the braff group

perspectives

1st Quarter 2007

A health care merger & acquisition quarterly

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M&A Quarterly Update

Home Health, Hospice, and Infusion Therapy Post Gains: Aggregate Deal Volume Declines

Results were mixed for health care service merger and acquisition activity for the first quarter of 2007. While total deal volume for home health, hospice, staffing, home medical equipment, infusion therapy, and specialty pharmacy was down 14% versus the 4th quarter of 2006, and down a modest 4.5% versus the same period last year, certain sectors recorded meaningful gains.

Notably, the **home health sector** remains extremely robust with 22 deals announced and or completed this quarter, compared to 24 transactions last quarter and up an extraordinary 83% over the same quarter last year. In particular, it was a busy quarter for **LHC Group** (NASDAQ:LHCG) and **ResCare** (NASDAQ:RSCR) which acquired three home health providers each, including ResCare's acquisition of $55 million **Kelly Home Care Services**. Also of note was **Jordan Health Services** acquisition of **Chartwell Home Care**. The transaction was significant in that it represents (a) yet another acquisition of a large Medicaid provider, further demonstrating the resurgence of this sector (see *M&A Market Watch: Private Pay and State Funded Home Health Providers*), and (b) private equity's continued interest in the sector as the transaction was accomplished in partnership with **Trinity Hunt Partners**, a Dallas based private equity group (PEG) affiliated with the **Lamar Hunt** family.

Additionally, we note a meaningful surge in activity in the **hospice arena**, with six deals in the first quarter of 2007, up from three last quarter and two transactions during the same period last year. Moreover, the nature of the transactions this quarter is emblematic of an emerging trend we have seen over the recent past. While hospice M&A activity has traditionally been dominated by publicly traded hospice providers and private equity groups, we are seeing increasing acquisition activity from non-hospice providers. Notably, in the first quarter, three of the six transactions were completed by *home health* firms **Amedisys** (NASDAQ:AMED) and **LHC Group**, both of which are seeking to expand their services beyond traditional Medicare home health (see page 2 for more on this and other developments in hospice mergers and acquisitions).

It was also a strong quarter for the **home infusion therapy sector** with five transactions, up from only one deal recorded last quarter. Moreover, similar to what we are (*see Update, page 4*)

First Quarter 2007 M&A Activity

Sector	4th Qtr. 2006	1st Qtr. 2007	% Change	1st Qtr. 2006	1st Qtr. 2007	% Change
HHA	24	22	-8.3%	12	22	83.3%
Hospice	3	6	100.0%	2	6	200.0%
Staffing	6	3	-50.0%	4	3	-25.0%
HME	12	5	-58.3%	15	5	-66.7%
Infusion Therapy	1	5	400.0%	7	5	-28.6%
Specialty Pharmacy	3	1	-66.7%	4	1	-75.0%
Total	**49**	**42**	**-14.3%**	**44**	**42**	**-4.5%**

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.

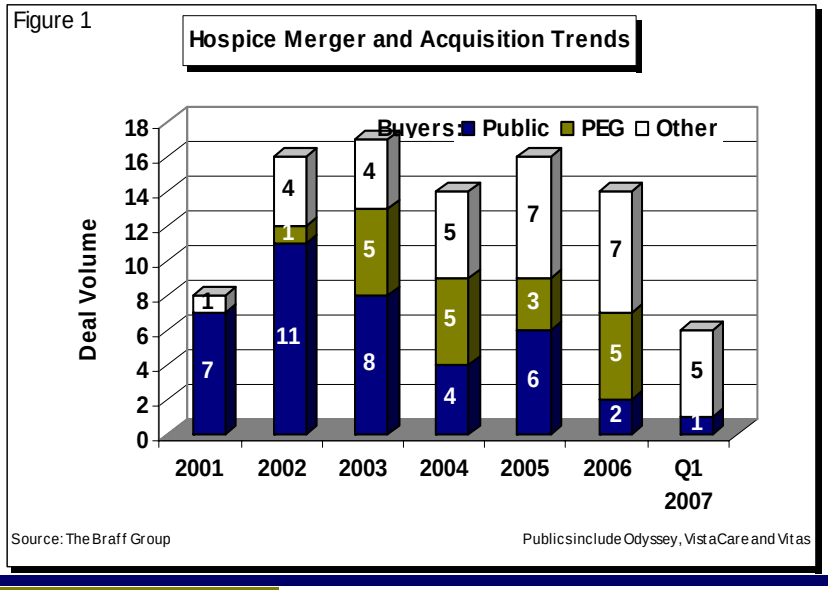
Hospice

"Hospice expenditures are expected to outpace the growth in spending projected for hospital, physicians, skilled nursing facility, and home health services"

As is quite evident from Figure 1 below, since the dramatic surge in hospice merger and acquisition activity between 2001 and 2003, total transaction volume has been relatively stable over the past five years. This is not, however, a function of a mature, static market. Far from it. As we discuss below, much has changed over the recent past — some depressing M&A activity, some fostering it — such that the net change in deal volume during the period has been minimal. As the market continues to evolve, however, we may be on the precipice of another surge.

Extraordinary growth in hospice programs and services. In 2002, the government sought to increase the awareness — and utilization — of hospice programs. In May of that year, then CMS administrator, Tom Scully sent a letter to the major National Medical Associations to engage "the physician community, as well as other health care professionals, [to] think more about hospice as they care for terminally ill patients." This came shortly after CMS published an article entitled, "End-of-Life Care Enhances Dignity and Peace As Life Nears Its End" which appeared in *The Physician Executive*; *Caring Magazine*; and *McKnight's Long-Term Care News*. Not surprisingly, this ushered in a period of substantial, and sustained increases in hospice utilization and new providers. According to MedPac in its 2006 Report to Congress on the Hospice Benefit, $9.8 billion will be spent on hospice in 2006, up 46.3% over the $6.7 billion spent in 2004. Moreover, the agency reported that "Hospice services' spending is projected to increase at an average rate of nine percent per year from 2004 to 2015. This rate outpaces the growth in spending projected for hospital, physicians, skilled nursing facility, and home health services".

Figure 1



Source: The Braff Group

Publics include Odyssey, VistaCare and Vitas

Such heady growth prospects, in turn, stimulated acquisition demand, first from publicly traded hospice providers looking to bolster their market coverage (2001-2003), and then from private equity groups (PEGs), initially attracted to the extraordinary run-up in stock price and market value the public providers were enjoying through 2003.

The Publics Stumble. The growth in M&A activity may have continued if not for the challenges several publicly traded providers began to face in 2004. After run-ups in stock price of more than 125% in 2003, both Odyssey and VistaCare saw their market values plunge in 2004, primarily due to difficulties in managing cost caps which had a direct impact on revenues, growth, and profitability. Three years later, with these and other challenges continuing to vex these providers, stock prices remain below January 2003 levels. More importantly from a merger and acquisition perspective, with their attention focused inward, since dominating the acquisition scene from 2001 to 2003 with a peak of 11 transactions in 2002, their influence has subsided substantially — accounting for only 2 deals in 2006 (see Figure 1).

Private Equity Groups. As indicated above, the outstanding returns generated by the publicly traded hospice providers up through 2003, initially drew private equity groups to the hospice sector. Despite the downturn in the public's fortunes, as we can see in Figure 1, they continue to play a significant role in

hospice M&A activity (in fact, in 2006, two new private equity groups entered the sector with initial platform transactions). Because, even though an initial public offering — or a divestiture to the publics — may no longer be the "obvious" exit strategy, as we discuss further below, the future for hospice looks extremely bright, both in terms of near-term financial returns and alternative divestiture options.

Hospice Market Outlook

Potential upsides of hospice reimbursement refinement. As we wrote in a recent article in *Caring Magazine* entitled "Five Predictions for Home Health and Hospice Over the Near Term", "with (a), a payment system that has gone unchanged since the hospice benefit was initiated 25 years ago, (b) MedPac reporting [substantial increases in spending], (c) increasing lengths of stays leading to a dramatic increase in providers exceeding cost limits, and (d) real concerns that payment rates do not reflect resource utilization for various different patient populations, there is much discussion regarding potential changes to the system. Although we may see a reduction in reimbursement in the aggregate, we believe hospice refinement will lead to better matching of payments to resource utilization, generating still-favorable margins across a broader array of patients. Furthermore, we expect the benefit to be modified to accommodate longer lengths of stay – both of which will create greater revenue and profit ***predictability*** and ***stability***", factors which taken together reduce risk and increase value. We may even see fundamental, utilization enhancing, changes in eligibility (see "Open Access" below). Our optimism notwithstanding, we note that with home health PPS refinement expected to be rolled out in late 2007 or early 2008, hospice reimbursement modifications are likely a minimum of two to three years from development.

The promise of "open access". Under the traditional Medicare benefit, patients choosing hospice services must "give up other Medicare services related to the curative treatment of their terminal disease" (MedPac, 2002). Given such a difficult choice, many patients that could benefit greatly from hospice programs either forgo them altogether or enter them literally in the last few days of their lives. Enter "open access" models currently being tested, surprisingly enough, by several forward thinking private insurers. According to an article that appeared in the *New York Times*, "A Chance to Pick Hospice, and Still Hope to Live" (February 10, 2007), insurers such as Aetna and United Health are "rethinking hospice care", allowing patients to receive hospice services as well as advanced, curative, medical treatments. On the federal level, the article goes on to say that "as part of a much broader effort toward revamping health care, Senator Ron Wyden, Democrat of Oregon, has introduced legislation that would end [the requirement that patients forgo other coverage if they want hospice care]". As for the expense, "one insurer, Blue Cross and Blue Shield of Rhode Island, which typically pays for treatments like chemotherapy as a way to relieve pain even while covering hospice care, says it has not seen a significant increase in the use of medical services because of this broader coverage". Perhaps even more encouraging, "at Dow Chemical, an employer in the Aetna experiment, the company's executives agreed to pay for the broader coverage because 'it's the right thing to do'". With estimates that "twice as many patients [that received hospice services] should have been in hospice programs", open access models could change the entire hospice equation, leading to an even greater surge in utilization than we have seen over the recent past.

New buyers entering the market. While the majority of acquisitions in the past have been completed by strategic players and private equity groups focused exclusively on hospice, we are increasingly (*see Hospice, page 4*)

"We expect to see more cross-sector M&A activity, particularly with the confluence of PEG sponsored hospice consolidators looking to cash in on their investments and Medicare home health providers, having reached critical mass in the markets they cover, looking to diversify and expand"

The Braff Group Index[1]

	Broad Market Average	HME	HHA & Hospice	Specialty RX & IV	Health Care Staffing	Hospitals	Long Term Care	eHealth	TBG Compos-ite	Spread
Q2 06	83.1	186.2	525.6	93.6	120.0	187.7	587.2	80.7	265.3	182.2
Q3 06	87.1	141.7	523.8	83.1	127.6	213.1	596.6	87.2	264.9	177.9
Q4 06	92.8	197.4	682.4	94.6	141.6	211.9	630.0	94.1	313.2	220.4
Q1 07	92.5	254.2	727.5	82.9	130.9	216.3	720.4	94.5	337.5	245.0
Change	**-0.3%**	**28.7%**	**6.6%**	**-12.4%**	**-7.6%**	**2.1%**	**14.4%**	**0.4%**	**7.8%**	**11.1%**

(***Hospice***, *continued from page 3*) seeing non-hospice buyers targeting the sector as part of a diversification and growth stimulation strategy. Consider the 2006 acquisition of private equity sponsored Trinity Hospice by Sunrise Senior Living, one of the nation's leading providers of assisted living facilities. Moreover, as we indicated in the *M&A Update*, page 1, three of the six hospice transactions in the first quarter of 2007 were completed by publicly traded *home health care* providers. We fully expect to see more of this cross-sector activity, particularly with the confluence of PEG sponsored hospice consolidators looking to cash in on their investments and Medicare home health providers, having reached critical mass in the markets they cover, looking to diversify and expand.

Supply and Demand. Given what we believe to be an extremely favorable outlook for hospice, as well increased acquisition demand from both private equity buyers and other senior service providers as indicated above, we sense that recent acquisition activity is being driven less by a lack of demand, and more by a lack of supply. With the first wave of for-profit providers that entered the market after hospice began to surge in 2002-2003 beginning to reach maturity, we may be in the midst of a "re-loading" phase that could lead to greater deal volume over the next one to three years.

All things considered then, though it will likely never reach the heights of activity that we see in the home health arena, we anticipate a vibrant hospice merger and acquisition environment over the foreseeable future.

(***Update***, *continued from page 1*), seeing in the home health sector, private equity continues to gain momentum and market share in infusion therapy with three of the five deals completed by three PEG sponsored buyers (for some perspective, note that based on TBG research, in 2005 there were no acquisitions by private equity funded companies, while in 2006, there were seven transactions completed by four PEG sponsors — see *M&A Market Watch: Home Infusion Therapy and Specialty Pharmacy Services*).

Finally, we observe continued softness in the, once transaction-volume dominant, **home medical equipment sector** with five deals this quarter, down 58% from last quarter, and down 67% versus the same period last year. This continues the trend that started in the beginning of 2006 following the passage of the Deficit Reduction Act which introduced a 36 month cap on oxygen beginning in 2009. We do, however, note two interesting developments: (1) With the recent release of the final competitive bidding rules including the first ten participating MSAs, we may see an increase in activity as buyers interested in developing or expanding their capacity in these MSAs target providers in these markets. (2) As we first reported in the 3rd Quarter 2006 edition of *Perspectives*, we are seeing more private equity groups express specific interest in the sector, pursuing a contrarian investment strategy to build capacity and capture share, with a willingness to revise the business model as the market dictates.

[1]The Braff Group Index measures the stock performance of 36 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.

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