

Valuation Strategies for Developing an Imaging Joint Venture

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Overview

- I. Why Value an Imaging Center Anyway?
- II. Three Basic Approaches to Valuation
- III. Valuation of a Minority Interest Versus a Controlling Interest
- IV. Valuation Continuum
- V. Factors That Influence the Value of an Imaging Center
- VI. Generally Accepted Appraisal Theory and the Construction of Buy-Sell Agreements
- VII. Conclusion

Why Value an Imaging Center Anyway?

Why Value an Imaging Center Anyway?

- Formation of new joint venture
- Admission of new radiologist partner within independent partner of venture
- Buy out of retiring radiologist partner within independent partner of venture
- Merger with another partner
- Entry of another partner into joint venture
- Outright sale of the joint venture
- Value-based management (maximize sustainable value)
- Litigation (involuntary termination of partner, dissolution of joint venture, divorce, etc.)

Why Value an Imaging Center Anyway?

Monetary value

versus

non-monetary value

Why Value an Imaging Center Anyway?

Given these parameters:

- Contribution of assets
 - owned
 - leased
- Contracts for
 - professional services
 - management services
 - billing services
 - medical directorship
 - other
- Source of patients
- Goals and objectives

You have to balance:

- Initial Contributions
- Income from contracts for:
 - Professional services
 - Management services
 - Billing services
 - Medical directorship
 - Other
- Governance
- Equity
- Income from joint venture
- Non-economic value

Why Value an Imaging Center Anyway?

Formation of New Joint Venture

	Partner 1	Partner 2
Initial Contributions	A1	A2
Income from Contracts	B1	B2
Governance	C1	C2
Equity	D1	D2
Income from Joint Venture	E1	E2
Non-Economic Value	<u>F1</u>	<u>F2</u>
TOTAL	T1	T2

Why Value an Imaging Center Anyway?

Formation of New Joint Venture

- At end of the day, the sum of A1 through F1 must equal the sum of A2 through F2 (T1 must equal T2)
- Each cash flow stream might consist of a normal component and an excess component
- The excess component of a cash flow stream can be altered to achieve balance
- The concept of balancing or boot

Why Value an Imaging Center Anyway?

Radiology Practice/Imaging Center Transition Issues

- The **admission** and **retirement** of radiologists to/from radiology group practices and/or imaging center ventures occurs with greater frequency than many may realize.
- These entity transition events are among the most divisive events that a radiology practice encounters.
- Differing opinions about the **valuation** of a radiology practice and/or imaging center and methods of **equity and compensation distribution** are the source of much conflict.
- Differing opinions about participation in the professional radiology operations and the technical radiology operations are also the source of much conflict.

Why Value an Imaging Center Anyway?

Radiology Practice/Imaging Center Transition Issues

- Retiring radiologists are increasingly less willing to accept traditionally low buy-outs.
- Young radiologists can not afford to buy into a radiology group practice at market valuations.
- Young radiologists can not afford to buy into an imaging center operation at market valuations.
- Incumbent radiologists use practice equity and/or imaging center equity to entice young radiologists to join their practice with neither party to the transaction understanding the value of the equity interest that is being exchanged.
- Practice political and cultural factors, as well as reliance upon past methods of handling transition issues, usually drive the decision making process.

Three Basic Approaches to Valuation

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- The Income Approach (the Discounted Cash Flow Approach)
- The Market Approach (the Public Market Comparable Approach and the Comparable Acquisition Approach)
- The Cost Approach

Three Basic Approaches to Valuation

The Discounted Cash Flow Approach

- Project the Net Revenues to Be Generated by the Company
- Project the Expenses Associated With That Net Revenue Stream, Analyzing the Variable / Fixed Nature of Various Expenses, Excluding Interest Expense
- Subtract the Expenses and Income Taxes From the Net Revenues to Obtain Net Income
- Convert the Net Income to Cash Flow by Adding Back Depreciation, Subtracting Capital Expenditures, and Subtracting Increases in Working Capital, but Not Subtracting Principal Payments

Three Basic Approaches to Valuation

The Discounted Cash Flow Approach (cont'd)

- Discount the Forecasted Debt-Free Cash Flows Back to Present Value, Thereby Accounting for Both the Time Value of Money and Forecasted Risks, Yielding Total Consideration
- Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

Three Basic Approaches to Valuation

The Public Market Comparable Approach

- Identify Publicly Traded Comparable Companies
- Analyze the Financial and Operating Performance of the Public Companies
- Analyze How Investors Are Pricing the Public Companies, and Why

Three Basic Approaches to Valuation

The Public Market Comparable Approach (cont'd)

- Make Inferences About How Investors Would Price, or Value, the Subject Company Through the Utilization of Various Ratios Such as:
 - Market Value of Total Capital / Net Revenue
 - Market Value of Total Capital / Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA)
 - Market Value of Total Capital / EBIT
 - Market Value of Equity / Book Value of Equity
- Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

Three Basic Approaches to Valuation

The Comparable Acquisition Approach

- Identify Acquisitions of Comparable Companies
- Analyze the Financial and Operating Performance of the Acquired Companies
- Analyze How Buyers Are Pricing the Acquisitions, and Why
- Make Inferences About How Buyers Would Price, or Value, the Subject Company Through the Utilization of Various Ratios, Such as Multiples of Net Revenue, EBIT and EBITDA
- Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value
- The Comparable Acquisition Approach is Typically Only Utilized to Value 100 Percent Interests

Three Basic Approaches to Valuation

The Cost Approach

- Adjust Assets and Liabilities, Both On- and Off-Balance Sheet, to Market Value
- Difficult to Value Imaging Equipment, Accounting for Owned Versus Leased Assets, Accounting for Condition and Utility of Equipment
- Difficult to Identify and Value Intangible Assets, Such as Customer List and Goodwill; Therefore, the Cost Approach Tends to Undervalue a Company
- The Theory is That a Company Utilizes its Entire Bundle of Assets, Including Tangible Assets, Working Capital, and Intangible Assets, to Generate the Primary Driver of Value: Cash Flow
- Therefore, the Cost Approach is Typically Only Utilized to Value Holding Companies (i.e. Non-Operating Companies) or Companies Which Should Be Liquidated

Three Basic Approaches to Valuation

Cost Approach

=

**Market / Income
Approach**

Valuation of a Minority Interest Versus a Controlling Interest

Valuation of a Minority Interest Versus a Controlling Interest

- Value Indications Must Be Adjusted for Factors Related to:
 - The Size of the Interest Being Valued (Minority v. Majority Interest)
 - On a Per Share Basis, an Investor Would Be Willing to Pay More for a Share of a Controlling Interest Than for a Share of a Minority Interest Holding
- Control of:
 - daily operations
 - cash distributions
 - strategic direction
 - professional philosophy
 - liquidity events

Valuation of a Minority Interest Versus a Controlling Interest

- Create Historical Pro Forma Cash Flow Statement
 - Typical Adjustments
 - Excess Physicians' Compensation
 - Excess Professional Fees
 - Excess Management Fees
 - Excess Billing Fees
 - Real Property Lease
 - Equipment Lease

Valuation of a Minority Interest Versus a Controlling Interest

- Create Historical Pro Forma Cash Flow Statement
 - Typical Adjustments (cont'd)
 - Non-Recurring Expenses
 - Rational Own Versus Lease Decisions
 - Other Personal or Discretionary Expenses on the Books of the Company
 - Automobile Leases
 - Compensation and Perks to Family Members
 - Discretionary Types of Insurance Coverage
 - Discretionary T&E and Club Dues
 - Discretionary Retirement Contributions

Valuation of a Minority Interest Versus a Controlling Interest

Imaging Center Valuation Model (Controlling Interest)

Valuation Calculation	<u>Status Quo</u>	<u>Adjusted</u>
Net Revenue	\$ 3,000,000	\$ 3,000,000
Professional Services Fee	900,000	450,000
Facility Rent	150,000	100,000
Other Operating Costs	<u>1,650,000</u>	<u>1,650,000</u>
Total Expenses	<u>\$ 2,700,000</u>	<u>\$ 2,200,000</u>
EBIT (Earnings Before Interest & Taxes)	\$ 300,000	\$ 800,000
Purchase Price:	EBIT	\$ 800,000
	Purchase Multiple	<u>x 5.0</u>
	Total Purchase Price	\$ 4,000,000

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Total Expenses	\$ <u>2,700,000</u>	\$ <u>2,700,000</u>
EBIT (Earnings Before Interest & Taxes)	\$ 300,000	\$ 300,000
Purchase Price:	EBIT	\$ 300,000
	Purchase Multiple	<u>x 4.0</u>
	Total Purchase Price	\$ 1,200,000

Valuation Continuum

Valuation Continuum

Imaging Center and Radiology Practice Transition Issues

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- Differing opinions about the valuation of a radiology practice and/or imaging center and methods of **equity and compensation distribution** are the source of much conflict.
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Valuation Continuum

Low Valuation

High Valuation

Low	-----	Retiree Satisfaction	-----	High
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High	-----	Practice's Ability to Recruit	-----	Low
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High	-----	New Radiologist's Income Level	-----	Low
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Low	-----	Financial Risk to Borrower	-----	High
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Minority Interest

Controlling

Valuation Continuum

Lowest Value Per Share

- Point A: Net asset value as determined via a cost approach
- Point B: Minority interest value (equal to net asset value plus goodwill value)
- Point C: 50 percent interest value
- Point D: Controlling interest value (equal to net asset value plus goodwill value plus control value)
- Point E: 100 percent interest value

Highest Value Per Share

Valuation Continuum

- Additional Considerations
 - Valuation Continuum
 - Tail Protection Provisions
 - Tiers of Equity
 - Tiers of Entities
 - Modality
 - Professional/technical
 - Geography

Factors That Influence the Value of an Imaging Center

Factors That Influence the Value of an Imaging Center

- Internal Factors:
- Growth Potential / Historical Growth Rate
- Size (revenue, EBIT, number of procedures)
- Scope of modalities
- Profitability
- Condition of equipment
- Stability / Reputation
- C-Corporation vs. S-Corporation vs. Partnership vs. LLC
 - Objective is to achieve capital gain treatment for sellers
 - Buyers prefer to buy assets

Factors That Influence the Value of an Imaging Center

- Internal Factors (cont'd):
- Composition of Revenue
 - Hospital vs. Non-Hospital sources of revenue
 - Payor Mix
 - General vs. Sub-specialty
 - Technical Only vs. Global
- Sustainability of Revenue
- Billing Compliance
- Verifiability of Financial and Operating Data
- Hospital Contract Terms
 - Exclusivity
 - Term and termination provisions
 - Compensation
 - Change of control
 - Quality of relationship with administration

Factors That Influence the Value of an Imaging Center

- Internal Factors (cont'd):
- Depth / Composition of Staff
 - Age and number of radiologists
 - Sub-specialty radiologists
 - Quality of management personnel
- Level of Working Capital or Net Asset Value to Be Delivered at Closing
 - A Business is a Bundle of Assets Which Are Used Together to Generate a Cash Flow Stream; Included in This Bundle Are Tangible Assets, Intangible Assets, and Working Capital

Factors That Influence the Value of an Imaging Center

- External Factors:
- Opportunities for the Buyer, (i.e. “Synergies”)
 - Revenue Growth from Existing Clients
 - New Marketing
 - New Services and Offerings
 - Subsequent “Fold-In” Acquisitions
- Timing - Seller’s Market

Generally Accepted Appraisal Theory and Construction of Buy-Sell Agreements

- Given the three basic methods of valuation, the control continuum, the concept of sustainable cash flow, and the factors influencing the valuation multiple, we can turn to the impact of these concepts on the construction of a fair and equitable buy-sell agreement.
- Regardless of the legal form of the entity, there typically exists some form of legal agreement which specifies important characteristics such as, but not limited to:
 - the types and size of equity classes which exist,
 - the rights, privileges, and limitations associated with each class of equity,
 - the 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, and

Generally Accepted Appraisal Theory and Construction of Buy-Sell Agreements

- 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.
- The economic elements of a Buy-Sell Agreement must reflect a balance.
- The buy-in price or value for new partners must be set low enough to make it reasonably affordable and in order to allow for continued successful recruitment of young physicians.

Generally Accepted Appraisal Theory and Construction of Buy-Sell Agreements

- The buy-in price or value must not be unfair to existing partners, some of whom have contributed years of sweat-equity to build the entity.
- A new partner will typically participate in the profit distributions of the entity, 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 an entity, and the long-tenured contribution of a partner to the development of the practice goodwill.
- The buy-out price or value must not be set so high as to make it unaffordable for the entity and put the existence of the entity as a going concern at risk.
- The retiring partner will typically cease participating in the profit distributions of the entity, and the buy-out price must, to some degree, reflect these foregone cash receipts.

Generally Accepted Appraisal Theory and Construction of Buy-Sell Agreements

- In the traditional Buy-Sell Agreement, ownership was achieved and relinquished at some pro rata share of cash, accounts receivable, and equipment, less debt, or in other words, a pro rata share of net asset value.
- Although simple to calculate, this method completely ignored the value of any intangible assets and implied that ownership in an entity was simply an income-producing asset.
- No capital appreciation was attainable.

Generally Accepted Appraisal Theory and Construction of Buy-Sell Agreements

Valuation Continuum

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Highest Value Per Share

Conclusion

- Given these parameters:
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 - Goals and objectives
- You have to balance:
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 - Income from contracts for:
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 - Medical directorship
 - Other
 - Governance
 - Equity
 - Income from joint venture
 - Non-economic value

Haverford Healthcare Advisors

Haverford Healthcare Advisors specializes in providing valuation, merger and acquisition, and corporate finance advisory services to healthcare companies, with a specific focus on radiology practices and imaging centers. We provide valuation services, typically in connection with practice transition issues such as admitting new partners, retiring existing partners, and related matters, and with imaging center issues such as formation, dissolution, admitting new partners, and retiring existing partners. We represent and assist physicians and other healthcare company owners during the process of selling their companies, during the process of merging or partnering with other practices or companies, or during the process of growing through acquisition.

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