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EMBRACING UNCERTAINTY:
STRATEGIC ADVISORY IN UNPRECEDENTED TIMES

Background

Over the past decade, The Behavioral Health Industry (the "Industry") and, more specifically, substance abuse has been thrust to the forefront of general consciousness. Substance abuse from alcohol and the rampant use of opioids among other variants of pain medication has paved the way for the rapid development of the treatment Industry as alarming levels of addiction along the socio-economic spectrum have catapulted the Industry to record growth. Addiction treatment accelerated in the early 2000s when opioid medications, led by 1995 introduction of the prescription painkiller OxyContin, were widely hailed as a medical breakthrough, a long-lasting narcotic that could aid patients suffering from moderate to severe pain. Despite the treatment benefits, the proliferation of accessible prescriptions and the highly addictive nature of medications led to significant abuses – all of which are well chronicled by the medical industry and the media.

The Centers for Disease Control and Prevention ("CDC") and the National Institute of Alcohol Abuse and Alcoholism ("NIAAA") has stated that substance abuse exacts upwards of $468 billion annually in costs related to crime, lost work productivity, and health care, with over 70,000 dead annually from the effects of substance abuse. Such abuse perpetuates a wide swath of societal difficulties such as avoidable emergency room visits (2.5 million each year), mass incarceration (up to 85% of the imprisoned populous crimes relate to substance abuse related offense), and health care expense (1/3 of all hospital costs).

In the early stages of the decade, the Industry was a patchwork of small providers – many led by former recovering addicts and passionate recipients of treatment. Payment for such services was dominated by cash payments provided by the patients and out of network (OON) benefits for those patients with private insurance. Private insurance reimbursement in comparison to other forms of medical services was insignificant, accounting for 20.8% of spending in 2017 compared to 57.6% of all medical expenditures.

More recently, commercial insurance reimbursements have become the principal source of payment for addiction treatment services, with an increase to 31% in 2017 from 19% in 2006. With significant

levels of reimbursements flowing within an emerging avenue of health care, commercial payors have begun to mount increased pressure on providers to establish in-network reimbursement programs, conversely placing an additional financial burden on providers.

Over the past decade, the Private Equity (PE) industry has allocated concentrated levels of capital to the Industry, acting as a financial sponsor to many providers seeking additional capital to fund growth. Increases in regulatory pressure, both on a state and federal level, as well as changes in reimbursement patterns from commercial insurance providers (an increase of in-network contracts), has renewed the need for professional capital as the scale and sophistication of front-end revenue responsibilities surrounding billings, collections and coding have become paramount. There also exists a robust opportunity for Industry consolidation as smaller regional and single location providers are forced to consider significant capital expenditures to, in effect, maintain pace with the latest treatment methods and to support clinical operations with foundational administrative strength regarding revenue cycle management, accounting capabilities, marketing, compliance, etc.

Investment Rationale

Based on extensive expertise in treatment operations, transaction support, and revenue cycle management, Windham Brannon ("WB") was contracted in November 2019 by a large northeast private equity sponsor, seeking to acquire a Texas-based addiction treatment company. The buyer was seeking assistance administering end-to-end services spanning a Quality of Earnings ("QoE") assessment, revenue cycle management review, Industry accounting, and strategic financial modeling grounded in a thorough knowledge of the Industry.

Investment rationale:

- The target offered an established national brand
- Strong referral network as organic lead flow accounted for 89% of converted admissions
- Favorable industry trends (YOY growth of 3.4% to $18.5B by 2022)
- Growing reimbursement support and understanding by commercial insurance companies
- The target offered a debt-free operation, industry-leading operating margins, strong cash flows, and a seasoned management team
- Highly effective treatment program whereby 80% of patients complete the program among all treatment entities

Transaction Diligence Challenges

Although the Company presented many attractive attributes, the family-owned nature of the operation made the entity a difficult acquisition target as the reliability of financial information, efficacy of billing and coding, dearth of proper forecasting and the entanglement of personal assets and expenses created significant investment obstacles.

The transaction was proposed as a cash deal with the requirement that the majority selling shareholder roll a sizable amount of equity and carry a seller note (accounting for 22% of total consideration). Both securities would eventually survive the transaction. The Company, though well managed, employed a modified cash basis of accounting in which insurance reimbursements were recognized as revenue upon receipt (cash basis). Moreover, the target deferred cash payments received at the time of admission until delivery of the services, at which time the related revenue was rightfully earned.

GAAP methodology was preformed around depreciation, vacation accruals, treatment of fixed assets, bonus accruals, etc.

The team had to first ensure that the financial statements were GAAP compliant, consistently applied to prior periods.

The target company issued internally prepared financial statements – as there did not exist a requirement for certified or audited financial statements issued by an external accounting firm.

To instill transparency surrounding the Company's revenue cycle, the team developed an 18-month waterfall model that demonstrated month by month cash collections and juxtaposed those amounts against gross billings by revenue source (each commercial payor). From this support work, the Company could reliably support revenue estimates starting in Q1 2019. WB was also charged with updating the QoE Report (originally completed in Q1 2019). The original report was judged to be incomplete based upon issues surrounding adjustments to EBITDA, revenue clarity, and support required for accounts receivable.

WB's revenue estimates coupled with the proper application of GAAP procedures materially reduced 2019 adjusted EBITDA but paved the way for clarity around future revenue expectations.

Once the QoE was complete, the team began to publish monthly financial statements while conveying the results to both the investor and the executive team. WB also issued a comprehensive Revenue Cycle Management Report ("RCM") in which several deficiencies were noted – all related to the sub-optimization of billing and coding. The report included commentary and specific recommendations around:

- Timeliness of Coding
- Timeliness of Billing and insurance payments
- Effectiveness of payment posting
- Accuracy of payment posting to payer data
- Accuracy of registration data

Additionally, the capital table included a minority shareholder holding common equity coupled with an outstanding loan facility. The relationship was poorly documented and became acrimonious as diligence progressed. Past distributions and formal agreements had to be researched and documented. WB produced an Equalization of Past Distribution Schedule for the benefit of legal counsel and the accounting firm working with the minority shareholder. We supported negotiations with the minority shareholder reconciling all past activity.

Finally, the team had to separate the entangled real estate so that a proper Operating Company ("OpCo") could be separated from the Property Company ("PropCo"). The team then commenced sale to leaseback negotiations around four commercial buildings utilized in the operations of the Company.

Upon the successful closing of the transaction in late Q1 2020, WB was charged with post-transaction integration support. Providing comprehensive integration services to ensure proper cash management and financial planning and analysis ("FP&A") via the implementation of a 13-week cash flow forecast, a daily revenue to operations tracker (cash, census, levels of care), in addition to an operating forecast model through 2022.

We expect to transition a full-time CFO and finance team in the next 60-90 days.

CONTACT US FOR MORE INFORMATION
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