Valuing ASCs and Physician Practices

Becker’s Orthopedic-Spine-Pain ASCs Conference 2013
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.
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 future 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.
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.
• 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
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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