



Danger Zone: Acadia Healthcare (ACHC)

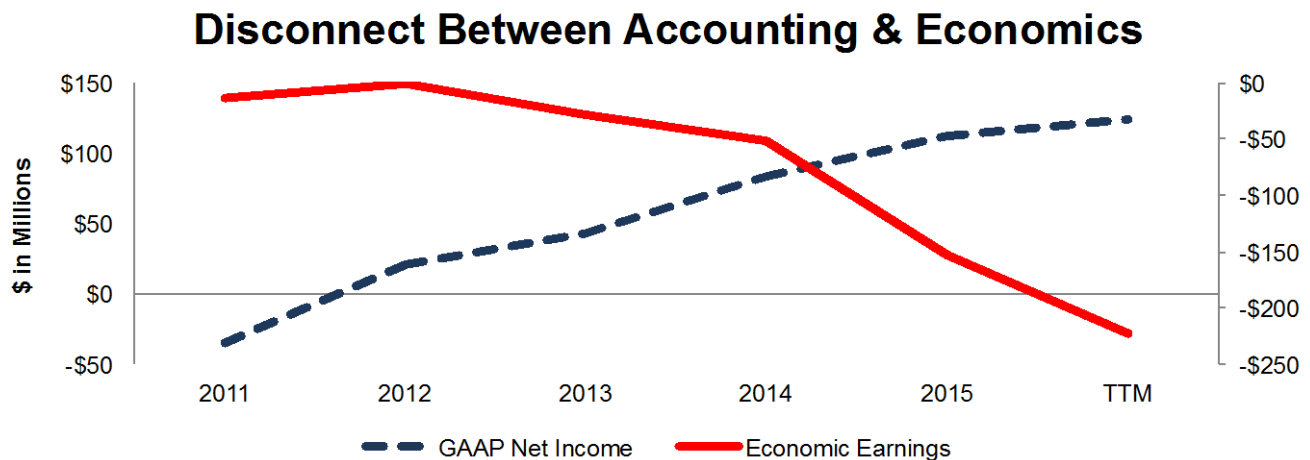
Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#) and Marketwatch.com

The [high-low fallacy](#) makes certain investments appear much more attractive on the surface. When one peers below the surface, the fundamentals of the business are often revealed to be in much worse shape. This week's Danger Zone pick has a history of executing a traditional roll-up strategy to great success - if you only care about revenue growth. For those that care about profits, the increasing losses and declining ROIC earn Acadia Healthcare (ACHC: \$55/share) a spot on [July's Most Dangerous Stocks](#) list and the Danger Zone this week.

GAAP Growth Masks Cash Costs of Acquisitions

Acadia's [economic earnings](#), the true cash flows of the business, have declined from -\$13 million in 2012 to -\$223 million over the trailing twelve months. These losses come despite GAAP net income growing from -\$35 million in 2011 to \$124 million over the last twelve months. See Figure 1. See the reconciliation of Acadia's GAAP net income to economic earnings [here](#).

Figure 1: Disconnect Between Revenue and Economic Earnings



Sources: New Constructs, LLC and company filings

The acquisition approach to growth accounts for the large discrepancy between the accounting earnings and economic earnings of ACHC. Since 2011, ACHC has undergone over 25 separate acquisitions, which have cost upwards of \$5.3 billion. While these acquisitions are “accretive” to EPS, they are highly dilutive to cash flows and ACHC’s balance sheet. From 2011-2015, Acadia’s debt grew 66% compounded annually to \$2.3 billion. Over the last twelve months, debt has ballooned to nearly \$3.8 billion, or 77% of the current market cap.

Smart acquisitions improve ROIC. ACHC’s acquisitions have not been smart. Since earning a 9% return on invested capital (ROIC) in 2012, the company’s ROIC has declined to a bottom-quintile 5% over the last twelve months. Similarly, ACHC has burned through cumulative -\$3.4 billion in free cash flow from 2011-2015, and over the last twelve months, FCF sits at -\$2.8 billion. No matter which way you slice it, ACHC’s acquisitions have drastically deteriorated the economics of the business.

Misaligned Executive Incentives Mean More Value Destruction To Come

Apart from base salaries, executives at Acadia receive annual cash bonuses and long-term stock-based awards. The cash bonuses are paid out for meeting adjusted EBITDA and adjusted EPS goals. As seen in Figure 2, these two metrics paint a much rosier picture than the economics of the business and have significant costs of business removed. Additionally, stock-based awards are given based upon meeting adjusted EPS goals and also have a time based vesting requirement. At the end of the day, the metrics chosen to incent executives do very little to create true shareholder value. By removing costs such as compensation expense or acquisition

costs, executives can grow the top line and adjusted metrics with little or no attention paid to the economics of their actions. The best way to create shareholder value, and align executives with the best interest of shareholders, is to tie performance bonuses to ROIC because there is a [clear correlation between ROIC and shareholder value](#).

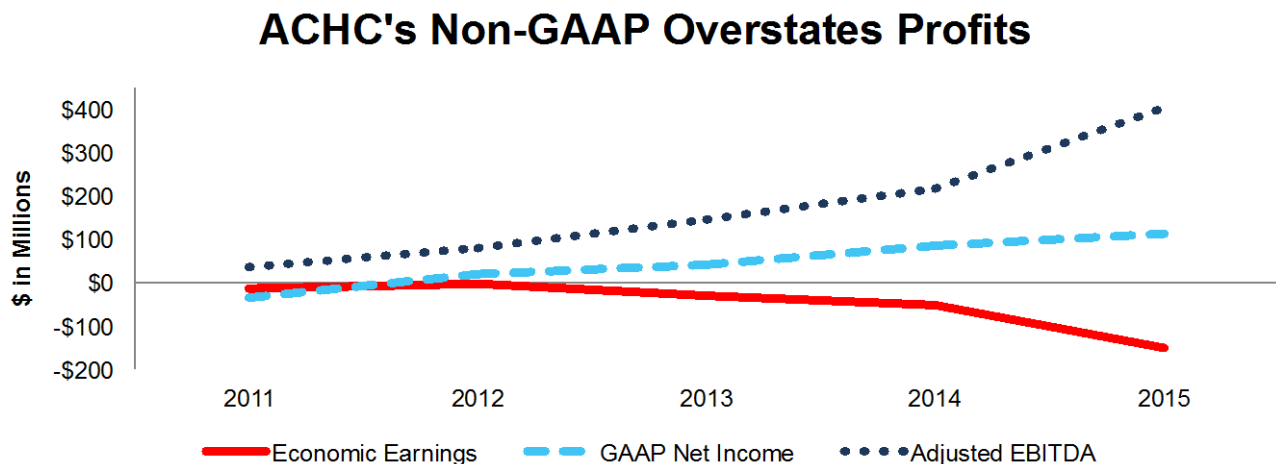
Misleading Adjusted EBITDA Rises While Profits Decline

While the decline in economic earnings is clear, investors following non-GAAP metrics would have a vastly different view of the firm. Companies routinely remove normal operating costs to create a more positive picture of business operations and ACHC is a poster child for the [dangers of non-GAAP earnings](#). Here are expenses ACHC has removed when calculating its non-GAAP metrics, including adjusted EBITDA and adjusted EPS:

1. Equity-based compensation expense
2. Transaction expenses related to acquisition
3. Sponsor management fees
4. Debt extinguishment costs
5. Loss/gain on foreign currency derivatives purchased in relation to acquisitions

These costs can be significant, particularly equity-based compensation expense and transaction expenses. In 2015, ACHC removed \$20 million (18% of GAAP net income) in equity-based compensation expense and \$36 million in transaction costs (32% of GAAP net income) to calculate its adjusted EBITDA. By removing these costs, along with the others, ACHC is able to report non-GAAP results that are much improved from economic earnings. Adjusted EBITDA grew from \$215 million in 2014 to \$405 million in 2015, 88% year-over year (YoY). GAAP net income grew “only” 36% YoY while economic earnings declined from -\$52 million to -\$153 million, or -194% YoY. This discrepancy, dating back to 2011, can be seen in Figure 2.

Figure 2: Misleading Non-GAAP Metrics



Sources: New Constructs, LLC and company filings

Lower Profitability Than Main Competitor: Acquisitions Not Adding Competitive Advantage

The behavioral healthcare industry is a specialized subset of the larger healthcare industry, and therefore has fewer true competitors. Acadia Healthcare competes primarily with Universal Health Services (UHS) and also hospitals and that may offer mental health services. By comparing ROIC, we can get a true measure across these specialized sectors to identify which firms are allocating their capital most efficiently. Per Figure 3, ACHC’s ROIC ranks below UHS and general hospital operators such as HCA Holdings (HCA).

When comparing margins its more apt to compare between UHS’s behavioral health segment alone, rather than hospitals in general where margins are impacted due to traditional hospital services. UHS’s behavioral health operating margin has topped 20% each year since 2011, and was 23% in 2015. Meanwhile, ACHC’s operating margin maxed out at 13% in 2014, and was 9% in 2015. Either way, ACHC has lower margins and ROIC than its direct competitor, which gives it less operational flexibility and pricing power.

Figure 3: ACHC's Profitability Hardly Matches Competition

Company	Ticker	Return On Invested Capital (ROIC)
HCA Holdings	HCA	14%
Universal Health Services	UHS	10%
LifePoint Health	LPNT	5%
Tenet Healthcare	THC	5%
Acadia Healthcare	ACHC	5%
Community Health Systems	CYH	4%

Sources: New Constructs, LLC and company filings

Bull Hopes Rest On Roll-Up Continuing

The bull case with all roll-up strategies revolves around the company continually finding new acquisition targets, purchasing them, and growing revenue and non-GAAP metrics.

With this in mind, ACHC has executed this strategy to perfection. However, the bull case unravels with each acquisition, as the ability to "move the needle" shrinks. An acquisition when a firm generates \$200 million in revenue is much more impactful than when the firm generates \$2 billion in revenue. Without revenue growth, roll-up strategies lose momentum, and the underlying economics of business are revealed for what they truly are.

Additionally, the current bull case would imply that the past acquisitions have been a quality use of capital, which as shown above, is simply not true. The market ultimately rewards firms that generate the highest return for each dollar of capital invested. In the short-term, ACHC can report non-GAAP metrics that stoke investor interest, but long-term, the economics of the business are trending in the wrong direction.

The largest risk to the bear case is simply time. As we know, the market can stay irrational longer than investors can stay solvent. There is no specific timeframe for roll-up strategies to slow down and the market wake up to the growing economic losses. In the meantime, another risk is that a hospital or other healthcare provider acquires ACHC. However, as we'll show below, only in the event a firm is willing to destroy shareholder value is ACHC worth more than its current share price.

Roll Up Scheme Worth Acquiring? Not If One Cares About Capital Allocation

The biggest risk to our thesis would be if a competitor were to acquire ACHC at a value at or above today's price. With the low to no growth environment in which many firms find themselves, large companies will overpay to create good optics or superficial EPS growth, regardless of the true economics of the deals. Unfortunately for those hoping for a buyout, we'll show below that Acadia Healthcare is not an attractive acquisition target because unless a competitor is willing to destroy shareholder value, an acquisition at current prices would be unwise.

To begin, ACHC has liabilities that investors may not be aware of that make it more expensive than the accounting numbers suggest.

1. \$123 million in [off-balance-sheet operating leases](#) (3% of market cap)
2. \$53 million in [net deferred tax liabilities](#) (1% of market cap)
3. \$12 million in [outstanding employee stock options](#) (<1% of market cap)

After adjusting for these liabilities we can model multiple purchase price scenarios. Even in the most optimistic of scenarios ACHC is worth less than the current share price.

Figure 4 shows what we think United Health Services (UHS) should pay for ACHC, given different growth scenarios that account for the capital outlay required to achieve such a scenario. UHS acquiring ACHC would increase its existing behavioral health segment while providing additional cross-treatment opportunities between its hospital care segment. However, there are limits on how much UHS would pay for ACHC given the cash flows being acquired.

Each implied price is based on a DCF scenario (linked below) assuming different levels of future revenue growth:

- [Scenario 1](#): 62% in (estimated) year one, 14% in (estimated) year two, and 11% in (estimated) year 3 and beyond.

- [Scenario 2](#): 62% in (estimated) year one, 14% in (estimated) year two, and 14% in (estimated) year 3 and beyond.
- [Scenario 3](#): 62% in (estimated) year one, 14% in (estimated) year two, and 18% in (estimated) year 3 and beyond

In each scenario, the estimated revenue growth rates in year one and two are equal to the consensus estimates for 2016 (62%) and 2017 (14%). For the subsequent years, we use 11% in scenario one because it represents the 5-year average revenue growth rate at UHS. We use 14% in scenario two because it represents a continuation of 2017 expectations. We use 18% in scenario three because it represents the average 2017 expected revenue growth rate of all mid to large cap health care firms under coverage.

Additionally, in each scenario, we assume ACHC's invested capital increases \$2.37 billion in year 1, which is equivalent to the change in fixed assets after the acquisition of Priory. This acquisition accounts for much of the revenue growth expected in 2016. We, then, conservatively assume that UHS can grow ACHC's revenue and NOPAT/free cash flow without any incremental capital outlays after year 1, an unlikely assumption, but nonetheless. We also assume ACHC achieves a 14% NOPAT/free cash flow margin. This margin is above UHS's NOPAT margin (9%), which is dragged down by its hospital care segment and above ACHC's current NOPAT margin of 12%.

The resulting implied values for ACHC in each scenario represent the maximum amount UHS should pay for ACHC, given the expected cash flows and the costs to achieve those cash flows.

Figure 4: Implied Acquisition Prices For UHS To Not Overpay For ACHC

Revenue Growth Scenario	ACHC's Implied Stock Value	\$ Value Destroyed For UHS	\$/ UHS Share Destroyed
20% CAGR for 5 years	\$13	(\$3,652)	(\$37.65)
22% CAGR for 5 years	\$21	(\$3,009)	(\$31.02)
25% CAGR for 5 years	\$31	(\$2,074)	(\$21.38)

Sources: New Constructs, LLC and company filings. \$ values in millions except per share amounts. \$ value destroyed equals the difference between implied price and acquisition at current market price plus net assets/liabilities.

Figure 4 shows that even if Acadia Healthcare can grow revenue 25% compounded annually, achieve 14% NOPAT margins, and require no excess capital spending (beyond year 1) for the next five years, the most UHS should pay for the firm is \$31/share – a 43% downside from current price. Note in even the most optimistic scenario that the average ROIC over five years only equals 9%, which is slightly below UHS's 10% ROIC. In order to achieve an ROIC equal to its current ROIC, UHS would either need to pay below \$31/share, or grow ACHC's revenue greater than 25% compounded annually while spending \$0 in incremental invested capital.

Without Acquisition, Shares Remain Overvalued

Without acquisition hopes, the expectations baked into the current stock price remain unrealistically high. Specifically, to justify the current price of \$55/share, ACHC must [grow NOPAT \(and free cash flow\) by 14% compounded annually for the next 12 years](#). In this scenario, ACHC would be generating over \$9 billion in revenue 12 years from now, which is greater than UHS's 2015 revenue and nearly double LPNT's 2015 revenue.

Even if we assume ACHC can [grow NOPAT \(and free cash flow\) by 12% compounded annually for the next decade](#), the stock is only worth \$30/share today – a 45% downside. Each of these scenarios also assumes the company is able to grow revenue and NOPAT without spending on working capital or fixed assets, an assumption that is unlikely, even if the firm ceased destructive acquisitions. However, this assumption allows us to create a very optimistic scenario. For reference, ACHC's invested capital has grown on average \$968 million (54% of 2015 revenue) each year since 2012.

Catalyst: Acquisitions Run Out Coupled With Regulation Roadblocks

While roll-up strategies can carry on for quite sometime but the downside when they run out has been well documented. We've previously analyzed firms engaging in a roll-up strategy, such as [InnerWorkings](#) (INWK), which fell 50% at its worst, and [Valeant](#) (VRX), which still trades down 65% from when we originally published these reports. The roll-up strategy either runs out of acquisition targets, or is no longer able to keep up the illusion of non-GAAP profits. As we saw with Valeant, non-GAAP earnings do not pay cash costs, and with ACHC's climbing debt, it could only be a matter of time before the roll-up runs out of steam. In this case,

investors would be forced to measure the firm on its fundamental merits, which as shown above, do not warrant a valuation anywhere near the current price.

Secondly, as with all acquisitions, each must be approved and upheld by the regulating body, whether in the U.S. or abroad. On July 14, 2016 it was announced that the U.K.'s Competition and Markets Authority referred Acadia's \$2.2 billion acquisition of Priory Group for investigation, as it could lower competition within the market. This acquisition is expected to more than triple ACHC's bed count in the U.K. and a finding that it stifles competition and cannot be completed could bring shares back to a more realistic valuation.

Lastly, the upcoming presidential election could provide a large negative catalyst for ACHC and many other healthcare providers. Under the current Affordable Care Act, mental health and substance abuse saw one of the largest coverage expansions. However, Republicans have made repeated, while unsuccessful, attempts to revoke much of the Affordable Care Act. Depending upon the winner of the 2016 election, these attempts could see a large increase. In 2015, 41% of U.S. revenue came from Medicaid, which Republicans have repeatedly proposed reduced funding, and 29% from commercial insurers. Changes to the ACA that in any way lower the coverage of mental health and substance abuse could have a material negative effect on ACHC's business.

Insider Are Selling While and Short Interest Grows

Over the past 12 months 12.6 million shares have been sold and 355 thousand have been purchased for a net effect of ~12.2 million insider shares sold. These purchases represent 14% of shares outstanding. As ACHC has fallen, selling has declined too, signaling insiders cashing in while ACHC's price was on the downturn. Additionally, there are 9.6 million shares sold short, or just over 11% of shares outstanding.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Acadia's 2015 10-K:

Income Statement: we made \$225 million of adjustments with a net effect of removing \$105 million in non-operating expenses (6% of revenue). We removed \$165 million related to [non-operating expenses](#) and \$60 million related to [non-operating income](#). See all adjustments made to ACHC's income statement [here](#).

Balance Sheet: we made \$1.2 billion of adjustments to calculate invested capital with a net decrease of \$36 million. The most notable adjustment was \$579 million (15% of net assets) related to midyear acquisitions. See all adjustments to ACHC's balance sheet [here](#).

Valuation: we made \$3.8 billion of adjustments with a net effect of decreasing shareholder value by \$3.8 billion. There were no adjustments that increased shareholder value. One of the largest adjustments was the removal of \$3.7 billion (77% of market cap) due to [total debt](#), which includes \$123 million in [off-balance sheet debt](#).

Dangerous Funds That Hold

The following funds receive our Dangerous-or-worse rating and allocate significantly to Acadia Healthcare.

1. Calamos Discovery Growth Fund (CIDGX) – 3.9% allocation and Very Dangerous rating.
2. Calamos Mid Cap Growth Fund (CMRX) – 3.8% allocation and Very Dangerous rating.
3. ICON Opportunities Fund (ICONX) – 3.7% allocation and Very Dangerous rating.

This article originally published [here](#) on July 20, 2016

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.



New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our [forensic accounting expertise](#) across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our [stock rating methodology](#) instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our [forward-looking fund ratings](#) are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.