

Thinking of Forming a Joint Venture? Valuation Issues to Consider

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Imaging Center Joint Ventures – Valuation Issues

- Independent, free standing imaging center merging with the parallel operations of a hospital or healthcare system
- Many of the same issues arise in the merger of:
 - Two independent, free standing imaging centers
 - The imaging operations of two hospitals
- Many of the same issues arise if the operations are radiation therapy services

Forces Driving the Valuation Issues

- Economic reasons
 - Business reasons (may be non-monetary)
 - Regulatory reasons
-

- Dispute reasons
- Shareholder reasons

Economic, Business, and Regulatory Forces

Given these parameters:

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

You have to balance:

- Initial contributions
- Income from contracts for:
 - professional services
 - medical directorship
 - billing services
 - management services
 - equipment rental services
 - other
- Governance
- Equity
- Income from joint venture
- Non-economic benefits

Economic, Business, and Regulatory Forces

- Formation of New Joint Venture

	<u>Partner 1</u>	<u>Partner 2</u>
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

- A1 does not have to equal A2, B1 does not have to equal B2, but T1 must equal T2

Valuation of Initial Contributions

- Fair market value of participants' initial capital contributions
 - Impacts allocation of equity holdings
 - Impacts allocation of future profits / losses
 - Impacts allocation of governance

Valuation of Initial Contributions

- Fair market value to be determined by a qualified independent appraiser
- “Fair market value” is defined as follows: the 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 arm’s length in an open and unrestricted market, when neither is acting under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Valuation of Initial Contributions

- Initial contribution could take the form of:
 - owned assets – real property or equipment
 - leased assets – real property or equipment
 - going concern entity
 - tangible value
 - intangible value (i.e., goodwill, going concern, trained workforce, referral relationships, tradename, etc.)
 - working capital
 - cash or notes

Valuation of Initial Contributions

- 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 Initial Contributions

Valuation size-of-interest 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 of Initial Contributions

- Each contribution typically valued on a 100% controlling interest basis
- Could create issues in formation of new buy-sell agreement for joint venture from a valuation perspective
- Could create issues in existing buy-sell agreement for contributed entities from a valuation perspective

Valuation of Initial Contributions

- Valuation methods
 - cost approach – typically excludes intangible value
 - market approach – typically includes intangible value
 - income approach – typically includes intangible value
- Valuation issues and complexities can be caused by:
 - hospital systems often do not have a true understanding of net collections and indirect expenses
 - owned versus leased assets
 - differing modalities, condition and utility of equipment, and capital expenditure requirements
 - which assets should be contributed

Valuation of Initial Contributions

Issues Unique to a Hospital's Accounting System and Mission

- Net collections not available
 - Volume statistics by CPT code must be utilized to determine net revenue
- Indigent patients
- Direct expenses
 - Fully-loaded labor costs are often significantly higher than non-hospital labor
 - Hospital labor more likely to be unionized
- Indirect expenses
 - Hospital's success at appropriately allocating indirect expenses varies widely

Valuation of Initial Contributions

- Valuation balancing problems can be solved through
 - tiers of equity
 - tiers of entities
 - modality
 - professional/technical
 - geography
 - non-compete agreements
 - tail protection provisions

Allocation of Global Reimbursement

- Joint venture performs technical component services only
- Patients / payors of imaging center are billed for both the professional and technical components of medical services, i.e., global billings
- Billing function performed in-house, by outside vendor, by contracted manager, or by professional physician practice entity

Allocation of Global Reimbursement

- Need to determine fair market allocation of global reimbursement which:
 - is economically fair and commercially reasonable (CMS: “sensible, prudent business agreement, from the perspective of the particular parties involved”)
 - satisfies applicable legal and regulatory criteria
 - complies with national standards for the profession
- Each imaging center has a different volume and mix of procedures performed
- Allocation can be set in aggregate (for administrative convenience) or by each type of procedure

Allocation of Global Reimbursement

- Starting point is typically based on an analysis of the then-most recently available Medicare-established RVU's for each CPT code, as published by the CMS
- Utilize historical or projected procedure mix for joint venture
- Determine weighted average technical component / professional component fee split

Allocation of Global Reimbursement

- Analysis assumes that every payor (other than Medicare) will make global payments for a given CPT code which may or may not equal in absolute terms the payments made by Medicare for that given CPT code, but that the proportion of any given payment between the technical component and the professional component will be equivalent
- Global fee allocation, from a relative perspective, will be identical for all payors

Allocation of Global Reimbursement

- The “as-calculated” global allocation may need to be adjusted for:
 - medical director services and requirements
 - billing and collection fees
 - professional supervision services and requirements
- Allocation of global reimbursement could change over time due to:
 - change in procedure mix, volume, and modalities
 - change in compensation schedules published by the CMS
 - incorrect assumptions in start-up business plans
 - other issues
- Prudent to have certain measurement dates for look-back provisions and to allow for adjustments to the allocation of global reimbursement

Fair Market Rate for Service Agreements

- Fair market rate to be determined by a qualified independent appraiser
- Stark law and regulations require that remuneration paid for services be consistent with fair market value
- Stark law and regulations define fair market value as the value in arm's length transactions, consistent with general market value
- For a service agreement, general market value is defined as the compensation that would result from bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party

Fair Market Rate for Billing Services

- Billing function performed by contracted manager, by professional physician practice entity, or by one of joint venture participants
- Billing rate must:
 - be economically fair and commercially reasonable
 - satisfy applicable legal and regulatory criteria
 - comply with national standards for the profession
 - be consistent with an arm's-length transaction
- If billing services are provided by professional physician practice entity or by one of joint venture participants, then setting fee equal to fair market value should protect the joint venture from regulatory and legal scrutiny

Fair Market Rate for Billing Services

- Perform market analysis
- Particular attention must be paid to:
 - how comprehensive is the range of requested billing services
 - what is the average dollar value per unit or procedure (due to mix of fixed and variable costs on part of the billing entity)
 - rationality from an economic and commercial perspective

Fair Market Rate for Management Services

- Management function performed by a contracted manager, by professional physician practice entity, or by one of joint venture participants
- Management rate must:
 - be economically fair and commercially reasonable
 - satisfy applicable legal and regulatory criteria
 - comply with national standards for the profession
 - be consistent with an arm's-length transaction
- If management services are provided by professional physician practice entity or by one of joint venture participants, then setting fee equal to fair market value should protect the joint venture from regulatory and legal scrutiny

Fair Market Rate for Management Services

- Perform market analysis by job function
- Fully-loaded compensation
- Profit component if management services performed by third-party vendor
- Particular attention must be paid to:
 - which entity do employees work for
 - rationality from an economic and commercial perspective
 - fixed versus variable nature of management services; prudent to have certain measurement dates for look-back provisions to allow for adjustments in management fees

Fair Market Rate for Equipment Rental

- Equipment leased from contracted manager or from one of joint venture participants
- Equipment rental rate must:
 - be economically fair and commercially reasonable
 - satisfy applicable legal and regulatory criteria
 - comply with national standards for the profession
 - be consistent with an arm's-length transaction
- If equipment rental services are provided by professional physician practice entity or by one of joint venture participants, then setting fee equal to fair market value should protect the joint venture from regulatory and legal scrutiny

Fair Market Rate for Equipment Rental

- Perform equipment appraisal
- Perform market analysis
- Particular attention must be paid to:
 - age, condition, nature, and utility of equipment
 - rationality from an economic and commercial perspective

Economic, Business, and Regulatory Forces

- Formation of New Joint Venture

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

Economic, Business, and Regulatory Forces

- Governance
- Equity
- Income from Joint Venture
- Non-Economic Value

Economic, Business, and Regulatory Forces

- Summary
 - Requirement for a qualified, independent appraiser to determine fair market value
 - The ancillary agreements (billing services, equipment leases, management services, etc.) should not increase regulatory concerns as long as the compensation terms for such agreements are consistent with fair market value in an arm's-length transaction

Economic, Business, and Regulatory Forces

- Summary
 - Fair market value rates must:
 - be economically fair and commercially reasonable
 - satisfy applicable legal and regulatory criteria
 - comply with national standards for the profession

Forces Driving the Valuation Issues

- √ Economic reasons
- √ Business reasons (may be non-monetary)
- √ Regulatory reasons

Dispute reasons

Shareholder reasons

Dispute Forces Driving Valuation

- Desire for rebalancing may occur due to changes (real or perceived) in:
 - Income from contracts
 - Non-economic value drivers
- Desire for dissolution may occur due to:
 - Internal factors: change in administration, shareholders, and/or mission
 - External factors: change in marketplace
 - Greed

Dispute Forces Driving Valuation

- Initial governance documents must anticipate structural changes in partners
 - Addition of new hospital to a healthcare system
 - Addition of new free standing imaging center
- Initial governance documents should allow for look-back provisions with respect to factors most likely to be dynamic
- Initial governance documents should provide a mechanism to unwind the venture

Shareholder Forces Driving Valuation

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.
 - Benefits of unilateral requirement of full participation versus benefits of flexibility associated with partial participation

Shareholder Forces Driving Valuation

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 and/or 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.

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 imaging centers, radiology practices, and radiation therapy centers. We provide valuation services, typically in connection with imaging center issues such as formation of joint ventures, dissolution, admitting new partners, and retiring existing partners, and with practice transition issues such as admitting new partners, retiring existing partners, and related matters. 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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