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THE BRAFF REPORT

Mental Health Takes Center Stage in a Post-Pandemic M&A Market

Should You Exit, Stage Left?

Orange is the new black.

60 is the new 40.

Is mental health the new autism?

Between 2016 and 2019, acquisition interest in autism services burned white-hot. Demand far exceeded supply, pushing valuations to levels typically reserved for companies far larger than the typical autism provider. But as COVID lockdowns took a substantial bite out of many providers' census, the market cooled dramatically (it has since regained much of its mojo).

Ah. But what COVID taketh away, COVID also giveth.

> **[In terms of acquisition demand and valuation], what COVID taketh away, COVID also giveth.**

In this case, outsized demand for mental health services as isolation, fear, financial stress, and Groundhog Day-like soul crushing routines chipped, chipped, chipped away at our collective psyches.

In a recent article published by *Psychology Today*, the title pretty much said it all:

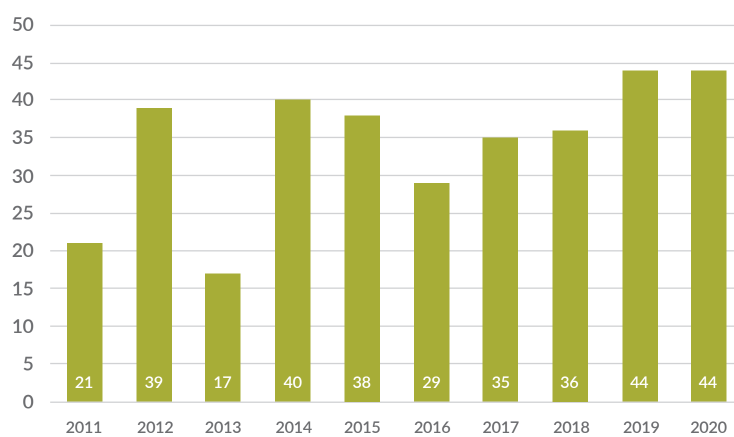
"Is a Mental Health Crisis the Next Pandemic?"[1]

We could cite the avalanche of statistics illustrating the toll the pandemic has had on the world's mental health, but intuition alone would bring you to the same conclusion.

No surprise then that investors began to rush the mental health space to catch the beginning of a wave that is just starting to build.

Let's look at the data drawn from proprietary information collected and analyzed by The Braff Group.

Mental Health Deal Trends



Source: The Braff Group

While repeating 2019's record tally was no small feat given the paralyzing effect COVID had on investors, the numbers hide a far more telling story.

Consider what they look like if we isolate private equity activity – activity which is often the best barometer of how much interest – or lack thereof – there is in a sector.

[1] "Is a Mental Health Crisis the Next Pandemic?" *Psychology Today*, March 17, 2021.

The robust, but steady across-the-board deal flow between 2019-2020 hides the 41% increase in aggregate PE activity (market-entry platform sized deals plus follow-on transactions). Even more telling? The 175% increase in market-entry transactions – the kind of deals that signal expectations of a growing market over the 5-7 year lifespan of many private equity investments.

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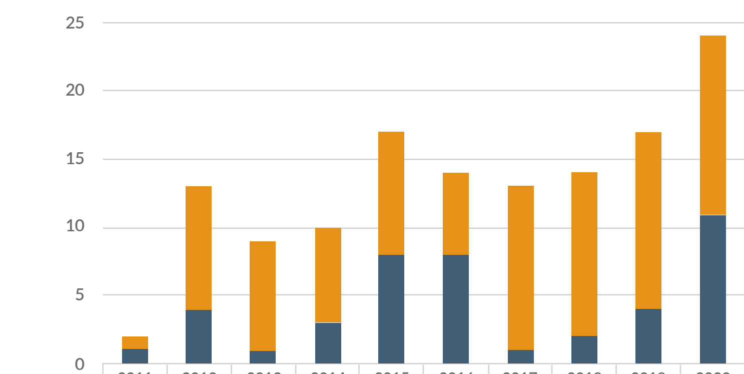
If we look at the data a different way, we can see that PE accounted for nearly 55% of all mental health transactions in 2020, eclipsing the proportion posted in 2013 when there were less than half as many transactions.

So, what explains private equity's burgeoning love affair with mental health providers?

Growing demand. We already cited the pandemic-fueled increase in demand.

But there's more at play here.

Mental Health Private Equity Sponsored Deal Trends

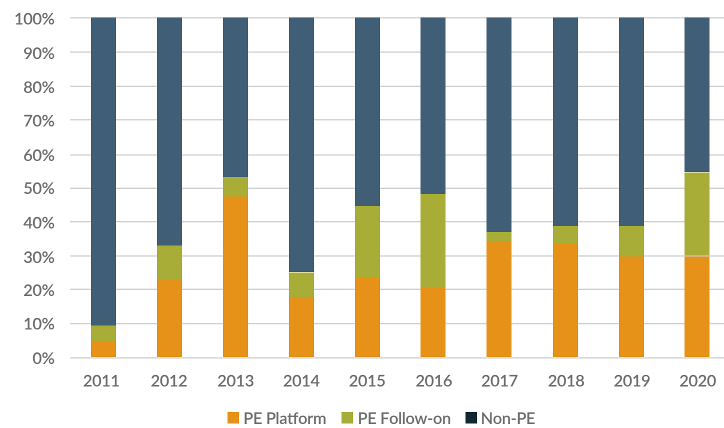


	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Follow-on	1	9	8	7	9	6	12	12	13	13
Platform	1	4	1	3	8	8	1	2	4	11

Source: The Braff Group

Increased Funding. Expanded "parity" laws passed with the Affordable Care Act mandating that insurers cover mental health treatment "on par" with other health care benefits has dragged insurers kicking and screaming through mounting unpaid (or substantially adjusted) invoices. While generally improving, the widespread demand and public attention to mental health issues will make it harder for insurers to dodge parity payments. What's more, increased funds are being dedicated to mental health issues at the federal, state, and local levels.

Percent of Mental Health Deals Completed by PE vs. Non-PE



Source: The Braff Group

Most recently, according to the American Psychiatry Association, the recently enacted American Recovery Act "...includes around $4 billion in funding for programs that support prevention of and treatment for mental health and substance use disorders."[2]

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[2] "APA Praises Inclusion of Mental Health Funding and Provisions in the American Rescue Plan Act of 2021," *American Psychiatric Association*, March 10, 2021.

Reduced Stigma Associated with Mental Health Treatment. While the stigmatization associated with mental health problems has been lessening for many years, the aforementioned public attention and empathy born of shared experiences is sure to erode it even further, clearing the way for marked increases in utilization.

Awareness. Then there's the apps. TalkSpace. HeadSpace. Calm. Just a tiny fraction of the estimated 20,000 mental health applications available today.[3] Highly visible advertising campaigns along with the sheer volume of apps will no doubt raise awareness and further reduce stigmatization. Additionally, though, we suspect many will be feeders to more conventional interventions as users seek more depth than what they can get from a screen alone.

Demand for Out-Patient Clinics. While we anticipate increased acquisition interest in all facets of mental health treatment – psych hospitals, PHP/IOPs, telepsychiatry, to name a few – office-based providers are receiving disproportionate interest from buyers. Companies such as Refresh Mental Health, a recently acquired portfolio company of Kelso Private Equity, and LifeStance Health, a portfolio company of Summit Partners, Silversmith Capital Partners and TPG Capital have substantially raised the profile of outpatient mental health with their eye-popping valuations – drawing new investors into the space like bees to money, uh, honey.

> **The long-term investment thesis [in mental health] is as compelling as it is easy to sell.**

What's more, the long-term investment thesis is as compelling as it is easy to sell.

- A market at the front end of expected mass increases in demand, utilization, and funding.
- Fragmentation that provides substantial opportunities to build critical mass.
- Opportunities to leverage technology and operating infrastructure to drive increases in profitability.
- And more than enough capital available to make it happen.

Optimism Bias and M&A Market Timing. In a report we issued last year, **"COVID has Sparked Investor Interest in Addiction and Mental Health: Should Providers Divest While It's Positively Giddy,"** we talked about optimism bias, and how it can affect when a provider might consider a sale.

According to *Verywell Mind*, "We tend to be too optimistic for our own good. We overestimate the likelihood that good things will happen to us while underestimating the probability that negative events will impact our lives. [Moreover], this optimism bias is incredibly difficult to reduce."

For example, as it relates to mental health utilization, we fully expect that it will spike because of the pandemic. But how much? And for how long? And what might we expect from those profit-minded insurance companies who will instinctively want to go into whack-a-mole mode when these expenses inevitably become more visible. The fact of the matter is that in health care services, the past is replete with sectors that have gone all bubblicious on anticipated or early stage shifts in market dynamics, only to deflate when such unbridled optimism became bridled with an overestimate here, an unanticipated development there; a slight market shift here, a new investment distraction there. So, it bears remembering that when expectations run high, many a shrewd seller will capitalize on optimism bias and sell the unlimited potential of promise.

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One More Thing: The Looming Rise in Capital Gains Tax. To be clear, despite a heated market and the impact of optimism bias on valuation, there are many reasons why one wouldn't want to sell. You could be growing at double digit rates with expectations to continue to do so well into the future. You could have children you plan to pass the business down to, or the professional and personal satisfaction you get from owning your business and helping others may far outweigh the incremental value you might be able to realize today.

[3] "Providing care in innovative ways," *American Psychological Association*, January 1, 2020.

But if you're on the proverbial fence, there's another reason you may want to advance your timeline. As we detail extensively in a recent article we published, **"The Looming 50% Rise in Capital Gains Taxes,"** there are good reasons to anticipate a significant tax increase in 2022 that could take a big bite out of your net proceeds. By our calculations, in the best-case scenario, if the anticipated tax hike is enacted, a typical health care service company would have to grow more than 20% in 2022 just to match the net proceeds it could have realized had they sold in 2021 (see the article on our website for further details).

Regardless of tax implications, when you consider all the above, if you are in the space it's gratifying to know that not only is mental health the new black, it's also the new green.

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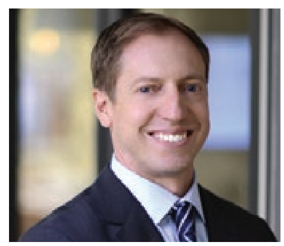

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20 YEARS & COUNTING

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