Learning Objectives

1. Explanation of the fair market value concept.
2. Description of the possible approaches and nuances of physician practice valuations.
3. Evaluation of the latest compensation models and trends in the market.

Business Valuation History 101*

- Informal methods of valuing a business
  - Imperfect markets
  - Disparity in the information available to the buyer and seller
  - Lack of a clear medium for conducting a transaction (e.g. $ vs. beads)
  - Opportunistic transactions

* Not an actual representation of history, rather the presenter’s opinion of what things were probably like a long time ago.

Business Valuation History 201*

- The history of formalized business valuation methods in the U.S. dates back to the 1920’s and the enactment of Prohibition Laws under the 18th Amendment.
  - Appeals and Revenue Memorandum (ARM) 34 was issued by the Internal Revenue Service to address business losses (intangible value) by those involved in the alcoholic beverage industry.

* Actually based upon fact.
What is Business Valuation?

- The act or process of determining the value of a business enterprise or ownership interest therein.

- Purposes include: M&A, Purchase Price Allocation, Dissolution, Shareholder Disputes, Buy/Sell, Succession Planning, ESOPs, Litigation/Damages, SBA & other Lending, etc.
  - Business valuations may vary depending on their purposes.

Who Values Businesses

- Several organizations have recognized business valuation credentials:
  - American Institute of Certified Public Accountants (AICPA)
    - Accredited in Business Valuation (ABV)
  - American Society of Appraisers
    - Accredited Senior Appraiser (ASA)
  - National Association of Certified Valuation Analysts (NACVA)
    - Certified Valuation Analyst (CVA)
  - Institute of Business Appraisers (IBA)
    - Certified Business Appraiser (CBA)

- Several other professionals provide similar services….know WHO you are hiring!

Standards of Value

Learning Objective 1

Explanation of the fair market value concept

- Intrinsic Value
- Investment Value
- Fair Value
- Fair Market Value

- Hypothetical willing buyer and willing seller
- Hypothetical willing buyer and rarely willing seller (litigation)
- Market participant (financial reporting)
- Analytical judgment of value
- Value to a particular investor
Standards of Value (cont.)

- **Fair Market Value**
  - 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. (Rev. Rul. 59-60)
  - The price, expressed in terms of *cash equivalents*, at which property would change hands between a *hypothetical willing and able buyer* and a *hypothetical willing and able seller*, acting at *arm’s length* in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. (International Glossary of Business Valuation Terms)
    - Assumes:
      - Hypothetical willing buyer/willing seller
      - Arm’s length
      - Cash equivalent

- **Fair Value**
  - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date. (Accounting Standards Codification 820)
  - Assumes:
    - Market participants
    - Hypothetical transaction
    - Market based measurement
  - Additionally relevant in some dissolution and shareholder disputes
    - Definitions vary state by state
    - Look to case law in non-financial reporting matters

- **Investment Value**
  - The value to a *particular investor* based on *individual investment requirements* and expectations. (International Glossary of Business Valuation Terms)
    - The value to a particular buyer.
      - (not “willing buyer/willing seller”)
        - What is the value to me?
    - Sometimes relevant in dissolution matters.
      - Again, definition can vary on a state by state basis.

- **Intrinsic Value**
  - The value that an investor considers, on the basis of an evaluation or available facts, to be the “true” or “real” value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price and strike price of an option and the market value of the underlying security. (International Glossary of Business Valuation Terms)
    - Represents an *analytical judgment of value* based on the perceived characteristics inherent in the investment, not tempered by characteristics particular to any one investor, but rather tempered by how these perceived characteristics are interpreted by *one analyst*.
    - The appropriate stock price for a company in the eyes of an analyst.
Standards of Value Summarized

- **Fair market value**: Hypothetical willing buyer and willing seller.
- **Fair value**: Hypothetical willing buyer but rarely a willing seller.
- **Investment value**: Value to a particular investor.
- **Intrinsic value**: Not really a standard; more used by analysts.

Standard of Value/Regulations & Guidance

- **Federal regulations and guidance in valuing payments to physicians**
  - **Stark Law**: Prevents a physician from referring designated health services ("DHS") to an entity, or the entity from billing for the DHS, if the physician or an immediate family member of the physician has a financial relationship with the entity, unless an exception applies.
    - Physician referrals under Medicare and Medicaid
    - Does not require intent to pay for referrals
  - **Anti-kickback Statute**: Payment for referrals
    - Anyone engaging in business with a federal healthcare program
    - Requires intent

Standard of Value/Valuation Process

Some Valuation Adjustments Affected by Stark/Anti-kickback

- **Revenue stream**
  - Cannot substitute more favorable payor reimbursement rates
    - Using a potential buyer’s payor contracts may result in higher practice value
    - Purchase of a practice under these circumstances may be considered a payment for patient referrals

- **Physician compensation**
  - Are the physicians going to be employed by the buyer?
    - Projected compensation should match physician compensation under buyer employment
    - Non-owner physicians should be included
    - Failure to do so may result in a higher practice value and be considered a device to pay for referrals

Goodwill

- “Goodwill is based on earnings and results from the ability of a company to realize a higher value than it would otherwise realize on its tangible assets alone. Factors include...company’s reputation, ownership of trade or brand name…”

- “The propensity of customers to return for repeat business. The criterion as to whether goodwill exists usually is the ability to earn a rate of return in excess of a normal rate of return on the net assets of the business, after reasonable compensation to operating personnel.”

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Learning Objective 2

Description of the possible approaches and nuances of physician practice valuations

Approaches/Methodologies

- **Asset Based Approach**
  - A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.

- **Income Based Approach**
  - **Capitalization of Benefits Method**
    - *Single period* valuation model that converts a benefit stream into value by dividing the corresponding capitalization rate.
  - **Discounted Future Benefits Method**
    - *Multiple period* valuation model that converts a future series of benefit into value by discounting them to present value at a rate of return that reflects the risk inherent in the benefit stream.

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### Asset Approach: Workforce In-Place

#### Fair Value Measurement of Assembled Workforce

<table>
<thead>
<tr>
<th>Position</th>
<th>Average Base Salary Per Employee</th>
<th>Average Fringe Benefits</th>
<th>Payroll Taxes</th>
<th>Estimated Total Compensation Package</th>
<th>Estimated Recruiting and Training Cost Per Employee</th>
<th>Starting Efficiency (%)</th>
<th>Time to Full Productivity (months)</th>
<th>Avoided Costs</th>
<th>Total Avoided Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billing Clerk</td>
<td>$28,642</td>
<td>$8,593</td>
<td>$2,291</td>
<td>$30,526</td>
<td>$5,728</td>
<td>50%</td>
<td>6</td>
<td>$4,941</td>
<td>$10,669</td>
</tr>
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<td>$30,526</td>
<td>$5,728</td>
<td>50%</td>
<td>6</td>
<td>$4,941</td>
<td>$10,669</td>
</tr>
<tr>
<td>Billing Manager</td>
<td>$38,797</td>
<td>$14,639</td>
<td>$4,792</td>
<td>$53,629</td>
<td>$9,750</td>
<td>50%</td>
<td>6</td>
<td>$8,417</td>
<td>$16,177</td>
</tr>
<tr>
<td>Cardio U/S Tech</td>
<td>$35,154</td>
<td>$15,054</td>
<td>$6,889</td>
<td>$58,098</td>
<td>$9,750</td>
<td>75%</td>
<td>6</td>
<td>$7,053</td>
<td>$12,456</td>
</tr>
<tr>
<td>Stress Test Tech</td>
<td>$45,154</td>
<td>$15,054</td>
<td>$6,889</td>
<td>$58,098</td>
<td>$9,750</td>
<td>75%</td>
<td>6</td>
<td>$7,053</td>
<td>$12,456</td>
</tr>
<tr>
<td>RN</td>
<td>$51,226</td>
<td>$16,018</td>
<td>$6,826</td>
<td>$75,053</td>
<td>$10,084</td>
<td>75%</td>
<td>3</td>
<td>$2,095</td>
<td>$12,622</td>
</tr>
<tr>
<td>Scheduler</td>
<td>$27,736</td>
<td>$8,318</td>
<td>$2,218</td>
<td>$38,262</td>
<td>$5,465</td>
<td>50%</td>
<td>6</td>
<td>$4,783</td>
<td>$10,328</td>
</tr>
<tr>
<td>Stress Test Tech</td>
<td>$35,154</td>
<td>$8,855</td>
<td>$2,441</td>
<td>$46,431</td>
<td>$9,565</td>
<td>75%</td>
<td>6</td>
<td>$2,185</td>
<td>$8,429</td>
</tr>
<tr>
<td>RN</td>
<td>$40,610</td>
<td>$15,995</td>
<td>$3,931</td>
<td>$63,546</td>
<td>$11,708</td>
<td>75%</td>
<td>3</td>
<td>$3,141</td>
<td>$12,602</td>
</tr>
<tr>
<td>Tech</td>
<td>$32,285</td>
<td>$10,986</td>
<td>$6,826</td>
<td>$50,093</td>
<td>$9,627</td>
<td>75%</td>
<td>6</td>
<td>$3,733</td>
<td>$12,380</td>
</tr>
<tr>
<td>Transcriptionist</td>
<td>$30,510</td>
<td>$9,753</td>
<td>$2,051</td>
<td>$44,314</td>
<td>$6,502</td>
<td>50%</td>
<td>6</td>
<td>$5,408</td>
<td>$12,100</td>
</tr>
<tr>
<td>Transcriptionist</td>
<td>$30,510</td>
<td>$9,753</td>
<td>$2,051</td>
<td>$44,314</td>
<td>$6,502</td>
<td>50%</td>
<td>6</td>
<td>$5,408</td>
<td>$12,100</td>
</tr>
</tbody>
</table>

**Pre-Tax Cost of Workforce**: $655,143
Less: Risk of Departure (2) (131,029)
Pre-Tax Cost of Workforce Recruiting & Training After Risk of Departure: $524,115
Less: pro-forma income taxes (3) (157,234)
**After-tax value of workforce**: $366,880

**Times: amortization benefit factor (4) 1.106**
**Fair Market Value of workforce**: $405,804
Rounded $406,000

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The Value Examiner

*The Cost Approach to Fair Market Value—and the Inclusion of Intangible Assets—for Physician Practices*
Normalizations and Adjustments

Objective
- Estimate the cash flow available to a potential buyer
- Compare the subject to similar businesses or industry averages
- Create meaningful projections
- Adjust values of net assets

Bases and methods of accounting
- GAAP/accrual basis
- Tax basis
- Cash accounting

Unusual/Non-recurring Items
- Marketing expenditure
- Material cost spike
- Litigation

Extraordinary Items
- Strike
- Natural disaster or fire
- Insurance proceeds (property or life)

Non-Operating Assets
- Excess/deficient working capital
- Excess cash/marketable securities
- Cars, boats, homes, other toys, etc.
- Real estate not used in operations
- Investment accounts inside the business
- Personal loans and receivables

Common Normalizations and Adjustments
- Accounts receivable
- FMV of fixed assets
- One-time events
  - Unusual/non-recurring items
  - Extraordinary events
- Non-operating assets and liabilities
- Discretionary items
  - Owners’ compensation
  - Related party transactions
  - Non-operating expenses
- Other “non-involved” parties on the payroll
- Fair market value rent/transactions
- Unreported income/expense

Evaluation of the latest compensation models and trends in the market

Learning Objective 3
Physician Compensation

- Reasonable, arm’s length compensation
- Experience of the physician
- Hours worked on a daily or periodic basis
- Responsibilities of the position
- Primary and ancillary duties performed
- The age of the physician
- Nature of the business
- Geographic setting
- Demographics of the service area
- Sustainable revenues

Physician Compensation & Practice Value

Total Value of the Existing Practice

- Non-Compete & Signing Bonus
- In-place, Trained Workforce and Patient Charts
- Fair Market Value Physician Compensation Based Upon Benchmark Measures
- Appraised Value of Furniture, Fixtures and Equipment

Identifiable Physician Practice Value

- Goodwill
- Physician Compensation at Historical Level
- Goodwill

Intangible Value
(Blood, Sweat & Tears)

Physician Compensation Adjustment

Benchmarking Conclusion – Internal Medicine

- Productivity based
  - Gross charges
  - Net receipts
  - Work Relative Value Units (wRVUs)

- Management of bottom line
  - Staff management
  - Operational management
  - Financial management

- Quality
  - Patient satisfaction scores
  - On-time starts
  - Turn-around time

Physician Compensation

- Productivity based
  - $34 per wRVU
  - 40% of net receipts
  - 25% of gross charges

- Management of bottom line
  - +/- 10% of practice operating budget
  - Sharing of net profit of practice profits/loss

- Quality
  - > 95% outstanding patient satisfaction
  - > 90% first patient seen on time

Incentive Alignment
Approaches/Methodologies

- **Market Based Approach**
  - **Guideline Public Company Method**
    - Based on the premise that pricing multiples can be derived from publicly traded companies and utilized to derive an indication of value of the subject interest.
  - **Guideline Company Transactions Method**
    - Based on the premise that pricing multiples can be derived from closed transactions (both public and private) and utilized to derive an indication of value of the subject interest.

Business Valuation Methods – Market Approach

- Ratios called “multiples” are calculated from market data based upon some measure of price compared to cash
- Comparable companies are selected based upon:
  - SIC/NAICS code
  - Various measures of size
- **Guideline Company Method**
  - Utilizes data from publicly-traded companies
- **Guideline Company Transactions Method**
  - Based upon reported transactions of private companies

Market Multiples

- Commonly used multiples:
  - Price to earnings ratio
  - Price / cash flow
  - Price / revenue
  - Dividend / price
  - Price / book value
  - Earnings per share
- Inversely related to a capitalization or discount rate

Business Valuation Methods – Industry Methods

- Also called “Rules of Thumb”
  - Often involve incremental measures of value based upon criteria specific to the industry
    - Motels = $20,000 per room
    - Auto rental agencies value = $1,000 per vehicle
    - Portable toilet companies = $1,000 per unit
    - Goodyear Tire stores = 35% of annual sales plus inventory
    - Golf courses = 4 x green fees, golf cart and driving range revenue
    - Major league baseball teams = 1.67 x Mark Cuban’s best offer + ½ parking lot
    - Medical practices = “priceless”
Personal vs. Enterprise Goodwill

- **Personal Goodwill**
  - Sometimes referred to as the professional “goodwill”.
  - The goodwill that is attributable to the individual.
    - Generated by the skills, knowledge, reputation, etc. of the individual.
  - The value of earnings or cash flow directly attributable to the individual’s characteristics.
    - Customers/Clients come to the individual, not the business itself.
      - Difficult to transfer.
      - Skill, knowledge, reputation, etc.
  - Not always attributable to the owners; sometimes key employees.

- **Enterprise Goodwill**
  - The goodwill that is attributable to the business.
  - Customers/Clients come back because of the name on the sign, not the individual service.
    - Easier to transfer

General Components of Goodwill (cont.)

- **Enterprise Goodwill (Normally transferable)**
  - Workforce
  - Literature
  - Sign/Name
  - Location

- **Personal Goodwill (Transferable)**
  - Personal in nature, but “may be” transferrable.
    - Acquisition of a practice with aging partners for access to relationships.
    - Transferrable through proper “training” and “transitioning”.
    - Can include customer lists, contact lists, network of prospects, etc.

- **Personal Goodwill (Non-transferable)**
  - “I want John Doe to handle my account.”
  - “I’m having my procedure done here because of Dr. X.”
  - “Mrs. Smith has been our advisor for 30 years….”

Capitalization and Discount Rates

- **Capitalization Rate (single period)**
  - The required rate of return for an income generating asset (subtracting long-term sustainable growth). Said differently, it’s the discount rate minus LT growth.

- **Discount Rate (multiple period)**
  - The required rate of return that an investor would demand, considering the risks connected with the benefit stream, to be enticed to make the investment.
Discounts/Premiums

- Discount for Lack of Control (Minority Discount)
- Discount for Lack of Marketability
- Key Man Discount (Personal Goodwill?)
- Non-voting Discount
- Control Premium
- Swing Vote Premium

Commercial Reasonableness

- Commercially Reasonable
- Fair Market Value
- Conforms to common practices for dealers in the type of asset/agreement
- Price current in any recognized market at the time of the transaction
- Hypothetical willing buyer and willing seller

Business Valuation Challenges

Most subjective elements in a business valuation...

- Discount/Cap Rate
- Projected Growth Rate
- Marketability/Minority Discount
- Normalization Adjustments
- Officers’ Compensation Adjustments

Strategies in Sales Transaction

1) Structure is as important as price
2) Asset vs. Stock Sale
3) Teams
   - Sign-on bonus
   - Non-compete payments/excess non-compete
   - Termination provisions
   - Handling of accounts receivable
4) Minimize taxes on sale
   - Capital gains
   - Existing company to pay all transaction expenses
   - Consider gifting to avoid taxes
5) Continue to lease real estate
6) Maintain and don’t close old company
   - Benefit
   - Retirement
   - Business expenses
Strategy Points

- Obtain a FMV valuation that complies with Stark and anti-kickback regulations
- Include the value of in-place workforce and patient charts in your overall value
- Challenge common elements in valuation process
- Transaction structure is as important as sales price
- Practice value vs. physician compensation