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The Role of Valuation in Physician/Hospital Arrangements

A Discussion of Key Considerations, Types of Arrangements and Practical Case Studies

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Presentation Overview

- I. The Role of Valuation
- II. Key Considerations
- III. Types of Arrangements
- IV. Case Examples
- V. Questions



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Hospital/Physician Relationships

- Hospitals and Physicians are involved in relationships for a variety of reasons including:
 - Need for professional services (both clinical and coverage) by the hospital;
 - Strategic alignment to increase market share;
 - Improved patient care, access and efficiency; and
 - Other unique or specific circumstances.
- Complexity of arrangements and compliance concerns have led to the need for qualified and knowledgeable advisors who thoroughly understand the increasing pressure on fair market value methodology and the use of fair market value analyses.



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Why Valuations are Needed

- Business Planning
 - Mergers/Acquisitions/Divestitures/Joint Ventures;
 - Buy-ins/Buy-outs;
 - Contractual Arrangements (Compensation, etc.); and
 - Litigation.
- Compliance and Corporate Governance
 - Regulatory: Fraud and Abuse, Stark, Sarbanes-Oxley, State Attorney General; and
 - Tax: Intermediate Sanctions, Inurement, Private Benefit.



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Valuation Implications

- Significant increases in number of situations requiring valuation analysis
- Valuation should be used more than it tends to be to facilitate the business issues/negotiations/compliance
- More creative/complex arrangements put pressure on existing data/methodologies – solved by combination of traditional valuation methodology and understanding of the operations and specific terms/nature of the agreements and applicable regulatory implications



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What a Valuation Doesn't Provide

- Coding Assessment
- Audit of Financial Information
- Legal Advice
- Transaction Due Diligence
- Note: Valuations typically rely upon data provided unless there is reason to believe that it is inaccurate.



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Standards of Value

- Fair Market Value
 - IRS Definition
 - Stark Definition
- General Market Value
- Investment Value
- Commercial Reasonableness



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Key Considerations

- Expectations vs. Reality
- Business vs. Regulatory Requirements
- Sources and Application of Data
- Complexity of the Transaction
- Types of Engagements
- Best Practices



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Expectations vs. Reality

- Preconceived/predetermined estimates of value can lead to disappointment, negative impact on deal and relationship
- Expectations of value must be reconciled with the reality of the situation and regulatory restrictions
- Valuation can become a negotiation point. Valuation conclusions may provide the boundaries within which to negotiate. Additionally, in the event both parties are privy to the results of the valuation, it may help to facilitate agreement upon a number.



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Business vs. Regulatory Requirements

- Valuation must take regulatory requirements into account when placing value (i.e. Stark, Anti-Kickback, group practice exception, private benefit & inurement, etc.) and must tie directly to the terms of the written agreement.
- Business requirements are often different from regulatory requirements.
- Business negotiation should occur within compliance parameters, with shared responsibility between client, legal and valuation advisors.



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Sources and Application of Data

- The source and quality of the information provided may have an impact on the valuation. For example:
 - Is the physician group willing/able to share individual physician historical and projected financial and other information? If not, what alternative methods are available for estimating the data?
- What benchmarks are most relevant and how many? Generally, conclusions based on single data sources are not the norm for most situations.



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Sources and Application of Data (continued)

- An understanding of the information is important. Considerations include:
 - In a compensation arrangement, is the physician a shareholder or a non-shareholder (or the equivalent, if employed) and are the services requested reflective of circumstances that clearly equate to one or the other? This may impact applicable benchmarking information.
 - In a practice acquisition transaction, what is the totality of the arrangement including post-acquisition compensation for all physicians involved?



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Complexity of the Transaction

- Complexity of the transaction may impact scope of valuation, length of time required for opinion and type of opinion provided.
- Formulaic compensation is often more complex than fixed fee arrangements. For example:
 - When the compensation is formulaic, there is often an array of possible compensation amounts to the group. What happens when there are extremes in productivity (either high or low)? Is there a ceiling or floor for payments? What impact does that have on fair market value?
 - Fixed fee arrangements are often a fixed payment in exchange for a given set of services. Therefore, the valuation analysis is generally simpler for fixed compensation than it is for formulaic compensation.
- The more complex the arrangement, the higher the likelihood of obstacles during valuation and the more important is valuation methodology.



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Types of Engagements

- Single-Client Engagement
 - Typically selected when valuation is to be used by one side vs. another in negotiations;
 - Can set the “ceiling” for the transaction (Different circumstances sometimes require “at fair market value” vs. “does not exceed FMV”); and
 - Sometimes challenging to obtain information from the other party (if valuation firm is engaged by the buyer).



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Types of Engagements (continued)

- Joint Engagement
 - May be used to set expectations of value for both parties during negotiations;
 - Can set the “ceiling” for the transaction; and
 - Sometimes challenging when the parties have differing expectations of value.



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Types of Engagements (continued)

- Under privilege
 - When valuation is to be used by one side vs. the other in negotiations;
 - When known or suspected compliance issues may exist;
 - When the review is retrospective;
 - Due diligence; and
 - Potential litigation.



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Types of Hospital/Physician Arrangements

- Acquisition/Divestiture
- Joint Ventures
- Professional Services Agreements
- Physician Compensation/Employment
- Call Coverage
- Administrative Services Agreements



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Acquisitions/Divestitures

- Pre-conceived expectations of the value of the entity (by either party) may be a stumbling block during the negotiating process.
- Terms of the deal may have impact on value
 - Assets and/or liabilities acquired
 - Is there a non-compete?
 - On-going role of seller after the transaction closes
- Subject company specifics may have impact on value
 - Risk profile
 - Post-transaction arrangements



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Joint Ventures

- It is important to understand what is being contributed to the joint venture and hence valued.
- Key questions to consider:
 - Is the value of the contribution to the joint venture consistent with the percentage of ownership?
 - How are future capitalizations of the joint venture going to be handled? Will it be consistent with ownership structure?
 - How will management duties be handled? If physician group will be paid for managing the joint venture, are the services at fair market value?
- Special attention should be paid to distribution of income and buy-in and buy-out provisions so that they adhere to compliance requirements.



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Professional Services Agreements

- Complexity of the compensation formula (particularly professional services agreements for a group of physicians) may have an impact on valuation of the agreement.
- When obtaining valuation of professional services agreements, consideration should be paid to:
 - Is the valuation of the compensation in the aggregate or at the physician level?
 - How are physician group expenses handled?
 - What is driving compensation? Productivity, as measured in wRVUs, net revenue or some other measure?
 - If comparisons to benchmarks are being made, has the valuation advisor constructed a benchmark group that is the exact make-up of the subject group or is he/she using general benchmark information?



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Physician Compensation

- Should physician compensation be based on local market rates or other methods? Basing compensation solely on local market rates may lead to a never ending upward spiral in compensation.
- Once a compensation amount is proposed to a physician, it is very difficult to ratchet that amount downward if the proposed compensation exceeds fair market value. Bringing valuation in early in the process may assist in setting expectations.
- What do you do if you have a very productive or a very unproductive physician? How do you stay within the bounds of fair market value?



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Physician Compensation (continued)

- In order to appropriately compare proposed compensation agreements to benchmark data, it is important to consider:
 - Are FTEs split appropriately between clinical and administrative FTEs (rather than being commingled together)?
 - Is the comparison against the correct benchmarks (i.e. are clinical benchmarks being compared to clinical subject data)?
 - Should any adjustments be made to benchmark data (time adjustments, regional adjustments, etc.).



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Call Coverage

- Compensation for call coverage is becoming more widespread.
- Rate should be dependent on whether coverage is “restricted” or “unrestricted”.
- Generally must take into account professional services provided while providing coverage.
- How should physicians be paid for administrative services provided while also on call or on site for coverage?
- Generally calculated using a combination of market data applied to the costs involved in providing the services.



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Administrative Services

- Now, less well defined how physician should be compensated for work performed with elimination of Stark safe harbor.
- Should there be a difference in payments for exact same work performed by a primary care physician vs. a specialty physician?
- Care should be taken to ensure that physicians are not “double dipping” – being paid twice for same work time (i.e. is a physician being compensated for providing on-site coverage AND receiving compensation for being a medical director simultaneously).



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Case Examples

- Expectations vs. Reality
- Fair Market Value vs. Investment Value
- Complexity of the Transaction



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Expectations vs. Reality

- Hospital acquiring specialty medical practice with significant ancillary revenue and profit on mid-level providers, which translates technically into significant goodwill
 - If hospital is not paying for goodwill, then physician compensation might take into account ancillaries to compensate physician-owners appropriately for reasonable time frame if legal requirements are met.
 - Can you compensate with consideration for ancillaries – group practice exception?
 - Shareholder vs. non-shareholder benchmark data?
 - If hospital is paying for goodwill, physicians must recognize that go forward compensation may not continue at historical levels that included returns for the risk of “ownership”.



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Fair Market Value vs. Investment Value

- Hospital acquiring a physician group owned ambulatory surgery center which directly competes with hospital surgery center.
 - Investment value could potentially include value specific to the hospital related to the removal of a competitor. Under the investment value premise of value, amount paid by hospital could be in excess of fair market value (goodwill).
 - Fair market value does not take into account a specific buyer. This premise assumes that a willing third party is purchasing the center. Is any value ascribed to the removal of a competitor?
 - Can fair market value include potential business generated by the physician group after the transaction?
 - Can fair market value include benefit that may be derived from change in payor contracts after the transaction?



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Complexity of the Transaction

- A Professional Services Agreement includes a compensation formula that is based on wRVUs for clinical services. The compensation amount paid per wRVU increases in tiers as productivity increases.
 - Key consideration is whether opinion is for the compensation in the aggregate for group's services or at the individual physician level.
 - Valuation advisor should determine the entire range of possible outcomes.
 - If opinion is to be for services in the aggregate, what happens when certain members of the group are unproductive and others are extremely productive? Does this cause compensation in the aggregate to rise above fair market value?



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Questions



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Who We Are

Sinaiko Healthcare Consulting, Inc. is a leading healthcare management consulting firm, assisting clients with mission critical assignments nationwide.

- Founded in 1990
- National practice; performed work in over 30 states and two foreign countries
- Serve academic medical centers, medical groups, health systems, IPAs, health plans and payors, with a particular emphasis on the provider side of the industry
- Service Lines:
 - Operational / Reimbursement Performance Improvement
 - Coding Audit
 - Compliance
 - Valuation and Transactions
 - Litigation Support
 - Strategic Planning



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Jeffrey E. Sinaiko

President

Mr. Sinaiko regularly addresses both broad strategic and highly detailed issues related to organizational structure, operations management, physician compensation/fair market value, regulatory compliance, and those encountered in facilitating complex transactions between for profit and not for profit entities. His clients include hospitals, health systems, medical groups, ancillary service providers and other healthcare provider businesses. He retains executive level oversight responsibility for Sinaiko's coding, compliance and reimbursement compliance services.

Mr. Sinaiko's specific and diverse activities have included serving as the lead advisor for the development of complex physician/hospital joint ventures; extensive physician compensation, fair market value and compliance work; testifying as an expert witness in a multi-million dollar Medicare Fraud action related to billing; leading the turn-around of a financially troubled hospital owned primary care group; facilitating the investment in an ancillary surgery center company; leading merger and acquisition due diligence teams performing detailed operational, reimbursement and financial due diligence; and performing the strategic analyses necessary for institutions to improve profitability, specific aspects of their operations or compliance and developing new business models.



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Managing Director, Valuation Services

Mr. Endicott is the Managing Director of Valuation Services for Sinaiko Healthcare Consulting. He is responsible for directing all aspects of the firm's valuation practice, including project administration, quality control, supervision of staff, client relations and business development.

Mr. Endicott is uniquely qualified to lead Sinaiko's valuation services practice. His experience both inside and outside of the healthcare industry at two global accounting/consulting firms provided him the vast experience necessary to grow Sinaiko's valuation advisory services business and to significantly enhance the sophistication of the valuation and business consulting the firm provides for its for-profit and not-for-profit clients.

Mr. Endicott joined the firm in 2004 after serving as an Associate Managing Director of Kroll, Inc., where he provided technical analyses, planning and project management for valuation engagements related to public and private companies. Prior to his position at Kroll, Mr. Endicott was a consulting manager for Arthur Andersen LLP, handling valuations of various business assets related to mergers, acquisitions, divestitures, joint ventures, tax planning, corporate reorganizations and financial reporting. At both companies, Mr. Endicott worked extensively with both for-profit and not-for profit clients in the healthcare industry.

Mr. Endicott earned his liberal arts degree from Lewis & Clark College and his MBA with an emphasis on finance from San Diego State University. He is a licensed Certified Public Accountant, accredited in business valuation, as well as an accredited senior appraiser.



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