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Know Your Value in a Practice Buyout

If you retire early from ophthalmic practice, it's easy to get shortchanged on the money you're owed. Sometimes it's a result of not being able to recognize elements of value that you added to the practice, a reluctance to negotiate for more lucrative separation pay or a failure to update business agreements to reflect increases in the practice's value. In addition to simply not being fair, being shortchanged might force you to tap your retirement funds earlier than you had planned to, reducing your tax-favored build-up of pension, 401(k) and IRA assets.

In this article, we explain what you need to know about your interest in a practice, and the practice's value as a whole, to make sure you're fairly compensated in a buyout if and when you retire early. (While this article discusses the buyout in the context of a group practice, the concepts apply similarly to solo practitioners who sell the entire practice upon retirement.)

Your Value in Real Dollars

A senior member of a successful group practice needs to take a critical look at his or her buyout deal well before the actual departure date. Unfortunately, many buyout agreements are drafted and signed, and then put away in a desk until retirement is imminent. An important first step in evaluating your deal is determining your value to the practice.

The concept that a senior physician and practice owner should reap some measure of value for his/her establishment and stewardship of a successful group practice is well-recognized in medical practice transactions. The recognition of one's interest in a practice's hard assets, accounts receivable and goodwill should be memorialized in legally binding partnership, shareholders and/or employment agreements. The biggest issue is whether the formula for determining the values under these agreements is reasonable. Examine closely what the formula says and convert it into a real dollar payout as though it were due today. Does it make financial sense and can the practice handle it realistically?

Valuation of an ophthalmology practice and any subsequent buyouts is measured with three major components: (1) hard assets, which include medical equipment, office equipment, and leasehold improvements; (2) accounts receivable; and (3) goodwill. Of these three, goodwill is generally the most valuable, but also has the most variation.

Measuring Goodwill

For practically all practices, the goodwill buyout of a senior physician recognizes two fundamental values: the institutional goodwill generated by past performance, and the anticipation that a relatively lucrative income stream will continue for some years in the future for the remaining physicians. There are several methods for determining the values, although none is 100 percent valid in terms of fairness and accuracy. In all cases, the real dollars must be understood and negotiated to accomplish two goals: The retiring doctor receives a fair price for the goodwill left with the practice, as well as his/her interest in accounts receivable and hard assets; and the remaining group members are not unduly squeezed by the required payments.

What constitutes goodwill? It includes the tendency of patients to return, and the patterns of referrals. Goodwill also is defined as the going concern value. This is the worth of having an ophthalmology practice that is fully operable, with a trained workforce and properly configured computer systems (hardware and software) and office space. Other assets associated with goodwill include medical charts, patient lists, phone and fax numbers, practice location(s) and perhaps even the practice's name.

Many groups choose to ignore or drastically undercompensate goodwill value. Such an attitude is economically unrealistic in at least two respects. First, there is a fairly clear market for the purchase and sale of ophthalmology practices at substantial goodwill values. If a successful typical ophthalmology practice can be sold for a goodwill price equal to 25 to 40 percent of its average annual gross income (and the seller keeps receivables and the buyer buys the hard assets), then logic calls for setting a co-owner's payout price that includes a comparable goodwill factor.

Furthermore, assuming that patients and referring doctors look not to the individual but to the group, then a senior member's departure may result in a windfall profit to the continuing partners if it weren't for a goodwill payout. Take, for example, a five-shareholder ophthalmology group that offers almost all of the possible subspecialty ophthalmology services. Together, the group is stronger and more diversified than any individual member.

Transition by the Numbers

Using the example of the five-doctor practice, assume that each member's salary, bonuses and retirement contributions total \$350,000 (not un-usual for a typical multi-specialty ophthalmology group) and that one of the partners gives 12 months' notice of his plan to retire early. The ongoing group would presumably recruit a new associate at a first-year salary of \$150,000 with no retirement plan contributions. Unless paid out to the de-parted senior partner, there would be an extra \$200,000 to divide among the continuing partners in the first year after retirement (See table). There would be similar (but, smaller) windfalls in each of the next few years until the new doctor had phased up to a full share of income equal to what the now-retired member had been paid.

Payout Economics				
	Year One	Year Two	Year Three	Year Four
(Departed) Senior Physician	\$350,000	\$350,000	\$350,000	\$350,000
(New) Associate	\$150,000	\$175,000	\$200,000	\$225,000
Differential	\$200,000	\$175,000	\$150,000	\$125,000
Cumulative Differential (No Payout)	\$650,000	.	.	.

Of course, to the extent a practice is so loosely fragmented that each partner has separate patients and/or referral patterns, the example would become less compelling. Most practices, though, expect to retain upwards of 80 percent of the patient volume even in an outright sale to an unrelated purchaser. The likelihood of a continuing group retaining most of a departing partner's patients, therefore, is very good in almost all circumstances, and it increases as the members' activities become more fully institutionalized and group oriented. So what should a practice buyout mean to an ophthalmologist in real dollars?

As an example, assume the same five-shareholder group grosses \$3 million; it owns equipment, furniture, leasehold improvements, etc. valued at \$400,000 and routinely carries accounts receivable of around \$550,000. (Hard assets are valued at cost less depreciation over a 10-year useful life, net of associated liabilities.) Formulas used to calculate the financial package vary greatly, but a fairly common method bases the buyout on the following structure:

- *Goodwill buyout:* The dollar value of goodwill can range anywhere from 25 to 40 percent of the total revenues of the practice for the year, or in this example between \$750,000 and \$1.2 million; a 1/5 interest would therefore yield the retiree between \$150,000 and \$240,000.
- *Accounts receivable buyout:* A 1/5 interest in the accounts receivable would yield \$110,000.
- *Hard asset buyout:* A 1/5 interest in the hard assets would yield \$80,000. So the retiring physician would be entitled to a payout of up to \$430,000. The terms and timing of the payout are, of

course, subject to negotiation. But the financial parameters are generally recognized and fairly easily to ascertain.

Remember, structuring a buyout and valuing your practice's assets can be a complex process. Because of this complexity, potential early retirees should seek the help of a consultant or attorney experienced in structuring medical practice buyouts. When done properly, however, you can relax and enjoy your new position as a retired ophthalmologist, confident in the knowledge you made the right moves to get there.

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