

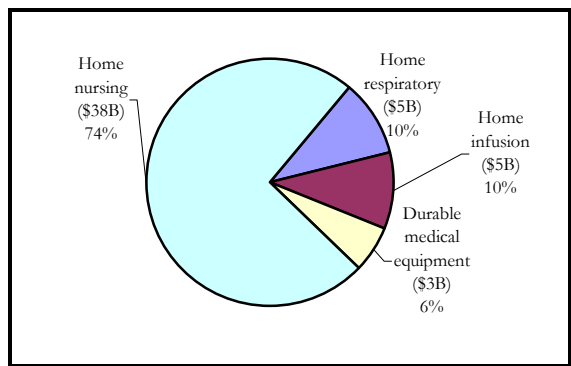
INTRODUCTION

The hearty, sustained growth phase that we had predicted this past summer for the home health care industry seems to be in full swing. With the uncertainties surrounding a presidential election behind us and with another market basket increase of 2.3% from Medicare effective 1/1/2005, the regulatory environment appears indeed benign relative to the near-term outlook for the industry. As such, our outlook for the home health care sector remains very positive over the next twelve months.

OVERVIEW OF THE INDUSTRY

The home health care sector is comprised of two subsectors: 1) home nursing and 2) home medical equipment. The total market size for the home nursing market for 2003 was \$38 billion. The Centers for Medicare and Medicaid Services (CMS) projects the home nursing market to grow to \$68.9 billion (6.8% CAGR) by 2012. Many of the home health care companies Victory Partners maintains relationships with are reporting solid, double-digit revenue growth for 2004. Companies are growing through cultivating additional referral sources and through expanded, more specialized service offerings.

Home Health Care Industry Segments



Source: CMS and Office of the Actuary

We view this as an attractive long-term market for investment for a number of macro reasons. First, home care is materially less expensive than care provided in the institutional setting. Second, demographics and the aging of the population should expand the home care market, as will likely be the case with most health care services subsectors.

Projected Population of U.S. Elderly (in 000s)

Year	Total U.S. Population	Total Elderly	Percent of Population
2005	295,507	36,695	12.4%
2010	308,936	40,243	13.0%
2015	322,366	46,791	14.5%
2020	335,805	54,632	16.3%
2025	349,439	63,524	18.2%
2030	363,584	71,454	19.7%

Source: US Bureau of the Census

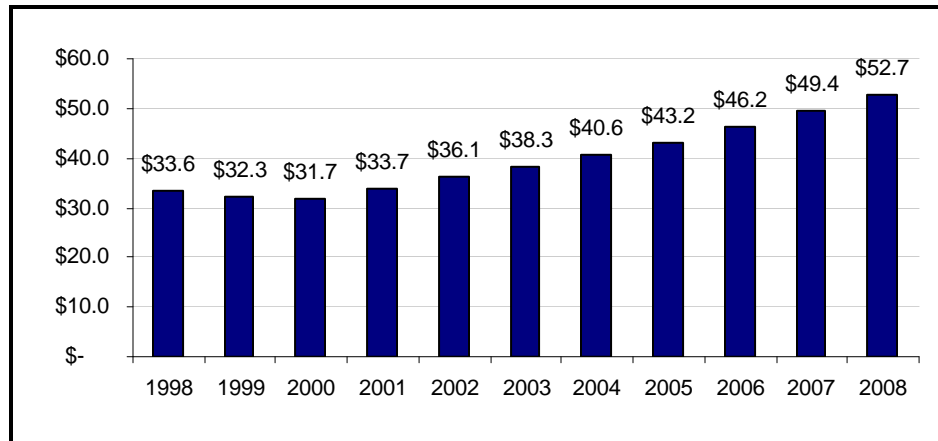
Third, increased consumer awareness should, in our opinion, increase the demand for home care relative to other types of care (e.g., in institutional facilities). Fourth, technological innovation has, and is, expanding the range of services that can be provided in the home setting, which is expanding the market.

RISK FACTORS

While we remain bullish on the home health care sector, it is important to note that there are considerable risk factors prevalent within the industry. First, although we view the current regulatory environment as relatively stable, political forces give some cause for uncertainty as it relates to Medicare reimbursement in the long-term and potential shift in the government's posture toward the industry. Second, because of the relatively low barriers to entry and the current favorable government views toward the industry, competition has increased dramatically of late. This competition has caused increased pressure on referral sources as well as company management. It is becoming more and more costly to run inefficient organizations as larger players take advantage of superior systems, experienced, talented management and economies of scale. Further, we are beginning to see powerful, venture-backed home health care companies merging into the fray. This is sure to place pressure on thinly-capitalized companies as they compete for talented nurses in the midst of the current labor shortage. Finally, we see labor prices continuing to increase and put further pressure on margins. However, considering the average age of a nurse in the U.S. is early-40s, home health is a nice alternative and less physically demanding than hospitals.

Home Health Care Nursing Expenditures

(\$ in billions)



Source: CMS and Office of the Actuary

INDUSTRY REGULATION AND OUTLOOK

When Medicare implemented the prospective payment system (PPS), its objective was to reduce unnecessary care and ultimately reduce overall medical expenditures. The government has gradually implemented these payment methodologies across the entire health care delivery system over the years. An interesting by-product of these reimbursement changes over the past decade has been the change in the visit mix before and after the PPS change went into effect. The implementation of the home care Medicare PPS system changed the incentive approach from low-cost, visit-based reimbursements, where home health aides were the primary caregivers, to an emphasis on more clinically intensive, rehab-oriented visits that utilize therapists and registered nurses more than aides. In essence, the reimbursement change had the effect of moving the home care market “clinically upstream” toward the institutional setting, which, in our opinion, has helped expand the range and type of services being provided in the home setting. This behavioral change ultimately creates a further opportunity for the government and commercial payers to ultimately try to reduce their overall expenditures by shifting more care to the home care setting.

Mix of Home Health Visits

Type of visit	Pre-PPS			Post-PPS	
	1997	1998	1999	2001	2002
Therapy	9%	11%	15%	25%	26%
Home health aide	49%	42%	35%	24%	23%
Skilled nurse	41%	45%	48%	50%	51%

Source: MedPAC March 2004 Report

In March 2004, MedPAC issued a report that indicated that under the PPS system, the overall clinical quality of

care has improved compared to before PPS (i.e. before 1997). We view this as another important data point, corroborating that care is becoming more efficient and clinically better and yet still providing an attractive financial incentive for home care providers. Moreover, Gentiva Health Services (NASDAQ: GTIV) and other companies operating in the home health sector have announced the beginning or continuance of stock repurchase programs – signaling a very positive view of the relative price of their company’s stock and their long-term outlook on the industry.

RECENT TRENDS IN THE HOME HEALTH CARE M&A MARKET

Victory Partners continues to see rapid consolidation taking place in the industry as smaller companies are being purchased by larger, well-capitalized organizations. Thus far in January 2005 we have seen 20 deals announced in the medical supplies and equipment industry and 8 deals in the health services industry for a total of almost \$2 billion in aggregate deal flow in *one month*. Several firms are pursuing “roll-up” strategies in which they plan to acquire several smaller companies and bring them together to create more formidable competitors and realize economies of scale and efficiency to improve profitability. We believe that these leaner, meaner companies will pose significant threats to the remaining small companies who choose to remain independent.

Victory Partners, LLC is actively involved in analyzing and representing companies in the Home Health Care Industry, having provided financial advisory services, performed recapitalizations, and completed M&A transactions for middle market companies.

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