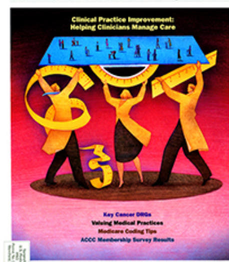

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Valuing Medical Practices

by J. Mark Clapp and Patti Jamieson, M.S.S.W., M.B.A.

Health care is changing, and physicians who were once content to heal patients are now struggling to learn how to manage the business of medicine. Many see managed care as a great threat, since insurance companies have changed not only how physicians are paid for their services but also the ways patients receive treatment. Case management, utilization review, economic credentialing, and contract negotiations are just some of the means used to influence physician decision making. Given the extent of the intrusion into physicians' lives, it is small wonder that medical professionals are looking for new ways to organize themselves into effective, efficient business organizations that can combat what is seen as the unfairness of managed care organizations.

The organizations to which physicians seem to be flocking come in four basic forms:

1) *Physician-run organizations.* These are growing rapidly. Medical professionals now recognize that although they may not have a long history of successfully running large-scale business operations, as clinicians they control the spending of up to 80 percent of the health care dollar. Consequently, they are becoming less willing to hand over to others the potential profits that can accrue to a successfully run physician organization.

2) *Hospital/health care organizations.* These systems are acquiring physician practices as a means of creating the integrated delivery systems needed to acquire and effectively manage the risk-based contracts that are rapidly becoming the norm in many parts of the country. Depending on the relation of the hospital administration to the medical staff, there is often a natural affinity between hospitals and physicians: Hospitals are usually well capitalized, and physicians are used to working with them.

3) *Insurance-run organizations.* In some markets insurance companies are buying physician practices to ensure a supply of providers for their newly developed managed care products. But while some insurance companies are acquiring medical practices, others are divesting themselves because of the huge loses they have suffered from not knowing how to manage and compensate physicians.

4) *Equity-based physician practice management companies (PPMs).* These are the newest, quickest growing, and perhaps most influential purchasers of medical practices. PPMs are large, publicly traded companies, such as Phycor and FPA Medical Management. While they have traditionally focused on primary care and multispecialty practices, over the last few years they have turned to niche specialties such as oncology, e.g., American Oncology Resources, Physician Reliance Network, and Response Oncology. With deep pockets and freedom from the not-for-profit concerns that can significantly impact practice value, PPMs are putting pressure on all other organizations that seek to maintain health care as a local or regional business.

Into this swirling cauldron of change comes the practicing physician. Regardless of who shows the most interest in acquiring a practice, physicians must ultimately ask themselves what their practice is worth and if the offer proposed is fair and equitable.

Practice value, or the inducements to sell that are offered by the acquiring party, is often the primary determinate of whether a practice will change hands. Practice value becomes the basis for exchanging cash, setting future compensation, issuing stock in the new corporation, granting representation, and perhaps even determining the extent of a physician's role, if any, in the governance of the acquiring organization.

REGULATORY INFLUENCE

The Internal Revenue Service (IRS) and the Inspector General of the Department of Health and Human Services stand as the watchdogs of the federal government to ensure that patients with government-funded health care are not channeled to providers because of external financial considerations.

The IRS, as the grantor of tax-exempt status, presents the greatest challenge to not-for-profit organizations that attempt to build a physician network through the acquisition of medical practices. It is the job of the IRS to ensure that these tax-exempt organizations do not overpay for a practice as a way of channeling Medicare and Medicaid patients into their hospitals. To ensure that practice acquisition is not used to channel patients, the IRS requires that physician practices be acquired at fair market value, which is defined as the price at which a willing buyer and a willing seller would agree, neither being under any compulsion to buy or sell, and both having a reasonable knowledge of the relevant facts (*Revenue Bulletin 59-60, 1959-1 C.B. 237*). Consequently, the valuation of a physician's practice in anticipation of a sale to a not-for-profit entity must follow a

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well-defined methodology. The ultimate punishment for not following IRS guidelines, although seldom imposed, is the revocation of a hospital's tax-exempt status.

The Inspector General of Health and Human Services must also prevent illegal referrals to providers who accept government payments for health care services. In addition, the Inspector General must track private inurement, the benefit received by a not-for-profit institution from the cash streams of a for-profit venture.

Because of the concerns of these two government agencies, not-for-profit entities that value a physician's practice are placed under greater scrutiny than their for-profit competitors.

HOW TO VALUE A MEDICAL PRACTICE

Determining practice value involves five major steps:

- determining what will be valued
- defining the basis of value
- evaluating the practice
- determining the appropriate valuation approach
- applying the appropriate valuation methodology

Step one: Determining what will be valued. A functioning medical practice is a combination of hard assets, invested capital, trained personnel, and physician reputation. In turn these assets produce cash flow that is used to pay operating expenses. The entity that acquires a practice may agree to acquire some or all of these elements, each of which has an effect on the ultimate practice value.

Common decisions made at this step usually rest on questions such as whether real estate will be included in the valuation, who will keep the accounts receivable, and what method (replacement, depreciated, or liquidation value) will be used to value hard assets and supplies.

Step two: Defining the basis of value. There are three different bases on which to determine the value of a practice: liquidation value, fair market value, and investment/strategic value.

- *Liquidation value* represents the value that an owner would realize if the practice were liquidated and assets sold off piecemeal. This usually brings the lowest price because it fails to recognize the inherent value of all the practice assets operating together.
- *Fair market value* represents the price at which property would exchange between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. As previously stated, this is the standard applied by the IRS to the acquisition of a medical practice by a not-for-profit entity.
- *Investment or strategic value* is more open-ended in that it represents the value to a particular buyer or seller and as such does not rest on the strict interpretations placed on the buyer under a fair market value transaction. However, if the buyer is a not-for-profit, justifying the purchase price becomes more difficult.

Step three: Evaluating the practice. Before purchasing a medical practice, the acquiring entity must assure itself that the organization it is about to acquire fits its own organizational goals and objectives. Determining fit is best accomplished by interviewing all the physicians in the target organization and asking questions related to personal and professional expectations. It is also helpful to understand what they believe will constitute a successful buyout.

Once a fit is deemed possible, the acquiring entity must determine if the practice is capable of continuing its operational and financial performance. Specific criteria used to assess practice performance and value include:

- *Demographics.* The patient base of a practice is exceptionally important to understand because it conveys a good picture of future performance. A practice with high indigent volume and low new patient volume indicates poor cash flow and stunted future growth. Likewise, a majority of elderly patients without a strong growth in younger patients is representative of a dying practice.
- *Physician productivity.* Profitability is directly related to the volume of patients seen in the practice. Comparisons to American Medical Association and Medical Group Management Association surveys will tell whether the practice and its physicians are as productive as their peers. Lower than average productivity translates into reduced value.
- *Location.* The significance of a medical practice location depends on the specific buyer. For a buyer wanting an inroad to a particular geographic area, an otherwise lackluster location may present an opportunity to increase geographic coverage and thus be a favorable factor that increases value. Another buyer may be interested in what is viewed as a poor location, which would act to lessen overall value, yet could still increase market share.
- *Insurer/managed care contracts.* In a changing health care market, participation in managed care panels and quantity of capitated patients are major indicators of practice value, since capitated patients represent consistent cash flow and are, therefore, to be highly valued.
- *Real estate/leases.* Whether a practice owns real estate may be a significant factor. Many physicians who own real estate as part of the practice want the real estate includ-

ed in the acquisition price. In contrast, many purchasers of medical practices are not looking to acquire real estate. Leases may also be a major factor, especially if the leases are long term and the purchaser intends to move the practice.

■ *Physician earnings.* Medical practices are cash based. After paying operating expenses, profits accrue to the shareholders and are distributed as compensation and bonuses. A physician's earnings in comparison to his or her peers in the market is a good indicator of practice value. In fact, many valuation methodologies are a variation of the concept of capitalizing excess earnings. In other words, how much a physician earns in excess of his or her peers becomes the basis for determining the value of the practice.

■ *Equipment/supplies.* A practice with outdated equipment will require additional capitalization, thus reducing future earnings. Medical and office supplies, equipment, and other hard assets are usually valued outside of the practice valuation by an independent appraiser who is knowledgeable of local market prices for these items.

■ *Billing and accounts receivable.* Practice profitability depends not only on physician productivity, but also on the ability of the office staff to account for services performed, accurately bill in a timely manner, and collect the receivables due the practice. Low net collection rates or high receivable balances are indicators of billing and collection problems. Although this will usually reduce the buyout value, it can pose an opportunity to the new owner for relatively rapid improvements in financial performance once the collection problems are resolved.

■ *Staffing.* A well-trained, knowledgeable staff is one of the physician's greatest assets. Staff members can literally make or break the practice and represent a huge subjective asset in the valuation. Likewise, a poorly trained staff will most likely require the new owner to provide expensive training and perhaps hire replacement staff before the practice is performing up to market standards.

A well-trained, knowledgeable staff is one of the physician's greatest assets.

■ *Competition.* The most productive and profitable practice may not be the most highly valued, especially if current competition is weak but is projected to increase in the near future. The risk of reduced revenues in the face of aggressive competition will have a significant effect on practice value. Likewise, a monopoly position achieved through superior customer satisfaction is a considerable plus to the practice, assuming it can be maintained in light of projected market changes.

■ *Reputation.* Reputation is a difficult factor to value, especially if the practice is small and the key physician(s) is near retirement. A retiring physician's reputation will not pass to his successor unless the successor has been around long enough to make a positive impression on the patients of the practice. As a result, reputation is treated differently depending on the specific buyer. Hospitals tend to place a higher value on reputation, especially when the practice belongs to a long-time, loyal member of the medical staff.

■ *Goodwill.* Goodwill is the value of physician/practice name and reputation, which results in continued patient flow for the purchaser of the practice. Goodwill may also be defined as the purchase price that exceeds the value of identifiable tangible and intangible assets, net of liabilities. Medical practices usually have both practice goodwill, which is associated primarily with the business, and professional goodwill, which is associated with the physicians in the practice. There are a number of methodologies for valuing goodwill. When goodwill exceeds the fair market value and the purchaser is a not-for-profit, IRS scrutiny can be expected.

Step four: Determining the appropriate valuation approach. The market generally recognizes three approaches—income, market, and cost—to valuing a medical practice, although within each approach there can be a variety of specific methodologies. The IRS, which is most concerned by the acquisition of medical practices by not-for-profit entities, claims that the income approach is most relevant because it has been approved for the valuation of intangible assets in several revenue rulings, and the intangible assets of medical groups often receive a substantial valuation.

■ *Income approach.* The income approach to estimating the business enterprise value focuses on incorporating operating characteristics of the practice into a cash flow analysis. Future cash flow that can be taken out of the practice without impairing profitability and operations is estimated. This cash flow is

Table 1. Asset Model

Assets	
Current assets	$1,500,000
Accounts receivable	$780,000
Furniture and equipment	$180,000
Medical supplies	$380,000
Office supplies	$14,000
Total Assets	$2,854,000
Liabilities	
Payroll taxes payable	($1,000)
Accrued retirement plan	$43,000
Employee insurance payable	$700
Total Liabilities	$42,700
Net Asset Value	**$2,811,300**

Table 2. Market Value Model

Fiscal Year	**Gross Fee Income**
January 1–December 31, 1996	$7,600,000
x Goodwill factor*	x 22%
Goodwill	**$1,672,000**
+ Net Asset Value	+$2,811,300
Practice Value	**$4,483,300**

* average goodwill factor of oncology practice per *1995 Goodwill Registry*, published by the Health Care Group, Plymouth Meeting, Pa.

Table 3. Capitalization of Excess Earnings Model

Fiscal Year	**Compensation per Number of Physicians**	**Weight**	**Total**
12/92	$470,000	1	$470,000
12/93	$570,000	2	$1,140,000
12/94	$600,000	3	$1,800,000
12/95	$740,000	4	$2,960,000
Total		**10**	**$6,370,000**
Weighted average	$6,370,000 divided by 10		$637,000
Average annual income per oncologist*			$320,000
Excess earnings			$317,000
Capitalization rate			÷ .5
Subtotal			**$634,000**
Expected growth 5% in two years			x105%
Subtotal			**$665,700**
x number of physicians			x6
Goodwill			$3,994,200
Net assets			+$2,811,300
Total Practice Value			**$6,805,500**

*average compensation for oncologist 75th percentile, 1995 MGMA survey

When considering a buyout, purchasers look at a medical practice as a business.

then converted to a present value by using a capitalization factor.

- *Market approach.* This approach uses the market price paid for businesses of similar operating characteristics. Since most small practice acquisitions are usually conducted in a private transaction, there is no reliable database of medical practice buyouts. The Health Care Group in Plymouth Meeting, Pa., does, however, publish a *Goodwill Registry* that records acquisitions reported to them. This is the closest that the market has to a database of public record.
- *Cost approach.* This approach measures value by determining the cost to replace an asset less an allowance for depreciation. Once the value of assets is determined, liabilities at book value are subtracted. This approach is based on the premise that an investor should pay no more for an intangible asset than the cost to replace that asset.

Step five: Applying the appropriate valuation methodology. The selection of a particular valuation methodology is determined by the availability of source data from the practice to support a particular approach as well as the use of the valuation. If the valuation is to support the buyout of a practice by a not-for-profit entity, the IRS requires the income approach, specifically, the discounted cash flow methodology. However, to ensure a correct valuation, the results should be tested against the results of a market and cost approach.

Specific methodologies used to determine practice value include:

Table 4. Discounted Cash Flow Model

Before Physicians' Salaries		Physicians' Salaries*		Net Cash Flow
$4,460,000	–	$1,920,000	=	$2,540,000

Projected Cash Flow (2% growth factor)

1996	$2,590,000
1997	$2,642,000
1998	$2,695,000
1999	$2,750,000
2000	$2,860,000
	$13,537,000

Average payment on $13,537,000 divided by 60 months equals about $226,000 per month

The present value of that income stream at a 15% discount rate for 5 years

$$\text{Present value} = \Sigma \frac{Ei}{(1+r)i}$$

Σ = Sum of
Ei = Expected ecomonic return in the ith period in the future
r = Discount rate
i = The period (usually stated in years) in the future in which the ecomonic return to be discounted is expected to be received

Total Practice Value **$8,987,285**

*average compensation for oncologist 75th percentile, 1995 MGMA survey

■ *Asset accumulation.* In this method adjusted book value includes all assets, both tangible and intangible, minus practice liabilities (Table 1). This method is used to value troubled businesses with no apparent goodwill value.

■ *Market value method.* This is one of the most common methods of evaluation. The appraiser attempts to compare other practices that have been sold to the practice being appraised. Information on prior sales is used to estimate goodwill for the practice being appraised. In this method the gross fee income for one year is calculated and multiplied by the "goodwill factor" (the amount of money paid for the practice as a percentage of the revenue generated during a given year). The goodwill value plus the net asset value (hard assets) equals the practice value (Table 2).

■ *Capitalization of excess earnings.* This method determines value by dividing a company's historical earnings by a prevailing or desired rate of return (capitalization rate). It is appropriate in situations where a company's value relates primarily to its earning capacity, i.e., the ability to generate a reasonably predictable stream of earnings. As part of this method, partners' earnings that exceed industry averages are added back to the earnings. Key to this methodology is an estimate of future earnings that reflects past performance, the selection of an appropriate capitalization rate, and allowances for a fair owners' salary (Table 3). Although the IRS allows use of this methodology only if there is not a better basis for making a determination, it is one of the most frequently used and misused valuation methodologies.

■ *Discounted cash flow.* This methodology has four components: projecting cash flows, determining a discount factor, calculating the present value of cash flows over an explicit forecast period, and determining continuing value beyond the end of the forecast period (Table 4). Each element in the process has a range of subjective factors that are usually determined by the experience and professional judgment of the appraiser. Each of these elements can and does have a significant impact on the final valuation. Thus, the skill of the appraiser becomes a key factor in the valuation.

■ *Comparative transactions.* This method looks at other acquisitions in both the public and private markets, as well as transactions used to determine buying in to the subject practice. Since accurate market data are difficult to find and the valuation of another practice does not take into account the specifics of the target practice, this method is best used as a guideline and not a specific determinant of practice value.

FINAL WORDS

The need for practice valuation is becoming more common, particularly since physicians are now viewed as key elements in shaping integrated delivery systems. Although the individual practitioner often believes that his or her practice is worth more than what has been offered, practice value is influenced by many factors, including the status of the purchaser (such as a not-for-profit hospital vs. a for-profit physician practice management company).

When considering a buyout, purchasers look at a medical practice as a business, and as with any business the ability to generate a profit is of primary importance. Unless there is some unique aspect to the practice, calculating a return on investment is often the most critical reason given to proposing a specific price.

Any price determined by a valuation is subject to negotiation, especially when one considers that fair market value is the price that a willing buyer and seller reach, assuming reasonable knowledge of relevant facts. The best way to negotiate the highest selling price for a practice is to understand the methodology used in the valuation process as well as all the factors that influenced the selection of subjective valuation criteria. Once the decision has been made to sell a practice, there is no reason to settle for less than the absolute maximum price that can be negotiated.