GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES

SEPTEMBER 20, 2012
Introduction

- Valuation and transaction advisory firm focused in the healthcare industry since 1995.

- 65 professionals and two offices in Dallas, TX and Nashville, TN.

- Clients located in all 50 states
  
  - Services provided include:
    - Business valuation (800+ valuations per year)
    - Professional service agreement valuation (300+ valuations per year)
    - Tangible asset valuation
    - Transaction advisory
    - Real estate valuation
Agenda

1. Practice Acquisitions – A Look Back in History
2. Practice Acquisitions – Physician Employment
3. Valuation 101: Practices & Ancillary Services
4. Physician Acquisitions: Current Trends
5. Physician Acquisitions: Hospital Best Practices
6. Questions
PRACTICE ACQUISITIONS – PAST & PRESENT

GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES
Physician Practice Management Companies (PPMCs)
- PhyCor (1998)
- Typically purchased equipment, A/R, real estate
- Provided management services for fee (% of revenue)
- Physicians were not employees

Hospitals Defensive Response: Integrated Delivery Network (IDN)
- Hospital-owned
- Typically purchased equipment, A/R, real estate, goodwill
- Physician was gatekeeper
- Ancillary services often included
- Physicians were employed
The PPMC / IDN Bust – late 1990s / early 2000s

- Physicians frustrated with how hospitals managed practices
  - Hospital’s lack of experience in billing for physician services
  - Grew too large too quickly
  - Lack of Physician involvement in decision-making

- Hospitals frustrated with Physicians’ lack of motivation and declining productivity
  - Prices paid for practices were too high to earn adequate ROI
  - Often caused by guaranteeing Physician salaries with no recourse
  - Resulted in significant losses to hospitals

- Many PPMCs / IDNs dissolved and physicians re-entered private practice
**Physician Practice Transaction Timeline**

**1993-1995:** Number of hospital-owned physician practices tripled

**1995-2002:** Hospital-owned physician practices suffered significant operating losses. Acquisitions slowed, divestitures increased

**1998:** PhyCor collapses

**2007 - Present:** “The Great Reconsolidation”
Driving Forces for Physicians:

- Physician desire to be shielded from market forces
- Reimbursement cuts – in some cases these have been drastic
- Increasing costs – particularly malpractice
- Increased in costly IT requirements electronic medical records (EMR)
- Reaction to Healthcare Reform
- Shifting physician demographics
- Shifting desire for work/life balance

2007 to Present: The Great Reconsolidation
Driving Forces for Hospitals:

- Herd mentality
- Secure/expand referral network – defensive strategy
- Advantageous reimbursement – particularly for ancillaries (imaging)
- Addressing staffing shortages
- Need for call coverage
- Healthcare Reform – Accountable Care Organizations (ACOs)
- Need to improve and exhibit quality of care
PHYSICIAN MARKET OVERVIEW

GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES
Number of Physicians has grown from approximately 400,000 in 1975 to 985,000, in 2010; CAGR of 2.7%
- 2012 AMA data;
Physician Market Overview

Physicians Employment Trends

- Number of physicians employed by hospitals has increased 34% from 2000 to 2010
  - As of 2010, approximately 25% of all physicians are employed by hospitals
According to MedPAC’s June 2011 report, from 2000 to 2009 the volume of physician services grew by 46%.

Growth rates for major procedures and Evaluation and Management (E&M) services 31%.
By 2025, the United States is projected to face a physician shortage of 131,000.
Valuation Primer - Practices

General Trends in Hospital Acquisitions of Physician Practices
**Regulatory Guidance**

**Regulatory Overview**

- **Fair Market Value ("FMV")** – the **ONLY** premise of value to meet the Anti-Kickback Statute and Private Inurement Regulations

- **Both for-profit and not-for-profit health care providers** that accept payments from government programs (i.e., Medicare) must ensure that exchanges between them and other providers are at FMV.

- **Definition**
  - The price, expressed in terms of cash equivalents, at which a property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy nor to sell, and when both have reasonable knowledge of the relevant facts
  - FMV can consider revenue increases or cost savings to the Practice that any hypothetical willing buyer would be able to influence but not specific downstream referrals the Practice drives to a health system
Stark Law
- Prohibits physicians from referring a patient to an entity with which the physician (or an immediate family member) has a financial relationship, when the referral is for the furnishing of certain designated health services (DHS).
  - Civil violation and restricts ownership

Anti-Kickback Statute
- Prohibits the payment or remuneration in exchange for, or in order to induce, the referral of patients or other businesses which are reimbursed under the Medicare program.
  - Criminal violation

Private Inurement
- Deals with tax-exempt entities providing excess benefits to non tax-exempt individuals or entities
**Valuation Approach**

*Fair Market Value vs. Strategic Value*

- **Investment Value or Strategic Value**
  - Premise of value used everyday in merger and acquisitions which are not required to meet Fair Market Value standards
  - Definition – The price, at which a property would exchange hands between a specific buyer and able seller; it is the value of a property to a particular investor

- **Examples of FMV / Investment Value**
  - Investment Value:
    - Adjusting the reimbursement rates for the sellers to Hospital-based (Provider-based)
    - Adjusting the cost structure to account for efficiencies or economies of scale that only a specific buyer could realize
  - Fair Market Value:
    - Adjusting reimbursement rates up to freestanding market averages
    - Adjusting the cost structure to reflect market norms for similar businesses
There are three accepted business valuation methods...

- **Income Approach**
  - Discounted Cash Flow Method

- **Asset (Cost) Approach**
  - Tangible Assets
  - Intangible Assets

- **Market Approach**
  - Guideline Public Company Method
  - Similar Transactions Method
Valuation Primer

The Income Approach...

- Examines historical financial and production information to estimate the future level of cash flows.
  - Projection of future revenues and expenses
  - Projection of future capital expenditures and working capital requirements

- Discount future after tax debt free cash flows

- Discounted or capitalized cash flow methods are commonly utilized for healthcare entities.

Present Value of Cash Flows = Value Indication
### Income Approach Illustration

#### PROFESSIONAL EARNINGS ONLY

<table>
<thead>
<tr>
<th>Revenues:</th>
<th>Projection Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Fee-for-Service (Professional ONLY)</td>
<td>Year 1</td>
</tr>
<tr>
<td></td>
<td>3,352,000</td>
</tr>
<tr>
<td>Adjustments &amp; Refunds</td>
<td>(1,856,000)</td>
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<tr>
<td></td>
<td><strong>Total Net Operating Revenues</strong></td>
</tr>
</tbody>
</table>

| Operating Expenses:                          |                |
|                                              | Year 1  | Year 2  | Year 3  | Year 4  | Year 5  |
|                                              | 1,006,000 | 1,037,000 | 1,070,000 | 1,103,000 | 1,138,000 |
|                                              | **Total Operating Expenses** | 1,496,000 | 1,540,880 | 1,587,106 | 1,634,720 | 1,683,761 |

| Operating Margin                             |                |
|                                              | Year 1  | Year 2  | Year 3  | Year 4  | Year 5  |
|                                              | 490,000  | 503,880  | 517,106  | 531,720  | 545,761  |

| Pre-Compensation Earnings                    | Year 1  | Year 2  | Year 3  | Year 4  | Year 5  |
|                                              | 490,000  | 503,880  | 517,106  | 531,720  | 545,761  |

| Provider Compensation                        | Year 1  | Year 2  | Year 3  | Year 4  | Year 5  |
|                                              | 392,000  | 403,000  | 414,000  | 425,000  | 437,000  |
| Provider Benefits                             | 67,000   | 69,000   | 71,000   | 73,000   | 75,000   |
|                                              | **Total Provider Compensation** | 459,000 | 472,000 | 485,000 | 498,000 | 512,000 |

| Distributable Cash Flow Available to Buyer   | Year 1  | Year 2  | Year 3  | Year 4  | Year 5  |
|                                              | 31,000   | 31,880   | 32,106   | 33,720   | 33,761   |

- **Provider Compensation often provided by hospital management**
  - **Pre- Compensation Split (95%/5%)**
**Physician Transaction Trends**

**Practice Valuation Compensation Trends**

**Components of value include:**

- **Upfront purchase price** (i.e. present value of cash flows)
- Increasing focus on **post-transaction compensation** going forward
  - Structure of the transaction may be important relative to how earnings of the practice will be paid out

*CHS – 2012* “The company recruited 855 new physicians for the first 6 months of the year, this compares to 658 physicians recruited in the same period a year ago. Additionally, we’ve added 39 mid-level practitioners during the first 6 months of this year. Physician recruiting remains a very strong element of our operating strategy.” – [Wayne Smith]
Valuation Primer

The Market Approach

- Estimates value by comparing the value of similar assets, securities or services traded in a free and open market to the subject asset, security or service.
  
  - Similar publicly-traded companies are not comparable from a size or growth standpoint and often include practices with a variety of management services agreements.
  - Similar transaction information in the public domain is rarely useful because details on transaction structure (including post-transaction compensation and employment terms) are not included.
  - Market Approach rarely used alone as a determinant of FMV for a physician practice.

Selected Multiple(s) x Subject Metric(s) = Value Indication
The Asset (Cost) Approach

- Takes into consideration the cost of replicating a comparable asset, security or service with the same level of utility.
- Typically used when the entity has historical losses or nominal projected cash flow.
- Typical Components...

**Tangible**
- Working capital
- Fixed assets
- Real estate (if applicable)

**Intangible**
- Trade name
- Medical Charts
- Trained Workforce

Tangible Assets + Intangible Assets = Value Indication
Valuation Primer

Components of Value...

Total Value
- Working Capital
- Fixed Assets
- Intangible Assets (Goodwill)

Retained by Physician
- Working Capital Less Inventory
- Personal Fixed Assets

Purchased by Hospital
- Inventory
- Fixed Assets
- Intangible Assets
Valuation Primer

Reconciliations of Valuation Approaches Summary

- Valuation firm will make a recommendation as to the weighting of the approaches
- Based on the facts and circumstances of the valuation
- Will weigh evidence of reliability of the value indications combined
CURRENT MARKET TRENDS – PRACTICE ACQUISITIONS

GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES
**PHYSICIAN TRANSACTION TRENDS**

*Types of Practice Transactions...*

- **A. Purchase of entire practice**
  - Physician employed
    - Ancillary cash flows may be included from post transaction compensation calculation

- **B. Ancillary only purchase**
  - Physician may not want to give up control
  - Physician not employed
  - Method to Integrate with Hospital without outright sale
  - Method of liquidation/risk mitigation

- **C. Purchase of practice with ancillary carve-out**
  - Ancillaries may be “carved out” in valuation
    - Carved out ancillary cash flows excluded from post transaction compensation calculation
A: Practice Valuation

- Professional Practice Valuation
  - Hospital will buy Fixed Assets – very little intangible value
  - Acquisition value versus ongoing comp structure
  - Ongoing compensation structure is a component of value which is paid out over-time rather than as an upfront purchase price

- Advantages
  - Physician – Maintain or higher compensation structure
  - Physician – Reduced practice management risk;
  - Hospital – Employed; alignment

- Disadvantages
  - Physician – Lower purchase price
  - Hospital – Decreased production by employed physician
### A: Practice Only

**PROFESSIONAL EARNINGS ONLY**

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
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</thead>
<tbody>
<tr>
<td><strong>Revenues:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Gross Fee-for-Service (Professional ONLY)</td>
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<td>3,452,560</td>
<td>3,556,137</td>
<td>3,662,821</td>
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<td>(1,911,680)</td>
<td>(1,969,030)</td>
<td>(2,028,101)</td>
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<tr>
<td>Total Net Operating Revenues</td>
<td>1,496,000</td>
<td>1,540,880</td>
<td>1,587,106</td>
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<th>Year 5</th>
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<tbody>
<tr>
<td><strong>Operating Expenses:</strong></td>
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<td>Total Operating Expenses</td>
<td>1,006,000</td>
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<tr>
<td><strong>Operating Margin</strong></td>
<td>490,000</td>
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<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Compensation Earnings</td>
<td>490,000</td>
<td>503,880</td>
<td>517,106</td>
<td>531,720</td>
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<tr>
<th>Year</th>
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<tr>
<td>Provider Compensation</td>
<td></td>
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<td>392,000</td>
<td>403,000</td>
<td>414,000</td>
<td>425,000</td>
</tr>
<tr>
<td>Provider Benefits</td>
<td>67,000</td>
<td>69,000</td>
<td>71,000</td>
<td>73,000</td>
</tr>
<tr>
<td>Total Provider Compensation</td>
<td>459,000</td>
<td>472,000</td>
<td>485,000</td>
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<td>Distributable Cash Flow Available to Buyer</td>
<td>31,000</td>
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**B: Ancillary Services**

- **Ancillary Valuation**
  - Physician is giving up income stream
  - Buyer will compensate physician for this lost income stream
  - Many ancillary businesses are still quite profitable
  - Acquisition market is quite active

- **Advantages**
  - Physician – Higher purchase price
  - Physician – Integration with hospital without losing practice autonomy
  - Hospital – Conversion to hospital based rates
  - Hospital – Align with physician

- **Disadvantages**
  - Physician – Compensation takes a hit; removal of technical earnings
  - Hospital – Referral pattern of patient base; maintain alignment
### PHYSICIAN TRANSACTION TRENDS

**B: Ancillary Only**

#### TECHNICAL EARNINGS ONLY

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<th>Projection Period</th>
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<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Gross Fee-for-Service (Technical ONLY)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Adjustments &amp; Refunds</td>
<td>(1,100,000)</td>
</tr>
<tr>
<td>Total Net Operating Revenues</td>
<td>900,000</td>
</tr>
</tbody>
</table>

| Operating Expenses:                |                |
| Total Operating Expenses           | 600,000  | 650,000  | 700,000  | 750,000  | 800,000  |

| EBITDA                            | 300,000  | 317,000  | 335,000  | 352,000  | 370,000  |

| Pre-Compensation Earnings         | -       | -       | -       | -       | -       |

| Provider Compensation             |                |
| Provider Compensation             | -       | -       | -       | -       | -       |
| Provider Benefits                 | -       | -       | -       | -       | -       |
| Total Provider Compensation       | -       | -       | -       | -       | -       |

| Distributable Cash Flow Available to Buyer | 300,000  | 317,000  | 335,000  | 352,000  | 370,000  |

- **In-office ancillary services**
  - Diagnostic Imaging, radiation/medical oncology, laboratory, sleep labs...
C. Purchase of practice with ancillary carve-out

- “Carve out” valuation
  - Ancillary (fully burdened) + Practice (fully burdened)
  - Ancillary valuation is based on the **technical earning ONLY**
  - No “double dipping”
    - Provider Comp is representative of professional earnings only

- Advantages
  - Physician – Monetize ancillary business
  - Hospital – Conversion to hospital based rates
  - Hospital – Align with physician

- Disadvantages
  - Physician – Compensation takes a hit; removal of technical earnings
  - Hospital – Referral pattern of patient base; maintain alignment
**Physician Transaction Trends**

*Valuation – Three Approaches*

<table>
<thead>
<tr>
<th>Professional Practice (Pro Fee)</th>
<th>Ancillary Business (Tech Fee)</th>
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</thead>
<tbody>
<tr>
<td>Income Approach</td>
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<tr>
<td>Discounted Cash Flow Method</td>
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<td>Similar Transactions Method</td>
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BEST PRACTICES IN VALUATIONS / TRANSACTION PROCESS

GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES
**BEST PRACTICES**

**Critical Steps in Best Practices...**

- **Timeline – Understand your closing date**

- **Involve key decision makers in communications**
  - Who are the stakeholders and what are their typical points of view with regards to the valuation process and outcome?
    - Physicians
    - Physicians representatives, administrator, billing personnel, accountant, legal counsel
    - C-Suite hospital executives
    - Hospital administrators; Legal Counsel

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**GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES**

**Appraisers and Attorneys Involved**

**Due Diligence**

**Pro Forma Financials**

**Executed Asset Purchase Agreement (APA) / Letter of Intent (LOI)**
**BEST PRACTICES**

**Critical Steps in Best Practices... (continued)**

- **Due Diligence**
  - How is this relevant to the valuation and where in the process does it fit in?
    - Consider requirements of all stakeholders in conjunction with valuation, legal and regulatory standards
    - Assess the quality of information available
    - Be very clear on the definition of “materiality” and if in doubt, avoid use of this term

- **Other Considerations**
  - Common mistakes to avoid for hospital executives
    - “Goodwill”
    - Affect of ancillary carve-outs on purchase price and on-going compensation to be paid
    - Use and examples of company-specific information vs. market-participant information
Final Thoughts

Presentation Summary

- Consolidation within healthcare markets
  - Be active and understand the changing landscape of physician practice acquisitions.

- Valuation of Practice is **NOT** Easy
  - Select a valuation expert with care – does the valuation expert have:
    - Credentials from recognized organizations (AICPA, ASA, NACVA)?
    - Experience with healthcare industry regulations and guidance?
    - Expertise on the impact of the regulations on a valuation?
    - Knowledge of relevant market survey data and its limitations?

- Best Practices in Hospital Acquisition of Physician Practices
  - Roles of the parties in a model transaction process
  - Involve key decision makers in communications

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**HCA – 2012** “With respect to use of cash, we continue to look for acquisition opportunities. Our pipeline, as the other companies have mentioned as well, remains very strong. We see some good opportunities there.” [Milton Johnson, CFO]
GENERAL TRENDS IN HOSPITAL ACQUISITIONS OF PHYSICIAN PRACTICES

SEPTEMBER 20, 2012

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