2023 HEALTHCARE PRIVATE EQUITY OUTLOOK & TRENDS

Look ahead with our take on Private Equity M&A trends in strategic & private equity investing.

As we kick off 2023, we are optimistic that the healthcare private equity (PE) market will be resilient despite various headwinds. As you think ahead, please consider the issues and trends summarized below that may be helpful to your deal-making process.

1. Has Your Exit Window Closed? Considerations for Minority Investment and Alternative Cash Generation Models in 2023

BY BRYAN BYLICA

As M&A activity slows and the credit markets become more constrained, business owners and PE sponsors with portfolio companies looking for liquidity are often faced with the prospects of lower valuations, onerous seller financing terms, or even a complete inability to sell. In these circumstances, a minority investment may provide a solution.

Minority investments are useful when the company's owner or sponsor seeks partial liquidity, growth capital, and industry expertise without giving up control of the business. PE firms have a mandate to invest their capital, even where M&A markets are slow, or a lack of access to credit markets makes traditional leveraged buyouts unworkable. In recent years, where this has been the case, PE firms have increasingly turned to minority investments as an attractive outlet for this capital. However, business owners and sponsors should consider several important factors when contemplating whether to pursue and ultimately accept a minority investment from a PE firm.

Minority equity investments often take the form of convertible preferred stock and will come with material governance and financial rights. PE firms will typically seek one (or more) board seats and board observer rights, as well as consent rights over certain fundamental and operational activities of the business. The preferred stock will likely contain minimum return thresholds that act as a liquidity preference (over and above the mere return of capital) or put rights that allow the PE firm to sell the preferred stock back to the company for a predetermined price based on a formula or initiate a sale process to achieve the PE firm's desired liquidity. The minimum return thresholds may be based on an accruing dividend akin to a preferred return hurdle and may be coupled with a multiple on invested capital hurdle. The put right may act as a de facto sale right if the company is not able to refinance the PE firm's minority investment. Understanding how these rights work is key to striking a balance that results in a partnership between the company and the PE firm that ultimately results in a positive outcome for both parties.

As you evaluate whether a minority investment from a PE firm may be suitable for your portfolio company, you should carefully consider the implications of partnering with a PE firm for the next several years and how it may alter, positively and negatively, how the company has historically operated. Because PE firms do not compete for minority investments on price alone, companies seeking minority investments should pay attention to the ancillary benefits, beyond valuation, that a PE firm offers. These often include access and credibility in financial markets, industry experience and expertise, more specific expertise that overlaps with the company's growth priorities, and access to operating partners that fill specific needs. Financial considerations beyond valuation include whether the PE firm can provide sufficient capital to meet the business' up-front needs and whether it can scale with the business as it grows.

2. Considerations in the Debt Markets for 2023 – Current and Future Credit Facilities

BY KATIE DAY

With the Fed suggesting the target rate may go higher than initially expected and inflation and supply chain issues continuing to create commodity pricing pressures, we expect uncertainty to persist in debt financing trends for early 2023. Companies without pressing debt restructuring needs may prefer a wait-and-see approach on financing and refinancing transactions, while companies particularly burdened by increasing commodity prices and rising rates may want to explore relationships with non-traditional financing sources, given traditional lenders may seek to push certain borrowers of their portfolios to correct for heightened risk and to redeploy funds at a higher rate. Non-traditional lenders will seek to take advantage of opportunities created by traditional lenders pushing borrowers elsewhere.

3. How Much Rollover from PPM 1.0 is Enough Rollover for PPM 2.0? Considerations for PPMs Structures Related to Physician Rollover Equity in the Second Sale Transaction

BY ANGELA HUMPHREYS

Many first-generation physician practice management (PPM) platforms have experienced myriad physician alignment issues with recruiting and retaining their physician partners. In addition, first-generation platforms that provide physicians with full tag-along rights have had to navigate physician buy-in and rollover equity in their "second transaction" exits. Many of these issues can be addressed on the front end with modifications to transaction structures. When evaluating new physician platforms or add-on transactions in the coming year, consideration should be given to items such as:

- Tying a portion of the rollover equity vesting schedule (anywhere from 20-50%) to a parent company exit transaction.
- Limiting tag-along rights to only a portion of the rollover equity (50-70%) so that physicians still have some skin in the game with the second buyer following the first parent company exit transaction.
- A clawback of cash proceeds (such as 20% per year) if a physician stays less than some time period (typically five years), including mandating that the sellers address this issue with an escrow on the sell-side of the transaction.
- Including local MSO joint ventures in combination with parent rollover equity to allow for ongoing distributions to physicians at the local practice level, either with or without put/call liquidity for some or all of the local MSO equity in a parent company exit transaction.

4. Employee Retention Tactics and Trends for 2023

BY LYMARI CROMWELL

Staffing shortages and the constantly-evolving landscape of employment laws are current complicating factors with respect to employee retention. Below are some ideas to keep in mind when facing shortages or retention issues:

- Using benefits such as mental health days; unlimited PTO; four-day workweeks; and monetary incentives, such as rolling retention bonuses (i.e., retention payment every quarter or every month), instant reward apps and on-demand wage payments. Employers should seek counsel before rolling out these benefits and incentives, as they may implicate state or federal laws related to wages, hours, paid time off, etc.
- Using independent contractors to fill hard-to-fill positions. However, some states – such as California, Illinois and Massachusetts – have stringent requirements to properly classify a worker as an independent contractor. Also, the U.S. Department of Labor (DOL) has issued a proposed rule to rescind the DOL's current independent contractor rule adopted under the Trump administration. The proposed rule would restore the DOL's prior multi-factor test, a more stringent rule when analyzing the classification of independent contractors. A legal review of any proposed engagement of an independent contractor is essential to avoid potential liability.
- Using contractual obligations to combat turnover, such as entering into an employment agreement with an employee and including a liquidated damages provision in the event the employee fails to provide a certain notice period (i.e., 30 days, 60 days, etc.) upon resignation. Another example is adding a liquidated damages provision to an employee non-solicitation provision in an employment or restrictive covenant agreement. The goal is to prevent employee raiding by employees who leave the employer and go elsewhere.

There is no question that employers today must be creative and flexible to recruit and maintain a stable workforce, but they should do so in a manner that does not run afoul of local, state and federal employment laws.

5. The Rise of ESG in Healthcare Private Equity

BY RYAN THOMAS & SEHRISH SIDDIQUI

PE firms are under increasing pressure from their limited partners to integrate environmental, social and governance (ESG) matters into their operations and investment practices at the fund and the portfolio company level. What was initially a priority for public companies in 2022 picked up momentum and became entrenched and here to stay for PE funds with institutional investors. Many funds now employ dedicated ESG specialists within their management companies to support these efforts and related limited partners (LP) communications and reporting. 2023 should only see increased adoption of ESG practices and initiatives throughout the PE community.

Healthcare-focused PE funds are no exception and should expect to see investor pressure soon, if not already, and should consider expanding their ESG capabilities and practices in 2023. ESG priorities for healthcare investors in 2023 could include the following:

- Enhance ESG-related diligence policies and procedures (in coordination with outside lawyers and advisors).
- Track KPIs and implementing common policies at the portfolio level.
- Focus on key ESG-related LP priorities such as diversity initiatives at board and portfolio company levels.
- Reduce the carbon footprint at the portfolio level.
- Concentrate on employee retention and wellness.
- Consider how to positively impact the community and regional economic development. For those healthcare services companies in particular that include multi-location and jurisdiction PPM organizations and that have a broad reach across numerous local communities, these focused efforts could have a tangible impact if coordinated at the management level and benefit the many geographies serviced by the larger organization.

PE funds with a developed internal ESG function and expertise should be best positioned to lead the market in these efforts and, ideally, garner the attention of the LPs with these priorities in 2023 and beyond.

6. Cyber Security & Ransomware Attacks

BY BOB BREWER

Cybersecurity threats that affect PE firms and their portfolio companies and targets continue to evolve rapidly. Unfortunately for PE firms, more sophisticated attacks – such as ransomware, critical third-party vendor outages, and supply chain attacks – can materially disrupt the operations of portfolio companies, ruin a portfolio company's relationships, and ultimately result in significant reputational and value downside. Concurrently, a continuous stream of new regulatory requirements and data privacy protection statutes are being promulgated that squarely impact PE firms and portfolio companies.

- The highest data breach percentages U.S. healthcare companies ever experienced were during the beginning of the pandemic. With a looming recession and geopolitics, indications are 2023 will be worse than the outset of the pandemic.
- Ransomware attacks now account for most healthcare data breaches and have quadrupled. This trend is likely to continue in 2023. Threat actors are more focused on both shutting down systems for ransom and exfiltrating data to sell it back multiple times to the data owner.
- Data from the U.S. Department of Health & Human Services (HHS) indicates a shift away from attacks on large hospital systems and payers to smaller providers and third-party vendors. We anticipate attackers to continue to focus on the types of companies PE firms invest in, like smaller and mid-sized healthcare entities and third-party vendors.

In light of these trends, PE firms should understand trends in the data security space, and the risk profiles, security systems and processes of their target and portfolio companies.

- In 2023, regulatory requirements and the threat of operational impacts will require a meaningful understanding of data security and quantitative security risk assessments by PE firms, with particular attention to unique risks faced by certain niche businesses. We expect tailored reviews to replace ineffective boilerplate approaches overly focused on managing data breach response.
- The uptick in breaches of third-party vendors highlights the need for actually conducting strong third-party risk management programs in 2023.
- While the average cost of a healthcare data breach has increased substantially, cyber insurance remains harder generally to acquire, particularly for smaller companies serving healthcare organizations. By leveraging broader insurance relationships, PE firms can assist these companies in the coming year.
- Ambulance chasing plaintiff's firms are more effective at monitoring state filings for each breach. Expect duplicative data breach lawsuits to increase in 2023 and insurers to focus more on coverage limits. PE firms can assist portfolio companies in 2023 by maintaining a relationship with counsel familiar with the PE firm's portfolio companies to efficiently manage these matters in a cost-effective manner and under privilege.

7. Structuring Earnouts

BY TATJANA PATERNO

Valuation expectations are still being reset and buyers are increasingly using various tools to bridge the gap between the parties' performance expectations for the target's business. Those tools include, among others, the following:

1. Seller notes.
2. Equity grants that are subject to vesting based on the future financial performance of the target business.
3. Earnouts.

Based on recent experience, we expect that the frequency with which earnouts will be used in 2023 will continue to increase as compared to earlier in 2022 when we were still in a seller's market. The size of earnouts as a portion of the purchase price is also likely to grow.

When structuring earnouts, consideration should be given to the following:

- Earnouts are prone to disputes, so clarity around the applicable earnout metrics (revenue, EBITDA, etc.), earnout period (1-3 years), payout formula, measurement standard (i.e., GAAP and exceptions to GAAP) is very important.
- If applicable, consider expressly addressing any potential Medicare/Medicaid recoupment issues and their effect on the achievement and payment of the earnout.
- For businesses that derive revenue directly or indirectly from federal healthcare programs, earnouts should be carefully structured, considering applicable healthcare laws and regulations, including the federal Anti-Kickback Statute, preferably at the LOI stage. Guardrails should be employed mainly if any business derived from the referrals of physician owners is being considered in the calculation of the earnout.

8. Healthcare Fraud – Increased Risk for PE Investors

BY TAYLOR CHENERY

As PE investment in the healthcare industry has increased dramatically in recent years, investors have faced increased scrutiny and potential exposure for liability under the False Claims Act (FCA). The government and private whistleblowers increasingly have targeted PE firms' portfolio companies and the firms themselves in fraud and abuse enforcement efforts. PE firms and owners have been named as defendants in and agreed to pay funds to settle numerous recent FCA enforcement actions. Moving forward, PE investors and their portfolio companies must consider ways to protect themselves and limit potential exposure when investing in healthcare, including:

- Conduct comprehensive diligence about the target company and the sector in which it operates.
- Maintain effective compliance functions that, where practicable, are separate from business and financial personnel and have a direct line of communication to the board and/or the company's chief decision makers.
- Make deliberate and informed decisions about how much direct involvement the PE investors will have in the portfolio company's operations.

9. Healthcare Regulatory – No Surprises/Surprise Medical Billing

BY JEFF DAVIS

Healthcare providers will continue to face challenges in 2023 related to the implementation of the No Surprises Act (NSA). The NSA banned surprise medical billing (also called "balance billing") in certain cases where insured patients are treated out-of-network and placed limits on how much providers can charge insured patients. The NSA created a federal independent dispute resolution (IDR) process to address out-of-network payment disputes between providers and payers, and the government's implementation of the IDR process continues to face legal challenges, with providers arguing that the regulations favor payers over providers. Depending on the outcome of the litigation, the government could further revise the IDR regulations in 2023. The NSA also required providers to share a good faith estimate (GFE) of expected charges with uninsured and self-pay patients. Although HHS has delayed enforcement of certain provisions of the GFE requirements related to co-providers, the overall GFE requirements continue to be in effect.

10. Unique Approaches to Incentivize Employees

BY BRITTANY MCCANTS

Many clients continue to face unique challenges in structuring compensation packages to compete for talent in tight markets. As executives and board members evaluate incentive compensation vehicles in 2023, below are a few conceptual items to frame the conversations:

- Adopting a long-term incentive compensation plan is a key step for a company to reward its employee base. Identifying the demographics of your employee base and their values is imperative. For example, younger employees tend to prefer access to cash versus equity that does not provide immediate value and will require an investment of their own limited capital (considering student loans and consumer debt). The type of equity to be offered is also a critical decision point. Stock options and restricted stock units are not taxable on grants. However, the appreciative value of these awards and the delay in their taxation can create barriers to accessing the benefit of these awards because of the significant tax impact on the employee upon vesting or settlement, as applicable. Companies will need to carefully evaluate the use of net settlement features and the recycling terms of their incentive plans to ensure alignment with meeting employee needs and equity plan operational compliance. Granting restricted stock

has the benefit of making employees immediate owners and beneficiaries of the historical value of the company. However, restricting stock grants to a wide class of employees potentially expands the number of individuals on the cap table who have information and voting rights which can present complexities in acquisition and/or investment activity.

- An alternative to plain-vanilla equity awards is phantom equity. Phantom equity provides value to employees while limiting the number of individuals with information and voting rights. These awards can also be used to avoid securities law exposure (if properly structured). The messaging around phantom equity needs to be carefully crafted to properly convey to the employees that the awards represent a contractual right to receive payment, even if the award is not a tangible set of shares. The downside to phantom equity is that the payouts are always taxed at ordinary income rates to the employee. However, employers can work with legal and tax counsel to structure gross-ups to put certain key employees in the same after-tax position as if their phantom award was taxed at long-term capital gains rates.

11. Section 220 Demand Considerations – Updates from Delaware Chancery Court

BY MARGARET DODSON & BRITT LATHAM

Section 220 books and records demands remain popular, especially from minority shareholders in healthcare PE post-closing disputes. However, decisions this year from the Delaware Chancery Court may help portfolio companies limit the scope of informal communications like email data, management materials, or investor communications sought pursuant to these demands. The Delaware Chancery Court has issued recent opinions that, among other things, do the following: Make it tougher for a demanding shareholder to obtain such communications if formal board materials are available, comprehensive and consistent with shareholder communications.

- Limit the shareholder's request for additional materials if they are not essential to the admittedly proper investigative purpose under Section 220.
- Praise companies for responding to – rather than rejecting outright – the shareholder's demand and providing relevant, formal board materials in its response.

Moving forward in the healthcare PE context, these cases underscore the importance of:

- Maintaining corporate formalities – including clear distinctions between the PE firm's work and the management and board work of the target healthcare entity.
- Taking the time to formally document board agendas, meetings and other board-level materials and communications so that the healthcare company is well-situated and prepared to respond to an inspection demand, no matter the context.
- If a shareholder has arguably stated a proper purpose, responding by providing well-documented, formal board materials, could fulfill the company's information-sharing duties under Section 220.

12. Breaking News: FTC Non-Compete Proposed Rule

In breaking news, on January 5, 2023, the Federal Trace Commission (FTC) issued a proposed rule that would ban employers from imposing non-competes on their workers. The FTC is seeking public comment. If passed, the rule would significantly alter the landscape between companies and their employees, as well as the ability to secure transactional non-competes.

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