

## KEY TRENDS IN VALUING PRACTICE ACQUISITION

### BECKER'S HOSPITAL REVIEW MEETING

MAY 10, 2013



BUSINESS VALUATION • PROFESSIONAL SERVICES VALUATIONS • ASSET APPRAISALS • REAL ESTATE • TRANSACTION ADVISORY • CONSULTING  
DALLAS • NASHVILLE

### OVERVIEW



- Historical Perspective of Practice Transactions
- Physician Practice Transaction Trends
- Valuation Primer
- Ancillary Business Transaction Environment



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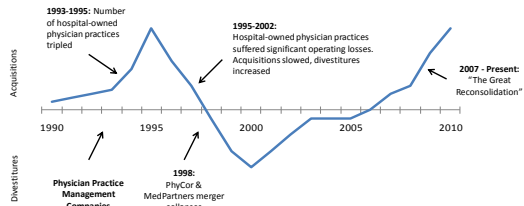
### BECKER'S HOSPITAL REVIEW MEETING

HISTORICAL PERSPECTIVE OF TRANSACTION TRENDS



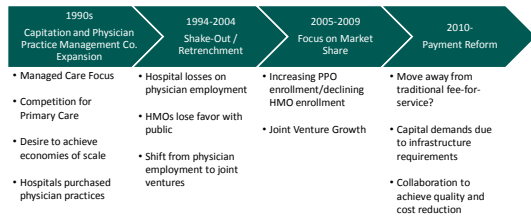
## HISTORICAL PERSPECTIVE OF PRACTICE TRANSACTIONS

### Physician Practice Transaction Timeline



## HISTORICAL PERSPECTIVE OF PRACTICE TRANSACTIONS

### The Evolution of Physician-Hospital Integration



## BECKER'S HOSPITAL REVIEW MEETING

### PHYSICIAN PRACTICE TRANSACTION TRENDS

# PHYSICIAN PRACTICE TRANSACTION TRENDS

Information & Statistics



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# PHYSICIAN PRACTICE TRANSACTION TRENDS

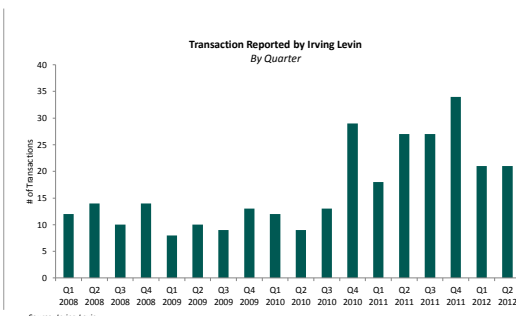
The Integrated Deliver Model – Part II



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# PHYSICIAN PRACTICE TRANSACTION TRENDS

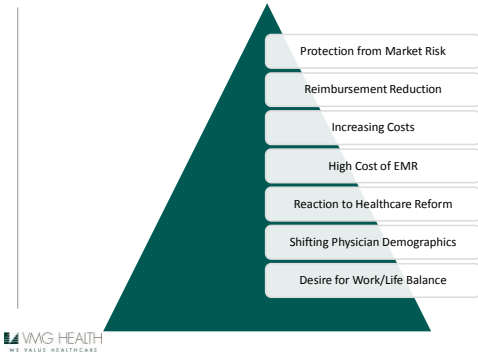
High Volume of Transaction Activity



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## PHYSICIAN PRACTICE TRANSACTION TRENDS

*Driving Forces for Physicians*



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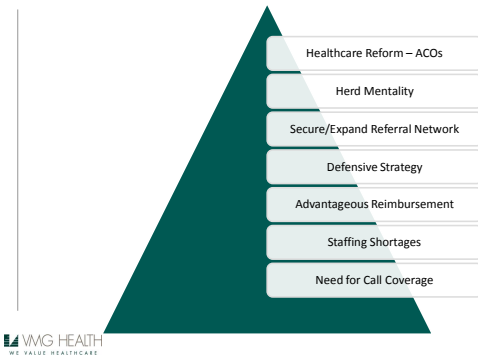
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## PHYSICIAN PRACTICE TRANSACTION TRENDS

*Driving Forces for Hospitals*



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## PHYSICIAN PRACTICE TRANSACTION TRENDS

The primary  
buyer of a  
physician  
practice is a  
healthcare  
system.



The transaction  
must be priced  
at Fair Market  
Value (FMV)

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## BECKER'S HOSPITAL REVIEW MEETING

## VALUATION PRIMER



## VALUATION PRIMER

## Regulatory Overview

## Stark Law

- Requires Fair Market Value

## Anti-Kickback Statute

- Requires Fair Market Value

## Private Inurement

- Requires Fair Market Value



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## VALUATION PRIMER

## Regulatory Overview

Fair Market Value ("FMV") – the only premise of value to meet the Anti-Kickback Statute and Private Inurement Regulations.

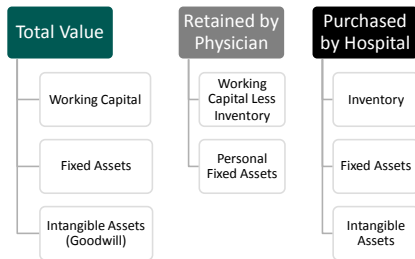
Both for-profit and not-for-profit health care providers that accept payments from government programs (i.e., Medicare) must ensure that exchanges between them and other providers are at FMV.

## Definition

- The price, expressed in terms of cash equivalents, at which a 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 nor to sell, and when both have reasonable knowledge of the relevant facts.



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**VALUATION PRIMER***Typical Components of a Transaction*


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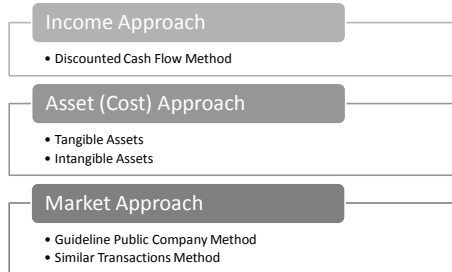
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**VALUATION PRIMER***Business Valuation Methods*


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**VALUATION PRIMER***Asset (Cost) Approach*

Takes into consideration the cost of replicating a comparable asset, security or service with the same level of utility. Typically used when the entity has historical losses or nominal projected cash flow.

**Tangible Assets**

- Working capital
- Fixed assets
- Real estate (if applicable)

**Intangible Assets**

- Legal title, protectable, separately marketable
  - Trade name
  - Phone number
  - Medical chart

**Tangible Assets + Intangible Assets = Value Indication**

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**VALUATION PRIMER***Market Approach*

Estimates value by comparing the value of similar assets, securities or services traded in a free and open market to the subject asset, security or service.

- Similar publicly-traded companies are not comparable from a size or growth standpoint and often include practices with a variety of management services agreements.
- Similar transaction information in the public domain is rarely useful because details on transaction structure (including post-transaction compensation and employment terms) are not included.
- Market Approach rarely used alone as a determinant of FMV for a physician practice.

**Selected Multiple(s) x Subject Metric(s) = Value Indication**

**VALUATION PRIMER***Income Approach*

Present Value of Future Cash Flows

- Projection of future revenues and expenses
- Projection of future capital expenditures and working capital requirements
- Physician compensation terms should be incorporated in the cash flow projection
- Historical information should be normalized
  - Personal automobile
  - Personal Travel
  - Other

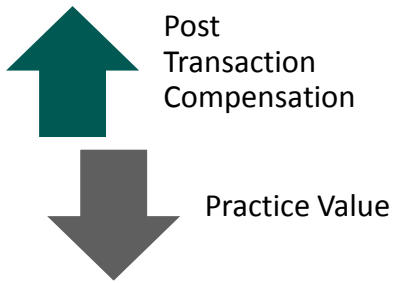
***If any value is paid over and above the tangible assets than this value should be supported by the Income Approach analysis.***

**Present Value of Cash Flows = Value Indication**

**VALUATION PRIMER***A Typical Physician Practice Acquisition*

A physician practice value is typically the value of the fixed assets with little intangible value and no goodwill. The exceptions to this are:

- ☐ Profitable employment relationships with physicians and mid-levels
- ☐ High levels of ancillaries (to be discussed later)
- ☐ Requires the physician(s) to sacrifice post-transaction compensation

**VALUATION PRIMER***Physician Compensation Post Transaction*


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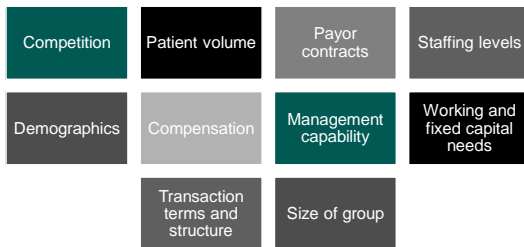
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**VALUATION PRIMER***Qualitative Factors Influencing Value*


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**VALUATION PRIMER***Personal Property Valuation Methods***Cost Approach**

- Based on the principle of substitution and establishes the maximum price as equal to the cost to replace the assets with other assets of similar utility.

**Sales Comparison Approach**

- Adjusting prices of recently sold assets or buying/asking prices to estimate the value to Subject Assets

**Income Approach**

- Discounted Cash Flow Method
- Fair Market Value Lease Transactions

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**VALUATION PRIMER***Cost Approach – Personal Property*

Takes into consideration the cost of replicating a comparable asset, security or service with the same level of utility. Adjustments are made to reflect depreciation/obsolescence related to physical, functional and economic obsolescence, where appropriate.

The cost approach is an approach typically used to estimate fair market value in continued use and begins with the historical cost basis included on a practice's depreciation schedule (financial reporting or tax). Most common methods of estimating replacement cost new are indirect (asset specific cost indices such as those published by the Bureau of Labor Statistics) and the direct (obtaining dealer quotes for new comparable equipment). Depreciation is then applied to reflect physical (wear and tear), functional (inefficiencies in performing the task designed for) and economic (outside factors). Quantifying economic without a business enterprise valuation is challenging.

**POSITIVES:**

Speed in developing an estimate

**LIMITATIONS:**

Most asset registers are not sufficiently detailed to provide either side of a transaction a clear understanding of what is being bought or sold.

**A straight cost approach analysis may not necessarily comply with Stark**

**VALUATION PRIMER***Sales Comparison – Personal Property*

Takes into consideration current sales prices, buying/asking prices of comparable equipment. The sales comparison approach factors in all forms of obsolescence, given the value represents market transactions. In order to perform a sales comparison approach, the information used as the basis of analysis must be sufficiently detailed to draw conclusions from comparable sales.

**POSITIVES:**

More detailed analysis reflecting market conditions at the time of the valuation.  
Greater clarity in identifying the assets subject to the transaction since most sales comparison approaches require a detailed inventory or greater asset detail to be provided  
More supportable value estimate that is Stark Compliant with detailed comparable sales

**NEGATIVES:**

Typically requires an on-site inspection and detailed inventory

**Preferred Approach for Fair Market Value in Exchange - Stark**

**VALUATION PRIMER***Income Approach – Personal Property*

Primarily used in estimating the fair market value lease rate for a group of assets that are not acquired. Many Health Systems have pursued this avenue for physician arrangements as a trial basis to determine whether there is a strategic fit.

**POSITIVES:**

Limits capital expenditures to employ physicians by leasing personal property assets, i.e. don't need to write a one-time check at the outset of the relationship  
Provides physician a return on their use of the assets during the course of the employment agreement, while still retaining ownership, if desired

**NEGATIVES:**

Typically requires all of the steps of a sales comparison approach, including an on-site inspection and detailed inventory  
Requires additional steps in reviewing structure of lease, financial reporting compliance, estimate of residual value at lease termination and estimating an appropriate market interest rate

**Considered for Health Systems that don't want to own assets**

**VALUATION PRIMER***Real Property*

Fair Market Value of the real estate component is often a critical part of any physician practice acquisition. Stark Law defines "fair market value" as "the value in arm's length transactions, consistent with the general market value." "General market value" means "the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to an agreement who are not otherwise in a position to generate business for the other party" at the time of the agreement. The Stark Law also requires that the overall agreement must be "commercially reasonable". Commercial reasonableness has been defined by the Department of Health and Human Resources as "a sensible and prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals."

**Fair Market Value and Fair Market Rent****VALUATION PRIMER***Real Property*

For lease agreements, Fair Market Value is considered to be equivalent to Fair Market Rent or Market Rent. Market Rent is defined as "The most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the lease agreement including permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs). Implicit in this definition are the following conditions:

- Lessee and lessor are typically motivated.
- Both parties are well informed or well advised, and acting in what they consider their best interests.
- A reasonable time is allowed for exposure in the open market.
- The rent payment is made in terms of cash in United States dollars, and is expressed as an amount per time period consistent with the payment schedule of the lease contract.
- The rental amount represents the normal consideration for the property leased unaffected by special fees or concessions granted by anyone associated with the transaction."

**Fair Market Value and Fair Market Rent Continued****VALUATION PRIMER***Real Property*

**There are essentially three methods used for the determination of Market Rent.** The first of these approaches, a return-on-depreciated-cost analysis, consists of performing a cost approach analysis and then estimating a market derived return of and on the subject's depreciated improvement cost and land value using a capital return methodology. This method is most applicable on new construction.

Another method, called a market rent comparables approach, consists of analyzing the rental rates of actual leases of comparable health-care facilities. For most properties, this is considered the most reliable. Note that comparability is a critical aspect. Don't use medical office space comparables to determine the rent of a surgery center.

A rental rate also can also be developed through an analysis of the subject's financial operations. This method is a variation of the income capitalization approach in that historical financial statements are reviewed and analyzed and a projection for the upcoming year is completed. From this amount, earnings before interest, taxes, depreciation, amortization, and rent ("EBITDAR") are estimated, and a rent coverage ratio multiplier that indicates how much rent can be supported within the EBITDAR amount is selected. However, many academics argue that a degree of business value is included this method and it is not commonly utilized.

**Fair Market Value Rent Methodology**

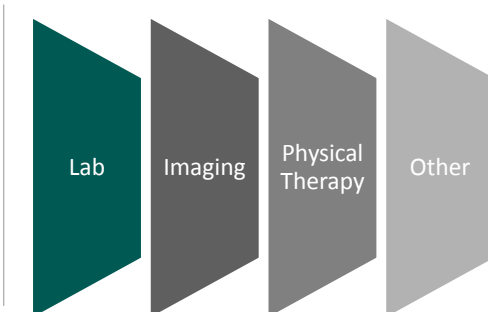
**BECKER'S HOSPITAL REVIEW MEETING****ANCILLARY BUSINESS TRANSACTION ENVIRONMENT****ANCILLARY BUSINESS TRANSACTION ENVIRONMENT***Ancillary Business Acquisitions***Types of Ancillary Transactions...**

- ☐ Purchase in context of entire practice
  - The Physician is employed by the acquirer and the ancillary cash flows are excluded from post transaction compensation calculations
- ☐ Ancillary only Purchase
  - Physician may not want to give up control
  - Physician not employed
  - Method to Integrate with Hospital without outright sale
  - Method of liquidation/risk mitigation

**Value Indication = Income Approach, Cost Approach or Market Approach**



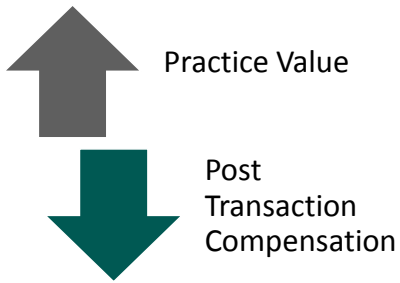
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**ANCILLARY BUSINESS TRANSACTION ENVIRONMENT***What Ancillary Businesses Drive Practice Value?*

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**VALUATION PRIMER**

*Physician Compensation Post Transaction*



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**BECKER'S HOSPITAL REVIEW MEETING**

CONCLUSIONS




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**CONCLUSIONS**

High Levels Uncertainty = Risk

Risk Impacts Valuations

Higher Risk = Lower Valuations



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## CONCLUSIONS

Uncertainty will be fact of life In healthcare

Impact of Reform Unknown

Bundled Payments or Fee for Service?



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## KEY TRENDS IN VALUING PRACTICE ACQUISITION

## Questions?

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