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Consultative Valuation: Preventive Medicine for Deal Development

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Take Steps on the Front-End to Avoid Potential Deal Breakers Later On

You've been working with a large physician group for months, putting together a deal to acquire their practice. You think you are in the home stretch. Now the attorneys say there are regulatory questions; the acquisition price may not comply with fair market value (FMV) requirements. The post-transaction compensation may be too high.

No one wants to have a deal unravel due to fair market value findings. Whatever trust and respect may have been cultivated between hospital and physicians may unravel at the same time. And you certainly do not want to deal with regulator-mandated changes months or years after a deal is consummated.

Both of these risks can be avoided when the fair market value assessment is made an integral part of deal development. By doing this, you can be certain that structures, values, and compensation will only be considered if they will pass the FMV test. Regulatory compliance is built in, so the FMV opinion will always be both positive and solid. The transaction process will go more easily, and the ultimate FMV opinion process will proceed smoothly, without surprises, and at lower cost.

MEETING REGULATORY STANDARDS WHILE STRUCTURING A DEAL THAT WORKS

Whether the deal being structured is a freestanding provider joint venture, a clinical co-management agreement, or an outright acquisition, the hospital is usually focused on its goals, feasibility, and physician relationships. The physicians are typically focused on maintaining an income stream and optimizing their financial position. Neither is focused on FMV considerations or likely to have had extensive experience with them.

By doing the FMV process in parallel to the deal structure, you can assure that deals are structured and priced appropriately and avoid the myriad of hazards that interfere with regulatory acceptance. For example, an objective valuation consultant will assure that:

- **Fundamental value calculations are done right:** Inappropriate offers to the physicians can result from errors in the technique used to determine capitalized earnings or discounted cash flow analyses, or in cost, asset, or market comparable valuation techniques. Chances are your organization has limited experience with these analyses. Consultative valuation makes sure they are done correctly — and upfront, so they can guide other aspects of the deal.
- **Tax effects are treated properly:** The "hypothetical buyer" required by valuation principles is usually a taxable entity, a fact that nonprofit hospitals often overlook. This can result in setting earnings potential, and therefore acquisition price, a great deal higher than it should be.
- **Earnings streams are treated correctly:** A hospital has certain advantages over the "hypothetical buyer," such as licensure status and leverage with commercial payers; however, if post-transaction reimbursement is factored into the acquisition price, fair market value principles will be violated and the deal will not survive regulatory scrutiny.
- **Capital costs are dealt with appropriately:** Enthusiasm can cause the parties to a deal to overlook the need to replace equipment to assure continued functioning or to meet competitive standards. An appropriate fair market valuation assessment will assure that replacement needs are factored into lease or acquisition agreements in ways that are acceptable from financial and regulatory viewpoints.
- **Payments for physician services are properly handled:** Hospitals may combine a business purchase or equipment leasing agreement with service or employment contracts for physicians. With ancillary services agreements, physicians can only be paid for their professional services since they no longer own the business. Payments that meet FMV requirements may be a long way from physician expectations. A valuation consultant can offer alternative approaches to addressing physician goals as well as familiarize physicians with regulatory constraints.

Keys to Success in Consultative Valuation

Consultative valuation requires the involvement of professionals who have expertise in both fair market valuation and hospital/physician relationships. Professionals engaged in the dual roles of valuation and deal structuring must establish and preserve an objective position to be effective.

The valuation consultant should be accepted by all participants from the outset. Two-sided communication is critical to maintain objectivity. Effective mechanisms such as appointed physician liaisons or working groups with free access to the valuation professional are essential.

Even at the early stage of ascertaining objectives, it is common to encounter fair market valuation challenges. The response is to evaluate, educate, and revise objectives — if possible. Sometimes one side or the other is not willing to revise its objectives sufficiently to fit within the appropriate regulatory framework. If that is the case, the early involvement of the valuation consultant has saved everyone the time and expense of developing a deal that would not meet regulatory scrutiny.

The negotiation process is delicate. The ongoing participation of a valuation expert provides a layer of protection for both sides. When properly implemented, consultative valuation results in productive negotiation, a smoother fair market opinion process, lower costs for that process, and a more successful transaction.