

The X Factor— Think About It

Ronald N. Riner, MD

The Journal of Invasive Cardiology
Volume 9, Number 4, May 1997

Reprinted by permission from The Journal of Invasive Cardiology
Copyright © 1997 by Health Management Publications, Inc.



The X Factor — Think About It

Ronald N. Riner, MD

Ford Model's founder, Eileen Ford, is known for saying that all successful models have an "X factor" — that something special you can't quite define or put your finger on. She saw it in Lauren Hutton and she identified it in Christie Brinkley, Candice Bergen, Brooke Shields, and Christie Turlington — all Ford models.¹ Likewise, in sports there is Ken Griffey, Jr., Michael Jordan, Tiger Woods, Tom Watson, Wayne Gretzky and a host of other athletes that stand out among their peers.

In every field of endeavor there are those stars or stellar performers who draw our attention and command salaries and perks that surpass others in their respective professions. In part, their salaries and fees for their services reflect their value and worth, or at least serve as a proxy for what we see as their value.

It is not my intent to bemoan society's tendency to value an athlete above that of a brain surgeon or a superbly trained cardiovascular specialist, but I would like to focus on a ever-increasing dilemma confronting the medical profession and designers of our new delivery systems. Namely, the concept or belief that every physician is equal in ability, i.e. — a physician is a physician is a physician. It is not uncommon to hear buyers and sellers of clinical practices state "I have 30 primary care practices" or "I have 25 specialists in our PHO" etc. This type of

referencing hints at treating professionals as commodities. The frenetic activity of the past several years leading to the buying and selling of medical practices is well known. Therefore, let's focus on some basics pertaining to these undertakings.

There are essentially three approaches to measuring business value and valuation for medical practices — the asset-based valuation methodology, the income-based valuation and the market valuation methodology.²

The *asset-based* valuation begins with construction of an adjusted balance sheet. The appraiser looks at the organization at a specific time and determines the book value of the practice at that time. The *income-based* valuation necessitates a historical revenue stream and the projected revenue streams to come and makes an attempt to value the future benefits of the practice. Finally, the third general classification of appraisal techniques is that of *market valuation*. It may, in fact, be built upon the first two approaches but goes beyond the asset-based approach and the income-based approach and addresses the issue of what the market would be willing to pay for the practice. The market value obviously may vary widely from the values determined in the other techniques.

The wide fluctuations in the prices paid for medical practices in the past several years has undoubtedly been fueled by the growing competition for physicians and their patients in a managed care environment. Market valuation methodology has been the predominant methodology in many medical practice acquisitions with resulting prices so high that recent buyers cannot even expect to

Dr. Riner is President of the Riner Group, Inc., a professional advisory and healthcare management firm offering services to physicians, healthcare systems and industry. A clinical cardiologist, he is a graduate of Princeton University and Cornell University Medical College. He is a fellow of the American College of Cardiology. He can be reached at 1034 S. Brentwood Blvd., Suite 1605, St. Louis, MO 63117. Phone (314) 727-7098, Fax (314) 727-2735.

achieve a return on their investment — a lesson they are only now coming to appreciate.

If the prices have been high, how do we address the economic benefits of a medical practice? It is frequently difficult to measure the economic benefits of a medical practice since the calculation is compounded by a multiplicity of terms and concepts that people use in referring to economic value. To the uninitiated this can be overwhelming and includes terms such as fair market value, growing concern value, investment value, goodwill value, liquidation value, intrinsic value, replacement value, and insurable value. Additionally, there may be other indirect economic benefits (referrals, use of outpatient laboratories, etc.) for an acquirer to consider. Again, it is not my intent to expound upon the terms. However, I do feel that it would be reasonable to highlight the concept of value in a medical practice that is *intrinsic* to the practitioner vs. the value of the practice that is transferable and *extrinsic* to the professional. The educational background, the caring tradition, the bedside manner and charisma of the individual physician contributes in a significant way to the profitability of his/her practice, but the reality is that these characteristics are not readily transferrable to another practice or physician, simply by virtue of contract or negotiated employment agreement. The business characteristics that are transferable include such things as the location of the practice, the payer mix, effective systems for billing and collections, productive managed care contracts and, hopefully, a significant volume of loyal clientele (think patients) who will continue to utilize the practice.

The intrinsic factors attributable to the practitioner are referred to as goodwill or intangible aspects of the practice. As one contends with the numerous issues involved in selling or buying of medical practices, there are probably very few issues that incite as much controversy as the issue of identifying and paying for the personal value of goodwill. The goodwill value of intangibles in a medical practice are extremely debatable and in fact, many purchasers of practices have recently purposely avoided the entire issue, assuming only the hard assets or the transferrable components of the practice. Cognizant of the fact that there are numerous surrogate measurements for the goodwill of a medical practice, in our experience too little effort and attention is paid to assessing the true asset of the practice — namely the practitioner or the professional who's performing the service within the practice.

A medical practice is a professional service business and, as in most professional service business-

es, the asset walks out the door each evening when the lights are turned off. The value of the hard assets is, relatively speaking, a minor component of the true value of the practice. This is also the situation for practices that are located in heavily managed care environments where patients are tied to the practice through contracts. The contract is no panacea, since these contracts are not of indefinite duration and it takes a patient population very little time to learn that the quality of the interaction has changed significantly when there is a significant turnover of the professionals or there has been the substitution of a perceived inferior quality or experienced professional.

In other industries, it has become very popular to focus on the intellectual capital of the business. It is surprising that in medical practice acquisitions we have yet to begin to apply those concepts in any large way. While it is true that intellectual capital does not necessarily equate to effective business performance, it is time to recognize that the value of the people is more important than the hard assets which have been acquired in many of the medical practice acquisitions and mergers over the past several years. There are some who would state emphatically that people aren't assets because you can't easily own them. This is particularly true of medical professionals, many of whom struggle to understand the issue of employment in their new organizational structures. Hospitals and health systems are beginning to understand that the real challenge posed by ownership of professional service firms is not the financial reporting or the measurement of the financial success. Rather, it is the management of these businesses. With successful management and quality practitioners comes positive cash flows and margins which allow you to successfully accomplish the mission and goals of the organization.

In many of the hospital mergers and acquisitions which have occurred throughout the country, there has been extremely little attempt made to understand issues pertaining to the medical professionals who work within the confines of those facilities. There has been almost blind acceptance and assumption that professionals are equally competent, caring and successful. In the future, it will become extremely important to place some type of value or assessment on the "human assets" involved in some of these mergers and acquisitions. What are the factors that drive the value of these professionals? Some of those measures might include:

- The educational background and training experiences and continued training experiences.

- An assessment of patient satisfaction.
- An assessment of employee satisfaction within a particular practice.
- Outcomes measurements as it refers to the care delivered.
- Operational measurements.
- Resource utilization.

Indeed, there are those who speculate that the old rules of accounting need to be adjusted for the new standards of capitalizing human "intangibles." Today's generally accepted accounting principles call for the immediate expensing of R&D cost. But, unlike the rent and interest payments, intangibles (human assets) often produce rich future rewards for which we currently do little accounting. There is a growing body of valuation experts who wish to make a strong case for treating most intangibles the same as hard assets and for the systematic and universal measure of intellectual capital.³

If one accepts the concept that the value of people becomes the true asset in a business, especially a professional service firm, the challenge to owners then becomes monitoring the performance of those assets in the marketplace. Certainly, a superb fashion model or great athlete is monitored not only by financial success but by the performance characteristics readily identifiable to their respective customer base. It may be necessary for us to look at top medical professionals in a similar fashion. What will be those measurements we would likely utilize? They may be parameters such as values, commitment, cultural maturity, communication capabilities, effective partnering, collaborative successes, educational and technical capability, innovation and management of risk, and competitive effectiveness and there will certainly be the opportunity to define new operational measurements for some of these factors?⁴ Having established measurement tools, we will need to reward individuals professionally and financially — no small fete in an environment which regulates the unit interaction between the doctor-patient such that a newly-minted brain surgeon is paid almost the same as a mature experienced professional.

It is my premise that those organizations and medical practices which take the time to investigate and identify measures of the intangible human components of their acquisitions, and reward the human assets appropriately, will be more successful in the future than those organizations that are merely amalgamating hard assets or acquiring any group of available physicians. In highly competitive environments we will see far more emphasis in the future on issues such as educational background and professional capabilities. We will have

less reluctance to measure those and less reticence to speak out against those who will fall below acceptable standards. The market forces of a highly competitive environment will dictate the necessity to focus on issues of human assets involved in these numerous mergers and acquisitions. The intellectual capital of an organization will need to be appropriately looked at in terms of the cash flows, profits, and margins. The old adage of "no mission no margin" will continue to apply. The real challenge posed by intellectual capital is, once again, not the measurement or financial reporting associated with it, but how to manage it and make it function effectively and profitably. In most industries it has taken an owner, not a salaryman, to build a business and a company. This is a fact that the new owners of medical practices need to confront. As more and more physicians seek the shelter of a secured salaried environment, the outcry mounts from hospital administrators and other buyers of medical practices concerning the financial underperformance of those practices. Where will be the points of compromise?

There will be a necessary interaction between strategy and human resource deployment, understanding and utilizing an investment perspective. Just as financial outlays for physical equipment will be evaluated from an investment perspective, expenditures on human resource activities and the acquisition of human resources will be evaluated in terms of return on that investment.⁵

Again, appropriate reward systems will need to be implemented. To focus solely on an investment of physical resources as opposed to the human resources in an acquisition is a policy that will be extremely short-sighted for those running the business and for our ultimate customers — the patients whom we serve. Our patients will demand and expect "The X-factor" in their physicians.

"In long-term relationships, we tend to overvalue what someone is not, and undervalue what they are."

— Anonymous

REFERENCES

1. *USA Today*, April 8, 1997.
2. Hekman KM. *Buying, Selling, and Merging A Medical Practice*. Chicago: Times-Mirror, 1997.
3. Forbes ASAP. *Is Intellectual Capital The New Wealth*, April 7, 1997.
4. Fitz-Nez J. *Are Your Human Assets Outperforming the Market?* American Market Association, February 1997.
5. Hall P. *Strategy in Human Resources*. Englewood Cliffs, NJ 07632.