How to Value an Ophthalmology Practice and Its Goodwill

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Plymouth Meeting, PA

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* Financial Interest

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  • Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
  • Shareholders of and Attorneys with Health Care Law Associates, P.C.
Who We Are

• Business and legal advisors to physicians
• Publishers of the Goodwill Registry, used in valuation of opthalmology and other medical practices
• Handle and advise re: practice buy-ins, buy-outs, sales, mergers and valuations

General Objectives

• Give you the tools to talk knowledgeably with your appraiser/consultant
• Give you basic framework to think about your own practice – before the moment of truth

Focus of Presentation

• Is on doctor-to-doctor sales and buy-ins
• “Private equity” is a different animal
  • Not yet available to most practices
**Why Are You Doing This Appraisal?**

- Complete sale of practice entity
- Partner buy-in
- Partner buy-out
- You need a valuation method that will work for all of these transactions

**Core Assets for Valuation**

- "Hard Assets":
  - Equipment, improvements, inventory, supplies, software
- Goodwill/intangibles:
  - Charts, phone numbers, patient base/flow, workforce, all systems ready to go
- All of these must be replicated if not purchased: "Buy" vs. "make"

**Working Capital Assets**

- Accounts receivable
- Cash, net of payables
- Generally excluded from an "asset sale"
- But generally included in a buy-in/stock sale
Goodwill Flashpoint

- Hard assets and accounts receivable: relatively non-controversial
- Goodwill: more difficult to value, and therefore often controversial

Hard Asset Valuation

- Ophthalmic equipment, business equipment, office buildouts
- Book Value?
  - Nearly always too low
  - Think about all the items that you “expensed”
    - Section 179: These assets have an immediate book value of zero
    - The rest have a book value of zero in 5-7 yrs

Specialized Appraisal

- May be feasible for high end items with active resale market (e.g., slit lamps)
- But not generally available/reliable for business equipment
- Leaves you with a partial appraisal
**Modified Book Value Approach**

- Eliminate assets no longer in use
- Recompute depreciation
  - 8-12 year life (overall)
  - Straight-line depreciation
  - Floor value: 20% of original cost
- Generally reasonable for most items

**Supplies/Inventory**

- Optical frames
- Contact lenses
- Premium IOLs
- Eye medications/drops
- Botox®, facial fillers
- Retina injectibles (e.g., Eylea®, Lucentis®)

**Valuing Supplies**

- Physical inventory, at cost:
  - Count number of units on hand
  - Multiply by acquisition cost
  - Somewhat laborious, but most accurate method
Another Approach

- Estimate supplies value based on annual usage
- Example:
  - Tax return shows “medical supplies” deduction for $120,000
  - Monthly cost is $10,000
  - Practice manager estimates typical inventory at 2 months’ worth of supply
  - Valuation is 2 X $10,000 = $20,000

Valuing Optical Frames

- Do a physical inventory
- But be sure to exclude frames that are no longer current

Accounts Receivable

- Not relevant for asset sales (retained by seller)
- But definitely relevant for buy-ins and buy-outs, which are stock sales
**AR in Buy-Ins**

- New partner shares in AR on the books as of buy-in date
- Need to value AR. New partner “pays for” AR via income shifts to senior doctor, over time.

**AR in Buy-Ins**

- Alternative: “Redlining”
- Excludes AR from buy-in
- Do not need to value AR
- All proceeds of AR go to senior doctor
- Is your system capable of doing this tracking?

**Valuing Receivables**

- Face value
  - Excluding “deadwood” over 180 days
  - And amounts in collection
- Times historical collection ratio
- Sometimes reduced further by collection fee (e.g. 6%)
AR Example

- Example: Face value of AR is $120,000.
- $20,000 of this is over 180 days
- Net face value is $100,000
- Historical collection ratio = payments/charges = 60%.
- Final collectible value is $60,000

“I shouldn’t have to buy into my own receivables”

- Associate may feel that he has an ownership stake in his AR, because he generated them
- But typically the associate was paid a guaranteed salary to generate those AR

“I am buying a 50% stock interest, but I shouldn’t have to buy 50% of the AR. (I am the low producer.)”

- This is a valid concern, if the income division formula is production based
- Instead of buying into 50% of the whole, associate buys into 100% of his/her own personal production
Cash

- Excluded from asset purchases
- Included in buy-ins
  - Unless it will be bonused out to current owners as compensation

Other Miscellaneous Assets

- Prepaid items e.g. malpractice insurance
  - Include as an asset in buy-in and buy-out
- Autos, artwork and other “personal” items:
  - Exclude as personal to doctor

Liabilities

- Bank debt, accrued retirement, vendor payables (esp. retina drugs)
- Generally excluded from asset sales
  - Buyer does not assume liabilities
**Buy-Ins and Buy-Outs**

- Liabilities are included in calculation of stock price
  - They reduce the stock price
  - If corporate assets are $100, and liabilities are $40, net stock value is $60

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**What is Goodwill?**

- The sum total of all intangible assets
  - Charts and patient lists
  - Phone numbers
  - Corporate name
  - Institutional reputation/past advertising
  - Familiar location

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**Goodwill**

- Also includes “going concern” values/items
  - Trained workforce in place;
  - Leasehold/location secured;
  - Policies and procedures developed;
  - All systems in place and ready to operate
Practical Application

- Sales: Goodwill is part of purchase price, add to equipment and supplies to arrive at total purchase price
- Buy-In: Goodwill is "purchased" via pre-tax income shift

Goodwill Valuation

- Three basic methods:
  - Income Approach
  - Market Approach
  - Asset Approach

Income Approach

- Examples: Discounted Future Cash Flow, Capitalized Earnings
- Future revenues and expenses are projected to yield estimated future earnings
- Earnings are discounted to present value using a rate that reflects riskiness of these future cash flows, like a bond.
### Income Approach: Concerns

- Difficult to predict future revenues and expenses - esp. with ownership change
- Hard to determine the true “earnings” of a doctor PC.
- Most PCs “zero out” any earnings by paying bonuses, at years’ end, to avoid taxes
- “Required rate of return” is subjective

### Cap Earnings Example 1

<table>
<thead>
<tr>
<th>$400k</th>
<th>Available for owner</th>
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</thead>
<tbody>
<tr>
<td>- 300k</td>
<td>“Reasonable Salary”</td>
</tr>
<tr>
<td>100k</td>
<td>“Profit”</td>
</tr>
<tr>
<td>÷ 20%</td>
<td>Required Rate of Return (= 5 x “multiple”)</td>
</tr>
<tr>
<td>$500k</td>
<td>Valuation</td>
</tr>
</tbody>
</table>

### Cap Earnings Example 2

<table>
<thead>
<tr>
<th>$400k</th>
<th>Available for owner</th>
</tr>
</thead>
<tbody>
<tr>
<td>- 350k</td>
<td>“Reasonable Salary”</td>
</tr>
<tr>
<td>50k</td>
<td>“Profit”</td>
</tr>
<tr>
<td>÷ 20%</td>
<td>Required Rate of Return (= 5 x “multiple”)</td>
</tr>
<tr>
<td>$250k</td>
<td>Valuation</td>
</tr>
</tbody>
</table>
In Example:

- 16.6% differential in “reasonable salary” assumption ($300 vs. $350) yields
- 50% differential in valuation ($500 vs. $250)

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<tr>
<td>$500k</td>
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</tbody>
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<tr>
<th>Cap Earnings Example 3</th>
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<tbody>
<tr>
<td>$400k</td>
</tr>
<tr>
<td>$300k</td>
</tr>
<tr>
<td>100k</td>
</tr>
<tr>
<td>÷ 25%</td>
</tr>
<tr>
<td>$400k</td>
</tr>
</tbody>
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**Asset Approach**
- Value of business is the cost to replicate its components (equipment, goodwill), less an allowance for depreciation
- Very difficult to determine the cost of replicating goodwill or other intangibles
- Rarely used for medical practices

**Market Approach**
- Aka “Comparable Sales”
- Same idea as pricing a house
- Comparables provide a benchmark
- Adjust for individual features

**Market Approach**
- Does not eliminate subjectivity
- But subjective elements are acknowledged
- Benefit of this method is its link to “real world” prices paid by others.
  - Fair market value is what a buyer will actually pay and a seller will actually take
Review of HCG Goodwill Registry Data

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Goodwill %</th>
<th>Notes</th>
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</thead>
<tbody>
<tr>
<td>2006 - 2010</td>
<td>27.47%</td>
<td>10 Year Average</td>
</tr>
<tr>
<td>2011 - 2015</td>
<td>28.81%</td>
<td>5 Year Average</td>
</tr>
<tr>
<td>2012 - 2015</td>
<td>29.17%</td>
<td>4 Year Average</td>
</tr>
<tr>
<td>2013 - 2015</td>
<td>29.14%</td>
<td>3 Year Average</td>
</tr>
<tr>
<td>2014 - 2015</td>
<td>30.38%</td>
<td>2 Year Average</td>
</tr>
<tr>
<td>2008</td>
<td>37.45%</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>22.10%</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>29.95%</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>16.98%</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>26.29%</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>27.44%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>26.33%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>28.83%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>26.11%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>34.64%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Goodwill Registry 2016
**Adjustments: Location**

- Is this a desirable place for physicians to live?
  - More potential physician buyers means more “demand” for the intangible assets of existing practices
- Major metro areas versus rural
- Coasts versus heartland
**Adjustments: Competition**

- If there is no competition, it will be easy to start a practice
  - Then why should buyer pay big $$$ for your goodwill?
  - Reduced or zero goodwill value in rural areas

**Adjustments: Competition**

- If there is cutthroat competition, buyers may be deterred
  - This also reduces goodwill

**Adjustments: Competition**

- Moderate to strong competition is favorable for goodwill
  - Hard to start a practice from scratch
  - Better to buy an existing practice
**Adjustments: Profitability**

- High profits excite buyers $\Rightarrow$ high goodwill
- Even average profitability is attractive
  - "buying a job"
- Below average profitability or declining profitability is "scary" $\Rightarrow$ low goodwill

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**Other Potential Adjustments**

- Facility presentation/curb appeal
  - Up to date or run-down?
- Payor mix
  - Balanced (good)
  - Heavy HMO, capitation, Medicaid? (concern)
  - Elective services? Can be favorable in well-to-do areas

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**More Adjustments**

- Negative publicity or legal problems
- Practice reputation too dependent on Seller personal charisma
More Adjustments

- Seller work effort not readily replicable
- Seller sees 80 patients a day
- Most buyers cannot do this
- So continued high revenues not assured
- May be “fixable” if buyer can find an associate to help him cover the volume

Ancillary Businesses - Optical

- Typically valued in the same fashion as the “core” ophthalmology practice
- Equipment, inventory, receivables, goodwill
- Not truly a freestanding business

Ancillary Businesses – Real Estate

- May or may not be part of the transaction
- Priced by real estate professionals
Ancillary Businesses – ASC

- Generally a separate entity from the ophthalmology practice
- Valued as a multiple of earnings
  - 2-4X EBITDA (earnings before interest, taxes, depreciation and amortization) for doctor-to-doctor sales
  - 6-8X EBITDA for sales to national surgery center companies

Questions?

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