WHITE PAPER

Understanding Valuations

Valuation nomenclature has changed over the years. Practice values used to be referred to as a percentage of collections, but today's most common reference point is a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA). Traditionally, a solo practitioner thought of earnings as the total remuneration from the business in a given year. The reality, however, was that a portion of those earnings was compensation for the physician providing clinical care, and a portion represented profit generated from the business. Historically, valuations were largely considered the total earnings of the owner, whereas investors focus on the profits of the business as a basis for valuation. Further, investors consider the actual cash flow of the practice on a debt-free basis as the best predictor of their return on investment. This has led to the focus on EBITDA as a measure of a practice's performance, and this is how most other businesses are valued.

What is the right multiple?

There is no easy answer to that question because the multiple is meant to assess the opportunity of the investment and its relative riskiness as well as provide a reasonable rate of return for investors. There are many factors that influence multiples, including location, trained staff, stable or growing revenue stream, payor mix, condition of the facility, mix of services, patient demographics, and profitability.

For group practices, although having a pipeline for future growth is important, the most significant influence on the multiple is historical growth. It is also important to recognize that the higher multiples are applied to those businesses that have a qualified management team in place to support continued growth and ensure replicable earnings, as well as documented policies and procedures to scale the business.

Business owners often focus exclusively on the multiple and don't recognize that equally as important as the multiple is the number the multiple is being applied to – the EBITDA. The traditional valuation of a solo practitioner's office is based on historical performance of the business as a predictor of future performance. The typical adjustments applied to the historical financials are to: 1) bring owner compensation to fair market value, and 2) account for nonrecurring and discretionary expenses.

In contrast, the valuation of a group practice is typically done on a prospective basis, which involves forecasting the performance of the business, in addition to making adjustments for owner compensation, nonrecurring expenses, and discretionary expenses. The purpose of forecasting for group practices is to help a prospective investor see the true investment opportunity, which may not be reflected in the historical financial performance. For example, if a group acquired a practice partway through a given year, the historical financials only reflect that partial additional impact on revenue and EBITDA. The EBITDA adjustment in this example is to show the prospective investor the impact of the acquisition for a full year.

The other nuance in today's marketplace is the different perspective on earnings from different types of buyers. A private equity firm is generally looking to make an investment in a business or partner with the founder of the business and therefore will want to keep as many members of the management teams in place as possible to operate the business and drive performance. However, they may make a downward EBITDA adjustment if they feel additional management team members are needed to continue to grow and support the business.

Conversely, strategic buyers (those who have existing group practices and experience in the industry) may make upward EBITDA adjustments for synergies, including duplicative management team members or third-party vendors, more favorable lab and supply contracts, and more favorable payor contracts. Generally speaking, a private equity firm will likely pay a higher multiple but on a lower EBITDA, whereas a strategic buyer will likely pay a lower multiple on a higher EBITDA.

If you are considering a transition, aside from the valuation of your business, it is critical to understand the other terms necessary to close a transaction. In many cases, there are legal provisions that can have significant economic consequences and therefore should be considered when looking at the "value" of the business. Using an experienced consultant will ensure that you negotiate the best price and transaction terms for your given situation.

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