

IN MERGERS & ACQUISITIONS, GROUP HOMES ARE GNOMES NO MORE

In mythology, unicorns are magical beasts with *horns* spiraling from their foreheads. In finance, however, they're magical early-stage companies with *valuations* spiraling to a billion dollars or more. You know, the kinds of companies whose value seems to rise proportionately to the *losses* it generates – completely disconnected from reasoned risk-return fundamentals unless you sprinkle them with a whole lot of pixie dust.

Such M&A valuation “*disconnects*” are often driven by factors that have little to do with the company per se, but create the conditions or the incentives that support them. Factors such as an imbalance of acquisition supply vs. demand, access to debt, market misreads, and market momentum, which, taken together, can create what Alan Greenspan famously described as “irrational exuberance.”

Notably, these disconnects can go *both* ways. You may only hear about the unicorns that get the Wall Street glitterati all atwitter. But there are also less glamorous disconnects that yield valuations *below* a company's underlying risk-return attributes.

We call these Gnomes – those medieval elfin oddities that rule the underground (until they become garden gnomes, which are an entirely different story).

Well, for the past 20 years or so, the king of the gnomes has been group homes and community-based service providers.¹

At the very least, the group home economic model should make them “rainbow ponies.” Consider these heady attributes: strong public support as an alternative to institutional settings, relatively steady funding, long-term placements, comparatively uncomplicated operating model, and an underpinning in real estate.

Taken together, group homes provide as much of a “risk-free,” annuity-like, stream of returns as you can ever hope for in health care services.

Akin to a certificate of deposit where, in exchange for the safety of a guaranteed return, you might plunk down a thousand bucks to generate \$50 in annual interest (which, if you think about it, imputes a valuation multiple of 20x).

Now, we're not suggesting that an investor should only require a 5% return on the acquisition of a group home. After all, while *relatively* steady, state funding often ebbs and flows with the economy. And then there are the liability risks, as well as NIMBY (not-in-my-back-yard) constraints to growth. But a 25% return – equating to a rule of thumb valuation multiple of 4x that has clung to the sector like a wet blanket for 20 years or so? Nope. Nada. Gnome.

So why have such valuations prevailed?

Mostly, the disconnect has been a function of limited acquisition demand. Over the past three decades, health care service investors have targeted skilled nursing facilities, physical therapy, pharmacy services, home medical equipment, ambulatory surgery centers, and home health and hospice providers, among others. In fact, given its lack of uniformity born of a wide range of services offered in a wide range of settings to a wide range of populations, it wasn't until 2010 when buyers began to collectively swarm around behavioral health. Even then, the first segments in the queue were addiction treatment providers and psychiatric facilities.

As a result, over much of the past 20 years, the group home acquisition scene has been largely left to just a few early consolidators – perfect conditions to (a) allow limited demand to foment pricing arguably below the sector's risk-return fundamentals, and (b) create enough institutional memory to make such valuation patterns difficult to shake.

As we've seen repeatedly in other sectors, it is often private equity that shakes up the status quo. They come to the bargaining table un-encumbered by institutional memory, with fresh spreadsheets that include the strategic application of debt which can juice their returns.

¹ For ease of reading, when we refer to group homes throughout this publication, we are including the full array of community-based services provided to individuals with intellectual or developmental disabilities.

In so doing, PE is well-positioned to capitalize on the disconnect and swoop down on a sector, offer pricing above the gnome, uh, norm (that nevertheless meets their risk-return criteria), and rapidly consolidate and build scale. What's more, the early movers do this before the strategics and other PE firms react and (irony alert) transform the gnome into something resembling a unicorn.

And that's just what has happened in the group home space.

First, some context: in the private equity world, platform deals are typically sizeable, market-entry transactions that serve as a foundation to layer on additional "follow-on" deals and/or start-ups. As such, they are often reliable leading indicators of increased deal flow.

Now, consider this eye-opening factlet: based upon proprietary data collected and analyzed by The Braff Group, and given the relatively historical sleepy nature of the group home M&A market, **there has only been six private equity sponsored platform acquisitions in the space since 2005.**

But here's the kicker.

Five of those were completed in 2015, accounting for most of the remarkable surge in new PE investments in I/DD last year (see chart).

All of a sudden, a lot of dollars have poured into the group home space, creating increased demand for both platform and follow-on deals – and competition for the few strategics that have had the space, more or less, to themselves, for nearly three decades.

And with the new found love, valuations have soared – first for larger providers with revenues of plus/minus \$20m.

But it won't take long for the spike-up to trickle down to smaller providers as well.

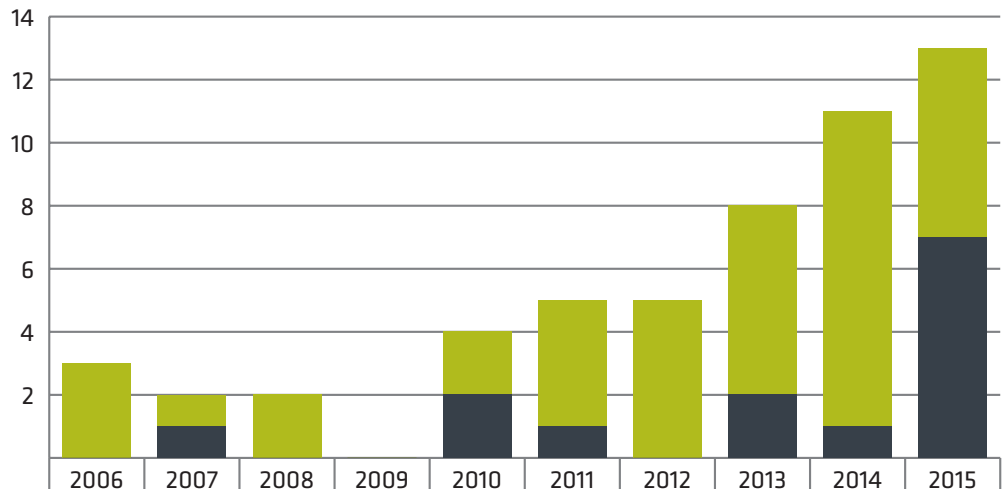
So if you've been patiently lying in wait underground for your time to come...

Rise up, Gnomes.

Private Equity Investment Trends in I/DD²

- Follow-on
- Platform

² Includes private equity investments in all I/DD related services including Group Homes, Long-Term Supportive Living, Autism Spectrum Services, etc.



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