ASC Valuation Update & Current M&A Trends

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Presentation Overview

I. Current Market Analysis
II. ASC Transaction Market
III. ASC Valuation – In Practice
Current Market Analysis

- ASC Industry is mature

- Economic Downturn Continues to Impact ASC Volumes, but Volumes Clearly Gaining Traction

- Significant Managed Care & Medicare Reimbursement Pressure

- Uncertainty Regarding Healthcare Reform’s Long-Term Impact on ASCs
Current Market Analysis

- All Signs Point to a Mature ASC Industry

- Growth in ASC Development has Leveled Off
- Same Center Growth has Flat-Lined
- ASC Supply Exceeds Physician Demand in Most Markets
- Significant Capacity at Many ASCs
- Growth in Observed ASC Mergers & Consolidation
- Initial Stages of Consolidation among ASC Management Companies
Current Market Analysis

- Declining Growth in New ASC Development

Prior to 2008: Significant ASC Development to Meet Physician Demand

Post 2008: Supply of ASCs has Met or Exceeded Physician Demand

>10% Annual Growth

2-3% Annual Growth
Current Market Analysis

- **Same Center Volume Growth Recovering**

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<th>2006</th>
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<th>2008</th>
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<tr>
<td>USPI</td>
<td>7%</td>
<td>6%</td>
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<td>4%</td>
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<td>1%</td>
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*Source: Company’s Annual Reports*

**Market Forces Driving this Trend:**

1. Diminishing Ability to Attract New Volume / Physicians
2. Trend stabilized and is beginning to show reversal after economic downturn (pent up demand)
Current Market Analysis

- Growth in Excess Capacity reached inflection point, currently trending in positive direction.

**Median Cases per OR per Day**

- 2007: 3.1
- 2008: 3.0
- 2009: 2.6
- 2010: 2.7
- 2011: 3.0

**25% Decline in OR Utilization from 2007 to 2010**

Source: VMG Health Intellimarker ASC Survey
Current Market Analysis

- Greatest Challenges Facing ASCs in Today’s Market

  I. Inability to Attract New Physician Investment & Volume
     - Declining Physician Investor Pool
     - Price Prohibitive Cost for Investment
     - Inability to show Attractive Return
     - Existence of Alternatives for Physicians

  II. Declining Reimbursement Rates
     - Out of Network Drying Up
     - Squeezed by Managed Care
     - Current & Projected Medicare Pressure
Current Market Analysis

- Supply of ASCs has Exceeded Demand from Physicians

# of Eligible Physicians per ASC

- 9-10% Annual Growth in ASCs
- 2-3% Annual Growth in Eligible Drs
- >40% Decline In Eligible Drs Per ASC
Current Market Analysis

- Aging Physician Demographic will Further Limit Recruitment & Volume

Demographics of the Physician Workforce

- **1980** – Approx 20% over Age 55
- **1990** – Approx 30% over Age 55
- **2007** – Approx 40% over Age 55

Current Market Analysis

- **Supply of New Physicians will Likely not Meet Demand of Existing ASCs**

  First – Year MD Enrollment per 100,000 Population has Declined Since 1980

  ![Graph showing decline in first-year MD enrollment per 100,000 population from 1980 to 2020.](image)

  **Source:** “Help Wanted: More US Doctors – Projections Indicate American will Face Shortage of MDs by 2020” by AAMC
Current Hospital Employment Trends

New Competition: Hospital Employed Physicians on the Rise

Since 2000:
- Employed PCPs has Doubled
- However Employed Specialists has increased 5-fold

Source: “Toward Accountable Care” from the Health Care Advisory Board at the 2010 Special CEO Sessions (June 2010)
Current Market Analysis

- **What to Expect in a Mature Industry Environment?**
  - Attracting new volume is the greatest challenge
  - Increase in mergers and limited ASC failure
  - Moderated returns for most ASCs
  - Hospitals becoming more involved

- Independent ASCs are not increasing in number – control valuations should remain high for well run ASCs with a good story

- The value range of minority shares should become wider, as ASCs struggle to find physicians
ASC Acquisition Market – Who are the Buyers?

I. Acute Care Hospitals – *On the rise, better HOPD rates, physician affiliation strategy, growth in market share*

II. National Owner/Operators – *Acquisitions, growth strategy and expense synergies*

III. Other ASCs – *Mergers, expense synergies*

IV. Physician Owned Hospitals – *Barred from adding capacity – need strategy to expand*
And What Do They Pay?

I. Acute Care Hospitals – *industry-wide capital constraints, balance many priorities*

II. National Owner/Operators – *usually very motivated, focused on ASCs*

III. Other ASCs – *Mergers, usually no cash changes hands – relative valuation*

*All ASCs are Not Created Equal with Respect to Valuation Multiples*
ASC Transaction Market

• **Rationale for sellers continues to evolve...**

  I. **Physicians** – *recruiting help, capital partner, better leverage, operational know how, reform worries, life-cycle of professional practice, etc.*

  II. **Regional Owner/Operators** – *Dramatic shifts in physician employment locally, physician frustrations force divestitures*

  III. **National Owner/Operators** – *Limited, but it happens*

• **Increase in turnaround opportunities**

• **Increase in multi-party joint ventures – best of both worlds**
  o Two mgmt companies partner as controlling member
  o Mgmt company / hospital partner as controlling member

• **De novo development still happening, but limited**
Evidence of management company consolidation 2011

- Amsurg acquires National Surgical Care
  - 18 surgery centers
  - $173.5 million in cash
  - 1.4 x Revenue, 8.0 x EBITDA

- Surgery Partners acquires NovaMed
  - 37 surgery centers, 19 states
  - $214 million, assumes $105 million of debt
  - 1.4 x Revenue, 5.1 x EBITDA
ASC Transaction Market

- Minority share valuations affected by macro trends
  - Range of minority valuation multiples have declined
  - Many ASC opportunities for physicians – large supply, moderate demand
  - Alternative investment risk is higher
    - Turnarounds and de novos are attractive alternative to high cost of ownership in profitable ASC’s
    - Leads to decline/moderation of minority value for profitable ASC’s

All ASCs are Not Created Equal with Respect to Valuation Multiples
Summary

- Purposes for ASC valuation
- Primary drivers of value
- Valuations of a controlling interest
- Valuations of a non-controlling equity interest
- Considerations for hospitals acquiring and converting ASCs
Purposes for ASC Valuation

- Over-riding purpose for most ASC Valuations is compliance with the Federal Anti-Kickback Statute
  - No specific application of Stark Law or limitations on physician ownership since outpatient surgery is not a designated health service (DHS)
  - Statute prohibits offer, solicitation, payment or receipt of remuneration if intent is to induce referrals of patients or other business paid for in whole or in part by a federal program
  - Includes certain exceptions, or *Safe Harbors*, that allow certain conduct that would otherwise violate the statute, one of which is
    → ASC Safe Harbor
ASC Valuation – In Practice

Purposes for ASC Valuation (continued)

- ASC Safe Harbor
  - Protect opportunity for investment in ASCs by physicians who use the ASC as an “extension of practice”
  - 4 Categories
    1. 100% surgeon-owned ASCs
    2. Single-specialty ASCs
    3. Multi-specialty ASCs
    4. Hospital / Physician ASCs
  - Permitted Investors:
    - Physicians performing surgery that meet the “one-third” tests
    - Multi-specialty groups whose individual physicians all meet the requirements to invest individually
    - Physicians and others not employed by the ASC or an investor and are not in a position to make or influence referrals to the ASC or any of the investors
Purposes for ASC Valuation (continued)

- **ASC Safe Harbor (continued)**
  - “One-third tests”
    - One-third of practice income comes from ASC procedures (“one-third income test”)
      - *Not applicable to single-specialty ASC*
    - One-third of physician’s ASC procedures performed at the subject ASC (“one-third procedures test”)
  - Investment returns must be directly proportional to capital investment
    - Safe Harbor does not consider investment at different times / prices
    - OIG Advisory 01-21 views subsequent purchases at *fair market value* as reasonable basis
  - Not all, and perhaps not even a majority, of ASCs fit in the safe harbor
Primary Drivers of Value

- **ASC Inputs Analysis**
  - **Revenues**
    - Case volumes analysis
    - Net revenue per case analysis
      - Net revenue per case varies widely by specialty
      - Impact of reimbursement changes on net revenue per case varies widely by specialty
  - **Operating expenses**
    - Not complex
    - Largest components, staffing and supplies are mostly variable
  - Need to determine the ongoing sustainable EBITDA

- Benchmarking is helpful to understand opportunities and trends
Primary Drivers of Value (continued)

- Primary Drivers of Value = Revenues
  - Case volumes considerations
    - By physician – critical to understand where individual physician utilizers are at in respective practices
      - Risk associated with wide vs. narrow distribution of physicians
      - Physicians approaching end of productive path
    - By specialty – critical to understand changes in operating expenses and reimbursement
      - Growth associated with lower revenue or higher revenue specialties
    - By payor type – critical to understand impact of changes in reimbursement, particularly Medicare
      - Impact of transitioning from out-of-network to in-network with commercial/managed care payors
Primary Drivers of Value *continued*

- Primary Drivers of Value = Revenues *continued*
  - Reimbursement considerations
    - Impact of changes in Medicare reimbursement
      - Largest negative impact
        - GI
        - Pain
      - Largest positive impact
        - General Surgery
        - OB/GYN
        - Orthopedics
        - ENT
    - Impact of Workers Comp reform in many states
    - Impact of transition from out-of-network to in-network
      - *OON is NOT valued the same as In Network reimbursement by most buyers*
Primary Drivers of Value (continued)

- Medicare ASC reimbursement rate impact
Primary Drivers of Value \textit{(continued)}

- Out of network reimbursement impact
  - Timing – immediate vs. future
  - Converting to in-network likely impacts volumes as well
  - Consider impact on operating expenses
  - Similar impact on reimbursement if a joint venture ASC is receiving hospital or hospital-like reimbursement
Valuations of a Controlling Interest

- National ASC companies generally price transactions as a multiple of EBITDA
  - Generally 7.0x + less Debt
  - Before applying the multiple, EBITDA may be adjusted for projected changes in reimbursement
    - Medicare
    - Transition from out-of-network to in-network
      - May also take into account change in volumes associated with this transaction
  - Not in all cases, but in most, the national ASC companies get a management contract for management fees that are typically 5% to 7% of net revenues
Valuations of a Non-Controlling Equity Interest

- Converting the value indication for a controlling interest in an ASC to a non-controlling equity interest requires consideration for the somewhat unique provisions typically included in the operating / ownership agreements:
  - No management fee
  - Most ASCs not only make regular distributions of virtually all distributable cash but are often required to do so
  - Provisions to buy or sell ownership interests at fair market value or based on a formula such as 3.0 to 5.0x EBITDA less debt
  - Non-compete agreements
  - Physician owners actively participate in clinical and operational management
  - Physicians are not only owners but customers
Considerations for Hospitals Acquiring ASCs

- Valuations of ASCs historically operated as a department of a hospital (HOPD) – much less relevant today than 2 years ago
  - Historical financial data may require a great deal of adjustment
    - Revenues converted to free-standing levels
    - Operating expenses presented on hospital department income statements usually not all inclusive and at the same time may include a number of complex cost accounting allocations
  - Some case volume not eligible for performance post-conversion to free-standing facility
  - Complexities in reflecting conversion to a free-standing entity while at the same time, not anticipating the change in ownership when projecting earnings / cash flows
    - Consideration for potential competition
Considerations for Hospitals Acquiring ASCs (continued)

- Valuations of ASCs being purchased for the purposes of converting to HOPD – more relevant today than 2 years ago
  - Often involve marginal or underperforming centers but not always the case
  - Physicians and operators understand the potential impact on reimbursement
  - May be pressure from all sides to move toward Investment Value standard
  - Historical financial data should be used as is
    - Revenues in the valuation remain at free-standing levels
    - Operating expenses considered in the valuation should reflect continuing operations
  - Usually inappropriate for FMV – but hospital’s business case should consider impact on volumes
  - Reliance on Cost Approach not at all uncommon – consider relevant intangibles such as CON, Development Fees, Licensing, etc.
What Does the Future Hold?

Summary

- Continued Consolidation in the Industry
- Increased Hospital involvement in the ASC Industry
- Industry Participants should Expect Reduced Reimbursement
- Completely Independent ASCs will have Greater Risk Exposure
- As a Low Cost Provider, ASCs will Have a Place at the Table
Questions

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