Obamacare helps private equity get its rehab clinic fix
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By Olivia Oran
(Reuters) - Investors are pouring money into the operators of U.S. rehab centers as many more Americans get health care coverage for addiction treatment, driving up valuations and triggering a consolidation of businesses in the fragmented sector.

Under President Barack Obama's healthcare law, new health plans must cover ten core health benefit areas. This includes substance abuse and mental health disorders, opening up services such as alcohol and drug detox or addiction therapy to many Americans who previously couldn't afford them.

The healthcare law also allows young adults to stay on their parents' insurance plans until age 26. This offers coverage to many young people struggling with drug abuse and eating disorders.

And the economic recovery has helped as well, as it means more people can afford to pay the expenses that the plans won't cover.

There are now a growing number of major investors, led by private equity firms and healthcare companies, seeking to take advantage of a market for addiction services that experts say has grown to $35 billion a year now from $21 billion in 2003.

Prices for rehab businesses are climbing so high that some of those who bought assets in the previous decade are taking their profits and selling to a new wave of investors betting on the sector on expectations of continued strong growth.

"The appetite among private equity firms for these assets tends to be greater because there is less payer reimbursement risk and the growth opportunities are so great," said James Clark, a managing director at investment bank Harris Williams & Co.

The latest wave of investors includes Goldman Sachs Group Inc's private equity arm, which gave tens of millions of dollars to two healthcare industry veterans Mitch Eisenberg and Lewis Gold at a company called Advanced Recovery Systems late last year to acquire and develop rehabilitation clinics. Franklin, Tennessee-based investment banking boutique Brentwood Capital Advisors is similarly backing another management team led by former Universal Health Services executive Scott Kardenetz to build a rehab center business, according to people familiar with the matter.

Goldman said in a statement that it was part of an investor group that "funded more than $50 million towards the recapitalization of an existing asset in central Florida and committed significant additional capital towards the de novo build-out of new facilities as well as the pursuit of add-on acquisitions, on a national basis."

Advanced Recovery Systems and Brentwood Capital did not respond to requests for comment.

They are competing against several major publicly traded companies in the sector, including Acadia Healthcare Company Inc and Universal Health Services Inc, which have also been acquiring such assets. Acadia agreed in October to buy CRC Health Group for $1.2 billion from private equity firm Bain Capital LLC, which bought the company for $723 million in 2006.

AAC Holdings Inc, the parent of American Addiction Centers - which operates six substance abuse facilities across the U.S. - has seen its shares climb nearly 70 percent since going public in early October.

MENTAL HEALTH LAW

When Obamacare was signed into law in 2010, many investors wondered whether it would end up being quashed in Congress or the courts before it was implemented. But once its healthcare exchanges began providing plans to millions of Americans this year, investors became more convinced that there was a longer-term opportunity.

A 2008 mental health parity law that requires health plans that offer mental health and substance use disorder benefits to provide coverage comparable to other medical and surgical benefits has also helped.

According to a 2013 National Survey on Drug Use and Health, an estimated 22.7 million Americans needed treatment for a problem related to drugs or alcohol but only about 4.1 million people received treatment at a specialty facility.

"The affected patient population today has greater financial resources, which combined with a stronger economic environment, enables patients to pay for treatment," said Rich Harding, a managing director at investment bank Moelis & Co.

With the prices for rehab businesses climbing as demand outstrips supply for such assets, investors are keen to snap up more clinics so they can lower costs per patient and keep profit margins healthy.

While there are more than 14,500 specialized drug treatment facilities in the United States providing care for substance use disorders, the industry is very fragmented and the largest operators do not own more than several dozen treatment centers, which offers plenty of scope for consolidation.
Facilities are often small, with the average operator holding no more than 150 beds, analysts said. Because of efficiencies of scale, larger facilities and bigger firms are more likely to have higher margins, as are those that focus on patients that can pay through their own means or private insurance rather than relying on government-backed insurance.

Earnings before interest, tax, depreciation and amortization (EBITDA) margins at rehab treatment centers, as a percentage of revenue, can reach as high as 25 percent, according to brokerage William Blair.

Market valuations have been surging. Shares of Acadia and AAC Holdings are trading at 32 times and 56 times their projected 12-month earnings respectively, versus 17 times for a broader group of U.S. healthcare companies, according to Thomson Reuters data.

Among those selling is private equity and venture capital firm Frazier Healthcare. Its high-end rehabilitation facility operator Elements Behavioral Health, for example, is up for sale, sources said. Elements Behavioral Health, which was set up in 2008, did not reply to a request for comment. Frazier Healthcare declined to comment.

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