CHAPTER 11

Buying or Buying into a Practice: What is an A/I Practice Worth?

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WHY VALUE A MEDICAL PRACTICE?

Medical practices have different values for different reasons, which are often based on **why** the dollar value of the practice is important.

There are many reasons to value a practice, including but not limited to:

- Sale/purchase of the practice (the reasons for which may vary)
- Merger with another solo, group, hospital or chain practice
- Buy-in of a new associate or pay-out to a retiring senior partner
- Divorce (the most common reason for valuation)
- Insurance and estate planning
- Economic damages in litigation
- Curiosity and strategic planning

For the purposes of this manual, this chapter will deal primarily with evaluating a buy-in offer from a group offering employment and with purchasing a practice.

VALUE IS NOT EXACT

You should know in advance that there is no perfectly accurate way to determine the value of a practice, regardless of whether you guess, or pay the most knowledgeable medical practice appraisers on the planet for their opinion. That is not to say that you cannot come up with a reasonably defensible working value that might be acceptable to an employer or a seller of a practice, or a buy-in or pay-out formula for a retiring senior partner or a courtroom. However, a **value** is an opinion, not to be confused with a **price**. Reasonable people can differ on their opinions of value, because they are using different assumptions.

Value is a concept based on judgment applied to a set of circumstances. It is an economic concept that sets it apart from price. Value is a creation of individual opinion. A practice can have a **value**, or **worth**, without a sales **price**. Value is determined; price is negotiated between two specific parties, each with their own unique situations and needs. Practice value depends on **why** the opinion of value is needed.

There are a number of **standards** (types) of value. The standard of value applied to a particular appraisal will be determined either by the requirements of law, such as in a divorce or estate proceeding, or by the preferences of the client and the appraiser. Some standards of value are fair market value, fair value,

investment value and intrinsic value. **Fair market value** is the standard most often used for buying or buying into a practice.

There are also different **premises** of value. A premise of value differs from a standard of value in that it identifies the assumption on which the appraisal reasoning proceeds, such as a fair market value under the **premise of a going concern**, or under the **premise of forced liquidation**. The optimal premise for viewing a particular set of assets depends on the purpose of the appraisal. If, for example, a prospective buyer wished to know the value of a target doctor's practice for purposes of buying and continuing the practice, he or she would be best served by an appraisal on the premise of a going concern. A lender who wanted to test the adequacy of the same practice as collateral for a loan would typically be interested in an appraisal based on a premise of liquidation.

A common statement made by employers is, "Come work for me for two to three years and I'll let you become a partner by just buying your share of the value of the equipment, with no payment for goodwill." It may sound like a tempting deal, but the reduced salary received during those two to three years may far exceed the worth of the ownership being offered. The reduced salary can be viewed as the equivalent of goodwill, and is described below.

Reasonable people can disagree on value. Valuation experts commonly disagree on the value of a practice. These discrepancies may be based on differing assumptions, standards or premises underlying the opinion; errors or bias (bias is a violation of appraisers' professional ethics, and it does occur). The valuation's basis should be clearly stated in the narrative text of the appraisal, and there should be no indecipherable "legalese" or "voodoo math." Appraisers are supposed to lay out clearly for the reader exactly how they reached their opinion, so any non-expert reader can follow the appraiser's assumptions, reasoning and mathematics. When valuing a practice on your own, you should do the same. The purpose of drawing your attention to the issue of underlying assumptions is that they are an important part of arriving at a value. For example, one important assumption in practice valuation is whether Medicare and other insurance reimbursement will increase or decrease in the future.

Most Owners Overvalue Their Businesses

Most business owners are proud of their businesses, whether they are medical practices or any other type of business. They have spent years of "blood, sweat, and tears" building it up and believe there is much value to that effort. The success of the business also may be a large part of the owner's ego. Most owners, therefore, have an opinion of the dollar value of their practice that is higher than the market's opinion, as represented by knowledgeable buyers. On the other hand, many physicians believe the gossip heard in the physicians' lounge at the hospital that proclaims that, "Medical practices no longer have value." Many buyers have a similar opinion, but it is not based on fact. A practice's value depends on many factors. Owning a practice that provides the owner $500,000 more in income per year than would similar employment elsewhere can represent true value to a potential purchaser. Determining the practice's worth is what the field of valuation is all about.

PRACTICE APPRAISAL — AN UNLICENSED PROFESSION

You might be surprised to know that medical practice valuation is not a licensed activity in most states (with Florida being the main exception), but laws change. Anyone can use the title "medical practice appraiser". For example, a general-business consultant or certified public accountant (CPA) may be approached by a physician who wants to find a new associate to join and buy into a practice. The CPA will apply the generalized valuation formulas used for other professional-services clients, such as in law, architecture, engineering or dentistry. The CPA may not know the difference between an A/I and an ENT practice, or be familiar with Stark law, proposed Medicare reimbursement reductions or ancillary services. The CPA may not be willing to spend $500 to buy an annual physician compensation report for normalization of market rate incomes, plus a $500 annual goodwill valuation report to do just one physician office valuation, which is often for free to their client. The resulting "appraisal" can therefore be grossly inaccurate and is usually overvalued, because most other businesses are worth more than a medical practice due to higher risks in medical practices. The owner then is likely to unfairly reject reasonable offers, believing that they are too low.

In short, the appraisal industry is unregulated, often uninformed about medical practices and has a number of charlatans and incompetents, as does every profession, so scrutiny of an appraiser's credentials and references is strongly recommended.

OVERVIEW OF A/I SPECIALTY VALUATION

When assessing the fair **market** value of a practice, you have to look at what the **market** is doing. Median annual income for allergists ranges from $280,00 median, depending on region, up to a 90th-percentile income of approximately $500,000, per various studies. Age of practice and build-up of a shots practice has impact also.

The "baby boomer" allergists are aging out of practice, with an inadequate supply of replacement physicians, just as patient demand is forecast to surge as a result of healthcare reform legislation. The effects of the physician shortage are quite regional, so location has a significant impact on salability if not hypothetical value. Virtually every rural area in America needs more doctors and can't attract them.

Note that an increasing demand combined with a shrinking supply does not mean an increasing value of practices, as it does with commodities. What it means is that it may often be cheaper to start a practice from scratch rather than having to buy one, which decreases the value of existing practices.

According to the American College of Physicians (ACP) and the Medical Group Management Association (MGMA) websites, the specialty of internal medicine (the source of most new allergists) is in crisis. The ACP "is concerned that the practice environment for those in medical practice has become so encumbered with regulation and practice hassles, at a time when reimbursement for care provided by physicians is declining, that physicians

are finding it increasingly difficult to provide care for their patients."

Furthermore, "Declining reimbursement, rising operating costs, increasing liability insurance costs, proliferating information technology tools and services, and the growing complexity of health care administration are the key environmental factors facing the medical group and health care industry," according to William F. Jessee, MD, FACMPE, recently the MGMA president and CEO. "Reimbursements from Medicare and private payors have not kept pace with annual increases in operating costs. It continues to be a major concern in every practice."

Because many insurance plans base their reimbursement on a percentage of Medicare, a reduction in Medicare reimbursement has wide-ranging impact for all physicians because of reduced projections of future income. Practice valuation is very dependent on forecasts of future income.

Practice value is at risk because of changes in Medicare and its attendant impact on most insurance plans. The reimbursement cuts planned in Medicare payments may once again be delayed, but the continuing trend of reimbursement is inarguably downward, not upward. Because income is a prime determinant of practice valuation, **especially income above the normal employed-physician earnings,** any reduction in gross income could seriously reduce the net income and goodwill value of many practices. It already is having an impact on current values because of the increased risk of future reductions in income.

Technology and advances in medicine and science also can impact practice value. For example, gene therapy or sublingual immunotherapy approval could impact patient health, reducing the need for shot therapies and related income. Electronic medical records, or EMRs, in many cases are shown to initially decrease productivity and increase costs, further eroding profits and therefore value. A local hospital/ACO buying up all the referrers can reduce income and value.

Implications for A/I Practices

The supply side of allergy practices for sale – and group practices seeking associates – will likely exceed the number of willing and able candidates, keeping the value of allergy practices low. The easier it is to start a practice from scratch, the less goodwill value remains in current practices for sale. On the other hand, successful practices with above-average income will be an attractive alternative to physician employment at lower wages with less autonomy.

The shortage of allergy physicians nationwide will likely make the costs of employing allergists increase and the sale of practices more difficult, resulting in a lowering of practice sale values.

How to Value a Practice

Appraisers usually will use more than one approach to value a practice, then attempt to reconcile the different findings. The three approaches are **income, market,** and **asset.**

The **income approach** values a practice by its earnings. Appraisers — and the Internal Revenue Service, or IRS — typically prefer the income approach to valuation. There are different methods to do this, and different income streams that can be

used, but an overly simplified example is to total all the income and personal benefits to the owner, subtract the market-rate compensation for the owner's actual labor and then value the remainder as a "dividend." For example, an allergist with a benefit stream of $500,000 for a 40-hour workweek that would pay $310,000 by employment would have a dividend of $190,000 ($500,000-$310,000). That $190,000 would be a benefit of ownership, so the appraiser attempts to identify what amount of investment would be required to yield that dividend. Most allergy practice sales now reflect pre-tax returns of ≥60%, so $190,000 would represent a 60% annual return (a "cap" rate) on an investment of approximately $316,000 as the value of the practice. Medical practice purchases are risky investments and demand high returns. This is why practices with low income have little to no value above the "eBay" value of the assets if they earn no dividends for the owner. A typical buyer would not buy a practice that earned them less than would a "job." A common error made by general appraisers when valuing a medical practice is to use the wrong cap rate or wrong income stream, resulting in inflated opinions of value. The identified pre-tax rate of return may sound high until compared with alternative investments available to buyers willing to take comparable risks. For example, it is not unusual to see capitalization rates of 20–35% for pre-tax earnings after owner compensation for professional practices not subject to Medicare or insurance company reimbursement, denials or clinical malpractice risks, such as accounting, law, architecture and engineering. Medicine is far riskier, and demands a higher return.

The **market comparison approach** evaluates a practice by comparing it to other practices that recently have sold. The difficulty lies in trying to find dependable facts on those other practices. One common method is to separately value the tangible and intangible "goodwill" assets, and add them together to find the value of the entire practice. This is wrong. Goodwill is what is left after the value of tangible assets is subtracted from the total value. The national Goodwill Registry tracks the value of intangibles, variously described as goodwill or inclusive of goodwill, in medical practice sales and buy-ins across the country, and maintains the largest database available on these statistics. However, data on fewer than 30 allergy practice transactions are available for the past 10 years.

On close scrutiny, we find that the mere application of the median or average goodwill value of the past decade's transactions to gross revenues has minimal relevance to a specific practice situation. It is erroneous to think that the current business value in a market that has fallen has the historic average or median value. For example, using the stock market as an illustration, a stock whose value has fallen from $10 to $3 over the past decade currently does not have the average or median value of around $6; it has a current value of $3. As an extreme example for illustration, when blindly applying a median goodwill: revenue ratio of 25% to two practices, each with $1,000,000 in collections, with one being a well-managed cash practice in an excellent location with a $500,000 profit, and the other being a poorly-managed Medicaid practice in a terrible location with a $100,000 loss, both yield the same goodwill value, which is clearly illogical. **It is earnings (dividends) that are preeminent in identifying value in businesses**, as previously discussed. The Goodwill Registry reports earnings as seller's discretionary earnings (SDE), which includes

the owner's compensation for labor. **This provides a different perspective than that available in the income approach, which excluded compensation for labor in finding dividends**. Using SDE is still not as good as using "dividends," inasmuch as an underperforming practice with no dividends might still yield a "value"— that is, a SDE theoretic value when the overall 10-year average ratio is applied to it.

It is unfortunate that more allergists do not report their transactions to the Registry to make it more statistically relevant. If you have a transaction (sale or buy-in) to report, you can contact the author via email at KBorglum@PracticeMgmt.com for details.

The terms "goodwill" and "intangible value" often are used interchangeably, but they can have different meanings under valuation theory. The value of intangibles can include a favorable location, going-concern value, use of the seller's name, favorable leasehold, a covenant not to compete, compensation for past managerial and entrepreneurial services, patient lists, credit records, patient care contracts and employee contracts, as well as assignment of future income from the practice. On the other hand, the Small Business Administration, which guarantees loans made by banks to businesses (as in practice purchases), has its own different definition of goodwill, as "the value left over when subtracting tangible asset values from the price."

Due to the limited number of comparable reported sales, and lack of underlying data, there is no good rule of thumb to use in the market approach. The formula of **X percent × collections** is worthless, and **X percent × SDE** is not much better.

The **asset approach** rarely is used to value allergy practices, because allergy practices are not asset intensive, as opposed to radiology, for example. This approach does pertain to average or underperforming practices with low income, when the value of the tangible assets is worth more than the business income stream. For example, an allergy practice with $100,000 worth of assets, with income less than employment (i.e., no dividends), would have the highest value using the asset approach. When using the asset approach in valuing an allergy practice for purchase or buy-in, you might want a current inventory of pharmaceuticals and immunologicals as of the date of transaction, due to seasonal fluctuations and to avoid "spend-down" by the seller.

A **reality check** on the value of a practice is that the purchase should pay for itself in five or fewer years, using earnings for labor exceeding comparable employment.

Appraisers should follow expert scientific methods accepted by the professional appraisal associations, but some appraisers do not, and appraisal-report quality varies significantly. A valuation report from an appraiser specializing in medical practices and following standards of the Institute of Business Appraisers or the American Society of Appraisers; Uniform Standards of Professional Appraisal Practice or other professional standards should give the best result, if they understand the risk and cap rate factors. However, it is still just one person's opinion.

A number of books (including one by the author of this chapter) go into this topic in much greater detail and are listed in the references section.

DISCOUNT FOR LACK OF CONTROL BY A MINORITY SHAREHOLDER

A minority interest – as in a buy-in – in a business does not have control, as does a majority interest, resulting in a question of a discount for a lack of control (DLOC). A DLOC is applied for the lessened ability of a shareholder with 50% or less ownership of the company. When a shareholder has 50% interest, either person can block the action of the other shareholder(s) but cannot force an action with the voting rights of their shares. When a shareholder has less than 50% interest, the other majority shareholder(s) owning more than 50% can force their will on the minority shareholder. Decisions subject to control include compensation for individual physicians; employment and pay scale of family or others; election of directors and officers; appointment of management and the powers of management; acquisition or sale of assets; relocation; payment or allocation of profits and dividends; incurring debt and even sale of the company. Other factors having impact are commonly described as senior doctor rights (SDR). For example, a seller transferring 50% ownership to an associate might stipulate that the seller retains the practice lease and phone number in event of dissolution; or retains all the practice medical records and a job for the seller's spouse as manager; or requires a noncompetition agreement of the buyer; or doesn't have to take call or has a tie-breaker vote or veto; or gets the pick of new patients. The ability to exert control over SDR is of monetary value, and the inability to have control reduces monetary value. This is the basis for the DLOC. The most important issue in regard to the value of the ownership is the control of profit or dividends. The larger the number of shareholders — and the more equitable the language in physician employment and governance contracts — the less likely a DLOC is appropriate, because control is limited contractually. A typical DLOC often ranges between 20% and 40%. So if the whole practice is worth $100,000, 40% might be worth only $24,000.

There is no firm rule as to the use of, or lack of, a minority discount, but the valuator must consider it within the context of various agreements among the owners as well as the prospects for future distributions of cash. Although it would be most accurate to do an extensive and in-depth evaluation of governance and contractual factors, for simplicity in limited reports I apply a 35% discount on <50% ownership, and 10% discount for 50% ownership, considering that a 50% ownership is much more desirable with more control than any lesser "true" minority ownership interest. My rationale is that if the average discount for a minority interest is approximately 35%, a 50% ownership interest is more than twice as desirable and should have significantly less than a 17.5% (half of 35%) discount; hence a 10% discount.

VALUE VS. PRICE

Practice **value** should not be confused with **price**. Value is determined; price is negotiated. Price refers to the amount the practice sells for. Successful negotiation between two individuals, each with their own perceived value regarding the transfer of a practice, results in a price.

In a practice transaction, price is negotiated under specific circumstances by a given buyer and a given seller, each with a personal motivation. To estimate value, an appraisal professional makes assumptions

regarding these factors. Encapsulated in standards of value and premises of value, these assumptions significantly affect an appraiser's findings.

Think of an appraisal as being similar to what Kelly Blue Book says a used car is worth. If it's the car you always wanted, in the perfect color, and right in front of you, you certainly might pay more than KBB's appraisal. For example, if it is the only way into a community in which you must live because of family or other personal reasons, you might be willing to pay a price more than fair market value, or more than other candidates are willing to pay, for a practice.

SUMMARY

In most buy-ins, pay-outs, and practice sales, both the buyer and seller of a medical practice are interested in the **fair market value under the premise of a going concern**, which means the value of the practice if operated in a normal and customary basis without an interruption of income due to the transfer of ownership. Negotiation between those parties results in a price that might differ from value.

What is an A/I practice worth? An exact answer may be impossible to identify, but a reasonable answer can be found that makes sense in a given set of circumstances.

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