The U.S. Healthcare Industry:

Focus on the Hospice and Palliative Care Industry

Summer 2004

Introduction

Hospice and palliative care ("hospice" or "hospice care") offers terminally ill patients an alternative to the traditional institutional setting of an acute care hospital. The mission of hospice care is predicated on "caring", not "curing", and the belief that individuals have the right to die in a dignified and pain-free manner. Delivered through an integrated team involving doctors, nurses, home health specialists, social workers, clergy and volunteers, hospice care is focused on providing expert medical care, pain management, and emotional and spiritual support to patients and their families.

A large number of hospice programs are owned by, or are part of, a larger healthcare delivery system, typically not-for-profit hospitals. The strategic rationale for hospice to be a part of an integrated healthcare system is two fold. First, hospice is a critical and growing piece of the healthcare continuum and enables acute care providers to offer patients an alternative to traditional end-of-life care situations. Second, hospice programs can act as a strong link to the community, given the large number of volunteers and the high level of emotional attachment.

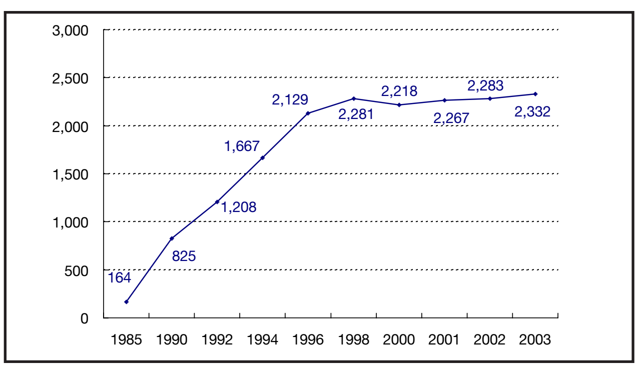
While the primary objective for many hospice programs may not be financially driven, this paper discusses several important financial trends that may provide an opportunity for owners to monetize hospice assets and deploy the associated capital within their core operations while retaining some of the strategic benefits.

Market Overview

It has been estimated that the average healthcare per capita expenditures for patients in their last year of life are approximately six times greater than expenditures for surviving patients.[1] This trend is magnified when analyzing the monthly expenditures during the last year of life - where the average monthly expenditures during months one through six are approximately $2,250, versus over $8,000 for the final month of life.[2] This is due primarily to the intensity of care and the dramatic increase in acute care hospital usage provided to terminally ill patients.

As a sub-sector of the larger U.S. healthcare industry, hospice is a relatively small and highly fragmented component. There are over 2,300[3] licensed programs providing hospice care, generating aggregate annual revenue of approximately $4.5 billion. This translates into less than $2.0 million of revenue per provider annually. In addition, the hospice industry accounts for less than one half of one percent of the $1.4 trillion annual U.S. healthcare spending and only 1.5% of annual Medicare spending. In terms of the number of providers, not-for-profit organizations dominate the industry -- comprising 70% of all providers.[3]

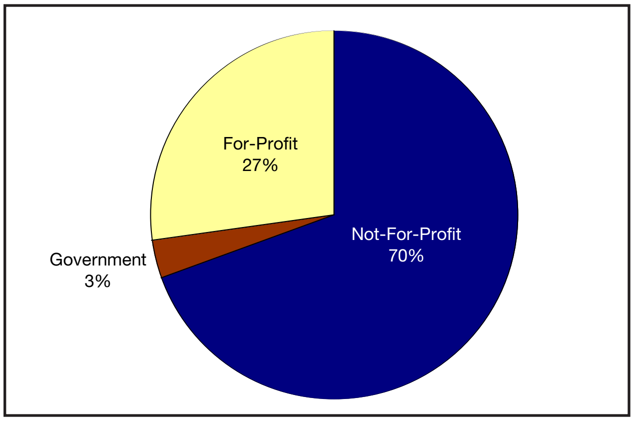
Number of Hospice Providers



Source: National Hospice and Palliative Care Organization

However, nine of the top ten providers, as measured by average daily census ("ADC") are for-profit. ADC refers to the total number of patients, regardless of the level of service. There are currently four defined levels of service; 1) routine home care; 2) continuous home care; 3) respite care; and 4) general inpatient care.

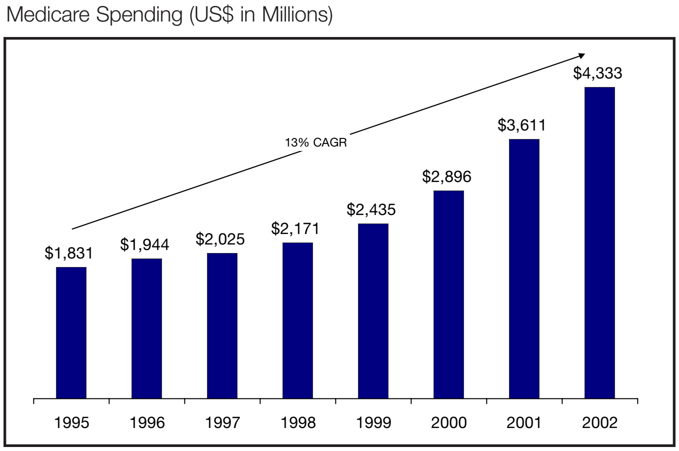
Type of Ownership



Source: National Hospice and Palliative Care Organization

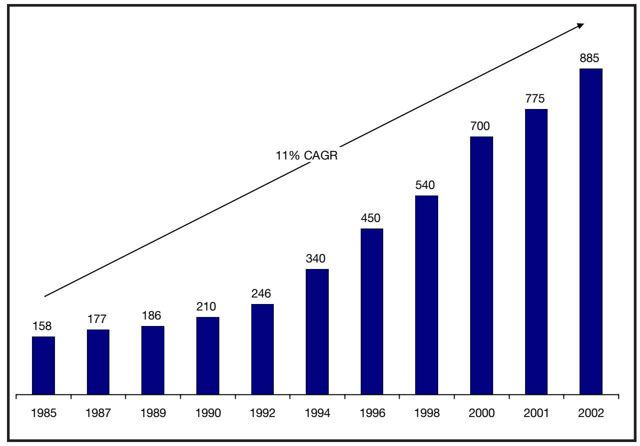
Despite its small size, hospice is becoming a critical part of the healthcare continuum and continues to grow rapidly. Medicare spending on hospice care grew at a 13% compounded annual growth rate between 1995 and 2002, while aggregate patient volume grew at an 11% compounded annual growth rate between 1985 and 2002. According to the National Hospice and Palliative Care Association ("NHPCO"), 37% of an estimated 1.8 million non-sudden deaths in 2002 were patients cared for through hospice. Census data supports the theory that patient volume will continue to grow, as there is an uneven acceptance of hospice on a state-to-state basis.

Medicare Spending (US$ in Millions)



Source: Center for Medicare and Medicaid Services

Hospice Patients (000's)



Source: National Hospice and Palliative Care Organization

Trends in Hospice

Growing Revenue Opportunity - Several Wall Street analysts predict that hospice patient volume will continue to grow at a rate approximately equal to the historical annual rate of 11%. Assuming the current weighted average daily reimbursement rate of $145/day and a median length of stay of 21 days,[3] the hospice industry is set to grow by $1.7 billion --- from $4.5 billion to $6.2 billion --- between 2002 and 2006, or 36%. There are several factors underlying this growth trend:

- The increasing size of the over-65 population;
- Encouragement from the Center for Medicare and Medicaid Services, because hospice is viewed as a lower cost alternative for end-of-life care;
- Higher usage rates as hospice becomes viewed as a more accepted and appealing alternative by doctors, patients and families; and
- Higher usage rates by non-cancer patients.

Medicare Exposure - Despite hospice's reliance on Medicare for 81% of its revenue, the reimbursement outlook remains favorable. Hospice has received annual inflationary increases while many other healthcare service sectors have had flat or downward trends. The positive outlook on hospice reimbursement is due to:

- Generally, the cost of care for a patient electing hospice is significantly lower than the cost of care for that same patient in an acute care hospital setting. Consequently, the growing acceptance of hospice as a way to address terminal illness results in a direct financial benefit to Medicare; and

- Hospice is an extremely small component of total Medicare spending (1.5%), making any reductions in reimbursement insignificant to the overall Medicare budget.

Industry Consolidation Underway - If history is any guide, there will be regional and national hospice consolidators in the for-profit realm and local strategic buyers in the not-for-profit sector. It has been difficult to transcend state boundaries, even for the hospital systems, so not-for-profit providers consolidating beyond state borders will be rare. With the maturation of the hospice industry, consolidation is beginning to accelerate. As described below, this is the result of 1) an increase in the number of interested investors and the amount of investment capital available, and 2) a heightened interest in divesting of such businesses by current owners.

- The recent emergence of several relatively large publicly traded and private equity-sponsored companies creates an underlying vehicle for consolidation, as growth and sustainable profitability become driving forces within the industry.

- Hospice is highly sensitive to scale. Once the ADC breakeven point is reached (30-40/month[4]), operating margins in the 10% range are achievable and increase as the census rises. In fact, larger hospice providers have operating margins in the 20% range.

- Operators of other elder care services, such as long-term care, assisted living, and skilled nursing, are seeking to leverage their expertise into hospice services. Because hospice requires less capital and can be operated on the existing infrastructure, the opportunities for margin growth are significant.

- Finally, many hospice providers are willing to pursue a change of control transaction due to the historic ownership structures. Many hospitals own hospice programs and are now divesting these programs to focus on core operations and using the sale proceeds to fund capital investment. Additionally, there is a large majority of hospices that are small individual proprietor programs. The owners of these programs view a sale as a way to quickly monetize their asset in the face of growing competition and increasing capital requirements.

When considering the sale of a hospice program, an owner must carefully consider the financial as well as the non-financial aspects of a transaction and how it will impact the organization's overall mission. In many cases, owners may be able to maintain the strategic benefits of ownership by retaining certain "control" aspects, such as name preservation, advisory board seats, agreements with the new owner to continue or

Table 1: Significant Hospice Providers

Provider	Status	Estimated ADC	Estimated Revenue (MM)	Market Share[A]
Vitas Healthcare Corporation	Public, For-Profit	8,500	$490	10.9%
Odyssey Healthcare, Inc.	Public, For-Profit	7,700	$360	8.0%
VistaCare, Inc.	Public, For-Profit	5,200	$192	4.3%
Manor Care, Inc.	Public, For-Profit	4,500	$376[B]	8.4%
SouthernCare Hospice, Inc.	Private, For-Profit	3,500	$180[C]	4.0%
Beverly Enterprises, Inc.[D]	Public, For-Profit	2,000	$87	1.9%
Trinity Hospice, Inc.	Private, For-Profit	1,400	$72[C]	1.6%
LifePath[E]	Private, Not-For-Profit	1,300	$67[C]	1.5%
WellSpring Hospice Care	Private,For-Profit	750	$38[C]	0.9%

A - Based on an assumed $4.5 billion revenue industry.
B - Hospice and Home Health Care.
C - Estimated by Shattuck Hammond Partners LLC.
D - Pro Forma based on acquisition of Hospice USA, LLC.
E - Pro Forma based on proposed acquisition of Good Shepherd Hospice of Mid-Florida, Inc.

Table 2: Selected Hospice Transactions

Date[A]	Target	Buyer	Transaction Value (MM)	Value to: EBITDA[B,C]	Census[B]
06/2004	Good Shepherd Hospice of Mid-Florida	Lifepath Hospice and Palliative Care	$26.3	13.8x	$60,000
05/2004	Hospice USA	Beverly Enterprises, Inc.	$77.0	8.5x	$96,250
01/2004	Crown of Texas Hospice	Odyssey Healthcare, Inc	$22.5	N/A	$56,250
12/2003	Vitas	Roto-Rooter	$650.0	17.5x	$82,000
09/2003	Heritage Hospice, LLC	Odyssey Healthcare, Inc.	$11.8	N/A	$42,143

A - Announcement Date.
B - Per company reports, press releases and Shattuck Hammond estimates.
C - EBITDA equals Earnings Before Interest Tax and Depreciation and Amortization.

Table 3: Premium Valuation Comparison

Company	Enterprise Value to LTM EBITDA[A,B,C]	LTM P/E[B,D]
Odyssey Health	13.5x	23.7x
Vista Care	11.7x	21.5x
Beverly Enterprises	7.3x	21.8x
Manor Care	9.2x	22.3x
Home Nursing Average	14.3x	34.2x
Respiratory Therapy Average	6.7x	13.4x
Hospital Average	9.6x	18.9x

A - Enterprise Value equals Market Value of Equity plus Net Debt, as of June 2004
B - LTM equal to "Last Twelve Months"
C - EBITDA equals Earnings Before Interest Tax and Depreciation and Amortization.
D - PE equal to Price of Common Stock/Earnings to Common Stock.

implement hospital-based inpatient facilities, and/or right of first refusal on any subsequent sale.

Valuation - Due to their strategic nature, many hospice programs are receiving premium valuations upon a change of control transaction. The most appropriate valuation metrics when considering an acquisition are "Enterprise Value/EBITDA" and "Enterprise Value per Census." Several recent transactions have had values in excess of 8x EBITDA and over $40,000 per census.

In addition, publicly traded hospice providers and companies with significant hospice operations also command a premium valuation in comparison to many other sectors of the healthcare services industry.

Summary

The hospice and palliative care industry is growing from its roots as a small, niche sector of the healthcare services sector into a more widely accepted end-of-life alternative for terminally ill patients. As the industry grows and becomes more attractive from a financial point of view, competition within the industry is becoming more intense. This structural change among market participants, coupled with the attractive financial returns is driving consolidation and value.

For owners of hospice programs that are non-core operations, a sale can be viewed as a desirable "portfolio optimization" strategy. As the healthcare industry has repeatedly demonstrated, specific industries go through cycles of consolidation and high value followed by a period of divestiture and low value. A sale now is an opportunity to raise low-cost capital. As the cycle evolves, there will likely be an opportunity to "buy back" into hospice at a lower relative valuation.

END NOTES:

1. Health Affairs, Vol 20, Issue 4, 188-195

2. Center for Medicare and Medicaid Services

3. National Hospice and Palliative Care Association

4. JP Morgan Securities, Inc., December 11, 2003," The Hospice Industry - An Integral Part of the Healthcare System"

About Shattuck Hammond Partners

Shattuck Hammond Partners LLC is an independent full-service investment bank serving all sectors of the healthcare industry. Our professional staff of investment bankers is one of the largest and most experienced groups on Wall Street focusing on healthcare. Through offices in New York, San Francisco, Atlanta and Chicago, Shattuck Hammond Partners provides municipal and corporate finance services to healthcare providers and payers nationwide. Our services include: strategic advisory and capital planning services; valuations and fairness opinions; mergers, acquisitions and divestitures; restructurings; not-for-profit conversions; private placements of debt and equity; underwriting; and trading.

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