marketWATCH

HOME MEDICAL EQUIPMENT

TAX INCENTIVES CONTRIBUTE TO RECORD YEAR IN BROAD HEALTH CARE SERVICE M&A ACTIVITY

With the expiration of the Bush Tax Cuts and the implementation of a 3.8% surtax on capital gains scheduled for December 31st, we predicted a surge in M&A activity in the third and fourth quarter as sellers sought to maximize their post-tax returns. It came as no surprise, then, that after a third quarter that produced the second highest tally of home medical equipment, pharmacy service, home health, hospice, behavioral health, and health care staffing M&A transactions since we began cataloguing deal flow in 2001, the fourth quarter delivered even better results. With a record 106 deals in Q4, 2012 closed out at a new high with 379 deals, up 12% vs. 2011.

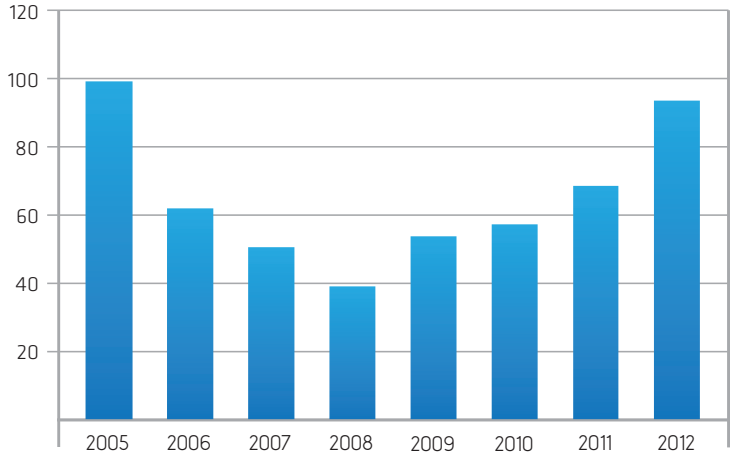
It should be noted, however, that these external tax considerations add considerable "noise" to any trend analysis. Bearing this in mind, however, below is our view on home medical equipment M&A activity for the year.

Home Medical Equipment Transaction Volume Approaches Record Levels

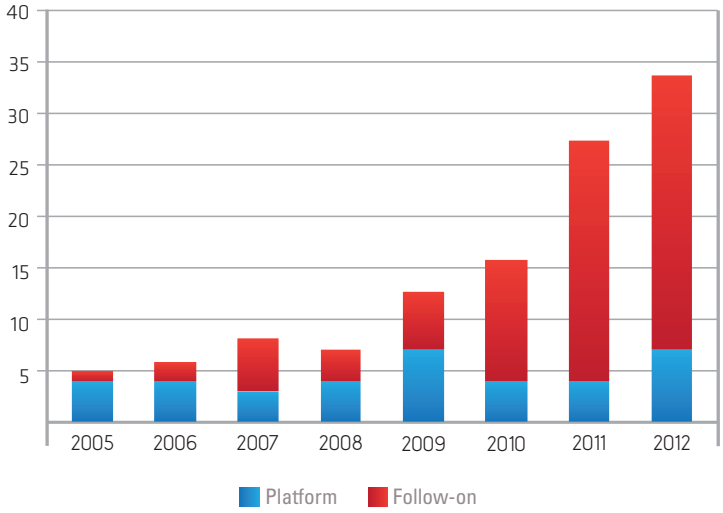
Even with the added tax incentives, there is no question that from an M&A perspective, the home medical equipment sector has been on a tear. Based on proprietary data collected and analyzed by The Braff Group, HME transaction volume climbed for the fourth consecutive year, spiking nearly 35% in 2012 to close at 93 transactions, just shy of the record 99 deals tallied in 2004 and 2005.

But, the similarities between then and now end there. As further illustrated in the chart below, while private equity played virtually no role in the consolidation wave of 2005, accounting for only five, or 5%, of the deals completed that year, PE accounted for a record 34 transactions in 2012 – nearly 37% of the total volume.

Home Medical Equipment Deal Trends



Private Equity Investment Trends in HME



Source: The Braff Group

Furthermore, as we have detailed in previous editions of *marketWATCH*, unlike the 2004-2005 period during which strategic acquirers overwhelming focused their acquisition interests on oxygen and respiratory providers, the investment community has disproportionately turned their attention to the largely overlooked – and, therefore, ripe to be consolidated – providers of supplies, rehabilitation, and mobility products and services. As such, the home medical equipment merger and acquisition market of today is far more eclectic and diversified than that of the past, creating divestiture opportunities for virtually every segment, niche, and specialty provider, unlike we have ever seen before.

Not unexpectedly, as across-the-board acquisition demand began to rise, so did valuations, from what we euphemistically referred to as "opportunistic" (i.e. "just-get-me-out-of-this" low), to more fully valued based on the risk-return fundamentals the market would more accurately – and, less emotionally – suggest.

Competitive Bid Results Put the Market In Flux

But, that was all before the Round 2 competitive bidding pricing was announced on January 30th of this year – pricing that, on average, is 45% less than the current Medicare fee schedule. While substantial discounts were anticipated, they were far more than what the industry might have otherwise expected, given that Round 1 bids nearly three years ago came in at an average 32% below the then Medicare allowables. More over, in a crushing blow specifically to the diabetic supply industry, bid pricing for national mail-order diabetic testing supplies averaged a whopping 72% below the current fee schedule.

Given these developments, whatever predictability in acquisition demand and pricing that had slowly, but inexorably, emerged since the downturn began in 2006, has largely fractured over the past 30 days. Much as we have seen in other health care service sectors that have suffered sudden, unexpected, and unfavorable pronouncements regarding reimbursement, we anticipate, at least for a short term, a marked slowdown in acquisition activity as would-be buyers and sellers alike (a) turn inward to evaluate the go-forward prospects of their own businesses, and (b) move through the "cat and mouse – let's see what the other guy does first" period that temporarily freezes markets in transition.

As the market shock wears off and committed players begrudgingly, but creatively, re-act and re-engineer to adapt to these new realities, the M&A market will likely rebound. As for valuation, there will certainly be downward pressure. However, with the kind of breadth and volume of M&A growth we have seen over the past four years, there may be enough momentum inspired acquisition demand in place to hold a free-fall in check.

Stay tuned.

THE BRAFF GROUP DIFFERENCE

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

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.

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