the braff group

perspectives

3rd Quarter 2006

A health care merger & acquisition quarterly

M&A Quarterly Update

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Perspectives is a quarterly health care merger and acquisition journal published by The Braff Group.

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Third Quarter M&A Deal Volume Down 23.4%: Home Medical Equipment and Staffing Continue to Struggle

After posting a strong surge in the second quarter, transaction volume fell 23.4% in Q3 largely due to substantial declines in activity in staffing and home medical equipment of 73% and 44% respectively. Similarly, deal volume was down 29% compared to the same quarter last year. Not surprisingly then, as we enter the final quarter of 2006, activity year-to-date is down 18.3%. ***Unless we see a dramatic, and unprecedented spike in activity in the fourth quarter, 2006 will go down as the first year that we have not seen an increase in transaction volume since The Braff Group began capturing this data in 2001.***

As we have indicated in previous editions of *Perspectives*, the decline in the **HME sector** is part of an overall trend that began when the newly conceived 36 month oxygen caps were introduced in the Deficit Reduction Act announced in December 2005 and subsequently passed in February 2006. With the President's budget released shortly thereafter calling for ratcheting these caps further back to 13 months, and the OIG releasing its own report in September supporting such an initiative, perhaps ***the most interesting development in 2006 is not that HME deal volume has declined nearly 39% year-to-date, but that, in fact, even with the tremendous risk "overhang", there have still been 43 deals completed thus far***. The nature of these deals, however, has changed. Where many buyers previously targeted large transactions, few are willing to place such large "bets" today. Rather, the focus in the current environment is to acquire smaller companies to strategically fill in service gaps. As such, ***private equity groups, that heretofore were unwilling to compete with strategic buyers for the most coveted "platform" companies, are slowly warming up to the strategy of investing in the sector at values below the 2004-2005 peak periods***. Such a ***contrarian play*** could pay off handsomely should the reimbursement climate improve even modestly. Even absent such favorable news, the strategy may yield substantial returns as providers re-engineer their service mix, clinical protocols, and operations to capture greater volume at lesser margins.

As for the **staffing sector**, while industry analysts project sustained growth through 2010 (and the companies that comprise The Braff Group's health care staffing index have posted median growth for the sixth consecutive quarter, the longest streak since the first quarter of 2003), overall acquisition demand is, somewhat inexplicably, tepid. There remains meaningful interest in companies that (continued on page 4)

Third Quarter 2006 M&A Activity

Broad Industry	2nd Qtr. 2006	3rd Qtr. 2006	% Change	3rd Qtr. 2005	3rd Qtr. 2006	% Change	YTD 2005	YTD 2006	% Change
HHA	25	23	-8.0%	20	23	15.0%	58	59	1.7%
Hospice	3	5	66.7%	8	5	-37.5%	13	10	-23.1%
Staffing	11	3	-72.7%	8	3	-62.5%	28	18	-35.7%
HME	18	10	-44.4%	22	10	-54.5%	70	43	-38.6%
Infusion Therapy	3	4	33.3%	4	4	0.0%	11	14	27.3%
Specialty Pharmacy	4	4	0.0%	7	4	-42.9%	11	12	9.1%
Total	**64**	**49**	**-23.4%**	**69**	**49**	**-29.0%**	**191**	**156**	**-18.3%**

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.

Private and State Funded Home Care

"With extremely solid long term growth prospects and the promise of a larger second wave of acquisition activity, we anticipate a long period of consolidation and rising valuations for private home care"

When discussing non-Medicare, private duty services, it is important to further segment the sector into those firms that focus primarily on services reimbursed privately, or through private insurance (Private) and those that specialize in services reimbursed by Medicaid or other state funded programs (State Funded) as each have very different operating, clinical, customer service, and financial dynamics. These dynamics, in turn, drive revenues, profitability, risk, merger and acquisition demand, and ultimately, valuation.

Private Home Health.

Generally, as we define it, in addition to being reimbursed "out-of-pocket" or through insurance, private home health is characterized by skilled and non-skilled care, typically in shifts of 4, to 8, to 24 hours (including "live-ins"). It also includes "non-medical" home care, which, as the name implies, focuses primarily on companionship, light housework, meal preparation, errands, and various other non-medical support services. What distinguishes private home health, however, from virtually every other home care service segment, is that patients truly are customers. As such, the sector is extremely service, relationship, and management oversight intensive – dynamics that drive an operating model in which, quite often, the most successful long term players are those that are relatively small and managed directly by an owner that has a personal stake in the firm's performance. No surprise then that (a) *Private Duty Insider* reports that the median size of a private agency in 2005 was $1.4 million and (b) many of the largest providers in the market have gotten to size by developing owner-operated "branches" through franchising, management equity participation, or by offering management significant owner-like incentives including profit sharing and "phantom" stock.

Implications for M&A.

With market dynamics that foster relatively small, owner dependent businesses that make it extremely difficult to complete enough transactions (and successfully operate them) to reach a critical mass of $50 to $100 million worthy of lucrative size premiums upon exit, private home care is not particularly well-suited for a classic "roll-up" consolidation strategy — a strategy, we might add, that has been extremely prevalent in other home care sectors, particularly Medicare home health and infusion therapy today. But this does not mean that there isn't any demand for acquisitions. Given the unique attributes of private home care, for those providers wishing to develop a private duty presence and skill set, an acquisition is often far more predictable and successful than that of a home grown startup. Not surprisingly, the first wave of acquisition demand has come from well established Medicare providers, including not-for-profits, looking to expand their service offerings. The next wave, however, could push private home care to the forefront of M&A activity. Right now, the primary thrust of buyers and builders in the home care arena is to increase their Medicare capacity. However, once (a) they achieve the Medicare penetration they are targeting and/or (b) the reimbursement outlook for Medicare begins to darken, we expect a spike in demand for private home care providers to stimulate growth, create a seamless continuum of care, and diversify payer risk. With Medicare home health entering its third year of accelerated consolidation, and with soaring budget deficits likely to threaten the sector's six year run of no cuts in reimbursement, this second wave is likely not far off.

Valuation

Over the recent past, valuation of non-Medicare home care providers has been benchmarked against that of Medicare providers. Given that private providers tend to be smaller than their Medicare colleagues with revenues sometimes concentrated among a limited number of long length of stay patients (which can be interpreted as increasing risk), buyers have traditionally pegged the value of private home care behind that of Medicare. However with (a) private reimbursement substantially less risky than that which is government funded, and (b) long length of stay patients offering more predictable, "annuity-like", revenue streams than "episodic" patients, the overall risk-return fundamentals of Medicare versus private home care is arguably more comparable. Even though soaring values of Medicare agencies have enhanced valuation of private providers, our read of the market is that the current acquisition frenzy around the Medi-

care arena has restrained tangible — and intangible — demand for private home care, holding values somewhat in check. However, with extremely solid long term growth prospects and the promise of a larger second wave of acquisition activity, we anticipate a long period of consolidation and rising valuations.

State Funded Home Care

In addition to being funded primarily through Medicaid and other state funded programs, particularly home and community based waivers (HCBS), state funded home care differs markedly from private home care in terms of service intensity and scalability. While state funded providers certainly strive to offer the highest levels customer service, given limited funds and demand that often exceeds providers' resources, it is simply impractical to provide the kind of one-on-one, customized, "never-say-no" array of services private home care patients can demand, pay for, and receive. Accordingly, with more uniform services that are referral source, rather than consumer driven, these businesses are quite scaleable. In fact, particularly in densely populated areas where the need is often the greatest, it is not unusual for state funded providers to generate revenues of $40 to $50 million in revenues or more.

Changing Market Conditions.
According to data presented by the *Kaiser Commission on Medicaid and the Uninsured* in its recently issued annual report on the health of Medicaid programs nationwide, from 1997 to 2002, at the same time the rate of growth in Medicaid spending began to rise steadily and substantially, increases in state tax revenues began to fall as dramatically. At its worst point in FY 2002, spending growth surged 12.4%, while tax revenues actually fell 7.8%, plunging the Medicaid program into extraordinary financial distress – and casting a dark cloud over state funded home care providers. But what a difference four years makes. Since spending growth peaked in 2002, the rate has declined for four consecutive years. Equally important, over the past three years, tax revenues have increased such that for the first time since 1998, in FY 2006, revenue growth exceeded that of spending. Consequently, according to the Kaiser report, while cost containment strategies are still prevalent, "26 states have plans to restore cuts from previous years, expand to new populations, or make positive changes to Medicaid application and enrollment procedures". In combination with legislation mandated under the Deficit Reduction Act that gives states more flexibility in designing consumer focused, non-institutionally based health care services, "a total of 38 states plan to adopt expansions of HCBS [Home and Community Based Services waivers]". So while the fear of Medicaid that peaked in the aftermath of 2002 clearly lingers, the tempered reality is that the current outlook for Medicaid in general, and Medicaid reimbursed home care services in particular, is as bright as we have seen in nearly ten years.

Implications for M&A.
Over the recent past, acquisition interest in state funded home care has been limited to private equity groups that have targeted large providers as a means to gain a foothold in a market and obtain an infrastructure upon which to layer on Medicare and other services. As we enter what could be the beginning of a favorable reimbursement and utilization cycle, we expect to see large state funded providers that have largely sat on the M&A sidelines for the last four to five years reconsider and initiate regionally focused consolidation strategies. We may also begin to see private equity groups target Medicaid providers for the returns they can bring directly (rather than as a means to a Medicare end).

Valuation
Though state funded providers tend to be substantially larger than private home care agencies and do not suffer from a concentration of revenues among limited numbers of patients, valuation metrics for state funded home care has also lagged behind Medicare — in this case due to thinner margins and comparatively greater payer risk. From a practical perspective however, with recent acquisition interest generally limited to the largest providers, there has been virtually no market for state funded providers under $10 million in revenues, except at valuations best described as "opportunistic". As we enter 2007 however, we are cautiously optimistic that a more broad based merger and acquisition market for state funded providers will emerge, giving rise to greater demand at values that more reasonably reflect the sector's current risk-return fundamentals.

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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 Composite	Spread
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
Q3 06	87.1	141.7	523.8	83.1	127.6	213.1	596.6	87.2	264.9	177.9
Change	**4.8%**	**-23.9%**	**-0.3%**	**-11.2%**	**6.4%**	**13.5%**	**1.6%**	**8.1%**	**-0.1%**	**-2.4%**

While the broad markets rose 4.8%, the TBG Composite Index was down slightly (-0.1%) on mixed results across the sectors we cover. Notably, on news that Office of the Inspector General (OIG) recommended that the oxygen rental period be reduced from 36 months to 13 — identical to that in the President's 2007 budget proposal — the Home Medical Equipment sector fell 23.9%. This adds to the woes of a sector, which, since the end of the first quarter of 2006, has plunged 56.6%.

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.

Q3 Public Company Performance and Valuation Benchmarks

Sector	HME	HHA	Hospice[1]	Staffing	Specialty RX & IV	Composite
Mean EBITDA %	**23.80%**	**9.20%**	**11.90%**	**5.30%**	**5.10%**	**11.41%**
Median EBITDA %	**24.80%**	**7.70%**		**5.50%**	**5.10%**	**8.00%**
Mean MVIC : Revenues[2]	**1.31**	**0.89**	**0.79**	**0.75**	**0.40**	**0.86**
Median MVIC: Revenues	**0.89**	**0.69**		**0.83**	**0.22**	**0.80**
Mean MVIC : EBITDA[2]	**5.53**	**8.74**	**8.55**	**15.30**	**9.63**	**9.62**
Median MVIC: EBITDA	**5.68**	**8.70**		**15.90**	**9.63**	**8.55**

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).[1]Two firms included in the sector, therefore mean and median calculations are the same. [2]Figures reflect valuation ratios.

(continued from page 1)
focus on locum tenens, allied staffing, and, increasingly travel nursing. Accordingly, we remain optimistic that M&A activity will catch up with the sector's vastly improved outlook.

It was a busy quarter for private equity groups — large and small — as the investment community continues to target the broad home health care arena.

Home nursing continues to draw investment dollars as ***Eos Partners*** recapitalized ***Addus Healthcare***, a large home care provider based in Chicago with substantial operations, particularly in Medicaid, in the central and western U.S. Additionally, ***Mainsail Partners***, CA and ***Calvert Health Partners***, MD completed initial transactions in home health care.

Kohlberg & Company, NY, which recently backed ***American Homecare Supply***, a Pennsylvania based home medical equipment consolidation play that was eventually sold to ***Air Products***, re-entered home care with platform investments in two New England based home infusion therapy providers.

In hospice, ***Thoma Cressey Equity Partners***, IL, funded ***Cloverleaf Partners*** to acquire Arizona based ***RTA Hospice***. Like Kohlberg, TCEP has also had prior success in home care. In 2004, the firm divested its interests in home infusion therapy provider ***Critical Care Systems*** to ***Curative Health Services***.

Finally, we note the divestiture of ***Trinity Hospice***, a portfolio company of ***KRG Capital Partners***, CO, to ***Sunrise Senior Living***. This marks yet another successful investment and exit in the home care arena for KRG. In 2005, the firm divested its holdings in ***CCS Medical***, a diabetic, respiratory, and other medical supplies provider, to ***Warburg Pincus***, NY.

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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.