Valuing Physician Practices and Ancillary Service Lines
A Unique Perspective on Orthopaedic Practice Transactions

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Physician Practice Acquisition Overview

• Significant Consolidation / Acquisition Activity for Healthcare Providers
  • These transactions began in 2009, shortly prior to the signing of PPACA (March 2010)
  • Driven largely by changing reimbursement models and costs associated with PPACA compliance
  • Formation of Accountable Care Organizations
  • Buyers initially focused on cardiology, but now focused on acquiring primary care physicians and large multi-specialty physician practices
Physician Employment/Practice Acquisition

- Practice acquisition/employment transactions are occurring at a feverish pace.
- Valuators are polarized with respect to certain valuation approaches for practices.
- To establish FMV, you must first consider the proposed terms of the arrangement.
- Employment agreements can have many different features...and all must be considered when establishing FMV.
Physician Employment/Practice Acquisition

• Not only hospitals and health systems making acquisitions.
• Significant acquisition activity from insurance companies and managed care administrators to expand their network.
• Are these acquisitions subject to FMV standard?
The chart illustrates the physician employment trend over the past decade, primarily driven by reimbursement pressure and PPACA.
History of Physician Practice Acquisitions

- The chart illustrates the physician practice acquisition trend over the past decade.
- These two databases report only a small percentage of the total acquisition activity in the US, but the data confirms HAI’s experience of heightened acquisition activity following the passage of PPACA.
Acquisition Structure & Compensation Models

- Over 95% of transactions are structured as an asset purchase and subsequent employment of physicians, with the buyer acquiring:
  - Inventory
  - Tangible Assets (equipment, etc.)
  - Identified Intangible Assets

- Post-Acquisition compensation must be factored into purchase agreement. The majority of clinical compensation models are driven by productivity:
  - wRVUs x Conversion Factor
  - % of Professional Collections or Pre-Compensation Earnings
  - Hours or shifts worked
Acquisition Structure & Compensation Models

- **Alternative structure considerations**
  - Synthetic employment (PSA, etc.)
  - Carve out of department or select physician specialties
  - Lease of practice’s tangible assets and employees
  - Ancillary carve-outs
Overview – FMV Standard

• Healthcare regulations stipulate *fair market value* as the applicable standard of 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”*
Use of Valuation Approaches

• Three generally accepted 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 (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.
Approaches to valuing physician practices (or any business entity) include Market, Cost and Income.

A Market approach is generally of little value due to lack of comparability and/or reliable data for practice transactions.

A Cost approach restates the entity’s balance sheet, including specifically identified intangible assets (e.g., workforce in place, etc.)

An Income approach discounts (thru DCF) expected future cash flows to the buyer.
The central argument among appraisers regarding physician practice valuation is whether or not intangible value can exist in the absence of an income stream which *fully* supports the intangible value.

- Certain respected appraisers espouse “Cash is king... income is the sole determinate of physician practice value.”
- Other appraisers identify and value specific intangible assets with no consideration of the income of the practice.

- **Positions on either end of this spectrum are likely incorrect.**
How is intangible value generated in physician practices?

- Leverage off employed physicians or mid-level providers.
- Provide ancillary services (e.g., MRI, Physical Therapy or DME).
- 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; most transactions involve a post-transaction compensation increase, further impacting potential intangible value.
Physician Practice Acquisitions

- How is intangible **not** derived in a physician practice?
  - By giving MDs credit for revenue enhancements or expense reductions generally unavailable in absence of a transaction
- If a medical oncologist is employed by a hospital, the hospital likely will:
  - Bill for infusion services at a higher rate
  - Potentially benefit from 340b pricing (typically a savings of 30-35%)
- **Strategic/investment value vs. FMV**
Physician Employment/Practice Acquisition

HAI’s positions on practice valuation

• No one valuation methodology is appropriate in all cases.
• In order for intangible value to exist there, we do not need to fully support value by an income approach. (*Cost approach can be used, but must be based on a valuation of a legitimate contractual obligation*).
• Post-acquisition compensation must be incorporated into the valuation analysis under all valuation methodologies.
HAI’s positions on practice valuation

- “Make believe” DCF assumptions are not a justifiable methodology to support intangible value.
- Increases in compensation relative to historical levels will result in a “compensation offset”.
- Some compensation models will result in the purchase price being limited to that of the fixed assets only.
Physician Employment/Practice Acquisition

HAI’s positions on practice valuation

• 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.)

• Practices typically less concerned with liquidity event than locking in compensation as long as possible and partnering with viable long-term partner
QUESTIONS?
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