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HOME HEALTH & HOSPICE SERVICES

DESPITE HEADWINDS, HOME HEALTH AND HOSPICE M&A ACTIVITY MARCHES ON

Despite the initiation of the first of what could be a series of four annual reimbursement cuts to home health through re-basing, despite the ongoing threat of additional cuts to fund ever-mounting physician pay cuts, despite repeated incursions of data collection, benefit scrutiny, and investigative reporting that continue to chip away at a hospice sector that was once untouchable and beyond reproach, and despite daily, often politically inspired, pronouncements of the obvious success — or equally obvious failure — of health care reform, deal makers in home health and hospice continue to march on unbowed. Based upon proprietary data collected and analyzed by The Braff Group, both sectors posted strong results for the first quarter of 2014.

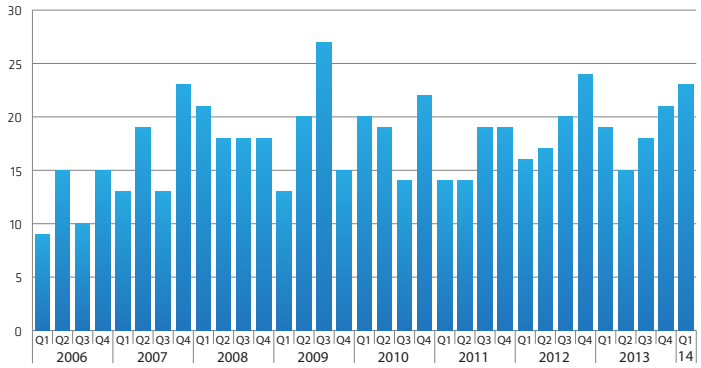
Transaction volume in Medicare home health grew for the third consecutive quarter, rising nearly 10% over the previous quarter, and up 21% vs. the same period last year. In fact, the 23 deals completed is the second highest quarterly tally since the third quarter of 2009.

While not quite as robust, it was also a strong quarter for hospice M&A with nine transactions, just shy of the 10 completed last quarter, and a continuation of a rebound in activity that began nine months ago.

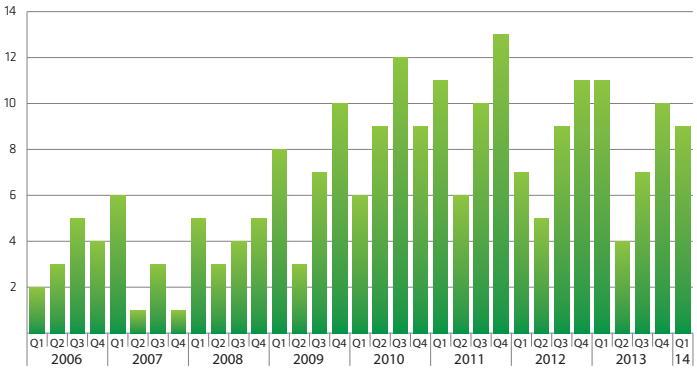
So, is the activity we are seeing an act of hubris, or adroit insight?

Well, somewhere between hubris and adroit insight lies judicious confidence – the attitude which probably best describes buyer attitudes in the current market. While risk certainly abounds, it is largely contained within reasonably predictable boundaries. Yes, there will likely be additional cuts to home health reimbursement from rebasing. But, the limits to those cuts are well known (a maximum of 3.5% per year). Furthermore, with (a) industry pressure to skinny-down these cuts amidst data that suggests that red ink is becoming the new black, and (b) market basket updates that should at least partially offset them, there is reason to believe that net cuts will be less – perhaps, meaningfully less. As for hospice, mounting data collection, heightened administrative scrutiny, and the "definitely-maybe" threat (opportunity?) of payment reform has clearly increased the sector's risk profile. But, much like home health, the risk appears manageable. And, unlike home health, deep cuts do not appear to be imminent.

Medicare Home Health Deal Trends



Hospice Deal Trends



Source: The Braff Group

The Home Care and Hospice Investment Thesis – The Theory

All in then, the current meme in home health and hospice mergers and acquisitions goes like this: The need for these services is self-evident – and growing – as payment models evolve to reward coordinated care providers to direct patients to the most cost-effective settings (i.e., home). Less skilled operators will increasingly find it difficult to remain profitable as margins decline. Others will choose to opt out as they find it increasingly frustrating to continue answering "the calling." As such, an increased number of sellers will come to market, driving down pricing. Opportunistic buyers will then be able to acquire these entities, install professional management, sales know-how, and technology to prop up their profitability. Simultaneously, with fewer and larger players lording over the market, they will be best positioned to meet the needs of accountable care organizations, bundlers, Medicare Advantage plans, and other integrated/coordinated/capitated multi-service providers and capture exclusive or semi-exclusive contracts that will further drive out competition. Game. Set. Match.

If you are one of those less well capitalized, less sizeable providers though, step away from the ledge. The investment thesis above is a powerful one that has helped sustain a vibrant mergers and acquisitions market in home health and hospice for a sustained period, despite all the challenges. It is also not quite so clear cut.

The Investment Thesis – A Somewhat Different Reality

Less skilled operators will be challenged as margins decline. But, with few exceptions, virtually every sizeable home care and hospice provider generates lower profit margins than their decidedly slimmer, less administratively burdened, smaller (and more nimble) competitors. And, with limited opportunities to reduce costs through economies of scale, size is not a particularly good predictor of profitability – or long term sustainability.

Increasing numbers of sellers will come to market? Theoretically, yes, but not "en-masse" as the thesis would suggest. As home health and hospice have matured, so have a large cross section of the principals that own them – principals that are in the latter stages of their career, but not ready for retirement. So, the thought process in vogue for contemplative sellers frequently goes like this: "Tough as it may be, what else would I do if I sold? At least I'm making a living and doing something rewarding." As a result, the would-be rush of sellers is less like a flood than it is an over-flow of the dam. A breach for sure, but contained.

What about pricing? While we have previously indicated that pricing has certainly slipped, it has not plunged, due, in part, to the fact that sellers have not swarmed the market in great enough numbers to alter the balance of demand vs. supply in buyers' favor. In fact, if anything, while pricing has not returned to the peak levels of 2005-2009, it has edged up slightly as Armageddon has not materialized.

As for the threat of being shut out of a market increasingly controlled by coordinated – and contracted – care providers, our sense is that this is very real. However, in most markets (though not all), the penetration of these models is too limited, at least for now, to have widespread impact on less well positioned providers.

So, are buyers wrong? Not at all. The basic themes are all there. And likely there to stay.

But, they won't fall in place as predictably, inevitably, nor as quickly, as a set of dominoes lined neatly in a row.

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