

2 PERSPECTIVES

SECOND QUARTER 2009

A health care
merger & acquisition
quarterly review

the braff group

Second Quarter 2009 Deal Volume up 33% over Q1 Mid-Year Volume Down 29% vs. Last Year

The past six months have been challenging for mergers and acquisitions across all industries, including health care services.

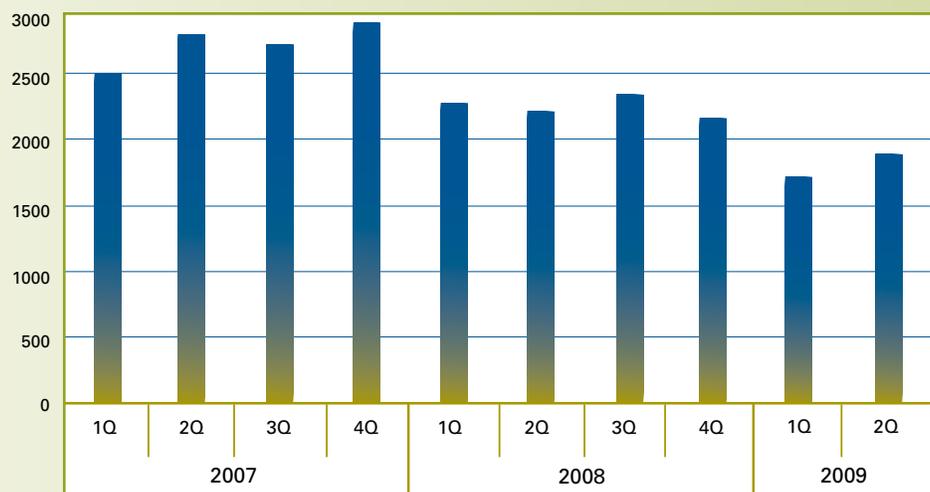
Some of the factors impacting health care M&A, however, may be somewhat different than those driving other industry segments.

First, an overall view of the M&A landscape for the first half of 2009.

Based on data derived from *Thomson Reuters*, **Chart 1** illustrates United States middle market M&A activity across all sectors between 2007 and 2009.

Chart 1:
United States
Mid-Market M&A
Deal Volume

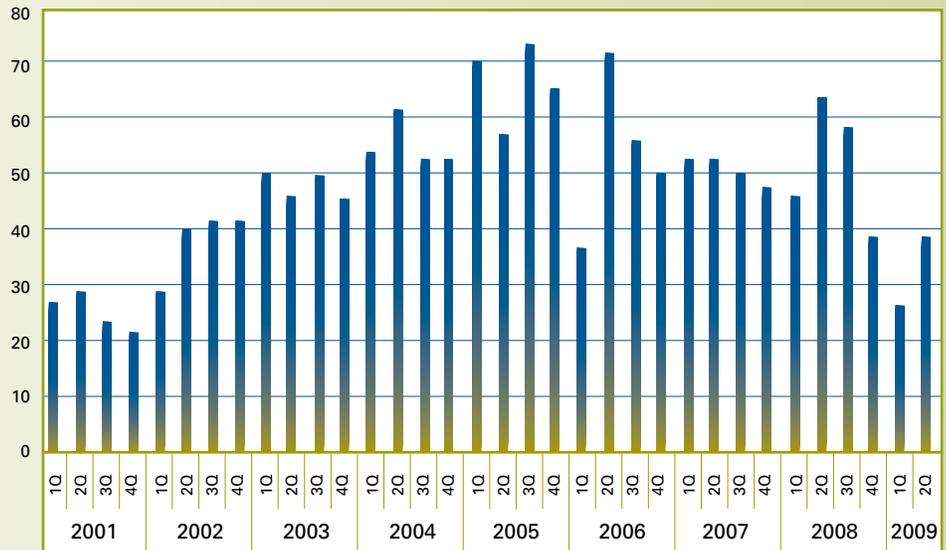
Includes all deals
under \$500m



Source: Thomson Reuters

Chart 2, which is based on proprietary data compiled by The Braff Group, illustrates transaction activity across all the health care service sectors we cover – home infusion therapy, specialty pharmacy, institutional pharmacy, home health care, hospice, home medical equipment, and health care staffing – from 2001 to 2009.

**Chart 2:
Health Care Services
Deal Volume**



Source: The Braff Group

Clearly, transaction activity over the past six quarters has generally trended downward in the middle market as a whole and in health care services, which could lead one to conclude that both segments were likely casualties of the recessionary economy and the constrained credit markets.

However, as illustrated in Figure A, a closer examination of the data reveals meaningful differences in the magnitude and timing of these changes – variances that we believe are not anomalies, but rather the result of different economic drivers.

While the recession and limited access to credit has had a negative impact on all M&A, these factors have had far more impact on the broad M&A market than on health care services.

Figure A:

Changes in M&A Deal Volume		
	All Middle Market*	Health Care Service
2008 vs. 2007	-17%	-7%
First 6 months 2009 vs. Last 6 months 2008	-21%	-21%
Q1 2009 vs. Q4 2008	-21%	-27%
Q2 2009 vs. Q1 2008	+9%	+33%

*Deals under \$500 million

Essentially, our sense is that while the recession and limited access to credit has had a negative impact on all M&A, particularly private equity sponsored activity (which we will discuss later), these factors have had far more impact on the broad M&A market than on health care services specifically.

Rather, it is *health care reform* that is most responsible for the downturn in health care service transaction volume.

Consider that in 2008, when the credit crunch began in earnest and the recession was beginning to be felt across all aspects of our economy, middle market activity across all segments fell 17% vs. 2007, while health care service deal volume fell only 7%. Moreover, in 2008, home health, hospice, and staffing each recorded increases in transaction activity.

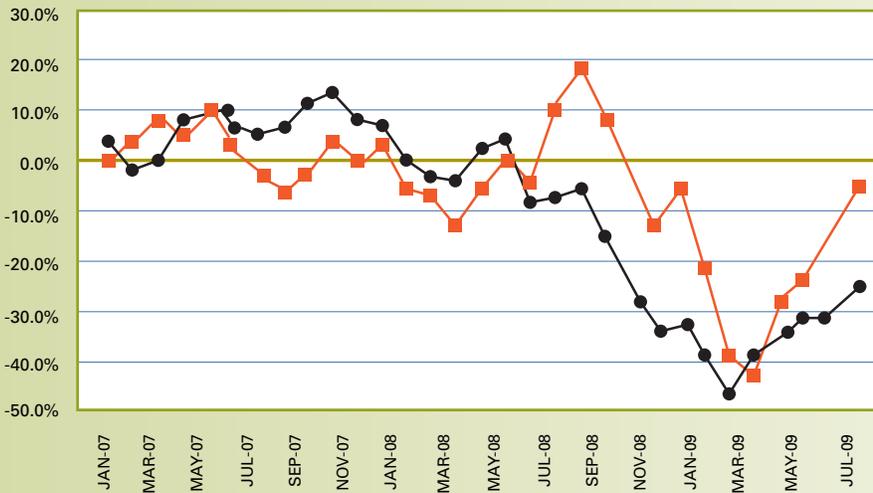
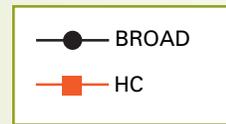


Chart 3:
TBG Broad Market
Index vs. Health Care
Composite Index



Source: The Braff Group

Further, while period to period middle market activity declines have been fairly steady over the past 18 months of economic disruption, declines in health care service M&A activity spiked during the first quarter of 2009 when (a) President Obama initially unveiled his budget that included dramatic changes in health care spending and (b) health care reform began to take shape.

Finally, as the first signs of economic recovery began to emerge during the second quarter, middle market activity increased 9%. Alternatively, health care service activity surged 33%. While improvements in the economy helped, we suspect that while health care reform is still very much in the air, investors have rebounded from the initial shock of these potential initiatives and have been more quick to return, albeit cautiously, to sectors that, even under duress, possess extremely attractive growth and demand characteristics.

Not surprisingly, our premise that health care M&A activity has been far more affected by health care reform than broad economic conditions is further bolstered by changes in The Braff Group stock indexes.

As we can see in **Chart 3**, while our composite, broad market index, comprised of the Dow Jones Industrial Average, the S&P 500, and the NASDAQ 100, began its near steady decline towards the end of 2007 when the economy began to slide, the TBG Health Care Composite Index surged to a record *high* in August of 2008. While the broad market declines finally began to pull down health care shortly thereafter, the biggest drop, as indicated above, occurred in the first quarter of 2009 when reimbursement change and health care reform picked up steam. Moreover, while the broad markets have reacted favorably to recent improved market conditions, health care has thus far demonstrated a stronger and faster recovery, owing again, we suspect, to a tempering of fear related to reform initiatives.

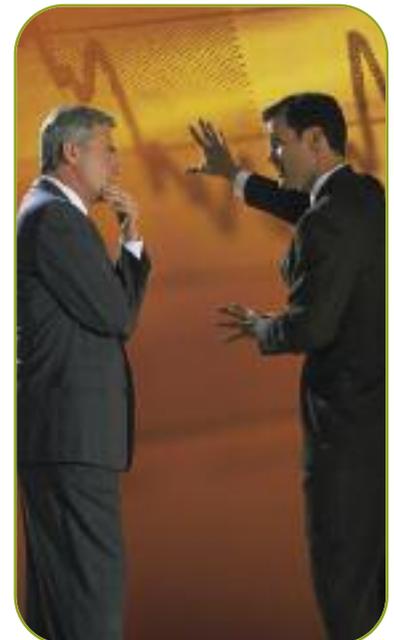
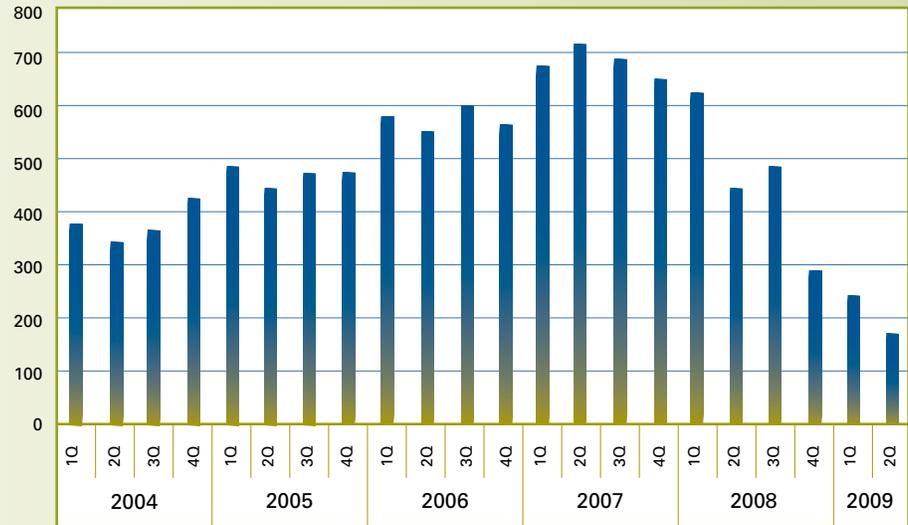


Chart 4:
Total Private Equity
Deal Volume –
All Industries



Source: Pitchbook Platform

Chart 5:
Private Equity
Investment in
Health Care Services

For Home Health, Hospice, Durable Medical Equipment, Health Care Staffing, IV, Institutional Pharmacy and Specialty Pharmacy



Source: The Braff Group

Private Equity Sponsored Activity

With limited access to credit, private equity is finding it increasingly difficult to generate the leverage-driven returns they had grown accustomed to in 2006-2007. Accordingly, as we can see quite clearly in **Chart 4**, private equity has substantially withdrawn from the buy-out market across all industries, turning inward to shore up existing portfolio companies.

As we can see in **Chart 5** (in which we further break down private equity activity between initial platform and subsequent “add-on” activity), the fall-off in private equity deal volume has trickled down to health care services as well, albeit somewhat less dramatically. This is likely due to the fact that, health care reform notwithstanding, from an investment stand point, the sector is comparatively more attractive than those whose fortunes are more closely tied to the economy as a whole.

We also note that while overall private equity sponsored deal flow continued to decline in the second quarter, private equity investment in health care services rebounded sharply during the same period, echoing similar dynamics that we noted earlier in the performance of the TBG Health Care Composite Index vs. the Broad Market Index.

Sector Specific M&A Performance

Pharmacy Services

As illustrated in **Chart 6**, after a particularly dismal first quarter, transaction activity picked up somewhat in the second quarter of 2009. Perhaps, most noteworthy, is the fact that during the first half of the year, we have identified only one specialty pharmacy transaction. This is likely due to the fact that, amidst the current economic uncertainty, buyers across all industries are increasingly less inclined to make big bets on transactions greater than \$50 million, preferring instead to focus on smaller deals between \$5-15 million. With revenues often in the \$25-50 million dollar range and more, for the time being, the appetite for specialty pharmacy has slackened.

Additionally, we note that compared to the health care services we track as a whole, private equity has played a disproportionately greater role in pharmacy services transactions (see **Chart 7**). Accordingly, the fall-off in private equity activity has likewise had a disproportionate downward impact on pharmacy deal volume.

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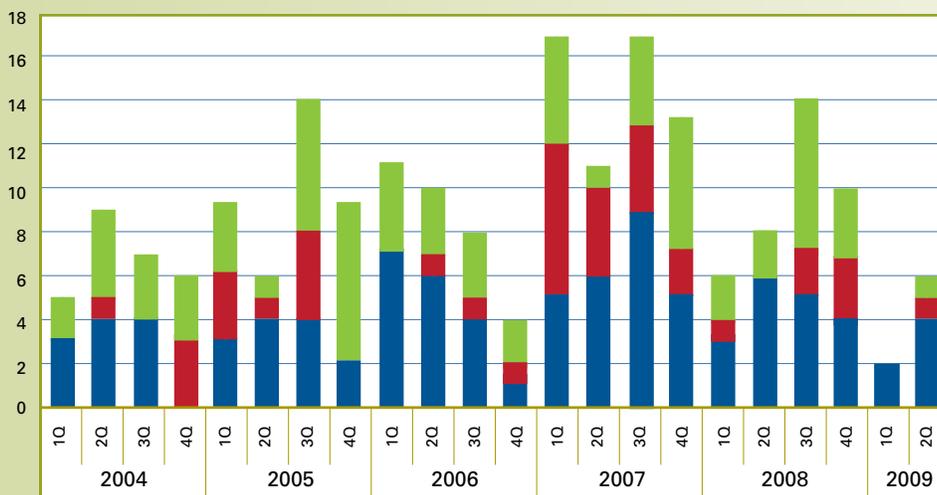


Chart 6:
Pharmacy Deal
Volume by Segment

■ SPECIALTY PHARMACY
■ INSTITUTIONAL PHARMACY
■ IV

Source: The Braff Group

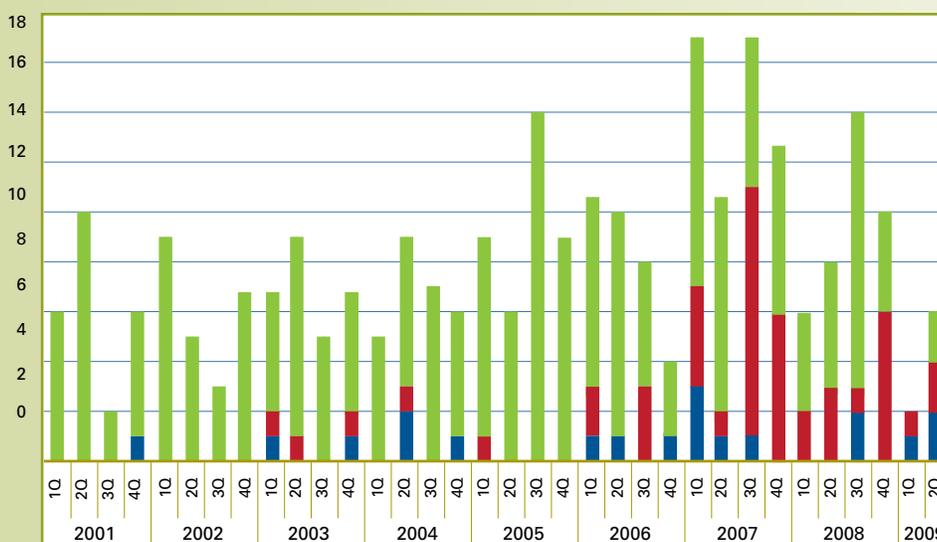


Chart 7:
Private Equity vs.
Non-Private Equity
Pharmacy Deal Volume

■ Non-PEG TRANSACTIONS
■ TOTAL ADD-ON
■ TOTAL PLATFORM

Source: The Braff Group

Home Health Care: Medicare, State-Funded, and Private Pay

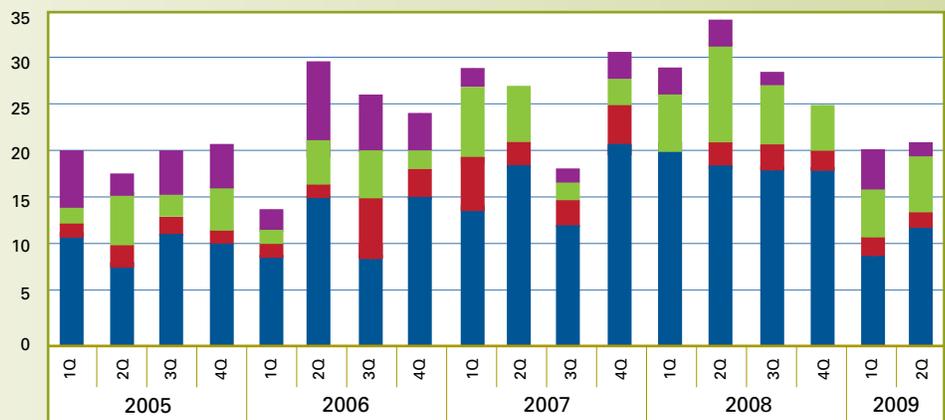
Again, we see a familiar pattern in home health care with a fairly steady fall-off in M&A activity from its peak reached in the second quarter of 2008 (see **Chart 8**).

But a closer observation reveals some other interesting trends.

First, of all the sectors The Braff Group covers, Medicare home health is, by far, under the greatest amount of reimbursement and economic uncertainty as lawmakers have proposed up to \$57 billion in cuts over 10 years to fund health care reform initiatives. Accordingly, it is quite notable that even under such duress, transaction activity did *not* grind to a halt and 22 deals were completed in the first six months of 2009 to lead all the health care service sectors we track. Furthermore, we saw an uptick in activity in the second quarter, perhaps reflecting, as suggested earlier, greater confidence on behalf of buyers regarding (a) the ultimate outcome of health care reform and/or (b) their ability to manage through it.

Second, and perhaps not at all unexpected, with state government tax revenues plunging as a result of the recessionary economy, Medicaid programs are very much in flux and are facing a host of “good news/bad news” developments. On the positive side, according to the Kaiser Commission on Medicaid and the Uninsured, the American Recovery and Relief Act of 2009 (ARRA), which provides states with increased Medicaid funding through December 2010, “has been pivotal in helping states address budget shortfalls, avoid or soften Medicaid program cuts and preserve eligibility.” On the downside, however, according to Kaiser’s report, with “few if any states [expecting] state revenues to have fully recovered by 2011”, many state “Directors are seriously concerned about the impact to Medicaid when the enhanced FMAP [Federal Medical Assistance Participation] ends in 2011.” On the upside, once again, various health care reform proposals call for expansions of Medicaid programs and funding, which could trickle down to increased utilization of cost effective home and community based services. But, on the downside, Kaiser reports that Medicaid directors are wary that even with increased federal funding,

Chart 8:
Home Health Care
Deal Volume by
Segment



Source: The Braff Group



**Chart 9:
Private Equity
Investment in
Home Health Care**

Medicare, Medicaid
and Private Duty

Source: The Braff Group

they will not have the full complement of resources necessary to support these initiatives. Given these unknowns – and the risk that goes along with it – consolidators have been somewhat wary of investing in Medicaid focused providers. Accordingly, transaction volume in this segment is down from its peak period which extended from the second half of 2006 through 2007.

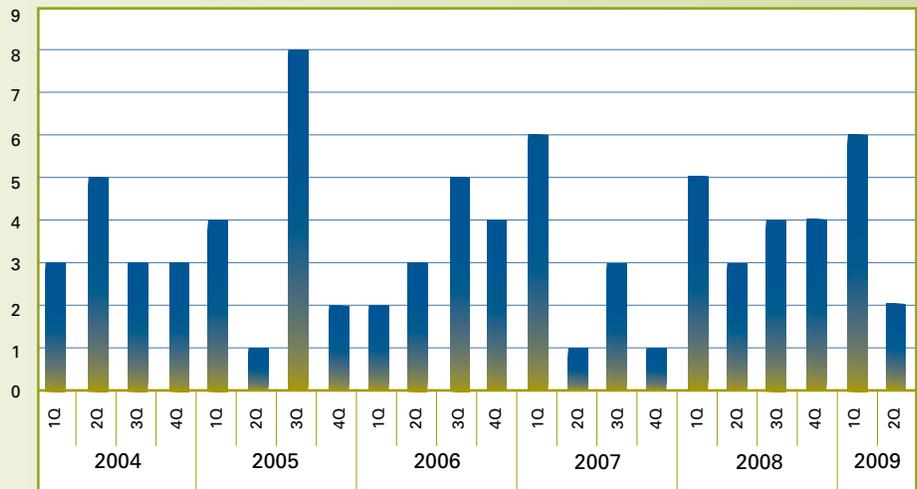
Finally, even though patients have been cutting back hours as a result of the difficult economy, absent the vagaries of government reimbursement, transaction volume in private duty home care has held strong. Moreover, we fully anticipate that, regardless of how health care reform eventually plays out, the risk attendant to government funded health care services is certainly more palpable. As such, we expect an increasing number of buyers to begin seeking out private pay expansion opportunities. Coupled with the fact that many new recent entrants are beginning to reach business cycle maturity and may therefore consider divestiture opportunities, we expect transaction volume in private duty home care to grow steadily, and significantly, over the next 12-36 months.

One final observation of note. As illustrated in **Chart 9**, given the credit crunch and the specter of health care reform, after 12 consecutive quarters in which private equity invested in new home health platform companies, no such transaction has been completed since the third quarter of 2008. While private equity continues to “buzz” around the space and continues to make add-on investments to existing home care portfolio companies, we anticipate continued caution until the direction of the economy, credit, and reform become substantially clearer – and in the best case scenario, more predictable.



We expect transaction volume in private duty home care to grow steadily, and significantly, over the next 12-36 months.

**Chart 10:
Hospice Deal Volume**



Source: The Braff Group

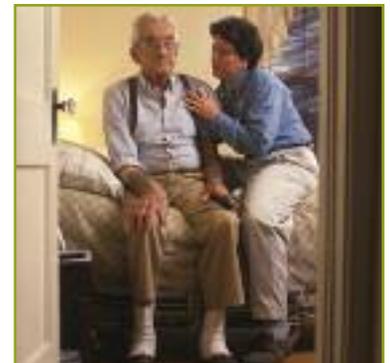
Hospice

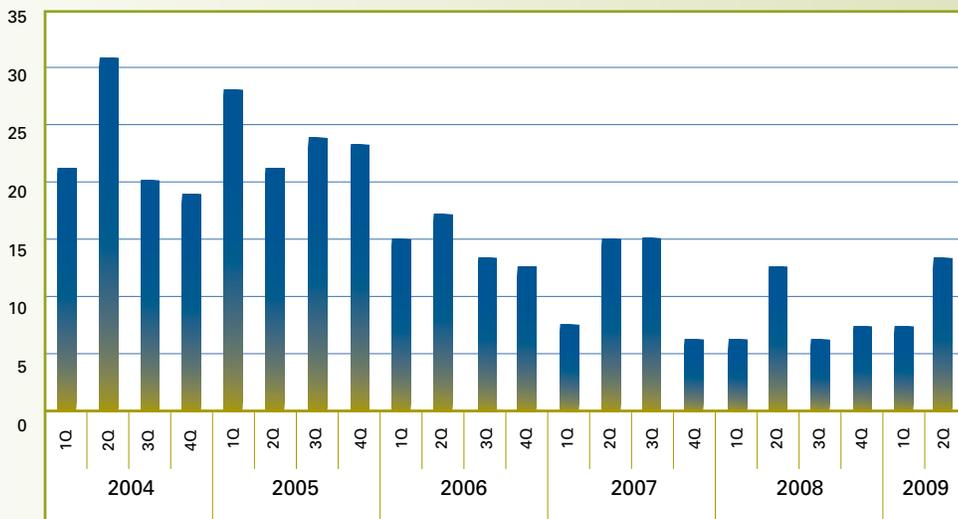
With Medicare and Medicaid home health facing potentially substantial near-term reimbursement change, and MedPAC not recommending a change to hospice reimbursement until 2013, hospice has emerged as the most stable health care service sector. Accordingly, despite what was likely a temporary dip in activity in the second quarter of 2009, hospice M&A activity is generally up over the past 18 months.

While hospice reimbursement reform initiatives are very much in flux, we believe that reform could be beneficial to the industry.

Moreover, while hospice reimbursement reform initiatives are still in discussion, we believe that reform could be beneficial to the industry. The basic outline, promulgated by MedPAC and the Home Health and Hospice Financial Managers Association, calls for a redistribution of payments such that reimbursement is greater at the beginning and end of an episode (when resource utilization is more intense). By adopting such a system, margins would improve for shorter length of stay patients, reducing the need for hospices to offset losses of short-term patients, by seeking out long-term patients. This, in turn, would help hospices remain financially viable without bumping up against annual payment caps.

Considering all of the above then, we fully anticipate an increase in hospice merger and acquisition demand, volume, and value over the next 12-24 months.





**Chart 11:
Home Medical
Equipment Deal
Volume**

Home Medical Equipment

As we have long reported, with the risk overhang of competitive bidding and recommendations to reduce the cap on oxygen reimbursement from 36 months to 18 or less – risks that became evident between 2004 and 2005 yet remain un-adjudicated – transaction volume has fallen off dramatically. Notably, however, for the first six months of 2009, it is the only sector that we cover that posted an increase in transaction volume over the same period last year (19 vs. 18). Moreover, the 13 transactions completed during the second quarter of 2009 were the most we’ve seen in the HME sector since the third quarter of 2007 (see **Chart 10**).

Rather than this being indicative of the leading edge of a rebound in home medical equipment M&A, our sense, unfortunately, is that the increase is more a result of long term, would-be sellers (that have grown tired of the continued unknowns and scrutiny from congress) reluctantly deciding to consider risk adjusted buy-out proposals that free them to pursue other ventures, or retire.



With health care staffing in so much immediate turmoil, even the modest eight transactions completed in the first half of the year is somewhat unexpected – as was the pick-up in the second quarter.



Health Care Staffing

Besides private pay home care services, in which we have anecdotal evidence of revenue declines, the only other sector we cover that has been hurt directly by the economy has been health care staffing. However, unlike private duty, where we have seen modest cutbacks in patient utilization (which, in some cases, has been offset by increased census and/or pricing), the staffing sector has been battered.

According to Braff Group research, over the past three consecutive quarters, the publicly traded health care staffing firms we cover posted the greatest median declines in revenue since we began tracking them in 2000. This is due, in large part, to the fact that as a result of the economic downturn, demand for temporary health care staffing is down as (a) hospitals have experienced reductions in census as prospective patients have put off discretionary health care procedures, (b) staff nurses are taking on more hours and (c) attrition and turnover are down.

With the sector in so much immediate turmoil, even the modest eight transactions completed in the first half of the year is somewhat unexpected – as was the pick-up in the second quarter. With firms understandably focusing inward to stem further revenue erosion, we would not anticipate a meaningful rebound in health care staffing transaction volume until the economy rebounds in earnest.

The above notwithstanding, with far fewer acquisition opportunities than per diem or travel nursing, demand remains high for allied staffing and locum tenens companies.

Sector instability notwithstanding, acquisition demand remains high for allied staffing and locum tenens companies.

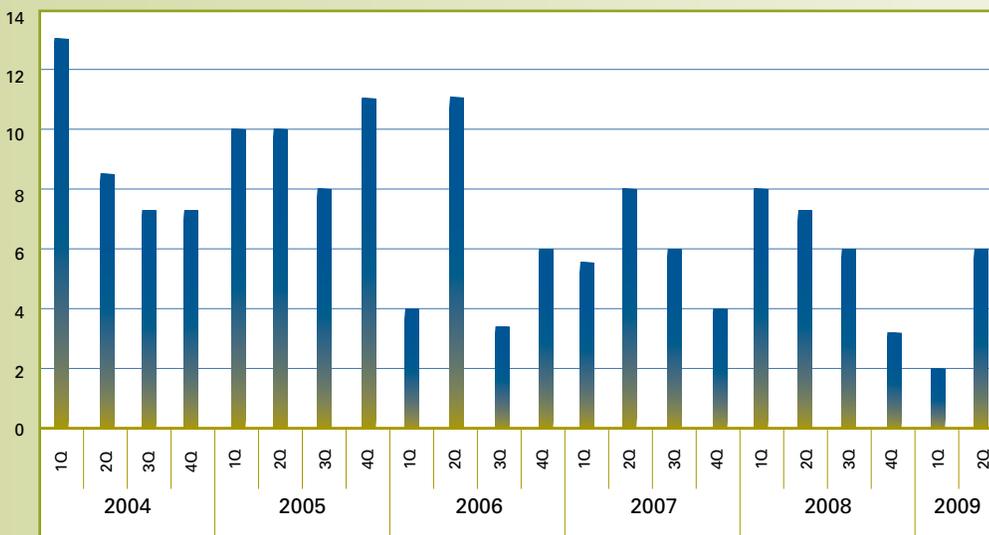


Chart 12:
Health Care Staffing
Deal Volume

Intelligent Dealmaking®

The Braff Group

is the leading investment banking firm specializing in the home health care, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment market sectors.

The firm provides an array of transactional advisory services including sell side representation, debt and equity recapitalizations, strategic planning, and valuation.

Since being founded in 1998, The Braff Group has completed more than **150 healthcare transactions.**

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