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
### Benchmarks
- Range of services: ≥6 distinct services
- Ambience: Excl’t 1st impression
- Management systems: Up-to-date (<2 yrs)
- Staff morale: Excl’t attitude
- Equipment: Less than 10 years old
- Operating expenses: 55-60% generally
- Malpractice: None in 10 years
- Legal risk: Miniscule
- Cash management: A/R ≤ 45 days

### Lower Risk
- Growth: Above average growth
- Patient retention: Good patient retention
- Physician tenure: Long term doctors
- Staff retention: Long term staff
- Referral sources: Strong referral ties
- Competition: Leader in the community
- Managed care: Few HMOs
- Accessibility: Good location

### Lower Risk
- Range of services: Diversified subspecialties
- Ambience: Pleasant, clean, safe
- Management systems: Current, robust
- Staff morale: Very high
- Equipment: Current, good repair
- Operating expenses: No serious open issues
- Malpractice: Minimal legal risk
- Legal risk: Above average
- Cash management: A/R ≤ 45 days

### Higher Risk
- Growth: Shrinking practice
- Patient retention: Patient exodus
- Physician tenure: Short term doctors
- Staff retention: High turnover
- Referral sources: Few referrals
- Competition: Numerous, large practices
- Managed care: Many HMOs
- Accessibility: Poor location

### Higher Risk
- Range of services: Single offering
- Ambience: Cluttered, dirty, unsafe
- Management systems: Old, out-of-date, weak
- Staff morale: Poor
- Equipment: Old, broken, can’t fix
- Operating expenses: Greater than average
- Malpractice: Some serious open items
- Legal risk: A few serious problems
- Cash management: Weak, slow

### 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

ROI (%) = \[
\frac{\text{Money gained or lost}}{\text{Money invested}}
\]

Risk Free ROI

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

Risk Premiums

- Large, strong established business
- Large business in competitive industry
- Large business in highly competitive field
- Small business in competitive field
- Very small, one man business

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

- Medical practice: 20-50% 2 – 5 X
- ASC: 25-50% 2 – 4 X
- Optical dispensary: 50-100% 1 – 2 X

ROI for Ophthalmology

- Dominant ophthalmology practice: 4-5 X
- Strong practice: 3-4 X
- Weak/struggling practice: 2-3 X
- Failed practice: Assets

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%
**Profit**

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

**Imputed Profit**

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$1,000,000</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>$550,000</td>
<td>55%</td>
</tr>
<tr>
<td>Physician labor</td>
<td>$400,000</td>
<td>40%</td>
</tr>
<tr>
<td>Imputed profit</td>
<td>$50,000</td>
<td>5%</td>
</tr>
</tbody>
</table>

Physician labor: Cost of a locum tenens or substitute

**Example**

- Small, one man practice
- Poor condition, imminent retirement after 40 yrs
- Imputed profit = $25,000 (0.5M revenue)
- ROI (%) = 0.25% (RF) + 3% (risk premium) = 3.25%
- Value = $25,000 / 3.25% = $77,408
- 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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