

M&A Market Watch Special Edition:

Potential Impact of Home Health PPS Reform

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

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On April 27th, CMS finally published the long awaited proposed rule for refinements to the Medicare home health prospective payment system (the full text of the rule can be accessed at CMS's Home Health Agency Center at www.cms.hhs.gov/center/hha.asp).

Among many changes, the proposed rule includes the following highlights:

- Expansion of the current case mix model of 80 HHRGs to 153 HHRGs
- Replacement of the 10 visit therapy threshold with thresholds of 6, 14, and 20 visits
- Gradual increase in payments for therapy visits between thresholds
- A five equation model that provides for additional payments for episodes 3 and up¹
- Case mix adjustment for non-routine medical supplies
- Elimination of SCIC (significant change in condition) adjustment
- Add-on adjustment for LUPA only, or first episode LUPA claims
- 2.75% reduction in base payment rates 2008-2010 to adjust for PPS "creep", i.e. increases in average case mix weight due to factors other than changes in patient characteristics

Reimbursement Implications

Given (a) the complex interrelationship between the various and numerous changes to the rule, and (b) the likelihood that companies will adopt different behaviors — clinical, marketing, operations, and more — in response to them, the overall impact of the new rule, *if it is adopted as currently written*, will likely not be fully understood until late 2008. However, it is instructive to look at the macro analysis provided by CMS below:

According to the agency's analysis, *after factoring a 2.9% market basket update for 2008*, overall payments will *rise* a modest 0.95%, or approximately \$140M. In breaking down the data further however, while CMS projects an increase of 3.50% for free-standing, voluntary, not-for-profit agencies and a 3.56% increase for all not-for-profits (free-standing and facility based), the agency forecasts that free-standing,

| Source: CMS | Percent Change, from CY07, Current PPS, to CY08, Current PPS | Percent Change, from CY08, Current PPS, to CY08, Proposed Revised PPS | Percent Change, from CY07, Current PPS, to CY08, Proposed Revised PPS |
|----------------------------|--------------------------------------------------------------|-----------------------------------------------------------------------|-----------------------------------------------------------------------|
| Agency Type | | | |
| Unknown | 2.89% | -6.70% | -4.00% |
| Free Standing Vol/NP | 2.90% | 0.58% | 3.50% |
| Free-Standing Proprietary | 2.88% | -4.85% | -2.11% |
| Free-Standing Government | 2.86% | 0.51% | 3.39% |
| Facility-Based Vol/NP | 2.89% | 0.73% | 3.65% |
| Facility-Based Proprietary | 2.87% | 0.26% | 3.13% |
| Facility-Based Government | 2.86% | -0.23% | 2.63% |
| Subtotal Free-standing | 2.89% | -2.71% | 0.10% |
| Subtotal Facility-Based | 2.88% | 0.59% | 3.50% |
| Subtotal Vol/NP | 2.90% | 0.65% | 3.56% |
| Subtotal: Proprietary | 2.88% | -4.65% | -1.90% |
| Subtotal: Government | 2.86% | 0.17% | 3.04% |
| GRAND TOTAL | 2.89% | -1.88% | 0.95% |

¹Although CMS refers to a four equation model — (1) early episodes with less than 14 therapy visits, (2) early episodes with 14 or more therapy visits, (3) late episodes with less than 14 therapy visits, and (4) late episodes with 14 or more therapy visits, we note an entirely separate equation for all episodes (early or late) with 20 or more therapy visits. Accordingly, we view this as a five equation model.

proprietary agencies will see a 2.11% drop in reimbursement, and that all proprietary agencies — free-standing and facility based — will experience a 1.90% decline. CMS suggests that this is due, in part, to the fact that “LUPA episodes are relatively common among non-profit agencies and free-standing government-owned agencies. Our proposal for an additional payment for certain LUPA episodes would tend to increase payments for such classes of agencies with higher-than-average LUPA rates, while tending to decrease payments for agencies with comparatively low LUPA rates”. While CMS does not specifically address the impact of eliminating the 10 therapy visit threshold, the redistribution of therapy bonus payments is clearly designed to (a) reduce the behavioral “incentive” to reach this threshold, and (b) to distribute these incremental payments more evenly across a wider band of utilization, both of which could reduce reimbursement to those, generally for-profit providers, that have aggressively targeted therapy intensive populations.

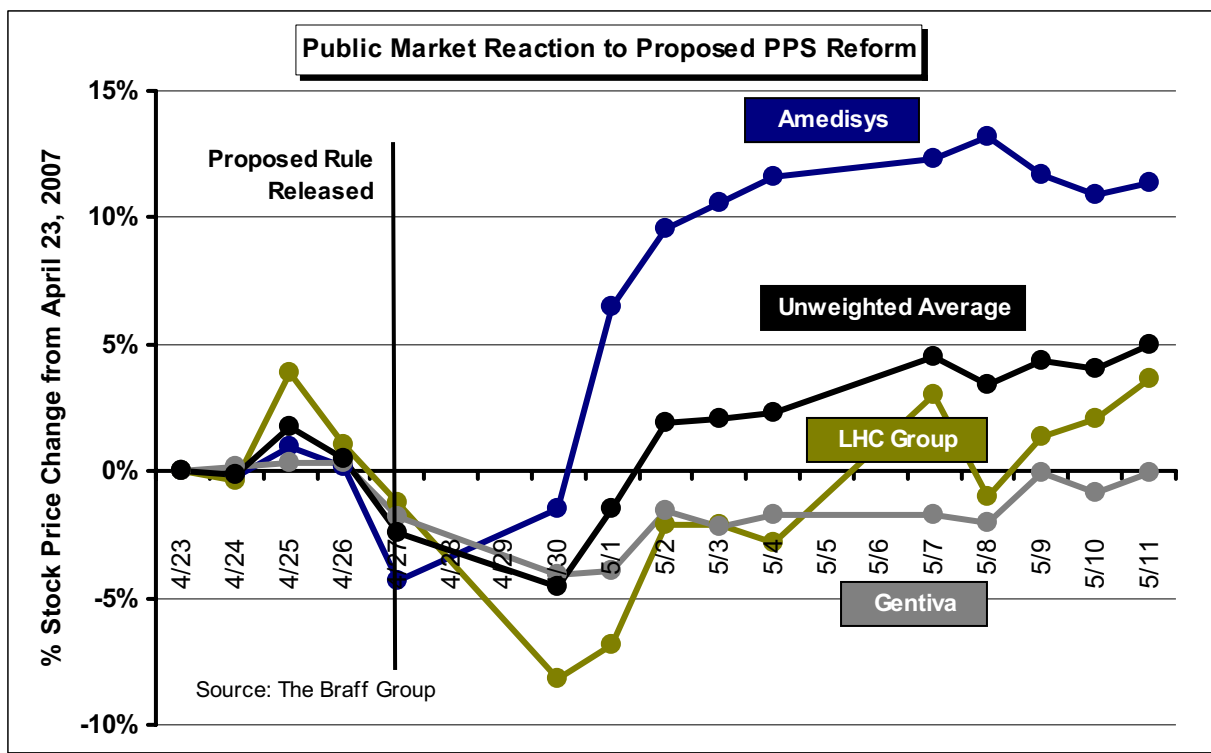
The above notwithstanding, we note that CMS figures reflect estimated changes in *total* spending — a *macro* analysis that we would expect includes a wide range of results. It comes as no surprise, then, that *home health line* recently reported that “Seattle benchmark vendor OCS’s [Outcomes Concept Systems] initial analysis of data from some 1,600 HHA locations indicates ‘agency-level per-episode reimbursement changing 20% in *each* direction’ [emphasis added]” depending on an agency’s unique patient characteristics. The take-away here? Financial impact will vary — plus *or* minus. More importantly, we expect that adept agencies will be able to adjust their business models, as necessary, to sustain performance.

Near Term Implications for Financial Returns, Merger and Acquisition Activity, and Valuation

- 1. Downward pressure on reimbursement has already been factored into M&A demand and valuation:** Budget neutrality notwithstanding, industry observers have long anticipated that PPS refinement would amount to a de-facto cut in reimbursement. Furthermore, buyers committed to Medicare reimbursed services recognize that they are investing in a market sector that, for the foreseeable future, will experience steady margin pressure. As such, after a string of no-cuts to Medicare home health that began with the initiation of PPS, reimbursement challenges have been fully expected — and factored into — acquisition demand and valuation.
- 2. The unexpected 2007 update softens the impact of the case mix creep adjustment.** Although the three year 2.75% case-mix creep adjustment was not anticipated, the 3.3% update for 2007 also came as a surprise, softening the impact of this change. Furthermore, we note that with CMS relying on a market basket update to sustain budget neutrality, we suspect there may be a greater likelihood that the update will survive in 2008 — and perhaps through 2010, a development that few, if any, buyers have even remotely considered.
- 3. At this time, the cuts to reimbursement for proprietary providers appear manageable.** Even if we allow for CMS calculations to be off by a *factor of two*, projected reimbursement cuts in CY 2008 for free-standing proprietary providers would be less than 5% (and less than 10% even if the 2.9% market basket update is eliminated). While such cuts are significant and may have an impact on service levels and patient access, under the current episodic reimbursement system which allows for substantial flexibility, creativity, and innovation to serve patients, we anticipate that providers will be able to adjust their operating and clinical protocols, and to deploy technology-based solutions to recover some, or all, of this lost margin. Furthermore, as suggested above, even if the revised rules have a more significant downward impact on certain agencies that service certain types of patients, i.e. those with diagnoses of subcutaneous skin ulcers, hypertension, diabetes, and CVA (source: Strategic Healthcare Programs), within the context of their mission (for-profit, not-for-profit, etc.), we expect that agencies will adapt their marketing strategies to develop a more favorable patient mix.
- 4. Any reduction in margins will be accompanied by a reduction of risk, thereby sustaining valuation.** Buyers have almost universally “discounted” the value of high profit margin, high therapy providers, to account for the perceived risk of specializing in this service sector. With the elimination of the 10 visit therapy threshold in favor of three thresholds of 6, 14, and 20, as well as the provision of incremental payments for visits between thresholds, revenues for therapy patients are more evenly distributed. Hence there is less incentive to “game” the system and less perceived exposure to government oversight, substantially reducing risk — a key variable in assessing value. As a result, we expect that any fall-off in revenues and profits for high therapy providers will be off-set by an increase in valuation multiples, reflecting this lower risk.

5. The reaction of the public markets reflects confidence in the sustained value of home health care.

As the accompanying chart indicates, if we look at the change in stock market prices for Amedisys (NASDAQ:AMED), LHC Group (NASDAQ:LHCG), and Gentiva (NASDAQ:GTIV) from the week prior to the release of the proposed rule (to account for any market reaction in anticipation of its official release) through the 10 trading days after the announcement, we can clearly see that while each was down in its immediate aftermath, all have since recovered. Moreover, perhaps due, in part, to one market analyst's report on Amedisys suggesting (with appropriate and due caution) that under their existing, i.e. most realistic modeling, Amedisys may actually see an increase in revenues per episode, the firm's stock price surged more than 10% reaching a 52 week high on May 8th. Such returns bode well for the continued merger and acquisition strength of the sector, as buyers (particularly private equity groups that continue to target home health) frequently take their investment — and valuation — cues from the public markets.



- 6. PPS reform may serve as a hedge against further cuts over the near term.** Given that under a best-case scenario PPS reforms will go into effect no earlier than January 1, 2008, and that it will likely take substantial time thereafter — at least 12-24 months — for CMS and the industry to fully assess the financial and clinical impact of these measures, we would expect that Congress will show due caution in initiating any further reimbursement cuts during this transitional period.
- 7. Reforms may stimulate increased transaction volume.** Again, although it would appear that these refinements will be manageable, after seeing market values for home health agencies plunge after the initiation of the Balanced Budget Act of 1997, we expect that PPS reform will spur a number of providers to go to market. With current acquisition demand far exceeding current supply however, we do not anticipate a supply imbalance that could put downward pressure on valuation — at least yet.
- 8. It is a proposed rule that may, in fact, change.** While buyers are closely following PPS reform initiatives, given that the first read is that they are workable, with so many unknowns in a market where risk is ever present, the prevailing attitude at this point appears to be "business as usual". As such, we have not seen any meaningful change in acquisition strategies, demand, or valuation.

In consideration of all the above, while the proposed rule is a source of concern, we expect the Medicare home health merger and acquisition market — which has surged dramatically over the past three years — to remain vibrant over the near term.

About The Braff Group

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In 2006 the firm was awarded 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 Canadian Valley Medical Solutions - the third consecutive year The Braff Group has received this award. The firm was also recognized as a finalist for Boutique Investment Banking Firm of the Year in 2005 and 2006. The Braff Group has also been honored as one of the fastest growing companies in the Pittsburgh Region by the Pittsburgh Business Times.



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