the braff group

perspectives

3rd 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

HOME HEALTH M&A ACTIVITY HITS ALL TIME HIGH AS OVERALL 3RD QUARTER VOLUME COOLS

After the Home Medical Equipment sector posted a record number of transactions in the 2nd Quarter, the Home Health sector set a record of its own with 14 deals in Q3, eclipsing the previous high of 13 set during the first quarter of 2003.

Leading the way was **Parthenon Capital's** investment in **AccuMed Home Health** of Austin, Texas, a leading regional provider of home health services in the Southeast. Simultaneous with this platform acquisition, AccuMed acquired Vanguard Home Health and A+ Healthcare Specialists. Combined, AccuMed currently operates 33 branch offices in 6 states.

This further highlights the growing interest of private equity groups (PEGs) in the home health arena given its strong economic fundamentals and comparatively stable reimbursement environment. In the first quarter, PEG activity included acquisitions of **Tender Loving Care Health Care Services** by **Crescent Capital Investments** and **Cambridge Home Health Care** by **Transaction Capital Partners**.

On the Specialty Pharmacy side, while there was only one transaction, it was a significant one. In August, **MIM Corporation (MIMS:NASDAQ)** and **Chronimed (CHMD:NASDAQ)** announced a strategic merger. The combined entity, which will operate under the name BioScrip, will be one of the largest specialty pharmacies in the nation. According to a MIM press release, the merger capitalizes on each entity's strength in balancing "community based care with centralized, nationwide capabilities", a combination high touch/distribution operating model gaining wider acceptance in the Specialty Rx sector.

Merger and Acquisition Transaction Volume

Sector	Q3 2003	Q4 2003	Q1 2004	Q2 2004	Q3 2004	▲ Q3 '03	▲ Q3:Q2
Home Medical Equipment	23	18	19	30	19	-17%	-37%
Home Health Agencies	7	11	12	8	14	100%	75%
Specialty Pharmacy	4	5	5	4	1	-75%	-75%
Infusion Therapy	1	2	0	3	4	300%	33%
Hospice	5	4	4	5	3	-40%	-40%
Staffing	9	4	12	9	7	-22%	-22%
Total	**49**	**44**	**52**	**59**	**48**	**-2%**	**-19%**

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: Hospice

Over the past 30 months, the Hospice merger and acquisition market has changed substantially in terms of (a) the nature and breadth of buyers, (b) supply and demand, and (c) valuation. We are also beginning to see a slight shift in the sector's risk profile.

The past as prologue. To better understand these changes, it is helpful to consider where the market stood at the end of 2002. CMS was in the midst of a major campaign to urge "the physician community, as well as other health care professionals [to] think more about hospice as they care for terminally ill patients". While other Medicare programs were being targeted for rate reductions and were under intense scrutiny for potential abuses in utilization, Hospice was at the other end of the spectrum. As such, compared to virtually every other health care service we track, Hospice had the lowest risk profile. At the same time however, we reported that the demand for hospice acquisitions was relatively light — limited primarily to **Odyssey Healthcare (ODSY:NASDAQ)** — keeping valuations far below what their attractive risk profile would suggest. As such, we felt the sector was ripe for private equity buyers to take advantage of this risk-value arbitrage, and establish competitive positions in the market through focused acquisition efforts.

Fast forward to the end of 2004, and changes in the hospice M&A market become readily apparent.

The nature of buyers targeting Hospice has changed. As we predicted at the end of 2002, based on an analysis of both public and non-publicly announced Hospice transactions tracked by The Braff Group since 2001, private equity groups (PEGs) are clearly making their presence felt in hospice M&A. While from 2001 through 2002 we were able to identify only 1 entry level hospice platform acquisition — and no subsequent "add-on" transactions, over the past 18 months we have seen 5 equity sponsored platform transactions and 5 subsequent add-on deals. As such, while private equity buyers completed only 1 of 24 hospice deals in 2001-2002, since then they have accounted for 11 of 28 deals — more than 39% of the transactions — an extraordinary shift in acquisition activity.

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More buyers are targeting Hospice. In the 2001-2002 period the buyer market was dominated by Odyssey which accounted for a remarkable 75% of the transactions. Since then, as more and more private equity groups have entered the market, while still a prolific buyer, Odyssey's share of transactions has naturally declined — to about 36%. Moreover, while the volume of deals has increased, the number of transactions per buyer from 2001-2002 to 2003-Q3 2004 has declined more than 37% from 3.43 to 2.15 as the breadth of buyers has risen. We expect this trend to continue over the next 12-24 months as (a) previously quiet **Vitas (CHE:NYSE)** and **VistaCare (VSTA:NASDAQ)** more aggressively seek acquisitions, (b) long term care providers increase their community based service offerings by layering on hospice — similar to

strategies already adopted by **HCR Manor Care (HCR:NYSE)** and **Beverly Enterprises (BEV:NYSE)**, (c) home health agencies consider diversifying their service offerings, and (b) private equity groups continue to seek inroads into the market.

The supply and demand curve has changed dramatically. Not surprisingly, with the expansion of buyers there is substantially greater competition for hospice acquisition candidates. And when you factor out the not-for-profits which lack the financial incentives to sell (and account for about 65% of hospice providers), it is apparent that the universe of potential sellers is limited indeed. As such, unlike the conditions that prevailed through 2002, demand far exceeds supply today.

Threats to hospice are beginning to emerge. While not a groundswell of concern regarding the long term strength of hospice, challenges are on the horizon. First and foremost, we are beginning to see companies running into difficulties with respect to their annual cost caps. This is not entirely unexpected as providers try to identify an optimal mix of patient types and adjust their marketing and operating strategies accordingly — a delicate task (much like managing home health agency patients scheduled for 10 or more physical therapy visits) that will likely improve over time. Second, given the estimated 30% annual growth in hospice expenditures since 2001 (which, given the benefits of hospice, has been CMS' intent), MedPac is rightly beginning to focus some attention on the sector. While not a problem in and of itself, in our complex health care system it is extremely difficult to accurately gauge savings in one area as a result of increased spending in another. As such, the financial benefits of hospice may be difficult to isolate. Third, as recently as February the Rand Corporation issued a report bringing these very savings into question. Researchers found that while "cancer patients who chose hospice care were about 1 percent less expensive for Medicare", overall, "expenses were 4 percent higher ... among patients who used hospice services compared with similar patients who received traditional medical care". While researchers were quick to point out that the findings do not negate the enhanced quality-of-life and quality-of-care benefits hospice can offer, with budget deficits soaring, they are a source of concern. The above notwithstanding, on the upside CMS has indicated that a review of hospice reimbursement is a low priority at this time.

Valuations are climbing. Even as threats emerge, compared to all the other sectors we cover — home medical equipment, home health care, infusion therapy, specialty pharmacy, and health care staffing — hospice continues to have the most favorable risk profile. And with demand outpacing supply, valuation has gone up substantially, first for larger players and now for smaller, non-platform companies in the $2M to $5M revenue range.

Why the timing difference? As suggested above, when private equity groups enter a sector, they generally begin with an acquisition of a large, platform size company — $20 million or more in revenues — which has an infrastructure in place to support

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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
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	164.8	204.4	322.4	58.1	230.0	153.3
Q3 04	73.8	217.9	399.4	140.9	155.3	180.6	305.8	58.0	207.9	134.0
Change	**-3.8%**	**-19.5%**	**-5.6%**	**-22.5%**	**-5.7%**	**-11.6%**	**-5.2%**	**-0.2%**	**-9.6%**	**-12.6%**

It was a rough quarter across the board as every sector posted declines sending the TBG Composite Index down 9.6%. The largest fall off was attributable to the Specialty Rx & IV sector, which dropped 22.5% largely on profit warnings from Accredo and a tepid market response to the announced merger of MIM and Chronimed. The HME sector declined 19.5% due to (a) unfavorable nebulizer medication pricing released by CMS and (b) an OIG report indicating that, on average, Federal Employee Health Benefit Plans (FEHBP) paid approximately 15.5% less for oxygen than Medicare.

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

Sector	HME	HHA	Hospice[1]	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	**28.5%**	**8.6%**	**11.6%**	**4.40%**	**6.10%**	**10.46%**
Median EBITDA %	**29.3%**	**6.4%**		**5.00%**	**5.10%**	**6.51%**
Mean MVIC : Revenues[2]	**1.58**	**0.63**	**1.38**	**0.69**	**0.58**	**1.16**
Median MVIC: Revenues	**1.43**	**0.37**		**0.65**	**0.50**	**0.75**
Mean MVIC : EBITDA[2]	**5.53**	**6.64**	**13.37**	**22.66**	**8.67**	**16.28**
Median MVIC: EBITDA	**5.55**	**5.63**		**12.89**	**8.65**	**9.00**

Public Company Performance and Valuation Benchmarks are based on 24 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.

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subsequent smaller acquisitions and/or start-ups. So when the first wave of private equity groups entered the market, the larger players reaped the first surge in valuation — a surge that continues today. These PEGs — and more to follow — are now beginning to execute their follow-up, "add-on" acquisition strategies, driving up the demand for, and valuation of, non-platform providers.

As in all health care situations, hospice valuation is dependent on a variety of tangible and intangible factors — most notably average length-of-stay, admission trends, breadth and depth of market penetration, management, and others. Broadly speaking however, **for firms that develop and implement comprehensive divestiture strategies,** we note the following trends:

For those providers with an average daily census below 250, over the past 12-18 months valuation has climbed from a rather tepid plus or minus 3.0 x earnings before interest, taxes, depreciation, and amortization (EBITDA) to 4.0 to 5.0 x EBITDA. Reflecting increased value accorded to platform sized companies, for firms with average daily census greater than 250, valuations have grown to 5.0 to 7.0 x EBITDA.

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The Braff Group is a middle market 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.