the braff group

perspectives

3rd Quarter 2005

A health care merger & acquisition quarterly

M&A Quarterly Update

3rd Quarter Transaction Volume Surges 16% on Strength of Hospice and Specialty Pharmacy Sectors

With 58 transactions announced or completed during the 3rd quarter, acquisition activity was up 16% over the prior quarter. As we enter the 4th quarter, year to date volume is near dead even with that of last year, with 170 deals.

With only 4 hospice transactions announced or completed during the first six months of 2005, there was a substantial surge of activity during the 3rd quarter with 6 transactions. At 10 deals year-to-date, the sector remains slightly behind the pace of last year in terms of volume. In terms of deal size however, we note a substantial difference. With an abundance of platform-sized transactions in 2004, the hospice M&A market has moved into a more "mature" acquisition phase, with an increasing proportion of smaller "layer-on" transactions.

This quarter also saw a spike in activity in the specialty pharmacy service (SPS) sector with 6 transactions, notably **Express Scripts' (ESRX:NASDAQ:)** $1.3 billion acquisition of **Priority Healthcare (PHCC:NASDAQ)** and **Omnicare's (OCR:NYSE)** $268.75 million acquisition of privately held **excelleRx**. Omnicare's acquisition is particularly noteworthy in that as a provider of pharmacy products and services for approximately 400 hospice agencies serving patients in 46 states, excelleRx expands Omnicare's reach beyond its core long term care institutional pharmacy base. With **Medco's (MHS: NYSE)** first quarter $2.2 billion acquisition of **Accredo**, the sector will once again be well represented in the top 10 deals of 2005 as the line between pharmacy benefit management, specialty pharmacy, infusion therapy, and perhaps now even institutional pharmacy, continues to blur and large providers consolidate within and across multiple fronts.

Finally, the home health care sector continued to shine with 16 deals this quarter contributing to a 31% increase in deal volume year-to-date 2005 vs. 2004. Of particular note was **Amedisys' (AMED: NASDAQ)** $106.4 million acquisition of private equity held **Housecalls**, adding to a growing number of larger sized transactions completed thus far in 2005. Furthermore, fresh from their Initial Public Offering completed in June 2005, **LHC Group (LHCG:NASDAQ)** completed three transactions during the quarter.

Third Quarter 2005 M&A Activity

Sector	Q2 2005	Q3 2005	%	Q3 2004	Q3 2005	%	YTD 2004	YTD 2005	%
Home Medical Equipment	21	19	-10%	20	19	-5%	72	67	-7%
Home Health	14	16	14%	16	16	0%	36	47	31%
Specialty Rx	2	6	200%	3	6	100%	9	12	33%
Infusion Therapy	3	4	33%	4	4	0%	11	9	-18%
Hospice	1	6	500%	3	6	100%	12	10	-17%
Staffing	9	7	-22%	7	7	0%	29	25	-14%
Total	**50**	**58**	**16%**	**53**	**58**	**9%**	**169**	**170**	**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.

Inside this issue:

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Industry Spotlight: Home Medical Equipment

"After contending with a near unending string of price cuts – the latest being MMA inspired FEHBP reductions announced earlier this year – buyers are finally beginning to not dislike non-Medicare and non-oxygen services as much as they have in the past"

Compared to all the other home care related sectors – Medicare and non-Medicare home health, home infusion therapy, specialty pharmacy, and hospice – the home medical equipment sector, by far, has enjoyed the longest, uninterrupted string of consolidation activity; a period that began in the early 80s and continues to remain vibrant 20 years later. Such a long run of consolidation is a testament to the industry's ability to re-imagine and re-configure merger and acquisition strategies to adapt to, and prosper under ever-changing market conditions. Such is the case over the past twelve months, where we have seen substantial shifts in merger and acquisition strategy, largely in response to reimbursement and health care policy initiatives spawned by the Medicare Modernization Act (MMA).

Beyond Medicare Oxygen. Don't get us wrong here. Buyers still love Medicare oxygen revenues – Medicare for its quick cash turnover and oxygen for its uncapped, sustained profitability. It's just that after contending with a near unending string of price cuts – the latest being MMA inspired FEHBP reductions announced earlier this year – buyers are finally beginning to **not dislike** non-Medicare and non-oxygen services as much as they have in the past. We have even heard buyers mention the "D" word of late. That is, the value of Diversifying their portfolio – at least to some degree – away from a strict reliance on Medicare and/or oxygen. While far from a stirring endorsement, this shift in attitude has had a remarkable impact on merger and acquisition activity in recent months. No longer does a firm have to generate 60-70% of its revenues from respiratory products and services to attract acquisition attention (a mix of 40-50% will now often suffice). As long as reimbursement is at least plus or minus $150.00 per month (uncapped), buyers are increasingly less likely to substantially discount the M&A value of oxygen revenues and profits derived from managed care and/or private insurance. Moreover, we have even seen buyers acquire firms that focus on providing oxygen to skilled nursing facilities – a specialty, which, in the past, has been actively avoided.

Infusion Moves up the Priority List. While it would be an overstatement to suggest that, from a merger and acquisition perspective, home infusion therapy is the "new oxygen", it is the product line which has seen the most dramatic increase in acquisition interest – and activity – over the past year. There are several key reasons for this. First, consistent with the theme suggested above, infusion therapy offers home medical equipment providers substantial diversification away from Medicare and oxygen in a product environment in which they are (a) already in, and/or (b) comfortable with. Second, as buyers become larger and the pool of oxygen focused acquisition candidates gets smaller, it is increasingly difficult for firms to rely solely on HME providers to achieve increasingly ambitious growth targets. Having largely been relegated to the M&A sidelines since the market peaked in the mid 90's, the IV sector offers a wealth of acquisition opportunity. Third, and perhaps most importantly, with Medicare beginning to cover home infusion therapy drugs in 2006 as part of the MMA prescription drug package, if the infusion industry is successful in convincing regulators to pattern the benefits after those currently in place in many Medicare Advantage programs (Medicare Part C) or have the benefit shifted to Part B, infusion therapy could prove to be an extraordinary – and perhaps the most significant – growth engine for providers over the near term[1].

Managed Care Makes a Comeback. Once again, turning to the Medicare Modernization Act, one of the most important health care economic policies

[1]As of mid-December, no action has been taken by CMS to pattern the benefit after those currently in place in many Medicare Part C programs or to have the benefit shifted to Part B, either of which would provide the basis to receive reimbursement for critical support services (under current guidelines, according to the National Home Infusion Association (NHIA), "part D will not cover or reimburse for the majority of pharmacy and nursing services, supplies, or equipment necessary to

embodied and advanced by the legislation is the reallocation of dollars away from government run Medicare Fee For Service (FFS) to privately administered Managed Care Organizations (MCOs). To facilitate such a shift, under the MMA, MCOs received substantial increases in payments, enough so that according to Urban Institute senior fellow Robert Berenson MD, compared to traditional Fee for Service plans, under the MMA, payments to Medicare Managed Care plans on average are 16% greater than FFS (it should be noted that immediately after the MMA was passed, one of the most active sectors in health care mergers and acquisitions was in the HMO/Managed Care arena as companies sought to acquire more capacity – and more lives – to take advantage of such favorable reimbursement). Many observers believe that unlike the last incarnation of managed care – where overly restrictive access for patients and excessively low and equally slow payments for providers insured its demise – the lucrative kick-start combined with lessons from the past bodes well for success this time around. Subsequently, revenues attributable to managed care are no longer being shunned by buyers in the M&A market. Moreover, in select situations buyers are beginning to target firms with managed care contracts, both for the opportunity to capture more revenues as more beneficiaries move into these plans and to gain the experience and expertise necessary to develop profitable programs of their own in other markets.

Nebulizer Medications Slammed Again. The third quarter ended with the industry feverishly working to dissuade CMS et. al. from reducing nebulizer dispensing fees. Alas, in November, the agency announced cuts of 47.4% and 17.5% for a 30 day supply (following the first month) and a ninety day supply respectively. While it is too early to evaluate the merger and acquisition impact of these changes, after the nebulizer M&A market recovered somewhat in 2005 when the initial dispensing fees restored some profitability to the segment, with these additional cuts, we anticipate substantially reduced appetite for (and valuation of) an acquisition candidate's neb med program.

Leveraging Nebulizer Platforms Into Other Product Lines. While the profitability – or potential lack thereof – hung in the legislative balance for much of 2004, buyers with large, established nebulizer medication programs did not sit by idly awaiting the final outcome. Rather they recognized that the nebulizer customer management, product procurement, billing, and delivery infrastructure could be leveraged to support other product lines with similar market characteristics. Accordingly, over the past 12 months we have seen buyers selectively target diabetics suppliers and other specialty product providers that serve patients with chronic conditions. With the recent cuts in dispensing fees described above, we may see more of this strategy as buyers try to re-deploy their nebulizer infrastructure capacity to support potentially more profitable products.

The Impact of Competitive Bidding. While the specter of competitive bidding looms over the industry as we move closer to the initial roll-out in 2007, from a merger and acquisition standpoint, it has had limited impact to date. As of this writing, absent the identification of (a) the first 10 MSAs to be included and (b) a fully developed and articulated basis upon which winners will be selected (paramount of which is product line and geographic coverage requirements), there is simply not enough information necessary for providers to significantly factor competitive bidding into their M&A planning. On the periphery however, we have seen certain buyers favoring – though not necessarily aggressively targeting – markets in which they (a) anticipate competitive bidding may be implemented and (b) have coverage gaps. Similarly from the seller's perspective, *(continued page 4)*

"In select situations buyers are beginning to target firms with managed care contracts, both for the opportunity to capture more revenues as more beneficiaries move into these plans and to gain the experience and expertise necessary to develop profitable programs of their own in other markets"

safely administer these therapies"). NHIA reports that a recent study conducted by Muse & Associates concludes that "consolidating coverage for home infusion therapies under Medicare Part B beginning January 1, 2006 would result in a **maximum** (emphasis added) net cost to Medicare of approximately $182 million in federal fiscal year 2006, **but offers the potential for significant overall savings through reduced hospital admissions** (emphasis added)".

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 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
Q3 05	80.0	396.1	490.6	126.9	115.8	219.6	511.6	87.5	278.2	198.2
Change	**3.3%**	**10.9%**	**4.3%**	**-11.1%**	**-26.4%**	**-15.4%**	**10.5%**	**24.7%**	**3.9%**	**4.2%**

The TBG Composite Index continued to shine rising for the fourth consecutive quarter. But the results were mixed across the sectors. The quarter ended with Long Term Care at a new all time high, HHA & Hospice just off a record high set in August, and eHealth closing at its highest level since we started the index in February of 2000 (due in part to a favorable market response to WebMD's new IPO (Emdeon) and IDX's impending sale to General Electric). Conversely, the decliners posted double digit drops with the Healthcare Staffing sector, feeling the effects of World Health Alternatives' financial and legal issues, plummeting 26.4% 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.

Q3 Public Company Performance and Valuation Benchmarks

Sector	HME	HHA	Hospice[1]	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	**21.70**	**10.30**	**8.50**	**2.40**	**4.90**	**8.63**
Median EBITDA %	**18.30**	**7.10**		**1.70**	**4.70**	**6.35**
Mean MVIC : Revenues[2]	**1.94**	**0.88**	**1.14**	**0.77**	**0.66**	**1.05**
Median MVIC: Revenues	**1.64**	**0.47**		**0.83**	**0.69**	**0.86**
Mean MVIC : EBITDA[2]	**8.60**	**8.26**	**14.64**	**23.24**	**13.76**	**12.50**
Median MVIC: EBITDA	**8.81**	**7.97**		**23.73**	**13.94**	**10.79**

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)

for companies located in large potential first-round MSAs that have seriously contemplated a sale for other business, financial, and/or personal reasons, the threat of competitive bidding likely has tipped the scale for some in favor of a sale.

Once the competitive bidding MSAs and guidelines are announced, however, we anticipate a surge of activity in these markets as committed firms seek to round out their capacity, as necessary, to position themselves to bid successfully. The larger question, the one that will have a dramatic impact on valuations in these bid areas, is how the delicate balance of supply and demand – one which arguably favors sellers today – will play out. With an expected increase in acquisition demand, it is also reasonable to expect an increase in potential sellers that are ill-suited or unwilling to participate in competitive bidding. If the increase in demand is equal to, or greater than, the increase in supply, valuations will hold, or tick upwards respectively. **If**, however, a wave of sellers floods the market, valuations could suffer. But that is a big "if", one that will depend, in part, on the role (or lack thereof) apportioned for smaller providers in the competitive bidding programs[2]. Furthermore, if ever there was an industry capable of adapting to seemingly unadaptable initiatives, it is the home medical equipment industry. Accordingly, counter to predictions of mass exodus, we suspect that providers that have the energy and enthusiasm to persevere will find opportunities to do just that.

[2]Among other provisions, according to the American Association for Homecare, the Hobson-Tanner Bill (HR 3559), introduced in July of 2005 would "allow all qualified providers that are small businesses and that submitted a bid below the current allowable to participate at the selected award price".

the braff group

Corporate Office
1665 Washington Road
Suite 3
Pittsburgh, PA 15228

Phone: 888-922-5169
412-833-5733
Fax: 412-833-3143
www.thebraffgroup.com

Chuck Gaetano
Atlanta
888-723-9263

Reggie Blackburn
Atlanta
866-455-9198

Patrick Clifford
Chicago
888-922-1834

Bob Leonard
Ft. Lauderdale
888-922-1836

Steven Braff
San Diego
888-922-1833

The Braff Group is a leading 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.