

perspectives 1st Quarter 2006

A health care merger & acquisition quarterly

M&A Quarterly Update

Transaction Volume Declines 35% in Q1 2006 to its Lowest Level in Four Years

The year got off to a rocky start with 38 transactions, down 35.6% from the 59 deals in Q4 2005 and down 39.7% compared to the same quarter last year. Only one sector — infusion therapy — posted meaningful gains. To put this fall-off in perspective, the last time we tallied fewer than 38 transactions was in the first quarter of 2002 with 29.

Interestingly, while we expected a fall-off in activity in the home medical equipment sector (more on this below), the 22% decline in deal volume compared to Q4 2005 was somewhat less than we expected. The big surprises were in home health and health care staffing, which experienced deal volume declines compared to last quarter of 57% and 70% respectively. As mentioned above, the only winner was infusion therapy which posted six transactions in the first quarter, up substantially over the two deals last quarter and three in the same quarter last year.

So what do we make of all this?

A sequence of known and anticipated events have emerged to increase the perception of risk across a wide swath of health care providers, including those in

home care.

Deficit Reduction Act

The first quarter of 2006 was set up in December with House and Senate versions of the Deficit Reduction Act (DRA) which was officially passed February 1st of this year. Among many other provisions, the DRA called for the following:

- Establishment of a 36 month cap on oxygen reimbursement, a key product for home medical equipment providers
- Elimination of the 2.8% update for Medicare home health providers scheduled to begin January 1, 2006
- One year reinstatement of a 5% rural add-on payment for home health providers in rural markets.

The President's 2007 Budget

A mere five days after the passage of the DRA, the President released his **2007** budget, which called for a tightening of the oxygen cap even further — to 13 months — and a continued freeze on reimbursement rates for home health providers at 2005 levels. While many observers believe that the reduced cap, and other proposed cuts to Medicare spending are (continued, page 2)

Inside this issue:

Given the fall-off in acquisition activity during the First Quarter of 2006, we have dedicated this edition of *Perspectives* to a discussion of the issues that may have lead to these results and what the implications may be for the rest of 2006

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First Quarter 2006 M&A Activity

Sector	4th Qtr. 2005	1st Qtr. 2006	% Change	1st Qtr. 2005	1st Qtr. 2006	% Change
HHA	21	9	-57.1%	17	9	-47.1%
Hospice	1	2	100.0%	3	2	-33.3%
Staffing	10	3	-70.0%	10	3	-70.0%
HME	18	14	-22.2%	27	14	-48.1%
Infusion Therapy	2	6	200.0%	3	6	100.0%
Specialty Pharmacy	7	4	-42.9%	3	4	33.3%
Total	59	38	-35.6%	63	38	-39.7%

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.

First Quarter 2006 M&A Analysis

(continued from page 1) “dead-on-arrival”, especially in an election year, other issues on the horizon are amassing to keep these threats alive.

A Changing Political Landscape

Regardless of one’s politics, as the President’s approval ratings continue to slide, the coming election could lead to a shift in power in Washington. Accordingly, there is a possibility that the 2007 Budget, which will likely be hammered out in earnest post-election, will be addressed by a “lame-duck” Congress with little to fear from the voting public. Add to this mix the fact that House Ways and Means committee chairman Bill Thomas is retiring at the end of the year. Historically a staunch critic of home care and an advocate of reimbursement cuts, there is substantial concern, especially with a “lame duck” Congress in tow, that Thomas’ “swan song” could be extremely problematic for the industry.

The Physician Wildcard

In addition to the mounting deficit that could be further burdened by the cost of Medicare Part D, physician reimbursement may complicate issues further. Physicians are scheduled to take a 4.6% cut in Medicare rates in 2007. They will be lobbying hard to get this cut, and other problematic reimbursement language, revised. Should they be successful — as many industry observers believe could be the case — Congress will need to find as much as an estimated \$3.3 billion in cuts (and perhaps more) to offset the give-backs and remain budget neutral.

The question then is how these issues may have impacted Q1 activity — and may continue to affect M&A activity throughout the year.

Home Medical Equipment

Even (a) after two years of substantial cuts in nebulizer and oxygen reimbursement and (b) competitive bidding set to

begin in 2007, the 36 month oxygen cap clearly laid to rest any notion that the industry had earned at least a brief respite from any further assaults on reimbursement. Moreover, while the 36 month cap is problematic in and of itself, to many observers, the greater concern is that it creates a new mechanism to further reduce reimbursement (and sure enough, as stated above, those fears were realized with the President’s 2007 budget proposal capping oxygen reimbursement at **13** months). While few observers believe the 13 month limit will prevail, it is not difficult to imagine Congress offering an easy compromise by “only” shaving 3, 6, 9, or even 12 months off the current cap.

Suffice to say that as we entered the first quarter, the tenor of the industry was one of substantial concern and strategic introspection, both of which contributed substantially to the decline in the number of transactions — though not as much as we anticipated. While the number of transactions completed by the Nationals declined 50% compared to Q4 2005, some of the slack was picked up by smaller regional players — albeit with smaller transactions.

In examining HME transaction activity over the past 5 quarters, it is clear that the fall-off in acquisition activity from the Nationals is not a one quarter event but rather part of an ongoing trend (see Exhibit 1). This would suggest that in addition to the issues described above, there are other issues in-play impacting their acquisition activity.

And indeed there are. Issues such as management re-organization. Strategic re-engineering. Focus on organic growth and others. From an M&A standpoint, this is good news. Because though the reimbursement climate looks to remain largely unsettled over the next six to nine months, many of these other issues are likely to be settled over the

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near term. Accordingly, while we do not expect a rebound in activity to the peak levels we saw in 2004, we do anticipate increased activity in Q3 and Q4.

Furthermore, we expect to see a change in the profile of "ideal" acquisition candidates, which heretofore have been firms focused predominately on Medicare oxygen. Not surprisingly, with reimbursement pressure focused squarely on this segment, we anticipate — and have already begun to see — buyers target firms that are somewhat more diversified. While a respiratory core is still preferred, it is a core with a greater breadth of respiratory services including CPAP and BiPAP and a greater breadth of payers beyond traditional Medicare. Additionally, we note increased selective interest in non-respiratory product lines including infusion therapy, diabetic, and other supplies to chronic populations.

Home Health Care

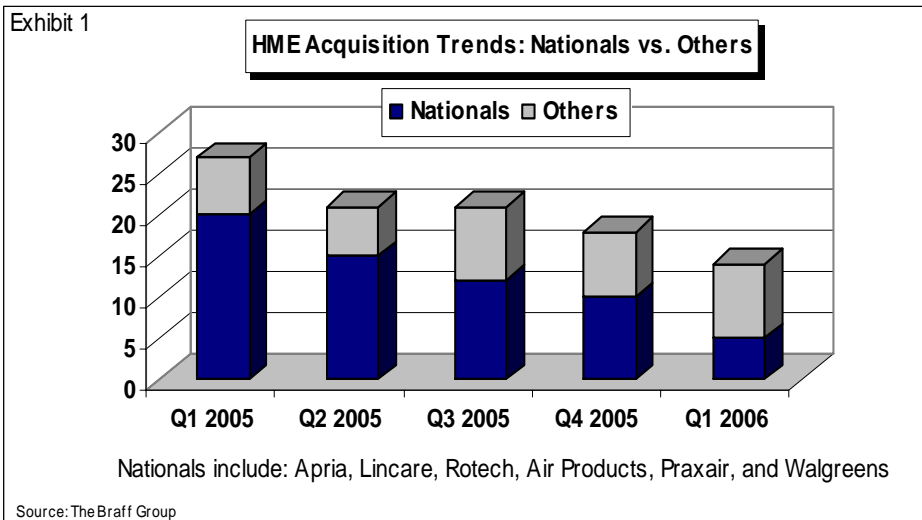
By far, the biggest surprise of the quarter was the decline in home health transaction volume, which fell 57% compared to last quarter and 47% vs. the same quarter last year. It is possible that the DRA and the President's budget proposal may have temporarily interrupted the dramatic surge of activity that began in earnest in 2005. We say temporarily because while the price freezes are certainly unwelcome, they

are far more attractive — and psychologically benign — than price cuts. And given the sustained interest in the sector that we are receiving from strategic and private equity buyers alike, our current read is that this fall-off is likely more of an anomaly than anything else.

Further supporting this observation is the fact that among the Q1 deals was **Gentiva Health Service's (GTIV: NASDAQ)** acquisition of **The Healthfield Group**, which, at a price of \$454 million, represents, to the best of our knowledge, the largest home health transaction completed in at least the past five years.

We do note however that given the changing political landscape and the physician wildcard discussed above, what occurs during the fourth quarter — particularly the two months post election when the 2007 budget will likely be finalized — may have a substantial impact on home health M&A activity through much of 2007. As we reported in our M&A Annual Report "arguably, acquisition demand, activity, and valuations may have accelerated too far, too fast, leaving the industry vulnerable to a market 'correction' wherein buyers 'over-react' to [even modest reductions in reimbursement]. This could send demand, activity, and valuations below (continued on page 4)

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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.

The Braff Group Index

	Broad Market Average	HME	HHA & Specialty Hospice	Specialty RX & IV	Health Care Staffing	Hospitals	Long Term Care	eHealth	TBG Composite	Spread
Q2 05	77.5	357.2	470.2	156.2	157.3	259.5	463.0	70.2	269.8	192.3
Q3 05	80.0	396.1	490.6	142.3	115.8	219.6	511.6	87.5	280.5	200.4
Q4 05	81.4	330.4	491.5	115.1	119.7	204.2	563.2	90.0	275.4	194.0
Q1 06	84.8	326.2	486.6	119.9	125.1	193.8	643.5	100.8	285.3	200.5
Change	4.2%	-1.3%	-1.0%	4.1%	4.6%	-5.1%	14.3%	12.0%	3.6%	3.3%

Long Term Care continues to shine, ending the quarter up 14.3% and reaching a new record high for the fifth consecutive month. Also up double digits was eHealth, which, for the first time since each sector was indexed to 100 on February 29, 2000, closed above the 100 mark. It has been a long road back for eHealth, but with substantial resources being devoted to electronic medical records and other technology-based solutions to curb health care spending, the sector may continue to surge. Also of note, any fall-out from the passage of the Deficit Reduction Act on the Home Health and HME sectors appears to be relatively contained, as each fell only a modest 1% during the quarter.

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 %	22.60%	8.90%	9.70%	3.60%	4.20%	9.41%
Median EBITDA %	19.90%	7.50%		2.50%	4.30%	7.10%
Mean MVIC : Revenues ²	1.67	0.81	1.16	0.86	0.95	1.05
Median MVIC: Revenues	1.24	0.49		1.05	1.01	1.03
Mean MVIC : EBITDA ²	6.98	8.96	12.43	20.55	19.86	12.23
Median MVIC: EBITDA	6.60	9.82		18.17	19.86	10.36

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).¹Two firms included in the sector, therefore mean and median calculations are the same. ²Figures reflect valuation ratios.

(continued from page 3)
where they "should be" just as rapidly as they rose. In time, equilibrium would be restored. But should this occur, market timing will become increasingly critical for prospective sellers looking to catch "the wave".

Health Care Staffing

With (a) the health care staffing industry recording revenue growth in 2005 after consecutive years of declines, (b) projections for continued growth in 2006 and 2007 and (c) substantial increased interest in firms that provide allied and locum tenens services, the 70% decline in transaction volume in both Q1 2006 vs. Q4 2005 and Q1 2006 vs. Q1 2005 was nearly as surprising as what we observed in home health. As we are unaware of any other factors that would explain such a decline, this is also likely an anomaly. That said,

unlike what we have seen in home health, the rebound in health care staffing M&A activity that began in 2004 has been substantially comprised of opportunistic, value-driven transactions, and as such, may be somewhat more fragile and unpredictable. Accordingly, this sector bears close scrutiny over the coming year.

Infusion Therapy.

As suggested above, infusion therapy is the only sector that played to form in the first quarter, posting meaningful gains with six transactions. We expect this trend to continue as acquirers look to capitalize on anticipated market growth, the potential of an explicit Part D benefit, expanding opportunities in "specialty infusion", diversification away from Medicare, and a market buoyed by overall enthusiasm regarding increased utilization of pharmaceuticals.