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HEALTHCARE MANAGEMENT ADVISORS

Beyond 'Shark Tank': Applying Healthcare Valuation Multiples Is Harder than It Seems

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It's a familiar scene from a blockbuster show: A billionaire investor sizes up a company by dividing the value of the company by its annual profit to find the *multiple*. It's a metric used to assess the market value of an asset, and in the world of "Shark Tank," it comes to investors quickly and easily.

But while the sharks are telling you the math, they aren't showing you their work. That's important to know in an era of rapid consolidation in healthcare, when healthcare leaders want to quickly and easily determine what a company is worth based on simple arithmetic.

Often, leaders use EBITDA (earnings before interest, taxes, depreciation, and amortization)—a measure of an organization's financial performance—and multiply it by the average price point at which similar organizations have been sold to determine the valuation. But when investment banking professionals and other healthcare finance experts reference a multiple to determine the organization's value, the output usually results from other critical factors they are considering—even if it appears to come to them very quickly.

These factors include the following.

1. **The relative risk of the target and the comparables**. Businesses perceived to be riskier sell for lower multiples. What makes the relative risk of a target acquisition higher than that of comparable companies? Examples include instances when the target offers a more limited range of services, has a smaller referral base, has fewer physician providers, or includes a large percentage of providers nearing retirement.

2. **The organization's strategic position in the market**. Businesses with higher potential for future growth sell for higher multiples. Typically, organizations with established platforms for growth are mid-size or large organizations that are well-positioned to extend into new markets, such as through acquisitions or joint ventures. For many healthcare service companies, there is a correlation between the size of the company and the EBITDA multiple.

3. **A forecast of future profits versus past performance**. Especially in a post-pandemic environment, leaders run the risk of oversimplifying valuations when they quickly apply multiples, Shark Tank style. A valuation professional, on the other hand, will rely on an understanding of historical operations and any permanent or temporary changes to assess the future earnings potential of the target based on the unique factors of the target's operations. For instance, what does cash flow look like nearly two years after the pandemic? What steps has the organization taken to improve quality of care while reducing costs, and how do these efforts position the organization to participate in value-based payment models? Has the organization's payer mix changed since the pandemic began—and will the introduction of new entrants to the market put the organization's payer mix at risk? These questions are especially important in the current environment, wherein almost two years of recent historical performance has been impacted by COVID-19. By crunching the numbers, valuation professionals determine not just the organization's prospective growth, but also its expected expenses and profitability.

4. **Due diligence**. Most initial acquisition offers are subject to due diligence. Because a prospective buyer does not want to surprise a seller with a change in offer terms, the protection afforded by the due diligence period following the acceptance of an offer provides the risk-mitigation necessary for a seasoned transaction expert to quickly arrive at an initial value estimate. This expert can make preliminary observations about the many factors noted above and very quickly consider the positive and negative impacts of each influencing factor in the context of historical performance and future earnings potential. These experts generally have well beyond the 10,000 hours of training and practice in their field and are in a class of "Outliers" that have achieved meaningful levels of mastery. Their quick delivery of a preliminary offer, based on a multiple, is an example of the mental math that a "Shark Tank" expert might make that someone who isn't well-versed in valuation could miss.

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5. **Regulations that might limit consideration of post-transaction improvements to the organization**. If the target company has plans for improvement that will occur post-transaction regardless of a particular investor, these improvements would be considered for their own merit. However, evaluating post-transaction changes to the operation in assessing the value of an organization must be approached with an understanding of the valuation premise. In the case of "fair market value," post-transaction changes to the business that are the result of the benefits and improvements made by the specific buyer are not permissible. In addition, to comply with Stark and Anti-Kickback regulations, the entire benefit package of the transaction components must be considered, including arrangements related to physician compensation. Not all buyers are subject to Stark and Anti-Kickback regulations. They may not be limited to the "fair market value" standard and might consider the synergetic benefits the specific buyer brings to the table and rely on "strategic value" or a different basis when determining an offer.

   For example, if a private equity firm were to say, "Here are the improvements we intend to make once the deal is closed," the expected improvement in value will likely be reflected in the purchase price. In contrast, hospital buyers, subject to Stark law and the Anti-Kickback statute, *cannot* say, "We will improve your payer contracts after the deal is closed and will increase the purchase price to reflect this."

   As demonstrated, valuation professionals must have an understanding of any regulatory limitations on a specific transaction. To the viewer of the "Healthcare Shark Tank," where one panelist is a hospital with Medicare business and another panelist is a private equity buyer, there may be confusion around the different multiples spoken because comparing a fair market value indication and a strategic value indication is like comparing potatoes and tomatoes: both are edible and they sound similar, but they are certainly not the same.

PUBLISHED TRANSACTION MULTIPLES—PROCEED WITH CAUTION

When transactions close, limited information is sometimes published in a press release or communicated in publicly available annual reports. This information may be limited to revenue, earnings, and transaction price. Often, less information is available. In even more limited circumstances, information related to the consideration and structure of the purchase might be indicated. Additionally, the published information generally includes transactions involving buyers that are and are not subject to Stark and Anti-Kickback regulations. Therefore, the transactions might represent a mix of transactions subject to the fair market value standard and others that are not.

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THIS ARITHMETIC ISN'T SIMPLE

The danger in liberally and simplistically applying a multiple to determine the value of a healthcare asset is that without the appropriate context, leaders could get the wrong answer. This could lead them to verbally make promises to other parties—such as during negotiations for a proposed acquisition—that they may not be able to keep.

By engaging a healthcare valuation professional who intimately understands the methodologies for determining a healthcare asset's value, leaders can more confidently enter negotiations knowing they have an accurate understanding of the organization's worth.

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