

M&A Sector Report

Independent Market
Research from
The Braff Group

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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.

M&A Market Watch: Private and State Funded Home Health

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When discussing non-Medicare, private duty services, it is important to further segment the sector into those firms that focus primarily on services reimbursed privately, or through private insurance (Private) and those that specialize in services reimbursed by Medicaid or other state funded programs (State Funded) as each have very different operating, clinical, customer service, and financial dynamics. These dynamics, in turn, drive revenues, profitability, risk, merger and acquisition demand, and ultimately, valuation.

Private Home Health.

Generally, as we define it, in addition to being reimbursed "out-of-pocket" or through insurance, private home health is characterized by skilled and non-skilled care, typically in shifts of 4, to 8, to 24 hours (including "live-ins"). It also includes "non-medical" home care, which, as the name implies, focuses primarily on companionship, light housework, meal preparation, errands, and various other non-medical support services. What distinguishes private home health, however, from virtually every other home care service segment, is that

patients truly are customers. As such, the sector is extremely service, relationship, and management oversight intensive – dynamics that drive an operating model in which, quite often, the most successful long term players are

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those that are relatively small and managed directly by an owner that has a personal stake in the firm's performance. No surprise then that (a) *Private Duty Insider* reports that the median size of a private agency in 2005 was \$1.4 million and (b) many of the largest providers in the market have gotten to size by developing owner-operated "branches" through franchising, management equity participation, or by offering management significant owner-like incentives including profit sharing and "phantom" stock.

Implications for M&A.

With market dynamics that foster relatively small, owner dependent businesses that make it extremely difficult to complete enough transactions (and successfully operate them) to reach a critical mass of \$50 to \$100 million worthy of lucrative size premiums upon exit, private home care is not particularly well-suited for a classic "roll-up" consolidation strategy — a strategy, we might add, that has been extremely prevalent in other home care sectors, particularly Medicare home health and infusion therapy today. But this does not mean that there isn't any demand for acquisitions. Given the unique at-

tributes of private home care, for those providers wishing to develop a private duty presence and skill set, an acquisition is often far more predictable and successful than that of a home grown startup. Not surprisingly, the first wave of acquisition demand has come from well established Medicare providers, including not-for-profits, looking to expand their service offerings. The next wave, however, could push private home care to the forefront of M&A activity. Right now, the primary thrust of buyers and builders in the home care arena is to increase their Medicare capacity. However, once (a) they achieve the Medicare penetration they are targeting and/or (b) the reimbursement outlook for Medicare begins to darken, we expect a spike in demand for private home care providers to stimulate growth, create a seamless continuum of care, and diversify payer risk. With Medicare home health entering its third year of accelerated consolidation, and with soaring budget deficits likely to threaten the sector's six year run of no-cuts in reimbursement, this second wave is likely not far off.

Valuation

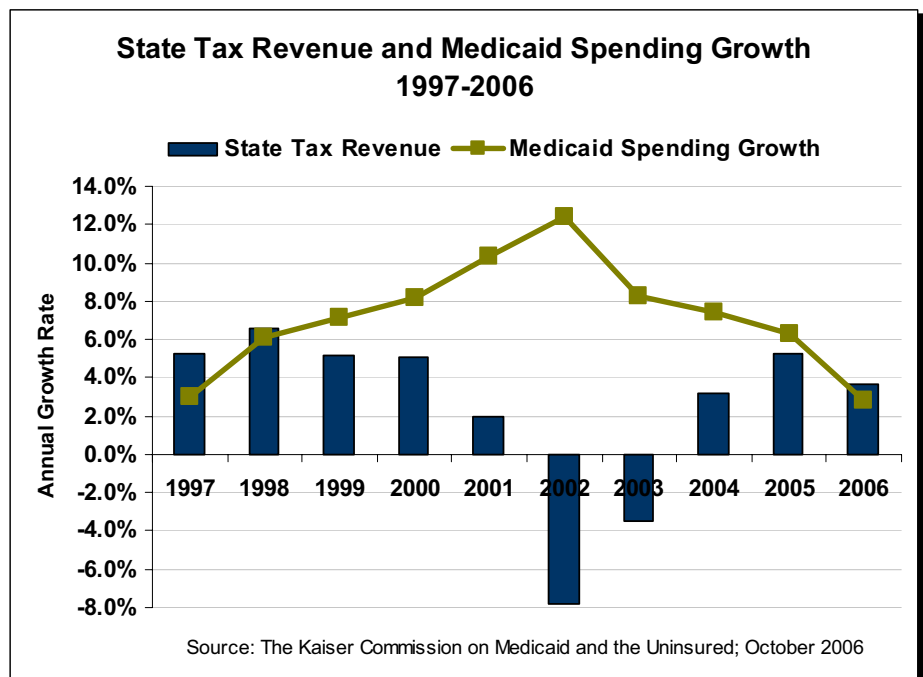
Over the recent past, valuation of non-Medicare home care providers has been benchmarked against that of Medicare providers. Given that private providers tend to be smaller than their Medicare colleagues with revenues sometimes concentrated among a limited number of long length of stay patients (which can be interpreted as increasing risk), buyers have traditionally pegged the value of private home care behind that of Medicare. However with (a) private reimbursement substantially less risky than that which is government funded, and (b) long length of stay patients offering more predictable, "annuity-like", revenue streams than "episodic" patients, the overall risk-return fundamentals of Medicare versus private home care is arguably more comparable. Even though soaring values of Medicare agencies has enhanced valuation of private providers, our read of the market is that the current acquisition frenzy around the Medicare arena has restrained tangible — and intangible — demand for private home care, holding values somewhat in check. However, with extremely solid long term growth prospects and the promise of a larger second wave of acquisition activity, we anticipate a long period of consolidation and rising valuations.

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State Funded Home Care

In addition to being funded primarily through Medicaid and other state funded programs, particularly home and community based waivers (HCBS), state funded home care differs markedly from private home care in terms of service intensity and scalability. While state funded providers certainly strive to offer the highest levels customer service, given limited funds and demand that often exceeds providers' resources, it is simply impractical to provide the kind of one-on-one, customized, "never-say-no" array of services private home care patients can demand, pay for, and receive. Accordingly, with more uniform services that are referral source,



rather than consumer driven, these businesses are quite scaleable. In fact, particularly in densely populated areas where the need is often the greatest, it is not unusual for state funded providers to generate revenues of \$40 to \$50 million in revenues or more.

Changing Market Conditions.

According to data presented by the *Kaiser Commission on Medicaid and the Uninsured* in its recently issued annual report on the health of Medicaid programs nationwide, from 1997 to 2002, at the same time the rate of growth in Medicaid spending began to rise steadily and substantially, increases in state tax revenues began to fall as dramatically. At its worse point in FY 2002, spending growth surged 12.4%, while tax revenues actually fell 7.8%,

plunging the Medicaid program into extraordinary financial distress – and casting a dark cloud over state funded home care providers. But what a difference four years makes. Since spending growth peaked in 2002, the rate has declined for four consecutive years. Equally important, over the past three years, tax revenues have increased such that for the first time since 1998, in FY 2006, revenue growth exceeded that of spending. Consequently, according to the Kaiser report, while cost containment strategies are still prevalent, “26 states have plans to restore cuts from previous years, expand to new populations, or make positive changes to Medicaid application and enrollment procedures”. In combination with legislation mandated under the Deficit Reduction Act that gives states more flexibility in designing consumer focused, non-institutionally based health care services, “a total of 38 states plan to adopt expansions of HCBS [Home and Community Based Services waivers]”. So while the fear of Medicaid that peaked in the aftermath of 2002 clearly lingers, the tempered reality is that current outlook for Medicaid in general, and Medicaid reimbursed home care services in particular, is as bright as we have seen in nearly ten years.

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Implications for M&A.

Over the recent past, acquisition interest in state funded home care has been limited to private equity groups that have targeted large providers as a means to gain a foothold in a market and obtain an infrastructure upon which to layer on Medicare and other services. As we enter what could be the beginning of a favorable reimbursement and utilization cycle, we expect to see large state funded providers that have largely sat on the M&A sidelines for the last four to five years reconsider and initiate regionally focused consolidation strategies. We may also begin to see private equity groups target Medicaid providers for the returns they can bring directly (rather than as a means to a Medicare end).

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Though state funded providers tend to be substantially larger than private home care agencies and do not suffer from a concentration of revenues among limited numbers of patients, valuation metrics for state funded home care has also lagged behind Medicare — in this case due to thinner margins and comparatively greater payer risk. From a practical perspective however, with recent acquisition interest generally limited to the largest providers, there has been virtually no market for state funded providers under \$10 million in revenues, except at valuations best described as “opportunistic”. As we enter 2007 however, we are cautiously optimistic that a more broad based merger and acquisition market for state funded providers will emerge, giving rise to greater demand at values that more reasonably reflect the sector’s current risk-return fundamentals.

About The Braff Group

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. The firm provides merger and acquisition representation, strategic planning, and valuation services. Since being founded in 1998, The Braff Group has completed more than 90 transactions.

In 2004 and 2005, The Braff Group was honored as one of the fastest growing companies in the Pittsburgh Region by the Pittsburgh Business Times in its annual ranking of the 100 fastest growing privately held firms in the area. Additionally, The Braff Group was awarded the 2005 Healthcare Deal of the Year by the M&A Advisor, a leading publication dedicated to middle market merger and acquisition activity, for its representation of Northwestern Memorial's Home Care Division. This is the second consecutive year The Braff Group has received this award. The M&A Advisor also recognized the firm as a finalist for Investment Banking Firm of the Year in 2005.



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