Home Health and Hospice Mergers & Acquisitions

After an extraordinary 2021 that topped the previous record for private equity deal volume by more than 50%,¹², and propelled aggregate home health and hospice deal volume to a level 28% greater than its previous high-water mark, expectations were that we would see a falloff in activity in 2022.

The big question was how much?

Especially considering the macroeconomic storm clouds forming:

1. **Tax rate incentive disappears.** Some of the surge in transaction volume in 2021 was driven by fears that the special tax treatment for capital gains would be eliminated effective 2022, which would essentially double the tax rate on proceeds from a sale. In the end, it didn’t happen. Nevertheless, as we entered the year, not only did this incentive disappear, but the pool of acquisition candidates was also almost assuredly diminished as would-be 2022 sellers advanced their exit timeline.

2. **Inflation marches on.** According to Forbes, “inflation began to spike in the U.S. in April of 2021, when it hit 4.2% [and] continued to climb, hitting 7% year-over-year by December 2021.” By June of 2022, “the rate peaked at 9.1%.”³ And with it, costs increased, especially wages, exerting pressure on EBITDA margins.

3. **Cost of debt rises.** The playbook for reining in inflation calls for increasing the Federal Funds rate, which increases the cost of debt and chips away at valuation. And so it went. In March, the Fed dipped its toe in the increased rate waters with a modest bump of 25 basis points. In May, it upped it another 50, and by June, the Fed increased rates yet again by 75 points. By the end of the year, the Federal Funds rate had risen from a range of 0.25 - 0.50 to 4.25 – 4.5, a 400 basis point increase in total.

4. **Russia invades Ukraine.** In M&A, there’s nothing like uncertainty to turn a hot market instantly cold. And there’s nothing like the breakout of war in eastern Europe – and all the geopolitical and economic consequences it can create – to spook buyers and provide the incentive to hide their cash in the proverbial mattress.

As a result, PitchBook reports that since the first quarter of 2021, the average yield for leveraged buyout loans has doubled from around 5% to plus/minus 10%.

So with all these factors converging that could directly or indirectly negatively impact acquisition demand, supply, financing, and pricing, you could be forgiven for expecting the volume of deals completed in 2022 to plunge faster than Bitcoin.

But it didn’t.

At the macro market level, private equity deal volume barely moved, down only 2% vs. 2021.

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² Since PE investment drives well over 50% of home health M&A, we look to PE trends as a good barometer of what we may anticipate in the sector.
What did fall, however, was the average size per transaction. As the accompanying chart shows, from the 2nd quarter of 2021, average deal size fell steadily from $159M to $99M in Q4 2022, a fall-off of 38% from its peak.

The upshot? PE still wanted to do deals. They just wanted to hedge their bets a bit and target smaller transactions, including follow-on deals.

**Health Care Services**

Before we analyze sector specific performance, it is instructive to examine the health care services M&A "heat map"⁴ to gain some context as to how home health and hospice M&A stacks up against other sectors.

Clearly, the breakout sector over the past five or so years has been behavioral health. Still, the trendline in home health and hospice M&A over the same period has been positive. Moreover, if we combine home health and hospice, the 800 plus total deals completed over the period compares quite favorably to behavioral health.

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⁴ The Braff Group has developed “Heat Maps” to better contrast M&A activity across varying sectors and segments. Along the vertical axis is the total number of transactions completed over the past five years. Along the horizontal axis is the slope of the trend line over that period. Taken together then, the higher and further to the right a sector is, the greater – and more robust - the acquisition interest in that sector, both in terms of volume and growth.
But if we drill down further, we can see that whereas Medicaid and private duty M&A activity last year was down 57% and 14% respectively vs. 2020, over the same period, Medicare certified home health was up a healthy 18%.

The recent strength in Medicare certified M&A is even more impressive when we isolate private equity activity in the space.

Consider market-entry, platform activity which is frequently a bellwether of what to anticipate in the future. Not only did we not see a falloff from 2021 to 2022, the 10 deals completed each year were the highest in a decade. With similar follow-on transaction results, total private equity sponsor deal flow in Medicare certified home health of 34 and 32 deals in 2021 and 2022 respectively were the highest we’ve seen since we began tracking activity in 2001, far exceeding the previous record of 25 set in 2018.

This is no doubt due to the fact that with reimbursement changes arising from the two-year phase-in of PDGM fully baked in by the end of 2021, the go-forward risk profile for the space was substantially lower in 2022.
Medicaid and Private Duty

The 2022 vs. 2020 falloffs in Medicaid and private duty are a little more difficult to explain, especially considering growing recognition of the role non-intermittent personal care services can play in reducing health care spending in population-based reimbursement systems. We surmise it is most likely due to (a) the limited number of acquisition candidates with enough size and scale to drive these initiatives, (b) increasingly narrow margins as bumps in pay rates lag the rapid increase in wages, and (c) specifically as it relates to private pay, greater price sensitivity as inflation and a down stock market has eroded perceived wealth.

Hospice

The story is a bit more complicated with respect to hospice M&A.

After an extraordinary spike in deal flow from 2018-2021, driven in part by the shift in acquisition interest from Medicare certified home health to hospice given the unknowns attributable to the phase-in of PDGM, deal volume in 2022 fell more than 40% vs. 2021 and 2020. After the kind of steep run-up in activity hospice enjoyed, it is not unusual to see a falloff in transaction volume as the supply of acquisition candidates shrinks. Moreover, we sense some valuation “fatigue” as competition for the most attractive acquisition candidates has driven purchase prices to unprecedented levels and buyers must work that much harder to realize synergies and recoup at least some of these premiums.
The results are much the same when we examine private equity activity in hospice, particularly the falloff in platform deals in 2022.

The good news is that, at least from a valuation perspective, the expectations for hospice – while perhaps more sobering – are far less dire than the recent contraction might suggest (more on this below).

Valuation

The Macro Environment

For all the macroeconomic issues delineated at the beginning of this report, the mantra coming from buyers in 2022 was that valuations were coming down. Yet, according to PitchBook and illustrated in the chart below, median US PE multiples in 2022 were actually up a tick from the prior year.

What may have changed though is the reference earnings against which the multiple is applied.

For several years now, the benchmark for earnings has been some form of “go-forward-proforma-EBITDA-if-everything-goes-perfect-and-nothing-goes-bad.” As 2022 unfolded, however, we confidently speculate that buyers – and perhaps more importantly, lenders – began exhibiting more discipline in calculating the earnings base. So while multiples may not have come down quite yet – values likely have with reduced determination of earnings.

What has likely held the downward pressure at bay is the enormous amount of “dry-powder” – unspent “use-it-or-lose-it” capital – competing for the limited number of highest quality (and therefore prospectively less risky) pool of acquisition candidates.

“For several years now, the benchmark for earnings has been some form of ‘go-forward-proforma-EBITDA-if-everything-goes-perfect-and-nothing-goes-bad.’”
Home Health and Hospice Valuation

For context, it bears mentioning that over time, for asset light service businesses, especially those with exposure to “strike of the pen” reimbursement risk such as home health and hospice, valuation multiples coalesce around 5-6x EBITDA. And for many years, with the exception of the larger providers that frequently fetch “size premiums,” pricing often fell within this range.

But over the past four to five years, amidst an environment of cheap debt, plentiful capital, and competition for deals, private equity has helped boost valuations substantially, with certified home health garnering 6-8x, hospice as much as 7-10x – and both well into double digits for the most attractive acquisition candidates. Broadly speaking, for Medicare certified home health and hospice, the ranges generally still apply, with home health holding steady, and hospice under pressure.

Private duty and Medicaid also enjoy an elevated pricing environment, but less so, putting the range for private duty to around 5-7x for multi-location providers with EBITDA in the $3-5M or more range, and 6-8x or more for sizeable Medicaid providers with revenues greater than 40-$50M. Notably, unlike home health and hospice, such premiums are far more elusive for providers that fall below these size thresholds.

The above notwithstanding, it can’t be stated enough that these are broad ranges that in no way account for the unique trends or risk profile characteristics that, when unfavorable, can knock them down, or when favorable, in a strategically orchestrated auction environment, can boost them substantially.
Outlook

Much as we wish we could say otherwise, the near-term outlook for home health and hospice is a bit murky.

First, there’s the scheduled May 11th ending of the Public Health Emergency which threatens to reinstate regulatory burdens that were eased during the pandemic. Then there’s the matter of CMS revisiting cuts in reimbursement for certified home health that it delayed last summer, the implementation of value based purchasing, the continued encroachment of Medicare Advantage, the hospice valuation fatigue we spoke of earlier, MedPac’s recommendation to reduce the cap by 20%, inflation, rising wages, and those macroeconomic issues with which we began this piece.

The good news is that in the ever growing, population health-based, often capitated, alternative payment models, the value of home care in improving outcomes at lower costs has never been more evident.

But, and there’s that pesky “but” that’s like a cold splash of water in the face, while outstanding divestiture opportunities for the most attractive acquisition candidates will no doubt remain, when we look back on 2023, the “word” may be sluggish.
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