether the source of payment is governmental or private. Where applicable, we attempt to structure our business relationships to comply with these statutes.

Fraud and Abuse Laws False Claims Act. We are subject to state and federal laws that govern the submission of claims for reimbursement. These laws generally prohibit an individual or entity from knowingly and willfully presenting a claim or causing a claim to be presented for payment from a federal healthcare program that is false or fraudulent. The standard for knowing and willful may include conduct that amounts to a reckless disregard for the accuracy of information presented to payors. Penalties under these statutes include substantial civil and criminal fines, exclusion from the Medicare or Medicaid

programs and imprisonment. One of the most prominent of these laws is the federal False Claims Act, which may be enforced by the federal government directly or by a private plaintiff by filing a qui tam lawsuit on the government's behalf. Under the False Claims Act, the government and private plaintiffs, if any, may recover monetary penalties in the amount of \$5,500 to \$11,000 per false claim, as well as an amount equal to three times the amount of damages sustained by the government as a result of the false claim. A number of states, including states in which we operate, have adopted their own false claims statutes as well as statutes that allow individuals to bring qui tam actions. We believe that we have procedures in place to ensure the accuracy of our claims. The Federal False Claims Act has been invoked in circumstances where there are claims submitted which violate the Stark Law described below.

In recent years, federal and state government agencies have increased the level of enforcement resources and activities targeted at the healthcare industry. In addition, the use of private qui tam enforcement actions against healthcare providers has increased dramatically in recent years.

Ethics in Patient Referrals Law (Stark Law). The federal Stark Law generally prohibits a physician from making referrals for certain Designated Health Services (DHS), reimbursable by Medicare or Medicaid, to entities with which the physician or an immediate family member has a financial relationship, unless an exception applies. A financial relationship is generally defined as an ownership, investment or compensation relationship. The first version of the Stark Law, which prohibited physicians from ordering only clinical laboratory services for Medicare patients from an entity with which the physician had a financial relationship, is often referred to as Stark I. The expansion of the Stark Law to include other DHS is often referred to as Stark II. DHS under Stark II now include, but are not limited to, outpatient pharmaceuticals, parenteral and enteral nutrition products, home health services, durable medical equipment, physical and occupational therapy services, and inpatient and outpatient hospital services. Among other sanctions, a civil monetary penalty of up to \$15,000 may be imposed for each bill or claim for a service a person knows or should know is for a service for which payment may not be made due to the Stark Law. Such persons or entities are also subject to exclusion from the Medicare and Medicaid programs. Any person or entity participating in a circumvention scheme to avoid the referral prohibitions is liable for a civil monetary penalty of up to \$100,000. A \$10,000 fine may be imposed for failure to comply with reporting requirements regarding an entity's ownership, investment and compensation arrangements for each day for which reporting is required to have been made under the Stark Law.

The Stark Law exempts certain business relationships that meet its exception requirements. However, unlike the Anti-Kickback Statute under which an activity may fall outside a safe harbor and still be lawful, a referral for DHS that does not fall within an exception is strictly prohibited by the Stark Law. The Centers for Medicare and Medicaid Services (CMS) has issued regulations addressing the Stark Law's prohibition on referrals for DHS and many of the available exceptions. Many of the Phase I regulations became effective on January 4, 2002 and the Phase II regulations became effective on July 26, 2004. We attempt to structure all of our relationships with physicians who make referrals to us in compliance with an applicable exception to the Stark Law.

In addition to the Stark Law, many of the states in which we and our franchisees operate have comparable restrictions on the ability of physicians to refer patients for certain services to entities with which they have a financial relationship. Certain of these state statutes mirror the Stark Law while others may be more restrictive. We attempt to structure all of our business relationships with physicians to comply with any applicable state self-referral laws.

Health Insurance Portability and Accountability Act of 1996 (HIPAA). To improve the efficiency and effectiveness of the health care system, the Health Insurance Portability and Accountability Act of 1996, Public Law 104-191, included Administrative Simplification provisions that required the Department of Health and Human Services (HHS) to adopt national standards for electronic health care transactions. At the same time, Congress recognized that advances in electronic technology could erode the privacy of

health information. Consequently, Congress incorporated provisions into HIPAA that mandated the adoption of Federal privacy protections for individually identifiable health information.

In response to the HIPAA mandate, in December 2000, HHS published a final regulation in the form of the Privacy Rule, which became effective on April 14, 2001. This Privacy Rule set national standards for the protection of health information, as applied to the three types of covered entities: health plans, health care clearinghouses, and health care providers who conduct certain health care transactions electronically. In March 2002, HHS published proposed modifications to the Privacy Rule, to improve workability and avoid unintended consequences that could have impeded patient access to delivery of quality health care. Following another round of public comment, in August 2002, HHS adopted final modifications necessary to ensure that the Privacy Rule worked as intended. Pursuant to the Privacy Rule, as of April 14, 2003, covered entities were required to have standards in place to protect and guard against the misuse of individually identifiable health information. (Small health plans had until April 14, 2004 to implement such standards.) Failure to timely implement these standards may, under certain circumstances, trigger the imposition of civil or criminal penalties.

The Privacy Rule establishes a foundation of Federal protections for the privacy of protected health information. The Privacy Rule does not replace Federal, State, or other laws that grant individuals even greater privacy protections, and covered entities are free to retain or adopt more protective policies or practices. We have implemented the standards set forth in the Privacy Rule, and these standards were in place on April 14, 2003. We believe that we and all of our franchisees are in compliance with the Privacy Rule or any more stringent federal or state laws relating to privacy.

Additionally, the Administrative Simplification provisions address electronic health care transactions and the security of electronic health information systems. Providers are required to comply with the standards by specific compliance dates established by HHS. For standards relating to electronic health care transactions, the compliance date was originally set for October 16, 2002. If the covered entity filed for an extension, the compliance date was postponed until October 16, 2003. We were materially compliant with these standards by the applicable compliance date. The security standards applicable to individually identifiable health information maintained electronically must be implemented by April 21, 2005. The standards for a unique national health identifier for providers used in connection with the electronic healthcare transactions must be implemented by May 23, 2007. We expect to be able to materially comply with these regulations by their applicable compliance dates.

Penalties for non-compliance with the Privacy Rule and other HIPAA Administrative Simplification provisions range from a civil penalty of \$100 for each violation (which can total up to \$25,000 per person per year), to criminal penalties, including up to \$50,000 and/or one year imprisonment, up to \$100,000 and/or five years imprisonment if the offense is committed under false pretenses and up to \$250,000 and/or ten years imprisonment for violating a standard with the intent to sell, transfer or use individually identifiable health information for commercial advantage, personal gain or malicious harm.

In addition to regulating privacy of individual health information and other provisions relating to Administrative Simplification, HIPAA includes several anti-fraud and abuse laws, extends criminal penalties to private health care benefit programs and, in addition to Medicare and Medicaid, to other federal health care programs, and expands the Office of Inspector General's authority to exclude persons and entities from participating in the Medicare and Medicaid programs.

Medicare Prescription Drug, Improvement and Modernization Act of 2003. The Medicare Prescription Drug, Improvement and Modernization Act of 2003 changed the way in which covered outpatient drugs are reimbursed by the Medicare program. In January 2004, payment for most drugs covered by Medicare decreased to 85% of the Average Wholesale Price (AWP) determined as of April 1, 2003. Beginning in 2005, reimbursement for most Medicare Part B drugs not paid on a cost or prospective payment basis will be set at either 106% of the average sales price (ASP) or through a competitive acquisition program to be phased in beginning in 2006. The competitive acquisition program will be established by CMS and will enable physicians in designated competitive acquisition areas to purchase drugs through contractors that have successfully bid for that right. Each physician will elect annually whether to obtain drugs through the competitive acquisition program. CMS will re-bid the contracts at least every three years. A significant part of the infusion drugs provided by our company are administered in connection with covered durable medical equipment (DME). The payment rate for drugs administered in this manner generally will continue to be 95% of the AWP in effect as of October 1, 2003.

While the majority of our revenue is reimbursed by managed care organizations and other non-government payors, these changes to the way Medicare pays for outpatient drugs and biologicals may reduce our revenue and gross margins on services provided to Medicare patients. Further, adoption of ASP as the standard measure for determining reimbursement by state Medicaid programs for the drugs we provide may reduce our revenue and gross margins.

Balanced Budget Act. Each state operates a Medicaid program funded in part by the Federal government. The states may customize their programs within federal limitations. Each state program has its own payment formula and recipient eligibility criteria. In recent years, changes in Medicare and Medicaid programs have resulted in limitations on, and reduced levels of, payment and reimbursement for a substantial portion of health care goods and services. For example, the federal Balanced Budget Act of 1997, even after the restoration of some funding in 1999 and 2000, will continue to cause significant reductions in spending levels for the Medicare and Medicaid programs. Medicaid reimbursement is at extremely low levels in some states. We carefully monitor state Medicaid reimbursement, and while we aggressively pursue managed care and other non-government payors, cutbacks in state Medicaid reimbursements could potentially have a significant impact on us or our franchisees.

Franchise Regulation. We are subject to regulations adopted by the Federal Trade Commission (FTC), and to certain state laws that regulate the offer and sale of franchises. The FTC Franchise Rule (Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures) and certain state laws require that we furnish prospective franchise owners with a Uniform Franchise Offering Circular (UFOC) containing information prescribed by the FTC Franchise Rule and applicable state laws and regulations. There are certain states that also regulate the offer and sale of franchises and, in almost all cases, require registration of the UFOC with state authorities.

We are also subject to a number of state laws that regulate some substantive aspects of the franchisor-franchisee relationship. These laws may limit a franchisor's ability to:

- terminate or not renew a franchise without good cause;
- interfere with the right of free association among franchise owners;
- disapprove the transfer of a franchise;
- discriminate among franchisees regarding charges, royalties and other fees; and
- place new facilities near existing franchisees.

These laws also may limit the duration and scope of non-competition provisions. To date, these laws have not precluded us from seeking franchisees in any given area and have not had a material adverse effect on our operations.

Although bills intended to regulate certain aspects of franchise relationships have been introduced into Congress on several occasions during the past decade, none have been enacted. We are not aware of any pending franchise legislation that in our view is likely to significantly affect our operations. We believe that our operations comply substantially with the FTC Franchise Rule and applicable state franchise laws.

SERVICE MARKS

We have registered with the federal government OPTION CARE®, OptionMed®, MBI® and iEmphys among others, as service marks. We believe that Option Care is becoming increasingly recognized by many referral sources as representing a reliable, cost-effective source of pharmacy services. We believe that the use of these service marks does not violate or otherwise infringe upon the rights of others.

INSURANCE

Our business may subject us to litigation and liability for damages. We currently maintain insurance for general and professional liability claims in the amount of \$1 million per claim and \$3 million in aggregate per policy year, plus \$5 million in umbrella coverage. Accordingly, the maximum coverage for a first claim in any policy year is \$6 million, and the maximum aggregate coverage for all claims in a policy year is \$8 million. We also require each franchisee to maintain general liability and professional liability insurance covering both the franchise and us, at coverage levels that we believe to be sufficient. These policies provide coverage on a claims-made or occurrence basis and have certain exclusions from coverage. These insurance policies generally must be renewed annually. There can be no assurance that our insurance coverage will be adequate to cover liability claims that may be asserted against us.

Professional liability insurance costs have increased significantly in recent years, and the number of insurance carriers willing to write professional liability insurance policies for healthcare providers has declined. There can be no assurance that adequate insurance will be available in the future at acceptable cost, if at all. To the extent that liability insurance is not adequate to cover liability claims against us, we will be responsible for the excess. A claim, or claims, in excess of our insurance coverage could have a material adverse effect upon our results of operations or financial condition.

EMPLOYEES

As of December 31, 2004, we employed 1,367 persons on a full-time basis and 601 persons on a part-time basis. Of our full-time employees, 108 were corporate management and administrative personnel and the remaining 1,259 were employees of company-owned locations, primarily in clinical, management and administrative positions.

We believe our employee relations are good. None of our employees is covered by a collective bargaining agreement.

RISK FACTORS

You should carefully consider the risks and uncertainties we describe below, together with all of the other information contained in this Annual Report on Form 10-K and our other filings with the Securities and Exchange Commission. Some of the following factors relate principally to our business and the industry in which we operate. Other factors relate principally to an investment in our common stock. (The risks and uncertainties described below are not the only risks and uncertainties that could develop. Other risks and uncertainties that we have not predicted or evaluated could also adversely affect our company.) If any of the following risks occur, our earnings, financial condition or business could be materially harmed, the trading price of our common stock could decline, and you could lose all or part of your investment.

Our revenue and profitability will decline if the pharmaceutical industry undergoes certain changes, including limiting or discontinuing research, development, production and marketing of the pharmaceuticals that are compatible with the services we provide.

Our business is highly dependent on the ability of biotech and other pharmaceutical companies to develop, supply and market pharmaceuticals that are compatible with the services we provide. Our revenue and profitability will decline if those companies were to sell pharmaceuticals directly to the public or fail to support existing pharmaceuticals or develop new pharmaceuticals. Our business could also be harmed if the pharmaceutical industry experiences any of the following developments:

- supply shortages;
- pharmaceutical recalls;
- an inability to finance product development because of capital shortages;
- a decline in product research, development or marketing;
- a reduction in the retail price of pharmaceuticals;
- changes in the FDA approval process; or
- government or private initiatives that alter how pharmaceutical manufacturers, health care providers or pharmacies promote or sell products and services.

If we lose relationships with managed care organizations and other non-governmental third party payors, we could lose access to a significant number of patients and our revenue and margins could decline.

We are highly dependent on reimbursement from managed care organizations and other non-governmental third party payors. For the fiscal years ended December 31, 2004, 2003 and 2002, respectively, 82%, 82% and 85% of our revenue came from managed care organizations and other non-governmental payors, including self-pay patients. Many payors seek to limit the number of providers that supply pharmaceuticals to their enrollees in order to build volume that justifies their discounted pricing. From time to time, payors with whom we have relationships require that we bid against our competitors to keep their business. As a result of such bidding process, we may not be retained, and even if we are retained, the prices at which we are able to retain the business may be reduced. The loss of a payor relationship could significantly reduce the number of patients we serve and have a material adverse effect on our revenue and net income, and a reduction in pricing could reduce our margins and our net income.

The loss of our contract with Blue Cross and Blue Shield of Florida would materially decrease our revenue.

Our principal managed care contract is with Blue Cross and Blue Shield of Florida, Inc. For the fiscal years ended December 31, 2004, 2003 and 2002, respectively, 15%, 17% and 20% of our revenue was related to this contract. The contract is terminable by either party on 90 days notice and, unless

terminated, renews annually each September for an additional one-year term. The loss of this contract, or a material reduction in our pricing or pharmaceutical sales under this contract, would materially decrease our revenue and net income.

Recent legislation changing the way Medicare reimburses healthcare providers for covered outpatient drugs, or other future changes to the scope or method of reimbursement from Medicare or Medicaid, could cause our revenue and gross profit margin to decline.

For the fiscal years ended December 31, 2004, 2003 and 2002, respectively, 18%, 18% and 15% of our revenue came from reimbursement by federal and state programs such as Medicare and Medicaid. Reimbursement from these and other government programs is subject to statutory and regulatory requirements, administrative rulings, interpretations of policy, implementation of reimbursement procedures, retroactive payment adjustments, governmental funding restrictions and changes to or new legislation, all of which may materially affect the amount and timing of reimbursement payments to us. In particular, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 changed the way in which Medicare reimburses providers for covered outpatient drugs. In January 2004, payment for most drugs covered by Medicare decreased to 85% of the Average Wholesale Price (AWP) determined as of April 1, 2003. Beginning in 2005, reimbursement for most Medicare Part B drugs not paid on a cost or prospective payment basis will be set at either 106% of the Average Sales Price (ASP) or through a competitive acquisition program to be phased in beginning in 2006. A significant part of the infusion drugs provided by our company are administered in connection with covered durable medical equipment (DME). The payment rate for drugs administered in this manner generally will continue to be 95% of the AWP in effect as of October 1, 2003. While the majority of our revenue is reimbursed by managed care organizations and other non-government payors, these changes to the way Medicare pays for outpatient drugs and biologicals may reduce our revenue and gross margins on services provided to Medicare patients. Further, adoption of ASP as the standard measure for determining reimbursement by state Medicaid programs for the drugs we provide may reduce our revenue and gross margins.

In addition, budgetary concerns in many states have resulted in and may continue to result in, reductions to Medicaid reimbursement as well as delays in payment of outstanding claims. Any reductions to or delays in collecting amounts reimbursable by government programs for our products or services or changes in regulations governing such reimbursements could cause our revenue and profitability to decline.

Our margins could decrease if there are changes in the calculation of Average Wholesale Price (AWP) for the pharmaceuticals we sell, or if managed care organizations and other private payors replace Average Wholesale Price with a different reimbursement system.

Our gross profit is largely controlled by our ability to purchase pharmaceutical products at discounted prices and to negotiate profitable managed care contracts. In many cases, we purchase pharmaceuticals at less than the published AWP for those pharmaceuticals. The AWP has been a standard form of pricing often used in the healthcare industry to determine discount and reimbursement amounts. Accordingly, we have contracted with a number of private payors to sell pharmaceuticals at AWP or at a percentage discount off of the AWP. AWP for most pharmaceuticals is compiled and published by private companies, including First DataBank, Inc. A reduction in AWP for the products we provide to patients could reduce our revenue and narrow our gross profit margins.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 will result in the replacement of AWP with ASP as the standard measure for determining Medicare reimbursement for certain covered outpatient drugs. The adoption of ASP or any other measure for determining reimbursement by some or all of the managed care or other private payors with whom we contract could have a significant impact on our future revenue, results of operations and financial condition.

We are subject to pricing pressures and other risks involved with third party payors.

In recent years, competition for patients, efforts by traditional third party payors to contain or reduce healthcare costs, and the increasing influence of managed care payors, such as health maintenance organizations, have resulted in reduced rates of reimbursement. Changes in reimbursement policies of governmental third party payors, including policies relating to Medicare, Medicaid and other federal and state funded programs, could reduce the amounts reimbursed to our customers for our products and, in turn, the amount these customers would be willing to pay for our products and services, or could directly reduce the amounts payable to us by such payors. Pricing pressures by third party payors may continue, and these trends may adversely affect our business.

Also, continued growth in managed care plans has pressured healthcare providers to find ways of becoming more cost competitive. Managed care organizations have grown substantially in terms of the percentage of the population they cover and in terms of the portion of the healthcare economy they control. Managed care organizations have continued to consolidate to enhance their ability to influence the delivery of healthcare services and to exert pressure to control healthcare costs. A rapid concentration of revenue derived from individual managed care payors could harm our business.

If we do not adequately respond to competitive pressures, demand for our products and services could decrease.

The markets we serve are highly competitive and subject to relatively few barriers to entry. Local, regional and national companies are currently competing in many of the healthcare markets we serve and others may do so in the future. Some of our competitors have greater financial, technical, marketing and managerial resources than we have. Consolidation among our competitors, such as pharmacy benefit managers (PBMs) and regional and national infusion pharmacy or specialty pharmacy providers could result in price competition and other competitive factors that could cause a decline in our revenue and profitability. We expect to continue to encounter competition in the future that could limit our ability to grow revenue and/or maintain acceptable pricing levels.

Some biotech pharmaceutical suppliers in the specialty pharmacy industry have chosen to limit the number of distributors of their products. If we are not selected as a preferred distributor of one or more of our core products, our business and results of operations could be seriously harmed.

We have identified a trend among some of our suppliers toward the retention of a limited number of preferred distributors to market certain of their biopharmaceutical products. If this trend continues, we cannot be certain that we will be selected and retained as a preferred distributor or can remain a preferred distributor to market these products. Although we believe we can effectively meet our suppliers' requirements, there can be no assurance that we will be able to compete effectively with other specialty pharmacy companies to retain our position as a distributor of each of our core products. Adverse developments with respect to this trend could have a material adverse effect on our business and results of operations.

Any termination of, or adverse change in, our relationships with a single source product manufacturer or the loss of supply of a specific, single source specialty drug could have a material adverse effect on our operations.

We sell biotech pharmaceuticals that are supplied to us by a variety of manufacturers, many of which are the only source of that specific pharmaceutical. In order to have access to these pharmaceuticals, and to be able to participate in the launch of new biotech pharmaceuticals, we must maintain good working relations with the manufacturers. Most of the manufacturers of the pharmaceuticals we sell have the right to cancel their supply contracts with us without cause and after giving only minimal notice. One biotech pharmaceutical, Synagis®, which is manufactured and distributed by MedImmune, Inc., represented 6.8%,

7.1% and 5.6% of our revenue, respectively, for the fiscal years ended December 31, 2004, 2003 and 2002. The loss of our relationship with MedImmune, Inc. or with one or more other biotech pharmaceutical manufacturer would reduce our revenue and profitability.

We have recently experienced, and expect to continue to experience, rapid growth by acquisitions. If we fail to manage our growth effectively, our business could be disrupted and our operating results could suffer.

Our ability to successfully offer our products and services in evolving markets requires an effective planning and management process. In 2004, 2003 and 2002, combined, we completed ten separate pharmacy business acquisitions. Our growth through acquisitions, combined with the internal growth of our business based on our business plan, may place a strain on our management systems and resources. This growth has resulted in, and will continue to result in an increase in responsibilities for management. To accommodate our growth and compete effectively, we will need to continue to enhance, expand and improve our management and our operational and financial information systems and controls, and to expand, train, manage and motivate our workforce. Our personnel, systems, procedures, or controls may not be adequate to support our operations in the future in light of anticipated growth. In addition, if we focus our financial resources and management attention on the expansion of our operations rather than on our ongoing operations, our financial results may suffer.

If we are unable to acquire additional local pharmacy facilities on favorable terms, we will be unable to execute our acquisition and development strategy.

Our strategy includes increasing our revenue and earnings through strategic acquisitions of infusion therapy pharmacies and related businesses. Our efforts to execute our acquisition strategy may be affected by our ability to identify suitable candidates and negotiate and close acquisitions. We continue to evaluate potential acquisition opportunities and expect to complete acquisitions in the future. The facilities we purchase may require working capital from us during the initial months of operation, depending on whether or not we acquire receivables as part of the acquisition agreement. We may acquire businesses with significant unknown or contingent liabilities, including liabilities for failure to comply with health care or reimbursement laws and regulations. While we generally obtain contractual rights to indemnification from owners of the businesses we acquire, our ability to realize on any indemnification claims will depend on many factors, including, among other things, the availability of assets of the indemnifying parties. In the future, we may not be successful in acquiring pharmacies or in achieving satisfactory operating results at acquired pharmacies, and we may not be able to acquire infusion therapy facilities that produce returns justifying our related investment. Furthermore, we may not be able to obtain sufficient capital resources to fund our acquisitions at terms acceptable to us, or at all. Future acquisitions may also result in the dilution of earnings.

An impairment of goodwill on our financial statements could adversely affect our financial position and results of operations.

Our acquisitions have resulted in the recording of a significant amount of goodwill on our financial statements. The goodwill was recorded because the fair value of the net assets acquired was less than the purchase price. We may not realize the full value of this goodwill. As such, we evaluate on at least an annual basis whether events and circumstances indicate that all or some of the carrying value of goodwill is no longer recoverable, in which case we would write off the unrecoverable goodwill as a charge against our earnings.

Since our growth strategy will likely involve the acquisition of other companies, we may record additional goodwill in the future. The possible write-off of this goodwill could negatively impact our future earnings. We will also be required to allocate a portion of the purchase price of any acquisition to the value

of any intangible assets that meet the criteria specified in the Statement of Financial Accounting Standards No. 141, Business Combinations, such as marketing, customer or contract-based intangibles. The amount allocated to these intangible assets could be amortized over a fairly short period, which may negatively affect our earnings or the market price of our common stock.

As of December 31, 2004, we had goodwill of \$65.4 million, or 24% of our total assets and approximately 45% of stockholders' equity.

Changes in state and federal government regulation could restrict our ability to conduct our business.

The marketing, sale and purchase of pharmaceuticals and medical supplies and provision of healthcare services generally is extensively regulated by federal and state governments. Other aspects of our business are also subject to government regulation. We believe we are operating our business in compliance with applicable laws and regulations. The applicable regulatory framework is complex, and the laws are very broad in scope. Many of these laws remain open to interpretation and have not been addressed by substantive court decisions. Accordingly, we cannot provide any assurance that our interpretation would prevail or that one or more government agencies will not interpret them differently. Changes in the law or new interpretations of existing law can have a dramatic effect on what we can do, our cost of doing business and the amount of reimbursement we receive from governmental third party payors, such as Medicare and Medicaid. Also, we could be affected by interpretations of what the appropriate charges are under government programs.

Some of the healthcare laws and regulations that apply to our activities include:

- The federal Anti-Kickback Statute prohibits individuals and entities from knowingly and willfully paying, offering, receiving, or soliciting money or anything else of value in order to induce the referral of patients or to induce a person to purchase, lease, order, arrange for, or recommend services or goods covered in whole or in part by Medicare, Medicaid, or other government healthcare programs. Although there are safe harbors under the Anti-Kickback Statute, some of our business arrangements and the services we provide may not fit within these safe harbors or a safe harbor may not exist that covers the arrangement. The Anti-Kickback Statute is an intent based statute and the failure of a business arrangement to satisfy all elements of a safe harbor will not necessarily render the arrangement illegal, but it may subject that arrangement to increased scrutiny by enforcement authorities. Violations of the Anti-Kickback Statute can lead to significant penalties, including criminal penalties, civil fines and exclusion from participation in Medicare and Medicaid.
- The Stark Law prohibits physicians from making referrals to entities with which the physicians or their immediate family members have a financial relationship (i.e., an ownership, investment or compensation relationship) for the furnishing of certain Designated Health Services (DHS) that are reimbursable under Medicare. The Stark Law exempts certain business relationships which meet its exception requirements. However, unlike the Anti-Kickback Statute under which an activity may fall outside a safe harbor and still be lawful, a referral for DHS that does not fall within an exception is strictly prohibited by the Stark Law. A violation of the Stark Law is punishable by civil sanctions, including significant fines and exclusion from participation in Medicare and Medicaid.
- The Health Insurance Portability and Accountability Act of 1996 (HIPAA) included Administrative Simplification provisions that required the Department of Health and Human Services (HHS) to adopt national standards governing electronic health care transactions. At the same time, it was recognized that advances in electronic technology could erode the privacy of health information. Consequently, Congress incorporated provisions into HIPAA that mandated the adoption of federal privacy protections for individually identifiable health information. HHS published a final regulation in the form of the Privacy Rule in December 2000, which became

effective April 14, 2001. The Privacy Rule was subsequently modified, and the final version was adopted in August 2002. The Privacy Rule set national standards for the protection of health information for providers and others who transmit health information electronically. By the compliance date of April 14, 2003, covered entities were required to implement standards to protect and guard against misuse of individually identifiable health information. We have implemented the standards set forth in the Privacy Rule and these standards were in place on April 14, 2003. We believe that we are in compliance with the Privacy Rule or any more stringent federal or state laws relating to privacy. Penalties for non-compliance with the Privacy Rule and other HIPAA Administrative Simplification provisions range from civil fines to criminal penalties.

In addition to regulating privacy of individual health information, HIPAA includes several anti-fraud and abuse laws, extends criminal penalties to private health care benefit programs and, in addition to Medicare and Medicaid, to other federal health care programs, and expands the Office of Inspector General's (OIG's) authority to exclude persons and entities from participating in the Medicare and Medicaid programs.

- Pharmacies and pharmacists must obtain state licenses to operate and dispense pharmaceuticals. If we are unable to maintain our licenses or if states place burdensome restrictions or limitations on non-resident pharmacies, this could limit or affect our ability to operate in some states which could adversely impact our business and results of operations.

We may become subject to federal and state investigations.

Both federal and state government agencies have heightened and coordinated civil and criminal enforcement efforts as part of numerous ongoing investigations of healthcare companies, as well as their executives and managers. These investigations relate to a wide variety of topics, including referral and billing practices. Further, amendments to the federal False Claims Act have made it easier for private parties to bring whistleblower lawsuits against companies. Some states have adopted similar state whistleblower and false claims provisions. The Office of the Inspector General of the Department of Health and Human Services and the Department of Justice have, from time to time, established national enforcement initiatives that focus on specific billing practices or other suspected areas of abuse. Some of our activities could become the subject of governmental investigations or inquiries. For example, we have significant Medicare and Medicaid billings. In addition, our executives, some of whom have worked at other healthcare companies that are or may become the subject of federal and state investigations and private litigation, could be included in governmental investigations or named as defendants in private litigation, resulting in adverse publicity against us. We are not aware of any governmental investigations involving any of our company-owned facilities or our executives. A future investigation of us could result in significant liabilities or penalties to us, as well as adverse publicity, and could seriously undermine our ability to compete for business, negotiate acquisitions, hire new personnel and otherwise conduct our business.

We may be subject to liability for the services we offer and the products we sell.

We and other participants in the health care market are, have been and are likely to continue to be subject to lawsuits based upon alleged malpractice, product liability, negligence or similar legal theories, many of which involve large claims and significant defense costs. A successful claim not covered by our professional liability insurance or substantially in excess of our insurance coverage could cause us to pay out a substantial award. In addition, we retain liability on claims up to the amount of our deductibles, which generally are \$250,000 per occurrence. Further, our insurance policy is subject to annual renewal and it may not be possible to obtain liability insurance in the future on acceptable terms, with adequate coverage against potential liabilities, or at all. Also, claims against us, regardless of their merit or eventual outcome, could be a serious distraction to management and could harm our reputation.

Our image and reputation may be harmed by actions taken by our franchisees that are outside of our control.

The majority of our local pharmacy locations are operated by franchisees. Franchisees are independent business owners and are not our subsidiaries or employees. Consequently, the quality of a franchised operation is dependent upon its owner(s) and manager(s). Franchisees may not successfully operate facilities or they may fail to comply with federal and state health care statutes and regulations. If they do not operate their franchises effectively or do not comply with applicable industry regulations, our image and reputation may suffer which could negatively impact our results of operations.

Our gross profit margins may decline if our franchise royalties are reduced.

We rely on royalty payments from our franchisees. For the fiscal years ended December 31, 2004, 2003 and 2002, we derived 2.2%, 2.6% and 2.5%, respectively, of our revenue from franchise royalties and related fees. Our franchisees pay royalties on their gross receipts. Because there is no cost of goods sold associated with this revenue, franchise royalties and other fees represent a significant portion of our gross profit. For the fiscal years ended December 31, 2004, 2003 and 2002, royalties and other franchise fees represented 7.8%, 8.6% and 8.1%, respectively, of our gross profit. If our franchisees encounter business or operational difficulties, our revenue from royalties may be adversely affected. Such difficulties may also negatively impact our ability to sell new franchises. In addition, if we are unable to successfully attract new franchisees or if our existing franchise owners do not enter into new franchise agreements with us when their current agreements expire, our franchise revenue, gross profit and overall profitability will decline.

The loss of one or more of our key employees could harm our operations.

Our success depends upon the availability and performance of our key executives, including our Chief Executive Officer, Rajat Rai, and our President and Chief Operating Officer, Richard M. Smith. We do not have key person insurance for any of our key executives. The loss of the services of Mr. Rai, Mr. Smith or any of our other key executives could have a material adverse effect upon our business and results of operations.

The current or future shortage in licensed pharmacists, nurses and other clinicians could adversely affect our business.

The healthcare industry is currently experiencing a shortage of licensed pharmacists, nurses and other healthcare professionals. Consequently, hiring and retaining qualified personnel will be difficult due to intense competition for their services and employment. Any failure to hire or retain pharmacists, nurses or other healthcare professionals could impair our ability to expand or maintain our operations.

Increases in the per share market price of our common stock in future periods could result in dilution of our earnings per share.

Increases in the market price of our common stock may result in dilution of our earnings per share related to the conversion feature of our 2.25% senior convertible notes. In accordance with EITF 04-08, our diluted shares must include the dilutive effect of our convertible notes for periods during which the average market price of our common stock exceeds its conversion price per the terms of the notes during a given period. The initial conversion price was set at \$18.01 per share (subject to future adjustment, as needed). If the average market price of our common stock should exceed the conversion price per share in a given period, our diluted shares would increase which could reduce our net income per diluted share for such period.

We may not have the ability to raise the funds to purchase our outstanding convertible senior notes on the purchase dates or upon a fundamental change or to pay the cash payment due upon conversion.

On each of November 1, 2009, November 1, 2014 and November 1, 2019, holders of our convertible senior notes may require us to purchase, for cash, all or a portion of their 2.25% senior convertible notes at 100% of their principal amount, plus any accrued and unpaid interest to, but excluding, that date. If a fundamental change occurs, holders of the notes may require us to repurchase, for cash, all or a portion of their notes. In addition, upon conversion of the notes, we will be required to pay the principal return, or, in certain circumstances, other amounts, in cash. We may not have sufficient funds for any required repurchase of the notes. In addition, the terms of any borrowing agreements which we may enter into from time to time may require early repayment of borrowings under circumstances similar to those constituting a fundamental change. These agreements may also make our repurchase of notes, or the cash payment due upon conversion of the notes, an event of default under the agreements. If we fail to repurchase the notes or pay the cash payment due upon conversion when required, we will be in default under the indenture for the notes.

Increased leverage as a result of our outstanding convertible senior notes may harm our financial condition and results of operations.

Our total consolidated long-term debt as of December 31, 2004 was \$86.3 million, which represents 37.1% of our total capitalization as of that date. In addition, the indenture for our convertible senior notes will not restrict our ability to incur additional indebtedness.

Our level of indebtedness could have important consequences, because:

- it could affect our ability to satisfy our obligations under the notes;
- a portion of our cash flows from operations will have to be dedicated to interest and principal payments and may not be available for operations, working capital, capital expenditures, expansion, acquisitions or general corporate or other purposes;
- it may impair our ability to obtain additional financing in the future;
- it may limit our flexibility in planning for, or reacting to, changes in our business and industry; and
- it may make us more vulnerable to downturns in our business, our industry or the economy in general.

Our certificate of incorporation, our bylaws, and Delaware law contain provisions that could discourage a change in control.

Some provisions of our certificate of incorporation and bylaws, as well as Delaware law, may be deemed to have an anti-takeover effect or may delay or make more difficult an acquisition or change in control not approved by our board of directors, whether by means of a tender offer, open market purchases, a proxy contest or otherwise. These provisions could have the effect of discouraging third parties from making proposals involving an acquisition or change in control, although such a proposal, if made, might be considered desirable by a majority of our stockholders. These provisions may also have the effect of making it more difficult for third parties to cause the replacement of our current management team without the concurrence of our board of directors.

AVAILABLE INFORMATION

We make available free of charge through our internet site (www.optioncare.com) reports we file with the SEC, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(c) or 15(d) of the Securities and Exchange Act of 1934, as soon as reasonably practical after we electronically file such materials with the SEC. Also available through our internet site is our Code of Ethics for our directors, officers and employees. In addition, interested parties can request a copy of our Code of Ethics free of charge by writing to Joseph P. Bonaccorsi, Senior Vice President, Secretary & General Counsel, Option Care, Inc., 485 Half Day Road, Suite 300, Buffalo Grove, Illinois 60089, or telephoning us at (847) 465-2100.

Item 2. PROPERTIES

Our executive offices, located at 485 Half Day Road, Suite 300, Buffalo Grove, Illinois, 60089, consist of approximately 29,000 square feet of leased space, pursuant to a ten-year and three month lease that began in June 2002. Monthly base rent payments range from approximately \$35,000 per month for the first year of the lease to approximately \$53,000 per month for the last year, plus applicable real estate taxes and maintenance costs. We have the option to accelerate the expiration date of this lease by three years upon payment of an acceleration fee. This executive office space is adequate to fulfill our needs for the foreseeable future.

In addition to our executive offices, we have over 50 facilities located in more than 40 cities throughout the United States. Our most significant building lease commitments, aside from our executive office lease described above, are for the following facilities:

Location (City, State)	Street Address	Lease Term	Approximate Square Footage	Total Remaining Commitment at December 31, 2004 (in thousands)
• Miramar, Florida	2804 Corporate Way	08/27/2002 - 10/31/2012	20,000	\$ 2,300
• Bellingham, Washington	477 West Horton Road	12/01/2001 - 11/30/2009	13,000	\$ 1,102
• Arlington Heights, Illinois	1155 W. Dundee Road, Suite 150	03/14/2003 - 08/31/2008	14,000	\$ 1,009
• Ann Arbor, Michigan	1350 Highland Drive, Suites D & E	07/01/2002 - 04/30/2009	17,000	\$ 976

Our facilities, most of which contain pharmacies, warehouse space and administrative offices, are all leased, with remaining terms ranging from one month to approximately nine years, and consist of approximately 400,000 square feet in total. The offices are in good condition, well maintained, and are adequate to fulfill our operational needs for the foreseeable future. We believe that if necessary, we could replace any of our leased facilities without significant additional cost or adverse affect on our business.

Item 3. LEGAL PROCEEDINGS

From time to time, we are named as a party to legal claims and proceedings in the ordinary course of business. Additionally, from time to time, governmental and regulatory agencies may initiate investigations or proceedings against us in the ordinary course of business, or which have general application to the businesses we operate. Presently, we are not aware of any claims, investigations or proceedings against us or any of our franchisees that we believe are likely to have a material adverse effect on our results of operations or financial condition.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.

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PART II**Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER REPURCHASES OF EQUITY SECURITIES**

Option Care is traded on the NASDAQ National Market under the symbol `OPTN`. The following table shows the high and low bid prices for our Common Stock for the periods indicated.

Calendar Quarter	High	Low
2004		
Fourth Quarter	\$ 18.84	\$ 12.77
Third Quarter	\$ 18.62	\$ 13.30
Second Quarter	\$ 15.83	\$ 11.05
First Quarter	\$ 13.89	\$ 10.34
2003		
Fourth Quarter	\$ 12.47	\$ 8.59
Third Quarter	\$ 12.68	\$ 9.70
Second Quarter	\$ 12.22	\$ 8.26
First Quarter	\$ 9.15	\$ 6.99

On March 1, 2005, the closing price of our common stock on the NASDAQ National Market was \$18.95. As of March 1, 2005, there were 298 holders of record reported to us by our transfer agent, U.S. Stock Transfer Corporation.

In May 2004, our Board of Directors authorized the adoption of a quarterly dividend policy. Each quarter, our Board of Directors will determine the dividend amount per share. During each of the quarters ended June 30, September 30 and December 31, 2004, our board declared a \$0.02 per share dividend.

All share and per share amounts in this Annual Report on Form 10-K for the fiscal years 2002 and 2001 have been adjusted to reflect the pro forma effects of the 5-for-4 stock split completed on May 1, 2002 for shareholders of record as of April 10, 2002.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Common Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plan or Program(1) (in thousands)
October 1-31, 2004	21,000	\$ 13.21	21,000	\$ 28,618
November 1-30, 2004	295,000	\$ 14.39	295,000	\$ 24,372
December 1-31, 2004				\$ 24,372
TOTAL	316,000	\$ 14.31	316,000	\$ 24,372

(1) On February 17, 2004, we announced that our Board of Directors authorized our repurchase of up to \$8 million in shares of common stock on the open market from time to time. Subsequently, on November 4, 2004, we announced that our Board of Directors, at their meeting on October 7, 2004, increased our stock buyback authorization to \$30 million. This \$30 million buyback authorization expires on October 7, 2005.

Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The table below provides you with certain of our summary historical financial data. We have prepared this information using our consolidated financial statements for the five years ended December 31, 2004, which have been audited by Ernst & Young LLP, independent registered public accounting firm. The selected consolidated financial data reflects our acquisitions, all of which were accounted for using the purchase method of accounting. This summary should be read in conjunction with our Consolidated Financial Statements and Notes thereto, and Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations.

Consolidated Statement of Income data (in thousands, except per share data):

	Years Ended December 31,				
	2004	2003	2002	2001	2000
Revenue	\$ 414,430	\$ 355,440	\$ 320,496	\$ 217,133	\$ 141,274
Cost of revenue:					
Cost of goods	251,613	205,916	183,329	116,057	68,197
Cost of service	43,802	41,438	37,550	28,599	19,588
Total cost of revenue	295,415	247,354	220,879	144,656	87,785
Gross profit	119,015	108,086	99,617	72,477	53,489
Operating expenses	87,767	93,030	76,077	54,907	40,415
Operating income	\$ 31,248	\$ 15,056	\$ 23,540	\$ 17,570	\$ 13,074
Net income	\$ 18,931	\$ 8,718	\$ 14,079	\$ 9,957	\$ 7,455
Net income per common share diluted	\$ 0.87	\$ 0.41	\$ 0.67	\$ 0.58	\$ 0.48
Pro forma net income and net income per common share diluted, had the non-amortization provisions of SFAS No. 142 been adopted for all periods presented:					
Pro forma net income	\$ 18,931	\$ 8,718	\$ 14,079	\$ 10,635	\$ 7,897
Pro forma net income per common share diluted	\$ 0.87	\$ 0.41	\$ 0.67	\$ 0.62	\$ 0.51
Weighted average number of shares and equivalents outstanding diluted	21,825	21,292	21,136	17,098	15,610
Dividends paid per common share	\$ 0.06	\$	\$	\$	\$

Consolidated Balance Sheet data (in thousands):

	As of December 31,				
	2004	2003	2002	2001	2000
Working capital	\$ 158,453	\$ 56,777	\$ 61,710	\$ 56,357	\$ 20,994
Total assets	269,847	166,534	158,850	125,262	66,825
Current portion of long-term debt	19	424	261	265	833
Other current liabilities	28,392	30,193	27,194	21,077	13,546
Long-term debt, less current portion	86,306	82	7,314	353	11,951
Stockholders' equity	146,563	129,020	118,601	100,766	38,668

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We provide specialty pharmacy services and home infusion and other healthcare services to patients at home or at other alternate sites such as infusion suites and physician's offices. We contract with managed care organizations and other third party payors who reimburse us for the services we provide to their subscribers. Our services are provided by our two central, high-volume distribution facilities, 39 company-owned locations and 83 franchised locations.

The year 2004 was marked by continued growth in revenue and net income, as well as strategic initiatives designed to pave the way for continued growth in the year 2005 and beyond. Revenue grew by 16.6% in 2004 to \$414.4 million from \$355.4 million in 2003. This growth was primarily due to indigenous growth in our company-owned offices and increased sales volume for Xolair®. Continuing sales efforts produced a same store growth rate of 11.9% for infusion and related healthcare services, with the largest increase being from anti-infective therapies. Specialty pharmacy services revenue increased 19.1% on a same-store basis primarily due to increased sales of Xolair®, human growth hormone and other specialty drugs distributed by our two central, high-volume distribution facilities and 39 company-owned locations. This revenue growth, combined with ongoing cost containment efforts and our improved management of accounts receivable, resulted in net income of \$18.9 million for the year 2004, an increase of 117.1% over the prior year.

In November 2004, we completed an \$86.3 million offering of 2.25% convertible senior notes due 2024 in order to provide us with the resources to fund future growth objectives. We intend to use the proceeds from the offering for business acquisitions, stock repurchases, working capital and other corporate needs. Concurrent with the completion of this offering, we terminated our credit and security agreement with J.P. Morgan Business Credit Corp. We continue to actively seek strategic and accretive acquisition opportunities, particularly in the area of home infusion.

The majority of our revenue is generated from managed care contracts and other agreements with commercial third party payors. We have one managed care contract, with Blue Cross and Blue Shield of Florida, Inc. (BC/BS of Florida), that represents a significant portion of our revenue. In the years 2004, 2003 and 2002, respectively, 15%, 17% and 20% of our revenue was related to this contract. As of December 31, 2004 and 2003, 7% and 9% of Option Care's accounts receivable was due from BC/BS of Florida. Our contract with BC/BS of Florida is terminable by either party on 90 days' notice and, unless terminated, renews each September for an additional one-year term. This contract renewed in September 2004 with no material changes. No other managed care contract represents more than 10% of our revenue.

We also generate revenue from governmental healthcare programs such as Medicare and Medicaid. For the years 2004, 2003 and 2002, respectively, 18%, 18% and 15% of our revenue came from these governmental healthcare programs. As of December 31, 2004 and 2003, respectively, 18% and 20% of total accounts receivable were due from these programs.

Many of the pharmaceuticals we provide are reimbursed at some percentage of the Average Wholesale Price (AWP) of the pharmaceuticals. AWP for most pharmaceuticals is compiled and published by private companies, including First DataBank, Inc. However, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 changed the way in which covered outpatient drugs are reimbursed by the Medicare program. Starting in January 2004, payment for most drugs covered by Medicare decreased to 85% of the Average Wholesale Price (AWP) determined as of April 1, 2003. Beginning in 2005, reimbursement for non-self administered drugs furnished to patients in conjunction with other Medicare covered services has been set at either 106% of the average sales price (ASP) or

through a competitive acquisition program to be phased in beginning in 2006. The eventual replacement of AWP by ASP as the standard measure for determining reimbursement by the Medicare program could have an impact on our future results of operations and financial condition, potentially reducing our revenue and narrowing our gross profit margins. While our Medicare exposure is relatively small, the adoption of ASP by state Medicaid programs or by managed care organizations and other private payors could have a more material impact on our results of operations and financial condition.

Acquisitions have been and will continue to be an integral part of our overall growth strategy. In February 2005, we acquired 100% of the outstanding stock of our franchise in St. Cloud, Minnesota. During 2004, we used \$4.1 million in cash to complete five small acquisitions in markets that we currently serve. While none of these acquisitions was material to our overall results of operations, they will help solidify our position and ongoing profitability in these markets. During 2003, we invested \$14.6 million in cash for acquisitions in Texas and Minnesota.

On February 18, 2005, our Board of Directors authorized a 3-for-2 stock split effective March 31, 2005 for shareholders of record as of March 17, 2005. The purpose of this split is to increase the liquidity of our common stock and make us an attractive investment option for a wider range of investors.

RESULTS OF OPERATIONS

The following table shows certain statement of income items expressed in amounts and percentage of revenue for the years ended December 31, 2004, 2003 and 2002 (amounts in thousands).

	Years ended December 31,		2003		2002	
	2004		Amount	% of Revenue	Amount	% of Revenue
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
Revenue:						
Specialty pharmacy	\$ 249,697	60.2 %	\$ 208,557	58.7 %	\$ 181,049	56.5 %
Infusion and related healthcare services	153,302	37.0 %	136,192	38.3 %	129,146	40.3 %
Other	11,431	2.8 %	10,691	3.0 %	10,301	3.2 %
Total revenue	414,430	100.0 %	355,440	100.0 %	320,496	100.0 %
Cost of revenue:						
Cost of goods	251,613	60.7 %	205,916	57.9 %	183,329	57.2 %
Cost of service	43,802	10.6 %	41,438	11.7 %	37,550	11.7 %
Total cost of revenue	295,415	71.3 %	247,354	69.6 %	220,879	68.9 %
Gross profit	119,015	28.7 %	108,086	30.4 %	99,617	31.1 %
Operating expenses:						