Private Equity Or ESOP?

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I. Private Equity

a. Definition: Private equity is an alternative asset class composed of funds that invest primarily in privately-held companies. Private equity is comprised of funds and investors that diversely invest in private companies.

II. ESOP

a. Definition: An alternative liquidity option for privately held businesses through an ERISA-authorized, defined contribution plan that invests in employer securities.

b. By the Numbers:

   i. ~7,000 ESOPs in the US

   ii. ~$1.3 trillion total assets held

III. Why Private Equity?

a. Monetization

b. Growth and Competition

c. Infrastructure Needs

III. Why Private Equity? (cont.)

Objective is to install a self-sustaining platform for physician-owners to monetize a portion of the practice, while retaining upside in growth for future partners and employees:

- Senior Partners (<7 year retirement in horizon)
  - Liquidate portion of equity stake in practice through tax-efficient transaction

IV. How Will Private Equity Affect Overall Healthcare Spending and Quality of Care?

a. Dermatology

- Private equity firms have acquired nearly 200 dermatology practices across the country over the past six years

- A JAMA Dermatology study found that 17 private equity-backed dermatology management groups rolled up 184 practices from 2012 to 2018, accounting for 381 clinics in at least 30 states

- Editorial in JAMA Dermatology called for a halt to private equity acquisitions of dermatology practices until data are available on how these deals affect quality of care and affordability for patients and payers.

IV. How Will Private Equity Affect Overall Healthcare Spending and Quality of Care? (cont.)

- Dermatology article called for researchers to study the impact of private equity ownership on physician and midlevel staffing, use of procedures and tests, payment rates, trends in provider compensation, autonomy, satisfaction and burnout.
- As value-based care becomes increasingly prevalent, outcomes data may play a bigger role in determining the valuation and strategic rationale for private equity consolidation of physician practices.

V. How is the Private Equity Deal Structured?

a. Physician Group Valuation

   i. EBITDA Calculation: Earnings before interest, taxes, depreciation and amortization is a way to measure a company's operating performance

   ii. The "multiple" is negotiated

   iii. Payment:

      - Typically 70/30 split - 30% is rollover equity
      - Physician-Owner compensation is reduced

VI. The MSO

Corporate Practice of Medicine - Issues

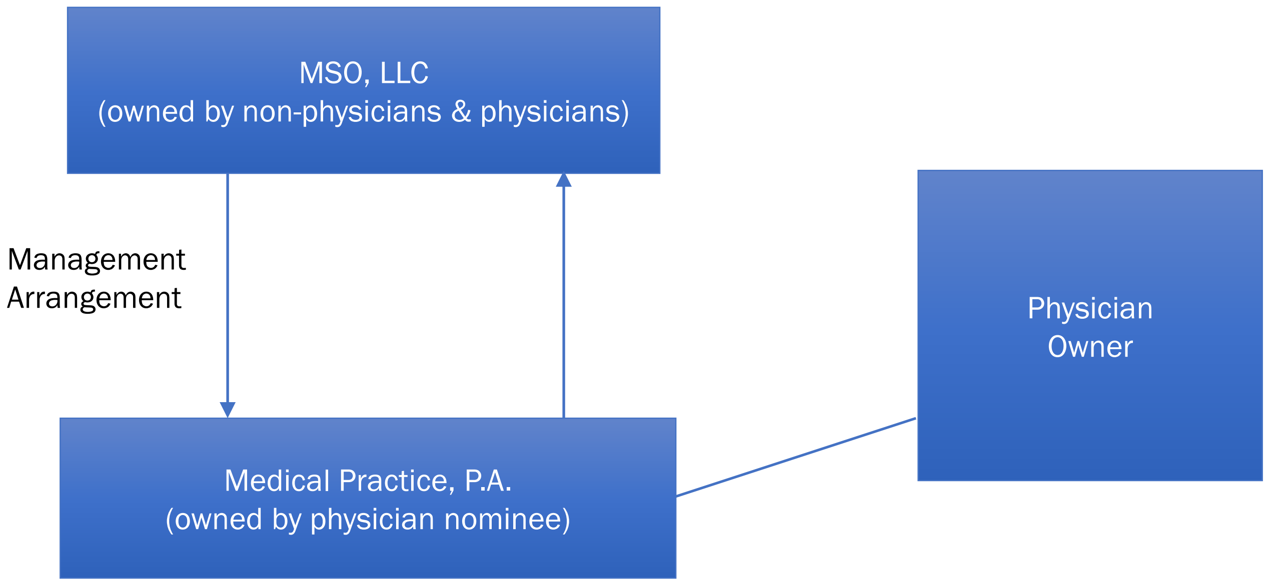
a. In New Jersey, corporations and other non-licensed entities are prohibited from providing medical services using licensed physicians and from splitting fees between physicians and non-physicians.

b. Violations can result in professional sanctions of the physicians and perhaps criminal and civil penalties against the officers and directors of the corporation.

c. To comply with these rules, PPMs often use a management services organization (MSO) structure.

VI. The MSO

Corporate Practice of Medicine – Issues (cont.)



- Fee structure varies (flat fee vs. percentage).
- Terms of control over physician owner(s) varies.
- MSO typically holds as many assets, contracts (payor and supplier), employees, as allowed.

VI. What is an ESOP?

An ERISA-authorized, defined contribution plan that invests in employer securities.

Who is the buyer?

- Trust representing at least 10 employees

Who sets the price?

- Shareholders and institutional trustee negotiate price
- Based on independent valuations

How is it funded?

- Commercial and/or seller financing
- Paid-off with pre-tax corporate cashflow

Who gets shares?

- FTEs are allocated shares proportional to annual comp

How is stock earned?

- A portion of all shares is allocated annually
- Shares vest within 3-6 years

How do employees redeem shares?

- When employees depart or retire, vested stock is repurchased by the company

VIII. ESOP Considerations

Pros:

- Day-to-day management unchanged and board will continue to oversee operations
- Selling partners can elect 1042 tax deferrals
- Company receives tax deductions and can become free of Federal and most states' income tax
- Partners hold control of transaction structure, including an option for minority sale
- Employees receive equity in the Company, opposed to a 3^{rd} party
- Meaningful upside for management

VIII. ESOP Considerations (cont'd.)

Cons:

Regulatory oversight by DOL and IRS

ESOP cannot pay more than fair market value

Requires ongoing administrative costs, including annual valuation, legal, and trustee fees (est. $250k/yr.)

Lenders only finance a portion of the purchase price; seller notes cover the balance

IX. Private Equity Considerations

Pros:

- Selling partners usually receive up to ~70% of the purchase price upfront
- PE firm professionalizes operations through strategic plans
- PE firm can support Company in executing add-on acquisitions

IX. Private Equity Considerations (cont.)

Cons:

- Sellers pay capital gains taxes
- Added hierarchy in business decisions (e.g. in M&A transactions, budgeting, etc.)
- Partners have no or limited upside in the company's future performance – new partners lose interest in joining practice
- Company does not benefit from ESOP specific tax deductions post-transaction
- Transaction structure is largely determined by PE buyer
- Risk of using excessive leverage, which is amortized with after-tax dollars
- Partners have no say in who PE firms later sell the company to

X. ESOP Alternative

ESOP provides an alternative liquidity transaction for selling partners with significant benefits to all parties:

- Selling Partners
- Company
- Management / Employees

X. ESOP Alternative (cont.)

Seller Benefits :

- Creates a buyer for Partners' equity and enables asset diversification
  - Partners hold control over design of sale structure
- Do not pay capital gains taxes if 1042 treatment is elected (individual election)
- Retain substantial upside through remaining equity / warrants
- Unlike M&A, definitive process and timeline ~4 months to close
- ESOP structure provides substantially greater after-tax cash flow than status quo
- Partners maintain control of the practicing entity
  - Existing partnership agreement continues to govern practice

X. ESOP Alternative (cont.)

Company Benefits:

- Company can become income tax free after the ESOP transaction
- If company closes as a C corporation, company gets “bucket” of deductions equal to sale value
- If company is 100% owned by an ESOP and becomes an S corporation, is 100% income tax free
- Post-transaction, tax-enhanced cash flow can be used to pay down financing and grow the business
- Retains flexibility to pursue other options in the future (M&A, IPO, sale to PE, etc)

Governance:

- Board of Directors will continue running company’s existing operations
- The company remains independent

X. ESOP Alternative (cont.)

Management Team and Employees:

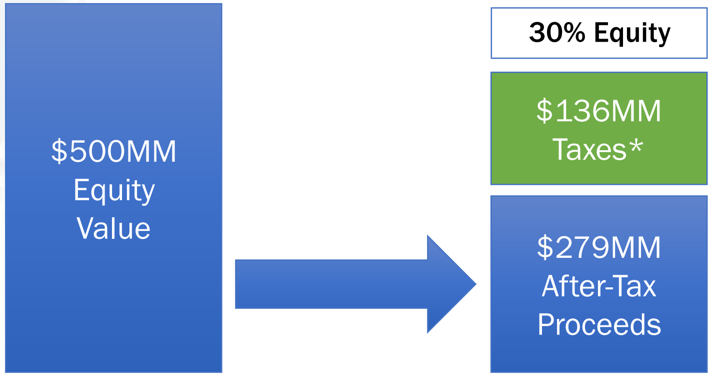
- Reward and incentivize management team and employees
- Employees receive substantial tax-deferred benefits over long-term
  - Stock in ESOP is allocated to employees over time based on wages
- Retain strong, independent company culture
- Provide key management team members with additional upside through SARs plan
- Create mechanism to attract top talent and grow the business

XI. Hypothetical Shareholder Proceeds at Closing

- Illustrative comparison below assumes 100% equity in MSO is sold to PE/ESOP for comparative purposes only (valuation analysis, capital market analysis, and recommended structure will require more information):

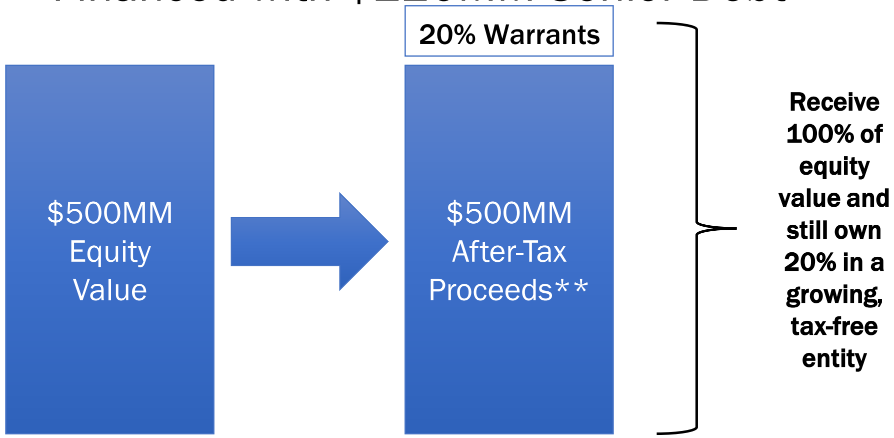
<u>Private Equity Sale</u>

Key Assumptions:
- $500MM Equity Value
- 30% Equity Rollover
- Financed with $220MM Senior Debt



<u>ESOP Sale</u>

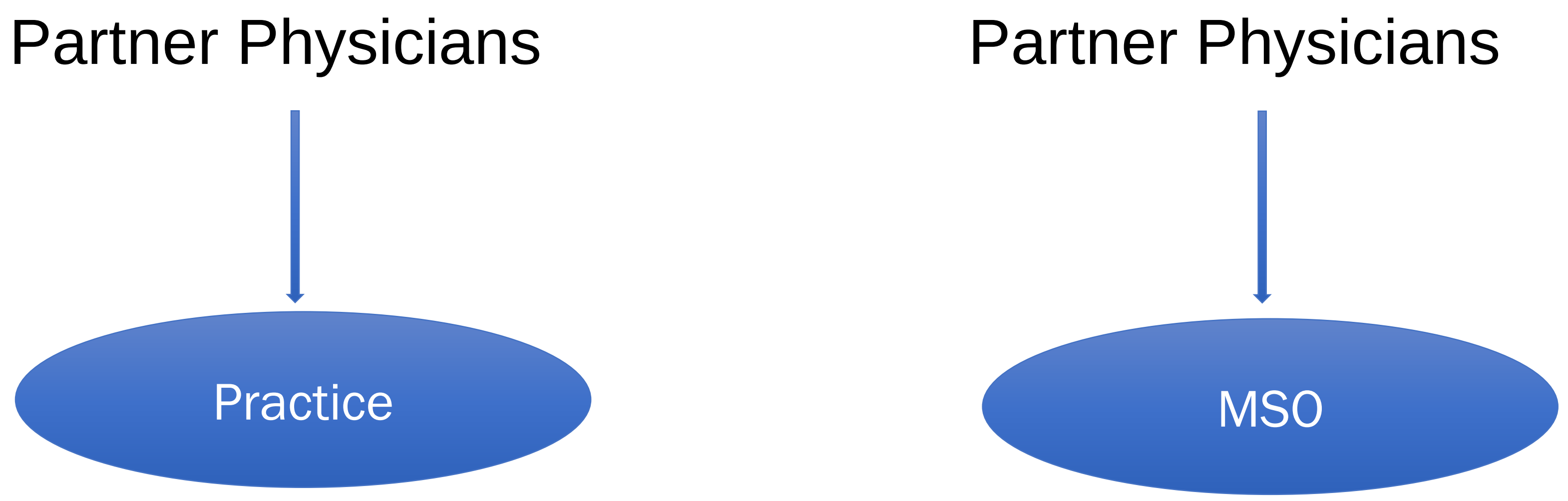
Key Assumptions:
- $500MM Equity Value
- 100% Sale w/20% Warrants
- Financed with $220MM Senior Debt



*Applicable capital gains tax rate in New Jersey up to ~35%, assumes ~33%
** ESOP sale may utilize seller notes to partially fund the transaction – recommended structure will aim to minimize this

XII. Current Ownership Structure

- Prior to the transaction, partner physicians' ownership stakes in the practice based on the practice's existing partnership agreement
- An MSO will be established as an LLC with all partner physicians owning pro-rata interests in the LLC based on current ownership stakes in the practice



XIII. ESOP Transaction Structure

As an ESOP sale, partners have control to determine sale structure. Broadly speaking, there are two transaction structures to consider:

<u>MINORITY SALE WITH OPTIONAL SECOND SALE</u>

- Partners sell a minority stake in the MSO in the first stage sale and have the option of a second stage sale at a later date
- Value at closing is enhanced through preferred equity sale
- Partners ***eliminate/defer capital gains tax*** on sale by electing 1042
- C Corp taxes are reduced through ESOP related non-cash deductions
  - Company has tax deductions equal to the first stage sale amount
  - Can take deductions each year equal to 25% of eligible payroll and can deduct reasonable dividends to ESOP (dividends are non-cash to company because returned by ESOP)
- Partners retain upside through unsold equity

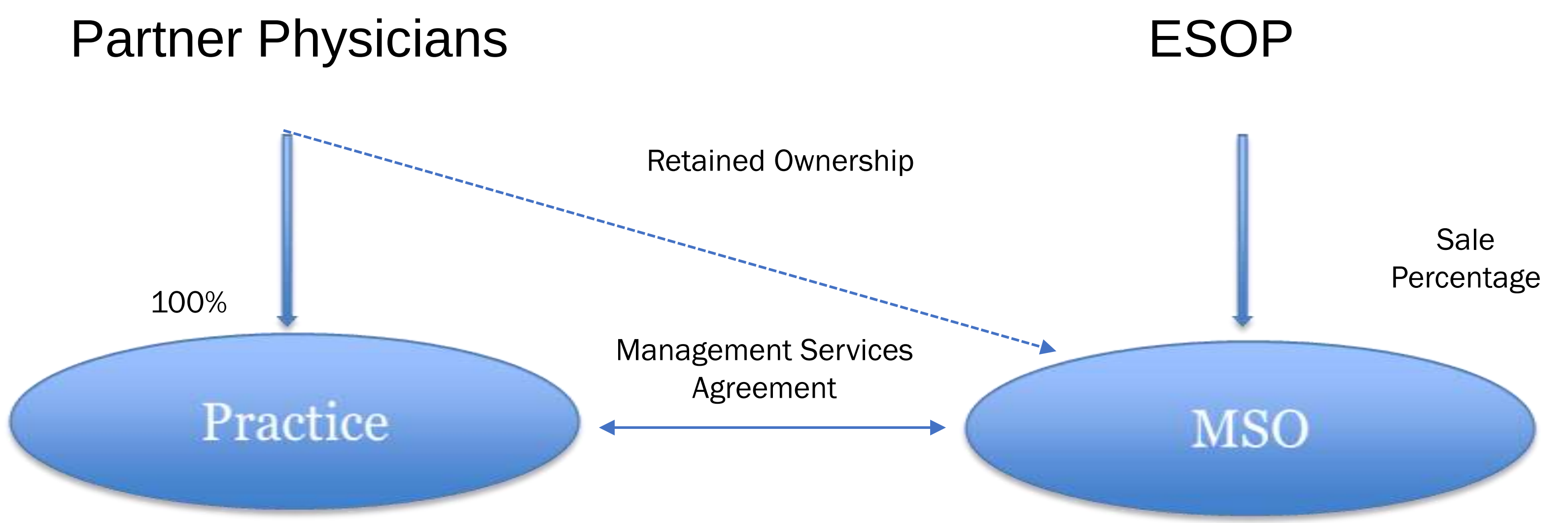
XIII. ESOP Transaction Structure (cont.)

MAJORITY SALE

- Incorporate as a C Corp
- Close as a C Corp
  - ➢ 1042 eligible (gives partners the option to defer/eliminate capital gains taxes)
  - ➢ Convert to S Corp in following tax year and operate tax free in perpetuity
- Partners retain significant upside in the company's future growth by receiving up to 40% in warrants as part of the transaction consideration

XIII. ESOP Transaction Structure (cont.)

Pre-transaction, the MSO is incorporated as a C Corp, allowing partners to elect 1042. Partners' ownership interests in this entity are then sold to the ESOP (recommended sale percentage to be determined after further analysis)
Partners continue to operate practice same as before. Approximately 70% of partner income continues to be paid out under current compensation structure



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