4 PERSPECTIVES

FOURTH QUARTER 2008

A health care merger & acquisition quarterly review

the braff group

Fourth Quarter Deal Volume Plunges 27%

Amidst Decline, Home Health Posts Record Number of Deals in 2008

In the wake of a worldwide recessionary economy and constraints to debt, health care services could not completely escape the malaise that has settled over the merger and acquisition environment. According to Thompson Reuters, global fourth quarter M&A activity fell nearly 35% in total dollars vs. the third quarter and 37% in volume compared to the same quarter last year. In the US, fourth quarter volume plunged an astonishing 55%. On an annual basis, global deal volume fell nearly 30% in 2008 vs. 2007, with the United States posting an even steeper full year decline of 37%.

Comparatively, from a merger and acquisition perspective the health care service sectors that The Braff Group tracks fared substantially better than the overall international and domestic markets. On an aggregate quarterly basis, transaction volume fell "only" 27% in the fourth quarter vs. the third quarter of 2008 and 20% vs. the same period last year. More importantly, on an annual basis, amidst the extraordinary declines indicated above, 2008 merger and acquisition activity in the health care service sectors we cover was off only 7% from that of 2007 with three sectors – home health, hospice, and staffing – actually posting increases.

Home Health Care: For the second year in a row, the home health sector recorded a record number of transactions with 119 deals, up slightly (3.5%) from its previous record of 115 deals set in 2007. The sustained acquisition interest in the sector mirrors what we have seen in the public markets. While The Braff Group's Broad Market Index fell 37% in 2008, our home health and hospice index of publicly traded providers soared 46% on sustained growth in revenues and profitability, disciplined and successful

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Chart A: Fourth Quarter 2008 M&A Activity

Source: The Braff Group

BROAD INDUSTRY	3rd Qtr. 2008	4th Qtr. 2008	% Change	4th Qtr. 2007	4th Qtr. 2008	% Change	YTD. 2007	YTD 2008	% Change
HHA	29	23	-20.7%	30	23	-23.3%	115	119	3.5%
Hospice	4	3	-25.0%	1	3	200.0%	11	15	36.4%
Staffing	6	3	-50.0%	4	3	-25.0%	23	24	4.3%
HME	6	7	16.7%	5	7	40.0%	48	34	-29.2%
Infusion Therapy	5	3	-40.0%	5	3	-40.0%	27	19	-29.6%
Specialty Pharmacy	6	2	-66.7%	6	2	-66.7%	16	13	-18.8%
TOTAL	**56**	**41**	**-26.8%**	**51**	**41**	**-19.6%**	**240**	**224**	**-6.7%**

The Top 10 Events That Shaped Health Care Service Merger and Acquisition Activity in 2008

In no particular order…

1. Barack Obama wins the presidency and the Democrats hold majorities in Congress.

Though certainly not a guarantee (recall that the Balanced Budget Act of 1997 was passed under the Clinton administration), Democrats (a) lean more favorably to Medicare, and (b) are generally less inclined to support privatization initiatives – notably Managed Care. Both bode well for Medicare funded health care services.

2. The credit crunch limits private equity's access to debt.

Generally speaking, in financially engineered transactions, the greater the amount of debt a private equity group (PEG) can deploy, the greater the rates of return it can enjoy. As debt becomes scarce and expensive, the primary tool PEGs can use to increase their rate of return is to reduce price, which may render their offers less competitive. Accordingly, we may begin to see reduced M&A activity from private equity.

3. The recessionary economy has contributed to substantial state budget shortfalls.

According to the Center on Budget and Policy Priorities, "At least 44 states faced or are facing shortfalls in their budgets for this and/or next year." With Medicaid accounting for a significant portion of most states' budgets, virtually all are looking to trim Medicaid spending to bridge their budget gaps – cuts that will likely trickle down to virtually all health care services.

4. Home Health Prospective Payment System Reforms are initiated.

After the industry made the difficult transition from the interim payment system to the prospective payment system, providers were extremely apprehensive about changing what they had, perhaps reluctantly, grown comfortable with. While under PPS reform, some agencies have benefited greatly, with others less so, our read is that, for the most part, providers feel that the revisions better match revenues and resource utilization, a positive iteration to the PPS model.

5. Blackstone Group acquires Apria.

While this may appear to be a home medical equipment event, we believe it is far more noteworthy from an infusion therapy perspective. After Apria's late 2007 acquisition of Coram, the firm was one of the largest providers of home infusion in the nation, with more than $800 million in IV revenue. Our sense is that with Apria's core home medical equipment business hampering its public stock valuation, Blackstone likely saw the acquisition as a "back door" into the infusion therapy arena – a sector that remains highly coveted in the investment community.

6. Publicly traded home health care providers soar while the broad markets plunge.

While The Braff Group's Broad Market Index fell 37% in 2008, our Home Health and Hospice Index surged an extraordinary 46% on the strength of (a) record growth and profitability, (b) successful acquisition strategies, (c) favorable PPS reforms, and (d) recognition that health care services are non-discretionary in nature and are less subject to downturns in the economy. This performance will likely bring more attention, investment dollars and, perhaps, credit to the home health care arena.

7. CMS begins collecting additional detailed information on Hospice.

In July, CMS began requiring that hospices report detailed information regarding visits performed by nurses, social workers, home health aides, physicians and nurse practitioners, as well as charge data.

This is likely a key step in gathering the information necessary to develop payment reforms for hospice. The good news is that the industry is mobilizing efforts to get "in front" of these reforms and participate cooperatively to improve the benefit.

8. Roll out of competitive bidding delayed.

In July, as part of the Medicare Improvements for Patients and Providers Act, Congress delayed the implementation of competitive bidding for home medical equipment (HME) – a delay that was financed by a 9.5% cut in reimbursement. With competitive bid pricing in the first 10 MSAs averaging about 26% below then current Medicare rates – and with many believing that momentum is gaining to eliminate competitive bidding entirely in exchange for less draconian reimbursement concessions – from a financial perspective, this could be viewed as a big win for the industry. But from an M&A perspective, it is not. In our view, the driving force behind the plunge in deal volume from a peak of 97 and 95 in 2004 and 2005 respectively to 34 transactions in 2008 is due to the 36 month cap on oxygen reimbursement. A cap, we might add, that many wish to ratchet down further to 13-18 months. Absent a complete elimination of cap language (a revision that, considering the delay in competitive bidding, will be that much more challenging to negotiate) we don't anticipate any significant up tick in HME consolidation activity.

9. Returns on Treasury Bills go *negative*.

On December 9th, ever so briefly, investors bid up three month treasury bills to the point where, for the first time, returns went negative. In so doing, investors were saying that they felt safer buying bonds at a guaranteed slight loss if held to maturity, than putting it in any other investment, or a bank, or even a mattress for that matter. We find this most meaningful in that it signaled an extraordinary crisis of confidence, a crisis that may give even the most confident of executives, in sound businesses, reason to pause when it comes to pulling the trigger on merger and acquisition fueled growth initiatives.

10. MedPAC considers going beyond recommending a freeze to the Medicare home health update.

As an alternative to the "annual" recommendation by MedPAC to freeze the home health update in 2010, in December, staff offered a draft recommendation to cut the episodic base rate by 5% in addition to the scheduled 2.75% creep adjustment. While only a draft recommendation (in early January, MedPAC voted instead to accelerate the 2011 creep adjustment to 2010), the industry's risk profile definitely ticked upward.

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acquisition strategies, favorable reimbursement reforms, and the predictability of continued demand for services that are non-discretionary in nature. Even in the distressed economic climate where access to debt is constrained, private equity continues to invest in the sector, accounting for 26 deals in 2008 vs. 33 in 2007. Although MedPAC recently issued a draft recommendation to accelerate rate reductions scheduled for 2011 to 2010 – an unexpected development that, while not yet endorsed by Congress (and may not be), sent stocks downward – we expect yet another year of robust activity given the sector's substantial upsides.

Infusion Therapy: Another area of particular interest is the infusion therapy arena, where, after setting a record number of transactions in 2007 with 27 deals, deal volume declined about 30% in 2008 to 19 transactions, the same as that recorded in 2006. Some of the decline may be due to timing, as we note that many would-be 2008 closings have been slowed as buyers and lenders are being more cautious in their deal making, ratcheting up scrutiny in all areas of due diligence. Furthermore, while demand remains high for acquisition candidates, in the comparatively small infusion therapy niche, after five consecutive years of increased transaction volume, the supply of attractive mid to large size acquisition candidates is beginning to shrink.

Specialty Pharmacy Services: In the related specialty pharmacy services sector, 2008 produced 13 deals, which, though down from 16 in 2007, is just below the average number of deals we have seen since 2001 (14.7) – a period during which the sector has shown no real peaks or valleys.

Hospice: While in raw numbers, hospice activity is comparatively modest, we saw a meaningful increase in deal volume in 2008 as the sector posted 15 transactions, up from 11 in 2007, and approaching the peak level of 17 deals achieved in 2003. As we have long surmised, transaction volume in the hospice sector has been far more limited by the supply of acquisition candidates than demand. After a lull in 2007, and as providers learn to better manage the oft vexing annual cap, it is no surprise that activity has ticked upward.

Home Medical Equipment: 2008 deal volume in the home medical equipment sector fell yet again – a 29% drop to close the year at 34 transactions. This marks the fourth straight year of decline from the sector's peak of 97 deals posted in 2005. Until (and unless) the oxygen cap provisions stipulated in the Deficit Reduction Act of 2006 are repealed, we anticipate more of the same tepid acquisition climate in this once high flying sector.

Health Care Staffing: Finally, we note that the health care staffing market posted a slight increase in transaction volume (24 deals in 2008 vs. 23 in 2007). This was somewhat unexpected in that, for the most part, outside the niche locum tenens, and allied staffing micro segments, (which *Staffing Industry Analysts* project to grow 14.0% and 4.5% respectively in 2009), as a result of the recessionary economy, declining hospital admissions (due to fewer elective procedures), and hence, reduced staffing needs, the larger per diem and travel sectors have seen contractions in market size, and, in turn, acquisition demand. With a far fewer supply of highly sought after (and highly valued) physician recruitment, locum tenens, and even allied staffing acquisition candidates available, we may see a slowdown in staffing M&A activity in 2009 – unless, we should point out, we see a surge of "opportunistic" (i.e. attractively priced) deals for struggling nursing providers. Time will tell.

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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.