Valuing an Acquisition: Don’t Stop at FMV

Daniel M. Grauman, Managing Director & CEO

Danielle Bangs, Manager
Sean Looby, Manager

When a healthcare organization is considering an acquisition, there are two imperatives: It should know both the fair market value (FMV) of the target organization (the value to a hypothetical buyer) and its investment value (the value to a particular buyer), and it should understand the difference between these values. An acquirer should carefully consider investment value and the business case before making a definitive commitment to a set of deal terms and closing a transaction.

THE CONSTRAINTS OF FMV

Generally, regulators require that FMV is the upper limit for the purchase price in a transaction involving healthcare providers. Not only does FMV define the price, but the calculation of FMV also is itself highly constrained. Only certain information can be used, and the transaction must be assessed based on the concept of the hypothetical buyer and seller, in which the hypothetical buyer represents the whole market of potential “arm’s length” buyers. The specifics of what any transaction is worth to any individual buyer cannot be considered.

Because of these regulations, FMV is based only on the prospective net cash flows of the target’s current operations and general market conditions. The impact of synergies, strategies, or any specific potential benefit or detriment related to the specific transaction and involved buyer and seller are not considered. For example, although revenue estimates can reflect factors such as the target entity’s own growth plans or impending changes in the entity’s current payment structure, certain transaction-specific revenue impacts cannot be considered, such as that of the target entity transitioning to the buyer's health plan contracts or the particular buyer's growth plans.

INVESTMENT VALUE TO THE SPECIFIC BUYER

Although FMV is critical to informing what a buyer can pay (or otherwise contribute) in a transaction, it is the assessment of investment value that will help the purchaser determine the price and terms that make sense for the organization. Understanding the investment value of a transaction illuminates the business case for pursuing it, ultimately helping the purchasing organization to decide whether to proceed.

Although transaction-specific factors are not considered in an FMV calculation, considering such impacts is instructive in determining investment value. The buyer should consider factors such as the financial impact of transaction-specific strategic objectives, synergies, and risks.

Measuring investment value requires developing post-transaction prospective financial estimates for both the target and the combined entity that reflect specific plans and scenarios, such as the consolidation of service lines/business functions, the process of transitioning to the buyer's payer contracts, or potential changes in physician referral patterns. Potential negative impacts, such as competitor response and impact on market share or the loss of existing affiliations, also should be quantified.

GETTING TO DEAL VALUE

Investment value may be similar to FMV in certain scenarios, but more often than not, the investment value of a particular transaction will differ from FMV, depending on the buyer's strategic objectives and plans and the buyer's ability to make the best use of the target's assets. Understanding both FMV and investment value provides guidance for setting or modifying purchase price and deal terms prior to deal close to ensure the deal's full value is realized.

Article reprinted from the hfm Healthcare Finance Blog, July 2017.

877.676.3600 www.veralon.com info@veralon.com