CURRENT ISSUES IN THE VALUATION OF HEALTH CARE ENTITIES

Presented by
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Goals for Today

• To provide an overview on critical issues in current healthcare industry business practices
• Introduction of key regulatory issues
• Review of valuation assumptions in the face of industry transactions
• Recognize when to implement the attorney-appraiser team approach
Discussion Outline

• Factors driving business practices in the healthcare industry and provider responses
• Regulatory overview affecting valuation and transactions
• New business relationships and impact on valuation approaches and methods
• Increasingly “typical” healthcare valuation engagements
• Appendix materials
Health Care Industry

- $1 trillion a year industry
- 44% paid by federal government
- 3.5% fraud in private sector
- 11% fraud abuse in Medicare ($20.3 billion of improper billing out of $177.4 billion in fee-for-service)
Drivers of Change in Healthcare Business Arrangements

- Revenue flows
  - Amount, method and timing of payments
  - Managed care penetration
  - Loss of patient base
  - Loss of control
  - Development of networks
- Expense control
Drivers of Change in Healthcare Business Arrangements

Hospitals are seeking:

- Income stabilization/growth
- Reduction of costs - providing care in the most efficient setting
- Broad provider access
- Prevention of market erosion
- Mid- to long-term partners
Drivers of Change in Healthcare Business Arrangements

Physicians are seeking:

- To maintain clinical autonomy and high quality of care
- Income stabilization/growth
- Relief from uncertainty and adverse business risk
- Investment opportunities
Drivers of Change in Healthcare Business Arrangements

Public companies are seeking:

- Investor return through earnings and earnings growth
- Acquisition of market share
- Reduction of clinical variation

WARNING: Short Term Perspective!
Provider Responses to Business Pressures

Hospitals

- Examine independence or interdependence status
- Affiliate, merge, sell
- Focus on core competencies and market strengths
- React to immediate financial needs
Provider Responses to Business Pressures

Physicians

• Birds of a feather / strength in numbers (IPA, PHO, PO, PPMC, etc.)
• Seek business partners
• Get focused & improve position
• Accept defeat / cut losses: earn less, move, sell out
Provider Responses to Business Pressures

Other Players

• Pure Play Providers seek broader bases of operations, multi year contracts
• National / Regional Firms become very competitive
• Marginal Players seek to hang on, watch market development
Regulatory Overview

- Healthcare is a highly-regulated industry
  - Fraud & abuse, private benefit/inurement, anti-referral prohibitions, antitrust

- Sanctions for non-compliance with the law are great
  - Loss of Medicare provider status, loss of tax-exemption status, astronomical financial penalties, incarceration
Medicare/Medicaid “Fraud” Investigations

• Medicare based on “trust”
  – Average 3% claims audited

• “Fraud” requires
  – Knowing
  – Reckless disregard
  – Intentional ignorance
Medicare/Medicaid “Fraud” Investigations

• HIPAA - $548 million for enforcement
  – 300 new OIG & FBI agents
  – 160 new federal prosecutors

• Operation Restore Trust
  • $188 million in civil penalties
  • 73 criminal cases
  • 218 exclusions from Medicare
Medicare/Medicaid “Fraud” Investigations

- PATH audits: Dartmouth-Hitchcock Medical Center spent $1.7 million defending audit which uncovered $768 in improper billings
- OIG nevertheless plans to audit all 125 teaching hospitals in country
Principal Industry Legal Issues Affecting Business Valuation

- Ethics in Patient Referrals Act (“Stark”)
- State “Stark” laws
- Medicare Fraud and Abuse Antikickback Statute
- §501(c)(3) of the Internal Revenue Code for tax-exempt organizations
- Corporate Practice of Medicine Laws
Stark Laws

*Ethics in Patient Referral Act - Elements:*

- Physician
- Makes referral
- For “designated health services” payable by Medicare
- To an “entity” (i.e., hospital)
- With which physician (or immediate family member) has a “financial relationship”
- **No protection** outside of enumerated exceptions
Stark Laws

“Financial relationship”

• “Ownership or investment interest”
  – Covers hospital-physician joint ventures

• “Compensation arrangement”
  – Includes management services contracts and all other contracts with physicians
  – Includes hospital payments to physicians
  – Includes recruitment assistance
Stark Laws

“Designated Health Services”

- Clinical lab
- Physical therapy
- Occupational therapy
- Radiology and diagnostic services
- Radiation therapy
- DME
- Home health
- Outpatient prescription drugs
- Inpatient and outpatient hospital services
- Parental and enteral nutrients, supplies, etc.
- Prosthetics
FAIR MARKET VALUE

- All transactions and considerations must be based on fair market value and the result of arms length dealing on commercially reasonable and available terms.
- The value or volume of referrals cannot be considered.
- The FMV consideration is one of the most difficult to address.
Stark Laws

3 Questions

• Does the physician (or a family member) have a financial relationship to the entity?

• Will the physician *make referrals* to the entity for designated health services that are paid by Medicare or Medicaid?

• Does an Exception apply?
Medicare Anti-kickback Law

• Covers the giving or receiving of *anything* of value to induce Medicare/Medicaid referrals
• Violation if only *one* material purpose is to induce referrals
• Violation = felony, possible loss of provider status, false claim liability
• OIG looking for “disguised” payments for referrals
• Protection available outside safe harbors
IRS Section 501 (c)(3) Compliance

- Covers tax-exempt organizations
- Exempt organization must serve public rather than private interests
  - Activities must “further tax-exempt purposes”
  - Net earnings of tax-exempt organization shall not inure to private persons (“private inurement”)

Compliance
IRS Section 501 (c)(3) Compliance

• Consequences of private inurement:
  – Loss of tax-exempt status (institutional)
  – Intermediate sanctions (board and managers)

• Relationship between hospital and physicians must further tax-exempt purposes of hospital
  – Private benefit to physicians must be “incidental”
IRS Section 501 (c)(3) Compliance

- Terms must be arms length and commercially reasonable
- Revenue sharing can amount to private inurement
In health care context, examine contracts for employment, services, and supplies, equipment and real estate leases, physician practice acquisitions, joint ventures, and compensation arrangements.
Why is Compliance Important?

• Reduces risk of legal violations
• Reduces risk of “whistle blower” (*qui tam*) suits
• Reduces risk of financial liability
• Reduces risk of unfavorable publicity
• Promotes integrity among employees
Corporate Practice of Medicine Laws

• In some jurisdictions, only physicians (or other licensed professionals) may practice medicine through professional services entities

• Focus is on maintaining the “independence” of the health care professional

• Enforcement may be strict or not
Corporate Practice of Medicine Laws

- From the valuation perspective, the following areas may be of concern
  - Employment relationships
  - Personal services agreements
  - Operation of medical and related professional practices
  - Joint venture relationships
  - Potential universe of buyers issues
States with “active” clear prohibitions include:

- California
- Illinois
- Iowa
- Kansas
- New York
- Tennessee
- Texas
- Washington
Emerging Business Strategies and Relationships

Industry consolidation through:

- Acquisitions
- Mergers
- Divestitures
- Partnerships
  - Equity & Non-equity arrangements
- Joint Ventures
Current Uses of External Opinions

- Acquisition and divestiture
- Employment/compensation agreements
- Joint venture agreements
- Operating agreements
- Hospital conversions (NFP to FP)
Current Trends in Transactions

- *Strategic decisions* still drive buyers in acquisitions
- *Unreasonably high prices* continue to be paid in many markets
- Risk rates continue to remain low despite capital market response
  - *WACC to Invested Capital currently as low as 15%*
- *Anecdotal information is confusing*
Current Trends in Transactions

- **Essential elements:**
  - Justification for action
  - Documentation of independent valuation, business review or fairness opinion
  - No double counting (avoid conferring excess benefit)
Impact of Fair Market Value

• FMV is not intrinsic value, nor investment value, nor strategic value
• The regulators know this
• Many buyers do not seem to care
Impact of Fair Market Value

- Cash concept of FMV sometimes difficult to convey when stock deals are offered
- Willing buyer, willing seller and leverage
  - Regulatory guidance requires adaptation of hypothetical parties
- Universe of buyers issues abound
The Disparate Universe Of Buyers in Healthcare

Strategic Buyers

Willing Buyer - Willing Seller

Low Ball Buyers
Increasingly Typical Valuation Engagements

- FMV of provider compensation
  - Employed physicians, medical directors, consultants, physician assistants, nurse practitioners, midwives
- Joint venture relationships
  - Valuation of partnership contributions for new ventures, dissolution of old ventures
- Valuation for disintegration
Increasingly Typical Valuation Engagements

• Medical practices - minority interests
• Restrictive and network agreements
  – Right of first refusal to purchase
  – Option to purchase
  – Network participation
    • Exclusive or non-exclusive
  – Non-solicitation provisions
Increasingly Typical Valuation Engagements

- Valuing invested capital of failed ventures
  - What defines “failed” when one partner chooses to continue?
- Valuing contracts for service when intangibles exist
- Identifying and valuing assets in strategic acquisitions
Case Study 1

**For Sale:** Assets of hospital, FFE, real property, physician network of practices

**Engagement:** FMV of physician network

- How is the value of the network’s referrals to the hospital included?
- How is the value of the in-place provider network to support managed care contracts considered?
- Result: Value of physician network is a fractional asset valuation of the whole entity - value is based on network alone - hospital-referred income and other benefits must be valued on the hospital’s valuation
Case Study 2

For Sale: Assets of a physician practice opened 3 years ago under a physician recruitment guarantee. Practice has $300,000 in cumulative start-up losses, partially because it depreciated its purchases rapidly.

Engagement: FMV of practice assets for sale to physicians

- How do you handle the start-up losses?
- If all losses were reclassified as equity, would the physicians receive an excess benefit?
- Result: Health law attorneys will interpret this in various manners. Attorneys will seek to convey that the deal will result in no excess benefit being conferred
Case Study 3

**For Sale:** Assets of a 2 year old clinical ancillary services business with losses over $400,000 including third party debt. Two partners each own 50%. Projections estimate break-even in 12 months; one partner wants out now.

**Engagement:** FMV of business assets to transfer via partnership agreement to one partner to yield 100% and control.

- Is this a going concern?
- What about release of debt guaranty?
- Result: Transfer of the 50% interest for release of guaranty and pro rata share of other payables
Case Study 4

**Issue:** Hospital wants to get out of the physician billing issues for a group of solo, independent contractor hospital-based physicians. Hospital offers exclusive multi-year contract for physician group. Physicians want to be kept whole in the start-up of their new corporation and want the working capital forgiven.

**Engagement:** Can the hospital do this?

- What assets or services are offered?
- What is the market price for comparable services?
- Do intangibles exist?
- Result: Hospital pays under the service contract inclusive of a one-time payment for “goodwill”
Summary

- A rapidly changing and consolidating industry
- Many opportunities for experienced appraisers
- Pick areas suited to your expertise
- Seek assistance - spread the risk
- CYA - Cover Your Assets
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Christopher J. Evans, FACHE has been with The Health Service Group, Inc. since 1994 and directs our physician services division.

Having directed community hospital referral relationships and the physician faculty outreach clinical activities at a major academic medical center, Chris brings a wealth of experience in affiliation and transaction relationships, physician compensation, valuation, feasibility studies, and administrative contracting issues.

Appendix Materials

Expanded Industry and Transaction Issues
Drivers of Change in Healthcare Business Arrangements

- Financial
- Competition
- Medical staff relationships
- Managed care penetration
- Payer relationships and position
- Personnel
- General management
Factors Driving Business Practices in Healthcare

Financial

• Overhead escalation and control
• Decreasing reimbursement - form and amount
• Lack of capital for growth
• Inability to see the need to invest in their business - little or no strategic financial management
Factors Driving Business Practices in Healthcare

Competition

• Increasing competition between providers
• Network development steering patients to specific delivery systems
• Pure play competitors entering markets and diluting patient base
• Outreach activities capturing market share
Factors Driving Business Practices in Healthcare

Medical staff relationships

- Cooperative or competitive between hospital and medical staff
- Frequent poor communications
- Sources of income and diversification
- Short term vs. long term thinking
Managed care penetration

- Stage and form of managed care penetration
  - Discounted fee for service, capitation, direct contracting
- Competition, market share, and contract access
- Capturing the premium dollar
Factors Driving Business Practices in Healthcare

Payer relationships and position

- Complement of payers in market
  - Carnivore, omnivore
- Health plan equity position or not
- Data analysis and data capabilities
Factors Driving Business Practices in Healthcare

**Personnel**

- Availability and quality of staff
- Compensation
- Investment in staff - training and retention issues
- Use of staff and cost minimization - benchmarking
Factors Driving Business Practices in Healthcare

**General management**

- Old paradigm mind set
- Short term leadership horizon
- Broad governance issues and strategic direction of the organization
- Failure to follow-through
Hospital - Physician Equity Opportunities

- Joint ventures
- Ancillary services - PT, OT, therapies
- Surgical and other diagnostic centers
- Skilled nursing and assisted living facilities
- Medical office buildings
- Condominiumization of hospital services - boutique model of delivery
Hospital - Physician Equity Opportunities

- Wellness, behavioral health, urgent care, occupational medicine, hospice and dialysis centers
- Creation of new delivery and contracting systems - PHOs, IPAs
- Privatization of health departments
Hospital - Physician Equity Opportunities

• Methods for acquiring & selling equity
  – Cash buy-in / pay-out
  – Earn out method - certain circumstances
  – Deferred compensation / buy-in
  – Buy-sell agreements
  – Recruitment agreements
Hospital - Physician Equity Opportunities

• Valuation/Fairness/Documentation
  – Standard of value
    - FMV, fair value, liquidation value, intrinsic value, strategic value
  – Purpose and function of valuation
  – Complete or limited valuation
Valuation issues cont.

- What is being valued: assets, stock, contract, capital contribution, etc.
- Universe of buyers
- Control or minority interest
- Marketability issues
  - Actual or hypothetical
Hospital - Physician Equity Opportunities

- Valuation issues cont.
  - Purchase - cash, stock or terms
  - Timing of valuation
Hospital - Physician Equity Opportunities

• Operating issues
  – Nature of the agreement (e.g., JV, operating, management, etc.)
  – Operating agreement provisions
    ◆ Control, succession and reporting mechanisms
    ◆ Management composition
Hospital - Physician Equity Opportunities

– Operating agreement, cont.

- Capital account contributions, events and provisions (failure to make additional contributions)
- Distributable cash
- Partner liabilities
- Tax exempt status issues
- Dissolution of company & buy-sell
Hospital - Physician Equity Opportunities

• Transaction issues
  – Timing of transaction - current valuation (e.g., within 3 months of closing date w/ updated balance sheet)
  – Terms and fairness - FMV
    ✶ Normally judged from the viewpoint of one side only in a deal (the other side has to concern itself with fairness from its viewpoint)
Hospital - Physician Equity Opportunities

• Transaction issues, cont.
  – A fairness opinion is no guarantee that the proposed deal is the *best possible* deal
  – Price is an important consideration
    ✥ Not all “prices” are comparable
    ✥ How should a stock deal compare with an all-cash deal?
Hospital - Physician Equity Opportunities

• Transaction issues, cont.
  – Not all stocks have equivalent attractiveness
    ✅ Liquidity is a concern
    ✅ Historical performance and the outlook for future performance
    ✅ Some stocks have more potential for rapid appreciation than others
Hospital - Physician Equity Opportunities

• Transaction issues, cont.
  – Re: Stock appreciation and attractiveness
    - The market will judge
    - Look at PPM stock price changes from 1/15/98 to 10/15/98