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M&A Q&A

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Two Experts Share Their Insights

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Uncertainty breeds timidity in the M&A business, but opportunities are out there for realistic buyers and sellers.

If you've been looking to buy a business or sell the one you have, a lot depends on the financial "climate" where slight shifts in perception can add up to thousands of dollars. With all bids in for the first round of competitive bidding, we checked in with two mergers and acquisitions (M&A) experts to get their take on the effects of uncertainty, and the opportunities on the horizon.

HME Today: The first round of competitive bidding for the first 10 MSAs closed on September 25. Has uncertainty about competitive bidding affected the M&A climate?

Tim Pontius, RRT, managing director for M&A firm Steven Richards & Associates (SRA), Tarpon Springs, Fla: The most obvious effect is on the companies actually located in the first 10 MSAs. The uncertainty of whether these companies will be able to even take new MCR patients, as well as the wide range of potential reimbursement rates for the next 3 years for winning bidders, has pretty much eliminated any M&A activity in these MSAs until the results are known.

Nothing slows down the pace of acquisition activity more than uncertainty. It makes it extremely difficult for buyers to calculate the value of companies if they are unable to predict revenues and profitability of the business going forward. Likewise, it is difficult for sellers to know if they are getting the true value of their companies. Once everyone sees the results of competitive bidding, and we have some certainty of who are qualified buyers at what rates, it will make it easier for both buyers and sellers to pursue transactions in these metropolitan statistical areas (MSAs).

While the uncertainty has also chilled activity outside of the initial 10 MSAs, we have continued to complete a number of transactions outside the first 10 MSAs this year as buyers and sellers find valuations that are acceptable to each. Once we receive the results of the first round of competitive bidding, however, we anticipate that activity will begin to pick up elsewhere as we get the first true insight as to possible results in future rounds of bidding. The results could also effect which types of businesses will be more profitable in the future, depending on how the bids come out for the various rate categories.

Jonathan Sadock, managing partner of M&A firm Paragon Ventures, Newtown, Pa: For acquirers of businesses with a preponderance of Medicare-related revenues, uncertainty has absolutely affected the M&A climate. Anytime there is proposed change that could affect revenue, growth, or profitability, there will be a correlating effect within the M&A markets. It is difficult for an acquirer to value a business whose profitability may be negatively impacted soon after the acquisition. Once the effects of competitive bidding on profitability are known, then acquirers will be able to get a handle on valuation.

Jonathan Sadock

There is another side of the competitive bidding coin. Some providers stand to significantly increase the size of their business as a result of competitive bidding. Although the per-patient valuation may decrease, overall they stand to increase revenues and profitability if they are strategic in their implementation. It should be noted that in some related sectors, the M&A environment is extremely active with a healthy balance of buyers and sellers. The majority of revenues and profitability of those businesses are not in jeopardy.

Historically, changes in health care reimbursement—and their effects on the M&A market—go in cycles. For buyers and sellers, the key is to deal with reality and manage risk. That should be reassuring to those who

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are proactively managing their business to take advantage of the resulting opportunities.

HME Today: What sector of the industry would you deem the hottest and why?

Pontius: The hottest sector of the industry remains, as it has for years, respiratory products. Oxygen and sleep continue to be the fastest-growing product lines among a majority of providers. Even with the reimbursement uncertainties surrounding many of these products (competitive bidding and the oxygen cap), buyers are still motivated by companies with a strong respiratory mix.

Other areas where we have seen increasing momentum in acquisition activity over the past 12 to 18 months include diabetic products, home infusion, and other sectors catering to chronic patients. For the most part, buyers in these two areas are not the same buyers who are interested in HME/respiratory companies. The diabetic supply businesses are typically centralized distribution companies focused on supplies, and the buyers of infusion companies are typically private equity-backed rollups that are singularly focused on pure infusion plays.

Sadock: The hottest sector currently is home infusion and specialty pharmacy. The five primary reasons for this sector's popularity include:

1. Home infusion generates strong margins and profitability. This is an acquisition attribute that attracts investors and propels valuation.
2. The revenues of these businesses are not currently in jeopardy of reimbursement cuts. In fact, current legislation (HR 2567) is proposed that will improve access to home infusion for Medicare beneficiaries. This will further improve the profitability and desirability of these businesses.
3. The number of infusible drugs that can be administered in the home has been increasing dramatically. With the increased access proposed by HR 2567, the positive impact can be significant.
4. The market is highly fragmented and synergistic "white coat" opportunities abound.
5. There are significant "barriers to entry" for start-up competitors. This makes existing businesses more attractive.

For home infusion stakeholders, premium opportunities are here today for those that want to seize the moment. The horizon looks equally appetizing for acquirers to continue to capitalize well into the future.

HME Today: Is it a buyer's market or a seller's market?

Pontius: Clearly in terms of supply and demand, there is much more supply on the market today than in years past. Meanwhile, most of the large national companies have suspended or greatly reduced acquisition activities—and the most active buyers today tend to be regional companies often looking to increase their market share in specific geographic footprints. And with all of the changes and uncertainties on the reimbursement front, we are seeing more sellers continuing to express interest in divestiture opportunities even at lower values.

Tim Pontius

Sadock: Those businesses with significant reimbursement risk and questionable valuation will find getting a deal done is very difficult. Those that do close will mostly be in strategic and niche markets. In sectors where demand is outpacing supply (such as home infusion, mail order, and alternate site services), the sellers will find it significantly easier to get a transaction closed. For strong, well-diversified, profitable providers in niche businesses, there is an incredible demand and strong valuations.

Of course, it depends on your perspective. Many business owners fail to look at their business from the viewpoint of an acquirer. A good deal in the current market environment is one that closes. Not to be coy, but when a transaction closes, the buyer and seller both feel that the value was fair. So I think we have a fair market, because that is where transactions occur—at fair market value. The laws of supply and demand apply.

HME Today: Do companies that rely on managed care contracts for reimbursement come across as attractive to buyers?

Pontius: There is more interest from the buyers in certain companies that are more reliant on managed care contracts. There is some value in being part of a closed network available to only a few choice providers with a more stable reimbursement climate. However, the level of interest depends on reimbursement rates under the contract.

A recently conducted 2007 SRA financial survey of approximately 600 providers showed that the fastest-declining segment of revenue by payor for providers is managed care. In the last 2 years alone, there has been more than a 50% decline in managed care revenue as a segment of providers' total revenue by payor.

HME Today: What do you find to be the biggest misconception among HME providers?

Pontius: The biggest misconception of sellers today centers on the prices that buyers are paying for HME companies. Many sellers still think it is a sellers' market, and that valuations are the same as they were 2 or 3 years ago. They don't recognize that buyers today are factoring in the effects of the impending oxygen cap, as well as the effect of competitive bidding on profits going forward. Buyers are looking into the future and projecting a company's profits based on how things will look a year or two down the road.

The reason that most sellers do not recognize this is that none of these changes to reimbursement has had any effect on their profits today. In the past, when CMS or legislators reduced reimbursement rates, the providers felt the impact immediately. As of today, providers have not felt the financial impact of the 36-month cap on oxygen, but it will have a dramatic impact in another 15 months, and the buyers are taking this into account today. Sellers need to recognize that external changes are causing values to fluctuate dramatically. At SRA, we get involved with HME companies much earlier in the strategic planning process to help them be prepared to take advantage of opportunities driven by rapidly changing dynamics.

Sadock: The biggest misconception is probably what needs to be done to prepare the business and get a deal done. Some business owners are totally surprised by soft market demand. They know they have a good, clean business, and can't understand why there is not an appetite for it. We continue to educate our clients and help them understand how the process works, and the factors that can propel a transaction along—and the factors that can derail it.

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