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Healthcare Valuation Series Part II: The Valuation of Intangible Assets

The four-part *HC Topics Series: Healthcare Valuation* will examine various aspects of valuation related to the healthcare industry. The first installment discussed the *fair market value* and *commercial reasonableness* standards utilized by various regulatory bodies and the application of these standards in valuing healthcare enterprises, assets, and services. Part II will address the valuation of intangible assets, and Part III will address the valuation of physicians' services. Part IV will conclude with a discussion of several of the more complex aspects of valuation related to the acquisition of physician practice enterprises and service lines; assets (both intangible and tangible); and, services, by exempt organizations. This *HC Topics Series* is excerpted from the book authored by HCC Chief Executive Officer, Bob Cimasi, entitled, "*Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services*," to be published by John Wiley & Sons early next year.

Last month's installment provided an in-depth discussion of the *fair market value* and *commercial reasonableness* standards as they are applied in the valuation of healthcare enterprises, assets, and services. Because of the heightened regulatory environment in which healthcare providers operate, it is essential that valuation approaches are congruent with general valuation principles, as well as industry-specific regulatory concerns, such as those imposed by the Stark Law, the Anti-Kickback Statute, and relevant provisions of the Internal Revenue Code. This month's installment of the *HC Topics Series: Healthcare Valuation* will discuss the valuation of intangible assets in the healthcare industry.

A significant majority of healthcare transactions do not encompass the simple acquisition of the entirety of a business enterprise as a *going concern*. Most often, these transactions are more complex in nature, encompassing a series of distinct, yet related, transactions and contractual relationships for the acquisition, lease, or co-venture of specified assets (both tangible and intangible), as well as, specified services (both clinical and non-clinical), on other than a *going concern basis* - with, perhaps, only some portion of the target enterprise (e.g., an ancillary service line) being considered as a *going concern enterprise*. Consequently, these transactions often present multiple, inter-related elements and a higher degree of complexity, and it is within these complex transactions that the specific identification and valuation of intangible assets is most often required.

The appropriate classification of assets and the goodwill related to a healthcare enterprise is critical to the valuation process. Each healthcare enterprise will have a unique and distinct profile as to the likelihood of existence of the various specific assets, and these assets may be classified in two general categories: *tangible* and *intangible*. *Tangible* assets are, "…*physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, and so on).*"[1] An *intangible* asset is a "…*nonphysical business asset that grants certain rights and privileges ([e.g.,] copyright, trade names, services marks, brand names, etc.) that have business enterprise economic value for owners. It is an asset without physical form, such as a patent, trademark, physician goodwill, or copyright*."[2]

Although the major distinction between these definitions of tangible and intangible assets is the aspect of their *physicality*, this is not an exclusive definitional barrier. In fact, *physical* tangible assets also possess an *intangible* aspect as regards to the legal rights of property ownership attached to them. Further, there is often some *physical* evidence or element of an *intangible* asset that provides some form of assurance as to its economic existence. For example, relationships between an employer and its employees that form the basis of "*trained-and assembled-workforce-in-place*," are intangible, however, they may be evidenced by employment agreements. *Intellectual property rights*, such as trade names, trademarks, service marks, patents and copyrights are intangible assets; however, they may be evidenced by *certificates, licenses and other related documents*.

Intangible assets fall into two broad categories: Intangible Real Property; and, Intangible Personal Property. Intangible Real Property consists of one or more *legal rights*, but not all legal rights, related to the use of real estate, such as easements, permits, and use rights.[3] Intangible Personal Property consists of all intangible assets that are not related to Real Property.

In the context of the valuation of healthcare enterprises, the typical focus of the classification of assets begins with determining the existence and ability to quantify *intangible assets*. There are several types of intangible assets that may be considered in the valuation of a

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healthcare enterprise. They include: Payor/Client-related Intangible Assets, such as managed care and provider service agreements;[4] Goodwill and Patient-Related Intangible Assets, such as custodial rights to medical charts and records;[5] Human Capital-Related Intangible Assets, such as staff/employee and provider employment agreements and trained and assembled workforce in place;[6] and, Intellectual Property-Related Intangible Assets, such as practice protocols; treatment plans; procedure manuals; trade names; and, trade secrets.[7] Other types of intangible assets include: Locations and Operations-Related Intangible Assets, such as leasehold interests or computerized management information systems;[8] Governance/Legal Structure Related Intangible Assets, such as organizational documents; income distribution plans; and, covenants not-to-compete;[9] Marketing and Business Development-Related Intangible Assets, such as advertising; franchise/licensing agreements; and joint ventures/alliances; Regulatory/Legal-related Intangible Assets, such as facility licenses; medical licenses; permits; and, certificates of need; Financial/Revenue Stream-related Intangible Assets, such as office share arrangements; management services agreements; and financing agreements; and, Technology-related Intangible Assets, such as computer software/network integration; technical/software documentation; and, maintenance/support agreements.[10] Intangible assets also consist of Professional/Personal Goodwill, which is generated by the reputation and personal attributes which accrue to an individual physician which may not be transaction,[11] and Practice/Commercial Goodwill, which is the unidentified, unspecified, residual attributes of the subject enterprise as an operating entity that contribute to the propensity of patients (and the revenue stream thereof) to return to the *subject enterprise* in the future and may be transacted.[12]

In recent years, there has been an increase in hospital-physician integration/transactional activity, which has led to *enhanced regulatory scrutiny* from the Office of Inspector General (OIG), the Internal Revenue Service (IRS), and the Department of Justice (DOJ), through such initiatives as the Fraud Enforcement and Recovery Act (FERA), the Healthcare Enforcement Action Team (HEAT), and in certain provisions of the Patient Protection and Affordable Care Act (ACA)[13] related to the *legal permissibility* of acquiring healthcare enterprises, services and assets. Significant valuation issues arise from these regulatory concerns, including: (1) establishing the very existence of certain tangible and intangible assets; (2) whether (and under which circumstances) it is legally permissible for hospitals to acquire those assets, (3) the selection of and appropriateness of certain valuation approaches and methods, within the selected *premise of value*, in appraising the *Fair Market Value* of these property interests.

There are three general valuation approaches that may be used: the *market approach*, the *asset/cost-based approach*, and the *income-based approach*; however, there is no single approach, method, or combination thereof, that is universally correct or that applies to every valuation. *Market approach* methods are premised on the foundation that actual transactions of similar entities provide guidance to value. *Asset/cost-based* approach methods, which may include cost based methods, establish a determinant of value by aggregating the value of each discrete asset of the enterprise. *Income-based* methods measure the present value of anticipated future economic benefits that will accrue to the owner of the subject entity. The choice of approach(es) or method(s) depends primarily upon the purpose of the valuation and the specific characteristics of both the subject entity and the subject interest. Although all valuation approaches and methods should be considered for the valuation of all Intangible Assets, this does not mean that *all* valuation approaches and methods are applicable to the valuation of *all* Intangible Assets.

Market approach methodologies may be used to estimate of the value of the subject asset based on transactions of properties *similar* to the subject asset. Asset/cost-based methods are often the most appropriate valuation methodology for certain types of intangible assets, such as *trained and assembled workforce*.[14] However, as the asset/cost approach has limited application in the valuation of land (i.e., land is not created, it exists and the cost to acquire would be representative of the market approach), this approach has a limited application, if any, to the valuation of Intangible Real Property. For certain intangible real assets, such as leasehold estates or certain use rights, the income approach may be the most pertinent method of valuation.

Assets, both tangible and intangible, are the *economic resources* of a company that contribute to the company's future economic benefit.[15] As all value is forward-looking, without assets to produce a future economic benefit, a company would have no value. Correspondingly, the value of any enterprise is bound up in the value of each of its discrete, separately identifiable assets. However, each and every asset, tangible and intangible, must be *identified* and *appropriately valued*, utilizing the most appropriate valuation methodologies, to estimate the value of the subject enterprise. As discussed in last month's installment, in the healthcare industry, the valuation standard of *Fair Market Value* allows the valuation of assets under the Anti-Kickback Statute and the Internal Revenue Code, which outline the legal permissibility of the payment of consideration for assets in exempt healthcare organization transactions.[16] Under this standard of value, intangible assets can be valued utilizing market-based, asset/cost-based, and income-based valuation methods. Next month's installment will explore these approaches in the valuation of physician services.

- "Healthcare Valuation Series: A Look at Fair Market Value and Commercial Reasonableness," Health Capital Topics Newsletter, Vol. 5, No. 10, October 2012.

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Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, 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 Intuition 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*" will be published by John Wiley & Sons in the Fall of 2013.

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 valuation and financial analysis for hospitals and other healthcare enterprises. Mr. Zigrang has significant physician integration and financial analysis experience, and has participated in the development of a physician-owned multi-specialty MSO and networks involving a wide range of specialties; physician-owned hospitals, as well as several limited liability companies for the purpose of acquiring acute care and specialty hospitals, ASCs and other ancillary facilities; participated in the evaluation and negotiation of managed care contracts, performed and assisted in the valuation of various healthcare entities and related litigation support engagements; created pro-forma financials; written business plans; conducted a range of industry research; completed due diligence practice analysis; overseen the selection process for vendors, contractors, and architects; and, worked on the arrangement of financing.

Mr. Zigrang holds a Master of Science in Health Administration and a Masters in Business Administration from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives, and serves as President of the St. Louis Chapter of the American Society of Appraisers (ASA). He has co-authored *"Research and Financial Benchmarking in the Healthcare Industry"* (STP Financial Management) and *"Healthcare Industry Research and its Application in Financial Consulting"* (Aspen Publishers). He has additionally taught before the Institute of Business Appraisers and CPA Leadership Institute, and has presented healthcare industry valuation related research papers before the Healthcare Financial Management Association; the National CPA Health Care Adviser's Association; Association for Corporate Growth; Infocast Executive Education Series; the St. Louis Business Valuation Roundtable; and, Physician Hospitals of America.

Anne P. Sharamitaro, Esq., is the Executive Vice President & General Counsel of **HEALTH CAPITAL CONSULTANTS** (HCC), where she focuses on the areas of Certificate of Need (CON); regulatory compliance, managed care, and antitrust consulting. Ms. Sharamitaro is a member of the Missouri Bar and holds a J.D. and Health Law Certificate from Saint Louis University School of Law, where she served as an editor for the Journal of Health Law, published by the American Health Lawyers Association. Ms. Sharamitaro has presented healthcare industry related research papers before Physician Hospitals of America and the National Association of Certified Valuation Analysts and co-authored chapters in "*Healthcare Organizations: Financial Management Strategies*," published in 2008.