the braff group

perspectives

1st Quarter 2005

A health care merger & acquisition quarterly

M&A Quarterly Update

First Quarter Transaction Volume up 16% on Strength of 44% Surge in HME Sector

The Home Medical Equipment sector got off to a roaring start in 2005 with 26 transactions — up 44% over the fourth quarter of 2004. With a total of 57 deals across all sectors, total transaction volume was up 16% over last quarter and 4% over the same period last year.

There were several deals of particular interest during the quarter.

Most notable was the announcement of a $2.2 billion acquisition of specialty pharmacy service (SPS) provider **Accredo Health (NASDAQ: ACDO)** by **Medco Health (NYSE:MHS)**, a pharmacy benefit management (PBM) company. The deal is noteworthy not only given its size, but also because it represents yet another PBM/SPS transaction; further evidence of the thinning boundaries between pharmacy benefit management and specialty pharmacy — a blending of services that also extends to home infusion therapy (for more information on this trend, request a copy of *M&A Market Watch: Infusion Therapy and Specialty Pharmacy*).

In its second transaction with the same company, **Amedisys (NASDAQ:AMED)** announced the acquisition of various home health care assets and affiliates of privately held **Winyah Health Care Group** of South Carolina. Based on a press release issued by Amedisys, the aggregate purchase price of cash, stock, and notes came to about 1 times revenue — noteworthy in a market sector in which there has long been a culturally rooted, artificial, yet strong cap on valuation holding pricing below one times revenue (for comparison purposes, consider the Home Medical Equipment and Specialty Rx sectors where valuation-revenue caps tend to be in the 1.5 to 2.0 times revenue range, a convention that is only partially explained by somewhat higher profitability). We have long pointed out that such a cap has held pricing to levels below that which the risk-return fundamentals of the industry would suggest. Furthermore we have predicted that increased confidence in long term prospects of the industry as well as increased competition from a growing number of buyers interested in the sector would begin to drive values up to, and beyond, this pricing cap as an individual

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Merger and Acquisition Transaction Volume

Sector	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005	Q1 '05: Q1 '04	Q1 '05: Q4 '04
Home Medical Equipment	21	31	20	18	26	24%	44%
Home Health Agencies	12	8	16	18	15	25%	-17%
Specialty Pharmacy	2	4	3	3	3	50%	0%
Infusion Therapy	3	4	4	0	3	0%	NA
Hospice	4	5	3	3	3	-25%	0%
Staffing	13	9	7	7	7	-46%	0%
Total	55	61	53	49	57	4%	16%

Prior period data is updated as new information becomes available, accordingly chart may differ from previous editions of Perspectives. Excludes deals where quarter is unknown.

Inside this issue:

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Industry Spotlight: Non-Medicare Home Health

Given critical differences in services, operating strategies, market dynamics, etc., in order to best understand the non-Medicare home health market, it is necessary to further segment the industry into "Private" and "State Funded" home health.

Private Home Health

Broadly speaking, private home health providers specialize in skilled and non-skilled "shift care" – typically durations of 4, 8, and 24 hours (round-the-clock) – which is reimbursed through private "out-of-pocket" pay and private insurance. This segment also includes privately reimbursed non-medical home care services.

Unique Attributes

What makes this sector so unique is that it is highly consumer-driven. As such, private home health is likewise an extremely relationship and service-driven business model that tends to require substantial day-to-day and customer-to-customer management involvement and oversight. Accordingly, this sector generally tends to be less scaleable than other home health care sectors (particularly those that focus on state funded services as described below). No surprise then that according to a survey conducted by *Private Duty Insider*, the median size of a private agency in 2004 was $1.5 million.

Implications for M&A

Because these firms tend to be relatively small – and highly owner dependent – it is extremely difficult to execute a classic national or regional "roll-up" acquisition strategy and complete enough transactions to get to a critical mass of $50 to $100 million or more – the size buyers want to achieve in order to realize lucrative size premiums upon exit. Accordingly, there are a limited number of "pure-play" private home health consolidators.

Strategies and Valuation

Rather, an acquisition strategy that is rapidly emerging is one in which larger $20-25 million dollar Medicare certified agencies – including those from the not-for-profit arena – are leveraging their platform infrastructures and targeting private providers within their coverage area to (a) diversify their payor mix as a risk reduction strategy and (b) gain market intelligence and experience in a sector that is poised for substantial growth (This is due, in part, to health care policy initiatives that will give rise to a shift in spending from Medicare to managed care plans administered by private insurance companies). With an increasing number of firms that have historically focused on developing their Medicare services nearing critical mass, we anticipate moderate, yet steady growth in demand for private home health providers. In combination with the rise in valuations for Medicare certified agencies, which serves as a reference point for — and substantially influences — all other home health transactions, we expect that values for private home health providers will continue to rise slowly, but steadily, over the near term.

"Buyers are beginning to target private home health providers within their coverage area to (a) diversify their payor mix as a risk reduction strategy and (b) gain market intelligence and experience in a sector that is poised for substantial growth"

State Funded Home Health

As the name would suggest, state funded home health providers focus principally on services reimbursed primarily though Medicaid waiver and other state and local funded programs. While skilled services may be part of the mix, the programs tend to offer predominately non-skilled home health aide, companion or homemaker services to a large number of beneficiaries. So unlike the private home health providers discussed above, state funded companies can often be quite large, with many in densely populated markets reaching sizes of $40 million and up. That said, while reimbursement for specific pro-

grams in certain states remains quite favorable, with states straining under the pressure of increasing Medicaid expenditures, such high volume typically comes at the expense of increasingly tight margins.

Recent Developments

Several key developments have put the sector in flux over the past 6-12 months. On a positive note, according to a Kaiser Foundation report, after two consecutive years of decline, state tax revenues grew 3.4% in 2004 and are expected to increase again in 2005. "Fewer states in FY 2005 (which begins in 2004) took new actions to control prescription drug costs, cut or freeze provider rates, reduce or restrict eligibility or benefits, or to increase beneficiary co-payments." The report even suggests that "some states have plans to restore previous Medicaid cuts or actually expand programs in FY 2005." Furthermore, in December the National Governors Association reported that, overall, the states reported budget surpluses of 4.8% (5% is considered healthy), up 50% from last year's surplus of 3.2%[1]. However on April 28th, 2005, Congress approved a budget resolution calling for $10 billion in Medicaid cuts over five years starting in fiscal year 2007 (an amount that, while sounding ominous, translates to a reduction of merely one half of one percent of the more than two trillion dollars in total projected Medicaid spending over the period according to the 2005 National Health Expenditures report). Back on the upside, the states are increasingly recognizing that perhaps the most promising solution to the Medicaid spending crisis is to "rebalance" expenditures from long term care to substantially less expensive "community based services" i.e. home care[2]. Simultaneously though, self directed care models that typically give Medicaid patients the control to pick their own caregivers – with the option of hiring family members, friends, and others – and the funding to pay for them continues to gain traction; a development that could siphon off some of the gains that may accrue through rebalancing initiatives.

Although a mixture of positive and negative developments, on balance we are more bullish on state funded programs than we have been in years. Deficits and consumer directed care notwithstanding, home care is extraordinarily well positioned to capture Medicaid dollars as they are re-routed to community based alternatives.

M&A Outlook Improving

Given the above, the M&A market for state funded home health which has pretty much been in a free fall over the past several years, appears to be stabilizing — and is beginning to show signs of a rebound.

In particular, we note that as investors become more comfortable with the long term prospects for the sector, we are seeing select buyers specifically target large Medicaid providers to capture a revenue base, operating infrastructure, and management team that is perhaps the most experienced in (a) recruiting and retention and (b) operating under tight margins — skill sets required to succeed over the long term in home health care (In a related development, at a recent Health Care Merger and Acquisition Conference we attended, we noted that while private equity groups generally shunned government reimbursed healthcare sectors in the past, several PEGs indicated that the ability to understand and manage through the ever-changing government reimbursement climate represents a significant "barrier to entry" which makes these firms more attractive acquisition candidates). With an infrastructure in place, their strategy is to then layer on additional Medicare or private services through acquisitions and start-ups – the ultimate goal of which is to create a fully diversified home care company.
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"Deficits and consumer directed care notwithstanding, home care is extraordinarily well positioned to capture Medicaid dollars as they are re-routed to community based alternatives"

[1]Excerpted from the 2004-2005 M&A Annual Report published by The Braff Group, February 2005.
[2]In fact, Val Halamandaris, President of the National Association for Home Care & Hospice recently gave a keynote address to the National Governors Association advising attendees regarding the opportunities to reduce Medicaid expenditures through greater utilization of home care services.

The Braff Group Index

	Broad Market Average	HME	HHA & Hospice	Specialty RX & IV	Health Care Staffing	Hospitals	Long Term Care	eHealth	TBG Compos-ite	Spread
Q2 04	76.7	270.8	423.1	181.9	164.8	204.4	322.4	58.1	230.0	153.3
Q3 04	73.8	217.9	399.4	140.9	155.3	180.6	305.8	58.0	207.9	134.0
Q4 04	80.5	404.2	446.9	160.6	182.0	194.5	382.5	69.2	254.6	174.0
Q1 05	77.6	420.2	425.5	160.9	157.7	236.1	412.9	64.6	257.9	180.3
Change	**-3.7%**	**4.0%**	**-4.8%**	**0.2%**	**-13.4%**	**21.4%**	**7.9%**	**-6.6%**	**1.3%**	**3.6%**

While the Broad markets sagged 3.7%, the TBG Composite index inched upwards 1.3%, closing at a new all time high. The results were mixed across the sectors however with those posting gains slightly outnumbering those on the decline by 4 to 3. Leading the way was the Hospital group which surged 21.4%, in part, on good news from HCA (NYSE:HCA) regarding increased numbers of insured patients and reductions in bad debt, and Long Term Care, which rose 7.9% despite continued discussions on RUG refinements, perhaps on news of financial buyers' continued interest in acquiring Beverly Enterprises (NYSE:BEV).

The Braff Group Index measures the stock performance of 38 companies in seven key health care service sectors. The Composite includes all the companies in the index. The spread represents the difference between the Health Care Composite and the Broad Market Averages. All stocks were indexed to 100 on February 29, 2000.

Q1 Public Company Performance and Valuation Benchmarks

Sector	HME	HHA	Hospice[1]	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	**29.40**	**8.70**	**10.60**	**2.40**	**6.40**	**10.43**
Median EBITDA %	**29.20**	**7.60**		**2.80**	**7.20**	**7.00**
Mean MVIC : Revenues[2]	**1.98**	**0.69**	**1.15**	**0.71**	**0.83**	**1.20**
Median MVIC: Revenues	**1.62**	**0.43**		**0.60**	**0.94**	**0.94**
Mean MVIC : EBITDA[2]	**6.44**	**7.34**	**18.55**	**19.59**	**12.13**	**15.61**
Median MVIC: EBITDA	**5.85**	**7.23**		**18.71**	**12.29**	**9.64**

Public Company Performance and Valuation Benchmarks are based on 22 publicly traded companies. MVIC equals Market Value of Invested Capital (total shares outstanding x stock price less cash plus non-working capital interest bearing debt).[1]Two firms included in the sector, therefore mean and median calculations are the same. [2]Figures reflect valuation ratios.

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While we do not expect to see consolidators focus exclusively on state funded home health, nor do we expect to see a flurry of activity in the sector, we do anticipate that buyers will once again give due consideration to these acquisition opportunities, especially as suggested above, as part of an overall service diversification strategy.

One final note. Given the rebalancing initiatives suggested above, many long term care providers are progressively looking to acquire home care and hospice companies as a defensive strategy. Interestingly — and perhaps counter-intuitively — these buyers are currently targeting the Medicare market to capture greater margins. This bears watching as Medicaid policy discussions continue to unfold.

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company's profits, growth opportunities, and unique circumstances warrant (in this transaction, we suspect that Winyah's certificates of need may have contributed substantially to the value of the deal). As this transaction would suggest, as well as discussions we are having with buyers every day, this price limiting "ceiling" is beginning to chip away.

One final deal of note. While the **VNA of Boston's** acquisition of **Senior Care Alternatives** was relatively modest in size, it represents the emerging trend discussed in this issue's industry spotlight — large certified providers targeting private home health providers to increase their knowledge of the sector and diversify their service and payor portfolios.

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