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The leader in Health Care Services Mergers & Acquisitions

INSIGHT INTO HEALTH CARE SERVICES MERGERS & ACQUISITIONS

THE BRAFF REPORT

The Looming 50% Rise in Capital Gains Taxes

Why You May Want to Consider an Exit in 2021

Part 1: Why We May See Increases in Capital Gains Taxes Enacted in 2022

Back in 2012, it was no secret that the Obama Administration was planning to let much of the Bush tax cuts expire, raising capital gains tax in 2013 from 15% to 20% (plus an **additional 3.8% surcharge** in specific situations to help fund the Affordable Care Act[1]). While not guaranteed, sellers didn't want to take the chance that they would incur a more than 50% increase in taxes. Accordingly, the number of deals completed in 2012 spiked, as sellers who might have otherwise sold their businesses in 2013 or 2014, accelerated their deals.

Well, it's beginning to look a lot like 2012.

Like the Obama Administration, the newly installed Biden Administration has indicated its intention to roll-back much of the tax cuts enacted under the Trump Administration. However, this time around, the Administration is considering eliminating special tax treatment for capital gains in their entirety for anyone earning more than $1 million (which would include most sellers). So instead of an aggregate rate of 20.0-23.8%, the highest marginal tax rate on the sale of a business would rise to 39.6%.

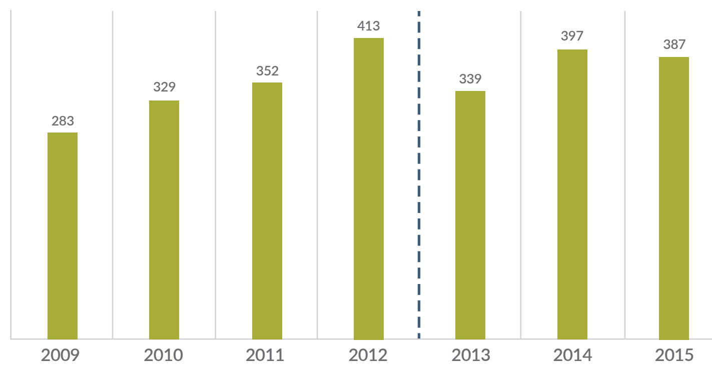
Now, with the Democrats controlling the Senate for at least the next two years, if such a change is to be made, it will almost assuredly happen before the end of 2022.

So, the question is, do sellers have a temporary reprieve until 2022, and if so, will such changes be made retroactive to the beginning of 2022, or might the window stay open for at least part of next year?

While very few people know exactly what the President's intentions are, we think there is very good reason to anticipate that (a) tax increases will be enacted, but (b) they will not be enacted until sometime in 2022.

The reasons are not particularly mysterious. After the extraordinary increases in deficit spending incurred in 2020 to address the financial burdens caused by the pandemic, the need for additional funds

HEALTH CARE SERVICES TRANSACTIONS BEFORE AND AFTER EXPIRATION OF BUSH ERA CAPITAL GAINS TAX CUTS 1/1/2013



Source: The Braff Group

> **[Regarding the potential for increased taxes], do sellers have a temporary reprieve until 2022?**

will be that much more acute. But with the economy in disarray, there is also good reason not to change policy until we begin to see some stability - hopefully by the fourth quarter. Moreover, with the pandemic drawing much of the Administration's policy focus, followed closely by improvements in infrastructure and immigration reform, there will likely not be much of an appetite to gum up the first phase of Biden's legislative agenda with highly politicized tax increases.

[1] The application of the 3.8% Net Investment Income Tax, among other things, depends upon whether the selling entity is organized as a "C" corporation or a pass-through entity, whether the deal is structured as a sale of stock or assets, whether the selling shareholder is active in the business or not, and the extent to which capital gains can be attributed to the sale of personal goodwill. Potential sellers should consult with their tax advisors to determine if, and to what extent, this tax may apply to their unique situation.

[Given other priorities] there will likely not be much of an appetite to gum up the first phase of Biden's legislative agenda with highly politicized tax increases.

So, if you're a betting man or woman, you would not be faulted for wagering that tax increases will be enacted sometime in 2022 before the next round of senatorial elections.

So, what does the math look like if you are a potential seller? And how does anticipated growth and potential changes in multiples impact these calculations?

To figure this out, we modeled and compared the net proceeds of a sale completed in 2021 under the current tax law, to what it might look like in each of the next five years considering potential changes in **growth** and **valuation**. See Part 3 for a complete list of assumptions.

Now to be clear, everyone's business and tax situation is unique and includes many variables not considered in our model. Accordingly, the analysis presented here is not intended to replace formal tax advice from a tax professional. Rather, it is intended to provide broad insights into the impact of potential changes in tax policy and divestiture strategies.

Part 2: The Impact of a Change in Capital Gains Tax on a Seller's Net Proceeds

The model, the results – and how to interpret them.

In each scenario, we calculate the change in the present value of net proceeds from a deal completed in 2021 under the current capital gains tax rates vs. one completed in 2022 to 2026 under the increased taxes and varying annual growth projections (for the purposes of this analysis, we are assuming an initial rate of 20% which excludes the 3.8% surcharge that applies to some, but not all, divestiture situations[1]). A negative figure illustrates net proceeds **less** than what it might have been in 2021; a positive figure **greater** than 2021.

As we emerge from COVID, pent-up acquisition demand - fueled in part by private equity's need to make up for time lost and dollars invested - has boosted valuation across most health care services sectors.

The Scenarios

We modeled four different scenarios. Before detailing each, three important caveats:

1. The model can be adapted to reflect different assumptions as detailed in Part 3.
2. As we emerge from COVID, pent-up acquisition demand – fueled in part by private equity's need to make up for time lost and dollars invested – has boosted valuation across most health care services sectors.
3. **While the initial multiple of 7.0 may apply to certain sectors, it is not intended to be viewed as a standard benchmark**. That said, whatever the multiple a seller can earn in 2021, it likely includes some COVID related pent-up demand premium.

How to read the tables: For each scenario, you simply need to find the intersection of a chosen growth rate with the year of a prospective sale to estimate the loss (or increase) in net proceeds you might anticipate vs. a sale completed in 2021. So, in Scenario 1, under the operating assumptions detailed in Part 3, if you grow 12% and complete a sale in 2022, the present value of your net proceeds under increased capital gains will be about 11.0% less than what you might have earned if you sold in 2021. But at the same growth rate, if you completed a deal in 2023, you would be up 13.2%.

- **Ranges shaded in RED represent declines greater than 5% and are likely to occur.**
- **Ranges shaded in GREEN represent increases greater than 5% and are similarly likely to occur.**
- **Ranges shaded in YELLOW represent changes between -5% and +5% and hence are less conclusive.**

Scenario 1:

Initial Cap Gains of 20%
Multiple of 7.0
No Margin Compression
No Multiple Erosion

This is the most optimistic scenario of the four, and it is also the most unrealistic, as health care services are continually under reimbursement pressure, and the current emergence from COVID premium is unlikely to last.

% CHANGE IN PRESENT VALUE OF NET PROCEEDS: 2021 Exit vs. Later Exit Under New Tax Treatment

Annual Growth	2022	2023	2024	2025	2026
0%	-27.3%	-21.8%	-16.6%	-11.7%	-6.9%
2%	-24.6%	-16.3%	-8.1%	0.0%	7.8%
4%	-21.9%	-10.6%	0.8%	12.2%	23.7%
6%	-19.1%	-4.8%	10.0%	25.1%	40.7%
8%	-16.4%	1.1%	19.5%	38.7%	58.9%
10%	-13.7%	7.1%	29.3%	53.0%	78.3%
12%	-11.0%	13.2%	39.5%	68.1%	99.1%
14%	-8.2%	19.4%	50.0%	83.9%	121.2%
16%	-5.5%	25.7%	60.9%	100.5%	144.9%
18%	-2.8%	32.1%	72.1%	117.9%	170.1%
20%	-0.1%	38.6%	83.7%	136.2%	196.9%

Scenario 2:

Initial Cap Gains of 20%
Multiple of 7.0
No Margin Compression
-3.5% Multiple Erosion

Somewhat more likely than the first scenario, Scenario 2 assumes that despite potential reductions in reimbursement, a provider can re-engineer direct costs to maintain their gross profit margins. That said, this scenario contemplates erosion of the COVID multiple premium, taking the multiple in our example from 7.0 in 2021 to just under 6.0 in 2026.

% CHANGE IN PRESENT VALUE OF NET PROCEEDS: 2021 Exit vs. Later Exit Under New Tax Treatment

Annual Growth	2022	2023	2024	2025	2026
0%	-29.5%	-26.0%	-22.5%	-19.0%	-15.5%
2%	-26.9%	-20.8%	-14.6%	-8.5%	-2.4%
4%	-24.3%	-15.4%	-6.5%	2.6%	11.7%
6%	-21.6%	-9.9%	2.0%	14.2%	26.7%
8%	-19.0%	-4.4%	10.8%	26.5%	42.8%
10%	-16.3%	1.3%	19.8%	39.4%	59.9%
12%	-13.7%	7.0%	29.2%	52.9%	78.3%
14%	-11.1%	12.9%	38.9%	67.1%	97.8%
16%	-8.4%	18.8%	48.9%	82.1%	118.7%
18%	-5.8%	24.9%	59.2%	97.7%	140.9%
20%	-3.1%	31.0%	69.9%	114.1%	164.5%

Scenario 3:

Initial Cap Gains of 20%
Multiple of 7.0
-.75% Annual Margin Compression
-3.5% Multiple Erosion

This is the most likely scenario for most health care service providers.

% CHANGE IN PRESENT VALUE OF NET PROCEEDS: 2021 Exit vs. Later Exit Under New Tax Treatment

Annual Growth	2022	2023	2024	2025	2026
0%	-32.2%	-31.2%	-30.2%	-29.2%	-28.1%
2%	-29.6%	-26.2%	-22.8%	-19.5%	-16.2%
4%	-27.0%	-21.0%	-15.1%	-9.2%	-3.5%
6%	-24.4%	-15.8%	-7.1%	1.5%	10.2%
8%	-21.8%	-10.4%	1.1%	12.9%	24.8%
10%	-19.2%	-5.0%	9.7%	24.8%	40.4%
12%	-16.7%	0.5%	18.5%	37.4%	57.1%
14%	-14.1%	6.1%	27.6%	50.5%	74.8%
16%	-11.5%	11.9%	37.1%	64.3%	93.7%
18%	-8.9%	17.7%	46.8%	78.8%	113.9%
20%	-6.3%	23.6%	56.9%	94.0%	135.3%

Scenario 4:

Initial Cap Gains of 20%
Multiple of 10.0
-.75% Annual Margin Compression
-10.0% Multiple Erosion

This scenario applies to those health care service sectors currently commanding hyper-premium valuation multiples including hospice, substance use disorder, autism services providers, and increasingly, outpatient mental health.

% CHANGE IN PRESENT VALUE OF NET PROCEEDS: 2021 Exit vs. Later Exit Under New Tax Treatment

Annual Growth	2022	2023	2024	2025	2026
0%	-37.0%	-41.3%	-44.5%	-46.6%	-48.0%
2%	-34.6%	-37.0%	-38.5%	-39.2%	-39.4%
4%	-32.2%	-32.5%	-32.3%	-31.4%	-30.2%
6%	-29.8%	-28.0%	-25.8%	-23.2%	-20.3%
8%	-27.4%	-23.4%	-19.2%	-14.6%	-9.7%
10%	-25.0%	-18.7%	-12.3%	-5.5%	1.6%
12%	-22.5%	-13.9%	-5.1%	4.0%	13.7%
14%	-20.1%	-9.1%	2.3%	14.1%	26.5%
16%	-17.7%	-4.1%	9.9%	24.6%	40.2%
18%	-15.3%	0.9%	17.8%	35.7%	54.8%
20%	-12.9%	6.0%	25.9%	47.2%	70.3%

Conclusions:

1. In every scenario, if you don't sell in 2021, you will have to delay a deal to 2023, **and** post growth of at least 10% per year, to reliably make up for the loss of proceeds under increased capital gains. **And if you aren't growing, even if we account for the distribution of profits through 2026, you can't make up for the loss in net proceeds**.
2. **In the most likely scenario for most providers – Scenario 3 – a provider would need to grow at least 14% per year through 2023 to reliably (green zone) get back to where they would have been if they sold in 2021. And if you're relatively mature and growing 5% or less per year, you won't be able to make up the lost proceeds through 2026**.
3. **The most dire situation, as reflected in Scenario 4, applies to sectors currently earning hyper-premium valuation multiples such as hospice, substance use disorder, autism services, and increasingly, outpatient mental health**; premiums that will inevitably erode as consolidators achieve their goals and the period of frenzied acquisition demand naturally falls off. Accordingly, a valuation decline from 10 times earnings to six by 2026 is very real. **In this case, a would-be seller would have to record annual growth of at least 11% for five years just to safely return to where they would have been had they sold in 2021**.

[If you are in a sector] currently earning hyper-premium valuation multiples such as hospice, substance use disorder, autism services, and increasingly, outpatient mental health... a would-be seller would have to record annual growth of at least 11% for five years just to safely return to where they would have been had they sold in 2021.

Clearly, there are far too many variables to consider to make many blanket statements regarding the impact of likely increases in capital gains taxes, net proceeds, and timing a sale transaction, except the following:

If you are contemplating a sale in the next two years, or if you are in a space currently receiving premium valuations, unless you have nerves of steel, it may be prudent to tap out in 2021.

In every scenario, if you don't sell in 2021, you will have to delay a deal to 2023, and post growth of at least 10% per year, to reliably make up for the loss of proceeds under increased capital gains.

Now the bad news. If you want to sell this year, since it can take six months or more to prepare for a sale, identify and contact prospective buyers, solicit and negotiate offers, complete due diligence, finalize a definitive purchase agreement, and pop the champagne to celebrate a closing wire transfer, **time is rapidly becoming of the essence.**

Don't shoot the messenger.

If you are contemplating a sale in the next two years, or if you are in a space currently receiving premium valuations, unless you have nerves of steel, it may be prudent to tap out in 2021.

If you would like to see how your numbers might look under different assumptions than those listed here, would like a copy of the model to work with on your own, or would like to discuss your particular circumstances, please feel free to contact us.

Part 3: The Model Assumptions and Variables

Below is a list of the basic building blocks of the model and our attendant assumptions for the typical health care services provider (these metrics are based in part on our extensive database of client performance measures, however they can be refined to reflect your individual circumstances).

Note that in all cases, excluding the applicability of the 3.8% surcharge which applies to select situations[1], our initial assumptions skew towards being more conservative, i.e., the less of an impact of delaying a transaction under rising capital gains. For example, a present value discount of 5% is substantially less than what it would be if we appropriately accounted for the unknown company-specific, health care policy, and broad economic risks attendant to owning a health care services company.

1. Earnings margin of 20% (this can be modified, but a large percentage of health care service providers fit in the plus/minus 20% range).
2. Direct cost of services of 50%, again, typical of service intensive health care providers.
3. True fixed costs of 17.5% of revenues (predominately limited to C-suite salaries, heat, light, rent, and technology infrastructure – other operating costs tend to be step-variable), the dollar value of which will not change over the time frame presented in the model.
4. Current capital gains tax and other taxes of 20% and 5% respectively; potential 2022 capital gains and other taxes of 39.6% and 5%. For simplicity sake, we are assuming that the entire proceeds are taxed in this manner. For the purposes of this analysis, we are excluding the 3.8% capital gains surcharge that applies to some, but not all, divestiture situations[1]. The model, however, can be revised to reflect this tax as appropriate.
5. Top 2022 marginal tax rate of 39.6%.
6. An initial multiple of 7.0 in the first three scenarios with a decline of 3.5% per year over the five-year period in Scenario 3.
7. A static multiple does not necessarily mean that we don't anticipate movement over the next five years. Rather, that under current environmental, investment, and health care economic policy reasons, we don't anticipate **large** swings in valuation. That said, there are several sectors that currently enjoy substantial valuation premiums which are unlikely sustainable over the five-year period. Accordingly, in Scenario 4, we modeled an initial multiple of 10.0 with a decline of 10% per year over the five-year period.

   As a reference point, if a sector is currently receiving a premium 10.0 multiple, a five-year decline of 10% per year would produce a multiple of 5.90 in year 5, a valuation benchmark far more in line with what we typically see for health care service providers.

   Currently, those sectors include:

   a. Hospice

   b. Substance use disorder treatment providers, particularly medication assisted treatment

   c. Autism services providers

   Note that there is one sector that could very well see valuation metrics rise over the five-year period – health care staffing (see The Braff Report, *Why Staffing Could be the Next Big Thing in Health Care M&A: An Investment – and Divestiture – Thesis*).
8. Annual growth of 0-20%.
9. Present value discount rate of 5%.
10. Percent of earnings distributable of 90% (remaining 10% necessary for increased working capital and normal capital investments).

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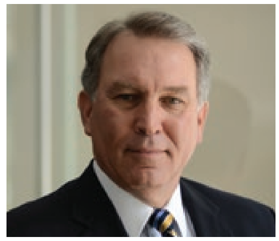

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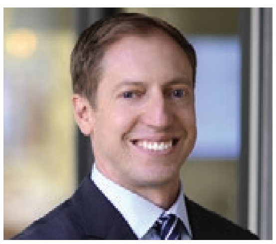

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20 YEARS & COUNTING

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