Provident Perspectives:

Transaction Structures in the COVID-19 Era

Examining the methods that are being used to close merger & acquisition transactions during the COVID-19 pandemic

Provident Healthcare Partners

Introduction

At the outset of the COVID-19 pandemic, Provident published a white paper, *COVID-19's Impact on Investment & Consolidation within Healthcare Services*, detailing how COVID-19 was impacting M&A trends within the healthcare services market. Much of the economic turmoil depicted in the previous white paper has held to be true; unemployment has skyrocketed, M&A activity has slowed significantly, and first quarter earnings announcements have shown that even the United States' largest companies like Amazon and Apple were not immune to the adverse impacts of COVID-19. Amidst all of this uncertainty, however, several transactions have still been completed. Transactions that have closed have necessitated flexibility from both buyers and sellers in order to arrive at creative transaction structures to push deals over the finish line. This white paper will delve further into these structures being used to complete M&A transactions and private equity recapitalizations in the COVID-19 environment.

Why Do Transaction Structures Have to Change?

As volumes have declined and revenue has deteriorated, several dynamics have changed within the market. Lenders are un-willing to provide robust financing commitments (if able to provide financing at all), which has made it difficult for private equity investors to finance platform transactions. Lenders have been a critical component in enabling strong valuations pre-COVID-19 by providing a cheap source of financing. Strategic acquirers also have a need to conserve resources to manage short-term cash flow and lines of credit for working capital.

Transactions that were scheduled to close at the end of the first or start of the second quarter of this year were based on financial metrics that largely deteriorated. This has created the substantial risk for buyers and lenders of closing a transaction based on pre-COVID-19 financials for a business experiencing a significant decrease in cash. Buyers are left with three options; they can close a transaction at the previously agreed upon terms in anticipation of a sharp V-shaped recovery, halt M&A until they've had an opportunity to fully assess the impact of COVID-19 on both their own business and the acquisition target's, or try to find a middle-ground that is enticing enough for sellers to transact, but mitigates some of the risk associated with closing a deal during the pandemic. While many have chosen to halt M&A entirely in the short-term, there are others that have elected to try and find a middle ground, especially where the transaction carries significant strategic importance.

On the other side of the table, sellers have continued to pursue transactions. Leveraging a creative structure remains a method for sellers to lock-in a valuation today as opposed to being exposed to the uncertainty of future valuations post-COVID, provides an opportunity to offload administrative responsibilities that have intensified during the pandemic, and allows for personal liquidity during a time where distributions may be impeded for an unknown period of time. Gaining access to the resources of a larger organization has also been highlighted as a meaningful benefit. This has left sellers with a choice to pursue an opportunity to close a transaction now or wait until after the pandemic subsides and their business recovers, at which point it will be possible to try and close a transaction at new terms.

Understandably, the initial reaction to the proposal of a transaction restructuring might be that the buyer is unfairly leveraging the pandemic to "re-trade" the deal. However, Provident's experience closing a transaction during the pandemic as well as agreeing to move forward on several others has been that COVID-19 has put buyers in the unfortunate situation of simply not being able to move forward at the previously agreed upon structure. In fact, many transaction restructuring proposals have been made by buyers in an earnest effort to keep the transaction on schedule as a show of good faith to the sellers. Additionally, when structured and negotiated properly, these new structures can be used to accomplish key objectives of the seller like preserving valuation and providing liquidity.

April 2020:

What Are The Transaction Structures Being Used?

There are three types of structures that Provident is seeing as alternatives to existing transactions within the market; all equity transactions, the usage of seller notes, and deferred proceeds. Each one of these structures comes with its own set of advantages and disadvantages that sellers need to be aware of when discussing a possible change of structure with a buyer.

All Equity Transaction:

The simplest structure is a transaction financed by all equity. With many third-party lenders backing out of providing debt financing, private equity firms have the option of financing a transaction in full directly from their investment fund. It is important to note that this is the least common structure being offered, because it still requires the most cash up-front and poses a greater risk to the investor. The benefit to sellers in this form of transaction is that it will typically result in more cash at closing relative to other structures. However, the drawback of an all equity transaction is the potential re-negotiation of purchase price in absence of third party lending to finance the acquisition. Sellers that feel strongly their business will rebound quickly once the pandemic is over may not be interested in this option if it doesn't preserve the original valuation.

Seller Note:

A seller note is a form of debt financing whereby the seller agrees to defer a portion of the purchase price and receive that portion in a series of installment payments with interest. A seller note can be used to replace the commitment of a third-party lender. It is a good way to preserve the overall valuation and still maintain meaningful cash at close. The strategy for most transactions using a seller note will be to re-finance the debt once the business returns to normal. Using a seller note is not without risk. Seller notes are generally unsecured, and if the business is unable to service the note or re-finance the debt in the future, sellers may never receive or only receive a portion of their deferred proceeds. In situations where sellers have strong conviction the business will recover following the pandemic, a seller note can be a valuable tool to bridge the gap between the cash a buyer is able to provide at closing and the overall valuation of the transaction, ensuring that the seller preserves the valuation of the business.

Deferred Proceeds:

The most complex option is structuring in deferred proceeds. These are transactions where the purchase price is spread out over a period of time, often with underlying metrics and targets that trigger additional payments. It is similar to the seller note in sharing the concept of deferring purchase price, however, there is more flexibility in terms of how and when the deferred purchase price is paid. Typically, sellers will receive a portion of the cash purchase price at close between 25-75%, with the remainder to be paid over an agreed upon timeline when certain targets are met, typically measured within 18 months of closing. The goal is that once the business returns to 100%, the sellers have received the purchase price in full. The benefit of this structure is that it allows the seller to preserve valuation while creating liquidity out of the business during this downturn. Additionally, within this structure for physician groups, there is the possibility of deferring a portion of the compensation scrape to better align with the cash received by the seller. This lessens the impact of the transaction on the current incomes of business owners, which is a major benefit during this period of time. These types of transactions can be difficult to structure from a legal standpoint, but with proper guidance from legal counsel there are compliant ways to implement this structure. A deferred structure is a great way for sellers to preserve valuation without necessarily having to provide seller financing to the business.

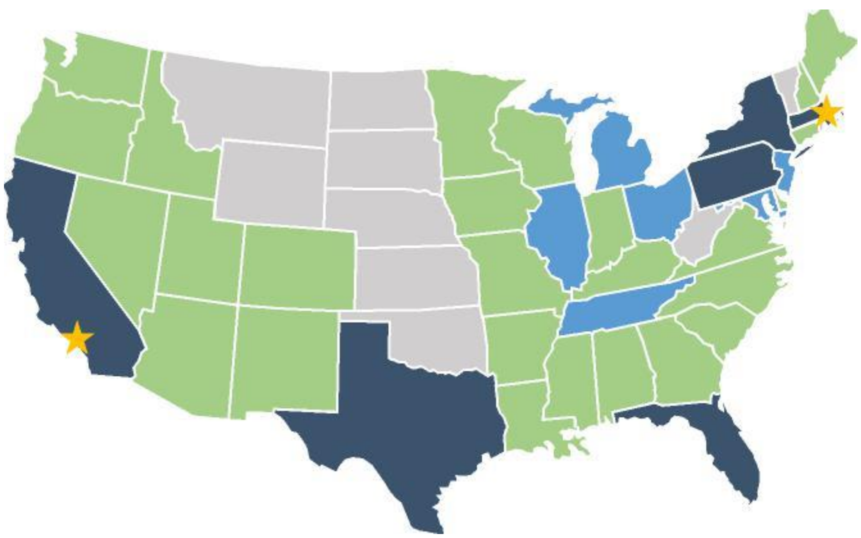
Concluding Thoughts

While there continues to be uncertainty within the market during these unprecedented times, motivated parties will continue using innovative transaction structures to close M&A deals amidst a challenging operational environment. The aforementioned transaction alternatives will not be a feasible solution for every transaction, but, when implemented properly and negotiated accordingly, they can be a valuable tool to arrive at a closing while preserving as much of the original terms of the transaction as possible. With the alternative for both buyers and sellers being to wait until the pandemic is over, it is Provident's expectation that these types of structures will continue to be leveraged as both parties look for a way to move forward amidst an uncertain economic backdrop.

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:



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

1-3 Transactions
4-6 Transactions
7+ Transactions
Provident Office

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.

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Provident is one of 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.

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