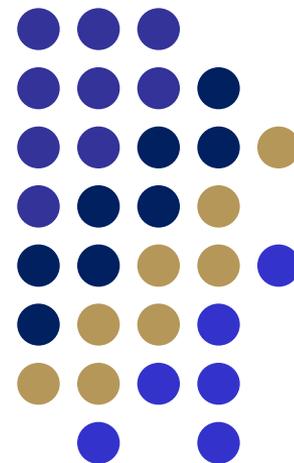


Valuations and M&A Activity

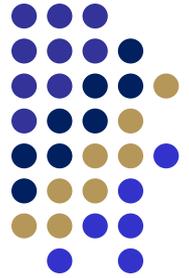
Todd J. Mello, ASA, CVA, MBA

Co-Founder and Partner


HealthCare Appraisers
INCORPORATED

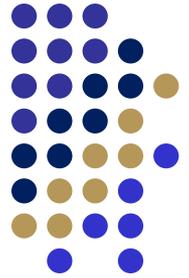


Disclosures



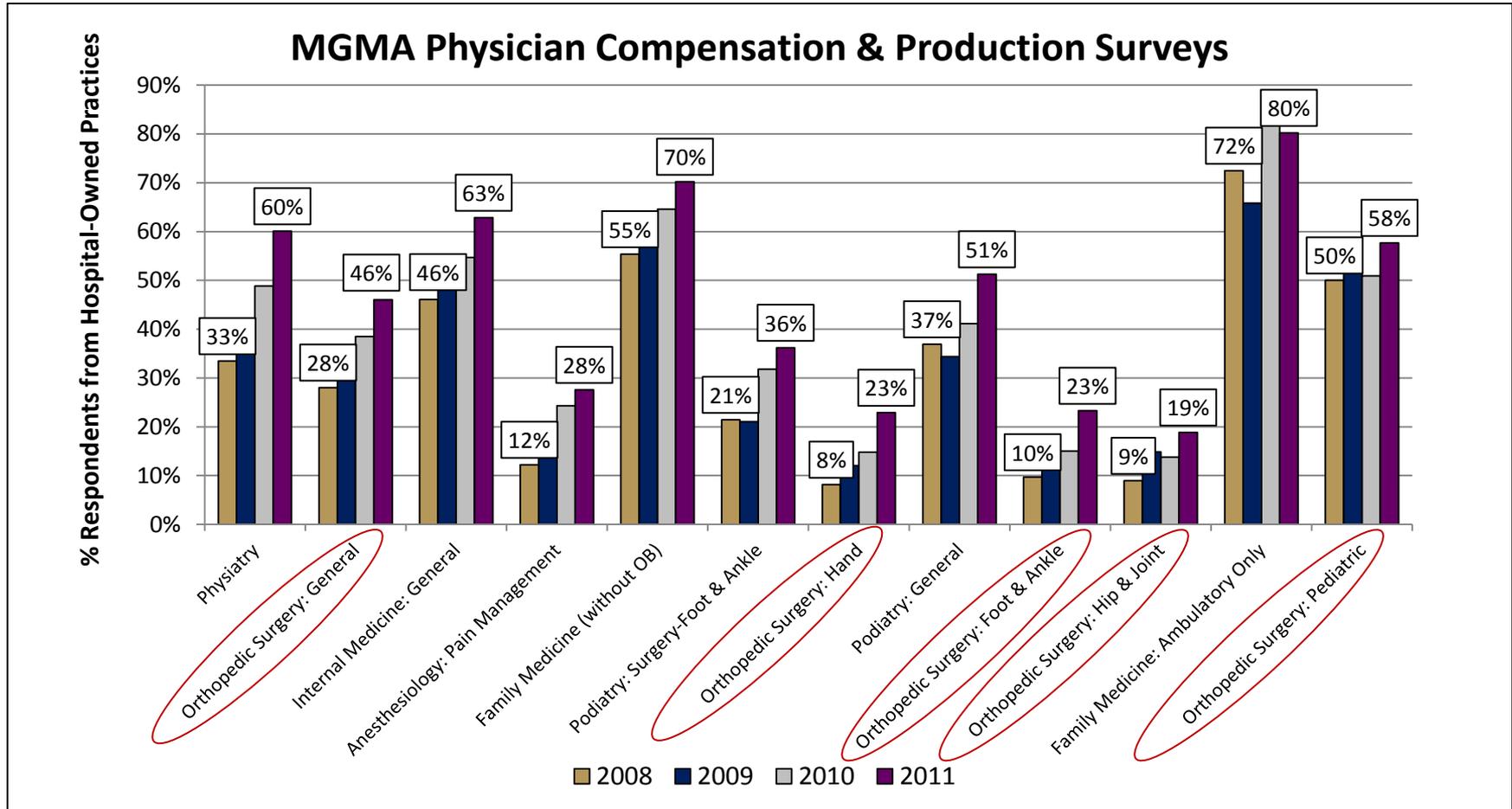
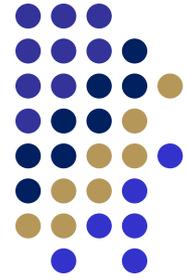
- Co-founder and owner in HealthCare Appraisers, Inc.
- No ownership in private or publicly-traded hospital chains, physician practice management companies, or ancillary medical businesses
- Regularly work in a professional capacity for physicians, health systems, and attorneys to perform appraisals of healthcare businesses and physician compensation

Key Objectives

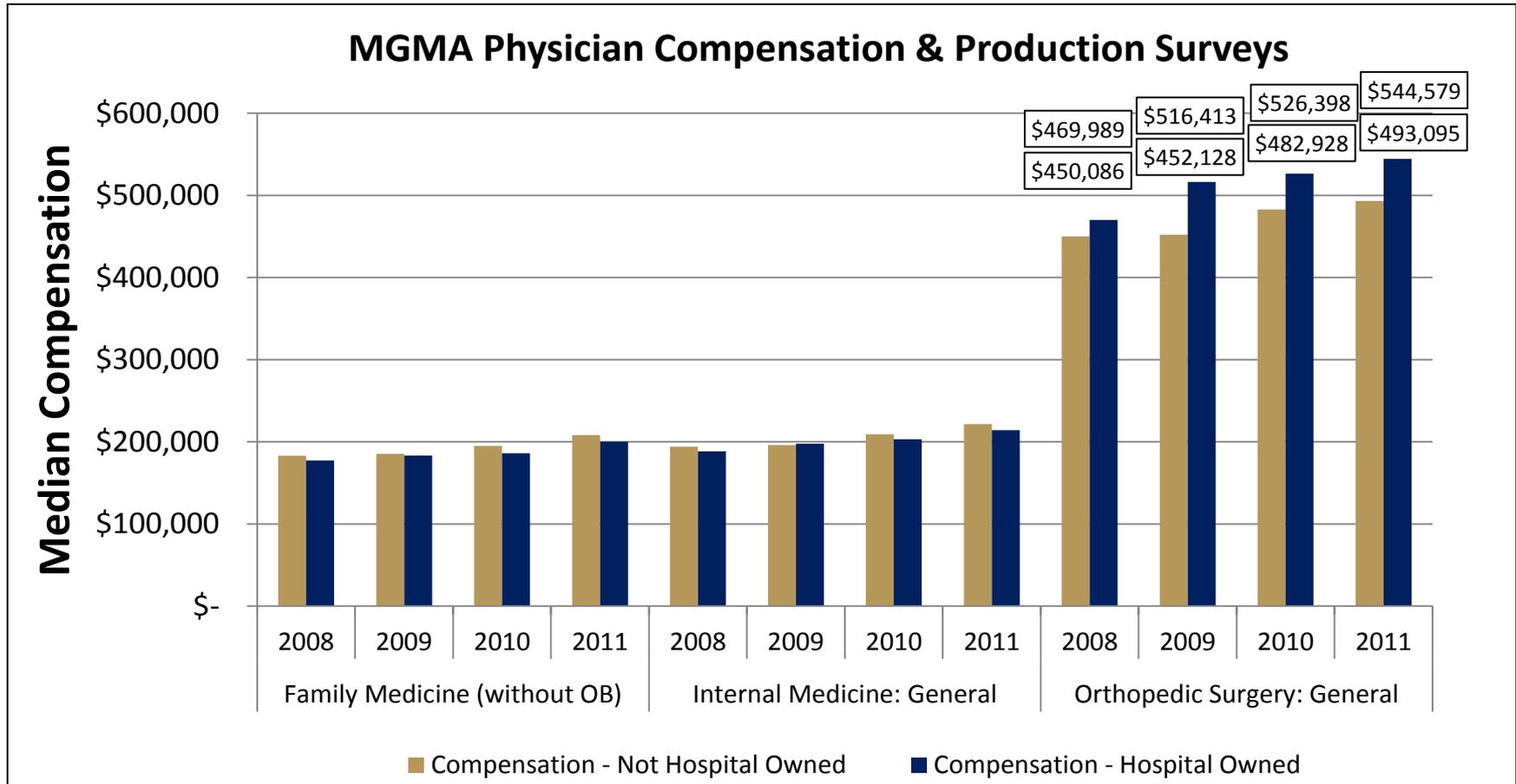
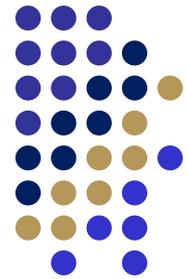


- Identify major trends affecting orthopaedic surgeons based on our unique perspective
- Identify challenges within valuation assignments involving practices, ancillary carve-outs, and ASCs

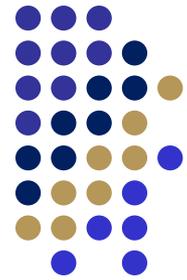
Physician Employment Landscape



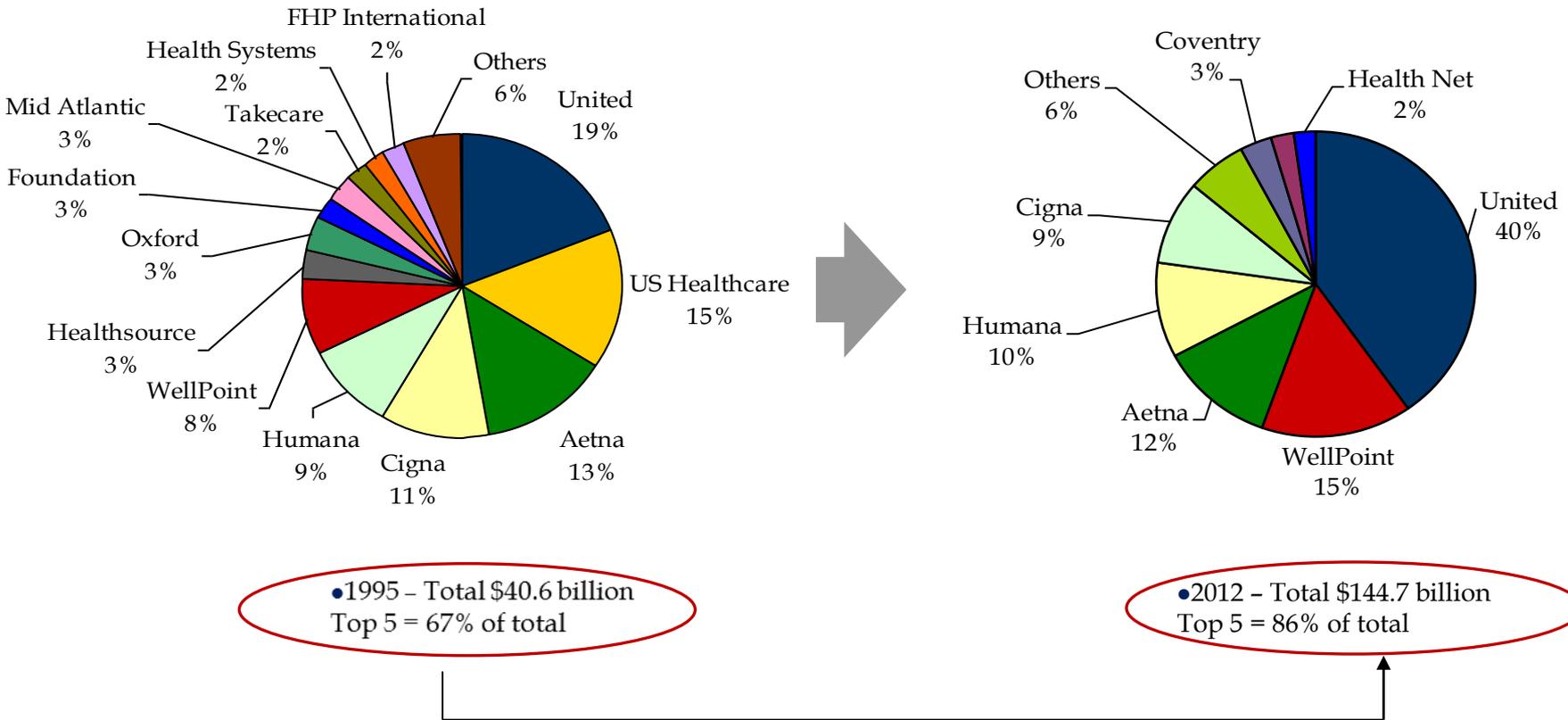
Physician Employment Landscape



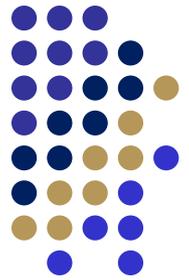
National Activity - Consolidation



Publicly-Traded Health Insurance Carriers (% of Total Market Capitalization)

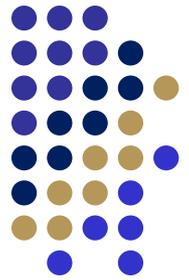


FTC Regularly Exercising Anti-Trust Authority on Providers



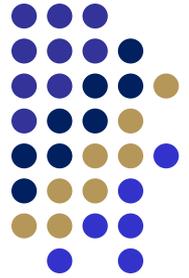
- 8/5/2013: FTC's trial date for challenge of Phoebe Putney Health System, Inc.'s acquisition of rival Palmyra Park Hospital, Inc. from HCA, in Albany, Georgia. FTC alleges reduced competition will increase hospital prices.
- 3/12/2013: FTC and Idaho Attorney General file complaint to block St. Luke's Health System acquisition of Idaho's largest independent multi-specialty physician practice group, Saltzer Medical Group, P.A.
- 11/16/2012: FTC and Pennsylvania Attorney General file complaint to block Reading Health System's proposed acquisition of Surgical Institute of Reading L.P. (a physician surgical hospital), citing reduced competition and increased healthcare costs.
- 8/06/2012: FTC and Renown Health entered into a settlement to release up to 10 staff cardiologists from "non-compete" contract clauses and join competing groups. Renown had 88 percent market share for cardiology.

National Activity – Payment Reform



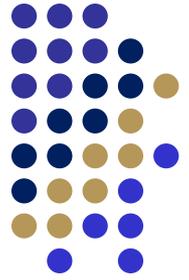
- Medicare spending growth achieved historic lows in 2010-2012
 - No consensus on why; recession partial explanation
 - HHS claims only 0.4% growth per beneficiary in 2012
 - Number of beneficiaries still growing
- Independent Payment Advisory Board (IPAB) created under the ACA will likely not submit first policy proposal in January of 2014
 - Triggered if Medicare spending growth exceeds CBO budget 5-year average
 - 15 member board appointed by President and confirmed by Senate
 - HHS is required to implement IPAB proposals, unless Congress enacts an alternative achieving required Medicare savings by August 15th of the same year
- 2014 OPPS Proposed Rule released July 8th seeks to consolidate 20 provider-based E&M technical codes into just 3 G-codes
 - Consolidating all severity levels and new vs. established patients
 - Medicare realizing that technical burden mostly same, regardless of complexity/severity

Valuing Physician Practices



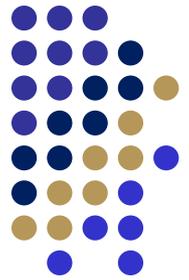
- Most likely one of the most difficult valuation assignments in healthcare. Why?
 - Typically no “bottom line”; all available income converted to compensation
 - Unlike PPM days of years past, most MDs unwilling to take reductions to compensation on a go-forward basis to fund up front purchase price
 - Should not ascribe value to practice for events generally unavailable in absence of a transaction
 - Appraisal conundrum – intangible value not supported 100% by cash flow

Valuing Physician Practices



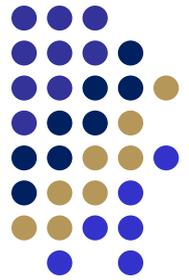
- “Make believe” DCF assumptions are not a justifiable methodology to support intangible value
- Arguments for costs to replicate can be made to support intangible value
- Increases in compensation relative to historical levels will result in a “compensation offset” to intangible value.
- Is there value in connection with most MD practices? Typically value created over time is manifested in MD compensation (*i.e.*, compensation to owners likely exceeds what can be earned as an employee within another practice setting.)
- Today’s transactions: most practices typically less concerned with liquidity event than locking in compensation as long as possible and partnering with viable long-term partner

Valuing Practice Ancillaries and Surgery Centers



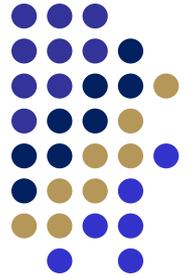
- MedPac June 2013 report calls out hospital payment premiums for outpatient surgery and ancillary services
 - Analysis focuses on services rarely provided in emergencies
 - If Medicare reimbursement rates neutralized across sites of service, commercial payors would likely follow suit
 - MedPac has no policy authority; only research function for Congress
- Under FMV standard, valuations for surgery and ancillary businesses to hospital would not change, but economics (ROI) for hospitals as buyers would definitely change
 - Business valuations will remain the same, but hospital interest in acquiring physician-owned surgery and ancillary businesses may become reduced

Valuing Practice Ancillaries and Surgery Centers



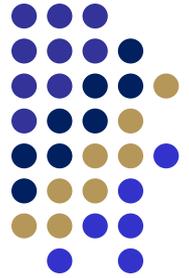
- Ancillary Carve-Outs: does the sum of the parts exceed the value of the whole?
 - Surprisingly, it can, depending upon ancillary and the specialty. How is this possible?
 - Ancillaries valued under an Income Approach, while compensation (assumes employment or PSA) valued under a pure market approach (e.g. per wRVU), which may double-count compensation derived from ancillary profits
 - Less of concern in orthopaedics, as primary ancillaries for orthopaedics are accounted for elsewhere outside the practice (e.g. ASC) and/or are may not be commonplace in respondent pool for comp surveys (e.g. MRI and PT)
 - More problematic specialties: cardiology, medical oncology

Common ASC Valuation Observations and Issues



- Most commonly cited ASC valuation metric: The Multiple of EBITDA
 - What is “EBITDA”?
 - What is a multiple? (see next slide)
 - Once size fits all? (see next slide)
- Despite challenges, there is still relevance to market multiples.
 - Results of our latest ASC valuation survey....

Market Multiples - Definition

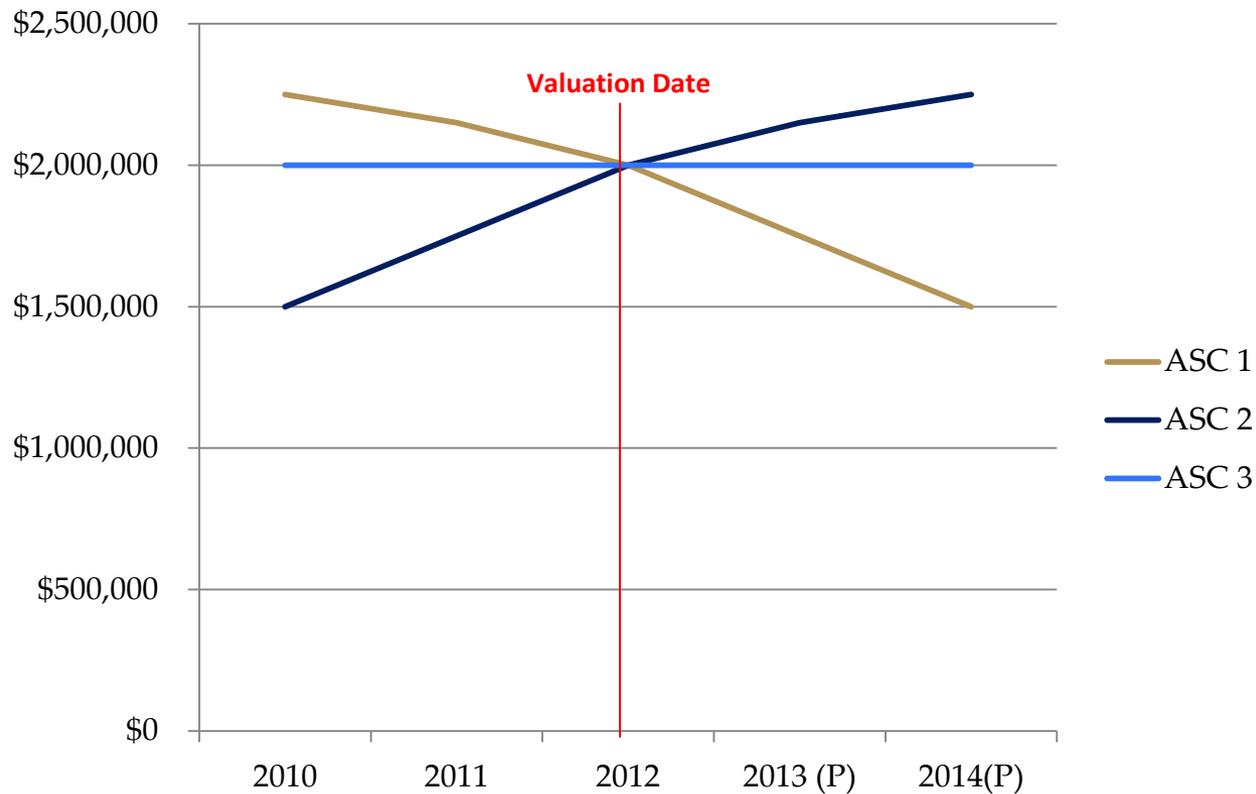


- A valuation multiple is appraiser shorthand for the present value of a perpetual earnings stream mathematically expressed as follows:

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

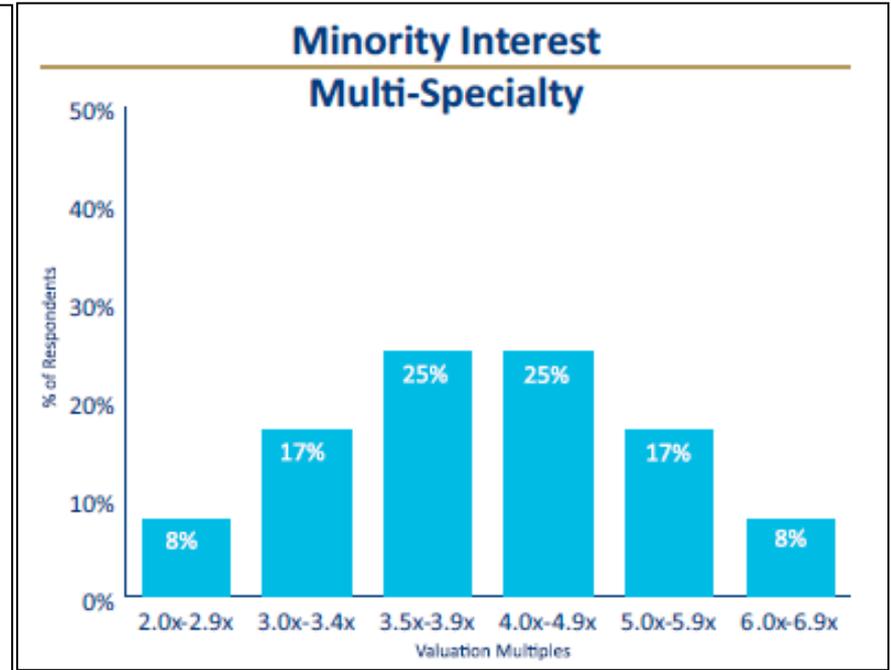
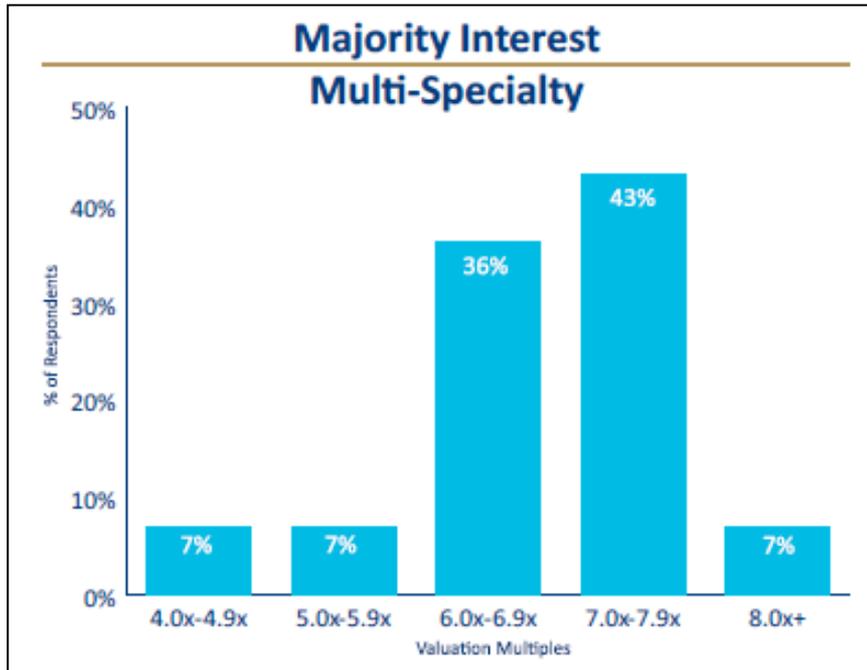
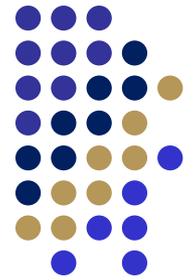
- Key components of a valuation multiple
 - 1) Definition of the **Earnings Stream**
 - 2) Estimation of **Risk (K)**
 - 3) Estimation of the rate of earnings **Growth (g)**

Three ASCs with \$2.0M EBITDA



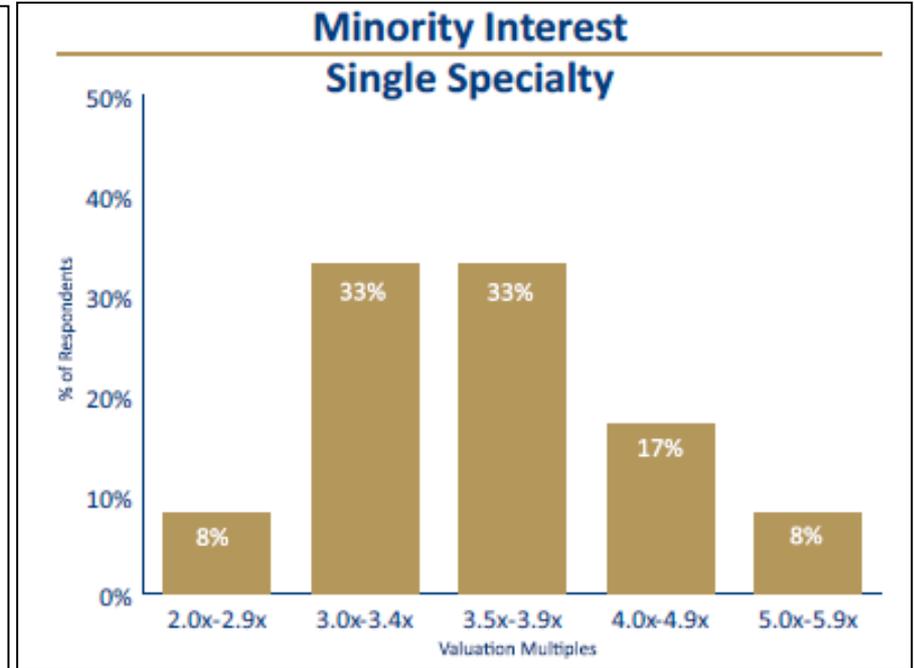
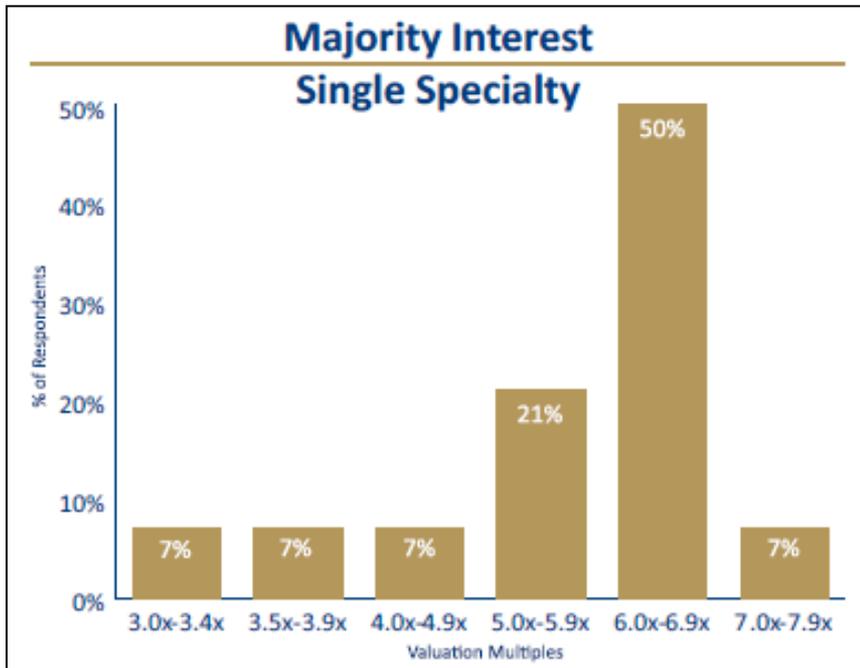
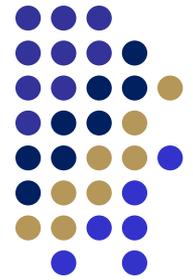
Source: Health Care Appraisers, Inc.

Market Multiples Multi-Specialty ASC



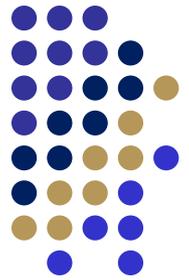
Source: Health Care Appraisers, Inc.

Market Multiples Single-Specialty ASC

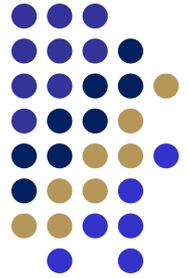


Source: Health Care Appraisers, Inc.

Main Takeaways



- Primary care receiving comparable compensation from hospitals, while orthopaedic surgeon disparity is very different
- Consolidation among providers is reaching levels in some markets that has inspired the FTC to intervene
- No impetus for broad-sweeping Medicare payment reforms in light of slowed spending increases at this time
- Business case for hospital purchase of physician-owned surgery centers and ancillary services may weaken in next several years
- Valuation of practices, ancillary carve-outs, and ASCs each have specific nuance and pitfalls of which you need to be aware



Thank You

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