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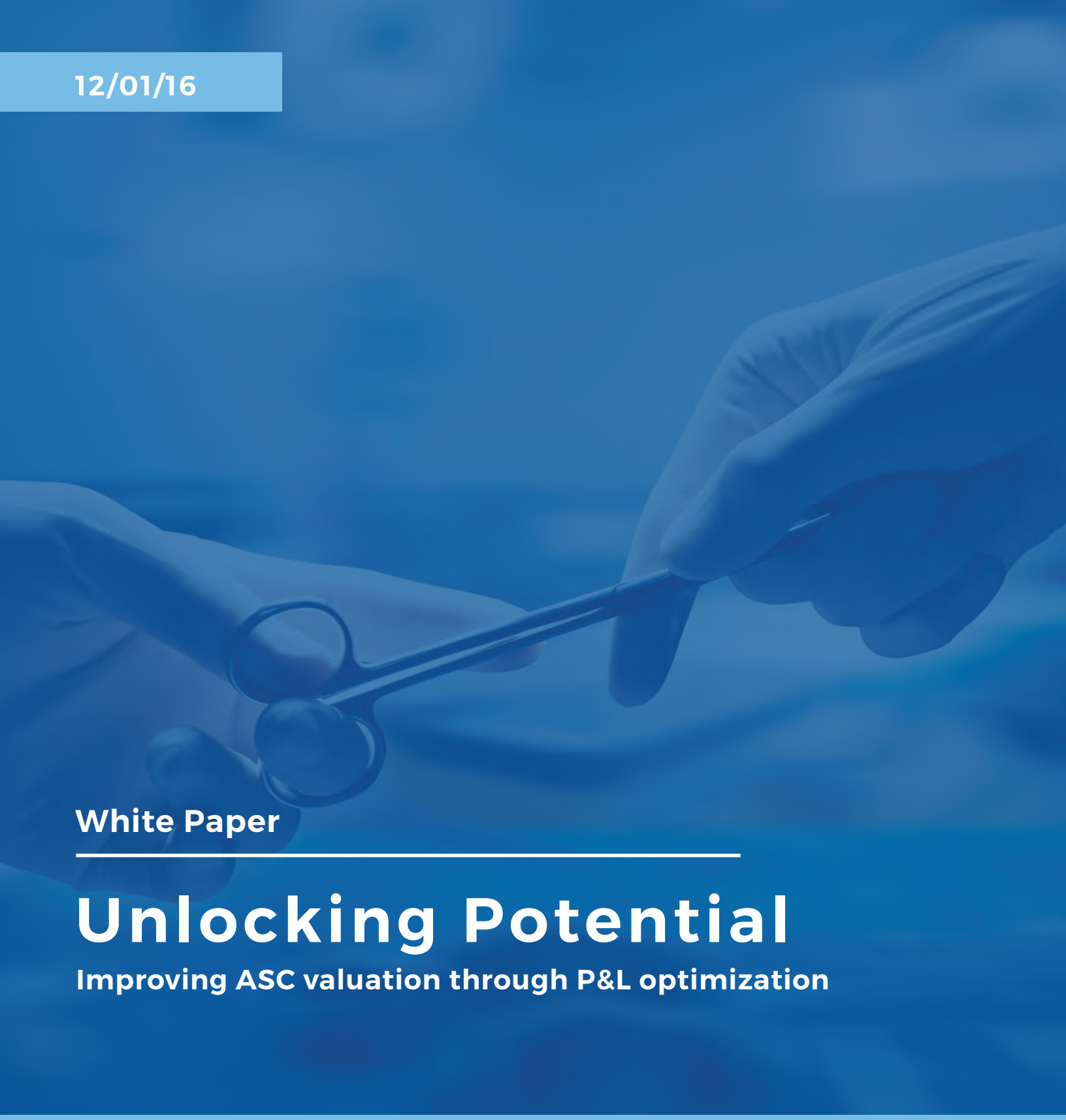


White Paper

Unlocking Potential

Improving ASC valuation through P&L optimization

Merritt Healthcare Advisors
Mergers & Acquisitions

01

Introduction

When the first ambulatory surgery center (ASC) opened in Arizona more than 40 years ago, its two physician owners were simply looking to bypass the scheduling delays, bureaucracy and inconvenience associated with inpatient surgical procedures.[1] Within a decade, however, a clinical revolution was underway, with outpatient surgery by the early 1980s making up about one-quarter of all procedures performed in the United States. And that was just the beginning. By the 1990s, same-day surgery had eclipsed 50 percent of all U.S. volume. About two-thirds of all surgical procedures in the United States are now performed at outpatient facilities.[2] Even more, the number of hospital beds in the United States has plummeted in the past few decades: In 2014, there were 786,874 U.S. hospital beds, compared with 901,056 in 1994.[3]

Today, the expansion of outpatient surgery in the United States continues, helped in large part by the implementation of the Affordable Care Act (ACA). With its emphasis on lowering costs and improving outcomes, the ACA incentivized further migration of complex cases out of hospitals and into surgery centers. And the market is already responding: Nearly 40 U.S. outpatient facilities are beginning to offer same-day total joint replacements,[4] procedures that previously required days of recovery in the hospital.

New federal reimbursement initiatives are accelerating this trend. In April 2016, Medicare rolled out bundled-based payments for more than 100,000 of the hip and knee replacements the federal government pays for each year.[5] Similar fixed-pricing models will make up about half of the healthcare money the government spends each year by 2018, putting additional financial pressures on hospitals to find a high-quality, low-cost alternative surgical venue.[6]

Existing U.S. surgery centers offer a proven solution for hospitals when it comes to meeting this challenge. The U.S. Department of Health and Human Services, Office of the Inspector General, estimates outpatient surgery saved patients and the federal government a combined $9 billion between 2007-09, and an additional $15 billion in savings is expected between 2012-17.[7] There's also no shortage of potential ASC acquisition opportunities for hospitals: Independent surgery centers make up about three-quarters of the 5,500 existing ASCs in the United States.[8]

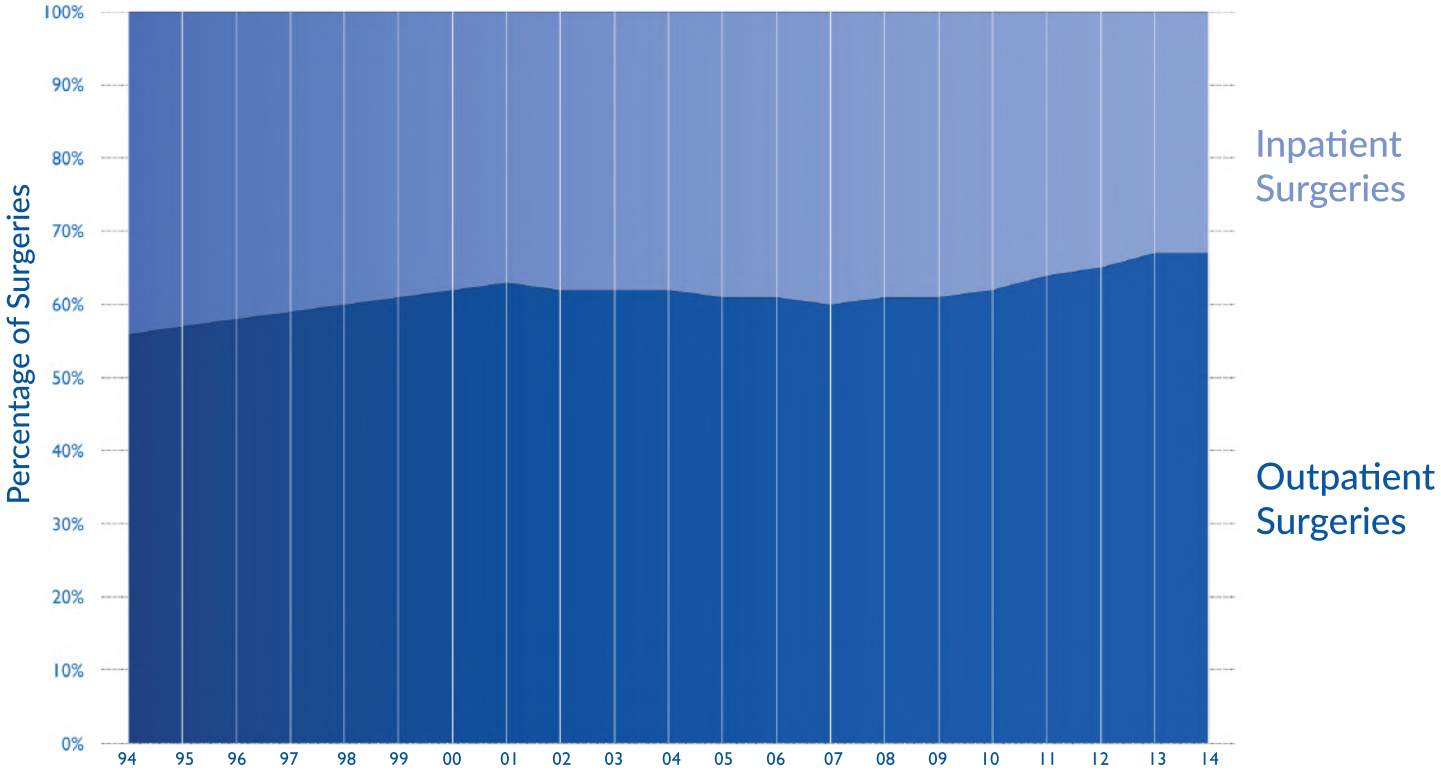
In addition, some physician ASC owners are deciding that perhaps now is the right time to sell an interest to a hospital or strategic partner—or at least consider it. First, outpatient surgery center buyers are offering premiums for ASCs at multiples in the high single digits. Because a sale of the ASC asset is most typically afforded capital gains tax treatment, this allows physicians to frontload a decade or more of ordinary income and reap significant tax benefits in the process. Second, there's also considerable uncertainty—understandable, considering the past decade—about where the industry is headed. Is nationalized healthcare or single payer a possibility? Will reimbursements continue to fall? It's too soon to say for sure. But if what's past is prologue, future healthcare reform will continue to favor economies of scale.

1 "Ambulatory Surgery Centers: A Positive Trend in Health Care," Ambulatory Surgery Center Association
2 "Percentage Share of Inpatient vs. Outpatient Surgeries," American Hospital Association
3 "Trendwatch: Chartbook 2016," American Hospital Association
4 "Replacing joints faster, cheaper and better?" Modern Healthcare, 2016
5 "Comprehensive Care for Joint Replacement Model," Centers for Medicare & Medicaid Services
6 Ibid.
7 "Medicare and beneficiaries could save billions if CMS reduces hospital outpatient department payment rate for ambulatory surgical center-approved procedures to ambulatory surgical center payment rates," U.S. Department of Health and Human Services, Office of the Inspector General
8 "Ambulatory Surgery Center Financial and Operational Benchmarking Study," VMG Health

Introduction cont.

For physicians considering a sale—or even just exploring the possibility down the road—performing proactive due diligence and facility optimization is the crucial first step in achieving the highest sale price for your business and improving near-term financial performance. This process starts with normalizing a facility's profit and loss statement (P&L)—the first thing a potential buyer asks to see when considering an acquisition. Complex issues such as accounting methodology can play a big role in improving an outpatient facility's income statement, and it's just one of the many areas that should be assessed during the review process.

Percentage Share of Inpatient vs. Outpatient Surgeries, 1994-2014



Source: American Hospital Association

Staffing and operations

Employee salary and wages represent 30 percent of the total operating expenses for an average multispecialty outpatient surgery center, while taxes and benefits add another 7 percent.[9] These line items on a facility's P&L often present significant opportunities for improvement when it comes to achieving the highest sale price.

For example, it is critical to benchmark your staffing model to determine whether your workforce structure is optimized. Positive adjustments can be made prior to marketing a facility, the benefits of which will accrue to the seller. These changes can include realignment of day-to-day job duties or adjustments in the staffing model based on case type.

When normalizing an income statement, it's also important to identify any nonrecurring, nonoperational expenses such as legal fees, consulting work and marketing expenses that can lower the valuation of a surgery center. Why is the money being spent? Will it be spent again next year? Answering these questions before a potential buyer does will help your team determine how to properly account for these outlays in financial statements and achieve the highest sale price.

	Patient Cost		Medicare Cost	
	ASC Co-pay	HOPD Co-pay	Total Procedure Cost ASC	Total Procedure Cost HOPD
Cataract	$193	$490	$964	$1,670
Upper GI Endoscopy	$68	$139	$341	$591
Colonoscopy	$76	$186	$378	$655

Source: Ambulatory Surgery Center Association

Revenue cycle

A facility's billing and coding operations can have a dramatic effect on its valuation. A preliminary due diligence review typically will use benchmarking and best practices to uncover potential red flags or anomalies in an ASC's revenue cycle. For example, the average multispecialty outpatient surgery center completes 18.5 cases per day, or 4,629 cases per year; has about $715,000 in cash on hand, or about 20 percent of total assets; 53 days of operating expenses on hand; and $1.2 million in working capital, or 15 percent of net revenue.[10]

An average multispecialty ASC also has about $1.4 million in gross receivables. About 55 percent of an average ASC's accounts receivable is between 0-30 days; 17 percent is between 31-60 days; 8 percent is between 61-90 days; about 5 percent is between 91-120 days; and about 15 percent is more than 120 days outstanding.

During a preliminary due diligence assessment, these high-level financial benchmarks can help identify problem areas and where additional resources can be allocated to optimize a center's financial performance.[11]

In addition, widespread coding errors inevitably will result in a financially underperforming center that receives a lower valuation during an acquisition. Depending on the scope of the errors, it's not uncommon for them to result in lost annual revenue—and many times that amount in a sale. Identifying these issues before a sale occurs allows current owners to improve processes and employee training, fine-tune near-term financial performance and achieve a higher sale price.

9 Ibid.
10 Ibid.
11 Ibid.

Supply chain, equipment and facilities

For an average outpatient surgery case, facility and occupancy costs make up 9 percent and medical and surgical expenses total almost 30 percent.[12] Between these two P&L line items, there's often considerable room for optimizing financial performance, lowering costs and achieving a higher valuation in the event of a sale.

For example, outpatient surgical facilities specializing in orthopedics have high medical and surgical supply costs, often making up one-third or more of the total operating expenses.[13] With so much overhead, overpaying for anchors, screws and implants necessary for these procedures can quickly erode the bottom line. Many of these issues can be addressed through participating in the right group purchasing organization, which offer ASCs access to lower-cost supply options through bulk-purchasing arrangements. Inventory control systems, too, can help facilities improve their P&L by limiting the ordering and storage of unnecessary supplies.

ASCs also are equipment-heavy businesses. While many of the clinical and operational tools and machines used in outpatient surgery centers are financed or bought outright, some are not. For a variety of reasons, facilities may lease rather than purchase equipment. How these leases are structured and defined may inadvertently lower the value of a center in the event of a sale.

How and when an ASC pays its rent also can have an effect on its sale price. An average multispecialty outpatient surgery center spends about 8 percent, or $490,000, of its total operating expenses on occupancy costs.[14] Depending on the timing of these payments, it's not uncommon for a facility to inadvertently make 13 rent or lease payments for their facilities during a 12-month period, throwing off an ASC's P&L—and lowering its valuation.

Managed care contracting

Commercial insurers typically make up about 60 percent of a multispecialty ASC's payer mix.[15] With such a high percentage of revenue dependent on these cases, managed care contracts can make an outsized contribution to an outpatient surgery center's overall financial performance. While providing vital patient volume to ASCs, these reimbursement agreements can be out of date or poorly negotiated. It's also not uncommon for facilities to join a provider network without fully understanding just how unprofitable many of the cases may be.

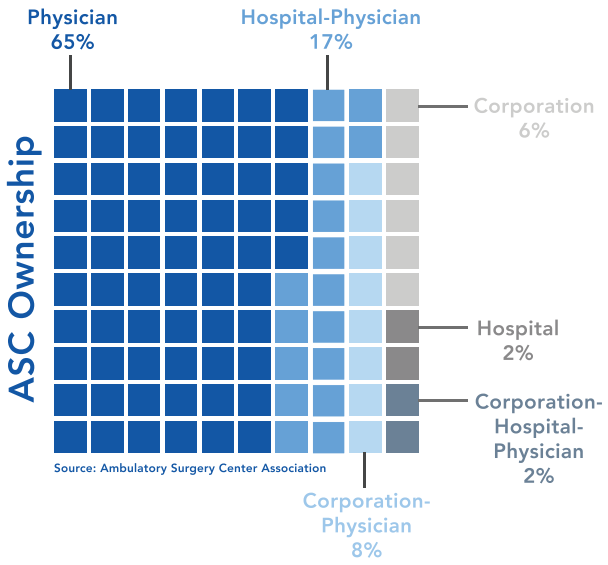
Finding the right combination of in-network and out-of-network patients is key to optimizing a facility's financial performance. An ASC may lose revenue simply by entering into a managed care contract with a payer that now reimburses more per case as an out-of-network provider. Would the increase in patient volume offset a difference in reimbursements? Every outpatient surgery center faces a unique set of variables in this regard, and an ASC's management team should assess the specific circumstances involved to understand the risks and benefits at hand.

12 Ibid.
13 Ibid.
14 Ibid.
15 Ibid.

Conclusion

As healthcare continues to transition towards value-based care, outpatient surgery will remain a cost-effective and safe alternative to expensive hospital stays. And with more than 5,000 existing facilities in the United States—most of them still independent—ASCs will continue to offer an attractive solution for hospitals and health systems that are looking to lower costs, improve outcomes, and increase patient volume and satisfaction. At the same time, the new healthcare landscape favors economies of scale, and increased regulations and shrinking reimbursements are forcing many physician owners to rethink the long-term viability of continuing to operate their ASCs independently.

Optimizing an ASC's financial performance for near-term growth or in preparation of a sale requires industry insights and transactional expertise to identify and resolve staffing, revenue cycle, supply chain, equipment and facility issues. Successfully navigating this highly complex and rapidly changing market also requires a clinical and operational specialization, an extensive relationship network to facilitate successful transactions between motivated buyers, and a proven track record of negotiating the best transaction possible.



About Merritt Healthcare Advisors

Merritt Healthcare Advisors is the leading provider of M&A consultative services for healthcare organizations across the country. In an era of increased competition for patients, shifting market dynamics, declining reimbursements and a heightened emphasis on costly technology, Merritt Healthcare Advisors is the proven partner for physician and hospital leaders seeking to optimize their value. Given the recent dramatic change throughout healthcare in both national and local markets, hospitals, health systems and physicians navigate a complex landscape when it comes to buying or selling a healthcare organization. As the only M&A advisory organization with active clinical operations, we have an unmatched perspective when it comes to coordinating beneficial transactions within the highly complex healthcare industry. http://merrittadvisory.com/