Top Five Drivers of Value for a Medical Practice
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An excerpt from Physician Practices: Key Value Drivers in a Changing Environment

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1. Top Five Drivers of Value for a Medical Practice

By Carol Carden, CPA/ABV ASA, CFE

The recent shift back to hospitals purchasing physician practices has elicited much discussion about what a physician practice is worth and what drives the value of the practice. While valuing entities that operate in the healthcare industry is anything but straightforward, here are the top five drivers of value for physician practices.

1. Physician extenders.
The existence of physician extenders, such as nurse practitioners or physician assistants, typically creates value for the practice because of their ability to generate revenues in excess of their costs. To create the most value, the extenders must be highly utilized and their compensation must be in line with their productivity. Given appropriate compensation, the resulting profit of the physician extenders’ work will fall to the bottom line of the practice and create value. Unlike with physician compensation, physician extenders do not typically receive as compensation all of the profits generated by their individual efforts. Additionally, the associated employee benefit and malpractice insurance costs are typically lower for physician extenders than they are for physicians, creating further opportunity for profits to be generated by the appropriate use of extenders.

Given the changes projected to come about due to healthcare reform, namely the significant anticipated increase in the insured population, it is likely that more practices will employ a physician extender staffing model, particularly in primary care, to help address demand and access in a climate that is already fraught with physician shortages.

2. Ancillary services.
Implementation of significant ancillary services, such as computerized tomography (CT) and magnetic resonance imaging (MRI), are capital-intensive endeavors. However, larger practices sometimes pursue this option as a means of generating additional revenue. Obviously, for the
ancillary service to generate additional value for the practice, the practice must have performed an adequate analysis of need for the service prior to implementation. An underutilized ancillary service could actually serve to detract from the value of the practice. However, if the volume exists to make ancillary service productive, the resulting profits serve to create value for the practice.

This value creation is highly dependent upon how the practice physicians are compensated. If the practice distributes all earnings to physicians in the form of compensation (as is typically the case for a physician practice), the existence of ancillary services results in higher-than-average physician compensation, rather than increased practice value. This is where an understanding and appropriate consideration of post-transaction compensation is critical. If, post-transaction, the physicians will be paid fair market value compensation for their personally performed services only (generally meaning the impact of ancillary revenues/profits generated are excluded), the result can be a decrease in physician compensation. Consequently, the reduced physician compensation allows the profits from the generation of ancillary services to fall to the bottom line of the practice as profits and, therefore, to increase the value of the practice.

3. Payer mix.

Payer mix can be a significant driver or detractor from practice value. If a practice has a significant presence of commercial insurers in its practice, all things being equal, the practice will generally have higher profits and, therefore, higher value than a practice with a more significant concentration of government-funded patients. Not only are commercial reimbursement rates typically higher than government payer rates (such as Medicare or Medicaid), but the rate of annual increase is also generally greater.

Practices with a significant concentration of governmental payers, in particular, need to understand the developments on the horizon in terms of changes to reimbursement. Healthcare reform is expected to have a positive impact on the trend in reimbursement for primary care services. However, as with most government initiatives, decreases in reimbursement for other specialties will offset increases. This is why it is important to understand not only the payer mix for purposes of anticipating changes in the commercial insurance rates, but also the potential impact on value for reimbursement shifts from Medicare and Medicaid. Most commercial insurance companies trend in a similar reimbursement direction as Medicare, but the adjustments typically come several years later for commercial payers.


Similar to payer mix, commercial insurance rates can be a driver or a detractor from the value for a physician practice. Obviously, the higher the proportion of commercial insurance payers in a practice’s payer mix, the more important the commercial insurance rates are to the financial outlook for a practice. Larger practices tend to have greater leverage with commercial insurance companies and have the potential to negotiate more favorable commercial reimbursement rates as well as higher annual rate increases. However, when a commercial insurer has a significant market
presence, the existence of commercial insurance patients in a practice can serve as a detractor from value. As an example, healthcare providers in Alabama have experienced commercial reimbursement rates from Blue Cross Blue Shield (BCBS) at much lower rates than other commercial payers, and in some instances, rates have actually been lower than Medicare rates due to BCBS’s effective use of market leverage.

5. **Overhead cost management.**

The management of overhead costs can benefit or harm a practice’s value. A practice that is staffed too heavily, for example, can suppress profits and value even when the practice otherwise has a strong commercial payer mix and favorable reimbursement rates. A wise exercise to undertake in any physician practice acquisition is to benchmark the overhead expenses and staffing ratios against similar practices in the industry to identify any anomalies that could be suppressing the value and to understand any efficiencies that cause the practice to be more valuable than it otherwise would be. Value can be created in a practice valuation by adjusting expense levels to industry norms, assuming that “any willing buyer” would be able to make such adjustments and the adjustments are not specific to a particular buyer. Also, when making such normalizing adjustments, it is important to consider the productivity level of the physicians working in the practice. For example, if the physicians are highly productive, there may be very legitimate reasons for the overhead to be higher than you might otherwise anticipate. You could create “false” value for a practice by normalizing it in a manner that is simply unrealistic. For example, a practice with physicians producing at the 90th percentile will likely need higher-than-median overhead costs to support such levels of productivity.

Determining the value of a physician practice is a complex undertaking. Understanding the key drivers that impact the value can lead to adjustments that improve and maximize it. However, most important, an accurate valuation will ensure that an acquisition is consummated at fair market value and minimize unexpected surprises in financial outcomes post-acquisition.

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