What's My Center Worth?

A practical guide to understanding ASC valuations

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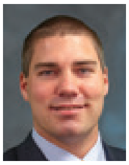

ASC transactions continue to be a hot trend in the health care mergers-and-acquisition arena for several strategic reasons. While an organization's motivation for buying or selling interests in an ASC will vary, common catalysts remain the same: i) a hospital's desire to purchase an ownership interest in a local ASC, ii) a large, for-profit organization's desire to purchase a majority interest in an ASC as part of its strategic plan, iii) a large, for-profit organization's desire to purchase a minority interest in an ASC as part of its strategic plan, and iv) a physician's desire to sell a minority interest due to retirement or relocation.

Following an organization's decision to purchase or sell an ownership interest in an ASC, obtaining a fair market value (FMV) appraisal of the ASC is a logical next step. Most health care transactions are consummated at FMV to ensure regulatory compliance. While simply applying a multiple of revenue or earnings before interest, taxes, depreciation, and amortization (EBITDA) might be an efficient and time-saving method for estimating the purchase price, a sound fair market value appraisal by an independent third-party valuation firm will address many quantitative—i.e., normalization adjustments to revenue and/or expenses—and qualitative—i.e., the ASC's risk profile—factors that should be considered and accounted for when appraising a business. It is advantageous to both parties that an independent valuation is obtained to defend the parties' motives and purchase price.

The Valuation Process

Three approaches are commonly used to value any asset. The "asset (cost) approach" is based on the anticipated cost to recreate, replace or replicate the asset; the "income approach" is based on the economic benefits anticipated to be derived from the asset; and the "market approach" is based on transaction data involving similar assets or services.

Additionally, there are multiple methodologies that fall under one or more of the above valuation approaches. The appropriateness of utilizing one or more valuation methodologies will depend upon the specific facts and circumstances of the asset being valued. However, multiple methodologies should be utilized to the extent possible and the results reconciled and/or weighted for purposes of determining the final conclusion of value.

ASCs are, typically, valued using the income approach and the market approach. The cost approach is not typically utilized in valuing ASCs given that an ASC has a significant portion of intangible value that will not be captured in the value of the ASC's tangible assets. As previously mentioned, a simplified way to think about the valuation of an ASC is as a multiple of EBITDA. Non-controlling interests in ASCs, typically, are appraised at three to five times EBITDA, while controlling interests, typically, are appraised at five to eight times, depending on the growth prospects and risk factors associated with a specific center.

The Income Approach

Operating Expense Adjustments

Certain operating expenses on an ASC's income statement need to be analyzed for potential normalizing adjustments before projecting future operating expenses. Any adjustments made to operating expenses must be applicable to any potential buyer (i.e., a specific buyer cannot be taken into consideration in an FMV context). Some typical operating expense adjustments include, but are not limited to:

- Facility rent expense—The rental rate per square foot for an ASC may not be consistent with local market rates. Research should be performed and normalization adjustments should be made if the ASC's rental rate varies from the local market.

- Management fees—Many ASCs pay a management fee to an outside company to perform day-to-day management functions of the center. These fees typically range from 5 percent to 8 percent of net revenue. If a particular ASC's historical management fee expense is below or in excess of this range, a normalization adjustment might be warranted.
- Billing fees—ASCs can outsource their billing and collection functions. These fees, structured similarly to management fee arrangements, typically range from 4 percent to 6 percent of net revenue. Historical billing and collection costs should be analyzed and adjusted if outside of this range.
- Personal, discretionary and one-time expenses—These costs should be eliminated. Examples include personal automobile expense, discretionary charitable contributions and one-time consulting or repairs expenses.

Projecting Revenue

The most commonly used method for valuing ASCs is the "discounted cash flow (DCF) method." Revenue projections are typically constructed on a revenue-per-surgical-case basis. Important factors that influence volume include capacity, case mix, local demand for services and competition. Additionally, factors that influence reimbursement include payer mix, contract renegotiations and case mix shifts.

ASC capacity usually can be estimated based on average time per case or maximum cases per day divided by operating hours or days per year. Consideration should be given to the specific ASC's case mix. For example, a center with a high concentration of pain management cases, which are less time-intensive than cases in other specialties, will be able to accommodate more volume than a center of the same size that has a high concentration of

orthopedics cases. As long as case volume remains below capacity, volume growth is typically a function of local demographics and competition. Consideration should also be given to the specifics of certain physician-users, i.e., a high volume-producing physician is nearing retirement, etc.

Growth in revenue per case is typically a function of payer mix. Absent other mitigating factors, annual reimbursement growth for governmental payers such as Medicare and Medicaid typically ranges from 0 percent to 2 percent. Commercial payer reimbursement growth tends to be a bit higher and could range from 2 percent to 4 percent annually. Projected reimbursement per case should be weighted by each payer's estimated reimbursement growth and each payer's percentage of the ASC's total charges. Aside from payer mix, other factors can affect reimbursement projections. ASCs periodically renegotiate their commercial payer contracts, and those negotiations can result in higher reimbursement. Multispecialty ASCs might also make efforts to shift case mix toward more complex cases, which can result in faster increases in revenue per case.

Projecting Operating Expenses

ASC operating expenses primarily consist of staff salaries and wages, medical supplies, billing and collections, management fees, and facilities and equipment. Variable expenses, such as medical supplies, are a function of volume or revenue and should be projected as such. Meanwhile, predominately fixed expenses, such as staff wages and facilities and equipment, typically increase at inflationary rates. Careful consideration should be given to volume projections and the effect volume has on staff wages expense, because a significant projected increase in case volume would likely merit an increase in an ASC's staffing to accommodate the additional volume.

As previously stated, individual operating expense items such as rent, management fees and billing fees, should be analyzed and adjusted, if necessary, to ensure they are consistent with fair market value. Further, total operating expenses—typically as a percent of revenue and per surgical case—also should be compared to applicable benchmark data to ensure the overall projections make sense relative to other ASCs. When possible, specific benchmark data should be used to ensure that the ASCs included in the benchmark data provide a valid comparison to the ASC being valued since factors such as number of ORs, case volume and case mix can impact an ASC's expense structure and average cost per case.

Risk Factors and the Discount Rate

After making adjustments to historical operating expenses, projecting ASC revenue and operating expenses, and making adjustments for certain items such as capital expenditures and changes in net working capital, the valuator discounts projected future cash flow to present value using a discount rate. A discount rate measures the degree of risk associated with the ASC's projected future cash flows. Discount rates have an inverse relationship with value: the higher the discount rate, i.e., more risk, the lower the value and vice versa. Important risk factors to consider when developing an appropriate discount rate for an ASC include:

- concentration of volume by referring physician;
- case mix by specialty;
- existing payer mix and potential changes;
- recent and potential regulatory changes;
- state certificate of need (CON) regulations; and
- current and potential future competition.

The Market Approach

When valuing an ASC, the indication of value from the income approach should be supported using the market approach. There are two methods utilized under the market approach when valuing an ASC: the "guideline public company (GPC) method" compares the subject ASC to public guideline companies, and the "mergers-and-acquisition (M&A) method" compares the subject ASC to historical privately held ASC transactions. There are usually large differences between the subject ASC and the guideline companies and transactions, and valuation adjustments are necessary to help mitigate the impact of these differences. For example, publicly traded companies are significantly larger than a single center and, therefore, an adjustment to the valuation multiple is required upon analysis of factors such as revenue, EBITDA and number of employees. An adjustment to derived valuation multiples will likely be required when utilizing the M&A method as well. Adjustments for future growth expectations and identifiable risk factors should also be considered.

Subsequent to the development of adjusted valuation multiples, the multiples must be applied to the subject ASC to arrive at an indication of value. Multiples of EBITDA and revenue are commonly used. EBITDA multiples are generally more appropriate than revenue multiples when developing indications of value for ASCs because EBITDA is a better measure of the economic benefit that a potential investor could expect. Revenue can be a misleading valuation metric due to substantial profit margin variation between companies in the industry.

Value Reconciliation

Upon developing multiple indications of value from various methodologies, the values must be reconciled. In most cases, a properly applied discounted cash flow (DCF) analysis is the most reliable indication of value because it is based on the economic benefits a hypothetical investor could expect to receive. Although the market approach is useful for reasonableness purposes, it is generally not relied upon as the primary method for the following reasons:

- EBITDA multiples are a relatively imprecise method of measuring future economic benefits;
- a significant number of differences usually exist between GPCs and the subject ASC, and adjustment methodologies are imprecise; and
- the underlying transaction data utilized in the M&A approach is often unreliable.

In Conclusion

Whether your organization is contemplating buying or selling interests of an ASC, we suggest obtaining an FMV appraisal of the ASC. An appraisal performed by a professional firm will ensure that all valid methodologies are appropriately applied and that the level of risk is diligently assessed. In an era of high volume ASC transactions, considering and applying the financial statement adjustments and valuation methodologies discussed here is a prudent business decision for buyers and/or sellers of ASCs. «

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