Special Considerations That Impact Practice Valuation

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What is risk?
- Indicator of threat
- Potential for loss
- Unexpected volatility of returns
- Standard deviation of historical returns
- Potential negative impact to an asset

Risk Factors in a Medical Practice
- Growth
- Patient retention
- Physician tenure
- Staff retention
- Referral sources
- Competition
- Managed care
- Accessibility

Risk Factors in a Medical Practice
- Range of services
- Ambience
- Management systems
- Staff morale
- Equipment
- Operating expenses
- Malpractice
- Legal risk
- Cash management

Benchmarks
- Growth 5-10% per year in dollars
- Patient retention 15-20% new patients
- Physician tenure At least 5 years
- Staff retention More than 3 years
- Referral sources Many and identifiable
- Competition Less than 4 MDs/100K
- Managed care Less than 10% of revenue
- Accessibility Easy to find, park

Financial Disclosure

Robert A. Wade, Esq. acknowledges a financial interest in the subject matter of this presentation.

Kevin J. Corcoran is President of Corcoran Consulting Group and acknowledges a financial interest in the subject matter of this presentation.
### Benchmarks

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range of services</td>
<td>≥6 distinct services</td>
</tr>
<tr>
<td>Ambience</td>
<td>Excl’t 1st impression</td>
</tr>
<tr>
<td>Management systems</td>
<td>Up-to-date (&lt;2 yrs)</td>
</tr>
<tr>
<td>Staff morale</td>
<td>Excl’t attitude</td>
</tr>
<tr>
<td>Equipment</td>
<td>Less than 10 years old</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>55-60% generally</td>
</tr>
<tr>
<td>Malpractice</td>
<td>None in 10 years</td>
</tr>
<tr>
<td>Legal risk</td>
<td>Miniscule</td>
</tr>
<tr>
<td>Cash management</td>
<td>A/R ≤ 45 days</td>
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</table>

### Lower Risk

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>Above average growth</td>
</tr>
<tr>
<td>Patient retention</td>
<td>Good patient retention</td>
</tr>
<tr>
<td>Physician tenure</td>
<td>Long term doctors</td>
</tr>
<tr>
<td>Staff retention</td>
<td>Long term staff</td>
</tr>
<tr>
<td>Referral sources</td>
<td>Strong referral ties</td>
</tr>
<tr>
<td>Competition</td>
<td>Leader in the community</td>
</tr>
<tr>
<td>Managed care</td>
<td>Few HMOs</td>
</tr>
<tr>
<td>Accessibility</td>
<td>Good location</td>
</tr>
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</table>

### Lower Risk

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range of services</td>
<td>Diversified subspecialties</td>
</tr>
<tr>
<td>Ambience</td>
<td>Pleasant, clean, safe</td>
</tr>
<tr>
<td>Management systems</td>
<td>Current, robust</td>
</tr>
<tr>
<td>Staff morale</td>
<td>Very high</td>
</tr>
<tr>
<td>Equipment</td>
<td>Current, good repair</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>No serious open issues</td>
</tr>
<tr>
<td>Malpractice</td>
<td>Minimal legal risk</td>
</tr>
<tr>
<td>Legal risk</td>
<td>Above average</td>
</tr>
<tr>
<td>Cash management</td>
<td></td>
</tr>
</tbody>
</table>

### Higher Risk

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>Shrinking practice</td>
</tr>
<tr>
<td>Patient retention</td>
<td>Patient exodus</td>
</tr>
<tr>
<td>Physician tenure</td>
<td>Short term doctors</td>
</tr>
<tr>
<td>Staff retention</td>
<td>High turnover</td>
</tr>
<tr>
<td>Referral sources</td>
<td>Few referrals</td>
</tr>
<tr>
<td>Competition</td>
<td>Numerous, large practices</td>
</tr>
<tr>
<td>Managed care</td>
<td>Many HMOs</td>
</tr>
<tr>
<td>Accessibility</td>
<td>Poor location</td>
</tr>
</tbody>
</table>

### Higher Risk

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<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range of services</td>
<td>Single offering</td>
</tr>
<tr>
<td>Ambience</td>
<td>Cluttered, dirty, unsafe</td>
</tr>
<tr>
<td>Management systems</td>
<td>Old, out-of-date, weak</td>
</tr>
<tr>
<td>Staff morale</td>
<td>Poor</td>
</tr>
<tr>
<td>Equipment</td>
<td>Old, broken, can’t fix</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>Greater than average</td>
</tr>
<tr>
<td>Malpractice</td>
<td>Some serious open items</td>
</tr>
<tr>
<td>Legal risk</td>
<td>A few serious problems</td>
</tr>
<tr>
<td>Cash management</td>
<td>Weak, slow</td>
</tr>
</tbody>
</table>

### Risk and Return

- The greater the amount of risk that an investor is willing to accept, the greater the potential return should be.
- Investors need to be compensated for taking on additional risk.
### Risk and Return

- A US Treasury bond is an extremely safe investment relative to all other investments
- A corporate bond needs a higher rate of return than a US Treasury bond – some risk of default
- A stock in a large, established enterprise needs a higher rate of return than a bond – share price might fall
- A stock in a small, start-up enterprise needs a very high rate of return – the business might fail

### Return on Investment

\[ \text{ROI} \% = \frac{\text{Money gained or loss}}{\text{Money invested}} \]

### Risk Free ROI

- A US Treasury bill is a risk free investment
- Lowest possible ROI

### Risk Premiums

- Large, strong established business – 6-10%
- Large business in competitive industry – 11-15%
- Large business in highly competitive field – 16-20%
- Small business in competitive field – 21-25%
- Very small, one man business – 26-30%

Source: Schilt's Risk Premiums

### Annual Revenue

- Largest – ≥$1 Billion
- Large – $0.1 - 1.0 Billion
- Small – $50 - 100 Million
- Very small – <$50 Million

Source: Security and Exchange Commission

### Multiples

- 10% ROI – 10 X Profit
- 20% – 5 X
- 25% – 4 X
- 33% – 3 X
- 50% – 2 X

Multiples are the reciprocal of ROI
### ROI for Ophthalmology

<table>
<thead>
<tr>
<th>Type</th>
<th>ROI Range</th>
<th>Multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical practice</td>
<td>20-50%</td>
<td>2 – 5 X</td>
</tr>
<tr>
<td>ASC</td>
<td>25-50%</td>
<td>2 – 4 X</td>
</tr>
<tr>
<td>Optical dispensary</td>
<td>50-100%</td>
<td>1 – 2 X</td>
</tr>
</tbody>
</table>

### ROI for Ophthalmology

<table>
<thead>
<tr>
<th>Type</th>
<th>ROI Range</th>
<th>Multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dominant ophthalmology practice</td>
<td>4-5 X</td>
<td></td>
</tr>
<tr>
<td>Strong practice</td>
<td>3-4 X</td>
<td></td>
</tr>
<tr>
<td>Weak/struggling practice</td>
<td>2-3 X</td>
<td></td>
</tr>
<tr>
<td>Failed practice</td>
<td>Assets</td>
<td></td>
</tr>
</tbody>
</table>

### Assets

- **Tangible assets**
  - Equipment and furnishings
  - Tenant improvements
  - Inventory
  - Cash, cash equivalents
- **Intangible assets**
  - Goodwill of the practice

### Cash & Cash Equivalents

- **Cash is an asset**
  - Valuation question is moot; dollar-for-dollar
- **Accounts receivable is a cash equivalent**
  - The risk of default is born by the holder
- **Valuation based on historical collection ratio**

### Goodwill

- **Goodwill is intangible; % of annual collections**
- **Goodwill varies widely**
- **Goodwill has declined for 30-40 years**
- **Typically 5-25% of annual collections**

### Goodwill

- **Large, strong established practice**
  - 20-25%
- **Small, strong practice**
  - 15-20%
- **Large, weak practice**
  - 10-15%
- **Small, weak practice**
  - 5-10%
The Health Care Group Goodwill Registry

Real Estate
- Considered separately
- Not part of practice valuation

Goodwill Distribution (2012-2014)

Profit
- Remaining money after expenses
- Profit distribution is a “dividend”
- Undistributed profit is “retained earnings”

Imputed Profit
- Revenue $1,000,000 100%
- Operating expenses $550,000 55%
- Physician labor $400,000 40%
- Imputed profit $50,000 5%

Physician labor: Cost of a locum tenens or substitute

Practice Valuation Techniques
- Comparison with sale price of similar practices
- Based on profitability and ROI
- Tangible and intangible assets

Example
- Small, one man practice
- Poor condition, imminent retirement after 40 yrs
- Imputed profit = $25,000 ($0.5M revenue)
- ROI (%) = 0.25% (RF) + 30% (risk premium) = 30.25%
- Value = $25,000 / 30.25% = $82,645
- Includes tangible and intangible assets
- Excludes cash, cash equivalents (A/R)
## Example: Buy-In
- Large group practice, excellent condition, ongoing
- Imputed profit = $250,000  ($5M revenue)
- ROI (%) = 0.25% (RF) + 25% (risk premium) = 25.25%
- Value = $250,000 / 25.25% = $990,099
- Includes tangible and intangible assets
- Cash, cash equivalents (A/R) = $833,000  (60 days)
- Basis for buy-in: $1,823,432

## Asset Based Valuation
- Annual collections  $5,000,000
- Goodwill  15%
- Intangible asset  $ 750,000
- Equipment, furnishings  $ 250,000
- Financial assets  $ 833,000
- Valuation  $1,833,000

## Hidden Liabilities
- Overpayments by third party payers due to erroneous or mistaken claims for reimbursement
- Misstatements of earnings due to poor or misleading accounting practices
- Payables or indebtedness that is not recognized by the practice, such as unpaid payroll taxes
- Equipment that is alleged to be owned but title is actually owned by a leasing company
- Unpaid income taxes due to erroneous tax returns

## Example: Overpayment
- Initial value = $250,000 / 25.25% = $990,099
- Cash, cash equivalents (A/R) = $833,000
- Initial basis for buy-in: $1,823,432
- Chart audit identified 4% overpayment for 5 years
  - Immediate refund: $1,000,000  (4% x $5M x 5yrs)
  - Restated value = $50K / 25.25% = $198,020
  - Lost value: $792,079
  - Available cash inadequate to pay refund

## Hidden Value
- Underutilization of services
- Inefficient patient recall
- Postponed or cached surgery
- Poor relations with referral sources

## Example: Underpayment
- Initial value = $25,000 / 30.25% = $82,645
- Chart audit identified 8% underpayment this year
- Utilization audit identified 4% revenue opportunity
  - Immediate additional payment: $40,000  (8% x $500K)
  - Potential value = $28K / 30.25% = $92,562
    - (Estimate 112% x $500K x 5% profit margin)
Other Factors

- Time really does equal money
- Location, Location, Location
- Contract assignment and restrictive covenants
- Old MD’s don’t die…they just take off-balance-sheet severance pay
- But sometimes they do - death
- And taxes - When does $1.00 equal 45 cents?
- Cash is king - or how much is a bird in the bush really worth?

Still More Factors!

- Gossip
- For your consideration - Equity offers
- Yogi Berra—”It ain't over till it’s over!”
  - Representations and Warranties
  - Post closing adjustments
  - Indemnifications
  - The point is…

Detection

- Examine tax returns and financial statements with a critical eye
- Look behind the numbers
- Chart review
- Utilization analysis
- Engage an equipment appraiser
- Engage a private investigator
- Ask questions - Leave no stone unturned
- Patience really is a virtue

Summary

- Return on investment (ROI) is proportional to risk
- Valuation Techniques
  - Comparable selling price
  - Asset based
  - Multiple of cash flow
- Everything is not on the financial statements
  - Hidden value
  - Hidden liabilities

Questions or Concerns:

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More help...

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