the braff group

perspectives

2nd Quarter 2005

A health care merger & acquisition quarterly

M&A Quarterly Update

Home Health Care Deal Volume up 50% As Other Sectors Stumble

Second quarter transaction volume was down 16% from last quarter and 21% versus the same quarter last year, largely on declines in the Home Medical Equipment sector which fell 27% versus last quarter and 39% compared to the same quarter last year. After a strong first quarter however, year to date activity in the sector is running 13% behind last year but remains on pace to approach the 90 transactions completed in 2004. Of particular interest in the HME sector was **Air Liquide's** divestiture of it's US homecare division, **Vitalaire** to **Apria Health Care Group (AHG:NYSE)**. In doing so however, Air Liquide, which was represented by The Braff Group, left open the possibility that it would return to the industry, stating in its press release that the firm *"will consider, in the large markets, including the USA, any attractive opportunity which would allow us to achieve critical mass"*.

The lone bright spot during the quarter was the continued strength of the Home Health sector which accounted for another 15 transactions — up 88% over the second quarter of 2004. Year to date, the sector is running a full 50% ahead of 2004. Not only is the volume of the activity up, but the number of sizeable transactions is up as well. Notable during the quarter was **Gentiva's (GTIV:NASDAQ)** acquisition of **Heritage Home Care Services**, the public giant's first acquisition in several years and **Healthfield's** acquisition of privately held **Capital Health Management Group**, a large North Carolina based firm, that grew, in large part, through a sustained, disciplined, acquisition strategy. Also of interest, after completing only one transaction in 2004, **ResCare (RSCR:NASDAQ)**, a leading provider of education, training, educational and support services for people with disabilities and special needs, acquired five home care firms in the second quarter alone in an effort to expand its in-home services to the elderly.

Finally, although the hospice providers in our TBG Index have begun to see their stocks rebound from the 50% plunge they experienced in 2004, the M&A market remains sluggish. As the market continues to stabilize and the industry becomes more adept with managing cost caps, we expect to see a rebound in deal volume.

Second Quarter 2005 M&A Activity

Sector	Q1 2005	Q2 2005	%	Q2 2004	Q2 2005	%	YTD 2004	YTD 2005	%
Home Medical Equipment	26	19	-27%	31	19	-39%	52	45	-13%
Home Health	15	15	0%	8	15	88%	20	30	50%
Specialty Rx	4	2	-50%	4	2	-50%	6	6	0%
Infusion Therapy	2	2	0%	4	2	-50%	7	4	-43%
Hospice	3	1	-67%	5	1	-80%	9	4	-56%
Staffing	7	9	29%	9	9	0%	22	16	-27%
Total	**57**	**48**	**-16%**	**61**	**48**	**-21%**	**116**	**105**	**-9%**

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: Health Care Staffing

"What appears to be inconsistent data is likely a reflection of the market's collective – and perhaps well reasoned – assessment that health care staffing (a) has no where to go but up and (b) that the rebound is near"

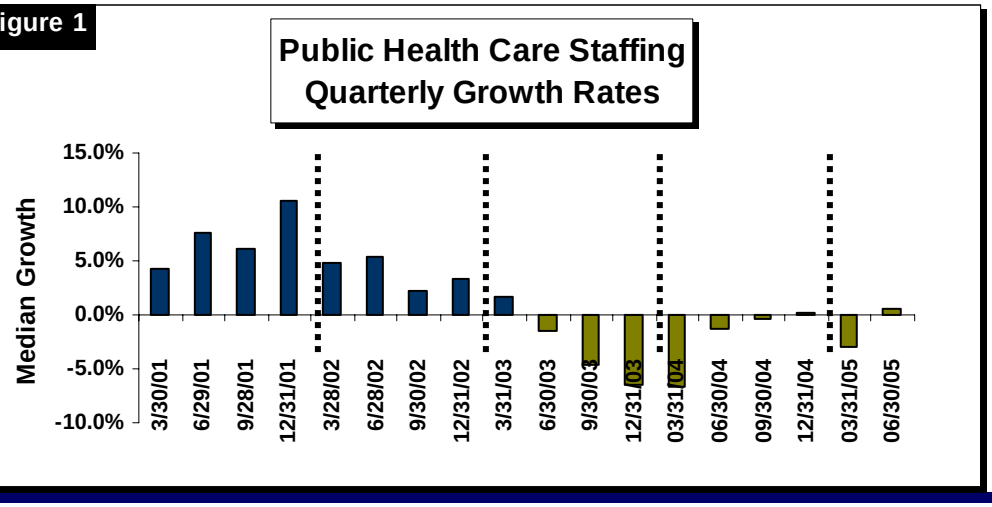
With respect to the various financial and merger and acquisition metrics we track for each of the sectors we cover, staffing is perhaps the most unusual in that many of the metrics appear to be inconsistent with one another. But a closer examination of these metrics reveals how they can co-exist with one another and more importantly, provides valuable insights into the psyche of the industry.

Revenue Trends. It has been well documented that since 2002 as (a) hospitals began to both rein in utilization of staffing services and aggressively negotiate pricing concessions to pare down expenses, and (b) caregivers began to return to the workforce in light of a down economy thereby reducing demand for temporary services, industry-wide revenues have fallen. According to *Staffing Industry Analysts*, from a revenue peak of $11.1 billion in 2002, sector revenues fell to $10.2B in 2003 and $9.8B in 2004. This trend is even more dramatic when looking at the median growth rates of publicly traded health care staffing firms since 2001 (see Figure 1). Since posting a median growth rate of 10.5% in the fourth quarter of 2001, the sector has declined steadily, turning to negative growth (contraction) in the second quarter of 2003 and continuing to contract for seven of the past nine quarters.

Public Market Trends. Given the above, it is no surprise that the public market performance of the sector has fallen off substantially. But here is where our metrics begin to diverge. While revenue trends have been largely unfavorable to flat for the last **14 consecutive quarters**, The Braff Group Index of Publicly Traded Health Care Staffing Companies bottomed out in the **second quarter of 2003** and has been rising slowly, but steadily, since (see Figure 2). Furthermore, since the bellwether valuation metrics for the sector – MVIC (Market Value of Invested Capital) to Revenues and MVIC to EBITDA – reached simultaneous low-points in the first quarter of 2003, they have likewise turned upward. In fact, MVIC to EBITDA has grown at a rate substantially greater than that of the TBG index closing out the second quarter at 15.6X (see Figure 3).

Merger and Acquisition Trends. M&A volume further belies the dismal industry revenue trends. Given long lead times, substantial investment in resources, and momentum that frequently builds in merger and acquisition activity, transaction activity tends to lag other industry metrics. Accordingly, the number of deals completed spiked in 2002 when the sector began to falter – ***after*** the revenue run-up in 2001. But

Figure 1



in the absence of any improvement in growth trends, following a decline in 2003, transaction volume surged to a new high of 37 in 2004.

So how do we make sense of all of this seemingly contradictory data?

Essentially, much of it can be traced to (a) extraordinary confidence in the role health care staffing will likely play in addressing the escalating and critical shortage of nurses and (b) comfort with, and experience in, the cyclical nature of the sector. The shortage of nurses is well documented. And with the Institute of Medicine recommending minimum staffing ratios and the State of California leading the way in enacting laws along the same lines, like it or not, hospitals will be hard-pressed ***not*** to tap staffing resources as a viable solution to their human resource problems.

Figure 2

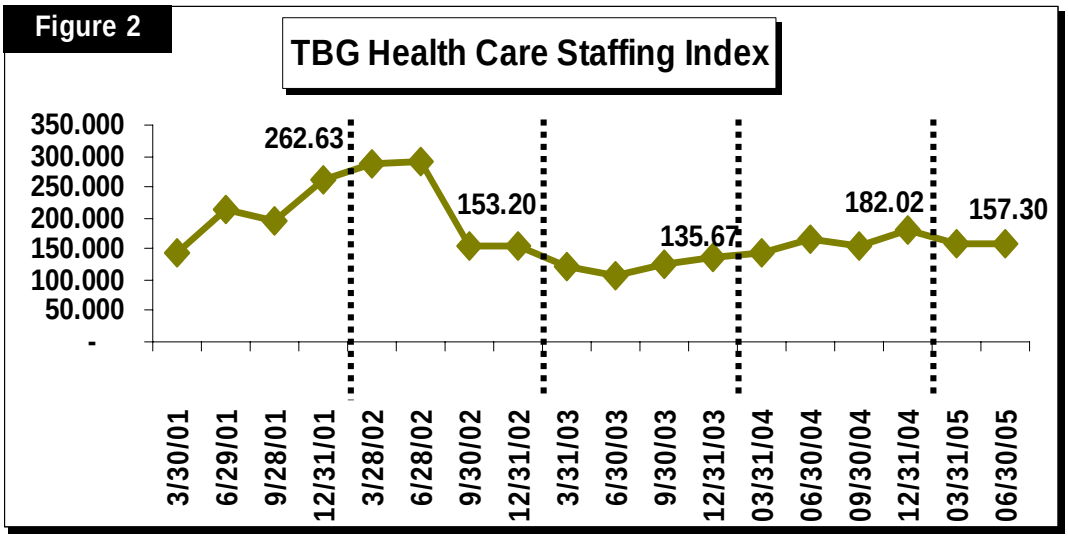
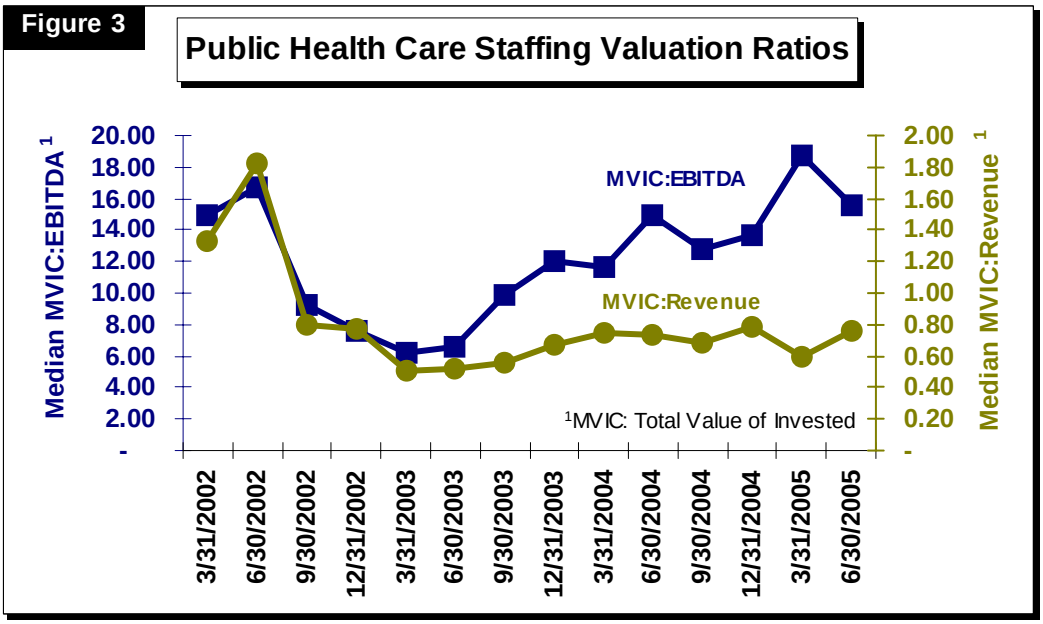


Figure 3



Therein lies the basis of the cyclical nature of staffing. Staffing expenditures tend to grow until economic pressures force customers to seek price concessions and/or other solutions. Eventually, after a periodic reduction in expense (utilization), the inescapable realities of demand – and the long term consequences of reacting insufficiently to it – kick in once again and an upward cycle begins anew.

Accordingly, what appears to be inconsistent data above is likely a reflection of the market's collective – and perhaps well reasoned – assessment that health care staffing (a) has no where to go but up and (b) that the rebound is near.

Bearing this in mind, the numbers now make sense.

1. While industry-wide performance appears to have bottomed out, in anticipation of an upswing — which may have begun as evidenced by our public firms' modest Q2 median growth rate — the market has slowly bid up the prices of public staffing firms.

2. This, in turn, has sent valuation benchmarks soaring as the numerator in these calculations (market value of invested capital) has gone up while the denominators (revenues and earnings) have gone down.

3. Finally, with respect to merger and acquisition activity, while the larger players that previously were the most active buyers continue to focus inward, (continued. page 4)

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
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	174.1
Q1 05	77.6	420.2	425.5	160.9	157.7	236.1	412.9	64.6	257.9	180.3
Q2 05	77.5	357.2	470.2	142.7	157.3	259.5	463.0	70.2	267.7	190.2
Change	**-0.1%**	**-15.0%**	**10.5%**	**-11.3%**	**-0.3%**	**9.9%**	**12.1%**	**8.6%**	**3.8%**	**5.5%**

As the Broad markets fell again, the TBG Composite Index continued to gain momentum with its second consecutive record quarter despite mixed results across the sectors. Long Term Care led the way, up 12.1%, on news of CMS' proposed regulations delaying RUGs' refinement and the possibility of no net change to reimbursement levels in 2006. Market enthusiasm continued to surround HHA & Hospice which rebounded nicely up 10.5%, establishing a new record index, in part due to the favorable response regarding LHC Group's IPO completion in June. On the flip side, Medicare FEHBP oxygen cuts announced on March 30 sent the DME sector reeling downward 15% for 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.

Q2 Public Company Performance and Valuation Benchmarks

Sector	HME	HHA	Hospice[1]	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	**22.80**	**8.50**	**8.00**	**2.90**	**5.70**	**8.90**
Median EBITDA %	**18.90**	**6.60**		**3.20**	**5.80**	**6.30**
Mean MVIC : Revenues[2]	**1.98**	**0.71**	**1.19**	**0.82**	**0.78**	**1.03**
Median MVIC: Revenues	**1.75**	**0.42**		**0.79**	**0.72**	**0.86**
Mean MVIC : EBITDA[2]	**8.58**	**7.94**	**17.15**	**14.28**	**13.43**	**11.07**
Median MVIC: EBITDA	**8.25**	**6.94**		**13.75**	**12.40**	**11.19**

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.

(continued from page 3)
a number of relative newcomers have aggressively and strategically entered the fray to gain capacity and share — at pricing that still reflects, in part, continued market instability — in advance of the expected rebound

Implications for Merger and Acquisition Activity. So what does this all mean for the near term prospects for health care staffing mergers and acquisitions? We anticipate further opportunistic consolidation activity from some of the current group of newcomers — and, perhaps, others — as they continue to build critical mass. As a result, we may see a slight increase in demand and transaction volume which, in turn, could begin to draw "early-movers" in the investment community back to the sector.

Though 2004 was a good start, a dramatic resurgence in M&A activity across a **wide** spectrum of buyers and sellers depends on if, and when, industry-wide revenues turn the corner. Just a small measurable up-tick in performance in perhaps as little as two consecutive quarters (note that for our publicly traded firms, Q2 was positive) will likely give substance to sector expectations and begin to turn the market from cautiously optimistic to guardedly enthusiastic, thereby attracting more capital, more buyers, more sellers, and continued momentum. Furthermore, from a valuation perspective, while we do not anticipate a return to the near frenzy-driven pricing from 2001 to 2002, a return to growth would begin to lower the sector's risk profile, giving a boost to pricing multiples that have languished over the past two years.

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