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HEALTHCARE MANAGEMENT ADVISORS

How Risk Affects Valuation

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Business valuation is as much an art as a science. It not only requires technical knowledge of valuation methodologies, it requires the valuator to have significant judgement and the industry experience to evaluate the entity in the context of a broad understanding of the industry.

One area where a valuator must exercise considerable judgement is in assessing the risk related to a specific business. The valuator must make critical underlying assumptions regarding something called the Company Specific Risk Premium (CSRP); this can have a material impact on the valuation conclusion. Risk is commonly equated to an investor's required return on an investment (the higher the risk, the higher potential return an investor will require). In simple terms, the higher the CSRP, the lower the valuation conclusion.

A component of the overall discount rate, the Company Specific Risk Premium attempts to quantify risks associated with a particular company that are not already quantified in the other risk premium components[1].

In healthcare, certain unique factors should be considered when determining the CSRP, including:

- **Potential Changes in Reimbursement:** In recent history, CMS has targeted certain services or specialties for reductions in Medicare reimbursements. To what extent do the projected cash flows rely on reimbursement levels that are at risk for potential reductions? Is the entity considering a particular bundled payment or value-based payment initiative? Do the projections include a provision for potential delays in implementation of proposed reimbursement changes?
- **Changes in Provider Complement:** Does the revenue rely on one provider's expertise or reputation? Is the continuation of the current services guaranteed? Are any of the providers contemplating retirement during the projection period? Do the

[1] Other components include the Equity Risk Premium (the additional return an investor could otherwise expect to receive from other publicly traded equity holdings), the Industry Risk Premium (the additional return an inventory would expect to receive in a particular industry), and the Size Premium (The additional return an investor would require from a company of a similar size).

projections assume ramp-up levels for new providers that have the potential to follow a different trajectory?

- **Changes in Technology:** Is the entity relying on equipment that will require significant upgrades in the near future? Are the costs of upgrades or maintenance documented and included in the projections? Will the current equipment be able to be used in its current setting (inpatient or outpatient)?
- **Competitive Forces:** How will consolidation activity among providers impact the business? Have any competitors recently entered or exited the market? Is management aware of any potential competition that could impact the projected volumes? Have any Certificate of Need applications been filed that could potentially divert existing patient care volume away from the entity? Does the business provide a service that is already offered by a larger healthcare entity, such as a hospital?
- **Changes in Population:** Is the business in an area with a large elderly population who are anticipated to utilize healthcare services at a greater rate? Is there an influx of young professionals nearby? Are the company's services geared to the current and future demographics of the area?

Each of the considerations listed above can impact the CSRP to a varying degree. Having a thorough understanding of the business being valued is imperative to determining an appropriate discount rate. A certain level of professional judgement is used when selecting a CSRP, but ultimately the valuator should rely on careful consideration of risk factors associated with the entity being valued.

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