Ophthalmology Practice Value and Goodwill

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*** Financial Interest**

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- Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
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Who We Are

- Business and legal advisors to physicians
- Publishers of the *Goodwill Registry*, used in valuation of ophthalmology and other medical practices
- Handle and advise re: practice buy-ins, buy-outs, sales, mergers and valuations

General Objectives

- Give you the tools to talk knowledgeably with your appraiser/consultant
- Give you basic framework to think about your own practice – before the moment of truth
- The appraisal process should not be a "black box" or a blizzard of numbers

Why Are You Doing This Appraisal?

- Complete sale of practice entity
- Buy-In to practice entity
- Buy-Out from practice entity
- You need a valuation method that will work for all of these transactions

What Makes Up Practice Value?

- The Big Three
  - "Hard Assets": equipment, improvements, inventory, supplies, software
  - Accounts receivable
  - Goodwill/intangibles: charts, phone numbers, patient base/flow, workforce, all systems ready to go
- All of these must be replicated (at great cost) if not purchased: "Buy" vs. "make"

Goodwill Flashpoint

- Hard assets and accounts receivable: relatively non-controversial
- Goodwill: more difficult to value, and therefore often controversial
  - Some advisors do not want to deal with it
  - Younger doctors may not have sufficient experience to understand it….
  - Or may be scared by doom and gloom prognosis for health care business

Hard Asset Valuation

- Ophthalmic equipment, business equipment, office buildouts
- Book Value?
  - Nearly always too low
  - Think about all the items that you "expensed"
    - Section 179: These assets have an immediate book value of zero
    - The rest have a book value of zero in 5-7 yrs

Specialized Appraisal

- May be feasible for high end items with active resale market (e.g., slit lamps)
- But not generally available/reliable for business equipment
- Leaves you with a partial appraisal

Modified *Book Value Approach*

- Eliminate assets no longer in use
- Recompute depreciation
  - 8-12 year life (overall)
  - Straight-line depreciation
  - Floor value: 20% of original cost
- Generally reasonable for most items

Supplies/Inventory

- Optical frames
- Contact lenses
- Premium IOLs
- Eye medications/drops
- Botox®, facial fillers
- Retina injectibles (e.g., Lucentis®)

Valuing Supplies

- Physical inventory, at cost:
  - Count number of units on hand
  - Multiply by acquisition cost
- You may already be doing this, to determine “Cost of Goods Sold” for your tax return (See IRS Form 1125-A)
- Somewhat laborious, but most accurate method

Another Approach

- Estimate supplies value based on annual usage
- Example:
  - Tax return shows “medical supplies” deduction for $120,000
  - Monthly cost is $10,000
  - Practice manager estimates typical inventory at 2 months’ worth of supply
  - Valuation is 2 X $10,000 = $20,000

Should AR be included in the valuation?

- Asset Sale: AR is generally excluded. (Seller keeps it.)
- Buy-Ins: May or may not be included.
- Buy-Outs: AR typically part of “deferred compensation” or “severence”

AR in Buy-Ins

- New partner shares in AR on the books as of buy-in date
  - Need to value AR. New partner “pays for” AR via income shifts to senior doctor, over time.
- Alternative: “Redlining”
  - Excludes AR from buy-in. Do not need to value AR. All proceeds of AR go to senior doctor.

Valuing Receivables

- Face value
- Times collection factor
- Sometimes reduced further by collection fee (e.g. 6%)

AR Example

- Example: Face value of AR is $100,000. Historical collection ratio = 60%. Collectible value is $60,000

Face Value of AR

- May need to separately value older accounts receivable
- Over 120 or 180 days:
  - True "deadwood" (exclude)
  - Or partially collectible (use substantially reduced collection ratio)
  - Any patient payment plans in there?

Another Approach

- Estimate upfront value with face-value-times collection ratio “snapshot”
- Then adjust value as collections are actually received, in next 3-6 months
- A “valuation” with the benefit of hindsight

“I shouldn’t have to buy into my own receivables”

- Associate may feel that he has an ownership stake in his AR, because he generated them
- But typically the associate was paid a guaranteed salary to generate those AR
- It would be a “double dip” to take the salary and the resulting AR

“I am buying a 50% stock interest, but I shouldn’t have to buy 50% of the AR. (I am the low producer.)”

- This is a valid concern, if the income division formula is production based
- Instead of buying into 50% of the whole, associate buys into 100% of his/her own personal production

Other Assets: Cash

- Asset Purchase/Outright Sale: cash is excluded. Seller keeps it.
- Buy-Ins: Cash should be included if it will be left in as working capital (rather than being bonused out as compensation to senior doctor)
- Buy-Outs: Same as Buy-In

Other Miscellaneous Assets

- Prepaid items e.g. malpractice insurance
  - Include as an asset in buy-in and buy-out
- Autos, artwork and other “personal” items:
  - Exclude as personal to doctor

Liabilities

- Asset Purchase/Outright Sale: Liabilities are generally excluded

Liabilities, cont.

- Buy-Ins and Buy-Outs
  - Liabilities are factored into calculation of stock price, as a reduction against equipment values
  - E.g., bank debt, retirement plan accruals
  - Vendor payables are often ignored – small change, hard to pin down
  - Exception: Retina drug payables can often be very large

What is Goodwill?

- The sum total of all intangible assets
  - Charts and patient lists
  - Phone numbers
  - Corporate name
  - Institutional reputation/past advertising
  - Familiar location

Goodwill

- Also includes “going concern” values/items
  - Trained workforce in place;
  - Leasehold/location secured;
  - Policies and procedures developed;
  - All systems in place and ready to operate

Practical Application

- Sales: Goodwill is part of purchase price, add to equipment and supplies to arrive at total purchase price
- Buy-In: Goodwill is “purchased" via pre-tax income shift

Goodwill Valuation

- Three basic methods:
  - Income Approach
  - Market Approach
  - Asset Approach

Income Approach

- Examples: Discounted Future Cash Flow, Capitalized Earnings
- Future revenues and expenses are projected to yield estimated future earnings
- Earnings are discounted to present value using a rate that reflects riskiness of these future cash flows, like a bond.

Income Approach: Concerns

- Difficult to predict future revenues and expenses - - esp. with ownership change
- Hard to determine the true “earnings” of a doctor PC.
  - Most PCs “zero out” any earnings by paying bonuses, at years’ end, to avoid taxes
- “Required rate of return” is subjective

Cap Earnings Example 1

$400k	Available for owner
- 300k	“Reasonable Salary”
100k	“Profit”
÷ 20%	Required Rate of Return (= 5 x “multiple”)
$500k	Valuation

Cap Earnings Example 2

$400k	Available for owner
- 350k	“Reasonable Salary”
50k	“Profit”
÷ 20%	Required Rate of Return (= 5 x “multiple”)
$250k	Valuation

In Example:

- 16.6% differential in "reasonable salary" assumption ($300 vs. $350) yields
- 50% differential in valuation ($500 vs. $250)
- Other key assumptions:
  - Projection of future revenues and expenses
  - Required Rate of Return

Asset Approach

- Aka the "build up" approach
- Value of business is the cost to replicate its components (equipment, goodwill), less an allowance for depreciation
- Rarely used for medical practices
- Very difficult to determine the cost of replicating goodwill

Market Approach

- Aka "Comparable Sales"
- Requires a database of comparables
- Same idea as pricing a house
- Benchmark value, based on comparables
- Adjust for individual features

Market Approach

- Admittedly some element of subjectivitity, when making adjustments
- But subjectivity is acknowledged and quantified
- Benefit of this method is its link to “real world” prices paid by others.
- Fair market value is what a buyer will actually pay and a seller will actually take

Review of HCG Goodwill Registry Data

Adjustments: Location

- Is this a desirable place for physicians to live?
  - Market for physician recruiting is national
  - More potential physician buyers means more “demand” for the intangible assets of existing practices
  - Major metro areas versus rural
  - Coasts versus heartland

Adjustments: Competition

- If there is little competition, it will be easy to start a practice.
- And if it is easy to start a practice, why should buyer pay big $$$ for your goodwill?
- If it is hard to start a practice (substantial competition), buyer will recognize the value of your patient flow

Adjustments: Profitability

- If you have a track record of making good money (whether W-2, or “profit, or both), that is attractive to buyers
- Even average profitability is attractive (“buying a job”).
- Below average profitability or declining profitability is “scary”

Other Potential Adjustments

- Facility presentation/curb appeal. Up to date or run-down?
- Payor mix (balanced, or heavy HMO, capitation, Medicaid). Good cash flow from elective services?

More Adjustments

- Negative publicity or legal problems
- Seller personal charisma or practice patterns are not easily replicable

Ancillary Businesses - Optical

- Typically valued in the same fashion as the "core" ophthalmology practice, even if a separate entity
  - Equipment, inventory, receivables, goodwill
- The optical shop is usually just an ancillary revenue stream of the ophthalmology practice
- Not truly a freestanding business

Ancillary Businesses – Real Estate

- May or may not be part of the transaction
- Priced by real estate professionals

Ancillary Businesses – ASC

- Generally a separate entity from the ophthalmology practice
- Valued as a multiple of earnings
  - 2-4X EBITDA (earnings before interest, taxes, depreciation and amortization) for doctor-to-doctor sales
  - 6-8X EBITDA for sales to national surgery center companies

Questions?

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