

# An Administrator's Guide to Dealing with a Business Valuation Consultant

Presented by

Curtis Bernstein, CPA/ABV, CVA, MBA

HealthCare Appraisers, Inc.



# The Valuation Process

- Selecting and Engaging a Valuation Consultant
- Engagement Planning
- Data Collection
- Site Visit
- Draft Report

# Valuation Consultants

## ■ Credentialed appraisers

- Certified by a professional appraisal organization
- Met experience requirements
- Mastered the body of knowledge for an appraisal specialty as evidenced by examinations and/or peer review of work
- Met education requirements
- Subject to professional standards and ethics codes
- Continues to meet continuing professional education requirements

# USPAP

- Uniform Standards of Professional Appraisal Practice (“USPAP”)
  - Promulgated by the Appraisal Foundation, which was started by the appraisal profession in 1987
  - Standards for appraisal work and reporting
  - USPAP-compliant appraisal reports required for certain regulatory purposes
  - Certain professional organizations require USPAP-compliant reports
  - Clients can request USPAP-compliant reports
  - Addresses real estate, personal property and business valuation

# Appraisal Professional Organizations & Certifications

- American Society of Appraisers
  - Accredited Senior Appraiser, Accredited Member
  - Specialties: real estate, business valuation, machinery & equipment
- American Institute of Certified Public Accountants (BV)
  - Accredited in Business Valuation
- National Association of Certified Valuation Analysts (BV)
  - Accredited Valuation Analyst, Certified Valuation Analyst
- Institute of Business Appraisers (BV)
  - Accredited by IBA, Certified Business Appraiser
- Appraisal Institute (real estate)
  - MAI, SRA

# Appraiser Engagement Contracts

Before you contract with an appraiser, consider:

- Selecting a qualified appraiser
  - Professional certifications
  - Education and training
  - Appraisal experience
  - Healthcare experience
  - Professional reputation

Before you contract with an appraiser, consider:

- Selecting the “Right Fit” appraiser
  - Experience in valuing the same or similar types of arrangements or transactions
  - Appraisal purpose and intended use: litigation, transactional, compliance review
  - Availability/timing
  - Fees

# Independence Issues

- Financial independence related to:
  - Client
  - Transaction
- Transactional independence
- Conflicts of interest
  - Appraisers are advocates for their appraisal opinion
  - Other consulting arrangements may entail client advocacy or advocacy-type work.

# Engagement Planning

## ■ Standard of Value – Fair Market Value

- A Surgery Center is not a designated health service under the Stark Law.
- Both the Anti-Kickback Law and the Stark Law require the Fair Market Value standard.
- If the center is partially owned by a health system / hospital, this entity may be concerned with Stark in relation to other referrals such as inpatient surgeries.
- Applicable when parties to the transaction are in a position to refer business to one another (*e.g.*, physicians and hospitals)

# Definition of Fair Market Value

- The term “fair market value” is generally defined as the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Source: International Glossary of Business Valuation Terms

- For purposes of this valuation, the general definition must be limited to comport with current healthcare regulations, which may significantly modify its applicability. Therefore, as used herein, the term “fair market value” is defined as the value in arm’s-length transactions, consistent with the general market value. In the context of the Agreement, “general market value” means the compensation that would be included in a service agreement as the result of *bona fide bargaining between well informed parties to the agreement who are not otherwise in a position to generate business for the other party.*

Source: 42 CFR §411.351 (as set forth by the Centers for Medicare and Medicaid Services or “CMS” with respect to physicians referrals to health care entities with which they have financial relationships). Furthermore, this definition is consistent with similar fair market value guidance related to the Anti-Kickback Statute (42 U.S.C. §1320a-7b) and with the definition relied upon by the Internal Revenue Services. See, for example, Treas. Reg. 53.4958 et seq.

# Engagement Planning (Con't)

## ■ Standard of Value – Investment Value

- The value to a particular investor based on individual investment requirements and expectations.
- *May* apply when the parties to a transaction is not in a position to refer business to each other
- Examples:
  - The sale of HealthSouth's surgery center division to Texas Pacific Group
  - The purchase of the entire interest owned by a third-party manager

# Engagement Planning

Scope Definition	Conclusion of Value	Information Considered	Procedures Performed to Collect and Analyze data	Valuation Approaches (Cost, Market, Income)
<b>APPRAISAL</b>	Single Amount or Range	<b>ALL</b> Relevant Information Available	<b>APPROPRIATE</b> Procedures to <b>ALL</b> Relevant Information	<b>ALL</b> Relevant Approaches
<b>LIMITED APPRAISAL</b>	Single Amount or Range	<b>LIMITED</b> Relevant Information	<b>LIMITED</b> Procedures to <b>NECESSARY</b> Information	<b>MOST APPROPRIATE</b> Approach(es) as Determined by Appraiser
<b>CALCULATION OF VALUE</b>	Single Amount or Range	<b>ONLY LIMITED</b> Relevant Information	<b>LIMITED</b> Procedures	<b>AGREED UPON</b> with Client

# Appraisal Scope of Work

- Intended use
- Complexity of subject arrangement or transaction
- Regulatory compliance considerations
- Best Practice: The greater the need to be certain about FMV, the higher the scope level

# Data Collection

## ■ Operating Agreements

- Control Provisions
- Non-compete agreements
- Limitations on ownership
- Restrictions on transfer

## ■ Financial Statements

- Historical earnings and distributions (not always a predictor of the future)
- Non-recurring revenues and expenses (*e.g.*, ALJ Hearing)
- Non-operating revenues, expenses, assets, and liabilities (*e.g.*, excess or deficient working capital, rent in excess of market value)

# Data Collection

## ■ Billing and Collection Reports

- Change in net revenue per case by payor over time
  - Also reviewed in relation to case mix
- Change in collections as a percent of charges over time
  - Reviewed to determine if charges have increase, reimbursements have increased without charges keeping pace, or center experienced a one-time large collection
- Change in case mix and reimbursement by case for each specialty over time

## ■ Utilization Reports

- Reviewed to determine physician practice patterns (*e.g.*, if a physician is near retirement, if a physician is ramping up)

# Data Collection

## ■ Projection

- Generally preferred that provided by client
- Other data collected (and notes from site visit) used to test veracity of projection (or create projection)

# Site Visit

- Meetings with administration from center and health system (if have any ownership)
  - Include medical director and any other physicians on governing board if available
- Discuss financial statements and operations
  - Review data received
- Discuss local market in relation to competition, reimbursement, demographics, etc.
- Discuss future goals and plans to meet goals
- Review patient flow through center

# Draft Report

## ■ Approach to Value

### ■ Asset Approach

- A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.

### ■ Market Approach

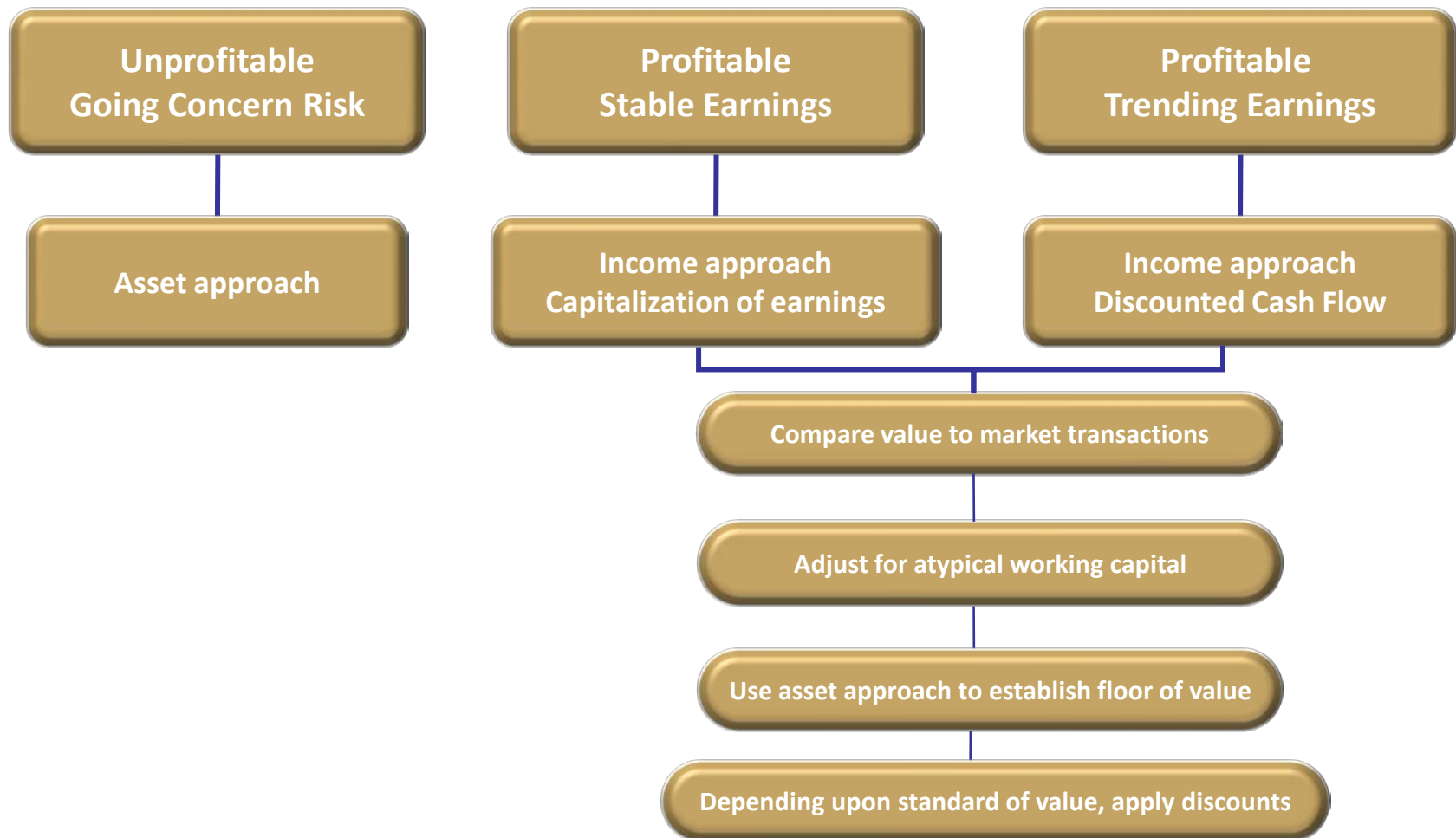
- A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

### ■ Income Approach

- A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated future economic benefits into a single present amount.

Source: International Glossary of Business Valuation Terms

# Valuation Approaches



# Asset Approach

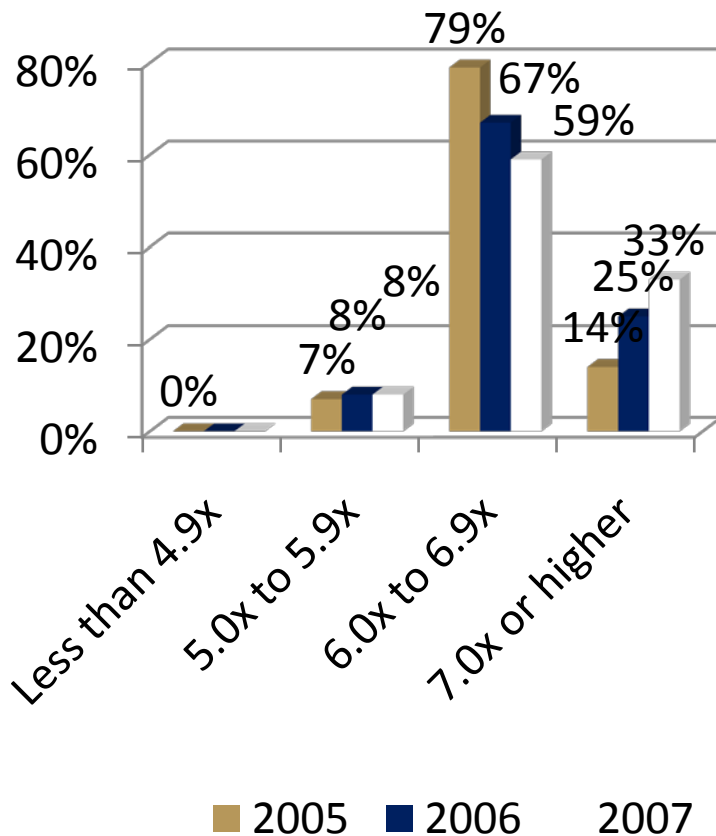
- The Asset-Based Approach is premised upon the idea that the value of a business or business interest can be determined with reference to the underlying assets owned by the business.
  - Typically this approach is most appropriate for asset-holding companies or for distressed companies with marginal profitability.
  - Generally considered a floor of value.

# Market Approach

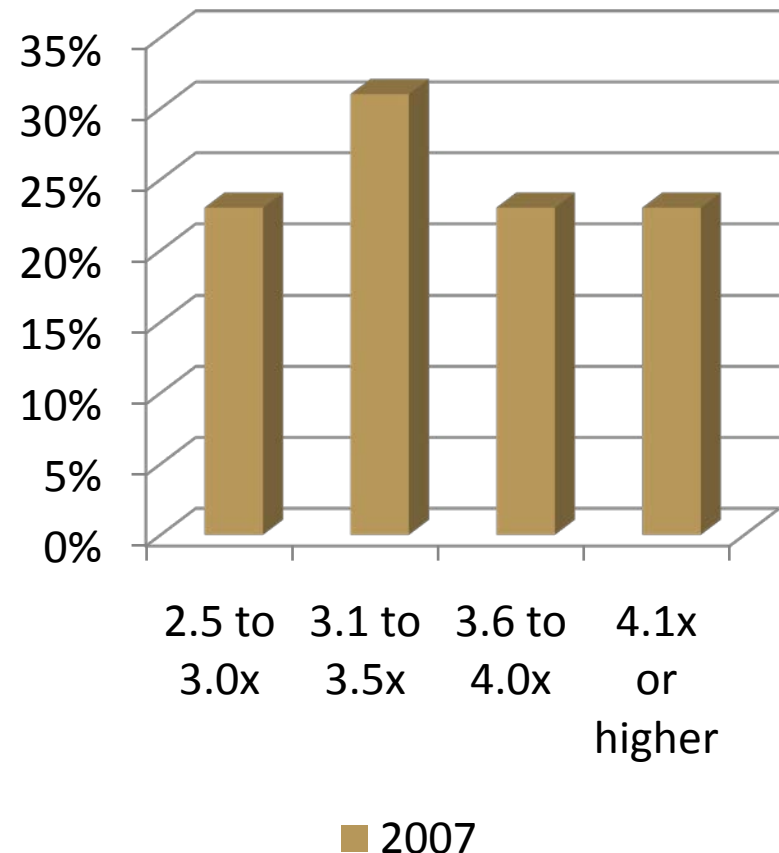
- The Market Approach is premised upon the idea that the value of a business or business entity can be reasonably determined with reference to the prices paid at arms-length for similar interests in the open and unrestricted market.
  - According to Revenue Ruling 59-60, this approach may yield the best indication of fair market value of a closely held asset.
  - Care must be taken to ensure that the companies used for comparative purposes are truly comparable to the subject interest.
    - When an insufficient number of comparable companies can not be found, or if the companies are only loosely comparable to the subject entity, this approach should be excluded.

# HealthCare Appraisers Valuation Survey

## Controlling Interest



## Minority Interest



# HealthCare Appraisers Valuation Survey

- Using data from data collection and site visit to apply market approach
- Per HAI survey, purchasers in ASC market:
  - Value potential acquisitions based on earnings before interest, taxes, depreciation, and amortization (EBITDA) less interest-bearing debt
  - Value based on trailing 12 months earnings
  - Multiple is effected by certificate of need, hospital involvement, and out-of-network contracting strategy
  - Higher multiples for opportunities for growth, nature of specialties, and extent of physician ownership

# Income Approach

- The Income Approach is premised upon the idea that the value of any business or business interest can be valued with reference to the future economic benefits expected to accrue to the owner of that interest.
  - These future economic benefits are discounted to their present value using a rate of return commensurate with the risk of the investment.

# Income Approach - Projection

- Starts with projection prepared by either client or by valuator with client's significant involvement
  - Projected for a period in which cash flow is not "stable" to the period in which cash flow stabilizes.
  - 5-year projection is commonly used because 5 years represents a business cycle in most industries.

# Income Approach - Methods

## ■ Capitalization of Earnings Method

- Cash flows are stable and will grow at a constant rate into perpetuity.

## ■ Discounted Cash Flow Method

- Cash flows are changing.
- Project until cash flows stabilize.

# Income Approach – Discount Rate

- Discount cash flows back to present value based on the risk of the investment
  - Discount rate also called cost of equity or weighted average cost of capital
    - Starts with return on large publicly traded stocks at 10%
    - Add increased risk for size (not as big or diversified as GE)
    - Subtract risk for industry (healthcare a safer investment than technology)
    - Add company specific risk not factored above

# Income Approach

## Company-Specific Risk

- Generally in the range of 4% to 10%
- Given factors:
  - Limited market – generally focused on local area
- Individual factors:
  - Limited experience at management level
  - Less checks and balances
  - Key man factor
  - Heavy reliance on a single customer

# Income Approach

## Present Value Formula

- Theory – if I want to receive X amount annually, how much money must I invest today at Y percent?
  - X is the projected cash flow stream
  - Y is the discount rate
- The higher the discount rate, the lower the value
- The lower the projected cash flows, the lower the value

# Discounts

## ■ Discount for lack of control

- An adjustment made to reflect the fact that, all things being equal, investors prefer to have control over their investments.
  - A minority interest holder in a closely-held business does not have the same rights and privileges as a controlling interest holder, and will therefore demand a discount to the otherwise pro-rata value of his or her interest.
- Because shares of publicly held corporations trade at minority interest values, price premiums paid in controlling interest acquisitions are easily observable.
  - Over time, these premiums have averaged 30 to 50% in most industries.
  - Most appraisers consider the inverse of the control premium a reasonable proxy for the discount for lack of control.

## ■ Discount for lack of marketability / liquidity

- An adjustment necessary to reflect the simple fact that unlike shares in publicly held corporations, there exists no ready market for the shares of closely held businesses.
- The empirical studies indicate marketability discounts ranging from 30% to 50% for minority interests, the discount applicable to controlling interests should be considerably less.
- No empirical studies for controlling interests exist but the courts have generally found discounts ranging from 0% to 30% are appropriate.
- Block specific
- Market specific

**858 Happy Canyon Road, Suite 240  
Castle Rock, Colorado 80108  
303-688-0700**

**[www.HealthCareAppraisers.com](http://www.HealthCareAppraisers.com)**

**Curtis Bernstein, CPA/ABV, CVA, MBA**

**[cbernstein@hcfmv.com](mailto:cbernstein@hcfmv.com)**

