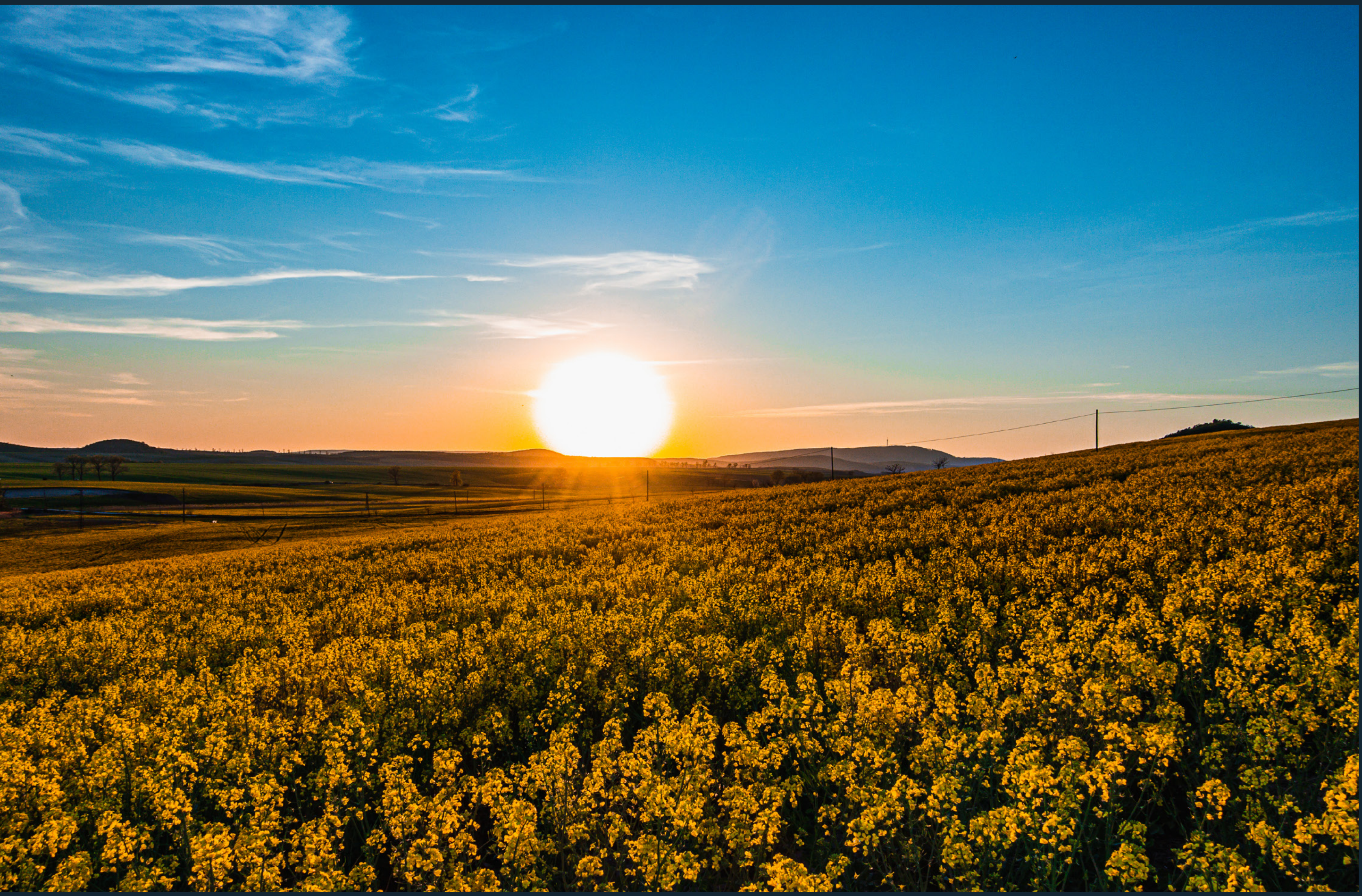
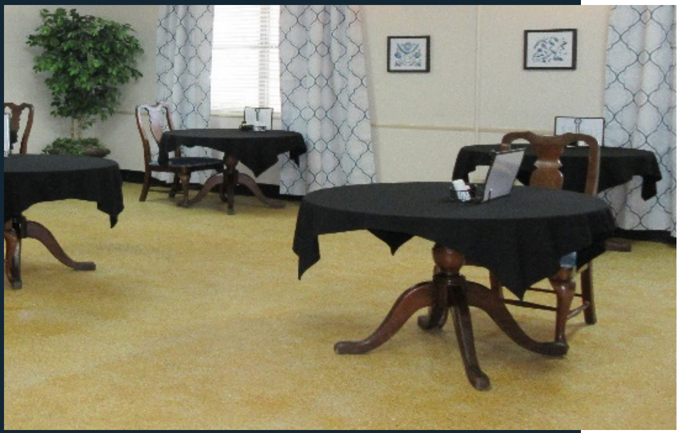
CREATIVE LEGACY PLANNING & EMPLOYEE OWNERSHIP FOR SKILLED NURSING OPERATORS

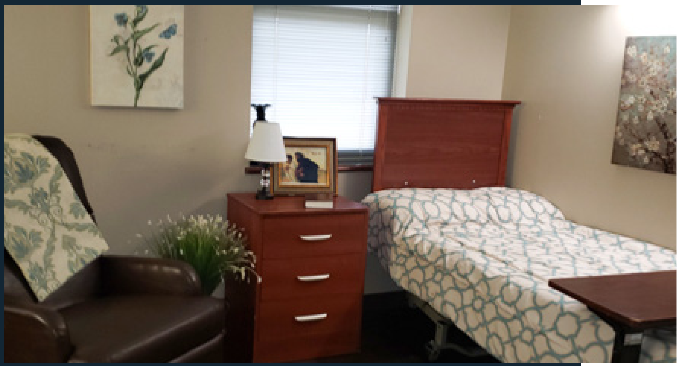
During the height of the COVID-19 pandemic, the Lument Mergers & Acquisitions (M&A) team advised a leading regional skilled nursing owner-operator (the company) in the Midwest on a nuanced two-phased transaction. Ultimately, the company was sold to a newly-formed employee stock ownership plan (ESOP), making it 100% employee owned and achieving the seller's key objectives. Despite the unprecedented operating environment, Lument seamlessly coordinated and navigated all aspects of the complicated transaction structure and exceeded client expectations.



SENIORS HOUSING & HEALTHCARE

M&A CASE STUDY





THE CHALLENGE

Assisting a Successful, Multi-Generational Owner-Operator with Legacy Planning and Potential Exit

The multi-generational ownership of the company had established a strong legacy in its respective markets, building its reputation for more than four decades. With nearly three dozen facilities, the company had grown into a sophisticated owner-operator and became the largest skilled nursing provider in its state. Additionally, a meaningful Medicaid rate increase had been implemented, which effectively doubled the company's already strong profitability.

However, the second-generation owner was beginning to contemplate legacy planning and a potential exit from the skilled nursing sector and started the process of interviewing potential investment banking advisors. Lument Managing Director and Head of M&A Laca Wong-Hammond began conversations with the owner, which spanned more than ten months and involved numerous iterations and analyses, ultimately earning his trust to be engaged as the exclusive sell-side advisor. However, shortly after engagement, the COVID-19 pandemic swept the country and industry, adding uncertainty to a variety of matters.

THE SOLUTION

Sale-Leaseback of the Owned Real Estate and Formation of ESOP for the Operations

PHASE 1

Lument worked intimately with the company to assess all potential strategic alternatives, including an outright sale, a sale-leaseback of the owned real estate (PropCo), and a sale of the operations (OpCo) to an ESOP. Ultimately, the owner elected to pursue a PropCo sale-leaseback and an OpCo ESOP via seller financing, subsequently approving Lument to commence a customized two-phased transaction process.

Despite the COVID-19 pandemic and the unforeseen challenges it presented, the company and Lument elected to continue with the transaction process. The first phase of the transaction solicited interest from PropCo investors, including real estate investment trusts, for sale-leaseback bids. Despite the industry-wide headwinds from the pandemic, rigorous negotiations resulted in sale-leaseback bids that ensured strong valuation with full credit given to the recent Medicaid rate increase and extremely tenant-friendly lease terms, such as lease escalators and covenants. These terms were particularly important, as the contractual lease agreement would have significant implications on the ESOP given that rent payments and liabilities are senior in priority to any OpCo structure.

PHASE 2

The second phase included the structuring of a master lease agreement utilizing the obtained lease terms, selecting an ESOP trustee, and negotiating the terms of the OpCo ESOP. Key negotiating points included company valuation, seller note terms, indemnification for representations and warranties, and management incentive plans. Lument mobilized quickly and, given the significant amount of preparatory work completed during the first phase, the ESOP transaction successfully closed on December 31, 2020, meeting the seller's tax deadline in less than five months from commencement.

As an arm's length transaction, the ESOP process was intensive, and included several rounds of negotiations with the ESOP trustee prior to agreeing to final terms and conditions. Ultimately, the OpCo ESOP closed an attractive EBITDA multiple (i.e., after incorporating the rent payments from the lease restructuring). The valuation also gave EBITDA credit to the Medicaid rate increases and current run-rate performance of the company, which had improved despite the pandemic. The financing terms provided the seller with a high single-digit interest rate and the company with an excess cash flow sweep for repayment, maximizing operational flexibility. Instead of taking the financing warrants that are customarily attached to the seller note to further increase the note's overall rate of return, the seller desired to transfer these to the ongoing executive management team via purchase warrants. These purchase warrants were in addition to the already robust management incentive plan that included strong base salary, cash bonus program, and stock appreciation rights – creating an attractive incentive package for retention and recruitment.

THE IMPACT

The Company Became 100% Employee Owned and the Owner's Key Objectives Were Accomplished

The ESOP transaction accomplished all of the seller's highest-priority objectives.

EMPLOYEE OWNERSHIP
Following the transaction, the company became 100% employee owned, significantly benefiting the approximately 2,750 employees.

REDUCED LIABILITY
Through the stock sale, the owner was able to alleviate his future personal litigation risk.

CHARITABLE GIFTING
The owner maximized his charitable gifting goals, successfully gifting certain selected assets and securities to desired religious charities.

TAX DEFERRAL
The owner was able to defer the long-term capital gains related to the sale through a 1042 exchange, investing the sale proceeds in qualified replacement property (i.e., blue-chip stocks and bonds of U.S. companies).

"Turning over the 45-year legacy of this company to the employees in the form of an ESOP was an easy decision, as employee ownership is a natural fit for a profession that is so labor intensive ... The harder part was the execution, and our banking and legal teams delivered."

OWNER & FORMER CEO

The ESOP continues to be an effective solution for operators, as Lument's professionals have subsequently advised or financed four of the largest companies in the skilled nursing and seniors housing sector that have transitioned to employee-owned plans or sold an ESOP.

"ESOP transactions are gaining popularity in recent years and can serve as an effective solution for operating company owners. Benefits include a fair valuation, path to liquidity, liability management, estate planning, and tax advantages, while also establishing company legacy via employee ownership and retention. The closing of this transaction is further evidence of the effectiveness of utilizing an ESOP structure for employee retention, while creating significant tax benefits for the company and its former owners."

LACA WONG-HAMMOND