# 2002 m&annual

## the braff group

**Inside:**



The Braff Group is a merger and acquisition firm that specializes in the home medical equipment, home health care, hospice, staffing, specialty pharmacy, infusion therapy and eHealthcare market sectors. We provide merger and acquisition representation, strategic planning, and valuation services


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## Highlights

- M&A Activity up 39.4%
- Top 10 deals exceed $1.2B
- Home Medical Equipment accounts for 41% of the year's 152 transactions
- TBG Composite Index falls 22.6% mirroring the Broad Markets
- Amidst changing reimbursement climate, sector specific risk profiles up and down

# The Year in the Merger and Acquisition Activity

**2002 was an extraordinary year for health care M&A activity as deal volume increased nearly 40% over 2001.**

From a merger and acquisition perspective, it was an extraordinary year as there were 152 public and non-publicly announced transactions in 2002, a 39.4% increase over the 109 deals in 2001. The growth was wide spread with all but one segment -- traditional home infusion therapy -- posting substantial gains. This reflects both investors' and buyers' continued confidence in the growth opportunities and market dynamics of the health care service sector.

Key observations in 2002:

- Just as in 2001, the greatest number of deals came from the home medical equipment segment, which accounted for 63 transactions, or 41% of the total for the year. This reflects extraordinary confidence in an industry that has enjoyed a virtually uninterrupted 10 year run in consolidation activity.

**Flush with monies raised from recent IPOs, both the Staffing and Hospice sectors posted the greatest increases in deal volume.**

- The staffing segment recorded the greatest increase in activity, doubling the number of deals completed in 2001. No surprise from an industry which attracted substantial investment capital, targeted in part to fund acquisitions, through three initial public offerings completed in the past 18 months.

- Just behind staffing was the hospice segment which saw its deal volume increase 87.5% over 2001. And just like the staffing arena, this was due in part to substantial activity from Odyssey HealthCare, a firm that went public in late 2001, as well as an overall increase in interest in hospice given Odyssey's extraordinary market valuation. This trend will certainly continue on the heels of VistaCare's successful IPO completed just before the end of 2002.

- Although the number of transactions in the home health segment increased 45% over 2001 and accounted for the second greatest number of deals in 2002, the segment continues to be an underachiever.

  **Although the number of transactions in the Home Health sector grew significantly in 2002, the volume is substantially less than the sector's profitability, risk profile, market size, and growth prospects would suggest.**

  This becomes quite evident when we compare home health to the home medical equipment sector. Under the prospective payment system, many home health providers are beginning to generate the kind of profits heretofore limited to HME providers. After the final cuts mandated by BBA 1997 are enacted, the reimbursement outlook for home health is quite favorable. As for HME, national competitive bidding and inherent reasonableness are on the horizon. After 10 years of consolidation, the supply of attractive HME acquisition candidates is diminishing. With virtually no activity during the transition from IPS to PPS from 1997 to 2000, and a substantially larger pool to begin with, there is an abundant supply of attractive home health acquisition candidates. All of this would suggest that home health M&A activity "should" at least be comparable to that of the HME arena, if not greater. Yet HME transactions outnumber home health by 2 to 1.

  Why? We believe that the industry is still reeling from the devastating affects of BBA 1997. No industry suffered more than home health, and a lot of scar tissue has built up. So even in an entirely new – and quite favorable – economic and reimbursement reality, buyers have been extremely slow to get back into the merger and acquisition game with valuation multiples that fully reflect these new realities. So activity remains focused on troubled companies and hospital divestitures, while many of the best providers are content to stay on the sidelines with their new-found profits. As a result, there is extraordinary opportunity for well funded newcomers to consolidate the market quickly and aggressively, and gain substantial market share in this highly fragmented sector.

- In 2002, there were 63 unique buyers – a 19% increase over the 53 buyers recorded in 2001. Additionally, the buyers in 2002 were more active, completing an average of 2.4 transactions versus 2.1 transactions per buyer in 2001.

- Although popular opinion suggests that publicly traded firms dominate merger and acquisition activity, the facts indicate that transactions are generally split evenly between public and private buyers, with private buyers holding the edge in both 2001 and 2002. This indicates that the pool of qualified buyers is both broad and deep ranging from relatively small independents to the large, billion dollar players.

- Based on purchase price, the biggest deals in 2002 were substantially larger than those in 2001. Whereas the top 10 transactions in 2001 accounted for a total purchase price of $436 million, the top 10 in 2002 accounted for $1.25 billion – an increase of 187%. Even if we exclude Gentiva's sale of their specialty pharmacy business to Accredo, which by itself was greater than the top 10 transactions of 2001, the observation still holds up. All of which suggests that there is an appetite for large deals, an appetite that is likely growing.

- Although specialty pharmacy transactions accounted for less than 10% of the deals completed in 2002, the sector made an extraordinary impact on M&A activity during the year, accounting for 7 of the 10 largest transactions in 2002.

**Based on a comparison of the top 10 deals completed in 2001 and 2002, transaction size increased substantially in 2002.**

| Sector | Number of Deals 2001 | % of Total | Number of Deals 2002 | % of Total | Change |
|---|---|---|---|---|---|
| Home Health Agencies | 22 | 20.2% | 32 | 21.1% | 45.5% |
| Hospice | 8 | 7.3% | 15 | 9.9% | 87.5% |
| Staffing | 11 | 10.1% | 22 | 14.5% | 100.0% |
| Home Medical Equipment | 44 | 40.4% | 63 | 41.4% | 43.2% |
| Infusion Therapy | 14 | 12.8% | 6 | 3.9% | -57.1% |
| Specialty Pharmacy | 10 | 9.2% | 14 | 9.2% | 40.0% |
| **Total Transactions** | **109** | **100.0%** | **152** | **100.0%** | **39.4%** |
| Unduplicated Buyers | 53 | | 63 | | 18.9% |
| % Public Buyers | 43.4% | | 49.2% | | |
| % Private Buyers | 56.6% | | 50.8% | | |
| Transactions per Buyer | 2.06 | | 2.41 | | 17.0% |

| Top 10 Deals 2001 | | | Top 10 Deals 2002 | | |
|---|---|---|---|---|---|
| Seller | Buyer | Price | Seller | Buyer | Price |
| Tender Loving Care | Med Diversified | 93,900,000 | Gentiva Specialty Rx | Accredo Health | 462,300,000 |
| Chartwell Diversified | Med Diversified | 90,000,000 | Amer. Homecare Sply. | Air Products | 165,000,000 |
| Interwest Home Med. | Praxair | 57,505,000 | USBioservices | AmerisourceBergen | 160,000,000 |
| eBioCare | Curative Health Srvcs. | 37,300,000 | Health Personnel Opt. | On Assignment | 150,000,000 |
| BioPartners in Care | Accredo Health | 37,100,000 | Patient Care | Schroder Ventures | 70,000,000 |
| Direct Staffing | ATC Healthcare Srvcs. | 32,975,000 | VitaRx | McKesson | 62,000,000 |
| ClinForce | Cross Country Staffing | 32,400,000 | Apex Therapeutic | Curative Health Srvcs. | 60,000,000 |
| Pharmacare Resources | Accredo Health | 25,500,000 | Choice Source Thera. | Caremark Rx | 48,500,000 |
| HHCA HME Division | Apria | 20,000,000 | Vitality Pharmaceutical | MIM Corporation | 45,000,000 |
| Excel Staffing Services | Medical Staffing Net. | 9,800,000 | Hemophilia of Sunshine St. | Priority Healthcare | 29,400,000 |
| Total Transactions | | 436,480,000 | | | 1,252,200,000 |

Excludes Braff Group transactions in which deal terms were not publicly announced

## The Year in the Public Markets

**In 2002, The TBG Health Care Composite Index fell 22%, mirroring the decline in the Broad Markets.**

In terms of stock price performance, it was a rough year for the 7 health care service sectors that comprise The Braff Group Index with every sector posting significant declines. As a result, the bellwether TBG Health Care Composite index fell 22.6% for the year. The good news? This decline mirrored losses in the broad markets, which fell 22% as well, suggesting that taken together, the decline may be attributable as much to overall weakness in the equity markets rather than anything systemic in these health care industries. It should also be noted that this decline comes after an extraordinary run up in pricing. If we take a longer, two year view, while the broad markets have fallen 32% over the past 24 months, the health care composite has **increased** 7%.

Key Observations:

- The market may be stabilizing. After six consecutive months of losses, the Composite Index rose slightly in November and December.

**While every sector posted losses in 2002, Staffing recorded the greatest decline, falling 38%.**

- The Staffing Sector posted the greatest decline, falling 38% for the year. As suggested by Smart Money, this may be due to the increased volatility of newly minted IPOs which, with limited track records, are more susceptible to price swings as investors have limited context to evaluate short term performance. With three of the six firms in sector having gone public in the past 15 months, it is particularly vulnerable to this phenomenon. No surprise then that the 12 month High-Low variance for Staffing – a simple measure of stock volatility – was 112%, the greatest of all the sectors we track.

- By this same measure, the least volatile sector was Home Health and Hospice, which recorded a High-Low variance of 37%.

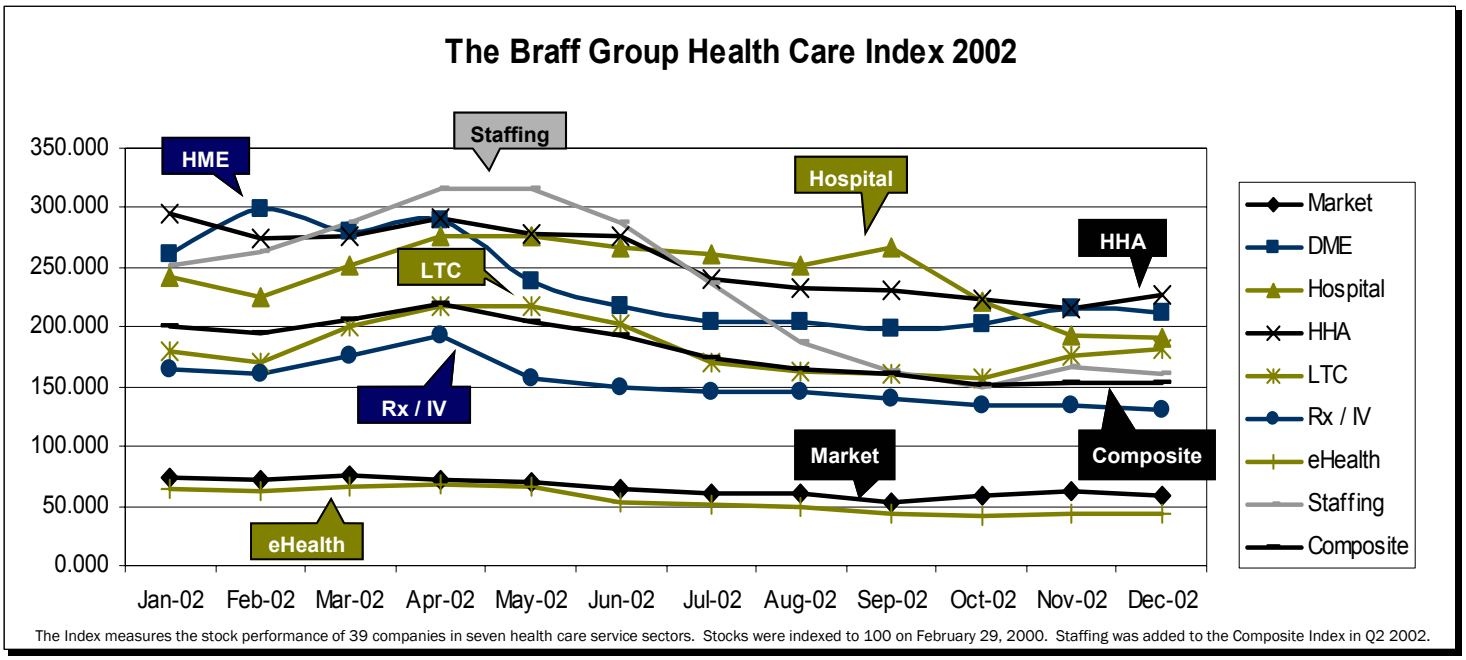
**The best performing sector was Long Term Care which fell "only" 10.9%**

- The best performing sector -- which in 2002 was the sector that declined the least -- was Long Term Care, which fell "only" 10.9%. It also had the two best performing stocks of the year -- Emeritus Corp and ARV Assisted Living – which posted gains of 155% and 101% respectively.

- Although the eHealth Sector also had a dismal year, closing down 33%, two of its members – IDX Systems and Web MD were among the top 10 individual performers of the year, posting gains of 31% and 21% respectively. Keep an eye on this sector. As systems mature and HIPPA drives standardized coding, eHealth may begin to deliver on its extraordinary promise.

**The Total Market Value of Invested Capital For Home Health and Hospice, Home Medical Equipment, IV and Specialty Pharmacy and Staffing fell from $17.4 billion to $15.6 billion.**

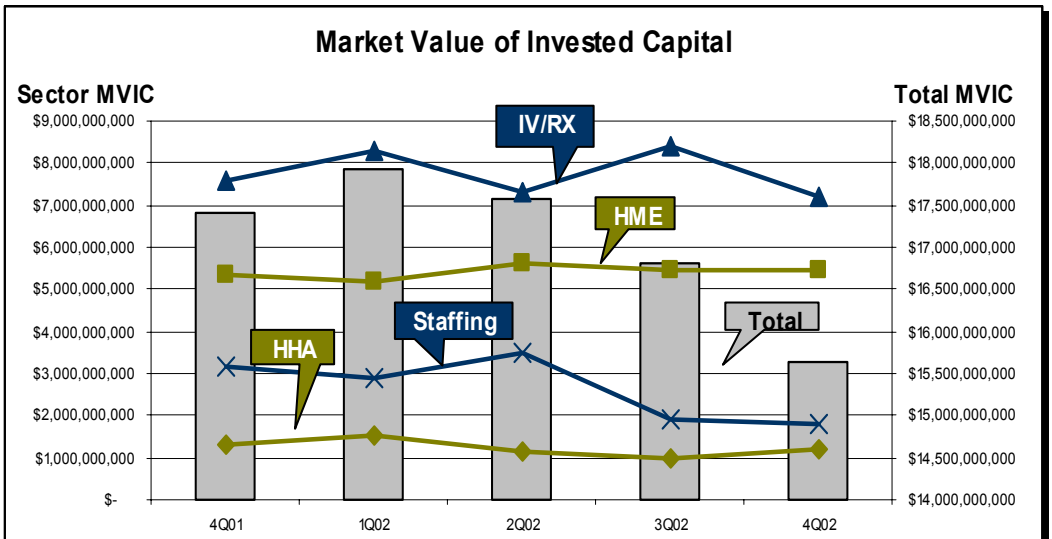
- The Braff Group Index is un-weighted, accordingly each company has an equal impact on the Index regardless of size. The Market Value of Invested Capital, on the other hand, reflects the total market value of each company in each sector, and therefore gives greater weight to larger firms, providing a different perspective on performance. For the sectors we track for this measure, over the past year, while the TBG index fell 25%, total MVIC fell from $17.4 billion to $15.6 billion, a decline of 10%. Moreover, while the HME Index fell 17%, MVIC for the sector actually increased 1.8%. This suggests that overall, from a market value perspective, larger firms fared better than their smaller counterparts.




The Index measures the stock performance of 39 companies in seven health care service sectors. Stocks were indexed to 100 on February 29, 2000. Staffing was added to the Composite Index in Q2 2002.

## The Braff Group Health Care Index 2002

| | Market | HME | HHA / Hospice | Staffing | Rx/IV | Hospital | Long Term Care | E Health | Composite |
|---|---|---|---|---|---|---|---|---|---|
| **2001 End** | 74.831 | 255.191 | 278.401 | 260.972 | 166.173 | 230.469 | 202.784 | 64.839 | 197.633 |
| **2002 High** | 75.327 | 299.352 | 295.333 | 316.645 | 193.742 | 277.049 | 217.376 | 67.221 | 219.186 |
| **Month (H)** | 3/28/02 | 2/28/02 | 1/31/02 | 4/30/02 | 4/30/02 | 5/31/02 | 4/30/02 | 4/30/02 | 4/30/02 |
| **2002 Low** | 53.193 | 199.095 | 215.677 | 149.678 | 129.695 | 190.540 | 157.710 | 41.411 | 151.720 |
| **Month (L)** | 9/30/02 | 9/30/02 | 11/29/02 | 10/31/02 | 12/31/02 | 12/31/02 | 10/31/02 | 10/31/02 | 10/31/02 |
| **H-L Variance** | 42% | 50% | 37% | 112% | 49% | 45% | 38% | 62% | 44% |
| **2002 Close** | 58.394 | 211.759 | 227.871 | 161.434 | 129.695 | 190.540 | 180.718 | 43.192 | 153.480 |
| **2002 Change** | **-22.0%** | **-17.0%** | **-18.1%** | **-38.1%** | **-22.0%** | **-17.3%** | **-10.9%** | **-33.4%** | **-22.3%** |




MVIC equals Market Value of Invested Capital (total shares outstanding x stock price plus non-working capital interest bearing debt).

| Top 10 Stock Performers of 2002 | |
|---|---|
| Emeritus Corp. (ESCD) | 155.5% |
| ARV Assisted Living (SRS) | 100.5% |
| Gentiva Health Services (GTIV) | 36.0% |
| Odyssey HealthCare (ODSY) | 33.8% |
| IDX Systems (IDXC) | 30.9% |
| WebMD (HLTH) | 21.1% |
| Lincare (LNCR) | 10.4% |
| HCA (HCA) | 7.7% |
| Universal Health (UHS) | 5.4% |
| Express Scripts (ESRX) | 2.7% |

# Top 10 Events of 2002

**The health care market rewards narrow product focus which in turn remains the most dominant acquisition strategy.**

1. **Accredo Acquires the Specialty Pharmacy Business of Gentiva.** The New Year's confetti had barely been swept up when this deal (which turned out to be the largest health care service transaction in 2002) was announced. But it wasn't the size that caught our attention. It was the market's reaction to it. In the 30 days following the announcement, Gentiva's stock rose 9.6% and Accredo's rose 20.8% (by the end of Q2 Gentiva surged an additional 26.6%, although Accredo fell a modest 3.8%). This proved once again, in case there were any lingering doubts, that the health care market rewards narrow product focus, which in turn remains the most dominant acquisition strategy.

**HME Buyers may once again look favorably on rural providers as a means to avoid competitive bidding and protect margins.**

2. **National Competitive Bidding Gains Legislative Momentum.** After years of being floated by Congress, the political and economic climate in Washington was just right in 2002 to allow National Competitive Bidding for durable medical equipment to gain extraordinary support. In fact, the beltway crowd suggests that the only thing that saved NCB from being passed this year was the lack of a passable Medicare reform package to attach it to. So the question may no longer be "if", but "when" and more importantly, "how". Since the greatest cost savings are likely to come from large, metropolitan areas, they will probably be first in line when competitive bidding is rolled out. So amidst a lot of unknowns, one possible implication of NCB is clear. Just like the mid '90s when buyers targeted companies in rural markets to avoid being subject to managed care, we expect that buyers may once again look favorably on rural providers as a means to avoid competitive bidding and protect margins.

**The risk profile of Medicare Certified Agencies is arguably at its lowest level since the early 90s.**

3. **Medicare Home Health Reimbursement Cuts Live.** The 15% cuts simply won't die. Though sentiment seemed favorable to axe these reductions, which went into effect October 1, 2002, the same thing that stopped competitive bidding prevented the cuts from being eliminated – the lack of a legislative vehicle to carry it. And unless Medicare agencies begin to collapse between now and when Congress takes up reform again in 2003, the odds are that legislators will leave "well enough" (or "bad enough") alone, and the cuts will stay. The good news? With the cuts in place, the industry may have earned a few years respite from additional, more damaging reductions in reimbursement. And that reduces the risk profile of Medicare home health to arguably its lowest level since the early '90s. A good thing in mergers and acquisitions where the lower the risk, the higher the valuations.

**If the NCFE saga is inappropriately seen as a referendum on the industry, investor goodwill could be compromised.**

4. **National Century Financial Enterprises Files Chapter 11.** When accounts receivable lender National Century Financial Enterprises ran into cash flow troubles of its own, it started a chain of events that is still being felt throughout the health care and financial communities – bankruptcy filings of public and private NCFE borrowers, law suits alleging improper financial oversight by investment banks J.P. Morgan and Bank One, and even discussion regarding the very legality of Medicare accounts receivable financing. It will be months (perhaps years) before the fallout can be accurately evaluated. The inaccurate evaluations, however, will likely come much sooner. And if the NCFE saga is inappropriately seen as a referendum on the financial stability and prospects of the entire industry, it could compromise the goodwill health care has finally earned from the investment community.

**Accounting scandals has made getting through due diligence more difficult.**

5. **Enron, WorldCom, Tyco and Adelphia Scandalize Accounting.** 2002 will likely be remembered as the year that profits became less important than the accounting methods used to determine them. The ensuing crisis in confidence proved bigger than Wall Street, extending to health care mergers and acquisitions. In due diligence, where concerns regarding fraud and abuse were previously limited to Medicare and Medicaid compliance issues, accounting issues are now being closely scrutinized. And in an industry where earnings can turn on varying assumptions regarding revenue recognition, accounts receivable collectability, inventory, and others, getting through due diligence is now that much more difficult.

6. **Two Years in a Row for Health Care IPOs.** After a long absence of any public offerings in the Health Care Service Sector, there were several highly successful IPOs toward the tail end of 2001 – among them Odyssey HealthCare, which turned out to be one of Wall Street's best for the year. Although a yearlong slump in the broad equity markets severely curtailed IPO activity in all sectors, Medical Staffing Networks and hospice provider VistaCare (which just completed its offering on December 17th and was up 25% after it's first full day of trading) nevertheless made it across the IPO finish line. Although not a groundswell of activity, on the heels of 2001, the investment community is sure to notice.

**In a difficult year for IPOs, two health care service companies completed public offerings.**

7. **American Home Care Supply is Acquired by Air Products.** With so many failed "roll-up" acquisition strategies in the past, this deal is noteworthy both in its success, and its formula for getting there: (a) solid, committed financing, (b) experienced management, (c) a disciplined, focused, acquisition strategy, and (d) an investor sensitive time line. Which should encourage other venture capital firms (many of which are scrambling to find attractive investment opportunities) to consider health care as a viable – and profitable – option.

**Health care roll-up strategies can be a viable, and profitable, option for Venture Capital investors.**

8. **Hospital Divestitures Put Drag on Valuations.** In an effort to focus on acute care, hospitals continue to divest ancillary health care services, including home health, home medical equipment, and infusion therapy. Old news. What is noteworthy, however, is the alarming regularity in which these businesses, many of which are quite valuable, are virtually given away or sold at well below market value prices in the name of expediency. The phenomenon is so common that in 2002, many buyers created acquisition strategies specifically targeting hospital based entities. Particularly in the home health agency sector, which accounts for the majority of hospital divestitures, this has had a depressing effect on valuation, slowing the market rebound to pre-BBA earnings multiples.

**Hospitals virtually give away non-core business segments in the name of expediency.**

9. **States Face Fiscal Woes.** In a recent article appearing in the New York Times, the National Governors Association stated that "plunging tax collections and soaring medical costs have created the worst fiscal problems for States since World War II". This was quite evident in 2002 as many States began aggressively looking at Medicaid to find dollars to fund budget deficits. Although Medicaid programs continue to be very attractive in many areas, the industry may soon find that the most important reimbursement battles will be fought at the States', rather than the Nation's, capitol.

**The most important reimbursement battles may soon shift from Washington to individual States' Capitols.**

10. **CMS Issues findings on the Financial Performance of Home Health Care providers.** In June of 2002, CMS issued a comprehensive report on the financial condition of the Home Health, Home Respiratory, and Home Infusion Therapy markets drawn from investment research reports, public financial filings, and interviews with key financial analysts. The report accurately illustrates that home health agencies are faring better under the Prospective Payment System and that large respiratory and infusion therapy companies can be extremely profitable. It also points out that (a) even in the most profitable sectors, profitability varies dramatically, (b) home health agencies have limited access to vital investment capital due, in part, to instability in government payment policies, and finally, (c) compared to larger home health providers "smaller companies struggle in today's rapidly changing market". The findings were interesting. The shift in attitude was extraordinary. Coming from an agency that has seemed to demonize the home health industry, the report was balanced, objective, and sensitive to business needs. A welcome and important change.

**A balanced report on Home Health Care by CMS reflects a positive change in attitude towards the industry.**

# Risk Profiles and Valuation: A Look Back and a Look Forward

**Industry Risk Profiles**

**Certain business segments are inherently riskier than others due to differences in market dynamics, reimbursement, and other factors.**

Value is highly dependent on risk. The greater the risk associated with an acquisition candidate, the lower the value, and vice versa. And just as one company can be riskier than another, due to differences in market dynamics, reimbursement, and other economic factors, certain business segments are inherently riskier than others. The following is a comprehensive review of the relative ***Risk Profiles*** of various health care service sectors at the close of 2002, and how these profiles and other external factors — particularly acquisition supply and demand — impact valuation today, and expectations in the future.

***Note that all references to value and multiples below reflect average or fair market value. They do not reflect investment value premiums that individual strategic buyers pay in competitive merger and acquisition markets to acquire companies that meet their unique acquisition goals and objectives.***

**Medicare Certified Home Health Care**

**Certified HHA multiples have risen dramatically and will continue to rise amidst declining risk and increased financial return.**

With the Prospective Payment System in place for more than two years, the most successful companies have re-engineered their businesses to provide the highest standards of care in the most cost efficient manner. The industry is ripe with operating benchmarks to properly monitor and gauge a businesses performance. Accordingly, profitability is substantially more predictable. With an aging population, the market outlook is extremely strong. And with the last vestiges of BBA 1997 reimbursement cuts effective October 1st 2002 (effective rate cuts of 4-5%) and March 31st 2003 (elimination of 10% rural add-on), the industry appears poised to enter a period of reimbursement stability, the likes of which have not been seen since the early 90s. Combined with unprecedented opportunities to generate real financial returns, we believe the risk profile for Medicare Certified Agencies is currently at the lowest point in the industry's history.

Accordingly, we would expect valuation multiples for certified agencies to be rising. And they have, in dramatic fashion. In little over a year, multiples have climbed steadily from an anemic 1.0 to 2.0 times EBITDA to 3.0 to 4.0 and up. If not for the plethora of highly discounted deals involving hospital based agencies which has put a drag on valuation (Top 10 Events of 2002), multiples would likely be closer to 5.0 times EBITDA. They will likely get there in 2003 as valuations, slowly, but surely, increase to match the sector's declining risk and opportunity for consolidation and growth.

**Non-Medicare Home Health Services.**

**The risk profile for home health services funded by private pay and private insurance is vastly different than that for services funded by various State programs.**

Under the broad heading of non-Medicare home health services, we include skilled and non-skilled home health, personal care and homemaker services, primarily reimbursed through private pay and private insurance, as well as skilled and non-skilled services primarily reimbursed through Medicaid Waiver and other state funded programs. The demand for these services is increasing, not only due to an aging population, but to supplement care that is no longer feasible under the Medicare prospective payment system. However, the risk profile of each segment is quite different.

Health care consumers are becoming more and more accustomed to upgrading care with their own, or their children's, out-of-pocket dollars. Additionally, consumers are turning to long term care insurance to supplement their home care needs. Accordingly, the reimbursement outlook for non-state funded services appears strong. As such, the risk profile for this segment dropped a notch in 2002. Unfortunately, the same can't be said for Medicaid Waiver or other state funded home health service providers. With many states facing severe budget deficits, funding for these programs is under intense scrutiny. And even though reimbursement remains solid in certain states, the market perception is that state funded home health is at greater risk.

**As valuation multiples improved for Medicare home health agencies, so did those for all other home health providers.**

This would suggest that in 2002, the multiples for non-Medicare, private pay and private insurance home health service companies would increase, while those for state funded programs would decrease. Well, yes and no. After the extraordinary upheaval in the Medicare home health market, entering 2002, the multiples for ***all*** home health service providers was substantially below what their relative risk profiles would suggest. But as valuation multiples improved for Medicare HHAs, so did those for ***all*** other home health providers. With an improving risk profile, private pay and private insurance providers saw their multiples rise to Medicare certified-like levels in the four times EBITDA range. And just like the certified HHAs, we expect these multiples to climb further in 2003. With an increasing risk profile, multiples for state funded providers did not rebound as far, settling in the three to four times EBITDA range. They will likely stay there until it becomes clearer how the various states intend to deal with their respective budget problems.

**Hospice**

**Compared to other Medicare home health programs, Hospice has the lowest risk profile.**

Consider the following: In April of 2001, CMS increased hospice rates by 5%. The current fee schedule for 2003 includes rate increases of 3.2%. In May of 2002, CMS administrator Tom Scully sent a letter to the major National Medical Associations to engage "the physician community, as well as other health care professionals, [to] think more about hospice as they care for terminally ill patients." This came shortly after CMS published an article entitled, "End-of-Life Care Enhances Dignity and Peace As Life Nears Its End" which appeared in *The Physician Executive*; *Caring Magazine*; and *McKnight's Long-Term Care News*. Suffice to say, while other Medicare programs are being targeted for rate reductions and are under intense scrutiny for potential abuses in utilization, Hospice is at the other end of the spectrum. As such, compared to virtually every other health care service we track, Hospice has the lowest risk profile.

**With limited demand to acquire Hospices, valuation multiples are lower than their risk profile would suggest.**

Logically this would suggest that Hospice enjoys the highest valuation multiples. But logic doesn't always prevail. In the current merger and acquisition environment, Hospice is actually at the lowest end of the valuation spectrum, mired at multiples of plus or minus 3.0 x EBITDA. This extraordinary risk-value "disconnect" is due to the economics of supply and demand. Although the supply of proprietary, for-profit hospice providers is rather limited (in 2000, the National Hospice and Palliative Care Organization estimated that only 20% of the Nation's 3,200 hospices were for-profit entities), the universe of buyers is even more limited. There are only two publicly traded hospice companies (Odyssey HealthCare and VistaCare), and given the vast difference in service requirements and reimbursement for hospice vs. other home health services, traditional home health providers have been reluctant to enter the market. Over the next year, we should begin to see increases in demand as (a) investors initiate "roll-up" strategies to capture Odyssey-like valuations of nearly 3.0 x ***revenues***, and (b) traditional home health agencies establish stand-alone hospice divisions to augment their growth and profitability. With

## Risk Profiles and Valuation continued

the limited pool of acquisition targets, even a slight increase in demand will likely have a significant impact on hospice valuation multiples.

### Home Medical Equipment and Respiratory Companies

**Although the risk profile for HME has increased slightly, the demand for quality acquisition candidates will keep valuation multiples in check.**

From BBA 1997 through 2001, the risk profile for HME and respiratory companies was fairly constant. Market dynamics were relatively stable, and reimbursement threats from competitive bidding, inherent reasonableness, and average wholesale pricing for nebulizer medications, while posing serious threats, never seemed to gain enough traction to become more than a steady, annoying drone. But this changed in 2002. If not for the lack of a Medicare Reform package to attach it to, some form of National Competitive Bidding very well could have been passed in 2002. The outcome may be different in 2003. And even if the industry manages to hold the line on NCB, CMS's authority to reduce reimbursement via Inherent Reasonableness is likely to be reinstated soon. Although the reimbursement impact of these developments is in no way imminent, it has progressed enough to create an up-tick in the industry's risk profile.

Market multiples, however, have held firm at 4.0 to 6.0 times EBITDA, and will likely stay that way in 2003. Again, the reason is supply and demand, but unlike the hospice sector where supply currently exceeds demand, the opposite is true in the HME segment. After a virtually uninterrupted ten year run of consolidation, the number of attractive acquisition candidates is dwindling, which has, and will continue, to keep any downward pressure on valuation multiples in check.

### Infusion Therapy and Specialty Pharmacy

Although infusion therapy and specialty pharmacy providers tend to be lumped into the same category, the risk profiles and attendant valuation multiples are very different. For the purposes of our discussions, infusion therapy providers are those firms that provide a broad range of intravenous therapies including total parenteral nutrition, antibiotics, pain management medications, chemotherapy, and others, generally within a limited geographic territory. Specialty pharmacy providers, on the other hand, tend to specialize in providing a limited number of specialty drugs, including growth hormone, blood factor, intravenous immune globulin, synagis, remicade, and others, frequently to chronic populations, and often over many states from a single infrastructure. As such, traditional IV therapy tends to have a greater service component, while specialty pharmacy is more akin to high-end distribution, albeit with all the billing and customer service components that go along with most home health care businesses.

**In the 10 years since the market wide rout of publicly traded home IV companies, the economics of the industry have vastly improved, but valuation multiples have rebounded sluggishly.**

Ten years ago, the infusion therapy market took a beating when Critical Care of America announced that they would miss their earnings targets by 20% due to pricing pressure from managed care. This sent the stock of CCA and virtually every publicly traded IV firm plummeting, as the risk of pricing pressures from managed care became real. At that point, the sector's risk profile was likely at its highest. In the ten years since, managed care rates in many areas have increased, margins have stabilized, companies have become more efficient, and profitability has been restored. With the added promise of Medicare coverage for IV in the future, the risk profile has dropped substantially from its 1992 peak. But you would hardly be able to tell from the sector's M&A market multiples. Although they have climbed from the plus or minus 3.0 range that followed the market rout in 1992, multiples have been stuck in and around 4.0 times EBITDA for a good five years or so, far lower than the sector's risk profile would suggest. The

reason? Again, the economics of supply and demand. With substantially fewer companies available in the market to acquire compared to the HHA and HME industries, there are far fewer buyers looking to consolidate this sector. As such, it continues to be a buyer's market.

This is in stark contrast to the specialty pharmacy sector. From an economic perspective, it is innately less risky than virtually all other home health providers. Often providing services over many states, business tends to be customer, rather than referral source, centric. As a result, there's little risk of losing large chunks of business should a referral source relationship sour. Generally, the sector is substantially less reliant on government sources for reimbursement, limiting its exposure to budget constrained Medicare and Medicaid. And finally, by targeting the needs of chronic patients, if sound customer acquisition and retention programs are in place, revenue streams are generally more stable and predictable. As such, the sector's risk profile is comparatively low. And with a good number of buyers targeting this relatively small niche, it's no wonder that in the M&A market, specialty pharmacy commands multiples of 5.0-7.0 times EBITDA , the highest of all the sectors we track.

**With combinations of comparatively low risk and high M&A demand, specialty pharmacy and staffing providers command the highest multiples of all the sectors we cover.**

### Staffing

Although staffing has typically been viewed as a cyclical industry, with such an extraordinary shortage of nurses and predictions for this deficit to substantially increase over the next ten years, staffing's current up-cycle is likely to last for a long, long time. Wall Street certainly agrees as three of five successful health care service public offerings over the past 12 months were staffing companies. On the downside, the industry's major limiting factor is the very one that drives demand – lack of nurses to fill available assignments. But back on the upside, one of the best ways to "acquire" nurses is through acquisition. So staffing multiples right now reflect a double dose of low risk and high M&A demand, driving multiples to a solid 5.0 and up.

## Public Market Performance and Valuation

Although large, publicly traded companies often receive higher valuations than smaller private firms given the market's perception that they have greater access to capital and other resources, seasoned management, a strong infrastructure, and market stability, they nevertheless provide interesting performance and valuation benchmarks.

**Year End Public Company Performance and Valuation Benchmarks**

| Median Measures | HME | HHA & Hospice | Staffing | Specialty RX & IV | Composite |
|---|---|---|---|---|---|
| EBIT Margin | 10.2% | 8.8% | 8.0% | 5.9% | 8.4% |
| EBITDA Margin | 19.1% | 11.1% | 9.3% | 6.2% | 10.2% |
| MVIC : Revenues[1] | 1.05 | 0.61 | 0.68 | 0.58 | 0.65 |
| MVIC : EBIT[1] | 9.98 | 18.98 | 8.65 | 12.01 | 11.00 |
| MVIC : EBITDA[1] | 5.87 | 14.89 | 8.06 | 9.96 | 9.01 |

Public Company Performance and Valuation Benchmarks are based on 22 publicly traded companies. MVIC equals Market Value of Invested Capital (total shares outstanding x stock price plus non-working capital interest bearing debt). [1]Figures reflect valuation ratios.

# The Return on Research

The Braff Group commits substantial resources to merger and acquisition market research and analysis, which has given us extraordinary insights into an ever changing merger and acquisition environment.

Specifically, the research has enabled us to identify…

- changes in the earnings basis for valuation
- critical shifts in consolidation strategies
- sector specific break points for size premiums
- trends in valuation that impact market timing
- public market factors that impact buyer activity
- relationships between the economy and health care M&A
- relationships between reimbursement and M&A activity
- new venture capital backed consolidators
- new patient census valuation benchmarks
- market driven methods to value new growth opportunities

It's all part of what we refer to as ***intelligent dealmaking***.

The edge that generates ***results***.

| | | | | |
|---|---|---|---|---|
| **MedLink Ohio** was acquired the braff group represented the firm | **Home Care of New York** was acquired the braff group represented the firm | **Infinity Infusion** was acquired the braff group represented the firm | **Pulmocare** was acquired the braff group represented the firm | **West Mont Home Health** was acquired the braff group represented the firm |
| **Oxenet** was acquired the braff group represented the firm | **Bellefonte HME** was acquired the braff group represented the firm | **SCCS Home Care** was acquired the braff group represented the firm | **Life Medical Pharmacy** was acquired the braff group represented the firm | **Beckett Health Care** was acquired the braff group represented the firm |
| **Medi-Rents** was acquired the braff group represented the firm | **Respiserve** was acquired the braff group represented the firm | **RCC Medical** was acquired the braff group represented the firm | **Lynchburg Respiratory** was acquired the braff group represented the firm | **Premiere Kids Care** was acquired the braff group represented the firm |
| **Mariner CT Home Care** was acquired the braff group represented the firm | **Harbor Home Care** was acquired the braff group represented the firm | **SNF Hospice** was acquired the braff group represented the firm | **Millenium Medical** was acquired the braff group represented the firm | **MedLink Florida** was acquired the braff group represented the firm |