4 PERSPECTIVES

FOURTH QUARTER 2009

A health care merger & acquisition quarterly review

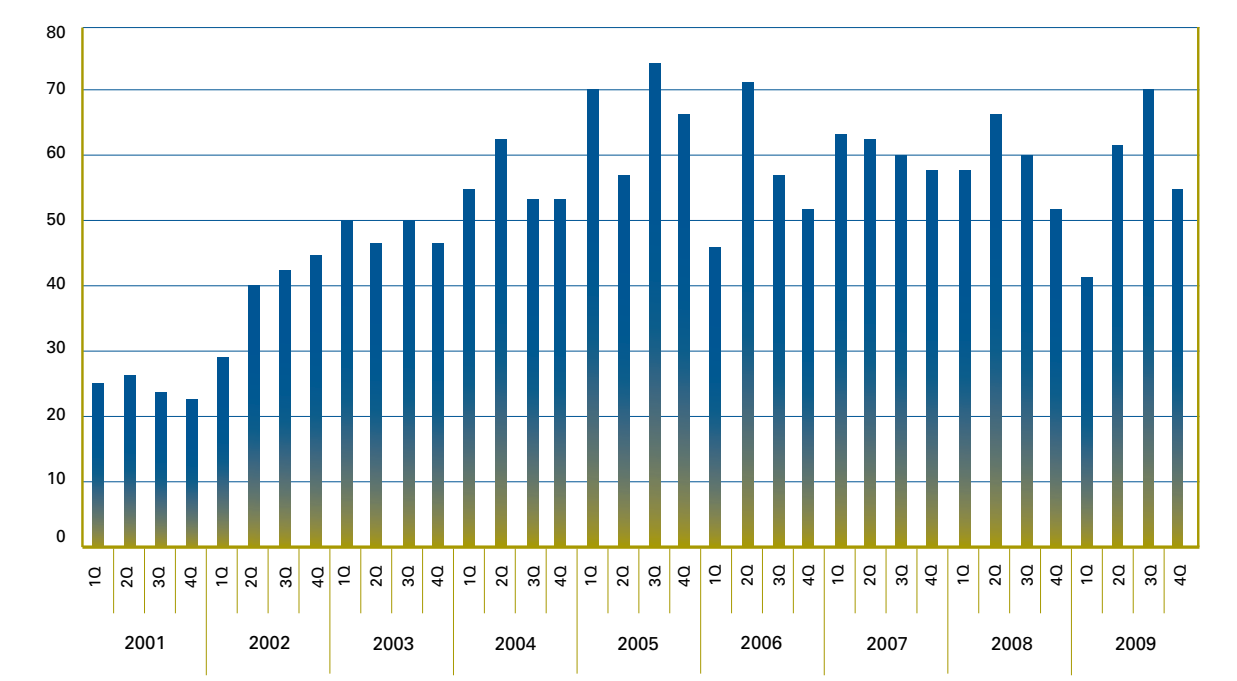
the braff group

In a Challenging Year, 2009 M&A Volume Down only 5.6%

2010 Well Positioned for a Surge in Activity

After first quarter 2009 transaction volume plunged to its lowest levels since the second quarter of 2002, amidst continued economic turmoil and the initiation of health care reform, one might have anticipated a disastrous year for mergers and acquisitions in the health care service sectors that we cover. But after substantial surges in activity in Q2 and Q3, as illustrated in **Chart 1**, the year ended with a total of 237 deals – down, in retrospect, what feels like a relatively modest 5.6% vs. 2008.

Chart 1:
Health Care Services Deal Trends



Source: The Braff Group

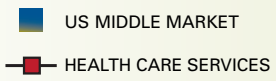
The results look even better when compared to aggregate middle market M&A activity for all industries, which, according to data culled from *Thomson Reuters*, fell 16.6% over the same period. As we can see in **Chart 2**, while trends in health care service transaction volume tracked closely with middle market M&A activity from 2007 through the first quarter of 2009, health care service deal-making recovered at a far faster rate than the overall mid-market, predictably trailing off in the last quarter as would-be buyers and sellers waited out the closing months of key reform debate.

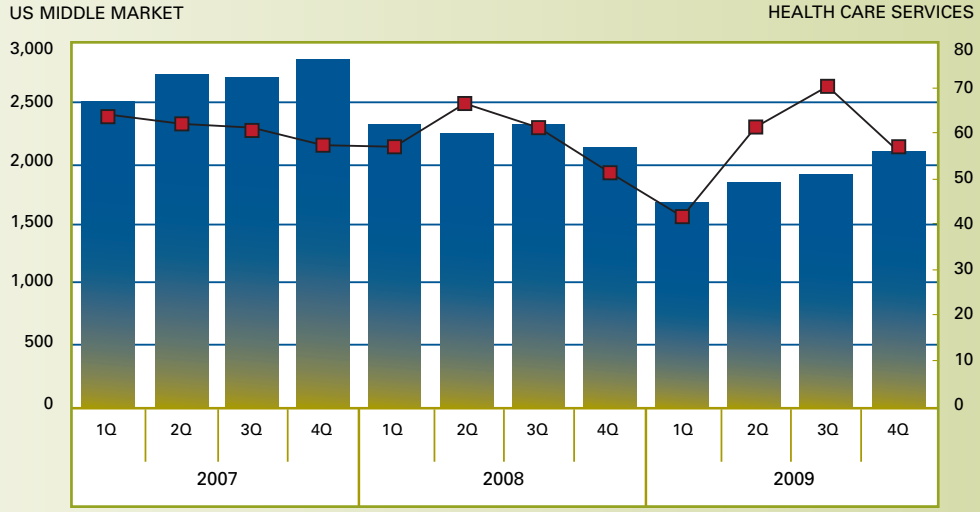
Health care service deal-making has recovered at a far faster rate than the overall mid-market.

The theme of investor confidence in health care services rebounding sooner and/or at a faster rate than all industries as a whole, is similarly reflected in the stock market and private equity activity.

As evident in **Chart 3**, when The Braff Group's Broad Market Composite Index, consisting of the Dow Jones Industrial Average, the S&P 500, and the NASDAQ 100, began its near steady decline toward the end of 2007 when the economy began to slide, our TBG Composite Index, that tracks the performance of 31 stocks in the home health and hospice, pharmacy services, home medical equipment, health care staffing, hospitals, long term care, and eHealth sectors, was on its way to a record **high** in August of 2008.

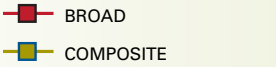
Chart 2: US Middle Market vs. Health Care Services Deal Trends

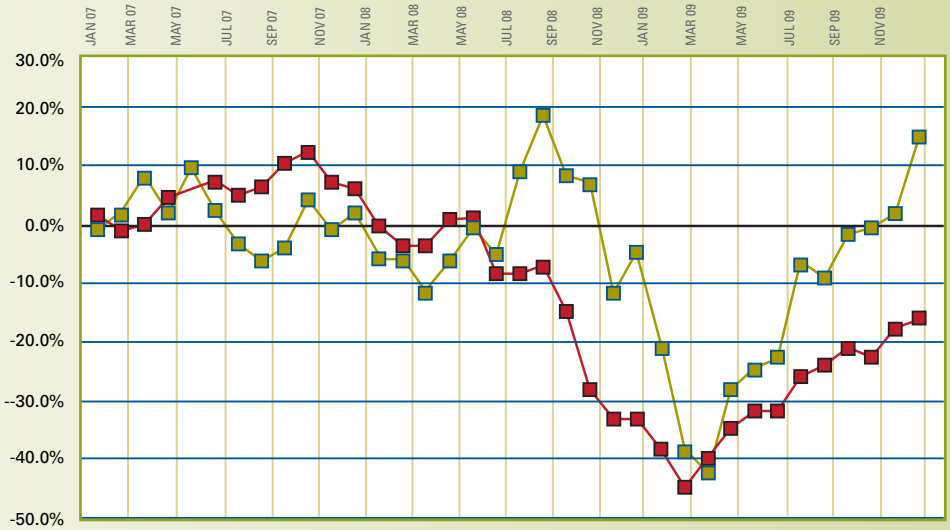




Source: The Braff Group / Thomson Reuters

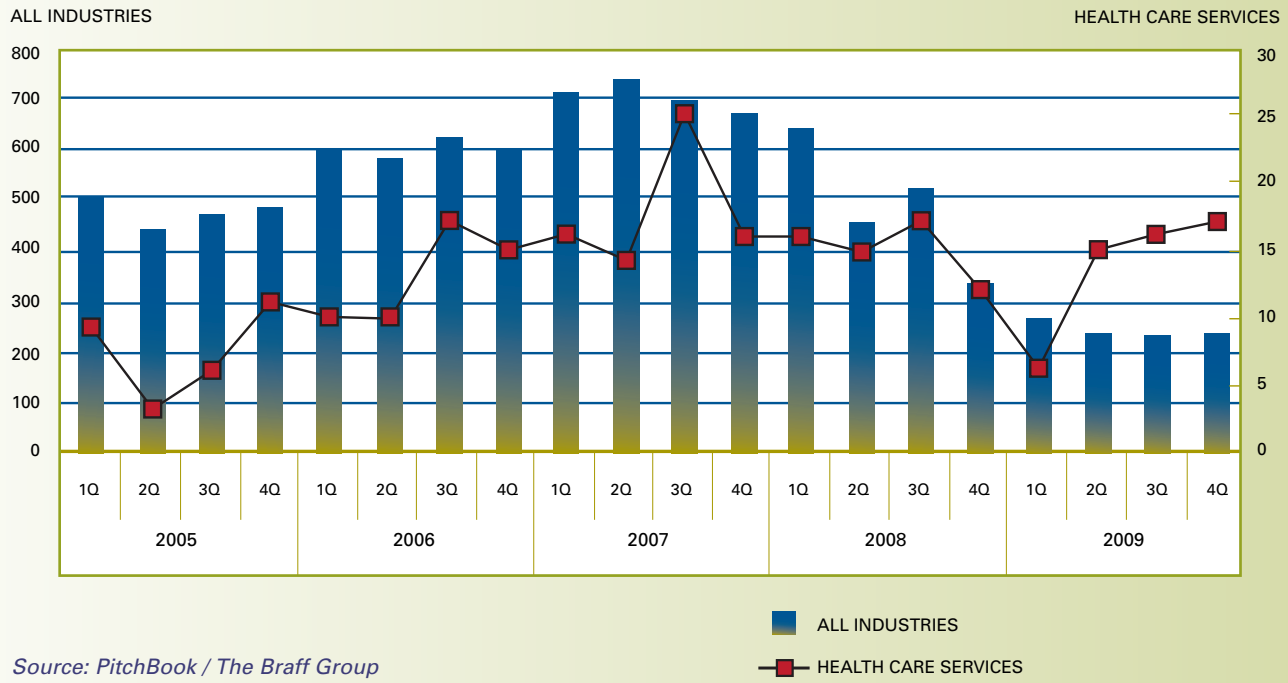
Chart 3: Changes in TBG Index: 2007 – 2009





Source: The Braff Group

Chart 4:
Private Equity Deal Trends for All Industries vs. Health Care Services



Source: PitchBook / The Braff Group

While the broad market declines eventually began to drag down the health care composite shortly thereafter, it wasn't until the first quarter of 2009, when changes in reimbursement and the beginnings of health care reform began to take shape, that health care services saw its most precipitous drops.

But owing to the recession resistant and market expansion investment fundamentals of health care, while the broad markets began to recover late in the first quarter, after the initial shock of health care reform gave way to a more reasoned assessment of health care's continued, long-term prospects, our Health Care Composite Index rebounded at a far faster rate, ending the year only 3.2% off its all time high.

After the initial shock of health care reform, the TBG Health Care Composite Index rebounded at a faster rate than the broad markets, ending the year only 3.2% of its all time high.

Again, we see the same pattern in private equity group (PEG) activity. As evident in **Chart 4**, according to *Pitchbook*, private equity deal flow for all industries has fallen steadily to its lowest levels since pre-2005. However, based on proprietary data collected by The Braff Group, private equity investment in the health care service sectors that we cover began to rebound meaningfully in the second quarter of 2009, as many of these investors sought out health care (and those attractive investment fundamentals) to restart their buyout activity.

Moreover, as illustrated in **Chart 5**, while *total* private equity investment in health care services fell 11.1% (despite the mid-year rally), initial investments in *platform companies* actually **rose** 25% in 2009. This bodes well for increased "follow-on" deals in 2010 and beyond as PEGs leverage their platforms' management, operating, and billing infrastructure to build scale and increase profitability.

As indicated above, the fall-off in health care service M&A activity *by number of deals* completed and/or announced was 5.6%. But, in terms of the size of those deals, the decline appears to be substantially greater. Based upon an analysis of the purchase prices of the largest deals in 2008 and 2009, for which purchase prices were publicly announced, aggregate and median purchase prices for the 10 largest deals of 2009 fell a stunning 86.4% and 88.4% respectively vs. 2008. This likely reflects that while buyers were quicker to return to health care services than other industry sectors, as demonstrated in detail above, they did so cautiously, limiting their investments to smaller transactions that required less credit, and more importantly, limited their risk exposure.

Overall Outlook

A variety of factors are converging that could make 2010 a record year for merger and acquisition activity in the health care services arena:

Post health care reform "bump". As illustrated in **Chart 6**, as the market began to recover from the initial shock of health care reform, the TBG Health Care Composite Index surged 97.8% since March, recovering almost all of what it had lost since its peak in August of 2008. That said, we believe an additional "bump" is likely to occur once reform is finally adjudicated, and the risk of the **unknown** unknowns – which are still exerting a downward pull on health care – is eliminated. And with it, we should see even more investor enthusiasm in health care services.

Private equity returns. After many private equity groups were content to remain on the sidelines in 2009, tending to their portfolio companies while the economy and the credit markets were in turmoil, sitting literally on billions of un-invested funds, the pressure will be on to re-engage in buyout activity in 2010. This return will be aided by an economy and credit conditions that slowly, but steadily, continue to show signs of improvement. According to proprietary Braff Group data, with private equity accounting for 25.3% of all deals since 2006, their collective activity is critical to sustaining M&A demand, volume, and valuations, especially for larger transactions of $50 million or more (which, as suggested above, fell disproportionately more in 2009 than deal volume for smaller transactions).

After many private equity groups were content to remain on the sidelines in 2009, the pressure will be on to re-engage in buyout activity in 2010.

Strategic buyers and prospective sellers will fully re-engage. With the uninterrupted drone of bad news regarding bank failures, bankruptcies, credit defaults, shrinking GDP, stimulus packages, and unemployment, which played out amidst debate regarding health care reform and critical reimbursement initiatives that initially drove the TBG Composite Health Care Index to its lowest level since June of 2003, it's no wonder why, much like private equity, many potential buyers and sellers chose to wait out the uncertainties that defined much of 2009. And, for those buyers and sellers that **did** test the markets, it's also no surprise that transactions were tougher to complete, as buyers sought to hedge their bets by lowering pricing while sellers tended to remain confident that the worst of reform would not come to pass. But, as the economic outlook has brightened and reimbursement exposure from health care reform has become more defined, would-be 2009 buyers and sellers will both hit the markets in 2010 – a combination of pent-up demand and pent-up supply which should drive transaction volume.

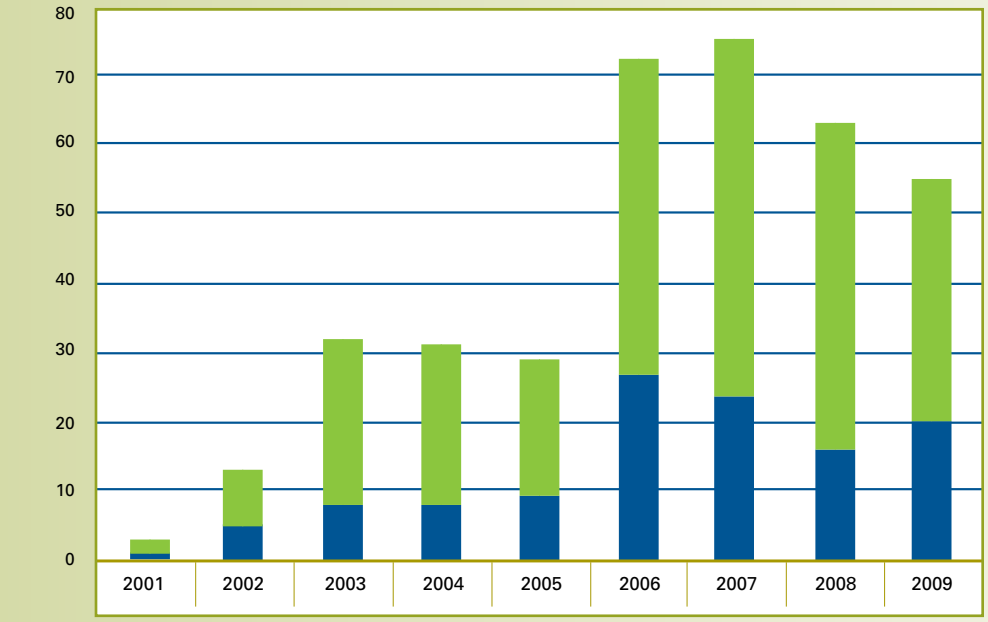


Chart 5: Private Equity Investment in Health Care Services

Source: The Braff Group

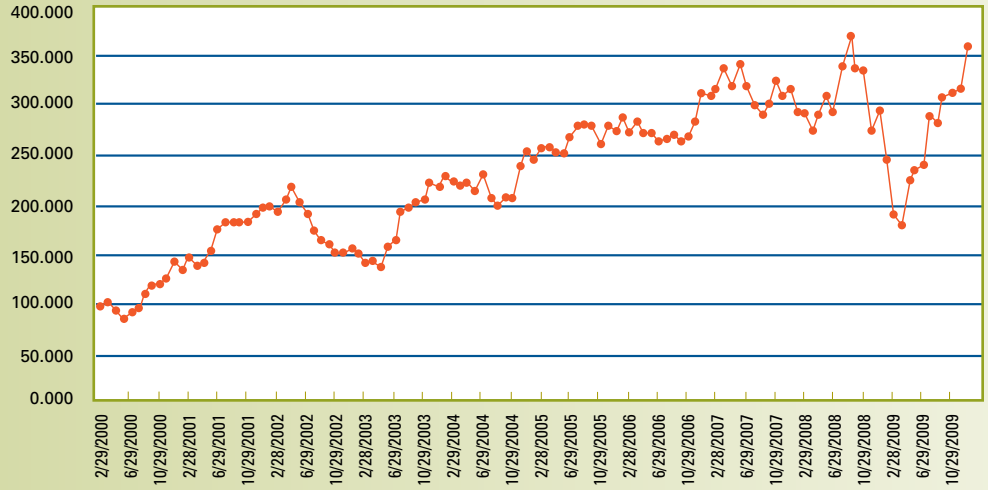


Chart 6: TBG Composite Health Care Index

Source: The Braff Group

A potential increase in capital gains tax will accelerate exit strategies. The Bush tax cuts initiated in 2001 are scheduled to expire on December 31, 2010. Accordingly, absent congressional intervention, long term capital gains tax will rise from 15% to 20% in 2011. Additionally, there is fear that capital gains tax may be raised even further to help fund health care reform or to begin to attack the nation's soaring deficits. With the potential for increased taxes of 5-10%, or more, many would-be *2011* sellers will accelerate their exit strategies and try and complete a deal in 2010.

All considered, 2010 is shaping up to be a year in which previously idled buyers, that need to acquire in order to generate investment returns (private equity) or sustain growth trends (strategic buyers), will aggressively return to an M&A market supplied by would-be 2009 sellers, 2010 sellers, and would-be 2011 sellers. Accordingly, the conditions are ripe for a substantial surge in transaction activity – both in volume and size – in the coming year.

Sector Specific Round-up

Pharmacy Services

From an M&A perspective, 2009 was a slow year for all of the pharmacy service sub-segments that we track – home infusion therapy, specialty pharmacy services, and institutional pharmacy. As illustrated in **Charts 7, 8, and 9**, each of these segments saw declines in deal volume in 2009, echoing similar trends seen in 2008. Unlike many of the other sectors that we track, our sense is that these declines are not a referendum on the economic health of these industries, rather they reflect other variables that have slowed deal activity.

Unlike most of the other health care service sectors we track, pharmacy services are largely insulated from the reimbursement cuts (directed primarily at Medicare reimbursed services) attendant to health care reform. Moreover, reform initiatives that are intended to increase the number of Americans covered by insurance would also likely increase the number of patients served by pharmacy service providers.

Even though the outlook for pharmacy services is bright, three key issues have depressed the M&A market over the past two years:

1. Based on proprietary data collected by The Braff Group, since 2006, private equity has accounted for 37.4% of total deal volume for pharmacy service transactions vs. 22.9% for non-pharmacy service deals. Accordingly, as the recession and the tight credit markets have slowed down private equity investment activity, the slow-down has disproportionately – and negatively – impacted buyout activity in pharmacy services.

2. Many pharmacy service providers, especially those in specialty and institutional pharmacy, tend to be large companies with revenues of $50 million or more. As indicated above, in such an unsettled economic environment, those buyers that have returned to the market have targeted smaller deals, again, disproportionately – and negatively – impacting pharmacy services.

3. The size of the combined pharmacy services segments in terms of number of providers is extremely limited with likely far less than 1,000 potential acquisition candidates (compared to home health and hospice which has more than 10,000 candidates). As such, after a run-up in activity that peaked in 2007 in which many of the well-known, long standing providers were acquired, there are simply fewer "mature" companies ready to test the M&A market. As such, while demand remains strong, especially for strategic acquirers, the supply of acquisition candidates – while improving over time – is currently the more limiting factor.

With its strong fundamentals and for many of the reasons discussed in the Outlook section previously (particularly the return of private equity and increased market confidence), much like the other health care service sectors we cover, we expect an up-tick in pharmacy service M&A activity in the coming year. While we anticipate the rebound may be at a slower rate, it may also be one that extends for a longer period of time.

Chart 7:
Home Infusion Therapy Deal Trends

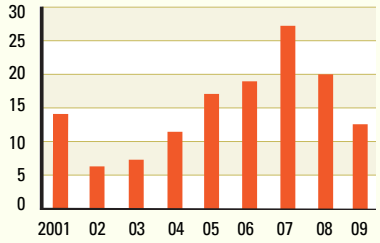


Chart 8:
Specialty Pharmacy Deal Trends

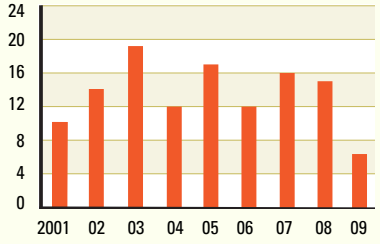
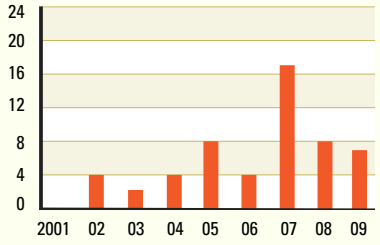


Chart 9:
Institutional Pharmacy Deal Trends



Source for Charts 7, 8, and 9: The Braff Group

Even in the face of initiatives calling for substantial cuts in reimbursement, the M&A market for Medicare certified home health agencies was extremely resilient in 2009 with 75 transactions.

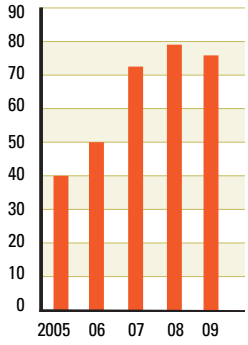
Home Health Care

Medicare Certified Home Health

As illustrated in **Chart 10**, even in the face of health care reform initiatives that have called for reimbursement cuts of between $43-57 billion over 10 years, the M&A market for Medicare certified home health agencies was extremely resilient in 2009, with 75 transactions – only 5.1% below the record 79 deals completed in 2008. This is even more noteworthy given the fact that, as illustrated in **Chart 11**, Q1 and Q4 activity was substantially off due to (a) reaction to President Obama's initial call for cuts in home health announced in February, and (b) decisions by buyers and sellers alike to delay year-end transactions in anticipation of gaining more clarity regarding the direction and magnitude of health care reform. Strong activity in Q2 followed by record transaction volume in Q3 clearly indicates that despite reform, buyers (a) recognize that in such a fragmented, relationship driven business, M&A is still a crucial element of a comprehensive growth strategy, (b) are confident that the worst scenarios will not come to pass, and (c) that they can reasonably manage through the cuts that ultimately do prevail.

Accordingly, with an anticipated favorable "bump" after health care reform is adjudicated (as discussed earlier), and greater confidence in the economy, we anticipate record breaking activity in the coming year, and a cautious, but steady increase in demand for larger deals.

Chart 10: Medicare Certified Home Health Deal Trends

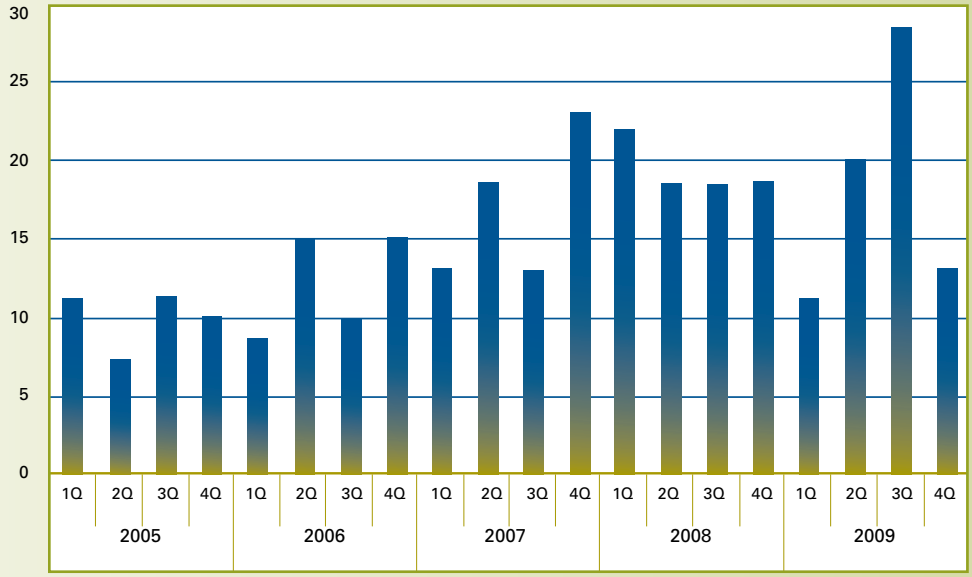


Source: The Braff Group

Medicaid and State Funded Home Health

As illustrated in **Chart 12**, in a fiscal year in which 48 of 51 states (including the District of Columbia) are projecting budget deficits – many well into the billions of dollars – it is perhaps no surprise that buyers have largely steered clear of Medicaid and other state program providers that rely heavily on state funding to pay for their services.

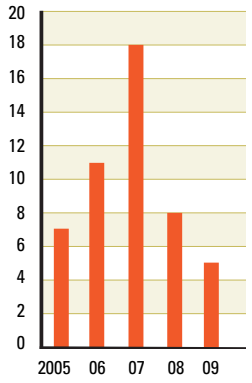
Chart 11: Medicare Certified Home Health Deal Trends



Source: The Braff Group

What is interesting to note, however, is that with (a) stimulus funds intended to shore up Medicaid financing in-place through the end of 2010, and (b) health care reform initiatives that greatly increase the federal funding for, and expansion of, Medicaid programs, if the economy improves and the states can muster the necessary resources on their part to support these initiatives, the sector may be on the cusp of substantial, long-term growth. This is particularly true for home and community based services that simultaneously represent a cheaper alternative to institutional care. As these issues will likely take a long time to play out, if they break favorably, we anticipate a steady increase in M&A activity for Medicaid and state funded providers over the next 12-36 months.

Chart 12: Medicaid and State Funded Home Health Deal Trends



Source: The Braff Group

One final observation of note. In November of 2009, Addus Homecare, a national home care provider deriving the bulk of its revenues from Medicaid and other state funded programs, completed an initial public offering, the first public offering in the home health care arena since LHC Group's IPO in 2005. As the only Medicaid focused publicly traded provider, buyers will be monitoring Addus carefully to evaluate the investment potential in this niche arena. As such, the M&A market for Medicaid focused providers may closely mirror the fortunes of Addus.

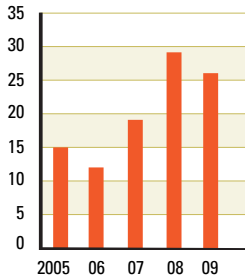
Private Duty Home Care

As illustrated in **Chart 13**, while 2009 was a strong year for M&A activity for private duty home care providers, with 26 deals completed, transaction volume was slightly off the record 29 transactions completed in 2008. This result was definitely not a referendum on demand, as many buyers are increasingly looking at private duty as both (a) a critical hedge against the heightened risk of Medicare, and (b) an attractive growth engine (either as a complementary line to other home care services or on its own). Rather, given the recession, many private pay providers experienced reductions in utilization in 2009 as clients reduced hours in response to real – and perceived – loss of wealth. Accordingly, with tempered, or perhaps negative growth in 2009, the past year was not ideal for many providers to pursue a divestiture. As the economy improves and utilization edges upwards, an increasing number of attractive private duty acquisition candidates will likely come to market.

Paired with rising demand, the sector is extremely well positioned for a long run of increased merger and acquisition activity.

In particular, over the near-term, we expect a surge in demand for private duty franchisors, as buyers, most notably private equity groups, begin to target these unique providers given (a) their size (in terms of system-wide sales) that often far exceed that of even the largest independents, and (b) their owner/operator business model that is particularly well suited for such service intensive, client-centric enterprises.

Chart 13: Private Duty Deal Trends



Source: The Braff Group

Hospice

In terms of merger and acquisition activity, hospice was, by far, the stand-out sector in 2009.

After a record setting year in 2008, the sector surged 47.4% in 2009, closing the year at a new record high of 28 transactions (see **Chart 14**).

Several factors converged to make 2009 such an outstanding year:

1. Compared to Medicare certified home health, rate reductions proposed for hospice appear relatively benign.

2. MedPAC recommended that payment reforms be instituted in 2013, providing for an enviable and predictable three year window of reimbursement stability.

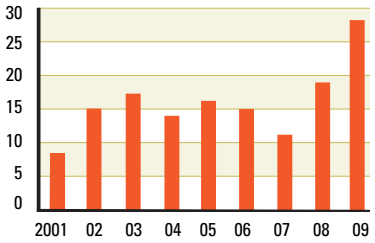
3. With reform proposals to redistribute payments so that there is increased reimbursement at the beginning and end of a patient's length of stay, short term patients are likely to become more financially viable. Accordingly, there will be less need for providers to carefully balance long and short length of stay patients in order to remain in the black – a strategy that can inadvertently lead to cap exposure.

4. After a run-up in transaction activity between 2001 and 2005, the pool of attractive acquisition candidates began to shrink. At the same time, however, the run-up spawned a wave of new, for-profit start-ups. With many of these companies reaching business cycle maturity, the supply of viable acquisition candidates has been on the rise.

5. Demand for attractive hospice candidates continues to increase as more and more ancillary service providers – notably Medicare certified home health agencies and skilled nursing facilities – target hospice as a complementary service line that can both spur growth and diversify risk.

When you combine the factors above with the macro market conditions discussed earlier that auger well for a strong 2010, we may likely see another record breaking year in hospice M&A activity in the coming year.

Chart 14: Hospice Deal Trends



Source: The Braff Group

Home Medical Equipment

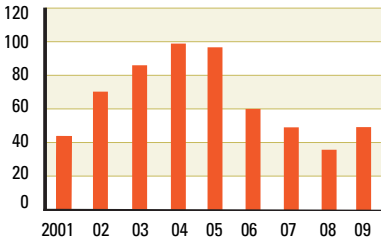
While merger and acquisition transaction volume in the home medical equipment sector remains far below the peak periods of 2004-2005, we did see a meaningful up-tick in activity in 2009 (see **Chart 15**).

Unfortunately, however, our sense is that this does not represent a change in how the sector is perceived by buyers and the investment community.

Since the passage of the Medicare Modernization Act of 2003 and the Deficit Reduction Act of 2006, among other items, the home medical equipment sector has been plagued by two key Medicare reimbursement initiatives – competitive bidding and a 36 month cap on reimbursement for oxygen. While the first round of competitive bidding, which was supposed to be initiated in 2007, was temporarily scrapped shortly after it was ultimately launched in 2008 (in exchange for a 9.5% cut in reimbursement), it is back on track to be rolled out in 2011. Furthermore, while the industry has fought hard to eliminate the 36 month oxygen cap (and with it, attempts to ratchet the cap down even further), it took effect, as scheduled, in 2009, and currently remains in place.

Given the above, market sentiment has not improved, and is therefore, not likely responsible for an increase in M&A activity. Rather, our sense is that the increased deal volume is attributable to an increase in the supply of acquisition candidates as prospective sellers, who have delayed going to market in the hope for more favorable resolutions to competitive bidding and the oxygen caps, have reluctantly decided to exit. With an increasing number of independent local and regional providers eager to acquire many of these companies at values that reflect this sustained reality, we expect this trend to continue in the coming year.

Chart 15: Home Medical Equipment Deal Trends



Source: The Braff Group

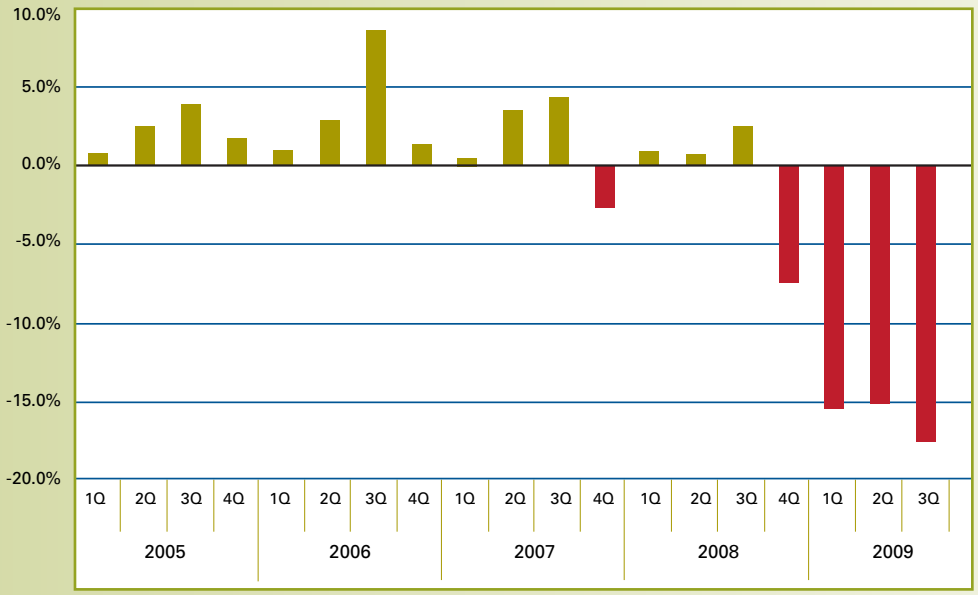


Chart 16: Median Quarterly Revenue Growth for Publicly Traded Health Care Staffing Companies

Source: The Braff Group

Health Care Staffing

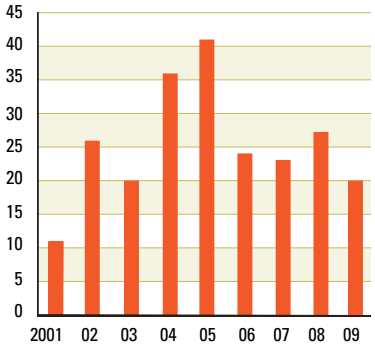
Perhaps the biggest surprise of 2009 from an M&A perspective was in health care staffing.

Given the recessionary economy and unemployment levels exceeding 10%, in health care, as in many other industry sectors, employee turnover is down and vacancies are filled quickly. Simultaneously, throughout 2009, with consumers reducing spending and unemployed workers losing insurance coverage, hospitals and other health care institutions have seen declines in census as would-be patients have cut back on discretionary procedures. Consequently, it comes as no surprise that demand for temporary health care staffing plummeted in 2009. As illustrated in **Chart 16**, based on a Braff Group analysis of select publicly traded health care staffing providers, median quarter over quarter revenue growth has gone negative in four consecutive quarters. Moreover, even in an improving economy, *Staffing Industry Analysts* projects further contraction in total health care staffing revenue of 1% in 2010, the only temporary staffing segment expected to fall (albeit slightly) in the coming year.

Given such a bleak year and projections that suggest that, while declines may bottom out during the coming year, full year 2010 revenues may still lag 2009, it was a surprise that health care staffing M&A activity held up as well as it did, falling off "only" 25.9% in 2009 vs. 2008 (see **Chart 17**). In fact, 2009 transaction volume was relatively consistent with what we have seen in health care staffing M&A since the market peaked in 2005. This likely reflects long term confidence in a sector where the demographic reality is that the demand for health care professionals will far exceed supply as our population continues to age.

As for the coming year, we anticipate continued acquisition demand for providers specializing in locum tenens and allied health care, segments within health care staffing that are generally (a) more recession resistant (and are projected to grow 3% and 2% respectively by *Staffing Industry Analysts* in 2010), and (b) higher margin niches.

Chart 17: Health Care Staffing Deal Trends



Source: The Braff Group

Intelligent Dealmaking®

the braff group

By devoting all our resources to health care services, The Braff Group simply knows more about what really matters in health care deal making. Buyers. Policy. Reimbursement. Operations. Profitability. Financing. Valuation. The crucial elements that drive the best deals and unparalleled results.

- **Four Time Winner, Health Care Deal of the Year, 2004, 2005, 2006, 2009**
- **Winner, Deal Maker of the Year, Chuck Gaetano, 2008**
- **Five Time Finalist, Boutique Investment Banking Firm of the Year, 2005, 2006, 2007, 2008, 2009**

The Braff Group was ranked NUMBER 1 in all US Health Care Service Deals in 2009

US Health Care Service Deals

RANK	FINANCIAL ADVISOR	DEALS
1.	The Braff Group	21
2.	IMAP	6
3.	Cain Brothers Co.	5
4.	BC Ziegler	3
4.	Goldman Sachs & Co.	3

The Braff Group was ranked NUMBER 2 in all US Health Care Industry Deals in 2009

US Health Care Industry Deals

RANK	FINANCIAL ADVISOR	DEALS
1	Goldman Sachs & Co.	23
2.	The Braff Group	19
2.	JP Morgan	19
4.	Bank of America Merill Lynch	12
5.	Morgan Stanley	11

Source: Thomson Reuters

About The Braff Group

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.

Since being founded in 1998, The Braff Group has completed more than 155 health care transactions.

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