

Constructing Fair and Economically Sound Buy-Sell Agreements

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Historically, most shareholders of a privately-held imaging center or radiology practice recognized the significance of constructing fair and economically-sound buy-sell agreements from an income-production standpoint. Few owners, however, realized that such an investment has value as a tradable commodity over and above its income potential. The events of the last decade have educated many shareholders and potential shareholders, that both the income stream and capital gain potential of this type of an investment needs to be considered. The rise and fall of physician practice management companies (PPMs) highlighted that healthcare was a business – a business with assets over and above the ones with the medical degrees who walked out of the building every evening. Industry consolidation undertaken by both PPMs and hospital systems demonstrated quite clearly that shareholdings in radiology companies had equity value, as purchase prices far above historical buy-sell type values were paid.

For years, partners in healthcare practices lived by the traditional shareholder agreement, or buy-sell agreement, whereby ownership was achieved at a price equal to some pro rata share of cash, accounts receivable, and equipment, less debt. Upon retirement, a physician shareholder would trade in their shares using the same formula. If the healthcare entity had grown during the tenure, increasing A/R and equipment, then maybe the payment received upon retirement would be slightly greater than the payment made upon admission as a partner.

Times have changed. Physicians were joined by non-physicians as shareholders or partners in healthcare entities, especially in the technical component of medicine. Existing partners, seeing their older colleagues sell their practices to PPMs or hospital systems for large sums, began to chafe at the concept of receiving less than a year's salary upon retirement. Existing partners began to question the financial logic of allowing young physicians to buy into such a potentially lucrative investment for a nominal fee set by a shareholders' agreement that was thirty years old. Young physicians began to balk when such buy-sell agreements were changed. And the same factors that drove the consolidation efforts by PPMs and

hospital systems – declining reimbursement and rising costs – created larger and larger radiology practices. As radiology practices and imaging centers grew in size, the potential for conflict between partners increased proportionately with the larger number of young and old owners.

Sooner or later, the owner of a private radiology practice or imaging center (collectively, a practice) will need to determine the value of their business. The need may arise when evaluating strategic alternatives in light of industry dynamics, such as competitive changes or reimbursement changes. Such strategies could include merging with another radiology practice, forming joint venture imaging centers with hospital groups, selling to a larger company in the current industry consolidation, or selling to private investors. The need for a valuation could arise in conjunction with practice transition issues, such as when it becomes necessary to buy out a retiring partner, to sell interests to new partners, or for estate planning purposes; or due to litigation, such as the involuntary termination of a partner or a marital dissolution matter. Ultimately, the alternatives can only be thoroughly examined after the owner(s) understand the value of their practice.

Three Methods of Valuation

Valuation experts employ specific methodologies to establish the value of a practice. There are three primary methods of valuing an interest in a practice: the discounted cash flow approach, the market approach, and the cost (or asset-based) approach. When circumstances permit, more than one approach is utilized to provide several independent indications of value, which then must be correlated by the valuation professional to yield a supportable preliminary conclusion. This preliminary conclusion must be adjusted for factors relating to the degree of marketability of the stock being valued and the size of the ownership interest being valued (for example, a minority



interest, a 50% interest, or a 100% interest). The appraisal profession, the Internal Revenue Service (the ultimate reviewer of many appraisals), and the tax courts have all established fairly consistent guidelines over the years for conducting these approaches, and the applicability of each in various situations.

Generally accepted appraisal theory can be defined as the body of knowledge, theory, practices, and methodologies utilized and held to be standard by professionals who participate in valuation, including valuation practitioners, textbooks, and treatises written by valuation experts, the American Society of Appraisers (the ASA), the courts, and the Internal Revenue Service (collectively, hereinafter referred to as Generally Accepted Appraisal Theory or GAAT). The ASA is the preeminent professional organization that governs the qualifications, appraisal education and knowledge, and professional ethics of the valuation community in this country. The ASA has codified (or participated in codifying) Generally Accepted Appraisal Theory with respect to the valuation of business or equity securities in the form of two closely related documents: the Uniform Standards of Professional Appraisal Practice and the American Society of Appraisers' Business Valuation Standards.

THE COST APPROACH

The cost approach involves the analysis of the net asset value of a company. When applying the cost approach, the appraiser seeks to restate the assets and liabilities appearing on the company's balance sheet, along with off-balance sheet accounts, to their fair market values. By subtracting the fair market value of the liabilities from the fair market value of the assets, the fair market value of the equity of the company can be calculated. It is often difficult to identify and value all of the intangible assets of a company, such as goodwill, going concern, customer lists and relationships, skilled workforce, technical know-how, etc. Therefore, this approach often undervalues a profitable, "going concern" entity. In compliance with valuation guidelines, the cost approach is typically utilized only in a situation where liquidation is anticipated, or in the valuation of a holding or investment company, as opposed to an operating company.

Yet, the cost approach is the very basis for the valuation formulas contained in most traditional buy-sell agreements, which focus on the book value of certain asset classes, such as A/R and equipment. For a healthcare entity, there is typically much value associated with intangible assets. Consummating a transaction at a price that ignores such intangible value means that the buyer received a bargain and the seller left money on the table. The cost approach is also easy to use; hence, it is still not uncommon today for many advisors who dabble in appraisal to utilize an asset-based approach. Placing one's trust in such unso-

phisticated appraisers is like trusting your general practitioner to read and interpret your MRI scan.

THE MARKET APPROACH

The market approach is based on the premise that meaningful inferences can be drawn by the appraiser about how the market would value a privately-held business through the examination of both how and why the market is pricing guideline or comparable companies. (Many persons are familiar with the market approach, since it is the common method used by real estate appraisers when appraising a home for mortgage purposes.) The market could involve transactions of companies listed on public exchanges or transactions of 100% interests in the acquisition market. The indicated market values of the comparable companies are related to their underlying financial and operating characteristics through the calculation of various ratios, such as the price-to-cash flow multiple. Analysis of these relationships result in benchmarks that can be applied to the financial and operating performance of the private company being appraised. For instance, if the appraiser identifies six comparable companies that are all trading at a price within the range of 4.5 and 6.0 times cash flow, then it is likely that the subject company is going to be priced within that same range.

DISCOUNTED CASH FLOW APPROACH

The premise of the discounted cash flow approach, also called the income approach, is that the value of an investment in an asset is equivalent to the present value of the future cash flows that will be generated by that investment. This approach involves projection of the most likely future cash flows that will be generated by a privately-held company, then discounting those cash flows back to present value at a discount rate, reflecting both the time value of money and the perceived risks that an investor would have associated with the probability of the company actually achieving those cash flows.

The market approach and the discounted cash flow approach are typically used in the valuation of a profitable, "going concern" business enterprise. In both approaches, the buyer of a practice is paying a purchase price today for an expected stream of cash flow into the future.

The Control Continuum

The owner of equity in a practice could own from 1% to 100% of the outstanding equity interests. If the investor owns less than 50% of the equity interests, the holding is deemed a minority interest. Conversely, if the investor owns more than 50% of the equity interests, the holding is deemed a controlling or majority interest. In between the minority interest and the controlling interest is the holder of a 50% interest, and the ultimate controlling

interest is the investor holding a 100% interest.

The owner of a minority interest in a company has limited power and control in company operations (absent provisions to the contrary that might be indicated in corporate governance documents, such as a shareholder agreement or a partnership agreement). The minority shareholders typically have no power to influence corporate policy, including the existence, magnitude, and timing of cash distributions, and cannot influence many of the factors that determine the value of an interest. A minority shareholder cannot realize the value of the assets and liabilities of the business through a liquidation, since minority shareholders generally have no ability to force a liquidation. Conversely, the holder of a controlling interest generally does have the ability to make financial and operational decisions that will influence earnings, and hence dividend policy. Therefore, on a per-share basis, an investor would be willing to pay more for a share of a controlling interest block than for a share of a minority interest holding. This concept is made tangible when one observes the premiums paid over the minority interest price in the acquisition of a controlling interest in a publicly-traded company.

As a simple example of the importance of control in the valuation of an entity, assume that a company has \$100 of revenue, and \$90 of expenses, leading to \$10 of income. Further assume that the \$90 of expenses includes a salary of \$30 paid to the president of the company (who owns 100% of the equity of the company), and rent, of \$10 which is paid to the same president who happens to own the real estate as an individual. Finally, assume that the market salary of an executive to perform the services that the president actually provides to the company is \$20, and the market rate for the real property rent is actually \$5.

If the president approached and offered to sell a 5% interest in the company to me, the interest would represent a minority interest. If I owned such a minority interest, typically I would have no ability to influence corporate policy, including the existence, magnitude, and timing of cash distributions. As a minority interest holder, I would not have the ability to reduce the president's salary from the actual level of \$30 to the market level of \$20, and I would not have the ability to reduce the rent paid from the actual level of \$10 to a market level of \$5. Therefore, I would evaluate the price that I would be willing to pay based on the following income statement for the company:

Revenue		\$100
Less expenses	-	90
Income	=	\$10

As a 5% shareholder, I might have access to 5% of the \$10 profit, or \$0.50, but only if the controlling 95% shareholder decides to make a cash distribution (assuming that the controlling 95% shareholder takes no steps to change any other fundamental operating or financial parameters, such as giving himself a raise).

Conversely, if the president offered to sell a 75% interest in the company to me, such an interest would represent a controlling interest. If I owned such a controlling interest, typically I would have the ability to influence corporate policy. I could adjust the president's salary to a market level of \$20 (or find another individual willing to serve as president at a market rate of \$20), and I could adjust the rent payments to a market rate of \$5. Hence, I would evaluate the price that I would be willing to pay based on the following income statement for the company:

Revenue		\$100
Less adjusted expenses	-	75
Income	=	\$25

As a 75% shareholder, I could then decide to distribute the \$25 in profits, \$18.75 of which would end up in my pocket. Or, I could decide to put myself on the payroll at a salary of \$20, which would leave only \$5 in profits. I could still distribute the \$5 of profits, personally recognizing 75% of the \$5, or \$3.75. This would leave me with \$23.75, thus indicating the value of control.

This simple example illustrates that, generally speaking, a majority interest is more valuable on a per-share or per-interest basis than a minority interest. Hence, on a per-share or per-interest basis, the following value continuum exists:

Lowest Value Per Share	Point A	Point B	Point C	Point D	Point E	Highest Value Per Share
	Net asset value as determined via a cost approach	Minority interest value	50% interest value	Controlling interest value	100% interest value	

Identifying the Sustainable Cash Flow Return on Investment

Whether the market approach or the discounted cash flow approach is utilized to value a business, cash flow is the key variable that drives value. Cash flow is typically defined as earnings before interest expense, taxes, depreciation, and amortization (EBITDA). (Certain buyers focus on another variation of cash flow called EBIT, or earnings before interest and taxes.) The owner of a radiology practice or imaging center has several ways to get earnings out of the company, thereby minimizing taxable income. Excess earnings can be

taken out of the company in the form of radiologist or owner compensation, or through payments to affiliated entities that may hold the real estate, fixed assets, or billing company utilized by the practice.

As indicated in the description of the control continuum, the ability to set compensation levels depends on the magnitude of control provided by the size of one's shareholdings. Hence, a minority investor would not have the ability to adjust compensation levels. However, in a group practice setting, in which each individual radiologist might hold a minority interest, the partners often work in concert to set compensation levels in a particular level; hence, the partners decide what portion of the practice's earnings to take out in the form of salary and what portion to take out as equity distributions, or returns on equity investments (such as equity distributions could take the form of dividends, S corporation distributions, or partnership distributions, depending on the legal form of the entity).

Therefore, when valuing an interest in a practice, one must first identify the size of the interest being valued. If a controlling interest is being valued, then the appraiser must adjust certain expenses to reflect their market levels. (Market levels of given expenses could be \$0 if non-operating expenses are being run through the company, such as personal travel.) Such adjustments lead to the creation of a pro forma financial statement, and a pro forma EBITDA, which then serves as the basis of a valuation. Conversely, if a minority interest is being valued, then the sustainable EBITDA will not reflect any adjustments, since the holder of a minority interest would not have the ability to change any expense levels.

Factors Influencing the Valuation Multiple

The valuation multiple utilized has a tremendous impact on the resulting value indication. The valuation multiple is time-specific, meaning that the appropriate multiple today might not be the appropriate multiple six months ago or six months in the future. Various factors impact the multiple, including:

Percentage Interest Acquired or Sold – On a per-share basis, a buyer will pay more for a controlling interest than for a minority interest. Generally speaking, the larger the percentage interest being transacted, the higher the multiple.

Growth Potential/Historical Growth Rate – What are the opportunities for revenue growth, from existing clients, new marketing, new modalities, new locations, and subsequent fold-in acquisitions? How do recent trends translate into future growth patterns?

Size – What is the size of the practice, in terms of revenue, earnings, number of radiologists, etc.? Typically, the larger the imaging operations, the higher the

multiple. It takes a potential buyer as much effort to evaluate a large target as a small target, so allocating the fixed costs of a large acquisition can lead to a larger return on the up-front efforts.

Profitability and Cash Flow – Are the costs under control, or would a buyer have to exert time and energy improving the profitability? What are the near-term capital requirements for upgrading equipment, adding modalities, or upgrading information systems?

Stability/Reputation/Quality of the Practice's Revenue Stream – Is the revenue stream sustainable? Are the billing methods in compliance? What is the nature of the relationship with hospitals under contract? Is the financial and operating data verifiable? The buyer's perceived risk of achieving projected cash flows in the future will impact the valuation multiple that they are willing to pay.

Depth and Composition of Professional Staff – How many radiologists are owners and employees, and what are their ages? Do they have sub-specialties? What are their reputations and relationships within the medical community? What is the quality of the management personnel?

Modalities and Equipment – What types of modalities are offered, and who is the competition for each type of modality? Is the equipment modern and upgraded, or are significant capital expenditures required in the near term?

Financial Leverage – How much interest-bearing debt exists? Buyers will pay a certain purchase price based on the pre-tax, pre-debt cash flow of an entity; the fact that the seller has financed the entity with debt as opposed to equity is a direct reduction in the take-home proceeds of a transaction for the seller.

Hospital Relationship(s) – What is the quality of the relationship with hospital administration? Is there a written contract? What are the provisions of the contract with respect to exclusivity, length of term, termination provisions, compensation, and change of control?

Synergies and Motivations – What potential operating and financial synergies exist? Are there economies of scale available through a combination? Why is the seller selling, and the buyer buying? What are the parties' specific motivations?

Form of Legal Organization – The organization of an imaging company, i.e., C corporation, S corporation, partnership, or limited liability company, can directly impact the purchase price paid. The objective is to achieve capital gain tax treatment for sellers, while balancing the desire of buyers to purchase assets as opposed to stock.

Timing – Due to external economic and industry factors, it could be a buyer's market or a seller's market. Valuation multiples change based on external factors, as well as factors inherent to the practice.

GAAT and the Construction of Buy-Sell Agreements

Now, turn to the impact these concepts have on the construction of a fair and equitable buy-sell agreement. No matter how the practice is legally organized, there is typically some form of legal agreement that specifies important characteristics, such as, but not limited to:

- Types of equity classes, along with the number of units of each.
- Rights, privileges, and limitations provided to and placed on each class of equity.
- Governance structure of the entity, including the voting rights and control elements afforded to each class of equity.
- Restrictions placed on the marketability of each class of equity.
- Provisions for allowing new equity holders, including conditions, terms, and purchase price.
- Provisions for allowing liquidity events by existing equity holders, including conditions, terms, and purchase price.

Such an agreement could be called, depending on the legal form of entity, the articles of incorporation, the corporate by-laws, the shareholder agreement, the buy-sell agreement, the partnership agreement, the limited partnership agreement, the membership agreement, among others. These agreements will be referred to collectively as the buy-sell agreement.

When constructing the economic elements of a buy-sell agreement, it is important to attempt to achieve a sense of balance. The buy-in price or value for new partners must be set low enough to make it reasonably affordable, and to allow for continued successful recruitment of young physicians. However, the buy-in price or value must not be unfair to existing partners, some of whom may have over 20-year tenures, and who have contributed years of sweat-equity to build the practice. From an economic perspective, new partners will typically participate in the profit distributions of the practice, and the buy-in price must, to some degree, reflect this new economic benefit.

Conversely, the buy-out price or value for retiring partners must be high enough to award the long-tenured contribution of a partner's professional (or personal) goodwill for use by the practice, and the long-tenured contribution of a partner to the development of the practice goodwill. However, the buy-out price or value must not be set so high as to make it unaffordable for the practice, thus putting the existence of the practice as a going concern at risk. The retiring partner will typically cease participating in the profit distributions of the practice, and the buy-out price must, to some degree, reflect these foregone cash receipts.

The traditional buy-sell agreement, ownership was

achieved and relinquished at some pro rata share of cash, accounts receivable, and equipment, less debt – in other words, a pro rata share of net asset value. Although simple to calculate, this method completely ignores the value of any intangible assets and implies that ownership in a practice is simply an income-producing asset; no capital appreciation was attainable. Perhaps it would be beneficial to refer back to the value continuum displayed on page 15.

The traditional buy-sell agreement set a transaction price at Point A. While Point A is quite attractive to incoming partners, and certainly affordable, it places new partners on equal economic footing with existing, potentially long-tenured, partners at no sweat-equity cost. In addition, although requiring a longer-term vision, each incoming partner will eventually become an outgoing partner, joining the ranks of those who seek some reward for years of service. In conformance with both GAAT and reason, Point A does not result in a buy-sell agreement that is fair and economically-sound.

Moving to the other extreme end of the value continuum, the 100% interest value, or Point E indicates that if the entire practice was sold, then each existing partner would receive a pro rata share of Point E, the highest possible per share value, based on unilateral control elements provided to the buyer, as well as the opportunity for synergies. However, in the construct of a buy-sell agreement, it must be recognized that in a group practice setting, each individual radiologist typically owns a minority interest in the equity of the practice. Hence, a partner who is facing retirement must recognize that the practice will continue on, and that their minority interest should not be purchased at a value that reflects any element of control. If the practice's buy-sell agreement did provide for retiring partners to be bought out at Point E, the practice could eventually go bankrupt and cease to exist, due to lack of cash from funding retirements. The bankruptcy could be an actual financial bankruptcy, or a bankruptcy of motivation on the part of remaining partners as their income levels plummet to fund the retirements. Point E is not appropriate for a fair and economically-sound buy-sell agreement.

Given that most practice equity holdings in a group practice setting are minority interests, and for the same reasons as specified for Point E, establishing a buy-sell agreement that suggests transactions should occur at Point D is also not appropriate.

Instead, transactions should be completed at a price or value in between, but not at Point A and Point C – at Point B, or at a slight discount to Point B.

Point B reflects both the net asset value of the practice and the goodwill of the practice. Clearly, an incoming partner should be expected to pay their fair share of the

tangible assets on the books of the practice, or net asset value. In addition, an incoming partner should recognize that the practice has both practice goodwill that has been built up over the years, including a reputation, an established location(s) as a going concern entity, a workforce in place, systems and procedures in place, a referral list, a client list, and other intangible assets. Over and above the practice goodwill, each of the existing partners has contributed their own personal or professional goodwill for the benefit of the practice. It is the existence of this collective practice and personal goodwill that results in the generation of cash flow for the practice. The intangible value of a practice is very real, has been built up over the years by existing (and previous) partners, and should, in all fairness, be paid for by an incoming partner.

To lessen the economic burden of Point B on incoming partners, and to ensure that the practice can still successfully recruit, a buy-sell agreement could be constructed that sets a transaction value at a slight discount from Point B. Buy-sell agreements in which the retirement value is also set at a slight discount from Point B is a way of existing partners demonstrating a desire to maximize the probability of the continuation of the practice.

Both the buy-in and the buy-out values set by a fair and economically-sound buy-sell agreement should fall within the range of a discounted Point B to Point B. Exactly where the buy-in and buy-out values fall within this range to a large degree depends on the existing shareholders, their risk/return perspective, their ideals, and their motivations.

Tail Protection Provisions

Occasionally, a long-tenured partner retires and receives a fair, but relatively low buy-out price, only to witness their former partners sell the entire practice eighteen months later at a much higher, controlling-interest level of price. Conversely, a new partner can buy in at a very low price, only to have his new partners vote to sell the entire practice twelve months later at a much higher, controlling interest level of price.

Tail protection provisions provide a phase-in and phase-out period with respect to receiving the proceeds from the sale of a controlling interest in the practice. The fear of such an event is more likely than the actual occurrence of such an event, but such tail protection provisions provide ease of mind among the shareholders.

To prevent concerns over events that certain parties would argue provide a windfall to a new partner or that punish a retired partner, a buy-sell agreement should contain tail protection provisions. The tail protection provisions could state that a retired partner received full value if a sale of the practice occurs within six months of retirement, two-thirds of full value if a sale occurs within the period of six

to eighteen months, and no additional buy-out if the sale occurs after eighteen months of retirement. Conversely, if a sale of the practice occurs within twelve months of a new partner joining, then the new partner only receives one-half of full value, and if the sale occurs within the period of one to two years following the buy-in, then the new partner receives 75% of full value for their shares.


Variations to Provide Flexibility

Every individual has differing perspectives with respect to risk and return. Even a carefully crafted, buy-sell agreement might not satisfy all members of a large group practice. For instance, not every young associate will be able to afford a given buy-in price.

To provide flexibility, it is not uncommon to structure an entity with tiered ownership, reflected in the buy-sell agreement. Each progressive tier would provide its holder with increasing rights and benefits, but at an increasingly higher buy-in price.

Two levels of partnership could be created, a junior partner and a senior partner, in which the buy-in for a junior partnership had a lower price than the buy-in for a senior partnership. Such a structure would allow an associate to buy-in at the junior partner level, and eventually when more economically viable, buy-in to the senior partner level. Each partnership level would contain different income amounts and priorities, different abilities to contribute toward corporate governance, etc. A variation of this model would provide for income partners versus equity partners. An income partner (the lower level) would receive the same share of profits as the equity partner (the higher level), but have extremely limited rights with respect to corporate governance and voting. The same effect can be achieved in a corporation with different classes of stock.

Another method of providing flexibility would be to separate the business, if operationally and legally allowable, into multiple entities along modality lines, professional/technical splits, or along geographical lines. This series of tiers would allow a new partner to buy in to the entities they choose at a gradual pace, thus better reflecting their own risk/return perspectives.

While this article provides general information, it does not represent specific legal, tax, or financial advice. Be sure to work with your attorney when constructing buy-sell agreements, to ensure legality of the agreement. 

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