3 PERSPECTIVES

THIRD QUARTER 2008

A health care merger & acquisition quarterly review

the braff group

Third Quarter Transaction Volume Down 23% with only Specialty Pharmacy Posting Gains

Year-to-Date Volume down 6%

From a merger and acquisition transaction volume perspective, it was a rough quarter as the number of health care service deals completed and/or announced fell 22.6% – from 62 deals in Q2 to 48 in the third quarter.

The largest fall-off during the period, both in raw deal count and percentage decline, was attributable to the home medical equipment sector, which, in lieu of a delay in the start of competitive bidding in 10 MSAs, received a 9.5% cut on all competitive bid items nationwide – another in a series of reimbursement changes that continues to plague the sector – and dampen acquisition interest. We also note a decline in infusion therapy transactions, that, while large in percentage terms (43%), amounts to a fall-off of only three deals over the period. That said, year-to-date, the sector is running 30% behind last year's record setting pace. Given the continued acquisition interest we are fielding from strategic and financial buyers alike (even despite challenges in the credit markets – see accompanying article, *The Impact of the Credit Markets and a Recessionary Economy on Merger and Acquisition Activity*), our sense is that the fall-off is likely more a function of deal timing than a shift in consolidation strategies or acquisition demand. On the positive side, there was an uptick in deal activity in the specialty pharmacy arena – which posted five transactions, up substantially over the two deals posted in the second quarter.

While the third quarter was down substantially, year-to-date, deal volume is running only 6.4% behind last year's pace. Notably, through the first nine months of the year, the home health care industry – the break-out sector over the past two years – continues to shine, with 87 transactions, up nearly 18% vs. the same period last year.

Chart A:
Third Quarter
TBG Health Care Service Sector Transaction Volume

Source: The Braff Group

SECTOR	2nd Qtr. 2008	3rd Qtr. 2008	% Change	YTD 2007	YTD 2008	% Change
Home Health Agencies	33	27	-18.2%	74	87	17.6%
Hospice	3	3	0.0%	10	10	0.0%
Staffing	6	5	-16.7%	19	19	0.0%
Home Medical Eqpt.	11	4	-63.6%	37	20	-45.9%
Infusion Therapy	7	4	-42.9%	20	14	-30.0%
Specialty Pharmacy	2	5	150.0%	11	10	-9.1%
TOTAL	**62**	**48**	**-22.6%**	**171**	**160**	**-6.4%**

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The Impact of the Credit Markets and a Recessionary Economy on Merger and Acquisition Activity

In the wake of the recent plunge in broad market stock indexes, an increasingly difficult and recessionary economy, and the troubled credit markets that, together, have necessitated massive government bailouts to banks, insurers (AIG), and the auto industry, there is much speculation as to how these developments will affect both the business fundamentals and merger and acquisition activity in the health care services arena.

In general, the impact is mixed, with many health care service providers likely to fare much better than other industries.

Here's how we see it.

Many – though not all – health care service providers will be substantially insulated from (a) the downturn in the economy and/or (b) limited access to capital.

The impact of a downturn in the economy. In the current recessionary economy, with unemployment running high, stock portfolios falling, consumer confidence – and, more importantly, spending – plunging, many industries – including some in health care – are facing severe downturns in business. In a recent article appearing in the *New York Times* entitled *Hospitals See Drop in Paying Patients*, the Times reported a triple whammy of **(1)** declining admissions for often lucrative, but discretionary (or non-time sensitive) procedures such as knee replacements, hernia repairs, and weight loss surgeries, **(2)** an increase in patients, unable to pay for care, seeking treatment in emergency rooms, and **(3)** an increase in bad debt expenses. In the private duty home care arena, where care is often perceived as discretionary, many providers are reporting a fall-off in hours as patients (e.g. customers), cut back services, reacting to a real – or perceived – drop in wealth.

But not all health care is discretionary in nature, nor paid for with substantial out-of-pocket dollars. Notably, the demand for Medicare home health and hospice services is "inelastic" (e.g. demand that is not highly sensitive to changes in an individual's financial resources) – and paid for by the government. And, with no Medicare legislation likely to pass before the end of the year that could threaten a reimbursement update scheduled to go in effect January 1, 2009, the near term funding outlook appears relatively stable. Note, however, that the same cannot be said for Medicaid reimbursed services, which, while similarly inelastic in demand, are funded in part by the states, many of which are facing severe budget deficits as a result of plunging tax revenues. Like Medicare home health, although the home medical equipment sector is already facing meaningful cuts in reimbursement, the fundamental reality of inelastic demand and government funding still holds. As such, these largely Medicare funded health care sectors are substantially (though not completely) insulated from the challenges of a downturn in the economy. On the pharmacy front, many of the services provided by home infusion therapy and specialty pharmacy providers are also non-discretionary. With a reliance on funding from private insurance, we do note, however, some potential exposure with a rise in unemployment (hence, a loss in employer funded coverage), and/or cut-backs in coverage.

The impact of limited access to capital (from an operational perspective). Unlike bricks and mortar and asset intensive providers such as hospitals and long term care that rely heavily on debt to finance day-to-day operations and growth, most of the health care service sector providers that we track – home health, hospice, infusion therapy, specialty pharmacy, health care staffing, and home medical equipment – need to finance little more than accounts receivable, and, for certain providers, inventory. With generally favorable turnaround in accounts receivable – especially for government funded services (but less so for those paid for by managed care) – most of these providers need little, and often, no lines of credit to fund day-to-day operations. Moreover, with minimal capital needs, basic growth and expansion can typically be funded by internal cash flow. As such, from an operational perspective, many of these providers have far less exposure to problems other industries are facing in the wake of a credit freeze.

The challenging credit markets will make it increasingly difficult for private equity groups to generate the returns they seek through acquisitions, however, in many cases, strategic buyers will step in to pick up some, or all, of the slack in demand.

It's an economic fact of life that in financially engineering company buyouts, in general, the greater the debt (versus equity) component of the purchase price, the greater the rate of return private equity can generate. Consequently, if the ability to leverage a deal becomes seriously constrained, the only way for private equity to generate the terms they seek is to lower the purchase price – which can place them at a competitive disadvantage to public and private strategic buyers that **(a)** are less constrained by the immediacy of generating out-sized returns and **(b)** can generate revenue enhancing and cost-saving synergies that financial buyers cannot. Clearly, the debt markets are seriously constrained, and, in some cases, frozen. So much so, that those in the capital markets have come to the conclusion that they can generate higher rates of return by buying highly (and likely overly) discounted mature debt instruments (i.e. those with a track record of on-time payments that suggest low risk of default), then issue new debt where, due diligence notwithstanding, there is no such track record. That said, in our current dealings with private equity and lenders alike, where leverage is available, total debt capacity has fallen from five (or more) times earnings before interest, taxes, depreciation, and amortization (EBITDA) to two to three times EBITDA. And, at least one observer suggested that where lenders generally used to prefer placing large amounts of debt, the preference now is to make smaller bets, making the largest buyouts that much more difficult to complete.

One strategy private equity groups are considering is financing transactions initially with 100% equity, and refinancing with debt later when the credit markets thaw out. While an effective approach to bridge the financing gap, the added risk attributable to an uncertain and unpredictable refinancing still puts some downward pressure on pricing. We should also point out that some PEGs manage their own debt funds, giving them ready access to debt capital that others cannot tap. Finally, we are beginning to see some PEGs look to the sellers themselves to finance a portion of the transaction, which, interestingly, with that much more of a seller's "skin in the game" (in addition to any retained equity), may give traditional lenders additional confidence to free up more credit.

All things considered though, the tight credit markets have put a crimp into both private equity demand and valuation of even the most attractive health care providers, even though, as discussed earlier, in many cases, the underlying risk-return fundamentals of these targets are largely unchanged. The good news though, as suggested above, is that strategic buyers – particularly those that are publicly traded and have been rewarded in the stock market for acquisition fueled top and bottom line growth – seem to be picking up any slack in demand.

The question is, can even these strategic buyers obtain the financing to continue their consolidation strategies? Difficult to predict, but, at least compared to their private equity counter-parts, they have several distinct advantages: **(1)** As indicated above, strategic buyers can often generate revenue enhancing and cost saving synergies, which effectively raises their debt capacity; **(2)** For publicly traded buyers, convertible debt is more liquid, hence, more valuable; **(3)** As ongoing entities (often with a long history of successful operations) that are typically less leveraged than PEG sponsored firms, sellers are likely to be more comfortable with seller debt as part of a strategic buyer's funding package; **(4)** In some cases, strategics can fund transactions, at least in part, with internally generated cash flow (albeit, perhaps, at a slower pace than when complemented with debt); **(5)** Although we have not seen much of this in the recent past, publicly traded strategics can fund deals, in part with stock. With strong track records, and "guaranteed" liquidity (generally in no more than a year), in the current market conditions, sellers may be more inclined to consider financing of this type. This may be particularly true in the home health care arena where *The Braff Group Index* of publicly traded companies has soared to new record highs, despite the challenging economic conditions.

Given all of the above, while other industries may suffer, we anticipate continued — and, in some cases — robust acquisition activity in the sectors we cover during this challenging period.

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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.

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If deal volume holds up in the fourth quarter, the sector may eclipse the record tally posted last year of 105 deals (records for both home health and all the sectors The Braff Group monitors). Year-to-date, health care staffing and hospice transaction activity are running dead-even with last year's pace, with 19 and 10 deals respectively. And not surprisingly, as suggested in **Chart A** (page 1), the largest year-to-date decline is attributable to the HME sector, down nearly 46% vs. the same period last year.

Highlights for the quarter include four new private equity platform acquisitions, three of which were in the home health arena:

Water Street Healthcare Partners' $147 million acquisition of a 69% interest in **Gentiva's** (NASDAQ:GTIV) **CareCentrix** home health and ancillary service management and coordination unit – a deal that allows Gentiva to focus more on its core, direct delivery model, generate cash, and participate in the spin-off's future growth by retaining a meaningful equity interest. **Summer Street Capital Partners'** acquisition of a controlling interest in Buffalo based regional provider, **WillCare** – a transaction that will likely jumpstart WillCare's desire to expand their geographic footprint. Finally, on the home health side, was a Braff Group led transaction between a private equity group, that prefers to go nameless, and **Freedom Healthcare, LLC**, a large, leading provider of private duty services in New Jersey. The transaction is notable not only given its size (in a home care niche in which median revenues are less than $2M, Freedom was substantially larger), but also due to its recapitalization by private equity (which heretofore, has been focused mostly on Medicare home health). We expect to see more private equity interest in private duty in the coming years, especially as the Medicare reimbursement climate becomes more challenging, and the private duty market begins to surge with predictable, and inevitable, increases in utilization. Lastly, in new private equity platform transactions during the quarter, in the specialty pharmacy arena, **Lake Capital Partners** recapitalized Braff Group client **IntraFUSION**, a Houston, Texas based specialty pharmacy physician practice management firm – a transaction which will help IntraFUSION expand the development and management of its physician office-based infusion centers throughout the country.