Health Capital Topics
Volume 10
Issue 7
July 2017
Jessica L. Bailey-Wheaton, Esq., Editor
Todd A. Zigrang MBA, MHA, ASA, FACHE, Publisher

Valuing Healthcare Market Entrance Barriers

The U.S. healthcare industry has often been characterized as having a unique economic structure compared to other U.S. industries. Unlike most industries, the healthcare industry contains numerous barriers to free market competition, such as market controls on price and quality.[1] In particular, market entrance barriers tend to result in a decrease in the supply of providers, reducing price competition, thereby increasing the price of provider services to healthcare enterprises leading to demands for increased reimbursement from third party payors, which price concessions will, eventually, lead to increased expenditures by consumers (i.e., patients).[2] Conversely, already existing healthcare providers in these areas benefit from the restrictions, as their competition is consequently limited.

Due to the specific nature of healthcare market entrance barriers, it is imperative that valuation professionals (and those that they advise) understand the classification and valuation of these types of intangible assets in identifying and quantifying the excess benefit derived by the existing firms that arises from the existence of healthcare market entrance barriers.

Over the past several years, trends within the broader economy have indicated that firms are employing intangible assets to ever greater extents.[3] The healthcare industry has echoed this trend with healthcare enterprises relying more heavily on intangible assets in the generation of their revenue stream.[4] *Tangible assets* are "*…physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, and so on).*"[5] In contrast, an *intangible asset* is a "*…non-physical business asset that grants certain rights and privileges…that have business enterprise economic value for owners*."[6] The intangible assets of a healthcare enterprise may be defined as those non-physical items that grant certain specified property rights and privileges of ownership and that have (or promise) economic benefits.

Market entry barriers typically encountered by healthcare enterprises may include:

(1) The need for large upfront capital investments for startup ventures or capital investments (e.g., electronic health records; big data analytics; or, costly equipment);
(2) Restrictions on access to customers, such as, narrow networks, which may act to limit a provider's access to a patient population if they do not participate in the network;
(3) Regulatory requirements, such as:
    (a) Licenses and accreditations;
    (b) Medicare/Medicaid certifications;
    (c) *Certificates of need* (CON); and,
    (d) Moratoria on certain licenses, such as nursing home beds.

The elements of *Fair Market Value* related to an *intangible* asset may be less perceptible on their face, as compared to *tangible* assets, conceivably giving rise to misconceptions regarding the procedures by which such assets may be valued. Notwithstanding those challenges, intangible assets, such as CON,[7] licenses, and other regulatory permissions (hereinafter referred to as "licenses and certifications"), may hold significant economic value, as the ability to employ the other acquired assets, both tangible and intangible, in the production of revenue is premised on the legal permissibility of the operation of the healthcare enterprise. In the absence of the acquisition of certain licenses and certifications, an acquirer would, in order to legally operate the healthcare enterprise, need to expend time, effort, and capital in the pursuit of obtaining these licenses and certifications. The avoidance of the costs associated with this investment of time, effort, and capital by the acquirer has value for which the acquirer would be willing to pay the seller to transfer these licenses and certifications as part of the transaction.

The existence of market entrance barriers may add significant value to the licenses and certifications held by already existing healthcare enterprises, as horizontal consolidators seeking to expand into a market containing these entrance barriers may find acquiring already existing licenses and certifications preferable to the uncertainty of the regulatory process related to acquiring a license or certificate *de novo*, if this option is even available to them.[8] This demand for existing licenses and certificates creates a market for these types of intangible assets.

There are numerous generally accepted healthcare valuation approaches, methods and procedures in valuating licenses and certifications in locations with market entrance barriers. The choice of approach(es) or method(s) depends primarily upon the purpose of the valuation report and the specific characteristics of the services being appraised. The objective and purpose of

(Continued on next page)

the engagement, the standard of value, as well as the availability and reliability of data must all be considered in the selection of applicable approaches and methods. The three (3) general classifications of approaches are the:

(1) **Market Approach** – The underlying theory is that a prudent investor has the ability to go to the marketplace and purchase similar services. Market approach based methods are premised on the foundation that actual transactions of comparable services provide guidance to the value of the services received.
(2) **Cost Approach** – The underlying theory is that a prudent investor would not pay more for services received than the cost of producing a substitute with the same utility. Cost approach based methods seek an indication of value by determining the current cost of reproducing or replacing the services received.
(3) **Income Approach** – Income approach-based methods measure the present value of anticipated future economic benefits that will accrue to the owner of the services. Economic benefit has several measures: cash flow, net income, net operating income, or payouts. In addition to estimating future benefits of the services, an appropriate rate, risk-adjusted for the subject property, by which the benefits are discounted, must also be developed.

Within each of the above-listed approaches, numerous valuation method(s) and technique(s) may be employed in valuing these market entrance barriers, following the careful consideration of the value standard sought, the purpose of the engagement, and the available data. Examples of techniques that may be used include, but are not limited to, the following methods:

(1) Merger and Acquisition Method;
(2) With and Without Method; and,
(3) Cost Approach-Based Method.

The Market Approach-based *Merger and Acquisition Method* analyzes actual transactions of similar property interests. This method is founded on the conceptual basis of the economic principles of *efficient markets* and *substitution*. When a relatively efficient and unrestricted secondary market for comparable properties exists, and that market accurately represents the activities of a representative number of willing buyers and willing sellers, then the market is most determinative of the value of the subject property. The *Principle of Substitution* holds that the cost of an *equally desirable* substitute, or one of equal utility, tends to set the ceiling of value, i.e., it is the maximum that a knowledgeable buyer would be willing to pay for a property. For example, evidence of the impact on the differential in value of nursing home bed licenses of a *moratorium state* (wherein healthcare enterprises are barred from obtaining new licenses to operate nursing home beds),[9] versus those licenses of a *non-moratorium state*, may be quantified from a comparison of the price paid for the acquisition of *skilled nursing facilities* (SNFs) in *moratorium states* with the amounts paid for acquisition of SNFs in *non-moratorium states*. Accordingly, an analyst may identify similar, prior transactions by reviewing past CON decisions (which typically describe the transaction at issue) through that specific state's department of health, via the agency's website, or by requesting the information from the agency.

Additionally, an example of a Market Approach-based *With and Without analysis* related to market entrance barriers may involve the review and analysis of transactions in states with, and states without, a specific market entrance barrier, e.g., comparing certain types of transactions (such as transactions of assets requiring a CON) in a specific state, in both CON and non-CON states, and then comparing the transactions, e.g., by calculating the price per bed for each of those transactions.

The *Cost Approach-Based Method* may also be utilized, whereby the valuation professional identifies the types of costs associated with obtaining the licenses and certifications. Examples of these costs are:

(1) *Application Costs*; and,
(2) *Opportunity Costs – Lost Profits.*

The range of the *application costs* incurred in obtaining the licenses and certifications may be calculated by examining the costs of the application process, including, but not limited to, the legal fees, consulting fees, cost of permits, and other fees/costs in a specific state over a certain time period. Upon gathering the applicable application cost information, and determining the specific cost categories included within the application process, a valuation professional may then determine which of those costs could likely be allocated solely to the process of obtaining the licenses and certifications (despite the cost being reported over the entire project's duration), e.g., fees and permits, and consulting fees. If, after isolating those costs, there is not sufficient data, the valuation professional may decide to consider data from applications around the U.S. to verify the validity and efficacy of the reported costs.

In addition to *application costs*, an entity applying for licenses and certifications would also incur *opportunity costs* equivalent to lost profits over the period during which the entity underwent the state's requisite regulatory process. In order to quantify these *opportunity costs*, the valuation professional may consider the economic principle known as the *Principle of Substitution*, that states that the cost of an equally desirable substitute (or one of equivalent utility) tends to set the ceiling of value, i.e., it is the maximum price that a knowledgeable buyer would be willing to pay for a given asset or property. As applied to the healthcare valuation process, this concept is embodied in selecting and applying valuation methods in a manner that recognizes that the *Fair Market Value* of healthcare assets is the aggregate present value of economic benefits to be derived from the ownership of the property interest(s), as an alternative to the level of economic benefit that may be projected to accrue from an alternative, hypothetical creation (or build-up) of

(Continued on next page)

property, e.g., assets, of the same type, setting, format, and location. This economic benefit of buying rather than building is referred to as the "*Incremental Benefit*."

The consideration of any value or benefit of ownership beyond the point that the hypothetical start-up matches the economic benefit available from the ownership of the established subject enterprise, referred to as the "*merger point*," requires the careful analysis of the reimbursement, regulatory, competitive and technological environment in which the hypothetical start-up would operate.

As it relates to the licenses and certifications to be obtained, depending on the state in which the subject interest(s) is located, the valuation professional may determine that this utilization of the *build or buy* method is appropriate, as in some states, an entity may obtain the licenses and certifications by one of two paths, either: (a) by purchasing an existing license(s) and/or certification(s), and filing a notice of change of ownership for that license(s) and/or certification(s) (the *buy*); or, (b) by obtaining a new license(s) and/or certification(s) through the state's required process (the *build*).

Due to the increased pace of transactions over the past several years between physician practices and other healthcare enterprises, and the increasing utilization of intangible assets, there has been a heightened level of regulatory scrutiny related to these transactions. Accordingly, increasing importance has been placed on obtaining a certified opinion of value, in accordance with professional standards, related to each of the discrete and separately identifiable tangible and intangible assets, including licenses and certifications, which comprise the transaction. This trend provides significant opportunity for those valuation professionals who understand the distinction and interrelationship of these assets, especially those that are unique to the healthcare industry.

---

1 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, & Services" By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Vol. I, Hoboken, NJ: John Wiley & Sons, 2014, p. 502.

2 "CON- Certificate of Need State Laws" By Richard Cauchi and Ashley Noble, National Conference of State Legislatures, August 25, 2016, http://www.ncsl.org/research/health/con-certificate-of-need-state-laws.aspx (Accessed 7/13/2017).

3 "New sources of growth: intangible assets" By Organisation for Economic Co-operation and Development (OECD), September 2011, https://www.oecd.org/sti/inno/46349020.pdf (Accessed 7/24/2017).

4 "What Ideas Are Worth: The Value of Intellectual Capital And Intangible Assets in the American Economy" By Kevin Hassett and Robert Shapiro, Sonecon, LLC, 2011, http://www.sonecon.com/docs/studies/Value_of_Intellectual_Capital_in_American_Economy.pdf (Accessed 7/24/2017), p. 3-5, 16.

5 "Valuing a Business: The Analysis and Appraisal of Closely Held Companies" By Shannon Pratt, Fifth Edition, New York, NY: McGraw-Hill, 2008, p. 1074.

6 "Dictionary of Health Economics and Finance" By David Edward Marcinko, New York: Springer, 2007, p. 197; "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, & Services" By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Vol. I, Hoboken, NJ: John Wiley & Sons, 2014, p. 709-710.

7 State CON programs require healthcare organizations to justify the need for, and be granted permission to implement, capital projects for healthcare facilities, service line expansions, and major equipment acquisitions. By nature, CON programs are anticompetitive, aimed at preventing over-investment in equipment and facilities by healthcare organizations, which ultimately leads to inflation in healthcare costs. As of the date of publication, 34 states and the District of Columbia have some form of a CON program, a decrease from the 49 states that had programs in 1987. "CON- Certificate of Need State Laws" By Richard Cauchi and Ashley Noble, National Conference of State Legislatures, August 25, 2016, http://www.ncsl.org/research/health/con-certificate-of-need-state-laws.aspx (Accessed 7/13/2017).

8 Some states have a moratorium specifically on nursing home bed licenses, i.e., healthcare enterprises are barred from obtaining new licenses to operate nursing home beds. "CON- Certificate of Need State Laws" Cauchi and Noble, August 25, 2016.

9 *Ibid*.

(Continued on next page)

HCC
HEALTH CAPITAL CONSULTANTS

(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**

HCC Services

- **Valuation Consulting**
- **Commercial Reasonableness Opinions**
- **Commercial Payor Reimbursement Benchmarking**
- **Litigation Support & Expert Witness**
- **Financial Feasibility Analysis & Modeling**
- **Intermediary Services**
- **Certificate of Need**
- **ACO Value Metrics & Capital Formation**
- **Strategic Consulting**
- **Industry Research Services**

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 Master 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 Institution of Chartered Surveyors); Master Certified Business Appraiser (MCBA – Institute of Business Appraisers); Certified Valuation Analyst (CVA – 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, and is the author of several books, the latest of which include: "*The Adviser's Guide to Healthcare – 2nd Edition*" [2015 – AICPA]; "*Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services*" [2014 – John Wiley & Sons]; "*Accountable Care Organizations: Value Metrics and Capital Formation*" [2013 - Taylor & Francis, a division of CRC Press]; and, "*The U.S. Healthcare Certificate of Need Sourcebook*" [2005 - Beard Books].

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). In 2016, Mr. Cimasi was named a "*Pioneer of the Profession*" as part of the recognition of the *National Association of Certified Valuators and Analysts* (NACVA) "*Industry Titans*" awards, which distinguishes those whom have had the greatest impact on the valuation profession.

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 co-author of "*The Adviser's Guide to Healthcare – 2nd Edition*" [2015 – AICPA], 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*. In addition to his contributions as an author, 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); 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's areas of expertise include advanced statistical analysis, econometric modeling, as well as, economic and financial analysis. Mr. Chwarzinski is the co-author of peer-reviewed and industry articles published in *Business Valuation Review* and *NACVA QuickRead*, and he has spoken before the Virginia Medical Group Management Association (VMGMA) and the Midwest Accountable Care Organization Expo.

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. He is a member of the St. Louis Chapter of the American Society of Appraisers, as well as a candidate for the Accredited Senior Appraiser designation from the American Society of Appraisers.

Jessica L. Bailey-Wheaton, Esq., is Vice President and General Counsel 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-Wheaton is a member of the Missouri and Illinois Bars and holds a J.D., with a concentration in Health Law, from Saint Louis University School of Law, where she served as Fall Managing Editor for the *Journal of Health Law & Policy*.

Daniel J. Chen, MSF, is a Senior Financial Analyst at HEALTH CAPITAL CONSULTANTS (HCC), where he develops fair market value and commercial reasonableness opinions related to healthcare enterprises, assets, and services. In addition he prepares, reviews and analyzes forecasted and pro forma financial statements to determine the most probable future net economic benefit related to healthcare enterprises, assets, and services and applies utilization demand and reimbursement trends to project professional medical revenue streams and ancillary services and technical component (ASTC) revenue streams. Mr. Chen has a M.S. in Finance from Washington University St. Louis.