

PATHOLOGY PRACTICE VALUATION FUNDAMENTALS

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HAVERFORD HEALTHCARE ADVISORS

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Overview

- I. Why Value a Pathology Practice Anyway?
- II. Three Basic Approaches to Valuation
- III. Valuation of a Minority Interest versus a Controlling Interest
- IV. Valuation Continuum
- V. Factors That Influence the Value of a Pathology Practice

I. Why Value a Pathology Practice Anyway?

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- Admission of new pathologist partner
- Buy out of retiring pathologist partner
- Merger with another practice
- Outright sale of the practice
- Litigation (involuntary termination of partner, divorce, etc.)

I. Why Value a Pathology Practice Anyway? Reasons for Hiring Pathologists Over Two-Year Period

Reasons for Hiring	2000(a)(b)
New Position	50%
Replacement for pathologist leaving	65%
Replacement for pathologist FT to PT	13%
Locum tenens position	6%
Merger	2%
Other	2%

(a) Percentage of pathologists *reporting that a pathologist was hired*

(b) Total exceeds 100% because multiple responses were allowed

Source: 2000 Practice Characteristics Survey Report - CAP

I. Why Value a Pathology Practice Anyway? Pathologist Resignation From Group Over Two-Year Period

Number of Resignations	2000(a)
One or more resignations	52%
No resignations	44%
No answer	4%
Total	100%

(a) Percentage of pathologists *in group practice*.

Source: 2000 Practice Characteristics Survey Report - CAP

I. Why Value a Pathology Practice Anyway? Reasons for Pathologist Resignations Over Two-Year Period

Reason for Resignation	2000(a)(b)
To take another pathology position	51%
Left the practice of pathology	11%
Retirement	49%
Termination	14%
Death	3%
End of locum tenens work	4%
Other	5%

(a) Percentage of pathologists *reporting that a pathologist had resigned.*

(b) Total exceeds 100% because multiple responses were allowed

Source: 2000 Practice Characteristics Survey Report - CAP

I. Why Value a Pathology Practice Anyway?

Pathology Practice Transition Issues

The **admission** and **retirement** of pathologists to/from pathology group practices occurs with greater frequency than many may realize.

These practice transition events are among the most divisive events that a pathology practice encounters.

Differing opinions about the **valuation** of a pathology practice and methods of **equity and compensation distribution** are at the heart of the conflict.

I. Why Value a Pathology Practice Anyway?

Pathology Practice Transition Issues

- Retiring pathologists are increasingly less willing to accept traditionally low buy-outs.
- Young pathologists can not afford to buy into to a pathology group practice at market valuations.
- Incumbent pathologists use practice equity to entice young pathologists to join their practice with neither party to the transaction understanding the value of the equity interest that is being exchanged.
- Practice political and cultural factors, as well as reliance upon past methods of handling transition issues, usually drive the decision making process.

II. Three Basic Approaches to Valuation

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Three Basic Approaches to Valuation:

- The Income Approach (the Discounted Cash Flow Approach)
- The Market Approach (the Public Market Comparable Approach and the Comparable Acquisition Approach)
- The Cost Approach

II. Three Basic Approaches to Valuation

- The Discounted Cash Flow Approach
 - Project the Net Revenues to Be Generated by the Company
 - Project the Expenses Associated With That Net Revenue Stream, Analyzing the Variable / Fixed Nature of Various Expenses, Excluding Interest Expense
 - Subtract the Expenses and Income Taxes From the Net Revenues to Obtain Net Income

II. Three Basic Approaches to Valuation

- The Discounted Cash Flow Approach (cont'd)
 - Convert the Net Income to Cash Flow by Adding Back Depreciation, Subtracting Capital Expenditures, and Subtracting Increases in Working Capital, but Not Subtracting Principal Payments
 - Discount the Forecasted Debt-Free Cash Flows Back to Present Value, Thereby Accounting for Both the Time Value of Money and Forecasted Risks, Yielding Total Consideration

II. Three Basic Approaches to Valuation

- The Discounted Cash Flow Approach (cont'd)
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

II. Three Basic Approaches to Valuation

- The Public Market Comparable Approach
 - Identify Publicly Traded Comparable Companies
 - Analyze the Financial and Operating Performance of the Public Companies
 - Analyze How Investors Are Pricing the Public Companies, and Why

II. Three Basic Approaches to Valuation

- The Public Market Comparable Approach (cont'd)
 - Make Inferences About How Investors Would Price, or Value, the Subject Company Through the Utilization of Various Ratios Such as:
 - Market Value of Total Capital / Net Revenue
 - Market Value of Total Capital / Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA)
 - Market Value of Total Capital / EBIT
 - Market Value of Equity / Book Value of Equity

II. Three Basic Approaches to Valuation

- The Public Market Comparable Approach (cont'd)
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

II. Three Basic Approaches to Valuation

- The Comparable Acquisition Approach
 - Identify Acquisitions of Comparable Companies
 - Analyze the Financial and Operating Performance of the Acquired Companies
 - Analyze How Buyers Are Pricing the Acquisitions, and Why

II. Three Basic Approaches to Valuation

- The Comparable Acquisition Approach (cont'd)
 - Make Inferences About How Buyers Would Price, or Value, the Subject Company Through the Utilization of Various Ratios, Such as Multiples of Net Revenue, EBIT and EBITDA
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value
 - The Comparable Acquisition Approach is Typically Only Utilized to Value 100 Percent Interests

II. Three Basic Approaches to Valuation

- The Cost Approach
 - Adjust Assets and Liabilities, Both On- and Off-Balance Sheet, to Market Value
 - Difficult to Identify and Value Intangible Assets, Such as Customer List and Goodwill; Therefore, the Cost Approach Tends to Undervalue a Company

II. Three Basic Approaches to Valuation

- The Cost Approach (cont'd)
 - The Theory is That a Company Utilizes its Entire Bundle of Assets, Including Tangible Assets, Working Capital, and Intangible Assets, to Generate the Primary Driver of Value: Cash Flow
 - Therefore, the Cost Approach is Typically Only Utilized to Value Holding Companies (i.e. Non-Operating Companies) or Companies Which Should Be Liquidated

II. Three Basic Approaches to Valuation

Cost Approach

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**Market / Income
Approach**

**III. Valuation of a Minority Interest versus
a Controlling Interest**

III. Valuation of a Minority Interest versus a Controlling Interest

- Value Indications Must Be Adjusted for Factors Related to:
 - The Size of the Interest Being Valued (Minority v. Majority Interest)
 - On a Per Share Basis, an Investor Would Be Willing to Pay More for a Share of a Controlling Interest Than for a Share of a Minority Interest Holding

III. Valuation of a Minority Interest versus a Controlling Interest

- Control of daily operations
- Control of cash distributions
- Control of strategic direction
- Control of professional philosophy
- Control of liquidity events

III. Valuation of a Minority Interest versus a Controlling Interest

- Create Historical Pro Forma Cash Flow Statement
 - Typical Adjustments
 - Excess Physicians' Compensation
 - Real Property Lease
 - Non-Recurring Expenses

III. Valuation of a Minority Interest versus a Controlling Interest

- Typical Adjustments (cont'd)
 - Other Personal or Discretionary Expenses on the Books of the Company
 - Automobile Leases
 - Compensation and Perks to Family Members
 - Discretionary Types of Insurance Coverage
 - Discretionary T&E and Club Dues
 - Discretionary Retirement Contributions

Practice Valuation Model (Controlling Interest)

Valuation Calculation	<u>Status Quo</u>	<u>Adjusted</u>
Net Revenue	\$ 3,000,000	\$ 3,000,000
Physicians' Compensation	2,300,000 (a)	1,300,000 (a)
Non-Physician Operating Costs	<u>700,000</u>	<u>700,000</u>
Total Expenses	\$ <u>3,000,000</u>	\$ <u>2,000,000</u>
EBIT (Earnings Before Interest & Taxes)	\$ 0	\$ 1,000,000
Purchase Price: EBIT		\$ 1,000,000
Purchase Multiple		<u>x 5.0</u>
Total Purchase Price		\$ 5,000,000

(a) Analysis of compensation

per pathologist	Partners (5)	\$ 400,000	\$ 200,000
	Associates (2)	\$ 150,000	\$ 150,000

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EBIT (Earnings Before Interest & Taxes)	\$ 0	\$ 1,000,000
Purchase Price: EBIT		\$ 1,000,000
Purchase Multiple		<u>x 3.0</u>
Total Purchase Price		\$ 3,000,000

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IV. Valuation Continuum

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IV. Valuation Continuum

Low Valuation

High Valuation

Low ----- Retiree Satisfaction ----- High

High ----- Practice's Ability to Recruit ----- Low

High ----- New Pathologist's Income Level ----- Low

Low ----- Financial Risk to Borrower ----- High

Minority Interest

Controlling Interest

IV. Valuation Continuum

Lowest Value Per Share

Point A: Net asset value as determined via a cost approach

Point B: Minority interest value (equal to net asset value plus goodwill value)

Point C: 50 percent interest value

Point D: Controlling interest value (equal to net asset value plus goodwill value plus control value)

Point E: 10 percent interest value

Highest Value Per Share

IV. Valuation Continuum

- Additional Considerations
 - Valuation Continuum
 - Tail Protection Provisions
 - Tiers of Equity
 - Tiers of Entities

**V. Factors That Influence the Value
of a Pathology Practice**

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Internal Factors:

- Growth Potential / Historical Growth Rate
- Size (revenue, EBIT, number of pathologists)
- Profitability
- Stability / Reputation
- C-Corporation vs. S-Corporation vs. Partnership vs. LLC
 - Objective is to achieve capital gain treatment for sellers
 - Buyers prefer to buy assets

V. Factors That Influence the Value of a Pathology Practice

Internal Factors (cont'd):

- Composition of Revenue
 - Part A vs. Part B
 - Hospital vs. Non-Hospital sources of revenue
 - Client Bill vs. Third Party Billing
 - General AP vs. Sub-specialty
 - Professional Only vs. Global
- Sustainability of Revenue
- Billing Compliance
- Verifiability of Financial and Operating Data

V. Factors That Influence the Value of a Pathology Practice

Internal Factors (cont'd):

- Hospital Contract Terms
 - Exclusivity
 - Term and termination provisions
 - Compensation
 - Change of control
 - Quality of relationship with administration
- Depth / Composition of Staff
 - Age and number of pathologists
 - Sub-specialty pathologists
 - Quality of management personnel

V. Factors That Influence the Value of a Pathology Practice

Internal Factors (cont'd):

- Level of Working Capital or Net Asset Value to Be Delivered at Closing
 - A Business is a Bundle of Assets Which Are Used Together to Generate a Cash Flow Stream; Included in This Bundle Are Tangible Assets, Intangible Assets, and Working Capital

V. Factors That Influence the Value of a Pathology Practice

External Factors:

- Opportunities for the Buyer, (i.e. “Synergies”)
 - Revenue Growth from Existing Clients
 - New Marketing
 - New Services and Offerings
 - Subsequent “Fold-In” Acquisitions
- Timing - Seller’s Market

Haverford Healthcare Advisors

Haverford Healthcare Advisors specializes in providing valuation, merger and acquisition, and corporate finance advisory services to healthcare companies, with a specific focus on pathology practices and clinical laboratories. We represent and assist physicians and other healthcare company owners during the process of selling their practices, during the process of merging or partnering with other practices or companies, or during the process of growing through acquisition. We also provide practice valuation services, typically in connection with practice transition issues such as admitting new partners, retiring existing partners, and related matters.

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