Ten Questions Lawyers and Clients Ask About FMV Valuations

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Nearly every health care business transaction must be based on some measure of fair market value (FMV).[1] Although the attorney's role in the *preparation* of a valuation to support a transaction is limited, most attorneys recognize the need to critically evaluate the opinions they and their clients obtain from valuation experts. Attorneys assist in setting expectations, and helping clients understand why their "back of the envelope" valuation may be unrealistic. This article answers questions that lawyers and their clients commonly ask during the business valuation process.

The Valuation Framework

In preparing an FMV analysis, valuators are required to consider three fundamental approaches to valuation: the income, market, and cost approaches. The income approach measures the value of anticipated economic benefits generated by the business. The market approach determines value by comparing the subject to similar businesses, interests, or intangible assets that have been sold, or comparable transactions in the marketplace. The cost approach is based on the principle of substitution, and represents the cost to build or replace a business or property with the same utility.

The approaches are applicable to varying degrees in different situations and must be applied in accordance with a hypothetical willing and able buyer and seller concept of FMV. The valuation conclusion is formulated on the basis of a comparison of the results of each applicable method.

Question 1: The buyer's reimbursement rates are better than the seller's. Why isn't that reflected in the valuation?

Applying the buyer's rates to the seller entity is inconsistent with the concept of the *hypothetical* buyer as defined above because an FMV conclusion does not reflect synergies expected from a specific buyer or transaction.

In many instances, an acquiring hospital or health system enjoys more favorable payer contracts than those held by smaller providers. A common argument for utilizing the buyer's payer rates is that the universe of hypothetical buyers is limited to larger entities with more favorable third-party contracts than the potential target. However, the favorable rates would only apply after consummation of the transaction. Their impact represents value contributed by the buyer, not the seller, and so reflects investment value, not FMV.

Question 2: Why does the valuation provide for taxation, when the buyer is a tax-exempt entity?

This question is frequently posed by sellers (and buyers) because a provision for income tax in a discounted cash flow analysis results in a lower valuation conclusion.

The premise of FMV requires consideration of the entire universe of potential buyers and sellers. Although a large number of transactions involving health care entities involve tax-exempt entities, the universe of hypothetical buyers also encompasses taxable entities.

To date, numerous Tax Court opinions have been issued that provide guidance for the treatment of pass-through entities.[2] It is difficult to find court opinions related to tax affecting nonprofit entities. The general consensus of the health care valuation community (as expressed in numerous articles and other publications[3]) is that nonprofit entities should be treated similarly to pass-through entities where the distribution of earnings to any individual in the form of compensation or investor distributions would ultimately be subject to taxation. Thus, in most cases, a valuation based on the income approach must include a provision for taxes to be consistent with FMV.

Question 3: Why did the valuator project changes in operating expenses that have historically been stable?

Closely held businesses are often operated in ways that are beneficial to the specific owner. For example, a business might secure an arms-length third-party service contract that guarantees a favorable arrangement for the life of the contract. These contracts create value for the entity—but only if transferable and then only until the contract ends. An FMV analysis must adjust or "normalize" for the kinds of changes in operating expenses that would result when the contract ends.

Rental rates are treated similarly. It is fairly common in small businesses that a business owner also is the landlord for the space in which the business operates. The business owner understands the economic realities for both the health care entity and the real estate entity and can structure the rental arrangement to favor the overall impact on owner earnings. The landlord is unlikely to provide the same preferential treatment to an unrelated lessee. In this example, the valuator would include a normalization adjustment to reflect an FMV lease rate for the space where the business operates.

Question 4: Were future capital requirements included in the projections, and is the estimate adequate?

The income approach reflects the estimated present value of all future cash flows generated by a business to a hypothetical buyer. In a discounted cash flow analysis, the valuator projects revenues and expenses for a discrete number of years, then projects the residual cash flows by estimating the operations of the business at a "steady state." Any understatement of expenses, including capital expenses, will result in overstated cash flows and an inflated valuation conclusion.

Equipment can break or become obsolete and must be replaced to maintain the existing revenue stream. These costs vary from year to year (for example, the average useful life of most imaging equipment is over seven years). The discrete projection period should be long enough to accurately capture future capital expenditures and reinvestments until average annual capital expenditures and relative depreciation are stable.

Question 5: Should plans for business growth be considered in the valuation?

Valuations that include speculative growth and unproven business plans carry the risk of being difficult to defend. One of the most important parts of the valuation process is forecasting future benefits that will be used in an income approach. Forecasts must consider the economy, the trends in the specific industry in question, and the local market characteristics.

Incorporating significant growth is not always consistent with the FMV standard; it may represent investment value. However, incorporating planned growth may be acceptable if said growth is based on a firm track record and documented actions that would be taken to achieve said growth. For example, in 2006, the Delaware Chancery Court issued an opinion on the case *Delaware Open MRI Radiology Associates, P.A. v. Kessler,*[4] which involved a shareholders' dispute. Each party retained a valuation expert and the two valuators reached conclusions that differed significantly. One (of many) differences between the experts' opinions was how the experts handled plans for company expansion. The court ultimately decided that it was reasonable for the valuation to include, at some level, the expansion locations, as there was substantial evidence supporting the company's commitment to opening the expansion sites.

Documentation demonstrating a business' historic achievement of strategic milestones can provide a foundation upon which to build a reliable and defensible analysis.

Question 6: Why is a partial ownership in the business worth less than its pro-rata share of the total business?

Ownership of a 40% share in a business may be worth less than 40% of the entire company value because this 40% owner may have limited control over critical aspects of the business, for example:

- Electing company directors and appointing officers;
- Declaring and distributing dividends;
- Entering into and approving contractual relationships; and
- Raising debt or equity capital for the company.

Numerous studies have been completed regarding the impact of lack of control. To determine the value of a non-controlling interest the valuator will determine an appropriate discount based on factors such as:

- *Nature of the cash flows*: Do the projected cash flows represent cash flows to a controlling owner (usually maximizing the benefit to owners) or to minority owners?
- *Financial control of the business*: Can the investor make decisions regarding distributions? Can the investor control the expense structure of the business?
- *Contractual restrictions*: Does the equity interest have to be held for a minimum amount of time? Can the shares be sold freely?
- *Governance*: Can decisions be made on simple majority or do you need super majority? Are there any existing employment agreements with corporate leadership that may limit the influence of shareholders?
- *Voting rights*: Are there different classes of shares with varying levels of control?
- *Size of the block of stock being valued*: Are voting rights pro-rata? If so, the smaller the ownership interest, the less influence the owner has on decisions.
- *Concentration of ownership*: Is the equity interest a "swing vote"? Is there one controlling owner, or are there multiple minority owners?

Simply stated, the hypothetical buyer is not willing to pay the same amount for a share in a business that is accompanied by little or no control as for a share with which the buyer can exercise influence or make changes to how the business is operated.

Question 7: Why does the valuator consider all aspects of a transaction rather than just the contract for which they've been engaged to provide an opinion of value?

Context is critical. A specific transaction may appear to be within the range of FMV, but when multiple contracts are entered into by the two parties, questions may arise regarding the appropriateness of the arrangement(s) in total.

The many components of a multi-contract relationship between two parties may not be obvious when reviewing a single services contract. The most common example relates to employment contracts. Based on a review of a clinical employment contract, it may not be apparent that related contracts have been offered for a medical directorship or to "lease" ongoing practice operations. The consideration paid for the pieces can be interrelated and must be considered in their totality to ensure FMV and commercial reasonableness.

Employment or service contracts offered in tandem with a business acquisition should be carefully reviewed.

Question 8: The transaction only involves one part of an organization—why is the valuator looking at related entities that are not part of the transaction?

When a transaction involves one division of a larger organization, a skilled valuation professional will ask for the financials of all closely related entities. To understand why, consider the effect of corporate practice of medicine laws. Organizations such as urgent care centers might be established as more than one legal entity to separate the clinical directives (PC) from standard business operations (MSO). This is often done to create a vehicle in which non-providers can invest. While the two entities are separate in function, the success of either may require the success of both, especially if the relationship between them is exclusive.

The two organizations might appear to operate as a single entity, and thus to determine the value of either company, the valuation professional will need to understand intercompany contractual obligations, cash transfers, and formal or verbal services arrangements between the related companies. Further, to properly consider the market approaches, the valuator will need to determine whether the appropriate “comparables” are those that resemble the whole business (urgent care center) or the specific legal entity in question (MSO).

Question 9: When applying the market approach to valuation, how should public company multiples be selected and applied?

A common market approach method is the guideline public company multiple method. It applies stock prices of guideline publicly traded companies (GPCs) in the same business arena to the non-public target. Ideal GPCs are in the same industry as the company being valued and provide similar services to similar customers. The GPC method seeks to identify investment opportunities that would be considered a reasonable alternative to the target, thus indicating the multiples investors are paying for investments in similar businesses.

When selecting GPCs, valuation analysts will seek companies in the appropriate industry and service lines that have normal operations (are not in distress or a period of major transition), have meaningful trading volume on relevant market exchanges, and have transparency in reported financials. After identifying a number of GPCs, the valuation professional will compare the characteristics of the target company to the GPCs.

Frequently, the target company is smaller and more geographically limited than the GPCs (e.g., a four-site regional imaging center vs. RadNet Inc., a national chain of such centers). A small target also will differ from GPCs in size, product diversification, and geographic market. The valuator will consider the additional risk associated with these factors and the characteristics of the subject company when selecting a value multiple.

However, significant consolidation has occurred among publicly traded health care companies over the past 10 years, resulting in fewer GPCs. For many health care transactions, especially physician-led practices, there are too few GPCs to develop a meaningful sample size. Without a meaningful sample size, the valuator cannot rely on this method.

Question 10: When applying the market approach, how should private company multiples be selected and applied?

Another market approach, the private company transaction multiples method, is often loosely applied by clients based on some “rule of thumb” or hearsay from their contemporaries. Clients will regularly call around to friends, colleagues, and competitors and present the results of their informal survey as satisfying FMV requirements.

Valuation accreditation organizations (AICPA, ASA, and NACVA[5]) warn against relying on rules of thumb; such analyses will not hold up to scrutiny. Proper application of private company transaction multiples requires identification and analysis of actual buy/sell transactions involving businesses (or assets) that are *comparable* to the target company.

Ideally, the valuator will identify and review a number of comparable transactions to develop a sizeable sample for comparison. Similar to the GPC method, the valuator will then review the characteristics of the specific target and those of the private transaction targets before selecting value multiples. Although the private transaction targets may be similar to the company being valued, a private company multiple is no less challenging to apply.

- Data is scarce. Difficulties posed by this method derive from the nature of “private” transactions as few buyers or sellers are required to make specific terms of their transactions public.
- Transaction data might lead one to presume that observed prices represent FMV, however:
  - Not all transactions are required to be at FMV. Examples include transactions involving private equity firms or for-profit entities and transactions where parties are not tax-exempt and no referrals exist between the parties.
  - Even if observed transactions are subject to FMV requirements, there is no guarantee the transactions are compliant with FMV.

A skilled valuator will consider all these factors to determine which transactions to include when selecting a value multiple. In many cases there is simply not enough information available to apply this method in a valid and reliable manner.

Conclusion

Every business enterprise is unique, no two health care transactions are exactly alike, and the devil is always in the details. There is no one formulaic method that can be consistently applied to determine FMV. An opinion of FMV is rendered based on the professional judgment of the valuator informed by industry economics, finance, accounting, health care law, and investment principles.

As change occurs in health care business models, health care regulations, and the disciplines influencing valuation, new questions will arise and new answers will be required to develop conclusions of FMV.

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1 Fair market value, defined by the Internal Revenue Service in Revenue Ruling 59-60, is the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

2 *Gross v. Commissioner*, T.C. Memo. 19999-254, *affd*. 272 F. 3d. 333 (6th Cir. 2001); *Wall v. Commissioner*, T.C. Memo. 2001-75, filed Mar. 27, 2001; *Heck v. Commissioner*, T.C. Memo. 2002-34, filed Feb. 5, 2002; *Adams v. Commissioner*, T.C. Memo. 2002-80, filed Mar. 28, 2002.

3 *Business Valuation and Taxes: Procedure, Law, and Perspective*, by David Laro and Shannon Pratt, Wiley Publishers, April 2005; Van Vleet, David R., "The S-Corporation Economic Adjustment Model," Business Valuation Review (Volume 23, No. 3, Sept. 2004); Paschall, Michael A., "Some Observations on Tax Affecting," Business Valuation Review (Volume 24, No. 1, Mar. 2005).

4 *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 2006 Del. Ch. LEXIS 84 (Apr. 26, 2006).

5 American Institute of Certified Public Accountants; American Society of Appraisers; and National Association of Certified Valuators and Analysts.

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