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Hawai‘i Health Workforce and IT Summit

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Business Owner Market: Exit Path Choices

- Key Employee(s), Co-Owner, ESOP: 41%
- Child / Children: 24%
- Third party: 29%
- Other: 6%

Source: Business Enterprise Institute, Inc. Member Survey 2011
Business Owner: Business Value

Source: Business Enterprise Institute, Inc. Member Survey 2011

- **LESS THAN $2 MILLION**: 16.30%
- **$2 MIL - $10 MIL**: 48.15%
- **$10 MIL +**: 35.56%
When Do Business Owners Want to Exit?

Source: BEI’s North American Business Owner Survey 2014

- 0-3 Years: 28%
- 3-5 Years: 21%
- 5-10 Years: 30%
- 10+ Years: 21%
What is an Exit Plan?

- Holistic approach to a Business Exit Strategy
- Receive maximum value for life’s work
- Limit the physician’s tax burden
- Keep control of the process
Ingredients for a Successful Exit

• Exit Plan based on the physician’s objectives
• Experienced team of advisors to design and implement the plan
• Cash flow and a quantified business value
• Strong management team in place
• Time
COMPONENTS OF A COMPREHENSIVE EXIT PLAN
within
The Seven Step Exit Planning Process™

OWNER OBJECTIVES

BUSINESS AND PERSONAL FINANCIAL RESOURCES

MAXIMIZING AND PROTECTING BUSINESS VALUE

OWNERSHIP TRANSFERS TO THIRD PARTIES

OWNERSHIP TRANSFERS TO INSIDERS

BUSINESS CONTINUITY

PERSONAL WEALTH AND ESTATE PLANNING

COMPREHENSIVE EXIT PLAN
Team of Professional Advisors

- Financial Planner
- Insurance Advisor
- Investment Advisor
- Business Attorney
- Estate Planning Attorney
- CPA
- Valuation Specialist
- Business Broker
- Investment Banker
- Business or Management Consultant
- Banker
Advisor Team Relationships

- Exit Planning Professional
- Physician or Medical Professional
- Business Consultant/Coach
- Financial/Insurance Advisor
- Asset/Wealth Manager
- Business Attorney
- Transaction Intermediary
- CPA
- Estate Planning Attorney
The Seven Step Exit Planning Process™

Step 1 – Identify Exit Objectives
Step 2 – Quantify Business and Personal Financial Resources
Step 3 – Maximize and Protect Business Value
Step 4 – Ownership Transfer to Third Parties
Step 5 – Ownership Transfer to Insiders
Step 6 – Business Continuity
Step 7 – Personal Wealth and Estate Planning
Why Do I Need a Business Valuation?

Step 2 – Quantify Business and Personal Financial Resources

Your practice could be a valuable asset!
Value of a Business Valuation

An independent business valuation can...

• Help you know what your practice is worth, aid in planning

• Provide prospective buyers with an independent opinion of value

• Help buyer/seller comply with Stark Laws and Anti-Kickback Statutes
Other Benefits of a Business Valuation

Benchmark your practice to similar types of practices
Determine reasonable compensation
Quantify goodwill
Maximize the value of your practice
Satisfy IRS appraisal requirements
Continuity planning
Business Valuation Process

1. Obtain an in-depth understanding of the business and business ownership interest
2. Perform a thorough financial and qualitative analysis
3. Consider all three (3) valuation approaches
4. Asset-based Approach
5. Market Approach
6. Income Approach
7. Consider valuation adjustments (e.g., discounts or premiums)
8. Reconcile indicated value(s) to arrive at a conclusion of value
9. Present findings in a report
Business Valuation “Simplified”

Value = Earnings / Risk

$200,000 / 20% = $1,000,000

Or

Value = Earnings X Multiple

$200,000 X 5 = $1,000,000
Beware of Rules of Thumb!

- A rule of thumb is a principle with broad application that is not intended to be strictly accurate for every situation (Source: Wikipedia)
A Tale of Two Physician Practices

- Both practices had “earnings” of $200K in 2014
- Physician practices sell for 5X earnings
- So both practices are worth $1 Million, right?
A Tale of Two Physician Practices

Additional Facts...

- Practice 1 has one physician and one office support staff employee
- Physician 1 takes a $100K salary

- Practice 2 has one physician, four nurse practitioners, and 2 office support staff employees
- Physician 2 takes a $700K salary

- Both practices are C corporations
- Reasonable salary for both physicians is $200K
# A Tale of Two Physician Practices

Effect of reasonable salary adjustment on value

<table>
<thead>
<tr>
<th></th>
<th>Practice 1</th>
<th>Practice 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical earnings</td>
<td>$200K</td>
<td>$200K</td>
</tr>
<tr>
<td>Salary adjustment</td>
<td>-100K</td>
<td>+500K</td>
</tr>
<tr>
<td>Adjusted earnings</td>
<td>$100K</td>
<td>$700K</td>
</tr>
<tr>
<td>Times: Value Multiple</td>
<td>x 5</td>
<td>x 5</td>
</tr>
<tr>
<td>Value of Practice</td>
<td>$500K</td>
<td>$3.5 Million</td>
</tr>
</tbody>
</table>
Maximizing the Value of Your Practice

Primary value drivers
- Earnings
- Risk

Ways to increase value
- ↓ Earnings
- ↓ Risk
- ↑ Earnings AND ↓ Risk
Maximizing the Value of Your Practice

“Controllable” Physician Practice Risk Factors

- Reliance on key providers (you?)
- Key referral relationships
- Payer mix
- Procedures / services mix
- Depth of management
Reasons forExiting

- Resignation
- Termination
- Death
- Disability
- Death
- Divorce
- Bankruptcy
- Disqualification
- Default
- Disagreement
Types of Buy-Sell Arrangements

- Redemption
- Cross-Purchase
- Hybrid
Valuation Mechanisms

- Agreed Value
- Formula Agreements
- Appraisal
- Insurance buy-out
Financing a Sale

- Cash
- Seller-financed buy-out
- Company-financed buy-out
- Insurance buy-out
Estate Planning Considerations

• Most wealth tied up in the business
• Different types of practices will implicate different considerations
  • Owner-dependent
  • Multigenerational
  • Marketable
• Gift & Estate Taxes
John Doe Physician, Inc.
Exit Strategy Payout Option #1

Total Exit Package for Owner

$3,000,000
(Not including rental income stream)

Buyout
$2,200,000

Employment Contract
$650,000
Yr. 1 = $300,000
Yr. 2 = $200,000
Yr. 3 = $150,000

Covenant Not to Compete
$150,000
($50,000 per year for three years)

Building Rent*
≈ $10,000/mo
(subject to appraisal)

*Based on RE market conditions
John Doe Physician, Inc.
Exit Strategy Payout Option #2

**Total Exit Package for Owner**

- **$3,000,000**
  (Not including commission nor rental income stream)

  - **Buyout**
    - $1,550,000
      (subject to appraisal)
  - **Employment Contract**
    - $1,000,000
      Yr. 1 = $300,000
      Yr. 2 = $250,000
      Yr. 3-5 = $150,000
  - **Fringe Benefits**
    - $200,000
      (40% per year for five years)
  - **Covenant Not to Compete**
    - $250,000
      ($50,000 per year for five years)

**Commission for New Revenue**

- 5% of any work referred

**Building Rent**

- ≈ $10,000/mo
  (subject to appraisal)

*Based on RE market conditions*
John Doe Physician, Inc.
After-tax Cash Flow – Stock Purchase

<table>
<thead>
<tr>
<th></th>
<th>Corporation</th>
<th>Seller</th>
<th>Buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout at $3.0M</td>
<td>-</td>
<td>($1,065,000)</td>
<td>-</td>
</tr>
<tr>
<td>Employment K</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Noncompete</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tax benefit / (cost)</td>
<td>-</td>
<td>(1,065,000)</td>
<td>-</td>
</tr>
<tr>
<td>Total cash inflow / (outflow)</td>
<td>-</td>
<td>3,000,000</td>
<td>($3,000,000)</td>
</tr>
<tr>
<td>After-tax cash flow</td>
<td>-</td>
<td>$1,935,000</td>
<td>($3,000,000)</td>
</tr>
</tbody>
</table>
John Doe Physician, Inc.
After-tax Cash Flow – Exit Strategy #1

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Seller</th>
<th>Buyer</th>
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<tbody>
<tr>
<td>Buyout at $2.2M</td>
<td>-</td>
<td>($ 781,000)</td>
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<tr>
<td>Employment K of $650k</td>
<td>$212,875</td>
<td>(316,225)</td>
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<td>Noncompete of $150k</td>
<td>60,600</td>
<td>(61,500)</td>
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<tr>
<td>Tax benefit / (cost)</td>
<td>273,475</td>
<td>(1,158,725)</td>
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<tr>
<td>Total cash inflow / (outflow)</td>
<td>(800,000)</td>
<td>3,000,000</td>
</tr>
</tbody>
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After-tax cash flow | ($526,525) | $1,841,275 | ($2,200,000) |
John Doe Physician, Inc.
After-tax Cash Flow – Exit Strategy #2

<table>
<thead>
<tr>
<th></th>
<th>Corporation</th>
<th>Seller</th>
<th>Buyer</th>
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</thead>
<tbody>
<tr>
<td>Buyout at $1.55M</td>
<td>-</td>
<td>($ 550,250)</td>
<td>-</td>
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<tr>
<td>Employment K of $1.0M</td>
<td>$ 327,500</td>
<td>(486,500)</td>
<td>-</td>
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<tr>
<td>Noncompete of $250k</td>
<td>101,000</td>
<td>(102,500)</td>
<td>-</td>
</tr>
<tr>
<td>Fringe benefits of $200k</td>
<td>80,800</td>
<td>(82,000)</td>
<td>-</td>
</tr>
<tr>
<td>Tax benefit / (cost)</td>
<td>509,300</td>
<td>(1,221,250)</td>
<td>-</td>
</tr>
<tr>
<td>Total cash inflow / (outflow)</td>
<td>(1,450,000)</td>
<td>3,000,000</td>
<td>($1,550,000)</td>
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<tr>
<td>After-tax cash flow</td>
<td>($ 940,700)</td>
<td>$1,778,750</td>
<td>($1,550,000)</td>
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</table>
John Doe Physician, Inc.  
After-tax Cash Flow – Summary

<table>
<thead>
<tr>
<th>Stock purchase vs Option #1</th>
<th>Corporation &amp; Buyer</th>
<th>Seller</th>
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</thead>
<tbody>
<tr>
<td>Stock purchase</td>
<td>($3,000,000)</td>
<td>$1,935,000</td>
</tr>
<tr>
<td>Option #1</td>
<td>(2,726,525)</td>
<td>1,841,275</td>
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<tr>
<td>Net benefit / (cost)</td>
<td>$ 273,475</td>
<td>($ 93,725)</td>
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<table>
<thead>
<tr>
<th>Stock purchase vs Option #2</th>
<th>Corporation &amp; Buyer</th>
<th>Seller</th>
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<tr>
<td>Stock purchase</td>
<td>($3,000,000)</td>
<td>$1,935,000</td>
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<tr>
<td>Option #2</td>
<td>(2,490,700)</td>
<td>1,778,750</td>
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<tr>
<td>Net benefit / (cost)</td>
<td>$ 509,300</td>
<td>($ 156,250)</td>
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Getting Started and Maximizing Value

• Hiring a Team
  • All of the necessary skill sets are represented
  • Professionals are familiar with each other and overlap of services are minimized
  • Pricing is generally better

• Formalize the Process
  • Engages professionals who understand the process
  • Keeps everyone on task and committed to the solution
  • Minimizes physician’s time away from their practice

• Sharing the News
  • Communicates your commitment to the transition
  • Provides an independent, third-party source of information to stakeholders
  • Offers one measure of value which may be used in other financial planning for the owner
Questions?