

2018 VALUATION SURVEY

PHYSICIAN – OWNED HOSPITALS





EXECUTIVE SUMMARY

We are pleased to release the results of the 2018 Physician-Owned Hospital (“POH”) Valuation Survey. In cooperation with Physician Hospitals of America, HealthCare Appraisers, Inc. (“HAI”) surveyed POH market participants to determine trends in the value of POHs, management fees charged to these entities, and trends related to POH revenue and expenses. Twenty-two entities responded to this year’s survey. The following summarizes highlights of the survey.

VALUATION MULTIPLES

Controlling Interest

We asked respondents what valuation multiples (on a total invested capital-to-EBITDA basis) they have observed in the market over the last 12 months for controlling interests in POHs. Responses varied, with 28 percent of respondents indicating a multiple less than 4.0x, and 24 percent responding a multiple of 8.0x or greater.

HAI Insight: We are not surprised by disparity in the responses based on transactions we have observed in the marketplace. POHs are certainly not immune to financial distress, as the regulatory environment, reimbursement pressures, and rising operating expenses can take a toll on financial performance. These factors may result in transactions taking place at a low multiple given negligible or negative cash flow. Examples include Doctors’ Hospital of Michigan being acquired in 2016 after experiencing financial distress, six Forest Park Medical Center hospitals sold after declaring bankruptcy in 2015 and 2016, and Miami Medical Center being sold in 2018 after declaring bankruptcy in

2017. This trend is expected to continue, as we note Gilbert Hospital and Florence Hospital at Anthem in Arizona closed in June of 2018 as a result of financial distress. Conversely, successfully run POHs generating substantial cash flows may have numerous potential purchasers looking to pay a multiple of 8.0x or higher, especially for POHs with a focus on spine and/or orthopedic procedures. HAI has been involved in many POH transactions that have resulted in valuation multiples above 10.0x EBITDA.

Minority Interest

We asked respondents what valuation multiples (on a total invested capital-to-EBITDA basis) they observed in the market over the last 12 months for minority interest buy-ins and buyouts. For buy-ins, responses of: (i) 3.0x to 3.9x; (ii) 4.0x to 4.9x; (iii) 5.0x to 5.9x; and (iv) 6.0x+ each received 24 percent of respondents’ votes. For buyouts, responses were 19 percent, 13 percent, 24 percent, and 31 percent, respectively, for each of these ranges.

HAI Insight: The distribution of responses were generally consistent for each range of multiples



outlined above. We believe this spread can partially be attributed to the fact that many POHs employ a formula for determining shareholder buy-ins and buyouts. While 43 percent of POHs rely on an independent fair market value (“FMV”) opinion for transactions, 52 percent of respondents indicated using a formula for determining a minority interest buyout. Using a formula results in a transaction that may not be consistent with FMV.

MANAGEMENT FEES

Respondents reported that management fees for POHs typically range from 5 percent to 6 percent of net revenue, though many respondents indicated utilizing an alternative structure, such as a flat fee arrangement. Providing access to group purchasing organizations, managed care contracting, and operations oversight/support were all included in the management services provided by the majority of respondents.

HAI Insight: Approximately half of the respondents provide coding services, revenue cycle services, human resources functions, and accreditation support, despite the fact that the typical fees charged are fairly consistent. This implies that certain POHs receive a higher level of management services in connection with their management fee than other POHs. Obtaining a fair market value opinion as to the management fee paid, or attempting to re-negotiate the management fee may result in a POH’s ability to reduce costs.

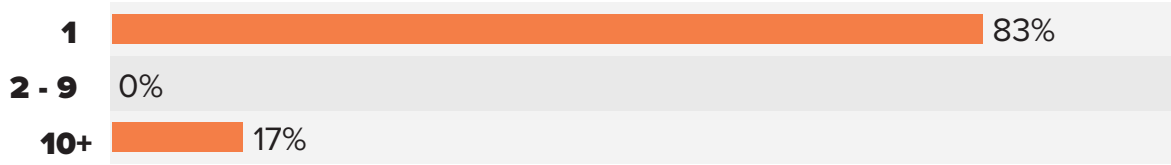
INCOME STATEMENT TRENDS

While 60 percent of respondents stated they expect a 2.1 percent or greater increase in POH commercial payor rates each year, 28 percent of respondents reported they expect reimbursement to remain flat. While many operating expenses are also increasing at average rates of 2.5 percent to 3 percent per year, several respondents reported higher expenses associated with drugs, with 28 percent reporting annual increases of 5 percent or higher in drug costs. However, 44 percent of respondents reported observing annual implantables expenses increasing at a rate of 1.9 percent or less.

HAI Insight: With a large percentage of respondents observing annual commercial reimbursement increases of 2.0 percent or less, many POHs are at risk of deteriorating operating margins if they are not able to implement significant cost controls (e.g., absent a shift in case volume or payor mix). Access to GPOs can help limit expense increases, and most respondents reported access to a GPO; however, they were still observing increases above long-term inflation for certain expenses. In future years, staff expenses are also a potential area of expense increase. While hiring is often a local issue, at a macro level, low unemployment throughout the country paired with the retirement of the baby boomer generation should put continued upward pressure on staffing expenses.

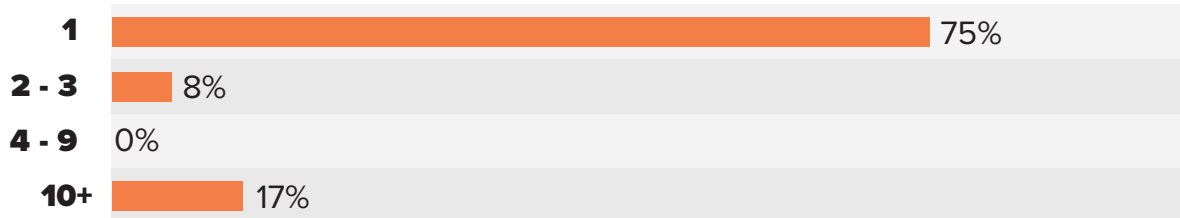
01

How many POHs do you have under ownership (ownership is defined as meeting or exceeding 50% ownership interest in a POH)?



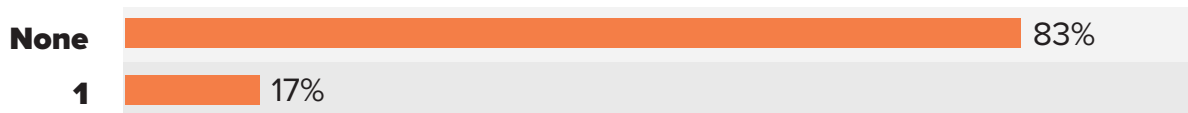
02

How many POHs do you have under management?



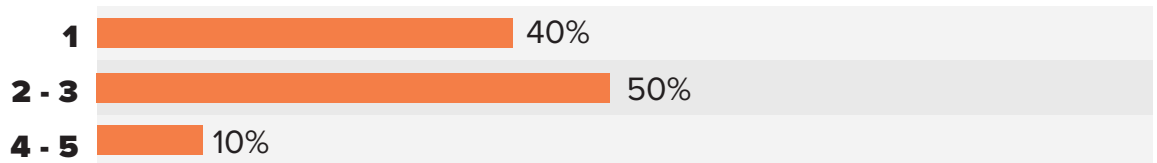
03

How many POHs have you purchased over the last year?



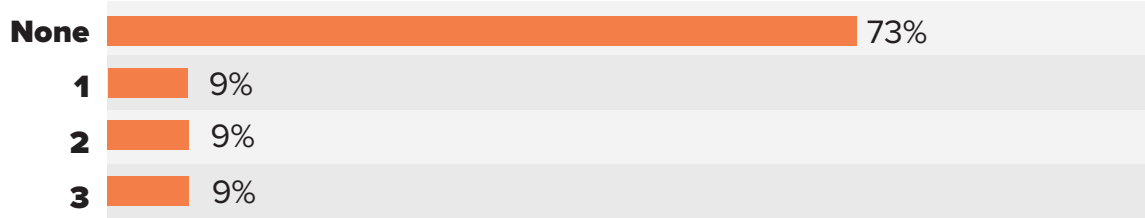
04

How many potential acquirers do you typically observe participating in the bidding process for POHs and other complementary businesses?



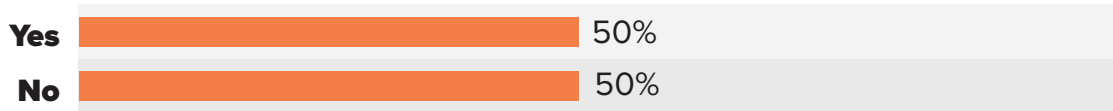
05

How many potential POH acquisition candidates did you perform due diligence on during the last year?



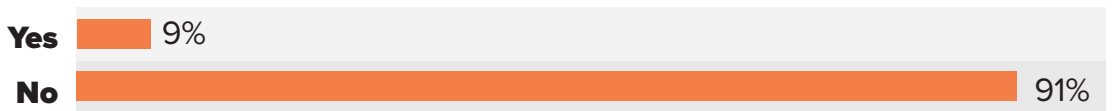
06

Do management fees vary based on revenue levels of the Hospital (i.e. a sliding scale)?

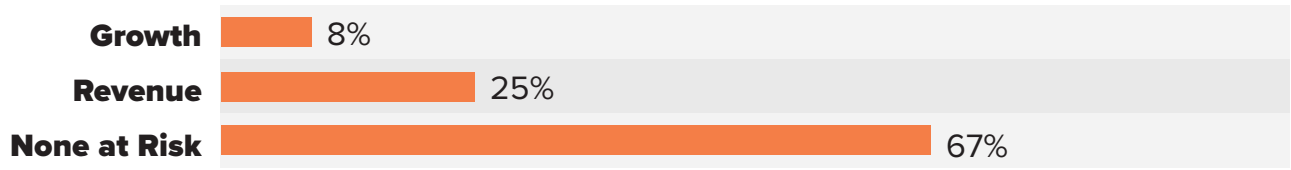


07

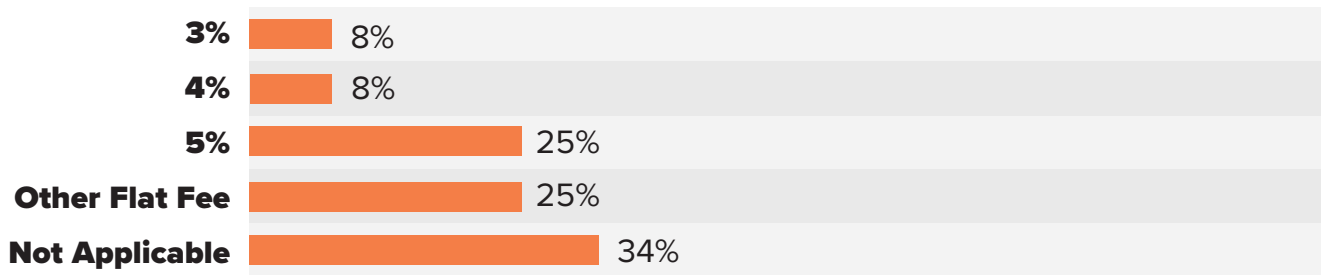
Do management fees vary based on the manager's level of equity ownership?



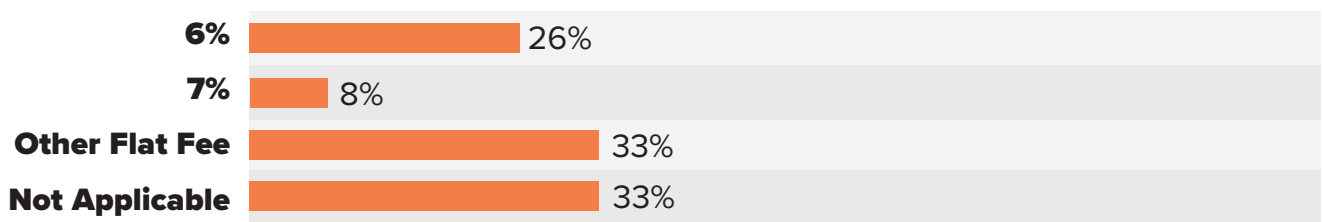
08 | Do you have any management arrangements wherein part of the fee is at risk? If so, which factors influence the magnitude of the management fee that is ultimately earned?



09 | What is the minimum management expense your POH incurs (stated as a % of net revenue)?

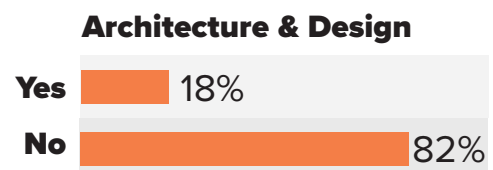
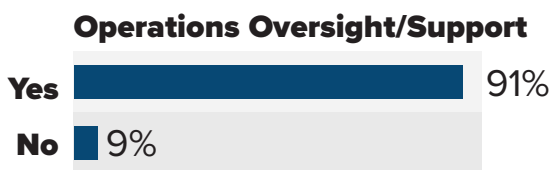
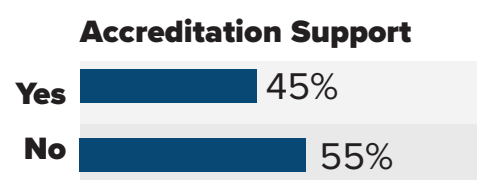
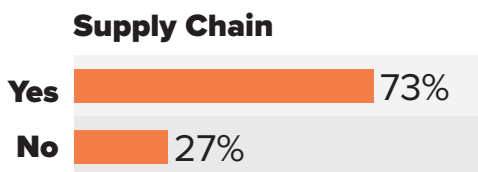
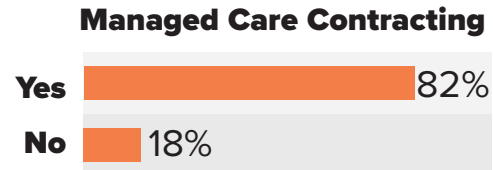
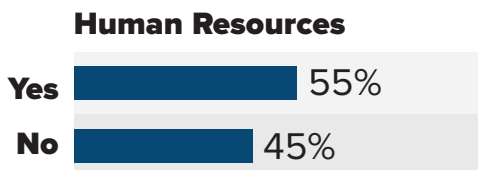
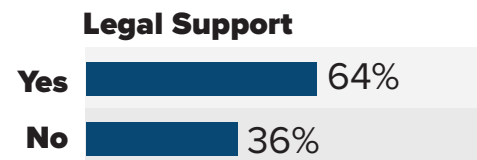
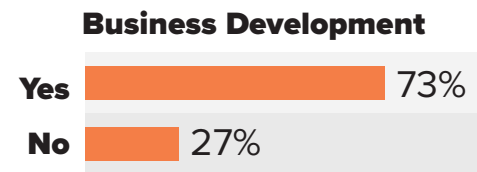
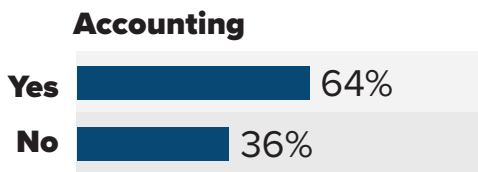
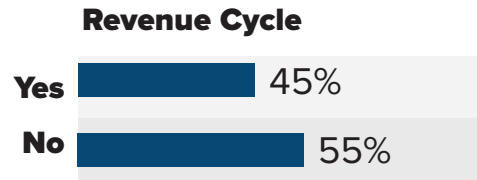
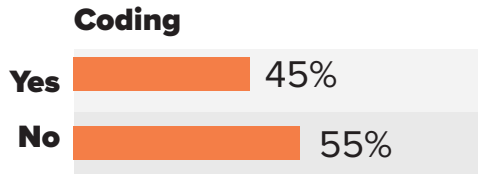


10 | What is the maximum management fee your POH incurs (stated as a % of net revenue)?

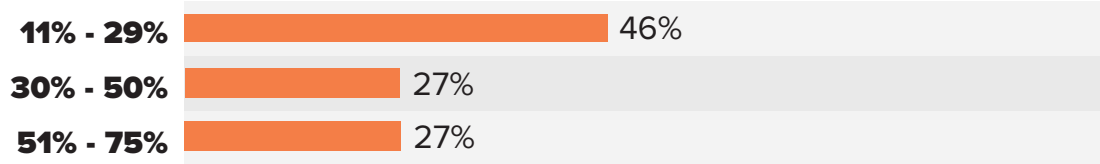


11

Which management services does your POH receive via its management agreement?

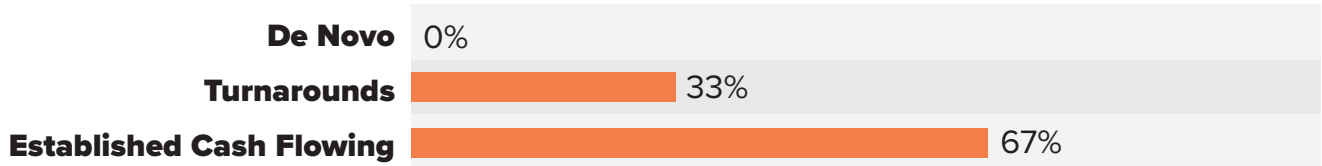


12 | From an equity standpoint, POH manager’s preferred ownership is:

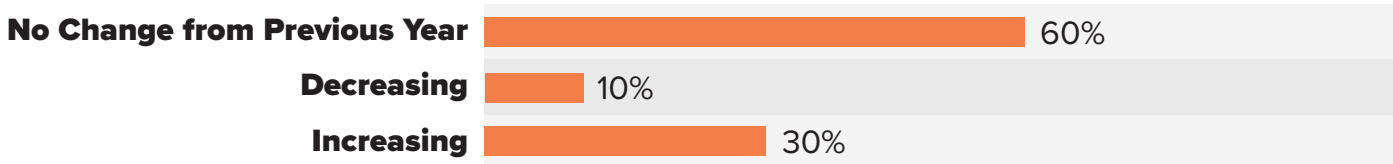


13 | With respect to the acquisition strategies of POHs, do you prefer established POHs with immediate cash flow, turnaround POHs at lower multiples/asset values, or de novo POH opportunities?

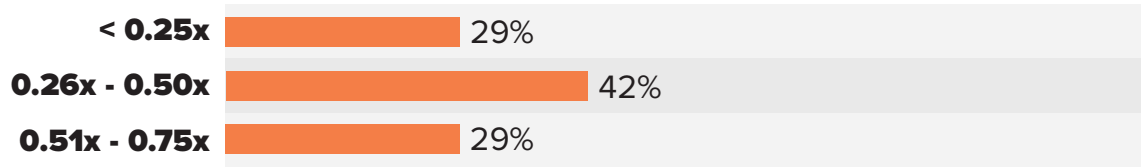
* We note that due to the regulatory environment, there is a moratorium on new POH development.



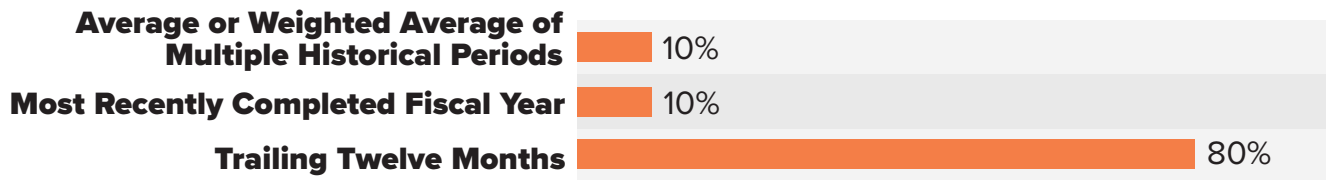
14 | In the past year, what best describes your observations related to competition for acquisitions?



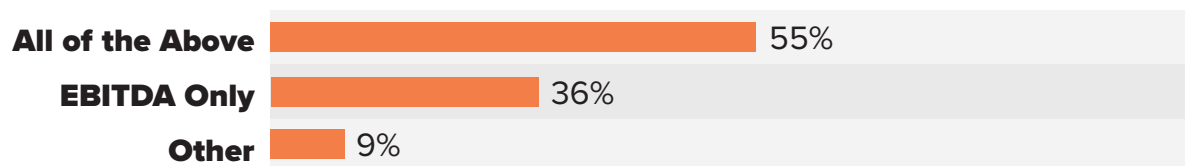
15 | What are your observations of the magnitude of the valuation multiple premium paid by your company in a Certificate of Need state?



16 | In valuing a potential POH acquisition candidate, what periods are most incorporated into the purchase offer?

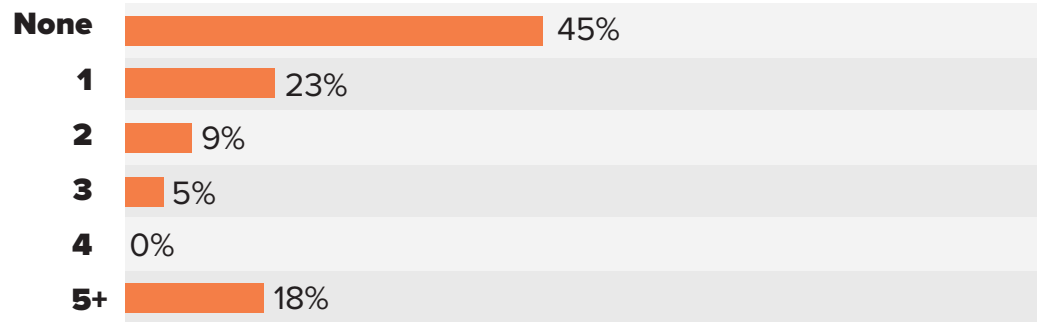


17 | When considering a potential POH acquisition candidate, on what primary earnings measure do you rely? EBITDA, Cash Flow to Shareholders, Net Income, or IRR?



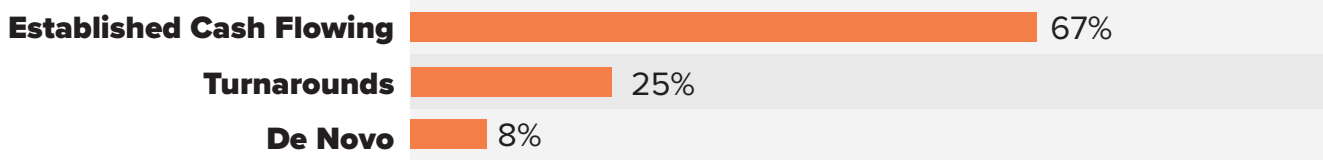
18

How many potential other complementary business (e.g., ASCs, urgent care centers, imaging centers, medical practices, etc.) acquisition candidates did you perform due diligence on during the last year?



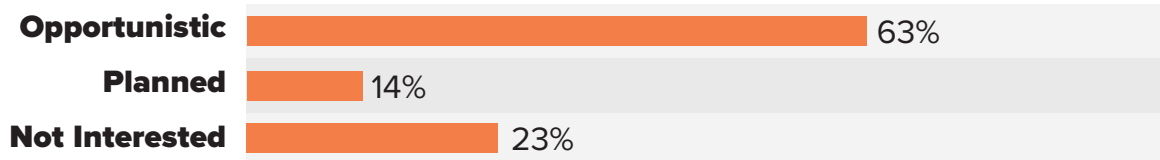
19

With respect to your acquisition strategy of complementary businesses (e.g., ASCs, urgent care centers, imaging centers, medical practices, etc.), do you prefer established companies with immediate cash flow, turnaround companies at lower multiples/asset values, or de novo opportunities?

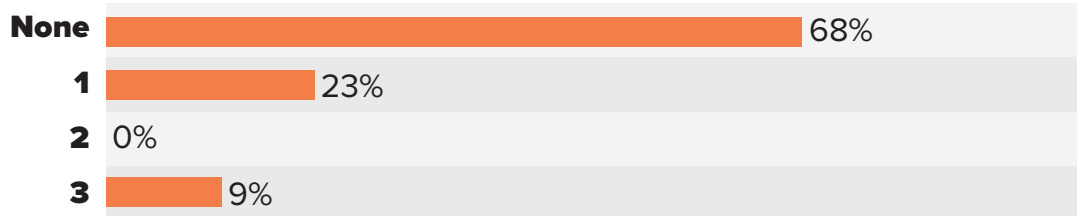


20

What best describes your company's posture with respect to selecting investment opportunities in complementary businesses (e.g., ASCs, urgent care centers, imaging centers, medical practices, etc.)?



21 | How many other complementary businesses (e.g., ASCs, urgent care centers, imaging centers, medical practices, etc.) did you purchase during the *last year*?



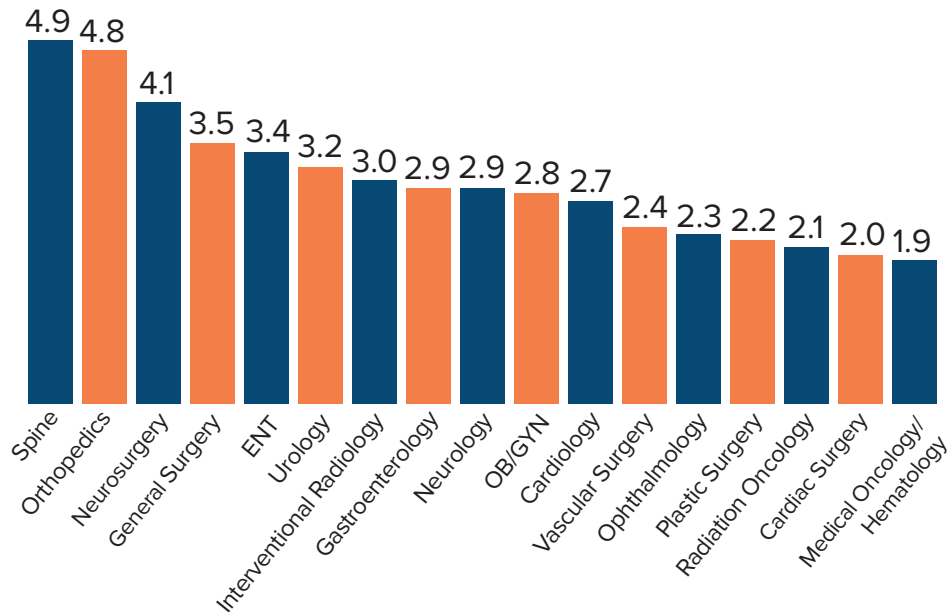
22 | How many other complementary businesses (e.g., ASCs, urgent care centers, imaging centers, medical practices, etc.) do you plan to purchase during the *next year*?



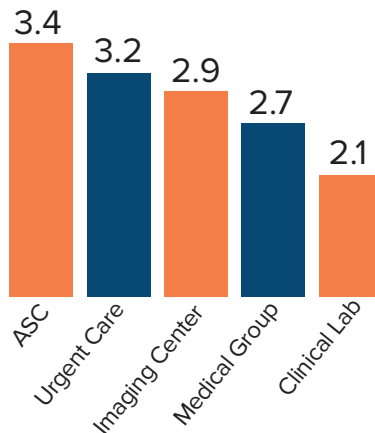
23 | Measured as a percentage of net revenue, what level of expense does your POH(s) incur for the following operating expense categories?

	Drugs	Medical Supplies	Implantables	Salary & Benefits	Occupancy
25th Percentile	1.6%	6.3%	15.0%	21.8%	5.0%
Median	2.0%	7.8%	18.0%	26.0%	5.3%
75th Percentile	4.0%	9.5%	28.8%	30.0%	9.3%

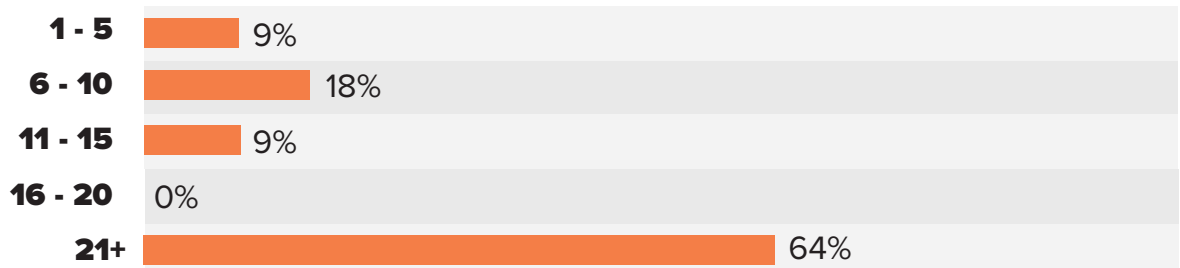
24 On a scale from 1 to 5 (5 being most desirable), of the following case types, please rank the desirability of having these cases performed at your POH, on a relative basis:



25 On a scale from 1 to 5 (5 being most desirable), of the following complementary businesses, please rank the desirability of acquiring or developing these businesses, on a relative basis:

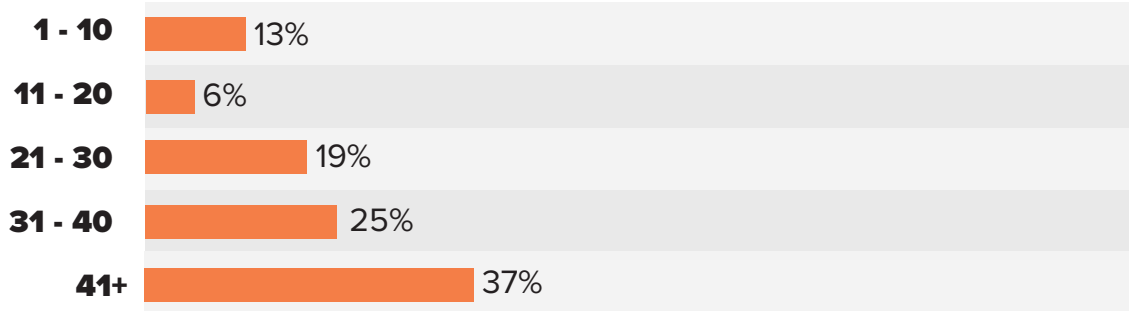


26 For *single-specialty* POHs, what is the preferred number of active physician owners?



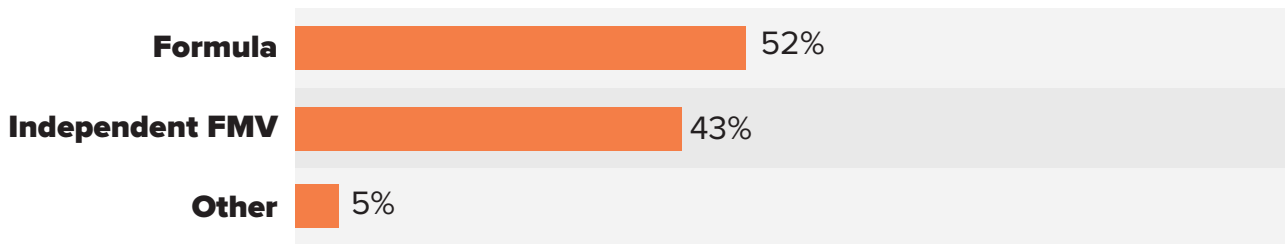
27

For *multi-specialty* POHs, what is the preferred number of active physician owners?



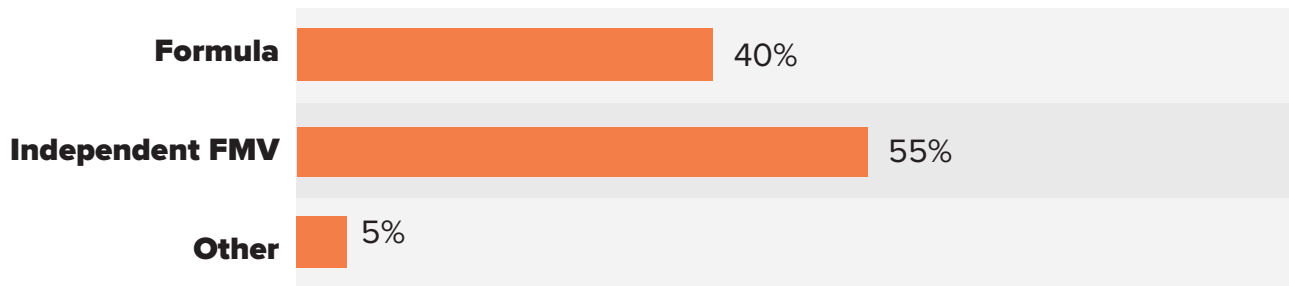
28

How do you determine value for POH buyout transactions (e.g., retiring physicians or departing physicians)?



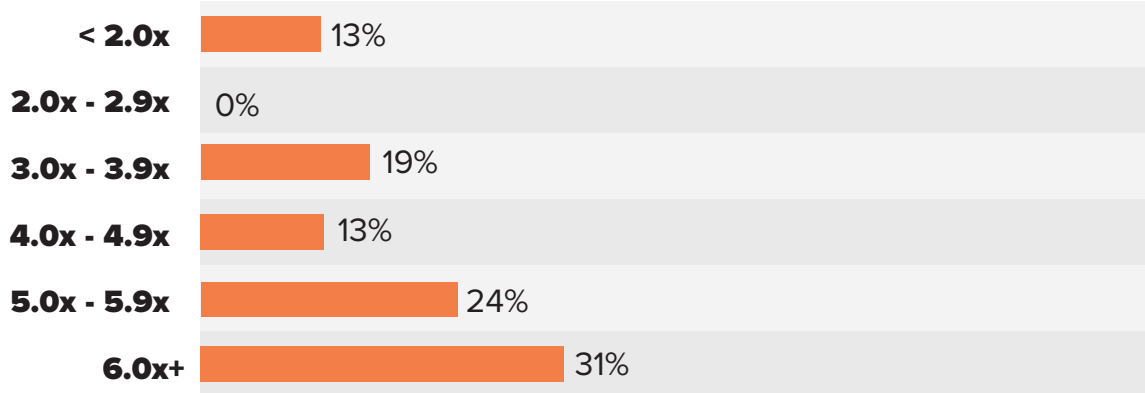
29

How do you determine value for POH physician-investor buy-ins?



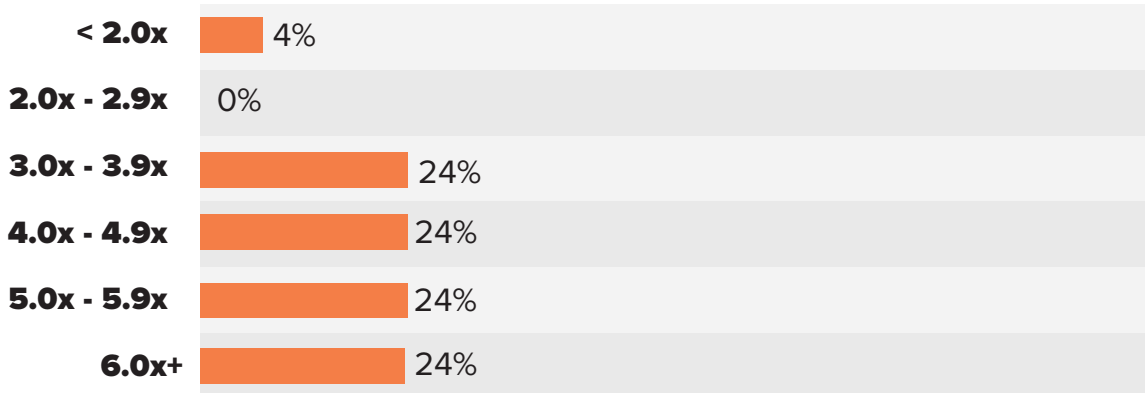
30

For *minority interest buyouts* of POHs, what total invested capital-to-EBITDA valuation multiples did you most typically observe in the marketplace during the past 12 months?



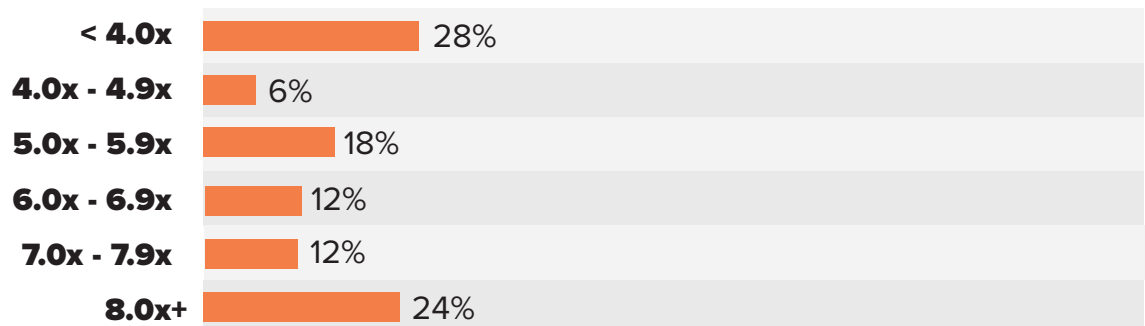
31

For *minority interest buy-ins* of POHs, what total invested capital-to-EBITDA valuation multiples did you most typically observe in the marketplace during the past 12 months?



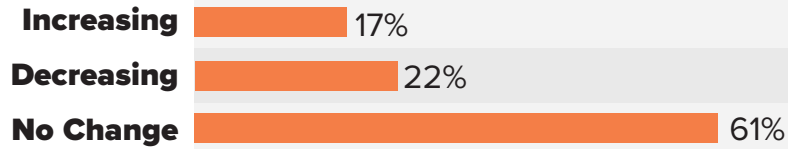
32

For *controlling interests* of POHs, what total invested capital-to-EBITDA valuation multiples did you most typically observe in the marketplace during the past 12 months?



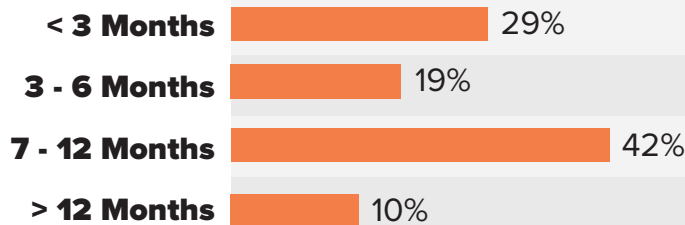
33

In the past year, what best describes your observation of the change in the total invested capital-to-EBITDA multiples paid (or considered) for POHs?



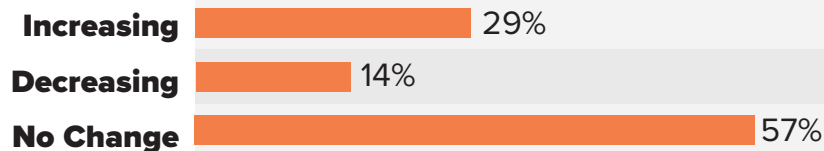
34

When syndicating minority ownership interests in POHs to new physician investors, on average how long does it take to identify the buyer and consummate the sale?



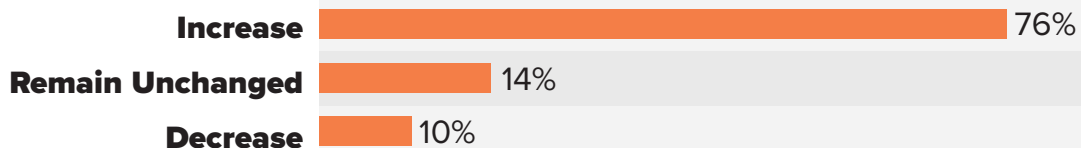
35

In the past year, what best describes your observations in the marketplace related to acquisition activity?



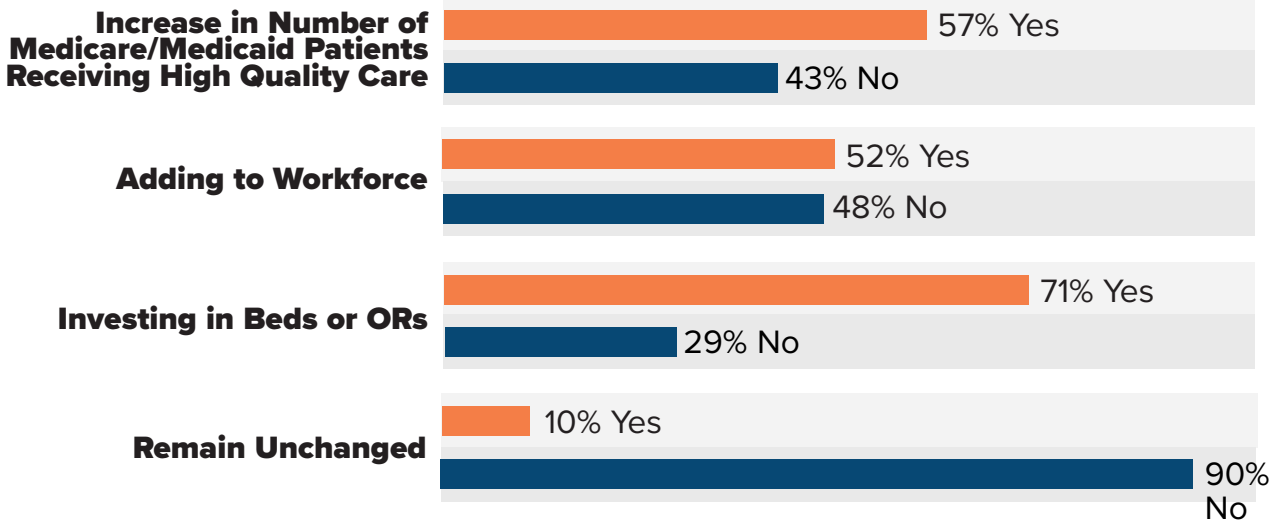
36

If Section 6001 of the Patient Protection and Affordable Care Act is significantly modified or repealed through other legislative action (e.g., H.R. 1156 - Patient Access to Higher Quality Health Care Act of 2017), do you anticipate the value of POHs to:



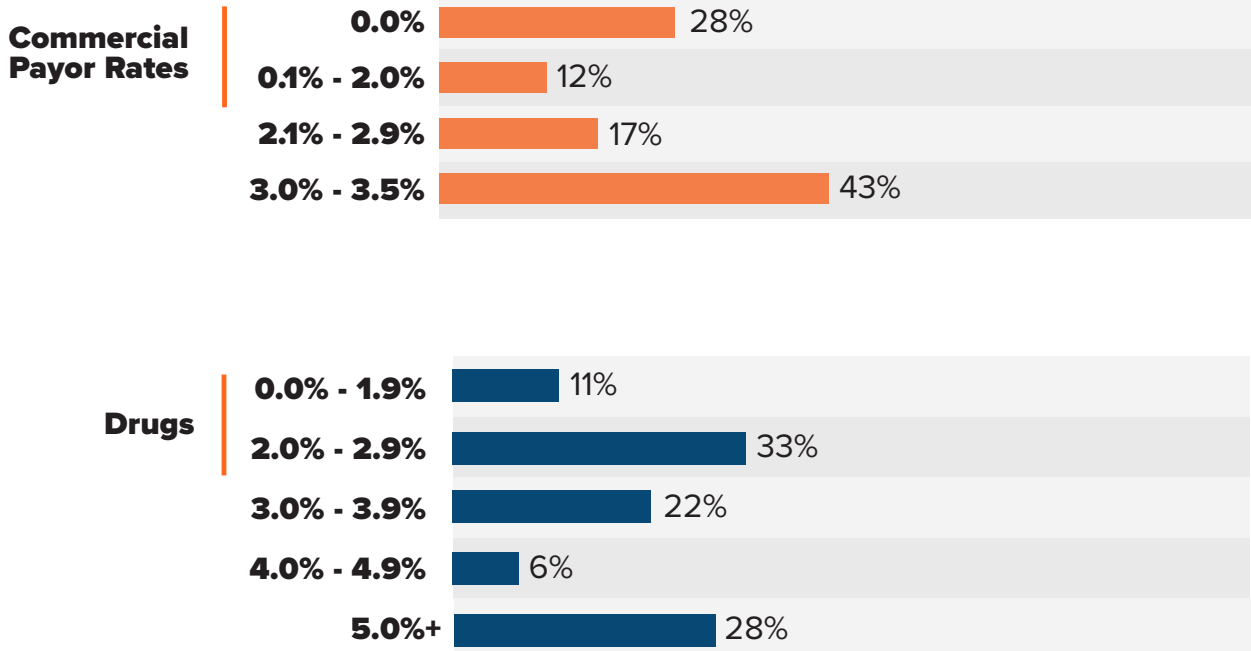
37

If Section 6001 of the Patient Protection and Affordable Care Act is significantly modified or repealed through other legislative action (e.g., H.R. 1156 - Patient Access to Higher Quality Health Care Act of 2017), what changes do you anticipate to occur at your POH(s)?



38

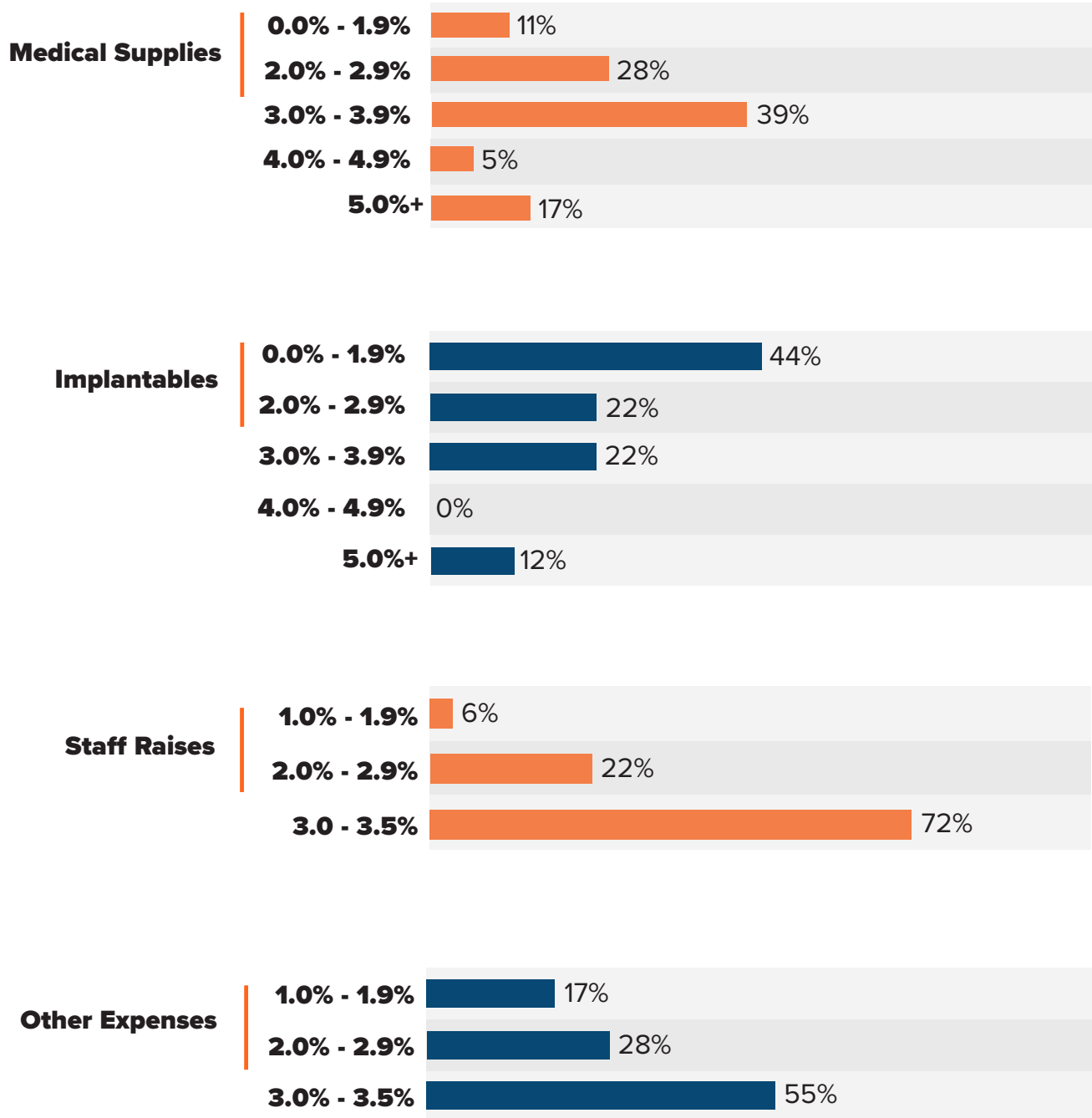
What is the typical annual increase observed in the POH market for the following items?



38

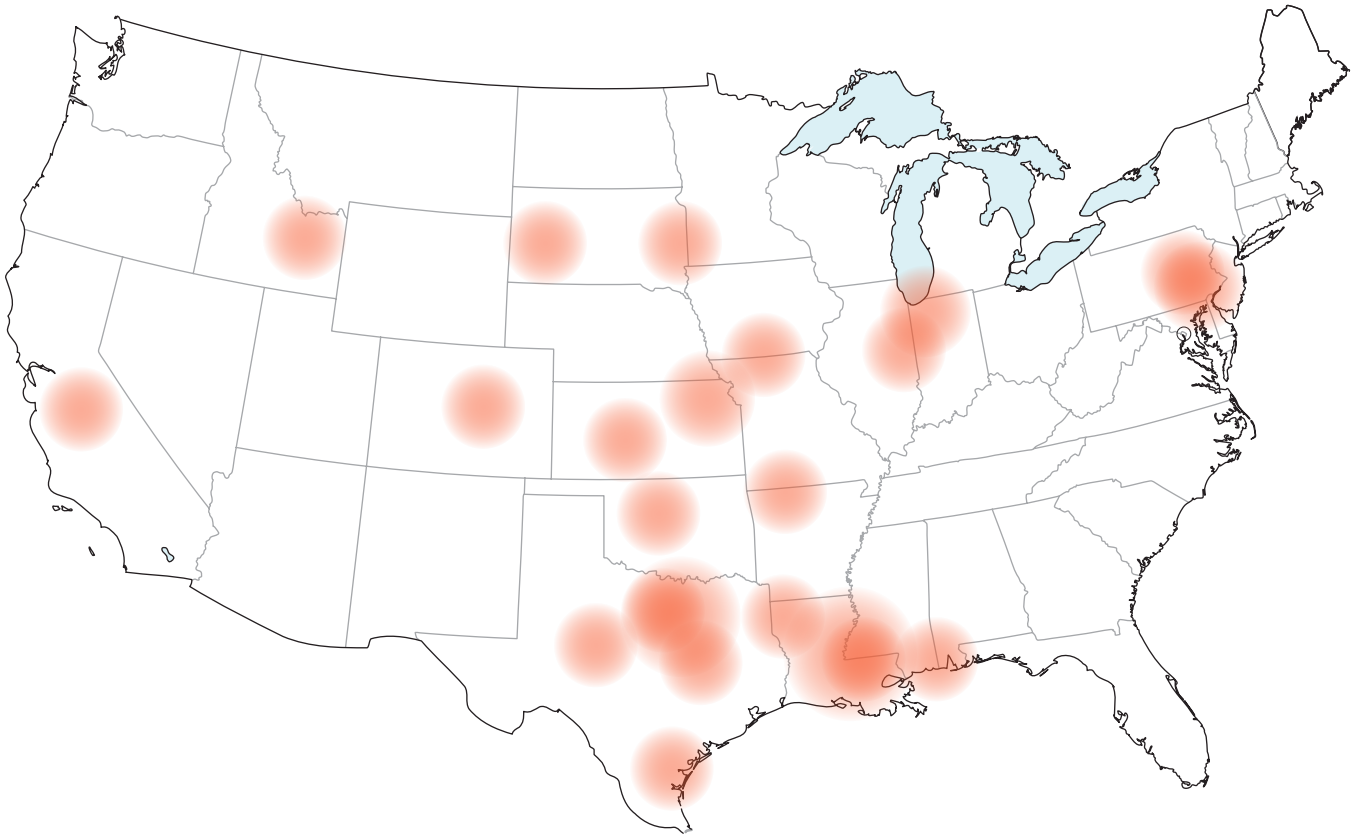
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What is the typical annual increase observed in the POH market for the following items?



PARTICIPANTS

In cooperation with Physician Hospitals of America, HealthCare Appraisers, Inc. surveyed POH market participants to determine trends in the value of POHs, management fees charged to these entities, and trends related to POH revenue and expenses. Twenty-two entities responded to this year's survey.



Disclaimer

The intent of this survey is to provide a summary of the respondents' views regarding valuation, acquisition activities, ownership preferences and other trends regarding POHs. Though our survey includes statistics regarding valuation multiples, this information should be used as general information only and should not be considered as HealthCare Appraisers providing any value guidance for any specific POH transaction. Business valuation is a complex process involving consideration and analysis of both financial and non-financial factors. The determination of fair market value should always be made by a qualified business appraiser with specific knowledge of the subject entity and healthcare industry.

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Matthew Muller is a director in HealthCare Appraisers' Denver office where he has provided advisory services in business valuation, litigation support, healthcare provider compensation relationships, and other financial matters to clients since 2010. His experience includes working with healthcare organizations, attorneys, administrators, providers, developers, consultants, investors, and bankers on transactions involving entities operating in the healthcare industry. Many of the transactions he analyzes involve Stark, Anti-Kickback, and/or other regulatory implications, which necessitate the analyses of fair market value and/or commercial reasonableness.

Mr. Muller earned a Bachelor of Business Administration in Finance from the Seidman College of Business at Grand Valley State University. He is an Accredited Senior Appraiser (ASA) in Business Valuation through the American Society of Appraisers.

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Nicholas Janiga is a partner in HealthCare Appraisers' Denver office where he has provided clients analysis and consultation in business valuation, litigation support, intellectual property, and healthcare provider compensation relationships since 2006. His experience includes working with healthcare organizations, attorneys, administrators, providers, developers, consultants, investment bankers, and private equity groups in connection with various transactions in the healthcare industry. Many of the transactions he analyzes involve Stark, Anti-Kickback, IRC 501(c)(3), and/or other regulatory implications, which necessitate the analyses of fair market value and/or commercial reasonableness. He also provides expert testimony in both deposition and trial settings.

Mr. Janiga holds a Bachelor of Business Administration from the Seidman College of Business, Grand Valley State University. He is an Accredited Senior Appraiser (ASA) in Business Valuation through the American Society of Appraisers.

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