

“Know Your Worth: The Value of an Orthopaedic Surgeon”



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Success

CALIFORNIA ORTHOPAEDIC ASSOCIATION ANNUAL MEETING

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Valuation Process

- History/Introduction
- Definitions
- Regulatory Issues
- What's needed
- Understanding What is Being Valued
- Valuation Approaches
- Conclusion

Valuation Process

History/Introduction

- Lots of Activity in '90s
- Back at the Table – Here we go again
- Why are we here again?
- Players

Why Are We Here Again?

- Reform is About Cost Reduction and Rationing of Care Through:
- Accountable Care Organizations (ACO)
- Bundled Payments/Package Pricing
- Shared Savings Models
- Capitation

Why Are We Here Again

- New Payment Models and Cost Reductions Will Require Intense Coordination of Care Between Physicians and Hospitals

Why Are We Here Again

- Focus on Health Care Cost Reduction
- Equipment Cost
- Instrument Coast
- Inpatient Utilization and Related Cost:
 - Supply Cost
 - Implant Cost
 - Infections
 - Readmissions

Why Are We Here Again

- Hospitals Are Under The Gun and Thus Feel They Must Have Strategy to Control Cost through Health Care Dollar

Valuation Process

History/Introduction

- Reason for Valuation
 - ▶ Who approached who
 - ▶ Financial or other reasons
 - ▶ Is better healthcare the ending result?

Strategic Value

- Unique to a particular purchaser
- May be a value because of something the target has developed or could be driven by other market activity – The Domino affect

Examples of Strategic Value

- Physician/Group has Developed Care Delivery Process that Incorporates Superior Outcomes at the Lowest Cost of Care when Looking at Ambulatory, Outpatient, Inpatient and Post Acute Care Cost

Examples of Strategic Value

- Group has Size, Scale and Delivery Model that Produced Exclusive Payer Contracts and Related Covered Lives

Examples of Strategic Value

- You are a Primary Provider in Current Hospital and Another Hospital/Foundation is Trying to Buy Your Group
- You are a Primary Provider in Current Hospital and Another Orthopaedic Group Wants to Merge with You (who may expect you to move your patients and change loyalties)

Examples of Strategic Value

- You are the Only Orthopaedic Group Available for Your Hospital/Foundation to Acquire
- Hospital/Foundation Owns Everyone Close and You are the Last One Standing

Valuation Process

Definition

Fair Market Value in health care is not the same as what Alex Rodriguez negotiates with the New York Yankees or Peyton Manning negotiates with the Indianapolis Colts...



*“I want a piece of advertising revenues, ticket sales, seat licenses, TV revenues, pay for performance, etc., etc., and I want it guaranteed for contract life with up-front bonuses.”
(Don't we all?)*

Valuation Process

Definition

Medicare & Medicaid Programs are, in Effect, Insurance Programs that want to Prohibit Fraud & Abuse, Inappropriate Referrals of their Insured & Otherwise General Conflicts; therefore, We have...

Fair Market Value

Valuation Process

Definition

Fair Market Value is defined by the Federal Register Vol. 69, No. 59, March 26, 2004, as “the value in arm’s length transactions, consistent with the general market value.” General market value is, “the price that an asset would bring as a 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, on the date of the acquisition of the asset or at time of the service agreement.”

Valuation Process

Definition

Fair Market Value is usually 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 the 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 value or value of anticipated or actual referrals.”

Valuation Process

Definition

Fair Market Value is defined by the tax court as, “the amount at which property would change hands between a willing buyer and a willing seller, with the former not under any compulsion to buy nor the latter under any compulsion to sell, both having reasonable knowledge of the relevant facts.” (Rev. Rul. 59-60, 1959-1, C.B. 237)

Fair Market Value assumes an ongoing business with management and owners operating in a rational way with a goal of maximizing value

Valuation Process

Definition

Commercial Reasonableness 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 of similar scope and specialty even if there were no potential designated health services referrals

Valuation Process

Regulatory Issues

Federal Anti-Kickback Statute

- Prohibits the payment of remuneration in exchange for, or in order to induce, the referral of patients or other business, which is reimbursable under Medicare or Medicaid.
- Criminal statute punishable by fine and/or imprisonment.

Valuation Process

Regulatory Issues

Stark Self-Referral Law

- Prohibits the referral of designated health services reimbursable by Medicare, Medicaid or other government programs, unless specifically excepted under the Act.
- Civil monetary penalties for a referral that violates Stark of a person who “knows or should know.”

Valuation Process

Regulatory Issues

IRS Intermediary Sanctions

- Excise tax imposed on those Section 501(c)(3) Hospitals that provides an excess benefit to or for the benefit of a disqualified person.
- IRS is concerned as to Hospitals furnishing benefits to physicians beyond fair market value for admitting patients who bring revenues to the hospital.

Valuation Process

Regulatory Issues

Fair Market Value if 3 Conditions are Satisfied:

1. The compensation arrangement or terms of transfer are approved by the Hospital's governing body, members of which have no conflict of interest with respect to the arrangement or transaction,
2. The Hospital's governing body obtained & relied on appropriate comparability data prior to making the determination, and
3. The governing body adequately documented the basis for its determination concurrently with making the determination.

Valuation Process

What's Needed

- Valuator Needs a Full Understanding of the Practice in Order to Determine Fair Market Value
 - ▶ Who is driving the integration
 - ▶ What are the thoughts of the physicians

Valuation Process

What's Needed

- Must Have an Understanding of the Interplay of Value of the Enterprise and Ongoing Compensation
- If You Sell Part of Your Business (MRI, PT,) You Cannot Continue to Receive Compensation For These Elements
- Must Evaluate What is More Important, Purchase Price or Compensation

Valuation Process

What's Needed

- Financial Information
 - Financials
 - Tax Returns
 - Depreciation records
 - Charges
 - Personnel
 - Compensation

Valuation Process

What's Needed

Site Visit

- ▶ Crucial for the valuator's due diligence
- ▶ Major sites
- ▶ Walk thru locations
- ▶ Understand the market conditions

Valuation Process

What's Needed

- Interviews
 - ▶ Practice Management
 - ▶ Physicians
 - ▶ Hospital Management

Valuation Process

Understanding What is Being Valued

- What is purpose for FMV & How is it Going to be Used?
- Specific Ancillary Income Stream
 - Magnetic Resonance Imaging Operation
 - Physical Therapy
 - Durable Medical Equipment
 - Pharmacy
 - ASC
 - Medical Office Building
 - Satellite office(s) or entire Practice
- Company Stock, All Business, All Providers, Everything of the Organization

Valuation Process

Understanding What is Being Valued

- Specific Assets Only - Tangible & Intangible
- Specific Assets & Liabilities - Tangible & Intangible
- Rules of Thumb May Not Always be Useful if You Do Not Know the Specifics of What is Being Valued & Why
- Specific Deal Terms, Understand How 3rd Party FMV Report Will Be Used

Valuation Process

Valuation Approaches

3 Basic Approaches:

Income Approach

Market Approach

Asset Approach

- All Approaches Should Be Considered in Every Fair Market Valuation, but All May Not Necessarily be Used in the Final Conclusion of Value - Some Approaches may be a Hybrid of the 3 Basic Approaches

Valuation Process

Valuation Approaches

- Stock Versus Asset Valuation; Legacy Agreements of the Company May Impact Overall Fair Market Value (termination notices, deferred compensation, PTO liabilities, etc.)
- Tax Implications for Seller
- FMV is Art & Science; Should be Expressed as a Range of Values
- Buyer Will Consider “Strategic Value” when Considering What to Offer Within this Range

Valuation Process

Income Approach

- Estimates the Value Based on the Present Value of Future Cash Flows Over a Discreet Number of Years.
- Terminal Value is Determined Based on the Final Forecast Year Using an Anticipated Long-term Growth Rate.
- Discount Rate & Capitalization Rate, Minority Discounts, Marketability Discounts.

Valuation Process

Income Approach

- When is Income Approach (particularly DCF) Used?
 - Ability to forecast future earnings & cash flows of a business, after making assumptions for future revenues, expenses, capital expenditures & physician compensation
 - Valuing only a specific segregated income stream, i.e., physical therapy, where physician compensation will be impacted

Valuation Process

Income Approach

- When is Income Approach (particularly DCF) Used?
 - ▶ If the business/practice has no future cash flows beyond FMV compensation to the providers, income approach may not be an appropriate methodology to use to value business enterprise or specific assets.

Valuation Process

Income Approach

- When is Income Approach (particularly DCF) Used?
 - If business/practice has no historical or future cash flows does this mean it has no value?
 - Can physician compensation be “normalized” in a DCF model of fair market value?
 - Valuing an income stream may be beneficial to a potential transaction, but it does have Pros & Cons.

Valuation Process

Market Approach

- Uses Actual Sales of Similar Businesses to Estimate the Value of a Company
- Application of Ratios from Guideline Public Companies
- Most Direct Approach, But also Difficult to Use Because of a Lack of Information Available for Closely Held Small Businesses

Valuation Process

Market Approach

- When is Market Approach Used?
 - Ability to identify truly comparable businesses
 - Ability to determine factors of comparable businesses that drive value
 - Can often be used as a “gut check” for other valuation approaches
 - Consistent applications of valuation approaches & techniques is a form of Market Approach

Valuation Process

Asset Approach

- Involves the Valuation of the Subject Company's Assets & Liabilities at their Current FMV
- Liabilities of the Subject Company May Be Removed From the Fair Market Valuation When the Parties are Only Interested in Specific Assets
- Start with Subject Company's Most Recent Accrual Basis Balance Sheet

Valuation Process

Asset Approach

- GAAP & Income Tax Basis Accounting Must be Considered When Analyzing Subject Company's Balance Sheet
- Book Value & Fair Market Value are Rarely the Same
- Most Company Accrual Balance Sheets Do Not Typically Capture Intangible Assets

Valuation Process

Asset Approach

- Tangible Assets and Liabilities
 - Cash
 - Accounts receivable
 - Supplies
 - Fixed Assets
 - Accounts payable
 - Accruals
 - Deferred compensation
 - Debt

Valuation Process

Asset Approach

- Intangible Assets of a Company May Include Patient List & Trained Workforce in Place of Providers & Non-providers, but May Also Include Name, Telephone Numbers, Accredited Programs, Relationships, or Other Specific Items

Valuation Process

Asset Approach

Intangible Assets of the Company May Be Driven Based On:

- History of the Company
- Location
- Market share
- Workforce turnover
- Recruitment supply/demand
- Practice performance
- Quality measurements
- Compensation trends
- Provider characteristics
- Management
- Provider roles/responsibilities outside of clinical work
- Overall operations
- PM & EMR systems & history
- Payer mix
- Reimbursement trends
- Legal Agreements
- Facilities practicing within

Valuation Process

Asset Approach

- May be the Most Appropriate Approach in Valuing a Well-established, Successful Physician Practice; Sometimes Considered to be the Minimum Value of a Business.
- Not All Businesses that have Tremendous Value have Positive Cash Flows, Beyond Provider Compensation/Distributions.

Valuation Process

Asset Approach

- Purchasers of a Medical Practice may be More Willing to Pay FMV for an Established Practice Versus Costs of Development of Denovo Practice

Valuation Process

Conclusion

- When Approached By Prospective Purchaser do not Turn Over Any Information Until You Have Met With Your CPA and Lawyer so You Can Understand What Data is Being Requested, Why and How You Need to Present the Data

Valuation Process

Conclusion

- Understand relationship of Company & potential acquirer - not all Physician practices are created alike, nor are all Hospitals & Health Systems created alike.
- Understand Regulatory Environment. Some Fair Market Valuation Engagements are Direct With the Seller, Some with the Buyer, Some jointly, Some with legal Counsel - Understand How the Valuation Report & Conclusion Results Will be Used.

Valuation Process

Conclusion

- Understand the definition of Fair Market Value, Willing Buyer & Willing Seller. (Does not mean we name our price & they have to pay it, nor does it mean we name our price and they have to sell it)
- Understand valuation Firm & their experiences in valuing Health Care businesses.

Valuation Process

Conclusion

- Draft valuation report does not mean report is up for negotiation with the Valuator. FMV results should not vary based on who engaged Valuator
- Valuator experience & professional judgment also important
- FMV compensation to the Providers must also be understood

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