Almost Family Positioned To Roll Up Home Health

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Summary

- Almost Family is executing its strategy to get bigger while the industry shrinks.
- Mix and operating leverage are likely to improve margins.
- AFAM offers positive cash flow, low leverage, and EPS growth at a discount.

Almost Family (AFAM) is the fourth largest home healthcare provider in the United States. The company has a Southeast and Midwest franchise with 240 branches. The business employs care givers to visit the infirm in their homes and administer nursing, therapy, and personal care. After a four-year pause awaiting regulatory certainty, management now sees an opportunity to take part in consolidating the industry. With the Medicare "rebasing outcome known," capital flows are expected to resume. Home health is a fragmented industry, and Almost Family is set to expand from about 2% market share.

The Center for Medicaid Services (CMS) plans to cut home health funding by a total of 14% over the next four years. Cuts of this magnitude are curious policy as the Federal Long Term Care Insurance Program, a different arm of the same government, says that home care costs range from $15 to $24 per day compared to nursing home care, which ranges from $148 to $462 per day. Using the midpoints, home care is 94% less expensive than an in-facility option. That said, CMS seems to believe that there are fraud issues with the industry, going so far as to require doctors to have face-to-face encounters with home health patients before getting reimbursed for claims. This is a provision in the Affordable Care Act. Kaiser Health News suggests that over 30% of home health claims may not survive CMS scrutiny. The industry is in full retreat with 3,800 home health jobs lost in February, according to the Labor Department. Only last week, Visiting Nurse Services of New York dismissed 775 employees in one of the largest healthcare layoffs in New York City that does not involve closing of a hospital. Congressional staffers see up to 40% of the industry operating in the red by 2017.

In the industry duress, AFAM and other public companies see opportunity. So far this year, Gentiva grew by 25% through the acquisition of Hardin Healthcare. LHC Group bought the home health business from Bioscrip, and Almost Family expanded its revenue base 42%, $150M/$357M, through the acquisition of Suncrest HealthCare, per my calculations. Gentiva has made statements about diversifying away from Medicare, and accessing dual eligibles, or people who have "trouble carrying out daily activities such as bathing and dressing." Almost Family appears to be the better buyer of the group, paying 0.5X revenue for their deal, $76M for $150M revenue. I tabulate that LHC Group paid 0.9X revenue, and Gentiva paid 1.0X revenues for their recent deals.

Using the multiples paid above, Almost Family looks to have made the most attractive acquisition in the industry this year. Not only did they pay the lowest multiple, management bought a business, which adds $16 million in revenues to their personal care franchise. Personal care is the fastest growing segment of the home health industry, expected to grow 70% over the current decade. Personal care involves assistance with dressing, shopping, meal preparation, and bill payment, and it is one of the few home health services that is a private pay service, not entirely dependent upon Medicare or Medicaid. As such, it is a higher margin business.

AFAM looks to have paid the least among their industry peers for an acquisition this year, and they brought in a better mix of higher margin personal care business. The company has followed-up on the Suncrest acquisition with two additional tuck-in deals. Being profitable and having low leverage, AFAM appears to be well positioned to execute a consolidation, especially compared to peer companies. The market share leader, Amedisys (AMED), is not profitable, and Gentiva (GTIV), a fellow acquirer, has nearly $1.2 billion in debt, about 4 times their equity.

While they are well positioned to continue their roll-up strategy, expectations are low for Almost Family. Consensus expects 39% revenue growth, essentially adding the Suncrest acquisition into the negative industry growth rate. At present, there does not appear to be much in the Street estimates for either further consolidation or share gains.

On the profitability side, management has identified $10 to $13 million in cost savings from the recent acquisitions. If achieved, these cost reductions ($11.5M midpoint * 40% tax rate / 9.3M shares = $0.74) would result in an EPS increase of $0.74 over the next year from synergies alone. This savings, along with improved margins from a higher personal care mix, makes up most of the consensus 306% earnings growth rate ($1.34/$0.33) for the 2014 year. Competitor Addus Homecare (ADUS), which has a higher personal care mix, has 7% operating margins compared to 3% margins at AFAM at present.

Growing personal care mix and operating leverage from the mergers are the best opportunities for the firm to raise the ROE from a 4% level to something above Almost Family's cost of capital. In the meanwhile, the business maintains positive operating cash flow.

The stock is down a third over the last two months, giving up the premium that the industry attracted after three closely timed merger announcements. AFAM trades at 16X estimated earnings, putting it at an absolute discount to Addus and LHC Group (LHCG), and a significant PEG discount.

Having completed the lowest multiple acquisition in its peer group while buying a larger mix of personal care business, Almost Family looks to be a good acquirer in a consolidating industry, in my opinion. Expectations are not aggressive, and I think that the company has the cash flow, balance sheet, and earnings growth rate to justify a higher relative valuation among its peer group.