Behavioral Health Mergers & Acquisitions

After an extraordinary 2021 that exceeded the previous record for private equity dealmaking by more than 50%¹,², and propelled aggregate behavioral health deal volume to a level 38% greater than its previous high-water mark, expectations were that we would see a fall-off in activity in 2022.

The big question was how much?

Especially considering the storm clouds forming:

1. **Tax rate incentive disappears.** Some of the surge in transaction volume in 2021 was driven by fears that the special tax treatment for capital gains would be eliminated effective 2022, which would essentially double the tax rate on proceeds from a sale. In the end, it didn’t happen. Nevertheless, as we entered the year, not only did this incentive disappear, but the pool of acquisition candidates was also almost assuredly diminished as would-be 2022 sellers advanced their exit timeline.

2. **Inflation marches on.** According to Forbes, “inflation began to spike in the U.S. in April of 2021, when it hit 4.2% [and] continued to climb, hitting 7% year-over-year by December 2021.” By June of 2022, “the rate peaked at 9.1%.” And with it, costs increased, especially wages, exerting pressure on EBITDA margins.

3. **Cost of debt rises.** The playbook for reining in inflation calls for increasing the Federal Funds rate, which increases the cost of debt and chips away at valuation. And so it went. In March, the Fed dipped its toe in the increased rate waters with a modest bump of 25 basis points. In May, it upped it another 50, and by June, the Fed increased rates yet again by 75 points. By the end of the year, the Federal Funds rate had risen from a range of 0.25 - 0.50 to 4.25 - 4.5, a 400 basis point increase in total.

4. **Russia invades Ukraine.** In M&A, there’s nothing like uncertainty to turn a hot market instantly cold. And there’s nothing like the breakout of war in eastern Europe – and all the geopolitical and economic consequences it can create – to spook buyers and provide the incentive to hide their cash in the proverbial mattress.

So with all these factors converging that could directly or indirectly negatively impact acquisition demand, supply, financing, and pricing, you could be forgiven for expecting the volume of deals completed in 2022 to plunge faster than Bitcoin.

But it didn’t.

At the macro market level, private equity deal volume barely moved, down only 2% vs. 2021.

US Private Equity Deal Trends*

*Includes estimates

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² Since PE investment drives well over 50% of behavioral health M&A, we look to PE trends as a good barometer of what we may anticipate in the sector.
What did fall, however, was the average size per transaction. As the accompanying chart shows, from the 2nd quarter of 2021, average deal size fell steadily from $159M to $99M in Q4 2022, a fall-off of 38% from its peak.

The upshot? PE still wanted to do deals. They just wanted to hedge their bets a bit and target smaller transactions, including follow-on deals (more on this later).

**Behavioral Health**

*Amidst the same backdrop that could have derailed the entire M&A market in 2022, behavioral health continued to shine.*

Given the anomaly of 2021, we believe it may be more instructive to compare 2022 to 2020. And in that regard, behavioral health continues to perform well.

Accordingly, as the chart below illustrates, while deal volume in 2022 fell 24% vs. the record set in 2021, it was still 4% greater than 2020, continuing the steady climb that began in 2014.

Moreover, behavioral health still dominates the current health care services M&A landscape, accounting for 41% of all the deals completed in 2022 (the same as 2021) with home health and hospice next in line at 29%.
In fact, as the heat map below illustrates, over the past five years, behavioral health far outdistances all the other health care service sectors we cover in terms of volume of deals and growth trends.

Segment Specific Performance

Turning our attention to specific segments in behavioral health, as the table above shows, while each was below their 2021 levels, non-autism I/DD, substance use disorder, and mental health, were all up significantly vs. 2020 by 21%, 18%, and 9% respectively.

Perhaps more telling is the behavioral health heat map.

*The Braff Group has developed “Heat Maps” to better contrast M&A activity across varying sectors and segments. Along the vertical axis is the total number of transactions completed over the past five years. Along the horizontal axis is the slope of the trend line over that period. Taken together then, the higher and further to the right a sector is, the greater – and more robust - the acquisition interest in that sector, both in terms of volume and growth.*
Behavioral Health Heat Map
Source: The Braff Group

Substance Use Disorder Heat Map
Source: The Braff Group

Mental Health. As we wrote about early in 2021 in The Braff Report: “Mental Health Takes Center Stage in a Post-Pandemic M&A Market,” mental health has broken out as the most sought out segment in behavioral health. The piece outlined in detail that this has been due to, among other things, increased demand (partly due to the fallout of the pandemic), increased funding, greater awareness, and reduced stigma associated with seeking treatment. No surprise then that the segment now occupies the coveted northeast corner of our behavioral health heat map.

Substance Use Disorder. While its growth has slowed, SUD still commands the top spot in total behavioral health deals completed over the past five years.

And given its cost-effectiveness and demonstrated outcomes, medication assisted treatment continues to be the most favored segment. But value to mid-range residential treatment is closing the gap as buyers embrace the fact that affordable private insurance and Medicaid funded services are where the people are, and hence where the cumulative demand and long-term prospects are the greatest.
**Autism Services.** As alluded to above, the growth in autism services dealmaking has leveled off amidst several high-profile stumbles of early consolidators, staffing shortages, and some negative press regarding quality of care. To some degree, this was predictable as any segment that burns as white hot as autism inevitably courts at least some measure of over-zealousness, over-utilization, and “questionable” quick-buck market entrants. So while we believe the long-term prognosis for the space remains attractive, we will likely see some instability in the market over the next 12-24 months.

**Intellectual and Development Disabilities.** Owing to its annuity-like revenue streams, I/DD, the energizer bunny of behavioral health M&A, continues to churn out deals, posting gains in 2022 vs. 2020. While it will likely never generate the headlines of SUD, autism services, or mental health, we expect it to remain a staple of the behavioral health M&A scene for investors seeking steady, predictable, performance for years to come.

**At Risk Youth.** Is at risk youth having a moment? With autism services taking off and acquirers beginning to aggregate it with I/DD and speech and occupational therapy, we’ve long thought we might begin seeing consolidators turn toward at risk youth as its own vertical or part of a continuum of youth-oriented services. And we’re beginning to see just that. In 2020 and 2021, the sector posted its highest deal counts in a decade with 19 and 21 respectively. Perhaps more telling was that over the same period, there were seven platform investments where previously the highest two-year total was four. So, while in raw numbers the output is still modest, the trend suggests that there may be opportunity here.

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**Private Equity Investment Trends**

As the chart below shows, PE investment trends in behavioral health fairly mimic total deal flow in the sector. Not surprising given how active sponsors have been in behavioral health.

What does bear mentioning is the relative increase in follow-on deals. As we indicated before, in uncertain times, investors tend to reduce their risk by shifting their spend from larger deals (new market-entry platforms) to smaller ones (follow-on transactions in sectors in which they have an established presence).

And that’s exactly what has happened in behavioral health. While platform deals were well off their 2020-2021 levels, follow-ons performed better, even posting a 10% gain over 2020. Moreover, follow-ons accounted for 81% of all private equity investments, its highest level since 2014 when there was decidedly less activity in the space.

“Buyers are embracing the fact that affordable private insurance and Medicaid funded services are where the people are, and hence where the cumulative demand and long-term prospects are the greatest.”
Valuation

The Macro Environment

For all the macroeconomic issues delineated at the beginning of this report, the mantra coming from buyers in 2022 was that valuations were coming down. Yet, according to PitchBook and illustrated in the chart below, median US PE multiples in 2022 were actually up a tick from the prior year.

What may have changed though is the reference earnings against which the multiple is applied.

For several years now, the benchmark for earnings has been some form of “go-forward-proforma-EBITDA-if-everything-goes-perfect-and-nothing-goes-bad.” As 2022 unfolded, however, we confidently speculate that buyers – and perhaps more importantly, lenders – began exhibiting more discipline in calculating the earnings base. So while multiples may not have come down quite yet – values likely have with reduced determination of earnings.

What has likely held the downward pressure at bay is the enormous amount of “dry-powder” – unspent “use-it-or-lose-it” capital – competing for the limited number of highest quality (and therefore prospectively less risky) pool of acquisition candidates.

This is certainly at play in behavioral health.
Unquestionably, all of the factors that have converged to propel the behavioral health mergers and acquisitions market toward a near decade’s long 45-degree rise in deal volume remain solidly in place.

But – and there’s that pesky “but” that’s like a cold splash of water to the face – there are likely just enough head-breezes (not quite headwinds) out there to slow things down a tad in 2023.

Staffing. Pressure on valuations. A diminished supply of acquisition candidates. The ending of the public health emergency (PHE) and the relaxed billing and compliance requirements that smoothed the path toward greater utilization.

So, similar to where we stood at the same time in 2022. Another strong 2023.

But a leveling off of the trendline.

**Outlook**

Broadly speaking, whereas immediately prior to 2022 the starting multiple for many behavioral health providers was plus/minus 10x, we are beginning to see more offers at plus/minus 8x. Notably, even at this level behavioral health is trading well above the historical normalized range of plus/minus 6x for asset-light, often third-party reimbursed providers.

That said, in a pro-active, strategically orchestrated competitive auction sales process, buyers are still – perhaps reluctantly – stretching to land top-tier sellers. So whereas in the past, we may have received two or three breakout offers for one of our behavioral health clients, in the current market we may receive only one or two.

So, in many cases, the recent bull market premiums are still there. They’re just harder to identify.

All the above notwithstanding, behavioral health has enjoyed an unusually long period of, what heretofore, were multiples reserved for larger companies with double-digit earnings growth, established infrastructures, management talent, and diversity of operations that often mitigate risk.

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Specializing in Health Care Services

The Braff Group is the leading mergers and acquisitions advisory firm specializing exclusively in health care services, including behavioral health, home health, home care and hospice, home medical equipment, health care staffing services, pharmacy services, and ancillary services. The firm provides an array of sell-side only transaction advisory services including representation, debt and equity recapitalization, strategic planning, and valuation. The Braff Group has repeatedly been ranked among the top 5 health care mergers and acquisitions advisory firms.

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