How to Value an Ophthalmology Practice and Its Goodwill

Mark E. Kropiewnicki, Esq., LLM
Daniel M. Bernick, Esquire, MBA*

The Health Care Group ®
Plymouth Meeting, PA

www.healthcaregroup.com

*** Financial Interest**

Mark E. Kropiewnicki, Esq., LLM

Financial Disclosure

- We Have the Following Financial Interests or Relationships to Disclose:
- Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
- Shareholders of and Attorneys with Health Care Law Associates, P.C.

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

Focus of Presentation

- Is on doctor-to-doctor sales and buy-ins
- “Private equity” is a different animal
  - Not yet available to most practices

Why Are You Doing This Appraisal?

- Complete sale of practice entity
- Partner buy-in
- Partner buy-out
- You need a valuation method that will work for all of these transactions

Core Assets for Valuation

- “Hard Assets”:
  - Equipment, improvements, inventory, supplies, software
- Goodwill/intangibles:
  - Charts, phone numbers, patient base/flow, workforce, all systems ready to go
- All of these must be replicated if not purchased: “Buy” vs. “make”

Working Capital Assets

- Accounts receivable
- Cash, net of payables
- Generally excluded from an “asset sale”
- But generally included in a buy-in/stock sale

Goodwill Flashpoint

- Hard assets and accounts receivable: relatively non-controversial
- Goodwill: more difficult to value, and therefore often controversial

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., Eylea®, Lucentis®)

Valuing Supplies

- Physical inventory, at cost:
  - Count number of units on hand
  - Multiply by acquisition cost
- 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

Valuing Optical Frames

- Do a physical inventory
- But be sure to exclude frames that are no longer current

Accounts Receivable

- Not relevant for asset sales (retained by seller)
- But definitely relevant for buy-ins and buy-outs, which are stock sales

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.

AR in Buy-Ins

- Alternative: “Redlining”
- Excludes AR from buy-in
- Do not need to value AR
- All proceeds of AR go to senior doctor
- Is your system capable of doing this tracking?

Valuing Receivables

- Face value
  - Excluding “deadwood” over 180 days
  - And amounts in collection
- Times historical collection ratio
- Sometimes reduced further by collection fee (e.g. 6%)

AR Example

- Example: Face value of AR is $120,000.
- $20,000 of this is over 180 days
- Net face value is $100,000
- Historical collection ratio = payments/charges = 60%.
- Final collectible value is $60,000

"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

"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

Cash

- Excluded from asset purchases
- Included in buy-ins
  - Unless it will be bonused out to current owners as compensation

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

- Bank debt, accrued retirement, vendor payables (esp. retina drugs)
- Generally excluded from asset sales
  - Buyer does not assume liabilities

Buy-Ins and Buy-Outs

- Liabilities are included in calculation of stock price
  - They reduce the stock price
  - If corporate assets are $100, and liabilities are $40, net stock value is $60

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)

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 3

$400k	Available for owner
- 300k	“Reasonable Salary”
100k	“Profit”
÷ 25%	Required Rate of Return (= 4 x “multiple”)
$400k	Valuation

Asset Approach

- Value of business is the cost to replicate its components (equipment, goodwill), less an allowance for depreciation
- Very difficult to determine the cost of replicating goodwill or other intangibles
- Rarely used for medical practices

Market Approach

- Aka "Comparable Sales"
- Same idea as pricing a house
- Comparables provide a benchmark
- Adjust for individual features

Market Approach

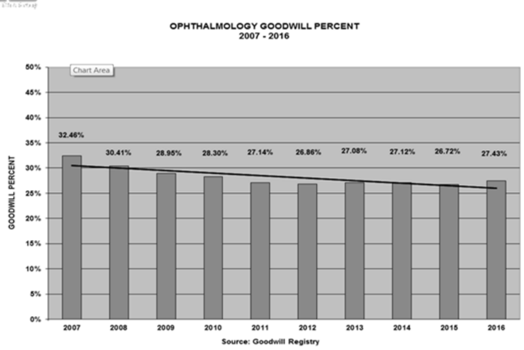
- Does not eliminate subjectivity
- But subjective elements are acknowledged
- Benefit of this method is its link to "real world" prices paid by others.
  - Fair market value is what a buyer will actually pay and a seller will actually take

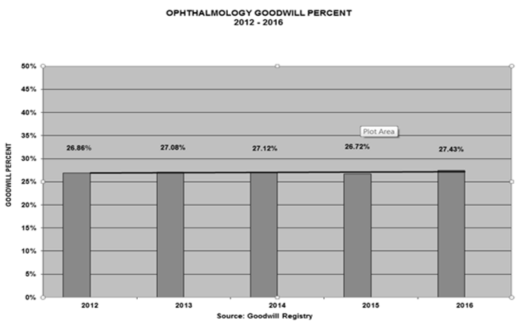
Review of HCG Goodwill Registry Data

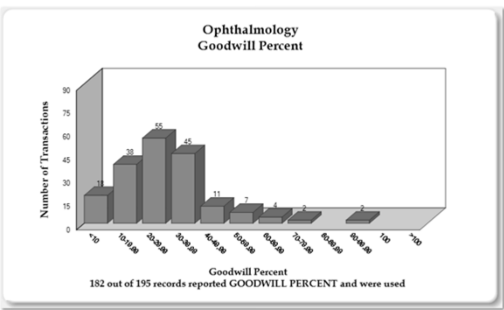
AVERAGE OPHTHALMOLOGY GOODWILL PERCENT

Year(s)	Goodwill %	
2006 – 2015	27.43%	10 Year Average
2011 – 2015	28.81%	5 Year Average
2012 – 2015	29.17%	4 Year Average
2013 – 2015	29.14%	3 Year Average
2014 – 2015	30.39%	2 Year Average
2006	37.45%	
2007	22.10%	
2008	29.69%	
2009	18.56%	
2010	26.29%	
2011	27.44%	
2012	29.23%	
2013	25.83%	
2014	26.11%	
2015	34.44%	

Source: *Goodwill Registry* 2016







Adjustments: Location

- Is this a desirable place for physicians to live?
  - 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 no competition, it will be easy to start a practice
  - Then why should buyer pay big $$$ for your goodwill?
  - Reduced or zero goodwill value in rural areas

Adjustments: Competition

- If there is cutthroat competition, buyers may be deterred
  - This also reduces goodwill

Adjustments: Competition

- Moderate to strong competition is favorable for goodwill
- Hard to start a practice from scratch
- Better to buy an existing practice

Adjustments: Profitability

- High profits excite buyers → high goodwill
- Even average profitability is attractive
  - “buying a job”
- Below average profitability or declining profitability is “scary” --> low goodwill

Other Potential Adjustments

- Facility presentation/curb appeal
  - Up to date or run-down?
- Payor mix
  - Balanced (good)
  - Heavy HMO, capitation, Medicaid? (concern)
  - Elective services? Can be favorable in well-to-do areas

More Adjustments

- Negative publicity or legal problems
- Practice reputation too dependent on Seller personal charisma

More Adjustments

- Seller work effort not readily replicable
  - Seller sees 80 patients a day
  - Most buyers cannot do this
  - So continued high revenues not assured
  - May be "fixable" if buyer can find an associate to help him cover the volume

Ancillary Businesses - Optical

- Typically valued in the same fashion as the "core" ophthalmology practice
  - Equipment, inventory, receivables, goodwill
- 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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