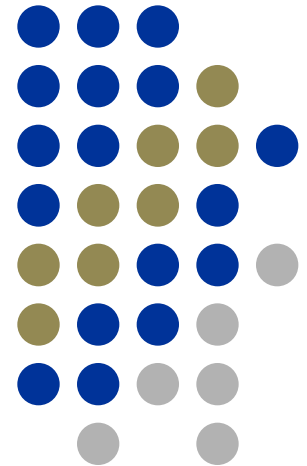


10 Common Mistakes in Valuing ASCs

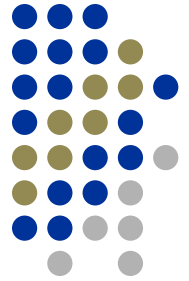
Presented By

Todd J. Mello, ASA, CVA, MBA, Founding Partner

June 9, 2016



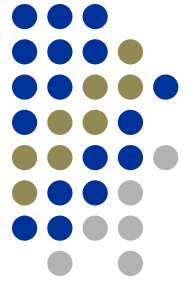
Presentation Outline



Presentation Geared Towards Non-Valuation Expert Audience

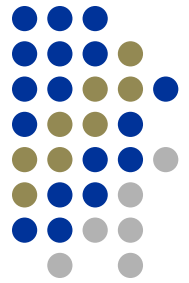
- Standard of Value in Healthcare
- Review of 10 Common Mistakes
- Q & A

Standard of Value



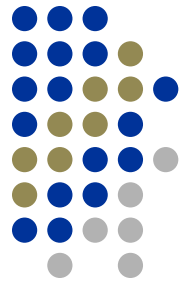
- Standard of value in most healthcare transactions is *Fair Market Value*. The definition of **fair market value** in healthcare is slightly different than the standard valuation definition.
 - the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical 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"*

#1: Confusing the Standard of Value



- 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?

#2: Blindly Applying Valuation Multiples



- Every year we publish a survey of multiples observed within the market (see slides in back of presentation)
- The Meaning Behind the Numbers

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

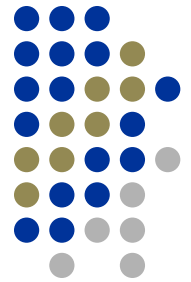
“A mathematical expression of risk and growth, which when applied to a perpetually recurring earnings stream results in an indication of value”

A multiple is mathematically expressed as follows:

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

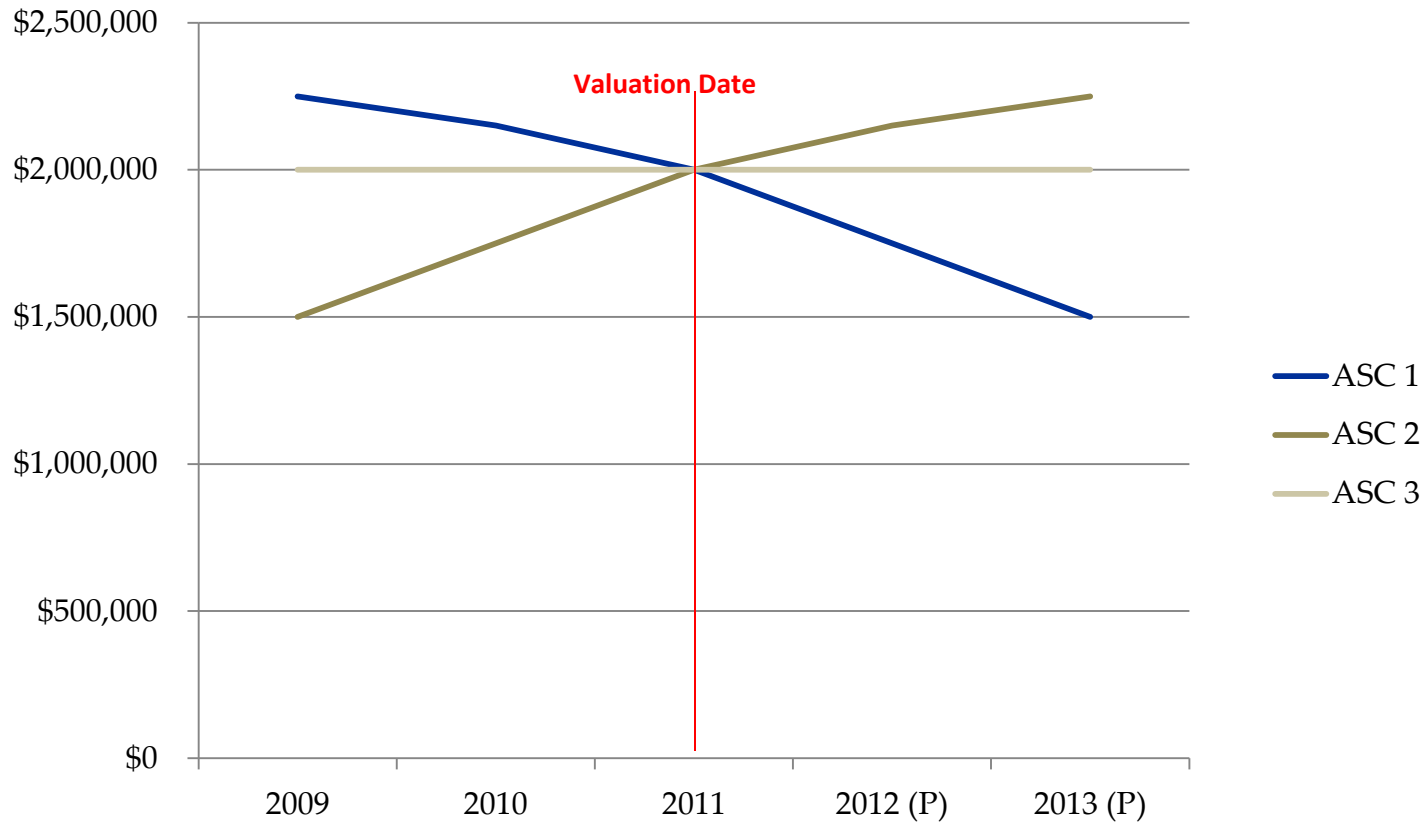
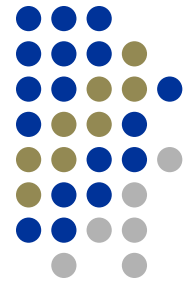
- Where, (K) represents the rate of return (risk), and
- (G) represents the growth rate of the earnings stream

What are Valuation Multiples?

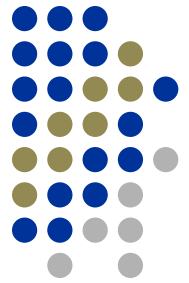


	<u>Varying Growth</u>			<u>Varying Risk</u>		
	<u>Scen 1</u>	<u>Scen 2</u>	<u>Scen 3</u>	<u>Scen 1</u>	<u>Scen 2</u>	<u>Scen 3</u>
k	17.0%	17.0%	17.0%	17.0%	19.0%	22.0%
g	2.0%	3.0%	4.0%	2.0%	2.0%	2.0%
Multiple	6.67	7.14	7.69	6.67	5.88	5.00

Three ASC's with \$2.0M EBITDA

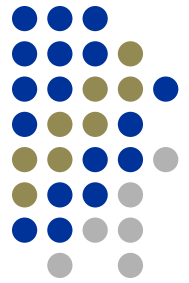


#3: Incorrectly specifying risk



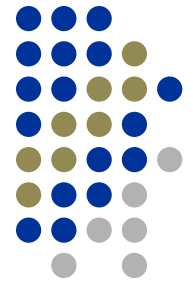
- Closely related to #2, while market multiples can be misapplied, there is also risk related to arriving at a valuation conclusion which doesn't comport with current market pricing (assuming no material adverse risk factors).
- *e.g.*, 15X multiple for a controlling interest;
3X multiple for controlling interest

#4: Failure to specify OON risk



- Risk associated with “Out of Network” ASCs can oftentimes not be adequately understood by inexperienced valuers.
- 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).

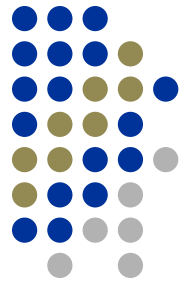
#4: Failure to specify OON risk



	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

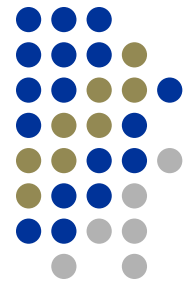
Note: Commercial Payor X, who represents a significant portion of case volume, goes "in network" BOY 2

#5: Failure to Normalize Earnings Streams



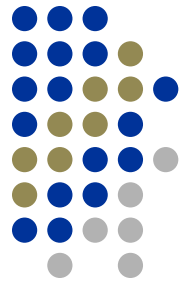
- Like any business, ASCs oftentimes will experience one-time, nonrecurring *expenses* which will inappropriately alter the expense structure and lower earnings.
 - Common examples include atypical legal and consulting fees and related party rent
- Normalizing adjustments can go either way and can also impact revenue
 - e.g., one time revenue recovery in cash basis financials
 - Failure to appropriately bill Medicare – yes, it happens

#5: Failure to Normalize Earnings Streams



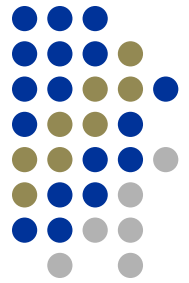
	2013	2014	2015
Cases	3,200	3,350	3,500
Net revenue/case	\$2,100	\$2,142	\$2,174
Net Revenue	\$6,720,000	\$7,175,700	\$7,609,455
Staffing	\$1,680,000	\$1,793,925	\$1,902,364
Supplies	\$1,344,000	\$1,435,140	\$1,521,891
Occupancy	\$330,000	\$339,900	\$350,097
Professional Fee	\$75,000	\$76,000	\$500,000
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%

#6: Income-based valuation techniques at inception



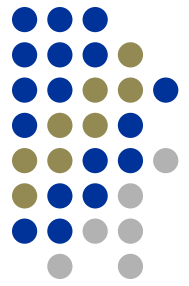
- ASCs routinely create forecasts at inception, which allow owning parties to develop some idea as to what the center could look like over time under various case volume and reimbursement assumptions/scenarios.
- While this is prudent business practice, pricing shares for start-up/de novo centers based on what the prospective physician investors expect to contribute to the center is very speculative and would be inconsistent with market pricing.
- Start-up valuations should typically be conducted using a Cost Approach, wherein project costs (*e.g.*, TI, FF&E, working capital for pre-opening and post) should be estimated and decisions made with respect to debt/equity financing. If a CON is involved, value should be ascribed to that intangible asset.
- Similarly, in pricing new shares in an existing center should not include the prospective surgeon's incremental volume

#7: Varying share prices for MDs



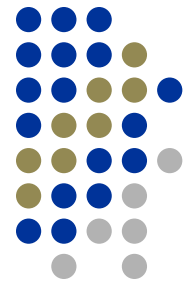
- Shares/units offered to different physicians around the same time period and based on expected contributions to the ASC would be illegal.
- While there is no one correct answer, the “same time period” should generally not exceed one year, and in certain cases, it could be several months or less depending upon what is occurring at the center.

#8: Mismatching of invested capital and equity earnings streams



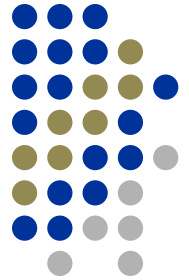
- Definition of invested capital
 - The total amount of money that was endowed into a company by the shareholders, bondholders and all other interested parties. Invested capital is often determined by adding the total debt and lease obligations to the amount of equity in the firm and then subtracting the non-operating cash and investments.
- EBITDA multiples need to be applied to invested capital earnings streams and not equity earnings streams (see next slide).
- Further, debt needs to be subtracted from invested capital to arrive at an equity value (see next slide).

#8: Mismatching of invested capital and equity earnings streams



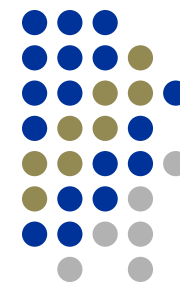
	Low	High	
Selected EBITDA Multiples (invested Capital)	6.0	7.5	A
Normalized Trailing 12 Month EBITDA	\$2,000,000		B
Net Income before tax	\$1,500,000		C
Interest-Bearing Debt	\$4,500,000		D
Value of Invested Capital	\$12,000,000	\$15,000,000	$E = B \times A$
Less Debt	\$ (4,500,000)	\$ (4,500,000)	
FMV of Equity (100% Marketable Interest)	\$7,500,000	\$10,500,000	$F = E - D$
Mismatch of Multiples & Earnings Streams	\$9,000,000	\$11,250,000	$G = A \times C$

#9: Limitless Capacity



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

#9: Limitless Capacity



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

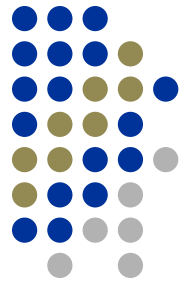
EBITDA		2,520,000	2,583,000	4,995,000	5,194,800	5,313,600
Depreciation		300,000	310,000	310,000	310,000	310,000

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

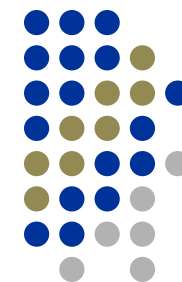
Plus: Depreciation and Amortization			310,000	310,000	310,000	310,000
Less: Capital Expenditures			(100,000)	(100,000)	(100,000)	(100,000)
(Increases)/Decreases in Working Capital			(18,000)	(612,000)	(54,000)	(72,000)
Free Cash Flow			\$1,555,800	\$2,409,000	\$3,086,880	\$3,140,160

#10: Failure to make other necessary valuation adjustments



- 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).
- “Normal” levels of working capital need to be assumed; surplus/(deficit) will be added to or deducted \$ for \$ from valuation

#10: Failure to make other necessary valuation adjustments



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
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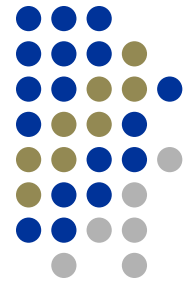
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Depreciation		300,000	310,000	310,000	310,000	310,000

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

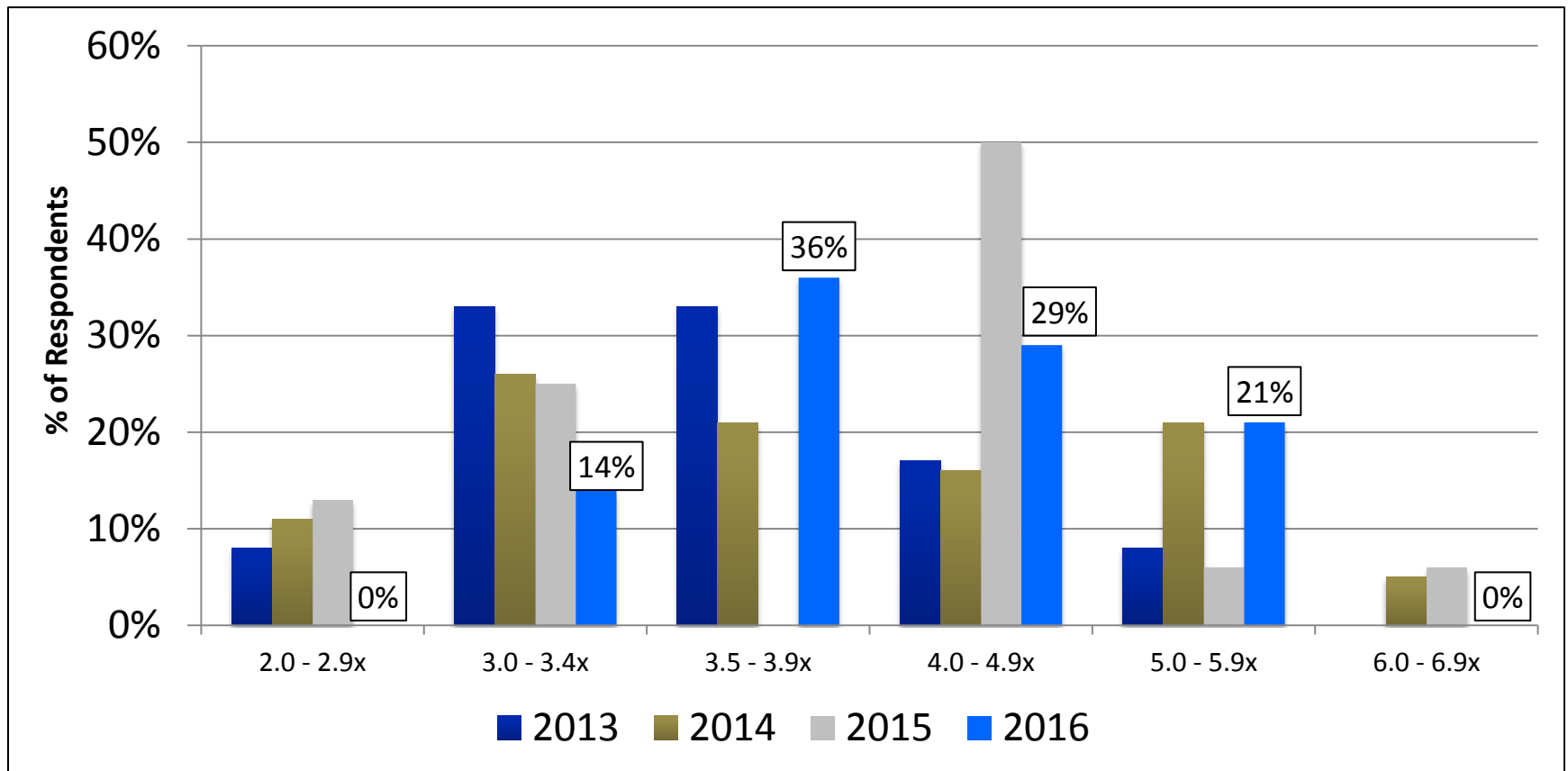
Adjustments to Determine Cash Flow

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

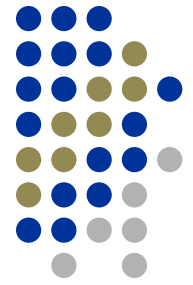
Observed Multiples for Minority Interests



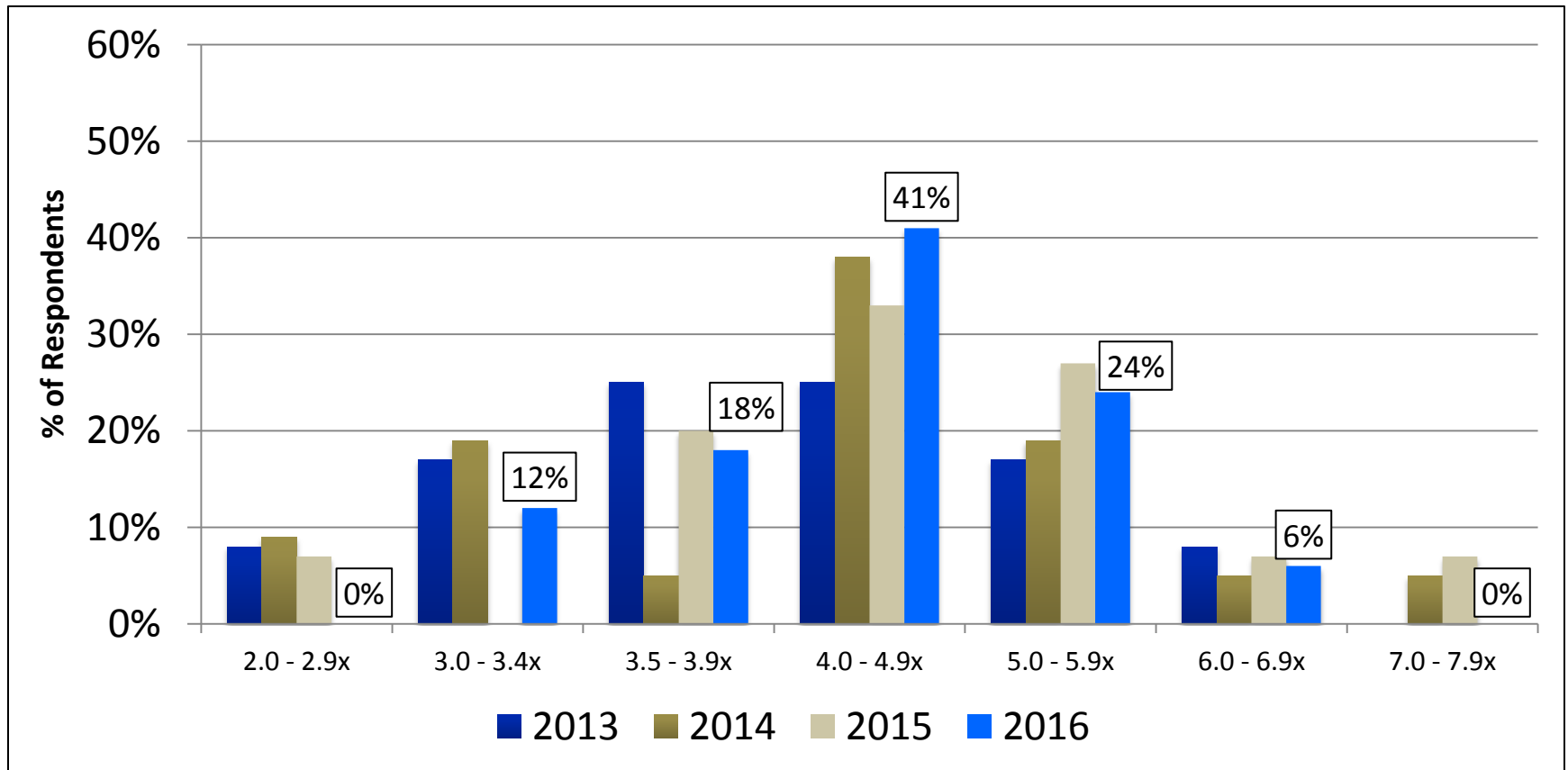
Single-Specialty Centers



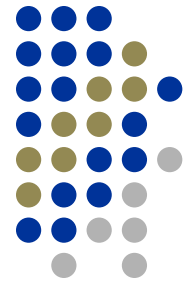
Observed Multiples for Minority Interests



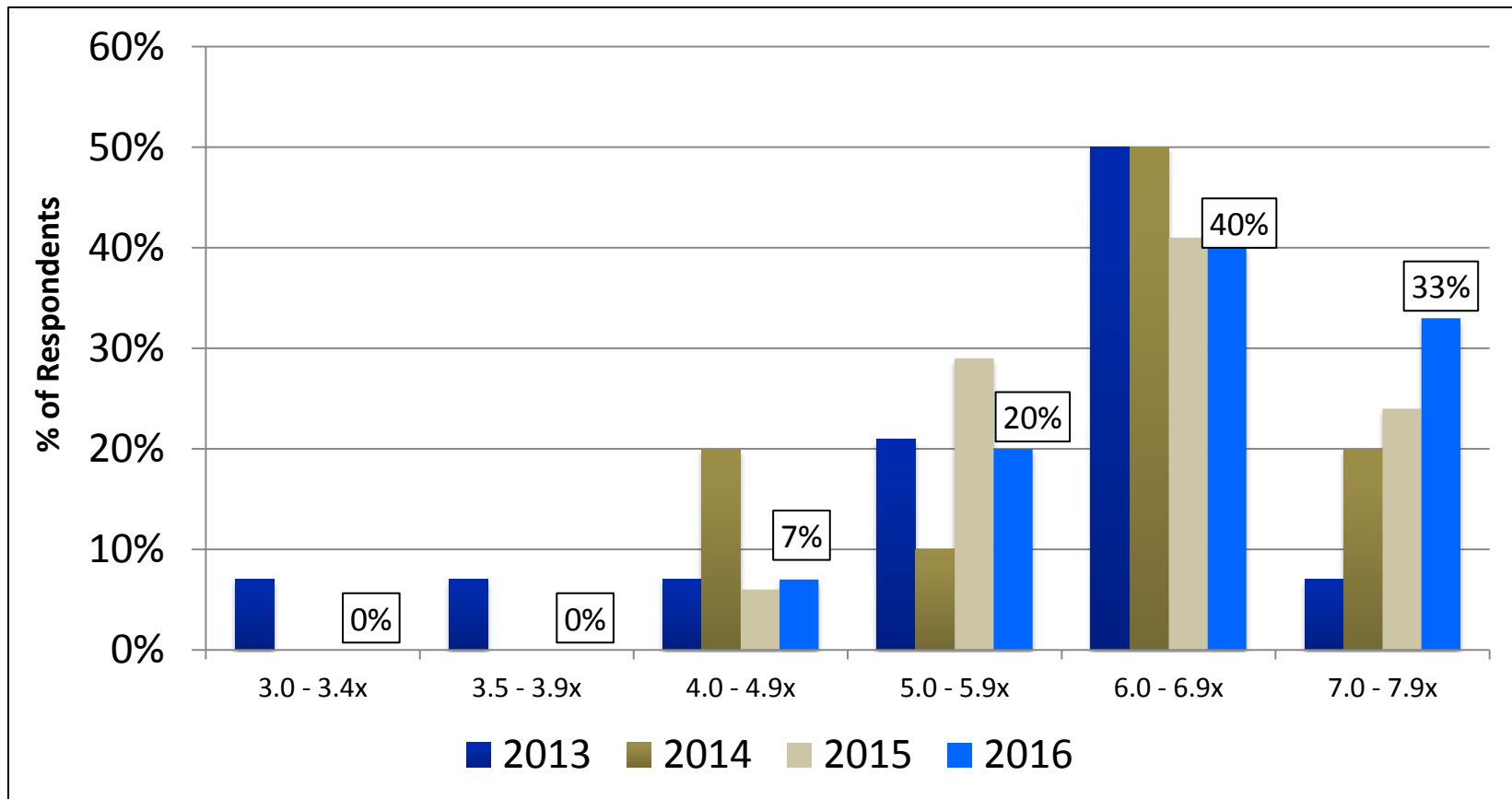
Multi-Specialty Centers



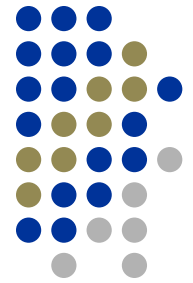
Observed Multiples for Controlling Interests



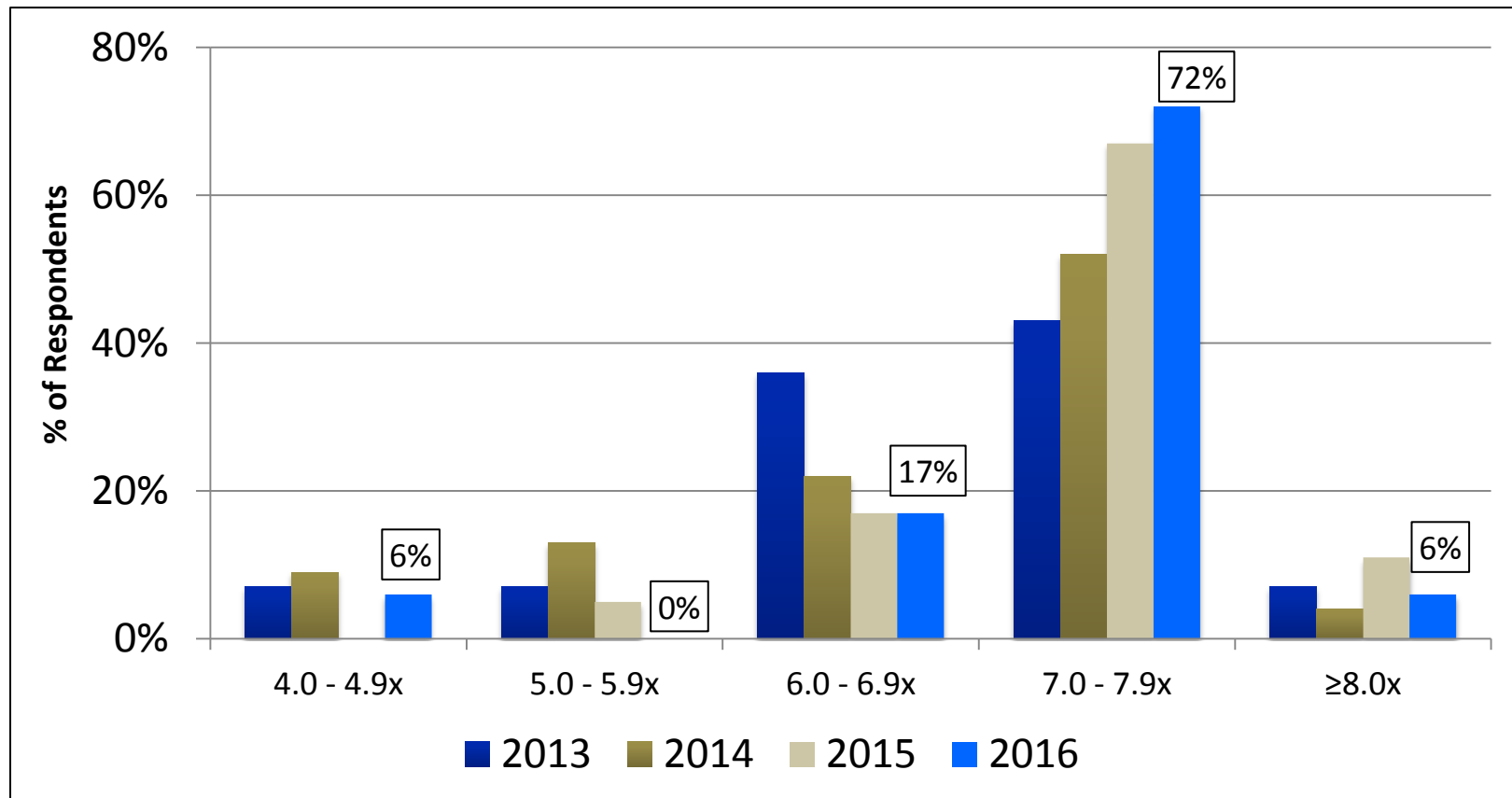
Single-Specialty Centers

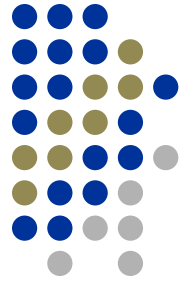


Observed Multiples for Controlling Interests



Multi-Specialty Centers





QUESTIONS?

10 Common Mistakes in Valuing ASCs

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