Trends in Strategies and Valuation of Physician Hospital Relationships

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VMG HEALTH

- Leading healthcare valuation firm in the country
- 100% focused on healthcare services sector
- 28 professionals located in Dallas and Nashville
- Perform over 600 valuations each year
- Our valuation opinions are used to support transactions in all segments within healthcare including but not limited to:
  - ASCs
  - Imaging
  - Cancer Centers
  - Physician Practices
  - Hospitals/Specialty Hospitals
  - Physician Service Agreements
PHYSICIAN HOSPITAL RELATIONSHIPS - TOPICS COVERED

- Market Trends Affecting Hospital Physician Relationships
- Maturation of Physician Owned Businesses ("POB") Market
- Reimbursement of Physician Owned Businesses
- Healthcare Reform
- Control Valuation Trends
- Minority Valuation Trends

Physician Owned Businesses ("POBs") covered include ASCs, Cancer Centers, Imaging Centers and Physician Hospitals
PHYSICIAN HOSPITAL RELATIONSHIPS – SEGMENTS NOT COVERED

The current environment is stimulating physician hospital arrangements in a large number of areas all of which are important to understand in relation to value of healthcare entities. This presentation will not address the following:

- Physician employment
- Physician practice acquisition
- Professional service agreements
- Under-arrangements
- Management service agreements
- Quality services agreements
PHYSICIAN HOSPITAL RELATIONSHIPS – MARKET TRENDS

Uncertainty Regarding

- Healthcare reform
- Declining reimbursement (professional and technical)
- The economy
- Tighter capital markets
- Regulations regarding physician ownership
- in-office ancillaries

*These factors are creating a perfect storm driving consolidation*
HISTORICAL EXIT OF SERVICE LINES OUT OF THE HOSPITAL

Why they left
- Poor physician relations
- Income opportunities
- Control

Impact to Hospitals
- High remaining cost structure
- Loss of high margin income
- Loss of relations with key physicians

Current market factors are creating a potential for re-consolidation
HOSPITAL RESPONSE TO MARKET TRENDS

- Acquiring practices and employing physicians
- Purchase physician owned ancillary business
- Joint venture with physician owned businesses
- Service agreements with physicians
- Recruit physicians to compete against physician owned businesses
PHYSICIAN RESPONSE TO MARKET TRENDS

- Sell ancillary businesses
- Sell practice
- Hospital employment
- Seek non-employment arrangements
  - Service line co-management, quality arrangements
- Seek service agreement payments
  - ED call coverage, medical directorships, committee participation
Many physicians have become disenchanted with joint ventures for the following reasons:

- Physician ancillary business are maturing
- Difficult to grow
- Reimbursement (Medicare and Commercial) is challenging
- Lower portfolio risk
- Lower valuations and fewer transactions

These factors create a perfect opportunity for hospitals to purchase
MATURITY OF PHYSICIAN OWNED BUSINESSES

- Decline in de novo development
- Decrease in same center revenue and earnings growth
- Initial stages of consolidation among management companies
- Significant capacity at many POBs
- Increasing consolidation of partnerships

*While all POB segments are maturing, the ASC market illustrates the challenges and opportunities of maturity*
ASC MARKET – EVIDENCE OF A MATURE MARKET

Drivers for Early Growth
- ASC management & development companies enter market
- Significant # of available physician participants
- Increasing # of cases suitable for outpatient setting

Indications of ASC Market Saturation
- Significantly diminished eligible physician investor pool
- Acquisitions replace de novo development as growth vehicle
- Increasing consolidation of ASC partnerships and limited ASC failure

The Maturing ASC Industry Yields New Challenges
ASC MARKET – EVIDENCE OF A MATURE MARKET

The growth in number of ASCs has exceeded growth in the number of eligible physician investors...

**Eligible Physicians per ASC**

- **9-10% Annual Growth in ASCs**
- **2-3% Annual Growth in Eligible Drs**
- **>40% Decline In Eligible Drs Per ASC**
Other Factors Limiting the Eligible Physician Investor Pool…

- Increase in hospital recruitment activity
- Movement of cases to in-office setting
- Early retirement of existing physician owners
- Shift in physician desire for work-life balance
- Enforcement of covenants preventing ownership in multiples ASCs
REIMBURSEMENT: CHALLENGES

The reimbursement environment is challenging for POBs for the following reasons:

- Medicare formulaic changes difficult to predict
- Uncertainty regarding Medicare Sustainable Growth Rate “SGR”
- Commercial payor reimbursement challenges
- Downward pressure on margins

*These factors affect ancillary companies’ ability to make prudent business decisions*
REIMBURSEMENT TRENDS – PART B FINAL 2010 RULE

- Sustainable Growth Rate Formula – Overall impact is 21.2% cut
  - Congress will need to pass law to overturn, House set to act
- Imaging
  - Increased equipment utilization rate from 50% to 90%
  - MRI (up to +2% in 2010, decreases +2011), CT (-10% in 2010)
  - Advanced imaging providers must be accredited beginning 1/1/2012
- Cancer Centers
  - 5% reduction phased in over 4 years (vs proposed 19% cut)
  - Radiation therapy equipment is exempt from utilization rate
- In Office Ancillaries
  - Downward pressure on reimbursement (i.e. nuclear medicine -36%)
  - Continued discussion on in-office ancillary Safe Harbor exceptions

*These changes will affect profit margins for POBs that rely on Medicare*
REIMBURSEMENT TRENDS: UNCERTAINTY

Imaging Utilization Rate – Medicare Payment Formula Change

The different proposed imaging utilization rates are a prime example of the uncertainty surrounding reimbursement and its future impact on value for physician owned businesses.

Utilization is one part of Medicare formula to determine technical reimbursement for imaging.

Higher Utilization Rate = Lower Medicare Payment
REIMBURSEMENT TRENDS: ASCs

2010 ASC Medicare Reimbursement

- Methodology is set but inputs to the formula remain uncertain
- 2010 rates - Based 25% on the historical ASC grouper payment system and 75% on the new OPPS methodology
- Rates have been formulaically reduced to 57.7% from 65% of HOPD rates
- Highest Medicare volume ASC procedures (ophthalmology, GI, and pain management) projected to decrease 2% to 18%
### Reimbursement Trends: Physician Owned Businesses

<table>
<thead>
<tr>
<th>Segment</th>
<th>Reimbursement</th>
<th>Impact on Value</th>
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<tbody>
<tr>
<td>ASCs</td>
<td></td>
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<tr>
<td>Imaging Centers</td>
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<tr>
<td>Cancer Centers</td>
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<tr>
<td>Hospitals</td>
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<tr>
<td>Physician Hospitals</td>
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*Hospitals have an opportunity to improve strategic positioning over POBs*
REIMBURSEMENT TRENDS: HOSPITAL/PHYSICIAN DRIVERS

ASC Rates: Comparing Physician Owned with Hospital Partner

<table>
<thead>
<tr>
<th>Specialty</th>
<th>National ASC Rate</th>
<th>Avg. Hospital JV Rate</th>
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<tbody>
<tr>
<td>Otolaryngology</td>
<td>$1,725</td>
<td>$2,380</td>
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<tr>
<td>OB/GYN</td>
<td>$1,673</td>
<td>$2,359</td>
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<tr>
<td>General Surgery</td>
<td>$1,522</td>
<td>$2,099</td>
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<tr>
<td>Ophthalmology</td>
<td>$1,226</td>
<td>$1,719</td>
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<tr>
<td>Orthopedics</td>
<td>$2,453</td>
<td>$2,863</td>
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<tr>
<td>Urology</td>
<td>$1,327</td>
<td>$1,823</td>
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<tr>
<td>Podiatry</td>
<td>$1,559</td>
<td>$2,167</td>
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Source: 2009 VMG Health Intellimarker: Ambulatory Surgical Center Financial & Operational Benchmarking Study

- The ability for the Hospital to leverage their commercial contracts can vary
- The increase in reimbursement can be seen across multiple industries (e.g. imaging, radiation therapy, etc)
- The reimbursement pressures have lead to an increase in physician hospital joint ventures
GENERAL GOALS OF HEALTHCARE REFORM

- “Bending the cost curve”
- Lowering the number of uninsured
- Improving the delivery system
- Incentivizing quality
- Increasing provider accountability

*Healthcare reform should be viewed by the ultimate effect on each segment’s system of healthcare delivery*
HEALTHCARE REFORM OVERVIEW

Physician Owned Businesses Should Think of Healthcare Reform from the Following Perspective:

- Healthcare reform will be a decade long process
- The majority of the content have no effect on POBs in the short run.
- Legislation changes will be the result of a series of compromises
- Industry trade organizations will have input into the process

*Healthcare reform should be viewed pragmatically*
HEALTHCARE REFORM OVERVIEW

Passing Healthcare Reform This Year Will be Challenging

- Final vote on a conference bill unlikely this year
- Public opinion shifting negative
- Senate and House bills have irreconcilable payment language
  - (Taxing Wealthy vs. Cadillac Plans)
- Abortion and Immigration are becoming wedge issues
- Coalition of Hospitals/Physicians/Device Manufacturers fragile
HEALTHCARE REFORM OVERVIEW

Positive News

- POBs will have time to adapt
- Quality will be rewarded
- Higher barriers to entry
- Weak players will exit the market
- Lower cost of business inputs and lower expenses

*Healthcare reform will reward high quality specialized providers*
HEALTHCARE REFORM SUMMARY

Benefits of hospital partnership

- Greater ability to adhere to quality reporting requirements
- Great ability to implement IT initiatives
- Shield POBs from isolated changes in regulations
- Greater ability to adapt to changes in payment system

*Hospital’s relative strength in the marketplace improves compared to physician owned businesses in the same segment*
There is no one multiple for a physician owned business!

- Value is dependent upon future earnings and risk
- Highly dependent upon actual facts and circumstances
- Historical earnings may not be representative of future
- Many risk factors must be incorporated into valuation
- Partnership risks
- External risks

Many partnerships have unreasonable expectations of value because of misleading statements regarding “multiples”
CONTROL VS. MINORITY VALUATIONS

Very Different Security Interests in the Same Business

KEY DIFFERENCE - Buying specific rights outlined in the operating agreement

Control Interest - Generally greater than 50% interest in the Entity
The right to manage the facility (management fee)
The right to dictate partnership agreement terms
Ultimate control over important decisions

Minority Interest - Generally less than 50% interest in the Entity
Inability to make key decisions
Subject to terms of management agreement
FACTORS THAT AFFECT VALUE

- Case volume, mix, and reimbursement
- **Growth** in volume and reimbursement
- Diversification (number & type of specialties, payors)
- Size of physician ownership, appropriate non-competes and ability to attract new investors
- Nature of payor contracts; is there a substantial portion of “out of network?”
- Ability to generate sustainable cash flow from operations and on-going distributions
- Financial leverage, working capital, and on-going capital expenditures
- Quality and age of facility and equipment
- Opportunities for expansion (rooms, surgeons)
- Competent management
- Barriers to entry (e.g. CON)
CONTROL VALUATIONS – CURRENT MARKET ENVIRONMENT

Factors Influencing Control Buyers

- Public market pricing depressed
- Fewer public companies due to LBO’s and private equity
- Far less availability of both debt and equity capital
- Large private buyers possess high leverage (i.e. LBO)
- Enhanced due diligence – buyers are very careful
- Need stability in earnings/growth
CONTROL VALUATIONS – CURRENT MARKET ENVIRONMENT

Question: Proposed to AmSurg’s CEO during financial reporting call “Why has acquisition activity decreased in 2009”?

“We just felt like this is a time to be very patient and to see what happens, and not to be overly aggressive until things stabilize or opportunities bubble up.”

- Chris Holden
AmSurg, President and CEO
July 23, 2009
CONTROL VALUATIONS – CURRENT MARKET ENVIRONMENT

Recent Acquisition History

- Public Ancillary Companies

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<td>13</td>
<td>19</td>
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<td>3</td>
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<td>14</td>
<td>7</td>
<td>2</td>
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<td>24</td>
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<td>44</td>
<td>18</td>
<td>12</td>
<td>10</td>
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<td>57</td>
<td>6</td>
<td>12</td>
<td>2</td>
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- Hospitals – We have seen an increase in control level purchases from hospitals
- Private Development Companies – Still buying but increased level of scrutiny on target companies
CONTROL VALUATIONS – CURRENT MARKET ENVIRONMENT

Recent Multiples for ASC Public Operators

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<td>10.3 x</td>
<td>9.0 x</td>
<td>8.8 x</td>
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<td>8.8 x</td>
<td>6.5 x</td>
<td>7.7 x</td>
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<tr>
<td>Novamed</td>
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<td>5.6 x</td>
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<td>6.4 x</td>
<td>4.7 x</td>
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<td>8.4 x</td>
<td>7.3 x</td>
<td>6.9 x</td>
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<td>5.6 x</td>
<td>6.7 x</td>
<td>6.6 x</td>
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CONTROL VALUATIONS – CONCLUSIONS

Current Market Dynamics Have Resulted in:

- Transaction pricing is down an estimated 5-15%
- More strategic thought related to acquisitions
- Importance of high quality earnings – low risk
- Importance of high quality cohesive physicians – low risk
- Hospitals acquiring controlling interest in POBs
MINORITY VALUATIONS

Minority Valuation Points to Consider

- Facts and circumstances drive value
- Depends on an accurate assessment of risk and growth opportunities
- Discounted cash flow analysis is primary methodology for valuation
- Operating Agreement / Partnership Agreement important in determining value
  - Does the Agreement dictate distribution of available excess cash flow?
  - Does the Agreement include non-competition covenants?
  - Does the Agreement include buy-back provisions?
TRENDS IN MINORITY VALUATIONS IN TODAY'S MARKET

It is increasingly difficult to market physician shares at historically accepted minority multiples...Why?

- Limited eligible physician investor pool
- Per share price for many business is cost prohibitive
- Inability to demonstrate attractive returns to potential physician investors
- Existence of alternatives for physician investors
Assumption of steadily increasing revenue and earnings growth

Year: 1 2 3 4 5 6 7 8 9 10

Transaction Date
October 2008

Net Revenue

Earnings

$0

Majority
Valuation:
6-7x EBITDA

Minority
Valuation:
4-5x EBITDA
WHAT CAN BE EXPECTED IN A MATURE MARKET?

< 20% of ASC’s will have steady growth
@ 50% will experience slow decline
@ 25% will lose significant physicians
@ 20% will have significant reimbursement impact
MINORITY VALUATIONS – MAJOR RISK CATEGORIES

- Market risk
- Physician risk
- Non-owner physician risk
- Payor risk

*The level of risk has a direct inverse correlation to the valuation of POB shares*
Risk Scoring Results are correlated to discounted cash flow analysis incorporating identified risk factors.

### Risk Scoring Summary

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<thead>
<tr>
<th>Risk Category</th>
<th>Risk Score</th>
<th>Multiple Factor</th>
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<tr>
<td>Market Risk</td>
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<tr>
<td>Physician Risk</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Non-Owner Risk</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Payor Risk</td>
<td>3</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>2.8</strong></td>
<td><strong>2.5</strong></td>
</tr>
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</table>
CONCLUSION

- The Great Re-Consolidation has begun
- Hospitals have replaced for profit operators as the primary consolidator
- The current market uncertainty has sparked consolidations
- Hospital physician transactions must happen at FMV
- Valuation multiples have declined slightly but are still strong
- The effects of healthcare reform are currently unknown

Business uncertainty driving valuation and strategic trends in physician hospital relations
VALUATION TRENDS

Questions?

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