Before You Go Any Further

Some context for this report.

If you consider yourself a potential seller, the following isn’t what you want to hear. There’s no getting around the fact that the market is less than ideal. So, the natural question you might ask yourself is, “What do I do now?”

The good news is you can use this “downtime” to do what most sellers rarely do – and regret later. That is, prepare.

- Get your financials in order. If you are sizable ($30-50M in revenues and greater), consider getting an audit. More importantly, if your financials are prepared on the cash basis of accounting, bring in an accountant familiar with your line of business to convert them to accrual.
- Related to the bullet above, consult with a tax advisor. Often there are opportunities to reorganize certain aspects of the business to gain more favorable tax treatment. Moreover, they can suggest the best ways to structure a deal before you go to market. Such proactive tax planning can go a long way toward bridging the gaps in buyer/seller expectations.
- Bring in an independent firm to do a compliance audit. You may think that you are doing everything right – and you probably are – mostly. It’s that “mostly” that can haunt you during due diligence and crater your deal.
- This may sound self-serving, but that doesn’t negate its value: Bring in an advisor now. A good advisor will, among other things, perform a valuation. Not only will this give you a better idea of what you can anticipate, but during the process, experienced advisors will almost always be able to make suggestions regarding the things you can do to increase your value.

Based on your individual circumstances, an exceptional advisor might recommend delaying a deal. So, if you recently opened new branches or product lines, you allow some time for them to establish a growth pattern that can truly be factored into your value.

- Find an attorney experienced in health care transactions. Even an experienced M&A lawyer that hasn’t worked in the space will likely be unaware of the nuances in health care deals that must be addressed in a definitive purchase agreement to protect your interests.
- Obtain a seller’s quality of earnings report. The ubiquitously known Q of E is not any audit. Rather a quality of earnings report, Q of E, essentially examines your financials, clinical and legal compliance, reimbursement environment, infrastructure, and other items particular to your company and circumstances to essentially determine what your financial performance would likely be the day after a deal is closed.

Oh, and one other thing.

Despite current conditions, quality companies can beat the trends and still command premium valuations.

And one other, other thing.

Just as predictable as the market would face a downturn in the wake of unprecedented deal volume at unprecedented prices, private equity will get back into the game – and sooner, rather than later.

This is particularly crucial in health care services M&A as, based on proprietary data collected and analyzed by The Braff Group over the past 10 years, PE has accounted for 53% of the transactions in the sectors that we cover. They simply can’t sit on their $854 billion of unspent capital forever. If it’s not invested, or if those investments are made too late in their fund’s life cycle, they can’t generate the returns they need to keep their limited partners happy. So they need to spend, and time is on a prospective seller’s side.

Now, on to the update.
Overview

Last quarter, we reported that health care services M&A activity in 2023 on an annualized basis was trending down 32% vs. 2022. While we fully anticipated that this trend would continue, there was always hope.

Well, hope denied.

Through the second quarter on an annualized basis, aggregate sector deal flow is still down 30% vs. the prior year.

Moreover, annualized 2023 numbers are down 21% compared to 2019 (pre-COVID). And if the current pace holds, volume will be the lowest since 2013.

The trend is even more dramatic if we examine numbers on a quarterly basis.
Notably, this decline is not isolated to health care services. In an article based upon data from Refinitiv entitled, "Global M&A Activity Plummets in 2023," Axios reported that:

"Global M&A hit $1.3 trillion year-to-date, which is down 38% over the same period in 2022 and not too much higher than the COVID shock era of first-half 2020. Remove 2020 and it’s the lightest first half figure in a decade."

"U.S. M&A was down 41% in terms of dollars and 5% in terms of deal number, reflecting a relative dearth of large transactions."

"Private equity-backed deal volume was off 51% globally, returning to 2018/19 levels, while U.S. activity was down 49%.

So, what gives?

Record deal flow at record pricing in 2021 and the first half of 2022 left buyers exposed to unfavorable changes in the macro environment. And those unfavorable dynamics have come in waves. Inflation. Increases in the Federal Funds Rate to combat inflation (which in turn, has raised the cost of capital and has stoked fears of a recession). Staffing shortages. Unrest in Eastern Europe.

Put them all together and M&A over the past 30 months has been positively Dickensian – it was the best of times, it was the worst of times.

Private Equity

PE Investment Trends in Health Care Services

With PE accounting for more than 50% of health care services deal flow, it comes as no surprise that sponsor activity is a near perfect mirror image of the overall services M&A market.

One of the more interesting downstream consequences of the current lull in transaction volume is the impact it is having on private equity holding periods.

We have previously reported that PE set a record in volume of deals completed in 2021, eclipsing the previous record by an astonishing 50%. But shortly thereafter, for many of the reasons stated above, exit deal flow began to slow dramatically. As a result, according to PitchBook,

"The downturn in US PE exit value...is even bigger than what the market endured during the global financial crisis, resulting in an estimated $60 billion shortfall in deal value."

"With exits expected to remain slow for the next few years, we will see a significant pileup of not-yet-exited PE assets as investors struggle to sell the portfolio companies that are entering their exit time frames. The mismatch between the explosion of deals made in the last few years and a challenged exit market will cause the backlog of investments to swell."

"PE investors will need to pick up their exit pace or will be confronted with 20% to 26% of the capital initially invested by funds to hit the maturity wall. The cumulative amount of still held investments could grow to over $360 billion in the next 12 years."

As a result, fund performance – which relies on exit activity – could be constrained, and sponsors will need to consider creative strategies to perhaps delay exits past the initial life of their funds or find other ways to return capital to their investors. Otherwise, an inflated supply of exit opportunities could drive down valuations, further compromising internal rates of return.
As will become quite evident as we drill down to specific service areas, every health care sector we cover has experienced virtually the same pattern – a pattern that mirrors that of the entire M&A market.

In what has become an annual rite of summer, CMS once again proposed additional cuts in reimbursement for Medicare certified home health agencies. This year (for 2024) – minus 2.2%. While not yet finalized – we are in the midst of a 60-day comment period – the uncertainty will likely tamp down deal activity in the space through the third quarter.

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After what can only be described as a meteoric rise in acquisition demand and valuation, the fall-off in hospice deal flow over the past 18 months has been particularly acute. With (a) recent bad press including a scathing article published by the Center for Economic and Policy Research entitled, "Preying on the Dying: Private Equity Gets Rich in Hospice Care," (b) increased scrutiny from regulators, and (c) the proposed expansion of the "36 month rule" (which tamps down on quick buy and sell acquisition and divestiture strategies) to include hospice, it will likely take some time for the sector to rebound.
Most notable over the past quarter is the bankruptcy filing of CARD, the largest autism services player in the market coupled with a $25 million "stalking horse" offer to purchase the company by Doreen Granpeesheh, its previous founder and CEO. A startling figure when compared to the estimated $600 million purchase price paid by private equity giant, Blackstone, a mere five years ago. Coupled with difficulties being reported by other sponsor-owned autism providers, a sector that rode a wave of PE activity to record deal flow and valuations, is facing the prospects of a market "correction" – M&A speak for a slowdown.

**Health Care Staffing**

**Health Care Staffing Deal Trends**

Source: The Braff Group
Even the health care staffing sector, which surged due to personnel shortages driven by COVID, has succumbed to recent trends. While still posting the highest quarterly total since the first quarter of 2018, the slowdown in deals over the past four quarters is undeniable. The macro environmental factors that have hobbled M&A activity nationwide are certainly at play. However, we also note while still substantially greater than where the health care employment market stood immediately prior to the pandemic, the deficit of job openings versus hires has contracted to the lowest level since March 2021, lowering the crisis level – and demand for temporary staffing – from bright red to orange.

In a classic case of good news—bad news, the home medical equipment sector is the only service sector we cover that saw increases in deal flow over the past two quarters. That’s the good news. The bad news is the quarterly output during this period was still among the lowest we’ve seen over the past five years.
In pharmacy services, after plummeting in Q1, the sector posted a modest rebound in Q2. Just like in health care staffing, macroeconomic conditions have contributed to the fall-off. That said, the slowdown in home infusion is also likely due to a diminishing pool of acquisition candidates following a noticeable pick-up in deal flow that began in the fourth quarter of 2020.

Outlook

Earlier this year we were optimistic that we would begin to see an upturn in deal volume towards the back end of Q3 into Q4. While mounting pressure on private equity sponsors to put their money to work may give deal flow a modest lift, recent comments by the Fed signaling the possibility of two additional rate hikes of 25 basis points each have dampened that optimism. Add in the uncertain reimbursement environment for home health, the market stumbles of leading consolidators in autism services, the easing of demand for health care staffing, and memories of the extraordinary premium multiples in 2021 and 2022 creating lingering valuation gaps between buyers and sellers, the hoped-for rebound may not come until 2024.
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