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BRAFF

HOME HEALTH & HOSPICE

SPECIAL EDITION
VALUATIONS IN HOME HEALTH AND HOSPICE
WHERE THEY'VE BEEN AND WHERE THEY'RE HEADED

If you understand how past events have shaped valuation over time, you can examine the landscape in front of you, and reasonably project how it is likely to change in the future – perhaps the most salient consideration in putting together a consolidation or exit strategy (or, perhaps more importantly, choosing which one is the best path for you).

Toward that end, we examine how valuation has changed in home health and hospice since 2001. Moreover, we offer reasons why, and what this suggests for the future.

First, a quick word about the figure on the following page. The chart is intended to represent ***relative changes*** in valuation ***multiples*** over time – they are not absolute in nature. Similarly, the interplay of these changes with the timeline is proximal. While cause and effect are quite real, the timing is not necessarily direct. Furthermore, while many variables contribute to these ebbs and flows, we've focused on those that we believe have had the greatest effect.

IPS to PPS. We start our retrospective in 2001, when Medicare home health completed the transition from cost-based reimbursement, to the interim payment system, and finally a prospective payment system that still exists today. Along the way, the industry lost 35% of its providers. So when PPS began in 2001, while the survivors were optimistic, they were nevertheless bruised, battered, and borderline befuddled as to how it would all play out. So the majority of providers hunkered down, with only the most intrepid of buyers looking for acquisitions. Demand was low. And valuations were lower.

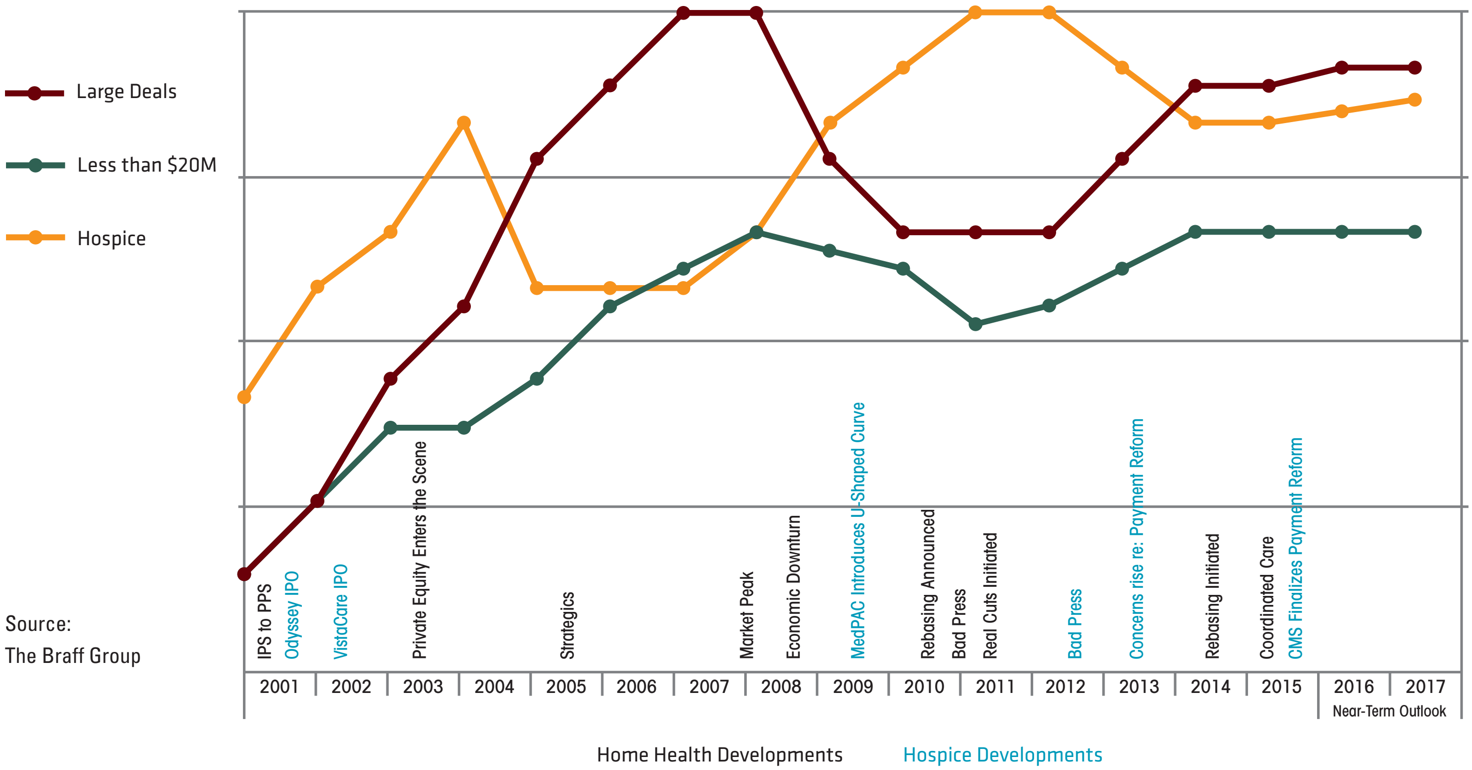
Hospice IPOs. In 2001 and 2002, Odyssey and VistaCare completed successful IPOs. In fact, in terms of post IPO stock price gains, in 2001, Odyssey's IPO was one of the most successful of the year (which no doubt, factored into VistaCare's decision to go public). With this kind of visibility – and results – hospice valuations quickly began to rise.

Private equity enters the scene. On the home health side of the ledger, by 2003, the market had figured out PPS, and profits began to flow. But strategic buyers were slow to react. And when they did, they brought with them valuations rooted in dollars per visit, a common metric that buyers relied upon under cost-based reimbursement that was completely irrelevant in a post-PPS environment. Consequently, their valuations were far below what the new risk-return fundamentals could support. This left the door wide open for private equity to pick up the slack, unburdened by the bias of the past. Valuations began to climb.

As for hospice, the reason for the appearance of PE was far simpler. Like bees to honey, moths to a flame, your staff to a box of donuts, the siren song of successful IPOs was all it took to beckon private equity into hospice.

Strategics finally enter the market. It took the home health strategics another 12-24 months to get comfortable in this entirely new M&A market. And having ceded the first moves – and some of the best acquisition candidates – to PE, they had a lot of ground to make up.

Valuation Trends in Medicare Home Health and Hospice



The fortunes of one sector can impact another. In sectors that are likely to draw similar buyers pursuing similar meta-strategies, when investment dollars flow to one sector, they are taken from another. Such is the case with home health and hospice. As buyers swarmed into home health between 2005 and 2008, even though the risk-return fundamentals of hospice were unchanged, demand slackened. And with it, valuations slumped.

Market peak. With increasing numbers of PE sponsors and strategic players battling for home health market share, valuations soared, peaking around 2007. During the run-up, the market bifurcated between large deals (purchase price or revenues greater than $20M) and those that were below this threshold. While both groups saw their valuations rise substantially, the demand for the larger acquisition candidates turned into a frenzy, creating an attractive market bubble (if you were a seller). But bubbles burst.

Economic downturn. By 2009, with the economy in the throes of a full-on recession, home health valuations began to fall. Not surprisingly, the larger players took a greater hit, nearly erasing the valuation gap between large and smaller agencies. The story was different in hospice, however. When the economy began to tank, hospice valuations had already contracted. So amidst the free-fall in home health, hospice, by comparison, took on the look of a safer play. So, counterintuitively, pricing edged upwards.

MedPAC introduces the U-shaped curve for hospice payment reform. In 2009, MedPAC floated a radical change to how hospice would be reimbursed. Although the prospect of upending the status quo rocked the industry, with legislation stipulating that such reforms be implemented no **earlier** than October 1, 2013, the timing was far enough out on the horizon that buyers did not factor the potential threat into their valuations.

Rebasing, bad press, and real cuts. Shortly thereafter, home health sustained a triple whammy: rebasing that called for four consecutive years of rate reductions beginning in 2014; congressional, judicial, and SEC inquiries regarding claims of over-utilization by the publicly traded players, and the first "real" year-over-year rate cut. Valuations plunged further. But in one case, what began as bad news, became the seed for an extraordinary recovery.

Payback for hospice. Earlier we explained why the surge in home health took a toll on hospice. Well, the tables turned between 2010 and 2011. When rebasing, bad press, and year-over-year rate cuts put home health on the skids, hospice was the beneficiary of increased demand and valuation.

Bad press for hospice, and payment reform looms closer. Hospice had long enjoyed an unsullied reputation. By 2012, however, some cracks in the armor began to emerge. Gentiva agreed to pay a $25 million fine for over-utilization and improper billing at its Odyssey subsidiary. Shortly thereafter, San Diego Hospice, a well-known not-for-profit became the target of a probe regarding improper admissions and lengths of stay, which ultimately led to its filing for bankruptcy. Couple the concerns that such practices could be endemic to the industry, and that a potentially highly disruptive payment reform was looming in the near-term, confidence in the sector waned, and valuations slipped.

Rebasing initiated. Perhaps counterintuitively, it was rebasing that rebuilt the home health M&A market. In mergers and acquisitions, the factor that flusters buyers the most is uncertainty. But with rebasing, even though the rule calls for annual rate cuts of up to 3.5% for each of 2014-2017, it effectively serves as a buffer against other reductions during the period. Presto chango – instant reimbursement clarity – for four consecutive years. Buoyed by that kind of predictability, as we moved closer to initiation, buyers that had been idle began revisiting home health (including several PE sponsors that had already invested and cashed out of home health once before). And valuations began to climb.

Coordinated care. At almost the same time that rebasing was initiated, the notion of coordinated care – and the critical role home health will likely play – began to take hold in the health care community. So on top of certainty, you could add the promise of increased utilization. And on top of that, you could add the competitive advantage accruing to larger players with the capacity to meet the needs of ACOs and other care coordinators. And how to get large quickly? Acquisitions. Game. Set. Match. Home health M&A was back.

The same is true for hospice. Most notably we've seen sustained acquisition interest from skilled nursing facilities seeking to build a comprehensive post-acute continuum.

CMS finalizes hospice payment reform. Recently, CMS issued a final rule on a revised payment system for hospice. And, unlike the radical U-shaped curve methodology floated by MedPAC in 2009, the CMS blueprint is far more iterative – and less disruptive – in nature (see our Summer Edition of **marketWATCH**, *Home Health and Hospice Deal Flow Continues to Slide As Hospice Payment Reform Debuts,* for greater insight). So the risk which has floated along the periphery of hospice since the ACA was passed has largely abated.

Given where we've been, and where we are now, where do we expect home health and hospice valuation to be over the next 12-24 months?

Valuation outlook for home health. You could reasonably anticipate that risk would begin to climb as we get closer to 2017 and the end of the rate cut buffer provided by rebasing. But home health received another gift in disguise with the passage of legislation to end the sustainable growth rate that has plagued physician reimbursement for years. In order to remain budget neutral, the annual home health update will be capped at 1% beginning in 2018, which, based on the recent past, amounts to cuts of 1.0 to 1.5% per year.

After four years of rebasing, will statutory reductions of 1.0-1.5% per year be enough to insulate home health from further cuts down the line? Possibly. But from an M&A standpoint, does it extend the period of relative "certainty" to past 2017? Absolutely. With private equity back in the mix, demand for sizeable players should remain strong. Moreover, we can anticipate a rise in demand for smaller follow-on deals. And as coordinated care begins to take shape, we will see more innovative, cross-sector activity.

So the table is set for sustained – and diversified – acquisition demand. Since home health valuations have been climbing steadily for three years now, there is less "room" for additional growth. So our bet is that while multiples will climb over the next 12-24 months, the gains will be more situational and incremental in nature.

Will they return to the bubblicious peak levels of 2007-2008? We doubt it. There's too much "institutional memory" about how fragile the sector can be.

Valuation outlook for hospice. For the first time since 2004, we expect hospice valuations to follow a similar path to home health for several reasons.

First and foremost, sector dynamics are pretty comparable. With payment reform in place and only modestly different from the current methodology, and with hospice also subject to the update cap – and the insulation from further cuts that come with it – the reimbursement climate is pretty serene.

For the most part, so is the climate regarding compliance. The industry reacted swiftly and collectively to the bad press that began to surface several years ago as providers worked to correct problem areas in admissions, discharging long-term patients (as appropriate), and generally being more vigilant in guarding against over-utilization, or tripping over the annual cap. This has left the sector stronger, which may explain why a recent series of snipes at the sector from the Washington Post, the New York Times, and USA Today have seemingly had little impact. Such relative calm will keep buyers in the market, and continue to attract new players developing a coordinated care strategy. And with initiatives such as concurrent care on the horizon that allow patients to continue to receive curative care while on hospice, enthusiasm for the sector is likely to remain strong.

Finally, while home health and hospice services are very different, with more and more providers offering both, the fortunes of one will be less likely to come at the expense of another.

So much like home health, we anticipate incremental, and situational upticks in valuation.

The most significant takeaway?

While there are always unknown unknowns lurking about, the unknowns that we do know seem tranquil and manageable, with upsides on the side – an M&A market dynamic that paradoxically screams, "Serenity Now!"

Call it the summer of George.

INTELLIGENT DEALMAKING IN HOME HEALTH & HOSPICE M&A

The Braff Group is the leading health care services mergers and acquisitions advisory firm with a dealmaking team focused exclusively on home health and hospice.

For more than 15 years, we have provided sell-side only transaction services to the home health care, hospice, private duty, and state-funded provider community and have completed more than 70 deals in these segments alone.

With more than 250 transactions completed overall, The Braff Group is ranked #1 in health care mergers & acquisitions.[1]

But we never forget that **your deal** is the one that matters to you.

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[1] Source: Thomson Reuters, based on number of deals between 2008 and 2014.

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