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Business Advisors for the Healthcare Industry

Private Equity Transactions for Ambulatory Surgery Centers (ASCs): Answers to the What? Why? And Who? Questions

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FINANCIAL DISCLOSURE

- We have no financial interests or relationships to disclose.

AGENDA

I. Private Equity Model for Ambulatory Surgery Centers ("ASCs")
II. Private Equity-Like Model for Health System Transactions
III. Regulatory Compliance Differences Between PE Firms and Hospital Transactions
IV. Valuation Illustrations
V. Comparison of Models and Other Dynamics to Consider
VI. Private Equity Investments in ASCs

Private Equity Model for ASCs

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PE ACQUISITION OF PRACTICES

First, let's define what we mean by "private equity"

- Private equity entity is an investment firm using institutional capital to purchase operating entities
- Main goal is to purchase an enterprise with compelling base value and then grow through add-on acquisitions (using additional leveraged capital) and upon expansion of EBITDA, eventually sell those aggregated assets
- Value is returned to investors primarily through liquidity events (i.e., sale of entities, initial public offerings, other transactions)
- Investments in healthcare entities may be directly from PE firm or more likely through PE-sponsored platform companies
- Platform companies are the initial entity purchased by a PE sponsor, which then entails add-on acquisitions
- Most deals involving PE buyers are actually led by a platform company, as opposed to the actual PE firm
- **Conclusion: PE is quite interested in ASCs; many times corresponding practices are included within the transaction**

*See later slide for specific PE firms

What impact do private equity investors have on healthcare market dynamics for ASCs?

- Healthcare is a local, community-oriented business … PE Investments introduce new competition and impact local market dynamics for physicians and hospitals; meaning, these are often "foreign" (not local) investors
- The dynamic surrounding the delivery of medical care revolves around clinicians and the organizations under which they operate (i.e., medical practices, hospitals, and similar entities) - this dynamic is relatively straightforward, albeit not always without some degree of complexity
- PE firms or PE-sponsored platforms who enter the market with significant capital reserves (and in many cases, less regulatory constraints) can cause substantial disruption to the relatively simple local healthcare market dynamic
- **Conclusion: Compared to health systems, PE affiliation offers potentially greater interest and transactional excitement, given consolidation and revenue growth opportunities that exist for ASCs.**

Typical deal characteristics of PE acquisitions of ASCs …

- Upfront value is created through the sale of an ownership percentage of the ASC; often a minority interest is retained
- EBITDA is applied in a discounted cash flow (DCF) model that determines enterprise value (Income approach)
- Or a multiple can be applied to this EBITDA, thus resulting in "market value" from this calculation
- A multiple is applied to the transaction value
- Reduction in physicians' ownership percentage is permanent, but physicians receive post-Transaction the value of the reduced income in upfront dollars. Plus, often they retain a minority interest.
- Some offset to the earnings reduction due to a decrease in ownership percentage may be realized through improved access to services and organic growth, post-Transaction*
- ASC will likely be sold or further consolidated based on owner preferences - a spin-off MSO can be established and exist going forward and may also be "sold" separately
- Usually, only a percentage (majority interest) of the ASC is sold to the PE firm; the physicians may get a "second bite of the apple" via subsequent sale of their retained equity
- ASC values will usually result in a market-driven multiple of their (independent of the practice) EBITDA.
- Medical practices related to the ASC may also be considered, though typically are separate legal entities.

**If the PE firm did not acquire a 100% ownership stake.*

ASCs PE TRANSACTIONS

- For a number of years, ASCs have been an investment target of PE firms interested in seizing opportunities in a fragmented market
- As providers seek to increase profitability, by decreasing expenses while increasing reimbursement, consolidation has become the norm
- ASCs have enjoyed a reputation of providing high-quality care and safe, efficient services to patients
  - They are generally more convenient than hospitals for both patients and surgeons and offer increased scheduling flexibility and minimal disruptions from emergencies
  - ASCs have the benefit of offering a lower cost alternative to the hospital environment
- Over time, thanks to advances in techniques and technology, ASCs have been able to perform a growing number of types of procedures
  - Most recently, CMS added total knee arthroplasty and six coronary intervention procedures, including cardiac stenting, to the list of Medicare's covered surgical procedures at ASCs in 2020
  - CMS is also considering adding 13 additional coronary intervention procedures to its ASC covered list in the future
- With a reputation for quality care at reduced costs, increasing opportunities for reimbursable cases, and protection from economic downturn, PE continues to show strong interest in investing in ASCs

*Information obtained from the following web sources:

- Proliferation of Private Equity Investment in ASCs

Web-link: https://www.wilentz.com/about/publications/2020-01-01-proliferation-of-private-equity-investment-in-ascs

ASCs PE TRANSACTIONS

- Physicians want to practice medicine without the headaches of administrative tasks and chasing insurers for payment. PE investors allow doctors to do just that
  - Often, PE firms already have relationships with payers and strategic expertise that can help grow ASC revenue and profit
- Physicians continue to remain interested in a PE investor, since, plainly stated, PE firms are offering more money than other investors, including physicians and hospitals
  - PE is paying anywhere from 6-12 times EBITDA for the ASCs
- Purchases are generally structured to give sellers long-term capital gains treatment, which creates significant tax savings
  - Many physicians consider this purchase price a windfall, and physicians who are close to retirement sometimes view these purchases as an exit strategy that allows younger physicians to take some money off the table immediately by realizing value for their interest now while continuing to share in the growth of the center

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ASCs PE TRANSACTIONS

- Common Terms in PE Transactions
  - PE firms usually create a subsidiary Practice Management Company within their portfolios to acquire and manage ASCs. Most transactions include some equity ownership in that parent management company
  - Selling owners should expect restrictive covenants prohibiting them from owning or operating a competing facility within the catchment area
  - Generally, the selling physicians will remain owners, thus a new shareholder agreement or operating agreement will be negotiated and drafted
    - Will most likely give significant decision-making authority to the PE firm
    - Further restrict transferability of the physicians' ownership interests and set forth when their interest can be redeemed
    - Physician may be expected to make a commitment of up to 10 years, with penalties for early withdrawal
- Physicians will request or require that most of the current ASC owners roll over part of the proceeds or ownership interests into a new entity
- It is likely that PE investments in ASCs will continue in 2020
  - As healthcare spending continues to increase and more currently hospital-based procedures are shifted to the ASC setting, PE's interest in investing in ASCs is unlikely to slow down

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Private Equity-Like Model for Health System Transactions

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PE MODEL FOR HEALTH SYSTEM TRANSACTIONS

- There are ways hospitals may compete with PE investments disrupting local healthcare markets
- Through a "PE-Like" transaction model, hospitals can provide more upfront value than under other models*
- Historically, hospitals have been reluctant to pay significant upfront dollars for practices
- Perspective has started to shift, ever so slightly
- Exploring whether they could pursue the same/similar structure as PE firms in their acquisitions of ASCs entities (i.e. purchasing the practice as an adjust acquisition of the ASC)
- Not changing stance on paying significant upfront dollars tied to intangible value alone
- Hospitals could consider paying more upfront if those dollars were tied to something more tangible (again, we are speaking of the practice, not the ASC)
- Structure remains within the required regulatory frameworks

**** Such models will usually apply to larger specialty groups wherein obtaining more value at closing is a preference; further, they more so apply for the corresponding practice entity – not the ASC***

PE MODEL FOR HEALTH SYSTEM TRANSACTIONS

Deals between hospitals and physicians have many characteristics and limitations

- How hospitals factor ROI vs PE firms
- Regulatory limitations exist for hospitals, but not something that PE firms or private, for-profit entities are required to follow

Key Characteristics

- Valuation: Upfront value is derived from DCF applied to the EBITDA
  - Upfront value tied to future earnings
  - Value received today in exchange for foregoing compensation in the future
  - Calculated using a DCF thus resulting in enterprise value (EV) after appropriate pro forma assumptions and discounts are applied
- Major Outside Ancillaries: Purchased by hospital in a separate transaction from the practice (e.g. ASCs)
  - Same as is often done in traditional alignment transactions
- **Conclusion: Health systems are increasingly interested in ASCs as a strategic option for delivering surgical services; As ASCs provide the opportunity for surgeons to perform specific procedures more efficiently and conveniently than they can in hospital-based operating rooms. And in order to the purchase the ASC component entity, they must also buy the practice. The practice may be purchased akin to a PE transaction to complement the ASC acquisition.**

Regulatory Compliance Differences Between PE Firms and Hospital Transactions

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REGULATORY & LEGAL DYNAMICS – LEGAL AND OPERATIONAL DUE DILIGENCE

- Billing and coding; entire revenue cycle management may impact closing
- Fraud and abuse issues will impact seller and buyer perspectives
- Separation of clinical practice from nonclinical assets and personnel
- Common licensure snafus
- Applicable antitrust thresholds

REGULATORY & LEGAL DYNAMICS – TAX IMPACT AND PLANNING

- Complex legal and debt structures
- Massive documentation
- Tax treatment and reporting on proceeds
  - Treatment may vary with multiple, related component seller entities
  - Distributions from S-Corporations may impact reaching seller consensus
  - Long-term capital gains vs. ordinary income

REGULATORY & LEGAL DYNAMICS – CONTRACT TERMS AND RISK ALLOCATION AMONG SELLER OWNERS

- At the beginning: letter of intent; exclusivity
- Holdbacks; escrows – earn-out requirements and contingencies
- Indemnities
- Representations and warranties
- Post-closing employment obligations
- Restrictive covenants
- Shareholders' agreement for rollover equity

Valuation Illustrations

VALLUATION ILLUSTRATION – PE BUYER

So how does the valuation work in the PE model?

- Relatively simple approach
- Though, there is significant technical analyses, modeling and assumptions required to derive an accurate dollar amount
- Key components of deriving enterprise value in the PE model result via the following:
  - Determine ownership percentage to be acquired
  - Develop pro forma financial model
  - Calculate EV using a DCF model

VALLUATION ILLUSTRATION – PE BUYER

Hypothetical Example of Acquisition by PE Firm

Acquisition by PE Firm		
ASC EBITDA		$800,000
Multiple on EBITDA		5.0
Transaction Value	(5x$800,000)	$4,000,000
Percentage Acquired by PE Firm		70%*
Adjusted Transaction Value		$2,800,000
Total Number of Shareholders		6
Proceeds of Transaction per Shareholder		$466,667

** Typically, the shareholders retain a minority interest in the ASC*

VALLUATION ILLUSTRATION – PE BUYER

- Each physician receives $666,667 in upfront value (assuming proceeds distributed evenly and 100% of the ownership percentage is acquired by the PE firm)
- Model also assumes the PE firm applied a multiple of 5x to the EBITDA amount, to derive their transaction value
- Limited *true* market multiples must be applied for such deal models
- Applying a multiple against the EBITDA to derive the value requires a varied multiple in each individual transaction, based on the financial resources, risk and flexibility of the parties involved*

** Independent valuation expert plus healthcare legal counsel should be utilized*

VALLUATION ILLUSTRATION – HOSPITAL BUYER

- Value of the ASC was derived via a DCF calculation
- A multiple of EBITDA may be used as a "reality check" to the DCF. In this illustration, the DCF approach, expressed as a multiple of EBITDA, would be 4.0 (obviously less than the 5.0 PE multiple)
  - Generally, PE firms pay a higher multiple than hospital buyers
- DCF is an entirely separate process that requires a discussion of its own to fully explain and understand its mechanics and how a valuation is ultimately derived; however, it is a methodology widely used and accepted, if implemented under the proper guidelines and standards, especially for hospital transactions
- Value of the ASC paid through the upfront proceeds of the transaction is less than the value paid in the PE acquisition

Comparison of Models and Other Dynamics to Consider

PE BUYER VS. HOSPITAL PE-LIKE MODEL

PE Buyer

Pros:

- ASC is often paid larger upfront value
- Physicians may maintain ability to participate in ancillary services
- ASC operations and risk assumed by new owner/operator (possible MSO)
- ASC may retain more impactful control over day to day operations
- Compensation potentially lifted if higher rates are achieved in the future and new owner allows physicians to benefit from those rates
- Earnings reduction mitigated via growth initiative, if physician retains an ownership percentage in the ASC
- Spin-off MSO might be established and exist going forward (may also be sold separately)
- Rollover equity to the Seller (future sales value)

Cons:

- New, unknown relationships
- Some PE groups have more clinical management / operations experience, than others
- May / may not be the lead portfolio company
- Limited participation in significant governance or management decisions (i.e., acquisitions, future sale, etc.)
- May significantly impact ASC culture, recruiting, staffing, etc.
- Material holdbacks usually exist
- Conditions to closing could impact speed to closing
- Perception of less stability
- Minority interest retained

Hospital Buyer

Pros:

- Hospital has been / will be in the business of delivering quality healthcare
- ASC perception of greater stability
- Known, current relationships
- Still receives upfront value (though likely less than with PE buyer)
- Upfront value received for ancillaries, as applicable
- Maintain positive dynamics of local healthcare services
- ASC operations and risk may be assumed by hospital
- Big fish in a small(er) pond
- Spin-off MSO might be established and exist going forward (may also be sold separately)
- Experience with clinical integration

Cons:

- Minority interest may be retained
- Greater loss of control and autonomy of ASC operations and leadership
- Lack of pathway to leadership for new physician employees in the group
- Less ability to participate in ancillaries due to regulatory constraints
- Limited future participation in growth or profitability of the group
- Minority interest may have little future value

DYNAMICS TO CONSIDER

- Must first understand the key drivers of the deal from the perspective of the ASC
- Sellers must answer is "Why are they doing this?" and "What is their greatest priority to achieve in doing a deal?"
- Is the main priority for doing a deal one of the following …
  - Maximize upfront value?
  - Accept lower upfront value in exchange for more stable income?
  - Maintain income but reduce risk of reductions of reimbursement from CMS and commercial payers?
  - Remove risk and difficulties of running an ASC?
  - Maintain independence while still achieving greater income stability?
  - Partner with another organization to increase opportunities for income diversity and growth via capital injection?
  - Address the needs of succession with the ASC?
- Understand the key drivers for ASCs
- Also, factor into the equation the possible sale of the practice

DYNAMICS TO CONSIDER

- If the consensus among the physicians selling their ASC is to maximize the valuation paid at the time of the transaction and ultimately forego their independence to an outside organization (hospital or PE firm), then the PE model may likely be the best option
  - Consider the ability to reach a consensus among all voting parties
- Realistically, health systems may not budget to pay (or even have available) the upfront funds – they may also consider some comparable scenario for the practice
- Larger specialty practices are likely the only interested entities in PE and PE-Like transactions (and vice versa)* plus their ASC investments are the primary attraction to PE firms

** Unless smaller groups can be aggregated into a larger consortium*

Private Equity Investments in ASCs

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CONCLUSIONS REGARDING PE AND ASCs

- PE offers the greatest interest (as opposed to health systems)
- PE firms have already completed many ASC deals
- 2020 experienced a decline in transactions, mostly due to COVID
- 2021 and following may experience a resurgence of deals
- Consolidation will continue and are appealing to PE investors
- Multiples are unpredictable and most likely generally lower (past their peak)
- Increasing demand for elective surgeries coupled with other outpatient surgeries driven to ASCs signal future revenue growth opportunities

Questions

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Transaction Updates

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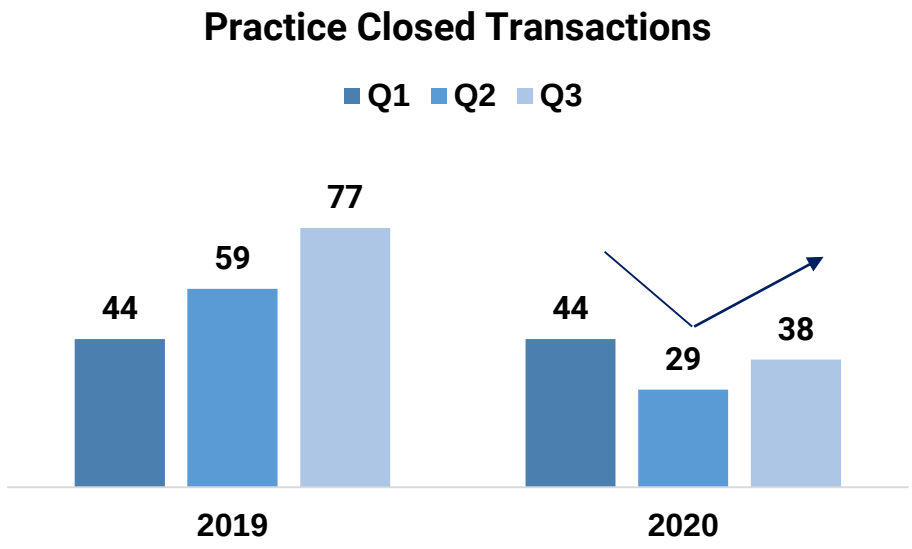
THE BLOOM ORGANIZATION
Healthcare Investment Banking

2020 Deal Activity

Comparison

Deal Activity saw a dramatic decline in Q2 2020. Results in Q3 show a rebound in activity.



Within Healthcare Services, Physician Medical Groups saw the steepest decline, at ~36.5%.

Service	2020 Decline (H'1)
Long Term Care	-32.8%
Behavioral Care	-27.5%
Managed Care	-30.8%
Physician Medical Groups	-36.5%
Home Health Care	-33.3%
Rehabilitation	-31.3%

Deals came to a halt. Practices rapidly implemented telemedicine

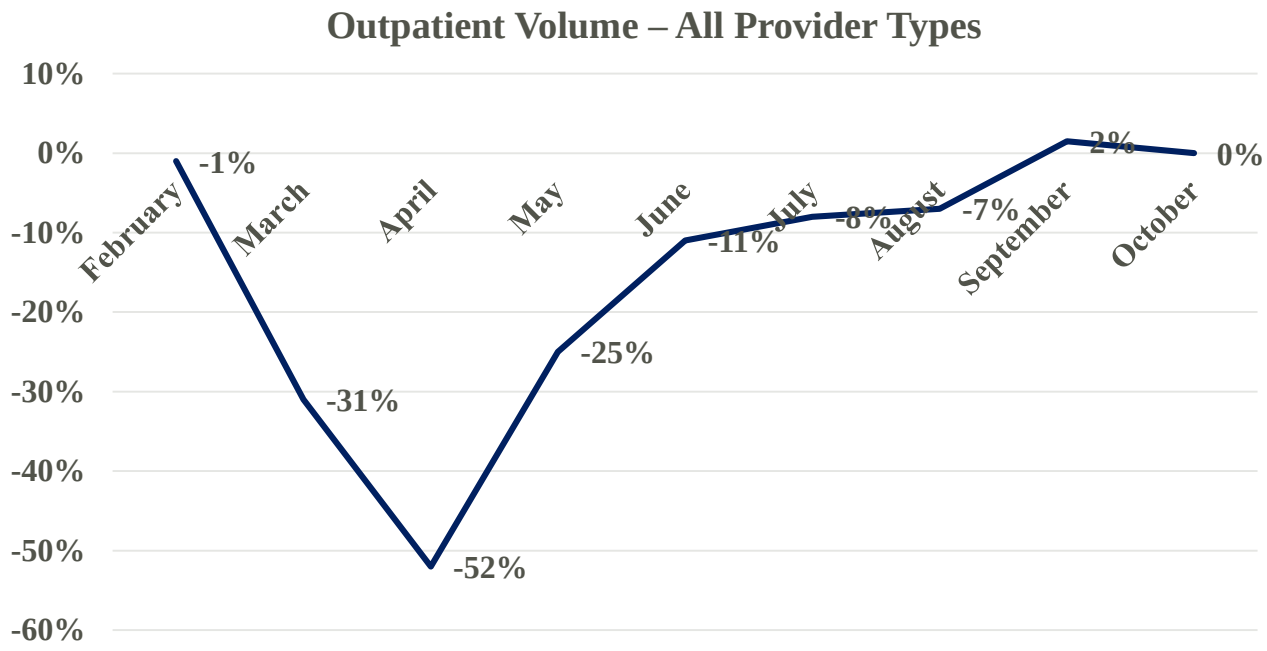
While investors focused on cash preservation with existing portfolio companies during the onset of COVID and Q2, we saw an uptick of Q3 closings using creative structuring to allocate risk between buyers and sellers.

THE BLOOM ORGANIZATION
Healthcare Investment Banking

2020 Deal Activity

Tracking Productivity

Productivity metrics help bridge the gap in valuation expectations. The steepest drops were seen between April – June. This "V" shaped recovery gives bankers comfort in pre-COVID EBITDA valuations.



Source: Ateev Mehrotra et al., *The Impact of the COVID-19 Pandemic on Outpatient Care: Visits Return to Prepandemic Levels, but Not for All Providers and Patients* (Commonwealth Fund, Oct. 2020). https://doi.org/10.26099/41xy-9m57

M&A Activity – 2021 and Beyond

Physician Practice Interest in M&A

In 2019, 30% of physicians who owned practices reported that they would sell their practice in the next two years, according to **Bain research.**

Strained finances and a sharp drop in procedure volumes have pushed organizations hard hit by the pandemic to entertain acquisition offers.

Bain's 2020 US Front Line of Healthcare Survey showed **70% of physicians** in independent practices were amenable to acquisition

What are the acquirers saying?

Hospitals

Fifty percent of hospital administrators say their organizations are highly likely to make one or more acquisitions in the next two years. Focus areas include outpatient facilities expecting a continued shift of care to the outpatient setting.

Private Equity

Record levels of un-allocated capital "dry powder" will promote investor activity.

Payors

Payors with strategies for developing provider networks will continue to be a source of consolidation.

Navigating the challenges of Deal Making

Challenges

Who was "hit" the hardest?

- Elective, procedure dependent
- Fee-for-Service ("FFS") Reimbursement
- Densely populated – COVID Incidence

How can a banker help?

- Establishing Normalized COVID EBITDA
- Bridge to Normalize
- Defining metrics for provider productivity for risk allocation

Deal Structuring Considerations

- Need to de-risk buyers and sellers
- Pre-COVID Normalized EBITDA "EBITDAC"
- Seller Notes
- Structuring notes with shared risk
- Due Diligence Considerations
- Lending Markets

Partnership Options

Aside from Private Equity, there are often several other options available to Sellers:

- Health Systems
- Strategic Acquirers
- Insurance Companies
- ESOPs

Alternative Monetization Strategies

Employee Stock Ownership Plan ("ESOP")

Companies often use ESOPs as a corporate-finance strategy to align the interests of their employees with those of their shareholders. Unlocking equity in a tax efficient manner.

Benefits of an ESOP

Shareholder Liquidity:

- Provide significant liquidity for shareholder at closing
- Maximize after-tax cash for shareholders

Eventual Corporate Tax Free Business

- Turn company into non-taxable business

Retain Upside:

- Retain upside in company's future growth while maintaining control

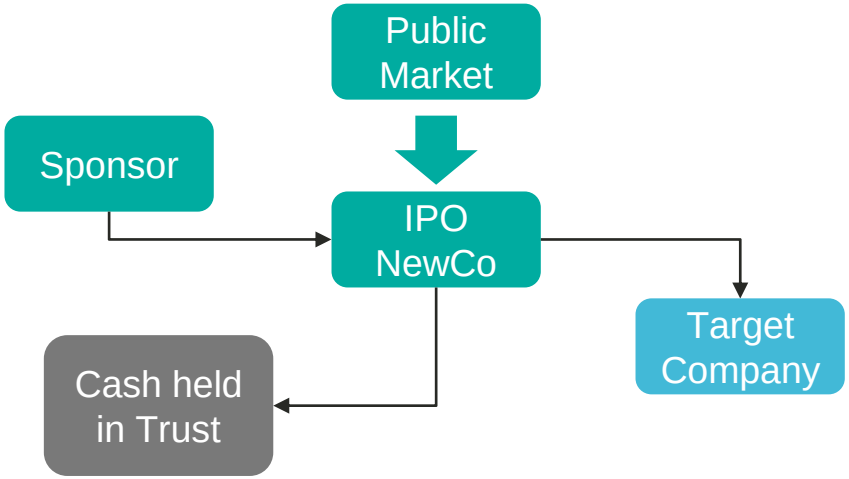
Flexible Approach:

- Attractive regardless of company performance
- Allow for different options in future- e.g. sell business, continue operations

Special Purpose Acquisition Company ("SPAC")

Special Purpose Acquisition Companies are an alternative vehicle for acquiring a Target Company.

- A SPAC pools money from public investors to form a blank-check company with the sole purpose of acquiring another company—or companies.
- The money raised through the IPO is put into a trust.
- The funds are held until the SPAC successfully identifies a viable merger or acquisition opportunity to pursue with the invested funds.



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Transaction Updates

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