

NightHawk Radiology Holdings Inc
Form 10-Q
October 31, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008**
- OR
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission File Number 000-51786

NightHawk Radiology Holdings, Inc.

(Exact name of registrant as specified in its charter)

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Delaware (State or other jurisdiction of incorporation or organization)	87-0722777 (IRS Employer Identification No.)
601 Front Street, #502, C ur d Alene, Idaho (Address of principal executive offices)	83814 (Zip code)
(208) 676-8321 (Registrant s telephone number, including area code)	

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Small reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of October 17, 2008, 28,605,767 shares of the Registrant s common stock were outstanding.

Table of Contents

TABLE OF CONTENTS

Part I

Item 1.	Financial Statements	
	<u>Condensed Consolidated Balance Sheets</u>	3
	<u>Condensed Consolidated Statements of Operations</u>	4
	<u>Condensed Consolidated Statements of Cash Flows</u>	5
	<u>Condensed Consolidated Statements of Comprehensive Income</u>	7
	<u>Notes to Condensed Consolidated Financial Statements</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
Item 4.	<u>Controls and Procedures</u>	27

Part II

Item 1.	<u>Legal Proceedings</u>	28
Item 1A.	<u>Risk Factors</u>	28
Item 6.	<u>Exhibits</u>	39
	<u>Signatures</u>	40

Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1. Financial Statements****NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)***(In thousands, except share data)*

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 55,239	\$ 31,956
Marketable securities		30,625
Trade accounts receivable, net	26,399	25,665
Deferred income taxes	615	655
Prepaid expenses and other current assets	2,826	2,812
Total current assets	85,079	91,713
Property and equipment, net	11,018	10,555
Goodwill	68,839	68,601
Intangible assets, net	81,485	87,133
Deferred income taxes	2,022	1,251
Other assets, net	3,724	4,213
Total	\$ 252,167	\$ 263,466
LIABILITIES		
Current liabilities:		
Accounts payable	\$ 6,063	\$ 6,071
Accrued expenses and other liabilities	4,245	12,881
Accrued payroll and related benefits	2,830	4,570
Long-term debt, due within one year	1,000	1,000
Total current liabilities	14,138	24,522
Insurance reserve	4,037	3,038
Long-term debt	97,750	98,500
Other liabilities	3,007	2,717
Total liabilities	118,932	128,777
Commitments and contingencies (Note 6)		
STOCKHOLDERS EQUITY		
Common stock 150,000,000 shares authorized; \$.001 par value; 28,605,767 and 30,312,322 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	29	30
Additional paid-in capital	241,007	249,274
Retained earnings (deficit)	(106,173)	(112,957)
Accumulated other comprehensive income (deficit)	(1,628)	(1,658)
Total stockholders equity	133,235	134,689

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Total	\$ 252,167	\$ 263,466
-------	------------	------------

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)***(In thousands, except share data)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Service revenue	\$ 43,441	\$ 45,151	\$ 127,887	\$ 108,956
Operating costs and expenses:				
Professional services (includes non-cash stock-based compensation expense of \$537, \$1,536, \$1,513 and \$3,567, respectively)	18,340	19,069	53,243	46,844
Sales, general, and administrative (includes non-cash stock-based compensation expense of \$1,361, \$3,160, \$5,549 and \$5,843, respectively)	15,367	15,754	50,002	36,861
Depreciation and amortization	2,829	2,608	8,585	5,251
Total operating costs and expenses	36,536	37,431	111,830	88,956
Operating income	6,905	7,720	16,057	20,000
Other income (expense):				
Interest expense	(2,090)	(2,389)	(6,466)	(3,665)
Interest income	307	746	1,210	2,468
Other, net	114	(27)	102	(59)
Total other income (expense)	(1,669)	(1,670)	(5,154)	(1,256)
Income before income taxes	5,236	6,050	10,903	18,744
Income tax expense	1,953	2,262	4,119	7,111
Net income	\$ 3,283	\$ 3,788	\$ 6,784	\$ 11,633
Earnings per common share:				
Basic	\$ 0.11	\$ 0.13	\$ 0.23	\$ 0.39
Diluted	\$ 0.11	\$ 0.12	\$ 0.22	\$ 0.38
Weighted averages of common shares outstanding:				
Basic	28,573,349	30,111,156	29,810,161	30,023,122
Diluted	29,733,210	31,170,449	30,852,398	31,012,036

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)***(In thousands)*

	Nine Months Ended September 30,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 6,784	\$ 11,633
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,585	5,251
Accretion of discounts on marketable securities	(21)	(285)
Amortization of debt issuance costs	486	234
Loss (gain) on disposal of fixed assets and other, net	582	(23)
Deferred income taxes	(574)	(4,795)
Non-cash stock compensation expense	7,062	9,410
Excess tax benefit from exercise of stock options	(234)	(1,325)
Provision for doubtful accounts	469	347
Changes in operating assets and liabilities (excluding effects of acquisitions):		
Trade accounts receivable, net	(1,272)	(7,573)
Prepaid expenses and other assets	(11)	(95)
Accounts payable	99	2,983
Accrued expenses and other liabilities	756	352
Accrued payroll and related benefits	219	1,343
Net cash provided by operating activities	22,930	17,457
Cash flows from investing activities:		
Purchase of marketable securities	(26,390)	(26,491)
Proceeds from maturities of marketable securities	33,755	36,128
Proceeds from the sale of marketable securities	23,302	
Purchase of property and equipment	(4,112)	(3,499)
Cash and cash equivalents from acquisitions, net		339
Cash paid for acquisitions	(7,650)	(125,736)
Net cash provided by (used in) investing activities	18,905	(119,259)
Cash flows from financing activities:		
Repayment of debt	(750)	(11,116)
Proceeds from exercise of stock options	556	962
Excess tax benefit from exercise of stock options	234	1,325
Purchase and retirement of common stock shares	(18,592)	
Proceeds from debt		100,000
Payment on line of credit		(1,679)
Debt issuance costs paid		(4,479)
Net cash (used in) provided by financing activities	(18,552)	85,013
Net increase (decrease) in cash and cash equivalents	23,283	(16,789)
Cash and cash equivalents beginning of period	31,956	46,501
Cash and cash equivalents end of period	\$ 55,239	\$ 29,712

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(unaudited)

	Nine Months Ended September 30,	
	2008	2007
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 5,416	\$ 3,356
Cash paid for income taxes	3,991	9,065
Non-cash investing and financing activities:		
Purchases of equipment included in accounts payable	284	(6)
Earnout liability included in accrued expenses settled in stock	2,078	
Debt issuance costs included in accounts payable and accrued expenses		41
Acquisition costs included in accounts payable and accrued expenses		700

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

(In thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Net income	\$ 3,283	\$ 3,788	\$ 6,784	\$ 11,633
Other comprehensive income:				
Change in fair value of interest rate swaps	101		35	
Less: deferred income taxes	(37)		(5)	
Net other comprehensive income	64		30	
Comprehensive income	\$ 3,347	\$ 3,788	\$ 6,814	\$ 11,633

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

NIGHTHAWK RADIOLOGY HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The accompanying unaudited condensed consolidated financial statements include the results of operations, financial position and cash flows of NightHawk Radiology Holdings, Inc and its subsidiaries (the Company). All material intercompany balances have been eliminated.

In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to present fairly, in all material respects, the Company's results for the periods presented. These condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such SEC rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in Item 8 of the Company's 2007 Annual Report on Form 10-K filed with the SEC on February 19, 2008. The results of operations for the three months and nine months ended September 30, 2008 are not necessarily indicative of results to be expected for the entire fiscal year.

The Company's unaudited condensed consolidated balance sheet as of December 31, 2007 has been derived from the audited consolidated balance sheet as of that date.

Use of Estimates The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company's management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of these estimates require difficult, subjective or complex judgments about matters that are inherently uncertain. Actual results could differ from those estimates.

On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, fair value of acquired intangible assets and goodwill, useful lives of intangible assets and property and equipment, income taxes, the loss contingency for medical liability claims, reserves for incurred but not reported (IBNR) medical liability claims, estimates used for the purpose of determining stock-based compensation and the Company's business services customers' expected net collections.

Trade Accounts Receivable Trade accounts receivable represent receivables for services and are recorded at the invoiced amount and are non-interest bearing. Company management reviews past due accounts receivable to identify specific customers with known disputes or collectibility issues. As of September 30, 2008 and December 31, 2007, the Company had reserved \$0.9 million and \$0.6 million, respectively, for doubtful accounts based on its estimate of the collectibility of outstanding receivables as of those dates.

Marketable Securities The Company determines the appropriate classification of investments in marketable securities at the time of purchase and reevaluates such designation at each balance sheet date. Marketable securities have been classified and accounted for as available for sale. The Company may or may not hold securities with stated maturities greater than 12 months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. The Company expects that the majority of marketable securities will be sold within one year, regardless of maturity date. The Company primarily invests in high-credit-quality debt instruments with an active resale market and money market funds to ensure liquidity and the ability to readily convert these investments into cash to fund current operations, or satisfy other cash requirements as needed. The Company does not invest in auction rate securities. During the three months ended September 30, 2008, all marketable securities were sold and the proceeds reinvested in short-term money market accounts as a conservative measure against the unfavorable conditions in the credit market and to better ensure access and recoverability. In October 2008, the Company reinvested these funds in short-term U.S. Treasury Bills. Our investments in money market accounts and short-term U.S. Treasury Bills are considered cash equivalents and accordingly are included in cash and cash equivalents on our balance sheet. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of other income or expense.

Table of Contents

Property and Equipment Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of each asset, which range as follows:

Computers, diagnostic workstations and telecommunications systems	3 5 years
Office furniture and equipment	7 10 years
Software	3 7 years
Leasehold improvements	Term of lease or asset life, whichever is shorter

Expenditures for maintenance and repairs are charged to operating expense as incurred and expenditures for renewals and betterments are capitalized. Upon sale or retirement of depreciable assets, the related cost and accumulated depreciation are removed from the records and any gain or loss is reflected in operating expenses.

Cost of computer software for internal use is capitalized and accounted for in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Capitalized costs are amortized based on their expected useful lives.

Depreciation expense for the three months ended September 30, 2008 and 2007 was \$0.9 million for both periods and \$2.9 million and \$2.0 million for the nine months ended September 30, 2008 and 2007, respectively.

Medical Liability Insurance The Company is exposed to risk of loss related to litigation that may arise from alleged malpractice and accordingly maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services on behalf of the Company.

The Company records reserves for both asserted and IBNR amounts. Asserted claims are reserved based upon the Company's best estimate of future probable costs. The IBNR reserve is intended to cover potential medical claims that might arise related to past medical services performed by the Company's affiliated radiologists. IBNR amounts are estimated using historical claims information and actuarial-based industry indices.

Concentration of Credit Risk Financial instruments that potentially expose the Company to concentration of credit risk consist primarily of cash, cash equivalents, marketable securities, and accounts receivable. The Company maintains its cash, cash equivalents, and marketable securities with high quality credit institutions and limits the amounts invested with any one financial institution or in any type of financial instrument. As of September 30, 2008 and December 31, 2007, a total of \$14.0 million and \$12.0 million, respectively, of cash and cash equivalents exceeded federal government insured amounts; however, in October 2008, the marketable securities then held by the Company were sold and reinvested in short-term U.S. Treasury Bills.

Recent Accounting Standards In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value according to accounting principles generally accepted in the United States of America, and expands disclosure requirements regarding fair value measurements. SFAS 157 emphasizes that fair value should be determined based on assumptions market participants would use to price the asset or liability. The provisions of SFAS 157 were effective for fiscal years beginning after November 15, 2007. The Company adopted this new accounting pronouncement as of January 1, 2008 and the impact of adoption was not significant. See Note 11 for disclosures regarding fair value measurements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 was effective for the Company on January 1, 2008. The Company has assessed this option and elected not to measure such financial instruments at fair value.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)) which establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to

Table of Contents

disclose to enable users of the financial statements to evaluate the nature and financial effect of the business combination. SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. SFAS 141(R) will be effective for the Company on January 1, 2009. The Company does not expect the adoption of SFAS No. 141(R) to have a significant impact on its financial position or results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* (SFAS 160). SFAS 160 requires that all entities in which its parent has a controlling financial interest be consolidated into the parent at 100 percent of fair value and the parent's consolidated net income include amounts attributable to both the parent and noncontrolling interest. SFAS 160 clarifies that non-controlling interests in subsidiaries be presented as equity and any changes to the ownership interest are considered equity transactions providing the parent maintains its controlling financial interest in the subsidiary. SFAS 160 will be effective for the Company on January 1, 2009. The Company does not expect the adoption of SFAS 160 to have a significant impact on its financial position and results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161) which amends and expands the disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS 161 will be effective for the Company on January 1, 2009. The Company is currently evaluating the impact of adopting SFAS 161 on its financial position and results of operations.

In April 2008, the FASB issued FASB Staff Position (FSP) SFAS 142-3, *Determination of Useful Life of Intangible Assets* (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, *Goodwill and Other Intangible Assets* (SFAS 142). FSP SFAS 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives. FSP SFAS 142-3 will be effective for the Company on January 1, 2009. Earlier adoption is not permitted. The Company is currently evaluating the potential impact the adoption of FSP SFAS 142-3 on its financial position and results of operations.

2. ACQUISITIONS

MIDWEST PHYSICIANS SERVICES, LLC AND EMERGENCY RADIOLOGY SERVICES, LLC.

On July 16, 2007, the Company acquired all of the outstanding equity interests of Midwest Physicians Services, LLC (MPS) and Emergency Radiology Services, LLC (ERS) from SPR Holdings II, LLC (SPR Holdings), a privately held company located in St. Paul, Minnesota. ERS is an off-hours teleradiology services company. MPS was formed by St. Paul Radiology, P.A. (SPR) to provide a suite of business process services including revenue cycle management, administrative, information technology and other services critical to the operation of a radiology group. The Company has combined these services with its professional services and proprietary workflow technology to offer its customers a more complete suite of professional and business process solutions.

The consideration for this acquisition consisted of (i) \$62.9 million in cash, including \$0.5 million in costs associated with the acquisition, and (ii) a warrant, issued to SPR, entitling SPR to purchase 300,000 shares of common stock of the Company at any time after July 16, 2010 and before July 16, 2017 at an exercise price of \$18.75 per share. The fair value of the warrant was calculated using a Black-Scholes model as \$3.3 million. Of the purchase price, \$57.5 million of the cash portion was paid to SPR Holdings at closing and the remaining \$5.0 million was placed into a third-party escrow account to secure SPR Holdings' indemnification obligations under the terms of the acquisition agreement. The funds placed in the escrow account, net of any indemnification obligations, will be released to SPR Holdings on the second anniversary of the acquisition.

In connection with the acquisition, MPS entered into a long-term administrative support services agreement, under which MPS will provide business process services to each of SPR and Midwest Radiology LLC, an affiliate of SPR and provider of imaging services, in exchange for a percentage of the net revenue generated by each of those companies.

Prior to January 1, 2008, the Company recognized revenue associated with ERS on a net basis due to the structure of the services agreement with SPR. As part of the Company's goal to align all of its professional radiology service entities under the same business model, effective January 1, 2008 the Company and SPR amended the services agreement which resulted in ERS recognizing revenue on a gross basis. This amendment resulted in the Company recording (i) \$1.3 million and \$3.8 million in revenue for the three and nine months ended September 30, 2008, respectively and (ii) \$1.0 million and \$2.8 million for professional fees related to these services for the three and nine months ended September 30, 2008, respectively. The combined impact to net income was equal to what would have been reported under the contract prior to the amendment.

Table of Contents

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The following table presents the allocation of the purchase price to the acquired assets and liabilities

	(In thousands)
Current assets	\$ 809
Fixed assets	1,814
Intangible assets	57,590
Goodwill	7,055
Assets acquired	67,268
Current liabilities	676
Long-term liabilities	311
Liabilities assumed	987
Purchase price	\$ 66,281

The Company recorded the assets acquired and liabilities assumed in the acquisition of MPS and ERS based on their estimated fair values on the acquisition date. Goodwill of \$7.1 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS 142. The total goodwill balance is deductible for tax purposes over 15 years. The results of operations of MPS and ERS have been included in the Company's consolidated statements of operations and cash flows starting on July 17, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company's management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements and tradenames, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value (In thousands)	Estimated Useful Life
Customer contracts	\$ 57,180	20 years
Tradename and trademarks	130	5 years
Noncompete agreements	280	5 years
	\$ 57,590	

All intangible assets are being amortized on a straight-line basis over their expected useful lives. See Note 4.

THE RADLINX GROUP, LTD.

On April 5, 2007, the Company completed the acquisition of all of the outstanding equity interests of The Radlinx Group, Ltd. ("Radlinx"), a privately held radiology services company, for consideration consisting of (i) \$53.0 million in cash at closing, including the assumption of \$12.6 million in liabilities which were paid in full immediately following the acquisition and \$0.3 million of certain costs associated with the acquisition, (ii) an additional \$0.4 million paid in the fourth quarter of 2007 as settlement of a contractual working capital adjustment and (iii) \$6.5 million in cash, equal to 25% of the revenues generated by certain identified customers during the one-year period following the closing, and paid in May 2008.

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Of the purchase price, \$5.3 million was paid at closing and placed into a third party escrow account to secure Radlinx's indemnification obligations under the terms of the acquisition agreement. In the first quarter 2008, as a result of the settlement of a medical malpractice claim that originated prior to the Company's acquisition of Radlinx, the previous owners of Radlinx utilized the entire \$5.3 million in the escrow account to satisfy their portion of the settlement arrangement. The Company also participated in the settlement arrangement; however, its total payment to the plaintiff was limited to \$0.2 million which was recorded to goodwill.

Table of Contents

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The following table presents the allocation of the purchase price to the acquired assets and liabilities:

	(In thousands)
Current assets	\$ 3,572
Fixed assets	663
Intangible assets	19,400
Goodwill	42,120
Assets acquired	65,755
Current liabilities	2,371
Long-term debt (current and long-term portion)	12,608
Deferred income tax payable	3,135
Liabilities assumed	18,114
Purchase price	\$ 47,641

The Company recorded the assets acquired and liabilities assumed in the Radlinx acquisition based on their estimated fair values on the acquisition date. Goodwill of \$42.1 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS 142. The Company estimates that \$30.0 million of the goodwill balance is deductible for tax purposes. The results of operations of Radlinx have been included in the Company's consolidated statements of operations and cash flows starting on April 6, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company's management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements, customer lists, the Radlinx tradename, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value	Estimated Useful Life
	(In thousands)	
Customer lists and relationships	\$ 16,800	10 years
Tradename and trademarks	1,500	5 years
Noncompete agreements	1,100	2 years
	\$ 19,400	

All intangible assets are being amortized on a straight-line basis over their expected useful lives. See Note 4.

Table of Contents**TELERADIOLOGY DIAGNOSTIC SERVICE, INC.**

On February 9, 2007, the Company acquired all of the outstanding capital stock of Teleradiology Diagnostic Service, Inc. (TDS), for \$23.8 million in cash, including certain costs associated with the acquisition. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. The following table presents the allocation of the purchase price to the acquired assets and liabilities:

	(In thousands)
Current assets	\$ 1,506
Fixed assets	197
Intangible assets	12,250
Goodwill	16,078
Assets acquired	30,031
Current liabilities	1,394
Deferred income tax payable	4,816
Liabilities assumed	6,210
Purchase price	\$ 23,821

The Company recorded the assets acquired and liabilities assumed in the acquisition of TDS based on their estimated fair values on the acquisition date. Goodwill of \$16.1 million, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and liabilities assumed, will not be amortized, consistent with the guidance in SFAS 142. None of the goodwill balance is deductible for tax purposes. The results of operations of TDS have been included in the Company's consolidated statements of operations and cash flows starting on February 9, 2007.

The determination of the estimated fair value of the intangible assets acquired required the Company's management to make significant estimates and assumptions. These assumptions included future expected cash flows from customer contracts, certain noncompete agreements, customer lists, the TDS tradename, and the useful lives of the intangible assets.

The amount allocated to intangible assets was attributed to the following categories:

	Acquired Value (In thousands)	Estimated Useful Life
Customer lists and relationships	\$ 11,350	10 years
Tradename and trademarks	400	5 years
Noncompete agreements	500	3 years
	\$ 12,250	

All intangible assets are being amortized on a straight-line basis over their expected useful lives. See Note 4.

AMERICAN TELERADIOLOGY NIGHTHAWKS, INC.

On September 30, 2005, the Company acquired American Teleradiology Nighthawks, Inc. (ATN). The acquisition of ATN was considered by the Company as an acquisition of two distinct businesses: (i) an off-hours teleradiology business that was supplemental to the Company's off-hours business and (ii) a nascent hospital business that focused on partnering with radiologists in order to supplement the services they provide to their hospitals. The acquisition agreement provided that if the hospital business proved to be profitable as established under the terms

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

of the agreement in the 18 months following the acquisition, additional shares of Company common stock would be issued. During the quarter ended March 31, 2007, the Company determined that the hospital business did not meet the profitability metrics set forth in the acquisition agreement and that no amount was earned as contingent consideration. This contingent consideration amount is currently subject to dispute. Although the Company does not believe that additional shares will be issued, the contingent consideration ultimately due is subject to resolution of this dispute by the parties.

Table of Contents**3. MARKETABLE SECURITIES**

Marketable securities include various available-for-sale securities. These securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported as a component of stockholders' equity. During the three months ended September 30, 2008, all marketable securities were sold and the proceeds reinvested in short-term money market accounts as a conservative measure against the unfavorable conditions in the credit market and to better ensure access and recoverability. In October 2008, the Company reinvested these funds in short-term U.S. Treasury Bills. Our investments in money market accounts and short-term U.S. Treasury Bills are considered cash equivalents and accordingly are included in cash and cash equivalents on our balance sheet. Gross unrealized gains and losses on marketable securities were not significant at December 31, 2007.

Below are the Company's marketable securities at fair value:

	September 30, 2008	December 31, 2007
	(In thousands)	
Due in one year or less:		
U.S. Government and Federal Agency Securities	\$	\$ 13,430
Municipal Securities		17,195
Total Marketable Securities	\$	\$ 30,625

4. INTANGIBLE ASSETS SUBJECT TO AMORTIZATION

A summary of intangible assets is as follows:

	September 30, 2008				December 31, 2007			
	(In thousands)							
	Estimated Useful Life	Historical Amount	Accumulated Amortization	Net Amount	Historical Amount	Accumulated Amortization	Net Amount	
Customer lists and relationships	6-10 years	\$ 30,770	\$ 5,565	\$ 25,205	\$ 30,770	\$ 3,156	\$ 27,614	
Tradename and trademarks	5 years	2,820	985	1,835	2,820	510	2,310	
Customer contracts	1-20 years	57,280	3,555	53,725	57,280	1,410	55,870	
Noncompete agreements	2-5 years	2,090	1,370	720	2,090	751	1,339	
		\$ 92,960	\$ 11,475	\$ 81,485	\$ 92,960	\$ 5,827	\$ 87,133	

Amortization expense was \$1.9 million and \$1.7 million for the three months ended September 30, 2008 and 2007, respectively and \$5.6 million and \$3.2 million for the nine months ended September 30, 2008 and 2007, respectively.

	Amount (In thousands)
Estimated Amortization Expense:	
Three months ending December 31, 2008	\$ 1,869
Year ending December 31, 2009	7,064
Year ending December 31, 2010	6,687
Year ending December 31, 2011	6,452
Year ending December 31, 2012	5,879
Thereafter	53,534

Total

\$ 81,485

Table of Contents

5. LONG-TERM DEBT

The Company has a fully syndicated term loan (the *Term Loan*) pursuant to which the Company has \$98.8 million in outstanding borrowings. The Term Loan will be repaid in quarterly installments of \$250,000 with the projected remaining balance of \$93.3 million payable on the maturity date of July 10, 2014.

Interest under the Term Loan is based, at the option of the Company, on either: (i) a floating per annum rate based on prime rate plus 1.50% or (ii) a floating per annum rate (based upon one, two, three or six-month interest periods) based on LIBOR plus 2.50% (6.27% at September 30, 2008). The Company also entered into two interest rate swap contracts during 2007 which, while in place, will maintain a fixed effective interest rate of approximately 7.40%. See additional discussion of the interest rate swap contracts in Note 10.

The Term Loan contains customary covenants, restrictions and prepayment provisions, and is guaranteed by certain of the Company's wholly owned operating subsidiaries, including NightHawk Radiology Services, LLC, the Company's primary operating entity, and is collateralized by substantially all of the Company's assets.

6. COMMITMENTS AND CONTINGENCIES

Letters of Credit The Company's Sydney and San Francisco office leases and the Company's malpractice insurance were collateralized by separate letters of credit in the amounts of \$0.2 million, \$0.1 million and \$0.4 million, respectively, as of September 30, 2008 and December 31, 2007.

Litigation The Company is involved in litigation in the normal course of business. After consultation with legal counsel, Company management estimates that at September 30, 2008 these matters were expected to be resolved without material adverse effect on the Company's financial position, results of operations, or cash flows.

Medical Liability Insurance The Company is exposed to risk of loss related to litigation that may arise from malpractice and maintains insurance for medical liabilities in amounts considered adequate by Company management. The Company's claims-made policy provides coverage up to the policy limits for claims filed within the period of the policy term, subject to deductible requirements. Coverage for affiliated radiologists is initiated when they begin providing services to the Company. The Company records reserves for both reported and IBNR claims. Reported claims are reserved based upon the Company's best estimate of future costs for claims in which a loss is deemed probable. In instances where the Company is not able to estimate the loss or range of loss that may be reasonably possible, the Company records no reserve. The reserve for IBNR claims is estimated using historical claims information and actuarial-based industry indices. The Company had an insurance reserve liability related to IBNR claims of \$4.0 million at September 30, 2008, and \$3.0 million at December 31, 2007. The Company had no reserves for reported claims as of September 30, 2008, and \$0.5 million at December 31, 2007. The reported claims reserved at December 31, 2007 were paid out in 2008.

7. STOCK COMPENSATION PLANS

Share-Based Award Plans The Company has two stock-based award plans, the 2004 Stock Plan (the *2004 Plan*) and the 2006 Equity Incentive Plan (the *2006 Plan*). In February 2006, all shares available for grant under the 2004 Plan were rolled over and became available for grant under the 2006 Plan. As of September 30, 2008, the Company had an aggregate of 4,375,178 shares of its common stock reserved for issuance under the 2004 Plan and 2006 Plan, of which 337,455 shares were available for future grants and 4,037,723 shares were subject to outstanding stock awards.

The Company's Board of Directors administers the plans and establishes to whom the awards are granted, and the terms and conditions, including the exercise period, of such awards. All stock options granted have an exercise price equal to or greater than the fair value of the Company's common stock on the date the option is granted. All restricted stock units (*RSUs*) are granted with an exercise price of zero. Both stock options and RSUs granted generally have contractual terms of ten years and vest over three years. Options and RSUs granted to employees and directors are valued using the multiple valuation approach, and the resulting expense is recognized using the accelerated method over the service period for the entire award.

Table of Contents

Stock Options The Company granted stock options covering 67,400 and 960,315 shares during the three and nine months ended September 30, 2008, respectively at a weighted-average exercise price of \$8.28 and \$8.88, respectively. The weighted-average grant-date fair value per share granted during the three and nine months ended September 30, 2008 was \$3.24 and \$3.55, respectively. A summary of stock-based award activity for employees and non-employees under the 2004 Plan and 2006 Plan are as follows:

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Stock Options				
Outstanding as of July 1, 2008	3,540,350	\$ 13.00		
Granted	67,400	8.28		
Exercised	(52,755)	2.95		
Cancelled	(113,643)	17.12		
Outstanding as of September 30, 2008	3,441,352	\$ 12.92	8.15	\$ 3,505

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Stock Options				
Outstanding as of January 1, 2008	3,497,210	\$ 14.85		
Granted	960,315	8.88		
Exercised	(225,623)	2.46		
Cancelled	(790,550)	19.51		
Outstanding as of September 30, 2008	3,441,352	\$ 12.92	8.15	\$ 3,505
Exercisable as of September 30, 2008	1,346,505	\$ 11.41	7.17	\$ 3,136
Vested and expected to vest as of September 30, 2008	3,344,427	\$ 12.91	8.12	\$ 3,499

Restricted Stock Units During the three and nine months ended September 30, 2008, the Company granted 34,250 and 503,421 restricted stock unit awards, respectively, at a fair value of \$8.49 and \$11.09 per share, respectively. Activity related to these restricted stock unit awards is as follows:

	Number of Awards	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Restricted Stock Unit Awards			
Outstanding as of July 1, 2008	581,624		
Granted	34,250		
Released	(19,029)		
Cancelled	(474)		
Outstanding as of September 30, 2008	596,371	1.79	\$ 4,306

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	Number of Awards	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Restricted Stock Unit Awards			
Outstanding as of January 1, 2008	254,574		
Granted	503,421		
Released	(141,945)		
Cancelled	(19,679)		
Outstanding as of September 30, 2008	596,371	1.79	\$ 4,306
Vested and expected to vest as of September 30, 2008	547,706	1.76	\$ 3,954

Table of Contents

Intrinsic value represents the amount by which the fair market value of the underlying stock exceeds the exercise price of the options. For all RSU awards, the exercise price is zero.

Recognition of Compensation Expense As of September 30, 2008, the total remaining unrecognized compensation cost related to unvested stock-based employee/director arrangements, net of an estimated forfeiture rate of 8.9%, was \$6.1 million and is expected to be recognized over a weighted average period of 1.06 years.

The Company measures the compensation cost associated with stock-based payments by estimating the fair value of stock options as of the grant date using the Black-Scholes option pricing model. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair value of the stock options granted. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The weighted average fair values of stock-based arrangements on the date of grant and the assumptions used to estimate the fair value of the stock-based arrangements were as follows:

	Three Months Ended September 30,	
	2008	2007
Dividend yield		
Expected volatility	48%	39%
Risk-free interest rates	3.02%	4.16%
Expected term for employees (years)	3.7	4.2
Expected term for non-employee (years)	10	10

	Nine Months Ended September 30,	
	2008	2007
Dividend yield		
Expected volatility	48%	36%
Risk-free interest rates	2.75%	4.66%
Expected term for employees (years)	4.0	4.1
Expected term for non-employee (years)	10	10

Expected volatility is estimated based primarily on evaluating similar companies' volatility rates and the Company's limited trading history. The Company started incorporating its trading history into the estimates on January 1, 2007. The risk-free interest rate is based on the U.S. Treasury yields in effect at the time of grant corresponding with the expected term of the options. The expected option term for employees is the number of years estimated that options will be outstanding prior to exercise considering vesting schedules, historical exercise experience and other relevant factors.

8. COMPUTATION OF EARNINGS PER SHARE

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Numerator:				
Net income	\$ 3,283,000	\$ 3,788,000	\$ 6,784,000	\$ 11,633,000
Denominator:				
Weighted average common shares outstanding-basic	28,573,349	30,111,156	29,810,161	30,023,122

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Effect of dilutive stock options and restricted stock units, and warrants	1,159,861	875,758	1,000,580	805,379
Effect of contingently issuable shares		183,535	41,657	183,535
Weighted average common shares outstanding-dilutive	29,733,210	31,170,449	30,852,398	31,012,036
Earnings per common share basic	\$ 0.11	\$ 0.13	\$ 0.23	\$ 0.39
Earnings per common share diluted	\$ 0.11	\$ 0.12	\$ 0.22	\$ 0.38
Anti-dilutive shares excluded from calculation	2,922,486	1,981,439	2,765,294	1,378,190

Table of Contents

9. INCOME TAXES

In accordance with interim reporting requirements, the Company uses an estimated annual effective tax rate for computing its provision for income taxes. The effective rate for the three months ended September 30, 2008 and 2007 was 37.3% and 37.4%, respectively. The effective rate for the nine months ended September 30, 2008 and 2007 was 37.8% and 37.9%, respectively.

10. DERIVATIVE FINANCIAL INSTRUMENTS

The Company recognizes all derivatives on the condensed consolidated balance sheet at fair value. The Company designates at inception whether the derivative contract is considered hedging or non-hedging in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. During 2007, the Company entered into two interest rate swap contracts with a combined notional amount of \$100 million in connection with its outstanding debt. The contracts expire on September 30, 2009 and 2010, respectively. These contracts, while in effect, will maintain an effective interest rate of approximately 7.40%. The contracts were initiated to maintain compliance with debt requirements and to protect the Company against changes in the interest payments associated with its variable-rate long-term debt, and therefore are considered cash flow hedges. As a result, as long as the swap is deemed highly effective, changes in the fair value of the swaps are recorded as either an asset (a gain position), or a liability (a loss position) on the balance sheet, with the offset recorded in accumulated other comprehensive income, a separate component of shareholders' equity. At September 30, 2008 and December 31, 2007, the fair value of the interest rate swap contracts resulted in net unrealized losses of \$2.7 million for both periods. For the three months and nine months ended September 30, 2008, the amount of hedge ineffectiveness was immaterial.

11. FAIR VALUE MEASUREMENTS

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company uses quoted market prices for identical assets to measure fair value of its money market funds and therefore considers all of the Company's money market funds as Level 1.

Table of Contents

The inputs used to determine the fair value of the Company's interest rate swaps based on the fair value hierarchy described above are regarded as Level 2. As discussed in Note 5 above, the Company's interest rate swap is based on a LIBOR rate. Fair value for the interest rate swap is based on a model-derived valuation using the LIBOR rate, which is observable at commonly quoted intervals for the full term of the swap.

The Company does not have any financial assets or liabilities measured using Level 3 inputs of the fair value hierarchy.

The fair value of money market funds using Level 1 inputs on a recurring basis as of September 30, 2008 was \$41.5 million. The fair value of the interest rate swap contracts using Level 2 inputs on a recurring basis as of September 30, 2008 was \$2.7 million.

12. SHARE REPURCHASE

On May 7, 2008, the Company announced that the Board of Directors had authorized a tender offer to purchase shares of its common stock not to exceed an aggregate purchase price of \$50 million. The tender offer commenced on May 14, 2008 and settled on June 19, 2008 with the Company purchasing and retiring 2,240,883 shares at a cost of \$18.6 million, including expenses.

13. RESTRUCTURING CHARGE

During the quarter ended September 30, 2008, the Company recorded a pre-tax charge of \$0.7 million in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). The charge was comprised of (i) \$0.5 million pertaining to vacated leased facilities, principally those located in Ann Arbor, Michigan and Coeur d'Alene, Idaho and (ii) fixed asset impairment charges of \$0.2 million for leasehold improvements and furniture and fixtures within the vacated leased facilities that no longer have value to the Company. The accrual related to vacated facilities is calculated net of any estimated sublease income which is estimated based on current market quotes for similar properties. If the Company is unable to sublet the vacated properties on a timely basis or is forced to sublet them at lower rates due to changes in market conditions, the Company will adjust the accruals accordingly. The charge was recognized in sales, general, and administrative expense.

The following table summarizes the components of the charge as of September 30, 2008:

	Asset Impairments	Lease Terminations (In millions)	Total
Additions during quarter ended September 30, 2008	\$ 0.2	\$ 0.5	\$ 0.7
Amount charged to assets	0.2		0.2
Balance as of September 30, 2008	\$	\$ 0.5	\$ 0.5

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Cautionary Statement for Purposes of Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

THIS QUARTERLY REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. THE STATEMENTS CONTAINED IN THIS QUARTERLY REPORT THAT ARE NOT PURELY HISTORICAL ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS RELATING TO FUTURE ECONOMIC CONDITIONS IN GENERAL AND STATEMENTS ABOUT OUR FUTURE:

STRATEGY AND BUSINESS PROSPECTS;

DEVELOPMENT AND EXPANSION OF SERVICES, AND THE SIZE, GROWTH, AND LEADERSHIP OF THE POTENTIAL MARKETS FOR THESE SERVICES;

DEVELOPMENT OF NEW CUSTOMER RELATIONSHIPS AND PRODUCTS;

SALES, EARNINGS, INCOME, EXPENSES, OPERATING RESULTS, TAX RATES, OPERATING AND GROSS PROFIT AND PROFIT MARGINS, VALUATIONS, RECEIVABLES, RESERVES, LIQUIDITY, INVESTMENT INCOME, CURRENCY RATES, STOCK OPTION EXERCISES, CAPITAL RESOURCE NEEDS, CUSTOMERS, AND COMPETITION;

ABILITY TO OBTAIN AND PROTECT OUR INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS; AND

ACQUISITIONS AND TRANSACTION COSTS AND ADJUSTMENTS.

ALL OF THESE FORWARD-LOOKING STATEMENTS ARE BASED ON INFORMATION AVAILABLE TO US ON THE DATE OF THIS QUARTERLY REPORT. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE DISCUSSED IN THIS QUARTERLY REPORT. THE FORWARD-LOOKING STATEMENTS CONTAINED IN THIS QUARTERLY REPORT, AND OTHER WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS MADE BY US FROM TIME TO TIME, ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN ITEM 1A OF THIS REPORT ENTITLED RISK FACTORS.

Overview

NightHawk Radiology Holdings, Inc. is leading the transformation of the practice of radiology by providing high-quality, cost-effective services to radiology groups and hospitals throughout the United States. We provide the most complete suite of solutions, including professional services, business services, and our advanced, proprietary clinical workflow technology, all designed to increase efficiency and improve the quality of patient care and the lives of physicians who provide it. Our team of American Board of Radiology-certified, U.S. state-licensed and hospital-privileged affiliated radiologists uses our proprietary workflow technology to provide professional services (interpretations, exams, scans or reads) to our customers in the United States. The reads that they perform consist primarily of off-hours preliminary reads, but increasingly include final and sub-specialty interpretations. In addition to these professional services, we also provide our customers with cardiac 3D reconstructions, clinical workflow technology, and business services, all designed to enhance the care they provide to patients and improve the efficiency of their practices. Our strategy for future growth is to leverage our position as the leading provider of radiology services by; continuing to expand our service offerings in final and sub-specialty interpretations, cardiac imaging services, client workflow technology and business services; expanding our customers' use of our radiology services as they implement coverage of additional hospitals; targeting new customers; and pursuing both strategic and tactical acquisitions.

Trends in our Business and Results of Operations

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

Revenue Trends. We generate revenue from a number of sources, including off-hours preliminary exams, business services offerings and final and subspecialty interpretations. The revenue growth that we have historically experienced has been due in large part to the growth of our off-hours preliminary business, which continues to make up the bulk of our revenue. The market for our off-hours preliminary business has historically experienced rapid volume growth. This volume growth has been driven by an increase in our customer base, an increase in utilization of our services by our customers, acquisitions, an expansion of our service hours, a high customer retention rate and growth in the use of diagnostic imaging

Table of Contents

technologies and procedures in the healthcare industry in general. In recent quarters, however, our volume growth has moderated as the market for these services has matured. In addition, the off-hours preliminary market has attracted regional radiology service providers that often offer their services at prices lower than ours and this increase in competition has resulted in some customer losses. These trends have resulted in downward pressure on our average prices and on our volumes and revenues. We expect these trends to continue in the foreseeable future. In response to such trends, our strategy is to sell new services (including final interpretations and business services) to our existing customers by communicating their value and demonstrating the advantages we offer over our competitors. Our future growth depends primarily upon our ability to execute such strategy. These new services accounted for approximately 20% of our total revenue in the third quarter of 2008, up from 18% in the prior year period.

Trends in Professional Service Fees. Since inception, our professional service fees have increased in absolute dollars each year, primarily due to the addition of new affiliated radiologists to perform an increased workload volume as our business has grown. We expect that our professional service fees will continue to fluctuate in absolute dollars as volumes vary.

Trends in Medical Liability Expense. Our medical liability expense has also increased in absolute dollars each year since inception, primarily due to increases in our medical liability premiums as our business has grown. The increase is also due to an increasing reserve for incurred but not reported (IBNR) claims based on growing volumes. We expect our medical liability premiums and our IBNR expense to continue to increase in absolute dollars in future periods as our scan volumes continue to grow. In addition, if we have claims in future periods for which we deem a liability to be probable, our medical liability expense will increase.

Trends in Physician Stock-Based Compensation Expense. The amount of physician stock-based compensation expense we record in a given period depends primarily on the number of shares subject to equity-based grants held by our affiliated radiologists, the number of hours worked, and the change in the value of our common stock in that period. Our expense in future periods for physician stock-based compensation will be driven primarily by changes in our stock price, new equity-based grants we make to our affiliated radiologists, and the rate at which those equity-based grants are earned over such periods.

Trends in Sales, General and Administrative Expense. Our sales, general and administrative expense has increased in absolute dollars each year since inception primarily as a result of increased payroll expenses in connection with higher headcount in support of the growth in our business. Our employee headcount increased from 473 at September 30, 2007 to 507 at September 30, 2008. We expect our general and administrative expenses to level-off in response to the moderating growth in our business and as we see the results of our cost reductions initiatives.

Trends in Employee Stock-Based Compensation Expense. The amount of employee stock-based compensation expense we record in a given period depends primarily on the number of shares subject to outstanding options and the valuation criteria used at the time of the grant. The amount of expense is also impacted by the accelerated method we use to expense these options and by forfeitures of non-vested options. Our employee non-cash stock-based compensation expense may decrease in future periods unless we choose to issue a significant amount of additional equity-based instruments.

Trends in Interest Expense. During the third quarter of 2007, we entered into two interest rate swap contracts with a combined notional amount of \$100 million to provide a hedge against changes in interest rates associated with our variable-rate long-term debt. While these swaps are in place, our effective interest rate is expected to be approximately 7.4%. These swaps expire in September 2009 and 2010. We expect our interest expense to fluctuate based upon the then prevailing market interest rates at the time of the expiration of the swaps.

Recent Developments

Restructuring Charge. During the quarter ended September 30, 2008, we recorded a pre-tax restructuring charge of \$0.7 million in accordance with Statement of Financial Accounting Standards (SFAS) No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). The restructuring charge was comprised of (i) \$0.5 million pertaining to vacated leased facilities located primarily in Ann Arbor, Michigan and Coeur d Alene, Idaho and (ii) fixed asset impairment charges of \$0.2 million for leasehold improvements and furniture and fixtures within the vacated leased facilities that no longer have value to us. All restructuring charges were recognized in sales, general, and administrative expense.

Share Repurchases. On May 14, 2008, we commenced a tender offer which settled on June 19, 2008 resulting in the purchase and retirement of 2,240,883 shares at a cost of \$18.6 million, including expenses. On July 8, 2008 we announced that our board of directors has authorized up to an additional \$10 million of share repurchases of our common stock. Under

Table of Contents

the program, repurchases may be made from time to time by us in the open market, in block purchases, or in solicited or unsolicited privately negotiated transactions in accordance with SEC rules and subject to factors such as market price, our operating results and available cash, general economic and market conditions, and other considerations we deem prudent. As of September 30, 2008, we had not made any such repurchases.

Recent Acquisitions. In 2007, we expanded our solution suite and customer base through a series of acquisitions:

In February 2007, we acquired Teleradiology Diagnostic Service, Inc. (TDS), a leading provider of off-hours teleradiology services on the West Coast, providing services to hospitals throughout California, the largest market in the United States,

In April 2007, we acquired The Radlinx Group, Ltd. (Radlinx), the third largest provider of teleradiology services in the country with affiliated radiologists located throughout the United States, and

In July 2007, we acquired Midwest Physicians Services, LLC (MPS) and Emergency Radiology Services, LLC (ERS). MPS provides a complete suite of business process services including revenue cycle management, human resources services, facilities management, accounting and financial services, transcription services, records management, operational support and quality assurance program support. ERS is an off-hours teleradiology services company.

Critical Accounting Policies and Recent Accounting Standards

The preparation of financial statements in accordance with GAAP requires our management to select and apply accounting policies that best provide the framework to report the results of operations and financial position. The selection and application of those policies requires management to make difficult, subjective and/or complex judgments concerning reported amounts of revenue and expenses during the reporting period and the reported amounts of assets and liabilities at the date of the financial statements. As a result, there exists the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

As of September 30, 2008, there have been no significant changes with regard to the critical accounting policies disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007. The policies disclosed included the accounting for revenue recognition and allowance for doubtful accounts, stock-based compensation, use of estimates, purchase accounting and long-lived assets including goodwill and other acquired intangible assets, income taxes, and derivative accounting.

See Note 1 Summary of Significant Accounting Policies Recent Accounting Standards to the Condensed Consolidated Financial Statements included in Item 1 of the Quarterly Report on Form 10-Q for additional information regarding recently adopted and new accounting pronouncements.

Table of Contents**Results of Operations**

The following table sets forth selected consolidated statements of operations data for each of the periods indicated as a percentage of service revenue:

	Three Months Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Service revenue	100%	100%	100%	100%
Operating costs and expenses:				
Professional services	42	42	42	43
Sales, general and administrative	35	35	39	34
Depreciation and amortization	7	6	7	5
Total operating costs and expenses	84	83	88	82
Operating income	16	17	12	18
Other income (expense):				
Interest expense	(5)	(5)	(5)	(3)
Interest income	1	2	1	2
Other, net				
Total other income (expense)	(4)	(3)	(4)	(1)
Income before income taxes	12	14	8	17
Income tax expense	4	5	3	7
Net income	8	9	5	10

Comparison of Three Months Ended September 30, 2008 and September 30, 2007*Service Revenue*

	Three Months Ended		Change	
	September 30, 2008	September 30, 2007	In Dollars	Percentage
Service revenue	\$ 43,441	\$ 45,151	\$ (1,710)	(4)%

The decrease in service revenue for the three months ended September 30, 2008 relative to the three months ended September 30, 2007 consists of a decrease of \$2.4 million in preliminary read revenue and a decrease of \$0.6 million in business services revenue, offset by an increase of \$1.2 million in final read revenue. The preliminary read revenue decline was predominately due to a 6% price decline. Preliminary volume was essentially flat as same site growth of 5% and approximately 7% growth in volumes from new customers were offset by the volume impact of customers lost over the past 12 months. The increase in final read revenue was due to a combination of 10% higher volumes attributed to the ERS acquisition and a 22% increase in the average price due to a modality shift towards more complex exams.

*Operating Costs and Expenses**Professional Services*

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

	Three Months Ended September 30,		Change	
	2008	2007	In Dollars	Percentage
Professional services	\$ 18,340	\$ 19,069	\$ (729)	(4)%
<i>Percentage of service revenue</i>	<i>42%</i>	<i>42%</i>		

The decrease in professional services expense for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 is primarily attributable to a decrease in physician stock-based compensation expense, partially offset by an increase in professional service fees related to higher read volumes.

Table of Contents*Sales, General and Administrative Expense*

	Three Months Ended September 30, (Dollars in thousands)		Change	
	2008	2007	In Dollars	Percentage
Sales, general and administrative expense	\$ 15,367	\$ 15,754	\$ (386)	(2)%
<i>Percentage of service revenue</i>	35%	35%		

The decrease in sales, general and administrative expense resulted primarily from lower non-cash stock-based compensation expense partially offset by the restructuring charge and a modest increase in payroll expense.

Comparison of Nine Months Ended September 30, 2008 and September 30, 2007*Service Revenue*

	Nine Months Ended September 30, (Dollars in thousands)		Change	
	2008	2007	In Dollars	Percentage
Service revenue	\$ 127,887	\$ 108,956	\$ 18,931	17%

The increase in service revenue from the nine months ended September 30, 2007 relative to the nine months ended September 30, 2008 resulted from \$10.8 million in additional revenue from the MPS and ERS acquisitions, \$6.7 million due to the TDS and Radlinx acquisitions and a \$1.4 million increase in organic revenue, primarily related to higher preliminary read volumes.

*Operating Costs and Expenses**Professional Services*

	Nine Months Ended September 30, (Dollars in thousands)		Change	
	2008	2007	In Dollars	Percentage
Professional services	\$ 53,243	\$ 46,844	\$ 6,399	14%
<i>Percentage of service revenue</i>	42%	43%		

The increase in professional services expense for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007 resulted primarily from the full year impact of the TDS and Radlinx acquisitions and an increase in scan volumes, partially offset by lower non-cash stock-based compensation costs.

Sales, General and Administrative Expense

	Nine Months Ended September 30, (Dollars in thousands)		Change	
	2008	2007	In Dollars	Percentage
Sales, general and administrative expense	\$ 50,002	\$ 36,861	\$ 13,141	36%
<i>Percentage of service revenue</i>	39%	34%		

The increase in sales, general and administrative expense resulted primarily from the full nine-month impact of the additional operating costs of the entities acquired in 2007, as well as restructuring charges and severance costs related to the departure of certain former executive officers in

2008.

Table of Contents**Liquidity and Capital Resources****Capital Resources**

Our capital resources include cash, cash equivalents and marketable securities. The tables below highlight significant aspects of our capital resources.

	September 30, 2008	December 31, 2007
	(In millions)	
Capital resources		
Cash and cash equivalents	\$ 55.2	\$ 32.0
Marketable securities		30.6
Total	\$ 55.2	\$ 62.6

Cash Flow Activities

The tables below highlight significant aspects of our cash flow activities.

	Nine Months Ended September 30, (In millions)	
	2008	2007
Cash flow activities		
Net cash provided by (used in):		
Operating activities	\$ 22.9	\$ 17.5
Investing activities	18.9	(119.3)
Financing activities	(18.5)	85.0
Increase (decrease) in cash and cash equivalents	\$ 23.3	\$ (16.8)

The discussion below highlights significant aspects of our cash flows.

Net Cash Provided by Operating Activities

Since our inception in August 2001, we have funded our operations primarily from cash flows generated by our operating activities, the sale and issuance of shares of capital stock and incurrence of long-term debt.

Net cash from operations was \$22.9 million for the nine months ended September 30, 2008 and \$17.5 million for nine months ended September 30, 2007.

For the nine months ended September 30, 2008, we generated net cash from operations of \$22.9 million from net income of \$6.8 million. Significant non-cash charges that affected net income that did not impact our net cash from operations during this period include depreciation and amortization of \$8.6 million and stock compensation expense of \$7.1 million. Changes in operating assets included an increase in accounts receivable of \$1.2 million and an increase in accrued expenses and other liabilities of \$0.8 million primarily from the restructuring charge taken in the third quarter.

For the nine months ended September 30, 2007, we generated net cash from operations of \$17.5 million from net income of \$11.6 million. Significant non-cash charges included in net income that did not impact our net cash from operations during this period include depreciation and amortization of approximately \$5.3 million and stock compensation expense of approximately \$9.4 million. Changes in operating assets

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

included an increase in accounts receivable of \$7.6 million and a \$4.6 million increase in accounts payable, accrued expenses and accrued payroll and benefits. These increases were primarily driven by our growth.

Net Cash Provided by (Used in) Investing Activities

Net cash provided by investing activities was \$18.9 million for the nine months ended September 30, 2008 compared to \$119.3 million used in investing activities for the nine months ended September 30, 2007. For the nine months ended September 30, 2008, net cash provided by investing activities was primarily attributable to sales and maturities of marketable securities of \$23.3 million and \$33.8 million, respectively, which were a result of our actions taken in light of unfavorable conditions in the credit market. Partially offsetting this increase was the earnout payment to the former Radlinx owners of \$6.5 million, an escrow payment to the former TDS owners of \$1.2 million, capital spending of \$4.1 million, and purchases of marketable securities of \$26.4 million. For the nine months ended September 30, 2007, net cash used in investing activities was primarily attributable to the use of \$21.8 million for the acquisition of TDS, \$41.0 million for the acquisition of Radlinx and approximately \$62.9 million for the acquisitions of MPS and ERS.

Table of Contents***Net Cash Provided by (Used in) Financing Activities***

Net cash used in financing activities was \$18.6 million for the nine months ended September 30, 2008 and was primarily attributable to the tender offer repurchase of \$18.6 million of our common stock in June 2008. Net cash provided by financing activities was \$85 million for the nine months ended September 30, 2007, consisting of \$100 million from our term loan, offset by \$4.5 million in debt issuance costs and \$12.8 million in debt repayments primarily for debt assumed in the Radlinx acquisition.

Financial condition and liquidity

We expect our long-term liquidity needs to consist primarily of working capital, capital expenditure requirements, share repurchases and future acquisitions. We intend to fund future liquidity needs from current capital resources and cash generated from operations. During the three months ended September 30, 2008, we sold all of our marketable securities and reinvested the proceeds in short-term money market accounts as a conservative measure against the unfavorable conditions in the credit market and to better ensure access and recoverability. In October 2008, we reinvested these funds in short-term U.S. Treasury Bills. We believe our capital resources are invested in safe investment vehicles and will be sufficient to meet our anticipated cash needs for at least the next 12 months.

Off-Balance Sheet Arrangements and Contractual Obligations***Off-Balance Sheet Arrangements***

Our Sydney and San Francisco offices leases are collateralized by separate letters of credit in the amounts of \$0.2 million and \$0.1 million, respectively, as of September 30, 2008. Our medical liability insurance policy is also collateralized by a separate letter of credit in the amount of \$0.4 million as of September 30, 2008.

Contractual Obligations

The following table presents a summary of our contractual obligations as of September 30, 2008:

(in millions)	Payments Due Within				Total
	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years	
Long-term debt obligations (a)	\$ 1.0	\$ 2.0	\$ 2.0	\$ 93.8	\$ 98.8
Interest on long-term borrowings	7.4	13.4	12.0	4.6	37.4
Operating lease commitments	1.9	3.5	2.5	3.7	11.6
Total contractual obligations	\$ 10.3	\$ 18.9	\$ 16.5	\$ 102.1	\$ 147.8

(a) See Note 5 LONG-TERM DEBT to the condensed consolidated financial statements included in Item 1 of the Quarterly Report on Form 10-Q for more information.

(b) Interest paid in all years may differ due to future refinancing of debt. Interest on our floating rate debt was calculated for all years using the effective rate as of September 30, 2008 including the impact of current interest rate swap contracts.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

Although a large number of our affiliated radiologists work from our centralized reading facilities in Australia and Switzerland, the professional service fees we pay to our affiliated radiologists are denominated primarily in U.S. dollars. As a result, only our support personnel and facility costs in those countries present foreign currency exchange risks. Because we are not currently subject to material foreign currency exchange risk, we have not, to date, entered into any hedging contracts. If a weakening U.S. dollar requires us to increase the amounts we pay to our affiliated radiologists in the future in order to maintain a constant level of compensation, our results of operations and cash flows could be affected. Currently, any foreign exchange risks are related to the foreign currency exchange rates between the U.S. dollar and the Australian dollar and between the U.S. dollar and the Swiss franc.

Interest Rate Sensitivity

We had cash and cash equivalents totaling \$55.2 million at September 30, 2008. These amounts were invested in interest-bearing money market accounts and are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. However, any declines in interest rates will reduce future investment income.

As of September 30, 2008, we had \$98.8 million in variable rate debt. Because of the two interest rate swap contracts entered in to during 2007, this outstanding debt is not subject to interest rate fluctuation until such contracts expire on September 30, 2009 and 2010. For more information on our interest rate hedging activities, see Note 10 Derivative Financial Instruments, of the Notes to Condensed Consolidated Financial Statements in Item 1 of the Quarterly Report on Form 10-Q.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of September 30, 2008, we carried out an evaluation, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2008, the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) were effective.

Changes in Internal Controls over Financial Reporting

During the three months ended September 30, 2008, there were no changes in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect such internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

We are involved in various legal proceedings arising in the ordinary course of our business activities. We maintain insurance policies with coverages that we believe are appropriate in light of the risks attendant to our business, and believe that the resolution of the current claims will not have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount of damages resulting from a current or future claim, an unfavorable resolution of a claim could materially affect our future results of operations, cash flows or financial position.

ITEM 1A. Risk Factors

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION OR OPERATING RESULTS COULD BE MATERIALLY ADVERSELY AFFECTED BY ANY OF THESE RISKS. THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE DUE TO ANY OF THESE RISKS AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. IN ASSESSING THE RISKS DESCRIBED BELOW, YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED IN THIS REPORT, INCLUDING OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, BEFORE DECIDING TO PURCHASE ANY SHARES OF OUR COMMON STOCK.

We have a relatively short operating history in an emerging market, which makes it difficult to evaluate our business and prospects.

We have a relatively short operating history in an evolving market. As a result, our current business and future prospects are difficult to evaluate. You must consider our business and prospects in light of the risks and difficulties we encounter as an early-stage company in a rapidly evolving market. Some of these risks relate to our potential inability to:

effectively manage our business and technology,

effectively manage the integration of companies that we have acquired, or in the future may acquire,

develop new services that complement our existing business,

market our services to our customers due to regulatory rules governing reassignment of payments, which could affect our customers ability to collect fees for services provided by our affiliated radiologists,

acquire additional customers and maintain current customers in a competitive environment,

successfully provide high levels of service quality as we expand the scale of our business,

manage rapid growth in personnel and operations,

effectively manage our medical liability risk, and

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

recruit and retain radiologists and other key personnel.

We may not be able to successfully address these and the other risks described in this report. Failure to adequately do so would harm our business and cause our operating results to suffer. Furthermore, our limited operating history has resulted in revenue growth rates that we will not be able to sustain, and therefore will not be indicative of our future results of historical operations. As a result, the price of our common stock could decline.

The market in which we participate is competitive and we expect competition to increase in the future, which will make it more difficult for us to sell our services and may result in pricing pressure, reduced revenue and reduced market share.

The market for professional radiology services and business process services is competitive and rapidly changing, barriers to entry are relatively low, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. In fact, in recent periods we have experienced an increase in competition from regional providers of services similar to ours. If we fail to compete effectively, our operating results will be harmed. Some of our principal competitors, including our largest competitor, Virtual Radiologic Corporation, offer their services at a lower price, which has resulted and may continue to result in pricing pressure and lost customers. If we are unable to maintain our current pricing, our operating results could be negatively impacted. In addition, pricing pressures and increased competition could result in reduced revenue, reduced profits or the failure of our services to achieve or maintain more widespread market acceptance, any of which could harm our business.

Table of Contents

In addition, if companies larger than we are enter the market through internal expansion or acquisition of one of our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively. These competitors could have established customer relationships and greater financial, technical, sales, marketing and other resources than we do, and may be able to respond more quickly to new or emerging technologies or devote greater resources to the development, promotion and sale of their services. This competition could harm our ability to sell our services, which may lead to lower prices, reduced revenue and, ultimately, reduced market share.

If we acquire any companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.

A key element of our strategy is to pursue strategic acquisitions that are complementary to our business or offer us other strategic benefits. Acquisitions in which we may engage involve numerous risks, including:

difficulties or delays in integrating physician compensation models,

difficulties in integrating operations, technologies, services and personnel,

diversion of financial and management resources from existing operations,

risk of entering new markets,

potential write-offs of acquired assets,

potential loss of key employees, and

inability to generate sufficient revenue to offset acquisition costs.

We have in the past and may experience in the future these difficulties as we integrate the operations of future companies we acquire with our operations.

In addition, if we finance acquisitions by issuing convertible debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. Including the acquisitions of Midwest Physicians Services, LLC, Emergency Radiology Services, LLC, Teleradiology Diagnostic Service, Inc. and The Radlinx Group, Ltd., we have made six acquisitions to date, and our management has experienced challenges in completing acquisitions and integrating acquired businesses with our operations. If we fail to properly evaluate and execute acquisitions, our business and prospects may be harmed.

If our arrangements with our affiliated radiologists or our customers are found to violate state laws prohibiting the corporate practice of medicine or fee splitting, our business, financial condition and our ability to operate in those states could be adversely impacted.

The laws of many states, including states in which our customers are located, prohibit us from exercising control over the medical judgments or decisions of physicians and from engaging in certain financial arrangements, such as splitting professional fees with physicians. These laws and their interpretations vary from state to state and are enforced by state courts and regulatory authorities, each with broad discretion. We enter into agreements with our affiliated radiologists pursuant to which the radiologists render professional medical services. In addition, we enter into agreements with our customers to deliver professional radiology interpretation services in exchange for a service fee. We structure our relationships with our affiliated radiologists and our customers in a manner that we believe is in compliance with prohibitions against the corporate practice of medicine and fee splitting. While we have not received notification from any state regulatory or similar authorities asserting that we are engaged in the corporate practice of medicine or that the payment of service fees to us by our customers constitutes fee splitting, if such a claim were successful, we could be subject to civil and criminal penalties and could be required to restructure or terminate the

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

applicable contractual arrangements. A determination that these arrangements violate state statutes, or our inability to successfully restructure our relationships with our affiliated radiologists to comply with these statutes, could eliminate customers located in certain states from the market for our services, which would have a materially adverse effect on our business, financial condition and operations.

Table of Contents

We may be unable to successfully expand our services beyond the off-hours emergency radiology market.

We have historically focused our business on providing emergency radiology services during the hours of 5:00 p.m. to 8:00 a.m. and 24 hours per day on weekends and holidays. In 2006, we expanded our hours of service to 24 hours, 7 days a week and began offering final reads and sub-specialty services, including cardiac imaging services, to enhance our service offerings to our customers. In addition, we acquired Midwest Physician Services, LLC to expand our suite of solutions that we offer to radiology groups. A key part of our strategy to offset the moderation of growth in our provision of preliminary reads involves providing final reads and sub-specialty services; however, our efforts to provide these final reads and sub-specialty services, or any other services beyond our current services offerings and radiology solutions, may not result in significant revenue growth for us. In addition, efforts to expand our services into these new markets may divert management resources from existing operations and require us to commit significant financial resources to an unproven business. To support these service offerings, we have recently opened two additional centralized reading centers in San Francisco, California and Austin, Texas, similar to our facilities in Sydney, Australia and Zurich, Switzerland. If we are unable to effectively and profitably expand our offerings in these areas, our business, financial condition and results of operations could be adversely affected.

If our affiliated radiologists are characterized as employees, we would be subject to employment and withholding liabilities and may be subject to prohibitions against the corporate practice of medicine.

We structure our relationships with our affiliated radiologists in a manner that we believe results in an independent contractor relationship, not an employee relationship. An independent contractor is generally distinguished from an employee by his or her degree of autonomy and independence in providing services. A high degree of autonomy and independence is generally indicative of a contractor relationship, while a high degree of control is generally indicative of an employment relationship. Although we believe that our affiliated radiologists are properly characterized as independent contractors, tax or other regulatory authorities may in the future challenge our characterization of these relationships. If such regulatory authorities or state, federal or foreign courts were to determine that our affiliated radiologists are employees, and not independent contractors, we would be required to withhold income taxes, to withhold and pay social security, Medicare and similar taxes and to pay unemployment and other related payroll taxes. We would also be liable for unpaid past taxes and subject to penalties. In addition, such a determination may also result in a finding that we are engaged in the corporate practice of medicine in violation of the laws of many states. As a result, any determination that our affiliated radiologists are our employees would materially harm our business and operating results.

Our growth strategy depends on our ability to recruit and retain qualified radiologists and other skilled personnel. If we are unable to do so, our future growth would be limited and our business and operating results would be harmed.

Our success is dependent upon our continuing ability to recruit and retain qualified radiologists. An inability to recruit and retain radiologists would have a material adverse effect on our ability to grow and would adversely affect our results of operations. We face competition for radiologists from other healthcare providers, including radiology groups, research and academic institutions, government entities and other organizations. In addition, our affiliated radiologists are typically U.S. citizens who must obtain visas to work in Australia or Switzerland. We have worked with the government of Australia to establish a visa program and have assisted our affiliated radiologists in the visa application process with the government of Switzerland, and to date all of our professionals have successfully obtained work visas in a timely manner. However, any future inability to obtain or difficulty in obtaining work visas for our affiliated radiologists, due to changing immigration regulations or otherwise, would jeopardize our business and harm our results.

In addition to recruiting radiologists, we must identify, recruit and retain skilled executive, technical, administrative, sales, marketing and operations personnel for our headquarters in Coeur d'Alene, Idaho. Competition for highly qualified and experienced personnel is intense due to the limited number of people available with the necessary skills. In addition, Coeur d'Alene has a relatively small pool of potential employees with the skills that we require, and is a small city in a relatively rural part of the country, making it difficult for us to recruit employees from larger metropolitan areas of the country. Failure to attract and retain the necessary personnel would inhibit our growth and harm our business.

We have been subject to medical liability claims and may become subject to additional claims, which could cause us to incur significant expenses and may require us to pay significant damages if not covered by insurance.

Our business entails the risk of medical liability claims against our affiliated radiologists and us. We or our affiliated radiologists are subject to ongoing medical liability claims in the ordinary course of business. Although we maintain medical liability insurance for ourselves and our affiliated radiologists with coverage that we believe is appropriate in light of the risks attendant to our business, successful medical liability claims could result in substantial damage awards which exceed the limits of our insurance coverage. In addition, medical liability insurance is expensive and insurance premiums may increase significantly in the future, particularly as we expand our services to include final and sub-specialty reads and cardiac imaging services. As a result, adequate medical liability insurance may not be available to our affiliated radiologists or us in the future at acceptable costs or at all.

Table of Contents

Any claims made against us that are not fully covered by insurance could be costly to defend against, result in substantial damage awards against us and divert the attention of our management and our affiliated radiologists from our operations, which could adversely affect our operations and financial performance. In addition, any claims might adversely affect our business or reputation.

We indemnify our radiology group and hospital customers against damages or liabilities that they may incur as a result of the actions of our affiliated radiologists or us. We also indemnify some of our affiliated radiologists against medical liability claims. Our indemnification obligations are typically payable only to the extent that damages incurred are not covered by insurance.

We have also assumed and succeeded to substantially all of the obligations of the businesses that we have acquired. Medical liability claims may be asserted against us for events that occurred prior to these acquisitions. In connection with our acquisitions, the sellers of the businesses that we have acquired have agreed to indemnify us for certain claims. However, we may not be able to collect payment under these indemnity agreements, which could affect us adversely.

If our customers terminate their agreements with us or if our customers' businesses materially decline, our financial condition and operating results could be adversely affected.

Our revenue is derived primarily from fee-for-service billings to our radiology group customers. Our agreements with our customers generally provide for one-year terms and automatically renew for successive one-year terms unless terminated by our customers or us upon 30 days prior notice. Our customers may elect not to renew their contracts with us, they may seek to renegotiate the terms of their contracts or they may choose to reduce or eliminate our services in the future. If our arrangements with our customers are canceled, or are not renewed or replaced with other arrangements having at least as favorable terms, our business, financial condition and results of operations could be adversely affected. In addition, if our radiology group customers' agreements with the hospitals that they serve are terminated, or if our radiology group customers' businesses begin to decline for other reasons (such as a material increase in the rate of uninsured patients or uncollectible accounts), our business, financial condition and results of operations could be adversely affected. For example, substantially all of our business process services revenue is generated from St. Paul Radiology, P.A. If the business of St. Paul Radiology, P.A. were to decline significantly or St. Paul Radiology, P.A. were to experience a material increase in uncollectible accounts, the revenue that we generate from the business process services that we provide would be adversely affected which, in turn, could adversely affect our business, financial condition and results of operation.

If our security measures are breached and unauthorized access is obtained to patient or customer data, we may face liabilities and our system may be perceived as not being secure, causing customers to curtail or stop using our services, which could lead to a decline in revenues.

We are required to implement administrative, physical and technological safeguards to ensure the security of the patient data that we create, process or store. These safeguards may fail to ensure the security of patient or customer data, thereby subjecting us to liability, including civil monetary penalties and possible criminal penalties. If our security measures are breached, whether as a result of third party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to patient or customer data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access to systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventive measures.

Enforcement of federal and state laws regarding privacy and security of patient information may adversely affect our business, financial condition or operations.

The use and disclosure of certain healthcare information by healthcare providers and their business associates have come under increasing public scrutiny. Federal standards under the Health Insurance Portability and Accountability Act of 1996, or HIPAA, establish rules concerning how individually-identifiable health information may be used, disclosed and protected. Historically, state law has governed confidentiality issues and HIPAA preserves these laws to the extent they are more protective of a patient's privacy or provide the patient with more access to his or her health information. As a result of the implementation of the HIPAA regulations, many states are considering revisions to their existing laws and regulations that may or may not be more stringent or burdensome than the federal HIPAA provisions. We must operate our business in a manner that complies with all applicable laws, both federal and state and that does not jeopardize the ability of our customers to comply with all applicable laws to which they are subject. We believe that our operations are consistent with these legal standards. Nevertheless, these laws and regulations present risks for healthcare providers and their business associates that provide services to patients in multiple states. Because few of these laws and regulations have been interpreted by government regulators or courts, our interpretations and activities may be challenged. If a challenge to our activities is successful, it could have an adverse effect on our operations, may require us to forgo relationships with customers in certain states, and may restrict the territory available to us to expand our business. In addition, even if our interpretations of HIPAA and other federal and state laws and regulations are correct, we could be held liable for unauthorized uses or disclosures of patient information as a result

Edgar Filing: NightHawk Radiology Holdings Inc - Form 10-Q

of inadequate systems and controls to protect this information or due to the theft of information by unauthorized computer programmers who penetrate our network security.

Table of Contents

Future changes in healthcare regulation are difficult to predict and may constrain or require us to restructure our operations, which could negatively impact our business and operating results.

The healthcare industry is heavily regulated and subject to frequent changes in governing laws and regulations as well as to evolving administrative interpretations. Our business could be adversely affected by regulatory changes at the federal or state level that impose new requirements for licensing, new restrictions on reimbursement for medical services by government programs, new pretreatment certification requirements for patients seeking radiology procedures, or new limitations on services that can be performed by us. In addition, federal, state and local legislative bodies have adopted and continue to consider medical cost containment legislation and regulations that have restricted or may restrict reimbursement to entities providing services in the healthcare industry and referrals by physicians to entities in which the physicians have a direct or indirect financial interest or other relationship. For example, Medicare recently adopted a regulation that limits the technical component of the reimbursement for multiple diagnostic tests performed during a single session at medical facilities other than hospitals. Any of these or future reimbursement regulations or policies could limit the number of diagnostic tests our customers order and could have a material adverse effect on our business.

Although we monitor legal and regulatory developments and modify our operations from time to time as the regulatory environment changes, we may not be able to adapt our operations to address every new regulation, and such regulations may adversely affect our business. In addition, although we believe that we are operating in compliance with applicable federal and state laws, our business operations have not been scrutinized or assessed by judicial or regulatory agencies. We cannot assure you that a review of our business by courts or regulatory authorities would not result in a determination that adversely affects our operations or that the healthcare regulatory environment will not change in a way that will restrict our operations.

Our growth and our continued operations as a publicly-traded company could strain our personnel, management and infrastructure resources, which may harm our business.

We are currently experiencing a period of rapid growth in our headcount and operations, which has placed, and will continue to place, a significant strain on our management, administrative, operational and financial infrastructure. We also anticipate that further growth will be required to address increases in the scope of our operations and size of our customer base. Our success will depend in part upon the ability of our current senior management team to manage this growth, as well as to manage our operations as a publicly-traded company effectively.

To effectively manage our anticipated growth, we will need to continue to improve our operational, financial and management processes and controls and our reporting systems and procedures. In addition, the additional headcount we are adding and capital investments we are making will increase our costs, which will make it more difficult for us to offset any future revenue shortfalls by offsetting expense reductions in the short term. If we fail to successfully manage our growth and our operations as a publicly-traded company, our business and operating results will be harmed.

Our operating results are subject to seasonal fluctuation, which makes our results difficult to predict and could cause our performance to fall short of quarterly expectations.

Historically, we have experienced increased demand for and revenues from our services during the second and third fiscal quarters of each year. We believe that these increases are a result of increased outdoor and transportation activities during summer months. During the first and fourth quarters of each fiscal year, when weather conditions are colder for a large portion of the United States, we have historically experienced relatively lower revenues than those experienced during the second and third quarters. We may or may not continue to experience this or other seasonality in the future. These seasonal factors may lead to unpredictable variations in our quarterly operating results and cause the trading price of our common stock to decline. Additionally, our ability to schedule adequate radiologist coverage during the seasonal period of increased demand for our services may affect our ability to provide appropriate turnaround times in our services to clients.

Interruptions or delays in our information systems or in network or related services provided by third-party suppliers could impair the delivery of our services and harm our business.

Our operations depend on the uninterrupted performance of our information systems, which are substantially dependent on systems provided by third parties over which we have little control. Failure to maintain reliable information systems, or disruptions in our information systems could cause disruptions and delays in our business operations which could have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

We rely on broadband connections provided by third party suppliers to route digital images from hospitals in the United States to our facilities in Australia, Switzerland and the United States. Any interruption in the availability of the network connections between the hospitals and our reading facilities would reduce our revenue and profits. Frequent or persistent interruptions in our services could cause permanent harm to our reputation and brand and could cause current or potential customers to believe that our systems are unreliable, leading them to switch to our competitors. Because our customers may use our services for critical healthcare services, any system failures could result in damage to our customers' businesses and reputation. These customers could seek significant compensation from us for their losses, and our agreements with our customers do not limit the amount of compensation that they may receive. Any claim for compensation, even if unsuccessful, would likely be time consuming and costly for us to resolve.

Although our systems have been designed around industry-standard architectures to reduce downtime in the event of outages or catastrophic occurrences, they remain vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures, terrorist attacks, computer viruses, break-ins, sabotage, and acts of vandalism. In addition, the connections from hospitals to our reading facility in Australia rely on two cables that link the west coast of the United States with Australia. Despite any precautions that we may take, the occurrence of a natural disaster or other unanticipated problems at our reading facilities or in the networks that connect our reading facilities with our hospitals could result in lengthy interruptions in our services. We do not carry business interruption insurance to protect us against losses that may result from interruptions in our service as a result of system failures.

Hospital privileging requirements or physician licensure laws may limit our market, and the loss of hospital privileges or state medical licenses held by our affiliated radiologists could have a material adverse affect on our business, financial condition and results of operations.

Each of our affiliated radiologists must be granted privileges to practice at each hospital from which the radiologist receives radiological images and must hold a license in good standing to practice medicine in the state in which the hospital is located. The requirements for obtaining and maintaining hospital privileges and state medical licenses vary significantly among hospitals and states. If a hospital or state restricts or impedes the ability of physicians located outside of the United States to obtain privileges or a license to practice medicine at that hospital or in that state, the market for our services could be reduced. In addition, any loss of existing privileges or medical licenses held by our affiliated radiologists could impair our ability to serve our existing customers and have a material adverse affect on our business, financial condition and results of operations.

Medicare and Medicaid rules governing reassignment of payments could affect our customers' ability to collect fees for services provided by our affiliated radiologists and our ability to market our services to our customers.

The majority of our customers are radiology practices. These customers, and not us, typically bill and receive payments from Medicare and/or Medicaid for the professional services provided by our affiliated radiologists. Medicare and Medicaid generally prohibit a physician who performs a covered medical service from reassigning to anyone else (including to other physicians) the performing physician's right to receive payment directly from Medicare or Medicaid, except in certain circumstances. We believe that the services provided by our affiliated radiologists satisfy one or more of the exceptions to this prohibition, but the various Medicare carriers and state Medicaid authorities may interpret these exceptions differently than we do. Because Medicare and Medicaid payments may comprise a significant portion of the total payments received by our customers for the services of our affiliated radiologists, if it were determined that we do not qualify for an exception, our customers could be prohibited from billing Medicare and/or Medicaid for the services of our affiliated radiologists and this would cause a material adverse effect on our ability to market our services and on our business and results of operations. Future laws or regulations, moreover, may require that we bill Medicare or Medicaid directly for new services we provide to our customers. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid.

Medicare reimbursement rules currently provide that the proper Medicare carrier to pay physician claims is the Medicare carrier for the region in which the physician or practice providing the service is located, rather than the Medicare carrier for the region in which the patient receiving the services is located. Many of our affiliated radiologists are located in a Medicare region that is different from the Medicare region in which the patient and treating hospital are located. Since it is incumbent on our customers to file with the proper Medicare carrier in order to receive payment, it may be necessary for our customers to enroll with additional Medicare carriers in order to properly submit claims for reimbursement. To the extent that our customers are unwilling or unable to do so, they may be unwilling to use our services unless we were to submit the claims. Should this occur, we would either be required to forgo business with such customers or be required to design, develop and implement an appropriate recordkeeping and billing system to bill Medicare and Medicaid. The Center for Medicare and Medicaid Services, or CMS, recently proposed amending the reimbursement rules to provide for reimbursement by the Medicare carrier for the region in which the patient and hospital are located regardless of the location of the physician. If adopted, the amended reimbursement rules would eliminate the need for our customers to enroll with additional Medicare carriers.

Table of Contents

Changes in the rules and regulations governing Medicare and Medicaid's payment for medical services could affect our revenues, particularly with respect to final reads.

Although most reads we provide are preliminary reads rather than final reads, we are providing an increasing number of final and sub-specialty reads and cardiac imaging services. Cost containment pressures on Medicare and Medicaid could result in a reduction in the amount that the government will pay for these reads, which could cause pricing pressure on our services. Should that occur, we could be required to lower our prices, or our customers could elect to provide the reads themselves or obtain such services from one of our competitors, and not utilize the services of our affiliated radiologists, which would have a material adverse effect on our business, results of operations and financial condition.

We may be subject to less favorable levels of payment based upon third party payor fee schedules.

Many patients are covered by some form of private or government health insurance or other third party payment program. Third party payors generally establish fee schedules or other payment authorization methods for various procedures that govern which procedures will be reimbursed by the third party payors and the amount of reimbursement. To the extent that such schedules impact the rates at which third party payors are willing to pay the healthcare providers with whom we contract to provide imaging services, we are indirectly impacted by such fee schedules. However, if we were to negotiate direct payment arrangements with third party payors in the future, we would be directly impacted by such schedules. In addition, there is no guarantee that Medicare, state Medicaid programs, or commercial third party payors will continue to cover professional radiology services. For example, in some states, the Medicaid program budgets have been either cut or funds diverted to other programs, which have resulted in limiting the enrollment of participants. This has resulted in an increasing number of bankruptcies and difficulty in collecting accounts receivable at hospitals in certain states. Any reduction or elimination in coverage for our services could adversely impact our business.

Our business could be materially affected if a U.S. Department of Health & Human Services Office of Inspector General study results in a recommendation that Medicare only pay for reads performed contemporaneously in an emergency room setting.

In its Fiscal Year 2009 Work Plan, the U.S. Department of Health & Human Services Office of Inspector General, or HHS-OIG, indicated that it would conduct a study and issue a report assessing the appropriateness of Medicare billings for diagnostic tests performed in hospital emergency rooms. Part of the assessment may include a determination as to whether the tests were read contemporaneously with the patient's treatment. It is possible that, in the final report, the HHS-OIG could recommend to CMS that it change its reimbursement rules to clearly indicate that CMS will only pay for reads performed contemporaneously with a patient's treatment by a physician located within the United States. If CMS were to adopt this recommendation, final reads may no longer be eligible for reimbursement if performed by a physician other than the one who performed the preliminary read. In turn, if our customers were no longer able to be reimbursed for certain final reads, our customers may seek alternative arrangements for the performance of their preliminary reads, which could adversely impact our business.

Changes in the healthcare industry or litigation reform could reduce the number of diagnostic radiology procedures ordered by physicians, which could result in a decline in the demand for our services, pricing pressure and decreased revenue.

Changes in the healthcare industry directed at controlling healthcare costs and perceived over-utilization of diagnostic radiology procedures could reduce the volume of radiological procedures performed. For example, in an effort to contain increasing imaging costs, some managed care organizations and private insurers are instituting pre-authorization policies which require physicians to pre-clear orders for diagnostic radiology procedures before those procedures can be performed. If pre-clearance protocols are broadly instituted throughout the healthcare industry, the volume of radiological procedures could decrease, resulting in pricing pressure and declining demand for our services. In addition, it is often alleged that many physicians order diagnostic procedures even when the procedures may have limited clinical utility in large part to establish a record for defense in the event of a medical liability claim. Changes in tort law could reduce the number of radiological procedures ordered for this purpose and therefore reduce the total number of radiological procedures performed each year, which could harm our operating results.

We may not have adequate intellectual property rights in our brand, which could limit our ability to enforce such rights.

Our success depends in part upon our ability to market our services under the NightHawk brand. However, we believe that the term NightHawk cannot be afforded trademark protection as it is a generic term used to describe the provision of off-hours radiology services. Other than DayHawk, we have not secured registrations of our other marks. Other businesses may have prior rights in the brand names that we market under or in similar names, which could limit or

Table of Contents

prevent our ability to use these marks, or to prevent others from using similar marks. If we are unable to prevent others from using our brand names, or if others prohibit us from using them, our revenue could be adversely affected. Even if we are able to protect our intellectual property rights in such brands, we could incur significant costs in doing so.

Any failure to protect our intellectual property rights in our workflow technology could impair its value and our competitive advantage.

We rely heavily on our proprietary workflow technology to distribute radiological images to the appropriately licensed and privileged radiologist best able to provide the necessary clinical insight in the least amount of turnaround time. If we fail to protect our intellectual property rights adequately, our competitors may gain access to our technology, and our business may be harmed. We currently do not hold any patents with respect to our technology. Although we have filed an application for a patent covering our workflow technology, we may be unable to obtain patent protection for this technology. In addition, any patents we may obtain may be challenged by third parties. Accordingly, despite our efforts, we may be unable to prevent third parties from using or misappropriating our intellectual property.

We may in the future become subject to intellectual property rights claims, which could harm our business and operating results.

The information technology industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. As an example, we are aware that on July 31, 2007, Merge eMed, Inc., or Merge, filed a complaint against another teleradiology provider, Virtual Radiologic Corporation, or VRC, alleging that VRC has infringed on certain of Merge's patents relating to teleradiology. In connection with that litigation, VRC has filed a Request for Reexamination with the U.S. Patent and Trademark Office, or US PTO, which asks the US PTO to re-examine the validity of the patents at issue. While we are not currently a party to any litigation, if Merge or another third party asserts that our technology violates that third-party's proprietary rights, or if a court holds that our technology violates such rights, we may be required to re-engineer our technology, obtain licenses from third parties to continue using our technology without substantial re-engineering or remove the infringing functionality or feature. In addition, we may incur substantial costs defending any such claim. We may also become subject to damage awards, which could cause us to incur additional losses and harm our financial position.

Monitoring potential infringement of and defending or asserting our intellectual property rights may entail significant expense. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

We are dependent on our management team, and the loss of any key member of this team may prevent us from implementing our business plan in a timely manner.

Our success depends largely upon the continued services of our executive officers, particularly Dr. Paul Berger, our Chief Executive Officer and Chairman of the Board. The loss of Dr. Berger, Tim Murnane, our Chief Operating Officer, David Sankaran, our Chief Financial Officer, or Jon D. Berger, our Senior Vice President of Strategy and Business Development could have a material adverse effect on our business, financial condition, results of operations and the trading price of our common stock. The search for replacements for any of our executives could be time consuming and could distract our management team from the day-to-day operations of our business.

If we fail to implement and maintain an effective system of internal controls, we may not be able to report our financial results in an accurate or timely manner, prevent fraud or comply with Section 404 of the Sarbanes-Oxley Act of 2002, which may harm our business and affect the trading price of our stock.

Effective internal controls are necessary for us to provide reliable financial reports in a timely manner and to prevent fraud. We cannot assure you that we will maintain an effective system of internal controls in the future. If we fail to adequately staff and train our accounting and finance personnel to meet the demands of operating as a public company, including the requirements of the Sarbanes-Oxley Act of 2002, or fail to maintain adequate internal controls, any resulting material weakness in internal controls could prevent our management from concluding the internal controls are effective and impair our ability to prevent material misstatements in our financial statements, which could cause our business to suffer. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements in a timely manner or prevent fraud may negatively affect the trading price of our stock or result in stockholder litigation.

Table of Contents

We may be unable to enforce non-compete agreements with our affiliated radiologists.

Our independent contractor agreements with our affiliated radiologists typically provide that the radiologists may not compete with us for a period of time, typically one year, after the agreements terminate. These covenants not to compete are enforceable to varying degrees from jurisdiction to jurisdiction. In most jurisdictions, a covenant not to compete will be enforced only to the extent that it is necessary to protect the legitimate business interest of the party seeking enforcement, that it does not unreasonably restrain the party against whom enforcement is sought and that it is not contrary to the public interest. This determination is made based upon all the facts and circumstances of the specific case at the time enforcement is sought. It is unclear whether our interests will be viewed by courts as the type of protected business interest that would permit us to enforce a non-competition covenant against the radiologists. A determination that these provisions are not enforceable could have a material adverse effect on us.

Enforcement of state and federal anti-kickback laws may adversely affect our business, financial condition or operations.

Various federal and state laws govern financial arrangements among healthcare providers. The federal anti-kickback law prohibits the knowing and willful offer, payment, solicitation or receipt of any form of remuneration in return for, or with the purpose to induce, the referral of Medicare, Medicaid, or other federal healthcare program patients, or in return for, or with the purpose to induce, the purchase, lease or order of items or services that are covered by Medicare, Medicaid, or other federal healthcare programs. Similarly, many state laws prohibit the solicitation, payment or receipt of remuneration in return for, or to induce the referral of patients in private as well as government programs. Violation of these anti-kickback laws may result in substantial civil or criminal penalties for individuals or entities and/or exclusion from participating in federal or state healthcare programs. If we are excluded from federal or state healthcare programs, our customers who participate in those programs would not be permitted to continue doing business with us. We believe that we are operating in compliance with applicable law and believe that our arrangements with providers would not be found to violate the anti-kickback laws. However, these laws could be interpreted in a manner inconsistent with our operations.

Because our customers submit claims to the Medicare program based on the services we provide, it is possible that a lawsuit could be brought against us or our customers under the federal False Claims Act, and the outcome of any such lawsuit could have a material adverse effect on our business, financial condition and operations.

The Federal False Claims Act provides, in part, that the federal government may bring a lawsuit against any person whom it believes has knowingly presented, or caused to be presented, a false or fraudulent request for payment from the federal government, or who has made a false statement or used a false record to get a claim approved. The government has taken the position that claims presented in violation of the federal anti-kickback law may be considered a violation of the Federal False Claims Act. The Federal False Claims Act further provides that a lawsuit brought under that act may be initiated in the name of the United States by an individual who was the original source of the allegations, known as the relator. Actions brought under the Federal False Claims Act are sealed by the court at the time of filing. The only parties privy to the information contained in the complaint are the relator, the federal government and the court. Therefore, it is possible that lawsuits have been filed against us that we are unaware of or which we have been ordered by the court not to discuss until the court lifts the seal from the case. Penalties include fines ranging from \$5,500 to \$11,000 for each false claim, plus three times the amount of damages that the federal government sustained because of the act of that person. We believe that we are operating in compliance with the Medicare rules and regulations, and thus, the Federal False Claims Act. However, if we were found to have violated certain rules and regulations and, as a result, submitted or caused our customers to submit allegedly false claims, any sanctions imposed under the Federal False Claims Act could result in substantial fines and penalties or exclusion from participation in federal and state healthcare programs which could have a material adverse effect on our business and financial condition.

Federal regulatory and law enforcement authorities have recently increased enforcement activities with respect to Medicare and Medicaid fraud and abuse regulations and other reimbursement laws and regulations, including laws and regulations that govern our activities and the activities of teleradiologists. These increased enforcement activities may have a direct or indirect adverse affect on our business, financial condition and results of operations.

Additionally, some state statutes contain prohibitions similar to and possibly even more restrictive than the Federal False Claims Act. These state laws may also empower state administrators to adopt regulations restricting financial relationships or payment arrangements involving healthcare providers under which a person benefits financially by referring a patient to another person. We believe that we are operating in compliance with these laws. However, if we are found to have violated such laws, our business, results of operations and financial condition would be harmed.

Table of Contents

Changes in the governmental interpretation or enforcement of the federal prohibition on physician self-referral may adversely affect our business, financial conditions or operations.

The federal Stark Law prohibits a physician from referring Medicare or Medicaid patients for the provision of designated health services by an entity in which the physician has an investment interest or with which the physician has entered into a compensation arrangement. Designated health services include both the professional and technical components of diagnostic tests using X-rays, ultrasound or other imaging services, CT, MRI, radiation therapy and diagnostic mammography services. Violation of the Stark Law may result in substantial civil penalties and/or exclusion from participation in federal health care programs for both the referring physicians and any entities that submit technical and/or professional component claims for any diagnostic tests ordered by those referring physicians. We believe that we have structured our arrangements between our affiliated radiologists and our customers in a manner that complies with applicable law. However, this law could be interpreted in a manner inconsistent with our arrangements.

The trading price of our common stock has been volatile and will likely remain volatile.

The trading prices of many newly publicly-traded companies are highly volatile, particularly companies such as ours that have limited operating histories. Since our initial public offering in February 2006, the trading price of our common stock has been subject to wide fluctuations. Factors that will continue to affect the trading price of our common stock include:

variations in our operating results,

announcements of new services, strategic alliances or significant agreements by us or by our competitors,

recruitment or departure of key personnel,

changes in the estimates of our operating results or changes in recommendations by any securities analysts that follow our common stock, and

market conditions in our industry, the industries of our customers and the economy as a whole.

In addition, if the market for healthcare stocks or healthcare services or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us.

If securities analysts do not publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.

The trading market for our common stock will rely in part on the availability of research and reports that third-party industry or financial analysts publish about us. There are many large, publicly-traded companies active in the healthcare services industry, which may mean it will be less likely that we receive widespread analyst coverage. Furthermore, if one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

The concentration of our capital stock ownership with insiders will likely limit your ability to influence corporate matters.

Our executive officers, directors, current five percent or greater stockholders and affiliated entities collectively own a relatively large percentage of the outstanding shares of our common stock. As a result, these stockholders, acting together, will have control over most matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions. Corporate action might be taken even if other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of

control of our company that other stockholders may view as beneficial.

Adverse changes in general economic conditions could adversely affect our operating results.

Our success depends upon our ability to continue to provide our services to our customers and the willingness of our customers to engage us for these services. The willingness and ability of our customers to engage us for our services depends upon a number of factors, including broader economic conditions and perceptions of such conditions by our customers. Adverse changes in the broader U.S. economy may have an adverse impact on the behavior of our customers and the extent to which they will be willing to engage us for our services. In addition, we may experience difficulty collecting accounts receivable in a timely manner, or at all, if our customers are adversely affected by prevailing economic conditions. Any of these factors could, in turn, have a material adverse effect on our business, financial condition, results of operations and cash flows.

Table of Contents

A change in our customer composition may impact our collection rates.

An increasing number of our customers are hospitals or hospital groups. As changes occur in general economic conditions, hospitals may be required to modify their budgets and/or move funds to other programs as directed by their management or changes in government funding. Recently, we have noticed an increasing number of hospitals becoming insolvent as government funds decrease to hospitals in certain states. If this trend continues and impacts our customers, our collection rates may decrease and our bad debt expense increase which, in turn, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We are exposed to foreign currency exchange risks, which could harm our business and operating results.

We maintain significant operations in Australia and Switzerland, and are exposed to adverse changes in exchange rates associated with the expenses of our operations in these countries. However, we do not currently engage in any hedging transactions to mitigate these risks. Although from time to time we review our foreign currency exposure and evaluate whether we should enter into hedging transactions, we may not adequately hedge against any future volatility in currency exchange rates and, if we engage in hedging transactions, the transactions will be based on forecasts which later may prove to be inaccurate. Any failure to hedge successfully or anticipate currency risks properly could adversely affect our operating results.

In addition, a third of our affiliated radiologists live in Australia and Switzerland, but receive compensation from us in U.S. dollars. Any relative weakness in the U.S. dollar compared to the Australian dollar or Swiss franc may increase the cost of living for our affiliated radiologists and make it less attractive for our affiliated radiologists to sign or renew their service contracts with us.

Provisions in our certificate of incorporation and bylaws and Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.

Our certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions:

establish a classified board of directors so that not all members of our board are elected at one time,

provide that directors may only be removed for cause,

authorize the issuance of blank check preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt,

eliminate the ability of our stockholders to call special meetings of stockholders,

prohibit stockholder action by written consent, which has the effect of requiring all stockholder actions to be taken at a meeting of stockholders,

provide that the board of directors is expressly authorized to make, alter or repeal our bylaws, and

establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company.

Table of Contents

ITEM 6. Exhibits

Exhibit

Number	Description
31.1	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NIGHTHAWK RADIOLOGY HOLDINGS, INC.

Date: October 30, 2008

By:

/s/ DAVID M. SANKARAN
David M. Sankaran
Senior Vice President and Chief Financial Officer

(Principal Financial Officer)