15 Things to Know About ASC Valuation

Presented By

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HealthCare Appraisers

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1: Experience Matters

- Like most niches, generalists tend to fail to understand the nuances of the industry and the valuation do’s and don’ts…….accordingly, only hire an expert with significant experience in the space – reputable appraisers supplied with the same data should arrive at reasonably similar results

2: Standard of Value

- Standard of value in most healthcare transactions is *Fair Market 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"*

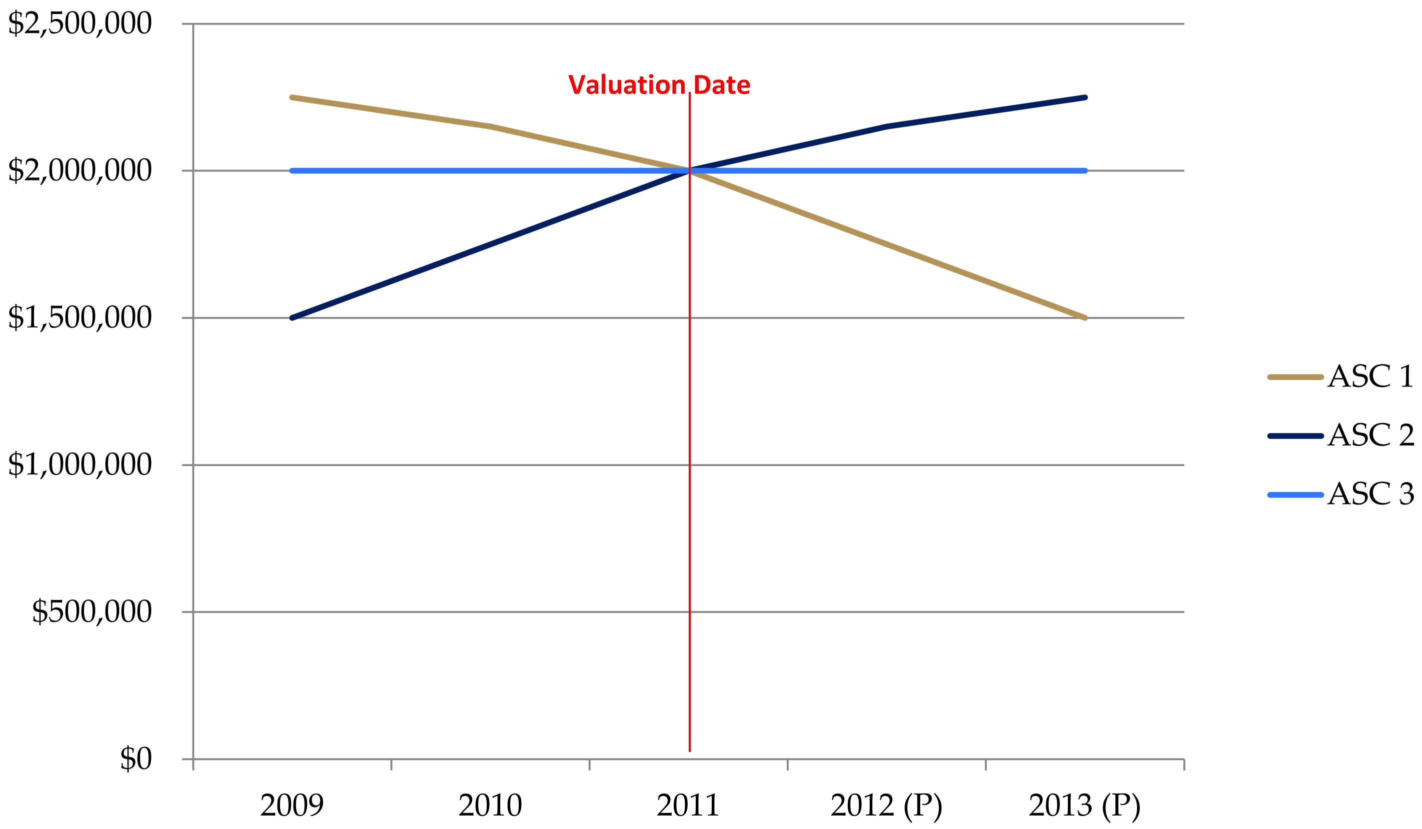
#2: continued

- FMV vs. Investment/Strategic Value
  - In connection with a hospital's 100% acquisition of an ASC, can we consider overlaying hospital's outpatient department fee structure onto the valuation?
  - Similarly, can we consider overlaying hospital's payor contracts?
  - Acquirer's specific overhead structure
  - Assume a hospital wants to buy an ASC for purposes of shutting it down.
    Impact to value?

#3: Valuation is *Forward* Looking

- Historical performance may or may not provide the best indication of future performance
- Consider 3 ASCs, both with $2.0 MM of EBITDA as of the valuation date; would the valuations be the same?

#3: continued



$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
Valuation Date
2009
2010
2011
2012 (P)
2013 (P)
ASC 1
ASC 2
ASC 3

#4: Three Primary 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 or 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.
- When do they apply?

#5: Which factors generally contribute to higher valuations?

- For a given level of cash flow, the following factors tend to enhance value:
  - Multispecialty (diversification of case types)
  - Diversification of surgeons – majority of cases not done by a single surgeon
  - High % of cases performed by owners who are “motivated” to continue working
  - An established history of continually seeking new owners
  - History and expectation of continued distributions
  - Growth in cases and earnings; reimbursement growth less certain
  - Little debt over time
  - Barriers to entry (*e.g.*, CON)
  - Predominantly in network with Commercial payors

#6: Blindly Applying Valuation Multiples

- **Every year we publish a survey of multiples observed within the market**
- **The Meaning Behind the Numbers**

The Finance Definition (a.k.a. Appraiser speak)

"A mathematical expression of risk and growth, which when applied to a perpetually recurring earnings stream results in an indication of value"

A multiple is mathematically expressed as follows:

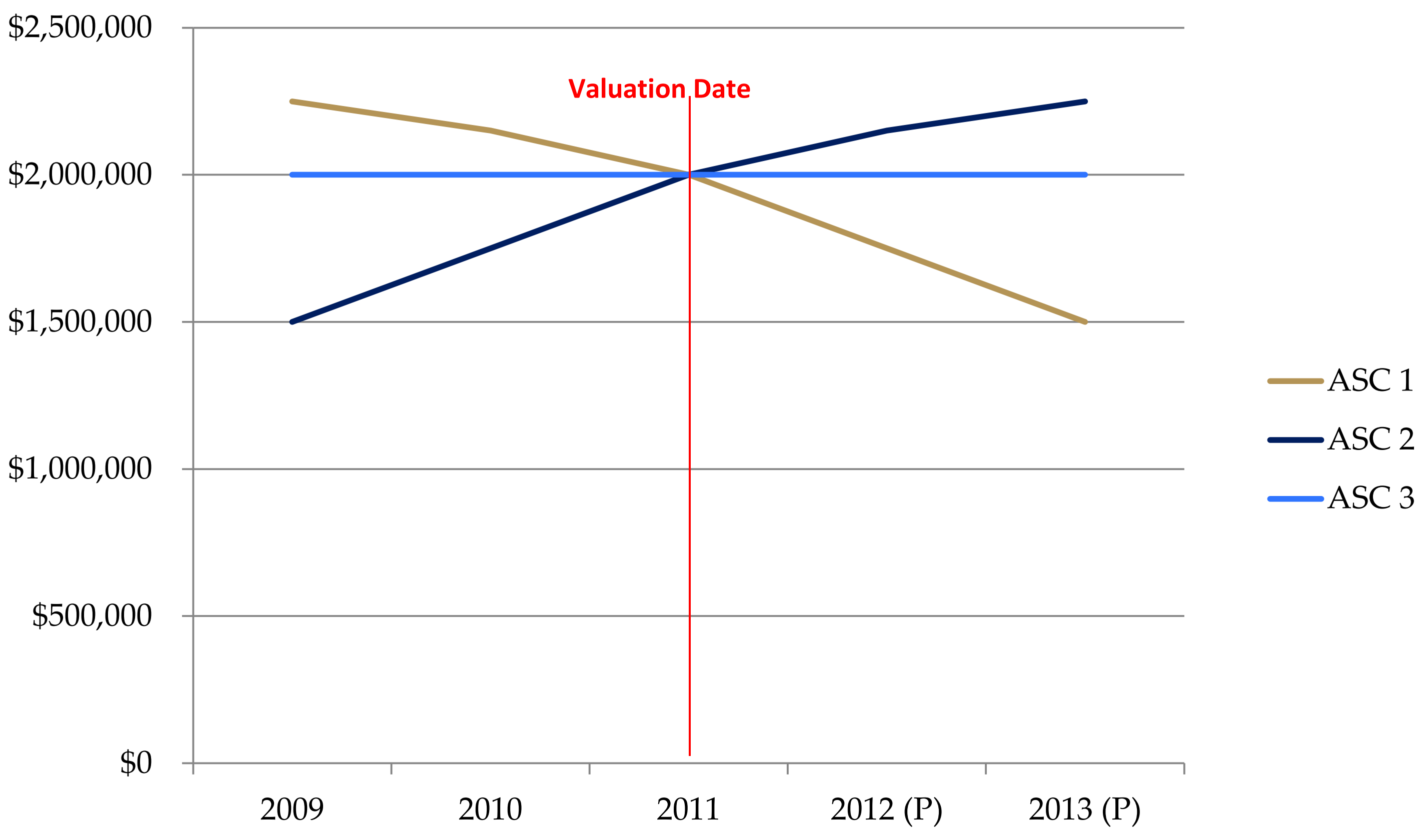
$$\frac{1}{(K-g)}$$

- Where, (K) represents the rate of return (risk), and
- (G) represents the growth rate of the earnings stream

#6: *continued*

	Varying Growth			Varying Risk		
	Scen 1	Scen 2	Scen 3	Scen 1	Scen 2	Scen 3
k	17.0%	17.0%	17.0%	17.0%	19.0%	22.0%
g	2.0%	3.0%	4.0%	2.0%	2.0%	2.0%
Multiple	6.67	7.14	7.69	6.67	5.88	5.00

#6: continued



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#7: Incorrectly specifying risk

- Closely related to #6, while market multiples can be misapplied, there is also risk related to arriving at a valuation conclusion under an Income Approach which doesn't comport with current market pricing (<u>assuming no material adverse risk factors</u>).
- *e.g.*, 15X multiple for a controlling interest;
  3X multiple for controlling interest

#8: Failure to specify OON risk

- Risk associated with “Out of Network” ASCs can oftentimes not be adequately understood by inexperienced valuators.
- Risk is primarily associated with the uncertainty around if, when and how much rates will be reduced.
- If there is reasonable certainty as to when the “conversion” may occur, it’s better modeled specifically into the cash flows, as opposed to being built into the cost of capital/discount rate (see next slide).

#8: continued

	Year 1	Year 2	Year 3	Year 4	Year 5
Cases	2,200	2,640	2,838	2,980	3,000
Net revenue/case	$4,700	$3,000	$3,045	$3,091	$3,137
Net Revenue	$10,340,000	$7,920,000	$8,641,710	$9,209,902	$9,411,105

Note: Commercial Payor X, who represents a significant portion of case volume, goes "in network" BOY 2

#9: Formulas in Governing Docs

- Just because it "says so" in your Operating Agreement, doesn't mean its FMV.

#10: Normalized Earnings Streams

- **Like any business, ASCs oftentimes will experience one-time, nonrecurring *expenses* which will inappropriately alter the expense structure and lower earnings.**
  - Common examples include ***atypical*** legal and consulting fees and related party rent.

- Normalizing adjustments can go either way and can also impact revenue.
  - *e.g.*, one time revenue recovery in cash basis financials
  - Failure to appropriately bill Medicare – yes, it happens

#10: *continued*

	2013	2014	2015
Cases	3,200	3,350	3,500
Net revenue/case	$2,100	$2,142	$2,174
Net Revenue	$6,720,000	$7,175,700	$7,609,455
Staffing	$1,680,000	$1,793,925	$1,902,364
Supplies	$1,344,000	$1,435,140	$1,521,891
Occupancy	$330,000	$339,900	$350,097
Professional Fee	$75,000	$76,000	**$500,000**
Other	$725,000	$739,500	$754,290
Total Expenses	$4,154,000	$4,384,465	$5,028,642
EBITDA	$2,566,000	$2,791,235	$2,580,813
	38.2%	38.9%	33.9%

#11: Limitless Capacity….Not

- ASCs have practical capacity constraints.
- Creating projections which seem to ignore them is problematic (see next slide)

#11: continued

Summary Income Statement	Actual 2014	2015	2016	2017	2018
Cases	4,000	4,100	7,500	7,800	8,200
Revenue	$7,200,000	$7,380,000	$13,500,000	$14,040,000	$14,760,000
Operating Expenses	4,680,000	4,797,000	8,505,000	8,845,200	9,446,400
EBITDA	2,520,000	2,583,000	4,995,000	5,194,800	5,313,600
Depreciation	300,000	310,000	310,000	310,000	310,000
EBIT	2,220,000	2,273,000	4,685,000	4,884,800	5,003,600
Income Taxes @ 40%		909,200	1,874,000	1,953,920	2,001,440
Net Operating Income After Tax		1,363,800	2,811,000	2,930,880	3,002,160
Adjustments to Determine Cash Flow					
Plus: Depreciation and Amortization		310,000	310,000	310,000	310,000
Less: Capital Expenditures		(100,000)	(100,000)	(100,000)	(100,000)
(Increases)/Decreases in Working Capital		(18,000)	(612,000)	(54,000)	(72,000)
Free Cash Flow		**$1,555,800**	**$2,409,000**	**$3,086,880**	**$3,140,160**

#12: Minority vs. Majority Control

- Interests providing absolute control (*e.g.*, greater than a 50% interest) are worth more than interests which do not have the same control rights.

- Control granted by the governing documents. Examples include:
  - Major equipment purchases and investments
  - Debt signing authority
  - Admitting new owners
  - Granting physician privileges

#13: Taxes are Inevitable

- Taxes: While there is debate within the valuation community as to the appropriate tax rates to apply to a "flow through" entity, not tax affecting is generally regarded as a mistake; implicates standard of value issues (*e.g.*, non-profit acquirer).
- Even in the case of ASCs which are "flow through" entities – owners ultimately pay taxes on distributions; furthermore, market-based cost of capital inputs are calculated after-tax (see next slide).

#13: continued

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EBITDA	2,520,000	2,583,000	4,995,000	5,194,800	5,313,600
Depreciation	300,000	310,000	310,000	310,000	310,000
EBIT	2,220,000	2,273,000	4,685,000	4,884,800	5,003,600
Income Taxes @ 40%					
Net Operating Income After Tax		2,273,000	4,685,000	4,884,800	5,003,600
Adjustments to Determine Cash Flow					
Plus: Depreciation and Amortization		310,000	310,000	310,000	310,000
Less: Capital Expenditures		(100,000)	(875,000)	(100,000)	(100,000)
(Increases)/Decreases in Working Capital		(18,000)	(612,000)	(54,000)	(72,000)
Free Cash Flow		**$2,465,000**	**$3,508,000**	**$5,040,800**	**$5,141,600**

#14: Real Estate

- If your ASC owns R/E directly within the operating company (and not through a related party LLC or similar) then:
  - Cost of ownership must be normalized out of the cash flows and replaced with a FMV rent
  - R/E asset must be valued separately with the value of the equity in the R/E added back to value of "normalized" operating company valuation
  - Cost of capital implications if you don't do this

#15: How often should you get a valuation and what to expect?

- Depends on what is happening with center, purpose of valuation, and elapsed time since last valuation?
- What to expect?
  - Fees generally in low to mid teens
  - Timing 4 weeks from receipt of data
  - Fairly intensive data request list
  - On-site management interviews
  - Shelf life? Again, it depends….

QUESTIONS?

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