ACADIA'S ACQUISITION OF CRC:
THE RATIONALE, VALUATION, ARBITRAGE, AND IMPACT

As many of you have no doubt heard, on October 29, 2014, behavioral health giant Acadia Healthcare Company [ACHC: NASDAQ] announced its intention to acquire CRC Health Group, a portfolio company of private equity sponsor Bain Capital.

While further details are likely to emerge over time, the following is The Braff Group's analysis of the deal, and what it means for behavioral health.

The Big Deals Keep Coming:

The month of October has been remarkable in terms of big deal announcements in health care services, particularly in behavioral health. First up was American Addictions Center's initial public offering – an offering that kicked off at a valuation of 22 x EBITDA, and closed out its first day up 24.3% (see *marketALERT: A Peek Inside American Addiction Center's IPO*). A little more than a week later was the acquisition of home health care giant Gentiva Health Services by Kindred Healthcare, a leading post-acute provider. The same day was the IPO of Diplomat Pharmacy, a $2 billion specialty pharmacy services provider, that hit The Street at a valuation of nearly 22 x EBITDA, only to see it rise to a dizzying 25.7 x just a week later. And then, of course, the month closed out with Acadia-CRC.

An anomaly?

Not really.

As we detailed in our recent edition of *viewPOINTS: Are We Approaching an M&A Bubble?,* **there are many reasons why the mergers and acquisitions market is hot – particularly in health care.** So while the flurry of deals is inspiring, it is not unexpected.

The Valuation is Deceiving.

According to Acadia press releases and its last 8-K filing, the company is paying approximately $1.175 billion for CRC – about $300M in the form of Acadia stock, and $875M in assumed debt. With privately held CRC generating a reported EBITDA of approximately $115M, the valuation comes in at 10.2 x EBITDA. Any time an asset-light service provider (particularly in health care with its reimbursement and regulatory challenges) captures a double digit multiple, it's a good day. But compared to American Addictions' eye-popping 22 x, the valuation might look light. But not if you dig a little bit further. Valuation is a function of risk and growth. Sitting on $875M in debt, CRC had a fragile balance sheet. Moreover, with a large portion of the firm's revenues coming from methadone clinics, CRC faces meaningful "concentration risk" should the industry see a shift in medication-assisted treatment – or a widespread reduction in reimbursement. What's more, with profit margins of more than 25%, a 10 x multiple corresponds to a multiple of 2.6 x revenues – a metric that puts CRC's valuation a smidge above that of AAC's 2.5. Finally, as best we can tell, beside the recent acquisition of Habit OPCO, CRC's growth appears to have slowed.

So was it a good deal?

You bet.

With Acadia stock in hand, Bain/CRC gains the liquidity it's been after. And unless Bain needs to cash out to close out its fund, it may realize even more value by holding and riding along with Acadia for a while.

The Acadia Perspective.

From Acadia's side of the table, the deal looks even better. With its DNA in psychiatric facilities and mental health, Acadia has been looking to build out its presence in addictions and substance abuse. But with go-forward revenues of nearly $1.2B, it can take a lot of deals, a lot of time, and a lot of resources to pick up enough critical mass to move Acadia's revenue needle. But with CRC, in one transaction they add $450M in addiction treatment services, instantly becoming a major player in a segment that has fast become one of the most sought out investment opportunities in health care.

Wall Street certainly likes it. And why not? They're paying a multiple of **10.2 x**, adding $115M of EBITDA to a company valued at **18.3 x** (Q3 2014 EBITDA annualized) **before the deal.** That means that if the collective wisdom is that the deal is a good one, Acadia can realize an increase in market valuation **above what they pay for CRC** equal to the multiple spread (Acadia's 18.3 x less the 10.2 x they're paying for CRC) times the additional EBITDA added. In this case, 6.1 x $115M or about $700M. Now we wouldn't expect the math to work out perfectly – there's simply too many other variables at play. But based upon Braff Group estimates and calculations, the immediate anticipated "arbitrage" was pretty close. Just two days after the announcement, in anticipation of the deal closing, Acadia's stock jumped 17.3%, gaining $9.14 a share, increasing the firm's enterprise value about $1.8B –**approximately $630M more than what they paid for CRC** ($1.175B).

More Market Mojo

In a sector that has already seen its M&A fortunes soar over the past four years, the Acadia-CRC deal will only add more market mojo – especially coming so soon after American Addictions' successful IPO. Moreover, given the size of the deal, and the high visibility of the participants, the transaction will push behavioral health further up the private equity food chain, attracting PE sponsors that target the upper end of the middle market. In so doing, it creates an M&A dynamic where consolidators at one level develop the acquisition candidates for the next – "trickle-up" deal-making that provides exit opportunities for behavioral health providers of all sizes.

A Final Observation: Should Smaller Providers Feel Threatened by a $1.5B Competitor?

While observers may reflexively intuit a larger player's ability to muscle out smaller competitors, at least at this point, the threat in most health care services is more fluff than stuff. Why? Size becomes a competitive advantage when it creates one or more of the following: purchasing power, economies of scale, market recognition, contracting advantages, or presumed product and service excellence. While such may be the case in manufacturing, technology, and other consumer industries, the size advantage is much more elusive in health care:

- **Purchasing Power.** In behavioral health care, the cost of goods sold is mostly people, vs. goods. Therefore, the value of purchasing power is de minimus.

- **Economies of Scale.** There are definitely economies of scale in residential treatment services. Once you get past break even, any additional contribution margin drops to the bottom line. However, **since these economies are generated location by location**, larger providers have little advantage over their smaller competitors on a facility-by-facility basis.

- **Market Recognition.** With so much of health care referral source driven, the value of size, and the recognition that comes with it, is limited. In more consumer driven health care, however, such as addictions and substance abuse, advertisement-driven brand awareness can play an important role. But not a "knock-out" role. Internet and search engine optimization which can be leveraged by providers of all sizes – for far less cost – goes a long way to leveling the competitive playing field.

- **Contracting.** In health care, contracts can create barriers to entry to providers that don't have those relationships. Now this may become more significant over time, as ACOs and other coordinated care entities seek exclusive relationships with providers that demonstrate the best outcomes. However these relationships are, again, almost entirely on a local basis vs. a national basis. In other words, if a behavioral health provider is competing for a contract to serve patients in the Washington, DC area, the fact that a nationwide provider has facilities in Florida, California, Texas, etc. gives them no advantage over a provider that only serves DC. What's more, lest we forget, in addictions and substance abuse, the very reason so many patients are "out-of-network" is that, with clients traveling all over the country to access care, narrow networks just don't work.

- **Presumed Service Excellence.** In many businesses, the assumption is that if you're big, you must be good. Not so much in health care – in fact, frequently the opposite. Many a health care marketer has repositioned the messaging of their small size from that of a provider with presumably limited resources, to a provider that offers more personalized, clinically effective care as compared to its dispassionate "corporatized" competitors.

So fear not.

If you're an independent provider, the increase in acquisition demand and valuation stemming from consolidation far outweighs its threats.

Disclaimer (to keep our lawyers happy): The calculations presented herein are based upon the aggregation and interpretation of data presented in quarterly filings submitted by Acadia Healthcare Company, as well as press releases issued by other reputable third parties. In some cases, where information was unclear or unavailable, we made estimates based upon the sources cited as well as our best and reasoned understanding of the information as presented. While it is possible that our numbers may differ somewhat from others' analyses, including Acadia, we are confident that they are accurate both directionally and in terms of magnitude, providing a sound foundation for our interpretations of both the transaction and its potential impact on the addictions and substance abuse industry as a whole. This notwithstanding, our analysis should not be used for evaluating the purchase of these or other securities, nor should it serve as the factual basis for any other purpose.

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