

MarketWATCH

2008

The Impact of the Credit Markets and a Recessionary Economy on Merger and Acquisition Activity

In the wake of the recent plunge in broad market stock indexes, an increasingly difficult and recessionary economy, and the troubled credit markets that, together, have necessitated massive government bailouts to banks, insurers (AIG), and the auto industry, there is much speculation as to how these developments will affect both the business fundamentals and merger and acquisition activity in the health care services arena.

In general, the impact is mixed, with many health care service providers likely to fare much better than other industries.

Here's how we see it.

Many – though not all – health care service providers will be substantially insulated from (a) the downturn in the economy and/or (b) limited access to capital.

The impact of a downturn in the economy. In the current recessionary economy, with unemployment running high, stock portfolios falling, consumer confidence – and, more importantly, spending – plunging, many industries – including some in health care – are facing severe downturns in business. In a recent article appearing in the *New York Times* entitled *Hospitals See Drop in Paying Patients*, the *Times* reported a triple whammy of **(1)** declining admissions for often lucrative, but discretionary (or non-time sensitive) procedures such as knee replacements, hernia repairs, and weight loss surgeries, **(2)** an increase in patients, unable to pay for care, seeking treatment in emergency rooms, and **(3)** an increase in bad debt expenses. In the private duty home care arena, where care is often perceived as discretionary, many providers are reporting a fall-off in hours as patients, (e.g. customers), cut back services, reacting to a real – or perceived – drop in wealth.

But not all health care is discretionary in nature, nor paid for with substantial out-of-pocket dollars. Notably, the demand for Medicare home health and hospice services is “inelastic” (e.g. demand that is not highly sensitive to changes in an individual’s financial resources) – and paid for by the government. And, with no Medicare legislation likely to pass before the end of the year that could threaten a reimbursement update scheduled to go in effect January 1, 2009, the near-term funding outlook appears relatively stable.

the braff group

Chuck Gaetano
Atlanta
888-723-9263

Reg Blackburn
Atlanta
866-455-9198

Mark A. Kulik
Atlanta
888-922-1838

Bob Leonard
Ft. Lauderdale
888-922-1836

Steven Braff
Palm Springs
888-922-1833

The demand for Medicare home health and hospice is “inelastic” – and paid for by the government. As such, these sectors are largely insulated from challenges of a downturn in the economy.



(Note, however, that the same cannot be said for Medicaid reimbursed services, which, while similarly inelastic in demand, are funded in part by the states, many of which are facing severe budget deficits as a result of plunging tax revenues.)

Like Medicare home health, although the home medical equipment sector is already facing meaningful cuts in reimbursement, the fundamental reality of inelastic demand and government funding still holds. As such, these largely Medicare funded health care sectors are substantially (though not completely) insulated from the challenges of a downturn in the economy. On the pharmacy front, many of the services provided by home infusion therapy and specialty pharmacy providers are also non-discretionary. With a reliance on funding from private insurance, we do note, however, some potential exposure with a rise in unemployment (hence, a loss in employer funded coverage), and/or cut-backs in coverage.

The impact of limited access to capital (from an operational perspective).

Unlike bricks and mortar and asset intensive providers such as hospitals and long term care that rely heavily on debt to finance day-to-day operations and growth, most of the health care service sector providers that we track – home health, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment – need to finance little more than accounts receivable, and, for certain providers, inventory. With generally favorable turnaround in accounts receivable – especially for government funded services (but less so for those paid for by managed care) – most of these providers need little, and often, no lines of credit to fund day-to-day operations. Moreover, with minimal capital needs, basic growth and expansion can typically be funded by internal cash flow. As such, from an operational perspective, many of these providers have far less exposure to problems other industries are facing in the wake of a credit freeze.

The challenging credit markets will make it increasingly difficult for private equity groups to generate the returns they seek through acquisitions, however, in many cases, strategic buyers will step in to pick up some, or all, of the slack in demand.

It's an economic fact of life that in financially engineering company buyouts, in general, the greater the debt (versus equity) component of the purchase price, the greater the rate of return private equity can generate. Consequently, if the ability to leverage a deal becomes seriously constrained, the only way for private equity to generate the terms they seek is to lower the purchase price – which can place them at a competitive disadvantage to public and private strategic buyers that **(a)** are less constrained by the immediacy of generating out-sized returns and **(b)** can generate revenue enhancing and cost-saving synergies that financial buyers cannot. Clearly, the debt markets are seriously constrained, and, in some cases, frozen. So much so, that those in the capital markets have come to the conclusion that they can generate higher rates of return by buying highly (and likely overly) discounted mature debt instruments (i.e. those with a track record of on-time payments that suggest low risk of default), then issue new debt where, due diligence notwithstanding, there is no such track record. That said, in our current dealings with private equity and lenders alike, where leverage is available, total debt capacity has fallen from five (or more) times earnings before interest, taxes, depreciation, and amortization (EBITDA) to two to three times EBITDA.

And, at least one observer suggested that where lenders generally used to prefer placing large amounts of debt, the preference now is to make smaller bets, making the largest buyouts that much more difficult to complete.

One strategy private equity groups are considering is financing transactions initially with 100% equity, and refinancing with debt later when the credit markets thaw out. While an effective approach to bridge the financing gap, the added risk attributable to an uncertain and unpredictable refinancing still puts some downward pressure on pricing. We should also point out that some PEGs manage their own debt funds, giving them ready access to debt capital that others cannot tap. Finally, we are beginning to see some PEGs look to the sellers themselves to finance a portion of the transaction, which, interestingly, with that much more of a seller's "skin in the game" (in addition to any retained equity), may give traditional lenders additional confidence to free up more credit.

All things considered though, the tight credit markets have put a crimp into both private equity demand and valuation of even the most attractive health care providers, even though, as discussed earlier, in many cases, the underlying risk-return fundamentals of these targets are largely unchanged. The good news though, as suggested above, is that strategic buyers – particularly those that are publicly traded and have been rewarded in the stock market for acquisition fueled top and bottom line growth – seem to be picking up any slack in demand.

The question is, can even these strategic buyers obtain the financing to continue their consolidation strategies? Difficult to predict, but, at least compared to their private equity counter-parts, they have several distinct advantages: **(1)** As indicated above, strategic buyers can often generate revenue enhancing and cost saving synergies, which effectively raises their debt capacity; **(2)** For publicly traded buyers, convertible debt is more liquid, hence more valuable; **(3)** As ongoing entities (often with a long history of successful operations) that are typically less leveraged than PEG sponsored firms, sellers are likely to be more comfortable with seller debt as part of a strategic buyer's funding package; **(4)** In some cases, strategics can fund transactions, at least in part, with internally generated cash flow (albeit, perhaps, at a slower pace than when complemented with debt); **(5)** Although we have not seen much of this in the recent past, publicly traded strategics can fund deals, in part with stock. With strong track records, and "guaranteed" liquidity (generally in no more than a year), in the current market conditions, sellers may be more inclined to consider financing of this type. This may be particularly true in the home health care arena where *The Braff Group Index* of publicly traded companies has soared to new record highs, despite the challenging economic conditions
See page four for related article.

While the recessionary economy and the tight credit markets cast a pall over virtually all industries – health care included (if for no other reason than it creates a crisis of confidence that may give even the most confident of executives in sound businesses reason to pause when it comes to pulling the trigger on new investment and growth initiatives) – the fact remains that certain industries are far less exposed to these downward pressures than others. The extent to which a business requires minimal capital to fund day-to-day operations, demand for services are relatively inelastic, and said services are paid for by third party payors (e.g. the government), current economic conditions will have lesser impact. To a large extent, these are characteristics of many health care service providers. Accordingly, we anticipate continued – and, in some cases – robust acquisition activity in the sectors we cover during this challenging period.



[In the light of the deteriorating credit markets], one strategy private equity groups are considering is financing transactions initially with 100% equity, and refinancing with debt later when the credit markets thaw out.

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.

The Braff Group Home Health and Hospice Index Surges 16.4% Against a 15.6% Decline in the Broad Markets

Once again, the *TBG Home Health and Hospice Index* is showing signs of running counter cyclical to the broad markets.

Much like during the recessionary period following the bursting of the dot com bubble from 2000-2001, when *The Braff Group Home Health and Hospice Index* steadily rose as the broad markets were in near free fall, we may be seeing a similar pattern emerge in 2008.

This time around though, the reasons are different.

In the first post-recessionary period which was brought about, in part, by the collapse of the technology sector, investors fled, en masse, to seemingly far less risky, more predictable safe havens such as health care. During this period, virtually all of the health care service sectors that we track surged, as the *TBG Health Care Service Composite Index* ended 2001 up 98%, while the broad markets were down 25%.

But, in this recessionary period, the underlying root cause – the credit crisis – and its resultant impact on employment, consumer purchasing, new growth initiatives, and more, has left few market areas unscathed, with home health, perhaps, one of the few exceptions. As such, amidst an extraordinary downturn in the public markets over the past few months, on October 31st, the *TBG Home Health and Hospice Index* surged to a new record high of 1,167.2 at the very same time that virtually all of the other health care service sectors that we track – hospitals, long term care, home medical equipment, health care staffing, and eHealth – are at or approaching some of their lowest levels ever.

Here's why.

As discussed in greater detail in the accompanying piece *The Impact of the Credit Markets and a Recessionary Economy on Merger and Acquisition Activity*, home health and hospice expenditures are non-discretionary and government funded, therefore, both demand and payment for services are less subject to a downturn in the economy. Furthermore, home health and hospice generally do not rely heavily on credit to fund day-to-day operations. As such, these providers have less exposure to deteriorating credit conditions.

It should come as no surprise then, that given the above, while other industries are faltering, many of the public providers making up *The Braff Group Home Health and Hospice Index*, reported favorable revenue and earnings growth, leading to an October spike of 16.4%, while the broad markets fell 15.6%. In fact, over the 12 months ending October 2008, while the *TBG Broad Market Index* has fallen nearly 36%, our home health and hospice index soared an extraordinary 65%.

As the challenges of the current recessionary period play out, we should not be surprised to see even greater investment interest in home health and hospice – a development that could lead to another long rise in stock values.