January 13, 2020

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Gregory Coy
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By email and registered mail

To Mr. Coy,

We write today to express concerns regarding what we believe are numerous questionable practices and deficient disclosures made by your client, OrthoPediatrics Corp. ("the Company").

On December 2, 2020, we published an initial research report which highlighted numerous concerns we had regarding the Company's practices and disclosures. Management declined to provide a direct response to our report. On December 30, 2020, we shared via Twitter that FOIA requests suggested the Company was under an active SEC investigation. In response, OrthoPediatrics released a form 8-K the next day which admitted to this SEC inquiry, notably, only after we pressed the Company's hand. In our view, these actions are demonstrative of a Company which is unwilling to substantially engage with the issues we've raised in our original report, including issues that we believe plague its financial statements, over which you provide an audit opinion.

We remind you that as the Company's independent auditor, you have a tremendous responsibility to obtain reasonable assurance that the financial statements are free from material misstatement. This responsibility includes a call to professional skepticism: to not merely take management at face value, but to examine the veracity of their claims firsthand. Our original report drew similarities to the unsavory practices we believe are occurring at your client, OrthoPediatrics, with companies such as ArthroCare, Valeant Pharmaceuticals, and MiMedx. Each of these fraudulent companies could have been recognized as such had their auditors stepped up to the plate:

In July 2014, the PCAOB brought sanctions against Randall A. Stone, CPA, ArthroCare's audit partner, in part as: "Stone ignored or failed to properly evaluate numerous indicators—known to him during the audit—that should have alerted him to the possibility that ArthroCare may have been engaging in fraudulent financial reporting by improperly recognizing revenue on sales to DiscoCare, Inc. ("DiscoCare"), one of its largest distributors."

In the case of Medicis Pharmaceutical Corporation, E&Y, as auditor, failed to exercise proper skepticism over sales to distributors with a right to return – an issue we believe now also plagues OrthoPediatrics. Medicis was forced to restate its financials and ultimately paid an $18 million settlement, $7 million of which was footed by E&Y. Medicis was eventually acquired by Valeant Pharmaceuticals, another scandalous company, which – as is also the case for OrthoPediatrics – generated sales on consignment.

Finally, In November 2019, the SEC charged MiMedx executives with fraud, stating in part that the group "misled MiMedx's outside auditors, members of Mimedx's Audit Committee, and outside lawyers who inquired about these transactions."

For the sake of brevity, we consolidate our concerns as it pertains to your role as independent auditor of OrthoPediatrics into three categories, each of which we expand upon below:

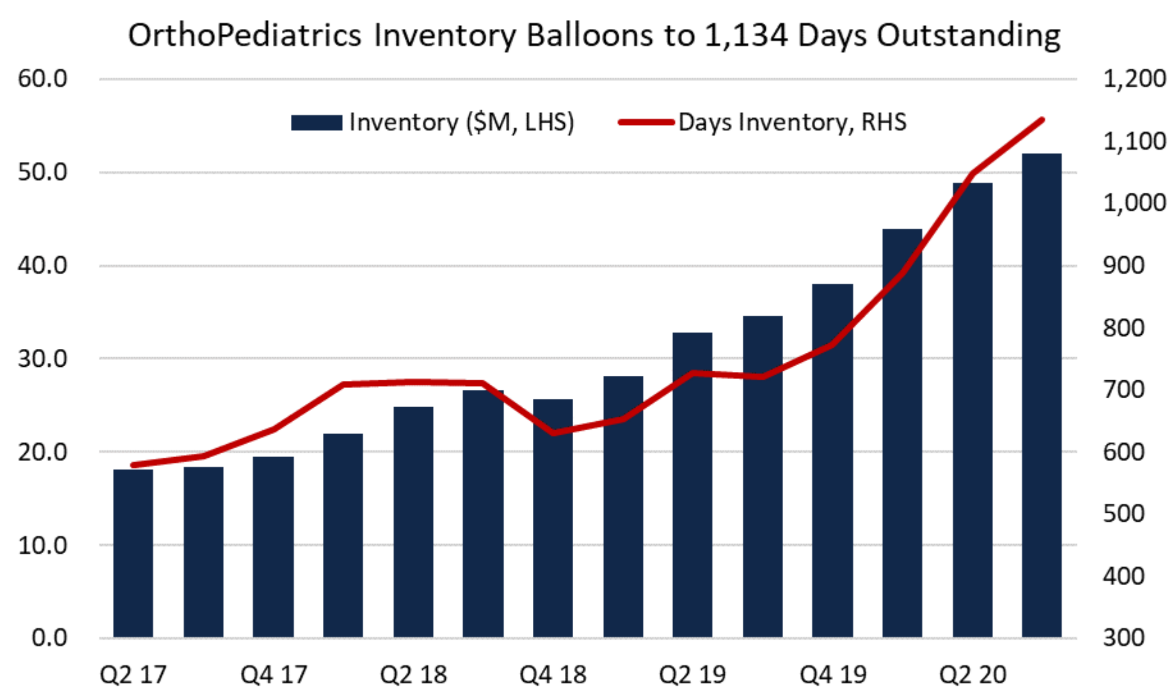
(1) Inventory position

(2) Revenue recognition and direct sales to distributors

(3) Distributor inducements

We Think OrthoPediatrics Inventory Levels Deserve Increased Scrutiny

We believe OrthoPediatrics has failed to record proper inventory write-downs and/or establish reserves for product obsolescence. Over the past several years, the Company's inventory balances have ballooned, now reaching over 1,134 days outstanding, or 3.10 years:



We think the Company's own disclosures demonstrate that a write-down of these inventories is overdue. First, OrthoPediatrics depreciates its own sample inventory (including instruments and implants) across a two-year useful life. Given that sample inventory is found worthless after two years, we find it nonsensical that the loads of Company-owned inventory which has been sitting in the field for three-plus years has apparently yet to lose any substantial value at all.

Second, the Company itself acknowledges the relatively rapid pace of new product introductions, hence often leaving its older products – which have been sitting in the field for three-plus years – obsolete. See per CFO Fred Hite on the Company's Q3 2020 conference call:

> "We do anticipate to continue to roll out more sets here in the fourth quarter as we continue to invest in these sets. A lot of it is focused on new products, **products that had been developed or launched in the last couple of years** and continuing to get more of those sets out there, which is very encouraging to see."

The obvious flipside of this investment is product obsolescence, which has seemingly not occurred in any meaningful manner.

To illustrate the effects of what such a write-down might look like, consider that just a year ago, OrthoPediatrics held not 1,134 average days inventory, but 721 days. If we were to merely adjust the Company's current inventory position to reflect these year-ago levels of 721 days outstanding, current inventories would be $33.1 million, implying a net realizable value write-down of $19.0 million.

OrthoPediatrics states that inventory adjustments are included its cost of revenue, while cost of revenue for the last twelve months was $16.7 million. **Thus, an inventory write-down of this magnitude would bring last-twelve-month gross margins from 76.5% to just 49.8%.** We suspect that OrthoPediatrics has avoided conceding these meaningful, yet necessary inventory write-downs that ought to be in the normal course of business, as the result would be detrimental not only to the Company's gross margins, but represent a concession that its consignment model has not borne fruit. As such, we encourage Deloitte to further scrutinize the Company's inventories and management assumptions regarding useful lives.

We Believe OrthoPediatrics Has Channel Stuffed via Direct Sales to Distributors

OrthoPediatrics' revenue recognition policy states that (per the Form 10-K; our emphasis):

> "In the United States and in seven international markets, we primarily sell our implants, and to a much lesser extent our instruments, through third-party independent sales agencies to medical facilities and hospitals. **For such sales, revenue and associated cost of revenue is recognized when a product is used in a procedure.** In a few cases, hospitals purchase our products for their own inventory, and such revenue and associated cost of revenue is recognized when a product is shipped or delivered and the title and risk of loss passes to the customer."

We think this description, namely the stipulation that revenue is recognized "when a product is used in a procedure" remains all too vague and insufficient, and perhaps intentionally so. For example, this description offers no mention of purchase orders being created or fulfilled, let alone by whom (i.e., distributors, surgeons, hospitals, or OrthoPediatrics).

OrthoPediatrics also vaguely admits that it has the ability to recognize revenues upon shipment, as "revenue is recognized when the hospital obtains control of the product, typically either upon shipment or delivery of the product." Given the Company's consignment model, we believe the "shipment" here refers not to the shipment of product used for an upcoming surgery, but the shipment of product which replaces consigned product already used in surgery. While this model suggests a 1-to-1 ratio of shipments made to product used in procedures, based on the conversations we've had with multiple former employees and distributors, we believe the Company's ability to recognize revenues upon shipment has been abused to effectively ship excess product directly to distributors in a channel stuffing scheme.

OrthoPediatrics has long held the public stance that it does not sell product directly to distributors, nor do distributors take title to inventory. However, in the Company's January 2020 investor presentation released just yesterday, **OrthoPediatrics altered these disclosures, in what appears to us to be a first-time admission that "sales agencies are independent legal entities that take title to and resell product very rarely."** This new disclosure validates our concerns in two ways, while raising a new one.

First, this is an obvious departure from the Company's historical stance that its U.S. distributors do not ever take title to product, hence validating our concerns of channel stuffing.

Second, this disclosure again demonstrates that OrthoPediatrics is apparently only willing to reveal the truth of its business and accounting practices only after management's feet are held to the fire.

Finally, this – we suspect again intentionally vague language – now begs the question as to exactly what the Company deems as "very rare" purchases by its distributors. We also point out that **frequency** of purchases (as implied by this new disclosure) says nothing as to **magnitude** nor **timing** of purchases (i.e., near quarter-end, when the Company is pressed to meet estimates/projections).

To that end, rather than responding directly to the concerns raised in our original report, management has laundered a response through a sell-side analyst, who claimed that "Over the past eight years, sales [directly] to agencies have totaled $440,000 or just 0.2% of KIDS cumulative sales in this period." We suspect the true figure is far higher, given that one single distributor himself bragged to us that he himself had purchased roughly $250,000 alone, while others made various comments suggesting that this practice is far more prevalent. We also refer to you to the words of one former employee we spoke with, as was included in our original report:

> "Greg Odle [OrthoPediatrics Executive Vice President] made a call to distributors to ask them to buy product to make sales [projections / quotas]. So, what happened was the distributor cut a check to OrthoPediatrics to buy full sets … In my footprint, that happened to two people that I know of, and they weren't even larger players … We were quite a bit short [on revenues] going into [quarter end] … I can only assume that everyone [all distributors] got that call."

We understand that Deloitte does not perform full audits of the Company's supposed third-party distributors, yet we believe heightened auditing procedures surrounding the Company's U.S. and International distributor network is in due order given this pattern, as well as the numerous additional Company/distributor entanglements, including:

(1) OrthoPediatrics employees forming their own distributorships,

(2) distributors which maintain OrthoPediatrics email addresses and hold themselves out as employees, rather than third-party distributors,

(3) transactions between pseudo-captive distributors and (direct product purchases and allowances for returns), and

(4) OrthoPediatrics' newly-created "distributor relief fund" which purports to offer capital directly to distributors.

Among these distributors, we find several, as mentioned, that have been formed by OrthoPediatrics employees themselves. As such, we are concerned that they may effectively act as pseudo-captive, off-balance sheet entities:

Name	Former KIDS Role	Until	Name of Current Distributorship
Dan Brault	Sales Representative	Jun-20	Upstate Surgical Supply Corp
Mary Kate Rosenfelder	Sales Representative	Jan-20	RoseMed, LLC
Melanie Arnold	Medical Device Sales	Mar-16	MK Medical, LLC
Mark Phillips	Sales Vice President	Dec-15	Pediatric Device Solutions LLC
David Steinberg	Product Specialist	May-15	Core Medical Device Distributors Corp
Jessi Prahl Asmundson	Sales Specialist	Aug-12	EAV Medical Corp

We also route your attention to three additional distributors who we understand to be more significant contributors to OrthoPediatrics' business. We believe these larger distributors have the financial wherewithal to make direct product purchases when called upon by the Company:

(1) Trauma-Recon Corp, spearheaded by Tim Hinspeter and located in New York

(2) JTR Holdings, LLC, spearheaded by Jacob Rowe and located in Missouri

(3) Core Medical Florida, spearheaded by David Steinberg and located in Florida

Inducements: Equity-Based Awards, Returns, and Discounts/Commissions

Our original report detailed our belief that OrthoPediatrics has induced distributors to make direct product purchases in exchange for (a) equity-based awards, (b) opportunities to return product, and/or (c) product discounts or increased commission schedules.

The Company has not addressed these issues, but again opted to launder a flimsy response through a sell-side analyst, who cheekily stated that "KIDS may compensate its distributors and reps with stock, but we view this as a smart way to align incentives." We first note that, in keeping with the numerous other instances we've highlighted, OrthoPediatrics' previous omission of equity awards to distributors was only disclosed after we pressed the Company. Second, though the Company admits to the use of equity-based awards for distributors, OrthoPediatrics offered zero additional information as to what qualifies a distributor to earn such awards. Thus, the Company and its sycophantic sell-side analyst ignored the elephant in the room: awards may also serve as effective recompense for participation in the Company's channel stuffing scheme.

Moreover, the Company has chosen to ignore the issues of (b) allowing for returns, and (c) product discounts and increased commission schedules entirely unaddressed. In its Form 10-K, OrthoPediatrics discloses that outside of the United States, distributors are allowed to return products, yet makes no mention of allowances for returns within the United States. Instead, as the Company maintains that it doesn't sell directly to distributors, the topic of domestic returns ought to be null. However, as the Company has now conceded that U.S. distributors ("very rarely") do in fact take title, the subject of returns ought to be addressed. To that end, our conversations with multiple former employees and distributors characterized domestic returns as occurring regularly. We expect that as you further review the Company's relationship with distributors in this new light, you ought to find signposts of sales with the right to return, which could include (a) explicit provisions for such in the Company's initial purchase orders, (b) [re]purchases made **by** the Company **from** its distributors, and/or (c) undisclosed backdoor agreements which allow for returns.

These same witnesses told us that OrthoPediatrics has also offered distributors increased commission schedules in exchange for product orders. We again expect that as you review the Company in this new light, that you are diligent for signposts of such undisclosed arrangements.

Finally, we note that in March 2020, the Company established a "distributor relief fund" which it claims is "stabilizing the 168 domestic sales consultants who are focused virtually exclusively on OrthoPediatrics." However, outside of this initial disclosure, the Company has offered zero additional details as to what exactly this program entails (i.e., Loans? Forgivable loans? Direct cash payments?) or its financial implications. Given the numerous entanglements that the Company has with its distributors, both disclosed and undisclosed, we believe this "fund" also deserves special attention.

Thank you,

Culper Research