

A health care merger & acquisition quarterly

M&A Quarterly Update

M&A Market Rebounds Dramatically After Poor Start: Second Quarter Deal Volume Up 35%

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After a poor start to the year, merger and acquisition transaction volume rebounded dramatically in the second quarter with 58 deals announced and/or completed, a surge of nearly 35%. Moreover, volume was up slightly over the same quarter last year. Year-to-date however, M&A activity is down about 15% compared to 2005, with the most significant decline in both percentage change and raw deal volume attributable to the home medical equipment sector, which is still reeling from reimbursement changes stipulated in the Deficit Reduction Act passed in February.

The good news however was the **substantial rebound in transaction volume in both the home health and staffing sectors during the second quarter, which both posted triple digit gains over Q1.** Although both sectors are still running somewhat behind their respective record transaction paces recorded in 2005, these figures would appear to support our suggestion in the last edition of *Perspectives* that Q1 results for these sectors were an anomaly.

In addition, though the raw numbers are relatively small, we note meaningful gains through the mid-point of the year in both the infusion therapy and specialty pharmacy sectors — up 43% and 100% respectively — illustrating sustained strength in the phar-

macy services arena.

Of particular interest during the quarter, was private equity firm **Sentinel Capital Partner's** acquisition of **Interim Healthcare**, a transaction noteworthy not only for its size — Interim has system-wide sales of \$620 million — but also in that it was a “secondary buy-out” in which a private equity group (PEG) acquired a portfolio company held by one or more other PEGs — in this case, **Cornerstone Equity Investors** and **Bank of America Capital Investors**. With so much money held by private equity groups today, such PEG to PEG transactions are becoming more common nationwide — particularly, we note, in the health care services arena. By The Braff Group's count, this deal was at least the **seventh such secondary buy-out in the past 12 months.**

Finally, of note was **Walgreen's** acquisition of **Medmark Specialty Pharmacy Solutions**. This transaction marks yet another aggressive play by the pharmacy giant to expand its reach beyond the retail setting and leverage its strong brand name to create a diversified distribution and service model with capacity to move seamlessly from low touch mail order specialty pharmaceuticals to higher touch home infusion therapy and home medical equipment.

Second Quarter 2006 M&A Activity									
Sector	Q1 2006	Q2 2006	% Change	Q2 2005	Q2 2006	% Change	6 Mos. 2005	6 Mos. 2006	% Change
HHA	11	22	100.0%	18	22	22.2%	36	33	-8.3%
Hospice	2	2	0.0%	1	2	100.0%	4	4	0.0%
Staffing	4	11	175.0%	10	11	10.0%	20	15	-25.0%
HME	15	16	6.7%	21	16	-23.8%	48	31	-35.4%
Infusion Therapy	7	3	-57.1%	4	3	-25.0%	7	10	42.9%
Specialty Pharmacy	4	4	0.0%	1	4	300.0%	4	8	100.0%
Total	43	58	34.9%	55	58	5.5%	119	101	-15.1%

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.

Recent and Anticipated Valuation Trends for Medicare Certified Home Health Providers

"Immediately after Congress passed the Medicare Modernization Act which provided Medicare certified HHAs with regular updates scheduled through 2006, the sector's risk profile was arguably at its lowest — and most attractive — position since the mid 90s"

Since the Prospective Payment System (PPS) was initiated in late 2000 and we began to see the earliest indicators of a resurgence in merger and acquisition activity for Medicare certified home health agencies, valuations — both real and perceived — have changed dramatically. Moreover, during this time, we have noted somewhat unusual trends in the relationship between, and application of, the two most common foundations for valuation: **Economic Value** based upon pure risk-return fundamentals akin to fair market value, and **Investment Value** ascribed by specific buyers for specific companies, based on the confluence of the unique needs of buyers, the unique attributes of sellers and the balance between the supply of, and demand for, acquisition candidates.

The following is an analysis and graphical illustration of how the sector's valuation trends and anomalies (expressed as multiples of earnings before interest, taxes, depreciation, and amortization — EBITDA) have evolved over time, and where we expect them to move over the next two plus years.

First, some brief background. While pure, risk-return driven, fair market value-like pricing — or less — is certainly preferable to buyers, in a competitive merger and acquisition market there are many situations in which it is financially reasonable and appropriate for a buyer to pay more than fair market. For example, private equity firms lacking industry expertise or market presence, or strategic buyers looking to open up new markets or regions, may be willing to pay substantial **investment value premiums** for platform-type acquisition candidates with the human and operating infrastructure capable of supporting additional lower priced acquisitions or startups. A specific acquisition candidate can offer unique synergistic benefits to a particular buyer, creating additional value in an acquisition. Furthermore, in certain situations, buyers can afford to offer sellers value premiums in order to capture even greater **size-premiums** bestowed to large providers.

Finally, in most M&A markets, two conditions generally prevail: (1) the high end of the

investment value range typically **exceeds** fair market-like economic value, and (2) strategic buyers, with greater opportunity than financially driven buyers to capture revenue enhancing or cost reducing synergies, tend to set the high end of investment value range.

2001 to 2003: During the first full year of PPS when companies were in the midst of re-engineering their businesses to address an entirely new approach to providing — and billing — for home health care services, there was much uncertainty (and rightly so) regarding the accuracy of early revenue and profit reporting. With such risk, economic risk-return valuations were initially modest. However as the industry gained more experience and confidence in the system and financial returns became more reliable, predictable, and **less risky**, these valuations climbed steadily. While investment valuations followed a similar path, contrary to condition 1 described above, they lagged substantially **behind** what the economic risk-return fundamentals of the industry suggested. This was due to the fact that economic realities notwithstanding, after being blind-sided and financially brutalized by the Balanced Budget Act of 1997 (BBA 1997) and the transition from cost-based reimbursement to the Interim Payment System and finally PPS, strategic buyers were in little mood to commit substantial funds to pursue aggressive acquisition strategies. Rather, they took a wait and see attitude, substantially depressing acquisition demand and attendant investment value ranges. As for private equity buyers that would normally seize on such a valuation anomaly? Those that were interested in health care services focused their attentions initially on Hospice given the remarkable stock performance of several national players.

2004: Immediately after Congress passed the Medicare Modernization Act which, among many items, provided for extraordinary reimbursement stability for Medicare certified HHAs with regular updates scheduled **through 2006**, the sector's risk profile was arguably at its lowest — and most attractive — position since the mid 90s. No surprise then that as the sector entered this

three year window, pure economic risk-return based values peaked. What **was** a surprise was that even under these extraordinarily favorable circumstances, even after four years of experience under PPS, strategic buyers for the most part remained on the sidelines driving the unusual and “unfavorable” gap between investment value and economic value to its largest point. By year end however, amidst substantial declines in the fortunes of several publicly traded hospice providers and with opportunities to gain platform positions in the hospice sector beginning to wane, private equity buyers began to take notice of home health care.

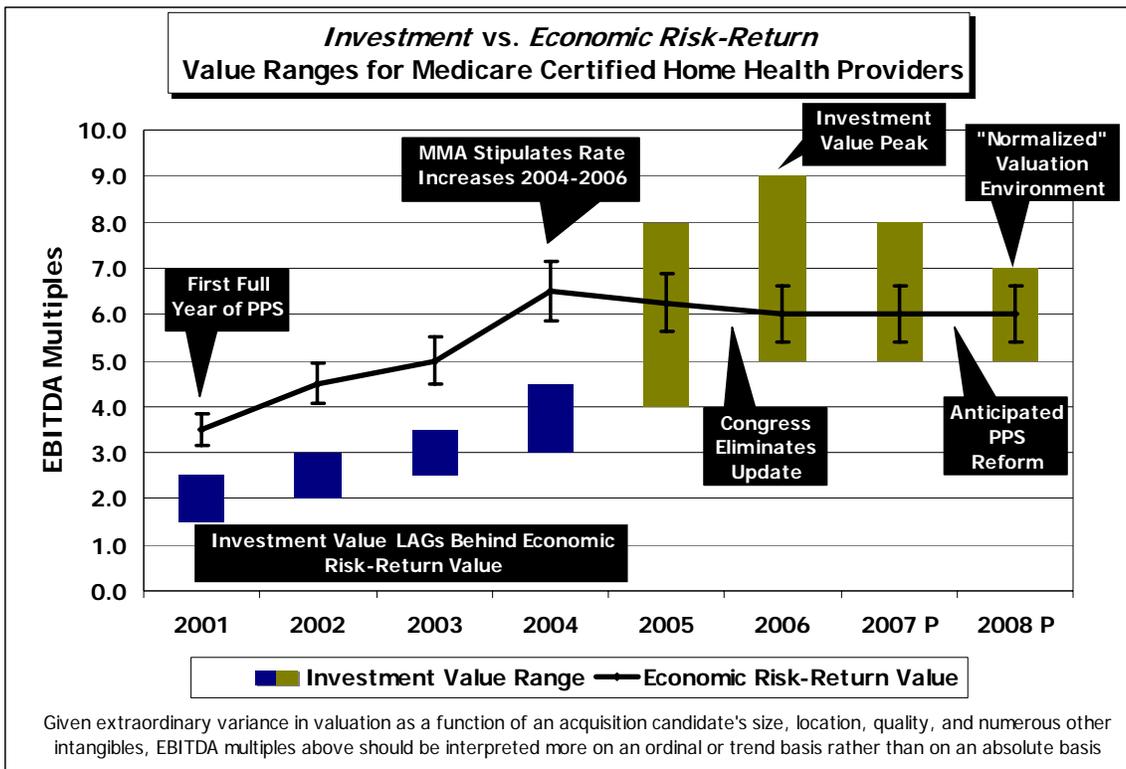
2005: As the industry passed the mid-point of the MMA sanctioned reimbursement “safe harbor”, risk naturally inched upward, exerting modest downward pressure on economic risk-return values. By mid-year however, eager to fill the acquisition void left by strategic buyers since 2001 and hoping to take advantage of the huge gap between investment and economic value that existed at the end of 2004, private equity groups (PEGs) rushed into the M&A market, spiking a demand for a relatively limited number of platform-sized acquisition candidates. The resulting imbalance of demand over supply — in an atmosphere of strong valuations for

publicly traded Medicare focused providers — drove investment valuations up dramatically. Moreover, the higher end of the range — driven by PEGs and not strategic buyers, contrary to condition 2 described above — finally surpassed pure economic risk-return valuations.

2006: As we entered 2006 and Congress eliminated the home health update through the Deficit Reduction Act, the sector’s risk profile again ticked upwards, pushing economic values down slightly for the second consecutive year. While the loss of the update was certainly meaningful, it was less so in terms of valuation dynamics because the industry did not suffer a **reduction** in reimbursement. The perception of the sector, then, remains one of relative **stability** which is a key to sustaining risk-return values. The above notwithstanding, with an increasing number and velocity of buyers entering the fray, in part making up for lost time from 2001-2004, the range of investment values has surged again, reaching what we believe will prove to be its peak in both absolute terms and relative to underlying economic risk-return value.

2007 Projected: Even with expectations that Congress will eliminate the proposed (continued on page 4)

“The range of investment values has surged again in 2006, reaching what we believe will prove to be their peak in both absolute terms and relative to underlying economic risk-return value”



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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.

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 05	80.0	396.1	490.6	142.5	115.8	219.6	511.6	87.5	280.5	200.5
Q4 05	81.4	330.4	491.5	116.8	119.7	204.2	563.2	90.0	275.7	194.3
Q1 06	84.8	326.2	486.6	121.3	125.1	193.8	643.5	100.8	285.5	200.7
Q2 06	83.1	186.2	525.6	93.6	120.0	187.7	587.2	80.7	265.3	182.2
Change	-2.0%	-42.9%	8.0%	-22.8%	-4.1%	-3.1%	-8.7%	-20.0%	-7.1%	-9.2%

The story of the quarter was the near 43% plunge in the Home Medical Equipment Index which closed out at 186.2, its lowest level since April 2003. The slide began in February with the passage of the Deficit Reduction Act which capped oxygen reimbursement at 36 months. Shortly thereafter, (a) the President issued his 2007 budget which proposed ratcheting the cap down to 13 months and, (b) proposals were issued to reduce reimbursement on several brand name nebulizer drugs to generic pricing. On a positive note, the Home Health sector continues to gain favor in the investment community, pushing the HHA and Hospice Index to a new record high of 525.6.

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.

Q2 Public Company Performance and Valuation Benchmarks

Sector	HME	HHA	Hospice ¹	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	19.90%	8.70%	11.20%	4.90%	5.10%	10.18%
Median EBITDA %	17.40%	7.70%		4.80%	5.10%	8.60%
Mean MVIC : Revenues²	1.43	0.85	1.08	0.72	0.51	0.91
Median MVIC: Revenues	0.95	0.72		0.80	0.57	0.82
Mean MVIC : EBITDA²	6.76	9.44	12.93	19.34	13.21	11.79
Median MVIC: EBITDA	6.32	8.86		19.61	13.21	10.95

Public Company Performance and Valuation Benchmarks are based on 20 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.

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update again for 2007, amidst continued reimbursement stability, we anticipate no meaningful change in economic risk-return values. That said, with more attractive acquisition candidates testing the market after the dramatic surge in activity and valuations post 2005-2006, we expect a lessening in the demand-supply imbalance which will likely drive down the top end of the investment value range.

2008 Projected: By late 2007 or early 2008, we anticipate PPS reforms will be implemented. While they are supposed to be budget neutral, our suspicion is that given extraordinary budget pressures, they may likely morph into de facto reimbursement cuts. And even if such reforms have no impact on overall spending, given reimbursement cuts that have befallen virtually all health care providers over the recent past, we believe it is prudent to project some sort of rate reduction for home health

providers in 2008. That said, absent an extraordinary cut, we expect that the home health sector, much like the home medical industry post BBA 1997, will be able to offset at least the first wave of cuts with reductions in expense and increased efficiencies. Accordingly, we anticipate that economic risk-return value multiples will hold, albeit against potentially lower earnings. We do however expect that as the acquisition frenzy of 2005 to 2007 dies down and the supply of, and demand for, acquisition candidates becomes more balanced, the high end of the investment value range will fall to a "normalized" level compared to economic value; a range that exceeds (and extends below) economic risk-return values, but in a somewhat narrower band. And with reduced demand from private equity, strategic buyers will likely be driving the higher end of this narrower band. All of which will be characteristic of a more mature merger and acquisition environment.