



# MarketWATCH

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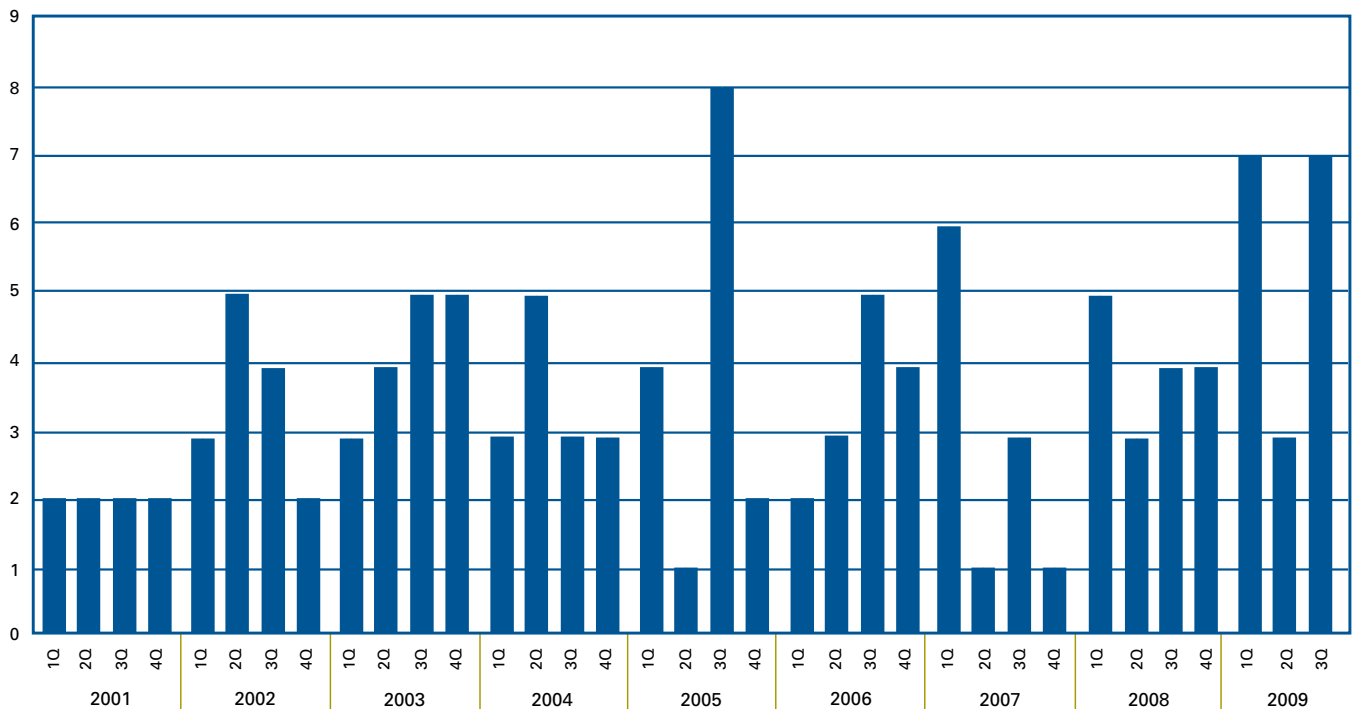
Insights from the Inside:

## Why Hospice Will Regain Its M&A Luster

In the early 2000's, when the stock prices of Odyssey and VistaCare soared, which caught the attention of private equity, hospice providers were perhaps the most sought after acquisition candidates in home care. But once Medicare home health shifted from cost based reimbursement to prospective pay and the industry successfully – and profitably – adapted to this new model, buyers (particularly private equity) began to turn their attention away from hospice to home health.

But conditions are ripe for a resurgence in hospice merger and acquisition activity – a market shift that has already begun as illustrated in **Chart 1**. In fact, through the first nine months of 2009, hospice deal volume has already equaled the record 17 transactions completed in all of 2003.

**Chart 1: Hospice Deal Trends**



Source: The Braff Group



*Although there has been concern regarding a near-term overhaul to the hospice payment system, MedPAC recently recommended that changes be instituted in 2013 which provides for an extraordinary three plus years of go-forward predictability in payment methodology.*

### **Here's why hospice is once again in the M&A spotlight.**

**Hospice saves money.** In a landmark study conducted in 2007 entitled "What length of hospice use maximizes reduction in medical expenditures near death in the US Medicare program," Duke University researchers concluded that "hospice use reduced Medicare program expenditures during the last year of life by an average of \$2,309 per hospice user."

**Hospice has earned extraordinary congressional goodwill.** In addition to saving money, with many in congress having experience with loved ones benefiting from the unique services hospice provides, the segment enjoys tremendous goodwill.

### **Given the above,**

**Compared to other home care segments, hospice reimbursement is currently the most stable.** While, as of this writing, there are cuts being proposed for hospice as part of health care reform (essentially reductions to annual updates), they are far less threatening than those being floated for Medicare home health. Moreover, although there has been concern regarding a near-term overhaul to the hospice payment system, MedPAC recently recommended that changes be instituted in 2013 which provides for an extraordinary three plus years of go-forward predictability in payment methodology.

Even if reform is instituted, however, we expect it may be quite positive for the sector.

With a focus on changing the flat per-diem rate to one that pays more at the beginning and end of an episode, short term patients, which generally generate losses for hospice providers, will become more financially viable. Accordingly, there should be far less incentive for providers to target longer-term patients – a financial "balancing act" that often leads to ruinous cap exposure. As a result, payment reform could contribute to a meaningful reduction in risk for the industry.

Furthermore, although health care reform remains extremely fluid, the original Senate Finance Committee bill contained provisions to (a) allow concurrent curative and hospice care for children in Medicaid and (b) to initiate a 26 site concurrent curative and hospice care demonstration project for Medicare.

Absent the need to forgo curative treatment, such provisions, should they be enacted, could vastly increase hospice acceptance and utilization.

Taken together then, the stage is set for a potentially long run of relative reimbursement calm, reduced risk, and increased utilization beyond simply demographics, the type of environment that both spurs acquisition demand and valuation.

**Medicare home health providers will want to diversify their reimbursement risk.** While we remain quite bullish on Medicare home health, the prospect of health care reform has increased the risk profile for the sector. In turn, the stock prices for publicly traded Medicare providers remain well below their October 2008 peak and the unabashed acquisition frenzy that characterized much of 2007 and 2009 has been somewhat tempered. In order to both sustain revenue growth and reduce near term reimbursement risk, we fully expect an increasing number of Medicare home health focused providers to seek out attractive hospice acquisition targets. And, notably, unlike other diversification strategies that can sometimes be viewed as off-focus, thereby adding less than proportionate value, given its similar Medicare and skilled services concentration, expansion into hospice will be viewed as a value creating complement to Medicare home health.

**There will be a greater supply of hospice acquisition candidates.** When the initial surge in hospice M&A activity began in the early 2000s, for-profit providers (which, unlike not-for-profits, have financial incentives to divest and, therefore, comprise the most likely acquisition candidates) accounted for about a third of the hospice industry. Not surprisingly, after the run-up in deal activity, the supply of acquisition candidates was diminished. That very surge in volume and acquisition demand, however, lured many new players into the sector. This made for-profit hospice the fastest growing sub-segment (more than doubling in number of providers since 2000), such that for-profits now comprise 50% of the industry. Many of those companies are now reaching business-cycle maturity and will be inclined to test the M&A market, substantially increasing the supply of acquisition candidates for the foreseeable future.

While we anticipate a return to the M&A enthusiasm that surrounded hospice in the early 2000s, we expect the nature of the activity to be somewhat different. Although the market has grown dramatically (from \$2.9 billion in 2000 to \$10.1 billion in 2007), it is still a comparatively small industry where many providers are not-for-profit, and, therefore, unlikely to consider a divestiture. Accordingly, it is a difficult industry to build hospice-only size and scale through multiple transactions over a relatively short investment period. Consequently, we anticipate proportionally less acquisition activity from hospice-only consolidators. The same is true for private equity groups which previously – and perhaps mistakenly – targeted hospice for its “roll-up” potential. Instead, as suggested above, we anticipate that the upcoming surge in activity will be led by Medicare certified companies and other ancillary providers (e.g. skilled nursing facilities) seeking risk-diversification and new growth vehicles.



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