the braff group

perspectives

Second Quarter 2004

A health care merger & acquisition quarterly

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Perspectives is a quarterly health care merger and acquisition journal published by The Braff Group.

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M&A Quarterly Update

DEAL VOLUME HITS ALL TIME HIGH ON STRENGTH OF HOME MEDICAL EQUIPMENT SECTOR

From a merger and acquisition perspective, if there was any doubt as to how the Home Medical Equipment industry would to react to cuts in nebulizer reimbursement in 2004 and potentially more damaging cuts scheduled for 2005, those questions have been resoundingly answered. Based on preliminary data gathered by The Braff Group, the HME sector accounted for a record 31transactions announced or completed during the second quarter. This amounts to an 82% increase in transaction volume over the same quarter last year and a 63% gain over the prior quarter. With 50 transactions year to date, the sector is also running 22% ahead of the 41 deals completed over the same period. Moreover, with the surge in HME transactions the quarter ended with 59 total deals, the largest tally since we began tracking M&A trends in 2001.

Why the substantial run-up in activity? In order to maintain steady state year-to-year growth, not only do buyers need to complete their "normalized" quotient of transactions (which due to the "law of large numbers" keeps growing as the base grows) but they also need to "back fill" these base revenues to offset enacted and projected cuts in reimbursement. As a result, not only are buyers ramping up transaction volume, but they are also targeting larger deals — a dual prong strategy to achieve aggressive growth goals.

Case in point, Praxair's $245 Million acquisition of Home Care Supply, which, to the best of our knowledge, ranks as one of the largest (if not the largest) HME transaction in recent years.

In other sectors (continued page 4)

Merger and Acquisition Transaction Volume

Sector	Q2 2003	Q3 2003	Q4 2003	Q1 2004	Q2 2004	Q2 '04: Q2 '03	Q2 '04: Q1 '04
Home Medical Equipment	17	23	18	19	31	82%	63%
Home Health Agencies	12	7	11	12	7	-42%	-42%
Specialty Pharmacy	5	4	5	5	4	-20%	-20%
Infusion Therapy	3	1	2	0	3	0%	n/m
Hospice	4	5	4	3	5	25%	67%
Staffing	4	9	4	12	9	125%	-25%
Total	**45**	**49**	**44**	**51**	**59**	**31%**	**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.

Industry Spotlight: Infusion Therapy and Specialty Rx

"There has been a significant shift in merger and acquisition strategies in the Infusion Therapy and Specialty Pharmacy Service markets".

Although infusion therapy and specialty pharmacy providers are often grouped together, they are quite different in terms of product lines, clinical oversight, distribution, etc. As such, from a merger and acquisition perspective, each is viewed quite differently. For the purposes of our discussions, infusion therapy providers (IV) are those firms that provide a broad range of intravenous therapies including total parenteral nutrition, antibiotics, pain management medications, chemotherapy, and others, generally within a limited geographic territory. Specialty pharmacy service providers (SPS), on the other hand, tend to focus on providing a limited number of specialty drugs, including growth hormone, blood factor, intravenous immune globulin, synagis, remicade, and others, frequently to chronic populations, and often over many states from a single infrastructure. As such, traditional IV therapy tends to have a greater service component, while specialty pharmacy is more akin to high-end distribution, albeit with all the billing and customer service components similar to home health care.

Evolving M&A Strategies

We have seen a significant shift in merger and acquisition strategies in the IV and SPS markets. As little as 12-18 months ago, most of the merger and acquisition activity was focused on the emerging specialty pharmacy side with its promise of a continuous pipeline of new, high margin biologics and a distribution model that is truly scaleable. The dominant buyers were large players already in the sector looking to leverage their infrastructures, add product lines, and/or expand geographic distribution, with a sprinkling of private equity groups looking to get a foothold in the sector. Consequently, with SPS garnering most of the attention, there was little interest in traditional IV. Accordingly, there were few deals – mostly small, opportunistic acquisitions. Midway through 2004, while some of the basic M&A strategies remain intact, they are clearly evolving.

PBM/SPS Strategies

In an effort to establish or increase their mail order pharmacy capacity in order to drive down costs, capture greater margins, and generate new revenue streams, pharmacy benefit managers (PBMs) are competing with existing specialty providers for the best SPS acquisition candidates. In fact, in 2003, Caremark Rx's acquisition of Advance PCS and Express Scripts' acquisition of CuraScript were two of the top 3 deals of the year in terms of size.

SPS/IV Strategies

As PBMs encroach on specialty pharmacy, it appears that SPS providers are looking to grow and establish a competitive advantage by increasing their capacity to offer products and services that require more clinical and in-person intervention – services that run counter to PBM's low cost operating and distribution models. And to provide these services

and develop their clinical capacity, they are targeting home infusion therapy providers – providing a much needed boost to M&A activity in the segment. Consider Curative Health Services' acquisition of Critical Care Systems, a $107 million, predominantely traditional IV provider, which, according to a press release, was done in part to "drive growth in the related core disease states that require a local clinical presence". Or consider Priority Health Care's recent acquisition of $65M Integrity Health Care, which according to president and CEO Steve Cosler "broadens our platform to enable us to provide a greater spectrum of high-touch therapies by establishing a more regional presence with our pharmacy and clinical services".

Private Equity Strategies

As the SPS/IV model continues to gain acceptance, we note that private equity groups who have been extremely cautious about entering specialty pharmacy at what they perceive to be the top end of the valuation curve, are now looking carefully at IV therapy companies – at relatively lower valuations – to serve as a foundation upon which to build specialty pharmacy and value.

HME Potential

As a result of the Medicare Modernization Act and reimbursement language that threatens to destroy the financial viability of nebulizer medications next year, we are beginning to see home medical equipment acquirers show interest in infusion therapy to both sustain growth and diversify away from Medicare. Furthermore, we expect to see some of these firms consider acquisitions of specialty pharmacy providers to leverage the operational and distribution infrastructure they have created to provide neb meds which they may be forced to idle in 2005.

Together then, with (a) the boundaries between pharmacy benefit management, specialty pharmacy, and infusion therapy blurring, (b) buyers and sellers more freely traversing the continuum of care – from mail order to high intervention in-home care, and (c) expectations that new buyers – private equity and home medical equipment – will enter the fray, the M&A market for SPS and IV is becoming substantially more balanced, inclusive, and vibrant.

Valuations Holding / Improving

Valuations are beginning to reflect this positive shift. While we may have expected a decline in fair market value multiples for specialty Rx as a result of margin pressures, they remain solidly in the 5.0 - 7.0 x EBITDA range – the highest of all the sectors we cover. With respect to infusion therapy, while multiples have been mired in the plus or minus 4 x EBITDA range for years, we expect the changing market to drive these values toward 5.0 and perhaps above. More importantly, with increased volume of activity coming from many different directions, for companies that develop and implement comprehensive divestiture strategies, the market is ripe for investment value premiums above fair market.

"The market is ripe for Investment Value premiums above Fair Market".

The Braff Group Index

	Broad Market Average	HME	HHA & Hospice	Specialty RX & IV	Health Care Staffing	Hospitals	Long Term Care	eHealth	TBG Composite	Spread
Q3 03	67.5	343.1	347.5	146.9	126.4	186.6	267.2	52.9	203.2	135.6
Q4 03	75.7	263.6	393.4	153.4	135.7	211.0	348.3	52.6	219.5	143.7
Q1 04	75.7	279.5	395.5	166.8	145.3	194.7	331.3	60.9	221.5	145.8
Q2 04	76.7	270.8	423.1	181.9	164.81	204.4	322.4	58.1	230.0	153.3
Change	**1.3%**	**-3.1%**	**7.0%**	**9.0%**	**13.4%**	**5.0%**	**-2.7%**	**-4.7%**	**3.9%**	**5.2%**

It was an outstanding quarter as several records were set. Home Health and Hospice closed at 423.1 on continued strength since the passage of the MMA and its favorable reimbursement language for the sector. Specialty Rx and IV reached its highest level since April 2002. With gains in Staffing and Hospitals, the Composite Index closed at an all time high of 230.0. Equally impressive, the spread between the Composite Index and the Broad Markets reached an all time high of 153.3, demonstrating the comparative strength of health care services.

The Braff Group Index measures the stock performance of 40 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.

Q2 Public Company Performance and Valuation Benchmarks

Median Measures	HME	HHA	Hospice	Staffing	Specialty RX & IV	Composite
EBITA Margin	16.8%	5.2%	14.2%	2.0%	4.9%	5.2%
EBITDA Margin	29.5%	6.7%	15.1%	3.8%	5.3%	6.7%
MVIC : Revenues[1]	**1.56**	**0.39**	**1.57**	**0.61**	**0.58**	**0.61**
MVIC : EBITA[1]	9.26	11.34	10.86	28.75	11.26	11.26
MVIC : EBITDA[1]	**5.63**	**6.40**	**10.23**	**14.96**	**9.75**	**9.75**

Public Company Performance and Valuation Benchmarks are based on 23 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]Figures reflect valuation ratios.

(continued from page 1) while the seven deals completed in the IV and Specialty Rx arena may seem relatively modest, three made quite an impact in terms of size.

First, there was Chronic Care Solution's $130 million acquisition of the diabetic, respiratory, ostomy, and Rx fulfillment division of Matria Healthcare. Backed by KRG Capital, CCS has grown to become a highly diversified provider of specialty pharmaceuticals and supplies nationwide. Second was Accredo's acquisition of Hemophilia Resources of America, an $84 million provider of hemophilia coagulation products and services. Lastly was Priority Healthcare Corporation's acquisition of Integrity Healthcare, a $65 million infusion company that enhances Priority's clinical capabilities.

See page 2 for further details on this transaction as well as an overview of merger and acquisition strategies in Specialty Pharmacy and Infusion Therapy.

One final deal of note — Beverly Enterprise's acquisition of Hospice USA, a $37 million hospice firm. With government agencies working to "re-balance" health care spending from institutional to community based care, a growing number of skilled nursing providers are pursuing acquisition and development strategies to extend their services into the home .

See the June Edition of The Braff Report for further details on this emerging strategy.

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The Braff Group is a 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.