



Transition in Equity Ownership: Planning Issues for Radiology Practices and Imaging Centers

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Disclosure:

- Kirk A. Rebane is co-owner of Haverford Healthcare Advisors and part owner of Aurora Diagnostics, LLC.
- Kirk A. Rebane is a consultant to various imaging centers and radiology practices.



Learning Objectives

- Attendee should be able to:
 - Understand in general terms the concept of value-based management
 - Understand the internal and external factors that drive value
 - Explain how to develop a model that balances the differing needs of younger owners vs. older owners in a buy-sell scenario
 - Explain how to provide for variability and flexibility in the arrangement so as to avoid future conflict.



Overview

- I. Radiology Practices and Imaging Centers Transition Issues
- II. Governance Documents
- III. Generally Accepted Appraisal Theory and The Construction of Buy-Sell Agreements
- IV. Valuation Continuum: Minority vs. Control



Overview (Cont.)

- V. Structural Solutions to Valuation Gaps
- VI. Factors That Influence Value
- VII. Valuation Study Workplan – Frequency, Procedures, and Timing
- VIII. Valuation Fundamentals
- IX. Case Studies



I. Radiology Practices and Imaging Centers Transition Issues



I. Radiology Practices and Imaging Centers Transition Issues

- Admission and retirement of radiologists to/from group practices and/or IC ventures occurs with greater frequency than many may realize.
- These entity transition events are among the most divisive events that a radiology practice encounters.



I. Radiology Practices and Imaging Centers Transition Issues (Cont.)

- Differing opinions about the valuation of a practice and/or IC and methods of equity and compensation distribution are the source of much conflict.
- Often, neither buyer nor seller understands the true value of equity to be transferred.



I. Radiology Practices and Imaging Centers Transition Issues (Cont.)

- Why is this important to the RBMA members?
- Because conflict trickles down the organization chart.
- If the administrator can manage successfully upstream (in addition to the daily task of managing downstream day-to-day operations), then potential conflicts can be anticipated and managed.
- Even a single unhappy shareholder can cause problems for both the administrator and the practice.



II. Governance Documents



II. Governance Agreements

- 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.
 - Governance structure of the entity, including the voting rights and control elements afforded to each class of equity.



II. Governance Agreements (Cont.)

- 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.



II. Governance Agreements (Cont.)

- 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.
- 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.



II. Governance Agreements (Cont.)

- Today, after years of observing an active acquisition market, shareholders understand that healthcare practices produce both income and equity value.
- If your practice's Governance Agreement is reflective of the traditional model, then you should anticipate conflict.



II. Governance Documents (Cont.)

- If you are privy to the Governance Documents, then review them and make sure the shareholder understands the pricing mechanism for transactions.
- If you are not privy to them, make it a point to periodically raise the issue to your shareholders.



III. Generally Accepted Appraisal Theory and the Construction of Buy-Sell Agreements



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

- The economic elements of a Buy-Sell Agreement must reflect a balance.
 - The buy-in price 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.
 - 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.



III. Generally Accepted Appraisal Theory (Cont.)

- 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.
- 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.



III. Generally Accepted Appraisal Theory (Cont.)

- Problems arise because:
 - 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 IC 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 also come into play.



III. Generally Accepted Appraisal Theory (Cont.)

- 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



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 (Cont.)

- 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 (Cont.)

- 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 (Cont.)

- Typical adjustments (Cont.)
 - 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 IX for detailed text)***



IV. Valuation Continuum (Cont.)

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
EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization)	\$ 300,000	\$ 800,000



IV. Valuation Continuum (Cont.)

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 (Cont.)

Low Valuation

High Valuation

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

Controlling Interest



V. Structural Solutions to Valuation Gaps



V. 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*



V. Structural Solutions to Valuation Gaps (Cont.)

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



VI. Factors That Influence Value



VI. Factors That Influence Value

- An administrator should understand the internal and external factors which drive value.
- Whether a tangible exercise listed on the manager's to-do list, or whether an implied responsibility within a job description, an administrator should be practicing value-based management.



VI. Factors That Influence Value (Cont.)

- A true organizational leader should be managing a practice with the goal of creating value for the stakeholders, including equity value for the shareholders.



VI. Factors That Influence Value (Cont.)

- A good manager who practices value-based management seeks to:
 1. Maximize sustainable value
 2. Monitor performance on a fairly real-time basis
 3. Understand and monitor the direct correlation between actions and value creation
 4. Manage the internal factors which can be controlled
 5. Anticipate the external factors which cannot be controlled



VI. Factors That Influence Value (Cont.)

- Understanding the correlation between actions and value-delta is critical to success, and can serve to optimize the planning process.
- Internal Factors:
 - Pro forma financial performance
 - Historical growth trends



VI. Factors That Influence Value (Cont.)

- Internal Factors (Cont.)
 - Growth potential – proactive or reactive
 - Size (revenue, EBITDA, test volume, centers, modalities)
 - Equipment age, condition, functional utility, and deferred CAPEX
 - Profitability



VI. Factors That Influence Value (Cont.)

- Internal Factors (Cont.)
 - Sustainability of revenue and EBITDA
 - Professional subspecialties and quality
 - Stability / reputation
 - Location and competition
 - Corporate structure: organizational, taxation, and ownership



VI. Factors That Influence Value (Cont.)

- Internal Factors (Cont.):
 - Size of interest being valued (i.e., minority vs. control)
 - Professional / technical mix
 - *Case Study: Technically, Not Technical Value (See Section IX for detailed text)*
 - Collection rates, payor mix, billing compliance
 - Reimbursement per scan



VI. Factors That Influence Value (Cont.)

- Internal Factors (Cont.):
 - Verifiability of financial and operating data
 - *Case Study: The Tax Dodger (See Section IX for detailed text)*
 - Depth, quality, composition, and versatility of management and staff
 - Information technology



VI. Factors That Influence Value (Cont.)

- External Factors:
 - State of general economy
 - Availability of patient funds for healthcare
 - Credit market for buyers
 - 50% of hospitals losing money
 - Government and healthcare reform (preventive medicine and diagnostics, EMR, volume impact from broader health insurance coverage, capital gains)



VI. Factors That Influence Value (Cont.)

- External Factors (Cont.):
 - Industry demographics
 - Reimbursement trends
 - Paradigm shift from inpatient to outpatient setting
 - Rapidly aging population
 - Increased incidence of cancer
 - Shift from prognostic and monitoring tests to preventive medicine
 - High growth in new technology



VI. Factors That Influence Value (Cont.)

- External Factors (Cont.)
 - Opportunities for the buyer (i.e., “synergies”)
 - Revenue growth from existing referral sources
 - New marketing
 - New services and offerings
 - Subsequent “fold-in” acquisitions



VII. Valuation Study Workplan – Frequency, Procedures, and Timing



VII. Valuation Study Workplan – Frequency, Procedures, and Timing

- Frequency
 - Third-party valuation opinions cost money, and you need to watch your company's bottom line. So how do you determine the frequency for valuations?
 - How often are your Governance Documents actually utilized?



VII. Valuation Study Workplan (Cont.)

- Frequency (Cont.)
 - How material (sizable) is the anticipated transaction?
 - Is the anticipated transaction taxable?
 - How much protection do you want to provide to the shareholders, the company, and yourself via the existence of a third-party appraisal in your file cabinet should the need ever arise to support the transaction pricing to a reviewing authority?



VII. Valuation Study Workplan (Cont.)

- Procedures
 - 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



VII. Valuation Study Workplan (Cont.)

- Procedures (Cont.):
 - Conduct conference call and/or onsite meeting to discuss follow-up questions
 - Research comparable companies and develop analysis comparing to subject IC
 - Refine financial model, based on conference call or site visit



VII. Valuation Study Workplan (Cont.)

- Procedures (Cont.)
 - Develop preliminary value conclusion
 - Provide preliminary conclusion to the client
 - 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)



VIII. Valuation Fundamentals



VIII. 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.



VIII. Valuation Fundamentals (Cont.)

- 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



VIII. Valuation Fundamentals (Cont.)

- 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



VIII. Valuation Fundamentals (Cont.)

- The Discounted Cash Flow Approach (Cont.)
 - 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



VIII. Valuation Fundamentals (Cont.)

- The Discounted Cash Flow Approach (Cont.)
 - 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



VIII. Valuation Fundamentals (Cont.)

- 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



VIII. Valuation Fundamentals (Cont.)

- Public Market Comparable Approach (Cont.)
 - 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



VIII. Valuation Fundamentals (Cont.)

- 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



VIII. Valuation Fundamentals (Cont.)

- The Comparable Acquisition Approach (Cont.)
 - 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



VIII. Valuation Fundamentals (Cont.)

- 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



VIII. Valuation Fundamentals (Cont.)

- The Cost Approach (Cont.)
 - 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



VIII. Valuation Fundamentals (Cont.)

Cost Approach

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Market / Income Approach



IX. Case Studies



IX. 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 at a market rate fee, management services



IX. Case Studies (Cont.)

Case Study: Technically, No Technical Value

Background: (Cont.)

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.



IX. Case Studies (Cont.)

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 ICONNE 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 shareholder would not have the ability



IX. Case Studies (Cont.)

Case Study: Technically, No Technical Value

Appraisal Issue: (Cont.)

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.



IX. 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.



IX. Case Studies (Cont.)

Case Study: The Tax Dodger

Background: (Cont.)

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.



IX. Case Studies (Cont.)

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 various checks to differing



IX. Case Studies (Cont.)

Case Study: The Tax Dodger

Appraisal Issue: (Cont.)

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!



IX. Case Studies (Cont.)

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 radiologist shareholders of



IX. Case Studies (Cont.)

Case Study: The Piggish Retirees

Background: (Cont.)

PIGCO was retiring at the end of that year. PIGCO took the FMV of a 100% interest, divided it by $\frac{1}{2}$, 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.



IX. Case Studies (Cont.)

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 retirement. Each time, PIGCO redeemed the



IX. Case Studies (Cont.)

Case Study: The Piggish Retirees

Appraisal Issue: (Cont.)

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.