

Valuation Issues Impacting ASCs

Presented By

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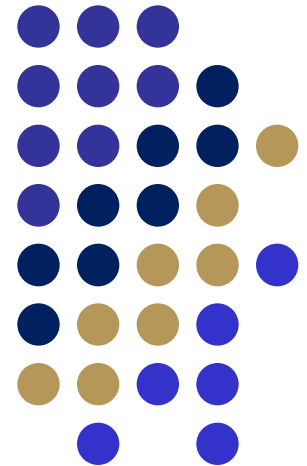
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HealthCare Appraisers, Inc.

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Overview – FMV Standard



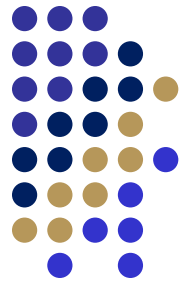
- Healthcare regulations stipulate **fair market value** as the applicable standard of value.
- The definition of **fair market value** in healthcare is slightly different than the standard valuation definition.
 - the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell ... *between well informed parties who are not otherwise in a position to generate business for the other party...*
 - *Implications of "hypothetical"*
- **Strategic value (or investment value)** is often confused with FMV and is generally precluded by healthcare regulation.

Use of Valuation Approaches



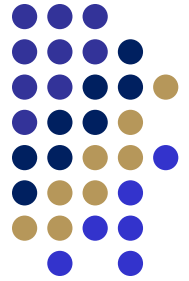
- Three generally accepted valuation approaches
 - Income Approach – A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated future economic benefits into a single present amount.
 - Market Approach – A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.
 - Asset (Cost) Approach – A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.

Use of Valuation Approaches



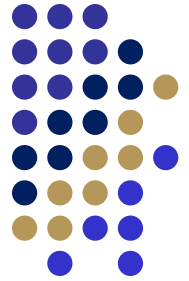
- The selection of the appropriate approach will depend upon the facts and circumstances of the entity
- Generally start-up/De Novo Centers are valued using a Cost Approach
- Operating ASCs are generally valued using the Income or Market Approach
 - Income Approach – Typically using a DCF Model excluding any case volume that may be brought or taken away by a the specific physician investor.
 - Market Approach – Typically using a comparable transaction method

Key Considerations in Use of DCF



- Case volume associated with prospective owners
- Strategic vs. FMV buyer related cash flow adjustments
- Matching cash flow with discount rate
- Capital structure and other assumptions associated with determining cost of capital

ASC Value Drivers & Risk Factors



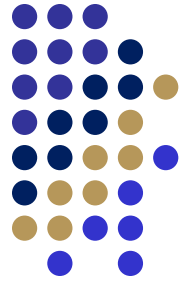
Value Drivers

- Growth – Historical & future
- Specialty mix
- Payor mix
- Certificate of Need
- Management /
Administrative oversight
- Hospital Participation

Risk Factors

- Single-specialty
- Limited Number of
owners/users
- Competition
- Out-of-network billing

Market Multiples - Definition

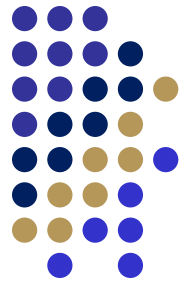


- A valuation multiple is appraiser shorthand for the present value of a perpetual earnings stream mathematically expressed as follows:

$$\frac{1}{(K - g)}$$

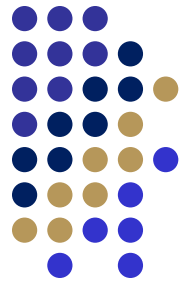
- Key components of a valuation multiple
 - 1) Definition of the **Earnings Stream**
 - 2) Estimation of **Risk (K)**
 - 3) Estimation of the rate of earnings **Growth (g)**

Market Multiples - Defining “Earnings”



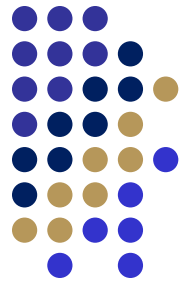
- Typically Measured as Earnings Before Interest Taxes and Depreciation (“EBITDA”), but can also be stated as cash flow, net income, distributions, etc.
- Single Period or Average? May be most recent year, trailing twelve months, 2-year average, etc. The appropriate measure is the one that is most indicative of future earnings capacity.
- In some instances historical earnings measures must be normalized to remove the effect of non-recurring income and/or expense items.

Market Multiples - Estimation of Risk



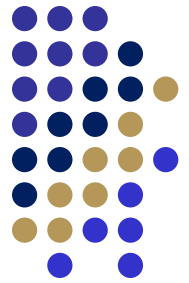
- Risk is defined as the degree of uncertainty as to the realization of investment returns (*i.e., the earnings stream*).
- Risk is measured as the required rate of return necessary for an investor to commit funds given alternative investments.
- For mature in-network ASCs the required rate of return is generally in the range of 18-22%, however, this can be significantly different if earnings are volatile or at risk.

Market Multiples - Estimation of Growth



- A valuation multiple is a “perpetual” valuation model.
- Because of this, there are limitations regarding the growth assumption that can be built into a multiple.
- Generally the growth assumption should not exceed the growth rate of the overall economy, which when measured as GDP, is less than 5%.
- Because of this limitation – valuation multiples should only be applied to stable businesses.

Key Components of a Multiple



1. Earnings Stream

The next time you hear that Dr. Jones sold his interest for 5x, ask yourself “5x what?”

2. Risk

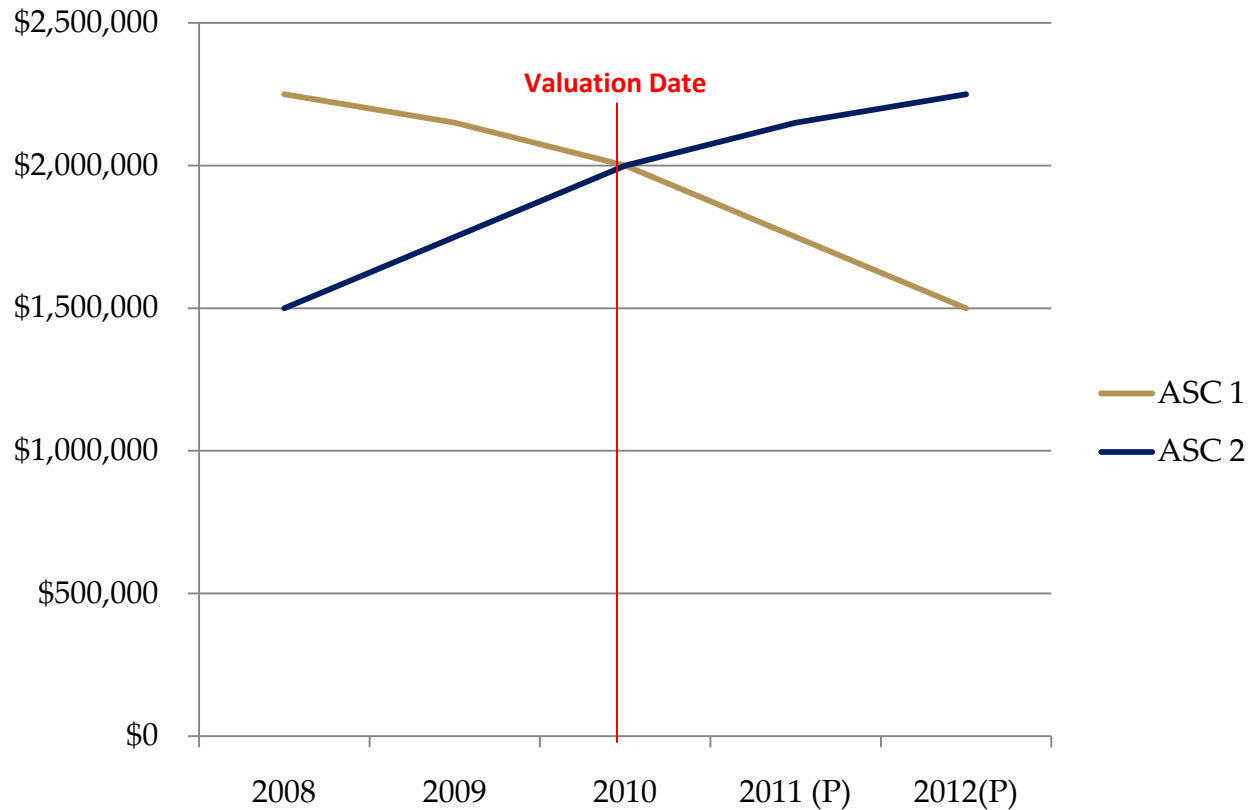
Not all earnings are the same! Two ASCs with \$2.0M of earnings may have completely different risk profiles.

Higher Risk = Lower Multiple

3. Growth

All things equal, **Higher Growth = Higher Multiple.**

Two ASC's with \$2.0M EBITDA



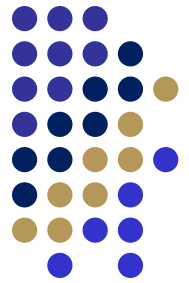
Market Multiples - Misapplication



Examples:

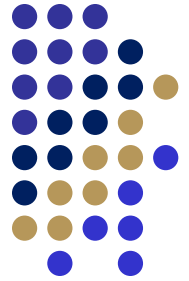
- Not adjusting EBITDA for one-time revenues or expenses.
- Applying multiple to an ASC with a high proportion of out-of-network commercial payor revenue without normalizing revenue to sustainable levels.
- Not subtracting debt from derived enterprise value.
- Not considering special marketability factors affecting the ASC.

Controlling vs. Minority Interest



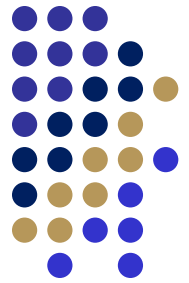
- Interests providing absolute control are worth more.
- Control typically granted by the governing documents.
 - Which matters require **board majority** vs. **board supermajority** vs. **member vote**?
 - Determine distributions.
 - Approve new investors.
 - Approve redemption of units for retiring/relocating investors.
 - Approve new contracts or operating agreement changes.
 - Sell the company or dispose of assets/assume debt
- Physician Investors may exert significant control regardless of share voting power

Marketability Concerns



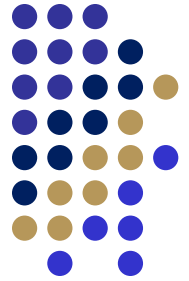
- **Marketability:** the ability to quickly convert property to cash at minimal cost.
- **Discount for Lack of Marketability:** deducted from the value to reflect the relative absence of marketability.
- Most minority investments in ASCs tend to be reasonably marketable, and discounts tend to be lower than other entity types.
 - Local market factors are key, including pool of potential physician investors, competing ASCs, Hospital employment, etc.
 - Provisions set forth in governing documents may have significant implications

ASC Valuation Trends



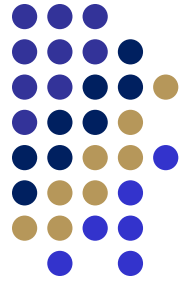
- Observed a significant increase in ASC acquisition activity in 2010.
 - Multiples paid for controlling interests shift slightly upward.
 - Anticipate stronger pricing for controlling interests in the coming year.
 - Valuation multiples for controlling interests, expressed as a multiple of EBITDA, were generally in the range of 6.0x to 7.0x less debt during the last year (*i.e.*, for centers which were predominantly or exclusively in network with Commercial payors).
 - The pricing of minority shares in ASCs has remained relatively stable.
 - Most minority interest transactions occurring between 3.0x to 3.5x EBTIDA less pro rata debt (*i.e.*, for centers which were predominantly or exclusively in network with Commercial payors) .

Common Valuation Challenges



- Chicken and Egg – Incremental volume associated with syndication efforts.
- Hospital transactions and hospital fee schedules.
 - Incremental risk/valuation implications associated with removing MD ownership on prospective basis (i.e., assumes 100% hospital ownership).
- Out of network strategies and valuation implications.
- De Novo valuation issues.

Impact of Post-Acquisition Service Arrangements on Value



- Management fees – when not paid historically, should they be factored into valuation? Answer - depends
 - Who is providing?
 - Are services necessary to operations? Would a reasonable hypothetical buyer agree?
 - Are the services priced at FMV?
- Added expense reduces cash flows and hence value of the business.

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