

# Evaluating Diversification Strategies

BY DEXTER W. BRAFF



**A**lthough this column concerns diversification, I want to begin by emphasizing that diversification is not for everyone. In fact, in some cases, there are compelling reasons *not* to diversify. For example, compared to companies that offer a comprehensive menu of products and services to multiple payor sources, firms with a laser-like focus on a narrow set of services and payors are frequently better positioned to offer higher quality services in a consistent and efficient manner. Additionally, whether consistently true or not, narrowly focused firms can enjoy the market clout of specialists: "We only do one thing; therefore we must do it better." Given the economic fundamentals of highly focused firms, Wall Street, as well as buyers pursuing acquisition strategies, often bestows higher valuations to non-diversified firms than to their diversified colleagues.<sup>1</sup>

## So Why Diversify?

While diversification may not be the best strategy to reap near-term rewards in terms of profit or value, it is clearly the most effective strategy to mitigate risk — particularly when considering reimbursement — and to moderate large swings in

revenue and profit over time.

Diversification also offers agencies additional growth outlets. For example, an agency may decide to pursue a classic product extension strategy in which it leverages its brand name and/or expertise to layer on complimentary products and services. Broadly diversified firms can "capture" patients at multiple entry points, and subsequently refer them to other services within the "patient care continuum." In its most elegant form, if a company invests in and takes full advantage of an infrastructure that can be shared by multiple business lines (admittedly, much easier said than done), diversification can generate revenue-enhancing and cost-reducing operational synergies.

In theory, then, diversification can be an effective business strategy. In practice, however, it is extremely difficult to execute, particularly when firms diversify into entirely different product and service categories and/or payors.

Herein lies a conceptual framework for evaluating diversification strategies:

**Level One Diversification.** This is the easiest diversification strategy — one that can offer substantial gains with minimal

distraction. At Level One, an agency does not stray far from its core services and payors. Rather, it diversifies from within. For example, this could include adding services within a product category; expanding geographically; or even developing a broad and balanced sales force and referral base in which no representative or referral "controls" a disproportionate amount of revenue. Consider the case of a certified home health agency that currently focuses on orthopedic patients, developing additional disease-specific programs for COPD and CHF in order to boost its revenues and reduce its risk of negative changes in therapy reimbursement. A hospice that focuses on long lengths of stay adopting a more open access model in order to reduce its risk of exceeding patient caps is another example. Or an agency may choose to expand into new geographic areas that inevitably increase its breadth of referral sources. All such examples can provide opportunities for agencies to increase their revenue and reduce their risk.

**Level Two Diversification.** This is where things get substantially more complex. At Level Two, agencies diversify into an entirely new product category or an entirely new payor, either of which takes the organization out of at least one of its comfort zones. Consider an HHA targeting managed care or participating as a provider in disease management programs; a Medicaid waiver company expanding into a new state with different Medicaid policies and reimbursement regulations; or a highly skilled private duty agency adding Medicare services. These examples represent "same major product line, new payor" diversification strategies.

At the other end of the spectrum — "same payor, new product line" examples — include HHAs expanding into hospice; private duty agencies adding case management services or non-medical home care; or Medicaid waiver firms adding specialized pediatric, MR/DD, or TBI services. By holding either their product lines or payors constant, agencies

<sup>1</sup> For example, compared to other publicly traded firms in their class, Amedisys, with its focus on Medicare Certified Home Health, and Lincare, with its focus on Medicare reimbursed respiratory products and services, both enjoy the highest valuation multiples in their sectors.

attempting Level Two diversification, tend to take on more manageable — though nonetheless challenging — tasks.

**Level Three Diversification.** As you may have surmised, at Level Three, agencies diversify into new product categories and new payors simultaneously. This is by far the most challenging of diversification strategies, and the one most prone to failure. For example, an agency diversifying into infusion therapy and/or home medical equipment, is a classic Level Three strategy — one that has had limited success due to the extraordinary difficulty entailed in managing and wringing operational synergies from such disparate products and services, including billing and collections, referral patterns, human resource requirements, cultures, etc.

Where such drastic diversification has been successful, firms essentially operate



their multiple business lines as separate entities. While this limits opportunities to capture synergistic operational strategies, such a model does provide risk diversification and outlets for growth. We have seen large Medicaid waiver agencies successfully diversify into Medicare services.

This is likely due to the fact that while Medicaid waiver services are generally far different than those of certified agencies, they are at least related, making the product jump a little more manageable.

As a company moves into new products and payors, operational complexity increases dramatically. Accordingly, in evaluating diversification options, it may be reasonable for agencies to tackle each hierarchy in turn, building the confidence and skill set required to succeed — and where appropriate — move to the next level.

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