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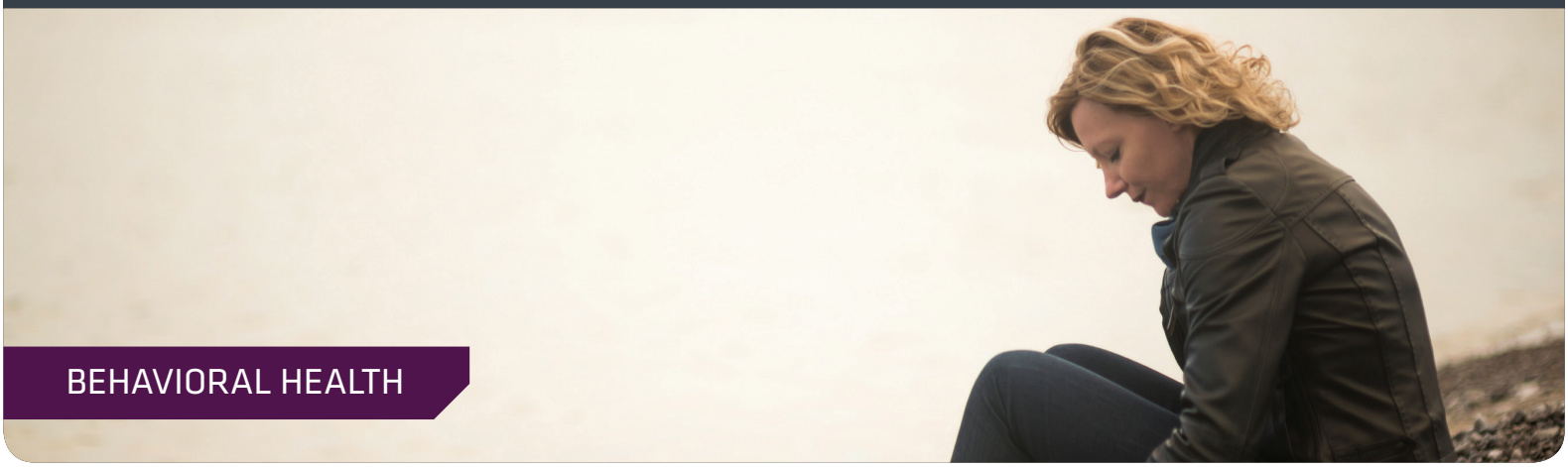


BEHAVIORAL HEALTH

A NEW PHASE IN ADDICTIONS AND SUBSTANCE ABUSE M&A[1]

Just below the surface of an addictions and substance abuse consolidation that might appear to be the same-old parity stimulated, private equity driven, high-end residential focused, start 'em up, roll 'em up and spit 'em out business model, lies the not-so-faint stirring of developments that have begun to ripple (and will eventually rumble) across the addictions M&A landscape.

The Plain Janes of today will become the new Belles of the Ball, ushering in a new phase of consolidation strategy, acquisition targeting, and valuation.

The Pebbles in the Pond

The Disparity of Parity. Much like the Kardashians will Instagram, Instagram, Instagram along their way toward irrelevance, the insurance companies are going to deny, deny, deny, along their way to the implementation of parity. And when they eventually start paying, they will reflexively zero in on the shortest, cheapest, "good-enoughest" intervention available.

Implication: While the promise of parity has stimulated investor interest in behavioral health care, driving demand and value across all sectors, **the real benefits of parity are likely to be felt most at the value end of the provider spectrum.**

The Rise Raises the Risk

You can't watch late night television without seeing the visage of Michael Cartwright of American Addiction Centers, Pax Prentiss of Passages Malibu, or some earnest looking operator urging you to call their addictions hotline…***now.*** Such is the nature of a highly competitive, lucrative, consumer-driven market. But with all the investment dollars flowing toward high-end residential treatment programs and the national marketing programs necessary to fill those expensive beds, this segment of the treatment industry has become extremely visible. Good for drawing attention from potential clients. But not so good for drawing the same attention from preternaturally untrusting payors and regulators.

The Rise Rallies the Riff Raff

A corollary to the above: with increased visibility, comes the often less than savory Johnny-come-latelies that barrel their way into a suddenly hot sector and live in the grey areas of utilization, billing, and clinical protocols. Can you say urinalysis?

Implication: Deservedly or not, **the risk profile for the high-end residential treatment model is rising – slowly – but steadily.**

[1] This edition of marketWATCH further develops concepts and trends initially published in *marketALERT: Medication Assisted Treatment Deals Signal a Shift in Addictions M&A.*

The Flipside of Being Outside

Due, in part, to the commonality that residential programs tend to draw clients well beyond their physical location, who are likely insured by a panoply of insurers (each of which may deal with said provider on a limited basis), we see substantial out-of-network reimbursement in addictions treatment. Before we proceed further, let's be clear about one item: there is nothing inherently wrong, or even unattractive, about a provider that appropriately derives the bulk of its business from out-of-network insurance. What is noteworthy, however, is if the rates are substantially higher than "typical" in-network reimbursement (as is mostly the case), payments are increasingly likely to be challenged, negotiated, or turned into an in-network contract.

Accordingly, the issue of out-of-network vs. in-network is not one of propriety. It is an issue of risk.

And risk is a substantial component of valuation.

In most of the sectors we cover, during an early, or less well-defined period of reimbursement reductions, in order to reflect price volatility, buyers typically adjust their valuation by discounting (reducing) the multiple applied to the then current EBITDA.

But this is not what we are seeing in addictions and substance abuse. Rather than adjust the multiple, most buyers are adjusting the then current EBITDA to reflect their most conservative estimate of in-network rates, which is purely a pro forma estimate of what may happen over, perhaps, a protracted period of reimbursement change. What's more, we've seen cases where buyers "double dip," adjusting both the multiple **and** the EBITDA.

This sets the bargaining table for potentially wide gaps in valuation. Consequently, many would-be sellers decide to hold off a sale, capture out-of-network profits while they can, and sell as a multiple of in-network EBITDA when it is real, and not "pro forma."

Implication: From a practical perspective, **it is easier to consummate a transaction with providers that are substantially in-network** (or offer their services at in-network rates), or where reimbursement tends to be consistent across payors.

The Dearth of Data

Due, in part, to the fact that it is particularly difficult to come up with meaningful, non-subjective outcome measures for behaviors, mental health, and cognitive functioning, much of the behavioral health sector is bereft of data-driven, evidence-based protocols. At best, outcomes are imprecise – and at worst, purely observational and anecdotal.

Implication: With insurers begrudgingly reimbursing "on par," for services that are costly and not uniformly adopted, **the money will follow the best available data.**

The Public Sector is Poised to Pop

As mental health has become part of our national dialogue and opiate abuse has soared, federal and state governments are increasingly getting involved to increase the access to, and utilization of, addictions and substance abuse treatment programs. That said, the federal government and most states are financially tapped out.

Implication: Public spending on addictions and substance abuse treatment programs will be laser focused on value, skewing to the least expensive interventions, particularly where evidence-based protocols are ambiguous.

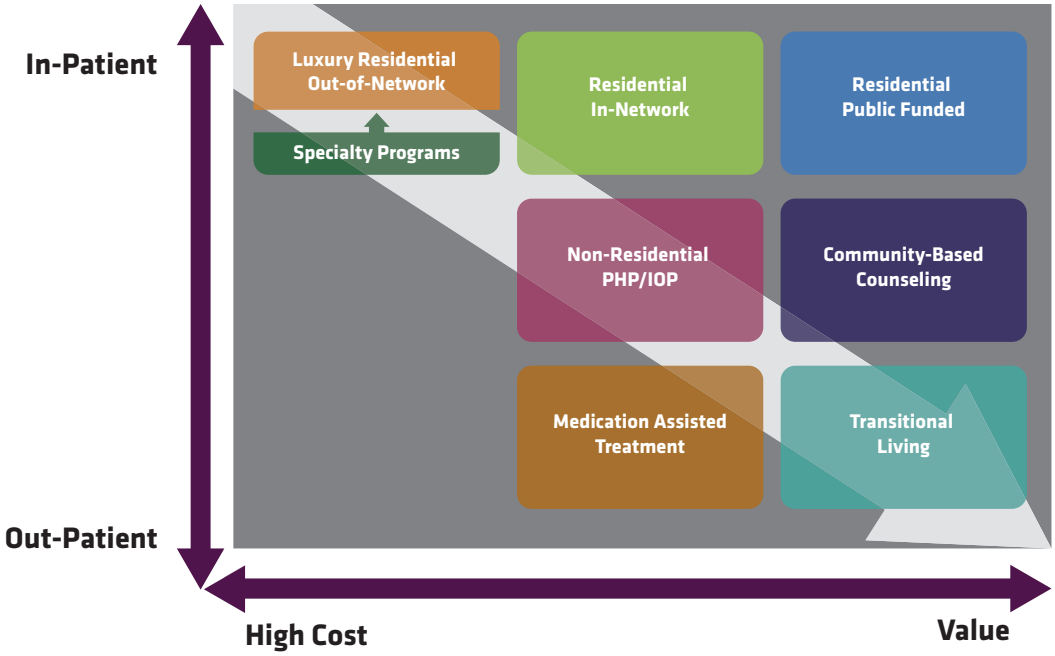
Putting it Together

When you consider all of these developments and their implications, a clear picture of the next phases of addictions and substance abuse M&A begins to emerge.

As (a) the insurance companies begin to initiate parity, (b) payment shifts from out-of-network to in-network (or equivalents), and (c) federal and state agencies step in to expand access and utilization, patients will begin to be funneled from high-end, full-service, in-patient settings toward more value oriented in-patient and out-patient treatment options.

Valuations will begin to shift accordingly as exposure from out-of-network reimbursement and increased payor and regulatory scrutiny raises the risk profile of high-end, in-patient services, and demand ramps up for lower cost community-based options which, ultimately, represent a substantially larger market opportunity.

The Next Phases of Addictions and Substance Abuse M&A



Unlike the ALS ice bucket challenge, this will not be a sudden shock to the system.

Rather, while we have seen some early movers (see Medication Assisted Treatment below), we anticipate that this new phase of addictions M&A will fully develop over an extended 3-5 year period. **Demand for premium residential programs still remains high.** However, over time, demand will be siphoned off toward the other end of the service spectrum.

First Up, Medication Assisted Treatment. As we discussed in great detail in our recently published *marketALERT: Medication Assisted Treatment Deals Signal a Shift in Addictions M&A*, the first sub-sector to feel the impact of these changes has been MAT. Our research reveals that in 2014 and 2015, **all** of the transactions in medication assisted treatment were completed by private equity. Moreover, in 2015 alone, there were three new PE sponsored, market-entry platform transactions in MAT (vs. only 1 in 2014). Given the unique characteristics of medication assisted treatment, particularly (a) its generally well-documented clinical and social outcomes (i.e. data), (b) cost efficacy, (c) relatively uniform services (which, from an M&A perspective, makes MAT providers easier to qualify, evaluate, and integrate post-closing), and (d) attractive margins, it's little surprise that it has been the first place that buyers have trotted out this evolving investment thesis.

Specialty Programs. We further note that, at least for a transitional period, buyers that want to stick with the high-end, residential model, will increasingly target specialty providers – notably those treating eating disorders, adolescents, or clients with co-occurring trauma – as, to date, these companies remain relatively under the radar. Consequently, they may be temporarily insulated from some of the headwinds facing more traditional programs.

Implications for Valuation and Deal Flow

Premium Residential Programs. We anticipate a modest tempering of demand, which will put some downward pressure on multiples. However, the most critical determinate of value in this segment will be how each individual buyer accounts for the potential conversion of out-of-network to in-network (or its equivalent) reimbursement.

Value Residential and Community-Based Programs. We expect a steady rise in demand – likely over a 3-5 year period – from several fronts. While we have seen little interest to date, we fully anticipate that private equity will switch up their Starbucks, read the tea leaves, and allocate some of that dry powder they always talk about toward these programs. Demand will emerge for publicly funded programs. What's more, we expect acquisition interest in value residential and community-based programs to surface from "adjacent" mental health providers, and even high-end residential programs seeking to round out their price point offerings.

Accordingly, we should see deal volume – and valuations – ***gradually*** track upwards with demand.

Medication Assisted Treatment. With (a) MAT well-positioned for this directional shift in M&A, (b) PE investment activity propping up its visibility, and (c) margins that can equal or exceed high-end residential providers, there is an outsized divestiture opportunity (read premium pricing) for platform-sized companies – right now. MAT will be at the front end of the wave of non-residential deal flow. And valuations are poised to surge as artificial revenue multiple caps begin to succumb to the segment's attractive risk-return fundamentals.

Specialty Residential Programs. With specialty providers likely at the trailing end of these market changes, the opportunity exists for such companies to realize first wave, high-end residential-like, valuation premiums. However, unlike the high-end residential market, we expect a more limited window of peak pricing, as market educated buyers will likely react faster to the same sorts of headwinds which will likely blow toward the specialty addiction market.

And one more thing.

While we're making predictions, we meant to predict that one day The Donald would lead the polls to become the Republican nominee for president.

But we forgot.

INTELLIGENT DEALMAKING IN BEHAVIORAL HEALTH CARE M&A

The Braff Group is the leading health care services mergers and acquisitions advisory firm with a team of dealmakers focused exclusively on behavioral health care.

For more than five years, we have provided sell-side only transaction services to the mental health, addictions and substance abuse, autism services, I/DD, at-risk-youth, and acquired brain injury provider community.

With more than 250 transactions completed, The Braff Group is ranked #1 in health care mergers & acquisitions.[2]

But we never forget that **your deal** is the one that matters to you.

Let us make it a great one.

[2] Source: Thomson Reuters, based on number of deals between 2008 and 2014.

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Behavioral Health
Ted Jordan
Atlanta
888-290-7080

Behavioral Health
Nancy Weisling
Chicago
888-290-7237

Reg Blackburn
Atlanta
866-455-9198

Pat Clifford
Chicago
888-922-1834

Mark A. Kulik
Atlanta
888-922-1838

Bob Leonard
Ft. Lauderdale
888-922-1836