Physician Alignment in Today’s Market

Acquiring Ancillary and Physician Services – A guide to FMV and Transactions
1. Introduction
2. Team
3. Acquisition Trends
4. The Valuation Process
5. The Transaction Process

PSA
Real Estate
Fixed Asset
Contact
Introduction
VMG Health Background

- VMG Health solely provides transaction advisory and valuation services in the healthcare industry
- Offices located in Dallas, Texas and Nashville, Tennessee
- Services include
  - Business Valuation
  - Transaction Advisory Services
  - Joint Venture Relationship Development
  - Professional Services Valuations
  - Tangible Asset Appraisals
  - Financial Reporting Valuations (ASC 805 & ASC 350)
  - Real Estate Appraisals
- Routine transaction advisory services have involved
  - Hospitals
  - Diagnostic Imaging Centers
  - Radiation Therapy/Cancer Centers
  - Rehabilitation Hospitals
  - Dialysis Facilities
  - Cath Labs
  - Physician Organizations
  - Ambulatory Surgery Centers ("ASCs")
  - Urgent Care Centers
  - Physical Therapy
  - Medical Transport
  - Home Health Agencies

VMG Health performs over 600 valuations per year throughout the United States and abroad

VMG Health currently employs over 50 professionals
VMG Client List

Hospital Systems and Hospitals

Specialty Hospitals

ASC Companies

VMG HEALTH
WE VALUE HEALTHCARE
VMG and HMA Relationship

- **Fair Market Value (Valuations)**
  - Hospitals
  - Ambulatory Surgery Centers ("ASCs")
  - Imaging Centers
  - Physician Practices
  - Urgent Care
  - Home Health
  - Rehab
  - Skilled Nursing Facility
  - Many Other Healthcare Entities

- **Transaction Advisory**
  - Summarize Valuation (Price)
  - Structure (Ownership & Legal Entity)
  - Negotiate Other Deal Terms (Management Fee, Compensation)
  - Industry Analysis
  - ROI Analysis
  - Consultant on the Benefit of Strategic and Health Management

- **Professional Service Agreement ("PSA")**
  - Physician Compensation
  - Co-management Agreements
  - Directorships

- **Fixed Asset Valuation**
  - Tangible Fixed Assets

- **Real Estate Valuations**
  - Rent Rates
  - Real Estate and Leases
Jim Rolfe

- Managing Director of Transaction Services

- Previously a Vice President of Acquisition and Development for Community Health Systems (“CHS”), the second largest healthcare system in the country

- 50 transactions over the past five years (Buy-side, Sell-side, and Joint Ventures)
  - Hospitals
  - Outpatient Facilities (ASC, Imaging Centers, Labs, etc.)
  - Physician Practices
  - Home Health Agencies
  - Post Acute Facilities

- $2.2 Billion in transactions over the past five years

- 18 whole hospital syndications with physicians
Jonathan Tyroch

- Manager in Business Valuation Services

- Extensive experience in healthcare business valuation

- Has performed over 500 valuations in 5+ years of experience
  - Valuation experience includes:
    - Ambulatory Surgery Centers
    - Physician Practices
    - Diagnostic Imaging Centers
    - Radiation Therapy Centers
    - Specialty Hospitals
    - Acute Care Hospitals
    - Air & Ground Transport Services

- Focuses on valuations for Hospital ancillary acquisitions and Hospital/Physician joint ventures
Jen Johnson, CFA

- Partner at VMG Health
- Leads Professional Service Agreements Division
- Previously with KPMG’s litigation department
- Former Finance professor from the University of North Texas
- Published and presented multiple times related to physician compensation and fair market value
Acquisition Trends
Systems Focusing on Vertical Integration

Hospitals Have Opportunity To Grow, Expand Market Share, and Leverage their Provider Based Rates

- Imaging Centers
- Surgery Centers
- In-Office Ancillaries
- Radiation Therapy
Ancillary Acquisition Structures

**Acquisition – Purchase 100% of center**

**Pros**
- HOPD rates – normally 30-40% higher
- A Defensive Tactic – controls out-migration
- Enhances leverage
- Increase in I/P volume
- Control of the patient

**Cons**
- Physicians have no skin in the game
- Higher financial risk
- Loss of volume

**Joint Venture – normally a 51%+ hospital and 49% physician**

**Pros**
- Some managed care leverage
- Maintains affiliation with physicians
- Recruitment and retention tool
- A Defensive Tactic
- Increase in I/P Volume
- Control of the patient

**Cons**
- Less reimbursement – leaving money on the table
- Loss of some control

**Joint Venture with third party and physicians – bring in an operator**

**Pros**
- Some managed care leverage
- Maintains affiliation with physicians
- Recruitment and retention tool
- A Defensive Tactic
- Increase in I/P volume
- Add needed operational expertise
- Control of the patient

**Cons**
- Less reimbursement – leaving money on the table
- Loss of some control

Others: Lease or real property affiliations
How To Value These Acquisitions?

Ancillary service valuations require the consideration of an Income Approach, a Market Approach, and a Cost Approach.

- The **Cost Approach**, or asset build up approach, considers the cost to recreate the hard assets of the business. The value derived under the Cost Approach generally represents a floor value as little to no intangible value is considered.

- The **Market Approach** considers public comparables and transactions in the business’s marketplace, including the application of Revenue and EBITDA multiples to the Business. Although a growing segment, available data is limited for ancillary service acquisitions.

- In the **Income Approach**, a discounted cash flow analysis is utilized to project the future cash flows of the specific business. These projected cash flows are then discounted back to the present to arrive at a value.

- A valuation cannot incorporate factors attributable directly to the buyer (i.e. better contract rates).
Physician Alignment Continuum

Risk

Integration

Recruitment Support

MSO Support

Joint Ventures

Management/Co-Management

Practice Acquisition
Two Valuation Issues

Fair Market Value of the Practice

- A practice typically has little intangible value
- To have a higher FMV, practice must have earnings
- Compensation is correlated to practice value

Fair Market Value Compensation

- Compensation must be set at FMV
- Compensation should consider practice value
- Historical/future results can support higher comp

Valuation process is subject to manipulation and faulty approaches.
The Valuation Process
The Valuation Process

A sample engagement by HMA

VMG Engaged

Gather

- Discussion on Potential Structure of Agreement by HMA
- Introduction to the Target Entity
- Collect Data (Standard Data Request)

Analyze

- Review, Analyze and Adjust Financials
- Review Assumptions and Quantify Performance
- Assess the risk of the Business
- Apply the Cost, Market, and Income Approaches
## Benefits of Receiving a FMV

<table>
<thead>
<tr>
<th>Compliance</th>
<th>Knowledge</th>
<th>Credibility</th>
<th>Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Stark • Anti-Kickback</td>
<td>• What the target is worth?</td>
<td>• Thousands of valuations • Both sides of the table</td>
<td>• No emotional involvement • Just the facts</td>
</tr>
</tbody>
</table>
Cost Approach

Cost Approach

Typically Relied Upon When

Low or Negative Earnings

FMV of a Physician Practice

Tangible Assets include
- Accounts Receivables
- Supplies Inventories
- Furniture and Equipment

Intangible Assets include
- Legal Title: Protectable
  - Trade Name
  - Telephone Number
  - Patient Charts
- Generates Economic Return
  - Non-compete
  - Workforce in place
  - Certificate of Need ("CON")
Market Approach

What is the Market’s Perception of Value?

- Guideline Public Company Method
  - Data gathered from health care M&A research

- Similar Transaction Method
  - Information is also gathered from experience

- EBITDA and Revenue Multiples differ depending on Center Specific Characteristics including:
  - Sector (ASC, Imaging, Phy. Practice)
  - CON
  - Earnings & Margins
  - Specialties/Modalities
  - Number of Owners
  - Number of Centers
  - Size
  - Location
Income Approach

**A Discounted Cash Flow (“DCF”) Analysis**

- **Financial Analysis**
  - Analyze historical financial and operational performance
  - Adjust Financials to create a base year
  - Remove non-recurring expenses

- **Quantify Assumptions**
  - What are factors contribute to the future of the Center (qualitative and quantitative)?
  - What is the expected growth rate and reimbursement trends of the industry?
  - What are the future operating expenses and capital investments requirements?

- **Discount Rate**
  - Weighted average cost of capital build-up methodology
  - Based on risk of projected cash flows
  - All qualitative and quantitative factors considered (offered services, concentration of owners, revenue and expense projections, demographic and industry factors)

- **Run DCF**
  - Inclusion of above operating expenses and capital expenditures assumptions
  - Forecast a 5 year projection period and terminal year (operations past 5 years)
  - Apply calculated Discount Rate
## Valuation Process Summarized

<table>
<thead>
<tr>
<th>Approach</th>
<th>Methodology</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost Approach</strong></td>
<td>- Value to recreate the business (asset build up)</td>
</tr>
<tr>
<td><strong>Market Approach</strong></td>
<td>- Application of accepted market multiples (Revenue, EBITDA, etc.)</td>
</tr>
<tr>
<td><strong>Income Approach</strong></td>
<td>- Discount Cash Flow analysis</td>
</tr>
</tbody>
</table>

**Reconcile appropriate Approach(es) to arrive at Total Invested Capital**

Deduct outstanding interest bearing debt

**Total Equity Value**

Include Industry data, finalize report, present to management of HMA
The Transaction Process
The Transaction Process

1. **Strategize with HMA**
   - Structure - Asset/Stock Deal
   - Valuation
   - Industry and ROI Analysis
   - Benefits of a Partnership
   - Benefits of HMA

2. **Review with Seller**
   - VMG Role and Expertise
   - Ownership Structure – 100% or JV
   - Other Deal Terms: MGMT Fee, Governance, Compensation

3. **Present LOI (With HMA)**

4. **Negotiate the Deal Terms**

5. **Execute LOI**

6. **Assist in Financial Due Diligence**

- PSA
- Real Estate
- Fixed Asset
From Valuation to Letter of Intent

Valuation Summary

- Total enterprise value: (value – debt and w/c) and midpoint
- Show the value as represented by an EBITDA multiple
- Show the value as represented by ownership structure

Valuation Overview

- Analyze assumptions
  - Historical Revenue, EBITDA, and Margins
  - Number of cases
  - Net revenue per case

Valuation Methods

- Cost Approach
  - Show value and relevant percentage of value
- Market Approach
  - Show value and relevant percentage of value
  - Include market multiples
- Income Approach
  - Show value and relevant percentage of value
  - Review DCF
  - Show Key Assumptions

Management Signs Off on Valuation

Schedule a Meeting to Review with Seller
## Sample Valuation

### FAIR MARKET VALUE RECOMMENDATION

**FINAL REPORT**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value of the Center, Total Invested Capital Level</td>
<td>$6,500,000</td>
</tr>
<tr>
<td>Less: Interest-Bearing Debt Outstanding as of March 31, 2011</td>
<td>-</td>
</tr>
<tr>
<td><strong>Fair Market Value of the Center, Enterprise Equity Level</strong></td>
<td>$6,500,000</td>
</tr>
<tr>
<td>Less: Normalized Working Capital (15.0% of Net Revenue)</td>
<td>(600,000)</td>
</tr>
<tr>
<td><strong>Fair Market Value of the Center, Adjusted Enterprise Equity Level</strong></td>
<td>$5,900,000</td>
</tr>
</tbody>
</table>

- **Total Invested Capital Indication- $6.5 Million**
  - Represents 6.4X NBY EBITDA multiple
  - Blend of Income and Market Approaches

- **Proposed acquisition interest 65.0%**
  - $3.8 million
  - Working Capital to be retained by the Seller
### General Assumptions

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>TTM 2011 Net Revenue</td>
<td>$3,704,145</td>
</tr>
<tr>
<td>TTM 2011 EBITDA</td>
<td>$1,022,344</td>
</tr>
<tr>
<td>TTM 2011 EBITDA Margin</td>
<td>27.6%</td>
</tr>
<tr>
<td>TTM 2011 cases</td>
<td>3,218</td>
</tr>
<tr>
<td>Net Revenue Per Case</td>
<td>$1,151</td>
</tr>
</tbody>
</table>

### Valuation Methods

<table>
<thead>
<tr>
<th>Approach</th>
<th>Total Invested Capital Indication (Rounded)</th>
<th>Weighted</th>
<th>Value Reconciliation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost Approach</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Invested Capital</td>
<td>$1,300,000</td>
<td>0%</td>
<td>-</td>
</tr>
<tr>
<td><strong>Indication includes</strong></td>
<td><strong>tangible assets, trained workforce</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>and working capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Market Approach</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Invested Capital</td>
<td>$6,600,000</td>
<td>50%</td>
<td>$3,300,000</td>
</tr>
<tr>
<td><strong>TTM 2011 EBITDA multiple</strong></td>
<td><strong>of 6.5x</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Income Approach</strong></td>
<td><strong>Discounted Cash Flow Analysis</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Invested Capital</td>
<td>$6,400,000</td>
<td>50%</td>
<td>$3,200,000</td>
</tr>
</tbody>
</table>

**Key Assumptions:**
- Revenue growth of 3.8%
- Expense growth of 3.3%
- Discount rate of 15.0%

**Total Invested Capital Indication - Reconciliation (Rounded)**: $6,500,000
Valuation to Letter of Intent

**Acquire 100%**
- Emphasis on Cash
- Focus on Value and Price
- Employment Post Transaction
- Benefits of HMA

**Joint Venture**
- Emphasis on Present/Future Cash flow
- Focus on Value and Price
- Ownership Percentages
- Governance
- Management Agreements
  - Fees
  - Co-Management
  - Medical Directorships
- ROI Analysis and Comparisons
- Understand Why Partnering
- Benefits of HMA
Why the Growth in Physician Alignment?

Association of American Medical Colleges work force projections indicate the U.S. will have a shortage of 91,500 physicians by 2020.

- Non-economic Reasons
  - Security – healthcare reform, changing reimbursement
  - Quality of Life – older and younger physicians, on average, working less hours

- Economic Reasons
  - Increased compensation: post employment or contracted arrangement
  - Better hospital-based reimbursement
  - Replace potential loss of ancillary earnings
  - Investment requirements for information technology
  - Participate in risk-based contracting, ACOs, quality initiatives
  - Integration trend
Physician Service Agreements

May be a result of joint ventures, acquisitions, employment or new independent contractor arrangements

- Administrative Services
- Call Coverage
- Co-management (fixed + variable)
- Management
- ACO models
- Subsidies
- Professional/technical splits
- Development
- Billing and Collection
- Leasing Arrangements
- All of the above
Valuation Starting Point

- Agreement Terms must be understood and are sometimes unclear at valuation stage, define:
  - What services will be provided?
  - How parties will be compensated?
  - Valuation should match the agreement

- No published standards for physician compensation valuations

- Appraisal firm should understand
  - Healthcare regulations
  - Valuation principles

- Regulatory Guidance
  - Fair Market Value
  - Data considerations

- Business valuation standards - a good place to start
Fair Market Value Definition

- Based on the anti kickback statute, and other healthcare regulations and guidelines, any transaction between hospitals and physicians must be at Fair Market Value.

- IRS definition - “the amount at which property would change hands between a willing seller and a willing buyer when the former is not under any compulsion to buy and the latter is not under any compulsion to sell and when both have reasonable knowledge of the relevant facts.”

- Provides a conclusion which should not reflect consideration for value or volume of referrals.

- Rely upon generally accepted valuation theory – consider multiple valuation methodologies and approaches: cost, market and income approach.
Relevant Data

- It is now likely a combination of several valuations will be required for one agreement, choose the right data/analysis to reflect each of the services

- Multiple, objective surveys suggested

- Data should not reflect referral relationships
  - Medical Director data
  - On-Call data
  - Competing Hospitals – Extra Caution

- Management and Billing – cost to replicate when not typical

- Quality – utilize P4P comparables (found in several types of arrangements)
  - Stick to regulatory guidance when it comes to paying for quality
  - More on this later in presentation
Clinical Compensation

- Historical Compensation drawbacks
- Income Approach challenges and relevance
- Cost-Market Approach – benchmark productivity

Common Misuse of Survey Data - $/WRVU

**EP Cardiology Example – Median $/WRVU**

- MGMA 90th Reported Compensation = $777,461
- MGMA Median Reported $/WRVU = $45.85
- MGMA 90th Reported WRVUs = 21,230
- Calculated Compensation = $973,283 (25% above 90th)

**EP Cardiology Example – 90th $/WRVU**

- MGMA 90th Reported Compensation = $777,461
- MGMA 90th Reported compensation/WRVU = $74.24
- MGMA 90th Reported WRVUs = 21,230
- Calculated Compensation = $1,576,190 (103% above 90th)

Always plug in your proposed compensation to expected production to calculate expected compensation
Tuomey Case Lessons

- Do not pay fulltime benefits/malpractice premiums for part-time services
- Physicians paid above the 75th percentile of market data should demonstrate productivity consistent with other physicians in this percentile
- Understand arrangements where the provider is not making money
- Compensation for administrative duties should be based on significant duties
- Valuation methodology is as important as total compensation
- Creative arrangements need to be carefully constructed, the government suggests getting an OIG Opinion
- No opinion shopping, carefully choose your valuation firm
Paying For Quality

- Hospitals critical success factors – shifting towards quality of clinical performance

- In late 2003, CMS and Premier Inc. launched the Hospital Quality Incentive Demonstration (HQID) for over 250 hospitals offering financial incentives for the top 20% of hospitals.

- Congress authorized the development and implementation of a value-based purchasing (VBP) program to replace the RHQDAPU program which reports quality (the precursor).
  - Performance (Incentives) would be based on either improving historical performance or attaining superior outcomes compared with national benchmarks.
  - Proposed ACOs include similar guidelines

- Numerous third party payors provide P4P payments to hospitals and physicians

- Executive compensation may soon be tied to quality outcomes!
Results of Quality Initiatives

- Hospital Quality Incentive Demonstration (HQID) - Raised overall quality by an average of 17% over its first four years with total payments in excess of $36.6 million and majority of hospitals improved their quality of care across the board

- In 2008, the Robert Wood Johnson Foundation and California HealthCare Foundation reported results of a national program that tested the use of financial incentives to improve the quality of health care.
  - Tested seven projects across the nation that adjusted compensation based on performance scores – hospitals and physicians.
  - Among the notable findings from the program were that:
    - Financial incentives motivate change
    - Alignment with physicians is a critical activity for quality outcomes
    - Public reporting is a strong catalyst for providers to improve care

- Less favorable findings and why
OIG & CMS guidelines provide a solid foundation regarding structuring quality care arrangements:

- Quality measures should be clearly and separately identified
- Quality measures should utilize an objective methodology verifiable by credible medical evidence
- Quality measures should be reasonably related to the hospital’s practice and consider patient population
- Do not consider the value or volume of referrals. Consider an incentive program offered to all applicable providers
- Incentive payments should consider the hospital’s historical baseline data and target levels developed by national benchmarks
- Thresholds should exist where no payment will accrue and should be updated annually based on new baseline data.
- Hospitals should monitor the incentive program to protect against the increase in patient fees and the reduction in patient care
- Incentive payments should be set at FMV
PSA Valuation Take Aways

- Understand agreement Terms
  - What are the services?
  - How is the compensation stated in the agreement (valuation should match)?

- Consider all facts and circumstances

- Rely upon appropriate data

- Use multiple valuation methodologies

- Commercially Reasonable
  - Facility needs – overlap of services?
  - Operational assessment
  - Understand total hours
Internal Compensation Calculators are based on systematic and unbiased overall guidelines which eliminate the user’s ability to include its results.

- Each indication of value considers the specialty and reflects the service provided by the physician.
- Utilizes multiple, objective national surveys reflecting clinical compensation and administration compensation and medical director compensation by specialty.
- Each indication delineates between employed and independent contractor agreements.
Real Estate
The certified real estate valuation team within VMG Health has over 50 years of combined experience.

The special nature of healthcare real estate assets requires a firm understanding of the business, financial and legal environment in which our clients work.

### Services
- Fair Market Valuation
- Fairness Opinions
- Rental Rate Analysis
- Market Feasibility Studies
- Ad Valorem/Property Tax Consulting
- Purchase Price Allocation and Impairment Testing
- Compliance
- Litigation Support

### Engagements
- Medical Office Buildings (MOB)
- Acute Care Hospitals
- Specialty Hospitals
- Rehab Hospitals
- Surgery Centers
- Dialysis Centers
- Assisted Living Facilities
- Skilled Nursing Facilities
- Senior Living Facilities
Fixed Asset Services

- To ensure compliance with regulatory guidelines, including federal and state anti-kickback statutes, and to ensure proper tax treatment for all parties, asset purchases must be conducted at the purchased assets fair market value.
- VMG Health’s healthcare and valuation expertise allows us to understand all potential issues when establishing fair market value for assets by any healthcare organization.

<table>
<thead>
<tr>
<th>Engagements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physician Practices</td>
</tr>
<tr>
<td>Imaging Centers</td>
</tr>
<tr>
<td>Ambulatory Surgery Centers</td>
</tr>
<tr>
<td>Cath Labs</td>
</tr>
<tr>
<td>Acute Care Hospitals</td>
</tr>
<tr>
<td>Specialty Hospitals</td>
</tr>
</tbody>
</table>
VMG Health Contact

Jim Rolfe
Managing Director of Transaction Advisory
rolfe@vmghealth.com
214-369-4888

Jonathan Tyroch
Manager of Business Valuations
jonathant@vmghealth.com
214-369-4888

Jen Johnson
Partner, Professional Service Valuations
jenj@vmghealth.com
214-369-4888