What is the CON in Your Transaction Worth?

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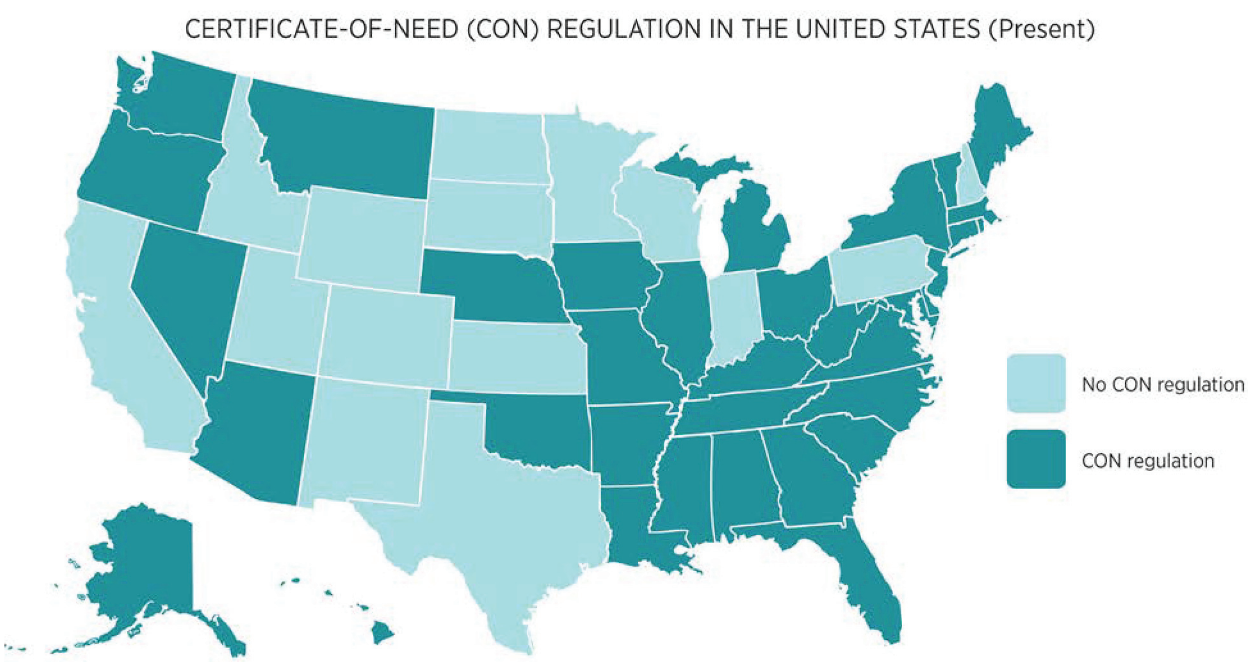
A Certificate of Need (CON) is a permit granted by a state authorizing a health care facility to establish, modify, or construct certain health care institutions, and to initiate certain health care services. In essence, obtaining a CON is a prerequisite for health care facilities to receive state licensure. Without the CON and subsequent licensure, a facility would not be able to contract with payers, treat patients, or operate. In most instances, once the CON has been implemented (i.e., the proposed construction or modification is complete) and licensure granted, the CON is no longer a unique asset, but rather a component of the license. Therefore, a CON can be viewed as either a legal right that has not yet been implemented or as part of an entity's license.

CON laws are intended to help curtail growth in health care costs by preventing unnecessary duplication and allowing coordinated planning of health care facilities and services. CON programs are not federally mandated. Currently, 35 states and the District of Columbia have some form of CON regulation[1]

Figure 1. CON Regulation in the U.S.



(see Figure 1). CON requirements and program complexities also vary from state to state. For example, Tennessee CON law covers 23 types of health care institutions, services, and related activities,[2] whereas Ohio CON law applies only to long term care facilities.[3] With so many states regulating health care facilities through CON laws, companies, attorneys, and consultants should be aware of how CON laws may affect a particular transaction.

At the outset, it should be noted that most states place significant legal restrictions on the transferability of a CON. For example, Tennessee law prohibits the "sale, assignment, lease, conveyance, purchase, grant, donation, gift or any other direct or indirect transfer of any nature whatsoever of a certificate of need."[4] While it is risky to make generalizations about CON rules across state lines, it is more likely than not that a CON cannot be freely sold or otherwise transferred as an independent asset, but rather be sold as part of the purchase of an entire organization/entity or after going through some regulatory process concerning the transfer.

To illustrate this concept, assume a company wishes to expand an existing facility or develop a de novo business. In certain situations, a company may prefer to "buy" a CON instead of apply for one because it may be easier, timelier or cheaper. In many cases, the only way to buy an unimplemented CON is to purchase the entire entity that owns the asset. However, it is not always as simple as acquiring the entity under question in a normal business transaction. For example, in Tennessee, if considering the purchase or sale of an interest greater than 50% in an entity in which the primary asset is an un-implemented CON, the governing board must approve a "change of control."

In instances where a company wishes to purchase a CON that has already been implemented as part of a licensed and operational facility, the license (operational rights) can usually be sold as an independent asset. Please note that in most cases, the license is sold as part of a larger asset purchase, including tangible assets. However, certain states may require a separate CON or other approval from the appropriate regulatory body if the transaction would result in the relocation of the facility or service represented by the CON/license.

Even in situations where a transfer process is time intensive and complicated, value could be present in acquiring/transferring an existing CON if the likelihood of authorization is significantly higher than receiving approval from a new CON application. Since there are likely to be differing permutations and exceptions to general non-transferability rules by state, consultation with legal counsel experienced in the specific state's laws may be advisable if one is contemplating a transaction that includes an implemented or unimplemented CON as an asset.

In light of these circumstances, when this article discusses the value of a CON, what is really being examined are the underlying legal and operational rights of a company that are represented by the ownership of a CON as a prerequisite for licensure or, when implemented, as part of the licensure itself.

When a CON Would Need to be Separately Valued

The separate valuation of a CON may be necessary in business transactions for purchase price allocation purposes, or in some instances, the CON may support the total valuation of the underlying business that is acquired or contributed. Transactions involving profitable entities are usually valued based on a discounted cash flow (Income Approach) or a multiple of EBITDA, earnings, or revenue (Market Approach). The resulting value of an existing facility established under either of these methods inherently includes all of the business assets, including the CON. When a business entity is not profitable or generating minimal cash flow, or not currently operating (unimplemented), separately valuing the CON could be crucial to establishing a purchase price or equity contribution to a joint venture.

In addition to financial considerations, the valuation of a CON could have regulatory and compliance implications. Transactions are often between health systems, physicians, or other referral sources. Due to inherent referral relationships, the valuation of the assets included in the transaction should be consistent with fair market value (FMV) as required by the Stark Law, the Anti-Kickback Statue, and, if involving a not-for-profit entity, possibly private inurement regulations. FMV is defined as:[5]

> *"[T]he price at which property would exchange between a hypothetical willing buyer and a hypothetical willing seller, when each party has reasonable knowledge of the relevant facts, and neither party is under compulsion to buy or sell."*

CON Value Drivers

While a distinct intangible asset may not be found directly on an entity's balance sheet, there is value that can specifically be attributed to a CON due to the time, effort, and expense associated with the CON procurement process. Furthermore, established facilities that possess CON authorization are able to provide services to the exclusion of organizations that do not. In this respect, a CON constitutes a legal right that has discernible value, not unlike a franchise. All things being equal, these limitations on competition will increase the value of an entity with a CON relative to an otherwise identical facility in a market with no CON requirement. The main characteristics that establish or create the relative value of a CON include, but are not limited to, the following:

1. **Probability of Obtaining a New CON**. If a new CON is unlikely to be granted to other market participants, it restricts the supply of competing facilities by creating a large barrier to entry. Limiting the supply of new competitors increases existing facility value, assuming demand remains constant. The probability of a new CON being awarded varies depending on the market and the specific service or activity for which CON approval is sought. For example, Mississippi currently has a moratorium on new CONs for inpatient

psychiatric facilities.[6] Tennessee has a "de facto" moratorium on skilled nursing beds over a set annual number.[7] As a result, the chances of being granted a new CON under these circumstances are fairly remote. On the other hand, in Michigan, the threshold for obtaining an ambulatory surgery center CON is relatively low and approval is more likely (based on the authors' prior experience).

2. **Complexity of the CON Application Process.** The value of a facility's CON will vary based on the state in which the entity operates due to the varying scope and complexities of the state's procurement process. The longer the application process lasts and the greater the costs associated with that process (application, legal, and consulting fees, etc.), the more valuable the CON. Time is an especially critical component as the opportunity cost of lost potential earnings could be significant. It should be noted that each state establishes its own CON criteria that can vary greatly.
3. **Competitive Environment in the Local Market.** The more competitive a market, the more likely other area competitors would contest a CON application. This could increase the time and costs associated with obtaining a CON, such as appeals, hearings, and possible litigation. In addition, the probability of being granted a CON could decline.
4. **Relative Profitability of Service Regulated by the CON.** The inherent value of any intangible asset is directly correlated to the economic benefits a party could achieve through the use of that asset. As a result, the more profitable a service line, the greater the potential economic benefit a party would be able to realize through the use of the CON. For example, a CON related to a profitable service such as orthopedic surgery or cardiology would be more valuable than a low margin business such as dialysis, all other factors being equal.
5. **Demand of Service Regulated by the CON.** The greater the demand for the regulated service in the local market, the more valuable a CON regulating that service. Potential volume seen at any facility is directly related to market demand, and the more volume a facility sees, the greater the realized economic benefits. In addition, existing facilities are more likely to be highly utilized and close to capacity in high demand markets. This may reduce risks associated with acquiring patients after project completion. Furthermore, demonstrating the "need" for a proposed facility could be easier, thereby reducing the difficulty of the application process.
6. **Capacity Granted by the CON.** Logic would indicate that the greater the capacity awarded by a CON, the more valuable the CON. However, when comparing the value of CONs allowing different capacities, assuming a static value per unit through a transitive type analysis could be misleading and inappropriate. The more capacity granted by a CON, the more profitability each unit of capacity would be as the required fixed costs to operate the service line under question are disseminated over a larger revenue-producing base. Therefore, a CON granting authorization for relatively greater units of service should be more valuable than a CON granting relatively fewer units of service. While the static per unit value might be helpful in establishing a rule of thumb, the value per unit may vary based on capacity.

Quantifying CON Value

Determining the value of a CON is a complicated process, and thus a one size fits all methodology is not appropriate. Specific facts and circumstances should be taken into account because CON values can vary widely by state, service, or even market. If you or your clients do not have expertise in valuing CONs, you might consider retaining an independent third party with extensive experience in health care and who understands the unique environment surrounding the industry.

There are three general valuation approaches that can be applied to any business or asset, including the Income Approach, Market Approach, and Cost (or Asset) Approach. First, the Market Approach derives value by referencing comparable transactions involving similar assets or entities. Secondly, the Cost Approach derives value based on the cost to obtain or recreate the same or similar asset of equal utility. Finally, the Income Approach values the entity or asset by discounting the future income producing capacity of the asset to present value using a risk-adjusted rate of return. In order to develop a framework to establish the FMV of a CON, the Market, Cost, and Income Approaches should be considered.

Market Approach

The underlying premise of the Market Approach to valuation is the economic principle of substitution—a prudent buyer will pay no more for a business or asset than it would cost to acquire a substitute with the same utility. The Market Approach is difficult to apply when separately valuing a CON because of the lack of publicly available information regarding specific CON pricing in arm's length transactions. Many deals are for an entire business that includes a multitude of tangible and intangible assets. With limited access to information, identifying the portion of the purchase price specifically applicable to the CON is a speculative exercise and may not be possible. Furthermore, information regarding CON pricing is not necessarily applicable unless it is in the same state or market and for the same type of service as the CON being analyzed. Based on these factors, a valuation analysis of a CON would rarely place significant reliance upon a Market Approach.

Cost Approach

The Cost Approach takes into consideration the cost of replicating a comparable asset or service with the same level of utility. This approach takes into account the actual expense of obtaining a new CON (legal, consulting, and application fees, etc.) as well as the cost of management time in research and preparation.

The Cost Approach is most applicable in situations where a CON could be obtained independently by going through the CON approval process. In most instances, this method will provide a minimum value because it assumes that the probability of obtaining a CON through the application process is 100.0%, which may or may not be the case. In situations where obtaining approval from a regulatory body is next to impossible (i.e., if there is a moratorium) a Cost Approach based analysis may not be appropriate.

The Cost Approach is seemingly the most straightforward of the approaches as the actual costs incurred by a specific facility to obtain a CON should be fairly simple to estimate. Many of the expenditures associated with procuring a CON can be observed from historical records. For instance, each state government's website provides the state filing fee, details around the procurement process, and the expected timeline. It may be more difficult, however, to quantify the incurred expenses for legal and consulting fees, for these vary significantly based on the competitive environment, particularly in situations where the CON may be contested or litigated. As a result, the time and expense associated with uncertain occurrences, such as an appeal or litigation, should be probability adjusted. Indirect expenses, such as management time, can also be difficult to identify as these could vary widely.

If information discussed above is not attainable, a valuation analyst should consult a respected CON lawyer with experience in the respective state. Most CON lawyers familiar with the regulations should be able to provide some guidance on estimated costs, the timeline, and the likelihood of an appeal or litigation. Based on our experience, the costs incurred from application development to eventual approval can range anywhere from $50,000 to well over $1.0 million, if litigation is involved.

Income Approach
The Income Approach estimates the value of a CON by quantifying the cash flows that a hypothetical market participant would realize through the use of the CON. The following discussion details specific methods a valuation analyst could utilize when developing an analysis under the Income Approach.

With or Without Analysis
A "with or without" analysis compares the financial performance of a hypothetical facility that has a CON currently in place with the operations of an identical facility that needs to go through the process of obtaining a CON. A facility with a CON can operate and realize the economic benefits through use immediately. An entity that has not obtained the necessary CON authorization must delay its operations, and possibly its construction, until the CON application process is complete. A with or without analysis simulates the value attributable to a CON by projecting these two scenarios and comparing their values discounted back to present value using risk-adjusted rates of return. Generally speaking, this method values the opportunity costs associated with acquiring an existing CON immediately rather than procuring a new one through an application process.

The differential in cash flow is a function of the projected profitability for a hypothetical facility, the time it takes to be awarded a new CON, and the costs associated with the application process. As previously discussed, the separate valuation of a CON is usually part of an analysis of an entire business (existing or proposed). When separately valuing a CON, the existing operations are often not very profitable, and the cash flows currently generated could be modest or even negative. To be consistent with FMV as earlier defined, the projected profitability should be estimated based on what the typical buyer or market participant could expect to realize, not necessarily what was achieved historically. Furthermore, projecting expected cash flow to a *specific* buyer or project would possibly be inconsistent with the definition of FMV and may be more associated with a strategic value analysis. Quantifying the cash flow a hypothetical buyer would receive is a complicated task that requires experience with the specific type of entity being analyzed, professional judgment, and access to benchmarking information.

The assumptions regarding how long the application process lasts before a new CON is granted are critical. The longer the time frame to obtain a CON and subsequently begin operations, the more potential cash flow a hypothetical buyer would forego. As a result, a with or without analysis should first calculate the cash flow differential utilizing multiple timing and risk assumptions and then weigh those indications based on the probability of success in the respective timeframes. These probabilities should be developed based on the specific facts and circumstances associated with the respective state process, market under question, and the service line being regulated. Based on our experience, operations can be delayed years, which could result in multiple millions of lost earnings.

When performing a with or without analysis to value a CON, it is essential to isolate the impact to cash flow from the specific CON asset. In some scenarios, the incremental cash flows could also be attributed to other mutually contributory assets outside of the CON, such as a non-compete agreement or goodwill.

Residual Income/Excess Earnings Method
This method isolates the "excess earnings" of a business related to a specific asset (in this case a CON) and the unidentifiable assets. The excess earnings are calculated by taking a hypothetical buyer's total expected discretionary cash flow and subtracting the required returns for the other identified assets associated with the business. These other assets typically include (1) the tangible assets such as equipment, furniture, and working capital, and (2) the identifiable intangible assets, such as non-compete agreements, licensure, trade name, and trained workforce. Required returns are determined based upon publicly available market data, industry experience, and professional judgment. Once the excess earnings are calculated, they are capitalized with an appropriate discount rate to arrive at a value indication. However,

unidentified assets such as goodwill may be included in this value estimate. As a result, an FMV analysis may only allocate a portion of the indicated value to the CON.

Valuing a de novo Enterprise

A hypothetical entity awarded with a new CON would have to create a new venture in order to realize any economic benefit through its use. Therefore, the value of a CON can be estimated by simulating the establishment of a hypothetical de novo business in the service line regulated by the CON. This approach is basically a combination of a multi-period excess earnings analysis and the with or without method. Utilizing this type of analysis may be appropriate when the likelihood of being granted a CON through an application process is remote.

Developing a de novo enterprise takes time, capital investment, and usually results in operating losses for a period of time as operations ramp up to normal capacity. As a result, the cash flow projections should account for time, the required investment in tangible assets (equipment, working capital, and possibly real estate) as well as the time and expense associated with hiring and training staff, obtaining licensure with Medicare/Medicaid, and becoming credentialed with commercial payers. The projected cash flows would then be discounted back to present value utilizing a proper discount rate to establish a value indication. This value indication would be entirely intangible in nature because the cash flow projection takes into account all of the required investment in tangible assets. In addition, certain identified intangible assets such as the trained workforce and licensure would not be included in the resulting value as their costs were included in the cash flows. Due to these factors, the residual value indication is inclusive of the CON, possibly non-compete agreements, and unidentified intangible value (mainly related to goodwill/execution risk). Similar to the excess earnings method, a valuation analyst should then make an allocation of this value to the CON based on specific facts and circumstances, experience, and professional judgment.

Similar to the with or without method, in order to comply with the classical definition of FMV, the analysis should pertain to what a hypothetical market participant should expect to achieve when developing a new facility, and not necessarily a specific project. Specific entities may be able to achieve, for example, higher than normal reimbursement and more efficient expense profiles than what a normal market participant would be able to realize. Including entity-specific synergies into a valuation analysis should only be considered when utilizing the strategic value standard.

Conclusion

Assessing the FMV of a CON is far from a simplistic process. Specific facts and circumstances along with each state's CON requirements can make the valuation process complicated and require significant professional judgment. If the CON value is not accurately accounted for in a potential transaction, an entity could risk significantly understating or overstating value or violating federal regulations such as the Stark Law. If you have questions regarding the FMV of an entity's CON and how it relates to the overall enterprise's value, you should contact and engage an experienced health care valuation consultant to assist in the process. ◆

Endnotes

1 Matthew D. Mitchell and Christopher Koopman, *40 Years of Certificate-of-Need Laws Across Amercia* (Sept. 27, 2016), *available at* https://www.mercatus.org/publication/40-years-certificate-need-laws-across-america.

2 Christopher Koopman and Anne Philpot, *The State of Certificate-of-Need Laws in 2016* (Sept. 27, 2016), *available at* https://www.mercatus.org/publications/state-certificate-need-laws-2016.

3 Certificate of Need Program, Ohio Dep't. of Health, *available at* https://www.odh.ohio.gov/odhprograms/dspc/certn/certneed1.

4 *See* Tenn. Code Ann. § 68-11-1620.

5 *See* 42 C.F.R. 411.351.

6 State Health Plan 2015, Mississippi State Dep't. of Health, *available at* http://msdh.ms.gov/msdhsite/_static/resources/6038.pdf.

7 *See* Tenn. Code Ann. § 68-11-122.