the braff group

MarketWATCH

2009

Insights from the Inside:

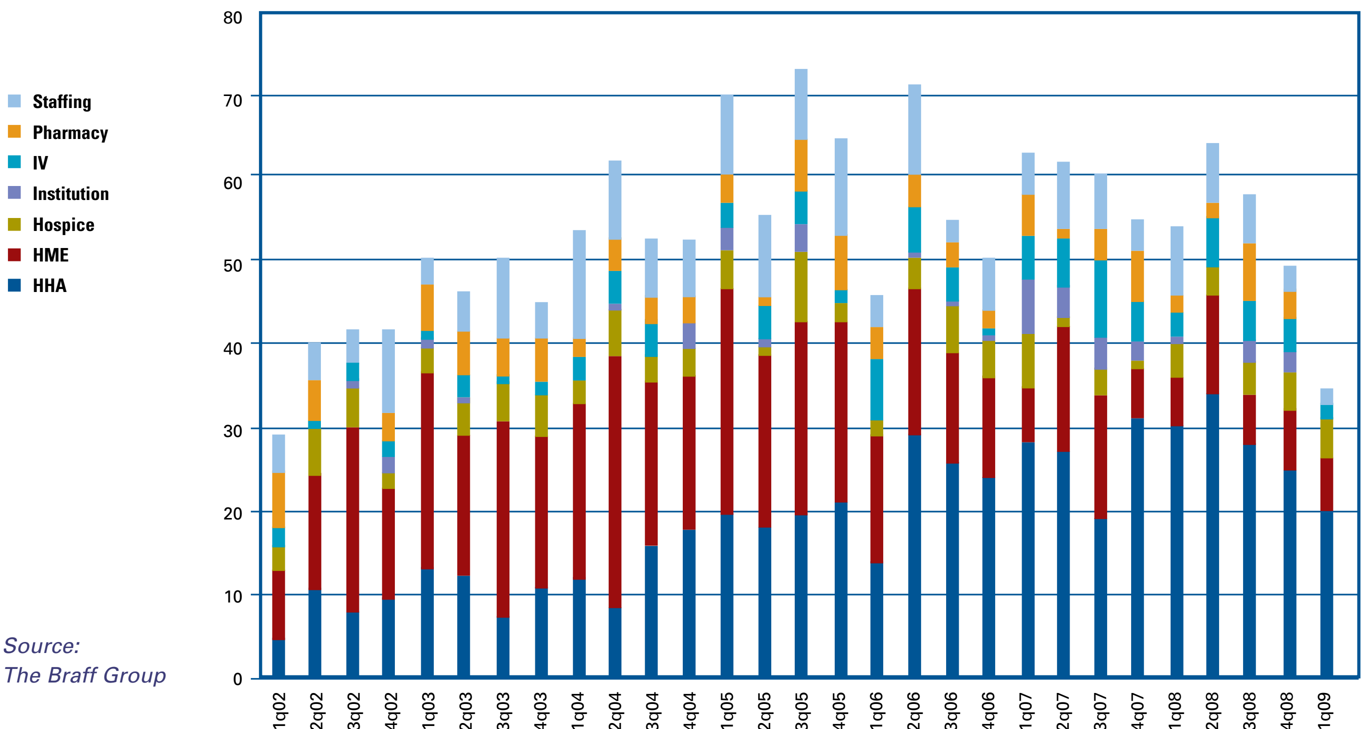
Health Care M&A in the Midst of the Recession

DEAL VOLUME CONTINUES TO DECLINE.

It remains a challenging merger and acquisition market, as M&A activity mirrors the overall malaise in the economy at large:

- According to a recent report issued by *Thomson Reuters*, "The volume of worldwide mergers and acquisitions totaled US $472.7 billion in announced deals during the first quarter of 2009, a decrease of 29.3% from 2008 totals and the lowest level for quarterly deal activity since the third quarter of 2004."
- In the United States, after an 18.9% decline in deal activity from 2007 to 2008, overall transaction volume continued to slide in the first quarter of 2009 with a drop of 23.2% versus the fourth quarter of 2008.

CHART A:
Health Care Services Transactions by Quarter



Source: The Braff Group

While strategic buyers focus primarily on the cash flow and the attendant risk of target companies in determining value, for private equity buyers, valuation is also influenced by external, capital and financing opportunities.

Deal Volume Continues to Decline *(continued)*

- Focusing specifically on lower middle market activity in the US (below $50M), according to Capital IQ, first quarter 2009 transaction volume declined 33.6% versus the last quarter of 2008.
- And finally, if we zero in on health care services, according to proprietary Braff Group research, after a relatively modest 7% decline in transaction activity in 2008 over 2007, the global slowdown finally caught up to this niche. Q1 2009 volume fell 27.7% versus Q4 2008 and to its lowest level since the first quarter of 2002.

The Role of Private Equity in the M&A Decline

The decrease of private equity buyout activity has played a substantial role in the decline in mergers and acquisitions.

According to *Thomson Reuters*, "Private Equity firms, with limited access to the global credit markets, continued to see major declines in merger activity into 2009. First quarter volume totaled US $15.8 billion in announced transactions, the lowest quarterly level for buyout activity since the fourth quarter of 2001." Moreover, "registering a 79.3% decline over the first quarter of 2008, financial sponsors accounted for just 3.4% of announced transactions during the first quarter, the lowest percentage since the first quarter of 2000."

In order to fully understand why private equity has a diminished appetite for buyouts, it is important to understand how the access to credit – or lack thereof – influences private equity's interest and/or ability to aggressively and/or competitively participate in buyout activity.

Insights from the Inside

THE POWER OF LEVERAGE

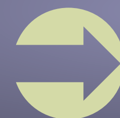
A private equity firm purchases a company for $20M.

In scenario A, the price is funded with 100% Equity.

In scenario B, the price is funded with $15M in debt and $5M in equity (75% Leverage). For simplicity sake, let's assume that the debt is interest only for the first five years with a balloon payment at the end of the fifth year.

The company grows and is able to capture a size premium exit multiple on higher earnings, and sells for $50M after five years.

We now calculate the PEG's rate of return in each financing scenario.



NOTE:
This is an overly simplified example designed solely to illustrate the concept of leverage.

It all comes down to **(a)** the enhanced financial returns a private equity group (PEG) can generate when it can effectively deploy debt to finance deals (see "The Power of Leverage"), and **(b)** the disparity that can exist between what the "real" risk-return values of a company are, and how much a private equity investor is willing to pay for them in a competitive M&A market.

While strategic buyers focus primarily on the cash flow and the attendant risk of target companies in determining value, for private equity buyers, valuation is also influenced by ***external, capital and financing opportunities***. When capital was ample, as we saw between 2006-2007, private equity groups rushed to market, creating a surge in demand that propped up deal values to peak levels (arguably above what the risk-fundamentals would support). Nevertheless, they still earned attractive leverage-driven rates of return.

During this period, as comparatively short-term investors, private equity was often able to out-bid strategic buyers for the most attractive companies.

But today, absent the flow of cheap, easy, "covenant-lite" credit (and the attendant power of leverage), private equity now finds itself on the other side of the investment paradigm.

In order to capture the out-sized returns they covet, in many cases they must acquire companies at values below what their risk-return fundamentals would suggest, putting them at a competitive disadvantage to many strategic buyers. Absent leverage, private equity has become more risk averse, with many turning their attention to sustaining their existing portfolio companies during these turbulent economic times.

Accordingly, demand from financial sponsors has softened, and with it, so have valuations at the highest, leverage-fueled tier (large, $50M plus, platform companies) that private equity targeted.

The good news is that downward pressure on valuations is far greater at this highest tier than it is in lower tiers.

In order to capture the out-sized returns they covet, in many cases private equity must acquire companies at values below what their risk-return fundamentals would suggest, putting them at a competitive disadvantage to many strategic buyers.

By effectively deploying leverage, a private equity firm can capture greater returns.

EXAMPLE:	**Scenario A: Zero Leverage**	**Scenario B: 75% Leverage**
Exit Price	$ 50,000,000	$ 50,000,000
Debt Repayment	0	15,000,000
Net Proceeds	50,000,000	35,000,000
Equity Investment	$ 20,000,000	$ 5,000,000
TOTAL RETURN ON EQUITY	**250%**	**700%**
ANNUAL RETURN ON EQUITY	**20.1%**	**47.6%**

Response

Regardless of the fact that much of the health care community continues to thrive in this difficult economy given the non-discretionary nature of the service they provide, buyers can't completely escape the uneasiness that surrounds them.

The Mood of the Times

While the merger and acquisition world is largely driven by numbers, capital, and rates of return, one should not ignore the significant role of psychology, emotion, and mood in getting deals done. And as we would expect, the overall mood at present is somewhat gloomy.

Remember that buyers are people too. People that have seen their own retirement accounts plunge with the markets; that read daily about bankruptcies and the rise in unemployment; that likely have cut back on their own expenditures (even if they are secure in their jobs and flush with savings), just to make sure they have a wide safety net in case the recession turns worse.

Regardless of the fact that much of the health care service community continues to thrive in this difficult economy given the non-discretionary nature of the services they provide, buyers can't completely escape the uneasiness that surrounds them. This, coupled with the uncertainty swirling around health care reform, has changed their behavior in several meaningful ways:

- Just like consumers are hoarding cash to prepare for the unknown, many buyers are doing the same, turning their strategic focus inward and reducing their pursuit of acquisitions.
- Buyers are seeking transactions that afford them a substantial margin for error (thereby reducing risk). Accordingly, some are offering reduced valuations driven more by generalized fear and anxiety than the "real" risk-return fundamentals of specific acquisition candidates.
- Even for those buyers that have been able to psychologically compartmentalize the overall down economy from the more positive outlook of the targets they seek, some are using the overall disruption in the markets as a strategy to secure lower valuations.
- When deals are being struck (it is important to remember that deals are, in fact, getting done, albeit fewer), due diligence has gotten tougher and broader, scrutiny is up all around, and hence, the deal cycle has lengthened substantially.

Seller's Response

With somewhat reduced acquisition demand from both private equity and strategic buyers, as well as fear of the unknown (be it real or strategically deployed), there has been downward pressure on valuations.

While we believe that for many health care service businesses, much of this downward pressure is due to external, "non-systemic" issues (i.e. reduced credit and an overall mood of concern) rather than anything that is endemic to them, there are some sectors that are facing either (a) "real" recession driven fall-offs in revenues (e.g. private duty home care) or (b) heightened risk – mostly due to potential reimbursement cuts attendant to health care reform (e.g. Medicare and Medicaid home care).

For all these reasons, we are beginning to see the emergence of valuation gaps between buyers and sellers.

For those recession resistant sellers that continue to thrive and are not facing potential cuts in reimbursement, absent any other reason to sell, it may make good sense for these sellers to wait out the lull in the marketplace.

Even for those health care service providers that are experiencing reductions in utilization or anticipate reimbursement cuts that potentially merit price reductions, the environment remains ripe for valuation gaps for the following reasons:

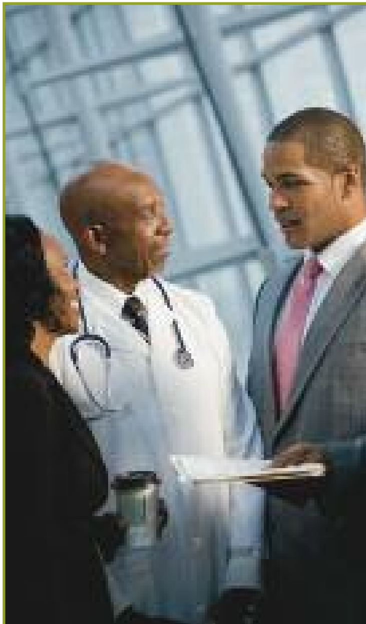
- Some buyers may layer non-systemic risk on top of anything that is more systemic in nature, driving values below what even the heightened risk-return fundamentals would suggest.
- If sellers that are seeing slowdowns in utilization due to the recession believe that the economy will rebound over the next year (and is not a long-term phenomenon), they will be unlikely to accept valuations reflecting any current reduction in revenues or profits.
- For prospective sellers facing potential, and perhaps substantial cuts in reimbursement, notably Medicare certified home health, we may see a triple threat. **First**, the downward pressure from the overall recession at large. **Second**, regardless of the likelihood that any reimbursement cut will be adopted, many buyers will factor in the full revenue and profit impact of all the measures under consideration. **Third**, even after factoring in all these potential reductions, we have seen some buyers apply a heightened risk-adjusted (i.e. lower) multiple on top of the potential revenue and profit hits, effectively (and improperly) accounting twice for reimbursement challenges. Under such a scenario, would-be sellers not overly alarmed by the magnitude of potential cuts might simply wait out the M&A market until reimbursement becomes clearer (and hopefully more favorable than any worst-case scenario).

None of the above scenarios should necessarily be construed as improper or even unreasonable on the part of buyers. Risk is highly subjective, and erring on the side of caution is expected. Even if a buyer were highly confident of the go-forward prospects for a sector and an acquisition candidate, many would still strategically try and leverage a market in flux to capture valuation concessions.

Our expectation is that, in the absence of substantial and harsh reimbursement cuts, many sellers may not bite.

We are beginning to see the emergence of valuation gaps between buyers and sellers.

With enhanced due diligence scrutiny and the resultant extended deal cycle, our sense is that the pipeline for deals about to close has grown substantially.



The Near Term Outlook

While the preceding may seem bleak, we remain quite bullish on the prospects for a near term up-tick in merger and acquisition activity in health care services. **Here's what we see, both positive and negative:**

POSITIVE SIGNS

- As the economy begins to show signs of recovery – even just a few consecutive months of positive economic indicators – the gloom that has contributed to the slowdown in M&A activity will slowly begin to lift.

- Even if a near-term recovery is elusive, a period of steady-state, flat economic performance will encourage would-be buyers, that are otherwise hunkering down and hoarding cash, to once again venture out into the M&A market.

- With enhanced due diligence scrutiny and the resultant extended deal cycle, our sense is that the pipeline for deals about to close has grown substantially (i.e. some of the drop in transaction volume may be due to a build-up of deals in process). As these deals close, volumes may rise, creating greater market confidence and bringing more buyers (and sellers) to the table.

- Private equity is unlikely to stay on the sidelines for a protracted period of time. They need to deploy their funds, or risk losing them. However, in a more risk-adverse environment, the general preference is to make smaller bets. Accordingly, some are entertaining minority investments which can provide sellers with some liquidity and/or capital, while still retaining majority ownership; others are offering attractive interest rates and terms for seller financing.

One caveat to the above: For those not particularly experienced in government reimbursed health care, that were nevertheless drawn to the sectors given the extraordinary run-up in enthusiasm and value over the last five years, we may see them turn their attention elsewhere in the face of health care reform. But for those PEGs comfortable with the predictable – and often innovatively and strategically manageable – peaks and valleys of government reimbursed services, we expect continued (albeit cautious) interest and investment in these fundamentally attractive sectors.

- The credit markets may be turning the corner towards recovery. According to *Thomson Reuters* First Quarter 2009 Debt Capital Markets Review, "In a sign that confidence may be returning to some corners of the global credit markets, the volume of debt new issues posted its highest quarter total in two years amidst increased corporate debt activity and the establishment of a series of government-led programs which provide attractive terms for global financial issuers. For first quarter 2009, global debt underwriting activity totaled US$1.7 trillion, a 23% increase from the first quarter of 2008 and the largest three-month period for debt capital markets issuance since the record-breaking second quarter of 2007." One quarter is certainly not enough to say that the crisis is over, but is a strong positive indicator.

- Similar to private equity's interest in making smaller investments, as strategic buyers regain their footing, we expect they may likewise spread their acquisition risk across a greater number of highly strategic, smaller sized transactions in the $5M to $20M range.

- With the Bush tax cuts – and attractive capital gains treatment scheduled to expire absent congressional intervention December 31, 2010, we anticipate at least a modest surge of sellers coming to market to capture enhanced, after-tax proceeds.

Outlook

NEGATIVE SIGNS

- The Achilles heel of mergers and acquisitions activity is uncertainty. Even if unknowns become known – and negative – while valuations may suffer, unless a sector is fundamentally and irretrievably damaged, market certainty will narrow valuation gaps enabling deals to be completed. From an M&A perspective then, while health care reform and its potential for wide-ranging reimbursement cuts may seriously impact near term transaction volume, it will not be nearly as damaging as the prospect that substantial future cuts may remain in play. Such protracted uncertainty could result in the kind of long-term, diminished M&A activity that has plagued the home medical equipment sector (which has labored under the threat of a substantial reduction to the 36 month oxygen cap since it was initiated in 2006).

- There is often a lag that exists between changes in the environment – either positive, or negative – and reactions in the M&A market. For example, after the market meltdown that occurred in the home health sector after the passage of the Balanced Budget Act of 1997, it took several years after the initiation of the attractive prospective payment system for buyers to shake off the residue of the past and confidently seek out opportunities. Similarly, after an extraordinary run-up in acquisition activity, the home infusion market was derailed (almost overnight) by public company announcements of substantially reduced margins in the early 90s. Even though the market substantially settled and stabilized at attractive and profitable margins in subsequent years, it wasn't until the mid-2000s that buyers re-emerged in earnest. Accordingly, if M&A activity in the health care services arena stays in a prolonged rut, even if conditions improve, it may take a while for buyers to fully re-engage.

- Perhaps the biggest wildcard on the table as of this writing is the proposal to essentially give the Medicare Payment Advisory Commission (MedPAC) legislative authority to enact their payment recommendations. With MedPAC providing valuable "cover" for Congress, we might see the enactment of potentially game-changing proposals that politicians running for re-election would otherwise not likely have the will to pass.

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Impact on Timing Transactions

So what does this all mean with respect to timing a potential divestiture transaction?

Much must be considered.

As we have written on in the past (see "When is the Best Time to Sell"), it still comes down to the intersection of (1) where a company sits in its growth curve, (2) an owner's individual and personal goals and objectives, and (3) the overall and sector-specific merger and acquisition market conditions.

This piece addresses only the third decision point.

The timing of a transaction depends upon the intersection of (1) where a company sits in its growth curve, (2) an owner's individual and personal goals and objectives, and (3) the overall and sector-specific merger and acquisition market conditions.

All other factors being equal then, as suggested above, for non-governmentally reimbursed health care providers where downward pressure in valuation is generally limited to the overall decline of the economy and in the credit markets, it might be prudent to hold on unless concerns over likely tax increases or an individual's exit planning dictate a near term divestiture.

For those health care service providers where significant impact from health care reform is looming, like many other business decisions, it comes down to an individual's appetite for risk. This requires an assessment of whether the upside of a general improvement in M&A conditions as described herein, plus the possibility of capturing more share (albeit perhaps at lower margins) if weaker competitors stumble, is enough to offset the potential – remote as it may be – of an Armageddon-like reimbursement change and/or the prospect of an increase in capital gains and other taxes.

The Braff Group is the leading investment banking firm specializing in the home health care, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment market sectors.

The firm provides an array of transactional advisory services including sell side representation, debt and equity recapitalizations, strategic planning, and valuation.

Intelligent Dealmaking is a registered trademark of The Braff Group.

OUR TEAM of EXPERTS

Chuck Gaetano	Reg Blackburn	Mark A. Kulik	Pat Clifford	Bob Leonard	Steven Braff
Atlanta	Atlanta	Atlanta	Chicago	Ft. Lauderdale	Palm Springs
888-723-9263	866-455-9198	888-922-1838	888-922-1834	888-922-1836	888-922-1833

thebraffgroup.com 888.922.5169