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M&A Market Watch: Recent and Anticipated Valuation Trends for Medicare Certified Home Health Agencies

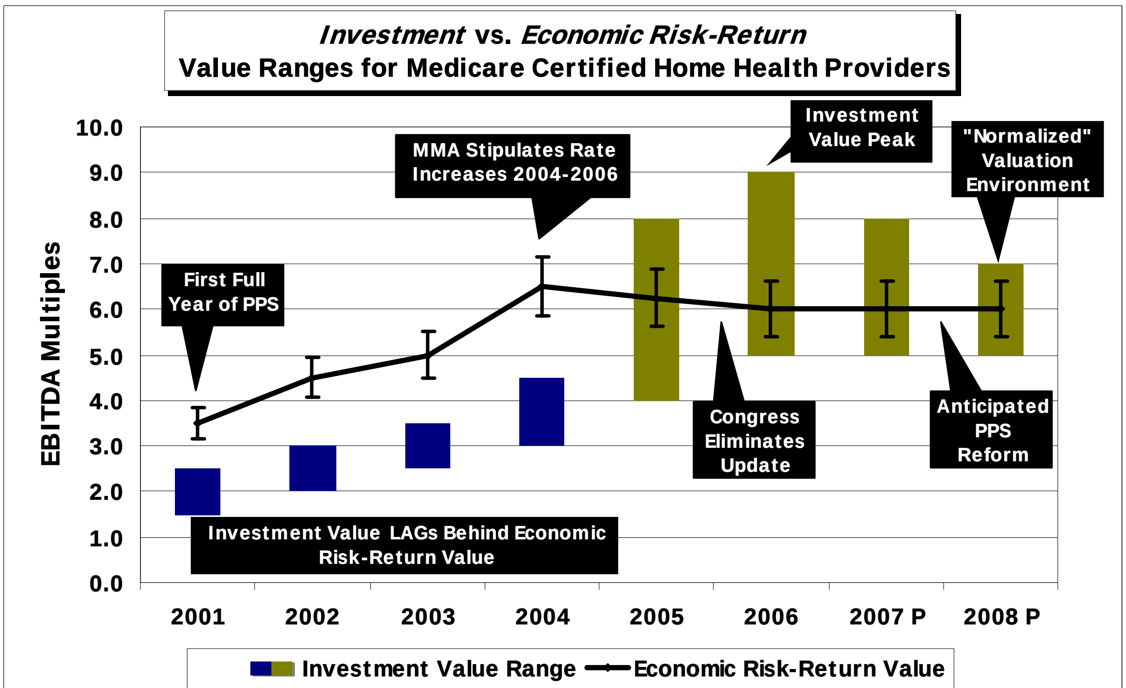
the braff group

Since the Prospective Payment System (PPS) was initiated in late 2000 and we began to see the earliest indicators of a resurgence in merger and acquisition activity for Medicare certified home health agencies, valuations — both real and perceived — have changed dramatically. Moreover, during this time, we have noted somewhat unusual trends in the relationship between, and application of, the two most common foundations for valuation: **Economic Value** based upon pure risk-return fundamentals akin to fair market value, and **Investment Value** ascribed by specific buyers for specific companies, based on the confluence of the unique needs of buyers, the unique attributes of sellers and the balance between the supply of, and demand for, acquisition candidates.

The following is an analysis and graphical illustration of how the sector's valuation trends and anomalies (expressed as multiples of earnings before interest, taxes, depreciation, and amortization — EBITDA) have evolved over time, and where we expect them to move over the next two plus years.

First, some brief background. While pure, risk-return driven, fair market value-like pricing — or less — is certainly preferable to buyers, in a competitive merger and acquisition market there are many situations in which it is financially reasonable and appropriate for a buyer to pay more than fair market. For example, private equity firms lacking industry expertise or market presence, or strategic buyers looking to open up new markets or regions, may be willing to pay substantial **investment value premiums** for platform-type acquisition candidates with the human and operating infrastructure capable of supporting additional lower priced acquisitions or startups. A specific acquisition candidate can offer unique synergistic benefits to a particular buyer, creating additional value in an acquisition. Furthermore, in certain situations, buyers can afford to offer sellers value premiums in order to capture even greater **size-premiums** bestowed to large providers.

Finally, in most M&A markets, two conditions generally prevail: (1) the high end of the investment value range typically **exceeds** fair market-like economic value, and (2) strategic buyers, with greater opportunity than financially driven buyers to capture revenue enhancing or cost reducing synergies, tend to set



Given extraordinary variance in valuation as a function of an acquisition candidate's size, location, quality, and numerous other intangibles, EBITDA multiples above should be interpreted more on an ordinal or trend basis rather than on an absolute basis

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

the high end of investment value range.

2001 to 2003: During the first full year of PPS when companies were in the midst of re-engineering their businesses to address an entirely new approach to providing — and billing — for home health care services, there was much uncertainty (and rightly so) regarding the accuracy of early revenue and profit reporting. With such risk, economic risk-return valuations were initially modest. However as the industry gained more experience and confidence in the system and financial returns became more reliable, predictable, and **less risky**, these valuations climbed steadily. While investment valuations followed a similar path, contrary to condition 1 described above, they lagged substantially **behind** what the economic risk-return fundamentals of the industry suggested. This was due to the fact that economic realities notwithstanding, after being blind-sided and financially brutalized by the Balanced Budget Act of 1997 (BBA 1997) and the transition from cost-based reimbursement to the Interim Payment System and finally PPS, strategic buyers were in little mood to commit substantial funds to pursue aggressive acquisition strategies. Rather, they took a wait and see attitude, substantially depressing acquisition demand and attendant investment value ranges. As for private equity buyers that would normally seize on such a valuation anomaly? Those that were interested in health care services focused their attentions initially on Hospice given the remarkable stock performance of several national players.

2004: Immediately after Congress passed the Medicare Modernization Act which, among many items, provided for extraordinary reimbursement stability for Medicare certified HHAs with regular updates scheduled **through 2006**, the sector's risk profile was arguably at its lowest — and most attractive — position since the mid 90s. No surprise then that as the sector entered this three year window, pure economic risk-return based values peaked. What **was** a surprise was that even under these extraordinarily favorable circumstances, even after four years of experience under PPS, strategic buyers for the most part remained on the sidelines driving the unusual and "unfavorable" gap between investment value and economic value to its largest point. By year end however, amidst substantial declines in the fortunes of several publicly traded hospice providers and with opportunities to gain platform positions in the hospice sector beginning to wane, private equity buyers began to take notice of home health care.

2005: As the industry passed the mid-point of the MMA sanctioned reimbursement "safe harbor", risk naturally inched upward, exerting modest downward pressure on economic risk-return values. By mid-year however, eager to fill the acquisition void left by strategic buyers since 2001 and hoping to take advantage of the huge gap between investment and economic value that existed at the end of 2004, private equity groups (PEGs) rushed into the M&A market, spiking a demand for a relatively limited number of platform-sized acquisition candidates. The resulting imbalance of demand over supply — in an atmosphere of strong valuations for publicly traded Medicare focused providers — drove investment valuations up dramatically. Moreover, the higher end of the range —driven by PEGs and not strategic buyers, contrary to condition 2 described above — finally surpassed pure economic risk-return valuations.

2006: As we entered 2006 and Congress eliminated the home health update through the Deficit Reduction Act, the sector's risk profile again ticked upwards, pushing economic values down slightly for the second consecutive year. While the loss of the update was certainly meaningful, it was less so in terms of valuation dynamics because the industry did not suffer a **reduction** in reimbursement. The perception of the sector, then, remains one of relative **stability** which is a key to sustaining risk-return values. The above notwithstanding, with an increasing number and velocity of buyers entering the fray, in part making up for lost time from 2001-2004, the range of investment values has surged again, reaching what we believe will prove to be its peak in both absolute terms and relative to underlying economic risk-return value.

2007 Projected: Even with expectations that Congress will eliminate the proposed update again for 2007, amidst continued reimbursement stability, we anticipate no meaningful change in economic risk-return values. That said, with more attractive acquisition candidates testing the market after the dramatic surge in activity and valuations post 2005-2006, we expect a lessening in the demand-supply imbalance which will likely drive down the top end of the investment value range.

2008 Projected: By late 2007 or early 2008, we anticipate PPS reforms will be implemented. While they are supposed to be budget neutral, our suspicion is that given extraordinary budget pressures, they may likely morph into de facto reimbursement cuts. And even if such reforms have no impact on overall spending, given reimbursement cuts that have befallen virtually all health care providers over the recent past, we believe it is prudent to project some sort of rate reduction for home health providers in 2008. That said, absent an extraordinary cut, we expect that the home health sector, much like the home medical industry post BBA 1997, will be able to offset at least the first wave of cuts with reductions in expense and increased efficiencies. Accordingly, we anticipate that economic risk-return value multiples will hold, albeit against potentially lower earnings. We do however expect that as the acquisition frenzy of 2005 to 2007 dies down and the supply of, and demand for, acquisition candidates becomes more balanced, the high end of the investment value range will fall to a "normalized" level compared to economic value; a range that exceeds (and extends below) economic risk-return values, but in a somewhat narrower band. And with reduced demand from private equity, strategic buyers will likely be driving the higher end of this narrower band. All of which will be characteristic of a more mature merger and acquisition environment.