

KEY TRENDS IN THE VALUATION OF AMBULATORY SURGERY CENTERS

BY JASON RUCHABER, CFA, ASA AND KYLE TORMOEHLEN, MBA



trends on valuation we need to understand the influence these trends have on the three fundamental building blocks of value.

These building blocks can be generally be grouped into three broad categories:

- 1) Factors that affect profit
- 2) Factors that affect growth
- 3) Factors that affect risk

FACTORS THAT AFFECT PROFITS

Profits, more specifically cash flows, are the fundamental building block driving the value of ASCs. All things equal, higher profits translate into higher value. Unfortunately, profit also seems to be a bright beacon on which legislators train their attention. Unfounded or not, profits are often seen by lawmakers as symptom of waste, and with

DURING 2009, HEALTHCARE REFORM became the central focus of the legislative agenda and permeated our day-to-day lives. But despite the fervor, competing political positions, public backlash, and the election of Scott Brown in Massachusetts have put the reform efforts in jeopardy. As of the date of this article President Obama has conceded that healthcare reform at the Federal level may die in Congress. Whatever the ultimate outcome of the current efforts, reform is not a topic that will likely to go away any time soon, and as Federal efforts falter, State-level efforts may increase. Because of this, it is important to digest the commentary and debate surrounding healthcare reform and identify key trends that will influence ambulatory surgery center (ASC) valuation for 2010 and beyond.

Valuation is generically discussed within the context of “valuation multiples”, and though this is a convenient manner in which to package a complex subject, the use of a valuation multiple can be very misleading. Mathematically a multiple is inversely related to risk, and directly related to expected growth in cash flows (i.e., higher risk = lower multiple and higher growth = higher multiple). Because of this, two seemingly similar entities may warrant significantly different valuation multiples. In order to properly assess the impact of industry

healthcare costs spiraling out of control in the United States, profitable entities are an easy target. Despite being a proven low cost solution for outpatient procedures, ASCs present a conundrum for our lawmakers. Businesses that are low cost and profitable do not fit into the formula for political gain. And though legislative efforts would be more effective by pursuing lower cost options for our healthcare delivery system, the belief that physicians are unduly influenced by profits is difficult to overcome. So, what does this mean for ASCs?

First, ASC reimbursement will likely face continued downward pressure. 2010 marks the third year of the four year phase in of CMS’ new payment system for ASCs. The new payment system, which for 2010 accounts for 75 percent of the reimbursement rate, is calculated as the ASC conversion factor multiplied by the hospital outpatient department (HOPD) relative weight. For 2010 the conversion factor receives a 1.2 percent inflationary update, but the relative weight has been further reduced to 57.9 percent of the HOPD rates. On a combined basis, 74 percent of all procedures performed in ASCs will see an increase in reimbursement from the phase in; however, the ten most frequently performed procedures will all see declines. Certain specialties are more heavily impacted than others, namely gastroenterology, which

will see a decline of 5 percent in 2010. Though 2011 is the final year of the phase in, CMS will likely continue to use the relative weight factors to keep ASC reimbursement in check. In addition, it is uncertain to what extent commercial payors will begin to incorporate Medicare reimbursement methodologies into their future contracts.

The focus on profit is also a warning shot for out of network centers. These ASCs have continued to lose favor with not only regulators, but also payors and investors. These centers, which do not contract with commercial payors, generate significant amounts of profits by billing under out-of-network benefits. Pressure to go in-network has intensified, and centers that continue to pursue the out-of-network strategy may face delayed or reduced payment.

FACTORS THAT AFFECT GROWTH

The ASC industry is showing signs of maturation. Since the early-2000s, the annual growth in newly licensed ASCs has leveled off, while the number of eligible physician investors per ASC has started to decline. According to a 2008 survey conducted by Deutsche Bank, eligible physician investors per ASC are down from more than 32 in 2000 to slightly over 20 by 2010. The oversaturation has led to increased competition for new physician investors. Today, ASCs are facing fewer recruitment opportunities, as many physicians are otherwise involved in competing centers and subject to restrictive covenants. The rise of the integrated delivery model has increased the prevalence of hospital employment arrangements with eligible physicians. This relationship will often preclude an ownership interest in a competing entity and will require the physician to divest ASC ownership. Because the viability of the ASC business model is highly dependent on its physician investors, ASCs unable to attract new physicians are experiencing decreases in cases, revenue and earnings growth.

This has been exacerbated not only by a tightening credit market and lack of funding for de novo centers, but also by moratoriums on new ASC licenses — especially in certificate of need (CON) states. Though credit markets will likely improve over the next few years, restrictions on new ASC development may be more prominent with the focus on containing healthcare costs. By restricting the supply of ASCs, theoretically the existing ASCs should be in a position to experience higher utilization rates of their ORs, thereby reducing cost. Additionally, higher barriers to entry foretell of future consolidation within the ASC market, as hospitals and for-profit management companies with greater operational experience and available access to capital seek continued growth through acquisitions (i.e., as opposed to a growth strategy based on the development of new centers).

Though the industry as a whole is experiencing maturation, individual centers may be poised for steady growth,

especially if de novo development is restricted and/or weaker ASC operators begin to exit the market.

FACTORS THAT AFFECT RISK

The assessment of risk is one of the most subjective areas of business valuation. In practice, a company-specific risk assessment is used to account for certain factors that cannot be implicitly modeled in the ASC's expected earnings and/or have been modeled with a degree of uncertainty such as the sustainability of ASC profits and growth. All things equal, cash flows that are perceived to be more risky will demand a higher required rate of return (i.e., resulting in a lower valuation multiple).

While CMS provides short-run guidance related to upcoming changes in ASC reimbursement methodology, it is often difficult to project how these changes will affect managed care contracts. As such, there is an element of uncertainty (i.e., quantified as risk) during certain dynamic periods such as healthcare reform. In addition, a reliance on a select few payors will increase the riskiness of future cash flows, as a decrease in reimbursement by one or more key payors may significantly impact profits.

Many older ASCs are experiencing a transitional period, as original physician investors are nearing retirement and performing less surgical cases. Because the pool of eligible physician investors is decreasing in many markets, certain ASCs have found it difficult to sustain historical growth rates in cases, revenue and profit. While physician retirement can be approximated into the projected cash flows, the reliance on key physician producers will add to the overall risk of the ASC investment that otherwise would be mitigated through a diversified physician mix.

SUMMARY

The combination of uncertainty related to reimbursement, reduced access to capital and increased competition for a limited number of qualified physician investors has resulted in a “buyers” market. Overall, buyers' negotiating power has reduced purchase multiples of years past, as buyers have become more disciplined/selective in their investment activity. Our recent valuation engagements have indicated the start of consolidation activities by hospitals, and to a lesser degree, for-profit ASC management companies. While healthcare reform is certain to present new challenges for the ASC industry, ASC transactions are likely to remain strong in 2010, though prices paid for ASC interests are lower than previous years. ●

Jason Ruchaber, CFA, ASA is a Manager in the Denver office of HealthCare Appraisers Inc. He can be reached at jruchaber@hcfmv.com or 303-688-0700.

Kyle Tormoehlen, MBA is a Senior Associate in the Denver office of HealthCare Appraisers, Inc. He can be reached at kylet@hcfmv.com or 303-688-0700.