AAC Holdings, Inc.

NYSE:AAC

Analyst: Andrew Varone
Sector: Healthcare

BUY

Price Target: $30.80

Key Statistics as of 11/12/2015

Market Price:	$22.50
Industry:	Specialized Health Services
Market Cap:	$503.21M
52-Week Range:	$15.09-46.60
Beta:	1.19

Thesis Points:

- High Grow Potential Through Macroeconomics
- Stock Undervalued Due to Pending Lawsuit
- Growth Stock Evident By Financial Growth

Company Description:

AAC Holdings, Inc. provides inpatient substance abuse treatment services for individuals with drug and alcohol addiction. The Company's staff deploys research-based treatment programs for detoxification, residential treatment, partial hospitalization, and outpatient care. AAC Holdings operates substance abuse treatment facilities throughout the United States.

Thesis

AAC Holdings is a BUY as it is positioned to gain market share in a $35B industry that is currently highly fragmented. As the only publicly traded company, they are positioned the raise capitals that privately traded companies are unable to do. This access to new capital has allowed them to have tremendous growth in the past twelve months since they released their IPO last fall. This growth is then fueled by the macroeconomics due to political change being needed. The high amount of incarceration makes the need for alternatives. The stock has recently seen a loss due a pending lawsuit the company has. The huge dip in stock price the company saw means an entry for new investors. Despite the potential distractions from this lawsuit, the company has still beat expectations in revenues and EPS and has the source of capital needed to continue their growth through pipeline beds in their inpatient facility and through acquisitions and startups. The target price of $30.80 will give the company an upside potential of 37%.

Industry Outlook

The U.S. addiction rehab industry is a $35B industry where twenty-three million people will fall victim to the chronic disease of addiction. Despite the high demand, only 2.5 million persons received treatment. This is due to many facilities being filled to capacity, insurance coverage for addiction rehab is limited and very little understanding is present from an entire society. Currently, the industry is highly fragmented with over 16,700 clinics and centers operated. The largest treatment advisors in this industry only have 1.4% of market share.

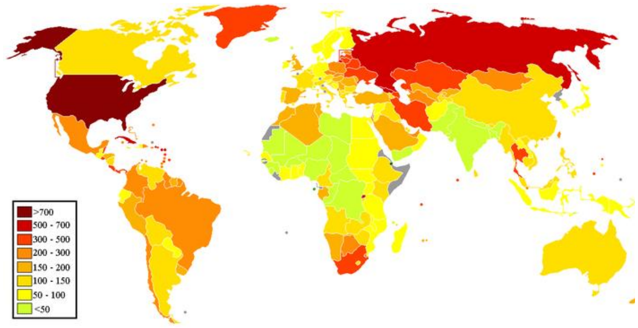
AAC's competitive advantage comes from the makeup of the enterprises instead of this industry. Out of the 8,100 enterprises in the United States, 67% are not-for-profits. AAC is also an inpatient center where only 26% of the industry in inpatient. Lastly with more than 1,500 employees, AAC is part of the 56% of the industry that have more than twenty employees.

Organic Growth

Currently, AAC operates nineteen substance abuse treatment facilities and one mental health facility specializing in binge eating disorders. They currently have 915 beds for inpatient treatment addictions and operate the following states for inpatient and outpatient addiction rehabilitation: Nevada, Texas, California, Florida, Tennessee, Mississippi, and New Jersey. Looking forward, AAC has 300 beds in their pipeline in increase their capacity and capture the excess demand that is available in the industry. They are planning to add 150 beds in 2016 which includes opening a new inpatient facility in California that will house 84 beds. The other 150 beds that are in the pipeline will be in used in 2017 with another facility that is opening up in New Jersey. Both of these facilities are owned by AAC and are both de novo startups. In the past twelve months, AAC has almost tripled the amount of bed in their pipeline. Being able to continue this growth will allow them to capture greater marketshare.

Mass Incarceration

The United States have a major economic issue in mass incarceration. Currently, the United States has roughly 5% of the population but, has 25% of its inmates.



With over 1.2 million locked up in state prisons, 750,000 in local jails and 200,000 in federal facilities, a total of 2.2 million are locked up. Mass incarceration has been gaining national attention not only because the United States outranks everywhere, the cost to house these inmates and run these penitentiaries is extravagant. It is estimated that local, state and federal governments spend anywhere from $20,000 to $50,000 for each inmate that is kept in these facilities. This translates to $80B that the U.S. spends every year on incarceration.
The American Civil Liberties Union, a program started to reduce the use of the criminal justice system to addresses social issues, believes that by 2020 the number of those incarcerated will be cut in half. This will have a ripple affect into the addiction rehabilitation industry. Drug arrest account for a quarter of the people that are locked in America. This has been a part of ineffective War on Drugs which has spent trillions of dollars over the past forty years without impacting usage as drug usage rates remain steady.

Changing Political Opinions

The Democratic Party has had views that will hurt healthcare revenues due to putting a cap on prescription drugs. This has caused many healthcare stocks to see a decline in their prices. Addiction rehabilitation is not following the same trend as they believe the War on Drugs is inefficient. The Democratic Party has been known for funding social programs which will include addiction rehabilitation. There has been a social push because of the high rate of incarceration. It is believed that instead of throwing in jails those who suffer from addiction, it will be better served having those suffering attend addiction rehab.
What has been big news in the past few weeks is Republican candidate, Chris Christie, speaking out on this issue of drugs. His entire argument can be summed up in one statement, there has been the surgeon general's statement on cigarettes increasing one's risk for cancer. If those who do not listen to the warning and continue to smoke and happen to develop cancer, society does not say that individual got what they deserve. Instead, they are offered all different treatments to help suppress and cure the cancer. This means that those struggling with addiction should not be blamed for gaining their addiction and throw into jail. They should receive help to help fight the addiction that they currently face.
Despite Chris Christie only bringing in 2% in the polls, the fact a Republican Candidate has this view on drug addiction shows the changing of society. Drugs will be a major point of emphasis of this upcoming presidential debate. Changing governmental spending from incarnating to rehabbing could cost government cost by two-thirds. This transition from incarnating to rehabbing will also increase demand of such facilities and offer a form of payment through government spending.

Undervaluation

Since its IPO in fall 2014, AAC has been steadily climbing up until it reached its peak of around $40 this July. At the end of July, it surfaced that there was deaths in the facility and members of the company including CEO, Jerrod Menz, faced second-degree murder charges. This caused the stock price to go down by 50% in the following days. Another lawsuit was filed later by a stakeholder that purchased shares earlier in August. The stock market did not react as much to this because the company argued of the lack of merit that the shareholder had. The shareholder purchased shares of the stock after the incident made news. The company is currently undervalued due to estimation that the lawsuit causing financial loss and impeding further growth.
The CEO has stepped down but still works for the company. He has been replaced by Michael Cartwright who has been on the board since 2011. Michael Cartwright has 20 years of industry experience as well as publishing a book titled "Believable Hope". Since Jerrod Menz stepped down, this gives him an opportunity to deal with the upcoming lawsuits while also lessening the distraction caused to the company.

The Lawsuit

The Lawsuit stems from an incident that occurred in 2010 where a patient died in their Californian Facility. There was accusation that the patient died due to mishandling and abuse but, the autopsy show that the patient died of natural causes. There was also a civil settlement that was finalized in 2014 with the widow of the patient. The arraignment was set for October 1st for the criminal charges but has been later pushed back to December 1st.

Despite the negativity surrounding the case, there is a positive outlook to be had. The first being is the nature of the business. The people that check into these facilities have thrown their lives away to get their fix from their addiction. They will go to any measure necessary if it means receiving that fix. There is going to be deaths within these facilities as it is the nature of the business. If the deaths were not caused from neglect or mishandling of controlled substances, not legal charges should be brought upon the facilities. Also, the facility named in the incident has had to renew six of their detox beds. On September 1st, all six were renewed for two years by California's Department of Health Services.

Pressure from Investors

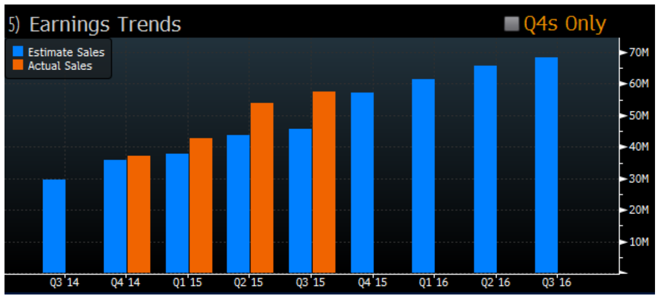
The last reason for undervaluation is pressure for short sellers on the stock. Being a small cap stock, there is little coverage from analysts. This continues to holds true on popular stock blog sites where users can submit their research on any stock. The small cap stocks will continue to have little interest on these sites. What is interesting with AAC stock is that despite being small cap, there has been high coverage over a six month period. Over six months, there was three articles submitted that said to short AAC due to different allegations raised in the articles. The first two articles did not reflect what was going to happen as the stock increased instead of decreasing. The last article written was based on the pending lawsuit and was a catalyst for the stock price dropping 50%. What makes this situation even more interesting is that the individual writing these articles about shorting AAC had already shorted AAC. Because of this, the market was over influenced causing the stock price to go lower than what it is actually worth.

Deerfield Partnership

AAC has entered into a $50M capital commitment with Deerfield. Deerfield is AAC largest institutional shareholder and leads healthcare specific investors with $6B under management. This capital is going to be used for AAC to help fund beds in their pipeline, mergers and acquisitions and for other de novo startups. $25M is convertible debt which will mature in 6 years and bears 2.5% interest rates. Also, it will have the convertible feature at $30 per share conversion price. Another $25M is available to the company through October 1st of next year. This will have a 5 year maturity and bears 12% interest rate. Lastly, there will be no prepayment penalty through 10/1/2017.

Financials

Despite the lawsuit surrounding the company, the company continues to operate and outperform analyst expectations. For this last quarter, they outperformed revenues by 23%, EBITDA by 15% and EPS by 50%.



They have also surpassed the sales for every quarter that they have been in business. With the growth of more beds, they should continue to surpass the estimated amount of sales from analysts. They have had a growth in debt due to the increase in their acquisitions and purchasing of beds in the pipeline. They also have had positive cash flows which will give them the choice to repay or refinance the majority of their debt when they come due in 2020.

AAC has a specific target market that focuses on higher pay. They can receive this higher pay for inpatient care because of the amenities that are offered in their facility. They do not focus on public or Medicaid/Medicare types of pay. This have no low marketing cost associated with them but, they have lower margins. They focus on in network, out of network and private pay for their services. These type of services require a higher marketing cost but they receive a higher margin for the services that are given.

Porter's 5 Forces

The threat of new entrants is low. To open a new inpatient facility, there is significant capital cost required. This is due to the high expenses with regards to the buildings and the equipment needed. There is also barriers of entry with running the business. To have detox beds for inpatient facility, they need to be approved by the state's department of health.

The threat of substitution is low-neutral. This is due to the drugs themselves. For a drug such as tobacco, there are multiple substitutes that people can will do instead of going to rehab. These includes the patches, gums and any other kind of methods for getting rid of the addiction. For drugs that are not controlled, there are not as many resources for them to beat their addiction. Because of this, there is very little threat for new entrants in this industry.

Bargaining power of buyers is low-neutral. This industry is fueled by people getting addicted to drugs. Since addiction is partially hereditary, there are people who become addicted to drugs after one use. On the other side, there are people who have been using certain drugs for life and have yet to become addicted.

The bargaining power of suppliers is neutral. Since they do not have deal with government insurances, they are not locked into the rates that they are charging. Since they deal with the patient themselves or their company, they are not susceptible to the rates that the government wants to charge. The only way for them to be affected by rates would for the government to set a cap like has been proposed for prescription drugs.

The threat of rivalry is high. The industry is highly fragmented with many company's owning little market share. Despite AAC being positioned well in the industry, there are going to be patient's that only go to these competitors. They also have capacity to the amount of customers they can see until more beds are added. This allows rivals to enter the market.

Summary

AAC is considered a BUY because of the upside that the company's has. They are in a highly fragmented industry where they have seen growth with the capacity of their facilities over the past year. The changing views of drugs and those struggling with addiction will fuel an increase of those that needed inpatient rehab. AAC is also considered a BUY as the price has taken a huge hit due to the incoming lawsuit. This has not affected the company's ability to grow as they have continued to beat analyst's predictions.

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AAC Holdings, Inc.	AAC	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 49.86%	BULLISH
		Andrew Varone	$22.56	$30.80	$33.81	0%		

General Info

Sector	Healthcare
Industry	Healthcare Providers and Services
Last Guidance	October 27, 2015
Next earnings date	February 24, 2016

Market Data

Enterprise value	$616.72
Market Capitalization	$4,449.48
Daily volume	0.22
Shares outstanding	22.41
Diluted shares outstanding	21.42
% shares held by institutions	26.01%
% shares held by insiders	61.37%
Short interest	25.45%
Days to cover short interest	14.24
52 week high	$46.60
52-week low	$15.09
5y Beta	0.00
6-month volatility	98.91%

Peers	Market Cap.
Acadia Healthcare Company, Inc.	$4,932.17
HCA Holdings, Inc.	$27,582.80
AmSurg Corp.	$3,912.56
Universal Health Services Inc.	$11,896.90
Community Health Systems, Inc.	$3,323.31

Current Capital Structure

Total debt/Common Equity (LTM)	0.29
Cost of Borrowing (LTM)	3.18%
Estimated Cost of new Borrowing	6.36%
Altman's Z	NA
Estimated Debt Rating	CCC
Current levered Beta	1.19
LTM WACC	10.56%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Cartwright, Michael	Chairman and Chief Executive Officer	$0	$1,928,177	$1,852,986
Phillips, Kathryn	General Counsel and Secretary	$0	$0	$1,679,646
Manz, Kirk	Chief Financial Officer	$0	$0	$0
Henderson-Grice, Candance	Chief Operating Officer	$0	$912,030	$0
McWilliams, Andrew	Chief Accounting Officer	$0	$0	$0
Stetar, Michael	Chief Technology Officer	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	23.01%	15.33%	50.00%	10.51%
Last Quarter-1	19.88%	56.54%	106.25%	25.03%
Last Quarter -2	10.28%	30.37%	50.00%	11.47%
Last Quarter -3	4.03%	17.56%	77.78%	22.67%
Last Quarter -4	20.20%	63.02%	114.29%	27.20%
Standard error	3.6%	9.9%	13.5%	8.88%
Standard Error of Revenues prediction	3.6%			
Imputed Standard Error of Op. Cost prediction	9.2%			
Imputed Standard Error of Non Op. Cost predictio	9.3%			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (88th Percentile), Bargaining Power of Customers (71th Percentile), Intensity of Existing Rivalry (50th Percentile), Threat of Substitutes (100th Percentile), Threat of New Competition (58th Percentile), and Overall (86th Percentile).

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 10 years

General Assumptions

Money market rate (as of today)	0.37%
Risk-Free rate (long term estimate)	2.93%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	7.0%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$175.30
FY2015	20.3%	$210.80
FY2016	25.8%	$265.20
FY2017	22.0%	$323.56
FY2018	18.8%	$384.52
FY2019	16.2%	$446.80
FY2020	14.0%	$509.35
FY2021	11.8%	$569.45
FY2022	9.6%	$624.11
FY2023	7.4%	$670.30
FY2024	5.2%	$705.15
Continuing Period	3.0%	$726.30

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Sub-industry)	Adjustment per year
Operating Cash/Rev.	0.00%	0.00%	0.0%
NWV/Rev.	22.07%	8.58%	-1.3%
NPPE/Rev.	55.35%	34.29%	-2.1%
Dpr/NPPE	6.35%	14.43%	0.8%
NOPAT MARGIN	12.08%	9.18%	-0.3%
Op. Exp./Rev.	78.92%	79.00%	0.0%
SBC/Rev.	2.53%	0.54%	-0.2%
Rent Exp./Rev.	1.20%	0.00%	-0.1%
R&D/Rev.	0.00%	0.39%	0.0%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	18.52%	11.03%	-0.7%
ROIC	50%	20.28%	-2.96%
EV/Rev.	3.00x	2.04x	-0.10x
EV/EBITA	16.87x	13.87x	-0.30x
Debt/Equity	29%	183%	15.4%
Unlevered beta	1.01	0.41	-0.06
Dividends/REV	0%	1%	0.0%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Money market rate
Other claims on the firm's assets	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
R&D expenses are not capitalized
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (6.79%, 7%, 7.21%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.09
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Implied Enterprise Value	Net Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	49.9%	10.6%	$155.20	$738.23	$133.61	22.41	$30.44
FY2015	33.1%	10.2%	$176.79	$783.44	$125.68	22.41	$33.50
FY2016	19.3%	8.7%	$210.02	$850.87	$134.69	22.41	$36.10
FY2017	19.3%	8.6%	$241.37	$914.74	$135.98	22.41	$38.97
FY2018	19.4%	8.4%	$269.36	$972.59	$128.02	22.41	$42.14
FY2019	19.7%	8.1%	$292.83	$1,022.30	$109.59	22.41	$45.59
FY2020	20.1%	7.9%	$310.96	$1,062.15	$79.90	22.41	$49.34
FY2021	20.6%	7.6%	$322.19	$1,089.94	$37.59	22.41	$53.40
FY2022	21.3%	7.3%	$325.30	$1,104.03	-$18.10	22.41	$57.80
FY2023	22.2%	7.0%	$319.57	$1,103.55	-$87.19	22.41	$62.55
FY2024	23.3%	6.7%	$304.91	$1,088.55	-$168.78	22.41	$66.85
Continuing Period	17.0%	6.8%	$286.51				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $30.8; the 3σ(ε)-adjusted target price is $33.81; and the analysts' median target price is $30.88

Sensitivity Analysis

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance