Health Capital Topics
Volume 8
Issue 3
March 2015
Todd A. Zigrang, MBA, MHA, ASA, FACHE, Publisher • Jessica L. Bailey, Esq., Editor ©

The Imperative of Considering the Concept of Highest and Best Use in Healthcare Valuation

A thorough understanding of financial valuation concepts is a requisite foundation for a well-reasoned and defensible valuation analysis.[1] At the outset of each valuation engagement, it is critical to appropriately define the standard of value and premise of value to be employed in developing the valuation opinion.[2] The standard of value defines the type of value to be determined and answers the question, "*value to whom?*"

The *premise of value* defines the hypothetical terms of the sale, i.e., "*…the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g., going concern, liquidation*,"[3] and answers the question of "*value under what further defining circumstances?*"

The selection of the *premise of value* can have a significant effect on its application in the valuation process. Two general concepts relate to the consideration and selection of the premise of value: (1) *value in use*; and, (2) *value in exchange*. An important concept that impacts the selection of the appropriate *premise of value* is that of *highest and best use*.

For example, in the absence of a reasonable expectancy of sufficient economic cash flow to support the value of the investment represented by the tangible assets utilized to generate the revenue stream of the enterprise, the highest and best use of the assets may be under, and the appraiser may select, a premise of value of "*Value-in-exchange as an orderly disposition of a mass assemblage of assets, in place*", which includes all individually identifiable tangible and intangible assets.[4]

The concept of highest and best use is defined as:

> "*…that use among possible alternatives which is legally permissible, socially acceptable, physically possible, and financially feasible, resulting in the highest economic return*."[5]

As Dr. Pratt points out, the concept of highest and best use drives the selection of the valuation premise, which may apply under the *Standard of Value* of *Fair Market Value*, to wit:

> "*Each of these alternative premises of value may apply under the same standard, or definition, of value. For example, the fair market value standard calls for a 'willing buyer' and a 'willing seller.' Yet, these willing buyers and sellers have to make an informed economic decision as to how they will transact with each other with regard to the subject business. **In other words, is the subject business worth more to the buyer and the seller as a going concern that will continue to operate as such, or as a collection of individual assets to be put to separate uses?** In either case, the buyer and seller are still 'willing.' And, in both cases, they have concluded a set of transactional circumstances that will maximize the value of the collective assets of the subject business enterprise*."[6] [Emphasis added]

Dr. Pratt goes on to explain that:

> "*…[t]ypically, in a controlling interest valuation, the selection of the appropriate premise of value is a function of the **highest and best use** of the collective assets of the subject business enterprise. The decision regarding the appropriate premise of value is usually made by the appraiser, based upon experience, judgment and analysis*." [Emphasis added]

Other guidance related to the concept of highest and best use can be found in the *Uniform Standards of Professional Appraisal Practice* (USPAP), as promulgated by The Appraisal Standards Board of The Appraisal Foundation, which is a codification of the standard practices to be utilized within the practice of appraisal and was created for the purpose of promoting and maintaining a high level of public trust in appraisal practice by establishing requirements for appraisers.[7]

According to Standards Rule 9-3 of USPAP:

> "*In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser **must** investigate the possibility that the business enterprise may have a **higher value by liquidation of all or part of the enterprise than by continued operation as is.***"[8] [Emphasis added]

This point is further elucidated in the comment to Standard 9-3:

(Continued on next page)

"*This Standards Rule* ***requires*** *the appraiser to recognize that the continued operation of a business is not always the* ***best premise of value because liquidation of all or part of the enterprise may result in a higher value.***"[9] [Emphasis added]

As illustrated above, the *highest and best use* of the invested capital in a given enterprise may ***not*** be in its *continued use as a going concern* but may, in fact, *be in-exchange*, either as an *orderly disposition of the assets* or in *liquidation*. In either sense, it should be noted that the decision to utilize the *premise of value in-exchange*, in contrast to that of *value in-use*, does not preclude the existence of a requisite valuation of the value of intangible assets. Intangible assets may well exist and hold significant economic value in exchange.

As stated by James Zukin:

"*The underlying asset approach considers the component parts of a business enterprise…[and] can be [performed] on either a net liquidation basis or by using the value of the underlying assets in continued use. The former basis is normally applicable when there is a distinct possibility that the business is worth more 'dead' than 'alive.' While the latter basis is normally applicable when there is little possibility of liquidation*." [10]

Zukin goes further in clarifying the existence of intangible assets by stating:

"…*the market value [of a business enterprise] cannot be lower than the net liquidation value of the [enterprise's underlying assets]…and [a]nother asset area requiring examination [when using the underlying asset approach] is [including the value of] the separately identifiable intangible assets*." [11]

The historical use of the assets comprising a healthcare enterprise, e.g., a physician practice, should provide no binding pre-supposition about the utility to be derived by a typical purchaser from the ownership of one or more of the subject assets. The historical inability of a particular owner to generate a positive net cash flow emanating from the subject asset(s) does not require (nor even imply) that a typical investor in a similar asset(s) would be likewise incapable of utilizing it to produce a positive stream of economic benefit. Investors may acquire assets, such as intangible assets, under different settings and circumstances which are not beholden to the current use of the assets by the seller of the subject intangible assets, or the current owner's difficulties in generating positive net economic benefit from the enterprise in its entirety.

The diversity in uses for assets among purchasers and sellers is an economic fact which gives rise to the difference in anticipated benefit to be derived from the ownership of the subject asset and the opportunity of the participants in a transaction to generate gains from trade. In fact, it is the existence of these differences in value, i.e., the aggregate expected economic benefit accruing to the owner of a particular asset, which underpins the concept of "*willing buyer*" and "*willing seller*." [12]

The expected future economic benefit accruing to the purchaser of a subject asset will tend to put a ceiling on the price the acquirer would be willing to pay. Likewise, the expected future economic benefit accruing to the seller of an asset will tend to put a floor on the price the seller would be willing to accept. Within the gap between the expected future economic benefits of the buyer and seller lies the gains of trade, which may be distributed between the market participants to arrive at the agreed upon transaction price for the subject asset.

According to the theory of utility maximization, rational market participants tend to make decisions in order to maximize their own expected personal utility,[13] with further assumptions pertaining to each participant's decision making criterion, to wit:

(1) *Perfect rationality* (e.g., in that they prefer more benefit to less); [14]

(2) *Perfect self-interest* (i.e., the decisions people make are based solely on the consequences to themselves); [15] and,

(3) *Perfect information* (i.e., an equivalency of knowledge between the parties of all information pertinent to the transaction, which is a key criterion in the definition of Fair Market Value). [16]

This concept of utility maximization was described by Jeremy Bentham (regarded as the founder of modern utilitarianism), as being based on the premise that utility derived from an object is its ability to:

"…*produce benefit, advantage, pleasure, good, or happiness or prevent the happening of mischief, pain, evil, or unhappiness to the party whose interest is considered*."[17]

Therefore, while value is a forward looking concept, market participants will vary in their opinions as to the utility to be derived from ownership or control of an asset. The job of the valuation analyst is to consider each of the appropriate concepts that provide insight and guidance to value, which, in addition to the appropriate standard of value, includes the consideration of the highest and best use of the assets of the enterprise, which informs the valuation analyst's selection of an appropriate *premise of value*.

1 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services" By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Vol. 1, Hoboken, NJ: John Wiley & Sons, 2014, p. 17-18, 26.

2 *Ibid*, p. 17.

3 "The Principles and Concepts of Valuation: Theory of Utility and Value, Value Influences, and Value Concepts" By Richard Rickert, Appraisal and Valuation: An Interdisciplinary Approach, Volume I, Washington, D.C.: American Society of Appraisers, 1987, p. 6-7.

4 Cimasi, 2014, p. 28.

5 Rickert, 1987, p. 55.

6 "Valuing a Business: The Analysis and Appraisal of Closely Held Companies" By Shannon Pratt, Fifth Edition, New York, NY: McGraw-Hill, 2008, p. 48.

(Continued on next page)

7 Preamble to the 2014 – 2015 Uniform Standards of Professional Appraisal Practice published by the Appraisal Standards Board of the Appraisal Foundation, p. U-5.

8 Standard 9 of the 2014 – 2015 Uniform Standards of Professional Appraisal Practice published by the Appraisal Standards Board of the Appraisal Foundation, p. U-62.

9 Standard 9 of the 2014 – 2015 Uniform Standards of Professional Appraisal Practice published by the Appraisal Standards Board of the Appraisal Foundation, p. U-62.

10 "Financial Valuation: Businesses and Business Interests" By James H. Zukin, New York, NY: Maxwell MacMillan, 1990, ¶ 2.10., p. 42-44.

11 *Ibid.*

12 Cimasi, 2014, p. 884-888

13 "The Theory of Political Economy" By William Jevons, 3rd ed., original work published by Macmillan and Co., London, 1888, electronic version from Library of Economics and Liberty utilized, http://www.econlib.org/library/YPDBooks/Jevons/jvnPE3.html#Chapter3 (Accessed 9/13/2012), Ch. 3, p. 2.

14 "Essays on Some Unsettled Questions of Political Economy" by John Stuart Mill, Library of Economics and Liberty, 1874, electronic version: http://www.econlib.org/library/Mill/mlUQP5.html (Accessed 12/18/2014).

15 "Introduction to the Principles of Morals and Legislation" by Jeremy Bentham, Oxford: Clarendon Press (1907) Chapter I.4.

16 "The Behavioral Finance Perspective" by Michael M. Pompian, CFA Institute, 2013.

17 Bentham, (1907) Chapter I.4.

(Continued on next page)

(800) FYI - VALU

Providing Solutions in the Era of Healthcare Reform

Founded in 1993, HCC is a nationally recognized healthcare economic financial consulting firm

- [HCC Home]
- [Firm Profile]
- [HCC Services]
- [HCC Experts]
- [Clients & Projects]
- [HCC News]
- [Upcoming Events]
- [Contact Us]
- [Email Us]

HEALTH CAPITAL CONSULTANTS (HCC) is an established, nationally recognized healthcare financial and economic consulting firm headquartered in St. Louis, Missouri, with regional personnel nationwide. Founded in 1993, HCC has served clients in over 45 states, in providing services including: valuation in all healthcare sectors; financial analysis, including the development of forecasts, budgets and income distribution plans; healthcare provider related intermediary services, including integration, affiliation, acquisition and divestiture; Certificate of Need (CON) and regulatory consulting; litigation support and expert witness services; and, industry research services for healthcare providers and their advisors. HCC's accredited professionals are supported by an experienced research and library support staff to maintain a thorough and extensive knowledge of the healthcare reimbursement, regulatory, technological and competitive environment.

Robert James Cimasi, MHA, ASA, FRICS, MCBA, CVA, CM&AA, serves as Chief Executive Officer of **HEALTH CAPITAL CONSULTANTS** (HCC), a nationally recognized healthcare financial and economic consulting firm headquartered in St. Louis, MO, serving clients in 49 states since 1993. Mr. Cimasi has over thirty years of experience in serving clients, with a professional focus on the financial and economic aspects of healthcare service sector entities including: valuation consulting and capital formation services; healthcare industry transactions including joint ventures, mergers, acquisitions, and divestitures; litigation support & expert testimony; and, certificate-of-need and other regulatory and policy planning consulting.

Mr. Cimasi holds a Masters in Health Administration from the University of Maryland, as well as several professional designations: Accredited Senior Appraiser (ASA – American Society of Appraisers); Fellow Royal Institution of Chartered Surveyors (FRICS – Royal Institute of Chartered Surveyors); Master Certified Business Appraiser (MCBA – Institute of Business Appraisers); Accredited Valuation Analyst (AVA – National Association of Certified Valuators and Analysts); and, Certified Merger & Acquisition Advisor (CM&AA – Alliance of Merger & Acquisition Advisors). He has served as an expert witness on cases in numerous courts, and has provided testimony before federal and state legislative committees. He is a nationally known speaker on healthcare industry topics, the author of several books, the latest of which include: "*Accountable Care Organizations: Value Metrics and Capital Formation*" [2013 - Taylor & Francis, a division of CRC Press], "*The Adviser's Guide to Healthcare*" – Vols. I, II & III [2010 – AICPA], and "*The U.S. Healthcare Certificate of Need Sourcebook*" [2005 - Beard Books]. His most recent book, entitled *"Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services"* was published by John Wiley & Sons in 2014.

Mr. Cimasi is the author of numerous additional chapters in anthologies; books, and legal treatises; published articles in peer reviewed and industry trade journals; research papers and case studies; and, is often quoted by healthcare industry press. In 2006, Mr. Cimasi was honored with the prestigious "*Shannon Pratt Award in Business Valuation*" conferred by the Institute of Business Appraisers. Mr. Cimasi serves on the Editorial Board of the Business Appraisals Practice of the Institute of Business Appraisers, of which he is a member of the College of Fellows. In 2011, he was named a Fellow of the Royal Institution of Chartered Surveyors (RICS).

Todd A. Zigrang, MBA, MHA, ASA, FACHE, 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 20 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 1,000 transactions and joint ventures. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the author of the soon-to-be released "*Adviser's Guide to Healthcare – 2nd Edition*" (AICPA, 2014), numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Accountant's Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies; Business Appraisal Practice*; and, *NACVA QuickRead*. 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 Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

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 Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers, where he has served as President of the St. Louis Chapter, and is current Chair of the ASA Healthcare Special Interest Group (HSIG).

John R. Chwarzinski, MSF, MAE, is Senior Vice President of **HEALTH CAPITAL CONSULTANTS** (HCC). Mr. Chwarzinski holds a Master's Degree in Economics from the University of Missouri – St. Louis, as well as, a Master's Degree in Finance from the John M. Olin School of Business at Washington University in St. Louis. Mr. Chwarzinski's areas of expertise include advanced statistical analysis, econometric modeling, and economic and financial analysis.

Jessica L. Bailey, Esq., is the Director of Research of **HEALTH CAPITAL CONSULTANTS** (HCC), where she conducts project management and consulting services related to the impact of both federal and state regulations on healthcare exempt organization transactions and provides research services necessary to support certified opinions of value related to the Fair Market Value and Commercial Reasonableness of transactions related to healthcare enterprises, assets, and services. Ms. Bailey is a member of the Missouri and Illinois Bars and holds a J.D. and Health Law Certificate from Saint Louis University School of Law, where she served as Fall Managing Editor for the Journal of Health Law and Policy.

Richard W. Hill, III, Esq. is Senior Counsel of **HEALTH CAPITAL CONSULTANTS** (HCC), where he manages research services necessary to support certified opinions of value related to the Fair Market Value and Commercial Reasonableness of transactions related to healthcare enterprises, assets, and services, and conducts analyses of contractual relationships for subject enterprises. Mr. Hill is a member of the Missouri Bar and holds a J.D. and Health Law Certificate from Saint Louis University School of Law.