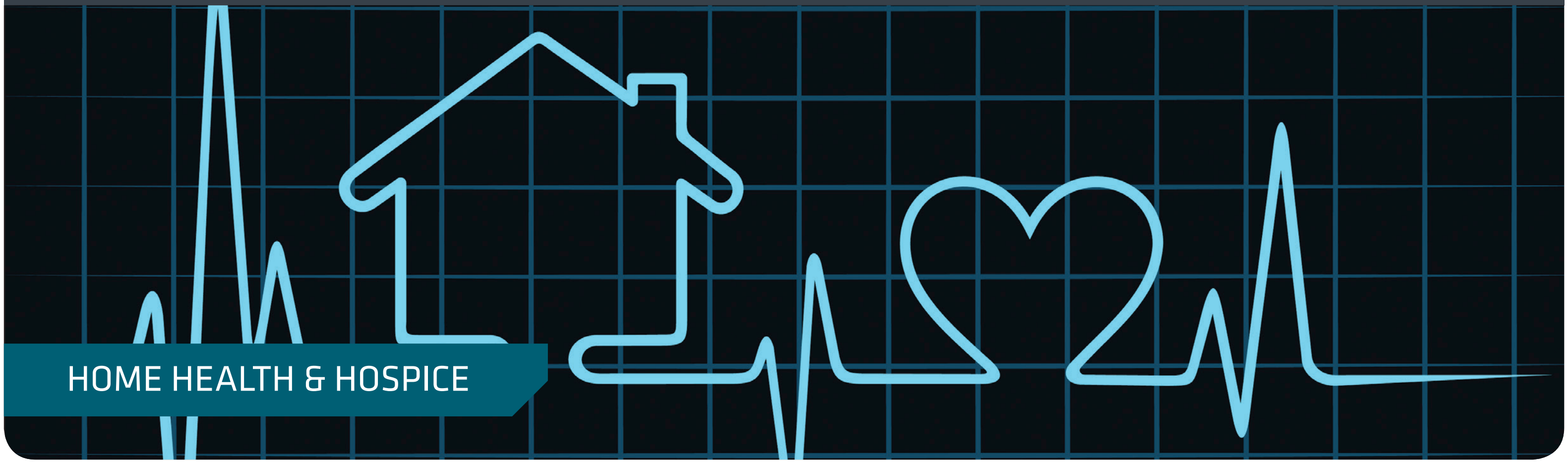
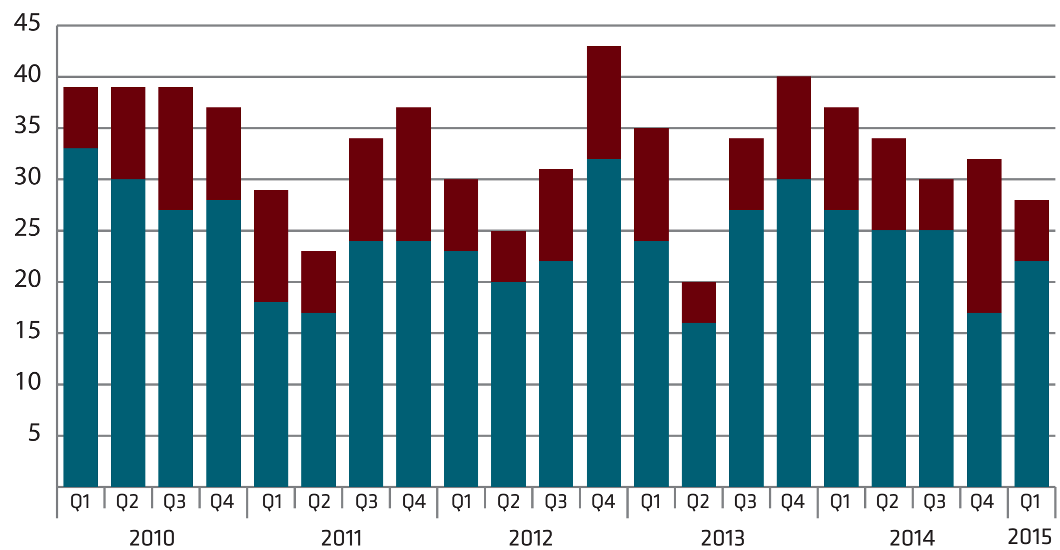


HOME HEALTH AND HOSPICE DEAL FLOW CONTINUES TO SLIDE AS HOSPICE PAYMENT REFORM DEBUTS **– AND WHY WE'RE NOT WORRIED (SORTA)**

A quick glance at the chart below reveals a disturbing trend in home health and hospice mergers and acquisitions. For five consecutive quarters, combined deal flow in these sectors has fallen more or less steadily, from 40 deals in Q4 2013 to 28 in Q1 2015. What's more, when we look at overall middle market mergers and acquisitions activity for all sectors, the trend, while not completely in the opposite direction, is certainly more encouraging.

So why aren't we worried (well, not worried too much)?

Home Health & Hospice Deal Trends



Source: The Braff Group

The fall-off, while not quite as dramatic, is fairly consistent with what we are seeing in the other health care service sectors we track. Consider the third chart below. When we exclude home health and hospice and only plot behavioral health care, pharmacy services, home medical equipment, and health care staffing, the downward slide, while not as steep, is clearly apparent. In fact, the only sector to record decent growth over the period was health care staffing.

So, from an M&A perspective, home health and hospice providers can take some solace in the fact that it's not just them feeling the downward dog.

It is only in the past two quarters that trends in overall mid-market M&A activity has diverged from health care services, with most of the differential concentrated in just one period – Q4 2013. So it will take a few more quarters to see if the divergence is more than just a blip n' slide.

Health care service investment fundamentals remain extremely attractive. If anything, at least from an M&A climate perspective, what has come out of Washington over the past few months has improved the risk profile for home health and hospice providers, making them incrementally more attractive to buyers. To wit:

Ding Dong, SGR is Dead.

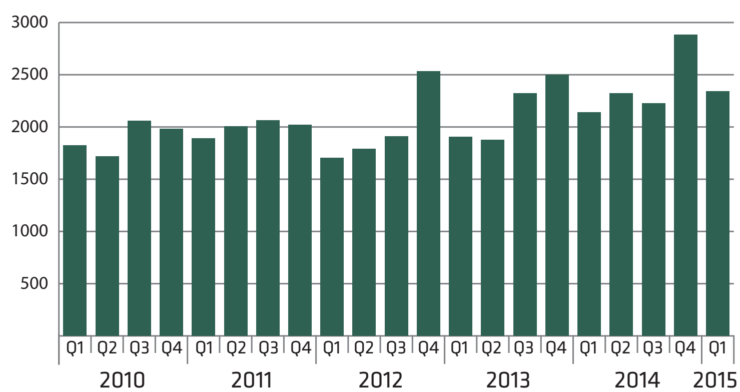
After ballooning to a size that threatened to block out the sun, Congress finally put a merciful end to the sustainable growth rate (SGR) which has long been plaguing physician reimbursement. No longer will health care providers have to nervously wait each year to see if they will be the "pay-for" that keeps the plates spinning. While payment challenges continue to loom, eliminating the doc fix will at least keep home health and hospice co-pays and other potential cuts from making an annual appearance on the congressional docket, thereby tamping down what had become a yearly rite of risk.

What's more, the repeal legislation "hardwires" the annual market basket update to 1% for all post-acute care and hospice providers beginning 2018. Even though this almost assuredly amounts to a grab of at least 1% from what it, otherwise, would be, it provides at least some measure of go-forward reimbursement clarity. And much like we saw with rebasing, the added ***predictability*** will likely boost home health M&A.

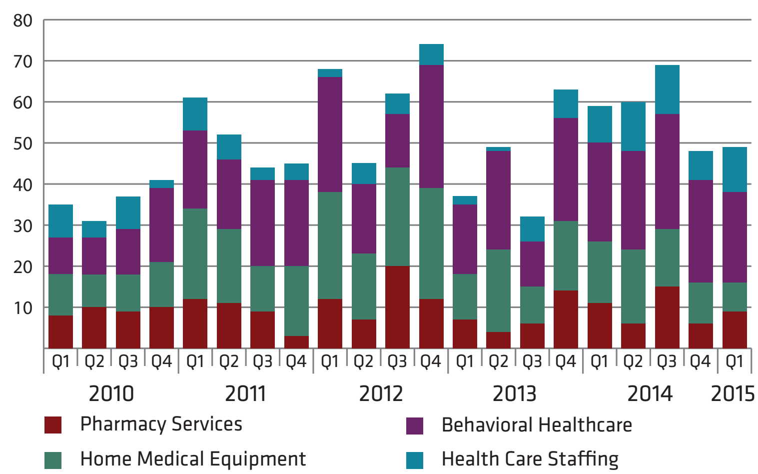
CMS and MedPAC Show Some Restraint.

Over the recent past, a home health or hospice provider could be forgiven for feeling unloved. Virtually everything coming out of CMS and MedPAC seemed to be invariably, and reflexively, negative. Well, over the past few months we have seen some breaks in this steady drone. First, CMS finally heeded the industry's call and came around to ease up on the narrative required to comply with face-to-face provisions. Then, most recently, MedPAC weighed in on the appropriateness of "service intensity add-on" payments (SIAs) for hospice patients residing in skilled nursing facilities (see more below on hospice payment reform). Though the proposed rule excludes such payments, MedPAC, which has repeatedly called for cuts in reimbursement for patients in SNFs, came out on the side of the industry, saying that such SIA payments are appropriate. Now surely, we're not

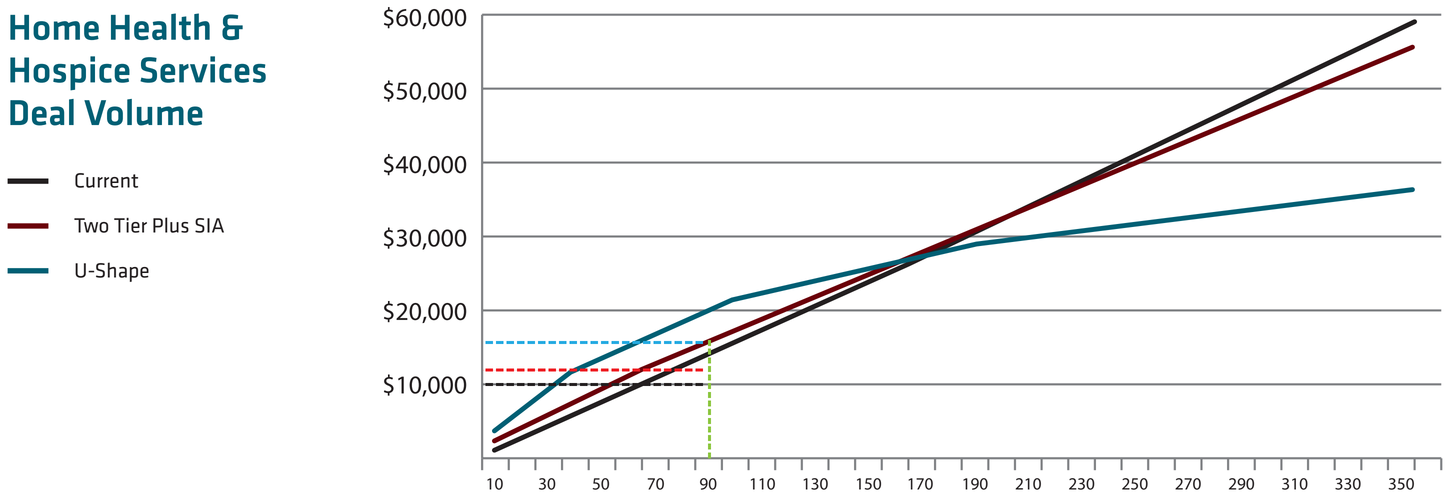
US Middle Market Deal Trends: All Industries



Health Care Services Deal Trends – Excluding Home Health & Hospice



Home Health & Hospice Services Deal Volume



in the middle of a Woodstock love fest. But even modest positions that benefit home health and hospice may signal that the fall-off in favor has bottomed out, and that the needle may be moving from adversarial to collaborative.

Hospice Payment Reform is Announced – and The World Hasn't Spun off its Axis.

About seven years ago, CMS was charged with revising the hospice payment system by 2013. So in March 2009, MedPAC got the conversation going with a potential design change. Instead of paying a static daily rate, the agency modeled an approach in which payments would be higher at both the beginning and end of an episode, when resource utilization would presumably be higher. In between, payments would be lower. Soon, MedPAC's "U-Shaped Curve" payment became the de facto reference point for payment reform. Whether the system would ultimately be good for the industry or not, it was clear that such stark departure from the fixed daily rate would significantly change providers' behaviors, ushering in a transitional stage that could put hospice M&A, at least temporarily, in a deep freeze.

2013 came and went without a new plan. The risk was still there, but it lingered just outside of the sector's collective consciousness.

Now, it's here.

And the status of the rule is far more "quo" than "whoa." Here's why.

To get a better sense of just how the CMS rule might affect the industry, The Braff Group thought it would be instructive to plot out the ***magnitude*** of change in reimbursement vs. the current fixed daily rate. And to make it even more interesting, we threw in a plot of MedPAC's original u-shaped curve (see footnotes for assumptions and explanation of the chart).[1,2]

What we found was fascinating – and extremely revealing:

1. No surprise that all the curves converge around 180 days – both alternative payment systems were designed to incent providers to keep LOS under 180.

2. The MedPAC proposal would have created the greatest variation in reimbursement vs. the fixed daily rate, substantially raising payments for short lengths of stay – and drastically reducing it for longer lengths. That's why, with only the MedPAC example to go by, the specter of payment reform loomed large.

3. Most noteworthy? Though the CMS rule follows the same principle as the MedPAC alternative, t**he variation in payments produces a curve that is only modestly different from the current fixed rate.**

[1] Our model includes several assumptions: We assumed that the fixed daily rate for 2016 would be 162.21, a 1.8% increase over 2015, the same overall increase in spending reflected in the new model. For the "service intensity add-on" payments, we assumed that providers would bill, on average, 50% of the maximum SIA payments allowed.

[2] Each curve represents a different payment system (Black – fixed daily rate; Blue – MedPAC U-shaped curve; Red – current rule proposed by CMS). Each point on a curve represents the total amount of reimbursement a provider would receive for a hospice episode under each payment system, depending on the number of days a patient is on service. For example, at 90 days on service, the fixed rate method (black) would produce $14,600 in revenues; MedPAC - $19,400; and the recent CMS rule: $15,700.

The outtake then is that, even though the new rule will usher in real change, it is not the game-changer the industry feared.

Moreover, although CMS indicates that this is just a first step in hospice payment reform, it's unlikely that we'll see a substantial revision anytime soon. So it's reasonable to anticipate a period of relative stability in hospice – a market condition that buyers crave as much as a Kardashian craves attention. So the beat goes on for hospice M&A. All things considered then, there's little reason to believe that home health and hospice M&A will be mired in malaise.

On the contrary, it's a good bet that deal flow will rise steadily – with odds far better than you get in Vegas.

INTELLIGENT DEALING IN HOME HEALTH & HOSPICE M&A

The Braff Group is the leading health care services mergers and acquisitions advisory firm with a deal-making 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.

Let us make it a great one.

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

FOR MORE INSIGHT INTO THE M&A MARKET FOR HOME HEALTH & HOSPICE AND WHAT IT MAY MEAN TO YOU, CONTACT OUR HOME HEALTH & HOSPICE TEAM:

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