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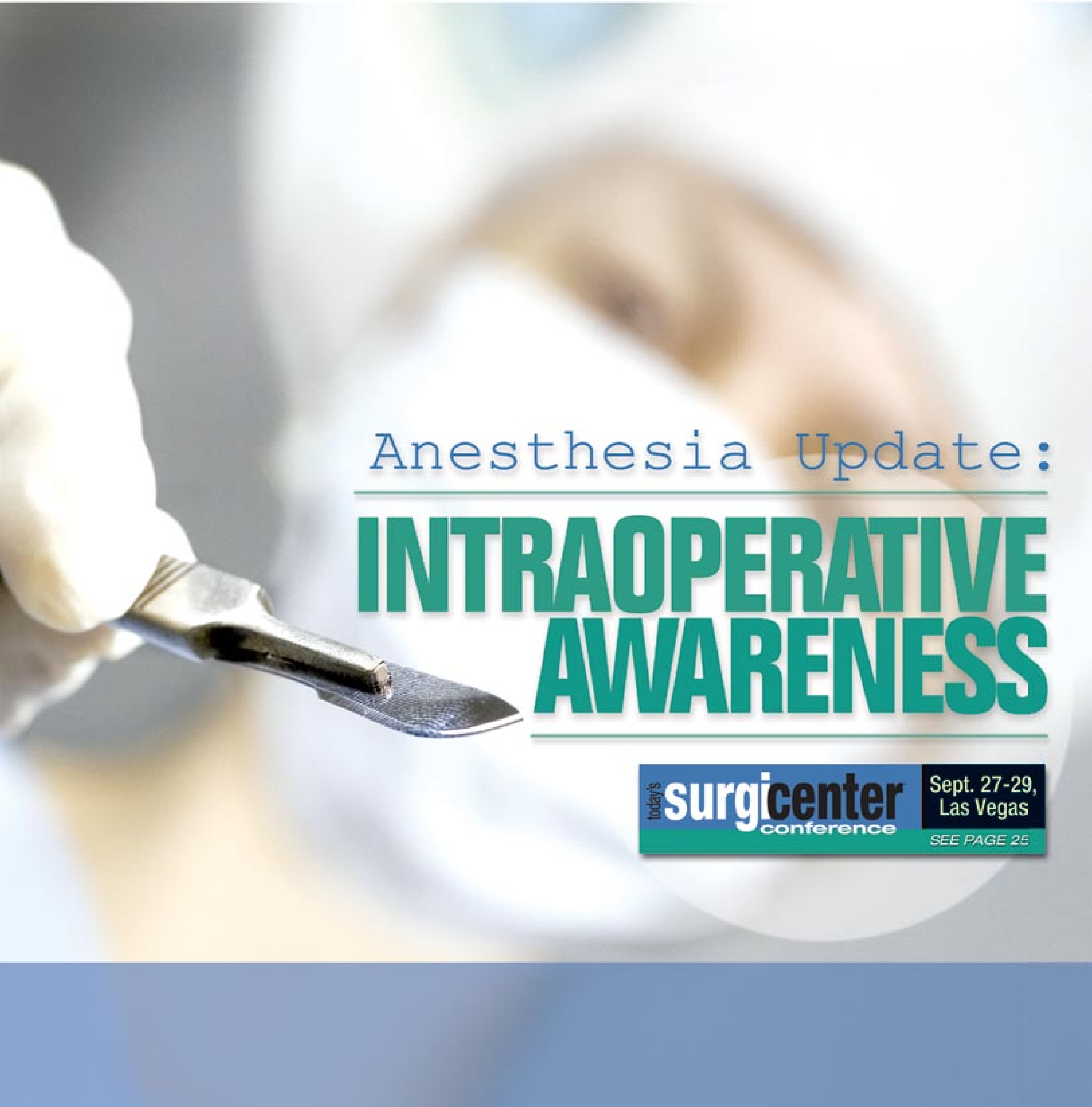

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By Jennifer Schraag

BUYing & SELLing ASCs

From examining current industry norms, to gearing up for the sale, to conquering valuations and appraisals, ASC owners and operators have much to do — and even more to consider — when looking to sell a center.

The ambulatory surgery center (ASC) industry is enjoying continued viability, with plenty of would-be operators scoping out good deals today, just as they have for the past several decades. According to Kenneth Hancock, co-founder, president, and chief development officer of Nashville-based Meridian Surgical Partners, surgery center partnerships typically seek a corporate partner for two reasons: to make an extra buck off their current successes or to acquire help for a faltering venture.

In the surgery center partnership that is financially successful, the partners decide to seek a buyer in order to realize a return on their investment by selling an interest in the partnership, Hancock explains. "The other scenario is a surgery center partnership that is struggling as a business to operate efficiently, must retire debt, must restructure or bolster the partnership, and seeks a corporate partner to turnaround the business. Surgery center partnerships that struggle typically do so because of poor planning; they initially overbuilt the center, incurred too much debt, didn't have enough physician partners and surgical cases, didn't raise enough capital, didn't focus on getting paid (i.e., insurance contracts) and is generally deficient regarding operations."

Once the decision is made to sell, the choice between the publicly traded or the privately held companies arise. Henry H. Bloom, president of Freehold, N.J.-based The Bloom Organization LLC, points out that public companies are "much more disciplined" in their approach to acquisition and growth, and they tend to be less flexible in their negotiations. On the other hand, he mentions that while private companies can offer the flexibility many may seek, they have a separate set of issues that may include funding, experience, and expertise.

Hancock says both company types are attractive alternatives to sellers. "Assuming that the private company has a strong capital structure and competent management, there is probably little difference to the seller," he states. "Both public and private entities plan to grow the surgery centers they acquire to achieve a return on investment. One could argue that the private companies are typically smaller companies and thus the significance of an acquisition receives greater focus in a smaller grouping of centers. The two market leaders USPI (United Surgical Partners Inc.) and HealthSouth, are both currently publicly traded that are likely headed private. Combined, they account for 300 surgery center partnerships. That leaves three 'pure-play' publicly traded companies that account for approximately 250 surgery centers: AmSurg, Symbion, and NovaMed."

Some of what Hancock speaks of can be solidified by the findings of the 5th Annual ASC Valuation Survey, recently completed by HealthCare Appraisers Inc. According to Todd J. Mello, MBA, AVA, co-founder and principal, some interesting markers have changed over the five years the company has been studying the ASC industry and its key players.

In the survey, HealthCare Appraisers Inc., looks at what is termed "pure play" — companies that focus solely on surgery centers. The survey includes four of the publicly traded companies: AmSurg, NovaMed, Symbion, and USPI.

"We've actually seen a decline in valuation multiples," Mello explains of current findings. "The value of equity compared to their earning before interest and taxes (EBIT) … USPI used to be 13.8 in 2004, and then it was down to 11.3 in 2005. In the nine months ending in 2006 (the latest available data for the survey), they were down to 6.9.

"The other businesses too have pretty much declined, and some have stabilized a little bit too, but I am seeing a decline in the valuation of publicly traded surgery center companies," Mello shares.

"We're seeing the multiples come down, but what is interesting is we aren't seeing the multiple in the private deals follow suit yet. Usually you see a big spread, but those are definitely coming closer together." He says there currently is a lot of competition and a lot of consolidation playing out within the industry, and with the Medicare reimbursement reductions coming down the pike, some specialties — such as gastroenterology and ophthalmology — are getting slammed.

"That is why I think companies like AmSurg are trading at a much lower EBITA multiples," adds Mello. "AmSurg is trading at a five EBITA multiple, whereas Symbion, USPI, etc., are in the sevens." He explains that this is due at least in part to AmSurg being a predominately single specialty company, and that the changes in reimbursement are already reflecting in its deals.

"There is still a lot of activity in the industry," he reiterates, adding, "and the private transaction multiples really haven't essentially adjusted downwards yet to reflect what's happening in the public markets, but I expect it will."

The Preliminaries of the Sale

The devil indeed can be in the details when it comes to readying any business for a sale. For surgery centers there are perhaps aspects that could be easily overlooked or not well thought out before courting a buyer.

One such aspect is property ownership. "Related party transactions are commonly overlooked," advises Bloom. "Many times the building is owned by the same people as the center, but through a different entity. When the owners of the center are the same as the landlord, rent is sometimes set well above fair market value rates with a goal of paying off the building debt early. However, if the center intends to admit new partners into the business, but not the real estate, a fair market value lease must exist. Related party transactions are important."

Bloom says general "housekeeping" is always a good idea too. "A center's performance (or lack thereof) is rarely sufficiently explained by a 'change in billing system' or 'turnover of employees.' If your center performs well and you have consistent, accountable policies and procedures that report those results, then you will be an attractive acquisition target," he asserts.

Hancock warns of the diligence a buyer takes a potential seller through. He says it includes a thorough analysis of the following five areas:

- Initial diligence request and analysis (an initial review of historical financial statements and a partnership analysis)
- Regulatory and legal diligence
- Financial diligence
- Billing and coding audit
- Managed care analysis

"If the seller is prepared to thoroughly answer these questions to the satisfaction of a buyer they're ready to seek a buyer/partner," he concludes.

Valuation/Appraisal of the Center

Hancock says that when a buyer is considering an investment in a surgery center business (acquisition) they are seeking an opportunity to grow the business and thus generate a return on investment.

"A seller needs to think of what advantages they have to attract a buyer," Hancock offers. He again mentions the two general thoughts that exist: a surgery center that is financially successful or a turnaround surgery center that is seeking help to advance the surgery center to a profitable business enterprise.

Regarding a successful center, he says the buyer focuses on further growing the surgery center with its current partners, but the buyer also looks at the feasibility of growth through adding physicians to the partnership. Hancock offers the following key considerations:

- Defining the growth opportunity
- Growth capacity
- Partnership stability
- Partnership commitment
- Age distribution and plans for retirement
- Physician inventory within the market
- Competition
- Payor mix
- Out-of-network contracting percentage
- Strength of local management and staff

"The answers to these questions strongly influence the buyer's motivation and pricing strategy in an acquisition," he explains. "If it's a turnaround opportunity the buyer is focused on the same considerations, but the dynamics are different. Here, the buyer is trying to determine what needs to happen immediately to turn the business profitable. Is the problem related to management, capitalization, physician partners, staff, insurance contracting, physical plant, competition, etc.? These opportunities are attractive to the buyer if a plan exist that outlines the key issues and solutions that will turn the business into a profitable enterprise. The buyer must be able to identify what's wrong and determine a solution for the problems to be attracted to this type of acquisition."

Other key points regarding appraisal include:

Prospects For Growth

- External - Physician recruiting environment
- Organic - Partnership profile (age and stage of career)

Risks to cash flow

- Payor mix (out-of-network)
- Case mix (Medicare rate reductions 2008)

Weak partnership

- Limited non-compete agreements
- Retiring physicians
- Dominant partner (revenue concentration)

Location

- Certificate of Need State
- Market demographics
- Competitive landscape

When "dressing up" your business for sale, Mello advises several avenues center owners can successfully take. "You want to have a center with a good mix of specialties — you don't want to have all your eggs in one basket," he warns (remember the AmSurg situation he mentioned earlier). "The specialties that are most popular, and this was highlighted in the survey as well, are orthopedics because it is generally very profitable; general surgery is pretty good; ENT is quite popular; pain management — depends what your payor mix is there — having a diversified center is a plus."

In addition to this mix of specialties, an even mix of active surgeons is also very important. "You definitely want to have a good compliment of owners," Mello adds. "What you don't want to see is 65 percent of the cases are done by one person and you have five other people who do the rest.

"Another way to maximize value is to wait until your center is up and running for a while. Wait until the center is established vs. when it isn't open yet or essentially limping along. The companies are not going to pay a lot of money for those. Get all the kinks out of the system. Make sure the case volume is there, make sure the staff is trained and efficient, wait for your receivables to begin collection … If you really want to get the most value out of the transaction, wait until your center is up 18-plus months — at least — and that you have a track record of success. Somebody is going to look at that and say, 'You know, this is a pretty good business to buy.'"

The future growth of the center is central, and Mello says the centers with growth ability are going to see higher multiples. "So look at maximizing volume. Is the center maxed out? There are commonly space limitations in ASCs; this needs to be considered."

Anyone that has ever tended the books of an ASC knows that every center has a very high level of fixed costs. One way to offset those costs is to increase the number of procedures in the center, Mello advises. "You will often see a center that is kind of limping along, breaking even, and all it needs to do sometimes is add one more four-man group," he explains. "The only incremental expenses associated with the extra cases these doctors would bring in are supply costs. So all of a sudden, those extra cases essentially dropped the bottom line — the revenue associated with those — and that center can turn the corner of breaking even or barely making it to being much more profitable."

Overall, surgery centers are generally a very good investment. According to Bloom, most issues in transactions center on items that were not disclosed immediately or uncovered very late in negotiations. "Every center has something that differentiates it from others," he warns. "Whether good or bad, it is our policy to fully disclose all issues at the outset and get them out of the way."

The Valuation/Appraisal Killers

The No. 1 most common aspect of a center that will inevitably reduce its appraisal is a high level of out-of-network payment. "Out-of-network payments can really boost net collections, but centers with out-of-network revenue

The Dynamics of Syndication

Typically, syndications involve physicians buying minority interests. Because they are buying a minority interest, their rights are greatly reduced from a majority interest shareholder and therefore their buy-in price is lower. The low price per share drives a very good return.

Henry H. Bloom, president of The Bloom Organization LLC, offers the following example. "A physician may buy 2.5 percent interest for $100,000 and reasonably expect to receive $33,000 in annual distributions — a 33 percent return. A majority interest purchaser would have had to pay twice the amount for the same interest and received only 16.5 percent return, because they have control of the entity."

The single greatest benefit to everyone involved is participation, Bloom says. When a new physician is allowed to buy in, he or she will participate in making the center successful. "When a physician writes a six figure check for a membership interest in a business, that physician will work to make sure that investment is fruitful. The more involved a new surgeon is in the business — be it quality control, governance or caseload — the better performance can be expected. The only detriment is to the seller, and even that is temporary and not long term."

Since all shares must add up to 100 percent, someone will have to be diluted. Whether directly or indirectly, some or all of the existing shareholders must give up some of their ownership at that minority discount, Bloom asserts. This detriment is barely felt before the new owner participation has a positive effect on the performance of the center and makes the remaining shares all the more valuable.

Kenneth Hancock, co-founder, president, and chief development officer of Meridian Surgical Partners, adds that syndication is the foundation of a partnership. "It goes well beyond the investment and return," he asserts. "Many times these partnerships are formed out of frustration of working at the local hospital. The hospital operating rooms tend to function at a very low level of efficiency preying on the physicians' time and quality of life. Fed up with that reality physicians will seek a better environment in which to operate. The syndication is a bond that allows physicians to come together as partners and work toward a common solution. The investment is but one of the threads that bond the partners together. No. 1 on their agenda is an efficient work environment and having less stress in their lives. A byproduct of an efficient and well run surgery center business is one that provides a good financial return to those partners that created the business." ❏

The No. 1 most common aspect of a center that will inevitably reduce its appraisal is a high level of out-of-network payment.

streams have become very unattractive," says Bloom. "The national players view this revenue stream as short lived."

Hancock pegs it best by saying this creates a false level of cash generated by the business. "It's key for the buyer to determine the stability of EBITDA prior to the acquisition," he clarifies. "A buyer must grow the cash flow of the business after the acquisition to generate a return on investment. A significant disconnect is created between the seller and buyer over this issue. The seller doesn't feel the pressure or chooses to ignore the pressure imposed by the insurance contractors; but the buyer can't take the risk that being forced in-network and the resulting negative impact to cash flow. A business with a high level of out-of-network payments should expect to receive a much lower valuation to account for that risk."

Mello agrees, adding that this set-up is a huge risk factor because the expectation as a buyer is that at some point "the gravy train is going to stop."

"What the center has done historically is interesting, but what you're buying into is the future cash flow. If you expect that future cash flow to be lower, then that is how you are going to value it," he explains. "In fact, one of the questions on the survey, 'What impact do out-of-network revenue benefits have on value?' received a response of 53 percent saying it detracts from value. So that's a huge risk factor." He adds that out-of-network reimbursement is seen most often in new centers where they do not get into payor contracts right away.

Since, as we have seen, the profile of the center's ownership is of great importance, other questions arise: the age of physicians, for example; are they in the prime of their career or nearing retirement? Those made up of mostly physicians near retirement are "a pretty big risk factor," according to Mello. "I'm not trying to age discriminate here, but you generally have to find physicians who are in the prime of their career, who are hungry, and really want to work hard."

Ownership structure must be set up to evolve with the entity, adds Bloom. "Over time, physician partners retire, move or change practice patterns. Without adequate protections in the operating agreement, the ownership structure may not change with the owners. Many times centers that do not have appropriate buy/sell agreements end up with ownership that is not commensurate with participations (i.e. 60 percent of a center is owned by a retired physician)."

Perhaps of greatest note is when looking to make a sale, always involve — from the very beginning — experts intimately familiar with the ASC industry.

"When considering a syndication or sale of your ambulatory surgical center, the importance of good legal and financial expertise cannot be overstated," Bloom reiterates. "If you have grown your business to the level that warrants a syndication or sale, then you have probably enjoyed recent operational and financial success as a result of your focus in those areas. As you move forward towards new partners or realizing some liquidity for all your hard work, there are new issues at play which have far reaching implications to your future as well as that of your business. The use of good financial representation as you navigate this life changing process will pay dividends that exceed your center's performance in the past." ❏