

ASC Valuation Methods

BY BRUCE MALLER



How can a very good thing go bad? Imagine these scenarios. Scenario No. 1: A group of surgeons risks a significant amount of personal capital to build an ambulatory surgery center (ASC). After much hard work, the ASC is a success with an excellent return on investment. Then one of the partners decides to retire. Suddenly, what was a harmonious and successful physician relationship disintegrates into an ugly legal battle over the price of the buy-out. Scenario No. 2: The founding members of a successful ASC all agree to allow an excellent, efficient young surgeon to buy in. What should have been a win-win situation deteriorates into uncomfortable disagreements about the buy-in price, resulting in an irreparable relationship and a lost business opportunity for both parties. Scenario No. 3: A hospital makes what it considers a very generous offer to buy a large share of a long-standing, successful ASC. The founding partners are all approaching retirement age and have been actively seeking an exit strategy. Some the partners agree that the hospital's offer is fair and wish to sell, while others feel it is unfair and wish to seek other offers. An internal battle over voting rights ensues. The partnership fractures into groups, and legal battles virtually destroy the ASC. The hospital buys the entire ASC in a fire sale for a fraction of the original offer.

All three scenarios above are not imaginary. They are real. What do they all have in common? The answer is the inability of the physician to understand valuation. In this column, Bruce Maller gives a superb overview of three valuation methods. A competent, experienced accountant or appraiser is needed for the detailed calculations. However, an overall understanding by all concerned physicians of the methodologies involved and their implications is essential in order to avoid the unfortunate scenarios described above.

— Pravin U. Dugel, MD

Author's note: The guidance in this article is of a general nature. The reader is strongly encouraged to engage experienced health care legal counsel before entering into any type of purchase or sale transaction. In addition, formal valuations are often suggested or required in order to address fair market value issues. The reader also is advised to contact an appraisal firm with experience in valuing ambulatory surgery centers.

Owners of ambulatory surgery centers (ASCs) normally will require a valuation for any type of sale transaction, including sale to a new partner, redemption of the interest of a terminating partner, or the possible sale of all or a portion of the center to a third party, generally a hospital or corporate ASC partner. Regardless of the specific transaction details, a carefully prepared and supportable business valuation can provide a much needed perspective. In all cases, the parties to the transaction must exercise caution so as not to violate

provisions of the federal anti-kickback statute.

Most transactions are private in nature and normally involve the sale of a minority interest between physicians or between a physician and the ASC operating entity. The operating entity may be a corporation, partnership, or limited liability company. For purposes of this article, reference to partner includes any owner, regardless of the type of legal entity.

There are three common methods for valuing an interest in an ASC: the cost approach, the market approach, and the income approach (normally based on an analysis of future cash flows). The appraiser's method(s) and assumptions will depend on the unique facts and circumstances associated with the transaction.

THE COST APPROACH

The cost approach involves the analysis of the net asset value of the company. When applying this method, the appraiser seeks to restate the value of assets and liabilities on the entity balance sheet to fair market value. By sub-

tracting liabilities from the fair market value of the assets, the fair market value of the equity of the business, or adjusted book value, can be calculated.

Valuing fixed assets is possible through an outside appraisal or by using one of two common adjusted book value methods. Under the first method, a percentage of accumulated depreciation is normally added back to the book value of assets in order to arrive at an estimate of the fair market value. Depending on the age of the equipment and furnishings, a range of 30% to 50% of accumulated depreciation is common. The add-back is completed because for most ASC equipment the depreciable life for tax purposes is normally shorter than the actual useful life of the equipment.

Under the second method, depreciation of fixed assets is restated on a straight-line basis using an expected asset life, normally in the range of 10 to 12 years. It is important to point out that different types of assets may require a different depreciable life. For example, computer hardware and software might require a 5-year life vs longer depreciable lives for equipment and leasehold improvements. A salvage value in the range of 10% to 20% of original cost is common for assets in use for more than their expected life.

The determination of the equity or book value of the business normally includes accounts receivable, as adjusted for contractual adjustments and expected bad debts. Other current assets of the business, including cash, notes receivable, inventory, and less current liabilities, are also taken into consideration. In order to have an accurate assessment of these items, it is necessary to complete accountant-prepared financial statements on the accrual method of accounting. These do not necessarily have to be audited financial statements; however, having an outside accountant review the statements adds an important measure of integrity to the analysis.

THE MARKET APPROACH

The market approach is based on the premise that the appraiser can draw meaningful inferences regarding the manner in which the market would value a privately held business through examination of comparable transactions. Given that information on private transactions is not available in the public domain, the appraiser normally would rely on his or her personal experiences involving similar transactions. Additionally, the appraiser will consider transactions involving companies listed on the public exchanges. Although transactions involving public companies normally have a number of different characteristics, they can be instructive in providing guidance within the context of a private deal.

The market approach is the most common method

with inter-doctor transactions or private transactions between a surgeon and a center. Most often, these transactions base the center's value on a multiple of net income (called EBITDA; see definition in next paragraph) less the outstanding long-term debt of the facility. Net income or EBITDA is normally measured for the previous tax year or trailing 12 months.

EBITDA stands for earnings before interest, taxes, depreciation, and amortization. In essence, it is the cash flow of the center after subtracting the cost of supplies and operating expenses from the collected receipts of the business. Depreciation and amortization are noncash expenses, while interest and income taxes are nonoperating expense items. In essence, EBITDA represents the cash available from business operations before debt service.

In the ASC sector, transactions involving public companies often fall within a range of five to seven times EBITDA. If an investor divides one by the transaction multiple, he or she can back in to the expected rate of return for the buyer. A multiple of six times EBITDA would suggest that the buyer is expecting or hoping for a 16.67% return on investment. The higher the multiple, the lower the expected rate of return. Conversely, the lower the multiple, the higher the expected rate of return.

In the case of private transactions, market multiples generally are lower than those involving public companies. First of all, transactions involving public companies often involve the purchase or sale of a majority interest in the business. A so-called controlling interest in the business normally warrants special consideration.

Minority interest holders typically have little influence over center governance. Generally, investors are willing to pay more for the ability to control voting shares in a business. This is seen on a consistent basis in transactions involving public companies. With voting control comes greater authority and the ability to control business operations. As such, a sale of a minority interest in the business normally warrants some discount to the market multiple seen in transactions involving public companies.

Lack of marketability is another important consideration involving private transactions. It is simply more difficult for a partner in a small, privately held company to dispose of an interest in the business. There is no ready market to acquire the shares. This additional factor often warrants some additional discount to the public company multiple.

Although there are numerous other factors that require careful consideration, transactions involving a minority interest between private parties often involve a discount in the range of 30% to 40% from public company multiples. In other words, if one is benchmarking

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against a six-times multiple involving a public company, absent other considerations, a range of 3.6 to 4.2 times EBITDA might be applicable for a private deal.

THE INCOME APPROACH

There are two common methods of valuation under the income approach: capitalization of earnings and discounted cash flow.

With the capitalization-of-earnings method, annual net operating income is divided by an appropriate capitalization rate, based on the expected rate of return for the buyer. This method assumes a steady, yet perpetual, cash flow and a constant cap rate. Given the inherent risk factors with this approach, many will use the discounted-cash-flow method instead.

The premise of the discounted-cash-flow method is that the value of an investment in an asset is equivalent to the present value of future cash flows that investment is likely to generate. This approach involves projecting future cash flows the company is likely to generate, and then discounting these cash flows back to the present value at a discount rate, which reflects both the time value of money and perceived risks associated with the probability of achieving those cash flows.

Although many appraisers would argue that this approach provides the strongest basis for valuing an interest in an ASC, the method is not common with private transactions involving ASCs. This method is more common in valuing commercial real estate.

CONCLUSION

Keep in mind that the ultimate determination of fair value is generally determined by good faith negotiations between a willing buyer and willing seller, neither under pressure to complete a transaction. Further contract terms may stipulate specific purchase terms (ie, a buy-sell agreement with mandatory repurchase terms for a given transaction). Regardless of the circumstances, both parties should employ experienced professionals in order to reach agreement on price while helping to facilitate an orderly sale process. ■

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