Understand the Value of Your Physician Practice

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Wendy S. Ingalls joined Mercer Capital in 2000 and serves as a vice president. Mercer Capital is a premier business valuation and investment banking firm serving a national and international clientele.

Business valuation services are provided for a wide variety of needs, including but not limited to corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.

Ms. Ingalls brings to Mercer Capital an extensive and varied accounting, valuation and audit background in private industry, internal auditing and public accounting. She has valued numerous closely held businesses and provided litigation support in divorce cases, employee stock ownership plans, stockholder disputes, damages and other valuation matters. In addition, Ms. Ingalls has also performed due diligence reviews for various companies for acquisitions, transaction consulting and fairness opinions.

Ms. Ingalls has broad industry experience providing corporate valuation and investment banking services to hundreds of companies in an array of industries. Specific industry experience includes, but is not limited to, agriculture, auto dealerships, construction, distribution companies, engineering firms, manufacturing, medical practices, printing, and retail.

About Mercer Capital

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When do you need to know what your practice is worth?

The ownership of every practice will change hands. The event that triggers the transfer can be categorized as either voluntary or involuntary. It is important for physicians to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved.

Voluntary transfers occur in a variety of ways. Consider the following:

- Sale of the entire practice under favorable circumstances.
- Pre-sale through a buy-sell agreement.

Involuntary transfers occur just as frequently and often under the most adverse circumstances:

- Death is the ultimate involuntary transfer.
- Divorce may result in retaining the practice, but other assets are transferred on the basis of the value of the practice.
- Sale of the practice when the physician is uninformed or required to sell due to financial or business conditions.

In most of these cases, these transactions are among the most important of the physician’s business and personal life. This article was written to inform you about key concepts of business value and provide a framework for determining the value of your practice.

The Ownership Transfer Matrix

As stated previously, all practice ownership will eventually be transferred. At Mercer Capital, we developed the “Ownership Transfer Matrix” to help you understand the different ownership transition scenarios. An understanding of the value of your practice is an important component in preparing yourself for any of these eventualities.

<table>
<thead>
<tr>
<th><strong>Ownership Transfer Matrix</strong></th>
<th><strong>Partial Sale/Transfer</strong></th>
<th><strong>Total Sale/Transfer</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Voluntary Transfers</strong></td>
<td>Physician Buy-Ins, Buy-Sell Agreements, Sale of Practice Interest</td>
<td>Sale of Practice</td>
</tr>
<tr>
<td><strong>Involuntary Transfers</strong></td>
<td>Divorce, Forced Restructuring, Shareholder Disputes, Buy-Sell Agreements</td>
<td>Death, Divorce, Bankruptcy, Physician Disputes, Buy-Sell Agreements</td>
</tr>
</tbody>
</table>
A PRIMER ON THE KEY CONCEPTS OF DETERMINING VALUE

It comes as a surprise to many physicians to learn that there is not a single value for their practice or practice interest. Numerous legal factors play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

**Valuation Date.** Every valuation has a “as of date” which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements, such as death or divorce, or be implicit, such as the closing date of transaction.

**Purpose.** The purpose of the valuation is important. A valuation prepared for one purpose is not necessarily transferable to another. There is no such thing as a “one-size-fits-all” approach in valuation.

**Standard of Value.** The standard of value is an extremely important legal concept because it will help determine the rules of the game. There are many standards of value just as there are many types of ownership transfers. The standard of value will influence the selection of valuation methods and the level of value. The most familiar standard is fair market value, which is most commonly used in tax matters. Other important standards are investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Matching the standard of value to the valuation is crucial in obtaining an accurate determination of value.

**Levels (Premise) of Value.** When physicians think about the value of their practice, they are almost always implicitly thinking about the value of the practice in its entirety. The value of a single share, for example, is the value of the whole divided by the number of shares. In the world of valuation, this will not be true if the aggregate block of stock does not have control of the enterprise. The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex question, yet it will be of great importance. A minority interest value can include discounts for the lack of control and marketability; therefore, it is quite possible for a minority interest to be worth proportionately far less than an ownership interest which is part of a control block.
INDUSTRY CONDITIONS / FACTORS

Health care is receiving intense focus from all levels of government, with particular emphasis on cost and access. Increasingly bold proposals are being made, which hold the promise of major changes in the way that health care is paid for in the United States. Many of these proposals are conflicting and represent radically different philosophical viewpoints. It is, therefore, impossible to predict with any degree of certainty which, if any, changes will occur.

For example, the insurance industry is offering the Consumer-Directed Health Plan, since the advent of a tax advantaged Health Savings Plan. This type of insurance, if it continues to grow as it has been, is expected to change the way patients utilize health care, and in return, the way physicians provide information. Specifically, patients are more likely to be cost conscious and compare prices. Physicians who want to remain competitive will be expected to have prices readily available and be competitively priced.

With the advent of Health Savings Accounts, doctors will likely be seeing more full fee patients. However, should the popularity of this type of medical plan grow rapidly, doctors may find themselves having to price their services competitively as patients may begin to compare service fees when they are paying out-of-pocket. Other examples include changing reimbursement rates and procedures for radiology and ambulatory surgery centers.

The medical industry continues to deal with a service fee growth rate that is much slower than the rate of inflation. This is primarily due to the government and the insurance industry which dictate, in large part, the amount to be paid for any particular service. While physicians may increase their nominal service fees, they typically cannot collect the entire fee because of contractual or Medicare limitations.

CONTINUOUS HOT BUTTON ISSUES

The status of Medicare reimbursements is always an issue for a physician practice, but has become of increasing concern. A growing number of practices are either not accepting or severely limiting Medicare patients. Aggressive contract pricing by managed care plans tends to further limit physician incomes.

Medical malpractice premiums are an issue of significance in assessing risk of cost inflation to medical practices. Premiums have continued to grow over the years due primarily to large damages awards, increasing legal fees and a decline in the number of insurance companies providing medical malpractice insurance. As of 2005, lawmakers in 48 states have introduced some form of medical malpractice reform legislation to their state legislatures. Of these 48, 27 states have actually enacted some form of reform.

When valuing a medical practice, the appraiser should evaluate the state’s current malpractice statutes with regard to direct risk to the practice. This is particularly important for practices that typically have high malpractice premiums, such as obstetrics and gynecology.

BALANCE SHEET

Medical practices often prepare financial statements on a cash basis. Adjustments must be made to the balance sheet to properly reflect an accrual basis accounting.

Accounts receivable are not reflected on cash basis financial statements. However, the practice should be able to provide an accounts receivable balances outstanding and aging. Because the practice does not book receivables, it will not have a history of bad debt write-offs. Therefore, receivables require further analysis than simply the current accounts receivable balance. A history of collections over several years should be analyzed and a determination of the estimated amount collectable should be made based on the historical rate of amounts collected, compared to amounts billed. Also, the analyst should look into average collection.
periods and analyze amounts aged over 90 days. An estimate of the collectable accounts receivable should be reflected in the balance sheet.

Medical practices frequently expense supplies. While the amount is nominal for some practices, it can be significant for others. A review of supply purchases can assist in estimating the value of supplies on hand and determine whether further review is warranted.

Some types of practices have significant machinery and equipment and some have none. The analyst must be careful to ascertain ownership of the machinery and equipment. It is not unusual for equipment to be owned by a separate company with common ownership with the practice. In that case, it must be determined whether lease rates approximate market value rates. A similar analysis should be performed for real estate leases or investments.

Accounts payable are not included in a cash basis financial statement. If the financial statements are on cash basis, the analyst must determine the amount payable.

**INCOME STATEMENTS**

Key items driving the earnings include:

- **Mix of patients** – Insured versus not insured, portion of patients under managed care, portion of patients on Medicare;

- **Patient base** – Is the patient base primarily a recurring base, as is generally the case for general practitioners, pediatricians, and other physicians considered to be primary care physicians, or is it primarily non-recurring, as for most surgeons;

- **Physician productivity** – Does the physician work long hours or is it typically a 40 hour work week or less? Does the physician make use of technology that could increase productivity? This is particularly important when evaluating normal compensation;

- **Relative value units** – Does the practice utilize RVU (relative value units)? This is a unit of measure similar to billable hours which measures a physician's efficiency. Medicare assigns RVUs to procedures and payment is determined by RVUs not hours;

- **Coding** – Does the practice routinely analyze its coding procedures?

- **Paraprofessionals** – Does the practice utilize paraprofessionals, such as nurse practitioners and physician assistants? Practices with a large quantity of relatively routine cases can increase efficiency by utilizing these somewhat lower paid specialists; and,

- **Ancillary services** – Does the practice have laboratory facilities or testing equipment? Practices that provide ancillary services frequently have higher earnings as they are not referring those services to another practice. Keep in mind that recent Stark amendments require that profits from certain ancillary services cannot be apportioned based upon who initiated (referred) the service internally.
THE VALUATION OF YOUR PRACTICE

There are three general approaches to valuing a business. These include the cost approach, the income approach and the market approach. As a general rule, every valuation should address value using these approaches. While some of these indicators may not be indicative of the overall value, each approach incorporates procedures, which may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one of these approaches (or perhaps several methods) as being most indicative of value for the subject interest under consideration.

The Cost Approach

This approach is rooted in determining the value of the assets. According to the Business Valuation Standards of the American Society of Appraisers, the cost approach is "a general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset." The net asset value method is in simple terms, a balance sheet approach to value. The aggregate value of the assets, net of the liabilities of the business, may be indicative of the value of the equity in the business. There are numerous methods employed to develop this indication of value. The method Mercer Capital employs most often is called the "net asset value method." The process involves identifying and adjusting the reported value of tangible assets and liabilities to their estimated fair market values. Some appraisers advocate determining the value of intangible assets and using them in the asset value method. Doing so simply converts the asset method to a version of the income approach since the intangible assets are most likely valued using an income method.

The asset approach is commonly used for divorce purposes in states that do not recognize personal and professional goodwill as a marital asset. In the case of divorce, it is important that this issue is discussed with the attorney. If the asset approach is used, analysis of the receivables will be a key issue. It may also be necessary to request that medical machinery and equipment be appraised by a qualified appraiser.

The Income Approach

Once again quoting the Business Valuation Standards of the American Society of Appraisers, the Income Approach is "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount."

The most common methods in the Income Approach are discounted cash flow (DCF) and single period capitalization of income. Simply put, the value of a business is directly related to the present value of all future cash flows or earnings that the business can reasonably be expected to produce. The mechanics of the income methodology require an expression of future cash flows or earnings, a growth rate in cash flows or earnings, and an appropriate discount rate with which to take the present value of such cash flows or earnings. The capitalization factor is simply an algebraic simplification of its more detailed counterpart – the discounted future earnings method (DFE). Value is negatively correlated to risk and positively correlated to expected growth. The scope of this article limits the depth of our discussion as this aspect of valuation has been memorialized in countless academic and investment publications over scores of years.

The Discounted Cash Flow Method

The most common application of the income approach in the valuation of physician practices is the discounted cash flow method. Revenue and expenses are projected over reasonable periods of time, typically five years.
Key variables in the revenue analysis are the source of payment, breadth of services, and doctor productivity. However, the analysis is only as good as the latest set of Medicare and insurance reimbursement rules.

Key variables in the expense analysis are the anticipated level of the physician compensation, use of paraprofessionals, equipment and rent. Physician compensation is driven by such factors as numbers of patients seen, severity of illness, and complexity of procedures (specialization). Ultimately, physician compensation is likely to be determined by a formula or will be fixed by a contractual agreement.

If guaranteed physician compensation is built into the model, it may affect the risk (resulting in a higher discount rate) or reduce the cash flow to be capitalized, thereby impacting value.

**The Single Period Capitalization Method**

Another method under the income approach is referred to as a single period capitalization method. As opposed to a detailed projection of future earnings, the analyst determines a base level of annual earnings and then determines a multiplier appropriate to that earnings expression. The most familiar form of this approach is the Price/Earnings (“P/E”) method which is the primary valuation metric observed in the public securities market.

**Conclusion**

Use of any income approach requires identification of a normalized cash flow on a stand-alone basis. This requires the use of benchmarking tools such as the Medical Group Management Association's Annual Physician Compensation and Production Survey Report, which includes data on physician compensation, as well as collections, productivity measures in relative value units (RVU), and other benchmarking data. The discount rate is also a key component for the income methodology and requires an analysis of the relative risk of various physician specialties, as well as a reasonable growth rate for the practice.

**The Market Approach**

The market approach is defined in the Business Valuation Standards as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.”

The market approach includes a variety of methods that compare the subject with transactions involving similar investments. A transaction source unique to the medical community is the Goodwill Registry. The Goodwill Registry provides a database of transactions throughout the medical community and is a unique source in that it breaks out the price paid for goodwill in practice purchases. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

For most practices, the market approach should be analyzed carefully. Regional influences are perhaps more significant to the value of a medical practice than in many types of businesses because of differences in payer mix, patient mix, and demand for services. Furthermore, historical transactions reflect the influence of these factors prevailing at the time of the deal. If future reimbursement rates change significantly, for example, for a specific type of medical practice, then historical transactions will have lost their relevance for valuation purposes. If the appraiser cannot obtain current transactions data, this method should be used with caution.
FINAL THOUGHTS
The point of this article is not to turn you into a valuation practitioner. However, the day will come when you have to confront the value of your practice, or your interest in that practice. On that day, we hope that you have digested this summary article, and are therefore able to have a productive conversation with your valuation expert.

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