

Private Equity Investment in Home Health Care: Is the Window of Opportunity Beginning to Close?

By Dexter W. Braff



Private Equity Groups (PEGs) have contributed mightily to the uninterrupted surge in merger and acquisition activity that began in earnest around 2002, and reached a record level of 107 deals in 2007. Reeling from the transition from cost-based reimbursement to the interim payment system – a period during which existing players were content to remain on the merger and acquisition sidelines – it was the private equity groups that first recognized the opportunity to aggressively and profitably consolidate the market, generating both excitement in the sector and contributing largely to a surge in valuations. According to Braff Group research, private equity groups accounted for a record 32 percent of home health transaction volume in 2006. In 2007, however, while the total number of PEG sponsored deals remained the same as the previous year (30), with an increase in total transaction volume, the percent of deals attributable to PEGs declined to 28 percent. A question then emerges: has private equity group interest in the home health arena peaked and is the window for continued investment beginning to close?

To gauge this, it is important to recog-

nize that from the time a PEG makes its initial, infrastructure-laden, “platform” investment, to the time it seeks an exit either through a sale or initial public offering (often after growing the business

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through multiple follow-on acquisitions or start-ups) is generally around three to seven years. So in making an investment

decision, private equity groups must consider not only what the market looks like at the time of entry, but it must also consider what the environment is likely to look like upon exit. This becomes particularly tricky in health care where changes in reimbursement can have an enormous impact on near-term revenues, profitability, risk, and hence, value.

No surprise, then, that some of the most prescient private equity groups made their initial investments during the period from 2002 through 2004, the period during which (a) the financial opportunities attendant to the newly initiated prospective payment system were fully realized (and expected to remain as is over the near term), and (b) the Medicare Modernization Act called for a three year span of stable reimbursement.

As we moved through 2005 into 2006, the wide-open investment window began to shut ever so slightly as (a) the end of the MMA reimbursement recommendations edged closer and (b) expectations for PPS reform began to take on the feeling of inevitability. Even so, many PEGs, taking investment cues from their colleagues, continued to invest in a home health market that was

still highly attractive over the near to mid-term, but was subject, perhaps, to an up-tick in risk upon exit.

Flash forward to 2008. Valuation is clearly at its peak. Several high-profile private equity sponsored consolidators have already exited. PPS refinement has been initiated with an unexpected and confidence shaking “creep” adjustment of nearly 11 percent to be phased in over the next four years. While early returns suggest that there will be some winners and losers under PPS reform, the risk profile for the industry has clearly gone up.

While we remain extremely bullish on the sector and are confident that the majority of agencies will be able to profitably adapt, we do expect more prospective sellers to test the M&A market, increasing the supply of acquisition candidates, which in turn, could put some downward pressure on the stellar market valuations we have seen to date. Add to all this, a credit market crunch, that if sustained, can constrain the buy-out financing and pricing of some of the larg-

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er, private equity sponsored companies nearing a sale, the exit horizon is becoming decidedly more murky.

As such, absent a more predictable exit environment, our read of the tea leaves is that while we will continue to see private equity groups make follow-on acquisitions to complement their existing home health portfolio companies, we will see a decline in new investments by new

PEGs over the next 12 to 24 months – a decline in demand that will initially impact platform type providers in the \$20-50M range. This in turn, will reduce the acquisition demand for follow-on transactions later on. The good news? As the combined appetite from private equity diminishes, we expect, and have already seen, strategics that had previously been overshadowed and in some cases, out-bid by the financial buyers, take a more aggressive acquisition stance. But at least in this current industry cycle, a period in which private equity has arguably had the greatest influence in stimulating the surge in merger and acquisition activity and value, the investment window appears to be closing.

About the Author: *Dexter Braff is president of The Braff Group, a leading middle market merger and acquisition firm that specializes in the home health care, hospice, staffing, infusion therapy, specialty pharmacy, and home medical equipment market sectors. The firm provides merger and acquisition representation, strategic planning, and valuation services. He can be reached at 888-922-5169, dbraff@thebraffgroup.com, www.thebraffgroup.com.*