Given critical differences in services, operating strategies, market dynamics, etc., in order to best understand the non-Medicare home health market, it is necessary to further segment the industry into “Private” and “State Funded” home health.

**Private Home Health**

Broadly speaking, private home health providers specialize in skilled and non-skilled “shift care” — typically durations of 4, 8, and 24 hours (round-the-clock) — which is reimbursed through private “out-of-pocket” pay and private insurance. This segment also includes privately reimbursed non-medical home care services.

**Unique Attributes**

What makes this sector so unique is that it is highly consumer-driven. As such, private home health is likewise an extremely relationship and service-driven business model that tends to require substantial day-to-day and customer-to-customer management involvement and oversight. Accordingly, this sector generally tends to be less scaleable than other home health care sectors (particularly those that focus on state funded services as described below). No surprise then that according to a survey conducted by *Private Duty Insider*, the median size of a private agency in 2004 was $1.5 million.

**Implications for M&A**

Because these firms tend to be relatively small — and highly owner dependent — it is extremely difficult to execute a classic national or regional “roll-up” acquisition strategy and complete enough transactions to get to a critical mass of $50 to $100 million or more — the revenue range buyers want to achieve in order to realize lucrative size premiums upon exit (this may explain, in part, why some of the largest providers of private pay services are firms such as Home Instead Senior Care, Griswold Special Care, and Comfort Keepers — firms that have implemented a franchisor-franchisee business model that allows each to build scale by developing and supporting owner/operators at the local level). Accordingly, there are a limited number of “pure-play” private home health consolidators.

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Strategies and Valuation

Rather, an acquisition strategy that is rapidly emerging is one in which larger $20-25 million dollar Medicare certified agencies – including those from the not-for-profit arena – are leveraging their platform infrastructures and targeting private providers within their coverage area to (a) diversify their payer mix as a risk reduction strategy, (b) develop a seamless continuum of care to serve patients — and their referring physicians — as their care needs and payment coverage evolves, and (b) gain market intelligence and experience in a sector that is poised for substantial growth (this is due, in part, to health care policy initiatives that will give rise to a shift in spending from Medicare to managed care plans administered by private insurance companies). With an increasing number of firms that have historically focused on developing their Medicare services nearing critical mass, we anticipate moderate, yet steady growth in demand for private home health providers. In combination with the rise in valuations for Medicare certified agencies, which serves as a reference point for — and substantially influences — all other home health transactions, we expect that values for private home health providers will continue to rise slowly, but steadily, over the near term.

State Funded Home Health

As the name would suggest, state funded home health providers focus principally on services reimbursed primarily through Medicaid waiver and other state and local funded programs. While skilled services may be part of the mix, the programs tend to offer predominately non-skilled home health aide, companion or homemaker services to a large number of beneficiaries. So unlike private home health providers that tend to offer “higher end” and more personalized services to a smaller cross section of beneficiaries that can afford to pay for them out-of-pocket or through private insurance, state funded companies can often be quite large, with many in densely populated markets reaching sizes of $40 million and up. That said, while reimbursement for specific programs in certain states remains quite favorable, with states straining under the pressure of increasing Medicaid expenditures, margins are becoming increasingly tight.

Recent Developments

Several key developments have put the sector in flux over the past 6-12 months. On a positive note, according to a Kaiser Foundation report, after two consecutive years of decline, state tax revenues grew 3.4% in 2004 and are expected to increase again in 2005. “Fewer states in FY 2005 (which begins in 2004) took new actions to control prescription drug costs, cut or freeze provider rates, reduce or restrict eligibility or benefits, or to increase beneficiary co-payments.” The report even suggests that “some states have plans to restore previous Medicaid cuts or actually expand programs in FY 2005.” Furthermore, in December the National Governors Association reported that, overall, the states reported budget surpluses of 4.8% (5% is considered healthy), up 50% from last year’s surplus of 3.2%. However on April 28th, 2005, Congress approved a budget resolution calling for $10 billion in Medicaid cuts over five years starting in fiscal year 2007 (an amount that, while sounding ominous, translates to a reduction of merely one half of one percent of the more than two trillion dollars in total projected Medicaid spending over the period according to the 2005 National Health Expenditures report). Back on the upside, the states are increasingly recognizing that perhaps the most promising solution to the Medicaid spending crisis is to “rebalance” expenditures from long term care to substantially less expensive “community based services” i.e. home care. In fact, citing studies completed by the Health Policy Institute of Georgetown University, Home Health Line recently reported that over the 10 year period between 1993 and 2003, the amount of long term care Medicaid dollars spent on home health care services rose from $8.4 Billion, or 16% of total long term care spending, to $27.8B or a 33% share. Simultaneously though, self directed care models that typically give Medicaid patients the control to

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pick their own caregivers – with the option of hiring family members, friends, and others – and the funding to pay for them continues to gain traction; a development that could siphon off some of the gains that may accrue through rebalancing initiatives.

Although a mixture of positive and negative developments, on balance we are more bullish on state funded programs than we have been in years. Deficits and consumer directed care notwithstanding, home care is extraordinarily well positioned to capture Medicaid dollars as they are re-routed to community based alternatives.

**M&A Outlook Improving**

Given the above, the M&A market for state funded home health which has pretty much been in a free fall over the past several years, appears to be stabilizing — and is beginning to show signs of a rebound.

In particular, we note that as investors become more comfortable with the long term prospects for the sector, we are seeing select buyers specifically target large Medicaid providers to capture a revenue base, operating infrastructure, and management team that is perhaps the most experienced in (a) recruiting and retention and (b) operating under tight margins — skill sets required to succeed over the long term in home health care (In a related development, at a recent Health Care Merger and Acquisition Conference we attended, we noted that while private equity groups (PEGs) generally shunned government reimbursed healthcare sectors in the past, several PEGs indicated that the ability to understand and manage through the ever-changing government reimbursement climate represents a significant “barrier to entry” which makes these firms more attractive acquisition candidates). With an infrastructure in place, their strategy is to then layer on additional Medicare or private services through acquisitions and start-ups — the ultimate goal of which is to create a fully diversified home care company. Such was the thought process underlying the classic buy, build, and exit strategy initiated by Transition Capital Partners (TCP), a Texas based private equity group. In June of 2000, TCP acquired what was then known as Texas Home Health Agency, which at the time focused predominately on providing services under Medicaid Waiver programs. In the ensuing years, the highly experienced management team devoted substantial resources to leveraging the base business to develop a substantial presence in the Medicare Home Health arena. A little more than five years later — a time frame consistent with what many PEGs characterize as the ideal 3-7 year investment horizon — TCP completed a successful divestiture of what had become a substantially larger, diversified firm with a substantial Medicare presence (the current “sweet spot” in home health mergers and acquisitions) to Friedman, Fleischer, and Lowe, a PEG out of San Francisco.

While we do not expect to see consolidators focus exclusively on state funded home health, nor do we expect to see a flurry of activity in the sector, we do anticipate that buyers will once again give due consideration to these acquisition opportunities, especially as suggested above, as part of an overall service diversification strategy.

One final note. Given the rebalancing initiatives suggested above, many long term care providers are progressively looking to acquire home care and hospice companies as a defensive strategy. Interestingly — and perhaps counter-intuitively — these buyers are currently targeting the Medicare market to capture greater margins. This bears watching as Medicaid policy discussions continue to unfold.
About The Braff Group

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. The firm provides merger and acquisition representation, strategic planning, and valuation services.

For the second consecutive year, The Braff Group was recently honored as one of the fastest growing companies in the Pittsburgh Region by the Pittsburgh Business Times in its annual ranking of the 100 fastest growing privately held firms in the area. Additionally, The Braff Group was awarded the 2004 Life Sciences (Biotech/Healthcare) Deal of the Year by the M&A Advisor, a leading publication dedicated to middle market merger and acquisition activity, for our representation of LifePlus, a regional home care provider based in Raymond, NH.