Why the Home Health Public Markets Stumbled

By Dexter W. Braff

With sustained growth, record financial performance, a reasonably benign reimbursement climate, and the prospects of an update in 2009, the Home Health sector posted extraordinary gains in 2008 while the rest of Wall Street declined. But how quickly things have changed. In the first two months of 2009, The Braff Group's Index of Home Health and Hospice providers has fallen 42 percent, giving up virtually all of the gains it achieved in 2008.

Why the sudden "about-face" in Wall Street's perception of home health care? The operative word is fear. Fear of the unknown – uncertainty; and taken together, an up-tick in risk.

Consider that in the last three months, in addition to its recommendation to eliminate the annual update, MedPAC floated a direct cut to episodic reimbursement, settling instead on a recommendation to accelerate the scheduled 2011 "creep" adjustment to 2010. Add to this President Obama's budget recommendation to cut Medicare home health spending $37 billion over 10 years, and the rout was on.

What is so critical to understand here is that even though as of this writing none of these proposals have made it into law, the mere possibility of any or all of these reimbursement challenges has been enough to drastically shake investors' confidence in Medicare home health.

> "... the fact that home health is still seen as a significant part of the solution to out-of-control health care spending, we anticipate that the industry will likely not bear the full brunt of all of the proposals on the table.

And to a certain extent, we understand. Our sense is that the market substantially over-reacted to MedPAC's pronouncements. Inasmuch as MedPAC has consistently recommended the elimination of the home health update, it is unlikely that investors had not already modeled a "no-update" vote for 2009 – and the foreseeable future. So the only real surprise was the acceleration of the 2011 creep adjustment. Since this cut was already known, the acceleration amounts to a one-year revenue adjustment – an adjustment that, from a practical perspective, has little impact on valuation.

The big shocker came from Obama's budget proposal which, in addition to including MedPAC's recommendations, goes further to reduce spending by possibly re-basing episodic base rates, creating "profit corridors," and introducing bundled payments to hospitals.

Given the complexity of calculating reimbursement base rates, (especially in light of the fact that (a) the new base will be driven off 2007 cost reports, that (b) have dramatically declined in accuracy since the initiation of PPS, and (c) don't include many real costs, such as telehealth), this proposal is cause for substantial concern. Even more problematic is the prospect of profit corridors, which would not only artificially cap profits at some pre-determined rate, but would subject the industry to greater and invasive financial and bureaucratic oversight.

Finally, a potential "game-changer" is the aggregating of all hospital, physician, and post acute services (for the first 30

days post discharge) into a single, bundled payment. Not only does this put the hospital in the position of contracting with home health agencies much like a managed care provider does (i.e. with potentially limited utilization and reimbursement), but also may encourage more hospitals to open competing agencies as a way to reduce costs and capture greater profits.

Given all the above, we nevertheless remain bullish on the sector. First, given the extraordinary goodwill the industry has garnered in Congress and the fact that home health is still seen as a significant part of the solution to out-of-control health care spending, we anticipate that the industry will likely not bear the full brunt of all of the proposals on the table.

Second, much like the market has likely anticipated no updates over the near term, we expect that all but the most optimistic of investors have considered – and modeled either explicitly or implicitly, rate cuts over the near term. As such, while recent news comes as somewhat of a surprise (partly because of expectations that an Obama presidency might be more benevolent to Medicare), it should not be completely unexpected. So the initial market response is likely more a function of an immediate, emotional reaction that will likely give way to more tempered financial analysis.

Third, should reimbursement decline, we anticipate that providers will be able to reengineer their operations to recapture substantial lost margins. Finally, whatever proposals are agreed upon, their impact will be felt over time. In the immediate aftermath, many of the publicly traded companies will continue to post record revenues and profits given their successful acquisition and integration strategies.

The above notwithstanding, to restore confidence, investors crave certainty. Be it good news or bad, as long as the investment community believes that reimbursement has been more or less, settled for the near to mid term, we expect the home health market to slowly but surely rise again. If fear lingers that additional cuts are inevitable and near term, the sector may remain in a prolonged rut.

About the Author: ***Dexter Braff*** *is president of The Braff Group, 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. The firm provides an array of transactional advisory services including sell side representation, debt and equity recapitalizations, strategic planning, and valuation. He can be reached at 888-922-5169, dbraff@thebraffgroup.com, www.thebraffgroup.com.*