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FAIR VALUE™

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Medical Practice Sales To Hospitals: A Valuation Minefield - Part III The Income Valuation Approach

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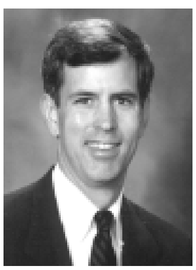
Introduction. The March and June issues of *Fair Value*™ outlined unresolved tax and regulatory issues associated with medical practice sales to hospitals and the information needs required to undertake the valuation. The thrust of this article is give the hospital chief executive, hospital board members and their legal advisors a greater appreciation of the income based valuation approach used in practice valuations.



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The need for a well prepared, unbiased valuation of the practice before negotiation or closure of a transaction is especially important in light of the recent revocation of a Florida hospital's tax exempt status resulting in part from overpayment for a practice. Additionally, new details regarding the Internal Revenue Service's views on appropriate valuation methodology and content are coming to light and are much more sophisticated and complex than previous revenue rulings for other tax related valuations. The IRS has a legitimate interest in insuring that practice transactions are for fair market value. Hospitals need to employ business appraisers who are familiar with and can fully comply with the Service's requirements and who will prepare sound and unbiased valuations.

Three Broad Classes of Valuation Approaches. There are three main classes of practice valuation approaches, summarized as follows:

- **Income approach-** This approach focuses on the value of the practice's income or cash flow. Whether based on actual historic results or future forecasts, value is based on the present value, today, of an anticipated future income stream. What is the value of what I am receiving as a return on my investment taking into account the risk and time value of money?

- **Market approach-** This approach examines the prices paid in the sales of similar practices and past transactions in the shares of the practice itself and what they imply about the current value of the practice.

- **Cost approach-** This gauges the market values of the practice's assets and liabilities. Since most practices typically have little more than accounts receivable and a modest amount of fixed assets, this approach might be of limited value.

Within each approach are specific valuation methods, each of which attacks value from a different vantage point. Due to space limitations this article will only address the income valuation approach.

Income Valuation Approach. In short, the income approach focuses on the value of the practice's total discretionary income streams or cash flows available to its physician shareholders (or the buyer). There are numerous methods within the income approach category which include the capitalization of earnings, excess earnings and discounted future income techniques. Additionally, the so-called "cost to create" variant can provide an alternative crosscheck of the alternative to purchase, the costs of starting a new practice.

The Value of Future Income. Whether historic or forecasted future results are used the bottom line is that all income methods are based on determining the present value of an *anticipated future income stream* to a buyer. Value is determined by discounting future income results back to a value today using a discount rate (an annual rate of return) that reflects risk and the time value of money. Income received each successive year into the future is worth less than if it had been received today (dollars received today could be re-invested), hence, the time value of money affects the value.

Risk Also Enters the Picture. If the risks associated with Practice A's income stream are less than those associated with Practice B, even though the both have the same predicted income streams, the buyer of Practice B will demand a higher annual rate of return. Thus the present value today of Practice B's same income streams will be lower than that of Practice A's. As will be shown later, determining the risk is a key part of the effort in valuing a practice.

Capitalization Methods. The capitalization of earnings is among the most common valuation methods. This technique arrives at a value by dividing the practice's income by a capitalization rate which incorporates both an investor's required annual rate of return for risk and a factor for future growth in earnings. Mathematically, the capitalization of income is a "single period" valuation technique that employs the following formula:

Formula for the use of the Capitalization of Income Method

$$\text{Value} = \frac{\text{Income Stream, Coming Year}}{(d-g)}$$

Where:

d= Required Annual Rate of Return For Risk

g= Annual Future Growth Rate

An Example Using the Capitalization of Earnings Method. Suppose Family Practice Associates (fictional) has annual income (after adjustments) for 1994 of $200,000. Further, income is expected to grow at a 3% annual rate in the future. After a full analysis of the practice the appraiser has estimates the annual rate of return required by a buyer for risk to be 28%. Therefore, the preliminary value of the practice by the capitalization of earnings method is $800,000, calculated as follows:

Calculating the Value of Family Practice Associates by the Capitalization of Earnings Method

Practice Income	Divided by: Capitalization Rate	Equals: Value Estimate
$200,000	0.25 (28%-3%)	$800,000

When one reads the stock pages and sees that a company's stock is selling for 20 times its per share earnings, if the future growth rate is assumed constant, this means that the market is capitalizing its earnings at 5% (the inverse of the price-earnings ratio). In our example above the implied price-earnings ratio is 4 times earnings (inverse of 25% cap rate).

Not the End of the Story. The cap rate we used was developed from market data on publicly traded stocks (small companies) which are minority interests with full marketability. Therefore, adjustments might be needed to reflect a premium for control (we're buying 100%) and illiquidity (lack of marketability). Additionally, other adjustments might come into play. For instance, if the hospital is not planning to purchase receivables then the practice value might need to be reduced to reflect additional working capital the hospital must infuse. Further, other "non-operating" assets and liabilities that the hospital might not wish to acquire (such as investment real estate) may also require adjustment.

That Sounds Easy. This sounds deceptively simple, but the key issues can vary materially from one practice to the next. The circumstances are never the same and the devil is often in the details. Take risk and the end result of a required rate of return as an example. After a detailed review of two family practices one might be so risky as to require a 70% annual rate of return while the other might require only 20% *even though both practices generate the* *same amount of income.* These two rates (adjusted for assumed growth of 3%) suggest that Family Practice Associates might be worth anywhere from $298,507 to $1,176,470, a wide range.

How does one know which rate (if either) to apply? The only way to determine the appropriate rate is to undertake a full study of the practice and to be attuned to current market conditions, not pull numbers out of the air. Additionally, the actual mechanics of estimating the capitalization rate are much more complex than this overview might suggest. And remember, they must withstand regulatory scrutiny.

Identifying Risk Factors Requires Diligent Effort. There are a wide variety of internal and external factors which affect practice risk and ultimately lead to the estimated required annual rate of return. The range of risk enhancing and risk mitigating factors are far too numerous to fully address here and will vary for each practice. The following brief summary illustrates some of the many areas that might be investigated:

- Specialty Issues
- Reputation Factors of Practice & Physicians
- Physician Compensation
- Patient Census & Related Information
- Number of Active Patient Charts
- Distribution by Pay Type & Related Trends
- Exposure To Medicare, Medicaid
- Procedures & Patient Events & Related Trends
- Marketing Considerations
- Patient Referral Sources
- Dependency On Employers, Payers, Insurers
- Competition
- Contractual Relationships With Payers, Hospitals, Employers
- Involvement In Managed Care Plans & Related Vulnerability
- Exposure to Capitated Payment Schemes & Related Financial Risk
- Employment Agreements, Covenants Not-To-Compete
- Practice Management Groups, Third Party Billing Services
- Leases of Real Property, Equipment
- Affiliated Entities, Such As Labs, Testing, Home Health Care
- Details On Any Loans Outstanding & Related Financial Risks
- Credit Availability, Terms, Collateral, Guarantees by Physicians
- Guarantees by Practice of Other Non-Practice Obligations of Any Kind
- Pending Or Threatened Litigation, History of Past Malpractice Claims & How the Frequency Compares To Peers
- Analysis of Financial Statement Trends, Condition, Risks
- Receivables Management
- Physician Productivity, Numbers of Patient Events & Procedures
- Impacts of Using Physician's Assistants & Family Nurse Practitioners
- Practice Overhead
- Gatekeeper roles In PPOs And HMOs
- Growth Constraints
- Health Care Outlook & Impacts of Reform
- Local Economy
- Worker's Compensation Claims
- Tax Problems
- Other "Off Balance Sheet" Liabilities

Clearly this is just a very limited snapshot of a very detailed analysis that must be undertaken. Every practice has its own unique risk factors that "quick and dirty" analyses will not adequately identify.

Income: That's Easy. Not so fast. What exactly is the practice income to be capitalized? Is it what is shown on the practice books? Physicians often do everything they can at year end (through salary, bonuses, profit sharing, prepayment of coming year expenses and delays of year end billings) to minimize the bottom line to legally reduce practice tax liability. Clearly this is not usually an accurate picture of the income generating capacity of the practice.

Factors That Can Impact Income to be Capitalized. Factors that impact the "income" to be capitalized might include items such as (just a sampling):

- What is the impact of converting the financials to an accrual rather than a cash basis?
- What adjustments are needed to eliminate unusual or non-recurring income and expense items?
- What will the physicians earn after the transaction as employees and what are the value implications? IRS and Medicare authorities are acutely interested in this issue and whether or not post transaction compensation

suggests that goodwill has not in fact been transferred to the acquiring hospital. This is a complex issue that experienced legal counsel should address. Also, hospitals want to insure that the compensation structure will reward and motivate physicians to maintain the same high productivity levels after being acquired so that their return from buying the practice will actually be achieved.

- Will the hospital lease the practice's facility from its physicians? Will it be at a fair market value rate? Will it be at the same rate that is reflected in historic results? Adjustments may be appropriate and legal counsel may need to consider whether any of these factors will run afoul of Medicare fraud and abuse statutes.
- Which year or years' historic results should be selected as the best indicator of future income?
- What is the anticipated future outlook for earnings? This might be impacted by specific managed care contracts, the retirement of a key producing physician, a change in patient mix and reimbursement rates, and various other issues.
- Will physician's assistants be utilized to leverage practice earnings and how will this change the economics of the practice and relationships with patients?
- Will the practice be able to recruit new physician talent to support continued growth in income? The high demand for family practice physicians by hospitals combined with the desire by many medical students to pursue higher paying specialties make it increasingly difficult to recruit new family practitioners to private practices.
- The thorough business appraiser will consult detailed medical practice studies to compare both the physicians and the practice on a variety of criteria relating to compensation, productivity, overhead and other factors and how these impact practice income.
- The IRS has recently set forth definitive ideas about specific income measures and factors that need to be considered which are more complex than those enunciated in earlier revenue rulings for other valuation purposes.

The Discounted Future Income ("DCF") Method. Rather than use a "one period" technique as with the capitalization of earnings, the discounted future income method involves projecting future practice income (e.g., earnings, cash flow, free cash flow, etc.) on a year-by-year basis, usually for five or seven years. The incomes for each year are then discounted back to their present value today at an appropriate discount rate (required rate of return on investment for risk) required by a buyer. At the final projection year the sale value for the practice is estimated (possibly based on capitalizing the final year's income stream) and then discounted back to its present value today. The summation of the present values of both the income streams and the future sale value yields a fair market value estimate of the practice. There are other offshoots of this method, including so-called "debt free" techniques which estimate the value of invested capital and then make adjustments to arrive at equity value. Another article in this issue of *Fair Value*™ gives a detailed explanation of this method and shows an example of its use.

The Internal Revenue Service has specific expectations of how this method is to be used, including income measures (not what you might think based on other valuations you might have seen in the past for other purposes), normalization adjustments, working capital and other factors that must be taken into account. These also incorporate certain key issues relating to Practice income taxation assumptions, and discount and capitalization rates.

The "Cost To Create" Income Method. A variant of the discounted future income method, this technique examines the present value of the current and future costs of starting and developing a new practice as an alternative to acquiring an existing practice. Forecasts are made for the startup practice over the estimated time period it would take to build it up to the level that could be achieved by buying an existing practice today. This method takes into account the risk and time required to reach the approximate earnings capacity of the Practice being valued and can serve as a crosscheck for the findings of the other methods.

The Income Approach Alone Is Not Enough. An appraisal must consider the cost and market approaches in addition to the income approach. Not only is this good valuation technique, but also because the IRS has indicated it will closely examine their use in reviews of practice transactions. The appraisal must also address a wide variety of issues that have only recently been outlined.

Valuation a Small Piece of a Complicated Area. The valuation is only a small subset of the complex subject of practice acquisitions that must involve the advice of skilled legal and tax counsel to avoid a variety of problems. This task is complicated by the lack of clear guidance as many legal, tax and valuation issues are still evolving and are not fully resolved by either regulations or case law. Although an independent valuation is no guarantee of avoiding problems, it is evidence of good faith by the hospital in arriving at an unbiased and professional estimate of value. Furthermore, and just as important, both the report and the appraiser must effectively and fairly communicate the value to the physicians with whom the deal must be struck and the hospital board that must give the green light to proceed. ♦

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