What Drives the Value of a Medical Practice?

*Carol Carden, C.P.A./A.B.V., A.S.A., C.F.E.**

In a complex healthcare environment, it is important to understand what drives the value of a medical practice, how to balance regulatory and business goals, and how physicians can positively impact the value of their practice.

Key words: Fair market value; Stark; anti-kickback; value drivers; physician extenders; compensation; non-competition agreements.

Recently there has been a shift back toward hospitals purchasing physician practices. This change is eliciting much discussion about what a physician practice is worth, what drives the value of the practice, and what methods are typically used to value physician practices. Determining what something is worth seems to be a straightforward concept. However, valuing entities that operate in the healthcare industry is generally anything but straightforward. This article will explain some of the complexities and issues involved in determining the value of physician practices. Specifically, we will discuss value drivers for physician practices, regulatory considerations that come into play, and how compensation both current and post-sale impacts practice values.

REASONS FOR VALUATION

In my experience, there are two primary reasons for practice valuations: 1) ownership buy-in/buy-out transactions; and 2) acquisitions by hospitals/health systems. Although unique considerations apply for each of the above reasons, the underlying valuation approach is generally consistent.

When valuing a practice for ownership buy-in/buy-out purposes, it is critical to understand the control elements associated with the particular interest being transferred. For example, a 26% ownership interest generally isn't controlling but may have certain "swing vote" characteristics for governance issues requiring super majority (i.e., 75%) approval. Such swing vote power can increase the value more than proportionally over, say, a 20% interest that does not have the same ability. Additionally, it is important to understand any restrictions on transferring the subject interest which could limit the pool of potential future buyers.

STANDARDS OF VALUE

Before delving further into our discussion about physician practice valuation, it is important to understand the different standards of value and how they impact valuation analysis. The standards of value, which vary depending upon the purpose of the valuation, include: 1) fair market value (FMV); 2) investment value; and 3) fair value. The definitions for each of these standards and how they impact the valuation analyses follows.

When considering fair market value, one must ignore the specifics of the transaction, and determine the value to "any willing buyer" and "any willing seller."

Fair market value is defined as: "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[1] This is the standard of value most commonly used for transactions involving healthcare entities due to certain regulatory issues such as the Stark Law and Anti-Kickback Statute (AKS). When considering FMV, one must ignore the specifics of the transaction, and determine the value to "any willing buyer" and "any willing seller." The issue of considering only hypothetical parties can be a difficult proposition and sometimes presents a challenge for the current owners to understand.

*Director, ValuePoint Consulting Group, 525 Portland Street, Knoxville, TN 37919; phone: 865-558-8118; fax: 865-558-8252; e-mail: ccarden@pyapc.com.
Copyright © 2008 by Greenbranch Publishing LLC.

Investment value is defined as: "the value to a particular investor based on individual investment requirements and expectations."[2] When determining value for purposes of facilitating an acquisition by a hospital, it is critically important to use the appropriate standard of value (generally FMV). Otherwise the transaction could be consummated in a manner that creates regulatory risk to the parties that did not otherwise exist. These regulatory parameters will be discussed in greater detail later.

When the Stark implications are being assessed, it is critical to consider not only past referral patterns, but also potential future referral patterns.

Fair value is a concept that is generally defined by the courts or by state statute. Fair value does not come into play very often in valuing physician practices unless the valuation involves a shareholder dispute or a divorce in some states. If valuing a practice under the fair value standard, it is important to consult with legal counsel to ensure that all necessary state law issues have been taken into consideration.

REGULATORY CONSIDERATIONS

We strongly recommend that an attorney with substantial experience in healthcare regulatory issues be involved with transactions involving any healthcare entities. The regulatory issues can be quite complex, and the penalties for violating these requirements can be severe. The following briefly discusses the four main areas of regulatory compliance considerations. A detailed discussion of the myriad of regulatory complications that can arise with healthcare transactions is beyond the scope of this article, but interested readers may want to do additional reading from the referenced materials.

Stark

In general, the Stark regulations govern referrals from a provider of Designated Health Services (DHS) to an entity in which the provider has a financial interest unless the arrangement falls into one of several safe harbor classifications. If the contemplated transaction involves a hospital acquiring a practice, the Stark implications are minimized as the referring physician will typically become an employee of the hospital, which is not deemed to be a "financial interest" for Stark purposes. Ownership transactions between two physician buyers do not generally trigger Stark implications unless there are significant ancillary services provided by one of the practices. When the Stark implications are being assessed, it is critical to consider not only past referral patterns, but also potential future referral patterns.

Anti-Kickback Regulations

The AKS prohibits the receipt or payment of anything of value to induce referrals of healthcare services.[3] There are 13 established safe harbors; however, even if the arrangement does not fit squarely into a safe harbor, it may still not be *per se* illegal. The purchase of a physician practice will not typically fit into one of the existing safe harbor classifications. Therefore, any analysis of the proposed physician practice transaction, particularly if the acquirer is a hospital, requires careful scrutiny to ensure the value of the practice is not negatively impacted by exposure to civil monetary penalties.

Department of Justice

Among other things, the Department of Justice (DOJ) governs transactions that have anti-trust implications in violation of the Sherman Act and the Clayton Act. DOJ concerns do not come into play in typical shareholder buy/sell valuations but may have implications in potential acquisitions of entire practices if the practice is very large. As in all areas of regulatory compliance, it is critical that the practice engage competent legal counsel with experience in these areas.

Private Inurement/Excess Benefit

The fourth regulatory area to consider is private inurement and excess benefit transactions as defined by the IRS. In general, the IRS is concerned about financial or other arrangements that result in a benefit to private individuals in excess of the benefit supported by arms-length market transactions.[4,5] These concerns come into play most heavily when valuing practice acquisitions involving a not-for-profit health system. In particular, the IRS is concerned that not-for-profit assets will be transferred for less than their FMV to private individuals. If a transaction is determined to contain private inurement or excess benefits, significant excise taxes may apply to both the organization making the payment as well as the individual receiving the benefit.

VALUATION APPROACHES

There are three basic approaches utilized for valuing healthcare and other types of entities. Depending upon the facts and circumstances of the particular practice being valued, some approaches and related methodologies may not be applicable.

Asset Approach

The asset approach establishes a value for the practice based upon its tangible and identified intangible assets. This approach is generally used for physician practices when the practice is not generating sufficient cash flows (after deducting normalized physician compensation) to make its operations more valuable than the underlying net

assets. The asset approach is generally not used for practices that employ physician extenders or that have a significant amount of ancillary services as the extenders and ancillary services typically generate profits in excess of the physicians' compensation.

Market Approach

The market approach is used to determine an indication of value for a business based upon various multiples developed from publicly-traded guideline companies and/or sale transaction data from other similar privately held businesses. The challenges of applying this approach are twofold. There are not sufficient publicly traded companies operating in the physician practice segment from which to draw comparisons. When utilizing merger and acquisition transaction data to develop valuation multiples for the practice, it is important to gather and consider as much information about the sale transactions as possible. For example, sometimes the published transactions include assets (such as real estate) that may or may not be included in your transaction. It is also difficult to draw conclusions about privately held practice sales across different geographic markets due to often significant differences in the reimbursement rates, demographics, and competitive environment. Additionally, many times the transaction data are limited or too stale to be relevant given the pace of changes in the regulatory environment affecting physician practices.

Income Approach

The income approach is used to develop a value for the practice based upon its ability to generate future net cash flows for the owners. Depending upon the circumstances, the methodologies used under the income approach can be either a single period capitalization of earnings or a discounted cash flow analysis. The income approach is the most commonly used valuation approach for physician practices that employ physician extenders or have significant ancillary services such as CT or MRI.

VALUE DRIVERS

As previously referenced, there are two primary drivers that generate value in a physician practice. The following section discusses these drivers and their potential impact on value.

Physician Extenders

The existence of physician extenders, such as nurse practitioners or physician assistants, typically creates value for the practice because of their ability to generate revenues in excess of their costs. To create the most value, the extenders must be highly utilized and their compensation must be in line with their productivity. Given appropriate compensation, the resulting profit of the extenders' work will fall to the bottom line of the practice and create value.

Ancillary Services

Implementation of significant ancillary services such as CT and MRI are capital-intensive endeavors. However, larger practices sometimes pursue this option as a means of generating additional revenue. Obviously, for the ancillary service to generate additional value for the practice, the practice must have performed an adequate analysis of need for the service prior to implementation. An underutilized ancillary service could actually serve to detract from the value of the practice. However, if the volume exists to make ancillary service productive, the resulting profits serve to create value for the practice.

IMPORTANT VALUATION CONSIDERATIONS

Compensation

The single most debated issue in any practice valuation is the level of physician compensation post-transaction and its impact on value. Typically, physician practices distribute substantially all the available cash in the form of physician compensation. A standard valuation approach is to normalize the physician compensation for purposes of determining the value of the practice to a buyer. This is particularly important if the buyer is a not-for-profit health system as the health system will need to ensure it can demonstrate that it is not paying compensation that is greater than FMV for a variety of regulatory reasons touched on previously in this article. However, what must also be considered is whether it is likely that the physician will accept this level of compensation. If not, the practice will be overvalued by normalizing the compensation.

Intangible Asset Treatment

When a practice is generating positive cash flow, there is generally some level of intangible assets that result. Many times, these assets come in the form of medical charts/patient lists, trained workforce, and practice name/reputation. It is important to understand that if a practice is generating losses, it will be difficult, if not impossible, to make the case that there is any intangible asset value generated. Most of the confusion around this issue is in regard to medical chart/patient list value. Most practices view their patient base as a valuable asset whether they have been able to produce positive financial results utilizing the patient base or not. However, if the potential purchaser is a health system, the health system must ensure that it does not pay for unproductive assets and inadvertently create the perception that it is paying for the patient base to induce referrals. That is not to say that there are not specific circumstances that warrant some level of payment even if the practice has

historically been unprofitable. These transactions must be carefully reviewed on a case-by-case basis, and it is imperative that competent healthcare counsel be involved in the discussion.

Non-competition Agreements

Non-competition agreements are often used to help protect the business from departing physicians who try to take part of the business with them. In some cases, non-competition agreements can have significant value. However, in order to have value, the agreement must be enforceable and the departing physician must actually be in a position to compete. For example, a non-competition agreement may not have much value in connection with a physician who is retiring or relocating to another geographic region since the physician is less likely to compete with the practice in the future. Even if the non-competition agreement doesn't have much value itself, the practice as a whole may be just as valuable due to the reduced risk of competition. However, if there is an opportunity for the departing physician to compete and no such agreement exists, the potential impact should be considered when estimating the practice's future cash flows.

CONCLUSION

Determining the value of a practice is a complex undertaking. Therefore, it's important to ensure the valuation professional not only understands valuation techniques and methodologies, but also the regulatory issues of the healthcare industry. Additionally, a thorough analysis must be performed of the current and projected physician compensation, the existence of extenders and ancillary services, and any proposed changes in reimbursement to ensure a well-thought-out and defensible result is obtained. ■

REFERENCES

1. Revenue Ruling 59.60, 1959-1, C.B. 237. Internal Revenue Service.
2. *International Glossary of Business Valuation Terms.* American Institute of Certified Public Accountants; American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, The Institute of Business Appraisers; 2001.
3. Federal Anti-Kickback Law and Regulatory Safe Harbors, Fact Sheet, November 1999,Office of Inspector General, Office of Public Affairs.
4. Intermediate Sanctions—Excess Benefit Transactions. Internal Revenue Service; www.irs.gov/charities/charitable/article/0,,id=123303,00.html.
5. Inurement—Section 501 (c)(4). Internal Revenue Service; at www.irs.gov/charities/nonprofits/article/0,,id=156404,00.html.