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2017 | BEHAVIORAL HEALTH
A MARKET IN FLUX

PREDICTABLY PREDICTABLE:
THE CHANGE IS ON IN BEHAVIORAL HEALTH M&A

At the end of 2015, The Braff Group predicted that behavioral health mergers and acquisitions was at an inflection point – that the trends that had formed the basis for the rapid acceleration in deal flow beginning in 2010 were poised for a significant makeover.

Well, a careful and detailed analysis of proprietary M&A data amassed by The Braff Group reveals that we were as spot on as 100 Dalmatians (we missed one).

Behavioral Health M&A is very much in a period of transformation – a period that will have a profound effect on who's buying, who's selling, why, and for how much.

First, an overview of transaction activity over the past decade.

Setting specific sectors aside, in aggregate, the story in behavioral health deal making can be summed up in one number – 45 – as in the trendline continues its near uninterrupted 45 degree climb up the charts, surpassing all the health care service sectors we cover except home health and hospice (Chart 1).

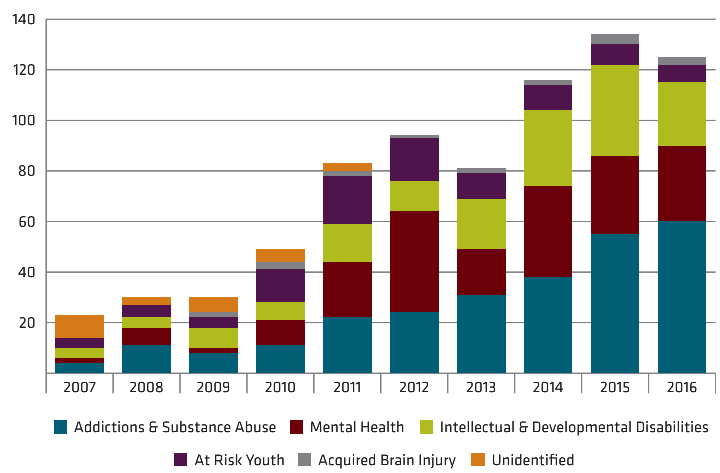
Private equity continues to be a force majeure in the space.

In 2016, PE sponsors accounted for a record 73 transactions, 60% of all the deals completed in behavioral health care.

Even more significant was the volume of market-entry, platform-sized activity that we saw (Chart 2).

After a 2015 that produced 28 new platform investments, more than double the previous high of 11 recorded in 2013, the question lingered as to whether or not this was a fluke. Well, if 2016 proved one thing, it was that this surge has more legs than The Rockettes.

Chart 1: Behavioral Health Deal Trends by Sub-Segment



Although down a tick from 2015, the 24 new platform investments in 2016 were still well above the trendline between 2007 and 2014.

And as sure as sequels to *The Fast and The Furious* will keep coming until they become *The Slow and the Slouching*, we know that platform deals are the gift that keeps on giving in the form of follow-on activity – secondary acquisitions that leverage the management and operations infrastructure of these initial investments.

No surprise then that "add-ons" in 2016 eclipsed last year's record by almost 20% – a tally that you can practically make bank will be surpassed yet again in 2017.

Enough background.

Let's see how Carnac the Magnificent we were in anticipating changes in the behavioral health M&A market.

Addictions & Substance Abuse: Lower Cost Residential and Community-Based Services

What We Predicted: As insurers begrudgingly accept parity, budget-conscious states are forced to respond to the opioid epidemic, and price sensitivity becomes an increasingly important variable in selecting treatment options, addictions and substance abuse treatment M&A will shift from high-end, residential services, to lower cost residential and community-based services.

What We Found: Call it a split decision. 2016 was a breakout year in non-residential addictions treatment M&A, matching the surprising tally of 2012 – results that both the environmental conditions and subsequent figures indicate were an isolated anomaly (Chart 3).

What's more, the pivot away from an initial focus on residential programs becomes even more profound when you add in community-based medication assisted treatment (see below).

Where we were surprised was both (a) the continued demand for high-end residential treatment facilities and (b) slower than anticipated movement towards more affordable options; all despite the Napoleonic efforts of insurance companies to beat the industry into in-network submission.

In fact, rather than a fall-off, we saw a rise in high-end residential treatment deal flow and fall-offs in both mid-range and value properties (Chart 4).

So what gives?

At the high end, the numbers are somewhat distorted by one private equity-sponsored buyer that made a Lady Ga Ga-like grand entrance onto the M&A stage with a gaudy six deals in

Chart 2: Behavioral Health Deal Trends by Buyer Type

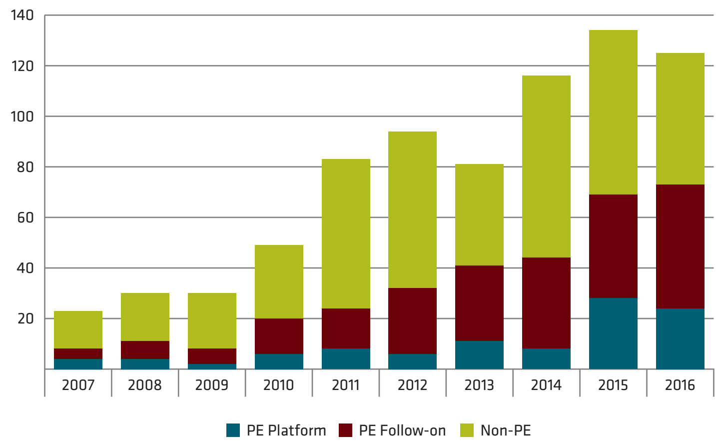
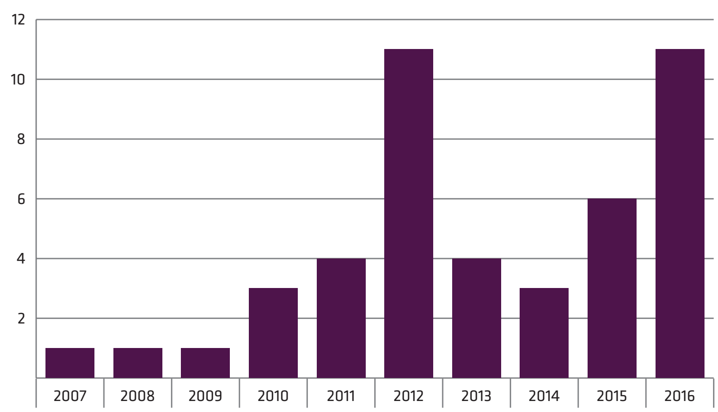


Chart 3: Addictions & Substance Abuse Non-Residential Deal Trends



2016. Take some or all of these transactions out of the equation, the picture looks quite different.

And as for the less-than-enthusiastic embrace of the lower price points in residential treatment?

The likely explanation is that the investment community is temporarily skipping over this leg of the treatment continuum and going all-in on MAT – a far easier and profitable consolidation play.

Medication Assisted Treatment

What We Predicted: Given the documented outcomes and comparatively low cost of medication assisted treatment, we expected this corner of addictions M&A to pop like a cork from a shaken bottle of champagne (Chart 5).

Chart 4: Addictions & Substance Abuse Residential Deal Trends by Price Point

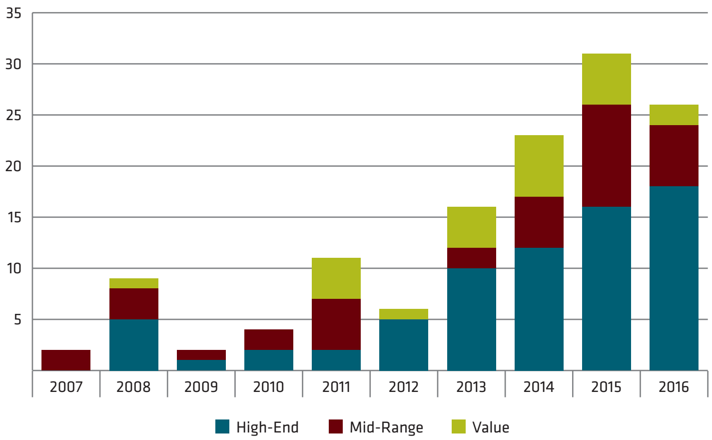
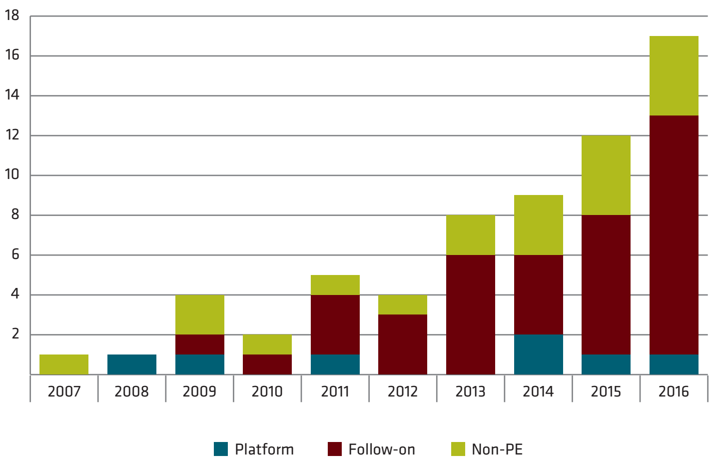


Chart 5: Medication Assisted Treatment Deals by Buyer Type



What We Found: Well, break out the Cristal. Pop, it did.

As the data clearly illustrates, after three consecutive years of record-breaking activity, deal making in MAT surged another 40 plus percent in 2016, fueled in large part by the unbridled assault on the market by private equity, which accounted for nearly 80% of the activity.

And if past is prologue and a surge of interest from private equity is a precursor to even more consolidation by wannabes, strategic, and other ancillary buyers - well, the table is set for a long run of heightened deal flow in this niche of the market.

Autism Spectrum Disorders

What We Predicted: About three years ago, after we noticed a modest spike in activity in 2013, we concluded that the M&A climate was fast becoming ideal for providers that specialize in autism spectrum disorders – an as yet untapped niche with ample opportunity to establish market differentiation and grow.

What We Found: We were not disappointed. Since 2013, The Braff Group has identified 27 transactions completed in the autism space, 237% more than the eight deals completed over the previous seven years combined (Chart 6). What's more, demand continues to far outstrip supply – so, while it will remain a niche market, we anticipate heightened consolidation activity in autism services for many years to come.

Individuals with Intellectual or Developmental Disabilities

And now for a prediction we didn't make. And one we'll make now.

With its oft long term clients and comparatively stable reimbursement, the risk return fundamentals of I/DD and particularly group homes is arguably extremely attractive. Counter intuitively, however, the sector has historically not received an active following. As such, it languished (and was undervalued) in a market essentially controlled by two primary buyers - ResCare and Mentor Holdings.

But somewhat out of the proverbial blue, perhaps seeing an opportunity to jump into a market devoid of much consolidation competition, private equity rushed into traditional I/DD in 2015 (Chart 7). So, after eight years of lukewarm collective interest in the space, The Braff Group identified eight – count 'em – eight private equity sponsored platform investments in a single year. This propelled the space to a record 30 deals, 50% more than the previous high.

So things were certainly looking up.

The only question was, absent new investment thematics, would the wide open field be enough to sustain a long cycle of elevated activity?

Well, bearing in mind that one year does not necessarily make a trend, the results in 2016 were disappointing.

After a Cinderella-like debut, private equity seemingly bolted from the M&A party as if it would all come crashing down at the stroke of midnight. And with it, volume in 2016 fell to its lowest level since 2012.

So what do we predict in I/DD (excluding autism) for 2017 and beyond?

The market will come back.

Not only are there eight PE firms that need acquisitions to leverage the platform investments they made in 2015, the opportunity to rapidly build competitive regional and national advantage in an annuity-like market is too attractive to let the old guard have it for themselves.

And as for the overall behavioral health space?

The transformation is just beginning, and many of the themes we discussed here will continue to develop for years to come. And, in a dynamic health care market where coordinated care initiatives are redefining the pathways consolidators must traverse to create sustainable value, we can be sure that whatever becomes the new status quo may not last very long.

What will endure, however, is that behavioral health will have a long run atop the M&A leaderboard.

Finally, while we're crystal balling it, we predict that this will be the second to last sentence in this edition of *marketWATCH*.

Nailed it.

Chart 6: Individuals with I/DD Deals by Sub-Segment

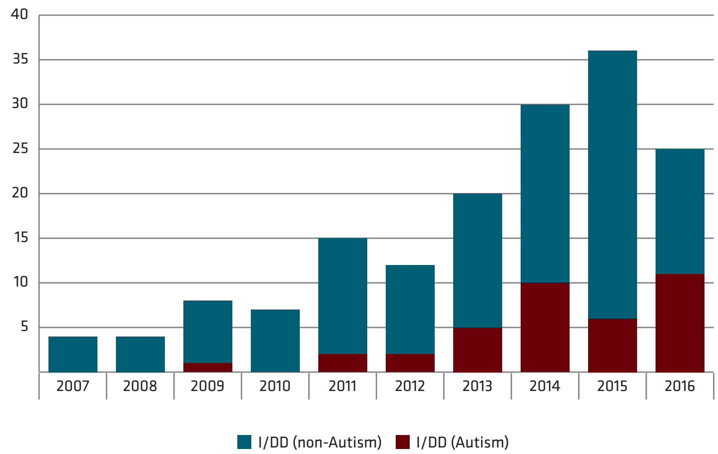
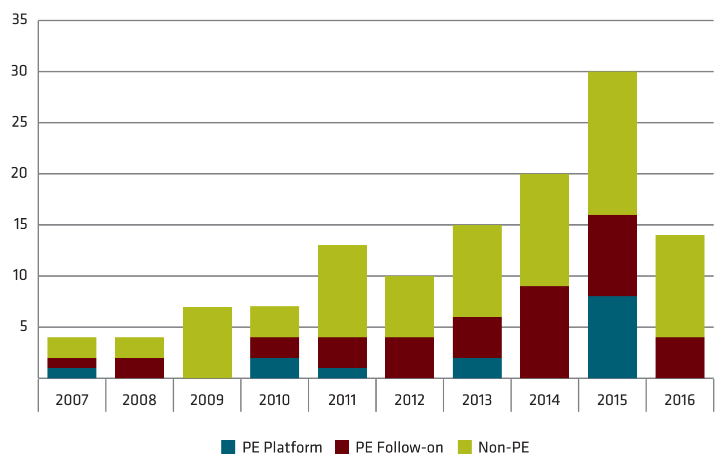


Chart 7: Individuals with I/DD (Excluding Autism) Deals by Buyer Type



FOR MORE INSIGHT INTO THE M&A MARKET FOR BEHAVIORAL HEALTH AND WHAT IT MAY MEAN TO YOU, CONTACT OUR BEHAVIORAL HEALTH TEAM:

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