

# Why You May Have a Rooting Interest in Publicly Traded Competitors

BY DEXTER W. BRAFF



It's been a run for publicly traded home health providers. Unless you are a shareholder though, far from a rooting interest, we've sensed quite a bit of hand-wringing that such strong performance will draw unwanted attention from Congress, MedPac, and CMS. The kind of attention that fuels talks of reimbursement cuts. Not to mention angst that burgeoning publicly traded firms threaten the very existence of local and regional providers.

**The Record.** Over the nearly five years we have compiled The Braff Group Index, which monitors public company performance in seven health care service sectors, home health and hospice has consistently been a top performer. Moreover, in July 2005, our home health and hospice index closed at a record high 501.7 (all sectors were indexed to 100 on February 29, 2000); a record not only for the sector but *a record for every sector we track*. Furthermore, around the same time, LHC Group of Louisiana successfully completed the first home health care Initial Public Offering since 1996, and has since seen its shares rocket 40 percent above its offering price<sup>1</sup>. Valuation metrics for the publicly traded firms are also climbing. Since 2002, median Market Value of Invested Capital (MVIC) to

Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) has risen relatively steadily from around five times EBITDA in 2002 to about seven times EBITDA. Moreover, Medicare focused providers, Amedysis and LHC Group, have realized attractive

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MVIC to revenue valuations of 2.2<sup>2</sup>.

**The Concerns.** There is no doubt that those who fashion health care reimbursement policy monitor the performance of publicly traded firms. But, for the most part, these observers understand that the performance of these firms is not necessarily a reflection of the industry as a whole.

Those who look beyond the numbers recognize that publicly traded firms have very different agendas, and serve very different constituents than hospital based providers and not-for-profits (which, not surprisingly, tend to have substantially lower margins). They also recognize (perhaps reluctantly) that home health is part of the solution to curbing health care expenditures, a solution that must be supported by health care economic policy that creates favorable economic opportunities for the industry. In fact, CMS hinted at this very need in its landmark “Home Health Industry Market Update” released about two years ago in which it stated that “HHA companies continue to have difficulty raising capital primarily due to their small size. Wall Street analysts suggest that investors will be more inclined to provide capital once government payment policy provides more stability and predictability”. The MMA did just that – creating reimbursement stability and predictability that has, in large part, put the industry in a position where it can deliver on its socio-economic promise.

Regarding the publics as a threat to other providers, we steadfastly believe that there will always be a place for strong local and regional providers, that, by their very nature, tend to have competitive advan-

<sup>1</sup> As of August 23, 2005    <sup>2</sup> Source: Capital IQ

tages such as flexibility, ability to react swiftly to changes in market conditions, a “blood, sweat, and tears” commitment that comes with owner vs. employee management, and the mere fact that Nationals must continually work to overcome the assumption (true or not) that big means just the opposite of the above: impersonal, inflexible, and slow to adapt.

**The Benefits.** It’s one thing to accept that perhaps it’s not so bad that the publics are doing well. It’s quite another to root for them. Here are two reasons why you may want to.

**1. As the publics’ fortunes go, so does the access to capital.** The capital markets – both debt and equity – take their cues, in part, from public market performance. So as the performance of the industry improves (as measured by the highly visible financial metrics of publicly traded firms), so does the access to capital to fund growth and expansion (as CMS suggested).

On the debt side, lenders are increasing the total amount of debt they are willing to lend (i.e. “debt capacity”) based upon a firm’s EBITDA. In so doing, many are showing greater willingness to provide unsecured debt; that is, debt that

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is not collateralized by the firm’s assets (principally accounts receivable), but is rather “secured” by a firm’s cash flow potential. While lenders generally prefer to lend large dollar amounts to larger firms, the opening of the debt markets has also trickled down to smaller providers.

On the equity side, private equity groups (PEGs) are increasingly looking at home health in which to pursue a classic invest, build, and divest strategy, a strategy that is increasingly appealing given the valuation metrics of firms like Amedysis and LHC Group.

**2. As the publics’ fortunes go, and the access to capital goes, so does valuation and the opportunity to divest.** The public markets, access to capital, and merger and acquisition activity are inexorably

linked. With the opportunity for large firms to realize substantial investment returns upon exit via an initial public offering (which, post LHC now appears substantially more viable) or divestiture to an even larger player, substantial portions of debt and equity capital are being deployed to fund acquisitions. This has spurred demand, which, in turn, has led to increases in valuation. Furthermore, as the market valuations of publicly traded firms increase, so does the opportunity for buyers – both publicly traded or not – to pay greater prices and still generate favorable “arbitrage” (i.e. buy low and sell high) upon exit. And as acquisition strategies mature from the current focus on platform sized entities to smaller add-on firms, such favorable opportunities will spread throughout the entire industry. 

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