HGP White Paper

Prepare and Prevent Common Due Diligence Issues in Health IT Transactions

Abstract

This white paper is designed to serve executives, investors, and acquirors in the health IT and health information services market with the goal of helping these individuals prepare for and maximize the value from a potential investment transaction, liquidity event, or acquisition. The paper includes a breakdown of over 50 due diligence topics across six core due diligence categories and contains representative examples of potential pitfalls, opportunities, and preparation strategies for these matters. A common thread among these topics underscores the importance of quality control and documentation. Every company should maintain an organized management and archiving system across all aspects of the business.

The enclosed analysis and opinions reflect the candid and unfiltered result of our experience leading and advising over 140 lower and middle market health IT transactions. Every company and every transaction has its own identity, and new issues arise in every deal that occurs. The enclosed materials are for informational purposes only and not for the purpose of providing legal advice. Do not act upon any such information without first seeking qualified professional counsel on your specific matter.

Healthcare Growth Partners (HGP) is an exceptionally experienced Investment Banking & Strategic Advisory firm exclusively focused on the transformational Health IT market. We unlock value for our clients through our Sell-Side Advisory, Buy-Side Advisory, Capital Advisory, and Pre-Transaction Growth Strategy services, functioning as the exclusive investment banking advisor to over 140 health IT transactions representing over $5 billion in value since 2007.

Please feel free to contact us with your feedback and questions.

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Accounting & Tax Considerations

We strongly advise all companies to maintain complete, consistent, and ideally GAAP accounting controls. Too often, early-stage companies underinvest in financial controls by taking the perspective that accounting is an area of compliance rather than strategic value. The cost of maintaining strong accounting controls is minimal, even by early-stage standards, and we cannot underscore enough the value and ROI of this function, which both protects and creates shareholder value when managed properly.

Revenue Recognition

When a buyer conducts due diligence, they will most likely perform a "quality of earnings" analysis (QoE) of the seller's accounting records. The QoE involves a third-party accounting firm retained to analyze the books of the selling company and provide insights into key aspects and trends of the Company's operations that help a buyer understand both the sustainability of the Company's earnings and how the business might perform on a go-forward basis. The scope includes uncovering deficient accounting policies and a common pitfall experienced by sellers is failure to comply with GAAP standards of revenue recognition, particularly with everchanging standards such as the introduction of ASC 606 for contracted revenue recognition. Health IT is notorious for a range of revenue models, including perpetual license, term license, prepaid subscription, monthly subscription, implementation, prepaid maintenance, gain share, and other core revenue streams. Given the potential accounting complexity coupled with accounting standards that can be hard to interpret, it is not uncommon for companies to be out of compliance with GAAP accounting policies for revenue recognition. However, even if not fully compliant, it is important that any adjustments that potentially arise from a QoE do not materially impact the financials presented in diligence materials, putting into question the Company's earnings and performance quality.

Expense Capitalization

Most health IT companies that we see at HGP do not capitalize any research & development (R&D) expenditures. The minority that do must ensure that they are performing this accounting tactic both accurately and consistently, from both a GAAP and tax perspective. Sellers should also be prepared for a buyer to challenge the policy of capitalizing expenses, and if they expect to be valued off EBITDA, be wary of how valuation might be impacted with or without expense capitalization. Finally, sellers should be self-aware about whether capitalized R&D is a one-time expense for software development or a recurring expense for software maintenance. A seller has a stronger case to take EBITDA capitalization adjustments for a one-time development project than for recurring development costs.

Owner Compensation

For businesses that are closely held, shareholder operators may pay themselves an above market or below market compensation package. Most buyers will "normalize" owner compensation to market rates when purchasing a business. Sellers should be self-aware of whether owner compensation will be adjusted up or down to market rates when considering how to value their business. If a seller believes owner compensation is above market and opts to present the delta to a normalized rate as an EBITDA addback, the owner(s) should be prepared to accept the normalized compensation if they maintain that role within the acquiring organization. Fair market value of owner compensation may also have an impact on tax matters, which is discussed later in this document.

Deferred Revenue

While deferred revenue is directly impacted by revenue recognition policies, in this case, we are referring to deferred revenue as a balance sheet liability. Deferred revenue is revenue that has been invoiced or collected but not yet earned (e.g., collecting upfront for a 1-year subscription agreement). In this example, if a company were to be sold on day 2 of the 1-year subscription agreement, a buyer would be responsible for delivering 364 days of subscription services without collecting any cash revenue (since the cash revenue was prepaid and received by the seller). Disputes often arise between buyers and sellers about if and how to adjust working capital (or purchase price) to account for revenue that is collected by the seller for services that are to be delivered by the buyer. In recent years, it has become increasingly common to include short-term deferred revenue (less than 1-year) in the net working capital calculation, rather than treating this as a negative adjustment to purchase price. Purchase accounting also puts limitations on how much deferred revenue may be recognized by the buyer (to a cost-plus measure). The range of outcomes for the treatment of deferred revenue in a transaction is varied and depends on the buyer practices and the specific circumstances of the deferred revenue. If a seller operates with a material deferred revenue balance, it is important to be aware of a potential buyer's proposed treatment as that impact can be significant to deal economics.

Working Capital

In most transactions, working capital is defined as cash-free current assets minus debt-free current liabilities (and deferred revenue, which is often a separate negotiation that rolls into working capital). A working capital target is designed to protect a buyer from a situation where a seller runs down accounts receivable through aggressive collections and runs up accounts payable by falling behind on payables leading up to closing a transaction, and then handing over this lopsided balance sheet to the unsuspecting buyer. In transactions with high variability in current assets and liabilities (e.g., businesses that sell large ticket, enterprise solutions that may create big swings in accounts receivable and deferred revenue), working capital may be a hotly contested item that can have significant implications on overall deal value. Understanding the methodology used to set the working capital peg and ensuring it is reasonable and fair to both buyer and seller is key in preventing any surprises in the true-up period.

Excess Cash

In parallel with working capital negotiations, the treatment of excess cash or the retention of a certain amount of cash on the balance sheet is an often-debated point. Almost all transactions are negotiated on a "cash-free, debt-free" basis, which assumes sellers are entitled to retain the cash on the balance sheet at closing. It is not uncommon for buyers to request a minimum amount of cash be left on the balance sheet to ensure the smooth continuity of operations after the closing. Whether or not the buyer "pays" for this minimum is negotiated and varies depending on the type of transaction. Further, if a seller has a material cash balance, a buyer may not want to "buy" an excessive amount of cash and may negotiate a cap, requiring the seller to sweep a certain amount from the bank account at closing, rather than allowing the full amount as a positive purchase price adjustment. While seemingly straightforward, the definition of cash in the purchase agreement should be carefully reviewed during negotiations (e.g., restricted cash, deposits in transit, customer deposits, timing, etc.).

Debt-Like Items

On the flip side, because the buyer typically does not get the benefit of the seller's balance sheet cash, the buyer does not assume the seller's debt. The definition of Indebtedness is typically highly contested as it determines which liabilities are retained by the seller and which are assumed by the buyer. While certain items are fairly black and white, other items can have varying interpretations depending on the buyer. Potential debt-like items to pay attention to include deferred revenue, accrued payroll, credit cards, tax liabilities, accrued bonuses, accrued commissions, etc.

GAAP vs. Non-GAAP

Revenue recognition and deferred revenue are both components of a bigger issue – accounting standards. Expense issues also arise when companies do not follow GAAP standards, particularly in booking accruals for items such as PTO, bonuses, and commissions, and to a less material extent, the booking of prepaid expenses. We encourage companies to implement GAAP accounting standards as early as possible. All companies must maintain consistent and complete accounting with thorough documentation. Noting that maintaining GAAP accounting standards can be a difficult task for many small companies, we suggest sellers have a firm grasp on their books' GAAP deviations to ensure relevant disclosures and negotiations are fairly and properly handled during due diligence.

Audit vs. Review vs. Neither vs. Quality of Earnings

In our experience in middle market transactions, we find it is more common than not for sellers to not have undergone a financial audit prior to initiating a sale transaction. While not a necessity, an audit can provide a seller a wide range of benefits, including helping a seller preemptively identify GAAP accounting issues as well as strengthen accounting controls. Further, an audit will increase the viability of underwriting rep & warranty insurance (RWI), which can de-risk a transaction for both buyer and seller, if economically feasible. That said, HGP is increasingly seeing transactions that successfully underwrite RWI without an existing audit. A financial review is a secondary alternative to an audit, however, in most cases, neither is a requirement for middle market transactions. HGP recommends considering a quality of earnings in advance of pursuing a sale process if the seller has either complicated accounting policies or significant EBITDA addbacks. While it is likely that a buyer will conduct their own QoE regardless, in these cases, the pre-emptive QoE can offer significant benefits to the seller in positioning for a successful sale process.

Financial Software Integration

In most cases, a company will utilize different software packages for accounting, invoicing, revenue recognition and pipeline/bookings management, ranging from sophisticated platforms such as QuickBooks, Salesforce, Hubspot and SaaS Optics to simple spreadsheets. To the extent a company has multiple corporate subsidiaries, it is very helpful if the financials roll-up into a single reporting entity. We strongly encourage integrating financial management tools to ensure consistent and seamless reporting across financial platforms.

Addbacks

Addbacks abound for all companies, large, small, public, and private. Addbacks are adjustments made to expenses (and sometimes revenue) to account for one-time or unusual events. Companies should be honest with addbacks, and include only those that are legitimate. Treating operating expenses as addbacks may result in the loss of trust, and trust is a key attribute to any transaction's due diligence process and negotiation. All addbacks need to be supportable under the assumption that a buyer will take a seller through a rigorous QoE process. Furthermore, addbacks and synergies are distinct and should be considered in separate categories.

Sales Tax

The most common tax issue in a health IT transaction is sales tax. Any company operating in the health IT space should be aware of sales tax law, such as the definition of nexus and the tax status of customers, which taken together can materially impact the applicability of sales tax. In healthcare, many non-profit customers are tax exempt, which often exempts the requirement to pay sales tax, if that is the case, a company should collect tax exempt certificates from these customers to document this status. In certain situations, there are customer contracts that state that the customer is responsible for paying sales tax if any tax is due – this is generally not an effective solution, and the IRS may ultimately come down on the company itself when it comes time to recover unpaid sales tax. To the extent that sales tax is due, a buyer may undertake a voluntary disclosure process and require a seller to set aside a special escrow for sales tax claims. Rules vary by state, and companies should closely monitor the applicable guidelines.

Federal Income Tax

Federal income tax issues are also common in transactions. Assuming a company is generally compliant with federal income tax guidelines, there are two common sources of federal income tax issues: 1) owner compensation, and 2) expense capitalization. Owner compensation involves an owner taking corporate deductions on above market compensation to reduce taxable income at the corporate level (in a C-Corp). Expense capitalization issues typically involve capitalizing expenses and taking an amortization tax shelter, but doing so with an incorrect accounting policy. Finally, income tax issues arise when the transaction results in a seller switching accounting policies. For example, if a buyer follows the accrual method of tax reporting and a seller follows the cash method, any additional tax due from adjusting the seller from cash to accrual tax reporting may be negotiated between buyer and seller, which is known as a Section 481 adjustment. The allocation of purchase price is also an important aspect of an asset, partnership or 338 transaction (further discussion can be found under Legal Issues). Sellers need to do their homework and agree with the buyer on the methodology of the purchase price allocation, so sellers do not subject themselves to unexpected ordinary income tax on certain transacted assets.

Section 1202: Finally, an overlooked section of the tax code is Section 1202. Section 1202 stipulates that certain investors in Qualified Small Business Stock may be eligible for an exclusion (sometimes in whole and sometimes in part) for gain in certain small business stock sales. Requirements to meet eligibility include a 5-year holding period, original issuance, and shareholder eligibility (at a high-level, eligible shareholders are all non-corporate shareholders). The percentage of exclusion depends on the issuance date with the lookback extending to 1993, however, for qualified small business stock acquired after September 27, 2010, the exclusion is 100%, and includes an exclusion from the alternative minimum tax. In other words, there are situations where capital gains can be avoided entirely for eligible investors in eligible stock. It is important to note that the exclusion is capped at the greater of $10 million or 10 times the basis of the initial investment.

Legal Considerations

Corporate Structure

Prior to entering into a potential transaction, sellers should confirm the legal validity of all organizational documents (by-laws, operating agreements, shareholder agreements, etc.) as well as ensure business qualifications are valid for each jurisdiction of the operation. The corporate structure, such as a C-Corp versus a partnership (LLC or S-Corp), may have significant tax implications on a transaction. Buyers often prefer to acquire a partnership (or assets of a partnership) due to the tax benefits from such a transaction (for example, an S-Corp taking the 338(h)(10) election), although many sellers are quick to setup as a C-corp. The tax benefit of a partnership structure may be so advantageous to a buyer that the purchase price may be 20% or more higher than an equivalent C-corp. Companies are encouraged to consult a tax advisor to ensure the most efficient tax structure. Further, many factors go into ensuring corporate structure compliance and taken together, the governing documents of a business should be understood well before entering into a potential transaction process.

Shareholder Considerations

Providing notice (e.g., information memorandums) and collecting signatures from shareholders may delay transactions or even force certain structures on a transaction. It is advisable to maintain regular communications with shareholders as well as a list of updated contact information to ensure the process of collecting signatures/ notices does not impact the deal timeline. As discussed above, it is important to ensure corporate structure compliance and a key factor that should be considered is the types of shareholders that comprise the cap table as certain structures (e.g., S-Corp) have shareholder restrictions.

Shareholder Disputes

Shareholder disputes come in all forms. Outside of legal disputes, shareholders may also be misaligned due to the value and form of their respective securities and simply disagree about objectives. We encourage shareholders to be open and clear about their objectives prior to entering into a transaction process to address shareholder disputes before they arise and before putting too many resources into a transaction process. Further, any promises made to shareholders should be properly documented.

Client Contracts

Sellers should have a form customer contract that is airtight, and whenever possible, work off that form agreement. When certain clients (government entities, large payers, or health systems) force a vendor on to their terms and conditions, sellers should try to mirror those terms as much as possible to their form contract. When forced off a form contract, companies should try to remain true to the terms and conditions of their form agreement as much as practically possible. Furthermore, all client contracts, amendments, statements of work, and business associate agreements should be well documented and archived to ensure easy and organized access to these files for due diligence. Service-level agreements and special indemnities need to be carefully considered with drafting customer contracts. It is important for sellers to be cognizant of any upcoming material customer contract renewals prior to launching a process, as any buyer will want to validate customer health during due diligence and assess any potential risk of customer churn. Generally, "opt-out" contracts are preferred over "opt-in" contracts as they translate into higher customer retention.

Special Contract Provisions

A critical part of any due diligence is the review of material contracts, with a heightened focus on special provisions. Special contracts come in many forms – outlined below are four of the more common clauses that may create obstacles in a due diligence process. As a general rule of thumb, contracts that inhibit a buyer's flexibility either operationally or in their own future exit should be avoided, or at a minimum cleaned up prior to engaging in a transaction.

Most Favored Nation Provisions: This clause, which can be found in customer contracts, restricts the seller from offering more favorable terms to another customer without also offering those terms to the beneficiary of the contract provision. These types of provisions can be problematic for the buyer as they can often be ambiguous and pose difficulties when assessed within the context of the buyer's broader customer base.

Right of First Refusal Provisions: A Right of First Refusal (ROFR) creates an obligation on the Company to notify the benefiting counterparty if the Company receives an investment and/ or acquisition offer and elects to actively explore such offer. The counterparty is granted the right to close a transaction on the same terms as the contemplated offer. A ROFR is a common provision extended by younger companies to key early customers or early strategic investors. As with other special provisions that are granted in the earlier stages, they can be easily overlooked, but often have negative future implications when the Company pursues a sale transaction. Primarily, a ROFR may impede a successful competitive process and even if the counterparty is unable to match an existing offer, the potential buyer may have reservations about inheriting the ROFR provision.

Customer Agreements with Joint IP: If a seller develops joint IP with a potential partner, the title and rights to that IP must be explicit to each party. This is just one of many vital elements to consider in ensuring the proper protection of intellectual property.

Reseller Agreements with Exclusivity: Sellers should avoid boxing themselves into reseller agreements with a form of exclusivity that, when assigned to a buyer as part of a transaction, may limit the buyer's ability to operate or create ambiguous IP rights.

Change of Control & Assignment Provisions

Customer and vendor contracts may include change of control or assignment provisions. A change of control provision requires a counterparty to provide written consent that the contract may be transferred to the buyer when the seller undergoes a change of control transaction. A facility lease is the most common example of a contract with a change of control requirement. Assignment comes into play during an asset purchase transaction, and in these situations, all contracts must be assigned from seller to buyer. A form client contract should explicitly state that consent is not required for change of control or assignment. Contract consents often slow a transaction and sometimes add additional risk because a consent may require approaching a large customer or partner about a transaction before the transaction has actually closed. It is advisable to be aware of any material customer or vendor contracts with change of control provisions to ensure a proper plan is in place to gather the required consents in advance of the closing.

FDA Issues, if applicable

FDA issues are somewhat minimal in the health IT market due to lack of general FDA oversight. However, digital therapeutics, clinical monitoring and clinical decision support vendors that fall into the category of software as a medical device should be acutely aware of FDA regulations to ensure compliance especially given the everchanging regulatory landscape. In 2020, the FDA launched the Digital Health Center of Excellence, which is an ongoing attempt to clarify the sometimes ambiguous regulatory standards that govern software applications that fall under the realm of the FDA. The FDA's Digital Health Policy Navigator is intended to help digital health companies remain in compliance with FDA regulations.

HIPAA Non-Compliance

The majority of HIPAA non-compliance violations come in the form of covered entities that are missing business associate agreements. However, bigger issues may arise when vendors are selling demographic and clinical data. Explicit and contracted data rights are a must when vendors are monetizing customer data and protected health information (PHI). Scrubbing PHI to make sure it is de-identifiable is also a requirement. Cybersecurity and encryption methods should be implemented to de-risk HIPAA violations, and to the extent HIPAA violations have been made, full disclosure should be reported.

Representations and Warranties Insurance

Representations and warranties insurance (RWI) is an insurance policy used in transactions to protect against losses arising due to the seller's breach of certain representations in the purchase agreement. The anticipated use of RWI makes a buyer's bid more attractive, as it streamlines the negotiation of the purchase agreement, provides more flexibility on the reps and warranties made by the seller, and a creates a cleaner path for both parties without limiting protections for the buyer. Notably, RWI allows a seller to feel more comfortable giving extensive representations and warranties as their exposure is limited, reducing friction in the deal negotiations. Further, RWI allows for the reduction or elimination of an escrow or holdback, which are significantly larger than the premium and retention associated with RWI, thereby increasing the shareholder proceeds received at close. While RWI will certainly streamline negotiations, it is important to keep in mind that the involvement of the RWI insurer and their representatives in due diligence may create a slight delay in the overall process timeline. As noted earlier, the use of RWI is becoming increasingly more common in middle market transactions, and it is encouraged that sellers seek this as part of the overall offer received from the buyer to the extent feasible. Furthermore, RWI carriers typically offer special policies that can cover specific indemnities and legal liabilities, and these can be helpful risk management tools as well as solutions to complex deal negotiations.

Outsourcing And Offshore Operations

In recent years, it has become increasingly common for companies to leverage outsourcing and offshore operations to optimize their business models. Outsourcing involves contracting with an external service provider (often in a foreign location) and offshoring refers to relocating part of the business functions to a foreign location, often via the establishment of a subsidiary. Leveraging an outsourcing and/ or offshoring strategy can allow a company to reap many benefits, though it is not without significant risks. Key risks to keep in mind include IP protection, quality control, security protection, compliance and regulation, political risks, employee turnover, etc. Regardless of which model a company opts to pursue, it is vital that the appropriate legal protections are in place to minimize risks. Further, if a company owns an offshore subsidiary, this may present some challenges to navigate through in a due diligence process (from a due diligence, deal structure, and legal documentation perspective, amongst others) and potentially extend the timeline as a buyer will need to conduct due diligence on the subsidiary as well. Overall, it is vital that if pursuing outsourcing and/ or offshoring, a Company takes an intelligent approach with airtight documentation that balances risks and uncertainties with potential upside.

Insurance

A software company typically maintains multiple insurance policies to protect the business from lawsuits and claims. These often include Directors and Officers (D&O) Insurance, Technology Errors & Omissions (E&O) Insurance, Cyber Liability Insurance, and Employment Practices Liability Insurance (EPLI). Collectively, these policies help protect companies and company officers and boards from lawsuits, product performance issues, data breaches, and employment claims. In many cases, customer contracts will require a company to maintain certain policy limits. Most investors will require a company to maintain minimum policy limits. In acquisitions, most acquirors will require a company to procure a tail D&O policy. Insurance policies are generally advisable risk-mitigation tools that help protect sellers and investors for pre-closing and post-closing liabilities and claims.

Human Resources Considerations

Employment Agreements

Several minor issues may arise in relation to employment agreements. Any verbal agreements between employer and employee must be put in writing. Employment agreements must contain assignment of intellectual property language to ensure the employer has title to the developed IP. Tax matters may arise in relation to guaranteed payments versus salaries and withholdings (especially when operating in multiple states). The most significant issues are option design and transaction bonuses, which are discussed in more detail later in this section. If an employee does not have an employment agreement in place, an offer letter typically suffices, or employees can sign separate necessary agreements such as Property Information and Inventions Assignment Agreements (PIIAs). Finally, proper classification of employees (exempt vs. non-exempt) is imperative as misclassification can have legal and financial consequences (e.g., law violations, back wages and taxes owed, etc.).

Non-Competes

Employment agreement issues may also arise when key shareholders and employees negotiate their contracts with potential buyers. The most sensitive matter is often the non-compete. The non-compete often includes a debate around the duration and scope, and with regards to scope, whether it should apply to the seller's or buyer's definition of business. It is worth noting that key shareholders will also typically be subject to a non-compete in the purchase agreement which may differ from the non-compete stipulated within the employment agreement. Non-competes that arise from employment agreements are subject to a higher level of scrutiny as it relates to enforceability as compared to non-competes that arise from the purchase agreement, which are subject to a more flexible standard.

Key Employee Retention

High employee attrition is a red flag for potential acquirers. Attrition at the executive level may also be a red flag. Companies should take executive turnover under consideration when evaluating the timing of a transaction. Furthermore, the transaction process itself should be designed around the objectives of the executive team and their personal plans to remain with or depart from the company. Finally, most buyers will want to design a transaction with incentives to retain employees. If a seller can structure employee incentives that benefit a buyer following a transaction, the seller should seize this opportunity to further this objective on behalf of a buyer.

Employee Disputes

Disputes between employee and employer are unfortunately not uncommon, however, so long as these disputes are not a red flag for greater issues, buyers are somewhat accustomed to handling these matters through indemnification or getting to a settlement pre-closing.

Benefit Plan Design

A company should ensure compliance with the many regulations (including ERISA) that govern benefits administration. Benefit issues also arise when there is a large discrepancy between seller and buyer benefit plans:
1) Seller benefits are superior to buyer benefits. While this may result in a synergy for the buyer, it also means that the seller's employees will be stepping into a less generous benefit structure, which may equate to an effective pay cut. Buyers can address this by translating the lower benefit cost into salary increases.
2) Seller benefits are inferior to buyer benefits. When this occurs, buyers may have to factor the higher benefit cost into their purchase price, thus reducing the effective profit of the selling business.

Employee Compensation vs. Market Rates

In transactions that involve a larger acquirer buying a smaller company, the most typical situation is one where the smaller company's employees receive below market salaries. To ensure employee retention, a buyer may need to adjust these salaries upward, thus resulting in a negative synergy. Negative synergies such as salaries and benefits are often the "price of doing transactions", and while a buyer may try to use this against a seller in a deal negotiation, this may or may not impact the purchase price.

Option Design and Transaction Bonuses

If employees have an economic participation in a sale transaction, either through options or transaction bonuses, terms must be accurately documented with clear and transparent terms and conditions. This documentation should be completed with advice from legal and tax counsel to ensure that option design and transaction payouts do not create any tax or indemnity issues for the seller. Companies should ensure that stock options are priced at or above fair market value and maintain documentation that supports this fact. As discussed earlier, employee retention is key, and thus properly communicating employee options and managing expectations is imperative to a successful transaction.

280G

Another matter related to employee payouts related to a transaction is the triggering of Section 280G, commonly known as "golden parachute payments". 280G is triggered when the amount of the compensatory payment that arises due to a change of control for a "disqualified individual" exceeds three times the individual's average annual compensation from the corporation or its related entities for the five years preceding the taxable year of the change in control. If 280G is triggered, a penalty in the form of a 20% excise tax is applied to the excess payment. This penalty can be avoided, however, if 75% of voting shareholders of a privately held company approve the payments and there is adequate disclosure to all of the Company's shareholders. Common types of payments that are considered part of the 280G calculation include transaction bonuses, the value of accelerating stock options arising in connection with the transaction, retention bonuses, and post-closing equity awards. A buyer may request a detailed analysis, and as such, a seller should be cognizant of the potential triggering of 280G.

Operations Considerations

Customer Concentration

There is no specific threshold for customer concentration. Our judgement is that this can occur when a single customer drives over 20% of total revenue, or when a handful of customers taken together generate 50% or more of total revenue. Client concentration can create synergy opportunities for an acquirer when a seller's customer concentration becomes a buyer's customer diversification, creating an arbitrage opportunity for the buyer. However, client concentration issues can be magnified when there is historical attrition or pricing pressure from key accounts. Sellers need to prepare for some form of customer reference calls to key accounts during the diligence process. These calls may be handled directly by a buyer with reference to the potential acquisition, under the guise of a partnership, or with design to look like a third-party market survey. Long-term contracts and strong reference calls can appease concentration issues. Customer concentration can also manifest itself through reseller relationships. Whenever possible, it is best to contract revenue on your paper versus reseller paper.

Customer And Revenue Retention

Retention rates, both customer and revenue, are key to the financial performance of a business and reflect the overall value proposition to customers. Each business has many unique factors that play into target retention rates and there are a few different metrics related to retention that buyers will focus on. Gross revenue retention is arguably the most important one, and, based on our experience in health IT, gross revenue retention rates exceeding 95% are exceptional, and companies should target rates in excess of 90%. Another key metric is net revenue retention which factors in upsell and downsell trends – companies should target a rate in excess of 100% to demonstrate current client growth. Lower retention rates may be acceptable depending on the nature of the product and market (e.g., B2C may experience higher attrition than B2B, and the SMB end-market typically has higher attrition than enterprise). Companies should document the rationale behind customer losses, not only to address this question when it comes up during due diligence, but also for best practices. Any known upcoming terminations should be appropriately and carefully disclosed during the diligence process not only from a legal perspective, but to maintain goodwill and trust with the buyer.

Customer Satisfaction

Net promoter score (NPS) is the most frequently used standard to document client satisfaction. NPS is an index ranging from -100 to 100 that measures the willingness of customers to recommend a company's products or services to others. However, NPS is certainly not a requirement, as it does not necessarily apply to all businesses. Client satisfaction is obviously reflected in retention, as well as return-on-investment measures, pricing power, and customer reference calls.

Pricing Trends

Price inflation is an excellent way to organically grow a business, in the same way that price compression is a difficult headwind. Pricing trends may be the result of a company's value proposition, competitive dynamics, technological advancement, and changes in market paradigms. Since pricing often has a dollar-for-dollar impact on profits, these trends may add or detract significant value to or from an enterprise. To the extent a business is undergoing some price fluctuation, either offensive or defensive measures should be taken leading up to a transaction to both create and protect value. Further, buyers will assess a seller's pricing strategy relative to competitors to gain insights into the Company's positioning within the marketplace, and as a sign as to the quality of the platform or service offered. Market leaders and market followers may be perceived differently, with leaders usually fetching a premium over followers.

Competitive Characteristics

Many of the points about customer and pricing trends link back to the competitive dynamics of the market. Sellers should be knowledgeable about competitive dynamics in their respective sectors and be prepared to articulate why they win or lose against key competitors. One of the most common competitive issues is the interplay between enterprise EMR and specialty health IT vendors. The general trend is that the competitive footprint of enterprise EMR is expanding and encroaching on specialty health IT vendors. For certain sectors, this interplay may dramatically alter the competitive landscape. We encourage companies to closely monitor competitive dynamics, as these shifts may be leading indicators of the optimal time to pursue a transaction.

Bookings Trends

Often the best time to sell is when the business is in the middle of a growth inflection, which also makes it the hardest time to sell. Bookings trends should be closely monitored, as revenue growth is the #1 driver of valuation multiples. We encourage companies to maintain strong operating metrics, since these metrics may support assigning more value to bookings and pipeline conversion. It is helpful if a company segregates bookings between new and existing customers. Strong historical data around operating metrics and key performance indicators can be used to extrapolate future expectations and provide counterparties with greater confidence in the accuracy of sales projections during transaction discussions.

Operating Metrics

Creating a strong link between operating metrics and financial metrics may help identify opportunities for revenue enhancement and resource allocation, as well as provide early indicators for opportunities and risks within the business. Gross margin is an underappreciated metric by many companies. To the extent possible, we encourage monitoring gross margin by product, revenue category, and even customer. Strong metrics reflect the sophistication and controls of the business, and all things equal, should result in better business performance as well as higher valuations.

Financial Projections: Budget vs. Actual

One of the most important items on this list is the performance of a business against projections during a transaction process. A reasonable buyer will give a company credit for the performance of the business up until the close date of a transaction, which may involve looking at a mix of trailing-twelve-month performance, run-rate performance, bookings, and near-term pipeline. Projections should be very carefully prepared leading into a transaction process to ensure that a company remains on plan, as this will increase a buyer's conviction in the seller's ability to hit projections and ideally give the seller credit for future performance. Unfortunately, many sellers come to market with overly aggressive projections, which results in an instinct by buyers to discount projections. To avoid re-pricing a transaction or a transaction falling apart altogether, sellers should honestly and carefully communicate the reasonableness and basis of their financial forecast.

HGP's Guidance for Operating Performance

HGP has observed a number of tangible and intangible company and transaction characteristics that typically define where a deal falls on the valuation distribution. The following metrics may serve as a useful guidepost for goal setting.

	BEST	GOOD	PASSABLE	AVOID
Recurring Revenue	Monthly Subscription or Monthly Transaction	Annual Subscription or Prepaid Transactional	1-Year+ Prepaid Subscription	Perpetual License + Maintenance
Revenue Metric	Contracted Annual Recurring Revenue	Annual Recurring Revenue	Trailing Twelve Month	Sum of Parts Revenue Multiples
Revenue Growth	35%+	20-35%	10-20%	<10%
Gross Margin	80%+	70-80%	60-70%	GM <70% for SaaS Lower for Services
Revenue Retention	95%+	90-95%	Depends on Customer Type	<90%
Customer Concentration	<10%	10-20%	20-30%	1 customer > 30% or a handful of >50%
Profitability	20%+	0-20%	Small Losses	Large Losses

Intellectual Property Considerations

Ownership of Work Product/ Invention

Software is a core intellectual property asset to most companies operating in the health IT and services market. Therefore, a clear and unambiguous title to this asset is an absolute necessity. A company must ensure that any individual or entity that touches the code enters into an invention assignment agreement that gives clear title to that work to the company (employer) and not the individual (employee or contractor). The same dynamic is true for technology that is licensed from another entity or licensed from research or academic institutions. In our experience, patents are not a requirement to secure value in a software asset, however, software companies must ensure that they have freedom to operate and are not infringing on other intellectual property. Because the secret sauce of most companies in the health IT market is their go-to-market strategy, we find that patents tend to protect value as much as they create it. "Knowledge qualifiers," survival, and indemnity caps are often hotly contested points in the IP provisions of a purchase agreement.

Open Source

In any transaction, a buyer will closely assess the use of open-source code to ensure that the underlying license agreement provides the company with the flexibility to redistribute that code as part of their software application without violating the open-source license. The General Public License (GPL) open-source license is well understood, however, copyleft standards generally must be followed when dealing with open-source software. According to GNU (the entity that governs GPL), "anyone who redistributes the software, with or without changes, must pass along the freedom to further copy and change it." This policy is in direct conflict with a copyright, the common standard for software intellectual property protection. When undergoing a transaction, a buyer is likely to perform a deep assessment of the use of open source, potentially using a third-party firm, such as Black Duck or Sema.

In-Licensing Third-Party IP

The use of third-party intellectual property within a proprietary software platform is common, either through white label or third-party licensing agreements. When pursuing a transaction, sellers must clearly articulate proprietary versus non-proprietary licensed intellectual property. From a legal perspective, licensing third-party IP can present issues if the licensing agreement does not clearly delineate who owns what IP when they are co-mingled. Finally, licensing third-party IP may create a dependence on a third party that the licensee cannot control. If the licensor is acquired by or partners with a competitor to the licensee, how might that kind of scenario change the relationship dynamics and competitive landscape? It is encouraged to vet these relationships from all legal and business angles.

Out-Licensing & White Label Agreements

Out-licensing, giving another party permission to use your IP, is the inverse of the relationship described above. Excluding customer contracts, white label agreements are the most typical form of out-licensing. While these agreements may be a tremendous revenue opportunity, they may also present challenges. Vendors should be very careful about re-seller and white label relationships that include exclusivity restrictions. A second issue in these agreements often involves a lack of clarity to title of jointly developed code improvements and modifications. From a business perspective, a white label agreement may mean that a vendor loses the relationship with the end-user, and a diversified base of hundreds of customers may turn into a single, concentrated customer relationship.

Client Rights

Client rights involve specific software license agreements with customers that involve joint-intellectual property or product guarantees that are not part of the standard form customer contract. Customization is the simplest form of specific license agreements. When customizing software, a vendor must ensure that any customizations are owned by the company and may be re-used with other customers. Future development guarantees may also present an issue, because to the extent these guarantees are not met, the vendor may be in violation of the customer contract. In some situations, a customer may require a source code escrow. While this sounds reasonable, source code escrows are often impractical.

Registrations & Documentation

While software businesses tend to be asset-light, often intellectual property is the #1 asset of the business. To protect this value, companies should comply with all registrations and documentation related to IP, including patents and patent applications, trademarks, trade secrets, contracts, domain names, escrows, and even social media. Ensure that this documentation is held in the company name rather than the individual.

Reps & Warranties

Given the importance and sensitivity around intellectual property related to software businesses, sellers should very closely scrutinize the representations and warranties that they sign up for in the purchase agreement. To prevent indemnity and litigation issues down the line sellers should also make sure that the related disclosures are accurate and complete.

Technology Considerations

Technology & Architecture Scalability

Other than customer acquisitions that result in a technology migration, an acquirer or investor's transaction thesis is predicated on growing and scaling the technology platform of the selling enterprise in most transactions. Therefore, a selling enterprise is in the best position for a transaction when its technology is designed to handle significantly more capacity and stress. In applicable cases, a buyer may even stress test a technology platform by artificially loading data or users to simulate how the platform functions in a more demanding environment. Processing speed, server capacity, and database structure are all relevant, as is the cost of scaling these architectural components. Third party licenses are a significant factor in the cost assessment as well. If significant investment is required to scale a platform, this may be reflected in the due diligence negotiation. "Technical debt" is the term most often applied to companies with platforms with dated or under-scaled tech stacks. The "debt" is the cost, both in investment and time, required to upgrade the platform to standards that meet the technical requirements of the acquiring entity. In a majority of transactions, an acquiring entity will engage a third-party consulting firm, such as Crosslake or West Monroe, to perform an assessment of the target's platform.

On-Prem vs. Cloud

In today's environment, the cloud is becoming more prevalent and is generally preferred to on-prem systems. Cloud computing offers efficiency, agility, productivity, decreased costs, among various other benefits, all of which lend to a more scalable platform, which as discussed above is more appealing to a buyer. Further, operating on the cloud will allow for a more streamlined and less costly integration process to the extent the buyer intends to integrate the seller's platform with their own. As the overall market transitions to the cloud, it is not uncommon for businesses that previously operated on-prem to migrate to the cloud. If a seller opts to pursue a migration, it is advisable to complete that process prior to engaging in a sale transaction or at a minimum be far enough along as a buyer may be hesitant to inherit what can be a costly and time-consuming project.

Multi-Tenant vs. Single Tenant

On a similar vein, the use of multi-tenant vs. single-tenant cloud architecture plays a significant role in assessing a platform's overall scalability. Both have their pros and cons, but at a high-level multi-tenant is the more scalable option and single tenant offers greater security. However, with the greater adoption of the cloud, multi-tenant is similarly becoming more common as it is more widely accepted to have data stored on the cloud. This is just one of the many areas that will be assessed during technical due diligence, which is primarily focused on determining scalability, technical debt (if any), security, and overall identifying potential for growth and risks.

Cybersecurity

Perhaps one of the most important topics in this whitepaper is cybersecurity – cybersecurity compliance is a foundational requirement for healthcare IT companies and has been growing in importance with the increasing complexity and frequency of cyberattacks and data breaches that compromise patient privacy and patient safety. While requirements vary and not all are relevant to all companies a few worth highlighting include Penetration Testing, Vulnerability Scans, Security Risk Assessments, and Privacy and Breach Risk Assessments. It is advisable to engage with a knowledgeable third-party to develop a strong and comprehensive cybersecurity and risk management strategy. Companies that want to set themselves apart as leaders in security, privacy, and compliance can pursue HITRUST Certification and SOC 2, which are recognized as gold standards of healthcare data security.

Platforms/ Version Control

Version control is an issue that predominantly impacts hosted and client-server applications versus true software-as-a-service (SaaS) platforms. Version control can manifest in two ways: 1) supporting multiple customers on multiple versions of the software platform, and 2) supporting multiple customers with multiple forms of product customization. With regards to the former, it is important to maintain clients on the same version of the software for both maintenance and security purposes. Regarding the latter, buyers will be frustrated if configuration is confused with customization in the due diligence process. Customization involves writing new code for individual clients, whereas configuration involves setting features within existing code. Configuration is viewed as superior to customization from a buyer and scalability perspective, however, there are instances where customization is unavoidable, particularly with large, enterprise clients. There is also often ambiguity between hosted and SaaS models. SaaS models are hosted, but hosted models are not necessarily SaaS. Vendors may run into issues with version and platform control with a hosted model in the same way they do with a client-server model. True SaaS involves a single code instance, which means every client is on the exact same version of code, and upgrades are delivered simultaneously across all clients.

Development Roadmap

The development roadmap may present two common issues: platform migration and vaporware. Platform migration often involves transitioning the platform from non-SaaS to SaaS or moving platform to platform on SaaS. Migration cost and potential customer attrition are key considerations to this process. In certain segments of health IT, the migration to SaaS is particularly difficult due to sensitivity around PHI, client preference for hosting their own data, and integrations. Amazon Web Services, Microsoft Azure, Salesforce, and Rackspace are common and generally acceptable hosting environments, as are healthcare specific platforms, such as ClearDATA. Companies often underestimate the cost of SaaS migration, and during due diligence, buyers will complete their own assessment. To the extent the two parties are far apart on the projected cost of migration, due diligence issues may arise. Vaporware is the promise of software that does not already exist. Sellers should be transparent about what is and is not offered in the current feature set, along with the status of technology on the development roadmap.

Regulatory/ Standards Changes

As CMS, HHS, and the FDA assert their influence in the health IT market, the industry is increasingly held to higher and greater regulatory standards. Meaningful Use was one of the first big tests for the market and resulted in market consolidation due to vendors' inability to keep pace with the cost and time required to meet the everchanging standards. FDA, FHIR, Meaningful Use, Interoperability, APIs, Reimbursement (MACRA, MIPS), and Communication (FTC) each require potentially onerous development and reporting requirements. The political regulatory climate should be kept in mind when entering a transaction process as it can both help and hurt valuation. Other contractual considerations include service-level agreements (SLAs) and meeting special requirements under the more rigid technical standards of government contracts, if applicable.

Code Documentation

As important as it is to standardize the code itself, it is equally important to have standard procedures for code documentation. Code documentation helps keep track of all aspects of an application and improves on the quality of a software product. Its main focuses are development, maintenance, and knowledge transfer to other developers. The knowledge transfer element is important to reduce the dependence on key contributors to the technology. Companies and coders should implement best practices and habits for code documentation early.

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About Healthcare Growth Partners

Healthcare Growth Partners (HGP) is an exceptionally experienced Investment Banking & Strategic Advisory firm exclusively focused on the transformational Health IT market. We unlock value for our clients through our Sell-Side Advisory, Buy-Side Advisory, Capital Advisory, and Pre-Transaction Growth Strategy services, functioning as the exclusive investment banking advisor to over 140 health IT transactions representing over $5 billion in value since 2007.

Our passion for healthcare inspires us to not only create value for our clients, but also generate broad, overarching improvements to the functionality and sustainability of health. With our focus, we deliver knowledgeable, honest and customized guidance to select clients looking to execute high value health IT, health information services, and digital health transactions. For more information, please visit www.hgp.com.

Contact Information

2001 Kirby Drive, Suite 814
Houston, TX 77019
(713) 955-7935
www.hgp.com