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FAIR VALUE™

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Medical Practice Sales To Hospitals: A Valuation Minefield - Part II

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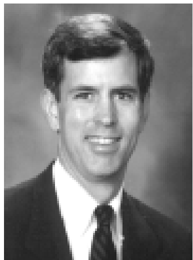
Overview. The March 1994, issue of *Fair Value* addressed the significant unresolved tax related valuation issues raised in the sale of medical practices to hospitals and the rapid pace of medical practice sales to hospitals that is occurring. In this and subsequent issues we will switch gears to address some of the many specific factors that are considered in the valuation of a practice. In this article, we will give an overview of the initial valuation information gathering to give insight into the degree of detail that must be explored to properly value the practice. In the upcoming September and December issues we will address how many of these factors actually affect values and the methodologies used in practice valuations.



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Importance of a Practice Valuation. Since valuations are being widely used by hospitals in helping set purchase prices for practices, it is essential that hospital chief executives insure that the valuations are properly and thoroughly prepared. Additionally, if medical practice purchases are poorly conceived and handled, they can negatively affect hospital-physician relationships and morale for years to come. Both the hospital and the selling practice must be convinced that the practice valuation was fair, unbiased and thorough, leading to a "win-win" for all parties involved.

Initial Information Gathering. The appraiser's first step is to provide the practice's managing physician with a complete list of initial information needs to prepare for the first meeting. The purpose of this effort, and ultimately the valuation itself, is to identify the risks and opportunities facing the specific practice which ultimately enter into an assessment of earnings capacity, return on investment and value. Although the actual list of information needs can run to 10 or more pages, and the issues will vary substantially by the size, complexity and specifics of the practice, these needs can be grouped into the following broad categories that will be discussed:

1) Financial- This includes items such as 5 years of practice financial statements and tax returns, accounts receivable and payable agings, fixed asset breakdowns & depreciation schedules and compensation by physician (5 years). This and other data will then be analyzed to determine underlying positive and negative trends, compare performance with peer medical practices nationwide, examine financial strengths and weaknesses and gain insight into the investment attributes of the practice. This analysis assists in determining the relative value afforded a purchaser of the practice, the financial returns from doing so and some of the associated financial risks.

2) Physician Data- It has been said in a medical practice that *"the inventory walks out the door every night;"* the physicians without whom the practice would not exist. Therefore, the business appraiser gains a detailed appreciation of the practice's physicians that make it all tick. Information gathered might include items resumes of all physicians, including ages, education, honors, positions held at hospitals, hospital privileges, health, key roles in the practice and local reputations. This and other questions will provide essential information as to what makes the practice successful and if so, the attributes that lead to the

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creation of goodwill, a factor which must be proven to exist if a part of the purchase price is for goodwill;

3) Physician Compensation- Detailed by physician, compensation components could include base salary, bonuses, profit sharing, deferred compensation and other benefits, such as cars, life or disability insurance and travel allowances. An important issue is how compensation is set, including the use of any performance based formulas, seniority structures and other similar arrangements and any special pay arrangements for roles performed for the practice. This would also include examining any employment contracts and covenants-not-to-compete.

Pay is an important valuation issue in terms of making adjustments to the practice income to be capitalized. But compensation also has numerous practical ramifications and risks to the hospital suitor who must carefully devise a proposed post-transaction structure that one, keeps physicians happy without undermining morale, two, rewards performance, three, retains a return on the hospital's substantial investment, and, four, is acceptable to the IRS and other authorities. Although we do not deal with these issues except as they pertain to valuation, we strongly advise our valuation clients to engage skilled attorneys with health care expertise in the earliest stages of a possible acquisition because of the linkages and ramifications of each individual deal's steps.

An essential item is the estimate of average weekly hours worked by the physician, used later in making compensation adjustments for valuation purposes. If two physicians both make $300,000, one working the median for his or her specialty of 60 hours per week, while the second works 90 hours, the performance of the second may be due less to goodwill than sheer overwork and may not be sustainable without hiring an additional physician. Therefore, the valuation must consider the specifics of what enters into the ultimate compensation and make appropriate adjustments for valuation purposes.

4) Practice Ownership- A breakdown of the current share ownership is obtained, including details on past transactions in the shares and any physician buy-in arrangements. This should also include copies of any buy/sell, shareholders or other similar agreements.

Details on buy-in arrangements are important for several reasons. First, they may be indicative of one indication of a market value, and second, they are likely to be examined by the IRS and how they relate to the price ultimately paid for the practice. As discussed in the previous issue, the prices paid in these arrangements can be misleading as to the total implied price, as the physician often must work for three to five years as an employee, often at a below market compensation before being offered the buy-in price. Therefore, the totality of the implied price may need to be considered and calculated, including not only the cash price paid at the time of the buy-in, but potentially the present value of any foregone compensation leading up to the purchase.

5) Patient Census- This might include information such as the demographics (age, sex), average tenure with the practice, the rate of turnover, whether repeat or one-shot procedural in nature and any related trends over time. For example, if a family practice has an aging patient base, without new younger patients to replace them, ultimately the practice would be expected to see its revenues decline in the longer term. In the near term, however, the practice can actually benefit, as older patients are greater users of medical services.

One risk factor to a practice is having a large percentage of its patients work for one or several employers. Large companies increasingly entrust their employee's medical care to the lowest bidder. A practice with a meaningful percentage of its patients working for one or several companies could lose much of its patient base overnight as a result of better bid by a competing practice. Patients face a difficult choice between where their employer will pay for them to go, versus the doctor with whom their trust and loyalty rests.

6) Distribution By Pay Type- This involves providing a detailed breakdown of the practice's current and historic gross revenues by patient payor type, including private pay, insurance, HMO, PPOs, Medicare and Medicaid, indigent and other related arrangements.

The source of the practice's payments can have a major impact on both its current and future earnings outlook. Particularly important under the current environment is the nature of any contractual relationships, such as participation in managed care arrangements. With many of these agreements very recent in nature, it may be that the near and intermediate term earnings capacity of the practice may differ materially from that reflected in historic financial results;

7) Marketing Issues- Simply stated, this involves finding out the who, what, when, where, why and how of attracting patients to the practice. While many medical practices do not have a marketing plan, those that do will generally be better positioned to thrive in an increasingly competitive marketplace.

8) Dependencies on Referrals- If the practice

depends on referrals from other physicians, what percentage of patients come from what physicians? Will these referrals continue if the practice is sold? Have any of the referring physicians recently sold their firms to a competing hospital; if so, they may be unwilling such to refer to the practice if it falls into the hands of a competitor hospital. Are the referring physicians bidding for managed care contracts with other practices? If so, this may result in the termination of referral relationships with non-participating firms.

9) Contractual Issues- This is an increasingly important area, covering the various constituencies with whom the practice has contractual relationships and the possible future financial and risks ramifications of each on the practice. These relationships might be with physicians themselves, hospitals, insurers, practice management groups, billing services, related parties, employers and a whole host of other permutations too extensive to list here.

10) Related Party Transactions- This is a broad category and could include leasing of real property or medical equipment from the practice's physicians, interests in medical related entities and other situations. These should be explored to determine the impact on the practice and inquiries made as to whether these relationships are on an arms length basis, or if they are possibly in violation of any anti-kickback provisions or other laws.

11) Contingent and Other Liabilities- It is important to ascertain the valuation impacts of any pending or threatened lawsuits, including any malpractice claims, tax or regulatory problems, guarantees of any debt, leases or other obligations and so on. Often what never shows on the balance sheet can be just an important as what it lists.

Conclusion. This article has only been meant to provide a very limited glimpse into some of the many issues that might be considered in the information gathering process of a medical practice valuation. The actual valuation must be undertaken by highly skilled valuation professionals who go to great lengths to prepare a well documented, reasoned and unbiased valuation estimate, and which is effectively communicated in a manner which many constituencies can understand. The hospital, the selling physicians and the IRS all have acute interests in insuring that a reasonable and fair value is the end result. The consequences of haphazard work can be a transaction lost and morale and tax problems. While a well-prepared valuation is no guarantee that the results are problem-free, it is a tangible show of professionalism and good faith by the hospital in reaching a mutually satisfactory end result. ♦

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