

# DJO Incorporated

## **The Prior Transaction**

On November 3, 2006, Blackstone acquired all of the outstanding shares of capital stock of ReAble in a merger transaction (the “Prior Transaction”). The total purchase price for the Prior Transaction was approximately \$529.2 million and consisted of \$482.5 million paid to former holders of shares of common stock, \$7.2 million related to the fair value of management rollover options that continued to remain as outstanding options to purchase ReAble common stock after the Prior Transaction (the “Prior Transaction Management Rollover Options”), and \$39.5 million in direct acquisition costs. The Prior Transaction was financed through a combination of equity contributed by Blackstone, cash on hand of ReAble, borrowings under our previous senior secured credit facility and proceeds from the 11.75% Notes. Upon the closing of the Prior Transaction, shares of ReAble’s common stock ceased to be traded on the NASDAQ Global Market.

## **Operating Segments**

Following the DJO Merger, we provide a broad array of orthopedic rehabilitation and regeneration products, as well as implants to customers in the United States and abroad. Our reportable segments are managed separately because each segment requires different sales and marketing strategies and in some cases offers different products (see Note 11 to our audited consolidated financial statements). We currently develop, manufacture and distribute our products through the following three operating segments:

### ***Domestic Rehabilitation***

We market our domestic rehabilitation products through the three divisions described below.

*DonJoy, ProCare and Aircast.* Our DonJoy, ProCare and Aircast division was acquired with the DJO Merger and offers products in the following categories:

- rigid knee bracing, which includes functional bracing for prevention and rehabilitation of ligament injuries, load shifting braces to relieve osteoarthritis pain and post-operative braces for protecting surgical repair;
- orthopedic soft goods, which include products that offer immobilization and support from head to toe;
- cold therapy products, which assist in the reduction of swelling and pain; and
- vascular systems, which include products intended to prevent deep vein thrombosis following surgery.

This division also includes our OfficeCare business, through which we maintain an inventory of soft goods and other products at healthcare facilities, primarily orthopedic practices, for immediate distribution to patients.

*Empi.* Our Empi division offers products in the following categories:

- home electrotherapy, which includes transcutaneous electrical nerve stimulation (“TENS”) for pain management and neuromuscular electrical nerve stimulation (“NMES”) devices for rehabilitation;
- bone growth stimulation products acquired with the DJO Merger, which promote the healing of bone tissue through combined magnetic field (“CMF”) technology;
- iontophoresis, which includes devices and accessories to deliver medication transdermally; and

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- home traction, which includes cervical and lumbar traction devices designed to provide decompression to the spine.

This division also includes our Rehab Med + Equip (“RME”) and EmpiCare business. RME sells a wide range of proprietary and third party rehabilitation products to physical therapists and chiropractors through a printed catalog and through an on-line e-commerce site. Through our EmpiCare business, we maintain an inventory of soft goods and other products at healthcare facilities, primarily orthopedic practices, for immediate distribution to patients.

*Chattanooga.* Our Chattanooga Group offers products in the clinical rehabilitation market in the following categories:

- clinical electrotherapy devices (such as TENS, NMES, laser, ultrasound and light therapy);
- clinical traction devices; and
- other clinical products and supplies such as treatment tables, continuous passive motion (“CPM”) devices and dry heat therapy.

### ***International Rehabilitation***

Our International Rehabilitation Segment, which generates most of its revenues in Europe, is divided into three main businesses:

- the international sales of our DonJoy, ProCare and Aircast products, including rigid knee bracing products, orthopedic soft goods, cold therapy products and vascular systems;
- our Ormed business, which provides bracing, CPM, electrotherapy and other products primarily in Germany; and
- our Cefar-Compex business, which provides electrotherapy products for medical and consumer markets and other physical therapy and rehabilitation products primarily in Europe.

### ***Surgical Implant***

Our Surgical Implant Segment develops, manufactures and markets a wide variety of knee, hip and shoulder implant products that serve the orthopedic reconstructive joint implant market.

### **Recent Acquisitions**

In recent years, our growth has been driven both by the introduction of products facilitated by our research and development efforts and by selected acquisitions of businesses or products primarily related to our Domestic Rehabilitation and International Rehabilitation Segments. In addition to the DJO Merger, which more than doubled our size and product range, we completed the following acquisitions in the last two years.

On August 9, 2007, a subsidiary of DJOFL acquired IOMED, Inc. (“IOMED”), which develops, manufactures and markets active drug delivery systems used primarily to treat acute local inflammation in the physical and occupational therapy and sports medicine markets. The purchase price of \$23.3 million consisted of \$21.1 million in cash payments to former IOMED equity holders at \$2.75 per share, \$0.8 million related to the fair value of vested stock options that were outstanding at the time of the acquisition, and \$1.4 million in direct acquisition costs. The acquisition was primarily financed with borrowings under our then existing revolving credit facility.

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On July 2, 2007, a subsidiary of DJOFL completed its purchase of substantially all of the assets of The Saunders Group, Inc. (“Saunders”) for total cash consideration of \$40.9 million, including \$0.9 million of acquisition costs. Saunders is a supplier of rehabilitation products to physical therapists, chiropractors, athletes, athletic trainers, physicians and patients, with a specialty in patented traction devices, back supports, and equipment for neck and back disorders.

On November 7, 2006, a subsidiary of DJOFL acquired Cefar AB (“Cefar”), a provider of electrotherapy and rehabilitation devices in Europe used for chronic pain, for women’s health (labor pain, incontinence, dysmenorrhea), electroacupuncture, and other rehabilitation activities. We have integrated the operations of Cefar with those of Compex SA, the European subsidiary of Compex Technologies, Inc. (“Compex”). Our strategy for the merged company is to develop both the professional/medical and consumer markets for electrostimulation across Europe and internationally, while continuing to sell products under both the Cefar and Compex brands. The purchase price for Cefar of \$27.1 million was comprised of \$16.3 million in cash, issuance of 573,134 shares of our common stock valued at \$9.5 million, and approximately \$1.3 million in acquisition costs. In addition, we also assumed Cefar’s existing debt of approximately \$3.8 million.

On February 24, 2006, we completed the acquisition of Compex. Compex manufactured and sold a broad line of TENS and NMES products used for pain management, rehabilitation, fitness and sports performance enhancement in clinical, home healthcare, sports and occupational medicine settings. We paid a total purchase price of approximately \$102.9 million, comprised of approximately 7.3 million shares of our common stock valued at approximately \$90.0 million in exchange for all of the outstanding common stock of Compex, options to purchase approximately 900,000 shares of our common stock valued at \$9.3 million in exchange for all of the outstanding options to purchase common stock of Compex, and \$3.6 million in acquisition costs.

### Market Opportunities

We participate globally in the rehabilitation, pain management, bone growth stimulation and reconstruction segments of the orthopedic device market. In the United States, we estimate these segments accounted for approximately \$6.7 billion of total industry sales in 2006. We believe that several factors are driving growth in the orthopedic products industry, including the following:

- *Favorable demographics.* An aging population is driving growth in the orthopedic products market. Many conditions that result in rehabilitation, physical therapy or orthopedic surgery are more likely to affect people in middle age or later in life. According to a 2007 United States Census Bureau – International Data Base projection, the aging baby boomer generation will result in the percentage of the North American population aged 65 and over to grow from 12.0% in 2008 to 16.0% in 2020 and to 20.0% by 2030. In Western Europe, the population aged 65 and over is expected to grow from 17.0% in 2008 to 20.0% in 2020 and to 24.0% by 2030. In addition, according to a 2007 United States Census Bureau – International Data Base projection, the average life expectancy in North America increased from 77.9 years in 2005 to 78.3 years in 2008 and is expected to grow to 81.3 years by 2030. In Western Europe, the average life expectancy increased from 79.2 years in 2005 to 79.7 years in 2008 and is expected to grow to 82.0 years by 2030. As life expectancy increases, we believe people will remain active longer, causing the number of injuries requiring orthopedic rehabilitation, bone growth stimulation and reconstructive implants to increase.
- *Shift toward non-surgical rehabilitation devices and at-home physical therapy.* We believe the growing awareness and clinical acceptance by healthcare professionals of the benefits of non-surgical, non-pharmaceutical treatment and rehabilitation products, combined with the increasing interest by patients in rehabilitation solutions that minimize risk and recuperation time and provide greater convenience, will continue to drive demand for these products. For example, TENS and NMES devices are increasingly

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being recognized as effective solutions for pain management and rehabilitation therapy, respectively. In addition, we believe that orthopedic surgeons are increasingly utilizing braces that assist in rehabilitation and bone growth stimulation devices that enable in-home treatment as viable alternatives to surgery. Many of our orthopedic rehabilitation products are designed for at-home use, which we believe should allow us to benefit from the market shift toward these treatment alternatives.

- *Lower cost alternatives appeal to third party payors.* With the cost of healthcare rising in the United States and internationally, third party payors are seeking more cost-effective therapies without reducing quality of care. For example, third party payors seek to reduce clinic visits and accommodate patients' preference for therapies that can be conveniently administered at home. We believe that many of our orthopedic rehabilitation products offer cost-effective alternatives to surgery, pharmaceutical and other traditional forms of physical therapy and pain management.
- *Increased need for rehabilitation due to increased orthopedic surgical volume.* The combination of increased prevalence of degenerative joint disease (such as osteoarthritis), an increased number of sports-related injuries, an aging population and improvements in orthopedic surgical technique (such as arthroscopy) has contributed to an increase in the number of orthopedic surgeries. We believe that orthopedic surgical volume will continue to increase, which should result in an increase in the need for our products.

### Competitive Strengths

We believe that we have a number of competitive strengths that will enable us to further enhance our position in the orthopedic rehabilitation device market:

- *Leading market positions.* We derived nearly one-half of our net sales in 2007 from products for which we estimate we have leading market positions, including soft goods, ankle braces, walking braces, rigid knee braces, clinical electrotherapy, TENS, NMES, iontophoresis, cold therapy, home and clinical traction and CPM devices. We believe our orthopedic and physical therapy rehabilitation products marketed under the DonJoy, Aircast, ProCare, Chattanooga Group, Empi, Cefar, Compex and Ormed brands have a reputation for quality, durability and reliability among healthcare professionals. We believe the strength of our brands and our focus on customer service have allowed us to establish market leading positions in the highly fragmented and growing orthopedic rehabilitation market.
- *Comprehensive range of orthopedic products.* We offer a diverse range of orthopedic devices, including orthopedic rehabilitation, pain management and physical therapy products, bone growth stimulation and surgical reconstructive implant products, to orthopedic specialists and patients for hospital, clinical and at-home therapies. Our broad product offering meets many of the needs of orthopedic professionals and patients and enables us to leverage our brand loyalty with our customer and distributor base. Our products are available across various stages of the orthopedic patient's continuum of care.
- *Extensive and diverse distribution network.* We use multiple channels to distribute our products to our customers. We use over 13,000 dealers and distributors and a direct sales force of over 500 employed sales representatives and approximately 900 independent sales representatives to supply our products to physical therapy clinics, orthopedic surgeons and practices, orthotic and prosthetic centers, hospitals, surgery centers, athletic trainers, chiropractors, other healthcare professionals and retail outlets. We believe that our distribution network provides us with a significant competitive advantage in selling our existing products and in introducing new products.

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- *Strong relationships with managed care organizations and rehabilitation healthcare providers.* Our leading market positions in many of our orthopedic rehabilitation product lines and the breadth of our product offerings have enabled us to secure important preferred provider and managed care contracts. We have developed a third party billing system. Our database includes approximately 9,000 different insurance companies and other payors, including over 1,000 active payor contracts. Our proprietary third party billing system is designed to reduce our reimbursement cycles, improve relationships with managed care organizations and physicians and track patients to improve quality of care and create subsequent selling opportunities. Further, our OfficeCare and EmpiCare businesses maintain inventory at over 1,300 healthcare facilities, primarily orthopedic practices, which further strengthens our relationships with these healthcare providers.
- *National contracts with group purchasing organizations.* Following the DJO Merger, we enjoy strong relationships with a meaningful number of group purchasing organizations (“GPOs”) due to our significant scale. We believe that our broad range of products is well suited to the goals of these buying groups. Under these national contracts, we provide favorable pricing to the buying group and are designated a preferred purchasing source for the members of the buying group for specified products. As DJO Opco made acquisitions and expanded its product range, it has been able to add incremental products to its national contracts. During 2007, DJO Opco signed or renewed six significant national contracts, and also added products from its recent acquisitions to a number of these national contracts. Following the DJO Merger, we believe we will be able to add additional products to these contracts.
- *Low cost, high quality manufacturing capabilities.* Our principal manufacturing facility is located in Tijuana, Mexico and has been recognized for operational excellence. Our low cost manufacturing principles drive manufacturing efficiencies by employing lean manufacturing, Six Sigma concepts and continuous improvement processes. Following the DJO Merger, we plan to move additional portions of our manufacturing to Mexico and expect to achieve savings from lower labor costs and implementation of more efficient processes. Further, we intend to extend lean manufacturing concepts to our manufacturing facilities in Clear Lake, South Dakota and Chattanooga, Tennessee.
- *Ability to generate significant cash flow.* Historically, our strong competitive position, brand awareness and high quality products and service as well as our low cost manufacturing have allowed us to generate attractive operating margins. These operating margins, together with limited capital expenditures and modest working capital requirements, significantly benefit our ability to generate free cash flow.
- *Experienced management team.* The members of our management team have an average of over 24 years of relevant experience. This team has successfully integrated a number of acquisitions in the last several years.

### **Our Strategy**

Our strategy is to increase our leading position in key products and markets, increase revenues and profitability and enhance cash flow. Our key initiatives to implement this strategy include the following:

- *Increase our leading market positions.* We believe we are the market leader in many of the markets in which we compete. We intend to continue to increase our market share by leveraging the cross-selling and other opportunities created by the DJO Merger and by implementing the initiatives described below. The DJO Merger will allow us to offer customers a more comprehensive range of products to better meet their evolving needs. We believe our size, scale, brand recognition, comprehensive and integrated product

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offerings and leading market positions will enable us to capitalize on the growth in the orthopedic product industry.

- *Increase sales force productivity.* We believe that our complementary distribution channels following the DJO Merger will provide an opportunity to increase the productivity of our sales force. Our sales representatives will generally have a targeted customer base with a broader product offering for those customers. We plan to encourage cross-selling and increase the productivity of the entire sales force by focusing our sales organization and implementing a sales compensation plan to incentivize our sales representatives to sell a broader range of our products. For example, as a result of the DJO Merger, we will combine our strong relationships with orthopedic surgeons and our strong relationships with physical therapists. In addition, we intend to market DJO Opco's bone growth stimulation products through Empi's extensive distribution network.
- *Maximize existing and secure additional national accounts.* We plan to capitalize on the growing practice in healthcare in which hospitals and other large healthcare providers seek to consolidate their purchasing activities to national buying groups. Contracts with these national accounts represent a significant opportunity for revenue growth. We believe that our existing relationships with national buying groups and our broad range of products position us well not only to pursue additional national contracts, but also to expand the scope of our existing contracts.
- *Continue to develop and launch new products and product enhancements.* We have a history of developing and introducing innovative products into the marketplace, and we expect to continue future product launches by leveraging our internal research and development platforms. We believe our ability to develop new technology and to advance existing technology to create new products will position us to further diversify our revenues and to expand our target markets by providing viable alternatives to surgery or medication. We believe that product innovation through effective and focused research and development, as well as our relationships with a number of widely recognized orthopedic surgeons and professionals who assist us in product research, development and marketing, will provide a significant competitive advantage. During 2007, we launched 38 new products, which generated over \$34.1 million in revenues and on a pro forma basis 51 new products, which generated \$38.2 million in revenues.
- *Expand international sales.* In recent years, DJO Opco successfully established direct distribution capabilities in several major international markets. We believe that sales to European and other markets outside the United States continue to represent a significant growth opportunity, and we intend to continue to expand our direct and independent distribution capabilities in attractive foreign markets. The recent DJO Merger and several of the acquisitions we made in 2006 have substantially increased our international revenues and operating infrastructure and have provided us with opportunities to expand our international product offerings. For the year ended December 31, 2007, we generated approximately 27.0% of our net sales from customers outside the United States as compared to 23.9% for the year ended December 31, 2006. On a pro forma basis, we generated international sales of approximately 25.0% for the year ended December 31, 2007.
- *Maximize cost savings opportunities.* We expect the DJO Merger to create significant opportunities to reduce manufacturing and other operating costs. We expect to achieve cost savings by leveraging our low-cost manufacturing capabilities, rationalizing our combined manufacturing and distribution footprints, increasing procurement savings and eliminating duplicative overhead functions. We also intend to eliminate overlapping operating expenses and expect to reduce expenses through improved leveraging of our benefits of scale created by the DJO Merger.

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## Our Products

Our products are used by orthopedic specialists, spine surgeons, primary care physicians, other specialist physicians, physical therapists, podiatrists, chiropractors, athletic trainers and other healthcare professionals to treat patients with musculoskeletal conditions resulting from degenerative diseases, deformities, traumatic events and sports related injuries. In addition, many of our non-surgical medical devices and related accessories are used by athletes and patients to prevent injuries and for at-home physical therapy treatment.

### *Domestic Rehabilitation Segment*

Our Domestic Rehabilitation Segment generated net sales of \$321.4 million and \$242.7 million for the years ended December 31, 2007 and 2006 (combined basis), respectively. When we refer to combined basis in this Annual Report, we refer to the mathematical computation of adding the Predecessor results with those of the Successor for comparative purposes. This combination does not comply with generally accepted accounting principles but is presented because we believe it provides the most meaningful comparison of our results. On a pro forma basis, our Domestic Rehabilitation Segment accounted for approximately \$649.1 million and \$574.3 million of our net sales for the years ended December 31, 2007 and 2006 (combined basis), respectively.

The following table summarizes many of our Domestic Rehabilitation Segment product categories:

<b>Product Category</b>	<b>Description</b>
Home Electrotherapy Devices	Transcutaneous electrical nerve stimulation (TENS) Neuromuscular electrical nerve stimulation (NMES) Interferential electrical nerve stimulation
Clinical Electrotherapy	TENS NMES Ultrasound Laser Light therapy
Patient Care	Nutritional supplements Patient safety devices Pressure care products Vascular systems products Continuous passive motion devices
Rigid Bracing and Soft Goods	Soft goods Lower extremity fracture boots Dynamic splinting Ligament braces Post-operative braces Osteoarthritic braces Ankle bracing Shoulder, elbow and wrist braces Back braces Neck braces

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Product Category	Description
Hot, Cold and Compression Therapy	Dry heat therapy Hot/cold therapy Paraffin wax therapy Moist heat therapy Cold therapy Compression therapy
Physical Therapy Tables and Traction Products	Treatment tables Traction Cervical traction Lumbar traction
Iontophoresis	Needle-free transdermal drug delivery
Regeneration	Non-union fracture bone growth stimulation devices Spine bone growth stimulation devices

### *International Rehabilitation Segment*

Our International Rehabilitation Segment generated net sales of \$104.1 million and \$60.5 million for the years ended December 31, 2007 and 2006 (combined basis), respectively. On a pro forma basis, our International Rehabilitation Segment generated net sales of approximately \$212.7 million and \$168.1 million for the years ended December 31, 2007 and 2006 (combined basis), respectively. The product categories for our International Rehabilitation Segment are similar to the product categories for our Domestic Rehabilitation Segment but certain products are tailored to international market requirements and preferences. In addition, our International Rehabilitation Segment sells a number of product categories, none of which are individually significant, that we do not sell domestically.

### *Surgical Implant Segment*

Our Surgical Implant Segment generated net sales of approximately \$66.6 million and \$59.1 million for the years ended December 31, 2007 and 2006 (combined basis), respectively. These net sales amounts do not change on a pro forma basis because DJO Opco did not conduct any operations in the Surgical Implant Segment.

The following table summarizes our Surgical Implant Segment product categories:

Product Categories	Description
Knee implant	Primary total joint replacement Revision total joint replacement Unicondylar joint replacement
Hip implants	Primary replacement stems Acetabular cup system Revision joint replacement
Shoulder implants	Primary total joint replacement Fracture repair system Revision total joint replacement (including reverse shoulder)

### **Research and Development**

Our research and development programs focus on the development of new products, as well as the enhancement of existing products with the latest technology and updated designs. We seek to develop new technologies to improve durability, performance and usability of existing products, and to develop our manufacturing process to improve product performance and reduce manufacturing costs. In addition to our

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own research and development, we receive new product and invention ideas from orthopedic surgeons and other healthcare professionals. We also seek to obtain rights to ideas we consider promising from a clinical and commercial perspective through entering into either assignment or licensing agreements.

We conduct research and development programs at our facilities in Austin, Texas; Chattanooga, Tennessee; St. Paul, Minnesota; Clear Lake, South Dakota; Vista, California; Anglet, France and Ecublens, Switzerland. We invested approximately \$18.0 million in 2007 (excluding approximately \$3.0 million of acquired in-process research and development (“IPR&D”), \$13.8 million in 2006 (on a combined basis and excluding approximately \$29.1 million of acquired IPR&D), and \$9.6 million in 2005 into research and development activities. On a pro forma basis, we invested approximately \$26.0 million into research and development activities for the year ended December 31, 2007. As of December 31, 2007, we had approximately 150 employees in our research and development departments.

### **Marketing and Sales**

We distribute our products through several sales and distribution channels that allow us to sell our products to a variety of treatment settings across new and complementary distribution networks.

#### ***Domestic Rehabilitation Segment***

We market and sell our Domestic Rehabilitation Segment products in several different ways. The DonJoy sales channel is responsible for selling rigid knee braces, cold therapy products, and certain soft goods. Certain DonJoy sales representatives also sell our Regeneration products. The DonJoy channel consists of approximately 410 independent commissioned sales representatives who are employed by approximately 45 independent sales agents. The DonJoy channel is primarily dedicated to the sale of our products to orthopedic surgeons, podiatrists, orthopedic and prosthetic centers, hospitals, surgery centers, physical therapists, athletic trainers and other healthcare professionals. Because the DonJoy product lines generally require customer education in the application and use of the product, our sales representatives are technical specialists who receive extensive training both from us and the agent and use their expertise to help fit the patient with the product and assist the orthopedic professional in choosing the appropriate product to meet the patient's needs. After a sales representative receives a product order, we generally ship and bill the product directly to the orthopedic professional, paying a sales commission to the agent. For certain custom rigid braces and other products, we sell directly to the patient and bill a third party payor, if applicable, on behalf of the patient. We enjoy long-standing relationships with most of our agents and sales representatives. Under the arrangements with the agents, each agent is granted an exclusive geographic territory for sales of our products and is not permitted to market products, or represent competitors who sell or distribute products, that compete with our existing products. The agents receive a commission, which varies based on the type of product being sold. If an agent fails to achieve specified sales quotas, we have the right to terminate our relationship with the agent. We have recently converted the Northern California and Pacific Northwest region to a direct sales model for products in the DonJoy channel and for ProCare/Aircast and regeneration products

The ProCare/Aircast channel consists of approximately 100 direct and independent sales representatives that manage over 380 distributors focused on primary and acute care facilities. Six vascular systems specialists are also included in this channel. Products in this channel consist primarily of our soft goods, vascular systems and other products, which are generally sold in non-exclusive territories to third party distributors as well as through our direct sales force. Our distributors include large, national third party distributors such as Owens & Minor Inc., McKesson/HBOC, Allegiance Healthcare and Physician Sales and Service Inc., regional medical and surgical distributors, outpatient surgery centers and medical products buying groups that consist of a number of health care providers who make purchases through the buying group. These distributors and our direct sales force generally sell our products to large hospital chains, primary care networks and orthopedic physicians for use by the patients. In addition, we sell our products through GPOs that are a preferred purchasing source for members of a buying group. Unlike our DonJoy products, our ProCare/Aircast products generally do not require significant customer education for

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their use. Our vascular systems pumps and related equipment are typically consigned to hospitals, and the hospitals then purchase the cuffs that are applied to each patient.

Our OfficeCare and EmpiCare businesses provide stock and bill arrangements for physician practices. Through OfficeCare and EmpiCare, we maintain an inventory of soft goods at over 1,300 orthopedic practices and other healthcare facilities for immediate distribution to patients. We then bill the patient or, if applicable, a third party payor. For certain facilities, we provide on-site technical representatives. The OfficeCare channel is managed by our DonJoy sales force. EmpiCare manages its locations through a combination of direct and indirect representatives.

Through our Empi channel, we market our prescription home therapy products primarily to physicians and physical therapy clinics, which include hospital physical therapy departments, sports medicine clinics and pain management centers, through our sales force of over 230 direct and independent sales representatives. In connection with these product lines, we currently have more than 830 managed care contracts. Our electrotherapy and orthotics products are generally prescribed to patients by a physician such as an orthopedic surgeon. The physician will typically direct the patient to a physical therapy clinic to meet with a trained physical therapist who provides the patient with the prescribed product from our consigned inventory at the clinic. This sales process is facilitated by our relationships with third party payors, such as managed care organizations, who ultimately pay us for the products prescribed to patients. For these reasons, we view physical therapists, physicians and third party payors as key decision makers in product selection and patient referral. Our home therapy products generally are eligible for third party reimbursement by government payors, such as Medicare and Medicaid, and private payors. In addition, we have an outbound telemarketing sales force of 42 representatives, who sell reimbursed electrotherapy supplies and other products directly to our patients. Our non-union fracture bone growth stimulator devices (OL1000) are sold primarily by approximately 155 employed and independent sales representatives specially trained to sell the product. The spine bone growth stimulator device (SpinaLogic) is sold by a few of our direct sales representatives and a network of independent spine products distributors. Most of our bone growth stimulator products are sold directly to the patient and a third party payor is billed, if applicable, on behalf of the patient.

Through our Chattanooga Group, we sell our clinical rehabilitation product lines to physical therapy clinics, primarily through a worldwide network of approximately 4,700 independent distributors, which are managed by our internal sales managers, and through catalogue sales. These distributors sell our clinical rehabilitation products to a variety of healthcare professionals, including physical therapists, athletic trainers, chiropractors, and sports medicine physicians. Except for distributors outside of the United States, we do not maintain formal distribution contracts for our clinical rehabilitation products. These distributors purchase products from us at discounts off our published list price. We maintain an internal marketing and sales support program to support our distributor network. This program comprises a group of individuals who provide distributor and end-user training, develop promotional materials, and attend over 36 trade shows each year. Our Chattanooga channel also includes 17 dedicated business-to-business sales representatives and catalog sales.

No particular customer or distributor accounted for 10% or more of product sales for the year ended December 31, 2007. Medicare and Medicaid together accounted for approximately 7.4% of our 2007 net sales. In the United States, in connection with these product lines, we currently have more than 80 preferred provider arrangements with third party payors included in the over 830 managed care contracts discussed above.

### ***International Rehabilitation Segment***

We sell our rehabilitation products internationally through a network of wholly-owned subsidiaries and independent distributors. In Europe, we use sales forces aggregating approximately 240 direct and independent salespersons and a network of independent distributors who call on healthcare professionals, as well as consumer retail stores, such as sporting equipment providers, and pharmacies, to sell our products. We intend to continue to expand our direct and indirect distribution capabilities in attractive foreign markets.

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## ***Surgical Implant Segment***

We currently market and sell the products of our Surgical Implant Segment in the United States to hospitals and orthopedic surgeons through a network of over 160 independent commissioned sales representatives who are employed by approximately 50 sales agents. Generally, our independent sales representatives sell a range of reconstructive joint products, including our products. We usually enter into agreements with sales agents for a term of one to five years. Agents are typically paid a sales commission and are eligible for bonuses if sales exceed certain preset objectives. Our independent sales representatives work for these agents. We assign our sales agents to an exclusive sales territory. Substantially all of our sales agents agree not to sell competitive products. Typically we can only terminate our agreements with sales agents prior to the expiration of the agreements for cause, which includes failure to meet specified periodic sales targets. We provide our sales agents with product inventories on consignment for their use in marketing our products and filling customer orders. Outside the United States, our surgical implant products are sold through independent distributors, principally in Japan and select countries in Europe.

To a significant extent, sales of our surgical implant products depend on the preference of orthopedic surgeons. We have developed and maintain close contractual relationships with orthopedic surgeons who assist us in developing our products. These orthopedic surgeons may give demonstrations using our products, speak about our products at medical seminars, train other orthopedic surgeons in the use of our products, and provide us with feedback on the acceptance of our products. We have also established relationships with surgeons who perform various consulting services for us, including conducting clinical studies on various products, establishing protocols for use of the products and participating at various symposia. Surgeons who assist us in developing our products are generally compensated with a royalty payment. Consulting surgeons are paid consulting fees for their services.

## **Manufacturing**

We use both in-house manufacturing capabilities and relationships with third party vendors to supply our products. Generally, we use third party vendors because they have special manufacturing capabilities or because we believe it is appropriate based on certain factors, including our in-house capacity, lead time control and cost control. Although we have certain sole source supply agreements, we believe alternate vendors are available, and we believe that adequate capacity exists at our current vendors to meet our anticipated needs.

Our manufacturing facilities are generally certified by the International Organization for Standardization ("ISO") and generally comply with FDA current Good Manufacturing Practice ("cGMP") and Quality System Regulations ("QSR") requirements, which provide standards for safe and consistent manufacturing of medical devices and appropriate documentation of the manufacturing and distribution process. Many of our products carry the European Community Medical Device Directive "CE" certification mark.

## ***Domestic Rehabilitation Segment***

Our manufacturing facility in Tijuana, Mexico is our principal manufacturing facility. In the future we plan to move additional manufacturing to our Mexico facility. Our Mexico facility has achieved ISO 9001 and ISO 13485 certification. These certifications are internationally recognized quality standards for manufacturing and assist us in marketing our products in certain foreign markets. Our Vista, California facility has achieved ISO 9001 certification, EN46001 certification and certification to the Canadian Medical Device Regulation (ISO 13485) and the European Medical Device Directive. Products manufactured at the Vista, California facility include our custom rigid knee bracing products, the pump portion of our vascular systems products and our regeneration products. Within both our Vista and Tijuana facilities, we operate vertically integrated manufacturing and cleanroom packaging operations and many subassemblies and components can be produced in-house. These include metal stamped parts, injection molding components and fabric-strapping materials. We also have extensive in-house tool and die

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fabrication capabilities, which typically provide savings in the development of tools and molds as well as flexibility to respond to and capitalize on market opportunities as they are identified.

We make Chattanooga division products, including electrotherapy devices, patient care products and physical therapy and chiropractic treatment tables and CPM devices, in our manufacturing facilities located in Chattanooga, Tennessee. These facilities use various manufacturing processes, including metal fabrication, coating, electronic assembly, mechanical assembly, woodworking and sewing. Our Chattanooga, Tennessee facility has achieved ISO 13485 certification.

Our home electrotherapy devices sold in the United States and certain components and related accessories are manufactured at our Clear Lake, South Dakota facility. Manufacturing activities at the Clear Lake facility include electronic and mechanical assembly, electrode fabrication and assembly and fabric sewing processes. Our electrotherapy products comprise a variety of components, including die cast metal parts, injection molded plastic parts, printed circuit boards, electronic components, lead wires, electrodes and other components. Parts for these components are purchased from outside suppliers and are, in some instances, manufactured on a custom basis. Our Clear Lake facility has achieved the ISO 13485:2003 certification. Our home electrotherapy devices which are sold outside the United States are primarily manufactured by outside third party vendors.

Many of the component parts and raw materials we use in our manufacturing and assembly operations are available from more than one supplier and are generally available on the open market. We source some of our finished products from manufacturers in China as well as other third party manufacturers. We also currently purchase certain CPM devices from a single supply source, Medireha, which is 50% owned by us. Our distribution agreement with Medireha grants us exclusive rights to the distribution of products that Medireha manufactures. The distribution agreement, which expires on August 14, 2009, also requires that we purchase a certain amount of product annually and that we seek Medireha's approval if we choose to manufacture or distribute products that are identical or similar, or otherwise compete with the products that are the subject of the distribution agreement.

### ***International Rehabilitation Segment***

Many of the products for our International Rehabilitation Segment are manufactured in the same facilities as our Domestic Rehabilitation Segment. We operate a manufacturing facility in Tunisia that provides bracing products for the French and other European markets. In addition, our Ormed and Cefar-Complex businesses source most of the products they sell from third party suppliers. Cefar-Complex currently utilizes a single vendor for many of its home electrotherapy devices.

### ***Surgical Implant Segment***

In our Surgical Implant Segment, we manufacture our products in our Austin, Texas facility. This manufacturing facility includes computer controlled machine tools, belting, polishing, cleaning, packaging and quality control. We initially obtained ISO qualification and CE certification for this facility in 1996 and updated our ISO qualification to the ISO 13485:2003 standard in 2005. The primary raw materials used in the manufacture of our surgical implant products are cobalt chromium alloy, stainless steel alloys, titanium alloy and ultra high molecular weight polyethylene. All Surgical Implant Segment products go through in-house quality control, cleaning and packaging operations.

### **Intellectual Property**

We own or have licensing rights to U.S. and foreign patents covering a wide range of our products and have filed applications for additional patents. We have numerous trademarks registered in the United States, a number of which are also registered in countries around the world. We also assert ownership of numerous unregistered trademarks, some of which have been submitted for registration in the United States and foreign countries. In the future, we will continue to apply for such additional patents and trademarks as we deem appropriate. However, we cannot guarantee whether our existing or future patents, if any, will

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afford adequate protection, whether any existing patent applications will result in issued patents, or whether our patents will be circumvented, invalidated or declared unenforceable.

Additionally, we seek to protect our non-patented know-how, trade secrets, processes and other proprietary confidential information, through a variety of methods; including having our vendors, employees and consultants sign invention assignment agreements, proprietary information agreements and confidentiality agreements and having our independent sales agents and distributors sign confidentiality agreements. However, these methods may not provide us with adequate protection. Because many of our products are regulated, proprietary information created during our development of a new or improved product may have to be disclosed to the FDA or another U.S. or foreign regulatory agency in order for us to have the lawful right to market such product. Our proprietary information may also become known to, or be independently developed by, our competitors, or our proprietary rights in intellectual property may be challenged, any of which could have a material adverse effect on our business, financial condition and results of operations.

We have distribution rights for certain products that are manufactured by others and hold both exclusive and nonexclusive licenses under third party patents and trade secrets that cover some of our existing products and products under development. However, if any of the distribution agreements were terminated or if we lost any of these licenses, we would not be able to manufacture or sell the related products, which could have an adverse effect on our future business, financial condition and results of operations.

The validity of any of the patents or other intellectual property owned by or licensed to us may not be upheld if challenged by others in litigation. Due to these and other risks described in this Annual Report on Form 10-K, we do not rely solely on our patents and other intellectual property to maintain our competitive position. We believe that the development and marketing of new products and improvement of existing ones is, and will continue to be, more important to our competitive position than relying solely on existing products and intellectual property.