NJHMR
HEALTHCARE MARKET REVIEW

BRACH | EICHLER LLC

Private Equity and Hospital Transactions: Is There Really a Second Bite at the Apple? Perspective Post-Transaction

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Ray Iannaccone, MD, FACEP
CEO
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Thomas J. Reck, CPA/ABV, CFF
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PANELISTS

Isabelle Bibet-Kalinyak, Esq.
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A seasoned and creative problem-solver, Isabelle Bibet-Kalinyak, Esq., concentrates her national healthcare practice representing clients in complex business transactions including private equity transactions, mergers, and strategic partnerships, HIPAA privacy and security compliance matters, ownership and compensation arrangements, employment and partnership negotiations, medical staff matters, and fraud and abuse issues including compliance with the Stark Law and the Anti-Kickback Statute. She works with management teams and boards of directors on the legal and strategic implications associated with various forms of corporate entities and healthcare integration models.

Isabelle leverages her keen affinity for the healthcare industry and her deep knowledge of that sector to serve as a trusted legal advisor to health systems, specialty hospitals, telemedicine virtual platforms, physician group practices (anesthesia, behavioral healthcare, chiropractic, dermatology, family practice, internal medicine, gastroenterology, OB-GYN, male and female fertility specialists, ophthalmology/optical, pathology, pediatrics, psychiatry, radiology, surgery, urology, veterinary), ambulatory surgical centers, dialysis facilities, laboratories, long-term care facilities, and individual physicians on a broad range of complex healthcare matters involving corporate, compliance, licensing, fraud and abuse, HIPAA, business alignment, life cycle management, Medicare and Medicaid rules, and other payor matters.

PANELISTS

Robert C. Goettling, Esq.
Principal, The Bloom Organization

Bob Goettling has thirty years of experience in the healthcare industry. He primarily focuses on the transactional aspects of physician practices, ambulatory surgery centers (ASCs), physician joint venture projects with health systems, private equity firms, and strategic buyers throughout the United States. Since 2007, Mr. Goettling has led The Bloom Organization's transaction services team. He is a licensed investment banker and securities principal. Mr. Goettling has been instrumental to The Bloom Organization's mergers and acquisitions advisory group, which has become the leading physicians sell-side advisory firm closing over $7 billion in transactions.

Before joining The Bloom Organization, Mr. Goettling co-founded NovaMed, Inc. (Nasdaq: NOVA), one of the original practice management firms in the 1990s, where he held a variety of senior-level executive positions during his twelve years with the company, including senior vice president of corporate development. Mr. Goettling had operational and development responsibilities and conducted numerous acquisitions, divestitures, and mergers while heading NovaMed's development team for over ten years. Mr. Goettling also had operational responsibilities for ASCs and physician practices during his years with NovaMed. After joining Henry Bloom, president and founder of The Bloom Organization, as the two pioneers of sell-side physician representation, they represented HIG Capital and its ASC company, Surgery Partners (Nasdaq: SGRY), which acquired NovaMed in 2011.

PANELISTS

Ray Iannaccone, MD, FACEP

CEO, Eastern Dental Management

Ray Iannaccone, MD, FACEP, is the CEO of Eastern Dental, a PE-backed DSO operating in the Northeast market. The company was acquired in mid-2020 after the prior PE firm narrowly avoided bankruptcy. Ray built a team of executives, stabilized the professional group, negotiated new rates with payors, and executed a rigorous review of costs. The company has had 30% revenue growth, 135% site-level EBITDA growth, flat corporate overhead, and a 12-point swing in EBITDA margin, with positive cash flows. He is planning additional improvements to margins and preparation for a growth phase or sale.

Prior to Eastern, Ray worked for Teladoc for almost a year helping them build out their provider network, compensation structures, and matching algorithms in order to deal with the unprecedented demand brought on by the pandemic. Before that, he served as the COO for Alteon, a PE-backed Emergency Medicine company that was rolling up regional groups. During this time, he also served as a board member for a medical imaging company that had a successful exit in 2020.

PANELISTS

Thomas J. Reck, CPA/ABV, CFF
Partner, Withum

Professional Experience

- Provides forensic accounting and business valuation services to New Jersey Courts, attorneys, corporations and individuals.
- Performs investigations pertaining to damage claims, business litigation, mergers and acquisitions and matrimonial matters.
- Provides business valuations, cash flow and lifestyle analysis, asset tracing and mediation services in matrimonial matters.
- Valuation services specific to the healthcare industry including various types of physician practices and ambulatory surgical centers.
- Forensic and Valuation services specific to the automotive industry.
- Valuation services specific to the restaurant and leisure industry.
- Compensation analysis for various industries including the healthcare industry specific to productivity metrics.

MODERATOR

John D. Fanburg, Esq.
Managing Member, Brach Eichler LLC

John D. Fanburg has more than 35 years of experience in health and hospital law, with an emphasis on corporate, transactional, and regulatory matters for physicians and healthcare institutions. John is known for providing strategic advice and transactional legal guidance in corporate M&A and regulatory matters.

John’s clients include major hospitals, multi-specialty and single specialty medical groups, ACOs, ambulatory surgery centers, ambulatory care facilities, investors in private equity transactions, imagery centers, laboratories, physician specialty organizations and IVF providers. His clients include local and national health care providers. John helps healthcare providers position themselves to deal with the constantly evolving medical marketplace, particularly healthcare reform. This includes advising clients about mergers and acquisitions, private equity transactions, various business ventures, and creative healthcare business arrangements.
In addition, as Co-Chair of Brach Eichler’s Cannabis Industry Practice, John provides counsel to companies and individuals who seek to participate in New Jersey’s growing medicinal cannabis industry.

THE CASE FOR GROWTH

	Current Year	Year 1	Year 2	Year 3
Revenues – Flat	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Labor and overhead – 5% increase	$1,400,000	$1,470,000	$1,543,500	$1,620,675
Net revenue before shareholder increase	$600,000	$530,000	$465,500	$379,325
Number of shareholders	2	2	2	2
Average income per shareholders	$300,000	$265,000	$228,250	$189,662
Annual percentage decrease in revenue		-12%	-14%	-17%

OVERVIEW OF STRATEGIC OPTIONS

	Description	Benefits	Drawbacks
Status Quo	• No transaction is executed • Owners continue to operate the practice and extract cash • Retain ability to sell in the future	• Retain control • No equity dilution • Less distractions	• No initial liquidity, growth capital • No new partner (no “strategic value add”) • Retain 100% of execution risk
Debt Recapitalization	• New debt capital is raised in lieu of selling equity • Smaller growing healthcare companies typically use proceeds for expansion capital • Unlikely that a lender would allow shareholders to use debt proceeds to fund a liquidity event	• Retain control • No equity dilution • Provides some liquidity	• Liquidity restrictions • Future cash flows committed • Debt covenants inhibit flexibility
Minority Recapitalization	• Owners of a business sell a minority equity stake to a third-party investor • Proceeds from investment typically utilized to fund growth, with a smaller portion allocated to provide shareholder liquidity • Investors often require continued involvement of physicians	• Retain control • Value-add partner, capital to support growth • Typically, partial liquidity	• Some equity dilution • Valuation may be lower than majority recapitalization • Limitations on future options
Majority Sale to Financial Buyer	• Owners sell a majority stake to a third-party investor or strategic acquirer, but maintain an ownership percentage via retained “rolled” equity • Outside investor provides incremental scale, capital, and strategic insights	• Value-add partner • Additional capital earmarked for growth • Significant liquidity	• Reduced control over operations
Majority Sale to Strategic Buyer	• 100% of the equity of the business is sold to an acquirer in exchange for cash / stock in the acquiring entity (e.g. large hospital system)	• 100% liquidity	• Loss of control • Limited future upside

KEY DRIVERS OF VALUATION

Investors, whether financial or strategic, are willing to pay a premium value for companies that have a compelling growth story and sustainable, stable operations.

Strong Team Large Market Opportunity Advantageous Competitive Positioning Attractive Growth Story and Financials	Rapid growth with efficient business model
Foundation for Future Acquisitions Create New Markets Extend Service Offerings or Capabilities	Uniquely positioned to capture large market opportunity
Differentiated Platform Best practices Material Synergies	Priority for the acquirer's strategic roadmap, including synergies and operating efficiencies

PRIVATE EQUITY PARTNERSHIP – PROS AND CONS

Advantages

- Majority recapitalization with PE group: typically, 51% - 80%
- Partial liquidity and growth: monetization of value of the practice
- Capitalize on favorable market conditions and strong PE interest in health care
- Participate in second liquidity event and maximize value in future
- Build platform or at least stronger market position through economies of scale and diversity of services
- Shareholders' involvement in growth of practice and platform
- Access to additional capital and therefore new opportunities
- Flexibility on rollover equity depending on succession plan of shareholders
- Maintain existing EMR, accounting and practice management team
  - ➢ Focus on best practices and economies of scale across offices
  - ➢ Build out management team: CEO, CFO, COO, maybe CTO, Director M&A
- Access to larger pool of patients and referral sources
- Access to more favorable payer contracts
- Access to more robust operational and administrative resources
- Better cross-coverage and access to sub-specialties

Disadvantages

- Loss of autonomy and control of the business (not necessarily operating control)
- Rely on new PE partners' competence to execute growth strategy
- Potential risk of culture clash
- Potential departure of some providers, referral sources and patients
- Capital markets and other outside factors may impact capital allocation throughout the life of the partnership
- Shifting personnel at PE partner can occur
- Lower compensation in general (base salary plus bonus, or percentage of collections)
- No more distributions as shareholders
- Decreased equity leads to reduced direct benefit from future growth and value

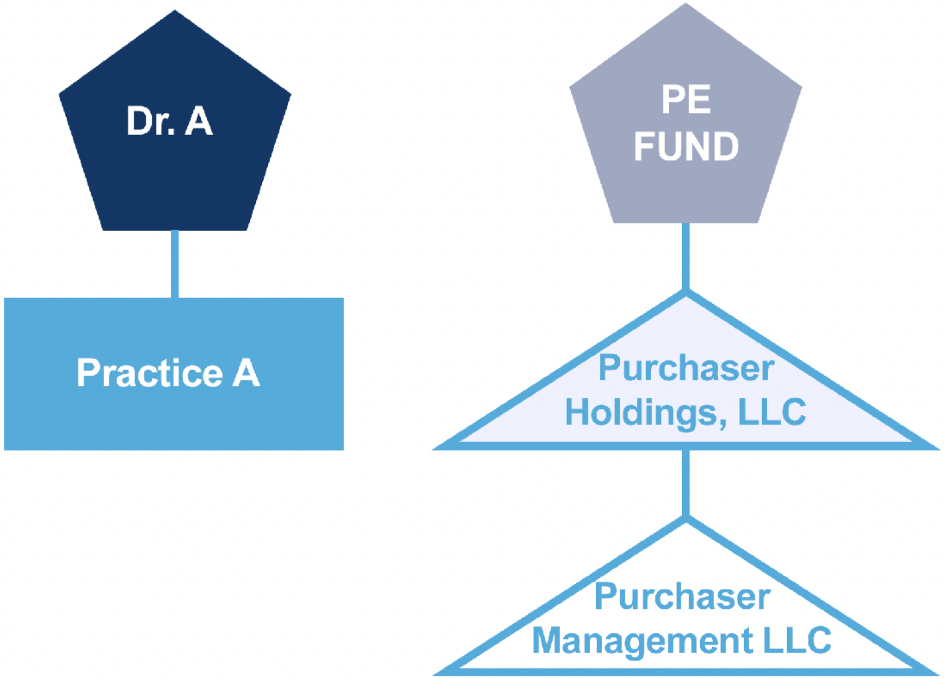
TRANSACTION IMPACT ON PHYSICIANS

Physicians at different stages of their careers will realize different benefits when partnering with a private equity group.

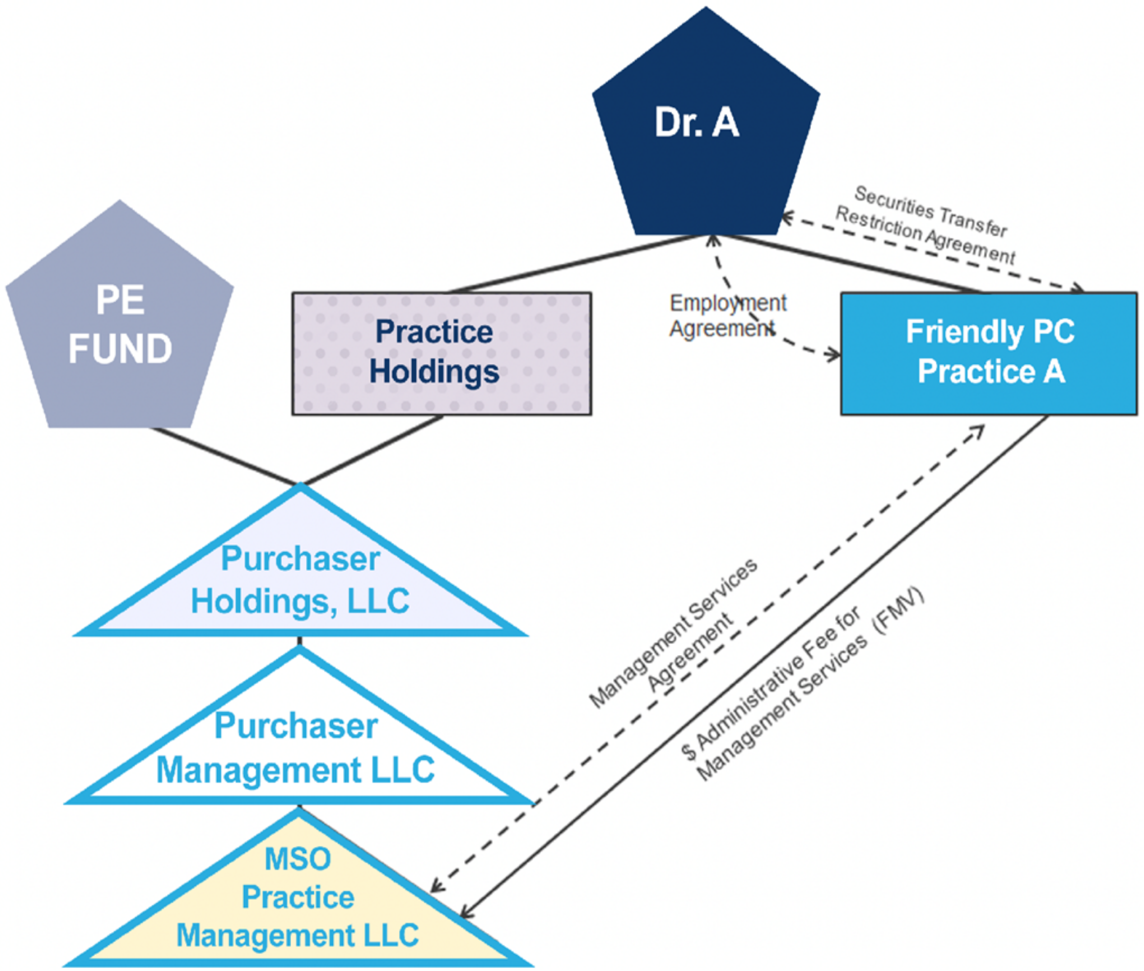
	Benefits to PE Partnership	Drawbacks to PE Partnership	Likely Economic Considerations
Existing Partners	• Receive credit for the value you've created • Take chips off the table (diversify holdings) • Find partner to help drive growth • Opportunity to participate in future transactions • Succession planning	• Investor will have an opinion on administrative (non-clinical) matters • Reduction / elimination of year-end distributions	• Cash consideration from transaction • "Rolled equity" from transaction • Ongoing clinical salary • Compensation for additional roles and responsibilities
Rising Partners	• Reputable partners will create an options pool for new partners • Systematic pathway to partnership, clinical governance, growth • Opportunity to participate in future growth	• Role is similar to an employed physician	• Clinical salary • Clinical incentives • Stock options
Retiring Partners	• Use a transaction to facilitate retirement • Receive some value for the practice you've helped build		• Cash consideration from transaction

PRIVATE EQUITY TRANSACTION EXAMPLE

- Doctor A owns Practice A
- PE Fund (Buyer) with Holdings and Management, LLC



POST TRANSACTION STRUCTURE



ILLUSTRATIVE TRANSACTION STRUCTURE

Private equity firms investing in the healthcare space traditionally structure transactions such that they provide physicians with both upfront liquidity and a "second bite of the apple" to incentivize performance going forward.

Common Transaction Dynamics

Flow of funds:

A practice's purchase is facilitated through several sources of capital (debt, equity from investors, "rolled equity," etc.). The cash flows to and from a number of parties, hence the term sources and uses.

Rolled equity:

"Rollover equity" is retained by current partners post-transaction. In this example, while it makes up 19.4% of enterprise value, it represents 31.7% of the new company's total equity ($20.0mm / $63.0mm).

Illustrative Sources and Uses

$ in Millions

Sources	Amount	Multiple of EBITDA	% of Sources	% Proforma Ownership
Debt	$40.0	4.0x	38.8%	
Sponsor Equity	43.0	4.3x	41.7%	68.3%
Rollover Equity	20.0	2.0x	19.4%	31.7%
Total Sources	**$103.0**	**10.3x**	**100.0%**	**100.0%**
Less: Financing Fees	-1.0	-0.1x	-1.0%	
Less: Transaction Costs	-2.0	-0.2x	-1.9%	
Total Enterprise Value	**$100.0**	**10.0x**	**97.1%**	

Uses	Amount	Multiple of EBITDA	% of Uses
Equity Proceeds to Shareholders	$80.0	8.0x	77.7%
Rolled Equity	20.0	2.0x	19.4%
Financing Fees	1.0	0.1x	1.0%
Transaction Costs	2.0	0.2x	1.9%
Total Sources	**$103.0**	**10.3x**	**100.0%**

Scenario:		
	Practice EBITDA	$10.0
	EV / EBITDA Multiple	10.0x

EBITDA:

Earnings before interest, tax, depreciation and amortization. Can be thought of more intuitively as Collections, less cost of services and operating expenses. During a transaction an advisor will work with you to remove any extraordinary expenses to maximize EBITDA. Note, a common adjustment made to EBITDA is the inclusion of a salary for partners (if they currently do not take one), based on a production-based model. A good estimate for ophthalmology practices is 35% of collections.

Debt:

As the name implies, debt is used to fund the purchase of the business. Note: you have no personal obligations associated with this debt. As it is paid down, equity flows to shareholders proportionally.

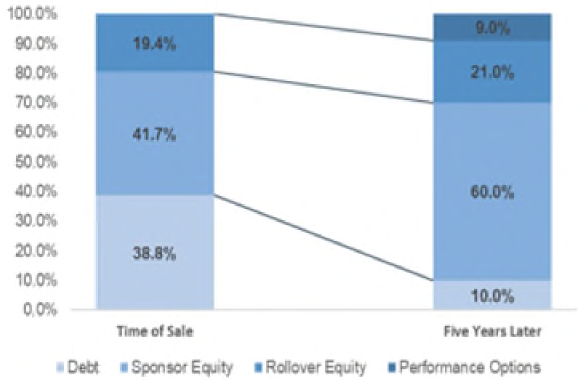
ILLUSTRATIVE TRANSACTION STRUCTURE (cont'd)

Private equity firms investing in the healthcare space traditionally structure transactions such that they provide physicians with both upfront liquidity and a "second bite of the apple" to incentivize performance going forward.

Post-Transaction Ownership, "Second Bite of the Apple"

- **Paying Down Debt, Creating Options Pool**
  - As the practice continues to perform, profits are used to pay down the debt used to fund the transaction
  - Reducing the debt increases the value of all shareholders' equity
  - Options pool is commonly created to attract and reward key providers; its creation dilutes private equity owners' and partners' rolled equity on a pro-rata basis

Equity Ownership Over Time



- **Second Bite of the Apple**
  - As part of their business model, private equity partners will seek to sell the practice or "exit the investment," typically within three to five years
  - Assuming that debt has been paid down, and the practice has grown, the second sale of the business can generate significate additional income for equity owning providers

Illustrative Proceeds at Time of Second Sale

EBITDA grows from $10.0mm at time of sale to $30.0mm in five years

12.0x EV / EBITDA Multiple

$360.0mm Enterprise Value = Equity Value

X 21.0% Partner Ownership

$75.6mm Partner Equity Value

= 3.78X cash return, ~30% IRR

IMPORTANT DO'S AND DON'TS FOR PRACTICE OWNERS

- Do have a consensus regarding your and your partners' interest in going to market *before* engaging in material discussions with potential buyers
- Don't share any proprietary or confidential information without NDA
- Do determine who will have knowledge of discussions and at which stages before beginning any discussions
- Do guard against unintended disclosure of discussions – protocols to preserve confidentiality
- Don't enter into any "exclusive dealing" arrangement without advice from legal counsel and/or investment banker
- Do carefully negotiate a robust LOI with assistance of legal counsel and/or investment banker
- Do have a succession planning strategy regardless of your age
- Don't overlook domestic relations and estate planning considerations regardless of age

QUESTIONS?