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Valuing Physician Practice Ancillary Services: Overcoming Challenges for Healthcare Counsel

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Valuing Physician Practice Ancillaries
Overcoming Challenges for Counsel

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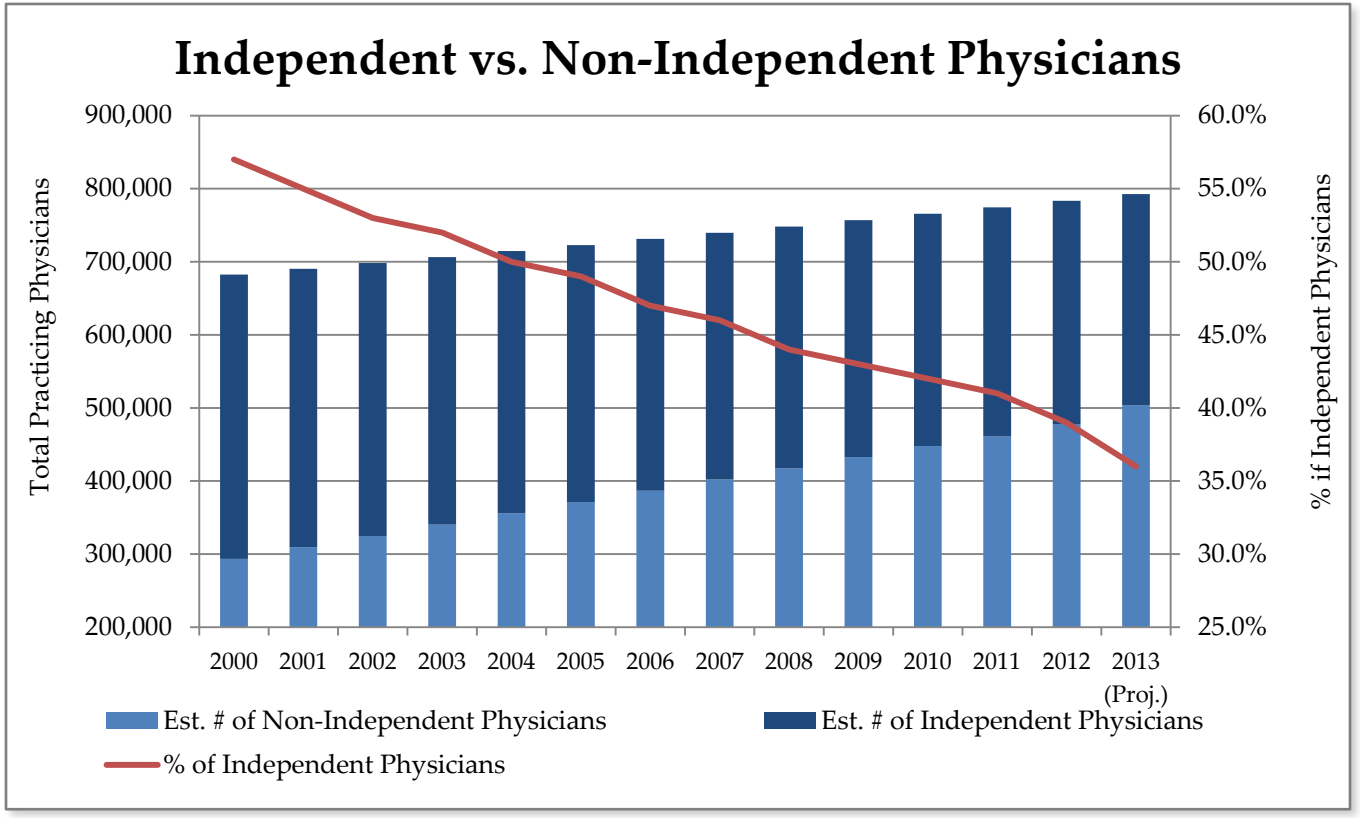
Practice Acquisition Overview

- Significant Consolidation / Acquisition Activity for Healthcare Providers
  - These transactions began in 2009, shortly prior to the signing of PPACA (March 2010)
  - Driven largely by changing reimbursement models and costs associated with PPACA compliance
  - Formation of Accountable Care Organizations
  - Buyers initially focused on cardiology, but now focused on acquiring primary care physicians and large multi-specialty physician practices

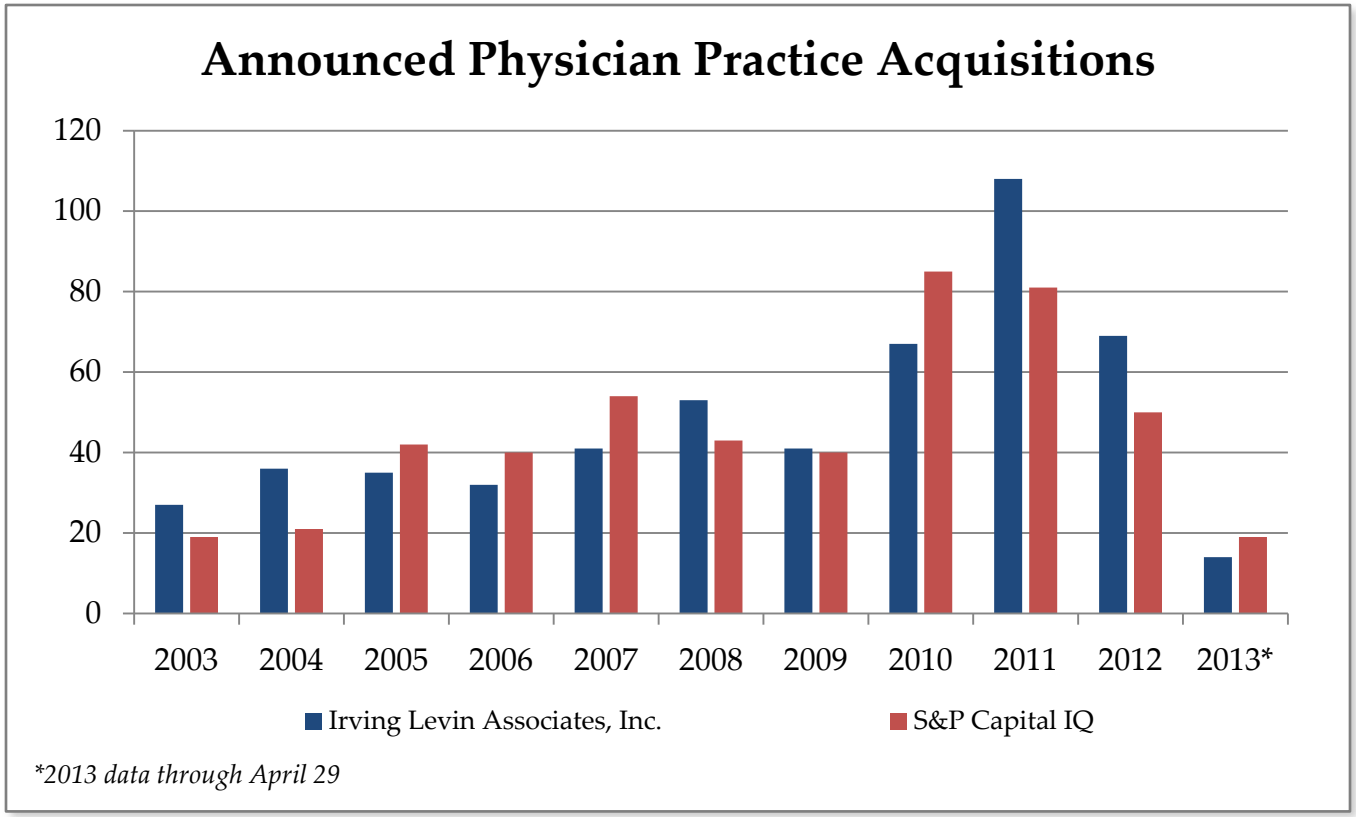
History of Physician Practice Acquisitions

- The chart below illustrates the physician employment trend over the past decade, primarily driven by reimbursement pressure and PPACA



History of Physician Practice Acquisitions

- The chart below illustrates the physician practice acquisition trend over the past decade
- These two databases report only a small percentage of the total acquisition activity in the US, but the data confirms HAI's experience of heightened acquisition activity following the passage of PPACA



Acquisition Structure & Compensation Models

- Over 95% of transactions are structured as an asset purchase and subsequent employment of physicians, with the buyer acquiring
  - Inventory
  - Tangible Assets (equipment, etc.)
  - Identified Intangible Assets
- Post-Acquisition compensation must be factored into purchase agreement. The majority of clinical compensation models are driven by productivity
  - wRVUs x Conversion Factor
  - % of Professional Collections
  - Hours or shifts worked

Acquisition Structure & Compensation Models

- Alternative structure considerations
  - Synthetic employment (PSA, etc.)
  - Carve out of department or select physician specialties
  - Lease of practice's tangible assets and employees
  - Ancillary carve-outs

Ancillary Services

- Ancillaries generate revenue for the practice that is separate (but often directly related to) the provision of professional services
  - Primary Care: Diagnostic Imaging, Lab
  - GI: Procedure Rooms, ASC, Lab
  - Cardiology: Imaging, Cath Lab
  - Orthopedic: MRI, ASC, Physical Therapy
- Because of this, historical compensation levels for the physicians will include ancillary related profits

Ancillary Services

- Stark Law In-Office Ancillary Services Exception
  - Applies only to a “group practice”
  - Only exception that allows a physician owner to refer DHS to his/her group practice and receive distributions of profits therefrom (note: ASC not considered DHS)
  - Must meet locus tests
  - Must meet tests for distributions of profits
  - President’s Budget seeks to “close the IOAS loophole”
    - Pushed hard by radiology, pathology and physical therapy groups

Valuation of Ancillaries

When is it appropriate to value practice ancillaries separately?

- Ancillary is a separate legal entity (or could be easily converted to such) (*e.g.,* ASC)
- True ancillary carve out (no employment)
- Ancillary is “atypical” for the given practice type and associated profits not likely included in “market comp” benchmarks

Valuation of Ancillaries

If Valuing Ancillary Service Line Separately:

- Could the practice actually sell the ancillary service line as a stand alone business?
- Are the assumptions used for ancillary services consistent with the professional practice?
- Are the risks differentiated between the ancillary practice and the professional practice?
- Is the physician compensation model consistent with carve out of ancillaries?

Standard of Value

- *Fair Market Value*

[T]he 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****. (emphasis added)*

Standard of Value

- In the healthcare industry, “fair market value” is a specifically defined term in the Stark law and regulations as follows:

- *[T]he value in arm’s-length transactions, consistent with the general market value. ‘General market value’ means the price that an asset would bring, as the result of* ***bona fide bargaining*** *between* ***well-informed*** *buyers and sellers who are* ***not otherwise in a position to generate business*** *for the other party; or 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, on the date of acquisition of the asset or at the time of the service agreement. (emphasis added)*

Valuation Methodologies

- Income Approach
- Market Approach
- Cost Approach

For ancillary valuation, the most commonly used methodology is the Income Approach, using a discounted cash flow (DCF) model.

The Key Question

- Does valuation under a discounted cash flow model necessarily consider the value or volume of referrals?
- Valuation as a “going concern” necessarily assumes continued operation as a business.
- Key to use of DCF is to verify individual assumptions are not in violation of FMV.
- What owners “have” vs. what buyers “get”.
- Also, consider the impact of the position of the OIG in Advisory Opinion 09-09

Separate Legal Entity

- Typically for non-DHS services (*e.g.,* ASC)
- Easiest of the models from a valuation and legal perspective
- Separate financial statements, payor ID, licensure, etc.
- Biggest consideration for valuation is risk profile

Ancillaries in Practice Acquisition

- In a whole practice acquisition, ancillaries are not typically valued separately.
- Historical comp and post-acquisition comp likely reflective of “normal” ancillaries
- If atypical ancillaries it may be appropriate to value the ancillary service line separately, but go-forward compensation must exclude any future participation in the ancillary
  - “Pay me now” or “pay me later”
  - Impermissible to pay 2x for the same ancillary business
  - However, many compensation methodologies used by hospitals/health systems are based upon survey methodologies that include ancillary revenue streams

Ancillary “Carve-out”

- Perhaps the most risky deal structure
- Practice group sells ancillary business (revenue stream) but remains a free-standing, independent practice
- “Customers” of business to be sold are, often, only the physicians who own, or work for, the selling practice
- Selling practice and its physicians asked to sign restrictive covenants
  - CNTC
  - Non-solicitation covenants
  - Covenants not to work for businesses with competing ancillaries
  - Covenants allowing buyer to co-locate purchased ancillary business with selling practice

Ancillary “Carve-out”

- Queries:
  - Who will be the customers of the purchased ancillary business?
  - Is the buyer purchasing as stand-alone business or simply a referral stream?
  - Stark Law Exception: “Isolated Transaction”
    - The total aggregate payment cannot take into account, directly or indirectly, the volume or value of referrals or other business generated by the referring physician
  - No AKS Safe Harbor likely available

Valuation and Regulatory Pitfalls

Lack of Financial Data

- Income statement
  - Revenue/Collections usually available
  - Cost structure not tracked separately, must be allocated (particularly overhead)
- Balance Sheet
  - Not available
  - A/R difficult to identify
  - Fixed asset register must be developed

Lack of Operational Data

- CPT data
  - Many codes may be billed globally
  - Requires technical professional split
- Overhead Allocation
- Reductions for non-transferred assets
  - Payor ID / Tax ID
  - Working Capital
  - Licensure?