A PEEK INSIDE AMERICAN ADDICTIONS CENTERS' INITIAL PUBLIC OFFERING:

IMPLICATIONS FOR THE INDUSTRY

As many of you are no doubt aware, earlier this year, Brentwood TN based American Addictions Centers (AAC) announced its intention to raise approximately $65 million in an initial public offering. In large part, the proceeds from the offering were to be used to pay down debt and build up its cash reserves to fund, among other things, potential acquisition and de novo developments. The offering was completed on October 2nd, and by a litany of measures, it was a rousing success.

Below is our analysis of the offering[1], and what it may mean for the entire addictions and substance abuse sector.

Share Pricing. Pricing an IPO is a delicate balancing act. You want it to be high enough to generate as much cash as possible for the seller. But you don't want to price it too high such that demand is weak or prices fall as active trading begins, thereby dampening the all-important post-IPO buzz that can keep a stock front-of-mind. Mission accomplished:

- Although the price range for the shares was originally projected to be between $12.00 and $14.00, the underwriters' read of the market immediately prior to the offering date was that demand was strong enough to realize a price above the range. Accordingly, they set the offering at $15.00 per share.

- On its first day of trading, the stock rose as much as 34% to $20.10, closing out the week at $18.65 – up 24.3% over the initial offering price.

Valuation. As recently as April 2014, in order, among other things, to properly allocate shares in connection with several internal restructuring transactions, the company obtained multiple independent valuations of its operations. Based, in part, on analyses of recently completed comparable transactions within the addictions and substance abuse sector, the company arrived at a fair market value of $8.54 per share. Based upon financial information culled from the company's S-1 and estimates made by The Braff Group, at an $8.54 share price, **the company was valued in April at approximately 13.0 x trailing 12 months EBITDA.**

With the most attractive companies in the sector commanding multiples of plus or minus 10x, given American Addictions' size (greater than $100M in revenues) and track record of expansion through acquisitions and de novo startups, this valuation was both consistent with the market and highly defensible.

Bearing this in mind, the implied valuations derived from the AAC IPO are impressive:

- Based upon the company's S-1 filing, with an Enterprise Value[2] just shy of $300M, if we adjust for discretionary bonuses paid to executive officers during the fourth quarter of 2013, on a trailing 12 month basis (the "gold standard" for private equity) the offering generated a robust initial valuation of 2.53 x revenues and 22.0 x adjusted and restated earnings before interest, taxes, depreciation, and amortization (EBITDA).

- If we simply annualize the company's 2014 results through June (which, due to growth, produce higher revenues and EBITDA, and hence lower, more conservative metrics), at the initial offering price, the imputed valuation is 2.47 x revenues and 18.7 x EBITDA.

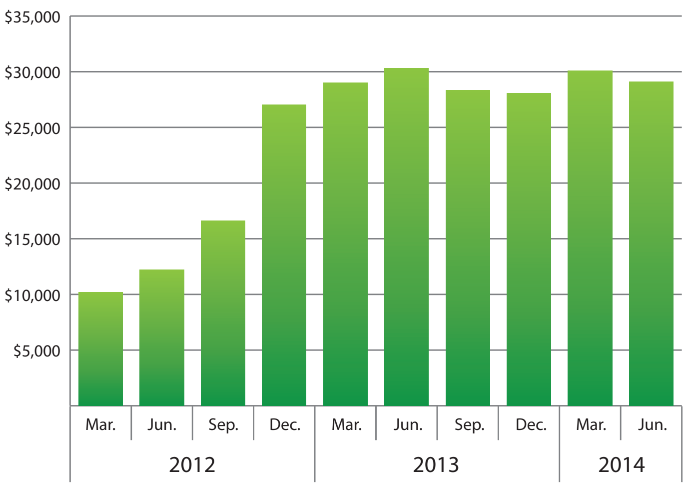
- With a week end closing price of $18.65, based upon the more aggressive last six months annualized results, the implied value of the company rose to 3.1 x revenues and 23.6 x adjusted and restated EBITDA.

- Finally, even if we use the most aggressive financial benchmark which annualizes the last quarter alone, the implied EBITDA multiple at the offering price of $15.00 was 17.3 x which rose to 21.8 x by the end of the week.

Other Takeaways

The Out-Of-Network Factor. Although the prospectus states that American Addictions is "generally an 'out-of-network' provider," **the risk of conversion to lower in-network reimbursement does not appear to have suppressed its valuation.** From a go-forward M&A perspective, this is noteworthy as the conventional assessment of risk regarding out-of-network may be somewhat overstated. While it is certainly true that as more clients become "in-network," reimbursement will go down – substantially in some cases — for most providers, the erosion will likely be slow, and not necessarily pervasive. Why? Because the very nature ofhigh-end, residential treatment centers, which draw clients

American Addictions Centers Quarterly Revenues



from around the country, with many different insurance plans, does not lend itself to narrow, in-network, contract relationships with payors. That's why there is so much out-of-network activity to begin with. And that's why the reflexive reaction to out-of-network reimbursement, though entirely understandable, may be rooted more in fear than reality.

The Growth Conundrum. With a valuation multiple hovering around 20 x EBITDA, you would expect a fast growing company. But in the case of American Addictions, the story is less black and white. As illustrated above, revenues over the past seven quarters are basically flat. So how can the company capture what is arguably a growth multiple? Similar to above, the answer lies in the nature of the industry. In residential services, growth is essentially limited to a provider's bed capacity. Once a facility is running steadily at high occupancy, incremental growth is difficult to muster unless the focus turns towards the development of non-residential, out-patient services [note that we believe the next phase in addictions M&A will, in fact, be out-patient]. So **growth tends to come in big chunks through acquisitions and new developments.** And in this realm, American Addictions is well situated. To finance acquisitions, not only does the firm have a strengthened balance sheet with available cash, it also has the added currency of its own liquid stock. What's more, AAC has four properties in various stages of development. So even though the recent past has been flat, there are clear, near-term, high value growth opportunities in its immediate pipeline.

More Heat in a Hot Market. For the most part, over time, in highly competitive, service oriented businesses, particularly in health care with its exposure to at least some third party reimbursement, valuations tend to fall in the range of 4 to 6 times EBITDA. With the most attractive, sizeable addictions treatment providers (EBITDA of $5M and up) fetching double digit multiples for an extended period of time, one could rightly wonder how much multiple expansion, or arbitrage, **if any**, private equity consolidators could anticipate upon exit. Well, if the valuation metrics for American Addictions hold, there is arbitrage room aplenty. And this will draw even more moneyed investors to the sector, further greasing the gears of a rocking M&A machine. Good news for sellers.

A Cloud in the Silver Lining? Lots of good to be taken from the American Addictions IPO. But it's not all kittens and rainbows. As we have seen countless times in other frenzied health care sectors, when the money flows in, so do the ne'er-do-wells, which can bring the sector the kind of attention it doesn't want. Markets in hyper-drive are extremely fragile. And sometimes all it takes to bring a high-flying sector crashing to the ground are a few, high profile cases of chicanery that paints the entire industry with a broad brush of suspicion (and in a sector sorely lacking definitive data to quantify the good work you do, the industry is particularly vulnerable).

Do we think a collapse is imminent? Not at all. But are market forces coalescing to surface the precursors to a shake out? Sadly, yes.

Something to consider in planning an exit strategy.

[1] Disclaimer (to keep our lawyers happy): The calculations presented herein are based upon the aggregation and interpretation of data presented in the S-1 filing submitted by American Addictions Centers, 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 American Addictions', we are confident that they are accurate both directionally and in terms of magnitude, providing a sound foundation for our interpretation of both the IPO 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.

[2] Enterprise Value is calculated by multiplying shares outstanding x share price – cash + long term debt

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