

The Ins and Outs of Medical Practice Valuation

There are many reasons why it's important to know the worth of your practice.

BY JON HULTMAN, DPM, MBA



Why would you want a valuation of your medical practice? Regardless of whether you are working as an employee or as an equity partner in a private practice, medical group, or some other entity, you are working in a business, and businesses have value. Knowing that value is essential for 1) anyone negotiating a buy-sell agreement, 2) associates who want to “buy-into” practices and become partners, 3) owners who want to be bought out upon retirement—given that one-third of practicing doctors today are over age 55, “exit strategies” are becoming increasingly important, 4) doctors who want to merge their practices and form groups, and 5) doctors who are being courted by medical groups, hospitals, or other entities in an effort to acquire their practices.

How much is a business worth? The standard business school response to this question would be, “it

depends.” Determining the value of a medical practice does not follow an exact science; however, the valuation process has become more scientific and objective over the years. The fact that medical practices are closely held businesses makes them challenging to evaluate. Unlike public companies that have readily available detailed

financial statements, owners of privately held companies are likely to include “non-operational” expenses, which may be over-paid (or

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and audited financial information which makes it possible to compare, closely held businesses—simply because they are “private” and are not as scrutinized and regulated—do not have this type of information as available.

If you were an investor interested in purchasing a privately held busi-

ness, you would face a significant challenge in trying to determine the fair market value for that business even if you were provided with all of its “detailed” financial statements. This is because the financials of privately held companies are likely to include “non-operational” expenses, which may be over-paid (or

Continued on page 128

service businesses—especially those where only the one or two owners provide the majority of the actual services—are especially difficult to value because the owners' personal abilities and skills may be difficult to compare with others in similar businesses, and new owners are likely to have a different set of unique skills. This hampers the ability to determine the owners' "replaceability." Although the process can be difficult, there is one by which privately held companies can be objectively valued. This process initially requires the "normalization" of financial statements, making it possible to compare any business with similar businesses. This comparison assists in determining relative value and risk-adjustments—taking into account the various risks associated with a continuation of a business' profitability.

Assets

The source of a business' value is its assets. If one were able to identify all assets of a medical practice and determine their value, the value of that practice as a whole could be found by simply totaling the values of all these assets. The difficulty with this process is that assets are both tangible (such as equipment and accounts receivable) and intangible (such as "goodwill" and control). Identifying and valuing tangible assets is relatively easy—involving little emotion. Valuing intangible assets, however, is much more difficult. The parties involved in any practice negotiation will generally come to a quick agreement on the value of the tangible assets, but there is often a wide gap in their perceptions of the value of intangible assets. Physicians are familiar with the term "goodwill," but few fully understand what this means or how it is measured. Since goodwill—an intangible asset—is often the main source of value in any profitable business (including a medical practice), a better understanding of how its value is determined can help reduce the emotion involved in the valuation process and narrow the gap in perceived value among all parties involved in negotiations.

Interestingly, prior to 1920, busi-

nesses typically sold strictly for the value of their tangible assets; few recognized that a business also had intangible ones. Prohibition brought the concept of intangible assets to light because taxpayers needed a way of determining the amount of value they had lost due to losses from changes in the alcoholic beverage industry. The IRS published Appeals and Revenue Memorandum 34 (ARM 34), which basically stated that goodwill exists if a business has "excess earnings" and

asset sells for a higher price than its fair market value). As when selling any type of business, regardless of the dollar amount determined to be that business' "actual value," the final sale price of a medical practice is what the buyer is willing to pay (which, in turn, is influenced by any alternative opportunities open to him/her) and what the seller is willing to accept (which is determined by the degree to which the purchase price and terms of the sale meet his or her long-term

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that the value of goodwill can be determined by capitalizing these excess earnings. Excess earnings are defined as the earnings of a business that are above the norm of companies of similar activity and size. We will discuss this in more detail later, but we will see that "goodwill" and "earnings" are closely related and that earnings above a certain point are more valuable than those below that point. Determining the actual amount of excess earnings (goodwill) and the risk associated with their continuation into the future are at the heart of the valuation process and the subsequent negotiations for determining a business' ultimate selling price.

Valuation and Sale Price

It is important to understand the difference between a valuation and an actual sale price. A business sale is based on its fair market value, which the IRS defined in Revenue Ruling 59-60 as follows: "The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." Fair market value is one of the three "Standards of Value," which also include fair value (applied when a minority owner may be an "unwilling" seller), and strategic value (when an

goals). Neither of these factors may necessarily correlate with the practice's "actual" value, but this is the reality of medical practice "buy/sell."

Practices with similar gross or net revenues can vary widely in value. The following are some of the factors that can impact value and, in turn, the selling price: office location, office appearance, condition of office equipment, diversity of the practice's referrals, the doctor's reputation in the community, historical payer and procedure mixes, population trends, the transferability of managed care contracts, the degree of training of the practice workforce, the practice's revenue and new patient growth rates, the physician's compensation relative to those in the local area and the industry as a whole, the amount of "excess" cash flow or earnings in the practice (beyond salary) that are available for distribution, the cost of living in the area surrounding the practice, the practice's fee range and billing procedures relative to the usual and customary fees, the amount the practice has invested in a certified electronic health record product and/or digital x-ray, and the level of risk associated with the profitability and excess cash flow of the practice continuing into the future. Individual negotiating parties are likely to give each of these factors a different level of priority and weight, and unfortu-

Continued on page 130

nately, subjectivity and emotion often come into play in a manner that results in poor decisions.

It is important to recognize too that an “open market sale” (when a doctor is exiting practice) presents a very different purchase scenario from one in which an associate is buying into a practice or buying out a retiring partner. A doctor buying into a practice faces greater cash flow challenges, and hence, greater risk than does one who is buying out a retiring doctor—a situation in which the entire cash flow of the departing owner/partner is being acquired by the new owner. In addition to the tangible assets, when buying out a retiring doctor, the buyer is purchasing the projected excess cash flow of the practice. It is this excess cash flow that will determine the buyer’s level of compensation after the purchase as well as free up the capital for him/her to make the purchase feasible (loan payments, etc.). When valuing a medical practice, it is the amount of net profit and excess cash flow that create the value referred to as “goodwill”. In addition to the tangible and intangible assets of the practice itself, another factor that can influence the perceived value of a practice as well as the amount a buyer is willing to pay for it is the possibility that the buyer himself/herself may be unique—one who has specific skills or a strategic purpose for the acquisition that may make it more valuable to him/her than to others.

This is certainly possible when practices are merging. There are also entities such as hospitals and networks looking to acquire practices. In these instances, throughout negotiations, the acquiring entities will attempt to minimize the strategic value the practice will afford them and, instead, will likely stress “security” and the physician’s “fear of the future” to argue that the value of the targeted practice is equivalent to its tangible assets alone—attributing no value to goodwill. The seller must be prepared to show these potential buyers where the practice does have intangible value. In all situations, it is best for both the “seller” and the buyer to apply objective and proven

methods to the process and to keep as much emotion out of the equation as possible.

The Endowment Effect

There are reliable “scientific” methods for objectively measuring the value of a practice; yet, emotion regarding “sale price” often derails the ultimate negotiations for a future partnership or merger that would actually be in the best long-term interest of all parties. We need to elimi-

sponse from the second group was \$8. Researchers refer to this phenomenon as the endowment effect, which Johnson explains in the following way: “Simply owning something increases its value.”

This experiment can help us to understand why negotiations involving practice buy-in and buy-out situations are difficult and often defy logic. If two groups can disagree this much over the value of a simple coffee mug, it is no wonder that the difference in

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nate this stumbling block from negotiations. While it is impossible to remove all emotion from the equation, following is an interesting study which explains how buyers and sellers often evaluate value from very different perspectives. Awareness of the seemingly simple concept revealed in this study can go a long way towards getting all negotiating parties on “the same page.” The following two paragraphs, taken from “Know the Value of Your Practice,” chapter ten of my recently released book, *The Medical Practitioner’s Survival Handbook*, helps to explain this phenomenon:

An interesting experiment conducted by Eric Johnson, co-director of the Center for Decision Sciences at Columbia University, gives valuable insight into why the perception of value can vary so widely between buyers and sellers. In this experiment, Johnson divided one of his classes into two groups, asking the first group how much they would pay for a coffee mug. The typical response he received was \$4. He gave the second group the same mug for free and then asked, “How much would I have to pay you to part with it?” What is important to recognize at this point is that Johnson is basically asking the same question of both groups, which is, “How much is this mug worth to you?” Surprisingly, the average re-

the perception between buyers and sellers of the value of a more complex entity such as a medical practice can be so extreme—with each party feeling that the other is being unreasonable. When negotiating price, it is helpful to understand that these issues of “behavioral economics” are an unspoken factor; yet, ultimately, practice valuation must be approached in an objective way, one that leads the buyer and seller to come to a reasonable agreement as to a practice’s fair value.”

In this example, sellers perceived the value of a specific commodity to be double that perceived by its buyers. In this particular example, little emotion was involved because the coffee mug was, basically, a commodity to which neither party had much attachment. Value should, therefore, have been relatively easy to agree upon; yet, this fairly large discrepancy was present. When a medical practice is being valued, this “endowment effect” plays an even bigger role, with perceived value easily differing by as much as 200% between the high and the low. In this situation, emotions are often intense. The owner, for example, has put in years of “blood, sweat, and tears” building a solid reputation in the community; how does one place a value on this time s/he has put in?

Continued on page 132

An associate, or a potential merging practice that has been in existence for a shorter period of time, can never match such an investment of time and emotion or value this practice at what the owner will. This gap in perception is what often derails

partnership or merger processes that would, over the long-term, actually benefit all parties to a far greater extent than if they were to retain the status quo. Ultimately, in successful negotiations, reason prevails. This is more likely when all parties are

aware of the potential influence that the “endowment effect” might have and deal with it at the beginning of the negotiation process.

Premise of Value and Method of Valuation

Once the “Standard of Value” to be used is determined (fair market value, fair value, or strategic value), the appropriate “Premise of Value” must be selected. The premises of value under which a business is valued include its: 1) book value, 2) going concern value, 3) liquidation value, or 4) replacement value. This discussion will focus on the valuation of a going concern. Going concerns have intangible value in addition to cash flow because their assets are assembled into a working system that produces income (such as a medical practice which has the necessary licenses, systems, and procedures in place, a trained work force, and an operational plant).

The most commonly used valuation methods are: 1) asset-based approaches, 2) income approaches, 3) market approaches, and 4) hybrid approaches (typically an income/asset approach). An asset approach (1) (book value, along with adjusted net assets) is typically used when valuing a company that has below-average financial performance and whose value basically consists of its tangible assets. An income approach (2) is utilized for a going concern that has demonstrated good or superior financial performance and typically has “excess earnings” available which can be valued using either a capitalization of earnings or a discounted earnings method. The market approach (3) compares value with comparable transactions in the market. A wide margin of error is typically created when using this approach in valuing a medical practice because there is little opportunity to compare ratios and benchmarks among “private” medical practices (even ones with similar revenue and patient volume) due to the fact that key statistics are typically unavailable for comparison (such as revenue per patient, new patient volume, collection ratios, normalized fi-

Continued on page 133

nancial statements, etc.). Regardless of the approach utilized, a “sanity check” is useful at the valuation’s conclusion to determine whether the ultimate valuation “makes sense,” is fair to all parties, and is financially feasible, given the cash flow available for making the buy-in or buy-out payments while also drawing a reasonable compensation.

Goodwill and Excess Earnings

Goodwill is the amount a buyer is willing to pay for a practice that is over-and-above the value of that practice’s identifiable tangible assets. Many “experts” have claimed that today’s medical practices no longer have goodwill, but this is generally not the case. It is clear that there can be a significant difference in value between two practices—one of which, for example, is opening its doors for the first time and another that has been operational for many

years, enjoys a top reputation in the community, has a stable and growing referral base, a well-trained work force, and—most importantly—a predictable cash flow. The latter practice in this example should have much greater goodwill value. Basically, goodwill is equivalent to the value of

the future after a “sale.”

The most accepted approach to valuing a practice’s goodwill is to identify and value these excess earnings. One method for an “owner” to do this is the following: s/he calculates the difference between his/her compensation and what s/he would

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a practice’s projected future cash flow. This value can vary considerably and is dependent on how much the practice’s cash flow exceeds the average compensation level for practices in its area along with the amount of risk associated with continuation of this excess cash flow into

need to pay an employed doctor to replace him/her. The amount of this difference is considered the practice’s “excess earnings,” and the goodwill value can then be calculated using a discounted cash flow model to determine the present value of these ex-

Continued on page 134

cess earnings. A capitalization rate that reflects the rate of return an investor would expect from a comparable investment, given a similar level of risk, is utilized to “discount” the excess earnings (goodwill). Discount and capitalization rates are set at levels that take into account all of the risks associated with achieving the predicted excess earnings into the future (such as: physician retention factors, the levels of training and education of both buyers and sellers, the ease of transfer of the practice’s reputation to a new practitioner, the number of patients in the practice, the types and number of contracts the practice is working with, the practitioners’ ages, the diversity of payers and services offered by the practice, the number of years the selling physician has been in practice, competition in the area, reimbursement levels, the amount of debt the practice is carrying, the current treasury bond rates, and the potential for adoption of healthcare reform and future reimbursement models that could reduce cash flow).

Since much of a practice’s value lies in the amount of its excess earnings, modified by the capitalization rate selected to reflect the risk of continuing those earnings into the future, analysis and negotiations are concen-

is where the money will come from that will become profit to the new owner, constituting his/her basis for compensation). The buyer is also looking for growth opportunities which might expand the value of the practice following the change in ownership. When executing a buy-in, the new partner will want to know the percentage of the excess cash flow that s/he is actually buying and how this will change his/her compensation going forward. As the risk to the con-

in small company stocks—because small companies have greater risk than large ones. As we get into riskier investments, such as speculative stocks, commodities, junk bonds, and venture capital funds, the expected rate of return goes up, which correspondingly pushes the capitalization rate up and the size of the initial investment down. When valuing medical practices in this context of market risk, it is important to keep in mind that most are very small businesses,

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tinuation of excess cash flow grows, so does the discount or capitalization rate necessary to compensate for this additional risk.

You may already have some understanding of how capitalization rates are used in other arenas to reflect levels of risk. For example, in financial markets, an investor will hold a particular security only if its expected return is high enough to compensate for any perceived risk. Today, using round numbers to make com-

the value of their expected cash flow is projected out over the long-term, the investment is illiquid, and a high degree of uncertainty currently exists in the industry—all factors which dictate that a higher capitalization rate be used.

We can use examples based on the expected rate of return to understand how capitalization rates are derived. We first determine the size of the annual return expected from an investment. For example, if we want to earn \$100,000/year from our investments in a CD and it pays a 1% rate, we realize that we would need to invest \$10,000,000! Since we probably do not have this much money to invest, we would need to take on more risk in order to achieve this same return from a smaller investment. Say we expect a 10% rate of return from the stock market. In this case, we would need to invest “only” \$1,000,000 in order to achieve this same \$100,000. To compare with a practice valuation—the desired \$100,000/year stock return would be equivalent to a desired practice yearly “excess earnings” of \$100,000 (goodwill), and 10% would be the capitalization rate that reflects the risk associated with receiving this expected \$100,000 each year into the future. The value of this \$100,000 in excess earnings is found by dividing this

Continued on page 136

When executing a buy-in, the new partner will want to know the percentage of the excess cash flow that s/he is actually buying and how this will change his/her compensation going forward.

trated in these two areas. When dealing with a closely held business, the process of “normalizing” the financial statements and having the parties come to agreement regarding just what the actual revenue and legitimate expenses are can be challenging. When executing a buy-out, the potential buyer will want to know 1) which expenses will “go away” following the sale and 2) how much of the current practice revenue is expected to continue into the future (because this

parisons easier, the risk-free rate of return for a short-term certificate of deposit is 1%. To attract an investor’s purchase of a long-term bond, a 5% rate of return may be expected because the risk of a higher inflation rate is less over the short-term than over the long-term. Investors today may expect a 10% rate of return when holding a stock market investment consisting of large company stocks while they would expect an even higher rate of return if investing

\$100,000 by, in this case, the capitalization rate of 10%. We, therefore, would value this practice at \$1,000,000.

It should be obvious that when buying a medical practice, or any small business for that matter, the risk is greater than when purchasing other types of investments. This means that the capitalization rate will need to be higher than 10%—which would lower the \$1,000,000 “goodwill value” calculated in our example above to reflect the value of \$100,000 in “excess cash flow.” Compare purchasing a practice with buying a stock

that all parties involved in an example negotiation are confident that they have projected an accurate annual excess cash flow figure. With this settled, the negotiators now need to determine the appropriate capitalization rate needed to reflect the level of risk associated with the continuation of this excess cash flow. Obviously, the owner will argue for a low rate, while the buyer will argue for a higher one. To keep the negotiation process objective, the owner needs to focus on all the concrete reasons that explain why the risks for his/her particular practice are lower than aver-

higher or lower rates, but the important thing is to base these arguments on objective, measurable data rather than on emotion. What is opportune about this process is that it demonstrates to both the buyer and the seller the source of the practice’s value, and it provides a mechanism by which to create the terms needed to make a final financial transaction feasible.

At this point, you should have a basic understanding of the medical practice valuation process. If there is no excess cash flow, the value of a practice will essentially be equivalent to the value of its tangible assets (equipment, leasehold improvements, and accounts receivable), minus any liabilities—with some consideration for net income. If there is excess cash flow, the practice will additionally have goodwill value—value greater than its tangible assets. The value of this goodwill may be increased or decreased—based on the amount of excess cash flow projected after “normalizing” financial statements, applying the capitalization rate selected to account for risk, and applying appropriate discounts to reflect a lack of marketability or lack of control (if a minority position is being purchased) of the practice. Always keep in mind that as stated earlier, the final sale price negotiated may be different from the calculated value. What matters most at the end of the process is that all parties consider that the final negotiated “deal” is fair and that the agreed-to terms are financially feasible for all. **PM**

While each valuation is unique (no two practices are alike), and there are no “rules of thumb,” the average capitalization rates used in valuing medical practices range from 17% to 30%.


portfolio, in which case we would be investing in large public companies and could reduce both the company and the industry risk by diversifying our investment among a number of companies and industries. This type of stock investment is fully liquid because there is a ready market of buyers. The medical practice, however, is a closely held company with no possibility for diversification—a means of reducing company or industry risk. Also, investment in a practice is illiquid, and the amount of excess cash flow, whose continuation in this small business is less assured, is sometimes difficult to determine. Because you are already familiar with the uncertainties associated with today’s healthcare industry, more risks will surely come to mind if, and when, you consider the purchase of a medical practice. These risks are issues which could result in a decline in the practice’s revenue or increase its expenses and, hence, increase the capitalization rate necessary to reflect those risks.

To understand how this applies in the real world of practice valuations necessary for buy-ins, buy-outs, and mergers, let us start with the assump-

tion that all parties involved in an example negotiation are confident that they have projected an accurate annual excess cash flow figure. With this settled, the negotiators now need to determine the appropriate capitalization rate needed to reflect the level of risk associated with the continuation of this excess cash flow. Obviously, the owner will argue for a low rate, while the buyer will argue for a higher one. To keep the negotiation process objective, the owner needs to focus on all the concrete reasons that explain why the risks for his/her particular practice are lower than aver-

Ibbotson Build-up Method

Capitalization rates used for valuations typically employ the Ibbotson Build-up Method. This method starts with knowing the current cost of equity and the risk-free rate of return and “builds up” this rate, based on the risk associated with such things as long-term bonds, public stocks, any risk associated with a particular industry, the risk of a specific company, and the size of that company (the smaller the company, the larger the risk). While each valuation is unique (no two practices are alike), and there are no “rules of thumb,” the average capitalization rates used in valuing medical practices range from 17% to 30%. There are always arguments for



Dr. Hultman is author of St. Anthony’s “Reengineering the Medical Practice” (1995) and has published over 300 journal articles. He graduated from CCPM, practiced for twenty-five years, and obtained his MBA from UCLA’s Andersen Graduate School of Management. Dr. Hultman currently serves as Executive Director of the California Podiatric Medical Association and CEO of Integrated Physicians Systems (IPS), a company that provides re-engineering, consulting, and strategic planning services for physician practices and IPA’s.