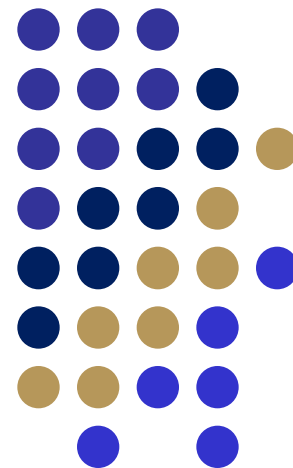


Valuations and M&A Activity

Todd J. Mello, ASA, CVA, MBA

Co-Founder and Partner

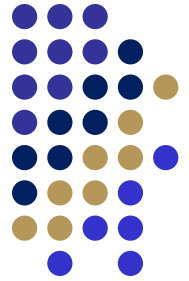


Disclosures



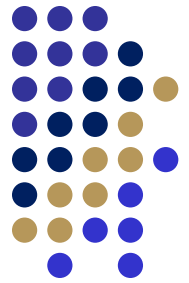
- Co-founder and owner in HealthCare Appraisers, Inc.
- No ownership in private or publicly-traded hospital chains, physician practice management companies, or ancillary medical businesses
- Regularly work in a professional capacity for physicians, health systems, and attorneys to perform appraisals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

Key Objectives



- Identify major assets which orthopaedic surgeons may own (in whole or in part) and discuss relevant valuation trends
- Identify challenges within valuation assignments involving practices and ASCs

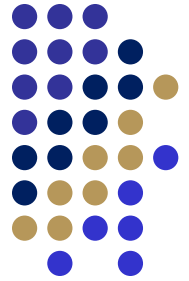
Notable Statistics



1. Specialty Hospitals

- Typically defined as a facility wherein 45% to 65% of inpatients fall into no more than two major diagnosis categories
- An increasingly aging population and expanding access to public and private healthcare insurance is projected to push revenue up 6.2% annually on average to \$57.2 billion over the five years to 2019
- According to the US Government Accounting Office, about 70% of specialty hospitals have some MD owners, and among these, total MD ownership averages slightly more than 50%
- Approximately 6% (or \$2.5 billion) of an estimated \$42.3 billion in annual revenue is attributable to Orthopaedic facilities
- However, a PPACA ban on MD ownership (unless “grandfathered” in before 12/31/10) will continue to restrict industry growth

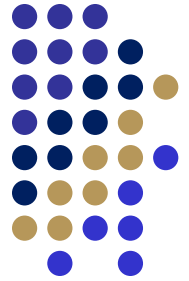
Notable Statistics



2. ASCs

- Due to legislation (PPACA) and improving economic conditions, revenue for the industry for 2014 is forecast to increase by 11.8%
- Although adults aged 60 and older will remain the largest market for the industry, individuals aged 20-39 are expected to make up a larger portion due to the introduction of wider healthcare access, as well as access through employer plans, as the national unemployment rate falls
- Industry revenue projected to grow by an average annual rate of 8.2% over the five years through 2018 to \$35.4 billion
- Given the continued “growth” characteristics of the industry, there are new players emerging, as well as consolidation amongst existing players

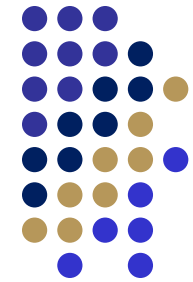
Notable Statistics



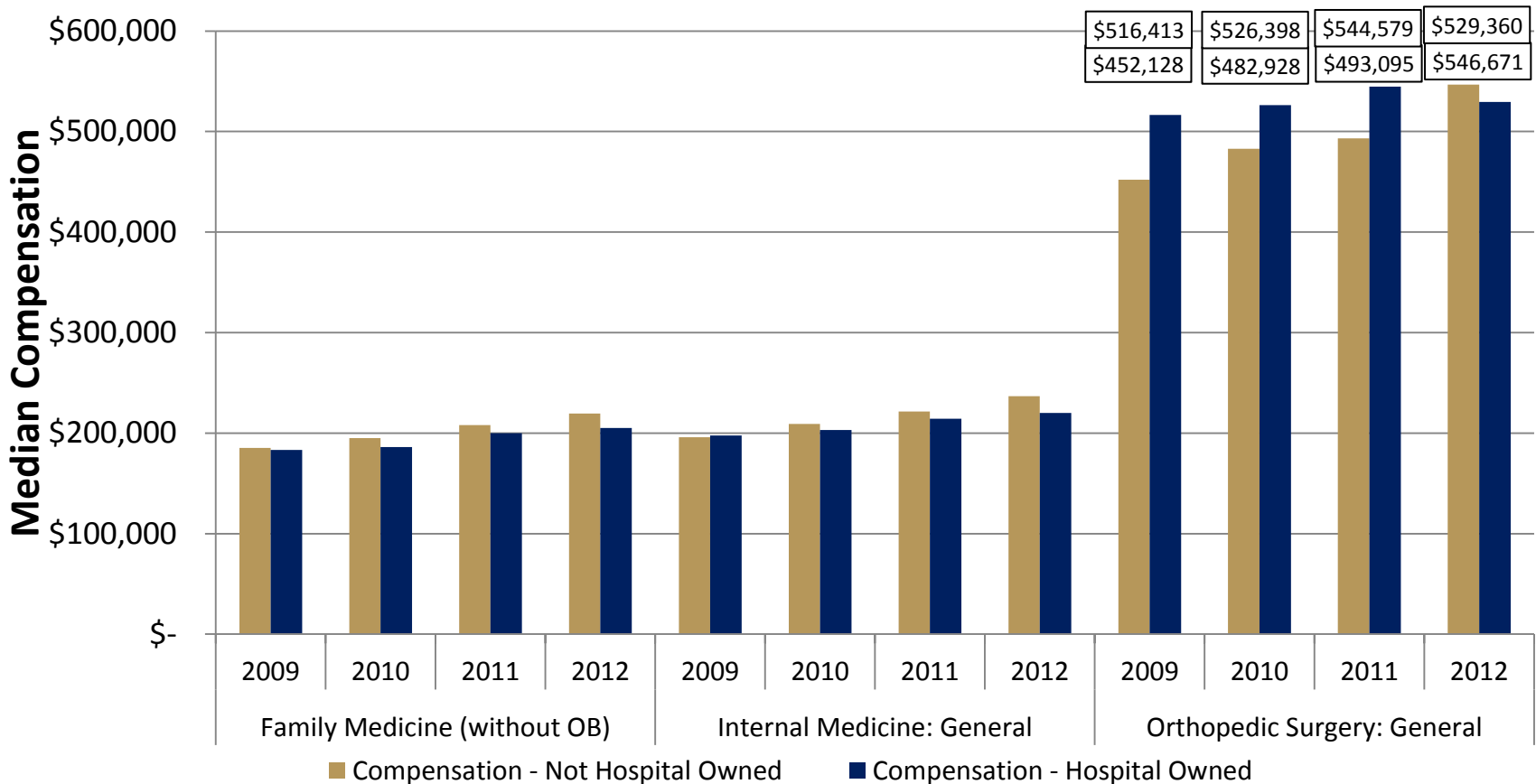
3. Demand for Specialist Professional Services

- Aging population and healthcare reform will bolster demand for industry services
- PPACA presents opportunities for health systems with integrated physicians to participate in potentially lucrative alternatives to fee-for-service payment, such as accountable care and bundled payment programs
- Supply of specialists has increased more than the supply of general practitioners over past five years, in part, due to differences in compensation. In a 2012 study conducted by UC Davis, over a lifetime a primary care doctor is likely to make about \$1.5 million less than a classmate entering into specialty care.
- Increasing costs and uncertainty in the healthcare delivery marketplace have encouraged many specialists, including orthopaedists, to seek hospital employment

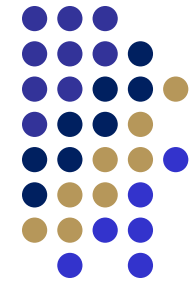
Physician Employment Landscape



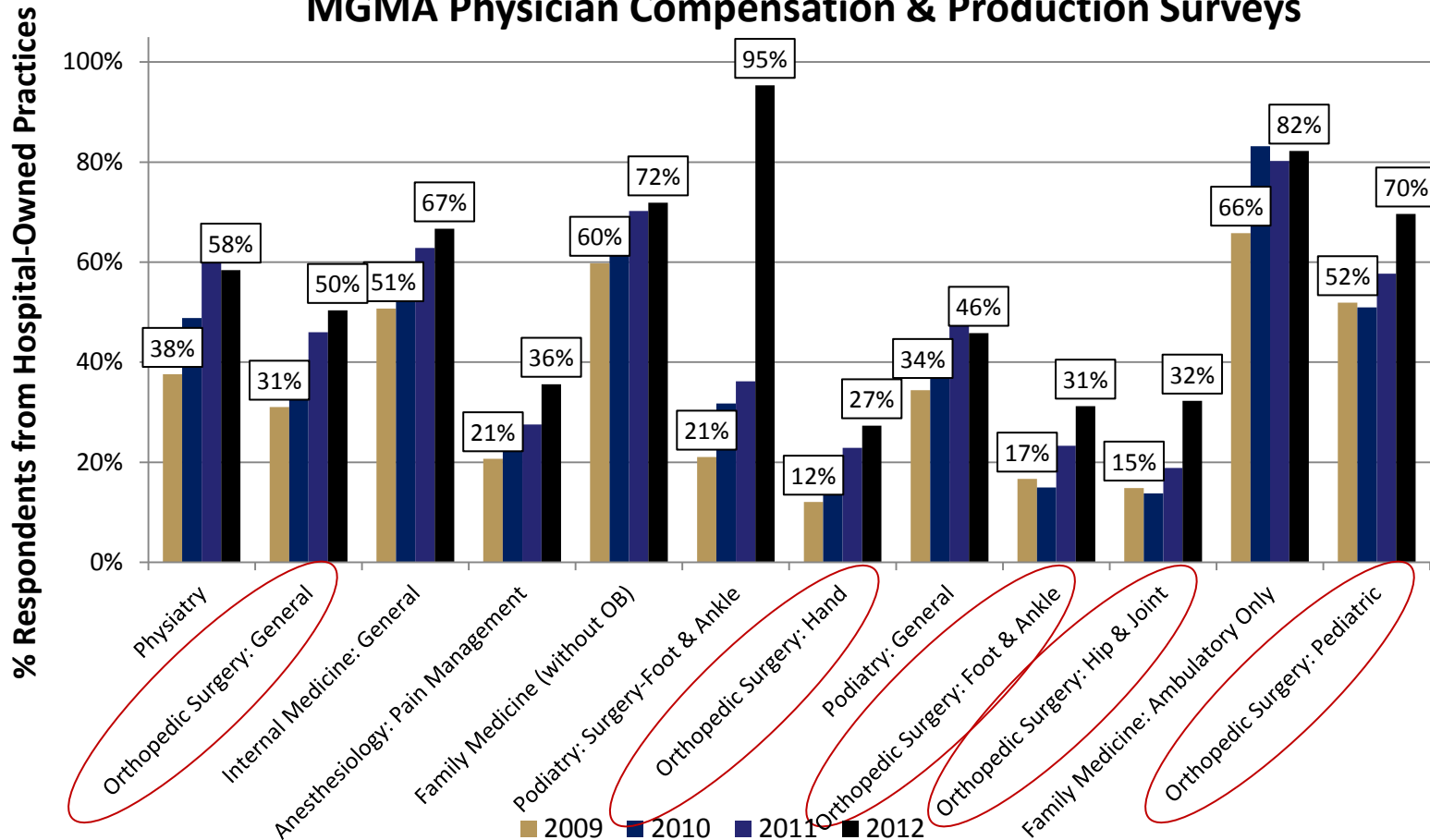
MGMA Physician Compensation & Production Surveys



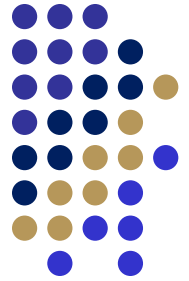
Physician Employment Landscape



MGMA Physician Compensation & Production Surveys

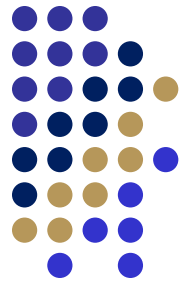


Valuing Physician Practices



- 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



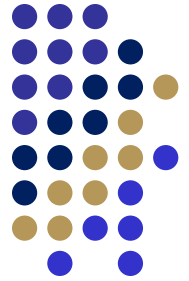
- “Make believe” DCF assumptions are not a justifiable methodology to support intangible value
- Arguments for costs to replicate can be made to support intangible value
- Increases in compensation relative to historical levels will result in a “compensation offset” to intangible value.
- Is there value 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

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

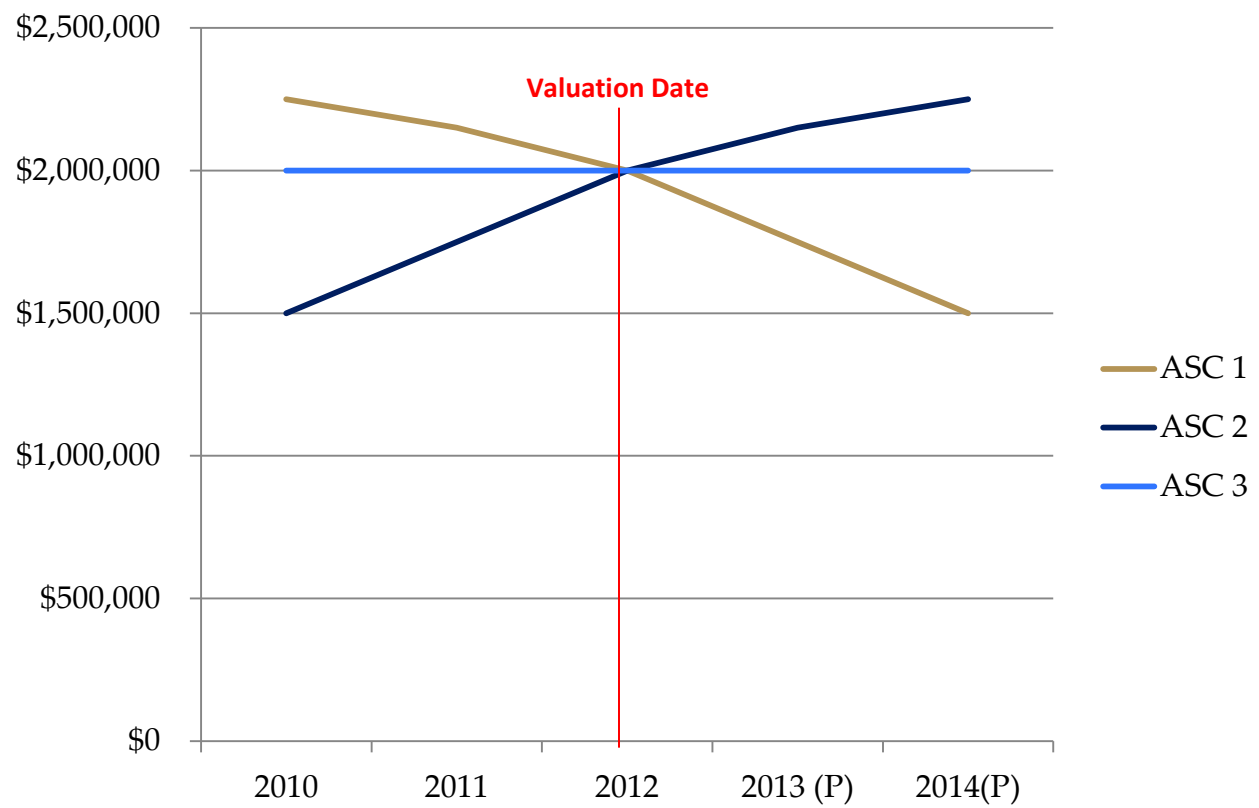


- A valuation multiple is appraiser shorthand for the present value of a perpetual earnings stream mathematically expressed as follows:

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

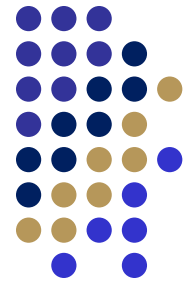
- Key components of a valuation multiple
 - 1) Definition of the **Earnings Stream**
 - 2) Estimation of **Risk (K)**
 - 3) Estimation of the rate of earnings **Growth (g)**

Three ASCs with \$2.0M EBITDA

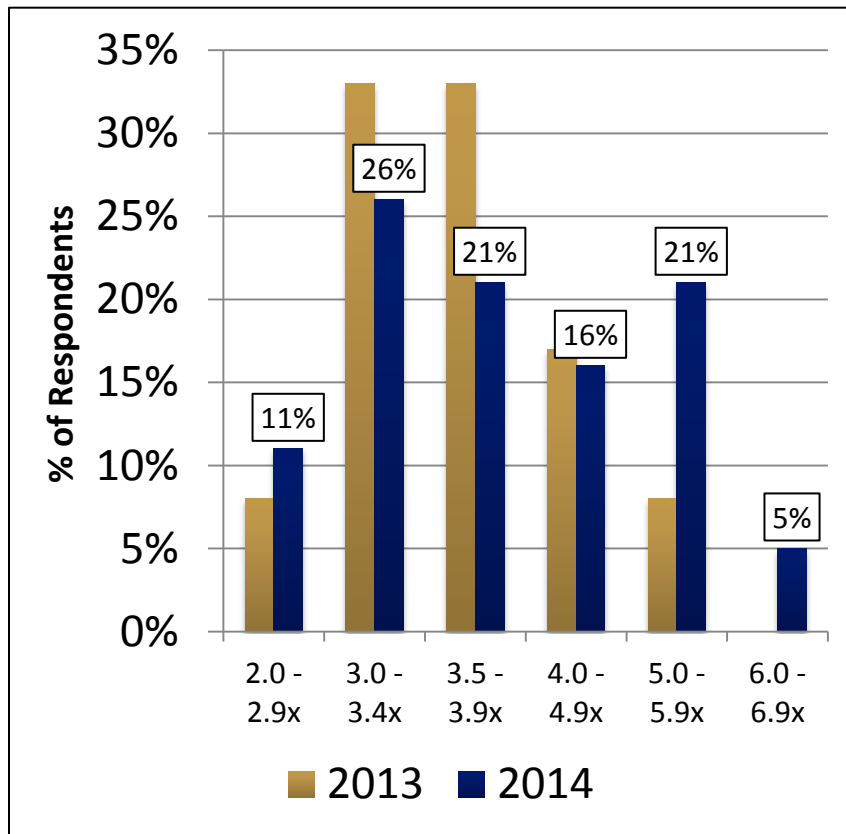


Source: Health Care Appraisers, Inc.

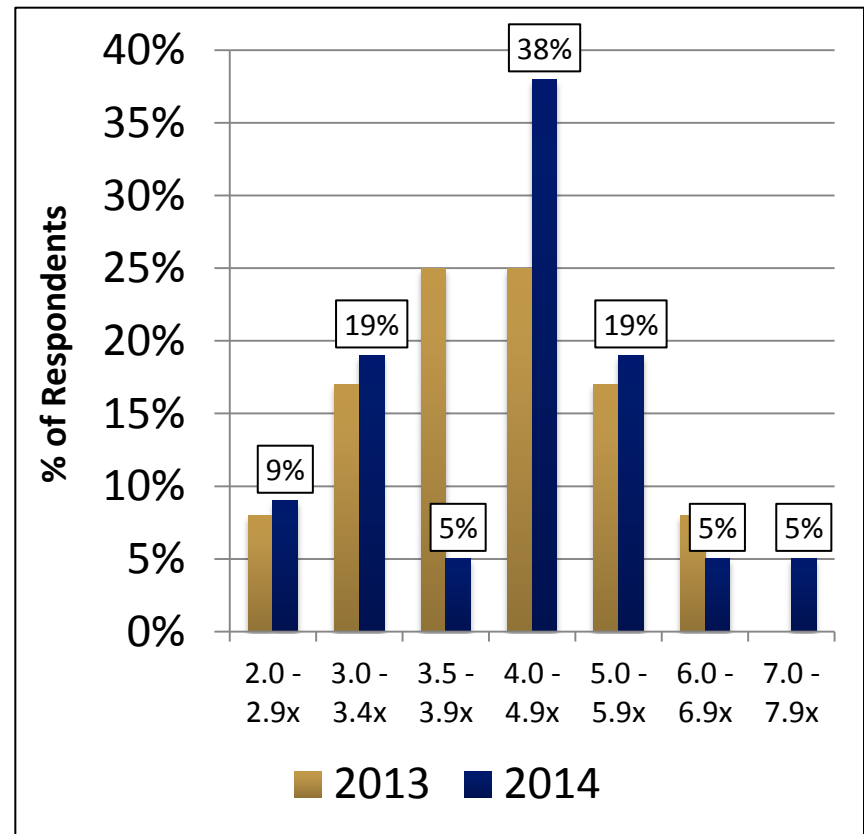
Observed Multiples for Minority Interests



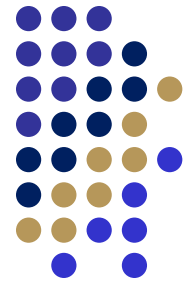
Single-Specialty Centers



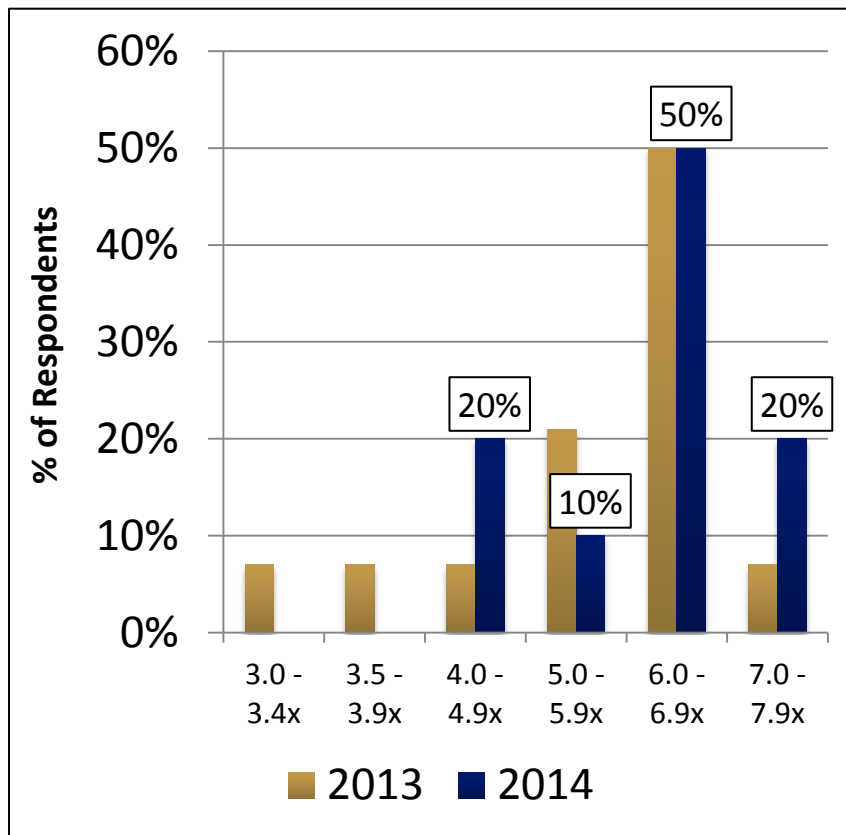
Multi-Specialty Centers



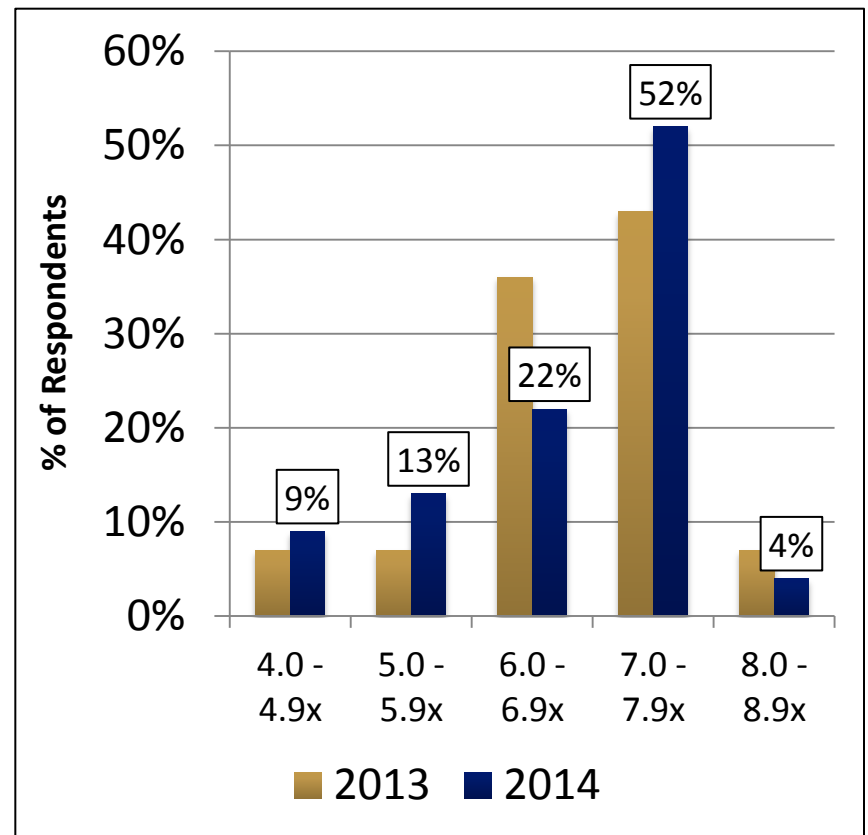
Observed Multiples for Controlling Interests



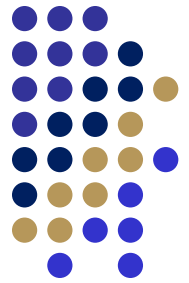
Single-Specialty Centers



Multi-Specialty Centers



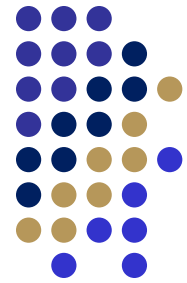
Why Are These Observations So Interesting?



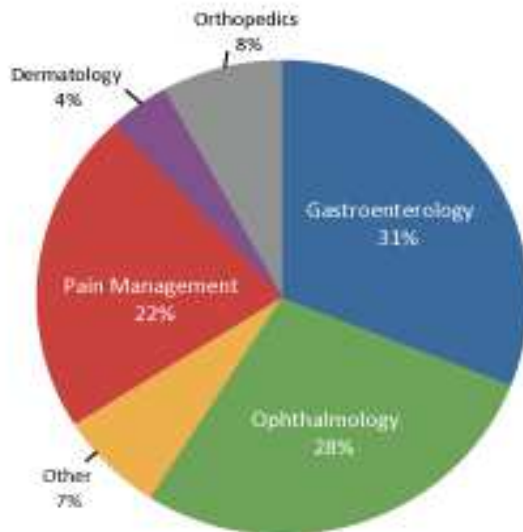
Select Arguments “For” Increased Valuations

- On average, the Medicare program and its beneficiaries share in more than \$2.6 billion in savings each year because the programs pays much less for procedures performed in ASCs, when compared to the same procedure performed in a hospital. Healthcare reform is moving towards value-based healthcare, a move which bodes well for ASCs.
- Opportunities remain for certain specialties (e.g. orthopaedics) to expand the number of procedures performed within an ASC. In fact, CMS is proposing to add 10 new spine procedures to the ASC list of payable procedures for 2015.
- Despite feverishness of acquisition pace and sustained duration, industry remains very fragmented (see next slide) and competition remains very high; strong projected growth over next five years

Why Are These Observations So Interesting?

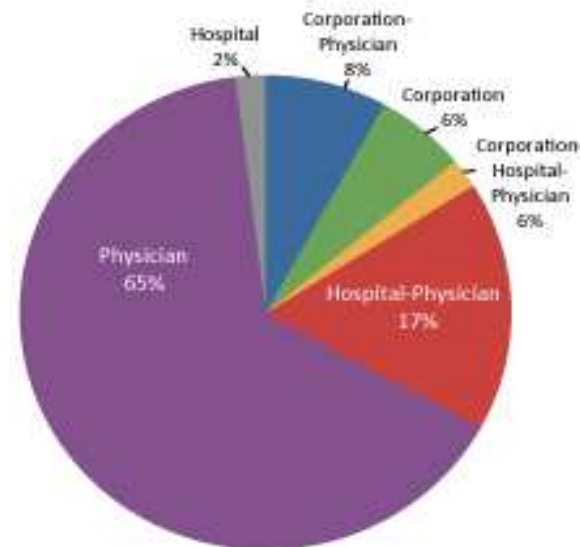


Medicare Case Volume by Specialty



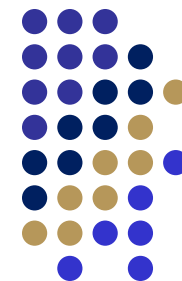
ASCA Analysis of CMS Claims Data 2010

ASC Ownership



ASCA's 2011 ASC Employee Salary & Benefits Survey

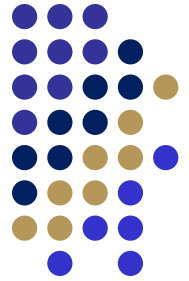
Why Are These Observations So Interesting?



Select Arguments “Against” Increased Valuations

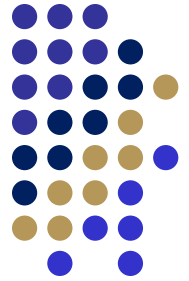
- ASC public company multiples seemingly may not support pricing
- Fewer surgeon investors to sustain ASC lifecycle (see hospital employment trends)
- Reimbursement under continued pressure
- In the case of hospital acquisitions of ASCs, the pricing arbitrage may be short lived (healthcare reform)

Main Takeaways



- Primary assets which an orthopaedist may own in whole or part: specialty hospital, ASC, professional practice – each represent opportunities and challenges to today’s surgeon; however, overall, valuations and transactional activity remain robust
- Valuation of practices and ASCs each have specific nuance and pitfalls of which you need to be aware

Thank You



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