

Financial Valuation of an Imaging Center: The Fundamental Issues

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Introduction:

The role of administrators of imaging centers and radiology practices involves providing management services in two distinct directions. First, the administrator must manage downward on the organization chart, shouldering numerous responsibilities with respect to both the day-to-day operations of the imaging center and the long term planning related thereto. But second, and perhaps less obvious at first thought, the administrator must manage upstream on the organization chart. Generally speaking, the administrator reports to the shareholders.

A prudent administrator will seek to manage the shareholders with respect to their needs and their expectations. Not only does the administrator have some level of responsibility to manage for and on behalf of the shareholders, perhaps even a fiduciary level of responsibility (note: not a legal opinion), an administrator can proactively avoid conflicts and problems by anticipating and managing material issues.

In terms of job satisfaction and competency, one could argue that nothing is worse than when there exists conflict above you. The tangible manifestations of such conflict trickle down the organization chart, impacting the stability and success of the imaging center's operations. And if it really is only a trickle, and not a flood, you might be lucky.

Why is this significant? Because the majority of the situations in which a financial valuation is required with respect to your imaging center company will involve shareholder transactions in which equity is exchanged for cash. Hence, the value of the equity needs to be known with certainty. These situations are ripe for infighting and conflict among the shareholders; even a single unhappy shareholder can cause problems for both the administrator and the imaging center.

Perhaps the second most frequent situation which requires a fair market value opinion involves the fees paid by an imaging center for various ancillary services, such as management services, professional interpretation services, billing services, etc. An administrator could find himself/herself in the midst of an entity-wide crisis if regulatory concerns deem any such payments for services to be set at rates which fall outside of reasonable ranges, hence perhaps indicating inducement. Such a result could not only indicate that the center has not been managed in a way to maximize profits (via the overpayment for services), but could also lead to sanctions and penalties.

However, if the administrator can anticipate the need for a financial valuation, can smoothly prepare for a valuation, can seamlessly manage the valuation process, and can successfully manage the expectations of the shareholders with respect to the valuation, the potential for conflict can be mitigated.

Reasons to Value an Imaging Center:

Most likely, your imaging center is part of a private company. You do not have the ability to look in the *Wall Street Journal* and check the stock price for your company. Hence, in any material situation in which you or your shareholders require the knowledge of how much your company is worth, you need to obtain the services of an independent, third-party appraiser.

Shareholder Transition Planning

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.

No matter what legal form of organization your center takes – whether a C corporation, an S corporation, a general partnership, a limited liability company – your company’s equity holders are party to various governance documents (the “Governance Documents”), including documents such as buy-sell agreements, or shareholder agreements, or membership agreements. These Governance Documents typically dictate the manner in which new equity holders are allowed to join the ownership structure, as well as dictate the manner in which existing equity holders are bought out. Under various scenarios, the Governance Documents outline the process, restrictions on liquidity, and pricing mechanisms for shareholder transactions. Pricing mechanisms could include a definition of value, the actual statement of the value, a formula in order to determine the value, and/or a process of selecting an appraiser(s) to independently determine the value.

Hence, whether in the formation of your imaging center’s Governance Documents, or in the maintenance or restructuring of such, you will often require the services of an independent third-party business appraiser. In the determination of value for use in conjunction with Governance Documents, your appraiser and you will need to recognize that the price set for the admission of a new partner must be low enough to make it reasonably affordable and allow for successful recruitment efforts. At the same time, the buy-in price can not be so low as to be unfair to existing partners who have contributed both cash and sweat-equity in the construct of a viable going concern entity. The buy-in price must also reflect the fact that a new shareholder will be participating in some level of profits on a going-forward basis. Conversely, with respect to the buy-out price for a retiring partner (which can be set at a different level than the buy-in price), the redemption value must be high enough to award the retiree’s tenure and contribution to the development of the practice’s goodwill, but low enough so as to make the redemption affordable and not put the entity itself at risk of not being able to continue as a thriving

going concern. Hence, the transactions facilitated by Governance Documents must seek to obtain a balance, which is often difficult to do.

Administrators are often put in the middle of these unbalanced valuation problems. Working with a qualified appraiser and a problem-solving attorney, a business manager should know that valuation balancing problems can be solved without forcing the buy-in parameters to be equivalent to the retirement parameters. Tiers of equity, tiers of governance, tiers of income allocation, and tiers of entities (via modality, professional / technical, geography, etc.) are all techniques that can solve seemingly corporate-culture-bending and corporate-ending situations. Tiers of entities is perhaps the most common solution, where a young radiologist is given the option of deferring or declining the opportunity to buy into an imaging center company which is separate from the professional practice. Working with the shareholders, the administrator must be able to convey the benefits of unilateral requirement of full participation versus the benefits of flexibility associated with partial participation. Financing assistance, tail protection provisions, and measurement dates for look-back provisions are other tools which can solve unbalanced valuation problems.

Historically, the typical buy-sell agreement orchestrated buy-ins and retirements at a price equal to a pro rata share of accounts receivable and fixed assets. Such agreements ignored the fact that an equity ownership position in a practice was an income producing asset, and provided no ability to realize capital gain appreciation. If the Governance Documents of your imaging center are still reflective of the traditional buy-sell agreements, then you should anticipate conflict the next time one of your shareholders begins the retirement process. Most shareholders of healthcare services companies have observed the active acquisition market of the past two decades, and understand that healthcare practices both produce income and equity value. However, it is a rare situation when the shareholders recognize that it is time to restructure the Governance Documents to reflect the new world order.

Assuming you are privy to the Governance Documents, review them and make sure that the shareholders understand the pricing mechanism for transactions. If you are not privy to them, make it a point to periodically raise the issue to the shareholders in your reporting upstream.

Third-party valuation opinions cost money, and more than ever, as an administrator, you need to watch your company's bottom line. So how do you determine the frequency for valuations? This question can be answered by examining the answers to the following questions:

- How often are your Governance Documents actually utilized?
- 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?

Corporate Strategic Planning

Shareholders might be considering transactions of a larger magnitude than those controlled by Governance Documents. The shareholders may have received an unsolicited offer to acquire the entire imaging center company. The shareholders may be considering the sale of their center, and as part of the overall decision process, the amount of after tax proceeds to be recognized from a sale is certainly an important factor. The shareholders may be considering the acquisition of a competitor, or a merger with another private imaging company. In each of these corporate-wide transactions, you will need to obtain a third-party opinion of value in order to both ensure that the economic terms of a transaction are appropriate and in order to determine how much in taxes to pay to the government assuming the transaction is a taxable event. Depending on one's working relationship with the shareholders, an administrator may play a crucial yet sensitive role in obtaining the third-party opinion.

The shareholders are just one segment of the typical imaging center's stakeholders. Other segments include the employees, the vendors, the referral sources, and the patients. The center's business manager plays a critical role in creating value for each group of stakeholders. However, it is often difficult for the administrator to monitor both changes in the value proposition and the direct correlation between actions and value-delta. With respect to the shareholder segment of stakeholders, one measuring stick is the value of equity; the primary motivation for investment is financial return. An administrator who practices value-based management, seeking to maximize sustainable value, can monitor performance on a fairly real-time basis, as well as monitor correlation, by obtaining periodic third-party opinions of value.

In the course of business, an imaging center company may contract for various ancillary services, such as management, billing, equipment leasing, medical director, and/or professional interpretation services. Depending on the types of parties involved in these types of transactions, and especially if one of the parties is not-for-profit, it is possible that the fees paid for such services must be set equivalent to fair market value. Overpayment for certain services could be deemed inducement for patient referrals. Underpayment can also often be construed to be motivated by inappropriate referral patterns. In general, Stark law and regulations require that remuneration paid for services be consistent with fair market value. Although regulatory bodies may never review a specific situation, obtaining support for the pricing levels at which various ancillary services are provided can often prove to be a valuable insurance policy, even if the third-party valuation opinion sits in a drawer and is never used. Peace of mind – for both the administrator and the stakeholders - has a value all its own.

Joint Venture Formation and Dissolution

The formation of an imaging center joint venture is a complicated, and often political, process, the burden of which often falls on the shoulders of the administrator. In a joint venture formation, each party typically contributes various types of assets,

including but not limited to cash, equipment, real property, employees and other elements of going concern, referral base and patients, and intangible assets such as goodwill. A party may contribute an entire bundle of assets, representing a going concern imaging center business entity. In order to allocate equity in the joint venture between the parties, the initial contributions need to be valued. In most circumstances, a third party opinion of value is required. In addition to equity, post-transaction income allocations and governance allocations may require assistance from the appraiser. Finally, as previously mentioned, any ancillary services agreements created in conjunction with the joint venture may need a third-party opinion in order to set the prevailing services fee.

During the life cycle of the joint venture, periodic appraisals may be required to assist in negotiations related to the rebalancing of equity, whether due to real, or perceived, changes in the venture. Third-party valuation opinions may also be required to assist in negotiations during the dissolution of joint ventures, where the death knell is caused by economic reasons (whether real or perceived), non-monetary reasons (such as change in administration or mission), or external marketplace factors. Once again, a business manager can help minimize the disruption felt by the various stakeholders by obtaining a high quality opinion of value.

Factors That Influence Value:

Whether managing the outside appraisal process required in a shareholder transition planning scenario, or during a corporate strategic planning process, an administrator should understand the internal and external factors which drive value. Further, and ignoring any specific situation involving a transaction, 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. A true organizational leader should be managing a practice with the goal of creating value for the stakeholders, including equity value for the shareholders. Understanding the correlation between actions and value-delta is critical to success, and can serve to optimize the planning process.

Internal factors can be controlled to some degree, and external factors can be monitored and planned for. Some of the most significant factors include the following:

Internal Factors

- Pro forma financial performance
- Historical growth trends (as a validation of sustainable performance)
- Growth potential - proactive or reactive
- Size (revenue, EBITDA, centers, modalities)
- Equipment age, condition, functional utility, and deferred CAPEX
- Profitability
- Sustainability of revenue
- Professional subspecialties and quality

- Stability / reputation
- Location and competition
- Corporate structure: organizational, taxation, and ownership
- Size of interest being valued (i.e., minority vs. control; on a per share basis, an investor would be willing to pay more for a controlling interest than a minority interest)
- Professional / technical mix
- Collection rates, payor mix, billing compliance
- Reimbursement per scan
- Verifiability of financial and operating data
- Depth, quality, composition, and versatility of management and staff

External Factors

- State of general economy
 - Availability of patient funds for healthcare
 - Credit market for buyers
 - 50% of hospitals losing money
 - Government stimulus plan (preventive medicine and diagnostics, EMR, volume impact from broader health insurance coverage, capital gains)
- 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
- Opportunities for the buyer (i.e., “synergies”)
 - Revenue growth from existing referral sources
 - New marketing
 - New services and offerings
 - Subsequent “fold-in” acquisitions

Conclusion:

A practice administrator is the keystone for the various stakeholders in an imaging center operation, managing in multiple directions. A good IC administrator practices value-based management, understands the direct correlation between actions and value creation, manages the internal factors which can be controlled, and anticipates the external factors which can not be controlled. An excellent IC administrator anticipates the need for third-party opinions of value in order to smooth transitions, to mitigate life-stage problems, and to create the peace of mind associated with having a well-constructed valuation report in the file drawer.

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