



Valuation of medical practices

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Outline

- **The need for valuation**
- **Questions**
- **Methods**
- **Some concepts**
- **Drivers and practical considerations**
- **Standards of value**
- **Example**
- **Goodwill**
- **.....Questions as we go**



Why is valuation needed?

- Practice Sale
- Retirement/withdrawal
- Relationship property
- Merger
- Litigation
- Introduction of a new partner/shareholder



Valuation questions

- Value of the practice?
- Shares in a practice?
- Running as efficiently as possible or are further revenues and cost optimisation possible?
- The strength of the income stream (and cash flows) which creates true value in the practice?
- Will the practice's future income stream reflect its current income stream?



Valuation methods

- Income approach
 - Capitalisation of earnings (normally used as pragmatic)
 - Discounted free cash flow (needs more detailed forecasts and assumptions)
- Asset approach
- Comparable market approach
 - Guideline company
 - Comparable sales
- Thumb rules
- Normally a hybrid approach is used: a combination of a primary method and a validation



Some valuation concepts

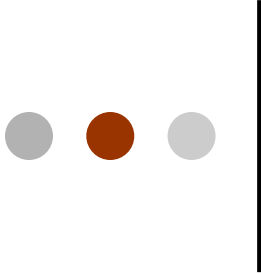
- Discount rate (rate of return) and capitalisation rate (discount rate less growth expectation).
- Discount rate is based on a risk free rate plus a premium for risk factors
- Typical risk factors include market risk, size, competition, key person and vary by practice
- Be careful of double counting risks in earnings/cash flows and risks
- Difference between discounting and capitalisation



Valuation drivers and practical considerations

➤ Revenue

- Sustainability
- Contractual arrangements
- Customer base
- Demographics
- Payment basis and capitation
- Dependence on current owners/doctors
- Transferability
- Referral base
- Location and competition



Valuation drivers and practical considerations (2)

- Costs
 - Salary costs
 - Physician direct expenses
 - Lease costs
 - One time costs
- Investment needed
 - Equipment requirements
 - Credit period?
- Systems and accounting processes
- These impact discount and capitalisation rates and maintainability



Standards of value: Not one standard definition: depends on context and purpose

- Fair market value: is the price a willing but not too anxious buyer, and a willing but not too anxious seller will agree on. Used in an arm's length transaction and when transferring practices to a trust or related party.
- Fair value: is the value which is fair to the parties in a transaction or dispute. Used in cases of shareholder dispute
- Specific Investor value: Value considered from a specific investor's perspective
- Value to the owner (being used in relationship property cases) reflects the value which could only be available to the owner of shares because of some unique non transferable attributes or skills.



Example (1/2)

Revenues	\$500,000
Expenses	\$380,000
Earnings	\$120,000
Add back interest	\$30,000
Add back depreciation	\$25,000
Add back physician compensation	\$200,000
Deduct market compensation for physician	\$150,000
Normalised EBITDA	\$225,000



Example (2/2)

- Normalised EBITDA: \$225,000
- Tangible assets: \$70,000
- Comparable multiple 2.5X to 3 X;
- Capitalisation rate 30% to 40%

- Value calculation:

	Low	High
Comparable company basis	\$562,500	\$675,000
Capitalised earnings basis	\$562,500	\$750,000
Asset basis	$70,000 + (2 \times 225,000) = \$520,000$	$70,000 + (2.5 \times 225,000) = \$632,500$
Average value	\$548,333	\$685,833



Goodwill

- Goodwill represents an intangible asset of a business. Includes value of the practice's brand/reputation, patient base, stable staffing, systems and procedures.
- Goodwill exists if the practice has a maintainable competitive advantage that generates above average profits that can be passed on to a new owner.
- That is, the practice profits exceed the amount that you can otherwise earn as a non-owner paying a management fee to a practice.
- No common basis for calculation; tends to be subjective.
- Necessary to demonstrate ability to produce an above average return for its owners.



Professional and practice goodwill

- Professional goodwill: attached to a particular doctor based on individual reputation, expertise, clientele.
 - Some factors: Age, health, abilities, skills, individual reputation, professional's referral base
- Practice goodwill: relates to a practice; is normally transferable and is based on reputation, clientele, location, systems, culture of the practice:
 - Some factors: location, size, firm reputation, profitability, source and recurrence of work, systems and organisation
 - Location goodwill is sometimes classified separately or could be included in practice goodwill
- Practice goodwill can be a contentious and disputable issue!!



Suggestions for managing practice goodwill

- Arrangements and processes for creating passive income without dependence on particular doctors (can be a double edged dagger if patients are keen on a specific doctor!)
- Stable and personable assistants and associates, who are able to operate at with minimal supervision and control (and who do not intend to, set up in competition in the same locality);
- Established relationships with allied health care professionals, such as physiotherapists, pathologists and chemists, ensuring the practice can provide a broad range of services.
- Clean modern premises that are easily accessible, have adequate car parking space and, preferably, a play area for children, with some form of entertainment for adults;
- Good location; and
- Specialist equipment, that has a high cost or market interest. This could create a barrier to entry for a particular type of procedure or treatment, thus bringing patients to this particular practice.



Summary

- Purpose
- Principles and standards
- Information
- Goodwill
- Focus on growing value
- Follow a plan!!

Questions and Sharing.....?



Thank You!!!