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MEDICARE CERTIFIED HOME HEALTH

As the chart below illustrates, based upon proprietary data gathered by The Braff Group, merger and acquisition transaction volume for Medicare certified home health agencies was down slightly in 2010 from the record levels set in 2008 and 2009, with 74 deals vs. 79 reached during the peak years.

Nevertheless, 2010 marked the fourth straight year of more than 70 Medicare home health transactions, more than 50% greater than what the sector saw in 2005 and 2006.

Medicare Certified Home Health Deal Trends

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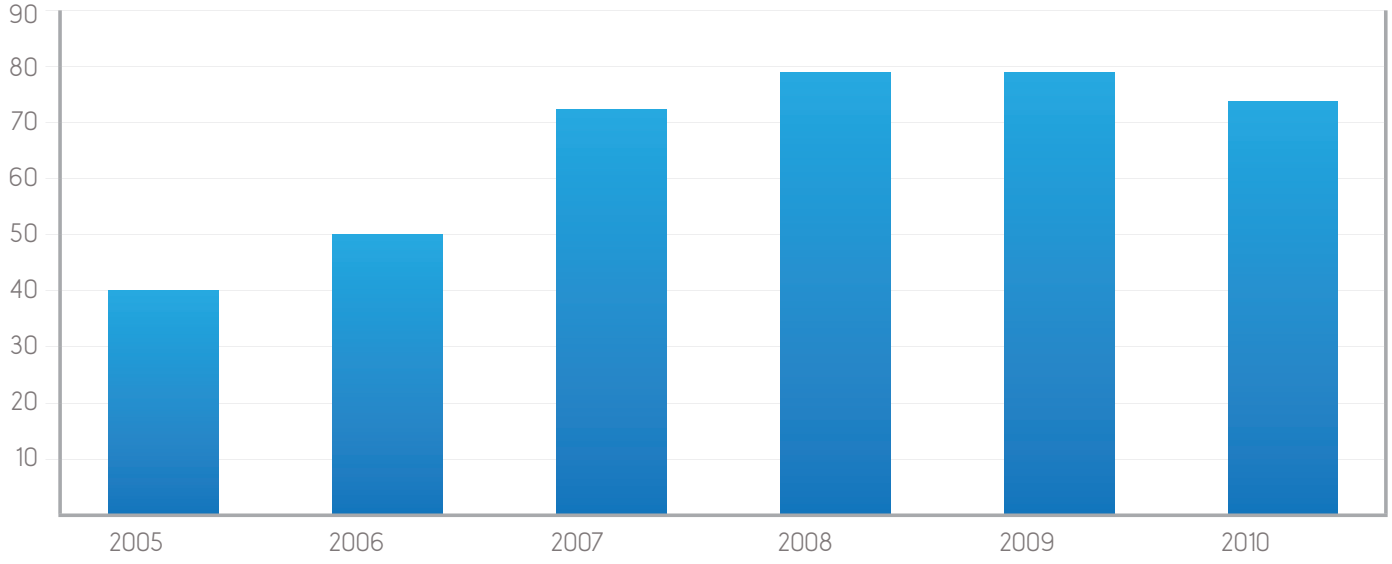


Source: The Braff Group

Moreover, it marks the fourth straight year that the segment led all the other sectors we cover in transaction volume – ahead of hospice, private duty, Medicaid home health, home medical equipment, infusion therapy, specialty pharmacy, institutional pharmacy, and health care staffing.

However, this consistency belies the fact that the merger and acquisition market for Medicare home health changed in many ways in 2010 – changes that will likely characterize the deal market for years to come.

How the Medicare Home Health M&A Landscape has Changed

Investigations of publicly traded Medicare providers have substantially raised the bar for compliance. In the wake of an April 26, 2010 Wall Street Journal article entitled, "Home Care Yields Medicare Bounty", that examined utilization patterns under evolving prospective payment reimbursement rules, Congress, the judiciary, and the SEC began investigations of several of the publicly traded providers. Not only did these actions – which remain unresolved at the time of this report – cause the stock price and underlying valuations of these providers to plunge, it also, quite naturally, made them – and other buyers – hypersensitive regarding the compliance of prospective acquisition candidates.

Accordingly, whereas in the past, buyers might be willing to work through some of the "gray" areas that might arise during the due diligence of an acquisition candidate (i.e. therapy utilization, recertification rates, case-mix weights, outliers, and the like), such is no longer the case.

In fact, the market is so skittish that just the hint of a potential problem or metric outside the bounds of what a buyer feels is "safe", has derailed deals, and will likely continue to do so over the near term.

> The uncertainty of Medicare home health reimbursement has begun to create "valuation gaps" between buyers and sellers.

Accordingly, ***compliance*** is the primary gatekeeper mechanism in Medicare home health M&A today. Buyers will ***not*** discount the price to reflect increased risk. They will simply walk (run) away.

The reimbursement climate, unexpectedly, remains cloudy, raising market risk. It's a given that government based reimbursement, especially in an era of escalating budget deficits, is inherently risky. That said, when health care reform was passed in March 2010, with market basket productivity adjustments and rate rebasing neatly laid out over a 10 year period – amounting to cuts of nearly $40 billion – it was hoped that the sector would at least benefit from clarity regarding future reimbursement.

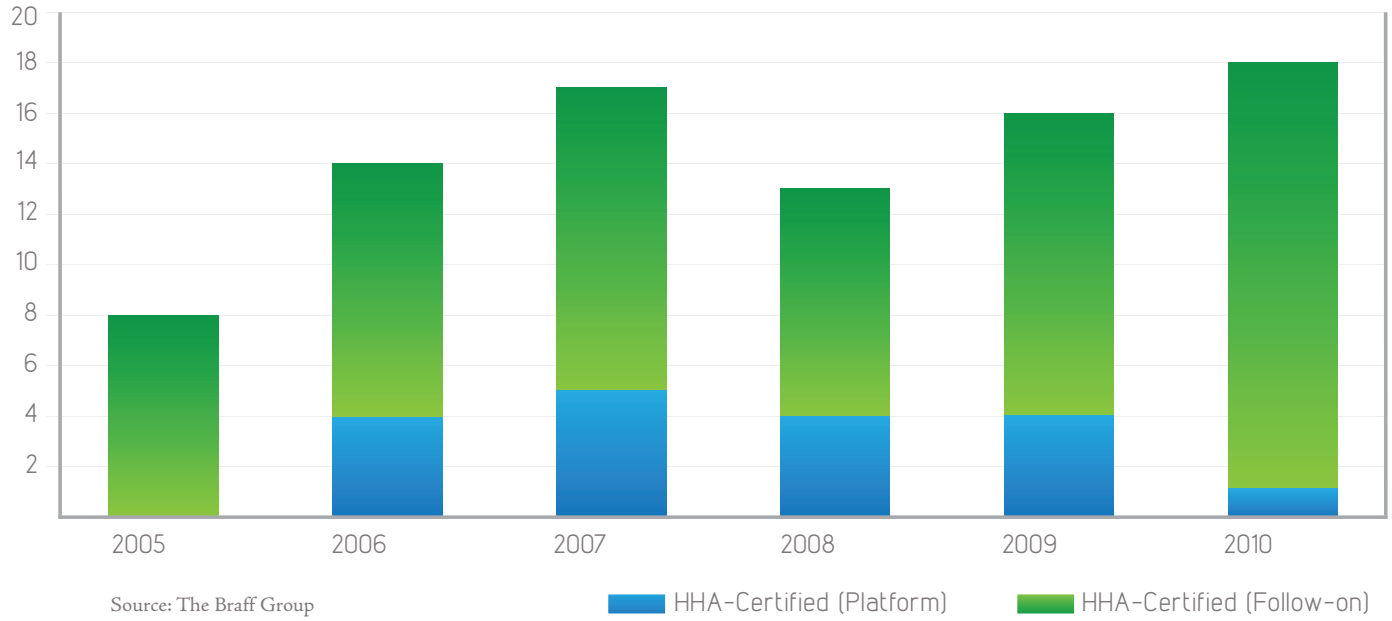
Well, the "clarity" lasted only a few months when CMS unexpectedly proposed raising, and adding an extra year, to anti-creep adjustments that had been initiated several years earlier. Moreover, MedPAC proposed accelerating rate rebasing, which was scheduled to begin in 2014, and reintroduced recommendations for patient co-pays.

Ultimately, the anti-creep was increased for 2011 and the additional year was rescinded (at least for now). While the acceleration of rebasing and additional years of anti-creep adjustments remain uncertain, and patient co-pays will likely be a tough sell amidst a prolonged recession, the mere fact that these "unexpecteds" were on the table at all raised the risk profile of the sector meaningfully.

Moreover, as a by-product of the intense scrutiny regarding compliance discussed above, we anticipate many providers will be less "aggressive" and err on the side of caution when it comes to coding, recertification, therapy visits, outliers, etc. Accordingly, in addition to the specter of reimbursement cuts discussed above, we may see indirect reductions to revenue coming from more conservative assessments and reduced episodes (the latter potentially further exacerbated by the physician "face-to-face" requirements which are enforceable as of April 1, 2011).

With threats to revenue coming from multiple directions, the outlook is somewhat murky. And, in mergers and acquisitions, where the market craves certainty, the ***uncertainty*** of Medicare home health reimbursement has begun to create "valuation gaps" between buyers who "price in" ***future*** risk and sellers who enjoy ***current*** profits.

Private Equity Investment in Medicare Home Health



Source: The Braff Group

New Platform Investments by Private Equity in Medicare Home Health has slowed. As the chart above suggests, with 17 platform-sized transactions completed from 2006 through 2009, private equity was a dominant buyer of many of the larger Medicare home health providers during this period. This, in turn, raised the demand for smaller "follow-on" deals to complement and expand upon their initial investments. In fact, private equity completed a record of 17 such follow-on deals in 2010.

But largely due to fears regarding increased regulatory scrutiny and reimbursement uncertainty as described above, there was only one new platform-sized market entry deal completed in 2010 – the lowest since 2005.

The implications of this are clear. First, we note that while private equity will continue to look at initial investments in home health care, they will do so with a heightened sense of caution that emerged in earnest in 2010. Second, with fewer new investments, the pace of follow-on deals will eventually trail off as private equity sponsors reach the end of their typical 5-7 year investment cycle. Taken together, although total private equity investment in Medicare home health (platform and follow-on) set a record in 2010, it may also turn out to be the peak in their collective activity. Accordingly, we anticipate diminished acquisition demand from a market force that helped propel Medicare home health to the forefront of health care service M&A.

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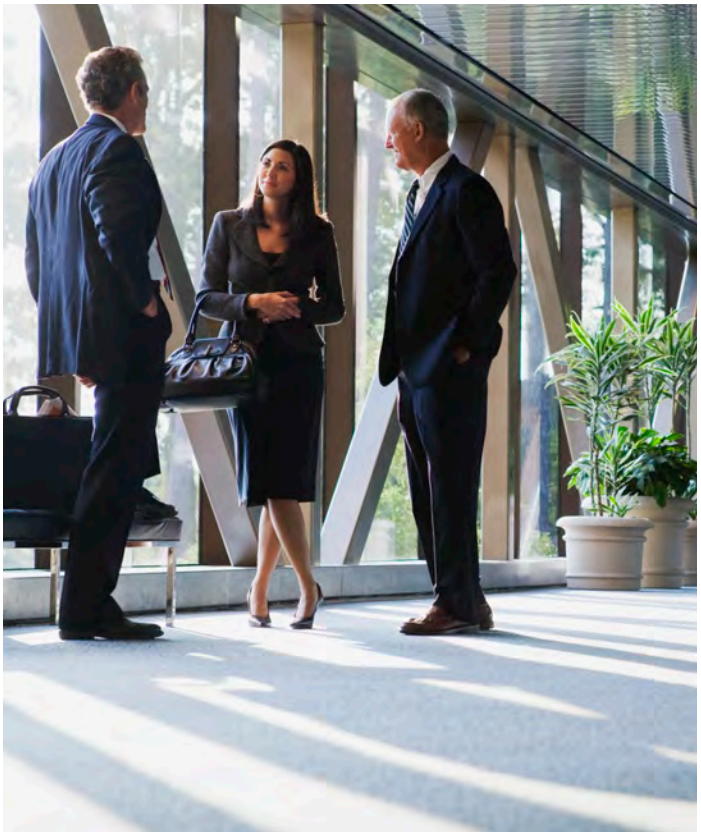
Cuts in reimbursement may make certain providers vulnerable. Recently we've read several market analysts' reports that suggest that as a result of the five percent cuts in reimbursement initiated on January 1, 2011, many providers will struggle financially. They go on to imply that this will increase the supply of "opportunistic" (i.e. cheap) acquisition candidates. While we agree that providers "on the edge" may indeed find it difficult to manage through these reductions, these firms represent a small minority of providers (in stark contrast to the magnitude of pain brought about by BBA 1997 that triggered a massive exodus of companies). Moreover, we suspect that many of the firms that ultimately succumb to these cuts may have fundamental operating, service mix, or market area challenges that may render them unattractive acquisition candidates – even at a reduced price. We do acknowledge, however, that the cuts, and those that are likely to be initiated in the future, may be the "last straw" that propels attractive, profitable, "on-the-fence" sellers to test the market.



THE BRAFF GROUP DIFFERENCE

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

Implications for Valuation

With increased government scrutiny, reduced reimbursement (and more potential cuts on the horizon), and a pull-back in private equity investment, all in an economic climate that remains tepid, it should come as no surprise that there is downward pressure on the valuation of Medicare certified home health agencies.

In fact, while our timing was a bit off, The Braff Group foresaw, as early as 2006, that the valuation of certified agencies had peaked, and that they would assuredly, and inevitably, contract – particularly at the highest end of the range – in our MarketWatch Report, "Recent and Anticipated Changes in Valuation of Medicare Certified Home Health Agencies".

What we predicted then is pretty much where we are today.

While multiples across the entire sector have fallen, the greatest drop was in values for the larger, platform-size providers, whose pricing was largely inflated by private equity armed with cheap debt, substantial investment funds, and the willingness to outbid existing strategic players.

Ultimately, absent the frenzied environment that characterized 2006-2008, values today are more in line with what the risk-return fundamentals of the industry would suggest.

The Outlook

While the market is not quite as robust as we saw in 2007 and 2008 in terms of transaction volume, pricing, and breadth of size, we remain extremely bullish on the sector – the demographics, economics, and opportunities in Medicare home health are simply too compelling. Furthermore, while opportunities will remain for companies of all sizes, we expect the "sweet spot" to move downstream, to companies in the $5M to $25M revenue range, whose values have fallen the least, and whose size is most attractive to both strategic and private equity buyers in a more risk adverse environment.

> While the Medicare home health M&A market is not quite as robust as we saw in 2007 and 2008, we remain extremely bullish on the sector.

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