Physician Practice Valuations: Evolving Definitions of Historical Approaches

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The consolidation of physician practices remains a consistent theme in health care headlines due to the increasingly prominent role of new industry players, such as strategic investors and retailers, combined with the challenges of maintaining an independent practice in today's complex operating environment. Although acquisitions are a longstanding industry norm, the valuation methods and approaches utilized to assess practice enterprise value have evolved.

It is critical to note that all practice acquisitions are to be within Fair Market Value (FMV) and are subject to regulatory restrictions - including the Stark Law and the Anti-Kickback Statute. Acknowledging that all practice valuations must be compliant with regulations, there are a few different approaches to consider.

While this article aims to highlight the evolving definition of an Asset Approach in the context of a physician practice acquisition by a health system, we'll begin by defining the three most common methods of approach:

- The Income Approach is based on the theory that the value of a company (practice) can be computed as the present value of the future returns of the enterprise discounted at a rate of return that reflects the risk of the investment. This approach can be implemented through a multi-period discounting or a single-period capitalization.
- The Market Approach is a general way of determining a value indication of a business, business ownership interest and a security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests and securities or intangible assets that have been sold or compared to publicly available market statistics (i.e., a market multiple).
- The Asset Approach, which can also be referred to as the Cost Approach, is based on the theory that the value of a business or business interest can be determined by analyzing the underlying assets owned by the business.

The appropriate approach or approaches used to value a physician practice will always depend on the facts and circumstances of the transaction. However, the Asset Approach has historically been at the forefront. In a privately held, owner-operated business, physician compensation is correlated to the profitability of the business. The practice owners retain the profits and, as a result, there is often limited, if any, free cash flow. Generally, the health system looking to acquire the practice seeks to maintain or enhance physician compensation post-acquisition – making the Asset Approach the most common in instances like this. While outside the scope of this article, a private equity acquirer will often require the physician owners to "scrape" or reduce their post-close compensation. This then allows for the Income and Market Approaches to be applied in assessing enterprise value.

When utilizing the Asset Approach, it is critical to evaluate all of the practice's assets – both tangible and intangible. A thorough asset-based assessment can be conducted in three phases:

1. UNDERSTAND ALL ASSETS THAT MAY BE RELEVANT TO A VALUATION

Tangible assets may seem straightforward – tables, chairs, supplies, etc. – but there is still a need to carefully consider what tangible assets should be included in a practice valuation. Even the straightforward

assets raise many questions. Should leasehold improvements be included in a practice valuation? How will accounts receivable be addressed? Are pharmaceuticals removed from medical supply counts?

The **intangible assets** may not have physical form, but they should not be ignored when assessing the practice's value. Intangible assets are more nuanced and merit thorough consideration.

There is no shortage of intangible assets that should be considered in every practice valuation, including but not limited to:

- Trained workforce
  - Non-physician workforce
  - Physician workforce
- Certificate of Need
- Brand name
- Panel cost avoidance (further defined below)
- Telephone numbers
- Intellectual property
  - Clinical protocols
  - Clinical pathways

2. IDENTIFY THE RELEVANT ASSETS AND ASSET CATEGORIES THAT SHOULD BE INCLUDED IN A VALUATION

It is imperative to acknowledge that not all intangible assets should be included in each practice valuation. Instead, the above summary represents a list of assets that may be applicable. Identifying the in-scope assets to be valued is a complicated task.

As an example, consider the value of a trained workforce. Valuation theory recognizes the importance of a company's trained and assembled workforce. Generally classified in the human capital category, the trained workforce is the value derived from employees' operating knowledge of relevant equipment, familiarity with the policies and procedures of the company, and experience in working with and communicating with each other. These factors generally contribute to the efficient and effective operation of a practice. Court cases have affirmed that an entity's established and trained workforce is an intangible asset with measurable value. But how is "trained" defined? What adjustments are made for newly hired employees or those nearing retirement? This high-level example shows that a deep dive into each asset category is required to ensure an accurate and compliant valuation. For guidance on how to answer these questions, partnering with an outside valuation firm dedicated to the health care space is recommended for any asset valuation.

3. VALUE THE UNDERLYING ASSETS OF THE PRACTICE

Determining the value of each asset is the final step. The Asset Approach is also referred to as the Cost Approach as the valuation methodology is based on the replacement cost of an asset. Unfortunately, there is no single source or method to determine the replacement cost of an asset. For this reason, a fundamental understanding of valuation theory and all valuation approaches, as defined previously, is required under the Asset Approach.

For example, a Certificate of Need may be valued under the Market Approach based on similar transactions in the marketplace. Likewise, the intangible asset of panel cost avoidance, referenced earlier in this article, is an example of an intangible asset value determined by the income approach.Specifically, panel cost avoidance represents the avoided costs of acquiring a turnkey business versus building it from scratch.

If you think about this through the lens of a physician practice, there are significant start-up costs to operationalize the practice and market its services to the community. Furthermore, once a practice is fully staffed and operationalized, there is still a ramp-up period required before operating at full capacity. A proforma analysis rooted in market data/third-party benchmarks can be used to identify the cost savings from a fully operationalized practice versus a de novo practice. The net present value of these avoided costs, which is derived from the Income Approach, may be incorporated into the Asset Approach.

The definition of the Asset Approach continues to evolve and understanding the nuances is important as organizations look to consider a more modernized and holistic approach to asset valuation. To ensure valuations are accurate and compliant, organizations should follow the three phases outlined in this article and partner with an expert trained specifically in health care valuations. As health care acquisition activity remains prevalent within the market, understanding the true value of the transaction by using current methodologies is critical to strategic and competitive growth.