Provident Perspectives:

COVID-19's Impact on Investment & Consolidation within Healthcare Services

Examining COVID-19's impact on healthcare services and the ripple effects it has had on M&A activity

Provident Healthcare Partners

Introduction

The sudden emergence of COVID-19 sent shockwaves throughout the globe and has caused widespread disruptions in just about every pocket of society. It has impacted most facets of daily life and brought our previously robust economy to a virtual standstill. The magnitude of the economic fallout is uncertain but estimates from reputable sources paint a grim picture. Recent postulations suggest that second quarter contraction levels could surpass 10% with unemployment levels reaching as high as 20%. COVID-19's impact on healthcare has been particularly profound, as delays, cancellations and closings have put strain on participants within the broader healthcare services space, providing opportunity for some segments while adversely impacting most.

Although it's extremely difficult to predict the severity of COVID-19's impact on the economy and on our healthcare delivery system, we do know that the shape of the recovery, efficacy of social distancing measures, and government and private sector response will play a large role in ultimately determining the timing and long-term effects of the pandemic. In this white paper, we examine COVID-19's current and longer-term impact on healthcare, particularly as it relates to M&A activity, as well as potential mitigation mechanisms that companies can utilize to better position themselves for when the dust finally settles.

Current State of M&A within Healthcare

The effects of COVID-19 have permeated much of our nation's healthcare system, placing significant financial and operational strain on providers, payors, and suppliers, alike. While some sectors are fairly insulated from the effects of the pandemic, most have been immobilized by the country's response to combat the virus. M&A activity within healthcare has been particularly affected as uncertainty grips deal participants, leading to mass delays in closings and sale processes.

Many private equity firms have paused new investments, repurposing their attention, capital, and resources to help prop up their existing portfolio companies. Firms have acted swiftly, lowering operating expenses, drawing down on revolving lines of credit, reducing workforces, and injecting their businesses with equity capital to help weather the storm. As a result, while some transactions have been completed, most have been delayed or restructured until there is more visibility around a return to normalcy or steady-state operations.

Lending Environment:

Lenders are key deal participants worth keeping an eye on to get a sense for the current state of affairs in M&A. Since most private equity transactions are partially funded by outside debt financing, the environment for lending is a key driver of M&A activity. The current uncertainty is difficult for underwriting since the primary metric that lenders use for the basis of their loans, Adjusted EBITDA, is not representative of the current and go-forward state of operations. Adjusted EBITDA figures are in a constant state of flux as many companies are operating at minimal capacity with massively reduced employee rosters and, in some cases, without any income streams at all. Uncertainty around earnings and ability to pay back loans also affects lenders' existing portfolios of assets as well.

As a result, most lenders have paused new commitments to focus on their current portfolios that have come under duress. Webster Equity Partners, for example, was unable to obtain third-party debt financing in their recapitalization of Gastro One, which was announced on April 7th. Both parties were able to make up for the difference through a seller note, a deal strategy we expect to become increasingly common in today's environment. Without third party debt, deals financed entirely with equity or that have sellers willing to offer financing to bridge capital needs, are more likely to push through to the finish line in this type of risk-off environment.

Existing Commitments

There are, however, still lenders that are standing by commitments in the later stages of processes. Strategic acquirers, for example, typically have lending relationships in place and more flexibility around restructuring terms. In those situations, the buyer is much more likely to be able to secure third party debt financing through drawdowns on existing revolvers. Such was the case with Ares Capital-backed Unified Women's Healthcare's (UWH) recapitalization with former Provident client, Unified Women's Healthcare of Texas (UWH), which we completed in early April in the midst of the pandemic.

Overall, there has been a clear short-term shift from growing portfolios to protecting them, as uncertainty shapes the environment for lending. There is no definite timetable for return to normalcy or what "normal" would even look like post-pandemic as well, which furthers the narrative around uncertainty and lowers lender risk tolerance. Those lenders that are still open for business are taking a more cautious approach by increasing diligence efforts, being more selective, and adjusting pricing to reflect added uncertainty.

Pockets of Resilience:

Despite many pandemic-fueled headwinds, there are still transactions being contemplated and even completed, especially in less affected geographies and with deals in the final stages of their processes.

Insulated Subsectors

There are also some subsectors that are insulated or that stand to benefit from the pandemic, such as telemedicine. Manner of care delivery, mode of payment, patient population demographics and nature of services will ultimately determine which sectors are more insulated from the corollary effects of the pandemic. Care provision models centered in clinics and around cash-pay, elective services will likely not fare as well as those focused on medically necessary procedures or remote care delivery. Hospice and homecare areas, for example, have not seen volumes curtailed due to the essential nature of services, increased labor pool and hospital preparation for COVID-19. Provident is in the midst of marketing a hospice and home health client that has seen outsized demand from the buyer community, in spite of COVID-19.

Strategic Acquisitions

Provident has also observed that strategic acquisition activity has proved to be more resilient than new private equity investment due to myriad factors. Private equity platforms typically incur significant costs post-closing, by making back office investments and spending a considerable amount of dollars on building out the infrastructure of the platform, a model that doesn’t mesh with an environment in which most businesses are focused on cutting costs. Strategic acquisitions conversely come with the benefit of existing corporate infrastructure, cost-cutting synergies and a broader network of affiliated companies to help diversify risk.

Strategic acquirers also have a clear segregation of business segments and often have teams exclusively dedicated to business development efforts not consumed by managing day to day operations in this strenuous environment.

In addition, strategic buyers are more likely to be held to tighter timelines if they’re further along in their investment. This cohort of buyers will likely feel an added sense of urgency to continue to be acquisitive during these times to bolster the platform footprint prior to a secondary transaction. Provident has observed this firsthand in representing Unified Women’s Health of Texas (UWH) in their acquisition by Ares Capital-backed Unified Women’s Health (UWH). UWH is in the later stages of their investment and has already begun to market the platform to buyers. Accretive acquisitions, such as the UWH transaction, are instrumental in increasing equity value prior to a secondary sale.

Weathering the Storm

Much like investors, sellers have also redirected attention to stabilizing their existing businesses. Provident has seen many companies extend the deadlines of sale processes to focus on mitigating the potentially devasting impact of COVID-19. With unprecedented government relief programs and expanded CMS coverage, there are many options afforded to business owners to help soften the impact of the pandemic. In the following section we explore various mechanisms and best practices that companies can implement to bridge the proverbial COVID-19 gap and weather the storm.

Unpacking the CARES Act:

On March 27th, in a swift response to COVID-19, the US government signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) into law, a $2.2 trillion aid and stimulus package unprecedent in size and scope.

$377 billion of the $2.2 trillion bill has been carved out to provide relief for small businesses, mainly by way of the Paycheck Protection Program (PPP), which is designed to keep workers on payroll by providing forgivable loans for companies that use the funds to maintain payroll, pay for rent, mortgage interest and utilities.

As a flood of applications come in, timing, in terms of receiving federal support, will be crucial for small business owners.

Additional Relief on the Horizon

Congress is also in the process of adding an interim bill to supplement the initial $2.2 trillion package and address a potential shortage of funds for the Paycheck Protection Program. An additional $250 billion is currently in the works which would provide more financing support for small businesses.

Paycheck Protection Program Highlights	
Loan Amount	Average monthly payroll for the past year multiplied by 2.5 and capped at $10M
Forgiveness	Tied to employers maintaining (or quickly rehiring) employees and maintaining compensation levels
Forgiveness Reduction	Proportionate to reductions in employees (vs prior year) and reduction in compensation, beyond 25% of prior year
Grace Period	Penalties avoided for furloughs as long as rehired and pay restored by 6/30/20
Deferral Period	Deferred for six months
Guarantees	Not tied to personal or collateral guarantees

Private Equity Access:

The Payroll Protection Program, in its current form, has garnered a lot of attention and buzz within the private equity community as the language suggests that private equity-backed companies do not have access to the program due to SBA affiliation rules. The prevailing view right now is that if a private equity firm has a controlling interest in a portfolio company, then the company would be considered an affiliate of the entire private equity portfolio, likely bringing employee size above the 500-person threshold.

Potential Exceptions

Attorneys nationwide are looking for possible exceptions, where there may be a loophole. One of the areas where this may be the case is in physician services where investments into practices are made through a Management Services Organization (MSO). Due to corporate practice of medicine laws, a non-physician cannot have ownership in a medical practice. As a workaround, many private equity firms invest into a MSO, that handles non-clinical business support for the practice, with a "friendly doctor" agreement that sweeps the profits from the practice up to the MSO.

These deal structures, which are commonplace in physician services, enable the physicians to own 100% of clinical assets and retain complete clinical control and autonomy, which may be a potential avenue for participation in the SBA loan program. There also may be an exception for private equity-backed companies that have preexisting SBA relationships as well. This is still a fluid situation with discrepancies on a case by case basis, depending on the management agreement between the two entities. We are following additional guidance closely and recommend speaking with legal counsel on the matter.

Federal Reserve Lending Program

To help address this issue, the Federal Reserve recently unveiled a new lending program aimed at small businesses between 500 and 10,000 employees. The program is part of the direct lending pool established by the CARES Act and is not run through the SBA. Because of this, it will not be subject to the same affiliation rules as the PPP, which prevented private equity access. Loan amounts are up to $25 million but come with some stipulations around leverage, use of funds and payroll maintenance.

Additional Modes of Government Relief:

The government also unveiled additional measures to help businesses combat the pandemic, such as disaster loans and deferral of payrolls taxes.

- Economic Injury Disaster Loan (EIDL) program offers up to $2 million in deferrable loans (four-year maturity) that carry 3.75% interest

- Ability to defer employer portion of payroll taxes; due in two installments with half due by the end of 2021 and the remaining balance due to by the end of 2022

With talks of additional relief and stimulus packages in the works, we're closely tracking supplementary programs that could be released in the near future.

CMS Relief & Aid:

In addition to government relief packages, CMS has also introduced other avenues worth exploring for providers and suppliers to help make up for lost revenue.

Accelerated and Advanced Payment Program

One immediate relief program for groups to take advantage of is CMS' expansion of the current Accelerated and Advance Payment Program, which now includes a broader group of providers and suppliers. Most companies will be able to request up to 100% of the Medicare payment amount for a three-month period with payments issued between seven and ten calendar days upon receipt of the request. This program, originally only accessible by inpatient hospitals, is designed to increase cashflow in times of national emergency. The recoupment period start date, which is typically 90 days after issuance, has been extended to 120 days from receipt of funds. Billings after 120 days will be used to reduce the balance incurred through the program. At 210 days from the date of initial payment, participants will be expected to start to repay the balance or incur interest (10.25%). Private insurers have started to follow suit as well through offering advanced payment and other support programs.

Expansion of Telehealth Services

In addition to the Accelerated and Advance Payment Program, CMS also expanded coverage for telehealth services to ensure healthcare delivery and payments, despite a wave of clinic closings. The updated policy under COVID-19 removes limitations around sites, frequency and physician supervision while providing flexibility in terms of reducing or waiving out-of-pocket costs and co-pays.

The program also expands its list of eligible services, pays the same as in-person services and now extends to new patients as well as established ones. Much of the commercial payor landscape has followed suit as well, providing an additional access point to render and receive services.

Provider Emergency Fund

CMS is also partitioning its $100 billion Provider Emergency Fund, $30 billion of which is said to be allocated to Medicare enrolled providers and suppliers based on Medicare payment volume. As the situation develops, we're keeping an eye on additional relief and stimulus programs to further the fight against the pandemic.

When the Dust Settles

Although there is much speculation, nobody can predict the shape of the recovery and what a return to normal looks like. Our assumption is that the recovery will be a gradual and uneven one, coming in waves as different swathes of the country experience varying degrees of infection at different times.

Regardless of how it all ultimately plays out, there will certainly be an outsized backlog of demand for healthcare services, which will inevitably lead to volume and workforce restoration. Businesses should start to think about how to prepare themselves to keep up with that pent-up demand so that they can be poised to capture as much of it as they can once the lights are turned back on. Of course, some demand prior to COVID-19 will inevitably be lost, especially as the term "normal" is redefined in a post-pandemic world, but companies should still plan to implement operational measures to ensure patient, provider and staff retention to succeed when the economy opens back up.

Appetite for M&A in a Post-COVID-19 World:

Just as there will be pent-up demand for healthcare services in the future, Provident expects there to be pent-up demand for deal making as well, since many processes were delayed during the outbreak. While company performance and sector trends will inform whether transactions need to be repriced, restructured, or altogether reassessed, macro-level factors will influence continued investor appetite and seller motivations to transact, albeit under more scrutinous diligence.

One fundamental tailwind that will propel post-COVID-19 deal making is the availability of capital to deploy towards healthcare acquisitions. Debt remains extremely inexpensive and private equity firms, collectively, have almost $2 trillion in dry powder to deploy for new investment. That capital must be deployed, or the private equity firm is at risk of forfeiting its management fees. Fundraising efforts within private equity from Limited Partners, such as pension plans, foundations, and endowments have been wildly successful in recent years. Provident expects this trend to persist, despite COVID-19, as private equity has become an integral strategy for most asset managers given returns relative to peer investment vehicles.

Healthcare, specifically, although significantly hampered by this outlier event, remains more recession resistant that most pockets of the economy due to the necessary nature of services and cost-sharing payor dynamics as well. Given a confluence of all these factors, Provident still expects there to be considerable buy-side demand for healthcare transactions.

Increased Seller Appetite

One of the corollary effects of COVID-19 could be an increase in seller demand as well. The devasting impact of the pandemic is expected to place a premium on size, access to capital and risk mitigation, all of which are key components of private equity backing. Transactions provide business owners the opportunity to monetize their equity, take chips off the table and diversify risk away from their business, an increasingly attractive value proposition in the wake of COVID-19.

Transacting also shifts significant operational responsibility and burden away from independent business owners. COVID-19-related burdens such as managing human resources and putting out operational fires are partially offloaded to the acquirer through a transaction. It remains to be seen how private equity platforms fare, but if the capital and resources afforded to those companies help to weather the storm, then we expect independent business owners to ascribe more value to being part of larger organizations, leading to more affiliations and partnerships.

Potential Changes to Deal-Making Post-Pandemic:

Although we expect transaction volume to pick back up in the back half of the year and in early 2021, there will be novel structures and approaches to the deal-making process in the interim. Provident expects that the fallout from the pandemic leads to increased utilization of contingency payment structures and "COVID normalization" adjustments to the Profit & Loss statement.

Valuation Landscape

Prior to COVID-19, the healthcare services space was one of the richest sectors in terms of valuation, with companies trading at some of the highest multiples that we've seen. The added risk stemming from COVID-19 injects a lot of certainty into the valuation landscape post-COVID-19. Multiples, which set the price for most transactions, are a function of growth and risk. Investors will closely track demand for services and whether or not they will continue to be hampered by social distancing and the loss of wealth and income. Go-forward growth estimates and a return to steady state will be crucial to preserving current valuation levels. Most investors understand that, although timing is uncertain, the disruption to business is a one-time event and not a product of deteriorating economic fundamentals.

The lending market is also a key determinant of valuation. The less debt financing that private equity firms can secure, the more equity capital they have to commit, which reduces their return profile and ultimately drives down the multiple they're willing to ascribe. Lender risk tolerance will be key to the M&A markets on a go-forward basis and with many lenders surely having dealt with defaults and breached covenants during the crisis, the prospect of reduced risk appetite and ultimately lower valuation is one we're keeping our eye on.

Creative Deal Structures

Provident expects some creative deal structures to take place to help bridge any potential funding gap and lock in deals at the same terms previously agreed upon. Seller notes, earnouts or holdback concepts will likely become increasingly more commonplace as deal participants look to structure around COVID-19 and give companies time to rebound to pre-COVID levels. The firm has already seen instances where buyers have structured cash payout schedules to adjust for COVID, wherein a portion of purchase price is paid at consummation of the deal, with additional payouts based on reaching certain targets or returning to run-rate volume metrics previously agreed upon.

We've also seen seller notes become more prevalent to help bridge the financing gap and preserve the same purchase price agreed upon prior to COVID-19. A seller note would allow sellers to see some amount of return (6-8%) that may actually outpace the market in the current environment. All of these structures aim to lock in terms and valuation while avoiding closing delays and offsetting risk by tiering the timing of payments or tying them to productivity targets.

COVID-19 Adjustments to EBITDA

In addition to restructuring deals, Provident expects that advisors will get creative around COVID-specific adjustments to seller financial statements. Most companies that go to market post-pandemic will likely have a proforma adjustment that normalizes the financials, during the COVID months, to reflect what the business would produce at "steady-state operations". It is paramount for companies to track data and KPIs that will enable the company to support and defend its "normalization" adjustment in diligence. Provident plans to release supplementary material in the coming days to further address this topic.

Winners and Losers From the Fallout

The adverse effects of COVID-19 has seemingly permeated all corners of the economy, even affecting sectors that have historically been noncyclical and resilient to downturns. The severity of COVID's impact is unclear at this stage as there are still countless unknowns.

Stratification Among Companies:

It is clear, however, that there will certainly be a stratification between winners and losers that emerge from this crisis. Not all private equity-backed platforms and independent businesses are created equal and unfortunately some will fare much better than others. This stratification depends mostly on how early companies implemented protective measures and how well companies are able to capture pent-up demand when the economic engine starts back up. Provident expects well capitalized, efficient businesses, that took swift action in the nascent stages of the crisis to fare the best. Those that right-sized variable costs early and secured fixed cost and loan payment deferrals before floods of requests came in will likely end up in a better position than most when we reach a point of normalcy.

Companies with the size, infrastructure and capacity to take on and absorb the excess volume will also fare better on the other side. Staff retention, extended hours programs and a robust back office to support increased volume will be paramount to taking advantage of the suppressed demand. Provident expects that larger businesses that are better equipped to manage this administrative burden and spread out patient volume will gain market share and position themselves better than most peers.

Divergence in Sectors

We expect that there will be a clear distinction between winners and losers among sectors as well, as some lines of businesses are inherently more insulated than others are. Some sectors will even benefit from the short-term and longer-term, secular trends likely to arise in the wake of the pandemic.

Digital Health & Telemedicine

Our healthcare system has been persistently stubborn in embracing digital technology, but the COVID-19 crisis may force our hand as health data analytics and new models of care have come to the forefront in the war vs COVID-19. Digital health platforms, such as telemedicine and population health management, stand to benefit the most from the sudden spread of the virus and the physical distancing that has resulted. Telehealth services, for example, once a novelty piece of the healthcare pie, will likely become a mainstay in the delivery of care going forward. The public markets echoed that sentiment and notion. From February 26th to April 1st, Teladoc's share price appreciated over 40% while the S&P500 was down over 25% during that same period. We expect that the accelerated use and increased adoption of telehealth will lead payors to continue to extend expanded coverage and rates for telehealth services, even after the acute effects of the pandemic subside.

Winners and Losers From the Fallout *Continued*

Mental Health & Telepsychiatry

Telepsychiatry, in particular, stands to benefit significantly from the unfortunate, outsized demand in mental health services that is expected to worsen due to the coronavirus. Experts believe that the economic and social upheaval, as a result of the pandemic, will inevitably lead to more stress, anxiety and depression, adding oxygen to an already existing flame in mental health services. The space was already gaining traction and attracting private equity investment prior to the outbreak and will surely become more in vogue as mental health and telehealth continue to see increased demand for services.

Essential vs Elective Procedures

Although the telehealth mode of care delivery has replaced routine visits, there are certainly some encounters that require face to face interaction. Providers that treat acute and chronic conditions that require medically necessary procedures and surgeries will fare much better than those focused around elective, nonessential ones. Areas such as interventional pain management, infusion therapy, retinal services and obstetrics have experienced far less volume declines than sectors such as dermatology and dentistry, which in most cases are operating at less than 20% capacity.

A telling metric, highlighting the severity of COVID's impact on elective procedures, is the percentage of dentist's offices that are now closed. Recent statistics indicate that over 95% of dentist's offices are currently closed, indicating just how disruptive and devastating the virus has been to elective-centric providers. Other providers, with significant income streams tied to cash pay procedures, such a cosmetic dermatologic services, premium cataract services and plastic surgery may suffer as a result of the economic fallout as well. With record breaking jobless claims, patients will generally have much less disposable income to spend on premium services not covered by insurance.

Alternative Care Settings

We also expect that center and clinic-based providers, particularly focused on geriatric patient populations, will experience volume declines of greater magnitude than providers focused on pediatric services and in alternative settings for care. Elderly patients most susceptible to the virus are unlikely to come back to centers and clinics in droves for procedures and visits that are able to be held remotely or in their homes. For that cohort of patients, especially as testing ramps up, homecare and other in-home provider services will be in much more demand than areas like skilled nursing facilities and assisted living facilities where infections are more apt to spread quickly. Council Capital's investment into in-home primary care provider, Physician Housecalls on April 1st, is an example of a transaction in a space much less prone to disruption in the long term. On the other side of the patient spectrum, pediatric services, spanning developmental, skilled nursing and behavioral services, will be also be more insulated from the virus, especially those centered in the home.

Finally, the current strain that COVID-19 is placing on the healthcare system, specifically hospitals, leads us to believe that ambulance services and nurse staffing services will experience an uptick in availability of labor and demand for their services as well. Also, as hospitals free up beds to care for COVID-19 cases, many older patients will need to be treated in alternative settings, leading to a higher number of patients needing hospice and palliative services. Provident is tracking those sectors closely and expects a pickup in deal activity over the coming months.

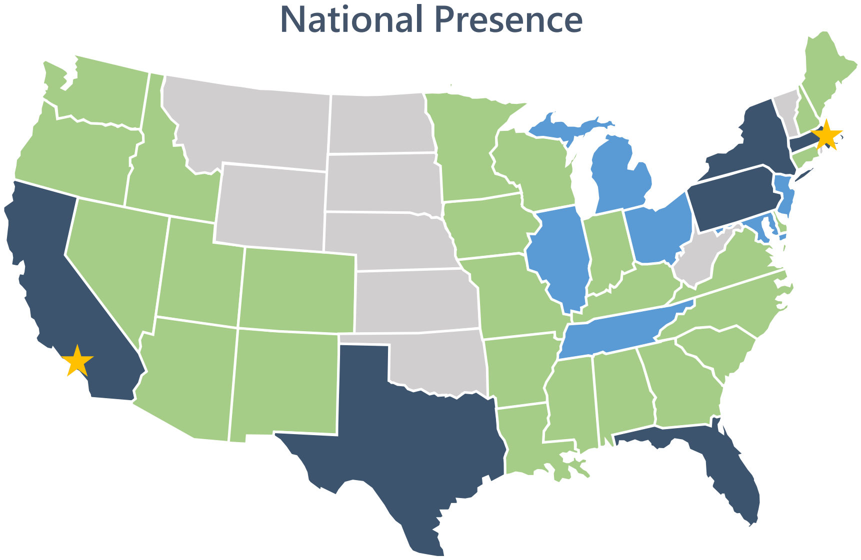
Concluding Thoughts

These are clearly unprecedented times that we're all trying to navigate through. It's clear that the fallout from the pandemic will lead to some fundamental, systemic shifts in our health system's care model, which will undoubtedly have corollary effects on competitive landscape and overall M&A activity within healthcare services. The key to success will be preparing, repurposing and adapting to these shifts to ultimately minimize the damage and benefit from the widespread changes. It's a very fluid situation which we are tracking very closely.

PROVIDENT HEALTHCARE PARTNERS

Provident Healthcare Partner's investment banking team works with privately owned healthcare companies to provide advisory services related to mergers and acquisitions. Prior to formal engagement, Provident works with companies to provide the upfront education to shareholders necessary to understand the economics, structure, and motivation of a transaction. Following the education process, if formally engaged, Provident leverages their extensive knowledge of the buyer universe to find the most compatible partner and drive valuations for a company's previously illiquid stock. Driving the entire transaction process, Provident facilitates and assists with deal structuring, negotiations, exit planning/processing, counseling amongst shareholders, and due diligence.

National Presence



1-3 Transactions

4-6 Transactions

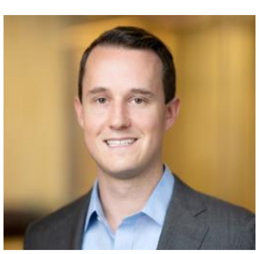
7+ Transactions

★ Provident Office

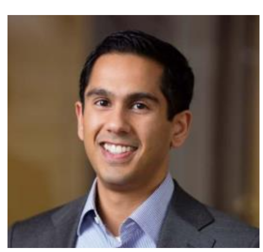
21+	Years of Healthcare Investment Banking
130+	Healthcare Deals Closed
12-15	Landmark Deals Per Year
25	Banking Professionals

Note: The above map represents states where Provident clients were headquartered. Provident has successfully closed transactions with clients operating in 45 states and Puerto Rico.

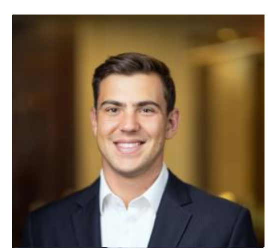
Provident Contacts:



Eric Major
Director



Ajeya Shekar
Vice President



Steve Grassa
Associate

Provident

Provident is the leading investment banking firm specializing in merger and acquisition advisory, strategic planning, and capital formation for middle-market and emerging growth healthcare companies.

The firm has a vast network of senior industry relationships, a thorough knowledge of market sectors and specialties, and unsurpassed experience and insight into the investment banking process.

Boston:
260 Franklin Street, 16th Floor
Boston, Massachusetts 02110
617-742-9800

Los Angeles:
315 S. Beverly Drive, Suite 504
Beverly Hills, California 90212
310-359-6600