The Business of Medicine:

Entry & Exit

Valuing an Existing Physician Practice

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Besides being a sacred, healing art, a physician practice is a business. As a business, an objective buyer will value a medical practice according to the return it is expected to give for the investment. So, the first question is, what's the return one gets from buying or buying into a physician practice? Since no two physician practices are exactly the same, some further analysis is required.

Valuing a physician practice is dependent upon a variety of components. Is it a high-demand specialty practice, general practice, solo or group practice? Is it organized for tax or liability purposes as an LLP, LLC, sole proprietorship, subchapter S, or regular C corporation? Further variety is introduced in the way a practice receives reimbursement. What proportions of the practice revenues come from governmental entities, private insurance companies, and direct pay from patients? How reliable are those revenues going forward? What are the rates the practice has negotiated with payors?

Supply and demand impact the value of a practice. In our current day, many baby boomer physicians are considering retirement. The availability of practices to purchase will be high for many years to come. This means one practice will be shopped against another by new physicians considering a purchase. The practices that buyers are going to consider first are those that have higher barriers to entry, high cash flows, great reimbursement rates, and the best return on investment.

"Barrier to entry" is an assessment of how difficult is it for someone else to begin offering the same service under the same conditions. Is it necessary to buy a lot of expensive equipment to start a similar practice? Does it take an abnormal amount of cash to fund receivables until the eventual collections are made? Is it hard to get the trained support personnel necessary to begin offering the services? Is it difficult to get an attractive location to practice? Is it hard to build a referral practice for these services? All of these questions and more must be considered when deciding whether the barrier to entry to compete is high or low. The lower the barrier to entry, the less a practice is worth in resale. Contrarily, the higher the barrier to entry, the more an investor (which is probably another physician) is willing to pay for a practice.

If one physician purchases a practice from another, an important question to ask is the expected retention rate of patients. What percentage of the patients will continue to go to the new physician? To get the right answer, an investor needs to know why the patients use that physician in the first place. Do patients see the physician because of geographic location? Is it because the physician is a specialist and patients come by referral due to the comfort referring physicians have with that specialist? Is it because the physician is part of a particular insurance plan? The source of patients and the consequent likelihood of patient retention with a different physician who acquires a practice are key to measuring the value of the practice.

In many cases, in order for a physician practice to have value, the physician selling the practice must transition the practice to the new practitioner over time. This gives patients (and in some cases referring physicians) a chance to get comfortable with the new physician. The selling physician can phase out over time. Abrupt changes in ownership create risk for an acquiring physician. Transitioned changes reduce the risk and therefore increase the value of a practice.

Probably the most important determination of what a physician practice is worth is the cash flow that the practice generates. Simply stated, cash flow is how much "cash" is generated on a yearly basis after paying all personnel (except the exiting physician), benefits, supplies, rent, equipment purchases, malpractice insurance, etc. For example, if a solo practice generates $200,000 in cash after payment of all expenses (but before any compensation and benefits paid to the physician), that is the annual cash flow someone would be purchasing. How does that compare to what a physician could earn if the physician worked as an employee for someone else or started up his/her own private practice? That is the decision point for most physicians when considering the purchase of a practice.

So what is the value of a practice? The issues analyzed above, as well as other unmentioned intangibles, make it a complex question. However, a typical small commercial business (of any type, not just a physician practice) is generally valued at 4-6 times cash flow. Included in this purchase price are any assets that are used to produce the acquired revenue and resulting cash flow. Not included in this calculation are assets not used to produce that cash flow. (Note: Any excess equipment or owned real estate should be carved out of the sale of a practice because they are not considered necessary to the generation of the acquired cash flow. However, subtracting out owned real estate also requires replacing those costs with the costs of leased real estate when figuring cash flow).

So, a ballpark method to value a practice would be: Starting with the cash flow of the practice (i.e. cash flow before the selling physician's compensation is paid), subtract from that cash flow number the compensation a purchasing physician would earn if they just went to work as an employee (compensation includes salary, benefits, bonuses, medmal insurance paid on their behalf, etc.), and then multiply that difference times either 4, 5, or 6 (representing 4. 5, or 6 years of cash flow). If the practice being purchased does not generate more cash flow than what a physician would earn by working as an employee for a third party, the practice has no commercial value to an investor physician.

Having said that, any business is worth what someone is willing to pay for it. So just because the formula says that's what a practice could be worth, that does not mean it will sell for that price. The practice may sell for less or more than that. An example of when it is worth more is if the purchaser already has a practice to be combined with the acquired practice. A combination could mean there would be a reduction in overhead costs.

An important note: A smart way to maximize the value of a practice is to transition the new owner in over a period of one to three years, allowing referring physicians and patients an opportunity to get comfortable with the change. This reduces risk for the purchaser. The purchase price can even be set based upon the patient retention rate at the end of an agreed period of time. If a seller does this, be sure to include a non-compete with the buyer in case it doesn't work out so the potential buyer can't practice within 10 miles of where the seller operates.