10 Common Mistakes in Valuing ASCs – and How to Avoid Them

Presented by:

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HealthCare Appraisers, Inc.

HealthCare Appraisers is the nation's leading specialist in providing fair market valuations and transaction consulting services to the healthcare industry. Comprised of over 100 professionals, and offices from coast to coast, we serve clients in all 50 states and around the world.

Our valuation and consulting services consider every FMV need from compensation and business enterprise valuations, to appraisals of fixed assets, intangible assets, and real estate. At HealthCare Appraisers, we're leading the industry through our service, expertise and innovation.

Outline of Presentation

Presentation Geared Towards Non-Valuation Expert Audience

- Standard of Value in Healthcare
- Review of 10 Common Mistakes
- Q & A

Standard of Value

Fair Market Value

- Standard of value in most healthcare transactions is *Fair Market Value*.

- The definition of **fair market value** in healthcare is slightly different than the standard valuation definition.
  - the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell … between well informed parties who are not otherwise in a position to generate business for the other party…

  - Implications of "hypothetical"

Mistake #1

Confusing the Standard of Value

- Fair Market Value *versus* Investment / Strategic Value
  - In connection with a hospital's 100% acquisition of an ASC, can we consider overlaying hospital's outpatient department fee structure onto the valuation?
  - Similarly, can we consider overlaying hospital's payor contracts?
  - Acquirer's specific overhead structure
  - Assume a hospital wants to buy an ASC for purposes of shutting it down.
  - Impact to value?

Mistake #2

Inappropriate Application of Valuation Multiples

- Every year we publish a survey of multiples observed within the market (see slides in back of presentation)
- The Meaning Behind the Numbers
- The Finance Definition of a Multiple (a.k.a. Appraiser speak)
  - "A mathematical expression of risk and growth, which when applied to a perpetually recurring earnings stream results in an indication of value"
- A multiple is mathematically expressed as follows:

$$\frac{1}{(K-g)}$$

  - Where, (K) represents the rate of return (risk), and
  - (G) represents the growth rate of the earnings

Mistake #2

Inappropriate Application of Valuation Multiples

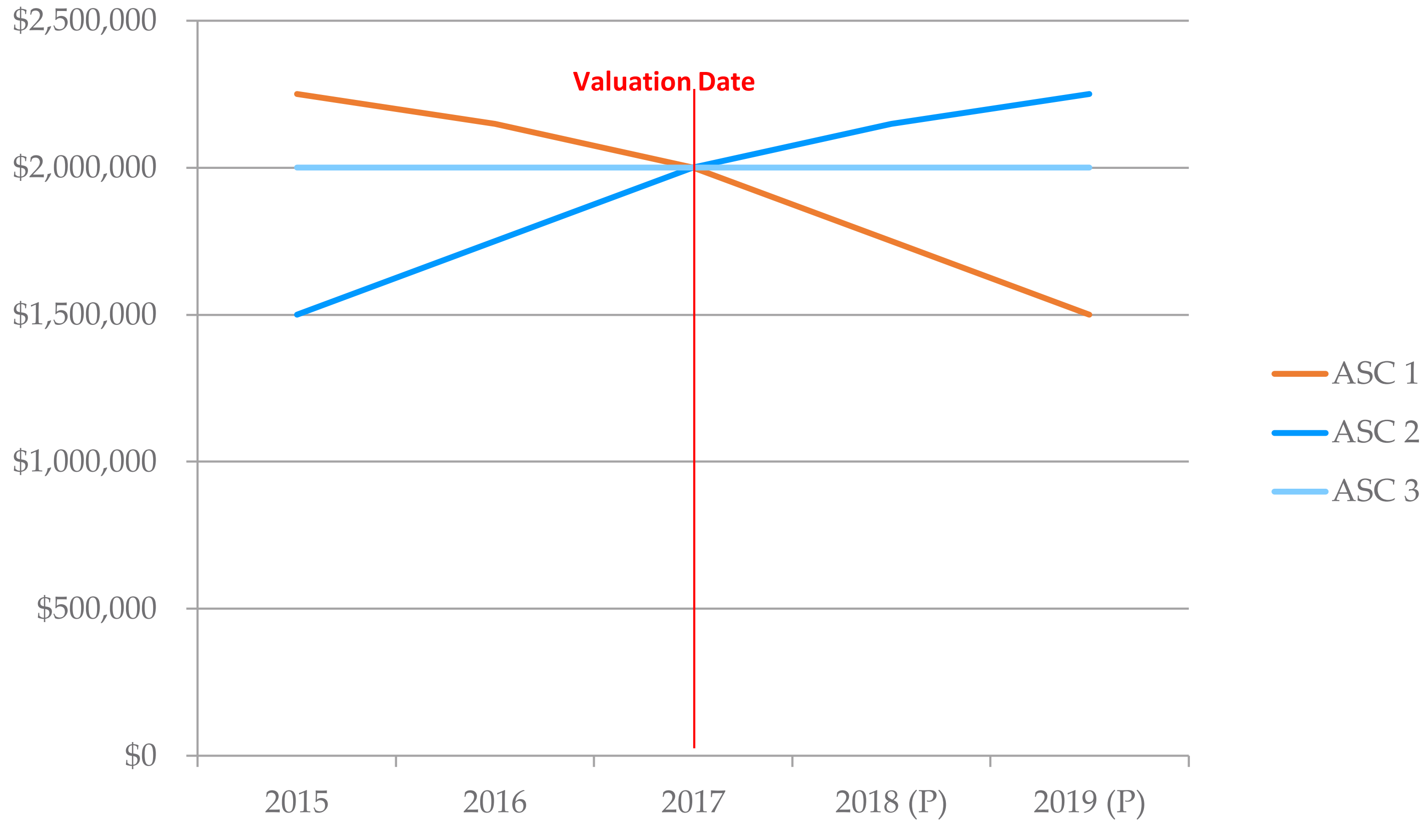
- Example of the Impact on Valuation Multiples from Varying Growth and Varying Risk

	Varying Growth			Varying Risk		
	Scen 1	Scen 2	Scen 3	Scen 1	Scen 2	Scen 3
k	17.0%	17.0%	17.0%	17.0%	19.0%	22.0%
g	2.0%	3.0%	4.0%	2.0%	2.0%	2.0%
Multiple	6.67	7.14	7.69	6.67	5.88	5.00

Mistake #2

Inappropriate Application of Valuation Multiples

- Example of Three ASCs with $2.0 Million EBITDA



Mistake #3

Incorrectly Specifying Risk

- Closely related to Mistake #2, while market multiples can be misapplied, there is also risk related to arriving at a valuation conclusion which doesn't comport with current market pricing (assuming no material adverse risk factors).
  - e.g., 15X multiple for a controlling interest;
    3X multiple for controlling interest

Mistake #4

Failure to Specify OON Risk

- Risk associated with “Out of Network” ASCs can oftentimes not be adequately understood by inexperienced valuators.

- Risk is primarily associated with the uncertainty around if, when and how much rates will be reduced.

- If there is reasonable certainty as to when the “conversion” may occur, it’s better modeled specifically into the cash flows, as opposed to being built into the cost of capital/discount rate (see next slide).

Mistake #4

Failure to Specify OON Risk

	Year 1	Year 2	Year 3	Year 4	Year 5
Cases	2,200	2,640	2,838	2,980	3,000
Net revenue/case	$4,700	$3,000	$3,045	$3,091	$3,137
Net Revenue	$10,340,000	$7,920,000	$8,641,710	$9,209,902	$9,411,105

Note: Commercial Payor X, who represents a significant portion of case volume, goes "in network"

Mistake #5

Failure to Normalize Earnings Stream

- Like any business, ASCs oftentimes will experience one-time, nonrecurring expenses which will inappropriately alter the expense structure and lower earnings.
  - Common examples include *<u>atypical</u>* legal and consulting fees and related party rent

- Normalizing adjustments can go either way and can also impact revenue
  - *e.g.*, one time revenue recovery in cash basis financials
  - Failure to appropriately bill Medicare – yes, it happens

Mistake #5

Failure to Normalize Earnings Stream

	2014	2015	2016
Cases	3,200	3,350	3,500
Net revenue/case	$2,100	$2,142	$2,174
Net Revenue	$6,720,000	$7,175,700	$7,609,455
Staffing	$1,680,000	$1,793,925	$1,902,364
Supplies	$1,344,000	$1,435,140	$1,521,891
Occupancy	$330,000	$339,900	$350,097
Professional Fee	$75,000	$76,000	**$500,000**
Other	$725,000	$739,500	$754,290
Total Expenses	$4,154,000	$4,384,465	$5,028,642
EBITDA	$2,566,000	$2,791,235	$2,580,813
	38.2%	38.9%	33.9%

Mistake #6

Income Based Valuation Techniques at Inception

- At Inception/De Novo, value should ***typically*** be determined using a Cost Approach.
  - Project costs (*e.g.*, TI, FF&E, working capital for pre-opening and post)
  - If a CON is involved, value should be ascribed to that intangible asset

- Using an Income Approach based on what the prospective physician investors expect to contribute to the center is very speculative and would be inconsistent with market pricing.

- Similarly, pricing new shares in an existing center should not include the prospective surgeon's incremental volume

Mistake #7

Varying Share Prices for MDs

- Shares/units offered to different physicians around the same time period and based on expected contributions to the ASC would be illegal.

- While there is no one correct answer, the “same time period” should generally not exceed one year, and in certain cases, it could be several months or less depending upon what is occurring at the center.

Mistake #8

Mismatching of Invested Capital and Equity Earnings Streams

- Definition of invested capital
  - The total amount of money that was endowed into a company by the shareholders, bondholders and all other interested parties. Invested capital is often determined by adding the total debt and lease obligations to the amount of equity in the firm and then subtracting the non-operating cash and investments.
- EBITDA multiples need to be applied to invested capital earnings streams and not equity earnings streams.
- Further, debt needs to be subtracted from invested capital to arrive at an equity value.

Mistake #8

Mismatching of Invested Capital and Equity Earnings Streams

	Low	High	
Selected EBITDA Multiples (invested Capital)	6.0	7.5	A
Normalized Trailing 12 Month EBITDA	$2,000,000		B
Net Income before tax	$1,500,000		C
Interest-Bearing Debt	$4,500,000		D
Value of Invested Capital	**$12,000,000**	**$15,000,000**	E = B X A
Less Debt	$ (4,500,000)	$(4,500,000)	
FMV of Equity (100% Marketable Interest)	$7,500,000	$10,500,000	F = E - D
Mismatch of Multiples & Earnings Streams	$9,000,000	$11,250,000	G = A X C

Mistake #9

Limitless Capacity

- ASCs have practical capacity constraints
- Creating projections which seem to ignore them is problematic

Mistake #9

Limitless Capacity

Summary Income Statement	Actual 2017	2018	2019	2020	2021
Cases	4,000	4,100	7,500	7,800	8,200
Revenue	$7,200,000	$7,380,000	$13,500,000	$14,040,000	$14,760,000
Operating Expenses	4,680,000	4,797,000	8,505,000	8,845,200	9,446,400
EBITDA	2,520,000	2,583,000	4,995,000	5,194,800	5,313,600
Depreciation	300,000	310,000	310,000	310,000	310,000
EBIT	2,220,000	2,273,000	4,685,000	4,884,800	5,003,600
Income Taxes @ 40%		909,200	1,874,000	1,953,920	2,001,440
Net Operating Income After Tax		1,363,800	2,811,000	2,930,880	3,002,160
Adjustments to Determine Cash Flow					
Plus: Depreciation and Amortization		310,000	310,000	310,000	310,000
Less: Capital Expenditures		(100,000)	(100,000)	(100,000)	(100,000)
(Increases)/Decreases in Working Capital		(18,000)	(612,000)	(54,000)	(72,000)
Free Cash Flow		**$1,555,800**	**$2,409,000**	**$3,086,880**	**$3,140,160**

Mistake #10

Failure to Make Other Necessary Valuation Adjustments

- Taxes:
  - Using the applicable tax rate when valuing "flow through" entities
  - General opinion is not tax affecting is a mistake

- Working Capital:
  - "Normal" levels of working capital need to be assumed
  - Surplus/(deficit) will be added to or deducted $ for $ from valuation

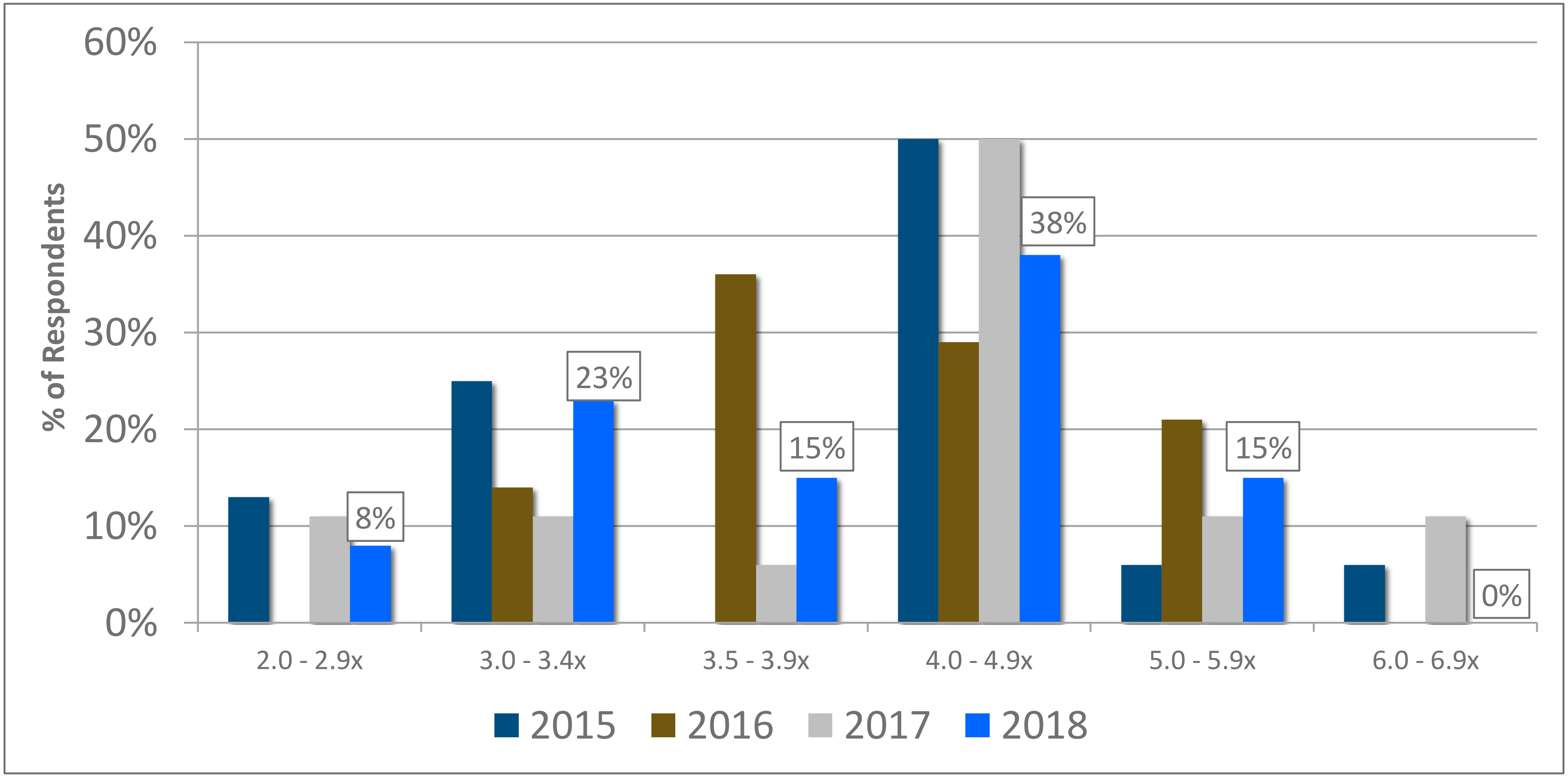
Mistake #10

Failure to Make Other Necessary Valuation Adjustments

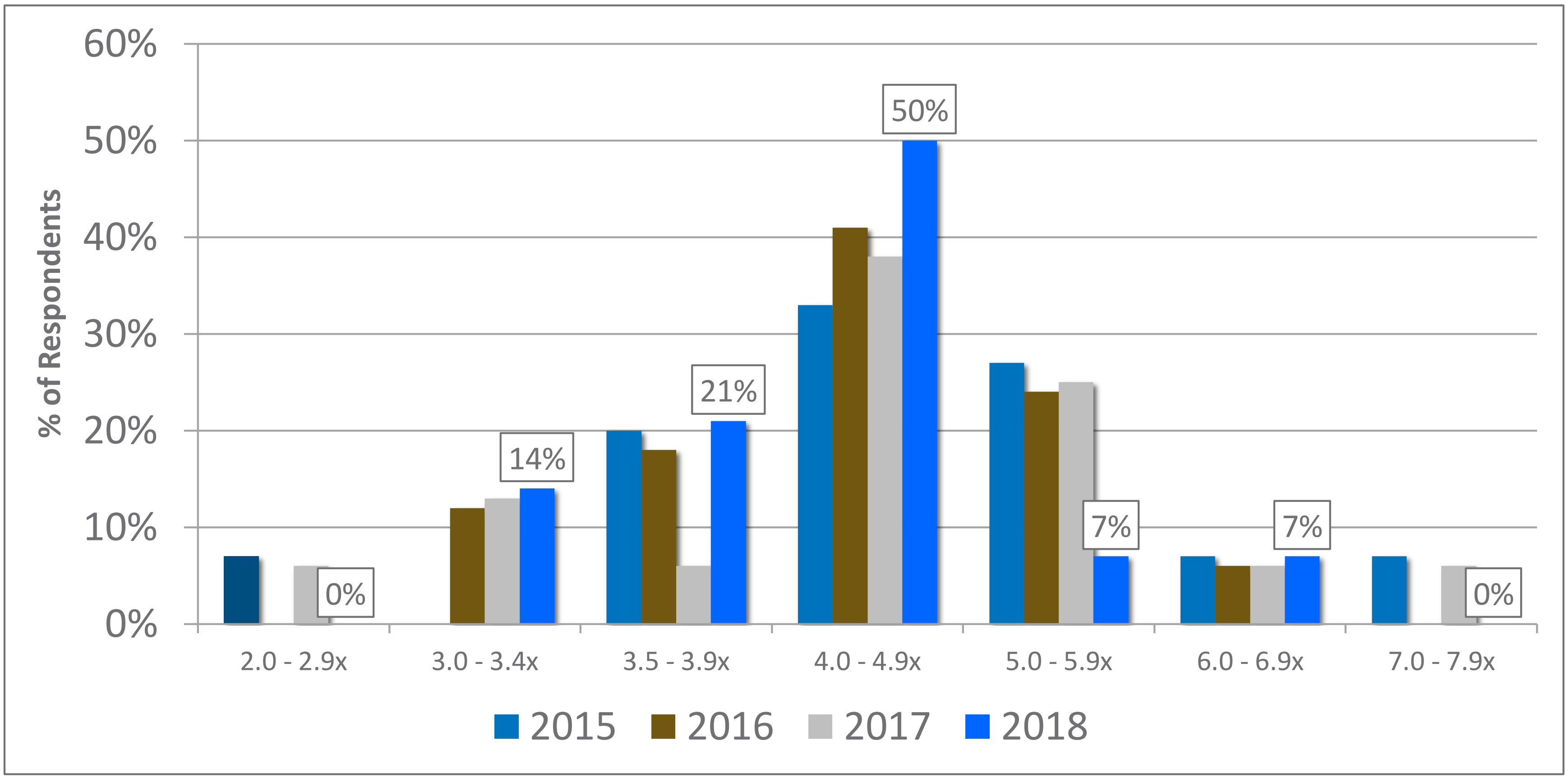
Summary Income Statement	Actual 2017	2018	2019	2020	2021
Cases	4,000	4,100	7,500	7,800	8,200
Revenue	$7,200,000	$7,380,000	$13,500,000	$14,040,000	$14,760,000
Operating Expenses	4,680,000	4,797,000	8,505,000	8,845,200	9,446,400
EBITDA	2,520,000	2,583,000	4,995,000	5,194,800	5,313,600
Depreciation	300,000	310,000	310,000	310,000	310,000
EBIT	2,220,000	2,273,000	4,685,000	4,884,800	5,003,600
Income Taxes @ 40%					
Net Operating Income After Tax		2,273,000	4,685,000	4,884,800	5,003,600
Adjustments to Determine Cash Flow					
Plus: Depreciation and Amortization		310,000	310,000	310,000	310,000
Less: Capital Expenditures		(100,000)	(875,000)	(100,000)	(100,000)
(Increases)/Decreases in Working Capital		(18,000)	(612,000)	(54,000)	(72,000)
Free Cash Flow		**$2,465,000**	**$3,508,000**	**$5,040,800**	**$5,141,600**

Observed Market Multiples

Minority Interest: Single-Specialty

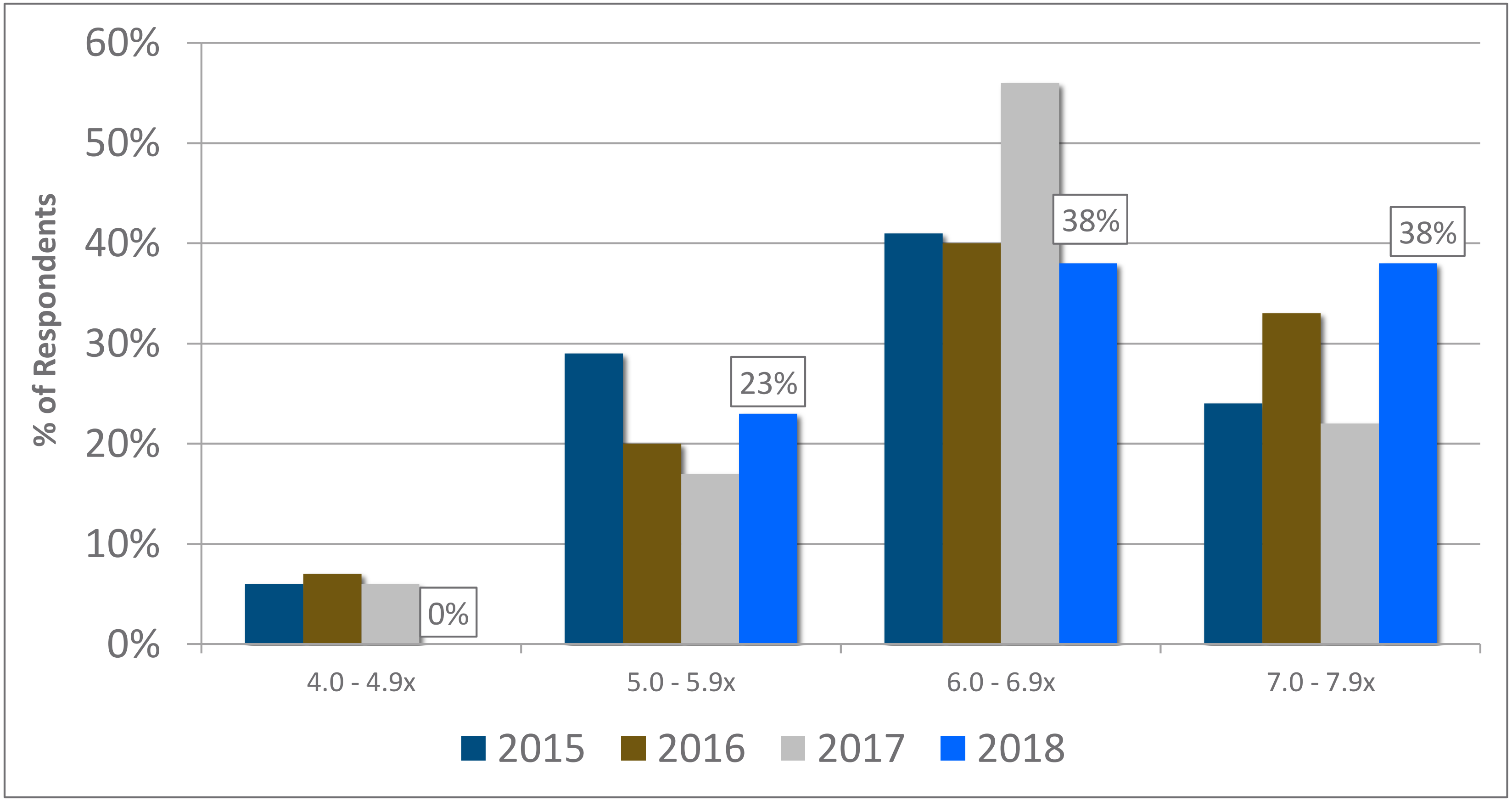


Observed Market Multiples
Minority Interest: Multi-Specialty



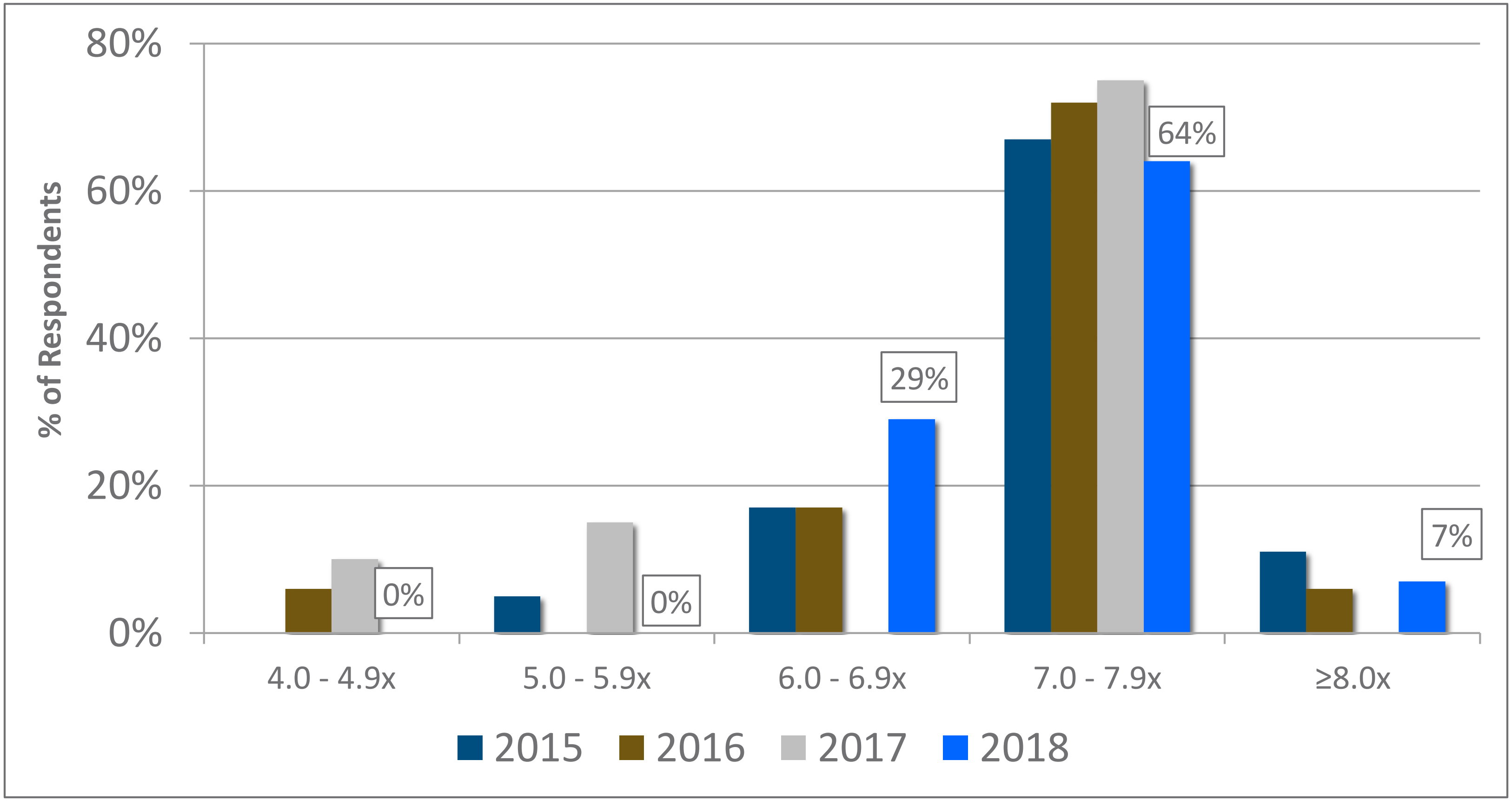
Observed Market Multiples

Controlling Interest: Single-Specialty



Observed Market Multiples

Controlling Interest: Multi-Specialty



Questions?

Please contact us if you have questions regarding this presentation.

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