Valuation of Management Services and Management Services Organizations

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As health care consumerism takes hold, technology evolves, and the industry continues to prioritize value-based care delivery, the definition of "work" for physicians has changed — and the ways in which physicians are compensated have evolved as well.

Physician compensation professionals are well versed in the many forms this can take - whether direct cash compensation such as base salaries, quality incentives, per member per month payments, call compensation, medical directorships, or indirect compensation such as retirement benefits and health insurance. An often-overlooked form of physician compensation, however, is the benefits received through Management Services Organizations (MSOs) and Management Services Agreements (MSAs).

Due to the rapid rise of new health care players entering the market, the adoption of value-based reimbursement, and evolving consumer demands, an increase in new partnerships is helping to transform clinical care delivery. This is evidenced by the volume of management services transactions, which have increased by 56% in the 12 months prior to November 15, 2021.[1] Private equity activity in health care is a significant contributor to this growth as these firms are able to scale multiple organizations by rolling up separate provider groups through an MSO. These trends are projected to continue as private equity leaders predict that MSOs (e.g., physician practice management companies) will attract the most health care investment in 2022.[2]

MSOs provide specialized management services to organizations and independent physician groups through an MSA. Management services may range from a single service to "turn-key" models that deliver all-encompassing clinical and administrative support to providers. These partnerships may be structured by MSOs and MSAs through direct physician ownership, hospital ownership or joint ventures. The financial arrangements of MSOs and MSAs face the same regulatory requirements as any provider organization. Federal fraud and abuse laws such as the Anti-Kickback Statute (AKS) and physician self-referral laws (Stark Law) remain in force. Additionally, state-specific provisions require a careful valuation of the MSO and MSA financial arrangements. For example, some states prohibit compensation to affiliated MSOs based on a percentage of professional collections, while in other states, it is a common practice to compensate MSOs based on a percentage of professional collections.

Recognizing that MSOs and MSAs face the same regulatory parameters as direct physician compensation, most organizations commit to a third-party fair market value (FMV) and commercial reasonableness (CR) valuation to ensure regulatory compliance. A third-party review of physician compensation is centered on one or more of the traditional valuation approaches, including the i) income approach, ii) asset approach, and iii) cost approach. Given that MSOs are expected to be profitable income-producing businesses (e.g., going concern entities), the income approach is the most commonly used as it is based on the present value of all expected future benefits from the business, discounted or capitalized at a rate of return that represents the risk of the company.

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1. https://www.pwc.com/us/en/industries/health-industries/library/health-services-deals-insights.html
2. "The Next Evolution of Private Equity" McDermott Will & Emery / WSJ Intelligence

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The valuation of a new MSO typically follows the income approach; however, when completing the valuation of an MSA, it is common to use a combination of the three traditional valuation approaches. This is the result of the many funds flow structures that an MSA may take, such as the percentage of revenue payment model, cost plus margin reimbursement, and fixed fee frameworks.

MSO and MSAs are complex arrangements that require a careful review and valuation. The valuation of an MSO or MSA should include close collaboration between the MSO and MSA leaders and investors. Often a third-party valuation firm with extensive experience with MSO and MSA arrangements is utilized to affirm the compliance of the arrangements. A transparent and collaborative approach to MSO and MSA valuations is necessary to identify the market opportunity by balancing the "story" of the MSO or MSA with a quantitative analysis. Without understanding the story, a valuation is just a collection of numbers. Predicted future earnings and costs can never be truly certain. Understanding the story is critical to ensuring regulatory compliance and is especially important in the valuation of young and maturing companies - which are frequently MSOs and MSAs.

To help ensure a successful partnership, the parties often address these questions in the development or renewal of an MSO/MSA:

- What are the benefits and costs for each party?
- Are costs and revenue transparently shared across parties?
- Are the management services well-defined?
- Is there documentation of the management services rendered?
- Have the management services or the underlying assumptions changed since an FMV opinion was provided?

As health care delivery continues to evolve, many provider organizations are likely to explore new partnerships. A collaborative team-based approach will define the story of the MSO or MSA and create a mutual understanding of services and benefits. There is not a bright-line test to determine the FMV or CR of an MSO or MSA, but that should not deter organizations from exploring these arrangements. An effective partnership can greatly mitigate regulatory risk and comes with a number of other potential benefits such as innovative care delivery models, decreased clinical and operational costs, and improved outcomes.

Looking for additional insight and information?

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