Valuing Management Service Organizations and their Services

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1993 - 2023

Presenter Bio

Todd A. Zigrang, MBA, MHA, FACHE, CVA, ASA, ABV, is the President of Health Capital Consultants (HCC), where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 28 years of experience providing valuation, financial, transaction, and strategic advisory services nationwide in over 3,000 transactions and joint ventures involving acute care hospitals and health systems; physician practices; ambulatory surgery centers; diagnostic imaging centers; accountable care organizations, managed care organizations, and other third-party payors; dialysis centers; home health agencies; long-term care facilities; and, numerous other ancillary healthcare service businesses. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the co-author of “The Adviser’s Guide to Healthcare - 2nd Edition” [AICPA - 2015], numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: The Guide to Valuing Physician Compensation and Healthcare Service Arrangements (BVR/AHLA); The Accountant’s Business Manual (AICPA); Valuing Professional Practices and Licenses (Aspen Publishers); Valuation Strategies; Business Appraisal Practice; and, The Value Examiner (NACVA). Additionally, Mr. Zigrang has served as faculty before professional and trade associations such as the American Society of Appraisers (ASA); the National Association of Certified Valuators and Analysts (NACVA); the American Health Lawyers Association (AHLA); the American Bar Association (ABA); the Association of International Certified Professional Accountants (AICPA); the Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute. He also serves on the Editorial Board of The Value Examiner and QuickRead, both of which are published by NACVA.

Mr. Zigrang holds a Master of Science in Health Administration (MHA)and a Master of Business Administration (MBA) from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives (FACHE) and holds the Certified Valuation Analyst (CVA) designation from NACVA. Mr. Zigrang also holds the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers, where he has served as President of the St. Louis Chapter. He is also a member of the America Association of Provider Compensation Professionals (AAPCP), AHLA, AICPA, NACVA, and NSCHBC.

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Introduction

- Overview of MSOs
- Regulatory Considerations
- Valuation Methodology
  - MSO Entities
  - Management Service Fees
- Value Drivers/Takeaways

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MSO Overview

What is a Management Services Organization (MSO)?

- Provides certain specified practice management and administrative support services to medical practices
- Services may include, but are not limited to: billing/collection, provision of EHR, payor credentialing, employment and supervision of non-clinical staff, HR, operational services
- May be owned by physicians, non-physicians, or both
- May purchase the tangible assets of the practice (e.g., space, equipment) and lease the assets back to the practice
- As the MSO grows, it may develop group purchasing, malpractice discounts, data aggregation opportunities, and help the practice to achieve economies of scale not otherwise available to a solo, small, or even medium-sized practice
- Alleviates the administrative burdens of operating a medical practice, allowing clinicians to focus on patient care

MSO Overview

MSO Continuum of Services

Comprehensive MSO

Full-service office management
Facilities planning and management
Purchase and maintain equipment and furnishings

Financial services: Budgeting, management, information reports, financial reports and forecasts, debt and staffing
Medical records management

Negotiate payor contracts for the provider group
Operate the information system, phone system, etc.
Utilization of management/quality assurance

Human resources management
Manage all nonprofessional staff
Consolidate/negotiate all insurance policies for group
Accounts payable and general ledger management
Conduct revenue cycle activities: coding, charge entry, billing, claims resolution, and collection activities
Centralized laundry service
Operate and standardize payroll, workers, compensation, and employee benefit accounts

Conduct marketing and public relations functions
Purchase all clinical supplies
Conduct all vendor contract negotiations: centralized contract negotiations
Obtain office supplies
Administration of continuing professional education

Physician/provider recruitment assistant
Management consulting services

Limited MSO

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Regulatory Considerations

Anti-Kickback Statute	Stark Law
• Criminal and civil law (intent required) • Applies to referrals from anyone • Applies to healthcare services paid for by any federal healthcare program • Makes it illegal for any person to knowingly and willfully solicit or receive, or to offer or pay, any remuneration in exchange for a patient referral • Safe Harbors set forth regulatory criteria that, if met, shield an arrangement from regulatory liability – failure to meet all of the requirements of a safe harbor does not necessarily render an arrangement illegal • Most Safe Harbors require compensation to be FMV	• Civil law (strict liability – no intent required) • Applies to referrals from a physician • Applies to healthcare services paid for by Medicare or Medicaid • Prohibits a physician from referring Medicare patients for designated health services to an entity with which the physician (or immediate family member) has a financial relationship • Exceptions set forth regulatory criteria that, if met, shield an arrangement from regulatory liability – must meet every requirement of the exception • Most Exceptions require compensation to be FMV

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What is Fair Market Value?

The standard of value that HCC utilized in this engagement is *Fair Market Value* (FMV). Fair Market Value is defined as the most probable price that the services/products would bring if exposed for sale on the open market. Further, the Fair Market Value standard assumes a transaction in which a hypothetical willing buyer and a hypothetical willing seller are each acting prudently, knowledgeably, and that the price is not affected by any undue stimulus.

Fair Market Value, in the context of the Stark Law, is defined as *"[t]he value in an arm's-length transaction, consistent with the general market value of the subject transaction."* Additionally, General Market Value, as referenced in the Fair Market Value definition, will be defined *"[w]ith respect to compensation for services, [as] the compensation that would be paid at the time the parties enter into the service arrangement as the result of bona fide bargaining between well informed parties that are not otherwise in a position to generate business for each other."*

In summary, Fair Market Value is the estimated price at which the service/product would change hands (value) between a (hypothetical) willing buyer and a willing seller, without consideration of any benefits that may be received from a specific provider.

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MSO Entity Valuation
Valuation Methodology Considerations

- Income Approach
- Market Approach
- Asset/Cost Approach

MSO Entity Valuation

Valuation Methodology Considerations

Income Approach

- Measures the present value of anticipated future economic benefits that will accrue to the owner of the property interest to be appraised
- Economic benefit of ownership has several potential measures, including:
  - Net operating income
  - Net income
  - Cash flow
- A risk-adjusted required rate of return, matched to the level of economic benefit employed (e.g., pre-tax/after-tax), by which the benefits are discounted, must be developed
- Income Approach based methods return a value of all assets (both tangible and intangible) of the MSO
- It assumes that the assets are sold in an assemblage of assets and as part of a going-concern, income producing business (i.e., profitable)

MSO Entity Valuation
Valuation Methodology Considerations
Income Approach

Forecast of Economic Benefits of Ownership

(1) Revenue
- Management Service Fees

(2) Expenses
- Administrative and Operating Expenses of MSO
- Direct Expenses of Managed Practices

(3) Working Capital and Cash Flows

(4) Discreet Period Cash Flows vs. Residual Period Cash Flows

(5) Multiple Scenarios?
- Best case, pessimistic, and optimistic scenario

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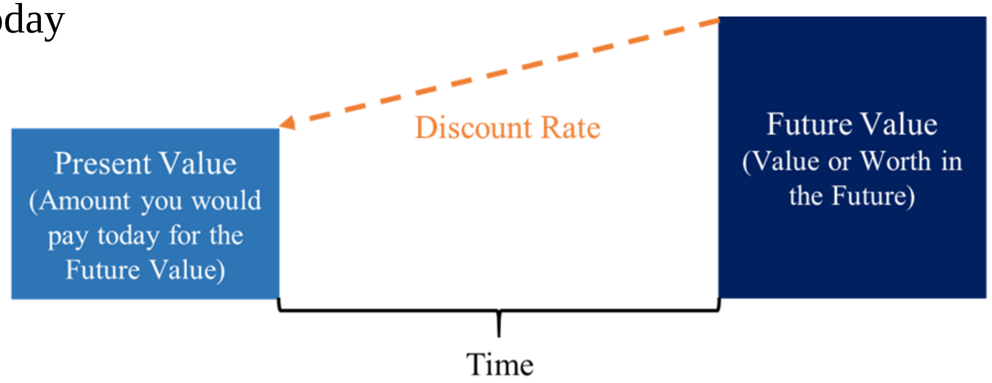
MSO Entity Valuation
Valuation Methodology Considerations
Income Approach

Risk-adjusted Required Rate of Return

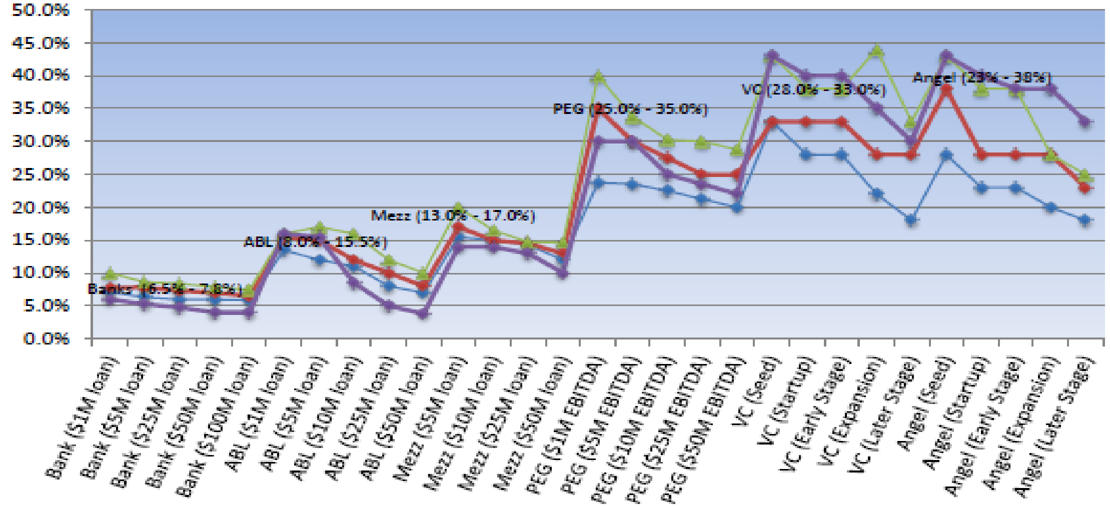
- A discount rate is the rate of return used to discount future cash flows and exit value back to their present value. This rate is often an investor's required rate of return they expect to earn relative to the risk of the investment. The discount rate:
  - Accounts for the time value of money
  - Accounts for the riskiness/uncertainty of an investment
  - Represents the opportunity cost for an investor
  - Acts as a hurdle rate for investment decisions
- The more uncertain the future value (increased risk of investment), the higher the discount rate, and the less you would be willing to pay today



MSO Entity Valuation
Valuation Methodology Considerations

Income Approach

Risk-adjusted Required Rate of Return – Cost of Equity



1 quartile Median (2022)

3 quartile Median (2021)

Source: PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT, PRIVATE CAPITAL MARKETS REPORT – 2023

Risk-adjusted Required Rate of Return – Weighted Average Cost of Capital

	Capital Structure	After Tax Cost of Capital	Weighted Average Cost of Capital
Debt	20.0%	8.00%	1.60%
Equity	80.0%	30.00%	24.00%
Total	100.0%		**25.60%**

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MSO Entity Valuation
Valuation Methodology Considerations
Income Approach

Discounted Cash Flow Method

		Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flows		$200,000	$400,000	$500,000	$555,000	$575,000
Time Factor (Midpoint)		0.50	1.50	2.50	3.50	4.50
Discount Factor Based on WACC @	25.6%	0.8923	0.7104	0.5656	0.4503	0.3585
Present Value of Forecasted Cash Flows		$178,458	$284,168	$282,811	$249,936	$206,165
Total Present Value of Discreet Period Cash Flows		**$1,201,538**	←Component of Value Attributable to Discreet Period Cash Flows (Years 1-5)			
Residual Period Cash Flows						
Year 1 of Residual Period	$592,250					
Capitalization Rate @	22.6%	(WACC reduced for long-term growth of 3% per year)				
Value of Residual Cash Flows at Valuation Date	$2,620,575					
Time Factor	4.50					
Discount Factor	0.3585					
Total Present Value of Residual Period Cash Flows		**$939,601**	←Component of Value Attributable to Residual Period Cash Flows (Years 6+)			
Total Present Value of Future Cash Flows		**$2,141,138**	(sum of Presenet Value of both Discreet Period Cash Flows and Residual Period Cash Flows)			

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MSO Entity Valuation
Valuation Methodology Considerations
Market Approach

- Market Approach computes value by comparing the value of similar businesses or assets trading in the open market
- Value may be established using:
  - Prices at which companies have changed hands (the Guideline Merged and Acquired Company Method)
  - Valuation multiples based on prices at which stocks of similar companies in a public market (Guideline Public Company Method)
  - Prices paid for equity in company in the past (Prior Transactions Method) – Revenue Ruling 59-60
- A significant challenge of utilizing Market Approach based methods is the difficulty in obtaining reliable transactions data from a sufficient number of reliably reported private transactions of closely-held enterprises, offering similar services, as well as identifying publicly-traded companies providing similar services.

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MSO Entity Valuation

Valuation Methodology Considerations

Market Approach

Comparable Transaction Summary						
	Size Characteristics			Benchmarks		
	Price (EV)	Revenue	EBITDA	EBITDA Margins	Revenue Multiple	EBITDA Multiple
10th Percentile	$ 5,724,800	$ 5,480,000	$ 1,100,000	6.7%	0.4	6.4
25th Percentile	$ 21,663,724	$ 21,000,000	$ 4,514,811	11.1%	0.8	7.4
Median	$ 106,097,000	$ 48,000,000	$ 19,715,000	18.3%	1.4	10.3
75th Percentile	$ 490,000,000	$ 138,016,000	$ 44,850,000	25.0%	2.3	15.1
90th Percentile	$ 1,080,000,000	$ 550,000,000	$ 88,200,000	34.6%	3.3	21.0
Average	$ 481,923,740	$ 155,583,541	$ 38,709,503	19.1%	1.8	12.0

Source: Scope Research Healthcare M&A Valuation Database

MSO Entity Valuation
Valuation Methodology Considerations
Asset Approach

- Separately identify and appraise each tangible and intangible asset of the MSO, then aggregate (sum) the separately appraised values into an accumulated value of the MSO in its entirety
- Asset Approach based methods focus on the value of the MSO's assets under hypothetical sale conditions instead of its earning potential. Thus, Asset Approach based methods are generally used in one of the following situations:
  - The MSO has no established, or future likelihood, of earnings (i.e., the MSO is "worth more dead than alive")
  - The MSO's value depends heavily on the value of its tangible assets, and there is little or no value added to its services from labor or intangible assets
- A valuation premise of Value-in-Use as a Going Concern cannot be supported for an MSO that fails to produce sufficient evidence to indicate a reasonable likelihood that it would be able to generate sufficient profit in the reasonably foreseeable future. In that event, the adoption of the "Value-in-Exchange" premise of value is indicated, and an Asset/Cost Approach based valuation method may result in an indication of the "highest and best use" of the assets controlled by the MSO

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MSO Entity Valuation
Valuation Methodology Considerations
Asset Approach

The value of the MSO resulting from the employment of the Asset Approach is reflective of the costs to establish the functional utility of the tangible and identifiable intangible assets that support the operation of the MSO, i.e., cost to replace or replicate the assets of the MSO.

(1) Organizational Startup Costs
- Legal
- Accounting
- Consulting
- Management expenses

(2) Development Costs
- Technology
- MSA Contract(s)

(3) Tangible Assets (typically minimal)

(4) Other Intangible Assets
- Trained and Assembled Workforce
- Data

MSO Services Valuation

Valuation Methodology Considerations

Management Service Fee Arrangements

There are a number of payment arrangements that an MSO can make with healthcare entities in regard to compensation for its services. Payment arrangements between an MSO and a practice include, but are not limited to:

- Percentage of an entity’s revenues or profits (not often used due to regulatory restrictions)
- Fixed fee arrangements
- Cost-plus fees based on the services provided to the practice
- Portion of cost savings that the MSO helped the entity realize

MSO Services Valuation

Valuation Methodology Considerations

Percentage of Revenue Arrangement

Considerations:

- Regulatory
- Return *of* Costs + Return *on* Costs
- Market Approach is commonly relied upon

Primary Care Practice Expense	Range of Industry Expense (% of Revenue)	
Total business operations support staff	3.50%	7.00%
Total front office support staff	5.00%	9.50%
Other administrative support	3.00%	5.50%
Total clinical support staff	10.00%	15.00%
Total support staff (non-provider) cost	21.50%	37.00%
Information technology operating cost	0.50%	1.00%
Drug supply	4.00%	7.00%
Medical and surgical supply	1.00%	3.00%
Building and occupancy	5.00%	8.00%
Furniture and equipment	0.50%	1.50%
Administrative supplies and services	0.55%	2.25%
Professional liability insurance	0.75%	2.25%
Other insurance premiums	0.50%	1.00%
Legal fees	0.10%	0.25%
Consulting fees	0.25%	1.50%
Outside professional fees	1.00%	3.00%
Promotion and marketing	0.10%	0.50%
Other ancillary services	0.25%	0.75%
Billing and collection purchased services	4.00%	6.00%
Total operating cost (before provider compensation)	40.00%	75.00%

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MSO Services Valuation

Valuation Methodology Considerations

Fixed Fee Arrangement

Considerations:

- Development of a Pro Forma
- Allocation of Practice Expenses to MSO and Practice
- Return *of* Costs + Return *on* Costs
- Income Approach is commonly relied upon
- Allowance for Growth

Allocation of Resources/Practice Expense	MSO	Practice
Personnel		
Physicians		X
Non-Physician Providers		X
Clinical Support Staff	X	
C-Level Leadership	X	
Marketing	X	
Billing and Collections	X	
Accounting and Finanee	X	
Human Resources	X	
Administative		
Other Resources		
Medical Supplies		X
Malpractice Insurance		X
Facility Leases	X	
Repairs and Maintenance	X	
Taxes and Licenses	X	
Technology	X	
Administrative Supplies	X	
Marketing	X	
Ancillary Services	X	
Other Office Expenses	X	
Professional Fees	X	
Business Insurance	X	

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MSO Services Valuation

Valuation Methodology Considerations

Cost Plus Arrangement

Considerations:

- Development of a Pro Forma
- Test of Reasonableness of Costs (the Return *of* Costs)
- Return *on* Costs
- Market and Cost Approaches are commonly relied upon

Outsourced Services	Range of Industry Markup on Cost	
Billing	15.00%	20.00%
Staffing/EPO	10.00%	15.00%
Consulting/Education/Training	15.00%	30.00%
Technology Services	20.00%	35.00%
Management Services	12.00%	17.00%
Marketing	10.00%	20.00%
Care Management	15.00%	25.00%
Group Purchasing	20.00%	30.00%
Transcription	10.00%	15.00%

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Value Drivers/Takeaways

- The structure
- Groups and providers involved
- Data infrastructure
- Don’t ignore one-time set-up costs or on-boarding costs incurred
- Utilization of % of reimbursement as a sanity-check or a “not-to-exceed” rate for the management fees
- What are the benefits and costs for each party? Willing Buyer and Willing Seller
- Are costs and revenue transparently shared across parties?
- Are the management services well-defined?
- Is there documentation of the management services rendered?
- Have the management services or the underlying assumptions changed since an FMV opinion was provided?

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Thank You!

For questions for information please do not hesitate to contact us.

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