Provident Healthcare Partners

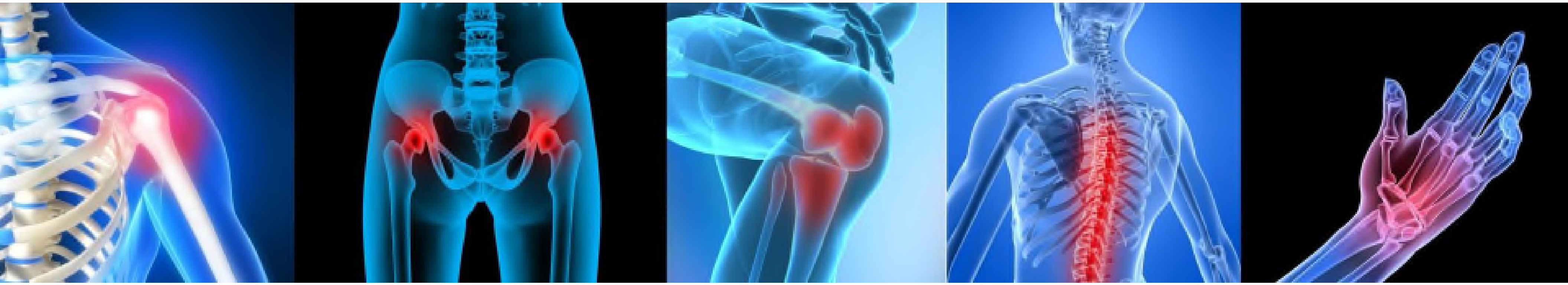
EPSTEIN BECKER GREEN

The Future of Health Care: Physician Practices and Private Equity Investments

Orthopedic Practices:

The Newest Focus of Private Equity Investment

July 27, 2017



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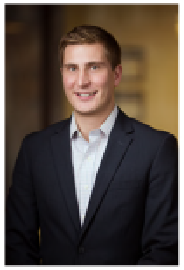

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Provident and EBG Introduction

Firm Overview
Provident Healthcare Partners

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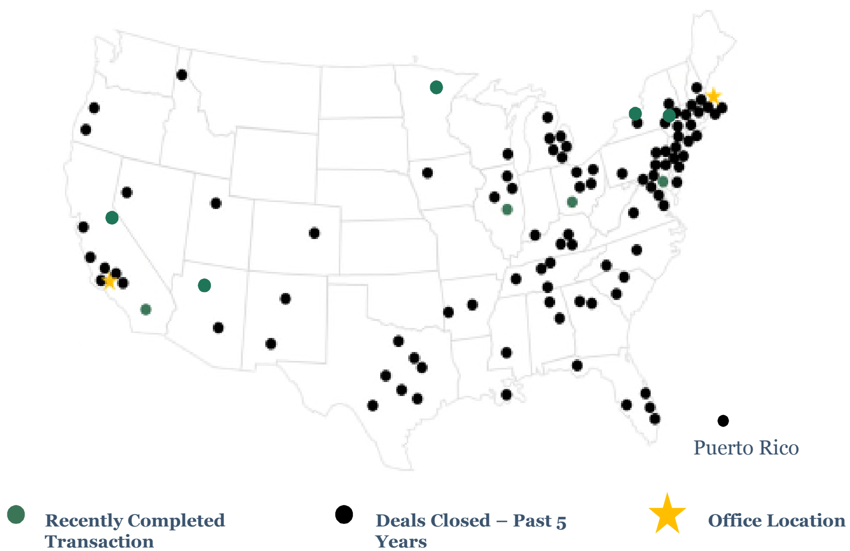
SERVICE OFFERING

- Investment bank focused exclusively on merger and acquisition advisory in the healthcare services industry
- The firm provides financial advisory services to a broad range of healthcare organizations including the following physician specialties:
  - Dermatology
  - Eye Care
  - Urology
  - Gastroenterology
  - Orthopedics
  - Pain Management
  - Dental Services
  - Behavioral Health
  - OB/GYN
  - Primary Care/Multispecialty
  - Ambulatory Surgery Centers



SELECT RECENT PHYSICIAN PRACTICE TRANSACTIONS

New West Physicians — We put your health first *Has been acquired by* OPTUM	Southeastern Spine Institute and Ambulatory Surgery Center *Has been recapitalized by* Candescent Partners	Women's Health Care Group of PA *Has been recapitalized by* Audax Group	Premier Pain Centers *Has been acquired by* National Spine & Pain Centers *A portfolio company of* Sentinel Capital Partners

120+	Deals Closed
30+	Physician Deals Closed since 2014
12-15	Landmark Deals Per Year
25+	Deal Professionals

- Investment banking services delivered exclusively to companies in the high-growth healthcare industry
- An established track record as one of the most active healthcare investment banks in the country
- Has emerged as an industry leading advisor to physician groups
- Experienced advisors to serve the complexities of broad shareholder bases and varied shareholder motivations among physician groups
- Focus on sell-side mandates resulting in the best long-term partnerships

Epstein Becker Green

Epstein Becker Green was **founded in 1973** exclusively as a health law firm dedicated to the success of the health care industry which remains the firm's focus today.

The firm is highly regarded as a **legal pioneer in the health care and life sciences industry** and have been nationally influential on health regulatory issues and business solutions for over four decades.

Epstein Becker Green attorneys have significant experience leading major health care company **mergers, acquisitions, sales and affiliations** on behalf of national health care companies (public and private), private-equity backed health care portfolio companies, and local and regional health care providers and companies.

24 Landmark Deals Per Year

168 Physician Deals Closed Since 2014

14 Offices Across the Country

250 Attorneys

120 Health Care Attorneys

70 Health Care Transactions Attorneys

- Supported by a deep multi-disciplinary team of healthcare regulatory, antitrust, reimbursement, tax, employment, benefits & real estate attorneys to assist in due diligence and all aspects of preparing groups for transactions and closings.
- Ranked among the top 10 firms in the 2017 *Modern Healthcare* "Largest Healthcare Law Firms" list.
- Ranked in Healthcare Nationwide and in the District of Columbia, New York, and New Jersey in 2017 by *Chambers USA*.

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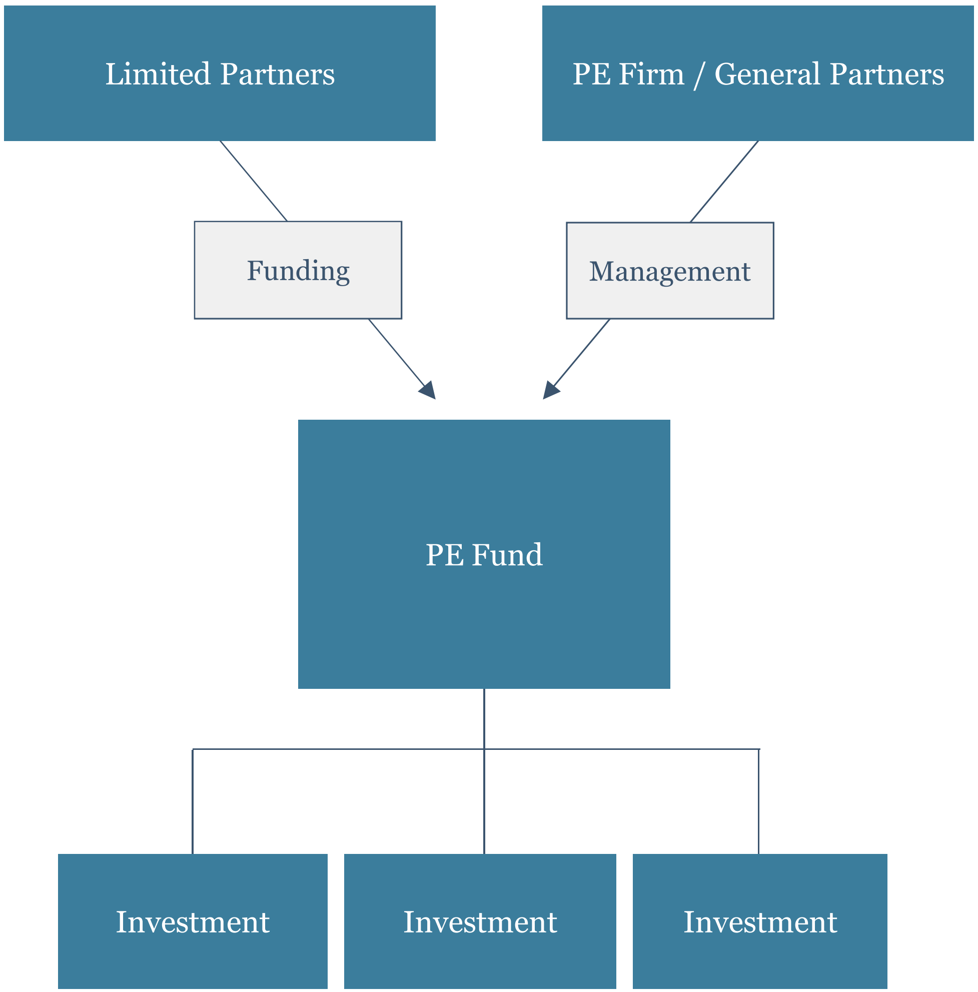
Goals of the Presentation

- Defining Private Equity
- Highlight Major Reasons Why Orthopedics is Now a Focus of PE
- Understanding Common Motivations for Pursuing a Transaction
- Walk Through Key Elements and Considerations for a Transaction
- Review top Health Care Regulatory Issues in Orthopedic Practice Transactions

Understanding Private Equity

What is Private Equity?

Private Equity Structure



Overview of a PE Fund

Private Equity

- Investors and funds that seek to make direct equity investments in privately-owned organizations
- Add value by growing organically, acquiring more companies, improving operations, and optimizing the capital structure

Limited Partners (LPs)

- Passive investors in private equity funds
- Includes: institutional investors, pension funds, endowment funds, and high net worth individuals
- Expect a high return; often higher than attainable in public markets

PE Firm / General Partners (GPs)

- Group of managers that raise money for individual funds and manage the funds and investments
- Paid from:
    - Carried interest: a percentage of returns when an investment is sold (commonly 20%)
    - Management fees: a percentage fee applied to the total funds invested by the LPs

Overview of Private Equity Funds

Overview of a PE Fund

Investments

- Funds make investments in privately owned companies that fit their experience and align with their thesis, which includes aspects such as:
  - Size
  - Industry
  - Geography
  - Timeline

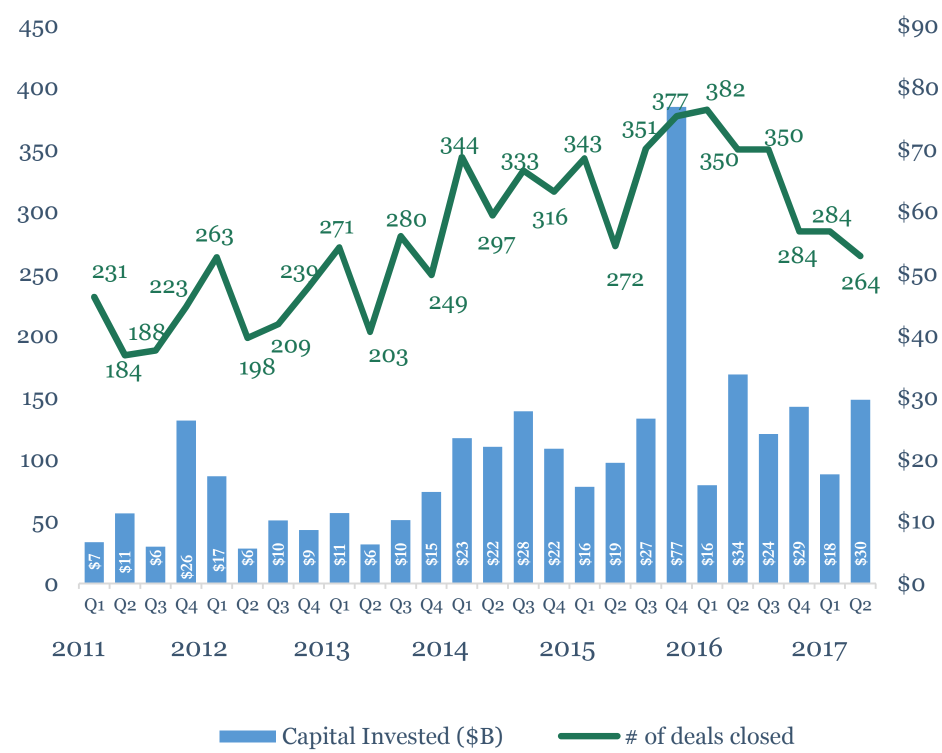
Investment Management

- Private equity groups operate on a 10 year lifespan; they spend the first 5 years making investments and the last 5 years exiting investments
- GPs commonly focus on helping companies grow through high level strategy, not day to day management
- Private equity groups understand the importance of aligning with physicians as they are the revenue generators of the business
- Owners are often required to retain a percentage of equity and be active in day to day operations
- Funds plan to exit investments after a set period (commonly 3-7 years)

Goals

- Funds aim to make a return on their equity (often about 3-4x)
- High returns lead to income for the GPs and in improved ability to raise funds for their next fund

Healthcare PE Deal Flow by Quarter



Private Equity Investment Strategy

Strategic Initiatives Leading to Growth

1. Refine Internal Infrastructure and Establish Growth Objectives
2. Consolidate Market Locally and Regionally
3. Establish Regional Hubs
4. Explore Exit

How Equity Value Appreciates

- Increase Synergies
- Bolster Management Team
- Expand Ancillaries
- Multiple Arbitrage
- Risk-Based Contracting
- Add On Acquisitions

Private Equity "Roll Up" Successes

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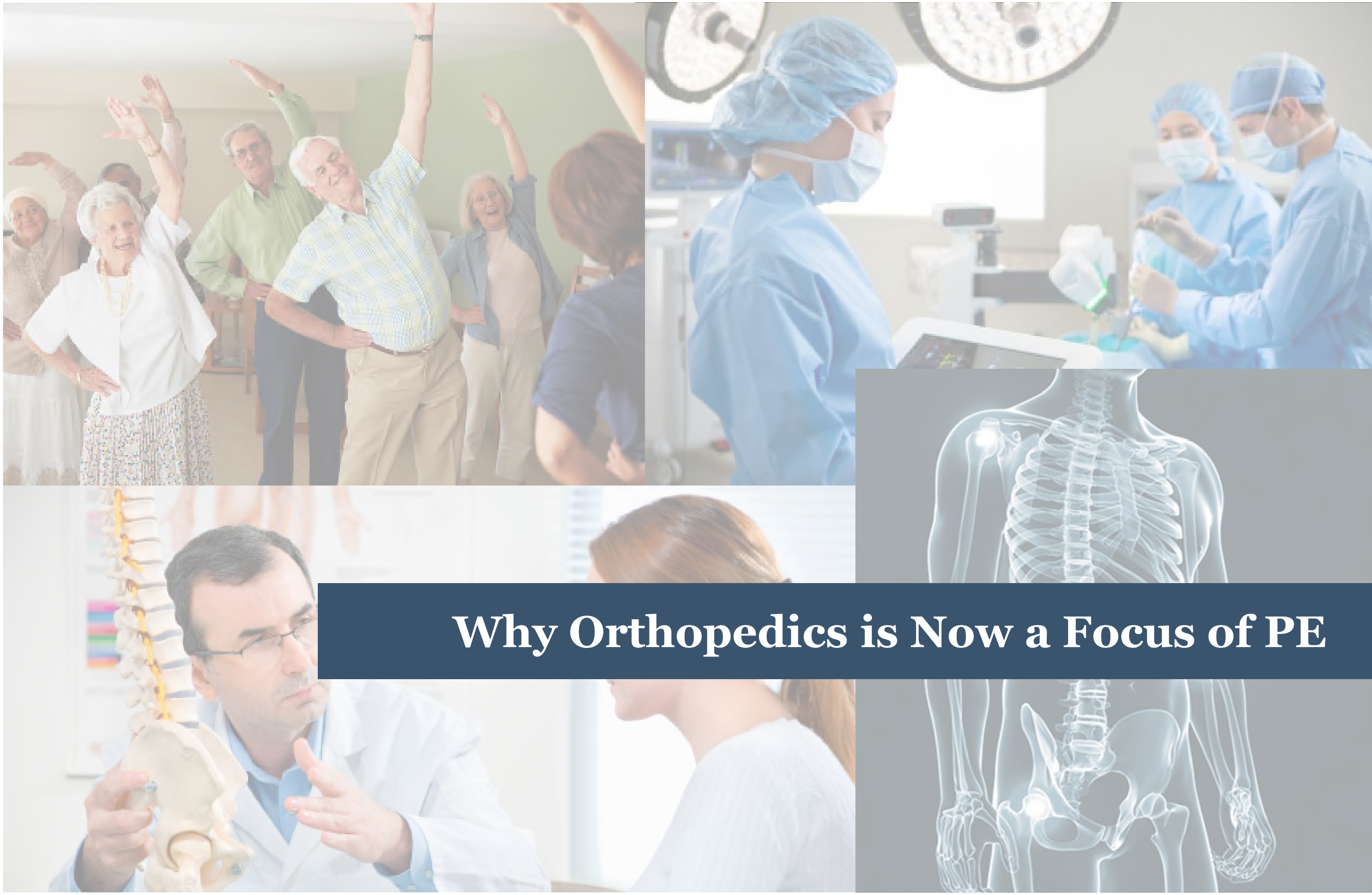
	Physician Practice/Private Equity Group	Add-on Acquisitions
Pain Management	**The Spine Center & Sentinel Capital** The Spine Center of The Center for Pain Management Sentinel Capital Partners	National Spine & Pain Centers New York Pain Consultants Manhattan Spine & Pain Medicine, P.C. Capitol Spine & Pain Centers Premier Pain Centers
Dermatology	**The Dermatology Center & Pharos Capital** The Dermatology Center / Rockledge MedSpa Pharos Capital Group, LLC	sōna MedSpa
Ophthalmology	**Katzen Eye Group & Varsity Healthcare Partners** Katzen Eye Group Varsity Healthcare Partners	Delaware Eye Care Center Lakeside Eye Group Madison Street Surgery Center Milauskas Eye Institute Inland EyeSpecialists Colorado Eye Center Hauser-Ross Eye Institute Chicagoland Retinal Consultants Omni Eye Specialists Denver Spivack Vision Center
Dental	**Great Expressions Dental Centers & Audax Group** Great Expressions Dental Centers Audax Group	Family Smiles Dentistry Wright Dental Care Family Dentistry ConsoliDent Exceldent Nanston Dental Group Goodman Orthodontics Smile Care Dental Willow Creek Dental

(1) Provident served as the exclusive sell--side advisor on all case study platform transactions



Why Orthopedics is Now a Focus of PE

A Market Positioned for Growth

Orthopedic Care

Growth Drivers

Growing Insured Population and Patient Base

- Growing in 65+ year old population
- Increase in insured US population
- Increase in chronic conditions including obesity and arthritis

Shift to Outpatient Care Settings

- Expansion of approved procedures by CMS

Transition to Value-Based Reimbursement

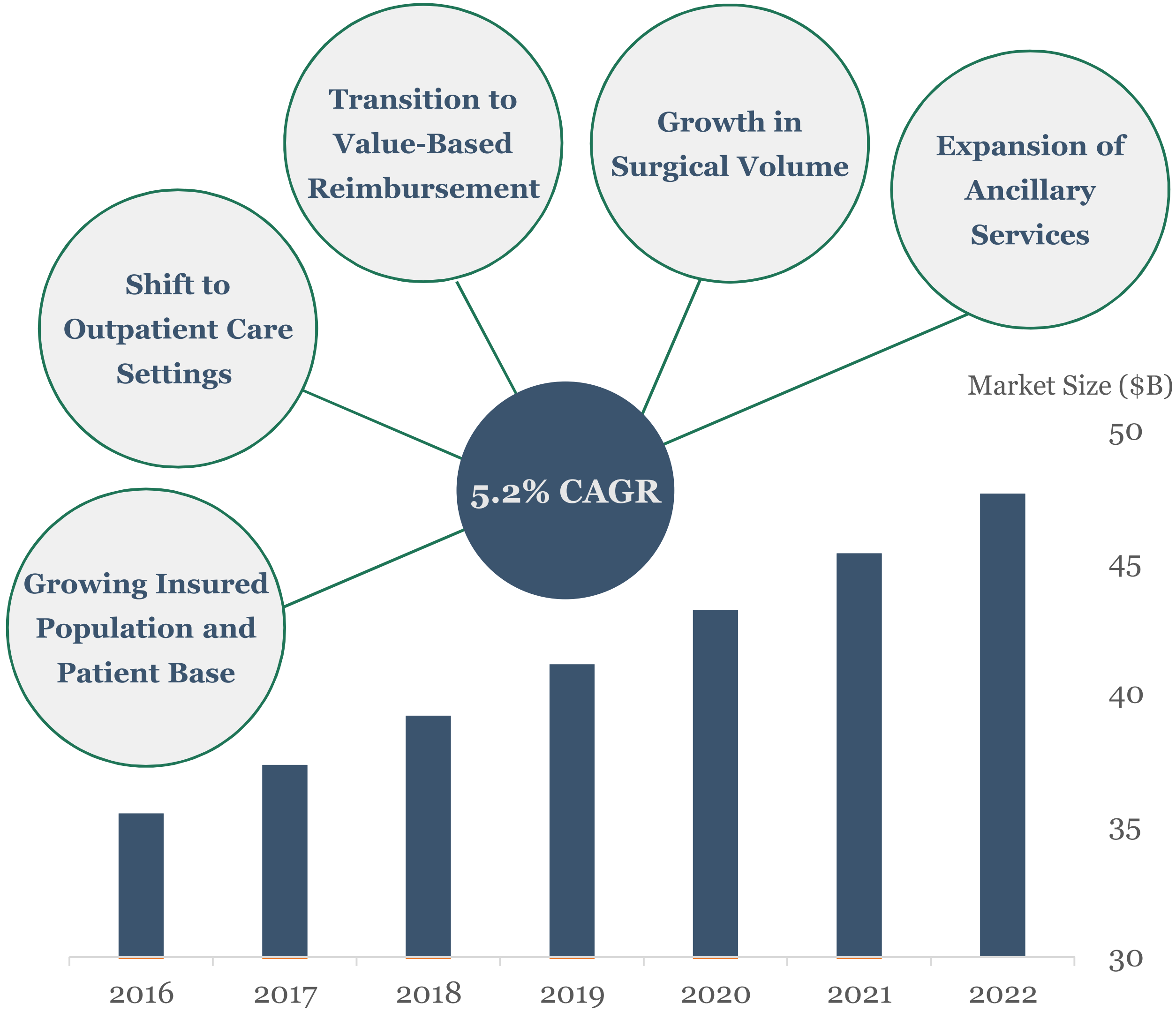
- Cost advantages of outpatient care are amplified by the need for efficient patient management

Growth in Surgical Volume

- Increasing total procedures
- Increasing stress on inpatient locations

Expansion of Ancillary Services

- Additional revenue
- Stronger referral sources



**Source: Sg2 Health Care Intelligence*

Replicate Success in Other Specialties

Beginning with significant investment into the dental space in the late 90's, private equity groups have experienced years of success in multisite, provider based business.

Private equity groups are looking to replicate the successes they experienced in other physician specialties such as dermatology and ophthalmology as orthopedics shares a number of similar traits to those specialties.

Sector	Investment Date	Platform Practice	Private Equity Group	Current Private Equity Portfolio Companies
Dental	1996	American Dental Partners	Summit Partners	35
Pain Management	2008	Advanced Pain Management	Excellere Partners	6
Dermatology	2011	Advanced Dermatology & Cosmetic Surgery	Audax Group	21
Ophthalmology	2014	Claris Vision	Candescent Partners	11
Gastroenterology	2016	Gastro Health	Audax Group	1
Urology	2016	Chesapeake Urology	Audax Group	1
OB/GYN	2017	Axia Women's Health *	Audax Group	1
Orthopedics	2017	Southeastern Spine Institute *	Candescent Partners	1

* Provident represented the selling shareholders in these transactions

Transaction Structure and Considerations

How Private Equity Deals Are Structured

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Most Common Private Equity Structure

A Multiple of "EBITDA"

- Transactions with private equity groups will be based on the ADJUSTED EBITDA of the group*
- The valuation for a group will be determined based on the multiples of 'EBTIDA' a buyer is willing to pay
- Example: $5million EBITDA at a 8x multiple is a $40 million valuation
- The exact multiple a private equity group is willing to pay is dependent on a number of factors including (but not limited to):
    - Size
    - Ancillaries
    - Geography
    - Growth
- **Adj. EBITDA explained on following slide*

Minority Vs. Majority

- There are two types of private equity deals: Minority or Majority
- A minority deal is equal to less than 50% sale.
- The vast majority of deals will be a majority sale
- Most commonly, a deal will be anywhere between 60 – 80 % sold equity
- By pursuing a minority partner, a practice limits the number of PE groups that would be interested as most funds look to make a majority investment
- There is a valuation premium for a majority transaction

"Roll Over Equity"

- Any physician practice transaction with a private equity group will involve roll over equity
- Private equity groups want physician shareholders to maintain a significant ownership in the business moving forward
- Most commonly anywhere from 20 – 40 %
- Allows private equity group to ensure physicians are tied to the business
- Allows physicians to participate in upside of business growth in future

Flexibility

- There are no two transactions exactly alike
- Private equity groups are willing to get flexible to meet the needs and goals of the right group
- The exact equity split can reflect the goals of the group
- "Earn Outs" structured in to reward a group's prior investment in growth
- Most deals feature significant cash at close, no claw backs, no contingency clauses, no benchmarks, etc.
- Physicians maintain control of daily clinical decisions

EBITDA Explained

EBITDA Overview

Accounting

EBITDA is the earnings of a business before interest expense, taxes, depreciation and amortization

- Interest is added back due to the assumption that the company will pay off any debt in a transaction
- Taxes are added back due to the change in tax structure as a result of the transaction
- Depreciation and amortization are added back due to the non-cash nature of those expenses

Deal Process

EBITDA is a proxy for cash flow

- A private equity firm's offer for total purchase price will typically be a **multiple of Adjusted EBITDA**
- **Adjusted EBITDA** provides a buyer with a normalized representation of the cash flow by adding back:
    - One-time nonrecurring expenses
    - Expenses varying from the market rate (salaries, rent, etc.)
    - Discretionary, non-business expenses of the shareholders

Visualization of EBITDA in a Deal Process

Revenue	**$10**
Expenses	$9
Net Income	**$1**
EBITDA Calculation:	
Interest	$0.50
Depreciation and amortization	$0.25
Tax	$0.10
EBITDA	**$1.85**

Add Backs to EBITDA	
Normalized compensation	$3
One-time expenses	$0.50
Discretionary expenses	$0.20
Other Income	$0.10
Adjusted EBITDA	**$5.65**
Purchase Multiple	*8x*
Purchase Price	**$45.2**

***All figures in Millions**

Implications of Adjusted EBITDA

Purchase Price

- Purchase price is calculated from Adjusted EBITDA and the purchase multiple, so an increase in Adjusted EBITDA will therefore increase the purchase price

Increasing Adjusted EBITDA using Add Backs

- Some add backs may result in a decrease in shareholder salary or discretionary expenses
- However, shareholders will benefit due to the increased value subject to the purchase multiple

Debt Capacity

- The amount of debt the a PE firm can use is based on a multiple of Adjusted EBITDA

Transaction Motivations

Business Considerations

Access to Capital

- Acquisitions to expand geographic reach & potentially diversify service lines
- Investments in infrastructure needed to grow:
  - Information technology/billing
  - Hiring supplemental management
  - Working capital for de novo growth

Resources of a Partnership

- Strengthen leverage for contract negotiations with payors
- Expertise needed to augment acquisitive growth strategy
- By increasing size and scale, the organization can improve access to care by offering greater sub-specialty expertise

Shareholder Considerations

Risk Mitigation

- Capital investments and debt will no longer be personally guaranteed by shareholders
- Monetization of equity during a strong market reduces impact of potentially significant future valuation changes
- Operational and financial business risks due to uncontrollable outside influences will be diversified away from shareholders

Liquidity Events

- Large upfront cash payment to shareholders
- In a PE transaction, shareholders can retain a percentage of equity going forward, thus participating in the accelerated growth of the company
- The potential exists for a second, third, and even fourth liquidity event for those shareholders with longer career horizons

Pursuing a partnership (whether that be a private equity firm, strategic consolidator, payor, or health system) can provide an orthopedics practice with opportunities to drive growth by utilizing access to capital, key industry relationships, and expertise in creating efficient operations. These groups look to align with physician shareholders in order to develop strategies that collectively benefit the newly capitalized organization, and physicians are heavily involved in creating a shared vision for the organization's future.

Ideal Candidate for Private Equity

Private equity firms look to make initial investments into a specific industry through a "platform" investment. There are a limited number of groups in orthopedics that would qualify as a platform, providing limited opportunities for investors interested in the specialty. We have identified the following factors that can set groups apart from their peers and positively influence valuation from a qualitative perspective.

Strong Internal Infrastructure (Billing, Finance, IT, HR, etc.)

Ancillary Services (E.g., Associated ASC)

"In-Network" with Major Payors

Strong Reputation in Respective Community

Patient-Centric Focus & Positive Outcomes Data

Investment in Growth

Diverse Payor Mix

Strong Management Team

Choosing the Right Partner

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Factors to Consider

Investment Approach & Strategy

Private equity firms have varied approaches; some are very hands-on, while others are more passive

Cultural Fit & Personality

When considering a transaction, philosophic fit is imperative and should be one of the main decision factors

Related Portfolio Company Experience

Groups that have experience with clinic-based healthcare sectors can bring more value to the investment

Average Return on Investment

Past investment returns in healthcare vary depending on the fund and are key to maximizing rollover equity

Relationships to Leverage

What value can they bring in terms of operating partners or potential executives?

Add-on Acquisition Pipeline

Have they had conversations with other potential add-on acquisitions in the orthopedics sector?

Conversation with References

Other portfolio company executives can speak to their experiences with the investor

Cross-Selling Opportunities

Do they have relationships with payors or hospitals that can be leveraged?

Major Considerations For Shareholders

	Newer Partners & Mid-Career	Late Career	All Partners
Rollover Equity	• Retain higher equity percentage • Participate in multiple transactions	• Retain less equity • Second liquidity event	• Continue as an owner • Secondary liquidity events
Cash at Closing	• Retire any medical school debt • Address other investments on hold	• Diversify wealth before retirement	• Take "chips" off the table • Multiple years of ordinary income at closing
Post-Closing Compensation	• Productivity-based	• Structured based on desired role post-closing	• Market-rate
Lifestyle Benefits	• Focus on practicing medicine • Less stress and risk as an owner	• Business development or CMO role if desired • Potential board seat	• Focus on patient care, not governance • Use an investor's capital instead of personal guarantees

Top Health Care Regulatory Issues in Orthopedic Practice Transactions

Overview

1. Due Diligence Process.
2. Common Regulatory Issues in Orthopedic Transactions.
3. Preparing for Private Equity Transactions: Regulatory and Clean-Up.
4. Questions.

Overview of Diligence Process.

- What is "due diligence" and why is it important to buyers?
- Diligence requests ask for certain information and documents, such as:
  - Financial records (e.g., P/L statements, billing and claims A/R, etc.).
  - Organizational documents (e.g., certificates of incorporation, by-laws, shareholder or LLC member agreements).
  - Malpractice insurance coverage and claims.
  - Material contracts (e.g., insurance or managed care contracts, employment agreements, etc.,).
- How do buyers analyze the produced due diligence materials?
  - Successor liability.
  - Emphasis on compliance issues in health care billing and referral "arrangements."
  - Impact on "sustainability" of revenues and practice reputation.

Common Regulatory Issues in Orthopedic Transactions.

- Coding and Billing
- Stark Law and Self-Referral Prohibitions
- Compensation, Investment and other Financial Arrangements
- Arrangements with Hospitals
- Compliance Program – Existence & Implementation

Common Regulatory Issues in Orthopedic Transactions.

Coding and Billing.

Common Billing and Coding Problems

- Documentation and Medical Necessity.
  - E.g., Joint Replacement (total knee or hip).
- Utilization Review and Comparison to Industry Norms.
  - Are procedures over-used as compared to industry norms?
- Upcoding.
  - E.g., Evaluation or management ("E/M") coding.
- "Unbundling."
  - E.g., Post-operative care.

Common Regulatory Issues in Orthopedic Transactions.

Coding and Billing.

Billing Problems Targeted in 2017

- Improper “incident-to” billing for services rendered by physician extenders, without adequate supervision.
- E/M codes pertaining to hospital consults that are not supported by documentation.
- Lack of documentation to support professional component for x-ray services.
- Durable medical equipment, prosthetics, orthotics and supplies (“DMEPOS”) billed improperly or without adequate documentation to support necessity or the delivery of DMEPOS.
- Improper CPT codes used for physical therapy billing and lack of documentation.

Common Regulatory Issues in Orthopedic Transactions.

Stark Law and Self-Referral Prohibitions.

- Federal Stark Law and State Self-Referral Prohibitions.
  - ***Physicians*** may not make referrals for ***DHS*** to entities with which the physician (or an immediate family member) has a ***financial interest***.
  - Bills may not be submitted by an ***entity*** if a referral violates the Stark Law.
  - ***UNLESS*** an exception applies.
- Certain exceptions are particularly available to a "Group Practice."
  - e.g., In-office ancillary services ("IOAS") and physician services exceptions.
  - Productivity bonuses should be based on personally performed services.
- "Group Practice" Definition – must meet multiple requirements.
- Payments from hospitals (and other referral recipients) require an exception.

Common Regulatory Issues in Orthopedic Transactions.

Stark Law and Self-Referral Prohibitions.

- Common Stark Law Diligence Concerns
  - Does the orthopedic practice rely on being a “group practice?”
    - E.g., for IOAS Exception
  - Does the practice meet the qualifications to be a “group practice?”
  - Does it meet the requirements for the exception?
  - If not, does another exception protect the arrangement(s)?
  - Potential liabilities?
    - Criminal, civil or monetary?
    - Sanctions or suspensions?

Common Regulatory Issues in Orthopedic Transactions.

Compensation, Investment and other Financial Arrangements.

- How are shareholders, employees and mid-level providers paid?
- Examining relationships with vendors, independent contractors, management or billing companies, hospitals and other referral recipients and sources.
  - In writing, signed, fair market value & commercially reasonable.
- Due Diligence Concerns
  - "Tainted Business"?
  - Liabilities?
  - Sustainability of revenues, profits and growth projections.

Common Regulatory Issues in Orthopedic Transactions.

Arrangements with Hospitals.

- Examples of hospital arrangements that warrant regulatory scrutiny:
  - Medical directorship (and other professional service arrangements).
  - Rental of space and equipment (both ways).
  - The provision of services for free or below “fair market value” (both ways).
- Other diligence concerns with hospital-orthopedic group relationships.
  - Restrictive covenants in contracts?
  - Change of control/assignment prohibitions?

Compliance Program – Existence and Implementation

- Has the orthopedic group adopted and ***fully implemented*** a corporate compliance program?
  - Review of policies, procedures and compliance/risk management programs.
  - Is the compliance program functional?
- Past areas of concern and actions taken to remedy previous deficiencies.
- HIPAA privacy and security compliance?

Preparing for Private Equity Transactions: Regulatory and Clean-Up.

- Avoid issues during negotiations with investors by conducting pre-transaction assessments and "clean-up."
- Detect and correct potential compliance and regulatory risks.
  - Monitoring and auditing with regulatory risk areas in mind.
  - Implement systems to ensure corrective action is working.
- Do not conceal potential compliance risks and violations in diligence!
  - NDA/Confidentiality Agreement/Common Interest Agreement.
  - Depending on the risk, the parties may address these problems with indemnification language and escrows and holdbacks.

Questions?

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