the braff group

marketWATCH

BEHAVIORAL HEALTH SERVICES

BEHAVIORAL HEALTH AND SOCIAL SERVICES M&A TRANSACTION VOLUME FALLS 43%...BUT DON'T READ TOO MUCH INTO IT

In aggregate, behavioral health and social services transaction volume plunged 43% in the first quarter of 2013 vs. the fourth quarter of 2012.

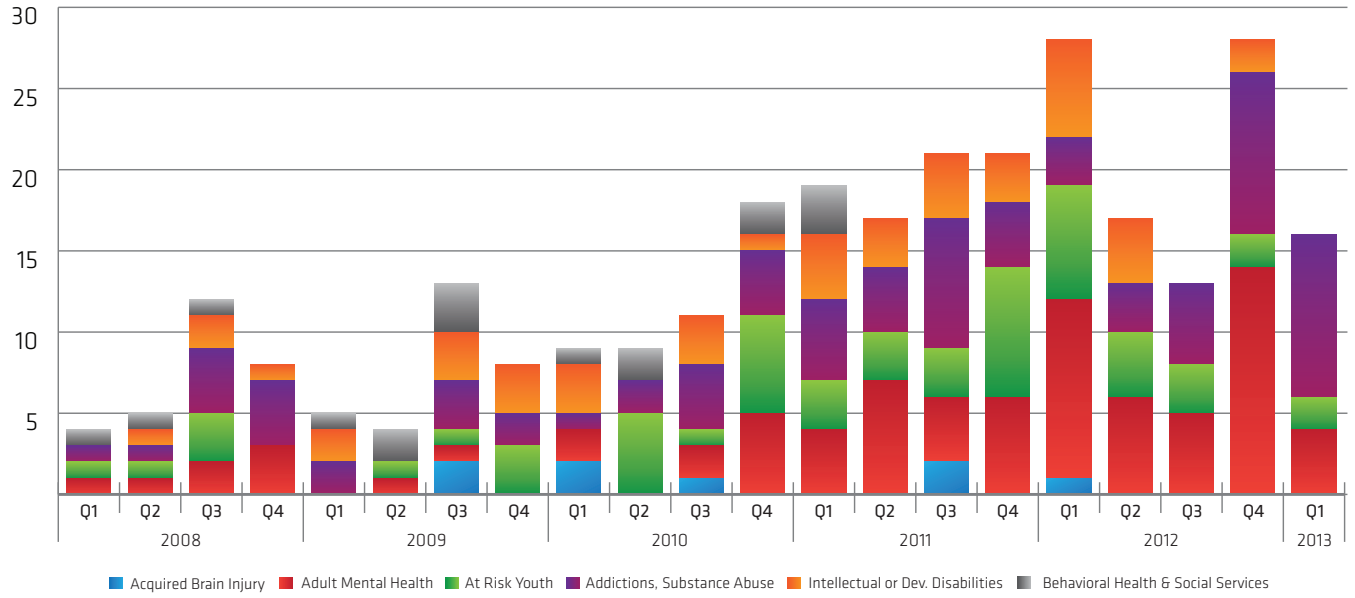
Under normal circumstances, this would be cause for substantial alarm. However, in this case, not only have the underlying fundamentals that have supported behavioral health and social services deals over the recent past remained unchanged, the dramatic fall-off was evident in all the health care service sectors we cover (see chart page 2).

If not systemic then, why the dramatic fall-off?

As it turns out, much of the decline is attributable to an artifice of the calendar that drove deal flow to record heights in Q4 2012, and created a vacuum for Q1 2013.

As you may recall from previous editions of ***marketWATCH***, with expectations that the Bush Tax Cuts for high earners would not be extended past December 31st, giving rise to a 5% increase in capital gains tax and the imposition of an additional 3.8% "surcharge" to help fund health care reform, aggregate capital gains was scheduled to rise from 15% to 23.8%. Consequently, many sellers who may have otherwise contemplated a deal in 2013 accelerated their plans to 2012 to lock-in the more favorable rates. As a result, deal flow surged prior to the year-end deadline. Furthermore, it created an environment where few sellers would entertain a sale at the beginning of 2013. After all, they would have effectively just missed the opportunity to protect 8.8% of their net proceeds – better to hold on until later in 2013, to let the "sting" wear off and, hopefully, regain some value with one or two quarters of additional growth.

Behavioral Health and Social Services Deal Trends



So, the plunge was both predictable – and inevitable.

Furthermore, we anticipate that it will take at least another quarter (or two) before the effect of this "anomaly" fully washes through the M&A pipeline. This, in turn, will make it difficult to read the tea leaves from transaction trends over the near term.

Addictions and Substance Abuse

The news wasn't all negative.

Remarkably, even with all of the tax-induced headwinds, transaction volume in addictions and substance abuse (ASA) equaled its record tally posted last quarter. For comparison purposes, note that adult mental health fell 71% and except for transaction volume for at risk youth (which at two deals, equaled that of Q4), addictions was the only sector we cover that didn't post a decline. Moreover, at least conceptually, and bearing in mind the above, this could reasonably be considered a period to period increase.

So, why did ASA persevere when all other sectors did not?

When you drill down on the proprietary data collected and analyzed by The Braff Group, the reason becomes abundantly clear.

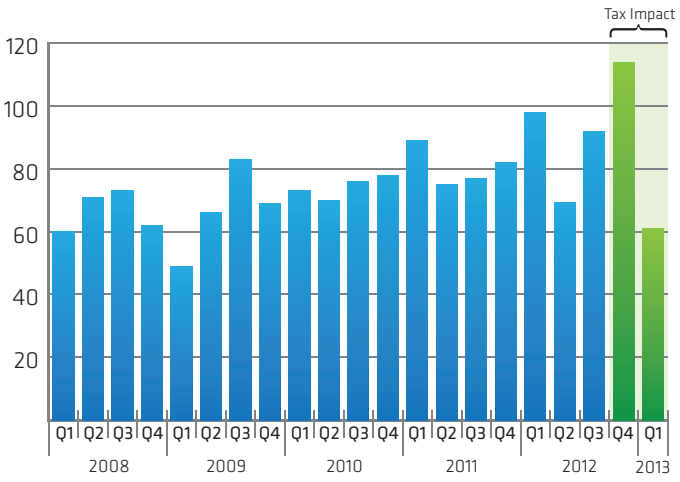
While private equity has consistently invested in addictions and substance abuse, PE has had a particularly outsized impact on the segment over the past two quarters, accounting for 60% of deal flow during the period. As a result, their burgeoning enthusiasm – born on a combination of "first mover" opportunity, strong margins, less governmental reimbursement, and expectations of increased utilization – was likely enough to offset the drag on M&A activity that dogged virtually every other sector.

Near Term Outlook for Behavioral Health and Social Services

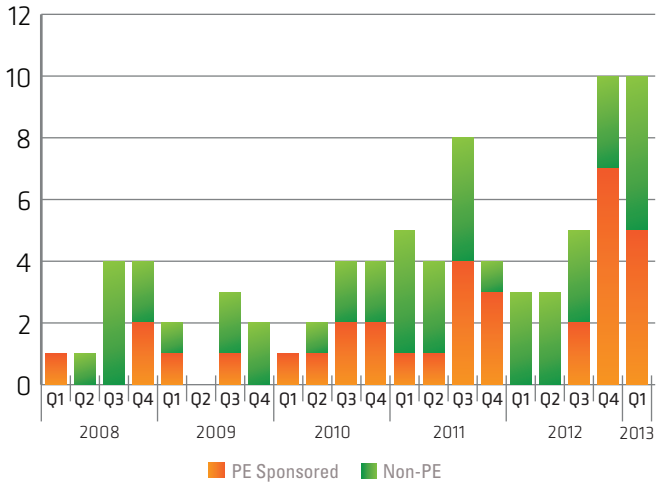
While, for the most part, we anticipate that all the sectors we cover will bounce back from this temporary decline, we are particularly confident that behavioral health and social services will return to its record breaking volume. On the strength of what we're already seeing in ASA, sustained and aggressive interest in adult mental health, particularly in residential settings, a growing interest in Medicaid reimbursed services given both expansion under health care reform and an improving economy, and the promise of wide-spread increases in utilization that "parity" initiatives may bring about, we expect that each BH/SS segment will not only thrive on its own, but will also support the favorable M&A "momentum" the industry currently enjoys.

Accordingly, absent a sharp downturn in the economy and/or unanticipated – and negative – health care policy developments, we expect that the market peak that emerged about 18 months ago will likely extend for the foreseeable future, creating a longer term "plateau" of opportunity.

All Health Care Services Deal Trends



Addiction & Substance Abuse Deal Trends Private Equity Sponsored vs. Non-PE



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Source: The Braff Group