What’s Your Worth?
Practice Valuation

Presented by:

Daryl Johnson, MAcc, CVA | Partner

HealthCare Appraisers, Inc.

What is the purpose of the valuation?

- Strictly for business reasons?
  - Examples:
    - Buy in or redemption of a physician owner
    - Sale to a financial investor
- Business reasons <u>and</u> regulatory compliance?
  - Examples:
    - Sale to a local hospital, insurance company or other buyer where there might be concerns regarding federal or state healthcare regulations (*e.g.*, the Stark law and the and anti-kickback law)
- An attorney can advise whether regulatory compliance is a factor

The FMV Standard

- Healthcare regulations stipulate ***fair market value*** as the applicable standard of value.
- The definition of ***fair market value*** for healthcare regulatory purposes is modified from 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"*

Valuation Considerations When Regulatory Compliance is Not a Factor

- Strategic value can be considered
- Examples of strategic value include:
  - The ability for a merged physician practice to cross refer to each other, or to establish critical mass to add ancillary services
  - A favorable managed care contract held by an entity that will provide reimbursement "lift" to the other
  - Expense savings that are unique to the specific buyer and seller

Primary Valuation Approaches

- Cost Approach
  - Considers the aggregate value of tangible assets (*e.g.*, accounts receivable, equipment and furniture) and intangible assets (*e.g.*, medical records, and possibly trade name and/or workforce in place)
- Income Approach
  - Considers a present value of the future cash flows *(e.g.,* a discounted cash flow, or DCF)
  - Typically, a cash flow stream is projected, and the cash flows are discounted to present value (along with consideration of a terminal value)
  - While the Income Approach considers past financial performance to help establish reliable projections, a practice valuation is a forward-looking exercise
- Market Approach
  - Considers the value of the target practice based upon sales transactions for other similar practices
  - Most often, appropriately comparable market comparisons are not available, so this approach is seldom used in valuing physician practices

Physician Practice Valuations - Income Approach

If the FMV standard must be met, how is intangible value generated in physician practices?

- Leverage off employed physicians or mid-level providers
- Provide ancillary services
- Perform allowed surgical procedures in-office (as opposed to hospital or ASC) and receive site-of-service differential
- MDs take pay cut (like old PPM deals); generally unpopular; many transactions involve a post-transaction compensation *increase*, further impacting potential intangible value

Physician Practice Valuations - Income Approach

If the FMV standard is not applicable, how can intangible value be generated in physician practices?

- Consider the synergies associated with a transaction between two specific parties, *i.e.*, give the physicians credit for revenue enhancements or expense reductions generally unavailable in the absence of a transaction.
- The synergies are included in the projections

Physician Practice Valuations - Income Approach

Capitalization of Earnings or Discounted Cash Flow?

- Same thought process for all business entities
  - Stable vs. Fluctuating Earnings?
- When using projected revenues and expenses, assumptions must be reasonable (for each individual line item and on an overall basis)
- “Lofty” projections are accompanied with higher discount rates

Physician Practice Valuations - Income Approach

Operational Analyses – Every practice has unique operational characteristics

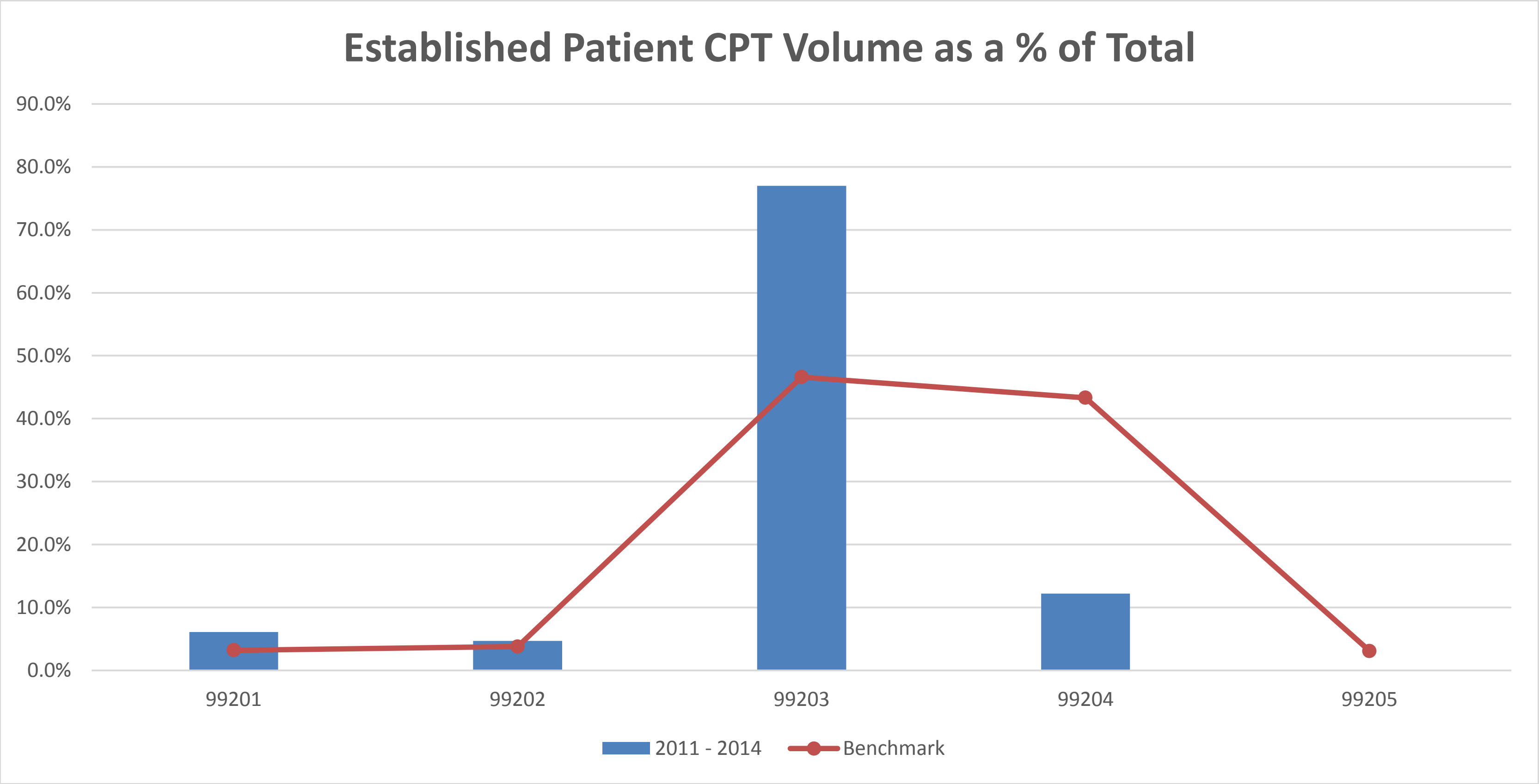
- Pre-Compensation Earnings is one of the most reliable metrics in determining financial health of a practice
- Consider normalization adjustments:
  - Payroll/Benefits
  - Occupancy
  - Discretionary Costs

Physician Practice Valuations - Income Approach

Operational Analyses

- Provider Mix
- Payor Mix
- CPT Mix
- E&M Coding Distribution
- What are the risks? What best informs projections of future profits?

Physician Practice Valuations - Income Approach



Physician Practice Valuations - Asset Approach

Review of the balance sheet

- What will/will not transfer in the transaction?
  - Need to understand treatment of working capital and liabilities in the transactions
- Most transactions are Asset Acquisitions (rather than Stock Acquisitions)
- Income tax considerations

Physician Practice Valuations - Asset Approach

Assets that typically transfer in these transactions:

- Fixed Assets (may or may not include leaseholds)
- Workforce in Place (Physician and Non-Physician)
- Medical Records (Electronic and/or Paper Charts)
- Telephone Number/Website
- Trade Name
- Other Intellectual Property

Physician Practice Valuations- Asset Approach

Workforce in Place

- Cost to Re-Create Method
- Consider both direct costs (out-of-pocket costs) and indirect costs (opportunity costs, downtime)
- Physician versus Non-Physician Workforce in Place
  – Reconcile Salary/Benefits information between approaches

Physician Practice Valuations - Asset Approach

Medical Records

- Cost of replication approach

Physician Practice Valuations - Asset Approach

Telephone Number/Website/Trade Name

- In physician practice valuations, most regulators accept these valuations based on a Cost Approach
- Usually look at marketing costs, time to develop and switching costs (*e.g.*, mailers)

Physician Practice Valuations - Asset Approach

Other Intellectual Property

- Published materials (need to be sure it is not reflected in workforce analysis via compensation)
- Networks
- Software/Applications
- Tradename

Physician Practice Valuations - Asset Approach

Accounts Receivable -

- Analysis of collectability
  - Aging
  - Payor mix
- Post-acquisition true-up
- Successor liability

Treatment of Physician Compensation

- Under an Income Approach, prospective physician compensation is inherent in the future cash flow projections
- Under a Cost Approach, any increases in physician compensation are generally an offset to purchase price associated with <u>intangible</u> assets

Valuation Discounts

- A practice valuation first entails the valuation of a 100% ownership interest (referred to as the *business enterprise value* or BEV)
- Discounts may be applicable for
  – *Lack of marketability* (*i.e.*, a discount to factor in the time and expense required to convert the practice value to a cash equivalent)
  – *Lack of control*

Discounts for Lack of Control

- A discount is typically applicable to a minority interest for lack of control. The discount for lack of control considers the actual control characteristics of the minority interest
- For example, there might be four owners each with a 25% interest, or there might be one owner with a 75% interest and one owner with a 25% interest
- The DLOC in the latter scenario would be greater
- Despite actual ownership, governing documents (*e.g.*, a shareholders' agreement) might establish different control provisions
- The DLOC typically ranges from 10% to 20%

Summary

- It is critical to establish whether the valuation is constrained by the FMV standard
- In determining the value of a practice, generally the *greater of* the Cost, Income and Market approaches is the concluded value
- If a practice is valued using the Cost Approach, those specific assets that were valued would be conveyed in the transaction
  - Any increase in physician compensation serves to offset intangible purchase price value

Summary

- If a practice is valued using the Income Approach, all assets of the practice are conveyed in the transaction, including *normal working capital*, *i.e.*, that level of net current assets needed to routinely operate the business
  - Adjustment to the purchase price would be made for excess working capital (*e.g.*, a surplus of cash or medical supplies), or a shortfall in working capital (*e.g.*, a large liability for accrued wages)

Summary

- The use of an Income Approach presumes that there are practice profits after payment of physician salaries (and it is that profit subject to the DCF analysis). If all profits are paid out as physician compensation, the practice will not have value under an Income Approach. Thus, a DCF assumes a pre-determined level of physician compensation, and that level must be maintained, at least for some number of years after the transaction.

Summary

- Be careful when considering any valuation "rules of thumb" (like a multiple of EBITDA)
- Notwithstanding, indications of current multiples are:
  - ASCs 6x to 8x for controlling interest in a multi-specialty ASC, and 3x to 7x for a minority interest in a single specialty ASC
  - Radiology centers 4.5x to 6x (controlling interest)
  - Physician practices ≈5x (or a 15% to 20% discount rate)

Questions?

What’s Your Worth?
Practice Valuation

Presented by:

Daryl Johnson, MAcc, CVA | Partner

HealthCare Appraisers, Inc.

djohnson@hcfmv.com

(561) 330-3488