

2 PERSPECTIVES

SECOND QUARTER 2008

A health care
merger & acquisition
quarterly review

the braff group

M&A Mid-Year Update

Based upon proprietary research conducted by The Braff Group and illustrated in **Chart A**, at mid-year, transaction volume in the healthcare service sectors we track was down 14.2% compared to the same period last year – from 113 deals during the first six months of 2007, to 97 deals in 2008. In both raw numbers and percentage decline, the largest fall-off was attributable to the much beleaguered home medical equipment sector with 13 deals thus far in 2008, down 35% (seven transactions) versus 20 deals during the same period last year. All of the sectors posted declines with the exception of healthcare staffing which was unchanged year over year. The good news, however, was that after a slow start, second quarter transaction activity was up nearly 11% over Q1 with infusion therapy, home health, and even the aforementioned home medical equipment sector posting meaningful gains.

Below is a more detailed review of M&A activity for the first six months of 2008 on a sector by sector basis.

Home Healthcare

At the mid-way point of 2008, home health transaction volume, with 51 deals, was down a modest 7.3% compared to the same period last year and remains on track to eclipse 100 transactions once again in 2008. Moreover, volume in the second quarter was up nearly 22% versus the same period last year.

CHART A:
TBG Health Care Service
Sector Transaction Volume
MID-YEAR

SECTOR	1st Qtr. 2008	2nd Qtr. 2008	% Change	YTD 2007	YTD 2008	% Change
Home Health Agencies	23	28	21.7%	55	51	-7.3%
Hospice	4	2	-50.0%	7	6	-14.3%
Staffing	8	5	-37.5%	13	13	0.0%
Home Medical Eqpt.	5	8	60.0%	20	13	-35.0%
Infusion Therapy	3	6	100.0%	11	9	-18.2%
Specialty Pharmacy	3	2	-33.3%	7	5	-28.6%
TOTAL	46	51	10.9%	113	97	-14.2%

Source: The Braff Group



From a public market standpoint, quarterly numbers reflecting both (a) successful adaptation to PPS reforms and (b) continued and successful acquisition and integration activity, have buoyed the TBG Home Health and Hospice index past the 1,000 mark (1,004.7) – the only sector we cover that has even remotely approached this level.

As we entered 2008, the big question was how buyers were going to react to significant changes made to the Medicare Prospective Payment System (PPS) – including a near 11% reduction in payments factored in over a four year period to account for reimbursement “creep” – that were set to take effect January 1, 2008. As the data suggests, while buyers and sellers alike continue to analyze and evaluate early returns on PPS reform, acquisition demand remained robust revealing an atmosphere of confidence in the industry’s ability to adapt to these reforms profitably. Furthermore, the period was marked by several large transactions – notably Amedisys’ [NASDAQ:AMED] acquisition of Tender Loving Care, a portfolio company of private equity group Arcapta, and Gentiva’s [NASDAQ: GTIV] acquisition of Home Health Care Affiliates. Moreover, from a public market standpoint, quarterly numbers reflecting both (a) successful adaptation to PPS reforms and (b) continued and successful acquisition and integration activity, have buoyed the TBG Home Health and Hospice Index past the 1,000 mark (1,004.7) – the only sector we cover that has even remotely approached this level – surging 60% since PPS reforms were initially announced in late April 2007.

Given all the above, the sector is extremely well positioned for a long run of attractive consolidation activity. The one potential weak spot, however, is in the Medicaid and Medicaid Waiver segment where an increase in the overall rate of spending in Medicaid is coming at the same time that the Wall Street Journal reports, amidst a difficult economy, “States [are being] Slammed by Tax Shortfalls [July 24, 2008].” Predictably, many states will look to trim healthcare expenditures to address anticipated deficits. The good news is that the most enlightened legislators recognize that a “rebalancing” of Medicaid expenditures from institutional care to far less-costly home and community based services (i.e. home care) may, in fact, be the solution to this pending crisis. In fact, there is a bill before Congress introduced by Senator John Kerry of Massachusetts entitled “Empowered at Home Act of 2008” (S.3327) that aims to promote such a rebalancing. Such initiatives could quickly mediate exposure in this vital home care segment shoring up M&A demand – and valuation.

Infusion Therapy and Specialty Pharmacy

Transaction volume in the first six months of 2008 is running slightly behind last year’s figures for both home infusion therapy and specialty pharmacy (each sector down two transactions). In this situation, however, the raw data belies the fact that the sectors are still squarely in the cross-hairs of a growing number of private equity sponsored and strategic buyers. Consider several of the high profile transactions announced and/or completed in the first half of 2008 – MBF Healthcare Acquisition Corp’s acquisition of Critical Home Care Systems; Walgreen’s acquisition of CuraScript Infusion Pharmacy, HealthExtra’s acquisition of HospiScript Services, and finally, Blackstone Group’s acquisition of Apria Healthcare Group [NYSE:AHG] (a transaction almost assuredly made possible by Apria’s late 2007 acquisition of Coram, making Apria a pharmacy service giant).

The challenge in today’s infusion therapy and specialty pharmacy M&A market has far more to do with the supply of acquisition candidates (or more accurately, the lack thereof), than any slackening in acquisition demand. When compared to the home health sector, which has more than 10,000 providers, the infusion therapy and specialty pharmacy

sector is likely comprised of no more than 1,000 providers. At an estimated one tenth the size – and the smallest of all the sectors we cover in terms of provider numbers – the supply of acquisition candidates is the limiting factor with respect to transaction volume. As a side observation, given the market size differences, it can be argued that the combined 14 transactions year-to-date for the infusion therapy and specialty pharmacy sector is far more impressive than the much lauded home health sector's 51 deals. The good news for pharmacy services then is that with imbalance of supply and demand firmly in favor of prospective sellers, the competition for deals is fierce, driving valuation predictably upwards.

Healthcare Staffing

As indicated above, with 13 transactions thus far in 2008, the only sector that has kept pace with 2007 is healthcare staffing, equaling the tally recorded during the same period last year. Adjusting for a surge in activity between 2004 and 2005 that was characterized by a large number of "opportunistic" acquisitions of distressed per diem companies suffering through an onslaught of margin erosion and utilization contraction, the healthcare staffing sector has been a steady performer in terms of M&A activity, generating 20-25 deals per year. And, this year looks to be more of the same. Buyers continue to target, in general order of preference, locum tenens (physician staffing), allied services (pharmacy, therapy, x-ray, and other non-nurse staffing), and travel nursing. Given the reasons suggested above, the demand for traditional, per diem nursing remains tepid.

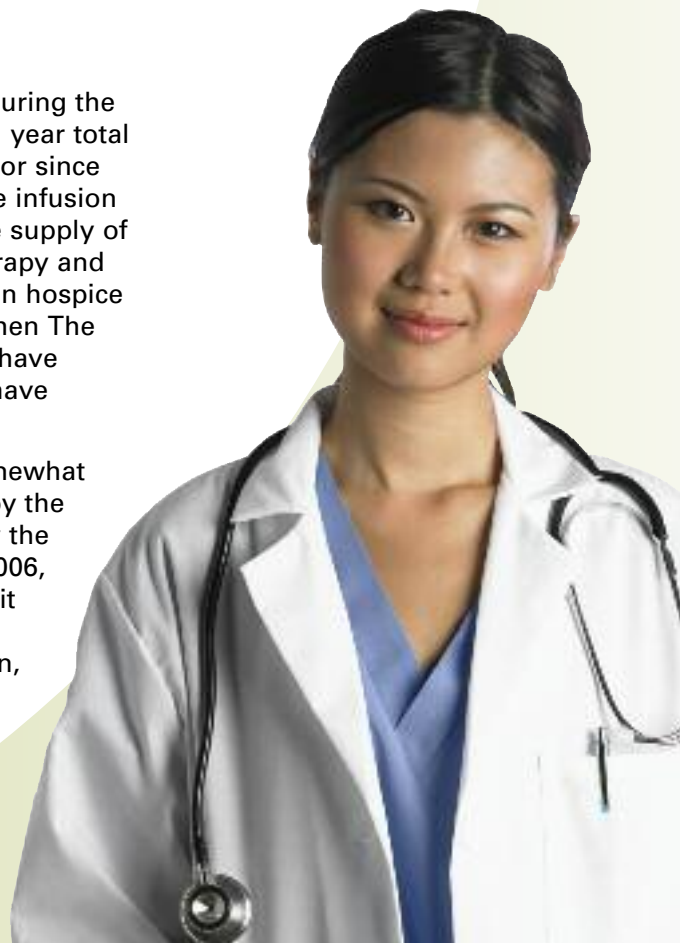
One interesting observation: We are seeing the emergence of several new, mid-size (below \$50M) buyers entering the merger and acquisition market – a development that could increase the breadth and depth of acquisition demand, particularly for smaller providers up to \$10M in revenues.

Hospice

As of mid-year, there were six hospice transactions, one less than during the same period last year, and pretty much on pace to match 2007's full year total of 10 deals, the lowest transaction volume we have seen in the sector since 2001 (eight deals). Why such continued sluggishness? Much like the infusion therapy and specialty pharmacy sector, while demand is strong, the supply of acquisition candidates is extremely limited. But, unlike infusion therapy and specialty pharmacy, when we say supply of acquisition candidates in hospice is limited, we're talking virtually zero. It's gotten to the point that when The Braff Group reports transaction activity (including hospice), buyers have expressed surprise that even the small number of deals we report have been completed.

Unfortunately, from an M&A standpoint, the supply shortage is somewhat endemic to the industry. First, according to an analysis conducted by the Centers for Medicare and Medicaid Services (CMS) and reported by the National Hospice and Palliative Care Organization (NHPCO), as of 2006, 55% of the nation's 3,000 hospice providers were either not-for-profit or government or community based. This essentially eliminates more than half the sector's providers from acquisition consideration, as these types of providers rarely consider divestitures.

Given the market size differences, it can be argued that the combined 14 transactions year-to-date for the infusion therapy and specialty pharmacy sectors is far more impressive than the much lauded home health sector's 51 deals.



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The Braff Group is a leading middle market 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.

Second, an increasing number of hospices are exceeding their annual cost caps given a reimbursement model that generally rewards patients with longer lengths of stay with higher profits than those with short lengths of stay (often generating losses). While still a relatively small percentage, according to a MedPac report issued in June of 2008 evaluating the hospice benefit, 7.8% of hospices in 2005 exceeded their cost caps, up from only 2.6% in 2002, an increase of 200%. Moreover, MedPac further reports that of the agencies that exceeded these caps in 2005, an extraordinary 89% were for-profit. In 2008, three years later, we suspect that these trends have escalated further as evidenced, in part, by the fact that buyers continue to lament the difficulty in finding acquisition candidates that do not have cost cap exposure. Unless and until the hospice benefit is revised, perhaps to an acuity based model that better balances reimbursement with resource utilization, we expect this problem to persist.

Given the above, many would-be hospice buyers today are focusing far more on start-ups, than acquisitions, to fuel expansion. This may change, however, as a surge in new for-profit hospice entrants, looking to capitalize on a growing sector with many supply-starved acquirers, begin to mature and test the M&A market.

Home Medical Equipment

The largest fall off in acquisition activity through the first six months of the year, both in raw numbers and percentage, was in the home medical equipment sector. At 13 transactions, the sector was down 35% compared to the 20 deals announced and/or completed during the same period in 2007. The decline was predictable and is part of a substantial downward trend that began in 2006 following the passage of the Deficit Reduction Act and, notably, a 36 month cap on oxygen reimbursement set to take effect January 1, 2009. Fearing that this cap may be ratcheted down to 18 months or less (which has been floated by the President, Congress, and other governmental bodies numerous times since the act was passed), the unknown has substantially chilled the M&A market. While the recently passed "Medicare Improvements for Patients and Providers Act" which included a delay in the implementation of Competitive Bidding initiatives (offset by a 9.5% reduction in reimbursement for select products) was welcomed by the industry, it is not nearly enough to overcome the threats attendant to the aforementioned oxygen caps. No surprise then, that to date, the delay in competitive bidding has had no visible impact on M&A demand or activity.

The above notwithstanding, the period was marked by two high profile transactions. First was the previously mentioned announcement of the Blackstone Group's intention to acquire Apria Healthcare Group. While we believe this deal may have been driven more by Apria's substantial infusion therapy holdings than its home medical equipment business, it nevertheless marks a landmark transaction in the sector. Perhaps even more noteworthy was the acquisition of Pacific Pulmonary Services by Teijin Limited, a Japanese based manufacturer and provider of home medical equipment. In such an unsettled environment, the market has been ripe for outside investors to come in and re-tool, or even re-imagine the entire service and delivery system. These investments clearly bear watching as they may yield insights regarding where the industry – and future M&A opportunities – may be headed.