Updated Thoughts on the Substance Use Disorder Space

Looking Ahead to 2025 in a Post-Trump Environment

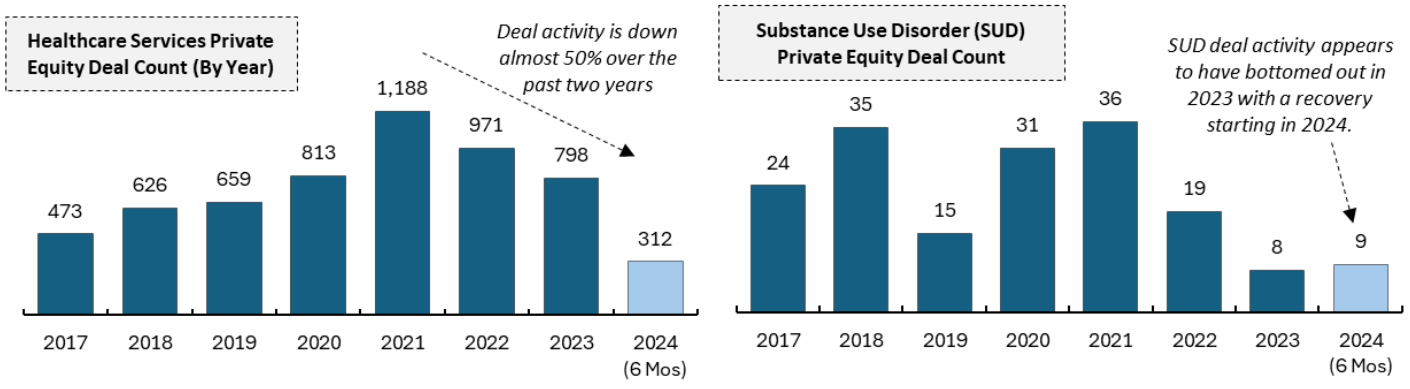
Last week, **we attended the *Behavioral Health Business* "*Executive Forecast: Substance Use Disorder Treatment in 2025*" Virtual Summit to get updated provider perspectives on the substance use disorder (SUD) marketplace.** The discussion included executives from *Hazelton Betty Ford*, *Bradford Health Services*, and *Boulder Care*.

The presentation reinforced our thesis that the SUD marketplace will experience significant consolidation and evolution in the coming years -- driven by 1) pressures on traditional fee-for-service reimbursement rates from managed care organizations, 2) a greater prevalence of value-based reimbursement models, and 3) a growing importance of data analytics and information technology. For more discussion, refer to our deep-dive research report on the SUD marketplace: ***Substance Use Disorder Market Update (Perspectives and Research)*** *(October 14, 2024).*

1) Early Thoughts on the Impact of a Trump Administration on SUD Providers

We agree with what appears to be the consensus view that M&A/deal activity among SUD providers will likely benefit from a more business-friendly Trump administration -- coupled with recent rate cuts by the Federal Reserve. Deal activity has been relatively quiet over the past year as investors have been forced to digest 500 basis points of rate hikes by the Federal Reserve over a roughly two-year period of time. However, we believe that there are a number of investors who are willing to put capital to work with smaller SUD providers who are open to consolidation in order to be able to offer a broader continuum of services and better scale patient acquisition costs. In fact, several providers at the Virtual Summit commented that current trends for patient acquisition costs are not sustainable. In particular, there has been a long predicted (but yet to be seen) wave of consolidation in the digital health space given the proliferation of vendors in 2021 and 2022. A possible harbinger here would be the recent acquisition of Lionrock Recovery by Brightside Health, essentially creating an end-to-end digital behavioral health and SUD platform. Refer to Figure 1.

Figure 1: Healthcare Services and SUD Deal Activity Finally Appears to be "Bottoming Out"



Source: Pitchbook (Healthcare Services Report; June 2024) and Bourne Partners

Several providers at the Virtual Summit voiced concerns over potentially reduced federal support for Medicaid under a Trump administration. Medicaid is a disproportionately large funding source for SUD patients accounting for 21% of all Americans with a mild, moderate, or severe SUD (or upwards of 10 million Americans). So, this is, of course, a valid

concern. However, we have heard other arguments that Medicaid might (paradoxically) expand under Republican leadership. There are ten states that have not expanded their Medicaid programs under the *Patient Protection and Affordable Care Act* (the ACA). A second Trump term could lure a few "red" states into the ACA Medicaid expansions by allowing the implementation of "work requirements." Section 1115 waivers for work requirements were pushed by the first Trump administration as a way to encourage people to evolve off of Medicaid dependency by requiring them to demonstrate they are seeking employment (or are active in some kind of community service). During Trump's first term, thirteen states implemented work requirements, but President Biden subsequently revoked them.

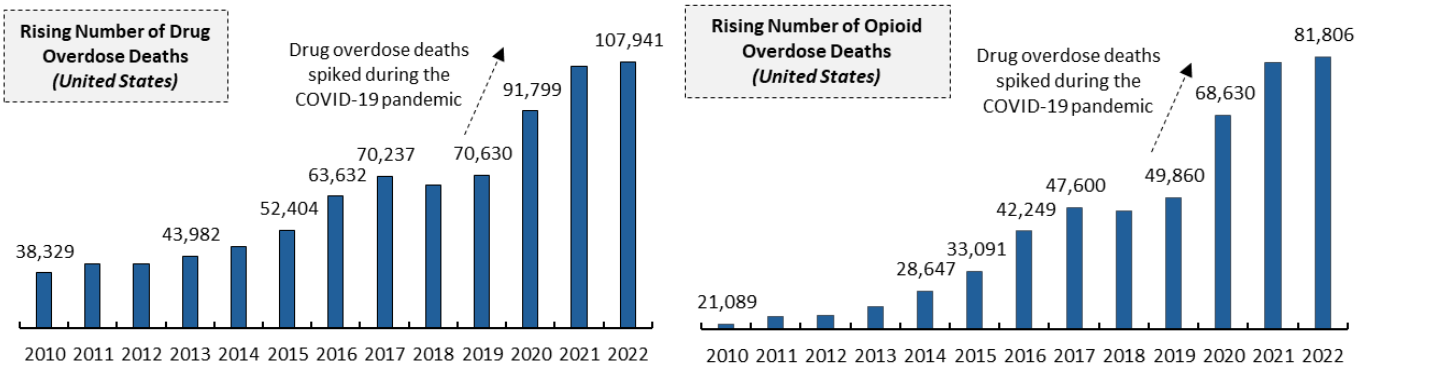
2) A More Flexible Regulatory Environment for SUD Providers

Within one week of his election victory, **President-Elect Trump is already promising to reduce regulations on all businesses** to give them more flexibility. Early in his first term, Trump issued Executive Order 13771 (Reducing Regulation and Controlling Regulatory Costs) in which he directed his agencies to eliminate two rules for each new rule added. He subsequently established a Regulatory Reform Task Force to govern this process. Going into this year's election, at a speech at the New York Economic Club, Trump promised to accelerate this de-regulation by eliminating ten new regulations for each new regulation added.

Two areas of favorable regulation under the Biden administration were highlighted at the Virtual Summit.

1) Patient Privacy. Several providers at the Virtual Summit echoed our view that recent updates to patient privacy regulations earlier this year (i.e., 42 CFR Part 2) could be a significant potential catalyst for the SUD space with respect to information technology adoption and the use of value-based reimbursement models. The reformed CFR 42 Part 2 regulations will now allow SUD providers to better share patient information by only requiring a single consent across multiple providers that care for a patient. Providers have long cited previously burdensome privacy regulations as a barrier to coordinate patient care as well as a contributing factor to the relatively slow adoption of electronic health record (EHR) and clinical software systems. Also, streamlined SUD privacy regulations will allow for greater access to patient data, which, in turn, should allow for better tracking of patient outcomes. This should help quality SUD providers to differentiate themselves in the eyes of health plans, employers, and patients.

Figure 2: Medication Assisted Therapy is Crucial for Those Suffering from Opioid Addiction Disorder



Source: U.S. Department of Health and Human Services (February 2024)

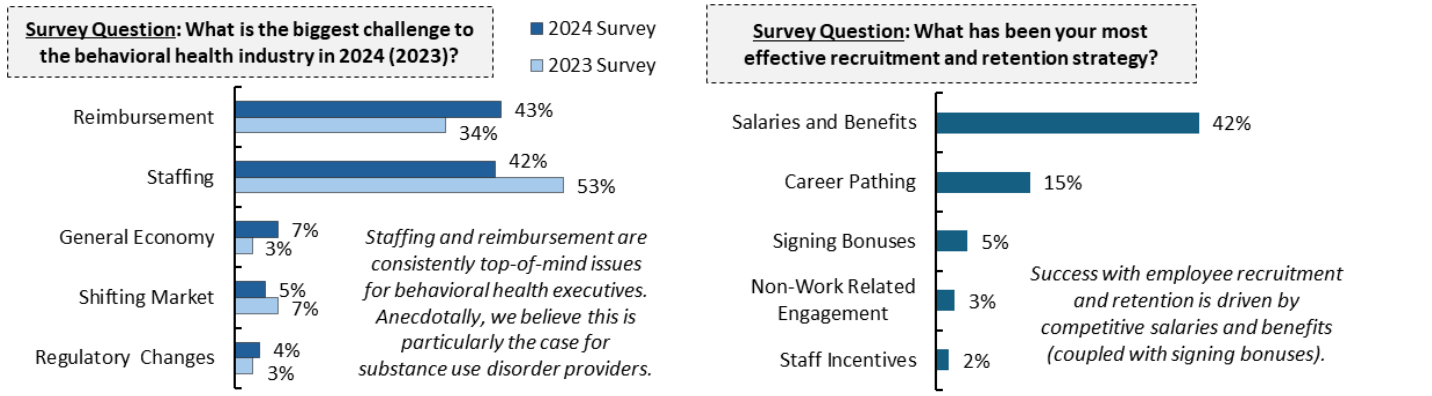
2) Medication Assisted Therapy (MAT). Another area of recent regulatory flexibility that came up in discussions at the Virtual Summit was in the area of MAT. MAT involves the use of medications (e.g., methadone, buprenorphine, and naltrexone) to treat certain SUDs. These medications can help to block the effects of opioids, halt withdrawal symptoms,

and reduce cravings. In April, the Substance Abuse and Mental Health Services Administration (SAMHSA) loosened the restrictions on patients maintaining supplies of certain drugs at home. Some medications, such as buprenorphine, can be prescribed by a physician and taken at home. However, other medications, such as methadone, can only be prescribed and dispensed at a federally certified clinic. Thus, patients needing these medications essentially have to physically visit a clinic daily (dealing with long lines, counseling requirements, and appointment scheduling) in order to take their MAT while a provider observes. Temporary COVID-19 regulations relaxed this requirement and allowed patients to take home 28 days of doses. The SAMHSA has made these new related rules permanent. Refer to Figure 2.

3) Labor Costs and Shortages

Staffing remains a major topic in any discussion on the SUD space. We believe that labor accounts for about two-thirds of the cost structure of a typical SUD provider, and access to labor is a precondition to any growth strategy. In the face of rising labor costs (and shortages), a strategy here is to use artificial intelligence (AI) software to automate administrative and documentation burdens on staff -- e.g., credentialing, licensing, coordination with other providers, messaging, charting, etc. This helps improve employee satisfaction (and, in turn, increases retention). Also, panelists at the Virtual Summit highlighted new AI applications that enhance employee recruitment by predicting the success of a candidate and subsequentially tracking employee satisfaction to pre-empt attrition. Finally, we heard several providers reference the importance of partnerships with graduate schools and universities. Refer to Figure 3.

Figure 3: Staffing Remains a Top Area of Focus for Behavioral Health and SUD Providers



Source: Behavioral Health Business (2024 Behavioral Health Outlook Survey and Report)

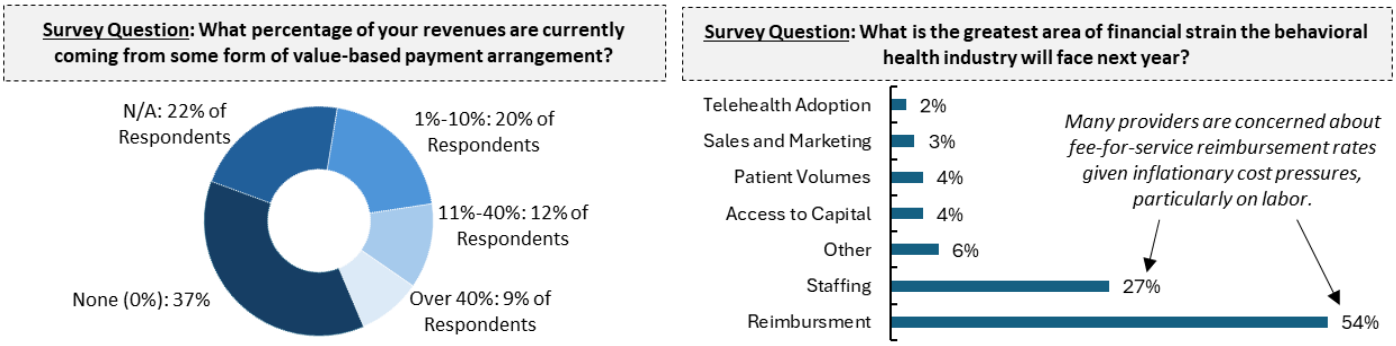
Of note, **patient no-shows were highlighted as a major drag on labor capacity.** The typical way for SUD providers to deal with no-shows is to double-book patients and charge no-show fees. One SUD provider at the Virtual Summit, Boulder Care, discussed a newly launched on-demand virtual SUD service (called the "Pop-In Clinic"), which allows patients near immediate access to care. Easy to access digital SUD solutions are common for patients who are commercially covered and who pay out-of-pocket. However, they are rare in the Medicaid space. Within about a year of its being launched Boulder Care is seeing improved patient retention and satisfaction. Also, this real-time access solution has materially increased the ability of Boulder Care to provide care to more people with its existing labor force.

4) The Use of Value-Based Reimbursement Models

The use of value-based reimbursement models and partnerships with managed care plans are two final topics that we heard discussed at the Virtual Summit. In our view, quality SUD providers should welcome value-based reimbursement models as a way to differentiate themselves for health plans, employers, and patients and to capture the full economic

value of their services -- as well as to avoid the inevitable pressures of fee-for-service reimbursement. Providers at the Virtual Summitt reported an increasing interest by employers with respect to workplace SUD initiatives. Also, in recent years, there appears to be a growing appetite among private Managed Medicaid plans to offer bonus payments to SUD providers who can sustainably demonstrate specific quality standards and patient outcomes. Today, we estimate that the average SUD provider generates less than 10% of its revenues from value-based arrangements, based on our conversations with executives. Refer to Figure 4.

Figure 4: Value Based Reimbursement Is Still Nascent in the SUD Space



Source: Behavioral Health Business (2024 Behavioral Health Outlook Survey and Report)

In our view, **value-based reimbursement leads to more collaborative relationships with managed care plans, employers and at-risk provider organizations**. SUD providers at the Virtual Summit highlighted the importance of understanding the pain points and expectations of their payers. This requires an information technology infrastructure that allows for the sharing of patient outcome data. The risk with value-based contracts is that payers will want to update performance metrics as contracts renew. (This can result in the "moving of goal posts" to the disadvantage of the provider.) To avoid this, SUD providers really need to know what they are good at before they attempt to negotiate these contracts. We believe an incremental approach can sometimes make sense -- i.e., focusing initially on taking-on risk in targeted areas where the provider has relative strength. As the provider gains experience and as trust builds between the provider and the payer, the contract can be expanded gradually into different areas.

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