Financial Valuation of an Imaging Center: The Fundamental Issues

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Disclosure:

Nothing to Disclose

Overview

I. Reasons to Value an Imaging Center

II. Factors That Influence Value

III. Structural Solutions to Valuation Gaps

IV. Valuation Continuum: Minority vs. Control

V. Valuation Fundamentals

VI. Valuation Study Workplan – Procedures and Timing

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements

VIII. Case Studies

I.Reasons to Value an Imaging Center

I. Reasons to Value an Imaging Center

- **What is the value of a private company?**
- **A valuation could be required for:**
  - **Shareholder transition planning**
    - **Formation, maintenance, or restructuring of a buy-sell or shareholder agreement**
      - ***See Section VII (GAAT and Buy-Sell Agreements)***
      - ***How often should I obtain a valuation of my IC?***

I. Reasons to Value an Imaging Center

– Shareholder transition planning (cont'd)

- **Admission of a new partner**
- **Buy out of a retiring partner**
  - *Shareholder transition events occur with more frequency and can potentially be more divisive than one could imagine*
  - *Often, neither buyer nor seller understands the true value of equity to be transferred*

I. Reasons to Value an Imaging Center

- Corporate strategic planning
  - As a component of the decision process related to the outright sale of an imaging center
  - Evaluate a purchase offer received for the IC
  - Stark law and regulatory concerns regarding fair market rates assigned to professional compensation arrangements and medical director agreements
    - *How often should I obtain a valuation of my IC?*

I. Reasons to Value an Imaging Center

– Corporate strategic planning (cont'd)
  - Set the price related to an acquisition target
  - Facilitate a merger, including allocation of equity
  - Value-based management (maximize sustainable value)
  - Inter-company transfer pricing
  - As a component of a feasibility study

I. Reasons to Value an Imaging Center

– Joint venture formation and dissolution

- **Valuation of initial contributions and allocation of equity holdings**
- **Allocation of future income and governance**
- **Stark law and regulatory concerns regarding fair market rates assigned to:**
  - **ancillary management, billing, and services agreements**
    - » ***How often should I obtain a valuation?***
  - **professional compensation arrangements and medical director agreements**
  - **rental / lease agreements (equipment, real property, employees, etc.)**

I. Reasons to Value an Imaging Center

- **Joint venture formation and dissolution (cont'd)**
  - **Rebalancing of equity due to real (or perceived) changes**
    - ***How often should I obtain a valuation of my IC?***
  - **Dissolution of joint ventures due to economic reasons (whether real or perceived), non-monetary reasons (such as change in administration or mission), or external marketplace factors**
  - **Inter-company transfer pricing**

I. Reasons to Value an Imaging Center

- Litigation and dispute purposes
  - Dissolution or rebalancing of joint ventures
  - Redemption of minority shareholder
  - Marital dissolution
- Taxes and government
  - Equity transfers are typically taxable events
  - Charitable contributions
  - ESOPs

II. Factors That Influence Value

II. Factors That Influence Value

- **Internal Factors:**
  - Pro forma financial performance
  - Historical growth trends
  - Growth potential - proactive or reactive
  - Size (revenue, EBITDA, centers, modalities)
  - Equipment age, condition, functional utility, and deferred CAPEX

II. Factors That Influence Value

- Internal Factors (cont'd)
  - Profitability
  - Sustainability of revenue
  - Professional subspecialties and quality
  - Stability / reputation
  - Location and competition
  - Corporate structure: organizational, taxation, and ownership

II. Factors That Influence Value

- **Internal Factors (cont'd):**
  - **Size of interest being valued (i.e., minority vs. control)**
  - **Professional / technical mix**
    - ***Case Study: Technically, Not Technical Value***

    (See Section VIII for detailed text)
  - **Collection rates, payor mix, billing compliance**
  - **Reimbursement per scan**

II. Factors That Influence Value

- **Internal Factors (cont'd):**
  - **Verifiability of financial and operating data**
    - *Case Study: The Tax Dodger (See Section VIII for detailed text)*
  - **Depth, quality, composition, and versatility of management and staff**

II. Factors That Influence Value

- External Factors:
  - State of general economy
  - Reimbursement trends
  - Opportunities for the buyer (i.e., "Synergies")
    - Revenue growth from existing referral sources
    - New marketing
    - New services and offerings
    - Subsequent "fold-in" acquisitions
  - Timing

II. Factors That Influence Value

- **Summary**
  - **Higher income for buyer post-transaction => higher transaction value**
  - **Higher income for seller post-transaction => lower transaction value**

III. Structural Solutions to Valuation Gaps

III. Structural Solutions to Valuation Gaps

- **Valuation balancing problems can be solved:**
  - **Tiers of equity**
  - **Tiers of governance**
  - **Differing income allocation**
  - **Tiers of entities (via modality, professional / technical, geography, etc.)**
    - ***Benefits of unilateral requirement of full participation versus benefits of flexibility associated with partial participation***

III. Structural Solutions to Valuation Gaps

- Financing assistance
- Non-compete agreements
- Tail protection provisions
- Measurement dates for look-back provisions
- Frequency of valuations

IV. Valuation Continuum: Minority vs. Control

IV. Valuation Continuum: Minority vs. Control

- Value indications must be adjusted for factors related to the size of the interest being valued (minority vs. 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**

IV. Valuation Continuum: Minority vs. Control

- **Why is a share of a controlling interest more valuable?**
  - **Control of daily operations and cost structure**
  - **Control of cash distributions**
  - **Control of strategic direction**
  - **Control of professional philosophy**
  - **Control of liquidity events**

IV. Valuation Continuum: Minority vs. Control

- **Create historical pro forma cash flow statement in order to serve as the basis for a controlling interest valuation**
  - **Typical adjustments**
    - **Excess officers' or physicians' compensation**
    - **Real property lease**
    - **Non-recurring expenses**
    - **Excess professional, management, and billing fees**

IV. Valuation Continuum: Minority vs. Control

– Typical adjustments (cont'd)

- **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
    - » *Case Study: The Piggish Retirees (See Section VIII for detailed text)*

IV. Valuation Continuum: Minority vs. Control

Imaging Center Valuation Model

Valuation Calculation	Status Quo (Minority Interest)	Adjusted (Controlling Interest)
Net Revenue	$ 3,000,000	$ 3,000,000
Professional Services Fee	900,000	450,000
Facility Rent	150,000	100,000
Other Operating Costs	$ 1,650,000	$ 1,650,000
Total Expenses	$ 2,700,000	$ 2,200,000
EBIT (Earnings Before Interest & Taxes)	$ 300,000	$ 800,000

IV. Valuation Continuum: Minority vs. Control

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

IV. Valuation Continuum: Minority vs. Control

Low Valuation **High Valuation**

Low	-----	Retiree Satisfaction	-----	High
High	-----	Practice's Ability to Recruit	-----	Low
High	-----	PC / Radiologist's Income Level	-----	Low
Low	-----	Financial Risk to Borrower	-----	High

Minority Interest **Controlling Interest**

V. Valuation Fundamentals

V. Valuation Fundamentals

- **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 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.**

V. Valuation Fundamentals

- Stark law and regulations require that remuneration paid for services be consistent with fair market value.

Three basic approaches to valuation:

- ***The Income Approach (the Discounted Cash Flow Approach)***
- ***The Market Approach (the Public Market Comparable Approach and the Comparable Acquisition Approach)***
- ***The Cost Approach – Excludes intangible value***

Includes intangible value (applies to the Income Approach and the Market Approach)

V. Valuation Fundamentals

- The Discounted Cash Flow Approach
  - Project net revenues to be generated by IC
  - Project expenses associated with 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

V. Valuation Fundamentals

- **The Discounted Cash Flow Approach (cont'd)**
  - 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
  - Discount the forecasted debt-free cash flows back to present value, thereby accounting for 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

V. Valuation Fundamentals

- **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

V. Valuation Fundamentals

- **Public Market Comparable Approach (cont'd)**
  - **Make inferences about how investors would price, or value, the subject IC through the utilization of various ratios, such as multiples of net revenue, earnings before interest expense, taxes, depreciation, and amortization (EBITDA), EBIT, or equity**
  - **Subtract face value of interest-bearing debt from total consideration, yielding equity value**

V. Valuation Fundamentals

- **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

V. Valuation Fundamentals

- **The Comparable Acquisition Approach (cont'd)**
  - **Make inferences about how buyers would price, or value, the subject IC through use 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**

V. Valuation Fundamentals

- The Cost Approach
  - Adjust assets and liabilities, both on- and off-balance sheet, to market value
  - Difficult to identify and value intangible assets, such as customer list and goodwill; therefore, the Cost Approach tends to undervalue an IC

V. Valuation Fundamentals

- **The Cost Approach (cont'd)**
  - **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**

V. Valuation Fundamentals

Cost Approach

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Market / Income Approach

VI. Valuation Study Workplan - Procedures and Timing

VI. Valuation Study Workplan – Procedures and Timing

- Send preliminary information request (Day 1)
- Develop financial model and follow-up questions from information received
- Develop multi-year projection
- Send detailed follow-up questions to client
- Conduct conference call and/or onsite meeting to discuss follow-up questions

VI. Valuation Study Workplan – Procedures and Timing

- Research comparable companies and develop analysis comparing to subject IC
- Refine financial model, based on conference call or site visit
- Develop preliminary value conclusion
- Provide preliminary conclusion to the client

VI. Valuation Study Workplan – Procedures and Timing (cont'd)

- Review preliminary conclusion with client
- Make any adjustments based on review
- Issue final value conclusion in format dictated in the engagement letter: value letter, presentation, narrative report, etc. (Day 45-90)

VII. Generally Accepted Appraisal Theory
and
The Construction of Buy-Sell Agreements

VII. Generally Accepted Appraisal Theory and The 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.

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- 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:
  - Types and size of equity classes which exist,
  - Rights, privileges, and limitations associated with each class of equity,

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- 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.

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- **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.**

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- The buy-in price 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 IC, and the buy-in price must, to some degree, reflect this new economic benefit.

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- Conversely, the buy-out price 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.

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- The buy-out price 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.

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- **In traditional Buy-Sell Agreement, ownership was achieved and relinquished at some pro rata share of cash, A/R, and equipment, less debt, or in other words, a pro rata share of net asset value.**

VII. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements (cont'd)

- **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.**

VIII. Case Studies

VIII. Case Studies

Case Study: Technically, No Technical Value

Background: An 11 radiologist practice (the "PC") located in the Northwest provided professional services to a hospital and two imaging centers. The PC was started 9 years ago by 4 radiologists (the "Founders"), who continued to be the sole shareholders of the PC. The first imaging center ("ICONE") was solely owned by the Founders via a corporate entity called HOLDCO. The second imaging center ("ICTWO") was a 50/50 JV with the hospital, where the Founders' share was also held by HOLDCO. At ICTWO, billing was done by the hospital

VIII. Case Studies

Case Study: Technically, No Technical Value

Background: (cont'd)

at a market rate fee, management services were provided by the PC at a market rate fee, and the professional interpretation fee paid to the PC was based on a standard Medicare PC/TC allocation. However, at ICONE, the combination of billing fee, management fee, and professional interpretation fee had been set above market rates, leaving very little profit in ICONE. The Founders approached the employed radiologists (the "New Docs") and offered to sell them interests in HOLDCO at a price based on a formula that existed in the original buy-sell agreement for HOLDCO.

VIII. Case Studies

Case Study: Technically, No Technical Value

Appraisal Issue: The New Docs, several of whom were young and poor, wrestled with whether or not the formula represented fair market value. They were also concerned about the diversion of profits from ICONE to the PC based on the above-market rate fees paid for billing, management, and professional interpretation. The New Docs finally decided to hire an attorney and an appraiser. The appraiser valued a minority interest in HOLDCO, and educated the New Docs about the fact that a minority

VIII. Case Studies

Case Study: Technically, No Technical Value

Appraisal Issue: (cont'd)

shareholder would not have the ability to change any pre-existing diversionary expenses. Hence, the true FMV of HOLDCO was less than the formula indicated. Since the Founders owned both the PC and HOLDCO, they were able to shift profits from HOLDCO to the PC, thus shifting value from HOLDCO to the PC. The attorney and the appraiser assisted the New Docs in negotiating for a change in fee structure at ICONE and/or the opportunity to hold an interest in the PC. The Founders decided to withdraw their offer to sell interests in HOLDCO.

VIII. Case Studies

Case Study: The Tax Dodger

Background: An imaging center company ("NOTAXCO") in the Southeast had $5 million in revenue and $1 million in cash flow. The owners of NOTAXCO decided to sell their company, engaged an investment banker, and took the company to market. In creating the pro forma financial statements, the investment banker noticed an expense item on the tax returns labeled "Payments to Related Entities." The expense was large, and included non-operating payments to related family entities according to the sellers.

VIII. Case Studies

Case Study: The Tax Dodger

Background: (cont'd)

The sellers supplied the intermediary with schedules allocating the expense to operating expenses and non-operating expenses. The pro forma income statement showed $1 million of cash flow after adjusting for the Related Entity expense.

VIII. Case Studies

Case Study: The Tax Dodger

Appraisal Issue: The investment banker obtained a $6.5 million offer for NOTAXCO, and the sellers eagerly signed a letter of intent with the buyer. During the buyer's due diligence, it became apparent that the outside accountant and the sellers had strived for years to cheat the IRS out of taxes by making payments to family entities for which no products or services were rendered, and through the use of 9 separate bank accounts. In addition, the CPA, on purpose, kept no general ledger, created no financial statements (just the tax return), arbitrarily allocated

VIII. Case Studies

Case Study: The Tax Dodger

Appraisal Issue: (cont'd)

various checks to differing expense line items depending on the year, and in general tried to keep a vague and misleading track for any potential reviewing authority. The buyer could only find documentation for $738,000, and reduced its offer from $6.5 million to $3 million. The deal fell apart, but the shareholders of NOTAXCO succeeded in avoiding a whopping $105,000 in income taxes that year via its accounting methods!

VIII. Case Studies

Case Study: The Piggish Retirees

Background: **A joint venture in the Midwest owned seven imaging centers. The 12 radiologists owned 50% of the JV via a separate corporate entity ("PIGCO"), with the local healthcare system owning the other 50%. PIGCO had obtained a valuation of a 100% controlling interest of the entire JV at one point in time in order to determine whether it should engage the healthcare system in discussions regarding the sale of the entire JV to a third party. The matter of a sale was shelved. However, 1 of the 12**

VIII. Case Studies

Case Study: The Piggish Retirees

Background: (cont'd)

radiologist shareholders of PIGCO was retiring at the end of that year. PIGCO took the FMV of a 100% interest, divided it by ½, and then divided it by 12 in order to determine at what price to buy out the retiree. Periodically, PIGCO obtained updates of its 100% valuation as it continuously assessed the reasonability of entering into conversations with the healthcare system to sell the entire JV to a third party.

VIII. Case Studies

Case Study: The Piggish Retirees

Appraisal Issue: The 100% valuation had made numerous adjustments in order to obtain an appropriate FMV indication (normalizing management fees, real property rental rates, labor costs, professional fees, etc.) of $20,000,000. The retiree was bought out at $833,333, half of which PIGCO borrowed on its LOC. (A subsequent analysis would indicate that the FMV on a minority interest basis was closer to $350,000.) Eighteen months later, 2 shareholders announced their retirement. Twelve months later, 3 more shareholders announced their

VIII. Case Studies

Case Study: The Piggish Retirees

Appraisal Issue: (cont'd)

retirement. Each time, PIGCO redeemed the retiree's interest based on a recent 100% controlling interest valuation and borrowed significant funds to complete the transactions. Suddenly, PIGCO had trouble recruiting new radiologists due to the severe economic burden of paying off the retirees and the LOC. Eventually, PIGCO was forced to sell its 50% interest to the healthcare system, at a partially distressed price, to get out of the financial mess.