

Valuation: The First Move Toward Physician-Hospital Integration

By William T. Carlson Jr.

When a group of cardiologists and a hospital agree to discuss the possibility of integration, the discussion typically follows a well-established path much like a three-act play: valuation, compensation and governance. This first of three articles will focus on valuation and some basic principles to guide cardiologists who are considering this move. October and November *Cardiology* will carry articles on compensation and governance, respectively.

Hospitals try to temper expectations by saying they cannot pay more than Fair Market Value (FMV) for a practice. While the concept captured in the Internal Revenue Code for non-profit hospitals and in the federal anti-kickback statutes for all Medicare providers is true, it is not the whole truth. What hospitals don't tell cardiologists is FMV is more art than science, and it is not a single dollar figure but varies based on both the practice and the valuation consultant. By way of example, I have seen valuations of less than \$100,000 per cardiologist to more than \$1,000,000 per cardiologist.

To determine FMV, most hospitals hire an outside accounting firm to provide an independent FMV opinion. To provide this FMV opinion, the group must provide at least 12 months of detailed financial data about its revenue, expenses and productivity.

Principle #1:
Do not provide any financial data without a signed Confidentiality Agreement.

The rationale for this principle is that you will have provided significant proprietary information about your practice if the transaction does not close. This data could enable the hospital to make offers to a few of the group's most productive cardiologists. Data could provide information concerning the group's commercial contracts thereby giving hospitals a potential negotiating advantage. While most hospitals act more honorably than that, a Confidentiality Agreement provides the group with legal rights in case they do not.

Principle #2:
Make the valuation firm a party to the Confidentiality Agreement.

Invariably valuation firms ask for more information than necessary to perform an initial valuation. However, because some of the information they request could yield a more accurate valuation report, you may want to provide it with some additional protection. If the valuation firm is a party to the confidentiality agreement, they can receive the raw data for purposes of their analysis, but would agree not to provide anything

but the analysis to the hospital without the cardiologists' permission. In addition, if the valuation firm violates the Agreement, it is easier to proceed against them if necessary.



Principle #3:
The income valuation approach may be the most popular, but is the least useful for physician practices.

Accounting firms typically use one of three methodologies to value a practice: income, market and asset. The income — or discounted cash flow — methodology is the one accounting firms gravitate to first because it is the one most often used in the sale of other businesses. This methodology looks at the EBITDA (earnings before interest, taxes, depreciation and amortization) trend for a business and assigns a “multiple” in order to calculate the business’s value. The multiple is higher if EBITDA is growing; if EBITDA

is stagnant or declining, the multiple is lower.



Of course, the problem is that most cardiology practices do not have earnings. As a matter of good tax planning, practices distribute their cash at year-end. While some accounting firms attempt a work-around for this “no earnings” problem, the simple truth is that the income method does not work well in the sale of cardiology practices.

Principle #4:
The market approach is the most accurate, but lack of data means it is not helpful.

A basic definition for FMV is the value a willing buyer will pay a willing seller when neither party is compelled to enter into the transaction. Therefore, in determining FMV, it would be helpful to know the price other cardiologists have received when they willingly sell their practice to a hospital buyer, especially when the price is a result of more than one hospital competing for that practice.

Multiple problems make this approach unrealistic. First, there is no national database that contains this information. After all, even national firms do less than a handful of cardiology practice sales a year. Second, it is impossible to control for all the variables that might affect a practice’s FMV. For example, a group of cardiologists who work at a single hospital will be valued differently from a group of the same size that works at six different hospitals. The value of groups also will be affected by such things as productivity, age stratification, number of diagnostic modalities and the usage of those ancillary services. As a result, the price one cardiology practice receives is unlikely to be indicative of the FMV of another practice, given the likely variance in these factors.

Principle #5:
The asset methodology is usually the fairest approach.

Because the asset approach is divided into tangible and intangible assets, it is usually the fairest approach. The tangible side of the equation is straightforward. It is the value of your computers, desks, nuclear cameras, echo machines and so on. Many accounting firms will use a book value approach for the initial valuation, but will hire an outside firm to inventory and value every tangible asset of the practice before the transaction is actually closed.

The intangible side of the equation is anything but straightforward. Most hospitals think intangible value is synonymous with “goodwill,” but such thinking is wrong. Said another way, most cardiology practices have an intangible value that should be recognized. For example, many groups have practice names, logos and even telephone numbers that are recognized throughout their communities.

However, because it can be difficult to value these intangible elements, the most common approach accounting firms use is called “workforce-in-place.” They will attempt to estimate what it would cost to re-create the practice by hiring replacements for the physicians, clinical and non-clinical staff. Accounting firms also often assign intangible value for a practice’s medical records. The amount will vary based on whether the cardiologists use paper charts or have transitioned to an electronic health record.

Because of the broad view that the asset method encompasses, it is most often thought to be the fairest valuation methodology.

Carlson is with Maynard Cooper & Gale, P.C., Birmingham, Ala.

