BEHAVIORAL HEALTH

A Healthcare Industry Special Report

2015 Edition

HAMMOND HANLON CAMP LLC

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Introduction

HAMMOND HANLON CAMP LLC ("H2C") specializes in the healthcare services industry, providing strategic and financial advisory services as a trusted advisor to clients nationwide. As such, the firm monitors a number of healthcare industry sectors, striving to keep clients abreast of trends and opportunities to support their decision making in an increasingly complex operating environment.

This report highlights the Behavioral Health sector, which includes the provision of mental health care and substance abuse treatment. It identifies key trends – including the relationship between supply and demand, reimbursement rates and coverage trends, and the impact of behavioral health issues on total health. In addition, the report addresses merger & acquisition activity and valuation trends, as well as provides an outlook on future opportunities and considerations for healthcare providers. An overview of the sector, including size, composition and key players is included in the Appendix.

Should you have any questions or desire to discuss the sector with an H2C professional, information about the firm and how to contact us is presented at the end of the report.

Key Trends

The Behavioral Health sector is currently characterized by growing demand with an imbalance in the supply and availability of facilities to meet current and estimated future needs. On the supply side, the availability of care declined significantly during the 1990s due to the government closure of state mental health facilities. In recent years, a combination of continued state budget pressures, the exit of many general acute care hospitals from the behavioral sector, and poor insurance reimbursement/coverage has further reduced the availability of care.

National expenditures for mental healthcare and substance abuse treatment were projected to reach $239 billion in 2014, a 6.4% CAGR since 2003.[3]

Demand for treatment, however, continues to grow as a result of the rising incidence of mental health illness and substance abuse, an aging population and an increased rate of dual diagnoses, as well as an enhanced awareness of mental health illness and social acceptance for treatment. This imbalance has resulted in legislative and reimbursement changes that mandate or provide significant motivation for the expansion of the behavioral care market and access to care.

- The Mental Health Parity and Addiction Act of 2008 provided for equal coverage between psychiatric or mental health services and physical health services. This legislation provides incentives and requirements for employers with greater than 50 employees to provide comparable coverage for mental health and substance abuse treatment and is projected to affect more than 113 million individuals. [1]

- The Patient Protection and Affordable Care Act will expand options for affordable coverage through insurance exchanges and through Medicaid expansion, both of which must comply with the Mental Health Parity Act. Before the Affordable Care Act, only about a third of individual health plans covered substance abuse – today coverage is mandatory.[2] Several states have also adopted parity laws requiring private insurance policies to have the same deductibles, co-payments and number of office or inpatient visits for mental health as for other covered illnesses.

At approximately 38,000 nationwide, the number of beds is well below the 50 per 100,000 people that advocates say is needed to provide inpatient psychiatric services.[4]

- In addition to these Acts and in the aftermath of recent fatal shooting events involving mentally ill individuals, Congress will be re-evaluating a bill first proposed in 2013 known as the Helping Families in Mental Health Crisis Act. The Act would reduce the power

[1] *Acadia Healthcare investor presentation, January 2014.*
[2] *Haggeman, Kelly. "Do a reality check when navigating substance abuse treatment coverage under ACA," Behavioral Healthcare, 2014.*
[3] *U.S. Department of Health and Human Services.*
[4] *2012 Report, Treatment Advocacy Center*

of the Substance Abuse and Mental Health Services Administration, or SAMHSA, and would shift mental health block grants to a new HHS assistant secretary. It would expand Medicaid to cover inpatient care at psychiatric hospitals and residential treatment facilities, expand courts' power to order involuntary inpatient mental treatment and authorize additional funding for outpatient treatment programs and research. While there is significant support for the bill, opposition is based upon a fear that the Act will shift the focus away from community-based mental healthcare providers which reach more people and prevent them from getting to the point of needing institutionalization.

In 2013, an estimated 43.8 million adults, or 18.6% of all adults in the U.S., had a mental illness.[8]

How expansion will affect state mental health and substance abuse treatment budgets will vary by state, since benefit packages and reimbursement rates are not uniform. However, most state budgets were reduced dramatically during the recession and still remain far below needed levels. According to data from the National Alliance for Mental Illness, 36 states have raised their behavioral healthcare budgets for 2014, while another eight have maintained their levels of funding.[5] Yet, many substance abuse treatment providers already refuse to treat Medicare and Medicaid patients because reimbursement is often much lower than what private insurance or cash patients pay. Access issues and availability of trained providers may become more of an issue in the future.

However, there appears to be an increased willingness of commercial insurers to pay for treatments. This may be due, in part, to recognition and studies of the impact of behavioral health issues on total health and overall cost of healthcare. Examples include a 2008 study that indicates that depressed people have a 37 percent greater chance of developing diabetes, and other research that shows people with heart disease are more likely to be depressed than otherwise healthy people, and that depression is linked to angina and heart attacks. [6]

An estimated 21.6 million individuals, ages 12 and older, suffer a substance abuse disorder.[8]

The Bureau of Labor Statistics estimates that access to mental health professionals is worse than for other types of doctors.[7] People with mental health issues in crisis often end up in emergency departments, escalating costs and demands on practitioners, who are often poorly equipped to deal with severely mentally ill patients. The loss of bed turnover for waiting patients caused by psychiatric boarding and the opportunity cost resulting from loss of those waiting patients cost emergency departments more than $2,200 per patient.

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[5] *Albright, Brian. "After years of deep cuts, state behavioral health budgets begin a slow recovery," Behavioral Healthcare, 2014.*
[6] *Trustee Magazine, "The Evolution of Mental Health Care," October 2013.*
[7] *Markham, Donna. "The Power of Group Therapy," August 2013. H&HN Daily.*
[8] *Substance Abuse Mental Health Services Administration Report, September 2014.*

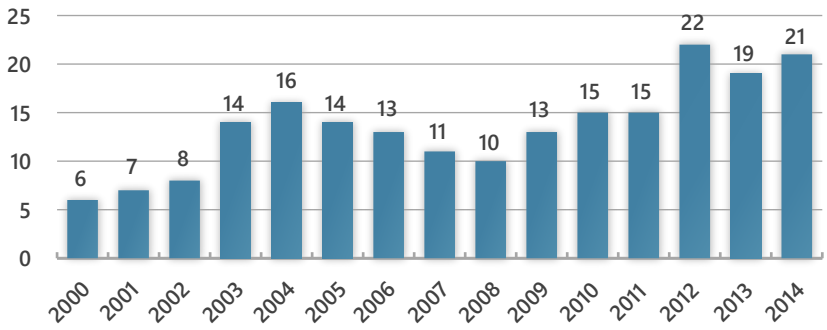
Hospitals are increasingly recognizing and directing strategies towards this issue. Catholic Health Partners, based in Cincinnati, Ohio, has taken steps to provide help to the mentally ill through group therapy – including training group practitioners in partnership with the American Group Psychotherapy Association, encouraging insurers to reimburse for group treatment and providing supporting clinical outcome data of its effectiveness. Others are integrating regular mental health screening in their primary care practices during regular office visits, or partnering with local specialty psychiatric facilities.

We are seeing all of these trends play out in the marketplace and, despite some uncertainty, participants and investors appear bullish on the sector and its growth potential. Consolidation across this fragmented market is increasing and major players are expanding through acquisition and new facility development – both to meet anticipated demand and to gain operating efficiencies.

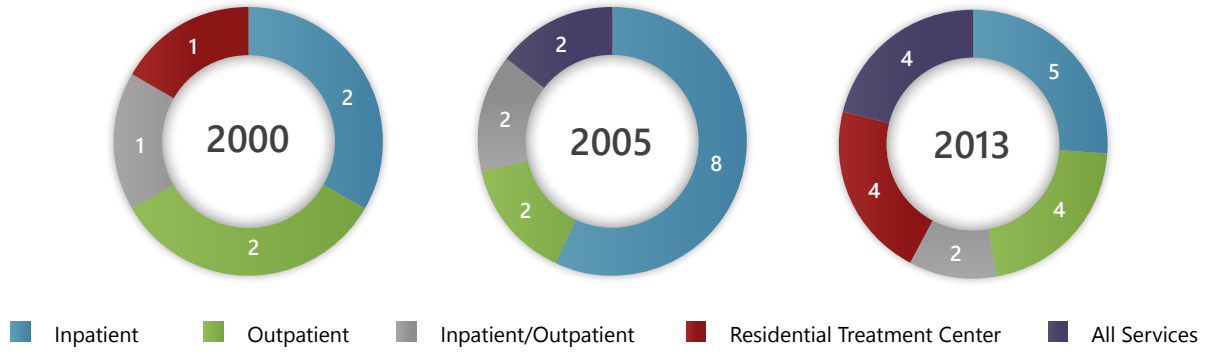
Merger & Acquisition Activity

Merger and acquisition activity in the behavioral health sector has increased since 2008, due in part to the 2008 Mental Health Parity Act. Historically, acquisitions have been a significant driver of both revenue and EBITDA growth of the publicly traded companies, driving market performance and valuations. And the high fragmentation in the market has provided ample opportunity for such consolidation. Further, there are significant barriers to entry for new players, given the high degree of specialization and regulation, similar to the acute care hospital segment. The types of transactions (by modality) have shifted over time as the face of the industry and major players have changed, with participants moving to provide a diversity of services rather than focusing primarily in one segment.

Behavioral Health Sector • Historical Merger & Acquisition Volume



Distribution of Transactions by Type of Service • Historical Merger & Acquisition Volume



Acadia Health, a relatively young company, is pursuing an aggressive growth strategy, completing acquisitions over the past two years and growing from 29 to 78 facilities since 2011.

Publicly-traded Acadia Healthcare is currently the primary buyer consolidating behavioral health and has been very active, expanding revenues by $600 million through acquisitions over the past three years. UHS also continues to expand through strategic acquisitions, but at a more measured pace following its 2010 acquisition of Psychiatric Solutions, Inc. and as a result of anti-trust concerns in many markets. Both Acadia and UHS expanded into the United Kingdom in 2014 with significant acquisitions of, respectively, Partnership in Care (PIC) and Cygnet Health Care (see transaction table below), likely seeking new markets for growth and capitalizing on the growing and underserved independent mental health market in the UK. [See Appendix for a profile of major players, including Acadia and UHS.]

Private equity firms have also become active acquirers and consolidators. The ability to achieve scale and enhance profitability – combined with a reliable exit strategy through the role of a larger provider – makes the behavioral health sector a very attractive investment opportunity. These firms have tended to show more interest in residential treatment centers and substance abuse facilities, likely due to the lower cost and capital requirements than those of the acute behavioral segment.

Other factors of the behavioral health business likely driving private equity investment include:

- Favorable payor mix with limited bad debt exposure
- Simple reimbursement system, with per diem rates and limited number of DRGs
- Growing market and awareness of behavioral health concerns and treatment options available
- Clear path to liquidity with serial strategic acquirers

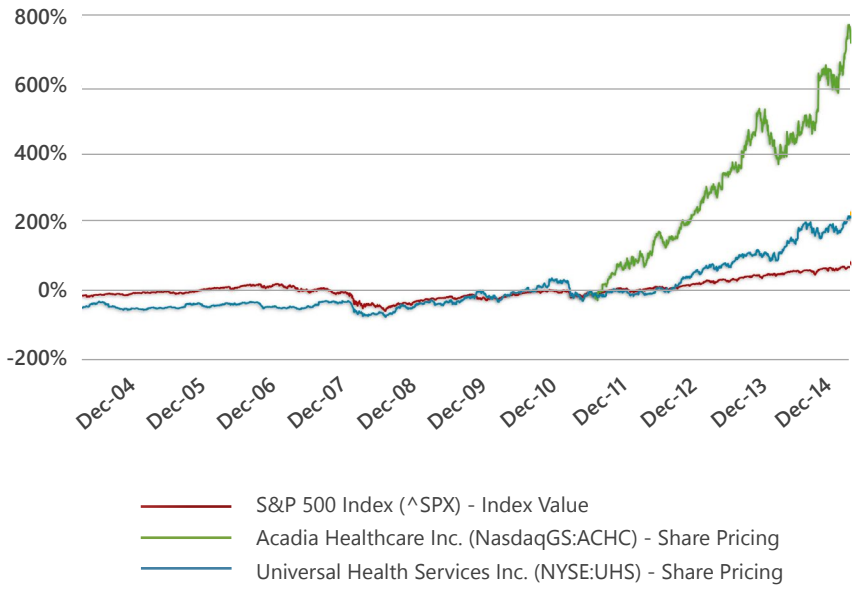
Highlights of recent transactions are shown below.

			Last Twelve Months		*Transaction Multiples*	
Announced	**Target / Acquirer**	**Implied EV**	**Revenue**	**EBITDA**	**Revenue**	**EBITDA**
12/04/2014	Belmont Center for Comprehensive Treatment (Einstein Healthcare Network) *Acadia Healthcare Company*	$35.0	$37.6	N/A	0.93x	N/A
10/29/2014	CRC Health Group *Acadia Healthcare Company*	1,180.0	450.0	115.0	2.62x	10.3x
09/26/2014	Cygnet Health Care Limited *Universal Health Services*	335.0	161.0	N/A	2.08x	N/A
06/03/2014	Partnerships in Care Limited *Acadia Healthcare Company*	662.0	285.0	75.0	2.32x	8.8x
06/20/2013	The Refuge, a Healing Place *Acadia Healthcare Company*	15.0	23.0	N/A	0.65x	N/A
04/05/2013	United Medical Corporation (2 facilities) *Acadia Healthcare Company*	91.8	25.0	N/A	3.67x	N/A
02/01/2013	Delta Medical Center *Acadia Healthcare Company*	23.0	44.4	(0.5)	0.52x	N/M
01/08/2013	Greenleaf Center *Acadia Healthcare Company*	N/A	7.0	N/A	N/A	N/A

And although based upon a relatively small universe, the strong stock performance of the publicly-traded participants over the last two years – relative to the S&P 500 and the acute care hospital sector, certainly reflects a positive outlook.

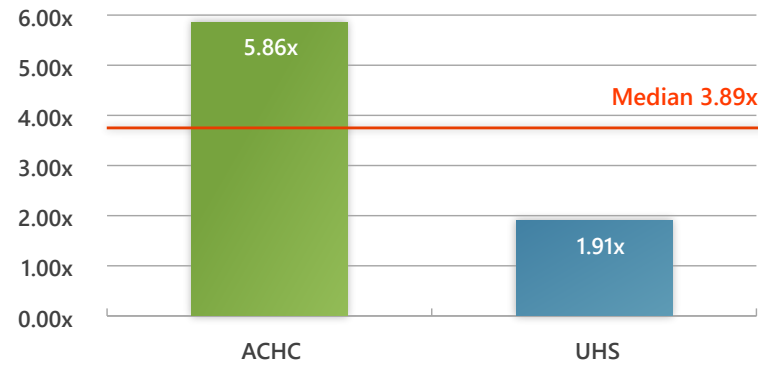
Favorable public and private equity markets are providing significant currency for continued investment in the behavioral sector – among both existing participants and new entrants.

Relative Stock Performance

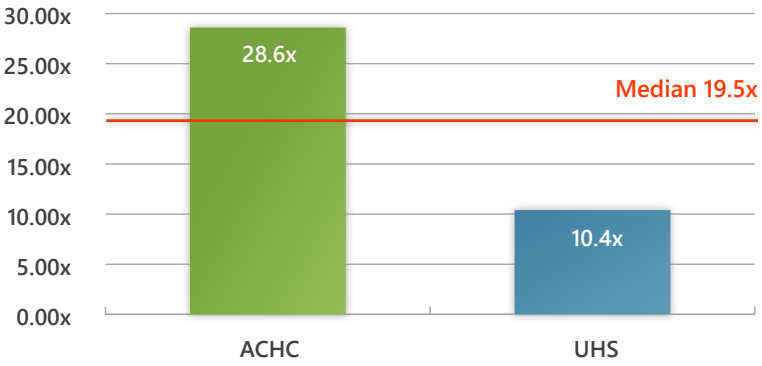


When viewed on an individual company basis, a significant trading differential emerges, however, between **Acadia** and **UHS**, the two publicly-traded companies in this sector. Given its smaller size and aggressive growth strategy, Acadia has been trading at higher valuation multiples relative to UHS, which is larger, has a significant acute care business and trades more like a mature company.

Publicly Traded Company LTM Revenue Multiples *(as of March 24, 2015)*



Publicly Traded Company LTM EBITDA Multiples *(as of March 24, 2015)*



Outlook & Implications

These trends and market characteristics suggest several key questions for healthcare providers:

- How essential is it to offer these services?
- Where are the growth opportunities in this segment?
- Where is reimbursement headed for behavioral health?
- What is the best strategy for including behavioral health in the continuum of care?
- How does mental health fit into Population Health Management?
- What is the Medicare dual diagnosis outlook?

There appears to be a growing willingness of insurance companies to pay for treatment, given the impact of mental health issues on total health.

The outlook for continued growth in the behavioral health sector is positive, driven by the aging population, expanded coverage and increased demand for mental health and substance abuse treatment noted previously. Although there remains uncertainty about reimbursement for the dual eligible population, the majority of reimbursement in this sector is driven by private pay and there appears to be a growing willingness of insurance companies to pay for treatment, given the overall cost of depression and its impact on other healthcare conditions, as noted previously.

Many general acute care hospitals offer behavioral health services, but have been focusing their expansion and bed growth in other specialty areas given the historical challenging characteristics of the sector and a focus on core competition. As such, growth has largely been pursued in the specialty hospital, freestanding residential and outpatient arenas, particularly in substance abuse and residential treatment. The publicly traded behavioral health companies continue to pursue aggressive growth in these modalities.

However, in response to increased demand, several health systems with excess acute care capacity are converting acute beds to behavioral, despite the potentially unfavorable economics associated with services. And in some instances, the systems have consolidated their systemwide behavioral capacity within an individual hospital in order to manage these patients more effectively.

In the Portland, Oregon market, four distinct health systems are in the process of consolidating their behavioral services. In response to a critical shortage of services, the four systems – Legacy Health, Adventist Health, Kaiser Permanente and Oregon Health Science University (the "Systems") – recently signed a letter of intent to develop a new Psychiatric Emergency Service that will be co-located with a centralized inpatient facility with 101 beds. Each system will move their psychiatric inpatient services to a new integrated behavioral center on one of Legacy Health's existing campuses. The Systems are in the process of developing a joint operating agreement detailing the management and operations of the center. Not only are the Systems expecting to increase access and reduce wait times for psychiatric beds, but the move to a dedicated behavioral center should enhance the quality of behavioral services in the market, improve the flow of patients through existing emergency departments, and provide the benefits of scale not currently available to the individual Systems.

General acute care health systems may want to rethink their involvement and approach to behavioral health, given some of the anticipated trends and the shift towards population health management. As reimbursement shifts towards at-risk contracts, it will be important for providers to effectively manage this population and offer a range of behavioral health treatment options either directly or in partnership with other providers.

For health systems that want to expand behavioral health services, the best approach will depend upon management's expertise and ability to perform and operate with the required efficiency.

What opportunities exist in this segment for not-for-profit health systems? According to Rich Bayman, Principal at H2C, an array of alternatives exist for health systems, but are often dependent upon state licensure and Certificate of Need ("CON") requirements. Similar to other non-acute services such as rehabilitation and long-term acute care, behavioral health may not be a core competency for acute care providers and may require specific management expertise to perform and operate with the required efficiency.

Opportunities may exist for not-for-profit hospitals to expand services to respond to growth trends through partnerships with specialty providers. Acute care hospitals and health systems can develop partnerships with specialty providers to serve a range of objectives, from building new facilities, to outsourcing the management of services and/or to jointly expand service offerings, depending on state licensure considerations. Beyond partnerships, transaction examples include the January 2014 sale of an acute inpatient psychiatric facility by Highline Medical Center, a not-for-profit healthcare system headquartered in Seattle, to Acadia, which announced plans to both add beds and transition beds from other uses. Another example was the May 2012 purchase of Gateway Healthcare, a Rhode Island community behavioral healthcare organization, by Lifespan, Rhode Island's largest healthcare system. Additionally, Universal Health System's continued growth into the behavioral health space, with eight behavioral health facility acquisitions in the past five years, exemplifies a publicly-traded company's expansion into the behavioral health sector.

Summary

H2C anticipates continued growth and acquisition activity within the behavioral health sector, representing opportunities for not-for-profit health systems, private equity firms and publicly-traded companies. Although cost pressures and a shortage of behavioral health specialists will challenge this industry, the positive outlook remains strong given growing patient access and demand, the shift towards population health and the increasing recognition of the importance of this sector on overall health care costs. Steve Davidson, Chief Development Officer of Acadia, believes that the future for behavioral health "looks better than it has ever been" in his three decades in the industry.

Hospital systems must decide the importance of behavioral health services within their continuum of care and whether to own, manage or partner with others to provide those services. H2C is well positioned to work closely with its health system clients to ask the critical questions and support the evaluation of alternative strategies and relationships regarding behavioral health services.

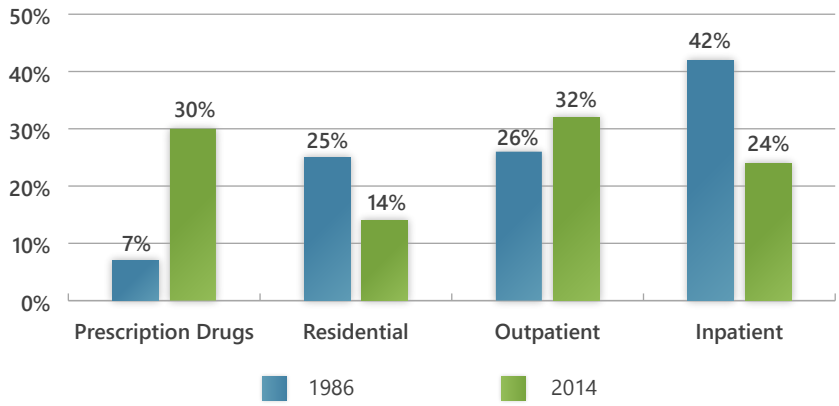
Appendix: Sector Overview

I. Size and Growth

The behavioral health sector is a large, fragmented and growing industry. The sector includes both mental health care and substance abuse treatment, for which national expenditures collectively were projected to reach $239 billion by 2014, a 6.4% CAGR since 2003.[9] These expenditures reflect professional services, prescription drugs, inpatient and outpatient treatment, as well as an array of other treatment related expenditures.

Over the last several decades, treatment has shifted from largely inpatient and residential services towards outpatient and pharmacological treatment modalities, as shown in the chart below.

Portion of Health Expenditures by Method of Service Delivery



Source: American Hospital Association; Quick Facts

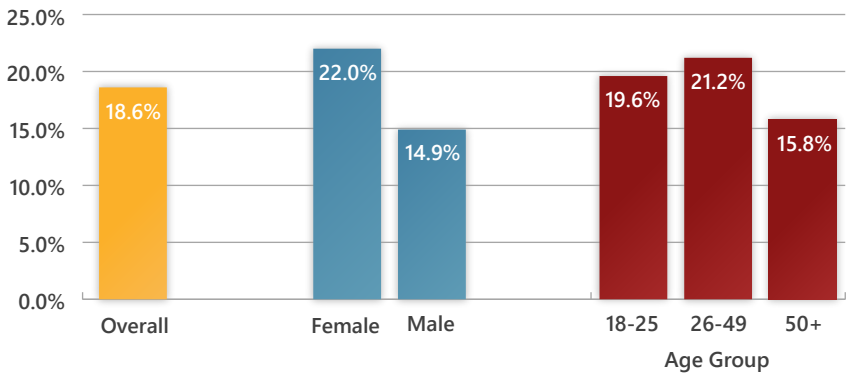
Behavioral health care is delivered through three types of channels: mental health and substance abuse "centers," mental health and substance abuse "clinics," and "psychiatric hospitals." With $11.6 billion in revenue and approximately 3,152 facilities, **Centers** primarily provide residential care and treatment for patients with mental illness, drug addiction, and alcoholism. Center services include lodging, supervision, evaluation, and counseling. Medical services may be available,

[9] *U.S. Department of Health and Human Services*

but are generally incidental. **Clinics** include a medical staff and primarily provide outpatient services related to diagnosis and treatment of mental health disorders and substance abuse. There are approximately 5,407 clinics nationally that generate $15.6 billion. **Psychiatric hospitals** are licensed to provide diagnostic and medical treatment, as well as monitoring services for inpatients suffering from mental illness or substance abuse disorders. They maintain inpatient beds and a staff of physicians, with a strong focus on medical treatment vs. counseling. There are approximately 419 licensed psychiatric hospitals generating $21.4 billion in annual revenue.[10] Many other general acute care hospitals also offer mental health services, as well.

An estimated 43.8 million adults, or 18.6% of all adults, in the United States had a mental illness in 2013, according to the National Survey on Drug Use and Health ("NSDUH") conducted by the Substance Abuse and Mental Health Services Administration ("SAMHSA").[11] Any mental illness ("AMI") is defined as an individual having any mental, behavioral, or emotional disorder. An additional 10 million adults, or 4.2% of all adults, were estimated to have serious mental illness. Serious mental illness ("SMI") is defined as having mental, behavioral, or emotional disorder that substantially interfered with or limited one or more major life activities.

Prevalence of Mental Illness Among U.S. Adults *(2012-2013)*

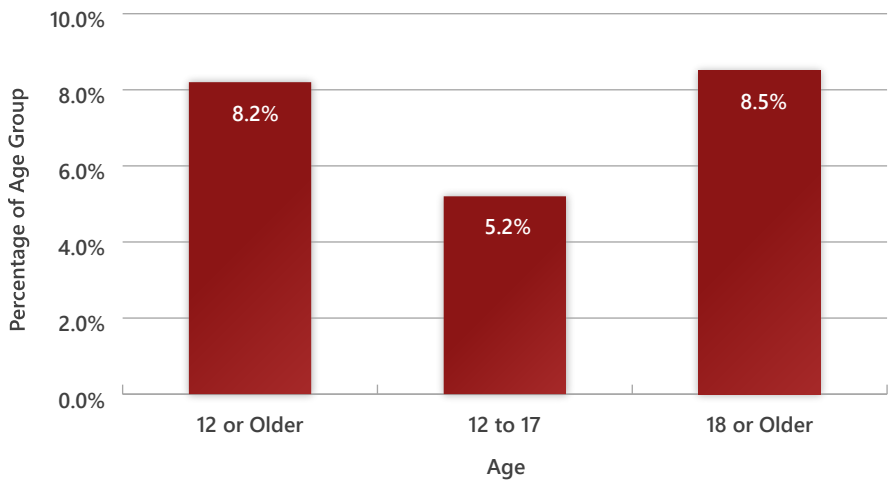


Source: National Institute for Mental Health

[10] *IBIS World Industry Report: Mental Health & Substance Abuse Centers in the US; Clinics; Psychiatric Hospitals*
[11] *Substance Abuse and Mental Health Services Administration report, Sept. 2014*

The prevalence of substance abuse among the population was estimated to be 8.2% or 21.6 million individuals ages 12 or older in 2013.[12] Substance abuse disorder (SUD) is defined as having dependence or abuse of illicit drugs or alcohol. Among those with SUD, only 11% reported receiving treatment at a specialty facility in the past year.

Substance Abuse Disorder *(2013)*



II. Competitive Landscape

The industry is highly fragmented with many small private facilities, hospitals, clinics and a few large publicly traded companies. Competitors tend to differentiate by type of facility – acute inpatient, outpatient clinic, residential, and by the focus of treatment provided – mental health and/or substance abuse, adult and/or youth.

The publicly traded companies in this sector include Universal Health Services, Inc. (UHS) and Acadia Healthcare (ACHC). Aurora Behavioral Health, Strategic Behavioral Health Inc. and Haven Behavioral Healthcare are owned by larger private equity firms and represent key players on the private equity side. A brief profile of these companies is shown in the following table and discussion.

[12] *Substance Abuse and Mental Health Services Administration report, September 2014*

	Status	Revenue[13] EBITDA	No. of Facilities	Services Offered	Comments
UHS	Public (NYSE: UHS)	$7,557 $1,391	231	▪ Inpatient ▪ Outpatient ▪ Residential Treatment Center	▪ Largest behavioral health provider in the country
ACADIA HEALTHCARE	Public (NASDAQ: ACHC)	$790 $155	78	▪ Inpatient ▪ Outpatient ▪ Residential Treatment Center	▪ Closed 5 acquisitions, adding 300 beds, since the start of 2013
STRATEGIC BEHAVIORAL HEALTH, LLC	Private	$30.2 $6.7	9	▪ Inpatient ▪ Outpatient	▪ Owned by Dobbs Management Services
Haven BEHAVIORAL HEALTHCARE Hope, Health & Wellness	Private	$21.2 $7.6	7	▪ Inpatient ▪ Outpatient	▪ Sold 3 inpatient facilities to Acadia in January 2012 ▪ Investors include Cressey & Company, Clayton Holdings and Ascension Ventures
Aurora Behavioral Health Care	Private	NA NA	13	▪ Inpatient ▪ Outpatient ▪ Residential Treatment Programs	▪ Located throughout California, Texas and the Chicago, Las Vegas and Phoenix areas

UHS is the largest behavioral health provider in the country, operating both acute care and behavioral health facilities in 37 states, with its largest presence in Texas, Nevada and California. Previously more focused on the acute care hospital segment, UHS expanded its presence in the behavioral segment substantially when it acquired Psychiatric Solutions. As a result, in 2012 half of UHS's revenue came from behavioral health, while 73% of its EBITDA was generated from its behavioral health business.[14] No other publicly-traded, acute care focused company has invested as significantly in the behavioral segment.

Acadia Health is a relatively young company led by executives from Psychiatric Solutions Inc. prior to its acquisition by UHS. It has taken advantage of the fragmentation in the industry and pursued an aggressive growth strategy, completing nine acquisitions within the past two years. It has grown from 29 to 78 facilities since 2011, improving its adjusted EBITDA margin from 16.2% to 20.6%.[15]

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[13] *UHS and Acadia LTM Revenue and EBITDA as of June 30, 2014; Aurora FY 2013 Revenue and EBITDA from December 31, 2013*
[14] *UHS Investor presentation, December 9, 2013*
[15] *Acadia Investor presentation, January 2014*

According to Steve Davidson, Chief Development Officer, Acadia expects continued growth through bed expansion and acquisition, especially in acute and adult residential facilities, to respond to substance abuse and dual diagnosis demand for services.

Founded in 2000, Aurora Behavioral Health Care is made up of thirteen free-standing acute psychiatric hospitals that are all accredited by the Joint Commission for Accreditation of Healthcare Organization and Medicare certified. The hospitals are located throughout California and Texas with additional locations in the Chicago, Las Vegas and Phoenix markets. Aurora offers a variety of services for behavioral health and chemical dependency for seniors, adults, adolescents and children including inpatient, outpatient and residential treatment programs.

Founded in 2006 and headquartered in Memphis Tennessee, Strategic Behavioral designs, builds, and operates behavioral health facilities throughout the country. They company provides a broad range of behavioral health services, such asincluding psychiatric, medical and nursing services, treatment planning, social skills training, substance abuse counseling and education, and recreation therapy, as well as individual, group, and family therapy services. Strategic currently operates facilities in Colorado, North Carolina, Nevada, and New Mexico.

Also founded in 2006 and headquartered in Nashville, Tennessee, Haven Behavioral Healthcare provides inpatient psychiatric stabilization and treatment to senior adults experiencing acute symptoms of depression, anxiety, psychosis or other severe behavioral problems. Haven also has highly specialized behavioral health services for active duty military and their families. Haven conducts operations in nine locations across seven states, including Arizona, Colorado, Hawaii, New Mexico, Ohio, Pennsylvania and Texas.

About H2C

HAMMOND HANLON CAMP LLC ("H2C") is an independent strategic advisory and investment banking firm with an exclusive focus on healthcare services companies and related organizations. Our commitment to exceed our clients' expectations begins with senior leadership on every engagement and continues with independent and objective strategic advice. Our belief in the markets and in the power of competition has resulted in loyal clients and long-term relationships.

A trusted advisor with the expertise to understand the unique complexities of the healthcare industry and an in-depth knowledge of the range of potential alternative transaction and partnership structures is an essential part of any team dedicated to designing and implementing a highly successful merger, acquisition or divestiture strategy. The experienced professionals at H2C are well positioned to serve as a trusted advisor to healthcare organizations that wish to better understand what alternatives are available and to expertly guide them in structuring and executing their strategies. We bring an in-depth knowledge and experience across the spectrum of healthcare service segments.

H2C offers services in the following areas:

- Strategy design, development and execution
- Mergers, acquisitions and divestitures, including affiliations and joint ventures
- Capital planning and management
- Capital markets financial advisory and private placements
- Real estate
- Bankruptcy and restructuring

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