Valuation of a Medical Practice
Need for a Valuation

- Practice Sale
  - To another physician
  - Acquisition by a hospital
  - Acquisition by other entity

- Retirement/Withdrawal
  - Buy/sell agreements
  - Buy out value based on FMV
  - Appraisal vs. formula methodology
Need for a Valuation

- **Divorce**
  - Refer to all related state law
  - Refer to all related state case law

- **Merger**
  - Distribution of initial equity interests
  - Distribution of sales proceeds
Need for a Valuation

- New Owner Buy-In
  - If buy-in will be based on FMV
  - Formula approach?
  - Structuring the buy-in
  - Tax reporting issues

- Litigation
Key Point #1

The "strength" of the practice's income stream and what it produces for the owner(s) is what creates true value in a medical practice.
The key to a successful valuation is deciding whether or not the practice's future income stream will mirror its present income stream.
Regulatory Issues Impacting the Valuation Process
Regulatory Issues

- Medicare Fraud and Abuse
  - Known as the "anti-kickback law"
  - Prohibits payments, offers, or inducements of any remuneration for referrals
  - Issue: If acquisition price exceeds FMV, transaction may be considered a remuneration for referrals
    » Generally applies to hospital acquisition transactions
Regulatory Issues

- Stark II self referral law
  - Prohibits physicians from making referrals for designated health services,
  - If a financial relationship exists between the physician and the entity to which he or she is referring
  - Stark definition of FMV
Defining Fair Market Value

Stark II regulations states, as follows:

- “Fair market value means the value in arm’s length transactions, consistent with the general market value. “General market value” means the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement. Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals.” (Federal Register, Vol. 69, No. 59, March 26, 2004, page 16128)

Valuation Note: This may restrict and prevent the use of certain market comps
Defining Commercial Reasonableness

Stark I regulations states, as follows:

- “With respect to determining what is “commercially reasonable,” any reasonable method of valuation is acceptable, and the determination should be based upon the specific business in which the parties are involved, not business in general. In addition, we strongly suggest that the parties maintain good documentation supporting valuation.” (Federal Register, Vol. 66, No. 3, January 4, 2001, page 919)

Also, Stark II regulations state the following:

- “An arrangement will be considered “commercially reasonable” in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential DHS referrals.” (Federal Register, Vol. 69, No. 59, March 26, 2004, page 16093)

- Valuation Note: Just because a transaction may be “fair market value” does not necessarily make it “commercially reasonable”
Regulatory Issues

- Private Inurement
  - Applies to tax exempt hospitals - section 501 (c) (3)
  - Defined: No part of a hospital's net earnings may inure to the benefit of any private individual
  - Issue: Sales price in excess of FMV
KEY Factors

Impacting the Valuation of a Medical Practice
Key Factors

- Revenue and Cost
  - Revenues
    » Increasing or declining?
    » Which year(s) to include in the valuation?
    » Where did the revenues come from?
      - Ongoing revenues?
        - If owner(s) stays
        - If owner(s) leaves
      - One-time revenues?
Key Factors

- Revenue and Cost
  - Revenues (continued)
    » Revenue adjustments: Teaching, subsidies, Drug studies, medical directorship, special service revenues
    » Look for missing revenues
      - Poor fee schedule
      - Poor coding practices
      - Poor billing and collection activities
Key Factors

- Revenue and Cost
  - Costs
    » Comparable to similar practices
    - Adjust to reasonable cost structure if necessary
    - Look for subsidies that will end (continued)
    » Look for excess doctor-related costs that are in reality disguised compensation
    » Make using normalization adjustments
Key Factors

- Costs to pay attention to:
  - Salary costs
  - Physician direct expenses (Travel, CME)
  - Expiring leases
  - One-time costs
  - Adding costs as projected revenues grow
Key Factors

Medical Specialty
- Impacts future reimbursement patterns
- Identify common patients seen and their related insurance structure
- Impacts determination of discount/capitalization rate
  » Adjustment for “reimbursement risk”
  » Impact on discounted future cash flow method
Key Factors

- **Referral Sources**
  - Applies to medical specialists
  - Issue: Will these referrals continue into the future uninterrupted?
    - Obtain and analyze referring doctor report
    - Analyze ages of the referring doctors
    - Identify recent changes to referral patterns
  - Impacts discount/capitalization rate
Key Factors

- **Payer Mix**
  - Has direct impact on revenue stream
    - Impacts what the practice is paid for the services it renders
  - Identify recent changes to practice payer mix
    - Ex. Growth in managed care and Medicare
  - Anticipate future changes in payer mix
  - Impacts reimbursement risk & revenue projection
Key Factors

- **Service Mix**
  - Identify how the practice generates its revenues
    - Obtain and analyze CPT Frequency Report
  - Issue: Will these same services continue if there is a change in practice ownership?
  - Impacts future income stream determination and related risks
Key Factors

- **Patient Demographics**
  - Identify demographics of practice patients
  - Issue: Will these demographics change in the near future
    - Move to a different a payer class which pays more or less
    - Ex. Patients moving into the Medicare program
  - Impacts discount/capitalization rate
  - Might impact revenue growth projection
Key Factors

- **Future Changes to Reimbursement**
  - Has direct impact on income stream
  - Issue: Continued payer changes in reimbursement rates
    - Medicare
    - Managed Care
  - Impacts discount/capitalization rate
  - Impacts future earnings projection
Key Factors

- Practice Transition
  - Issue: Will the current owner(s) be available to assist in the transition to the new owner?
    - If yes, can expect to maintain revenues
    - If no, anticipate a drop in patient volumes or referrals
  - Generally want a transition period of 6 mo.
Key Factors

- **Competition**
  - Issue: Are there, or will there be, competitors that will, or can, take patients away from the practice now and in the future?
  - Is a practice “risky” if it doesn’t have competition?
Review Data Gathering Checklist
Discount and Capitalization Rates
To "capitalize" means to convert the income stream into an indication of value by dividing or multiplying the selected definition of the stream by some factor, called a capitalization rate. Is derived from the discount rate.
Discount Rate

- A discount rate represents the total expected rate of return (stated as a percentage) that a buyer (or investor) would demand on the purchase price of an ownership interest in an asset (such as U.S. Treasury bills) given the level of risk inherent in that ownership interest.
- Discount rate is used to derive present value factors which are used to discount a future benefit stream to a present value.
Discount Rate

- Often calculated as the sum of (a) the "safe rate," (b) equity risk premium, (c) risk premium for size, and (d) a premium for the amount of risk involved in the investment.

- Safe rate is intended to represent the annual rate of return currently available from investments offering maximum security (and thus the lowest risk), and the highest degree of liquidity.
Discount Rate

- The equity risk premium is the extra return earned by an average equity investor in excess of long-term Treasury securities.

- There is obviously more risk associated with a smaller business than a major S&P 500 company; thus, everything else being equal, investors in a smaller business will demand a higher rate of return; this is the risk premium for size.

- The risk premium should take into account the (a) the risk that the predicated amount of future income from the investment will not actually be realized, and (b) risk of future loss, through unforeseen circumstances, of part of all of the principal amount invested.
Target the Following Practice Risks

- Competition risk
  - Number of competitors is growing

- Reimbursement risk
  - Evidence of changes to current reimbursement rates and related future trends

- Market risk
  - Evidence of changes to payer classes

- Ability to recruit physicians to practice
Concept of Practice "Earnings"

Practice revenues $xxx,xxx
Less adjustments $xxx,xxx
  Adjusted revenues $xxx,xxx
Practice overhead $xxx,xxx
Less adjustments $xxx,xxx
  Adjusted overhead $xxx,xxx
Adjusted net income $xxx,xxx
Add: Owner compensation $zzz,zzz
Subtract: Replacement compensation $zzz,zzz
Equals: “Earnings” $xxx,xxx
Earnings Surveys For Replacement Compensation

- MGMA Physician Compensation Survey
- MGMA Cost and Productivity Report
- American Medical Group Practice Association
- Modern Healthcare's Physician Compensation Report
- Issue: Post-acquisition compensation – how to handle
Valuation Methods

- Income Approach
  - Capitalization of earnings
  - Discounted future cash flow (income approach)
- Asset Approach
- Market Approach
  - Guideline Company
  - Comparable Sales
Methodology Issues

Discounted Cash Flow

– How to model future years
  » Detail out revenues and expenses with adjustments
  » Summary approach
  » Growth rate to use

– Anticipating capital expenditures
Methodology Issues

- Discounted Cash Flow (continued)
  - How to calculate working capital needs
  - Terminal year growth rate?
  - What is and is not included in the calculated value
  - How is real estate handled?

- Market Approach
  - Is there really one for medical practices?
Common Valuation Problems Encountered

- The doctor that does not work hard
- Overcoding
- There are no “earnings”
- Tax affecting an S corp, non-profit, or a partnership
- In a big group practice, some doctors create “earnings” while others do not
Questions

Answers
Valuation of a Medical Practice