HOME CARE AND HOSPICE M&A – NEW STRATEGIES, NEW BUYERS, AND CHANGING FORTUNES

THE MAGIC EYE KNOWS

Remember those magic eye posters with the colorful pattern of squiggles and be-bops? If you stared at them long enough, crossed your eyes, and balanced on one foot, a 3-D image of a kitten with a party hat would emerge.

Well, if you take away the kitten, the same holds true in mergers and acquisitions.

If you look carefully at the historical patterns of reimbursement, M&A strategies, supply and demand, and more, an image of what the market will be like over the next 12-36 months is revealed (and you don't even have to balance on one foot).

So, what does the Magic Eye say about expectations for home health and hospice M&A?

The value of Medicare certified home health agencies is just begging for a correction.

First, it was the phased-in cuts over four years that, perhaps counterintuitively, propped up the mergers and acquisitions climate for home health agencies. (The scheduled reductions insulated the space from further cuts, giving buyers near unprecedented visibility into payment rates through 2017 which, in turn, reduced the sector's risk profile.)

Then it was the development, implementation, and success of alternative payment models that reward the right care, at the right time, in the right place, that placed certified home health agencies squarely in the sights of an entirely new class of buyers (hospitals, skilled nursing facilities, and other adjacents) seeking to build a continuum of care.

Together, the confluence of these factors boosted demand for home health agencies, creating "market momentum" that has pushed valuations near the peak levels achieved around 2005-2008.

But peaks are as fragile as a golfer standing over a four-foot putt to win the Masters. It doesn't take much to bring on the yips.

Enter what appears to be unstoppable payment reform as CMS looks to up the LUPA thresholds, upend the standard 60-day episode, and undo the therapy thresholds. That's more than enough to turn a yip into an outright yap.

But wait, there's more…

Like a Kardashian abhors anonymity, mergers and acquisitions abhor uncertainty. While providers may be able to overlay the new payment model on their past business to begin to size up its impact, they cannot predict the behavioral changes other providers will undergo in response to new incentives. Buyers will assume the worst. Sellers will assume the best. And deal flow itself may go on double-secret probation.

This will likely begin six months before implementation and can be expected to last until at least six months after, once the financial impact of the reimbursement - and behavioral changes - become far more transparent.

Add it all up, valuations are a near lock to experience a slide, and much like we saw when the prospective payment system was initiated, the market for home health agencies could very well be on ice for a year (or more) beginning July 1, 2019.

Home health's loss will be hospice's gain.

While home health is in the cold, would-be buyers can either put on a parka or seek warmer climes. Given similar clinical underpinnings of home health and hospice as well as a far more stable payment methodology (at least for now), buyers will likely pivot towards the comparative safety and predictability of hospice.

We've seen this pattern before. Remember when home health experienced a triple whammy of congressional, judicial, and administrative inquiries regarding among other things, institutionalized overutilization (you know, the "Texas Hold'em" where providers were routinely holding on to patients for as many as six episodes, or more)? Well, as buyers retreated from home health, they turned to hospice, boosting the sector to its very own peak.

But, just like the penny you swallowed as a kid, it will take some time to work its way through the M&A system (See sidebar on the M&A Lag Effect.)

The time is nigh for private duty M&A.

In the past, the thesis that Medicare providers would look to acquire private duty companies to offset ripples in their sector never really took hold. This is largely due to PD's extraordinary customer service demands – demands that often require the do-whatever-it-takes survival instinct that is the province of an owner, rather than an employee division manager. That's why the owner-operator franchise model is so prevalent in the space.

But as personal care is increasingly being seen as a cost-effective way to monitor and manage patients, ensure medication compliance, head off unnecessary emergency room visits, and prevent hospitalizations and subsequent re-hospitalizations, despite the challenges suggested above, the conditions are ripe for integrating personal care with other post-acute providers.

That's why private duty has suddenly gotten more attention than the last donut at the weekly Monday morning staff meetings - a trend we expect shall continue and perhaps accelerate further over the near term.

Medicaid M&A yearns to break free.

Due in no small part to Medicaid expansion under the Affordable Care Act, interest in and demand for providers targeting Medicaid beneficiaries has ***generally*** risen. This is particularly the case in pediatric Medicaid as private equity sponsors look to mimic the success of the Epic consolidation and eventual exit to private equity powerhouse, Bain Capital.

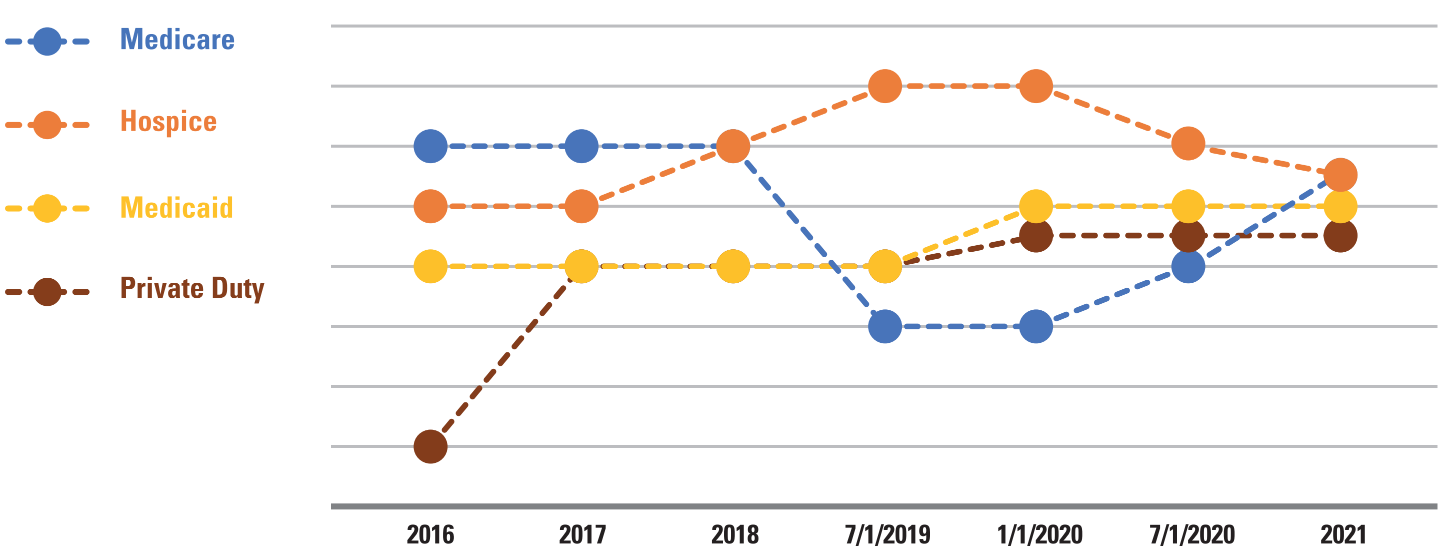
That said, the sector hasn't truly busted out as the market dynamics might suggest. Perhaps it's due to the typically thinner margins. Or maybe with reimbursement and eligibility determined at the state level, it's more challenging to leverage success from one state to another. Or maybe it's simply institutional bias against the sector because of what it isn't (that being Medicare).

Regardless, as states seek to divert more patients from skilled nursing facilities to home care, as they begin to realize that dollars spent on regular personal care may dwarf the costs of preventable (or delayable) hospitalizations, and as more private equity groups realize successful investments and exits, Medicaid M&A may yet break out.

Below you'll see a picture illustrating past and projected acquisition demand.

Of course, any one of the sectors may play out differently – there are too many unknown unknowns that may rejigger the anticipated trends.

Past & Projected Relative Acquisition Demand



Source: The Braff Group

But if you're trying to game out the timing of an investment or exit in these markets, it sure beats what you can divine from a 3-D image of a kitten wearing a party hat.

The M&A LAG Effect:

Over more than 20 years in health care M&A, our observation is that unless the event that shakes up a market is a Category 5 (like the balanced budget act and its spawn – the interim payment system), ***shifts in acquisition strategy – and to some degree, the magnitude thereof – tend to lag market disruptions.***

One explanation is the simple fact that with transaction timelines that can easily stretch six to nine months or more, it's not so easy to just shut down the pipeline.

Equally important is the confidence both buyers and sellers alike have developed over time in dealing with whatever CMS throws at them.

Other than the above-mentioned spawn of Satan which took out as many as a third of the agencies operating at the time, Darwinian selection has produced operators that are preternaturally optimistic that they possess the know-how, creativity, and flexibility to re-engineer their business and clinical protocols to not only get through disruptive events, but to possibly capitalize on them.

As such, even though they may **eventually** seek shelter when sector warning sirens blast, it will be more like a leisurely stroll than a mad dash for the bunkers. Accordingly, shifts in M&A strategy take some time to get institutionalized.

Now if you're following closely, you may think we contradicted ourselves above. After all, earlier we suggested that in response to changes in home health payment methodologies, buyers will begin to adjust as much as six months **before** the cuts are initiated.

But consider that with these reforms practically a lock, there is enough information for buyers to exit, stage left, **right now**. But if past is prologue, we won't see the pressure build to do so until we get inside of six months before implementation. The "lag effect" lives.

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