HEALTHSOUTH ACQUIRES ENCOMPASS:

HOW MUCH, WHY, AND WHAT IT MEANS FOR HOME HEALTH AND HOSPICE

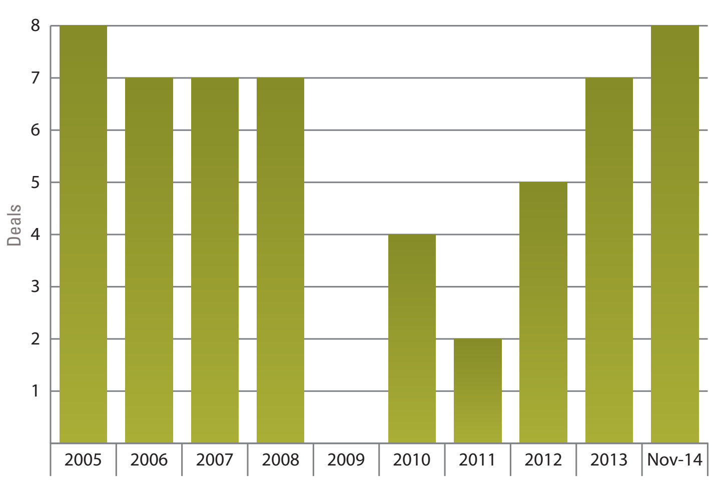
As many of you have no doubt heard by now, on November 24th, HealthSouth announced that it had entered into a definitive agreement to acquire Encompass Home Health and Hospice for $750M.

After a three year slow-down from 2009 through 2011, during which there were comparatively few large home health care deals, we are in the midst of a three year run-up with 2014 fast becoming a banner year for high profile transactions. June and July saw the sale of the two largest players in Michigan – Residential Home Health and Hospice and Great Lakes Caring, which, in aggregate, generated revenues approaching $300 million. Just a few months later was Kindred's head-turning acquisition of $2B Gentiva. And now we have Encompass, with Pediatric Services of America on the market, and others likely to follow.

So what in the health is going on?

A near perfect collision of economic, reimbursement, and policy factors has ignited an explosive period of home health and hospice mergers and acquisitions activity.

Large* Medicare Certified Home Health Deal Trends



*Revenues and/or purchase price greater than $20M

Arguably, the **match** that started it all was rebasing and its risk-abating promise of a relatively predicable – and manageable – reimbursement climate through 2016. The **fuse** was primed by a soaring stock market, more than $2 trillion in cash waiting to be invested by private equity and corporate investors, and cheap debt that can push returns – and valuations – even higher. What's more, it was coated with health care policy initiatives that brought new buyers to the market seeking opportunities to take the lead in coordinated care programs (ACOs, bundling, etc.). Finally, there was an abundance of **ordnance** in sizeable sellers looking for an attractive exit after pricing succumbed to a bad economy, bad perceptions, and bad press. Put it all together and you have a booming market.

Valuation

According to press releases and an analyst report from Stifel Nicolaus, the purchase price for Encompass is $710M (net of $40M in tax benefits). With trailing 12 month revenues of $355M and anticipated 2015 EBITDA of $75M, the valuation metrics come in at a dizzying 2.0 x revenues, and an equally impressive multiple of 9.5 x go-forward EBITDA.

For context, consider the metrics from the Kindred-Gentiva deal announced just 30 days earlier.

With a purchase price reported at $1.8B and trailing 12 month revenues and EBITDA for Gentiva of approximately $2B and $160M respectively, the valuation comes in at about .9 x revenues and 11.25 x EBITDA. Although at first glance they may appear otherwise, the metrics are quite comparable. Though the Gentiva EBITDA multiple appears meaningfully higher, recall that the earnings numbers for Gentiva are for a **trailing** 12 month period, while the earnings for Encompass are for **2015.** Assuming that Encompass is growing (a good bet for an acquisitive company), on a trailing 12 month basis, the equivalent valuation multiple is almost certainly greater than 10 x. As for revenue multiples, when you consider that Encompass's EBITDA margins are more than double that of Gentiva, it comes as no surprise that their revenue multiple is also more than two times greater than the Gentiva deal.

All things considered then, big deal valuation trends are a near mirror image of the transaction volume trends illustrated on the previous page. After plunging 40-50% in 2009 (a far greater decline than that felt by smaller providers), pricing for the most sought after large providers has largely recovered – at least for now.

Rationale

As alluded to above and detailed in a recent Braff Group publication, *viewPOINTS: Emerging Health Care Trends Begin to Upend M&A Strategies*, health care reform initiatives to coordinate care across the care continuum (from hospitals, to LTACHs, to skilled nursing and rehab facilities, to home care) have stimulated a new wave of acquisition demand. While buyers continue to target acquisition candidates within their own niche, we have seen an accelerating influx of "adjacent" companies seeking to acquire providers along the delivery continuum, particularly in post-acute settings. That's why Kindred and other skilled nursing operators have been acquiring home health companies – and why HealthSouth, the nation's leading rehab hospital provider, is acquiring Encompass.

Implications for Home Health and Hospice. All of the above has led to a renaissance in home health dealmaking – a resurgence that has also supported sustained deal flow in hospice.

Risk has moderated, debt and equity capital is flowing, demand is up, and so too are valuations.

So the obvious question: **Will it last?**

A sober examination of the factors that have converged to catapult the market would suggest **probably not.**

First, there's reimbursement risk. The current calm reflects confidence that home health is insulated from further cuts due to rebasing. But rebasing ends in two years. Then there's the threat of who's going to pay for the "pay-for" related to funding the never-ending "doc-fix" and the increasing penetration of lower margin Medicare managed care. What's more, with world conflicts seemingly escalating every day, and a new Republican controlled congress, we may see sequestration reopened to restore cuts to, and perhaps increase, defense spending. And that would likely reopen discussions regarding Medicare cuts (or worse yet, co-pays) to offset added expenditures.

Second, there is the all-too-familiar bubbling of the capital markets that giveth, and taketh away. Right now, it giveths, priming the M&A machine with lots of cash. And it will continue to do so – until it doesn't.

Finally, we have MedPAC re-thinking patient choice in post-acute services in favor of "soft" or "hard steering" to support patient management and control needs of ACOs and other coordinated care entities. Providers have long been concerned about being locked out of referral networks. But with misaligned financial incentives, patient choice, and strong marketing, the threat's been mostly a ghostly apparition. But align the incentives and allow for narrow networks of providers? It quickly begins to shape-shift into something far more real.

Spooky.

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