

The Advanced Business of Medical Practice
Certified Medical Planner Program©

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CHAPTER 18

The Science and Art of Medical Practice Valuation

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The value of a business (medical practice) represents a tremendous investment for both the buyer and seller, and it's shortsighted not to have a professional appraiser, working with both the buyer and seller so they understand the valuation issues involved. It's very easy in the emotion and passion of buying a business to make a mistake. And, competent professional business appraisers bring a dispassionate view of value that should be important to all buyers and sellers of businesses.

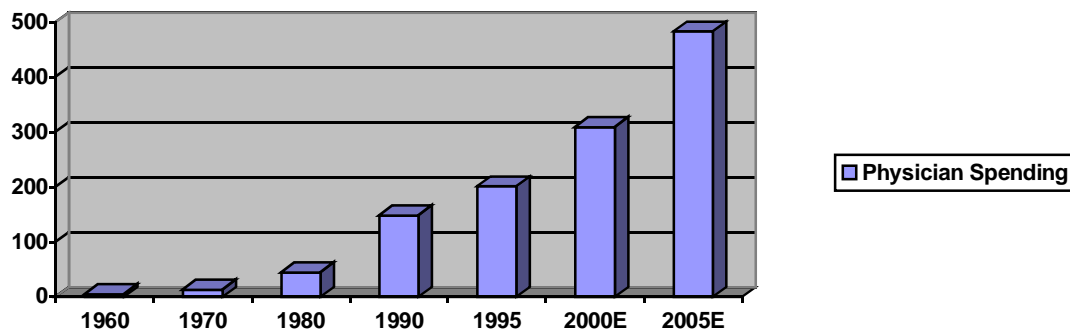
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The health care industry continues to undergo major revisions in its form of health care delivery. Market evolution has been described as revolutionary, fraught with continual organizational changes. Recent years have been marked by significant and increasing politically sensitive industry consolidations, although the frenzied rate of previous merger and acquisitions activity has abated. This occurred amid the bankruptcy of noted private organizations and practices, as well as the alleged and massive fraudulent activities of a highly visible publicly traded healthcare company. All despite the passage of the Sarbanes-Oxley Act in the winter of 2002, which required corporate executives to sign financial reports attesting to their veracity.

Today, the major industry segments grabbing the headlines are physician-to-physician consolidations. Other industry segments, such as long-term care, medical devices; pharmaceutical and supply distribution, PHOs (Physician Hospital Organizations) and PPMCs (Physician Practice Management Corporations) are no longer setting record levels in terms of volume and dollar value of business combinations. The macro-economic health care merger and acquisition fervor, as seen on the grand scale of several years ago, is virtually absent.

And so, why is there this urge to buy, sell or merge in the private clinical and micro-economic practice arena? Medical practice consolidation is being fueled by the rapid growth of managed care and the continuing squeeze on the health care dollar. Aging physicians are retiring, mid-life doctors are getting divorced, and newly minted physicians are desperately seeking to retain one last vestige of business autonomy.

The health care market is over \$1 trillion dollars, with physicians controlling 85% of total health care spending. According to the Health Care Financing Administration (HCFA), the government agency that administers the Medicare and Medicaid programs, direct spending on physicians has grown from \$5.3 billion in 1960 to nearly \$500 billion in the year 2005. The following chart illustrates this explosive growth trend in physician spending.



Source: Health Care Financing Administration, 2003.

Strong Impetus to Consolidate

The federal government is the largest single payer in the U.S., accounting for approximately one-third of all of health care expenditures. With the aging population, legislative efforts to control health care spending can only escalate. Further accelerating the urge to merge, many insurers are increasingly basing provider payments on some level of Medicare reimbursements. Medical practices are continually attempting to offset declining revenues by controlling costs and offering broader services. With market forces squeezing the health care dollar, continual change and industry consolidation is eminent, and is the reason for many public debates.

The Regulatory Climate

Federal and state fraud and abuse laws, self-referral laws, tax-exempt entities prohibitions on inurement and private benefit, and a host of other federal and state laws and regulations have significant impact on what medical practices can acquire and how those acquisitions are structured.

The IRS and the *Office of the Inspector General* (“OIG”), *Department of Health and Human Services* are scrutinizing the formation of integrated delivery systems (“IDS”), with major focus on physician transactions. The impact to the health care industry has been:

- Increased scrutiny by regulators
- Need for greater understanding of regulations and their impact on determining value
- Need for greater documentation in rationale and support of underlying value conclusions

Current health care policy issues are likely to address four broad areas: Medicare, Medicaid, access to care, and managed care. With Medicare and Medicaid taking up significant portions of the federal budget, efforts to bring revenues in line with spending will require painful reductions of provider payments. Under previously enacted Medicare reform legislation, provider-sponsored organizations (“PSOs”), that are groups of hospitals, physicians, and other providers, are allowed to contract directly for Medicare capitation. This legislation also has significant negative impact to physician payments, and in particular specialty practices. Medicare, Medicaid, access to care, and anti-managed-care legislation will continue to be hotly debated topics.

The Economic Climate

Other legislative risks negatively impacting traditional physician economics and independence, include:

- Health Insurance Portability and Accountability (HIPAA), risks
- Balanced Budget Amendment, risks
- Anti-Trust, risks
- Federal False Claims Act, risks
- Civil Asset Forfeiture, risks
- OSHA CLIA risks
- Drug Enforcement Agency, risks
- Environmental Protection Agency, risks
- Managed Care Contractual risks
- ERISA, risks
- Business and employee, risks
- Systemic economic, risks
- Workplace Violence and Terrorism, risks

Physician Merger Motivation

There are approximately 850,000 allopathic physician practitioners (MD) in the U.S., and according to the *American Medical Association*, slightly over 210,000 are organized in groups of three or more.

Additionally, there are more than 225,000 dentists (DDS, DMD); more than 160,000 optometric physicians (OD); 125,000 chiropractors (DC); 55,000 osteopathic physicians (DO), and about 13,000 podiatric physicians (DPM).

This huge fragmentation of medical practitioners has allowed for the proliferation of managed care organizations commanding significant reductions in provider payments.

Declining incomes and increasing administrative challenges have motivated a significant number of physicians to sell their practice assets and join hospital systems, align with corporate partners, or decide to merge with larger medical groups to form even larger regional groups. There are countless acquisition and physician management models, some successful and many unsuccessful. Undoubtedly there will be more models evolve as there will always be organizations that think they have built a better mousetrap. And the truth is these affiliations must be flexible and evolving to adapt to an ever-changing health care market.

Small medical group acquisitions continue at a steady clip despite the past collapse of behemoth corporations, like *MedPartners*, *PhyCor*, and *FPA Medical Management*. Investors have become increasingly abandoned the industry since *MedPartners* and *PhyCor* called off merger plans and when *FPA Medical Management* filed for Chapter 11 bankruptcy protection, in 1998. The publicized financial difficulties of many physician practice management corporations (PPMCs) are well known, as is the accounting debacle of *Health South* in 2003-2004.

In the past five years, the industry has lost substantial macro-economic value in the public equity markets. Fourth generations PPMC's are now small, locally directed, privately held, and physicians owned. Many have not met earnings expectations are re-inventing themselves once again as virtual Internet educational portals or retail sales sites. Initial public offerings are non-existent, analysts have been fired and venture capitalists have gone into hibernation.

Why all this market uncertainty? Generally, the September 11, 2002 incident, depressed domestic economy, continued threat of international terrorism with weapons of mass destruction (WMDs) and the SARS (Sudden acute respiratory syndrome) epidemic among others, have all been funneled into a vortex to create the current conundrum.

Economically, no one knows precisely the best formula for physician practice micro-integration. The move from a traditional fee-for-service environment to capitation and other fixed-fee reimbursements are shifting financial risks from payers to providers. Additionally, physicians are faced with ever increasing needs for negotiating clout, capital

for expansion, and administrative and management burdens in a time of declining incomes. All market forces continue to motivate private practitioners and physician consolidation.

The Need for Medical Practice Valuations

Physicians are entrepreneurial by nature and take great pride in the creation of their businesses. Market pressures are motivating physicians to be proactive and to make informed decisions concerning the future of their businesses. The decision to sell, buy or merge while often financially driven, is inherently an emotional one.

Other economic reasons for a practice valuation include changes in ownership, determining insurance coverage for a practice buy-sell agreement or upon a physician-owners death, establishing stock options, or bringing in a new partner. Practice appraisals are also used for legal reasons such as divorce, bankruptcy, breach of contract and minority shareholder complaints. In 2002, the Financial Accounting Standards Board (FASB) issued rules that required certain intangible assets to be valued, such as goodwill. This may be important for practices seeking start-up, service segmentation extensions, or operational funding. Other reasons for a medical practice appraisal, and the considerations that go along with them, are discussed here.

Estate Planning:

Medical practice valuation may be required for estate planning purposes. For a decedent physician with a gross estate of more than 1\$ million, his or her assets must be reported at fair market value on an estate tax return. If lifetime gifts of a medical practice business interest are made, it is generally wise to obtain an appraisal and attach it to the gift tax return.

And, realize the following price discounts / price premiums may apply in any case:

- **Practice Appraisal Discounts:** A discount may be applied to a medical practice valuation when there is no ready market for such interest, as in the case of a small town community, specialty provider or niche market. If the interest is not a controlling one, then a minority discount or lack-of-control discount may be appropriate. Two appraisals may even be used; one to value the practice, while the other to value the discount.
- **Control Premiums:** A control premium occurs when majority practice ownership provides a physician executive with the ability to: set practice business strategy, hire and fire employees, accept and reject managed care contracts, and determine compensation and perquisite levels, among other things.
- **Reverse Practice Appraisal Premiums:** On the other hand, the IRS may disallow a minority interest discount, and instead apply what is known as a swing-vote-premium (SVP). Let's say that if a 20% interest in a three doctor practice is being

valuated, and there are two other physician shareholders each owning 40%, the fair market value of that 20% may have significant and valuable controlling aspects, suggesting the SVP.

Buy-Sell Agreements

The ideal situation is for physician partners to put in place a buy-sell agreement when practice relationships are amicable. This establishes the terms for departure before they are required, and is akin to a prenuptial agreement in the marriage contract. Disagreements most often occur when a doctor leaves the group, often acrimoniously. Business operations of the practice decline, employee and partner morale suffers, feuding factions develop spilling over into the office, and the practice begins to implode creating a downward valuation spiral. And so, valuations should be done every 2-3 years, or as the economic circumstances of the practice change. Independence and credibility are provided, and emotional overtones are purged from the transaction.

Physician Partnership Disputes

Medical practice appraisals are often used in partnership disputes, such as breach-of-contract or departure issues. Obvious revenue declinations are not difficult to quantify. But, revenues may not immediately fall since certain CPT code reimbursements may actually increase. Upon verification however, lost business may be camouflaged as the number of procedures performed, or number of patients decrease after partner departure.

Divorce

Physicians getting divorced should get a practice appraisal, and either side may hire the appraiser, although occasionally the court will order an expert to provide a neutral valuation. Such valuations should be done in light of both court discovery rules and IRS requirements for closely held businesses. Generally, this requires the consideration of eight elements:

- Practice specialty and operating history
- Economic and healthcare industry condition
- Estimates of practice risks and future returns
- Book value and financial condition of the practice
- Practice future earning capacity
- Physician bonuses, dividends and distributions
- Intangible assets
- Comparable practice sales

Sometime, the non-physician spouse may even desire a lifestyle analysis to evaluate the potential for under reported income, by a forensic accountant, or appraiser. A family law judge is often the final arbiter of different valuations, and because of varying state laws there may be 50 different nuances of what the practice is really worth.

Additive Value and Organic Growth Ingredient

Sometimes, medical practice appraisals can add value where little actually exists, or add value where not apparent. For example, mature doctors may believe their practice is worth more than it actually is in the modern climate. Upon appraisal, they are devastated and can't understand the reasons for its minimal value. So consultants, business advisors and financial planners can work to leverage practice assets to greatest advantage. Tasks may be identified that require less labor, human resources may be outsourced, service line segments dropped according to CPT code reimbursement, paraprofessionals utilized as substitutes, and office processes automated to increase practice bottom line profits. Sans the appraisal epiphany, these changes may never have occurred.

Moreover, even successful practices can use periodic valuations as an ingredient to future organic and non-organic growth. Some basic concepts to grow a medical practice through appropriate mergers and acquisitions include:

Establish goals and a time frame:

When considering a merger, knowing where you want to go makes getting there more likely. And, although merging practices to achieve economies of scale may seem perfectly logical, be sure to have other objectives, as well. Set revenue and profitability goals, and leave time to digest the acquisition.

Have a strategic plan:

Make sure the new practice acquisition fits into your current medical service offerings as a complimentary line in a hot sector, or as an alternate to a service you do not currently provide. Complimentary services that require little continuing education might include botox injections for dermatologists and internists, as well as plastic or cosmetic surgeons. While counter-intuitive and alternative services might also include them for gynecologists and oral surgeons.

Other synergies include orthopedic surgeons teaming-up with podiatrists, ophthalmologists with optometrists and opticians, and chiropractors merging with osteopaths. A formal written business plan is an even better idea.

Address financial issues early:

Lending vast sums of money to buy medical practices is a new business for bankers, who are very conservative by nature. And, many venture capitalists have been burned in recent years by the PPMC implosion. Both may not fully understand new concepts, such as managed care, fixed reimbursement rates, or boutique medical practices.

The bureaucracy will cause much frustration, but getting the paperwork done early will provide an advantage over other potential buyers.

Be flexible:

With a preponderance of sellers, over buyers, in the medical marketplace today, the more accommodating you can be to the buyer, the better your chance to consummate the deal.

Purpose of the Practice Valuation

Therefore, it is critical that physicians fully understand the purpose of their valuation, and how their assets will be valued. Estimates of value can be markedly different dependent on the purpose of the appraisal. Some of the many reasons to value a medical practice include:

- What is the value of the medical operating business for purchase or sale?
- What is the value of a medical practice for merger with other medical groups?
- What is the value of practice assets for joint venture with a corporate partner?
- What is the value to establish the buy-in or buy-out arrangements for partners?
- What is the value of certain practice assets for purchase or sale apart from the ongoing business operations?

To arrive at an appropriate estimate of value, qualified appraisers will ask the following questions:

- What is the purpose of the valuation?
- What assets require valuation?
- Who will perform the valuation?
- Who will pay for the appraisal?
- What is your timeline?

The answers to these questions will guide the appraiser to select the appropriate definition of value and appraisal methods to value your practice.

Understanding Valuation Definitions

Most practice valuations for mergers and acquisitions use “*fair market value*” as the standard term used to derive a reasonable value for the medical practice. This key definition of value is important, as it guides the appraiser’s choice of methods to apply in determining the appropriate value. *Fair market value* means the appraiser will value your medical practice assuming an arm’s length transaction of “any willing buyer and any willing seller” scenario, and without synergies of a specific buyer.

Synergies common among the most likely hypothetical (any willing) buyers, however, are appropriately considered in valuing medical practices.

If you are selling your medical practice as a going concern business, inclusive of all the medical practice's underlying assets, then you should understand the term "**business enterprise**". The **business enterprise** of a medical practice equals the combined values of all practice assets (tangible and intangible) and the working capital of a continuing business. Stated another way, the business enterprise value is equal to the combined values of owner's equity and long-term debt, also referred to as the invested capital of the operating business.

The value of the "**Owner's Equity**" of a medical practice equals the combined values of all practice assets (tangible and intangible), less all practice liabilities (booked and contingent). In essence, the equity value is the net worth of the business (after deducting debt). The business enterprise value is the total sum for the business including the owner's net worth plus the long-term debt.

The business enterprise value and the owner's equity value definitions are relevant when you are contemplating a sale of your ongoing medical practice, inclusive of all medical practice assets. In transactions involving the sale of medical assets separate and apart from the ongoing business operations, other value definitions and methodologies will apply.

Many medical practices are acquired without working capital. The **working capital** of a medical practice equals the excess of current assets (cash, accounts receivable, supplies, inventory, prepaid expenses, etc.) over current liabilities (accounts payable, accrued liabilities, etc.). When working capital is not a part of the transaction, the business enterprise value is adjusted for the buyer's post acquisition build up of practice receivables and the associated delay from the collection of those receivables.

Other less formal terms and definitions include:

- The "**asking price**" is often an arbitrary and difficult to substantiate price which is typically reduce 25-50% after negotiations.
- The "**realistic price**" is one that both buyer and seller believe is fair.
- The "**friendly price**" is usually used for associates, partners or other colleagues.
- The "**creative price**" involves is derived by creative financing. For example, the practice may actually provide the down payment in this case.
- The "**emotional price**" may involve either a motivated buyer or seller who pays an under or over inflated price for the practice.

What Medical Practice Assets Have Value?

The medical practice's tangible and intangible assets can be grouped into four broad asset categories. Medical practice assets typically valued for merger and acquisition include:

Tangible (physical) Assets

- Real estate or leasehold improvements
- Medical equipment and furnishings
- Accounts receivable

Intangible Assets

- Goodwill

The tangible assets of the medical practice include medical office building furnishings, medical equipment, and practice receivables. Depending on the facts and circumstances, intangible assets include professional goodwill and may also include favorable leasehold improvements, location, patient relationships, a trained and assembled work force, and restrictive covenants, among others. The combination of all the intangible assets of a medical practice is collectively referred to as "*goodwill*".

Medical practices can be valued in their entirety as an operating business, often referred to as the business enterprise. The business enterprise value includes all of the underlying assets employed in the medical practice's business operations. The business enterprise analysis is the more cost-effective way of estimating practice value. Practice assets can also be valued apart from the operating business or in addition to the operating business. What assets can be acquired and the deal structure will determine whether there is a need to separately value the practice assets only, or in addition to the business operations.

Medical practices are dependent on the highly specialized skills of the physician providers. With the exception of practices that own real estate, typically the majority of practice value lies in intangible assets, or goodwill.

Defining the Standard of "Value"

In addition to fair market value, medical business appraisers generally refer to three other standards of value.

- **Investment Value** focuses on value to a specific physician buyer rather than value to a hypothetical buyer. For example, let us examine the physician owner of an ambulatory surgery center who is considering the acquisition of a competing ASC that operates in the same geographic market. The owner might calculate value based upon the knowledge that the combination of the two ASCs will create economies of scale and less competition. This would result in greater profitability per dollar of revenue. Therefore, such a buyer, all else equal, may assess a greater

value to the company than a buyer who would expect to operate the ASC in its current free standing situation, without the expected cost saving and corresponding expectation of increased cash flow.

- **Intrinsic Value** is similar to investment value however the practice is typically viewed in a stand-alone mode as a going concern. That is, value is based upon the expected cash flows of the practice based upon its current operating configuration. However, changes in operating policy, such as changing its financial structure can have an impact on its intrinsic value.
- **Going Concern Value vs. Liquidation Value** A medical practice or any business cannot be worth less than its liquidation value. Thus, liquidation value sets a floor for value. Liquidation value assumes that a practice's operations cease and assets are sold either piecemeal or in groups and obligations are satisfied. Liquidation value is generally based on an "orderly liquidation" process where assets are sold in manner to realize the greatest possible value for them. In contrast, a "forced liquidation" process is where assets are sold as quickly as possible often through an auction. Going Concern Value views a medical practice as a holistic combination of tangible and intangible assets in which the sum is often greater than its parts. This synergistic view of the practice is typically what is being valued.

Health Care Regulations – What Doctors Needs to Know

Federal and state regulatory oversight is increasing. The trend of not-for-profit community hospital conversions into for-profit groups is generating business for appraisers to perform Fairness Opinions to calm community benefit fears. A number of industry regulations must be considered, regardless of the buyer's tax status, when organizations acquire or affiliate with physicians. These regulations include:

- Medicare fraud and abuse legislation makes it a criminal offense to offer, pay, solicit or receive payment for patient referrals for business covered by a federal healthcare program
- Anti-self-referral legislation (Stark I and II) makes it illegal for physicians to refer Medicare patients for certain identified services if the physician holds an ownership interest in the business of the service provider. The legislation identifies health services such as lab work, radiology, magnetic resonance imaging, ultrasound, home health services, durable medical equipment, computerized axial tomography, and hospital services.
- Section 501c(3) of the Internal Revenue Code makes it illegal for not-for-profit organizations to pay more than or receive less than fair market value in physician and other transactions.

- Intermediate Sanctions allow the IRS to impose tax penalties on individuals in tax-exempt organizations as well as those physicians who benefit from excessive compensation.
- Antitrust laws protect against combinations that may preclude market competition
- The Sarbanes-Oxley Act was signed into law, in 2002.

Health South is the first major corporation to be prosecuted under the Sarbanes-Oxley Act that requires corporate executives to sign financial reports attesting to their accuracy and truthfulness. It will set valuation, criminal precedents and case law reports, for years to come.

Valuations Regulations that Impact Practice Value

Both the buyer and seller need to understand how industry regulation impacts practice value and also have an appreciation for accepted appraisal definitions and methodologies used by qualified appraisers to estimate value. *The Uniform Standards of Professional Appraisal Practice (USPAP)* are promulgated standards, which provide the minimum requirements to which all professional appraisals must conform. *USPAP* requires the three recognized approaches to value (the income, market, and cost approaches) be considered to estimate value.

In the fall of 1994 and 1995, the *IRS* first issued training guidelines pertaining to the valuation of physician practices. These guidelines suggest that appraisers consider all three of the general approaches to valuation as required by the *USPAP*. Specifically in transactions involving physician organizations, the *IRS* implied:

1. The discounted cash flow (DCF) analysis is the most relevant income approach.
2. The DCF analysis must be done on an “after-tax” basis regardless of the tax status of the prospective buyer.
3. Practice collections must be projected for the DCF based on reasonable and proper assumptions for the practice, market, and industry.
4. Physician compensation must be based on market rates consistent with age, experience, and productivity.

The Public Valuation Process

The market value of a publicly traded company’s equity can be calculated at a point in time by multiplying its share price by the number of shares of common stock outstanding. The share price is determined in the public marketplace by buyers and sellers who trade the stock.

Buyers of publicly traded company shares, such as the medical IT outsourcing firm, Superior Consultant Company, Inc. (NASD-SUPC), expend money now (invest) for the right to receive uncertain future economic benefits. The price (value) an investor pays for a share is based upon his or her assessment of the size, timing and certainty of receiving future economic benefits. Likewise, a seller of SUPC equity is willing to forego his or her expectation of future economic benefits if the investor believes that the benefits given up are worth less than the proceeds (value) from selling the ownership position. Thus, the share price of SUPC at a given point in time represents the value of future economic benefits as perceived by buyers and sellers of SUPC equity at a point in time. This value is observable through transactions in the marketplace.

The Private Valuation Process

Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.

IRS Revenue Ruling 59-60

In contrast to the above, closely held businesses, such as medical practices, clinics, surgery and wound care centers also produce economic benefits for their owners but the value of those companies cannot be directly observed by activity in traded markets. And so, valuation professions estimate value by applying valuation theory. The value of financial assets, whether traded or not is generally based upon the following:

- The level of expected distributable future cash flows
- The timing of those expected distributable cash flows
- The uncertainty in receiving expected future cash flows

Valuing your medical practice will require consideration of many other factors that influence value. A thorough valuation analysis will include a study of the economics of the health care industry, reimbursement trends, competitive market conditions, historical earnings trends, as well as management experience. These factors, collectively considered, influence the future prospects of your medical practice and, ultimately, its estimate of value as a going concern.

The appraiser will want to gain an understanding of the history of your practice, its operations, and local competition and payer contracting issues. The business and management fundamentals studied are patient retention and potential for new patient growth, providing services efficiently and cost effectively, timely collections for services, and maintaining competitive equipment and facilities.

After the need for an independent valuation is determined, here is what you can expect:

- Who pays the bill? An independent valuation appraiser may be engaged by the buyer, or seller or, in some cases jointly by both buyer and seller.
- Make sure the appraiser understands the health care industry and most importantly, educates both the buyer and seller in the conduct of an appraisal. All too often, values are misunderstood and may result in deals unnecessarily falling apart.
- The appraiser will request financial information, operating statistics, and other information in advance of a site visit.
- The appraiser should visit your medical practice to conduct key interviews and review the physical condition of the facilities and medical equipment.
- The appraiser will review historical practice patterns, financial and operating performance as a basis for forecasting future operations.
- The appraiser will adjust, or *normalize* historical financial data to eliminate one-time, non-recurring expenses, adjust for excessive or below normal expenses, and eliminate expenses not expected to be a part of future practice costs. The rationale for adjusting practice costs is to estimate the fair market value price of the business that is transferable.
- The appraiser should work with you to assist with the development of key assumptions concerning future reimbursement trends, physician productivity, practice cost structure, and physician compensation for use in financial projections.
- The appraiser should review valuation assumptions and forecasts with you.

Approaches to Medical Practice Value

As discussed earlier, industry regulations will govern how a deal will be structured, what medical practice assets can be acquired, which in turn will determine what assets require appraisal and what appraisal methods should be applied.

In most cases, a significant amount of practice value lies in the business operations as opposed to the physical assets. The value of a going concern medical practice is directly linked to the value of the practice's ability to generate economic benefits to its owners, as measured by future cash flows. As a result, the development of a reasonable forecast of future operations is crucial to determining a meaningful practice value. And, the three valuation approaches will be discussed.

Income Approach

Since medical practice value correlates directly with the measurement of economic benefits to owners, earnings or cash flow methods are the best tools for estimating practice value.

Capitalization of (Excess) Earnings Method

The *Excess Earnings method* estimates or adjusts value by dividing normalized historical or current earnings by an appropriate rate of return for the buyer.

Net Income Statement Adjustments

When analyzing a set of financial statements adjustments are generally needed in order to produce a clearer picture of likely future income and distributable cash flow. This normalization process usually consists of three types of adjustments to a medical practice's net income (profit and loss) statement.

1. Non-Recurring Items

Estimates of future distributable cash flow should exclude non-recurring items. Proceeds from the settlement of litigation, one-time gains/losses from the selling of assets or equipment, and large write-offs that are not expected to reoccur each represent potential non-recurring items. The impact of non-recurring events should be removed from the practice's financial statements in order to produce a clearer picture of likely future income and cash flow.

2. Perquisites

The buyer of a medical practice may plan to spend more or less than the current doctor-owner for physician executive compensation, travel and entertainment expenses, and other perquisites of current management. When determining future distributable cash flow, income adjustments to the current level of expenditures should be made for these items.

3. Non-Cash Expenses

Depreciation expense, amortization expense, and bad debt expense are all non-cash items which impact reported profitability. When determining distributable cash flow the link between non-cash expenses and expected cash expenditures must be analyzed.

For example, annual depreciation expense is a proxy for likely capital expenditures over time. When capital expenditures and depreciation are not similar over time an adjustment to expected cash flow is necessary. For example, a practice may have radiographic equipment with a useful life of fourteen years that are depreciated over seven years for tax and financial reporting. Depreciation expense will likely overstate the funds needed to maintain the equipment as the useful life exceeds the depreciable life and distributable cash flow. In determining distributable cash flow one must add back the annual non-cash depreciation expense and subtract an estimate of funds needed to fund medical equipment replacement. In this way the cash flow available for distribution to owners will be more properly stated.

Some practices reduce income through the use of bad debt expense rather than direct write-offs. Bad-debt expense is a non-cash expense that represents an estimate of the dollar volume of write-offs that are likely to occur during a year. If bad debt expense is understated practice profitability will be overstated. A close examination of accounts receivable to see if any past due accounts need to be written off is generally part of the due diligence a buyer of a practice will undertake. The calculation of distributable cash flow avoids this problem as the actual monies received from patients, and payers, rather than the revenue generated by patients is measured.

Balance Sheet Adjustments

Adjustments can also be made to a practice's balance sheet to remove non-operating assets and liabilities and to restate asset and liability value at market rates, rather than cost rates. Assets and liabilities that are unrelated to the core practice being valued should be added to or subtracted from value depending on whether they are acquired by the buyer.

Examples include, the asset value less outstanding debt of a vacant parcel of land, and marketable securities that are not needed to operate the practice. Other non-operating assets such as the cash surrender value of officer life insurance are generally liquidated by the seller and are not part of the business transaction.

Thus, CEM can provide a reasonable estimate of practice value in situations where limited information is available, or when the practice is likely to maintain stable cash flows. The main advantage of this method is it does not require assumptions regarding future forecasted operations for the medical practice.

Discounted Cash Flow (DCF) Method

The *Discounted Cash Flow (DCF)* method is favored by the IRS and is considered more relevant given the changing nature of the healthcare. The DCF is a sophisticated analysis requiring assumptions of forecasted practice operations regarding future reimbursements and physician productivity, practice efficiencies and competitive market conditions. An estimate of practice value is developed by discounting future net cash flows to their present worth based on market rates of return required by an investor physician.

In other words, the discounting process converts future expected distributable cash flows to arrive at their present value, according to several core valuation principles.

- The discounting process is one of converting expected future practice cash flows into a present value.
- The value of an investment is based upon the level of expected future practice cash flows, the timing of those cash flows and the risk or uncertainty attached to those cash flows.
- The discount rate represents the purchaser's (investor's) required rate of return.
- The discount rate or required rate of return is based upon a purchaser's (investor's) other opportunities to invest in alternative investments whose cash flows have similar risk and duration.

Thus, the value of your medical practice is primarily dependent upon future practice earnings that will provide an adequate return on an investment for the buyer. An informed buyer will not pay more than the present value of all anticipated future economic benefits of ownership. Supportable practice values are entirely dependent on realistic financial and operating assumptions about future practice operations.

Key DCF Assumptions

A DCF analysis includes a financial forecast projecting net cash flows for the business operations for usually a period of three-five years or until the practice achieves stable operations. In estimating practice value, key variables and assumptions used can have a significant impact to your value. The key DCF elements include:

1. Reasonable supportable projections of future practice revenues based on historical practice patterns and with consideration of future physician productivity, reimbursement trends and shifts in payer mix.

2. Reasonable supportable projections of future practice cost structure based on expected normal levels of practice expenses.
3. Projected physician compensation based on market rates for physicians with comparable age, experience and productivity.
4. DCF model calculates after-tax cash flows regardless of the tax status of the buyer. The tax rate is based on a blend of federal and state rates.
5. Reinvestment in the business are necessary for funding working capital needs and capital expenditure requirements to replace and acquire new equipment or other medical assets.
6. Terminal value represents the going concern value at the end of the projection period. Stated another way, it is a residual value for the expected remaining practice value at the end of the forecast period.
7. Discount rate is applied to the future net cash flows to arrive at the present (cash equivalent) value for the medical practice. The discount rate must be based on the industry's weighted average cost of capital that takes into consideration the specific risks for the practice.

The DCF analysis consistently produces higher values than other methods of estimating practice value because there may be supportable reasons to forecast improvements in future practice performance. Understanding the key DCF variables and assumptions used in the income method will assist in producing a meaningful estimate of practice value.

Determining the Required Rate of Return for DCFA

A physician's required rate of return takes into account that monies received sooner have a greater value than those received later, the greater the risk in receiving future cash flows the lower their current value and one must always keep in mind returns that can be earned on alternative investments.

The process of selecting an appropriate required rate of return begins with an assumption that all investors will require, at a minimum, the risk-less rate of return offered by government securities. Government securities with maturity similar to that of the duration of the investment in a private company are selected, and normally, a duration of ten to twenty years is used. Because of the minimal default risk associated with government securities, the rate is referred to as the risk free rate.

Physician investors typically require returns greater than the risk free rate. The additional return (in excess of the risk free rate) is called the risk premium. Risk premiums are generally calculated through an analysis of historically realized rates of return segmented by varying levels of risk. This analysis illustrates that higher historical rates of return occur in situations of higher risk. For example, securities issued by the U.S. government have lower rates of return than securities issued by large corporations. Returns on the equity of large corporations are greater than those of debt securities issued by the same firms. Thus, historical rates of return are generally used as a proxy for future required rates of return.

When valuing a practice one must compare the risk of the expected cash flows of the firm being valued to the risk of the cash flows of publicly traded securities and to determine an appropriate required rate of return based on that assessment.

It is generally assumed that the expected cash flows from an investment in a closely held business are at least as risky as those of large publicly traded firms. The combination of the large firm equity risk premium and the riskless rate of return provide an indication of the required rate of return for an investor in a large public firm. Beyond that, additional risk premiums related to firm size, proportion of debt, and industry conditions, and many other possible company specific risk factors may be appropriate. When valuing a small medical practice, appraisers generally employ required rates of return 15 percent to 25 percent beyond the current long-term risk free rate. However, this rate may vary greatly.

Market Transaction Approach

The market transaction method is a useful gauge in setting a valuation bottom and top range for comparison with the income approach. Market multiples are ratios developed by correlating market sale prices of guideline practices to key practice performance measurements. Common physician practice market multiples include comparisons of sale price to revenues, sale price to earnings before interest and taxes (EBIT), sale price to earnings before interest, taxes, and depreciation (EBITDA), and sale price to number of physicians.

Market transaction multiples are typically limited to serving as a benchmark for testing the reasonableness of the income approach. To apply the market approach, information on the guideline practices such as size of practice, specialty, number of physicians, growth potential, cost structure, payer mix and profitability are necessary for determining comparability to the medical practice being valued. Often, information concerning transaction specifics and practice particulars are either insufficient or not available for direct comparison with the practice being valued.

Cost Approach

The cost approach to estimating value calls for the identification and separate valuation of all the practice assets, including goodwill. Also referred to as "*Sum of the Assets*", this approach is more labor intensive and costly than using the business enterprise analysis to estimate practice value. Generally this approach is not very useful for estimating going concern value.

Although rarely used to estimate going concern value, another cost approach method may be used to estimate the costs that would be incurred to start-up a medical practice and develop to the current level of practice operations. The costs of establishing a new medical practice typically include the expenses involved in the recruitment of physicians, acquisition of space, office furnishings, patient treatment equipment, computer software, and medical records; advertising for staff; and losses incurred during the start-up period.

This estimate of “*replacement cost or cost avoidance*” value represents an upper limit (or ceiling) of value. It has limited use as an accounting artifice, and no prudent buyer would pay for an existing medical practice a price equivalent to what it would cost to build and develop a new medical practice.

The most appropriate application of the cost approach involves the valuation of medical practice tangible assets. However, valuing only the tangible assets used in a profitable, medical practice is not representative of the business value of the company. Since the intangible assets typically represent a significant portion of practice value, the cost approach is generally not considered useful in estimating the value of a going concern medical practice.

Understanding Corporate Deals Structure

Although now less common than a few years ago, corporate deal structures often acquire substantially all of a medical practice’s assets, excluding the working capital, and then enter into employment agreements with its physicians. In this scenario, the selling physician is left with the accounts receivable, cash, and the practice liabilities. Most of these asset purchases are cash deals. When the sale price is based on an enterprise value, this usually provides the physician with the ability to settle the practice debt.

Stock Purchase v. Asset Purchase

There will be some variation in appraisal methods dependent on whether the transaction is structured as a stock purchase or an asset purchase. Due to corporate practice of medicine laws in some states and desires of buyers not to assume practice liabilities, most practice acquisitions are structured as asset purchases. In an asset transaction, the buyer will receive a tax amortization benefit associated with the intangible value of the business. This tax amortization represents a non-cash expense benefiting the buyer. In this case, the present value of those future tax benefits **is additive** to the business enterprise value.

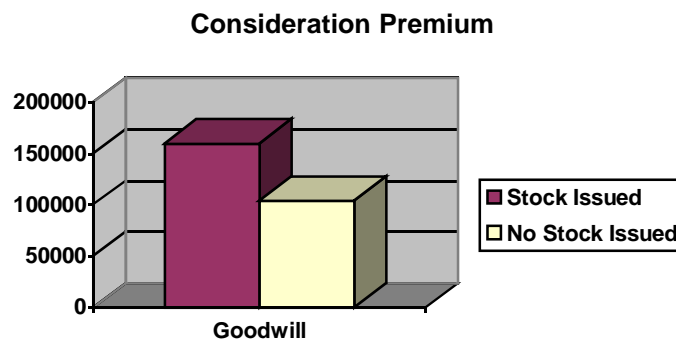
Corporate Partner Transactions

PPMCs historically acquired medical practice assets, excluding real estate, and entered into *management service agreement (MSA)* with physicians. There were a myriad of MSAs involving fees based on a percentage of revenue, compensation based on a percentage of practice profits, and some fee arrangements that varied with managed care enrollment levels. The negotiated MSA fee depended on the scope and level of services provided, such as practice management, administrative services, contract negotiations, and marketing. The past market of a few years ago saw fees drop to 5%- 18% of relevant revenues, dependent on the level and menu of services provided. MSAs are now no longer in vogue, except for very large corporations and health systems.

Practice management agreements with physician organizations are coming under closer scrutiny as well, particularly when the agreements are fee-based revenue arrangements for management services. The *OIG* is concerned when compensation arrangements for management services based on a percentage of net revenues include business from managed care contracts arranged by the PPMC. The *OIG* may imply such activities implicate *Anti-Kickback* because the compensation will, in part, be for marketing services.

Market uncertainties since 1998 have resulted in downward pressure on prices paid for physician groups by physician practice management companies. It has been estimated that prices for multi-specialty groups fell by as much as 25% in 1998, even more in 1999 and 2000.

For example, in 1998 some PPMCs paid as high as 8 to 10 times EBIT to secure a strategic practice. Since the industry fallout however, those sale prices have fallen to a range of 2 to 4 times EBIT, or lower. The deals usually involve a combination of cash, common stock, notes receivable, and possibly assumption of liabilities. When common stock is used as payment, considerable premiums are included in the sale price to compensate for the risk of receiving stock instead of cash. The use of equity adds a premium of as much as 50% or more to the sale price.



Source: Adapted from CHIPS, 2002

Restrictive Covenant Value is Goodwill

Restrictive covenants for physicians usually involve covenants not-to-compete related to the sale of a medical practice or other assets. The value of covenant-not-to-compete lies in the protection it affords the buyer from potential loss of income due to competition from the selling physicians.

To estimate the value of a covenant-not-to-compete, the income approach is considered to be the most appropriate method. The cost to secure the agreement is irrelevant to the value of the protection afforded the buyer. The sales comparison approach requires sales of similar or like assets; because each medical practice is unique and public data are unavailable for transactions of physician's non-compete agreements, the sales comparison approach is not useful. Generally, an income approach includes the value associated with a non-compete agreement as part of the intangible asset value. As such, the non-compete agreement value is **not additive** to your business enterprise practice value. Instead, it is a component of practice goodwill, which can be separately valued if desired.

Buyer Mistakes (“Caveat Emptor”)

Significant federal funding has been provided targeting physician transactions with penalties potentially imposed on both the physician and individuals in the acquiring organizations. Recently, there were several federal investigations of for-profit hospital systems alleging those systems deliberately overpaid for physician practices as inducement to receive patient referrals (a violation of the anti-kickback statute). When selling your practice beware of the following buyer blunders:

- **No Outside Appraisal Performed**
If the buyer is a tax-exempt entity or participates in federal healthcare programs **...Get an independent third-party valuation from a qualified appraiser...** There are too many stories of hospitals and health systems that bought practices with no appraisal. **BIG MISTAKE!**
- **Overpaying Physician Practice Value**
Some buyers obtain a business enterprise value, and will also obtain separate values for the medical equipment and non-compete agreements. These values can be useful in allocating the overall purchase price. The business enterprise value, however, represents an estimate for a 100% ownership interest in the medical practice. The separate values for the assets are **not additive** to the business enterprise value, but rather are components of the total value of the business. Some buyers have overpaid for physician practices by adding these separate asset values to the overall business enterprise value to determine the sale price. **BIG MISTAKE!** Not understanding values can be misconstrued as overpaying in exchange for patient referrals.

- **Overpaying for Physician Compensation**
Industry surveys have reported that more than 75% of practices acquired fall short of projected productivity used in the valuation. This fact coupled with exposure to IRS audit and intermediate sanctions has increased the need to value practices based on reasonable appropriate projections of practice collections and market rates for physician compensation.
- **Not Buying Insurance on the Physician**
Much of the value to an investor rests with the physician's skill and talent to remain with the practice after acquisition. The buyer expects to achieve a return on the investment in the medical practice based on future cash flows and to eventually recoup the purchase price. Since most practice acquisitions are cash deals, the buyer is at significant financial risk due to a business interruption associated with an unexpected loss of life or permanent disability.

Finding Qualified Medical Practice Appraisers

Finding a qualified medical practice appraiser is not always an easy task. Your office accountant or a general business valuation expert may not be familiar with the current managed care environment, nor the specifics of your medical specialty. So, consider the following guidelines:

- Make sure appraisers use generally accepted IRS methods and have a proven track record with the government for medical appraisals.
- Make sure the valuation is written, substantiates medical practice value, provide detail to support conclusions, and is signed by the appraiser.
- Avoid conflict of interest or self-dealings. Seek an unbiased and independent viewpoint.
- Make sure the appraiser will qualify as an expert witness and is presentable on the witness stand, if needed.
- Request references and examples for previous medical practice appraisals.
- Inquire about experience in publishing, speaking and teaching medical practice valuations techniques.

Organizations that accredit business, but not necessarily medical practice appraisers, include:

- Institute of Business Appraisers: (www.go-iba.org), awarding the certifications of Certified Business Appraiser (CBA), Master Certified Business Appraiser (MCBA), and Business Valuators Accredited in Valuation (BVAL).
- National Association of Certified Valuation Analysts (www.nacva.com), awarding the designations of Certified Valuation Analysts (CVA), Accredited Valuation Analyst (AVA) and Certified Forensic Financial Analyst (CFA).
- American Society of Appraisers (www.appraisers.org) offers the ASA (American Society of Appraisers) designation for business appraisers.
- American Institute of Certified Public Accountants (www.aicpa.org), providing the Accredited Business Valuation (ABV) for CPAs, only.

Since some appraisers feel that certain organizations set the bar for certification significantly higher than others, the ASA website at www.apriasers.org offers a comparison of the accreditation criteria required by all four major organization.

Well-known medical practice and healthcare system appraisers include the big 10 consulting firms for larger healthcare organizations. The impression that “bigger is not always better” may be confirmed by the Arthur Andersen debacle.

Medical practice niche players include Health Capital Consultants, Inc., (www.healthcapital.com) who provide medium sized practice valuations, software and Certificate of Need (CON) economic determinations. And, the Institute of Medial Business Advisors Inc, specializes in small practice valuations, and confers the designation Certified Medical Planner© (CMP©), on its related independent consultants and advisors (www.MedicalBusinessAdvisors.com).

How Much Money is Your Medical Practice Really Worth?

Now that you have a background of what factors influence value, needs for valuation, a general understanding of appraisal theory and how industry regulations impact value, the valuation process and methodologies employed, we get to the heart of the matter.

Understanding Your Value

Understanding value is crucial to a successful negotiation. Both buyers and sellers too often misinterpret the value conclusions of appraisers straining buyer/seller relationships and unnecessarily jeopardizing deals.

How to Maximize Medical Practice Value

There are a few critical areas you can review for opportunities to maximize your practice value.

- Use the DCF method to estimate practice value. This method consistently produces higher values than others, but recall the USPAP edicts.

Practice Revenue:

- Can the practice and local market support adding additional providers such as physicians or mid-level providers? Providers usually take two to three years to ramp up their practice before they begin to significantly contribute to the bottom line. Generally, adding a mid-level provider will produce a greater impact to value, as their compensation levels are lower than physicians.
- What future provider productivity is expected?
- Does the practice plan to offer new services?
- Is the current practice fee schedule at market rates? Is there an opportunity for fee increases?
- Is there an opportunity to improve payer mix?

Review Practice Costs:

- Eliminate any unnecessary practice expenses. Identify any unusual, non-recurring costs.
- Eliminate any physician-related costs not likely to be paid by a buyer.
- Eliminate any special perks of business ownership.
- Adjust for any over-inflated salaries of relatives and eliminate any unnecessary salaries.

Physician Compensation Inverse Relationship to Value:

- Although physician compensation must be based on market rates, fair market value is a range. Practice value correlates directly with the net cash flows available after all practice expenses including physician compensation. As a consequence, the higher the compensation the lower the practice value, and conversely, the lower the compensation the higher the practice value. As little as a \$10,000 swing in salary can have significant impact to value, and as physician compensation rises, practice value falls.

Completing the Transaction

Depending on whether the likely buyer is a health system or a corporate partner, the deal structures will vary. From the physician's perspective, deal negotiations are based on consideration of personal and financial planning goals. Some of the key negotiations considered in the "art of the deal" include:

Working Capital – In or Out

Including working capital in the transaction will increase the sale price.

Stock versus Asset Transaction

Structuring the deal as an asset purchase will increase practice value due to the tax amortization benefits received by the buyer for intangible assets of the practice.

Common Stock Premium

The sale price can be as high as 50% more than a cash equivalent price for accepting the risk of common stock as part of the payment.

Physician Compensation

If your personal financing planning goals are to maximize practice value, negotiating a lower salary within a range you feel comfortable with will increase the sale price.

Understanding Private Deal Structure

Now, assuming a practice sale is a private transaction, deal negotiations are based on the following discount and premium, pricing methodologies, as presented below:

Seller Financing

Many transactions involve an earn-out arrangement where the buyer puts money down and pays the balance under a formula based on future revenues, or gives the seller a promissory note under similar terms. Seller financing decreases a buyer's risks, the longer the terms, the lower the risk. Longer terms demand premiums, while shorter terms demand discounts. Premiums that buyers pay for a typical seller-financed practice are usually more than what you would expect from a simple time value of money calculation, as a result of buyer risk reduction from paying over time, rather than up front with a bank loan, or all cash.

Down Payment

The average down payment for a modest solo medical practice is about 20-25%. This increases the buyer's risk, the greater the amount, the greater the risk. Consequently, sellers who will take less money up front can command a higher than average price for their practice, while sellers who want more down usually receive less in the end.

Seller Involvement

The key to practice purchase success boils down to how many of the selling doctor's patients, and managed care contracts, can be transferred to the new doctor, owner. The most important factor in transitioning patients is the involvement of the selling doctor. The system of seller financing and earn out arrangements can work well if the seller continues to be involved in the practice, and can create an incentive for the seller to make the transaction work. Sellers typically remain at least for six months, and usually for not more than a year, to ensure a seamless transaction. When a deal fails, it is usually due to lack of seller commitment.

Location

Variations between the value of a practice in a major metropolitan city and one in a small town can be as much as 20%, just for the location. Usually, practices in a small town have a larger, but less affluent basis. Managed care penetration is another factor to consider.

Profit Margin

Determining medical practice profitability is distinctly different from determining a practice's value. It is not unusual for selling doctors to run every expense imaginable through their practices, in order to reduce profit and hence, taxes. In many cases however, a practice with high overhead can be sold for the same price as one with low overhead, because all expenses are not transferable, as we have seen when the NIS becomes normalized.

Taxation

Tax consequences can have a major impact on the price of a medical practice. For instance, a seller who obtains the majority of the sales price as capital gains, can often afford to sell for a much lower price, and still pocket as much or more than if the sales price was paid as ordinary income. In a usual deal structure, 70% of price value is in the seller's patient list, medical records, name brand, good will and files, all of which qualify for capital gains treatment. Then 20% is paid for the selling doctor's continuing assistance after the sale, and 10% goes to a non-compete agreement, both of which are taxed at ordinary income. But, a buyer willing to allocate more for items with capital gains treatment, or a seller willing to take more in ordinary income, can frequently negotiate a better price.

CONCLUSION

The above discussion solidly presents the reasons for, and methodology behind, acquiring a professional appraisal when contemplating the sale, purchase or merger of any medical practice.

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THE END

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