

M&A Sector Report

Independent Market
Research from
The Braff Group

2007

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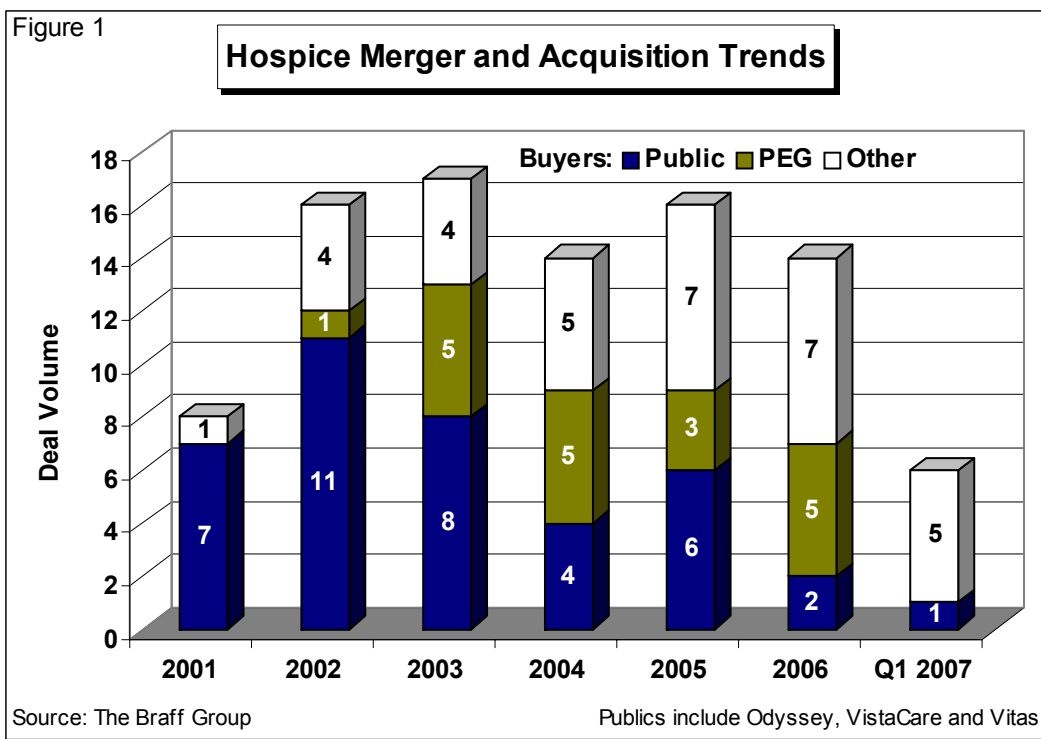
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The Braff Group is a leading middle market merger and acquisition firm that specializes in the home health care, hospice, home infusion therapy, specialty pharmacy, home medical equipment, and staffing market sectors. We provide merger and acquisition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

M&A Market Watch: Hospice

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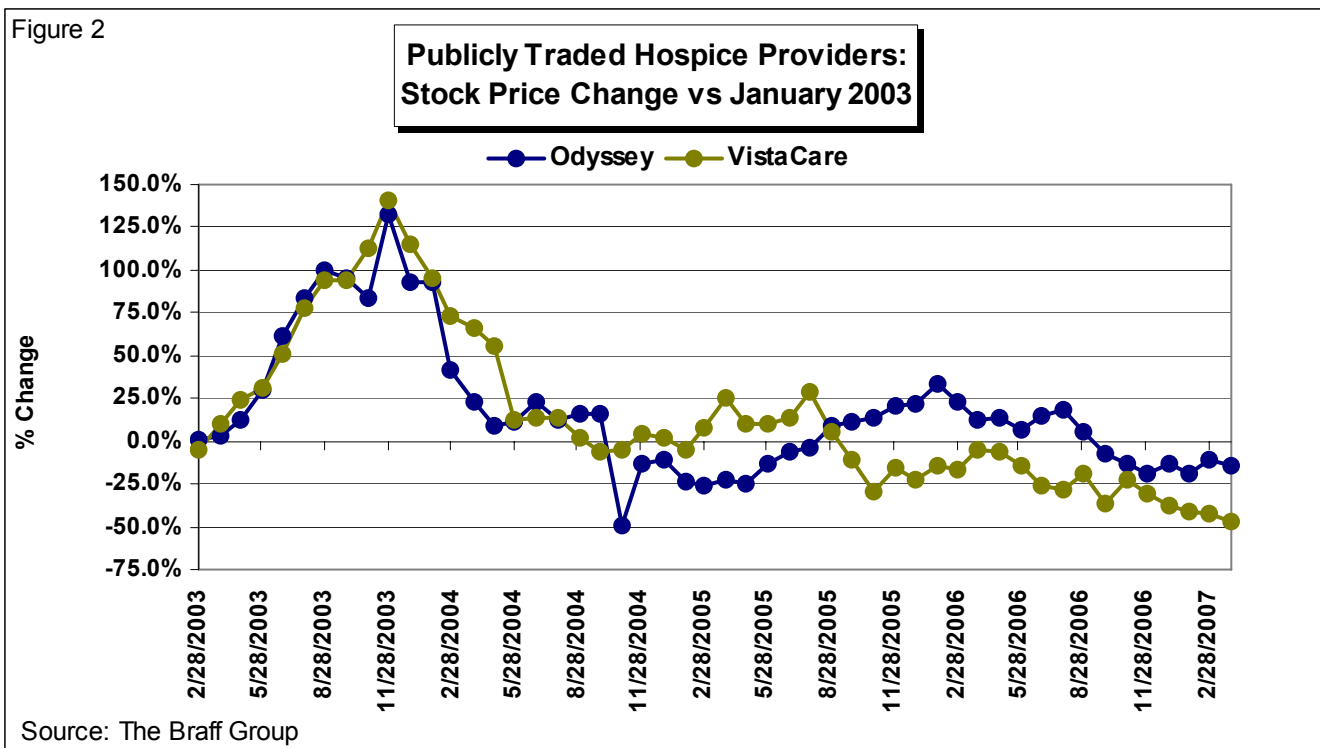
As is quite evident from Figure 1 below, since the dramatic surge in hospice merger and acquisition activity between 2001 and 2003, total transaction volume has been relatively stable over the past five years. This is not, however, a function of a mature, static market. Far from it. As we discuss below, much has changed over the recent past — some depressing M&A activity, some fostering it — such that the net change in deal volume during the period has been minimal. As the market continues to evolve, however, we may be on the precipice of another surge.



Extraordinary growth in hospice programs and services. In 2002, the government sought to increase the awareness — and utilization — of hospice programs. In May of that year, then CMS administrator Tom Scully sent a letter to the major National Medical Associations to engage “the physician community, as well as other health care professionals, [to] think more about hospice as they care for terminally ill patients.” This came shortly after CMS published an article entitled, “End-of-Life Care Enhances Dignity and Peace As Life Nears Its End” which appeared in *The Physician Executive*; *Caring Magazine*; and *McKnight’s Long-Term Care News*. Not surprisingly, this ushered in a period of substantial, and sustained increases in hospice utilization and new providers. According to MedPac in its 2006 Report to Congress on the Hospice Benefit, \$9.8 billion will be spent on hospice in 2006, up 46.3% over the \$6.7 billion spent in 2004. Moreover, the agency reported that “Hospice services’ spending is projected to increase at an average rate of 9 percent per year from 2004 to 2015. This rate outpaces the growth in spending projected for hospital, physicians, skilled nursing facility, and home health services”.

Such heady growth prospects, in turn, stimulated acquisition demand, first from publicly traded hospice providers looking to bolster their market coverage (2001-2003), and then from private equity groups (PEGs), initially attracted to the extraordinary run-up in stock price and market value the public providers were enjoying through 2003.

The Publics Stumble. The growth in M&A activity may have continued if not for the challenges several publicly traded providers began to face in 2004. As strikingly apparent in Figure 2, after run-ups in stock price of more than 125% in 2003, both Odyssey and VistaCare saw their market values plunge in 2004, primarily due to difficulties in managing cost caps which had a direct impact on revenues, growth, and profitability. Three years later, with these and other challenges continuing to vex these providers, stock prices remain below January 2003 levels. More importantly from a merger and acquisition perspective, with their attention focused inward, since dominating the acquisition scene from 2001 to 2003 with a peak of 11 transactions in 2002, their influence has subsided substantially — accounting for only 2 deals in 2006 (see Figure 1).



Private Equity Groups. As indicated above, the outstanding returns generated by the publicly traded hospice providers up through 2003 initially drew private equity groups to the hospice sector. Despite the downturn in the public's fortunes, as we can see in Figure 1, they continue to play a significant role in hospice M&A activity (in fact, in 2006, two new private equity groups entered the sector with initial platform transactions). Because even though an initial public offering — or a divestiture to the publics — may no longer be the “obvious” exit strategy, as we discuss further below, the future for hospice looks extremely bright, both in terms of near-term financial returns and alternative divestiture options.

Hospice Market Outlook

Potential upsides of hospice reimbursement refinement. As we wrote in a recent article in *Caring Magazine* entitled “Five Predictions for Home Health and Hospice Over the Near Term”, “with (a), a payment system that has gone unchanged since the hospice benefit was initiated 25 years ago, (b) MedPac reporting [substantial increases in spending], (c) increasing lengths of stays leading to a dramatic increase in providers exceeding cost limits, and (d) real concerns that payment rates do not reflect resource utilization for various different patient populations, there is much discussion regarding potential changes to the system. Although we may see a reduction in reimbursement in the aggregate, we believe hospice refinement will lead to better matching of payments to resource utilization, gener-

ating still-favorable margins across a broader array of patients. Furthermore, we expect the benefit to be modified to accommodate longer lengths of stay – both of which will create greater revenue and profit **predictability** and **stability**, factors which taken together reduce risk and increase value. We may even see fundamental, utilization enhancing, changes in eligibility (see “Open Access” below). Our optimism notwithstanding, we note that with home health PPS refinement expected to be rolled out in late 2007 or early 2008, hospice reimbursement modifications are likely a minimum of two to three years from development.

The promise of “open access”. Under the traditional Medicare benefit, patients choosing hospice services must “give up other Medicare services related to the curative treatment of their terminal disease” (MedPac, 2002). Given such a difficult choice, many patients that could benefit greatly from hospice programs either forgo them altogether or enter them literally in the last few days of their lives. Enter “open access” models currently being tested, surprisingly enough, by several forward thinking private insurers. According to an article that appeared in the *New York Times*, “A Chance to Pick Hospice, and Still Hope to Live” (February 10, 2007), insurers such as Aetna and United Health are “rethinking hospice care”, allowing patients to receive hospice services as well as advanced, curative, medical treatments. On the federal level, the article goes on to say that “as part of a much broader effort toward revamping health care, Senator Ron Wyden, Democrat of Oregon, has introduced legislation that would end [the requirement that patients forgo other coverage if they want hospice care]”. As for the expense, “one insurer, Blue Cross and Blue Shield of Rhode Island, which typically pays for treatments like chemotherapy as a way to relieve pain even while covering hospice care says it has not seen a significant increase in the use of medical services because of this broader coverage”. Perhaps even more encouraging, “at Dow Chemical, an employer in the Aetna experiment, the company’s executives agreed to pay for the broader coverage because ‘it’s the right thing to do’”. With estimates that “twice as many patients [that received hospice services] should have been in hospice programs”, open access models could change the entire hospice equation, leading to an even greater surge in utilization than we have seen over the recent past.

New buyers entering the market. While the majority of acquisitions in the past have been completed by strategic players and private equity groups focused exclusively on hospice, we are increasingly seeing non-hospice buyers targeting the sector as part of a diversification and growth stimulation strategy. Consider the 2006 acquisition of private equity sponsored Trinity Hospice by Sunrise Senior Living, one of the nation’s leading providers of assisted living facilities. Moreover, three of the six hospice transactions in the first quarter of 2007 were completed by publicly traded *home health care* providers. We fully expect to see more of this cross-sector activity, particularly with the confluence of PEG sponsored hospice consolidators looking to cash in on their investments and Medicare home health providers, having reached critical mass in the markets they cover, looking to diversify and expand.

Supply and Demand. Given what we believe to be an extremely favorable outlook for hospice, as well increased acquisition demand from both private equity consolidators and other senior service providers as indicated above, we sense that recent acquisition activity is being driven less by a lack of demand, and more by a lack of supply. With the first wave of for-profit providers that entered the market after hospice began to surge in 2002-2003 beginning to reach maturity, we may be in the midst of a “re-loading” phase that could lead to greater deal volume over the next one to three years.

All things considered then, though it will likely never reach the heights of activity that we see in the home health arena, we anticipate a vibrant hospice merger and acquisition environment over the foreseeable future.

About The Braff Group

The Braff Group is a leading middle market merger and acquisition firm that specializes in the home health care, hospice, home infusion therapy, specialty pharmacy, home medical equipment, and staffing market sectors. The firm provides merger and acquisition representation, strategic planning, and valuation services. Since being founded in 1998, The Braff Group has completed more than 90 transactions.

In 2006 the firm was awarded Healthcare Deal of the Year by the M&A Advisor, a leading publication dedicated to middle market merger and acquisition activity, for its representation of Canadian Valley Medical Solutions - the third consecutive year The Braff Group has received this award. The firm was also recognized as a finalist for Boutique Investment Banking Firm of the Year in 2005 and 2006. The Braff Group has also been honored as one of the fastest growing companies in the Pittsburgh Region by the Pittsburgh Business Times.



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