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Strategies for Minority Owners After the Deal

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AGENDA

I. Review and inform as to the governance and fiscal ramifications of retained minority interest equity by physicians, post-transaction
II. Review regulatory issues confronting a jointly owned (physician and private equity and/or health system) practice and/or other healthcare services entity
III. Key pre- and post-Transaction matters to consider when entertaining joint ownership with the former majority owner physicians assuming a minority interest

OVERVIEW OF PRIVATE EQUITY MODEL

PRIVATE EQUITY AFFILIATION MODEL

In general, these are the key components of deriving enterprise value in the PE model:

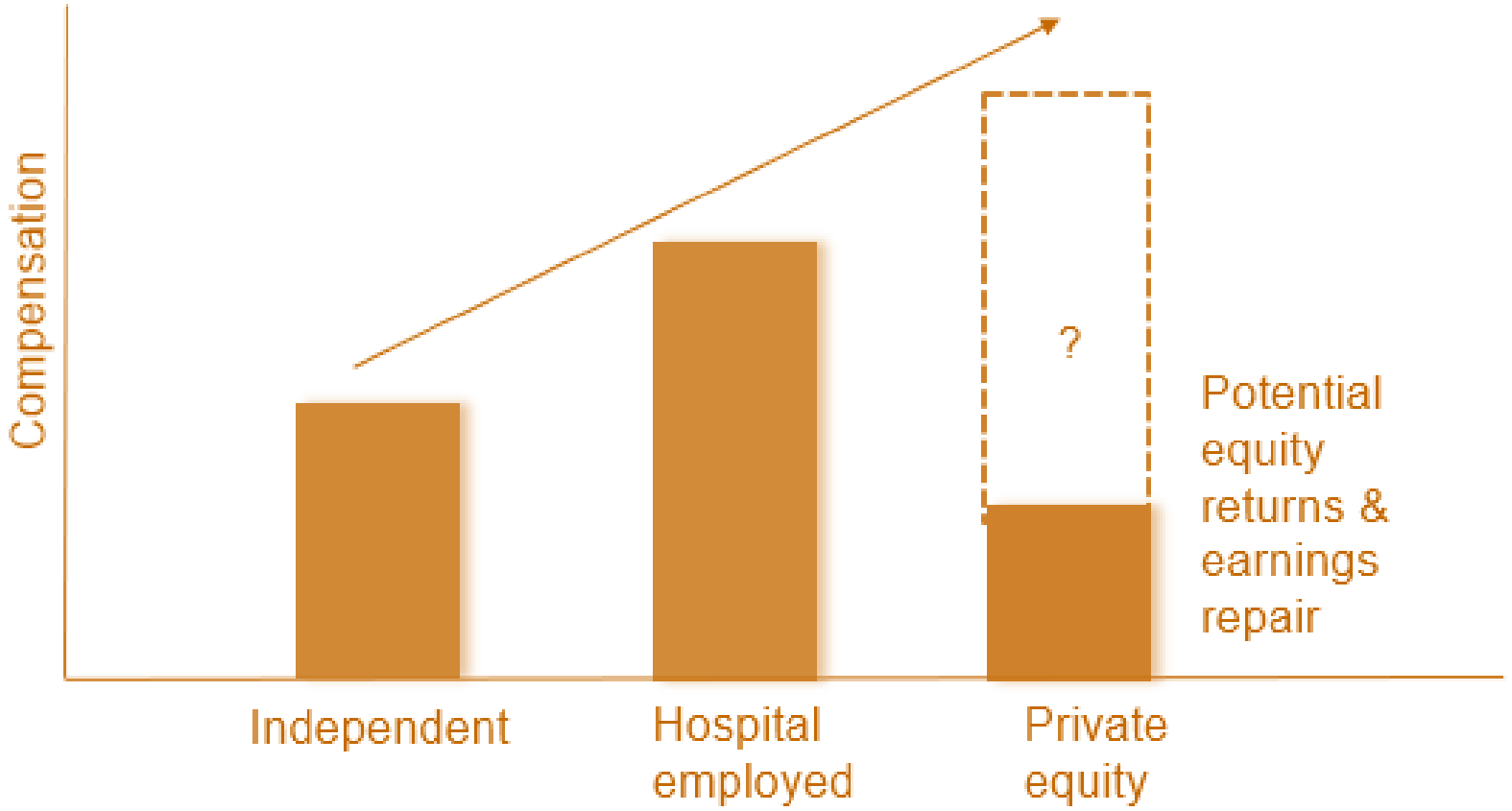
1. Determine the haircut (i.e., compensation reduction, also referred to as the "compensation scrape") to be applied across all physicians
2. Develop a pro forma financial model, wherein the compensation reduction, post-transaction is ultimately turned into EBITDA with growth over a 5-year projection period[1]
3. Calculate either a market approach multiple of EBITDA or a discounted cash flow valuation model using the financial tenets from the pro forma. This will derive an *enterprise value* for the entity following appropriate guidelines and standards

Example Acquisition by PE Firm		
Practice Revenue		$50,000,000
Total Physician Compensation (Pre-Haircut)		$25,000,000
Total Number of Physicians		10
Haircut	10%	$2,500,000
Reduced Compensation per Physician		$250,000
Multiple on Haircut		9
Transaction Value		$22,500,000
Proceeds of Transaction per Physician		$2,250,000

4. **The physicians become minority owners (via the "rollover" equity, discussed later) and thus no longer possess voting and governance control**

1. Note: there are very important and detailed steps that must go into the development of these models, but for this discussion, we assume the model follows all relevant and appropriate standards

COMPARISON OF COMPENSATION



- For an acquisition entailing post-transaction employment by a hospital, there is little money paid upfront
- In a Private Equity affiliation, there is a significant upfront payment plus "rollover equity"
- In both instances, the physicians convert from majority to minority (or no) ownership

Source: Adapted from Association of International Certified Professional Accountants, 2019

PLATFORM PRACTICE FOR PRIVATE EQUITY

- Serves as the "springboard" to expand ancillary offerings and roll-up further physician practices, thus driving down competition; builds upon the concept of "critical mass"
- Often, the first partner practice and one that has a proven track record of strong operational management, a robust array of ancillary streams, and a visible connection to their community
- Physician enterprises that become platform practices often wield more leverage, which can lead to better economic, structural, and governance opportunities
- Platform practices likely have some "unofficial influence" even as a minority owner
- Even platform practices do not possess control post-transaction; they are definitely a minority owner

ROLLOVER EQUITY

- In place of cash proceeds, equity holders of the selling practice/entity rollover part of the proceeds of the sale or ownership interest into the new private equity management entity

- Helps ensure that interests are aligned

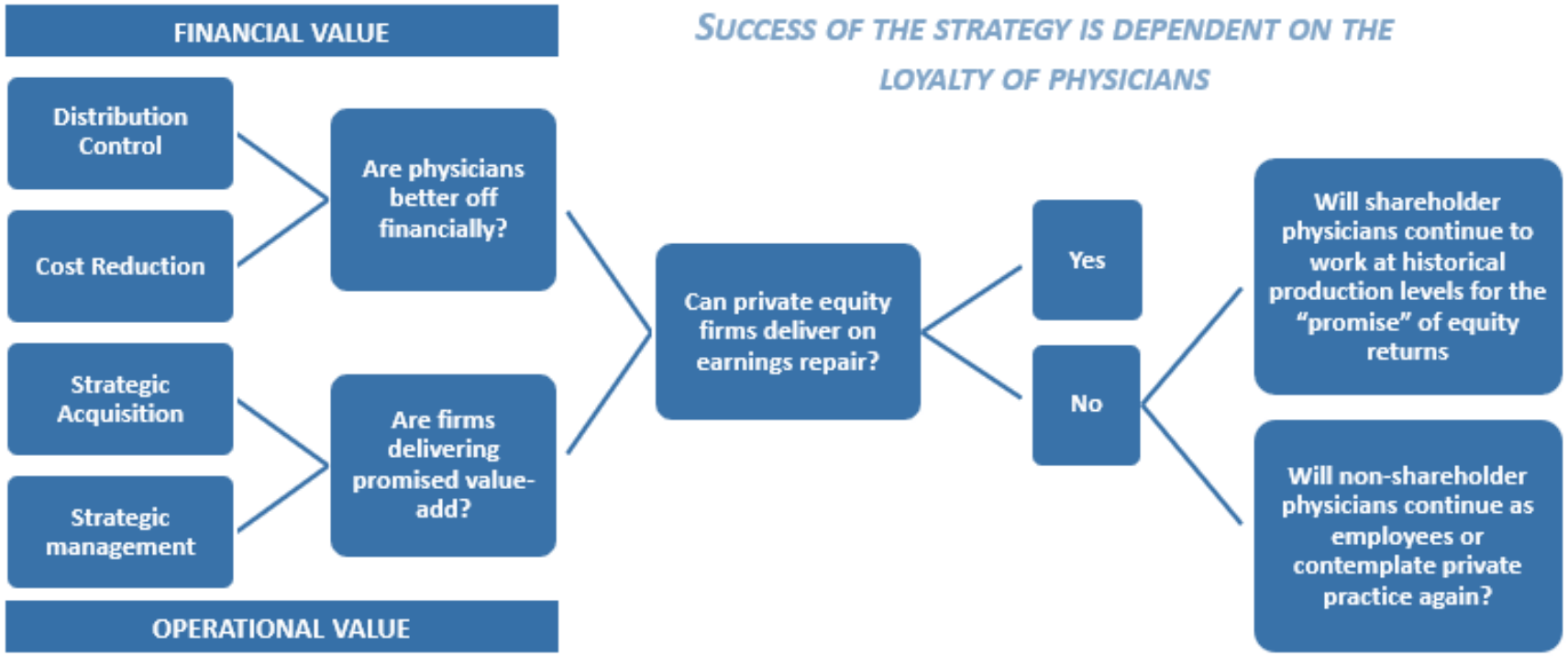
- Often subject to vesting

Selling Shareholders	% Ownership (Presale)	Proceeds Per Shareholders	Equity Rollover[1]	Cash at Close
Majority Owner	75%	$36,000,000	-	$36,000,000
Management Owners	25%	$12,000,000	$6,000,000	$6,000,000
Total	**100%**	**$48,000,000**	**$6,000,000**	**$42,000,000**

- The physicians have thus become minority investors in the rollover entity!!

Source: Adapted from Association of International Certified Professional Accountants, 2019

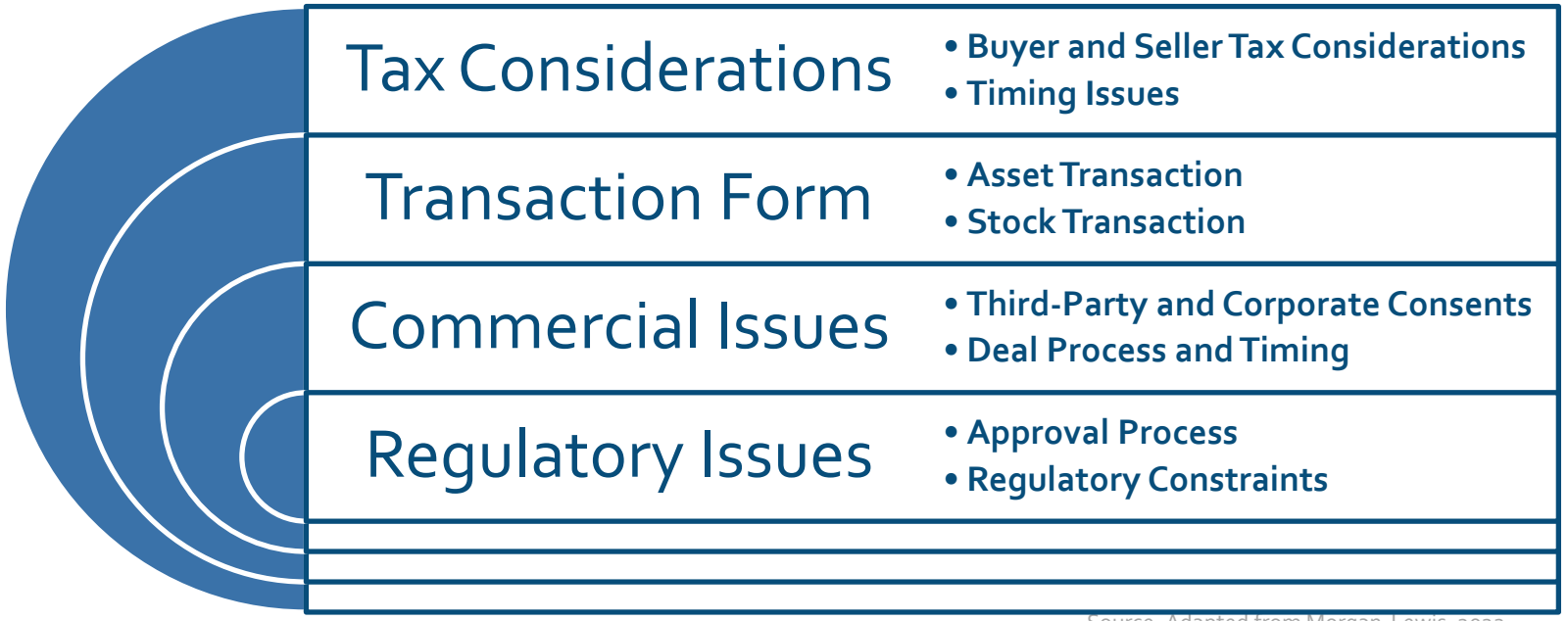
EQUITY RETURNS AND EARNINGS REPAIR



- Do physicians struggle to maintain/improve the patient experience if they lose their unilateral ability to drive change?
- If physicians lose operational control, do they still wield enough influence to manage costs?
- Are firms delivering value-add by providing capital, expertise, or greater payer acuity?
- Is the acquiring firm focused on increasing EBITDA to the detriment of the practice or patients?
- **Overall, when physicians no longer have control, does their partner (whether PE or Hospital) suffer? Do the physicians? What can be done to mitigate this?**

Source: Adapted from Association of International Certified Professional Accountants, 2019

CONSIDERATIONS IN STRUCTURING A TRANSACTION



Source: Adapted from Morgan Lewis, 2022

Potential Opportunities to Protect/Neglect Minority Owners

- Piggyback rights- protects minority owners when the majority owners sell. Gives minority owners the right to be included in the deal.
- Valuation of shares- in the shareholder agreement, specify the valuation method and that shares be sold at fair value in the event of a sale (mitigate their minority interest discounts).
- Non-compete- should a minority physician sell their ownership stakes, what does their non-compete say about their ability to practice elsewhere?
- Declaration of dividends- majority owners may elect not to pay dividends and instead reinvest in the business or pay executives higher salaries/bonuses.
- Subchapter S Corporations & LLCs- are allowed to transfer their tax liability to each shareholder proportionate to his/her ownership in the company. In conjunction with not paying dividends, this can serve to "squeeze out" minority owners.

POST-SALE CONSIDERATIONS- PHYSICIANS AS MINORITY OWNERS

PRIVATE EQUITY LONG-TERM PRIORITIES

- Health systems tend to focus on alignment, sustainability, incentives, and value achievement while the long-term objectives of many PE investments focus on creating equity value for subsequent sale (again and again).
- Some PE firms may have a strong impact on practice culture due to their focus on growth and profitability. Physicians, as minority owners, have limited influence on such an ownership paradigm.
- Generally, PE firms have little participation in local communities.

Suggested initiatives to address these challenges include:

Providing Competitive Compensation (Repair the "Scrape")

Motivating Physician Partners (Quality and Economics)

Adding Value Through Operational Efficiency (Improving Physicians Quality of Life)

Creating Equity Value (Rollover "Second Bite")

GOVERNANCE CONSIDERATIONS

Physicians in Private Practice (Pre-Sale Majority Owners)

- Governing Executive Committee/Board composition
- Board authority and operational/strategic role
- Shared responsibilities among Physician partners
- Hiring/firing authority
- Physician behavioral issues adjudication process
- Staffing changes and retainment policies; full operational control
- Control over future affiliation opportunities

Physicians as Minority Owners

- Less focus on day-to-day operations
- Platform practice may have more authority, but still a minority interest
- PE Board may include subject-matter experts from practice
- Lack of investment protection due to no or little veto rights
- Subject to supermajority voting rights of majority owners
- Balance of PE and clinical control through dedicated committees
- Financial performance control lessened
- Future sale not in physicians' hands

"SECOND BITE OF THE APPLE"

- A key difference between PE and hospital transactions is the "second bite of the apple," which *may* exist in a PE transaction, but would not exist in a hospital transaction. Thus, while there could be a more long-term economic opportunity in a PE deal, it is at risk in a variety of respects.
  - Physicians will likely have no (or little) say in their eventual employer/owner
  - Likewise, if their employer hospital sells, their new employer will be in control

- There are instances where the "second bite of the apple" does not resonate, for example…
  - Lack of performance, resulting in low sales value
  - Lack of PE-backed partner's performance overall
  - Multiples not as high as projected
  - Lack of consensus on a "best fit" partner to sell

OTHER AFFILIATION OPTIONS-HEALTH SYSTEMS' AFFILIATION

1. Employment- no equity, varied physician influence depending on the health system.
   a) Major loss of independence and autonomy
   b) Some managerial and oversight functions may remain at the physician level
   c) Overall, no control- "value" realized via post-transaction compensation
2. Traditional PSA- physicians still own their practice, but the administrative infrastructure is managed by the health system.
   a) Practice gives up its revenue and payer contracts
      i. If the Health system manages Accounts Receivable poorly, it may negatively impact physicians unless compensation is based upon wRVU productivity
   b) Health system employs staff and maintains most control over administrative duties
      i. Practice has less control over staff and the practice culture
   c) Health system may own equipment and assume real estate leases; physicians may retain and continue leasing (at FMV)
3. Global PSA- physicians own their practice and retain control over the administrative infrastructure.
   a) Health system owns accounts receivable and payer contracts
      i. If the Health system manages Accounts Receivable poorly, again, it may negatively impact physicians unless compensation is based upon wRVU productivity
   b) Practice feels independent since its physicians retain operational control

Conclusion: With health system affiliation, the "model" dictates the level of "control" – PSAs maintain more control at the physician level while employment entails little say by the physicians (unless negotiated into the Transaction)

PRE-TRANSACTION CONSIDERATIONS*

- **Understand Your Goals-** What is your greatest priority? Maximize upfront value? Reduce risk and difficulty involved with running an independent practice? Achieve greater income stability?
- **Choosing the Right Partner**- Many practices choose the highest EBITA bid and regret not considering other criteria. Some additional factors to consider include:
  - –Reputation and Track Record
  - –Available Resources
  - –Management Team
  - –Ability to grow base via capital to purchase additional practices
- **Benefits Beyond Transaction Value**- PE firms and hospitals may provide value beyond the partial cash buyout of a practice. Some strategic advantages include:
  - –Better financial modeling and analysis
  - –Additional brain power
  - –Uniform policies
  - –Significant capital for further investments in the practice
  - –Degree of continued independence and autonomy (even as a majority owner)

* These point to overall positives of potentially partnering with PE.

POST-MERGER INTEGRATION CONSIDERATIONS

Specific issues/initiatives such as those outlined below and on the following slide should be considered **prior** to any transaction, whether PE, hospital or any other buyer/investor. Overall, these illustrate more positives than negatives to a successful PE Transaction. Nonetheless, minority interests' leverage over such things is never as much **post-Transaction** as they are **pre-Transaction**!

- **Electronic Health Record**
  Will the new practice transition to the acquiring company's system? If not, are the two systems compatible? What options do minority owner physicians have if a cheaper, more cumbersome EHR is selected?

- **Communications**
  How quickly will the acquired company be integrated into corporate communication systems (email addresses, access to the company intranet, etc.)? How much say will the physicians retain regarding communications with patients?

- **Human Resources Programs**
  Will the newly acquired employees/providers be onboarded to the same standard as the existing company employees/providers? How will you ensure the timeliness of connecting benefits to employees/providers? Do the minority ownership physicians retain the ability to hire/fire staff? What are the standards for employee performance and what role do the physicians play in that process?

POST-MERGER INTEGRATION CONSIDERATIONS

- **Physical Facilities**
  Will the staff be integrated, or will two separate offices co-exist? Consider how the culture may be impacted if the acquiring practice emphasizes growth or a lean cost structure.

- **Day-to-Day Operations**
  What level of involvement does the acquiring practice have in day-to-day operations? How does this differ from existing operational processes for the minority physicians?

- **Financial Operations**
  How will consistency across multiple, formerly independent practices, be achieved regarding accounts payable, accounts receivable, revenue cycle policies and procedures, and other financial operations?

- **Compliance and Ethics Program**
  How do the acquiring practice's Code of Conduct policies differ from the acquired practice? What level of oversight do minority owners have over ethical standards and compliance?

CASE STUDY #1

A group of Physicians (part of Practice A) sold their surgical hospital to a large surgical management company. The physicians retained a small minority stake in the hospital.

- After the sale, the management company rewrote the operating agreement to discount the valuation of minority stakes to 3x of EBITDA for all future Transactions.
- The physicians lost **$260K** in the subsequent sale of their minority shares due to the operating agreement change, which was orchestrated by the new majority owner.
- Often, physicians have little legal recourse after the fact.
- What were some possible ways to have averted this situation?

	Discounted Valuation	Fair Market Value Pricing Model
Net Patient Revenue	$20,000,000	
TTM Net Income (Loss) Before Minority Interest, Sale of Investment	$4,000,000	
LESS: CJR Reimbursement (prior year)	($400,000)	
LESS: 1-Time Rate Lift (prior year)	($300,000)	
LESS: HHS Funds (prior year)	($200,000)	
Add interest expense	$20,000	
Add depreciation	$300,000	
Add amortization	$50,000	
TTM EBITDA	**$3,470,000**	**$3,470,000**
EBITDA Multiple	3.0 (direct application)	4.5 (implied)
Value of Invested Capital	**$10,410,000**	**$15,615,000**
Less: interest-bearing debt	($500,000)	($500,000)
Fair Market Value Transfer Price, 100%	**$9,910,000**	**$15,115,000**
Value Per 1% Interest	**$99,100**	**$151,150**
Value of 5% Interest	**$495,500**	**$755,750**

CASE STUDY #2

- Practice B is a 15-physician ENT practice in the Southwest.
- A PE firm engages Practice B in discussions regarding a deal and key leadership from both parties meets several times before a formal offer results.
- To better understand the deal and persuade other partners, Practice B engages a financial consultant and legal counsel to review the proposal.
- Advisors conclude that the PE firm has already partnered with another practice as their platform practice and are offering Practice B a deal consisting of little governance influence.
- Hospital alignment was also considered; Practice B has not solicited bids from other PE firms to this point.
- Other Practice B Partners do not support the lack of influence joining the new entity as a non-platform practice would entail.
- Lack of consensus significantly extends the process, giving doubt to the PE firm as to Practice A's seriousness.
- **Eventually the deal falls apart with Practice B remaining independent while utilizing the advisors to consider other options. A PE deal down the road is still possible. Practice B Partners resolve to reach an internal consensus on priorities before pursuing other transaction opportunities.**
- **What were the key mistakes and lessons learned from this singular PE experience?**

ABOUT THE PRESENTERS

ABOUT MAX REIBOLDT, CPA

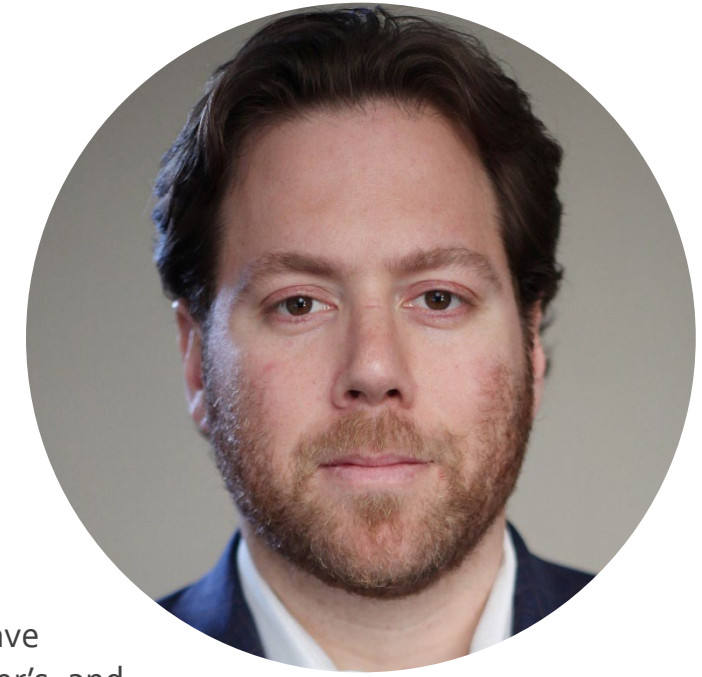
Max Reiboldt is president/CEO of Coker Group with 46 years of total experience; the last 27 years specifically focused on healthcare. He has experienced first-hand the incredible changes of healthcare providers, which uniquely equips him to handle strategic, tactical, financial, and management issues that health systems and physicians face in today's evolving marketplace.

From his extensive work with health systems/hospitals, medical practices, and related healthcare entities, Mr. Reiboldt understands the nuances of the healthcare industry, especially in such a dynamic age. He understands healthcare organizations' needs to maintain viability in a highly-competitive market. His experience of having "experienced everything" in the healthcare industry equips him to provide pertinent counsel to clients. Whether a transitional provider or a more cutting-edge healthcare entity, Mr. Reiboldt is uniquely qualified to work with these organizations to provide sound solutions to every day and long-range challenges.

As president/CEO, Mr. Reiboldt oversees Coker Group's services and the general operations of the Firm. He has a passion for working with clients, providing sound financial, strategic, and tactical solutions to hospitals and health systems, medical practices, and other healthcare entities through keen analysis and problem-solving. Working with organizations of all sizes, Reiboldt engages in consulting projects nationwide.

An avid writer and speaker, Reiboldt enjoys educating healthcare leaders through books, white papers, articles, and speaking at national symposiums. His expertise encompasses physician/hospital alignment initiatives, hospital service line development, clinical integration initiatives, financial analyses (including physician compensation plans), mergers and acquisitions, hospital and practice strategic planning, ancillary services development, PHO/IPA/MSO/CIN development, appraisals, and "accountable care era" consultation. As the industry moves to adapting to many changes in response to healthcare reform, including the entire "volume-to-value" paradigm, he leads Coker Group's efforts in this arena.

ABOUT ROY BEJARANO



In his role as Chief Executive Officer and Co-Founder of SCALE Healthcare Roy has interacted with several hundred multi-site provider based organizations across the majority of U.S. and financial institutions that provide investment capital to these rapidly evolving healthcare management platforms. Roy is particularly focused on MSO and practice level operations as well as broad strategic and competitive dynamics across the country's healthcare services landscape.

Prior to SCALE, Roy served as Physicians Endoscopy's Chief Strategy Officer & Co-President of Physicians Endoscopy's MSO initiative, where he co-led the firm towards its inaugural physician practice MSO partnership transaction with Capital Digestive Care. Prior to Physicians Endoscopy, Roy was Co-Founder and President of Frontier Healthcare, which was the largest ASC management company in New York at the time of its sale to Kelso & Company-backed Physicians Endoscopy in April 2017.

Roy is a frequent author of articles on healthcare industry trends and operational insights that have been published in leading healthcare journals such as Physicians Practice, EndoEconomics, Becker's, and ASC Focus, as well as a frequent speaker at healthcare conferences, having presented on multiple occasions at the McDermott Will & Emery Physician Practice Management & ASC Symposium, the McGuire Woods Annual Healthcare Private Equity Conference, the NY Metro ASC Symposium, the NJAASC Conference, and at Columbia Business School. He teaches a course on Entrepreneurialism at Columbia University and is also a Member of the Columbia Business School Healthcare and Pharmaceutical Management Advisory Board.

Before entering the healthcare industry, Roy had 12 years of investment banking, private equity, corporate development, strategic consulting, and asset management experience across Beige Group (Co-Founder & CEO), Houlihan Lokey and Citigroup/Salomon Smith Barney.

Roy attended the Columbia School of Business & the University of Manchester.

ABOUT ANDREW BLUSTEIN

Andrew E. Blustein is the Chairman of Garfunkel Wild, P.C. Mr. Blustein's practice includes the representation of hospitals, physicians, ambulatory surgery centers and other healthcare industry-related clients (both for-profit and not-for-profit). Mr. Blustein has been a leader in developing and implementing Compliance Programs for healthcare providers and health plans, advising ambulatory surgery centers and assisting hospitals in strategic affiliations. He frequently lectures on physician practice issues, private equity transactions, cyber-security, telemedicine, corporate transactions practice mergers and computer contracting.

Admitted to the New Jersey Bar, the New York Bar and the Connecticut Bar, Mr. Blustein is a member of the New York State Bar Association, the New Jersey State Bar Association (Health and Law Section); Prior Co-Chairman of the Westchester County Bar Association (Hospital and Physician Law Section) and the American Health Lawyers Association.

Mr. Blustein graduated from Vassar College in 1987 (B.A., Phi Beta Kappa, cum laude) in 1987 and Benjamin N. Cardozo School of Law (J.D., magna cum laude) in 1990.

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