Transition in Equity Ownership:

PLANNING ISSUES FOR RADIOLOGY PRACTICES AND IMAGING CENTERS

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The admission and retirement of shareholders, whether physicians or not, from the ownership of imaging centers and radiology practices occurs with much greater frequency than many administrators realize. Evidence of this fact can be seen in the RBMA's Radiology Hot Topics poll of January 2011, which indicates that two-thirds of practices recruited or hired a partnership-track physician in 2010; partnership-track, of course, implies an eventual admission event. These admission and retirement transition events are among the most divisive events that a practice or Imaging Center (IC) can encounter.

Potential conflict exists because the buyers and sellers often have different opinions about the valuation of the entity as well as different opinions about the methods of equity, compensation, and governance distribution. Indeed, quite often neither the buyer nor the seller truly understands the value of what's being transferred. When equity is exchanged for cash, either in buying or selling, and the parties are making decisions without full knowledge of all the facts, the situation is ripe for infighting and conflict.

As an administrator or manager of an imaging center and/or radiology practice, there are steps you can take to minimize the potential for conflict in these equity

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transition events. With a little knowledge and a few tools, you can better anticipate the coming of a transition event, better manage the process, and better manage the expectations of the shareholders.

Buy-Sell Mechanism

Ask your shareholders the following questions: Do we have a written plan regarding the manner in which new partners join, and at what price they join? Do we have a written plan regarding retirements? Do we anticipate any new partners or retirements in the foreseeable future? How can I help the company to prepare for smooth transition events? Don't ask them once and then forget about them; ask these questions at least once per year. One of the biggest drivers of conflict in transition events is a lack of prudent planning. If, at the very least, you help to remind your shareholders that they need to plan, then you have done the company a huge benefit.

Ideally, your shareholders will share the company's various governance documents with you, such as the buy-sell agreements, shareholder agreements, or membership agreements, thereby allowing you to be better prepared to plan for transition events. These documents typically dictate the manner in which new equity holders are allowed to join the ownership structure, as well the manner in which existing equity holders are bought out. Under various scenarios, the 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.

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, less the value of liabilities. Such agreements ignored the fact that a significant contributor to the overall value of the practice or IC is the value of the intangible assets: your goodwill, going concern, name and reputation, assembled and trained workforce, referral relationships, payor contracts, favorable location, etc. Hence, the value provided by such a traditional buy-sell agreement was artificially low. If the governance documents of your practice or IC 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 service companies have observed the active acquisition market of the past two decades and understand that healthcare practices produce both income and significant equity value.

A well constructed buy-sell agreement will seek to provide for fair transactions from both a pricing perspective and a mechanism perspective. With respect to new partner admissions, the price set either in your governance agreements or by your independent appraiser will need to be low enough to make it reasonably affordable and allow for successful recruitment efforts. The buy-in price has to recognize that young physicians tend to be less entrepreneurial, more risk-averse, and more focused on the work/home lifestyle balance. At the same time, the buy-in price cannot 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 being unable 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.

Fortunately, there are tools and techniques that can be used to help solve these unbalanced valuation problems without forcing the buy-in parameters to be equivalent to the retirement parameters. Tiers of equity (junior partner versus senior partner), 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 are perhaps the most common solution, in which a young radiologist is given the option of deferring or declining the opportunity to buy into an imaging center company that is separate from the professional practice. The benefits of unilateral requirement of full participation must be weighed against the benefits of flexibility associated with partial participation.

Value-Based Management

Not only should a business manager or administrator anticipate transition events and understand the role that valuation plays in such events, but the manager should also understand that he or she plays a critical role in creating value for the shareholders. The shareholders are investors, and are seeking a financial return. If the administrator recognizes that there exists a direct correlation between actions and value-delta, then the administrator can begin to practice value-based management. An administrator should seek to maximize sustainable value, monitor performance on a fairly real-time basis, understand and monitor the direct correlation between actions and value creation, manage the internal value factors that can be controlled, and anticipate the external value factors that cannot be controlled.

Some of the most significant factors impacting value include the following:

INTERNAL FACTORS

- Pro forma financial performance
- Historical growth trends (as a validation of sustainable performance) and growth potential
- Size (revenue, EBITDA, centers, and modalities)
- Equipment age, condition, functional utility, and deferred CAPEX
- Sustainability of revenue, EBITDA, and profitability
- Professional subspecialties and quality
- Stability / reputation
- Location and competition
- Corporate structure
- 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, and reimbursement per scan
- Verifiability of financial and operating data
- Depth, quality, composition, and versatility of management and staff
- Information technology

EXTERNAL FACTORS

State of general economy

- Availability of patient funds for healthcare
- Credit market for buyers
- Government and healthcare reform (preventive medicine and diagnostics, EMR, volume impact from broader insurance coverage, capital gains, etc.)

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

A good radiology practice or imaging center administrator practices value-based management, understands the direct correlation between actions and value creation, manages the internal factors that can be controlled, and anticipates the external factors that cannot be controlled. Further, a good administrator anticipates the need for well-planned and well-orchestrated transition events and understands the role that value and valuation play in order to mitigate conflict.

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