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HOME MEDICAL EQUIPMENT

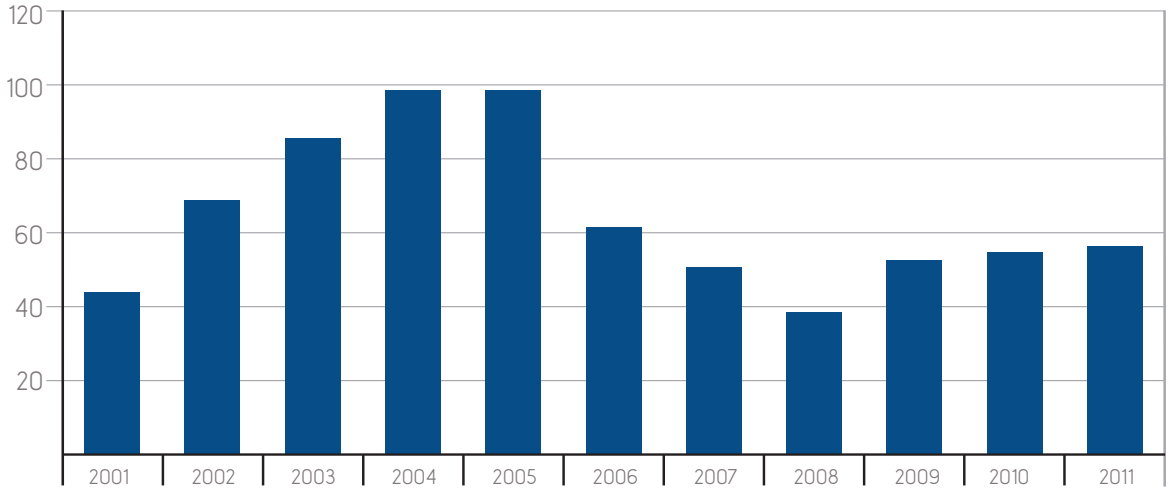
Is the M&A market for home medical equipment back? Not quite.

But such a brief answer belies the fact that much has changed, for the better, in the merger and acquisition market for home medical equipment – changes that have had, and likely will continue to have, profound effects on the types of companies buyers are targeting, the make-up of those buyers themselves, and valuation.

As is often the case, in order to get a glimpse into the future, we first must take a brief look at the past.

According to proprietary M&A transaction data that has been compiled by The Braff Group since 2001, in terms of pure deal volume, the home medical equipment sector peaked in 2004 and 2005, recording 99 transactions in each year (see chart below). After a four year run-up in activity, the defining event that sent the M&A market plunging was the Deficit Reduction Act of 2005 (DRA; which was signed into law February, 2006), which, among other items, included the introduction of a 36 month cap on oxygen reimbursement – the product line that heretofore had been the focal point of consolidation activity. With the introduction of this entirely new mechanism to cut oxygen reimbursement and the increased risk it conjured (shortly after the DRA was passed, then President Bush introduced a budget reducing the cap to 13 months), deal volume dropped 37%. It fell further still in 2007 and 2008. It wasn't until 2009 that we began to see a slight up-tick in activity – a trend that has continued through today.

Home Medical Equipment Deal Trends



The Increasing Influence of Private Equity

If we looked at this data in isolation, one would logically conclude that the HME M&A market bottomed out in 2008, and has arrived at a "new normal" of 50 plus deals a year. But when we drill down further into the data, an entirely different narrative emerges. As the chart below clearly indicates, over the past three years – those very years that suggest little more than status quo – we have seen a substantial increase in the number of deals completed by private equity sponsors.

This development becomes even more revealing, when we overlay private equity activity over total HME deal flow (see chart below).

Viewing the data this way, we can see that after dipping in 2004 and 2005, we are in the midst of a six year run during which private equity is increasingly exerting its influence on HME M&A activity, as measured by the percentage of deals completed by these investors. Moreover, in 2011, PE activity rose sharply, accounting for nearly half of all deals.

We have also seen a substantial shift in the makeup of these investments – the segments within the home medical equipment arena that private equity has targeted.

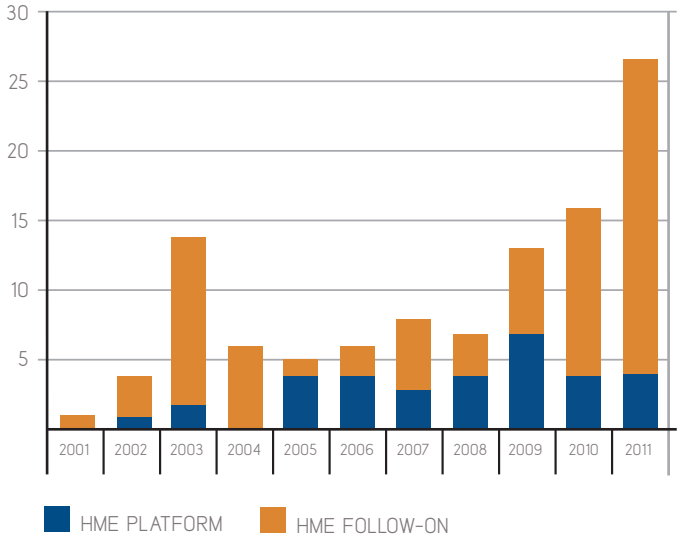
Per the chart below, from 2001-2005, activity was basically focused on three areas – basic home medical equipment and respiratory (HME/RT), supplies, and respiratory medications (RTRx). But as reimbursement in nebulizer medications plunged, so did acquisition interest in this segment post-2005

With respect to sleep and mobility/rehab products and services, despite limited activity by one buyer in sleep in 2004 and another in mobility/rehab in 2007, it wasn't until 2008 and 2010, respectively, that private equity really began looking at these niches. Unlike mobility and rehab, however, which surged dramatically in 2011, the interest in sleep seems to have been somewhat fleeting, peaking in 2009 and slowing ever-since. This is likely due to the fact that sleep labs and diagnostics are particularly challenging to scale, consolidate, and capture efficiencies. Additionally, with sleep labs typically in the plus/minus four bed size range, capital costs for multiple facilitiesare high and growth is constrained by capacity.

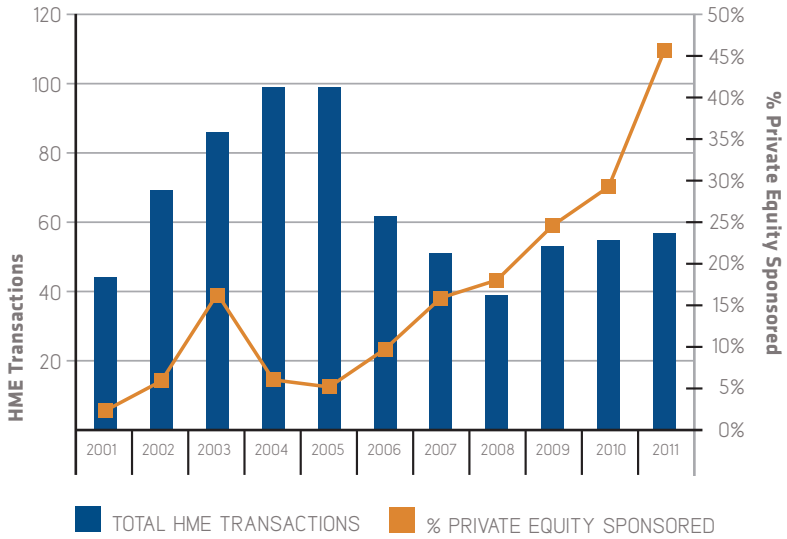
Finally, while interest in supplies has been steady since 2001, the segment has truly broken out over the past two years. Moreover, the 15 private equity sponsored supply deals completed between 2010 and 2011 were completed by eight different buyers (1.9 deals per buyer), demonstrating its broad appeal. By comparison, over the same period, the 12 PE deals completed in mobility rehab were completed by four different buyers (3.0 per buyer).

> Arguably, then, of all the sub-segments of home medical equipment, the supplies arena (diabetics, incontinents, CPAP supplies, etc.) is particularly well positioned for a sustained period of heightened M&A activity, both in terms of volume – and pricing.

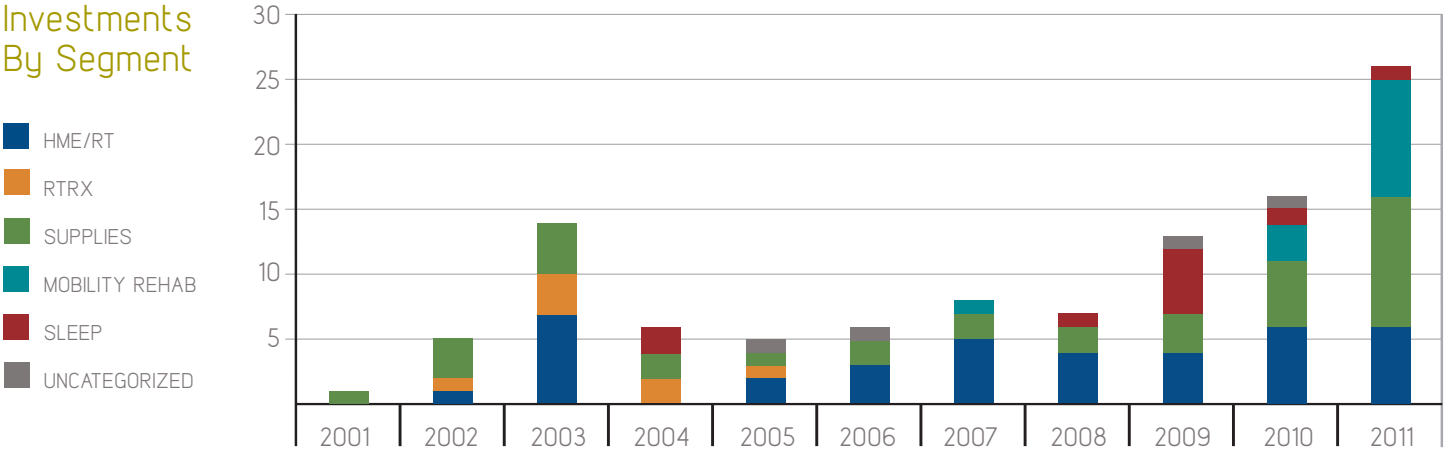
Private Equity Investment in Home Medical Equipment



Percentage of HME Deals Completed by Private Equity Sponsors



Private Equity Investments By Segment



So what's the take away from all of this?

With so many established national and regional providers in basic home medical equipment and respiratory products and services, there is limited opportunity to build the kind of size, critical mass, and competitive advantage private equity covets. Accordingly, PE investment in core HME/RT has been steady, but modest. Rather, particularly over the past three years, the focus has been on specialty providers, those that have been largely overlooked in the past (mobility/rehab), and those with the promise of capturing real and substantial economies of scale (supplies). Moreover, with 15 market-entry platform deals completed over the past three years, we anticipate continued record-breaking follow-on transactions over the next 12-36 months

Opportunities in Core Home Medical Equipment and Respiratory

Clearly, the market has become increasingly favorable for specialty providers. What about that for core HME/RT providers? The good news here is that it is much improved since the M&A market tumbled from 2006 to 2008. Buoyed perhaps by a ***somewhat*** clearer reimbursement picture (oxygen caps have held steady for five years and its full impact has been realized, and competitive bidding and pricing, while still problematic, is at least ***somewhat*** more predictable), the need to back-fill lost profits as margins compress, and perhaps a jolt of optimism as private equity floods the market, we have seen up-ticks in both acquisition demand and valuations.

Moreover, where the M&A mantra of the past was "oxygen, oxygen, oxygen…Medicare, Medicare, Medicare," buyers are looking for a greater balance in both product mix and payors, opening up opportunity to sellers that had been considered less than ideal in the past.

Finally, whereas the market was dominated by "serial" buyers in the past – the nationals, in particular, that often completed 20 or more deals in a given year – the buyer pool today is an amalgamation of select nationals (depending on the locale), well capitalized regionals, and a smattering of aggressive and entrepreneurial locals. This suggests that while a seller can not count on completing a deal with "the usual suspects" – as was largely the case pre-2006 – over the past five years the buyer pool has gotten broad and deep enough that in many situations, sellers can once again enjoy the value enhancing benefits of a competitive acquisition market.

Outlook

For the first time in many years, there is good reason to be optimistic about the go-forward M&A opportunities for a broad cross section of home medical equipment providers

While not as robust – or predictable – as it was pre-2006, there are enough buyers in the market committed to a future that appears a tad more clear (and dare we say optimistic given mounting evidence regarding the flaws in the competitive bidding process and the promising market-based alternative), to move pricing from what we euphemistically called "opportunistic" to a level far closer to what the risk-return fundamentals of the sector warrant. Accordingly, with private equity contributing to the mix, we anticipate increased merger and acquisition activity in the HME arena over the near term at increasingly attractive pricing.

THE BRAFF GROUP DIFFERENCE

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

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.

According to Thomson Reuters, for the three years ended 2010 –The Braff Group was ranked number one in Health Care Services merger and acquisition transaction volume.

Winner, Health Care Deal of the Year, 2004, 2005, 2006, and 2009.

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