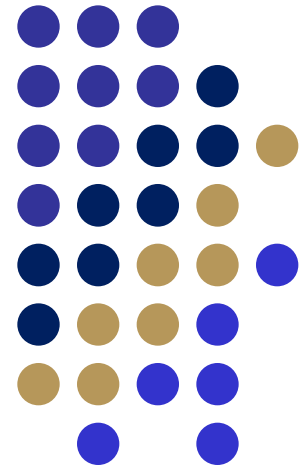


# Fair Market Value for Pathology Practices

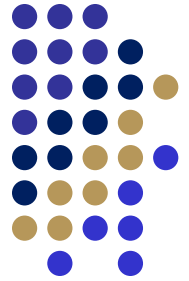
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**Jason L. Ruchaber, CFA, ASA**

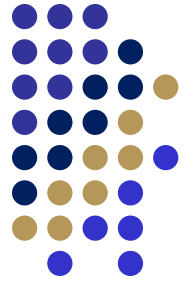
*Partner*



# Learning Objectives



- Current trends in Pathology transactions
- Overview of valuation methods and key concepts
- Discussion of factors that influence value
- Practical advice to increase value of your lab

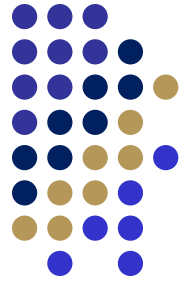


**Pathology Market**

# **CURRENT TRENDS**

# Anatomic Pathology Market:

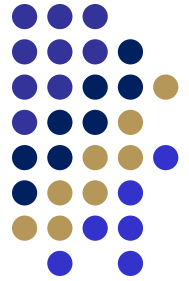
## History, Size and Structure



- U.S. anatomic pathology market grew by an estimated 8% between 2005 and 2010, and by an additional 5% in 2011
- More than 8,000 CLIA-certified histology labs in the U.S. (2011 Data)
  - 3,800 physician-office-based histology labs, 1,400 independent histology labs and 3,000 hospital-based histology labs
- More than 15,000 board-certified pathologists actively practicing in the U.S. (American Medical Association, 2011 Data)
- 55% of pathologists are office based; 31% are hospital-based; and 14% hold administrative, teaching or research positions

Source: The U.S. Anatomic Pathology Market: Forecast & Trends 2012, *Laboratory Economics, LLC*, (2012)

# Anatomic Pathology Market: History, Size and Structure

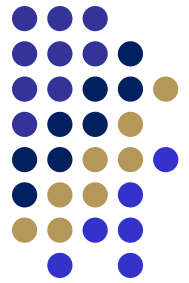


- U.S. anatomic pathology market is highly fragmented (2011 data, based on test volume)
  - Quest Diagnostics and LabCorp each have less than 10% of the market
  - Hospital based labs held a 52% share of the market
  - Independent pathology groups and labs held a 28% share of the market
  - Physician office-based pathology labs held 6% of the market

Source: The U.S. Anatomic Pathology Market: Forecast & Trends 2012, *Laboratory Economics, LLC*, (2012)

# Anatomic Pathology Market:

## Growth and Opportunities



- The anatomic pathology market will grow by an average of 6% to 7% per year between 2010 and 2015, less than 2005 to 2010 growth of 8%
- Pharmacogenomic testing linked to cancer drugs represents the biggest opportunity for pathologists and pathology labs
  - The PGx testing market is projected to grow by 31% per year from 2010 to 2015 to reach \$2.7 billion
  - The introduction of new higher-priced PGx tests could more than offset the pricing pressure on traditional pathology tests
  - In the future, payers and regulators may require PGx tests to accompany new cancer drugs

Source: The U.S. Anatomic Pathology Market: Forecast & Trends 2012, *Laboratory Economics, LLC*, (2012)

# Anatomic Pathology Market: Challenges and Threats

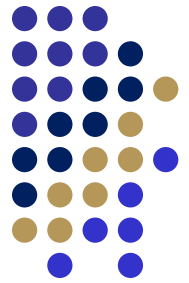


- Competition from physician Groups
  - Specialty physicians merging, adding ancillary services such as anatomic pathology labs to maintain/enhance income levels
  - A record 233 in-office pathology labs received CLIA certification in 2011
    - Urology, Gastroenterology and Dermatology physicians increasingly opening in-office pathology labs
- Competition from large commercial labs
  - Economies of scale facilitate greater sub-specialization, capital investment in equipment, etc.

Source: The U.S. Anatomic Pathology Market: Forecast & Trends 2012, *Laboratory Economics, LLC*, (2012)

# Anatomic Pathology Market:

## Challenges and Threats



- Significant Reimbursement Pressure

- 2013 Medicare Physician Fee Schedule - Sample Codes <sup>(1)</sup>

CPT Code	2013	2012	Percent Change
88305-TC	\$33.34	\$69.78	-52%
88304-TC	\$33.34	\$51.06	-35%
88312-TC	\$71.11	\$67.73	+5%

- Expiration of the “Grandfather Provision”

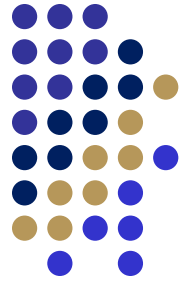
- Many labs previously billing on their own will seek reimbursement from Hospitals for Medicare (and maybe other) technical component work

Source:

1) Centers for Medicare & Medicaid 2012 and 2013 Physician Fee Schedule Final Rules



# Transactional Data



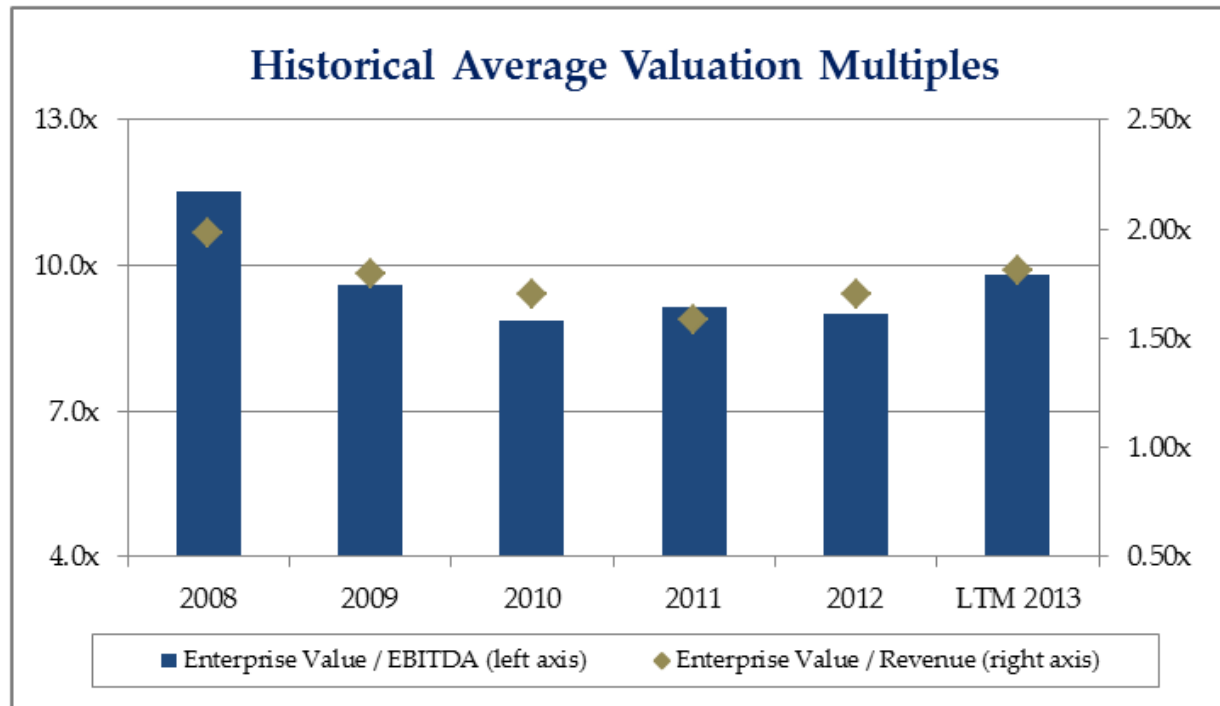
- More than 300 clinical and pathology lab transactions completed between 1996 and 2011, peaking in 2007 with 31 deals
- The most active buyers between 1996 and 2011 were AmeriPath (45 deals), LabCorp (41 deals), Aurora Diagnostics (22 deals), and Quest Diagnostics (18 deals)
- More than \$20 billion has been spent on lab mergers and acquisitions between 1996 and 2011. A record \$3.5 billion was spent in 2011.

Source: The U.S. Anatomic Pathology Market: Forecast & Trends 2012, *Laboratory Economics, LLC*, (2012)

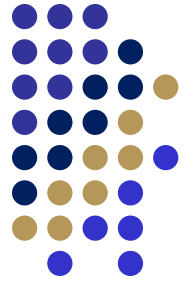
# Public Company Multiples



- HAI calculated EBITDA and revenue enterprise value multiples for DGX, BRLLI, and LH between 2008 and LTM 2013



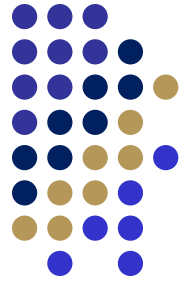
Source: Data compiled through the use of public filings obtained through the U.S. Security and Exchange Commission



## Pathology Valuation

# VALUATION METHODS AND KEY CONCEPTS

# Fair Market Value

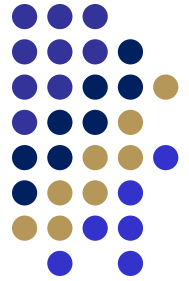


- Standard Business Valuation Definition:

*“the price, expressed in terms of cash equivalents, at which **property would change hands** between a **hypothetical willing and able** buyer and a hypothetical willing and able seller, acting at **arms-length** in an **open and unrestricted market**, when **neither is under compulsion** to buy or sell and when both have **reasonable knowledge of the relevant facts.**”*

Source: International Glossary of Business Valuation Terms

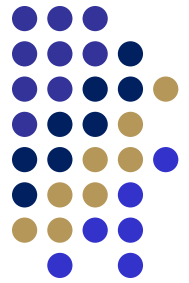
# Fair Market Value



- Stark (Healthcare) Definition:

*“the value in arm’s-length transactions, consistent with the general market value. “General market value” means the price that an asset would bring, as the result of **bona fide bargaining** between **well-informed** buyers and sellers who are **not otherwise in a position to generate business** for the other party; or the compensation that would be included in a service agreement, as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement.”*

# Overview of Valuation Approaches

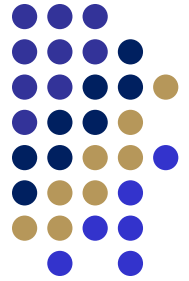


There are three general approaches to business valuation

- The **Market Approach** relies on data from comparable transactions (or stock prices) to derive an indication of value.
- The **Cost (or Asset) Approach** determines value for an asset based on the economic principal of substitution
- The **Income Approach** determines value by drawing reference to the expected future income generated by the Practice.



# Overview of Valuation Approaches



- **The Market Approach**
  - Private Transaction Method
  - Public Comparables Method
- **The Cost (or Asset) Approach**
  - Adjusted Net Asset Approach
  - Replication Cost Method
- **The Income Approach**
  - Discounted Cash Flow Method
  - Capitalization of Earnings Method

# Selection of Valuation Approach

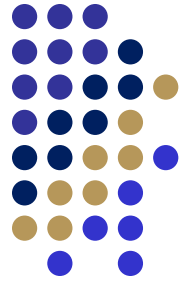


- According to Revenue Ruling 59-60

*“A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. **No formula can be devised that will be generally applicable to the multitude of different valuation issues ...** Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.”*

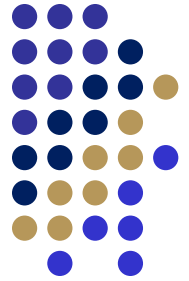


# Market Approach



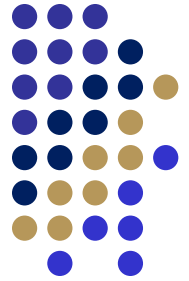
- Arguments FOR
  - Indication of value can be derived for an entity with minimal information available (e.g., revenue, EBITDA, lab volume)
  - Provides an easy to understand common-size benchmark for valuation
  - Useful as a “gut check” against other valuation approaches
- Arguments Against
  - Limited ability for valuator to understand specific deal terms as well as what is included within published data
  - For certain types of transactions, virtually no “non-tainted” data is available
  - Though conceptually easy to understand, very difficult to appropriately apply in practice.

# Cost Approach

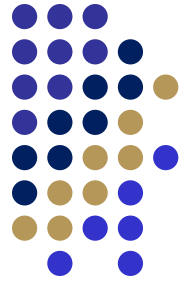


- Arguments FOR
  - Value not tied to “future referrals”
  - Provides “value floor” by building up to a value
  - Allocates value to identifiable assets
- Arguments Against
  - Paying for “cost to recreate” may not be commercially reasonable
  - Cannot allocate professional/technical value cleanly between assets
  - Tangible asset values may be distorted as lab equipment is often leased through reagent purchases
  - May not adequately account for intangible assets (licenses, etc.)

# Income Approach



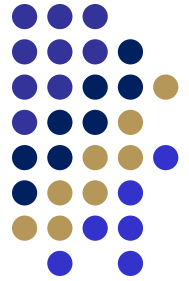
- Arguments FOR
  - Most robust analysis, ability to account for changes in volume, CPT mix, and reimbursement
  - Ability to match cash flows with the inherent risks associated with the industry and entity specific risks
- Arguments Against
  - Models highly sensitive to assumptions that may be easily manipulated
  - Carve-out of ancillaries difficult as separate financial statements / operational data is often not available



## Pathology Valuation

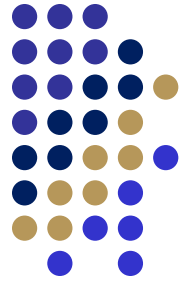
# FACTORS THAT INFLUENCE VALUE

# Factors that Influence Value



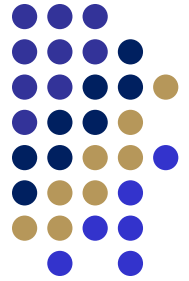
- Earnings
- Growth
- Risk
- Professional vs. Technical
- Pathologist compensation

# Factors that Influence Value



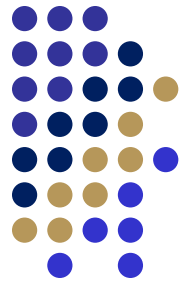
- Earnings
  - Magnitude of earnings
  - Profit margins (earnings divided by revenue)
  - Free Cash Flow
- Growth
  - Are earnings stable, trending up, trending down, etc.
- Risk
  - How volatile are earnings?
  - Are there key concentrations of risk that could materially impact practice (physician, payor, procedure type, etc.)
  - Are there factors that mitigate risk (CON, exclusive contract, etc.)

# Factors that Influence Value



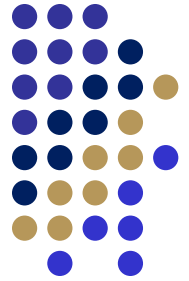
- Professional vs. Technical
  - Clinical Lab
  - Anatomical Lab
  - Lab Setting (Group Practice – Pathologist owned, Hospital, Multispecialty group, corporate provider, etc.)
- Pathologist Compensation
  - If professional practice and technical business (i.e., lab) are both acquired, valuation models must consider post acquisition compensation of pathologists
  - For globally billed lab services that pay a fee to outside pathologists, the pathology fee and or pro/tech split will need to be considered.

# Practical Advice for Increasing Value



- Know your business and your competitors
- Plan ahead
  - Have clean financial statements and operational reports
  - Eliminate waste and inefficiencies
  - Revisit payor contracts
  - Diversify referral sources
  - Prepare realistic budgets and strategic plan
  - Discuss the possible sale with appraiser, attorney, CPA





## Pathology Valuation

# QUESTIONS?