Pathology Practice Transition Issues and Strategies

Presentation to the
American Pathology Foundation
February 28, 2004

HAVERFORD HEALTHCARE ADVISORS

Christopher Jahnle, ASA
Managing Director

Overview

I. Pathology Practice Transition Issues

II. Financing the Practice Transition

III. Financing Illustration

IV. Sale of Practice

V. Valuation Continuum

I. Pathology Practice Transition Issues

- Admission of new pathologist partner
- Buy out of retiring pathologist partner
- Merger with another practice
- Outright sale of the practice
- Litigation (involuntary termination of partner, divorce, etc.)

I. Pathology Practice Transition Issues

Reasons for Hiring Pathologists Over Two-Year Period

Reasons for Hiring	**2002(a)(b)**
New Position	53%
Replacement for pathologist leaving	64%
Replacement for pathologist FT to PT	8%
Locum tenens position	6%
Merger	1%
Other	1%

(a) Percentage of pathologists *reporting that a pathologist was hired*

(b) Total exceeds 100% because multiple responses were allowed

Source: *2002 Practice Characteristics Survey Report - CAP*

I. Pathology Practice Transition Issues

Pathologist Resignation From Group Over Two-Year Period

Number of Resignations	**2002(a)**
One or more resignations	48%
No resignations	46%
No answer	6%
Total	100%

(a) Percentage of pathologists *in group practice*.

Source: *2002 Practice Characteristics Survey Report - CAP*

I. Pathology Practice Transition Issues

Reasons for Pathologist Resignations Over Two-Year Period

Reason for Resignation	2002(a)(b)
To take another pathology position	63%
Left the practice of pathology	6%
Retirement	41%
Termination	12%
Death	2%
End of locum tenens work	4%
Other	5%

(a) Percentage of pathologists *reporting that a pathologist had resigned.*

(b) Total exceeds 100% because multiple responses were allowed

Source: *2002 Practice Characteristics Survey Report - CAP*

I. Pathology Practice Transition Issues

- The **admission** and **retirement** of pathologists to/from pathology group practices occurs with greater frequency than many may realize.
- These practice transition events are among the most divisive events that a pathology practice encounters.
- Differing opinions about the **valuation** of a pathology practice and methods of **equity and compensation distribution** are at the heart of the conflict.

I. Pathology Practice Transition Issues

- Retiring pathologists are increasingly less willing to accept traditionally low buy-outs.
- Young pathologists can not afford to buy into to a pathology group practice at market valuations.
- Incumbent pathologists use practice equity to entice young pathologists 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.

II. Financing the Practice Transition

- Seller-pathologist (retiree) financing
- Buyer-pathologist (new recruit or existing associate) financing
- Practice financing
- External financing
- Any combination of the above
- Sale of practice

Objective: Facilitate the transaction while minimizing taxes and risk.

II. Financing the Practice Transition

Seller-Pathologist (Retiree) Financing

- Among the most frequently used methods
- Capital gains treatment of proceeds to seller possible if transaction is structured appropriately
- Ensures involvement of the seller in the transition process
- Sellers' receipt of proceeds is delayed
- Sellers' exposure to practice-risk is only partially reduced
- Does not maximize Sellers' proceeds

II. Financing the Practice Transition
Buyer-Pathologist Financing

- "Sweat Equity" route – i.e., reduced compensation during the buy-in period
- Ordinary income treatment for the seller
- Does not maximize purchase price
- Seller remains exposed to practice-risk
- Competitive impediment to attracting new recruits

II. Financing the Practice Transition
Practice Financing

- Extension of Seller-Pathologist financing discussed previously
- Leverages practice’s existing banking relationships
- Risk is shared among all practice owners

II. Financing the Practice Transition

External Financing - Overview

- Numerous lenders and loan brokers located throughout the continental United States.
- Lending criteria varies, but typical loan amounts range from \$25,000 to \$5 million.
- Loan amounts based on cash flow, or, in some cases, the "value" of the practice. For example, some lenders will loan \$1 million for every \$300,000 of cash flow before physician compensation. Others may lend \$1.25 for every dollar of cash flow. Others may lend up to 50 percent of the value of the practice.
- In some cases, collateral and/or life insurance may be required.
- Some firms specialize in Small Business Administration ("SBA") loans.

II. Financing the Practice Transition

External Financing – Other Types

- In addition to acquisition (including partner buy-outs) financing, many lenders and loan brokers will also provide financing for other purposes, such as:
  - working capital
  - equipment purchases
  - real estate purchases
  - expansion construction (i.e. building an addition)
  - debt restructuring
  - construction financing
  - leasehold improvements

II. Financing the Practice Transition

External Financing - Information Required

- Information frequently required by lenders and loan brokers includes the following:
  - financial statements and/or tax returns for buyer and seller
  - financial projections
  - SBA application, if borrower desires SBA financing
  - accounts receivable aging
  - copies of professional license and driver's license
  - other required information may include a lender specific loan application
  - recent CV

II. Financing the Practice Transition

External Financing – Other Observations

- Fees/points, if applicable, can frequently be rolled into the loan amount.
- Amount of equity required by the lender varies depending on the situation. In some cases, the lender may require a 10 percent down payment. In some cases, the lender may finance 100 percent of the transaction.
- Terms can vary from 3 to 10 years. For commercial real estate transactions, terms may be as much as 25 years. Some loans may be structured with balloon payments.
- Approval time can vary from several days to six weeks, depending on the complexity of the transaction.

III. Illustration: Multiple Financing Sources

- Associate pathologist buys the senior pathologist's equity interest for $600,000.
- Seller receives $300,000 in cash at closing and $300,000 in the form of a five-year seller note.
- Buyer pays $50,000 from her own funds and finances the balance of the down payment via a bank loan.
- Partner retires; associate succeeds to his $400,000 annual income.
- Associate's position is filled by newly recruited associate.

III. Illustration: Multiple Financing Sources

Income Statement	Status Quo
Net Revenue	$ 850,000
Physicians' Compensation	600,000 (a)
Non-Physician Operating Cost	250,000
Total Expenses	850,000
EBIT (Earnings Before Interest & Taxes)	$ - 0 -

(a) Analysis of compensation per pathologist:

- Shareholders (1)	$400,000
- Associate (1)	$200,000

III. Illustration: Multiple Financing Sources
Minority Interest Valuation

Income Statement	Status Quo	Adjusted
Net Revenue	$ 850,000	$ 850,000
Physicians' Compensation	600,000 (a)	400,000 (a)
Non-Physician Operating Cost	250,000	250,000
Total Expenses	850,000	650,000
EBIT (Earnings Before Interest & Taxes)	$ - 0 -	$ 200,000

Purchase Price:	EBIT	$ 200,000
	Purchase Multiple	x 3.0
	Total Purchase Price	**$ 600,000**

(a) Analysis of compensation per pathologist:

	Status Quo	Adjusted
- Shareholders (1)	$ 400,000	$ 200,000
- Associate (1)	$ 200,000	$ 200,000

III. Illustration: Multiple Financing Sources Cash Flow Projection

Physician Transition Projection
Cash Flow Projection

Purchase Price	600,000		
Composition			
Cash at closing	300,000	50%	$50,000 paid from MD's funds, $250,000 balance financed thru bank debt, 10 year term @ 8%
Seller Note	300,000	50%	5 year term @ 6%
Annual Salary	400,000		

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
Annual Salary	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000
Less:											
Total Tax (see below)	129,054	131,215	133,377	135,539	137,700	139,862	140,634	141,406	142,178	142,950	143,722
P&I on Bank Loan	45,000	43,000	41,000	39,000	37,000	35,000	33,000	31,000	29,000	27,000	0
P&I on Seller Note	78,000	74,400	70,800	67,200	63,600	0	0	0	0	0	0
Available Cash	147,946	151,385	154,823	158,262	161,700	225,138	226,366	227,594	228,822	230,050	256,278

Income Tax Calculation

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
Annual Salary	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000
Less:											
Interest on Bank Loan	20,000	18,000	16,000	14,000	12,000	10,000	8,000	6,000	4,000	2,000	0
Interest on Seller Note	18,000	14,400	10,800	7,200	3,600	0	0	0	0	0	0
State Taxes on Salary @ 3%	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Federal Taxable Income	350,000	355,600	361,200	366,800	372,400	378,000	380,000	382,000	384,000	386,000	388,000
Federal Tax*	105,860	108,021	110,183	112,345	114,506	116,668	117,440	118,212	118,984	119,756	120,528
State Income Tax	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Social Security Tax**	11,194	11,194	11,194	11,194	11,194	11,194	11,194	11,194	11,194	11,194	11,194
Total Tax	129,054	131,215	133,377	135,539	137,700	139,862	140,634	141,406	142,178	142,950	143,722

* Married, Filing Joint Rate Schedule
** Based on 2003 FICA limit

IV. Sale of Practice

- Maximize proceeds
- Loss of independence
- Could impact ability to recruit
- Capital gains treatment of proceeds
- Consents of third parties (i.e., hospital) required

IV. Sale of Practice

Income Statement	Status Quo
Net Revenue	$ 850,000
Physicians' Compensation	600,000 (a)
Non-Physician Operating Cost	250,000
Total Expenses	850,000
EBIT (Earnings Before Interest & Taxes)	$ - 0 -

(a) Analysis of compensation per pathologist:

- Shareholders (1) $400,000
- Associate (1) $200,000

IV. Sale of Practice
Controlling Interest Valuation

Income Statement	Status Quo	Adjusted
Net Revenue	$ 850,000	$ 850,000
Physicians' Compensation	600,000 (a)	400,000 (a)
Non-Physician Operating Cost	250,000	250,000
Total Expenses	850,000	650,000
EBIT (Earnings Before Interest & Taxes)	$ - 0 -	$ 200,000

Purchase Price:	EBIT	$ 200,000
	Purchase Multiple	x 5.5
	Total Purchase Price	**$ 1,100,000**

(a) Analysis of compensation per pathologist:

	Status Quo	Adjusted
- Shareholders (1)	$ 400,000	$ 200,000
- Associate (1)	$ 200,000	$ 200,000

Valuation Continuum

Low Valuation | **High Valuation**

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

Minority Interest | **Controlling Interest**

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 pathology practices and clinical laboratories. We assist physicians and other healthcare company owners in resolving practice transition issues. We also represent owners during the process of selling their practices, during the process of merging or partnering with other practices or companies, or during the process of growing through acquisition. We also provide practice valuation services.

Christopher Jahnle, ASA **Kirk A. Rebane, ASA, CFA**

41 Leopard Road, Suite 305, Paoli, PA 19301

Telephone: (610) 407-4024 Fax: (610) 407-4028

www.haverfordhealthcare.com