HBMA

HEALTHCARE BUSINESS MANAGEMENT ASSOCIATION

Transition in Equity Ownership – Planning Issues for Medical Billing Companies

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May 28, 2025

Learning Objectives

- Understand that the transition in equity ownership of a medical billing company must be planned for and carefully managed, whether the transition involves individual shareholder transactions or selling the entire company.
- Understand that the financial value (or price) at which these transition events take place is only part of the equation; the non-price parameters will survive the transaction and have a long term impact on the participants.
- Recognize that transition events are inevitable, and that good planning will help to minimize potential conflict and maximize the success of a transition event.

Overview

- Medical Billing Company Transition Issues
- Minority Interest Transfers
- Valuation Continuum: Minority vs. Control
- Controlling Interest Transfers
- Factors That Influence Value
- Valuation Study Workplan
- Valuation Fundamentals

Medical Billing Company Transition Issues

- In the balance of this presentation, the admission and retirement of shareholders will be referred to as Minority Interest Transfers, since each shareholder typically holds a minority interest in the equity (less than 50% of the equity).

- The sale of a majority (more than 50%) of the equity or a 100% interest in the equity of a medical billing company will be referred to as a Controlling Interest Transfer.

Minority Interest Transfers

- The admission and retirement of shareholders to/from RCM companies occurs with greater frequency than many realize.
- These entity transition events are among the most divisive events that a company encounters.
- Differing opinions about the valuation of an RCM company, along with methods of equity & compensation distribution, are the source of much conflict.
- Often, neither buyer nor seller understands the true value of equity to be transferred.
- The provision of equity to employees can prove to be a huge incentive and a strong retention device.
- Transition events are inevitable, and good planning will help to minimize potential conflict and maximize the success of a transition event.

Minority Interest Transfers (cont.)

- Governance Documents
  - Regardless of the legal form of the entity, there typically exists some form of legal agreement which specifies important characteristics such as:
    - Types and size of equity classes which exist.
    - Rights, privileges, and limitations associated with each class of equity.
    - Governance structure of the entity, including the voting rights and control elements afforded to each class of equity.
    - Restrictions placed on the transferability and marketability of each class of equity.
    - Provisions for allowing new equity holders, including conditions, terms & purchase price.
    - Provisions for allowing liquidity events by existing equity holders, including conditions, terms, and purchase price.

Minority Interest Transfers (cont.)

- Governance Documents (cont.)
  - In a traditional Buy-Sell Agreement, ownership was achieved and relinquished at some pro rata share of cash, A/R, and equipment, less debt, or in other words, a pro rata share of the book value of equity.
  - Although simple to calculate, this method completely ignored the value of any intangible assets and ignored that the entity was an income-producing asset.
  - This approach also assumes that no capital appreciation was attainable.
  - Today, after years of observing an active acquisition market, shareholders understand that medical billing companies produce both income and equity value.
  - If your company's Governance Agreement is consistent with the traditional model, then you should anticipate conflict.
  - Review the Governance Documents and make sure the shareholders understand the pricing mechanism for transactions.

Minority Interest Transfers (cont.)

- Generally Accepted Appraisal Theory & the Construction of Buy-Sell Agreements
  - The economic elements of a Buy-Sell Agreement must reflect a balance:
    - The buy-in price for new partners must be set low enough to make it reasonably affordable and in order to allow for continued successful recruitment of management.
    - The buy-in price must not be unfair to existing partners, some of whom have contributed years of sweat-equity to build the entity.
    - A new partner might participate in the profit distributions of the company, and the buy-in price must, to some degree, reflect this new economic benefit.

Minority Interest Transfers (cont.)

- Generally Accepted Appraisal Theory & the Construction of Buy-Sell Agreements
  - The economic elements of a Buy-Sell Agreement must reflect a balance (cont.):
    - Conversely, the buy-out price for retiring partners must be high enough to award the long-tenured contribution of a partner's professional (or personal) goodwill for use by an entity, and the long-tenured contribution of a partner to the development of company goodwill.
    - The buy-out price must not be set so high as to make it unaffordable for the entity. The going concern of the company could be put at risk if the buy-out price is too hih.
    - The retiring partner will typically cease participating in the profit distributions of the entity, and the buy-out price must, to some degree, reflect these foregone cash receipts.
    - The buy-in price does not necessarily need to equal the buy-out price.

Minority Interest Transfers (cont.)

- Generally Accepted Appraisal Theory & the Construction of Buy-Sell Agreements
  - Problems arise because:
    - Retiring shareholders are increasingly less willing to accept traditionally low buy-outs.
    - Young shareholders can not afford to buy into an RCM company at market valuations.
    - Incumbent shareholders use the potential of company equity to entice young management to join their company with neither party to the transaction understanding the value of the equity interest that is being exchanged.
    - Company political and cultural factors can also come into play.
  - There are tools and techniques to solve the unbalanced valuation problems, including tiers of equity, tiers of governance, tiers of income allocation, and tiers of entities.

Valuation Continuum: Minority vs. Control

- Value indications must be adjusted for factors related to the size of the interest being valued (minority vs. majority interest).
- On a per share basis, an investor would be willing to pay more for a share of a controlling interest than for a share of a minority interest.
- Why is a share of a controlling interest more valuable?
    - Control of daily operations and cost structure.
    - Control of cash distributions.
    - Control of strategic direction.
    - Control of liquidity events.

Valuation Continuum: Minority vs. Control (cont.)

- Basis for a Controlling Interest Valuation.
- Create a historical pro forma cash flow statement that is adjusted for non-recurring events or discretionary expenses.
- Typical adjustments include:
  - Excess officer's compensation.
  - Real property lease.
  - Non-recurring expenses.
  - Other personal or discretionary expenses on the books of the company:
    - Automobile leases.
    - Compensation and perks to family members.
    - Discretionary types of insurance coverage.
    - Discretionary T&E and club dues.
    - Discretionary retirement contributions.
  - Revenue and expenses adjusted to a run-rate basis.

Valuation Continuum: Minority vs. Control (cont.)

- Lowest Value Per Share
  - Point A: Net asset value (or book value) as determined via a cost approach.
  - Point B: Minority interest value (equal to net asset value plus goodwill and other intangible value).
  - Point C: 50 percent interest value.
  - Point D: Controlling interest value (equal to net asset value plus goodwill and other intangible value plus control value).
  - Point E: 100 percent interest value.
- Highest Value Per Share

Valuation Continuum: Minority vs. Control (cont.)

Low Valuation **High Valuation**

Low	Retiree Satisfaction	High
High	Ability to Recruit	Low
High	Shareholder's Income	Low
Low	Financial Risk	High

Minority Interest **Controlling Interest**

Controlling Interest Transfers

- The sale of a billing company is a common way for ownership to finally realize the fruits of their labor and financial investment, and can add one final pop to one's retirement funding.
- Conversely, the owners of an RCM company may be contemplating the acquisition of a smaller competitor.
- The sale of RCM companies occurs with greater frequency than many realize.
- Proper preparation for a sale is extremely important.
- The seller must understand the tradeoff between equity and compensation distribution.
- Often, the seller does not understand the true value of the equity to be transferred.
- Must recognize that transition events are inevitable, and that good planning will help to minimize potential conflict and maximize the success of a transition event.

Controlling Interest Transfers (cont.)

- Why are owners of RCM companies selling, or combining with their former competitors?
    - Opportunity to monetize the value of their company at capital gains rates.
    - Healthcare environment is changing, leading to uncertainty and greater risk (whether real or perceived).
    - Economic uncertainty.
    - Access to growth capital and business management expertise.
    - High cost of hardware and software – constantly changing.
    - Reduce back-office requirements.
    - Benefit from economies of scale.
    - Expand service lines.
    - Access to new customers and business.

Factors that Influence Value

- Management should understand the internal and external factors which drive value.
- Whether a tangible exercise listed on the manager's to-do list, or whether an implied responsibility within a job description, a manager should be practicing Value-Based Management.
- A true organizational leader should be managing an RCM company with the goal of creating value for the stakeholders, including equity value for the shareholders.

Factors that Influence Value (cont.)

- A good manager who practices value-based management seeks to:
  - Maximize sustainable value.
  - Monitor performance on a fairly real-time basis.
  - Understand and monitor the direct correlations between actions and value creation.
  - Manage the internal factors which can be controlled.
  - Anticipate the external factors which can not be controlled.
- Understanding the correlation between operational decisions and their impact on firm value is critical to success, and can serve to optimize the planning process.

Factors that Influence Value (cont.)

- As a leader:
  - You have to effectively use all the tools in your toolbox, and you need to proactively plan in order to take advantage of your strengths and market opportunities in order to minimize the impact of your weaknesses and market threats. (SWOT Analysis).
  - You need to create value for all of your company's stakeholders:
    - Your shareholders.
    - Your clients (and their patients).
    - Your employees.
    - Your vendors.

Factors that Influence Value: Internal Factors

- Internal Factors include:
  - Pro forma sustainable financial performance.
  - Historical growth trends.
  - Growth potential – proactive or reactive.
  - Size (net revenue, EBITDA, client contracts, etc.).
  - Verifiability of financial and operating data.
  - Stability, reputation, and quality – stickiness of client relationships.
  - Professional subspecialties and factors influencing each.
  - Workforce, staffing levels, and training.
  - Depth, quality, and versatility of management and staff.
  - Outsourced staffing.

Factors that Influence Value: Internal Factors

- Internal Factors include (cont.):
  - Technology solutions.
  - Equipment age, condition, functional utility, and deferred CAPEX.
  - Data management solutions.
  - IT security.
  - Historical performance and client referrals.
  - Client contract terms.
  - Size of interest being valued.
  - Corporate structure: organizational, taxation, and ownership.

External Factors that Influence Value

- External Factors Include:
  - State of general economy.
    - Availability of patient funds for healthcare.
    - Credit market for buyers.
  - State of healthcare industry.
    - Which specialties do you serve?
    - Preventive medicine, VBC, diagnostics, etc.
    - Rapidly aging population, increased incidence of cancer, etc.
  - Volume impact from changes in size of population with health insurance coverage.
  - Current and anticipated capital gains tax rates.

Valuation Study Workplan

- Frequency.
  - Third-party valuation opinions cost money, and more than ever, as a manager, you need to watch your RCM company's bottom line.
  - So how do you determine the frequency for valuations?
    - How often are your Governance Documents actually utilized?
    - How material (sizable) is the anticipated transaction?
    - Is the anticipated transaction taxable?
    - How much protection do you want to provide to the shareholders, the company, and yourself via the existence of a third-party appraisal in your file cabinet should the need ever arise to support the transaction pricing to a reviewing authority?

Valuation Study Workplan (cont.)

- Procedures
  - Send preliminary information request.
  - Receive and analyze information.
  - Due diligence interview – remote or onsite – to discuss follow-up questions.
  - Develop financial model and follow-up questions from information received.
  - Develop multi-year projection and weighted average cost of capital.
  - Research comparable companies and industry.
  - Refine financial model.
  - Develop preliminary value conclusions.
  - Review preliminary conclusion with client.
  - Issue final value conclusion in a format dictated by the nature of the engagement: value letter, PowerPoint presentation, narrative report, etc.

Valuation Fundamentals

- The American Society of Appraisers (ASA) is the preeminent credentialing organization for appraisers.

- Fair market value is defined as follows: the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is acting under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Valuation Fundamentals (cont.)

- Three basic approaches to valuation:

  - The Income Approach.
    - Variations include the discounted cash flow (DCF) approach or the income capitalization approach.
    - By far the most important valuation approach.
    - Includes intangible value.
  - The Market Approach.
    - Variations include the guideline company approach or the comparable acquisition approach.
    - Includes intangible value.
  - The Cost Approach.
    - Excludes intangible value.
    - Not typically utilized to value an operating company.

Speaker Information

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