

FINDING VALUE IN A TROUBLED ECONOMY

Determining the Fair Market Value of Certificates of Need

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THE HEALTHCARE INDUSTRY is generally thought of as “recession proof,” as the need for healthcare services doesn’t wane with the health of the economy. Although this is generally true — people do not stop getting sick in a down economy — people can lose their jobs, defer medical spending in favor of paying for day-to-day necessities, or seek work in new geographies. Unlike other industries, healthcare is very geographically focused. Because of this, even small fluctuations in a population can have a significant impact on the financial well being of a healthcare provider. Pair this with downward pressure on reimbursement and increasing operational costs, and even “recession proof” businesses can find themselves in financial difficulty.

Although there are varying levels of distress, there may come a point when a healthcare business owner must decide whether to continue operating the business and try to improve profits; close the business to avoid further losses; or sell the business to a buyer that may be able to operate it more successfully. Although it may seem counterintuitive, distressed businesses are prime acquisition targets for management companies and/or health systems. These strategic buyers usually have experience turning around distressed businesses for a profit or have existing capacity constraints that would be alleviated through such an acquisition. Unfortunately these buyers are often precluded from paying more than fair market value for such an acquisition due to Stark, anti-kickback and/or private inurement concerns, and payment for strategic

value elements must usually be avoided. For an unprofitable or marginally profitable business this may lead to the incorrect conclusion that fair market value is limited to the value of the furniture, fixtures and equipment. This is especially untrue when the business has valuable intangible assets such as a certificate of need.

OVERVIEW OF CERTIFICATES OF NEED

Certificate of Need (CON) programs are designed to limit healthcare facility costs by restricting the capacity of a given type of health service – generally outpatient or long-term care. By restricting capacity within a geography, existing facilities are thought to experience higher utilization rates, and therefore, lower costs per unit of care (e.g., per patient, bed, case, etc.). CON laws are administered on a state by state basis, and according to the National Conference of State Legislatures, 36 states currently have some form of CON program in place.

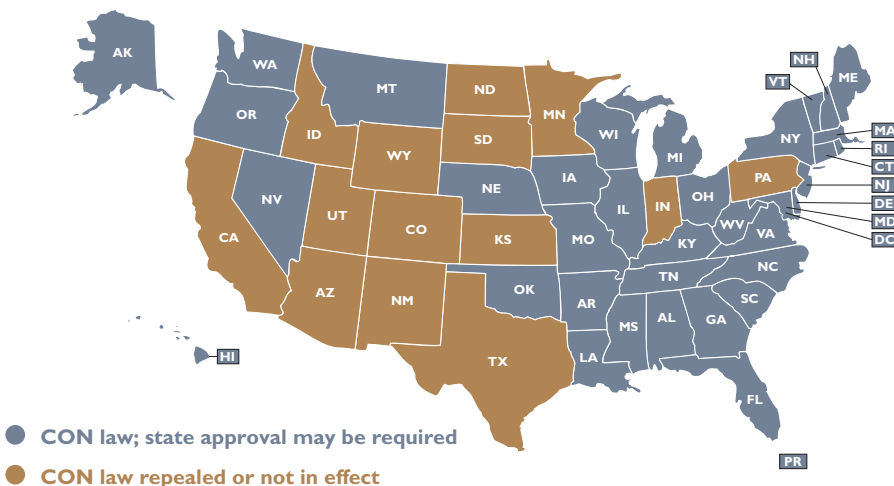
Applications for CONs are frequently contested by existing healthcare providers in an attempt to preclude new competition and preserve their existing business volumes. Every state is different with regard to the parameters of the CON grant, with some going so far as to designate the specialty, number of ORs, square footage, etc. of the entity to be operated under the grant. Under strict guidelines an entity may be required to obtain a CON for the addition of services, facility expansion or relocation or change in ownership.

In some cases states have issued moratoriums on new CON grants, effectively precluding the development of any new business for the particular covered service type. When CON grants become difficult or impossible to obtain, the only option for investors becomes the acquisition of an existing business with a CON.

VALUATION OF CONS

There are two basic financial theories under which a CON can be valued — cost to replicate and the income approach.

STATE CERTIFICATE OF NEED LAWS, 2006



Source: National Conference of State Legislatures

Compiled by NCSL, based on data from AHPA, June 2006

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FAIR MARKET VALUE

Cost to Replicate

The cost to replicate is a simple financial theory under which the value of an asset is determined with regard to the cost a buyer would otherwise incur to independently create or obtain the asset. The valuation methodology is only appropriate when there are readily available purchase or recreation alternatives. For example, the price one might pay for a bookshelf is limited by either the cost of the lumber and time to build the unit (assuming one had the skill to do so) or the cost of buying an acceptable substitute at the furniture store. This is not an appropriate valuation methodology if there are no available substitutes. For example, a painting by Monet should not be valued with regard to the cost of the paint and the canvas, as such an exercise would greatly underestimate the true value of the work.

Carrying this application to CONs, the cost of replication may be appropriate if there is a high likelihood of independently obtaining a CON through the normal application process. In such a case, the value of the CON may be limited to the cost that would otherwise be incurred due to application fees, legal, consulting and/or internal “man hours,” and the opportunity cost associated with waiting for approval.

Income Approach

When there are no available alternatives, such as is the case in states where there is a moratorium on CONs or where applications are heavily contested, a Cost to Replicate may not be an appropriate valuation methodology. In such environments the laws of scarcity apply, and appraisers must consider the economic benefits that can be realized

through the ownership of the CON. To accomplish this we use a variation of the Income Approach generally referred to as the return on assets model. Under this approach, the estimated total return of a business is allocated to the individual assets utilized in the operation of the business. This includes tangible assets such as working capital and fixed assets as well as intangible assets such as workforce in place, trade name, etc., and the CON.

This type of valuation model is frequently used for purchase price allocation following acquisition. Unlike a purchase price allocation, however, when dealing with a distressed entity looking to sell a CON, the allocation exercise should not begin with the actual entity, but rather a hypothetical entity. This is due to two primary

Summary Income Statement	PROJECTED					TERMINAL YEAR
	Year 1	Year 2	Year 3	Year 4	Year 5	
Net Operating Income After Tax	718,000	1,087,052	1,535,084	1,683,710	1,894,802	2,173,716
Plus: Depreciation and Amortization	468,000	482,000	496,000	518,000	543,000	250,000
Less: Capital Expenditures	0	(75,000)	(100,000)	(150,000)	(175,000)	(250,000)
(Increases)/Decreases in Working Capital	(572,000)	(232,000)	(118,000)	(74,000)	(71,000)	(31,000)
Free Cash Flow	614,000	1,262,052	1,813,084	1,977,710	2,191,802	2,142,716
Present Value Factor @ 29.1%	0.8801	0.6817	0.5281	0.4090	0.3168	
Present Value of Cash Flow	540,381	860,341	957,490	808,883	694,363	
Present Value of Projected Cash Flows	3,861,458	sum of above calculated separately				
Present Value of Terminal Value Calculation	4,465,872					
Indicated Market Value of Total Capital	\$8,327,330					

reasons: a distressed entity usually has a value that is suppressed or negative and the causes for the suppressed value of the entity are generally unrelated to the value of the CON. Among other things, mismanagement, poor payor contracts, loss of a key physician, malpractice, etc. can all result in an entity losing value. However, the premise of value for a CON should be based on the opportunity that it provides a potential buyer. Accordingly, the baseline for the return on assets model should be a hypothetical entity operating under the CON.

To apply this valuation methodology, begin with a financial forecast for the hypothetical entity over a five-year period. This forecast should be tempered with local economic conditions and assumptions and not one that blindly assumes national financial benchmarks are appropriate. It is important that both the income statement and balance sheet are projected so that economic returns can be estimated for all contributory assets. Once the forecast has been prepared, the weighted average cost of capital (WACC) should be developed for the hypothetical entity, which is a combination of the required rates of return of both debt and equity on a risk adjusted basis. Using the WACC and financial forecast, an estimate of the hypothetical entity value can be determined using a discounted cash flow (DCF) model. Although beyond the scope of this article, an example of such a model is shown above.

Using this value as a starting point, a return on assets model can then be developed. To do this, fixed assets and identifiable intangible assets are valued separately and individual rates of return are developed for each class of assets. Tangible assets are generally assigned a rate of return commensurate with known credit market instruments such as commercial paper rates for working capital and bond yields for fixed assets. Intangible assets, which embody significantly higher risk, are assigned higher rates of return.

Using the values determined for the tangible and intangible assets, and the value for the overall business, the value of "other intangibles," including the CON, can be solved for. It should be noted that the weighted average return on assets is always equal to the WACC estimated for the business. For purposes of estimated entity value over time, the WACC will decrease as the entity becomes proven, and the level of risk declines.

Multiplying the identifiable assets by their corresponding rate of return, economic rents can be estimated, which when applied to the cash flows gener-

ated by the entire business, will allow the appraiser to isolate the residual cash flows accruing to the "other" intangibles. This sounds complicated, but it is really a simple mathematical exercise. Using the table below, net working capital valued at \$572,000 with a required rate of return of 1.5 percent would justify an economic rent of \$8,580 per year ($\$572,000 \times 1.5$ percent). This economic rent is then subtracted from the total cash flow shown in the DCF model. This same application is done for each identified asset class until all that remains is the cash flow associated with the other intangibles. In this model, the economic benefit associated with the CON cannot be directly observed. Accordingly, we must split the remaining intangible cash flow according to its perceived source. Initially as much as 100 percent of the other intangible value may be associated with the CON, but as the business grows and establishes itself, other types of intangible assets will contribute to the overall value of the business. As such, the percentage of the overall intangible value associated with the CON must be reduced over time. After four or five years of operation it is possible that only a small percentage of the intangible cash flow should be assigned to the CON. Using the original DCF model for the business, and incorporating economic rents and a profit split to the CON, the valuation model would be prepared as follows on page 27.

Although the exercise has been oversimplified for illustrative pur-

ESTIMATED ASSET BALANCES BASED ON PROFORMAS						
Asset Allocation	Pre-Opening	Year 1	Year 2	Year 3	Year 4	Year 5
Net Working Capital	\$133,000	\$572,000	\$804,000	\$922,000	\$996,000	\$1,067,000
Fixed Assets	\$6,547,900	\$6,079,900	\$5,672,900	\$5,276,900	\$4,908,900	\$4,540,900
In-Place Workforce	\$0	\$282,000	\$311,000	\$340,000	\$371,000	\$382,000
Other Intangible Assets (estimated)	\$1,646,430	\$2,100,000	\$2,750,000	\$4,400,000	\$6,500,000	\$8,100,000
Total Invested Capital	\$8,327,330	\$9,033,900	\$9,537,900	\$10,938,900	\$12,775,900	\$14,089,900
Estimated Component Rates of Return on Assets over Time						
Net Working Capital		1.50%	1.50%	1.50%	1.50%	1.50%
Fixed Assets		6.00%	6.00%	6.00%	6.00%	6.00%
In-Place Workforce		35.00%	30.00%	25.00%	22.50%	20.00%
Other Intangible Assets		90.00%	70.00%	50.00%	35.00%	30.00%
Total Invested Capital	(WACC)	29.10%	26.15%	24.86%	23.91%	19.84%

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FAIR MARKET VALUE

Summary Income Statement	PROJECTED					TERMINAL YEAR
	Year 1	Year 2	Year 3	Year 4	Year 5	
Free Cash Flow	614,000	1,262,052	1,813,084	1,977,710	2,191,802	2,142,716
Economic Rents						
Return on Working Capital	(8,580)	(12,060)	(13,830)	(14,940)	(16,005)	(10,000)
Return on Fixed Assets	(364,794)	(340,374)	(316,614)	(294,534)	(272,454)	(215,000)
Return on Workforce	(98,700)	(93,300)	(85,000)	(83,475)	(76,400)	(75,000)
Free Cash Flow Available to Remaining Intangibles	141,926	816,318	1,397,640	1,584,761	1,826,943	1,842,716
% of Intangible CF Attributed to CON	80.0%	25.0%	15.0%	10.0%	7.5%	5.0%
Intangible Cash Flow to CON	113,541	204,080	209,646	158,476	137,021	92,136
Present Value Factor @ 16.0%	0.9285	0.8004	0.6900	0.5948	0.5128	
Present Value of CON Cash Flow	105,423	163,345	144,656	94,262	70,264	
Present Value of Projected Cash Flows	577,949					
Present Value of Terminal Value Calculation	295,295					
Indicated Market Value of Total Capital	\$870,000					
			TERMINAL VALUE CALCULATION			
			CON Cash Flow in Terminal Year	92,136		
			Divided by Capitalization Rate (wacc-g)	16.00%		
			Equals Terminal Value in Year 5	575,849		
			Present Value Factor for Year 5	0.5128		
			Present Value of Terminal Value	\$295,295		

poses, ownership of a CON can yield a significant value – even for a distressed company. This important value consideration should not be overlooked, and any business in a CON state contemplating a sale should seek the advice of a qualified health-care business appraiser. ●



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