the braff group

MarketWATCH

2008

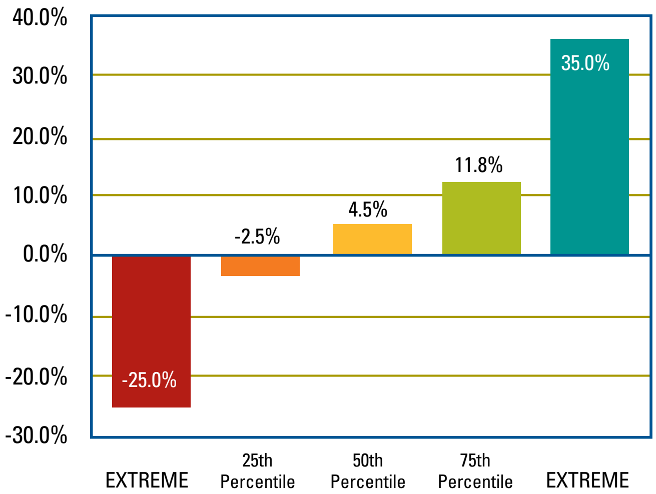
Medicare Certified Home Health

After a record 107 home health care transactions were announced and/or completed in 2007, several big questions loomed – somewhat ominously – over what the prospects would be for yet another year of vibrant, high value, merger and acquisition activity.

How would reforms to the Prospective Payment System (PPS) impact the performance of home health care providers, and more importantly, from an M&A perspective, how would these reforms impact acquisition demand? Would these reforms spur a rush of sellers to the market, creating a surge of supply that could put downward pressure on pricing? In a post "creep" adjustment world where even the most optimistic observers might reasonably anticipate reimbursement challenges over the near term, would private equity – the group that propelled home health into the M&A spotlight several years back – begin to slowdown their collective consolidation of the industry? And, even if a potentially cloudy future did not dissuade them from continued investment, would the year-long, and escalating credit crisis, force private equity to the sidelines?

Although the answers to these questions are still evolving, with several critical unknowns breaking almost perfectly for the home health industry, the sector continues to prosper, and in some respects, may be stronger than ever.

CHART A: Average Reimbursement Change (Non-LUPAs): 2007 vs. Q2 2008



Source: Outcome Concept Systems

Here's why.

The impact of PPS reforms have been largely manageable, and in some cases, beneficial.

While data continues to be collected and analyzed to assess the global affect of PPS reforms on revenues and profits, the early returns, while mixed, have been encouraging. As **Chart A** indicates, based on information reported by Outcome Concept Systems regarding average reimbursement per episode for its member agencies in the second quarter of 2008 versus that of 2007, 50% saw increases of 4.5% or more, while those at the 75th percentile, saw average reimbursement gains of 11.8% or more.

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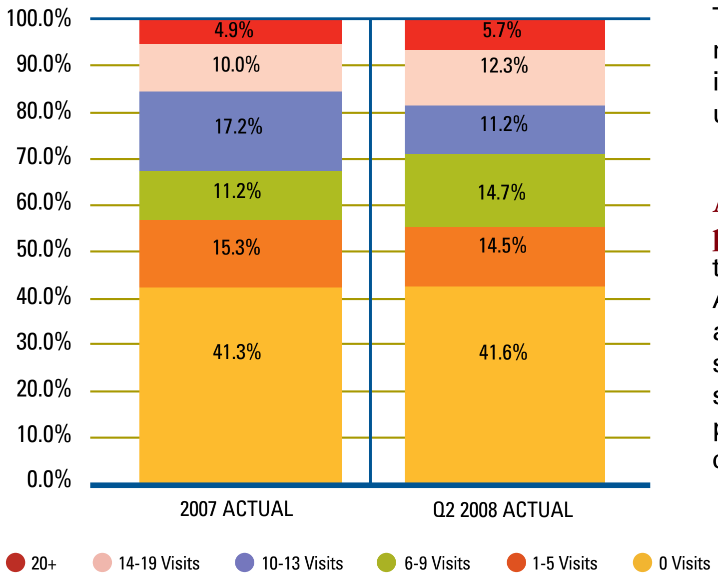
Moreover, as we saw when PPS was first initiated, it takes some time for agencies to evaluate, refine, and iterate strategies to best adapt to a new payment methodology. Accordingly, it would not be unreasonable to expect these numbers to skew even better in the coming months.

One of the reasons many agencies may be reporting increases in average revenue per episode may be due to changes in therapy reimbursement. Rather than provide for a single bump in reimbursement when an episode exceeds 10 therapy visits, under revised PPS, additional reimbursement is provided for episodes exceeding thresholds of 6, 14, and 20 therapy visits (with incremental reimbursement between each threshold). In so doing, the intent was to (a) reduce the financial incentive for agencies to "game" the system to get to 10 visits and capture extra reimbursement and (b) to provide adequate reimbursement to those agencies serving patients with therapy needs below and far beyond the 10 visit "bonus".

Based on information provided by Outcome Concept Systems regarding therapy utilization in the second quarter of 2008 versus that of 2007, in some respects, the changes appear to be working, however, in others, we note certain shifts in utilization that appear to be evolving – perhaps unfavorably. The good news is that the percentage of episodes falling in the bellwether 10-13 therapy visit category (just above the previous 10 therapy threshold) has declined nearly 35% from 17.2% to 11.2% with the largest raw percentage gain in the 6-9 visit category. The less good news is the increase in the combined high utilization categories (14-19 and 20 plus therapy visits) from 14.9% to 18.0%, which could be an indicator of possible "creep". While these numbers (a) may be anomalistic, (b) are likely to continue to evolve and (c) represent a subset of the industry, the upward movement in the high utilization category, where increased revenues are available, certainly warrants continued scrutiny.

The annual update is likely to survive. Typically, as we approach the end of the year, Congress must address cuts in physician reimbursement, which inevitably, subjects the annual Medicare home health update to scrutiny as a potential offset. But in July of this year, Congress agreed to an 18 month physician "fix", eliminating the pressure for a year end Medicare spending measure.

CHART B:
Therapy Utilization Trends



Source: Outcome Concept Systems

The fact that we are in a presidential election year makes this even more unlikely. Absent a spending initiative to attach it to, it's a good bet that the annual update will survive yet again.

Acquisition strategies have succeeded for high profile, publicly traded buyers. All of the publicly traded home health care companies – Almost Family, Amedisys, Gentiva, and LHC Group – have embraced acquisitions as a core component of their growth strategies. Furthermore, they have each demonstrated substantial discipline in their search, selection, and perhaps most importantly, integration of acquisition candidates.

As such, these acquisitions have contributed greatly to top and bottom line growth, and in so doing, have drawn plaudits from Wall Street. Also, the publics have been rewarded with higher stock prices, keeping the demand side of the M&A equation high.

Increases in strategic M&A demand has offset challenges of Private Equity. In the article we wrote entitled, "*Private Equity Investment in Home Health Care: Is the Window of Opportunity Beginning to Close*" (*Caring Magazine*, June 2008) we suggested that while the home health industry remains quite robust, given reasonable concerns regarding reimbursement over the next investment cycle (especially after the unexpected and significant "creep" adjustment was tacked onto PPS reforms), that we might begin to see a slowdown in new private equity investments. We have, in fact, begun to see a slowdown, but not due to reimbursement factors. As indicated above, with PPS reforms looking positive in many respects and with the 2009 update likely intact, private equity groups have not been scared off yet. Rather, the credit crisis has finally reached this segment of the M&A market. Given that many private equity group (PEG) buyers in the home health arena have routinely relied on less debt to fund their deals than in other industries, they have long side stepped the crunch…until now. But, in the wake of federal bailouts of Fannie Mae, Freddie Mac, and AIG, and the failing of Lehman Brothers (with more likely to come), even for the proportionately modest needs of PEGs targeting home health, the debt markets are, for all practical purposes, frozen. The good news as suggested above is that while we don't expect the freeze to last too long, and some private equity groups may ante up even more equity to get deals done, any slackening in demand appears to have been taken up by strategic buyers, keeping deal volume, and valuations, high.

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Sellers have not rushed to market. While the stream of acquisition candidates coming to market continues to be strong, we have not, as of yet, seen an appreciable acceleration of agencies reacting to PPS reforms and rushing to sell. That said, with eight years of strong performance since PPS was originally introduced, an uncertain reimbursement climate, and the institutional memory of the meltdown in valuations that occurred post Balanced Budget Act of 1997, we expect an up tick of mature, profitable companies coming to market – not enough to disrupt a supply-demand curve that currently favors sellers, but enough to support potential growth in M&A activity.

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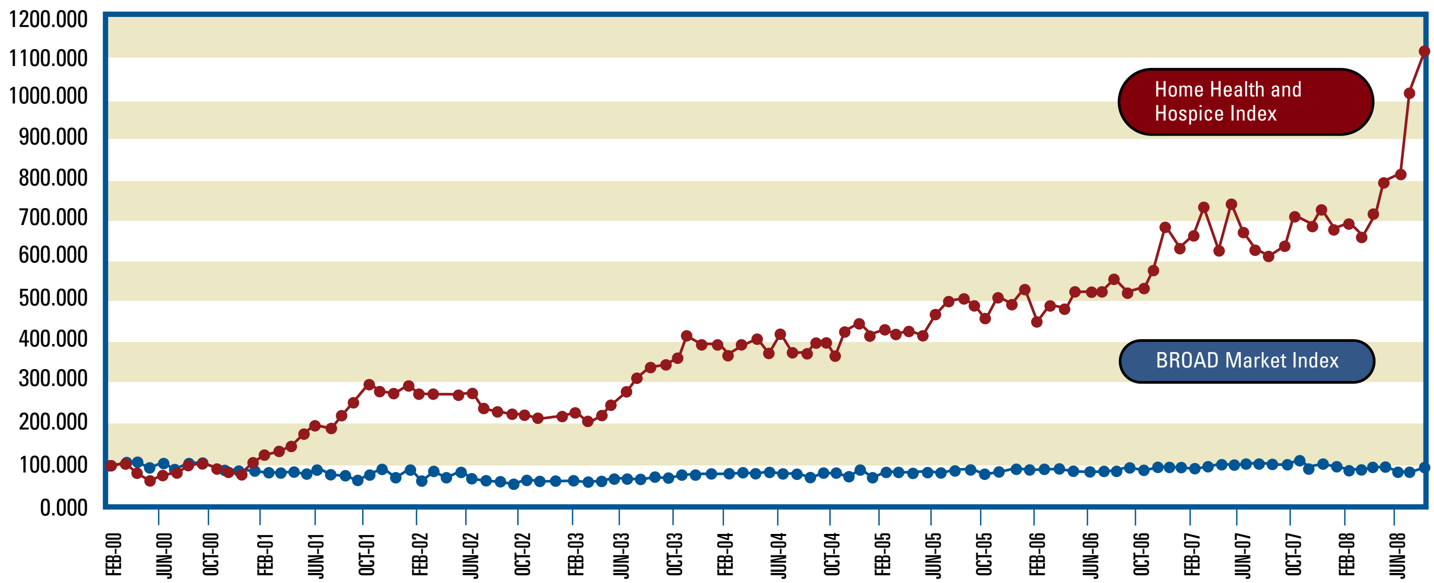
The Braff Group is the leading investment banking firm specializing in the home health care, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment market sectors. We provide an array of transactional advisory services including sell side representation, debt and equity recapitalizations, strategic planning, and valuation.

The TBG Home Health and Hospice public market index has surged to record levels. Given much of the above – favorable results under PPS reforms, an anticipated 2009 update, successful acquisition initiatives with substantial consolidation opportunities remaining – combined with the market reality that momentum begets momentum, the home health companies that comprise the TBG Home Health and Hospice public market sector have sent the index to unprecedented levels. Consider that in July, the index was the first of all the sectors we cover (home health and hospice, infusion and specialty pharmacy, health care staffing, home medical equipment, hospitals, long term care, and eHealth) to cross the 1,000 threshold closing at 1,004.7 (the next highest level was 746.2 reached by the long term care sector in April of 2007).

With an August 2008 close of 1,098.4, the index has surged a remarkable 75% since PPS reforms were originally announced in April of 2007, and 52% since the first of the year when they were implemented. Not surprisingly, such enthusiasm for the sector contributes mightily to (a) the acquisition appetites of both strategic and financial buyers, and (b) their ability to pay extremely attractive prices and still capture favorable "arbitrage" in the public markets or upon exit.

CHART C: TBG Home Health and Hospice Index

Source: The Braff Group



Outlook.

Although we entered 2008 with many questions regarding the direction the M&A market would take after a record breaking 2007, it would appear that the home health arena is extremely well positioned to drive continued M&A activity. According to Braff Group research, through the first six months of the year, the sector is on pace to once again eclipse the 100 transaction mark in 2008. And given all of the above, we may very well see sustained record breaking merger and acquisition activity for the next 12-24 months.