the braff group

marketWATCH

HOME MEDICAL EQUIPMENT

HME DEAL FLOW REFLECTS MACRO TRENDS AND SECTOR VOLATILITY

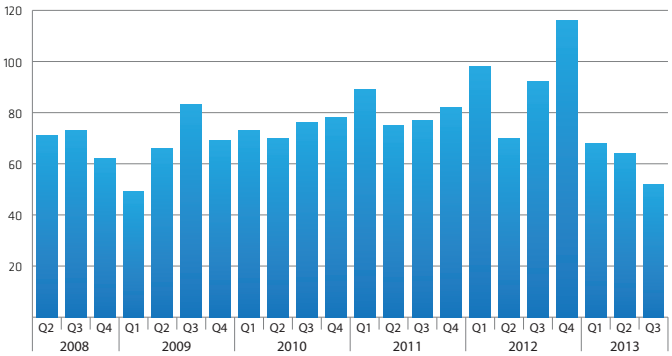
Across all health care sectors in aggregate, the first nine months of mergers and acquisitions activity in 2013 have been pretty bleak. Based upon proprietary data collected and analyzed by The Braff Group, after the tax incentive inspired surge in activity at the end of 2012, we have seen deal flow slide for three consecutive quarters, closing out Q3 2013 at the lowest levels since the first quarter of 2009. While private equity investment in all industries is generally down from a year ago, it has, more or less, leveled off. Not so in the health care service sectors we cover, where PE sponsored deal activity has plunged to its lowest level since the second quarter of 2010. Moreover, according to Thomson Reuters, over the first three quarters of the year, the aggregate M&A value of all health care transactions (including pharmaceuticals, medical devices, senior housing, etc.) has fallen 65%.

Not surprisingly, the conventional wisdom is that the "across-the-board" plunge is due to the extraordinary uncertainty regarding the initiation of health care reform. This is undoubtedly true. However, there is almost certainly another factor at work here.

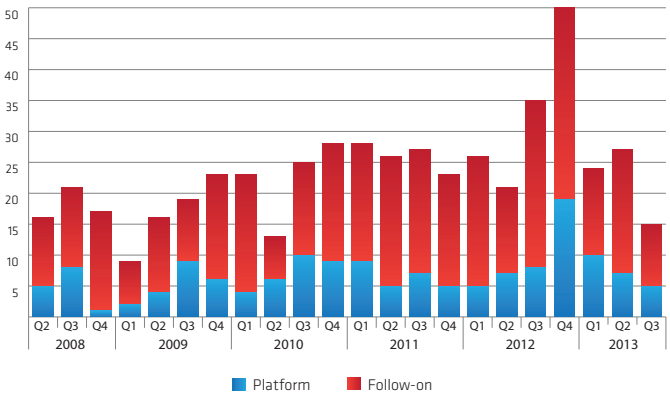
Distraction.

As The Braff Group vividly illustrated in its analysis of investment trends, pre-and post-technology bubble of 2001, health care investment tends to run counter to technology. When technology is down, stock market and corporate buy-out money rushes to comparatively safer, demand resistant, health care vehicles. But, when technology is up, the market becomes all a-twitter (pun intended) about the latest "billion dollar opportunity du jour." Even though the majority of these opportunities turned into "quicksilver" (remember pets.com, etoys, webvan?), the rush is on once again to chase the likes of twitter and its spawn, which has likely siphoned off some M&A demand in health care services.

All Health Care Services Deal Trends



Private Equity Investment in Health Care Services



Source: The Braff Group

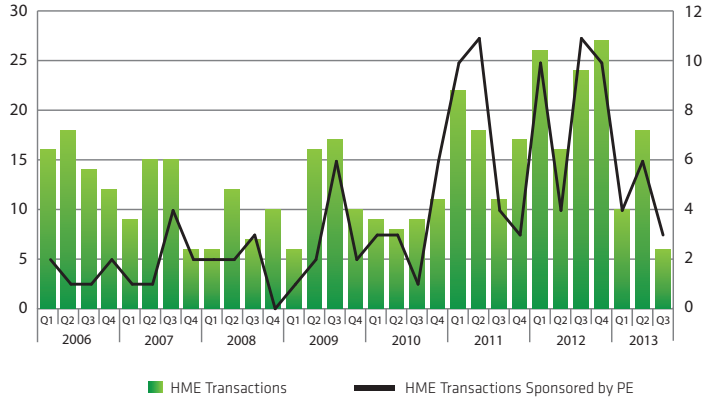
And, with the investment community (in the form of private equity) playing such a substantial role in home medical equipment mergers and acquisitions since 2010 (see correlation between PE activity and overall HME deal flow below), the sector is very much exposed to macro changes in investor sentiment.

But, there is definitely a sector specific factor in play that has conflated the macro trends.

If you examine the previous chart that tracks overall private equity investment in health care services, over the past two years, the trend more or less traces an upside down V shape reflecting (a) increased interest in health care services, (b) a peak coinciding with year-end 2012 tax incentives, and (c) a slowdown aided by health care reform and the "siren song" of technology. If you drill down to HME activity as shown below, there is a faint echo of this investment pattern. However, it is far more volatile and unpredictable. Some of this is a natural occurrence when we compare a relatively narrow data set (HME investment activity) to one that is wider in scope (all health care service investment activity) and can smooth out peaks and valleys.

While we do see such variation in all the sectors we cover, the magnitude is so much so in HME, that it can reasonably be stated that there is little pattern at all. Rather, the "trends" we see in investment and deal flow in home medical equipment are far more a reflection of a series of highly unpredictable, extraordinarily buyer specific, opportunity-driven transactions.

Home Medical Equipment Deal Trends



Source: The Braff Group

But, what about competitive bidding you say – it surely has had a substantial impact on the industry

We agree, with one caveat. Any reasonable observer would have factored in reimbursement cuts of 30% or more across the board when the Round 1 pricing was first announced nearly three years ago (only the most optimistic thought there might be a chance to reverse this policy). Accordingly, the aftermath of competitive bidding would have primarily played out in the first 12-18 months after initiation. But, not now. What competitive bidding has done, however, is create the conditions for this volatility, giving rise to new buyers and sellers, with vastly different acquisition and divestiture strategies

Post competitive bidding, the market has evolved into an eclectic mix of players: A "buy-side comprised of a wide assortment of acquirers targeting complex rehab, supplies, sleep and traditional HME; and a "sell-side" made up of companies that had limited exit opportunities in the past (notably rehab), as well as a growing number of market-weary providers that have simply - and individually - decided that they've had enough.

Collectively, then, a market that can just as easily produce 20 plus deals in a quarter, as it can produce five.

Implications for Exit Strategies. What this clearly means, from a seller's point of view, is (a) there is little value in attempting to "time" a transaction as the go-forward market is entirely unpredictable, (b) there may be multiple potential buyers for your company, and those buyers are rapidly, and situationally, changing, and (c) with long-term "risk-return" fundamentals virtually impossible to predict (or rely upon), valuation is almost entirely a function of identifying the best buyer, at the best time, to acquire your specific company, at your specific time.

Your prince (or princess) is probably out there. But, you may have to kiss a lot of frogs.

Call us to see how we can put our experience to work for you.

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