Valuing ASCs and Physician Practices

Becker's Orthopedic-Spine-Pain ASCs Conference 2013

HealthCare Appraisers
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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
  - <u>Income Approach</u> – 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.
  - <u>Market Approach</u> – 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.
  - <u>Asset (Cost) Approach</u> – 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.

ASC Valuation Approaches

- The selection of the appropriate approach will depend upon the facts and circumstances of the entity
- Generally start-up/De Novo Centers are valued using a Cost Approach
- Operating ASCs are generally valued using the Income or Market Approach
  - Income Approach – Typically using a DCF Model excluding any case volume that may be brought or taken away by a specific physician investor.
  - Market Approach – Typically using a comparable transaction method relying upon market multiples

Defining "Earnings"

- Typically Measured as Earnings Before Interest Taxes and Depreciation ("EBITDA"), but can also be stated as cash flow, net income, distributions, etc.

- Single Period or Average? May be most recent year, trailing twelve months, 2-year average, etc. The appropriate measure is the one that is most indicative of <u>future</u> earnings capacity.

- In some instances historical earnings measures must be normalized to remove the effect of non-recurring income and/or expense items.

ASC Value Drivers & Risk Factors

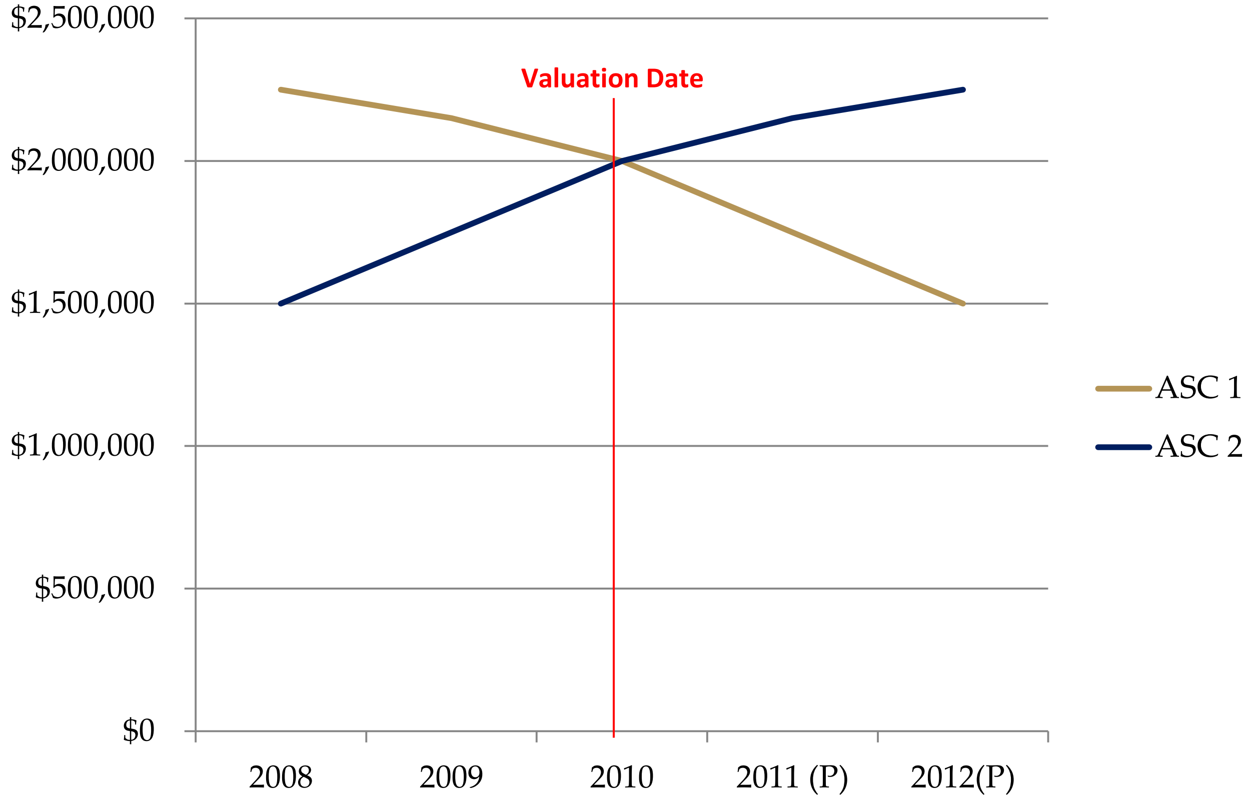
Value Drivers

- Growth – Historical & future
- Specialty mix
- Payor mix
- Certificate of Need
- Management / Administrative oversight
- Hospital Participation

Risk Factors

- Single-specialty
- Limited Number of owners/users
- Competition
- Out-of-network billing

Two ASC's with $2.0M EBITDA



ASC Valuation Trends

- Observed a significant increase in ASC acquisition activity and De Novo Centers in 2012.
  - Multiples paid for controlling interests shift slightly upward.
  - Anticipate stronger pricing for controlling interests in the coming year.
  - Valuation multiples for controlling interests, expressed as a multiple of EBITDA, were generally in the range of 6.0x to 7.0x for single specialty and 7.0x to 8.0x for multi-specialty, less debt during the last year (*i.e.*, for centers which were predominantly or exclusively in network with Commercial payors).

Common ASC Valuation Challenges

- Physician Syndication Modeling Challenges.
- Management Fees and Their Treatment.
- Hospital transactions and hospital fee schedules.
  - Incremental risk/valuation implications associated with removing MD ownership on prospective basis (i.e., assumes 100% hospital ownership).
- Out of network strategies and valuation implications.
- De Novo valuation issues.

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 Practice Acquisition Valuation Approaches

- 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.

Physician Practice Valuations

- 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.**

Physician Practice Acquisitions

- 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 <u>not</u> 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 position 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

Physician Employment/ Practice Acquisition

HAI's position 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.
- 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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