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WILL 2012 MARK THE END OF PEAK PRICING FOR HOSPICE PROVIDERS?

In a February, 2011 edition of ***MarketWatch***, The Braff Group presented its case as to when the hospice merger and acquisition ***"bubble"*** – the fleeting market driven ***premium*** buyers are willing to pay above what the risk-return fundamentals of the sector warrant – would burst.

In fact, we went so far as to predict that ***"if we pay attention to the tea leaves that are so neatly arranged before us, the prudent assessment of the hospice market is that the valuation bubble could burst at virtually any moment, but sometime in 2012 at the latest, when payment reform will temporarily derail the M&A market."***

In making this assessment, we identified the key conditions that would precipitate the decline; namely (a) any proposal for a direct cut in reimbursement in hospice services, (b) a specific proposal to cut reimbursement for hospice patients residing in a skilled nursing facility (SNF), (c) the emergence of any high profile compliance problems, and (d) the release of a blueprint for payment reform.

So where do we stand now, one year after we released our predictions that hospice valuations had peaked and were poised for a "correction"?

*"We have already begun to see **some** market deflation [in hospice valuation] for the very reasons, and others, that we laid out last year."*

First and foremost, we are standing by our prediction that the hospice valuation bubble will likely burst during the year, though for reasons we will discuss below, the market compression may arrive in the beginning of 2013 vs. 2012.

Second, and perhaps most importantly, we have already begun to see some market deflation for the very reasons, and others, that we laid out last year.

Let's tackle this development first

While, as of this writing, we have not seen a specific proposal to cut reimbursement for hospice patients residing in SNFs (though it very much remains a priority for MedPAC, CMS, OIG, and the GAO), nor has a blueprint for payment reform been released, the groundwork has been laid for a direct cut in reimbursement, and perhaps more importantly, compliance issues have emerged that have begun to compromise hospice's pristine image.

With respect to reimbursement cuts, hospice, like all other Medicare providers, is slated to bear up to a 2% cut in reimbursement in 2013 given the inability of the deficit reduction "super committee" to come up with $1.5 trillion in deficit reductions. Perhaps more ominous, though, is that Congress continues to consider alternatives to these mandatory cuts associated with "sequestration", which could subject hospice, and other health care providers, to even greater cuts, including co-pays, which could be a "game-changer" (and not in a good way).

As for compliance issues, late last year hospice was the subject of a decidedly unfavorable series of articles from Bloomberg and a June 27, 2011 piece in the New York Times detailing trends of increasing lengths of stay and the financial incentives for providers to target patients that may be borderline eligible for services. (Lest anyone underestimate the potential impact of negative press, consider the fallout from an April 2010 Wall Street Journal article that essentially alleged that certain Medicare home health providers were "gaming" the prospective payment system: This led to multiple investigations of the industry – including one by the Senate Finance Committee which released a scathing report in October 2011 – that contributed to an average 40% plunge in the valuation of the publicly traded home health providers). Furthermore, in February 2012, industry giant Gentiva Health Services agreed to a $25 million dollar payment and a five year corporate integrity agreement as part of a settlement with the US Department of Justice regarding an investigation of its Odyssey hospice unit. Moreover, this came after reports of whistleblower claims leveled against Vitas and AseraCare.

Both of these developments increased the risk profile of hospice – a crucial determinant of value – stimulating pricing pressure.

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Additionally, over the course of 2011, we noted a new development that has, to some extent, mitigated the acquisition "frenzy" that has helped fuel the hospice bubble. After a four year run-up in record breaking transaction activity, (see chart below), the pent up demand for quality acquisition candidates has been somewhat satiated. Combined with the fact that many home health providers that had also been acquiring hospices largely sat out 2011 as they dealt with their own reimbursement and compliance challenges, we saw the beginnings of a slackening of demand.

While the supply-demand imbalance for hospice is still favorable to sellers, it is definitely less so as we enter 2012.

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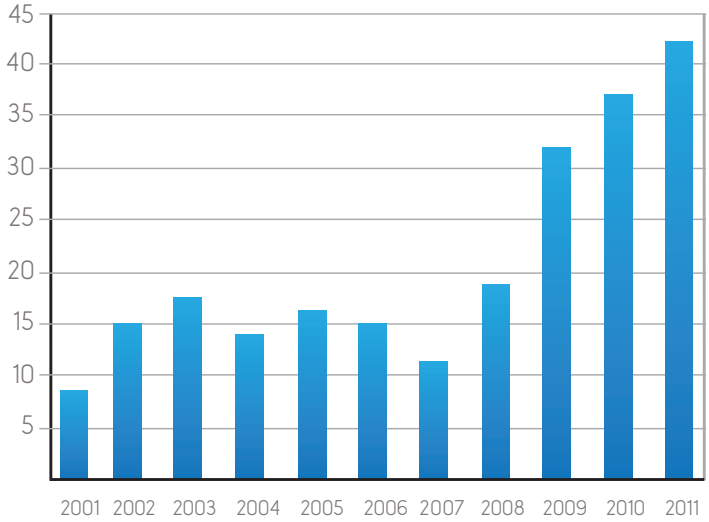
Hospice Deal Trends



Together, then, these events – expected cuts in 2013 (and the deficit fueled fear of more to come), mounting bad press, a slackening of demand, and the fact that the sector is one year closer to payment reform – have taken some of the air out of the hospice valuation bubble.

The good news is (a) while the bubble has somewhat deflated, it has not burst, and (b) much of the deflation has been limited to the largest providers, who, fueled in large part by the out-sized acquisition demand from private equity, garnered a disproportionate share of the run-up in valuation.

So where do we stand now in the first quarter of 2012?

The "big ticket" variable – hospice payment reform – looms ahead

Even if it is revenue neutral, which we doubt, reform could substantially shrink the hospice bubble as buyers and sellers turn inward to adjust to the changes, likely "freezing" the M&A market for at least six months.

When we issued our predictions last year, we expected a blueprint for payment reform to be released sometime in 2012. With so much on CMS's plate, we suspect the agency may delay a release until the beginning of 2013. In so doing, the agency could still meet its internally set time table for hospice reform, though ***implementation*** could be delayed to 2014. Moreover, increasingly, our sense is that payment changes for hospice patients residing in SNFs will be packaged with overall payment reform.

Accordingly, for many providers, the divestiture timing question comes down to an assessment of when the guidelines for payment reform will be released.

While we in no way believe that the market will collapse after this "final" bubble deflating element is in place, we strongly believe that in order to capture what remains of the valuation premium that hospice providers currently enjoy, a seller will have to close a deal before a proposed rule is issued by CMS.

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One final observation: Taxes

While the following is not a variable bearing down on peak pricing for hospice providers, it is nevertheless one that can impact the ***net proceeds*** a seller might enjoy in 2013 and beyond. And that is the threat of an increase in capital gains from 15% to 20% or more, if the Bush Tax cuts are allowed to expire December 31, 2012 (particularly for those earning $250,000 or more). While we will not opine on the likelihood of this happening, or not, we note that in the last run-up to the scheduled expiration of these benefits at the end of 2010, many otherwise ambivalent sellers in all industries went to market that year to lock-in the conceptually similar "peak" in favorable tax treatment.

THE BRAFF GROUP DIFFERENCE

The Braff Group is the leading merger and acquisition advisory firm specializing in health care services including behavioral health and social services, home health care, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment.

We provide an array of transaction advisory services including sell side representation, debt and equity recapitalizations, strategic planning, and valuation. Headquartered in Pittsburgh, PA, The Braff Group has satellite offices in Atlanta, Chicago, Ft. Lauderdale, and Palm Springs.

According to Thomson Reuters, for the three years ended 2010 –The Braff Group was ranked number one in Health Care Services merger and acquisition transaction volume.

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