



Issues in Healthcare Valuation

A Regulatory Update and Introduction to Compensation Valuation

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Healthcare Regulatory Update

Updates to the Stark Regulations in 2008:

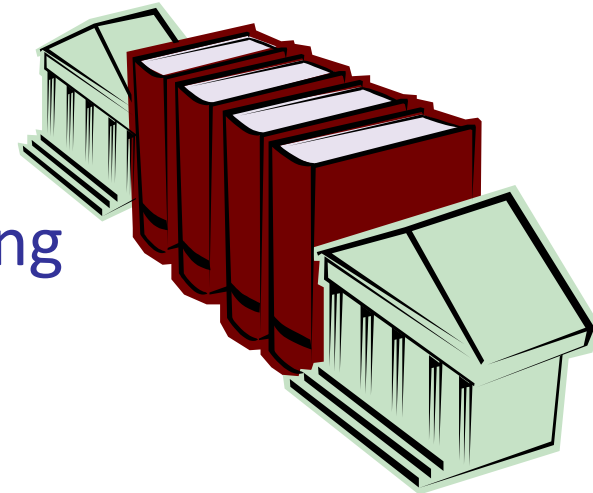
- Prohibition on per click leasing arrangements
 - Exception for per-click litho service deals
- Block leases: Concern about leases for less than 4-hour blocks
- Prohibition on percentage-of-revenue leasing arrangements
- Under Arrangements: Entity providing the service treated same as entity billing for the service – essentially prohibits under arrangements



Healthcare Regulatory Update

Updates to the Stark Regulations in 2008 (cont):

- “Stand in the Shoes”: Limits the Indirect Exception
- Period of Disallowance: Past violations put current billings at risk until corrected
- Anti-Markup Rules: New criteria
- Gain-Sharing: Must meet an existing Stark exception



Compensation Valuation



- A large proportion of the third-party valuations prepared for the healthcare industry appraise the FMV of service agreements.
- A new appraisal discipline is emerging for valuing service arrangements: Compensation Valuation or “CV”.
- In CV practice, appraisers often seek to apply or adapt concepts and techniques from the general valuation and the business valuation (“BV”) body of knowledge to valuing service arrangements.

Compensation Valuation



- Key Premise to CV Practice: All appraisal disciplines share a common conceptual framework:
 - Appraising under a specific definition of value
 - Three approaches: cost, market, and income
- The challenge of applying this framework to CV:
 - Appraisal body of knowledge developed for buy-sell transactions of property
 - CV seeks to value the compensation paid in service arrangements related to the provision or usage of goods and services for a period of time

Compensation Valuation



- Presentation Proposal: Concepts and techniques from general and BV body of knowledge can be systematically applied to the development of a CV body of knowledge.
 - Requires various adaptations and adjustments
 - Requires the use of analogical reasoning
- Why attempt to develop a CV body of knowledge?
 - Development is already happening (*e.g. 2009 BVR Guide to Healthcare Valuation*)
 - Advancement of the appraisal profession
 - Self-regulation as opposed to government regulation

Compensation Valuation



- Some precedent for CV in real estate leasing and intellectual property (“IP”) licensing and royalty valuations
- BV-related development: Fair value of owner’s services
- Healthcare valuation appears to be the most active market for CV:
 - Various forms of physician services
 - Goods and services (resources) provided as part of medical or healthcare procedures or activities
- BV appears to be the most relevant body of knowledge for CV.

CV: Market Approach



Market Cost Income

Market Approach as defined by the International Glossary of Business Valuation Terms:

A general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold.

CV: Market Approach



Application and adaptation to CV:

- Methods comparing subject arrangement to existing service agreements in the marketplace
- Principle of Substitution: Pay no more for a service than would for a substitute service of equivalent economic utility.
- Comparability of services provided
- Adjusting for comparability

CV: Market Approach



Application to CV: Comparability of Services Provided

- Physician qualifications
- Physician scope of duties
- Work time requirements
- Level of service provided
- Types of equipment provided
- Call coverage factors and burdens

CV: Market Approach



Using Physician Compensation Surveys

- Key Issue: Is the subject physician and service arrangement comparable to the physicians and practices in the survey(s)?
 - Review the respondent characteristics for the survey.
 - “Common size” the subject physician/arrangement by using various productivity metrics also reported by the survey: wRVUs, professional collections, collections/wRVU, work hours, encounters, wRVUs/encounter.
 - Be aware of the implicit/indeterminate factors in reported physician compensation: levels of ancillaries, ownership profits, usage of mid-level providers, medical directorships, compensated call coverage, etc.
 - Address distinctions between clinical and administrative services.

CV: Market Approach



Use of Market Transactions:

- Key challenge: Do you have enough information to assess comparability between the subject and the market comparable?
- Stark prohibition on the use of market data from referral source and DHS provider transactions
- Referral source/DHS provider transactions raise the same concerns as the use of related party transactions: family members, parent-sub, affiliates.
- Major pitfall: Uncritical use of market information

CV: Cost Approach



The Glossary definition: *A general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset.*

- In general valuation terms, the Cost Approach looks to the cost to replace or recreate the asset.
- Asset-based approach in BV: Re-create the BEV one asset at a time.

CV: Cost Approach



Application to CV: Cost Approach seeks to value the compensation for a service arrangement by valuing the cost to recreate or replace that service with one of similar capacity or utility.

- Value the cost of the individual resources included in the service, *i.e.* a build-up approach.
- Value the cost to re-create based on its historical cost as adjusted or normalized for FMV purposes.

CV: Cost Approach



Build-Up Technique:

- Break down the service into its constituent parts or into the discrete resources that are included in the service
- Obtain market or cost information on the usage or consumption of these resources.
- Critical issue: Re-create the same or comparable service.
- Cost includes a market return on the provision of the resources:
 - By individual resource
 - On total of all input resources

CV: Cost Approach



Adjusted or Normalized Historical Cost:

- Primarily for employment compensation:
What has the physician made in the past?
- The relevance of a physician's historical compensation depends on the degree of comparability between the physician's historical setting and the subject arrangement in terms of the services provided and the practice operating profile.
- Adjustments and normalization amounts are often needed to make historical compensation comparable to the subject employment arrangement.

CV: Income Approach



Market Cost **Income**

Glossary Definition: *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 economic benefits into a present single amount.*

- Note: Discounted cash flow (“DCF”) is only one method under the income approach in BV.

CV: Income Approach



- **CV Adaptation:** Value the compensation for services by evaluating the future economic benefits received by a party or both parties to a service agreement in terms of the rates of return and/or levels of profitability when measured against the levels of investment, risk, and resource utilization for the party.
- Rates of return and/or profitability are compared with market rates for similar investment, risk, or resource utilization profiles.

CV: Income Approach



Example: Prepare a pro forma for each side of a service arrangement and compare the profitability or return at a given price for the service.

- For the service provider, the compensation represents the revenue for the service.
- For the service user, the compensation represents a cost for a resource that is a part of a larger healthcare service or business operation.
- Compare the profitability or return in terms of the relative business and investment risks of each party.
- **This approach does not include the volume or value of referrals:** Only include the service or business related solely to the subject service arrangement.
- Pro forma for both sides may not be practicable for all forms of service arrangements.
- Income approach analysis may often serve as a reasonableness check.

CV: Income Approach



CV Adaptation of the DCF Method: Use a DCF model to solve for the level of compensation that makes the NPV of the cash flows equal a party's investment over the life of the contract.

- Generally, one assumes a liquidation of the business or assets at the end of the contract rather than a terminal value.
- Discount rate reflects the risk profile of the subject service or business.

CV: Income Approach



- Employment DCF: What compensation level makes the NPV of the cash flows from the practice equal to the investment of the employer in the practice?
- Litho DCF: What per-click price makes the NPV of the cash flows from the litho service equal to the investment of the litho service provider?

CV: Income Approach



Adaptation of the Excess Earnings Method to employment compensation:

- Calculate the net earnings of the practice before physician compensation (revenues less operating expenses).
- Calculate the required return on investment for the assets used in the practice.
- Subtract the required return from the net earnings before physician compensation.
- Remaining earnings are an indication of FMV physician compensation.

CV: Opinion Synthesis



- In appraisal practice generally, the appraiser evaluates the indications of value provided under each approach to arrive at an opinion of value.
- The appraiser has to assess the relative strengths and weaknesses of each approach and/or method relative to the subject arrangement.
- The results of one approach may or may not be the best reflection of the appropriate level of compensation for a service.
- Professional judgment is required to determine the value range based on the information gathered and the valuation analyses completed.
- Professional judgment is also required to determine when and how to use the various methods available for healthcare CV work.

CV: In Summary

Conclusion: General valuation and BV concepts and techniques can be adapted to valuing the compensation paid in service agreements.

- Like general valuation and BV, not all CV methods may be relevant or practicable to valuing a given service arrangement.
- There are many available CV methods for use in healthcare valuation by appraisal professionals.
- **The value of appraisal professionals to the healthcare industry is in using their expertise in the application of these various tools.**



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