

M&A Sector Report

Independent Market
Research from
The Braff Group

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The Braff Group is a leading middle market merger and acquisition firm that specializes in the home medical equipment, home health care, hospice, staffing, specialty pharmacy, infusion therapy and eHealthcare market sectors. We provide merger and acquisition representation, strategic planning, and valuation services.

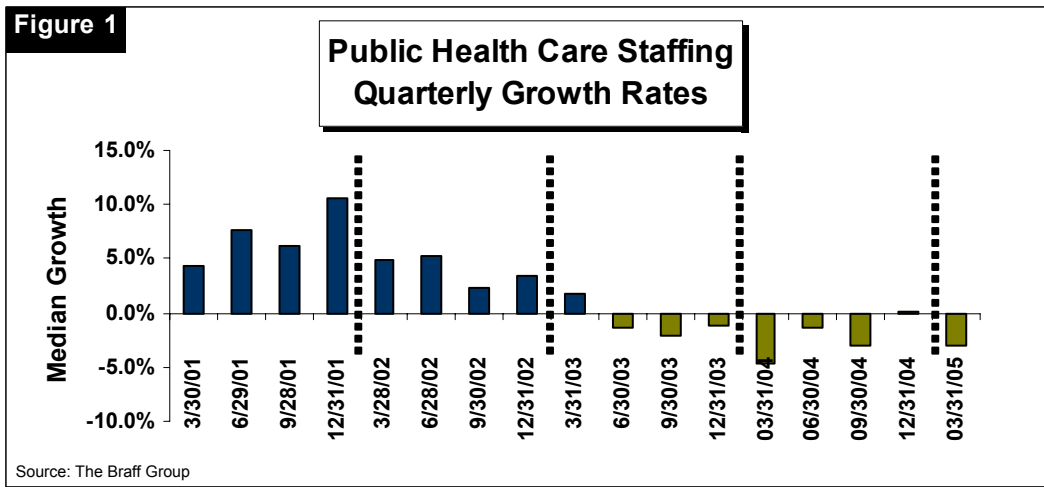
M&A Market Watch: Health Care Staffing

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With respect to the various financial and merger and acquisition metrics we track for each of the sectors we cover – health care staffing, home health care, hospice, home medical equipment, infusion therapy, and specialty pharmacy services – staffing is perhaps the most unusual in that many of the metrics appear to be inconsistent with one another. But a closer examination of these metrics reveals how they can co-exist with one another and more importantly, provides valuable insights into the psyche of the industry.

First, an examination of the trends.

Revenue Trends. It has been well documented that since 2002 as (a) hospitals began to both rein in utilization of staffing services and aggressively negotiate pricing concessions to pare down expenses, and (b) caregivers began to return to the workforce in light of a down economy thereby reducing demand for temporary services, industry-wide revenues have fallen. According to *Staffing Industry Analysts*, from a revenue peak of \$11.1 billion in 2002, sector revenues fell to \$10.2B in 2003 and \$9.8B in 2004. This trend is even more dramatic when looking at the median growth rates of publicly traded health care staffing firms since 2001 (see Figure 1). Since posting a median growth rate of 10.5% in the fourth quarter of 2001, the sector has declined steadily, turning to negative growth (contraction) in the second quarter of 2003 and continuing to contract for seven of the past eight quarters.

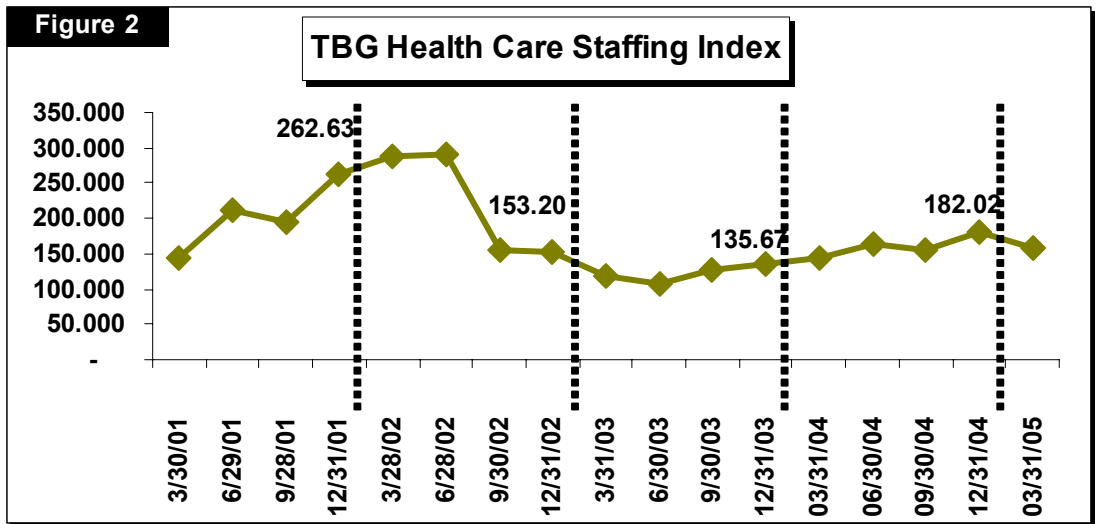


Public Market Trends. Given the above, it is no surprise that the public market performance of the sector has fallen off substantially. But here is where our metrics begin to diverge. While revenue trends have been largely unfavorable for the last **13 consecutive quarters**, The Braff Group Index of Publicly Traded Health Care Staffing Companies bottomed out in the **second quarter of 2003** and has been rising slowly, but steadily, since (see Figure 2).

Furthermore, since the bellwether valuation metrics for the sector – MVIC (Market Value of Invested Capital) to Revenues and MVIC to EBITDA – reached simultaneous low-points in the first quarter of 2003, they have likewise turned upward. In fact, MVIC to

Contradiction 1:

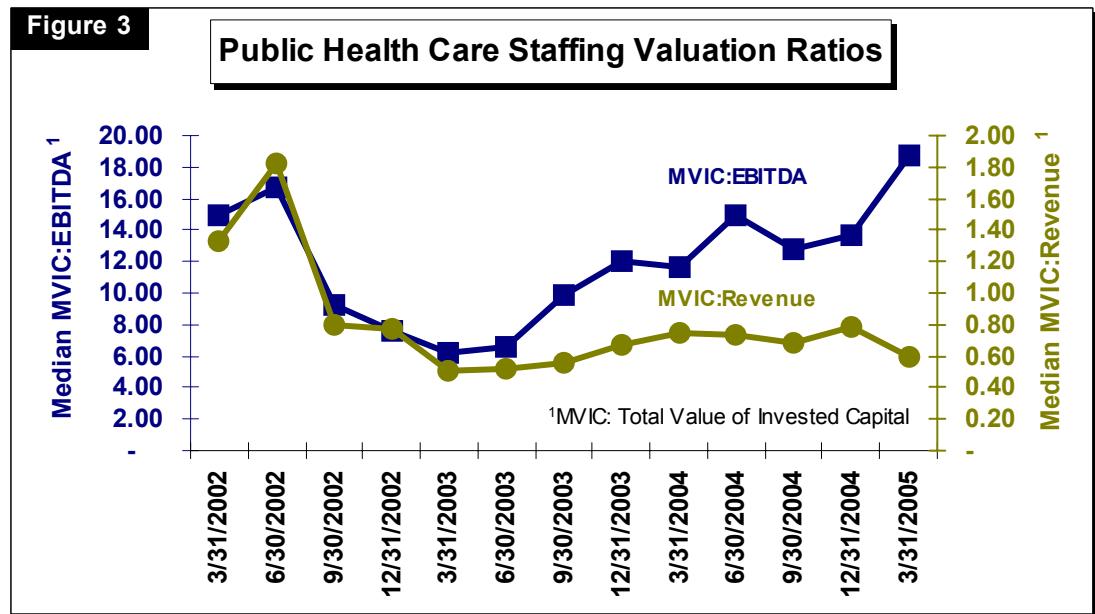
While revenue trends continue to be unfavorable, the TBG Health Care Staffing Index bottomed out in the second quarter of 2003 and has been rising slowly, but steadily since



Source: The Braff Group

Contradiction 2:

In the midst of continued industry instability, bellwether valuation metrics have been rising. In fact MVIC to EBITDA is currently at its highest level since June of 2002



Source: The Braff Group

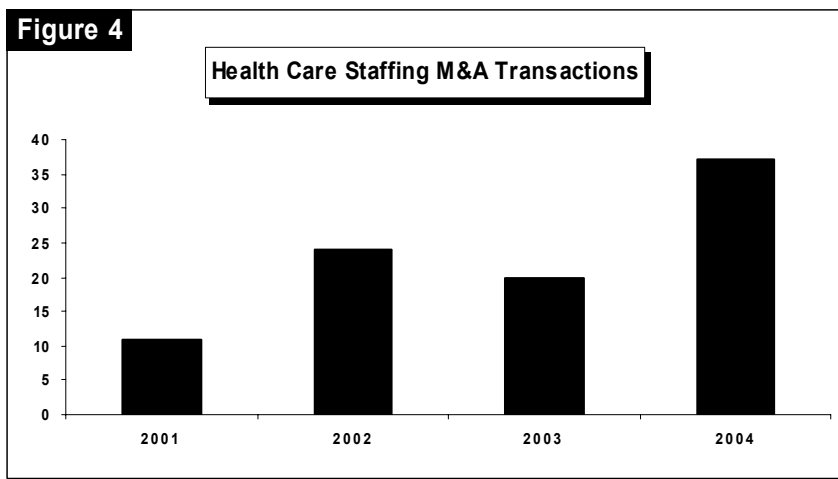
EBITDA has grown at a rate substantially greater than that of the TBG index and is currently at its highest level since June of 2002 (see Figure 3).

Merger and Acquisition Trends. M&A volume further belies the dismal industry revenue trends. Given long lead times, substantial investment in resources, and momentum that frequently builds in merger and acquisition activity, transaction activity tends to lag other industry metrics. Accordingly, the number of deals completed spiked in 2002 when the sector began to falter – *after* the revenue run-up in 2001. But in the absence of any improvement in growth trends, following a decline in 2003, transaction volume surged to a new high of 37 in 2004 (see Figure 4).

So how do we make sense of all of this seemingly contradictory data?

Essentially, much of it can be traced to (a) extraordinary confidence in the role health care staffing will likely play in addressing the escalating and critical shortage of nurses and (b) comfort with, and experience in, the cyclical nature of the sector.

The shortage of nurses is well documented. And with the Institute of Medicine recommending minimum staffing ratios and the State of California leading the way in enacting laws along the same lines, like it or not, hospitals will be

**Contradiction 3:**

In the absence of any improvement in growth trends, transaction volume surged to a new high of 37 in 2004

hard-pressed *not* to tap staffing resources as a viable solution to their human resource problems.

Therein lies the basis of the cyclical nature of staffing. Staffing expenditures tend to grow until economic pressures force customers to seek price concessions and/or other solutions. Eventually, after a periodic reduction in expense (utilization), the inescapable realities of demand – and the long term consequences of reacting insufficiently to it – kick in once again and an upward cycle begins anew.

Accordingly, **what appears to be inconsistent data above is likely a reflection of the market's collective – and perhaps well reasoned – assessment that health care staffing (a) has no where to go but up and (b) that the rebound is near.**

Bearing this in mind, the numbers now make sense.

1. While industry-wide performance continues to decline, in anticipation of an upswing the market has slowly bid up the prices of publicly traded staffing firms (Figure 2).
2. This, in turn, has sent valuation benchmarks soaring (Figure 3) as the numerator in these calculations (market value of invested capital) has gone up while the denominators (revenues and earnings) have gone down.
3. Finally, with respect to merger and acquisition activity, while the larger players that previously were the most active buyers continue to focus inward¹, a number of relative newcomers have aggressively and strategically entered the fray to gain capacity and share — at pricing that still reflects, in part, continued market instability — in advance of the expected rebound (Figure 4).

Implications for Merger and Acquisition Activity. So what does this all mean for the near term prospects for health care staffing mergers and acquisitions? We anticipate further opportunistic consolidation activity from the current group of newcomers — and perhaps others — as they continue to build critical mass. As a result, we may see a slight increase in demand and transaction volume which, in turn, could begin to draw “early-movers” in the investment community back to the sector.

Though 2004 was a good start, a dramatic resurgence in M&A activity across a **wide** spectrum of buyers and sellers depends on if, and when, industry-wide revenues turn the corner. Just a small up-tick in performance in perhaps as little as two consecutive quarters will likely give substance to sector expectations and begin to turn the market from cautiously optimistic to guardedly enthusiastic, thereby attracting more capital, more buyers, more sellers, and continued momentum. Furthermore, from a valuation perspective, while we do not anticipate a return to the near frenzy-driven pricing from 2001 to 2002, a return to growth would begin to lower the sector's risk profile, giving a boost to pricing multiples that have languished over the past two years.

¹In 2002 the largest nationals completed 15 of the 24 transactions compared to only 2 in 2004

About The Braff Group

The Braff Group is a leading middle market merger and acquisition firm that specializes in the home medical equipment, home health care, hospice, staffing, specialty pharmacy, infusion therapy, and eHealthcare market sectors. The firm provides merger and acquisition representation, strategic planning, and valuation services.

The firm was recently honored as the fastest growing health care company in the Pittsburgh Region and 4th fastest overall by the Pittsburgh Business Times in its annual ranking of the 100 fastest growing privately held companies in the area. Additionally, The Braff Group recently was awarded the Life Sciences (Biotech/Healthcare) Deal of the Year by the M&A Advisor, a leading publication dedicated to middle market merger and acquisition activity, for our representation of LifePlus in its divestiture to Apria Healthcare Group.



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