FAIR MARKET VALUE PRIMER

# MSO Management Fees

*Growing private equity interest in physician groups combined with continued consolidation and alignment initiatives within the healthcare industry have combined to increase the prevalence of the MSO model, which has unique fair market value compliance considerations.*

## GENERAL OVERVIEW

### MANAGEMENT SERVICES ORGANIZATIONS

Management services organizations ("MSOs") are entities that provide practice management and administrative support services to group practices, individual physicians, and other healthcare service providers in exchange for a fee. MSOs relieve physicians of non-medical business functions so they can concentrate on the clinical aspect of their practices. While these types of arrangements come in all shapes and sizes, they can usually be categorized into three main groups:

- **Third-Party MSO**: In some cases, there is no relationship between the MSO and physician practice beyond the services provided by the MSO under the management services agreement ("MSA"). In these arrangements, the services provided are typically, but not always, limited to one or more back office functions, which can include general management oversight, human resources, finance and accounting, marketing and business development, billing and collections, and information technology management, to name a few.

- **Captive MSO/Friendly PC**: On the opposite end of the spectrum, some MSO's are closely linked to the physician practice they serve, whether through common ownership or otherwise. Often these models are developed to facilitate non-physician investment in the operational side of the practice, while maintaining a separate professional corporation to preserve independent clinical decision-making. Particularly in states with corporate practice of medicine ("COPM") and fee splitting laws, ensuring the management fee paid to the MSO is fair market value is crucial.

- **Quasi-JV Model**: The third category consists of partnerships between healthcare providers that may or may not involve a separate MSO entity. These arrangements may take the form of a true joint venture, where one of the partners takes responsibility for management of the JV entity, while others may simply involve one healthcare provider purchasing

unique expertise and resources from another. The primary regulatory concerns with this category are the healthcare fraud and abuse laws, specifically the Stark Law and Anti-kickback Statute, as the parties, or their affiliates, are frequently in a position to refer patients to each other.

## MANAGEMENT FEE STRUCTURES

MSO management fees are typically structured using one, or a combination, of three main structures:

- **Percentage of Practice Revenue**: Percentage of revenue structures can help align the financial incentives of the MSO with those of the practice and are relatively simple to calculate and administer. However, they are prohibited in states with strict fee splitting laws.
- **Fixed Fee**: Fixed fee structures are generally permitted, but can present a challenge for growing practices where accurate budgeting is a challenge. As a result, fixed fee structures may also be modified to include a variable component, such as a fixed fee per provider.
- **Cost Plus Markup**: MSO cost plus markup structures are also generally permitted, but can be difficult to administer, and may not effectively align the financial incentives of the MSO with those of the practice.

## SERVICES PROVIDED BY THE MSO

The final key structural consideration in these types of arrangements is the division of services and resource responsibilities between the MSO and the practice. Arrangements range from general managerial oversight only, which is common for specialized outpatient facility management fees (e.g., ambulatory surgery centers or diagnostic imaging centers), to situations where the MSO is responsible for all of the legally permissible services and resources of the business. The services and resources that are legally permissible for the MSO to be provide can vary significantly from state to state, as many states require that decisions regarding items like malpractice insurance, medical supplies, and clinical support staff be made solely at the discretion of the physician practice. In certain situations, the employment of the physicians can also be the responsibility of the MSO through a wholly-owned entity licensed as a professional employment organization (“PEO”). The following is a common split of resource responsibilities in legally restrictive states:

# MSO Management Fees

| Sample Resource Responsibility by Entity | | |
|---|---|---|
| | Practice | MSO |
| **Personnel** | | |
| Physicians | X | |
| Mid-Level Providers | X | |
| Clinical Support | X | |
| On-Site Administration | | X |
| Marketing | | X |
| Billing and Collections | | X |
| Accounting and Finance | | X |
| Human Resources | | X |
| C-Level Leadership | | X |
| | | |
| **Other Resources** | | |
| Medical Supplies | X | |
| Malpractice Insurance | X | |
| Facility Leases | | X |
| Repairs and Maintenance | | X |
| Taxes and Licenses | | X |
| Technology | | X |
| Office Expenses | | X |
| Professional Fees | | X |
| Business Insurance | | X |

## TESTING FOR FMV

There is no single formula or rule of thumb that ensures that a management fee is FMV. Instead, the management services should be reviewed from several perspectives, each of which is based on economic concepts drawn from the three traditional approaches to valuation: cost, market, and income.

- **Test #1 (Cost)**: Does the management fee result in an implied markup on MSO operating costs consistent with other providers of similar outsourced administrative services to the healthcare industry?
- **Test #2 (Market)**: Does the management fee make sense relative to publicly-available market data?
- **Test #3 (Income)**: Can the practice cover its operating expenses, including fair market value physician compensation for its providers, and even generate a reasonable return for its owners? Is the division of overall profits reasonable?

### Test #1 (Cost): Does the management fee result in an implied markup on MSO operating costs consistent with other providers of similar outsourced administrative services?

The first test involves performing a detailed analysis of the manager's operating costs and determining an appropriate markup on those costs.

1. The cost component of this analysis may include the development of reasonable financial projections for the MSO, or alternatively, bifurcating historical income statements if the business previously operated as one entity.
2. The markup component involves reviewing margin data for similar service providers.

Publicly-available margin data for providers of management and other outsourced services to the healthcare industry is limited since this information is typically confidential. One publicly available

source of this data is the *Scope Research Valuation Database*, which publishes financial statistics and other information related to merger and acquisition transactions involving healthcare companies, including for outsourced service providers. The relevant margin data for a variety of outsourced service providers from this source is summarized below.

| Outsourced Services Margin Benchmarks | | | |
|---|---|---|---|
| Segment | Count | Average EBITDA Margin | Average Markup on Cost |
| Outsourcing: Billing | 8 | 25.0% | 33.4% |
| Outsourcing: Care Management | 6 | 16.0% | 19.0% |
| Outsourcing: Communications | 5 | 20.6% | 25.9% |
| Outsourcing: Consulting | 3 | 22.7% | 29.3% |
| Outsourcing: GPO | 2 | 45.8% | 84.5% |
| Outsourcing: Staffing | 13 | 12.9% | 14.8% |
| Outsourcing: Technology Services | 3 | 25.5% | 34.3% |
| Outsourcing: Transcription | 2 | 23.7% | 31.0% |
| Outsourcing: Workers Comp/Payer Services | 6 | 26.0% | 35.1% |
| Outsourcing: Other | 5 | 28.8% | 40.4% |
| **Total/Average** | **53** | **24.7%** | **34.8%** |

*Source: Scope Research Valuation Database*

### Test #2 (Market): Does the management fee make sense relative to publicly-available market data?

The second test involves comparing the proposed management fee to publicly-available third-party MSO management fee market data, usually as a percentage of practice revenue. The MGMA Cost Survey, which is a physician practice financial benchmarking survey, includes management fees paid by participating practices who outsource at least some management service functions to MSOs. These benchmark fees can be stated as percentage of practice revenue and compared to the proposed management fee; however, they typically only include fees for back office services, and may exclude certain services (billing may not be included, for example).

The management fee being analyzed often involves an MSO that is responsible for providing not only a full suite of back office administrative services, but also a variety of additional resources that are rarely provided by a third-party MSO, which may include on-site support staff, medical supplies, and facility and equipment costs, for example. As a result, it is important to make adjustments to eliminate the costs associated with these additional resources, as well as a reasonable markup on those costs, in order to make a valid comparison to the benchmark data. The following is a hypothetical example of these comparability adjustments that place the comparable management fee at 12.5% to 16.6% of practice revenue:

# MSO Management Fees

| Hypothetical Example of Comparability Adjustments | | | |
|---|---|---|---|
| | Assumed Markup | | |
| **Non-Comparable Components** | **0%** | **10%** | **20%** |
| Clinical Support Staff | $ 4,500,000 | $ 4,950,000 | $ 5,400,000 |
| Onsite Administrative Support Staff | 3,200,000 | 3,520,000 | 3,840,000 |
| Facility Leases | 2,000,000 | 2,200,000 | 2,400,000 |
| Medical Supplies | 500,000 | 550,000 | 600,000 |
| Total Non-Comparable Components | $ 10,200,000 | $ 11,220,000 | $ 12,240,000 |
| | | | |
| Proposed Management Fee | $ 18,500,000 | $ 18,500,000 | $ 18,500,000 |
| Less: Non-Comparable Components | (10,200,000) | (11,220,000) | (12,240,000) |
| **Comparable Management Fee** | **$ 8,300,000** | **$ 7,280,000** | **$ 6,260,000** |
| | | | |
| Practice Revenue | $ 50,000,000 | $ 50,000,000 | $ 50,000,000 |
| *As % of Practice Revenue* | *16.6%* | *14.6%* | *12.5%* |

**Test #3 (Income): Can the practice cover its operating expenses, including fair market value physician compensation for its providers and the management fee, and even generate a reasonable return for its owners? Is the division of overall profits reasonable?**

The final test involves reviewing the practice's financial statements and determining whether it can pay the management fee while also compensating its physicians at fair market value rates. If there is any profit left over after paying the management fee as well, the division of overall income between the practice entity and the MSO should be assessed for reasonableness. In situations where the MSO is responsible for all of the core business functions of the venture, it may be reasonable for the MSO to earn the vast majority of the overall income as long as the physicians receive fair market value rates. In these circumstances, the practice entity operates more like an outsourced professional service provider that would typically provide clinical services to a facility under a professional services agreement ("PSA"). Under PSAs, in return for limited downside risk, the outsourced professional service provider typically forgoes much of the overall profits beyond fair market value compensation for its providers.

# ABOUT BUCKHEADFMV

*BuckheadFMV specializes in the valuation of healthcare businesses, services, and assets of all kinds. Our focus is on providing well-supported FMV opinions for even the most complex arrangements and organizations, deep proprietary research on healthcare valuation issues, and a nimble approach to client service.*

## FMV OPINIONS

Our valuation experts provide fair market value (FMV) and commercial reasonableness opinions for a wide range of financial arrangements entered into by physicians, hospitals, and other healthcare entities.

## BUSINESS VALUATION

We have extensive experience in the valuation of healthcare organizations. Our singular focus on the healthcare industry enables our deep understanding and knowledge of healthcare valuation issues and market data.

## PHYSICIAN COMPENSATION CONSULTING

In addition to valuation services, we provide a variety of compensation-related consulting services, including physician compensation design and modeling.

## ASSET APPRAISALS

Our valuation experts also provide appraisals of furniture, medical and office equipment, medical records, and other selected assets in healthcare facilities. Our reports are specifically tailored to healthcare acquisitions and include documentation of compliance with the Stark Law and other healthcare regulations.

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