

# **Getting the Lowdown on Lab & Pathology Practice Valuation: Current Trends & Market Outlook**

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## Overview

- I. Reasons to Value a Lab or Path Practice
- II. Valuation Fundamentals
- III. Valuation Continuum: Minority vs. Control
- IV. Factors That Influence Value
- V. Selected Recent Transactions
- VI. How the National Labs Can Justify Their Valuations
- VII. Where Are Lab Valuations Heading?

## I. Reasons to Value a Lab or Path Practice

- What is the value of a private company?
- A valuation could be required for:
  - Corporate strategic planning
    - As a component of the decision process related to the outright sale of a lab or pathology practice
    - In order to evaluate a purchase offer received for the lab or pathology practice
    - In order to set the price related to an acquisition target
    - In order to facilitate a merger, including allocation of equity

## I. Reasons to Value a Lab or Path Practice

- Shareholder transition planning
  - Formation or restructuring of a buy-sell or shareholder agreement
  - Admission of a new partner
  - Buy out of a retiring partner
- Joint venture formation and dissolution
  - Valuation of initial contributions and allocation of equity holdings
  - Allocation of future income and governance
  - Regulatory concerns regarding fair market rates assigned to ancillary management, billing, and rental agreements
  - Rebalancing of equity due to real (or perceived) changes
  - Dissolution of joint ventures due to economic reasons (whether real or perceived), non-monetary reasons (such as change in administration or mission), or external marketplace factors

## I. Reasons to Value a Lab or Path Practice

- Litigation and dispute purposes
  - Dissolution or rebalancing of joint ventures
  - Involuntary termination of partner
  - Redemption of minority shareholder
  - Divorce
- Taxes and government
  - Equity transfers are typically taxable events
  - Charitable contributions
  - ESOPs

## II. Valuation Fundamentals

- Fair market value to be determined by a qualified independent appraiser
- “Fair market value” is defined as follows: the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is acting under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

## **II. Valuation Fundamentals**

### *Three Basic Approaches to Valuation:*

- The Income Approach (the Discounted Cash Flow Approach)
  - The Market Approach (the Public Market Comparable Approach and the Comparable Acquisition Approach)
  - The Cost Approach – Excludes intangible value
- } Includes Intangible Value

## II. Valuation Fundamentals

- The Discounted Cash Flow Approach
  - Project the Net Revenues to Be Generated by the Company
  - Project the Expenses Associated With That Net Revenue Stream, Analyzing the Variable / Fixed Nature of Various Expenses, Excluding Interest Expense
  - Subtract the Expenses and Income Taxes From the Net Revenues to Obtain Net Income

## II. Valuation Fundamentals

- The Discounted Cash Flow Approach (cont'd)
  - Convert the Net Income to Cash Flow by Adding Back Depreciation, Subtracting Capital Expenditures, and Subtracting Increases in Working Capital, but Not Subtracting Principal Payments
  - Discount the Forecasted Debt-Free Cash Flows Back to Present Value, Thereby Accounting for Both the Time Value of Money and Forecasted Risks, Yielding Total Consideration

## II. Valuation Fundamentals

- The Discounted Cash Flow Approach (cont'd)
  - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

## II. Valuation Fundamentals

- The Public Market Comparable Approach
  - Identify Publicly Traded Comparable Companies
  - Analyze the Financial and Operating Performance of the Public Companies
  - Analyze How Investors Are Pricing the Public Companies, and Why

## II. Valuation Fundamentals

- The Public Market Comparable Approach (cont'd)
  - Make Inferences About How Investors Would Price, or Value, the Subject Company Through the Utilization of Various Ratios Such as:
    - Market Value of Total Capital / Net Revenue
    - Market Value of Total Capital / Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA)
    - Market Value of Total Capital / EBIT
    - Market Value of Equity / Book Value of Equity

## II. Valuation Fundamentals

- The Public Market Comparable Approach (cont'd)
  - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

## II. Valuation Fundamentals

- The Comparable Acquisition Approach
  - Identify Acquisitions of Comparable Companies
  - Analyze the Financial and Operating Performance of the Acquired Companies
  - Analyze How Buyers Are Pricing the Acquisitions, and Why

## II. Valuation Fundamentals

- The Comparable Acquisition Approach (cont'd)
  - Make Inferences About How Buyers Would Price, or Value, the Subject Company Through the Utilization of Various Ratios, Such as Multiples of Net Revenue, EBIT and EBITDA
  - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value
  - The Comparable Acquisition Approach is Typically Only Utilized to Value 100 Percent Interests

## II. Valuation Fundamentals

- The Cost Approach
  - Adjust Assets and Liabilities, Both On- and Off-Balance Sheet, to Market Value
  - Difficult to Identify and Value Intangible Assets, Such as Customer List and Goodwill; therefore, the Cost Approach Tends to Undervalue a Company

## II. Valuation Fundamentals

- The Cost Approach (cont'd)
  - The Theory is That a Company Utilizes its Entire Bundle of Assets, Including Tangible Assets, Working Capital, and Intangible Assets, to Generate the Primary Driver of Value: Cash Flow
  - Therefore, the Cost Approach is Typically Only Utilized to Value Holding Companies (i.e. Non-Operating Companies) or Companies Which Should Be Liquidated

## **II. Valuation Fundamentals**

**Cost Approach**

**=**

**Market / Income  
Approach**

## III. Valuation Continuum: Minority vs. Control

- Value Indications Must Be Adjusted for Factors Related to:
  - The Size of the Interest Being Valued (Minority v. Majority Interest)
    - On a Per Share Basis, an Investor Would Be Willing to Pay More for a Share of a Controlling Interest Than for a Share of a Minority Interest Holding

## III. Valuation Continuum: Minority vs. Control

- Why is a share of a controlling interest more valuable?
  - Control of daily operations
  - Control of cash distributions
  - Control of strategic direction
  - Control of professional philosophy
  - Control of liquidity events

## III. Valuation Continuum: Minority vs. Control

- Create Historical Pro Forma Cash Flow Statement In Order to Serve as the Basis for a Controlling Interest Valuation
  - Typical Adjustments
    - Excess Officers' or Physicians' Compensation
    - Real Property Lease
    - Non-Recurring Expenses

## III. Valuation Continuum: Minority vs. Control

- Typical Adjustments (cont'd)
  - Other Personal or Discretionary Expenses on the Books of the Company
    - Automobile Leases
    - Compensation and Perks to Family Members
    - Discretionary Types of Insurance Coverage
    - Discretionary T&E and Club Dues
    - Discretionary Retirement Contributions

## III. Valuation Continuum: Minority vs. Control

### Lowest Value Per Share

Point A: Net asset value as determined via a cost approach

Point B: Minority interest value (equal to net asset value plus goodwill value)

Point C: 50 percent interest value

Point D: Controlling interest value (equal to net asset value plus goodwill value plus control value)

Point E: 100 percent interest value

### Highest Value Per Share

### **III. Valuation Continuum: Minority vs. Control**

**Low Valuation**

**High Valuation**

Low	-----	Retiree Satisfaction	-----	High
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High	-----	Practice's Ability to Recruit	-----	Low
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High	-----	New Pathologist's Income Level	-----	Low
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Low	-----	Financial Risk to Borrower	-----	High
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**Minority Interest**

**Controlling Interest**

## III. Valuation Continuum: Minority vs. Control

- Valuation balancing problems can be solved through
  - tiers of equity
  - tiers of entities
    - modality
    - professional/technical
    - geography
  - non-compete agreements
  - tail protection provisions

## IV. Factors That Influence Value

### Internal Factors:

- Growth Potential / Historical Growth Rate
- Size (revenue, EBIT, number of pathologists or total staff)
- Profitability
- Stability / Reputation
- C-Corporation vs. S-Corporation vs. Partnership vs. LLC
  - Objective is to achieve capital gain treatment for sellers
  - Buyers prefer to buy assets

## IV. Factors That Influence Value

### Internal Factors (cont'd):

- Composition of Revenue – Pathology Practice
  - Part A vs. Part B
  - Hospital vs. Non-Hospital sources of revenue
  - Client Bill vs. Third Party Billing
  - General AP vs. Sub-specialty
  - Professional Only vs. Global
- Composition of Revenue – Clinical Lab
  - Price Per Accession
  - Physician office clients vs. Nursing Homes
  - Medical testing vs. Substance Abuse testing
  - Hospital outreach vs. In-patient

## IV. Factors That Influence Value

### Internal Factors (cont'd):

- Sustainability of Revenue
- Billing Compliance
- Verifiability of Financial and Operating Data
- Hospital Contract Terms
  - Exclusivity
  - Term and termination provisions
  - Compensation
  - Change of control
  - Quality of relationship with administration

## IV. Factors That Influence Value

### Internal Factors (cont'd):

- Depth / Composition of Staff
  - Age and number of pathologists
  - Sub-specialty pathologists
  - Quality of management personnel
- Level of Working Capital or Net Asset Value to Be Delivered at Closing

## IV. Factors That Influence Value

### External Factors:

- Opportunities for the Buyer, (i.e. “Synergies”)
  - Revenue Growth from Existing Clients
  - New Marketing
  - New Services and Offerings
  - Subsequent “Fold-In” Acquisitions
- Timing - Seller’s Market

## V. Selected Recent Transactions

<u>Date</u>	<u>Target / Acquirer</u>	<u>Transaction Value (\$ Mil)</u>	<u>Trailing EBITDA</u>	<u>EBITDA Multiple</u>
9/05	Specialty Labs / AmeriPath	\$307	-\$7.3	NA
9/05	CPL / Sonic Healthcare	\$375	\$36.0	10.4
8/05	LabOne / Quest	\$934	\$69.0	13.5
5/05	Esoterix / LabCorp	\$150	\$12.5	12.0
2/05	USLabs / LabCorp	\$155	\$15.0	10.3
5/04	ImPath / Genzyme Genetics	\$215	NA	NA
4/03	AmeriPath / Welsh Carson	\$850	\$112.0	7.6
1/03	Dianon / Labcorp	\$544	\$39.0	13.9

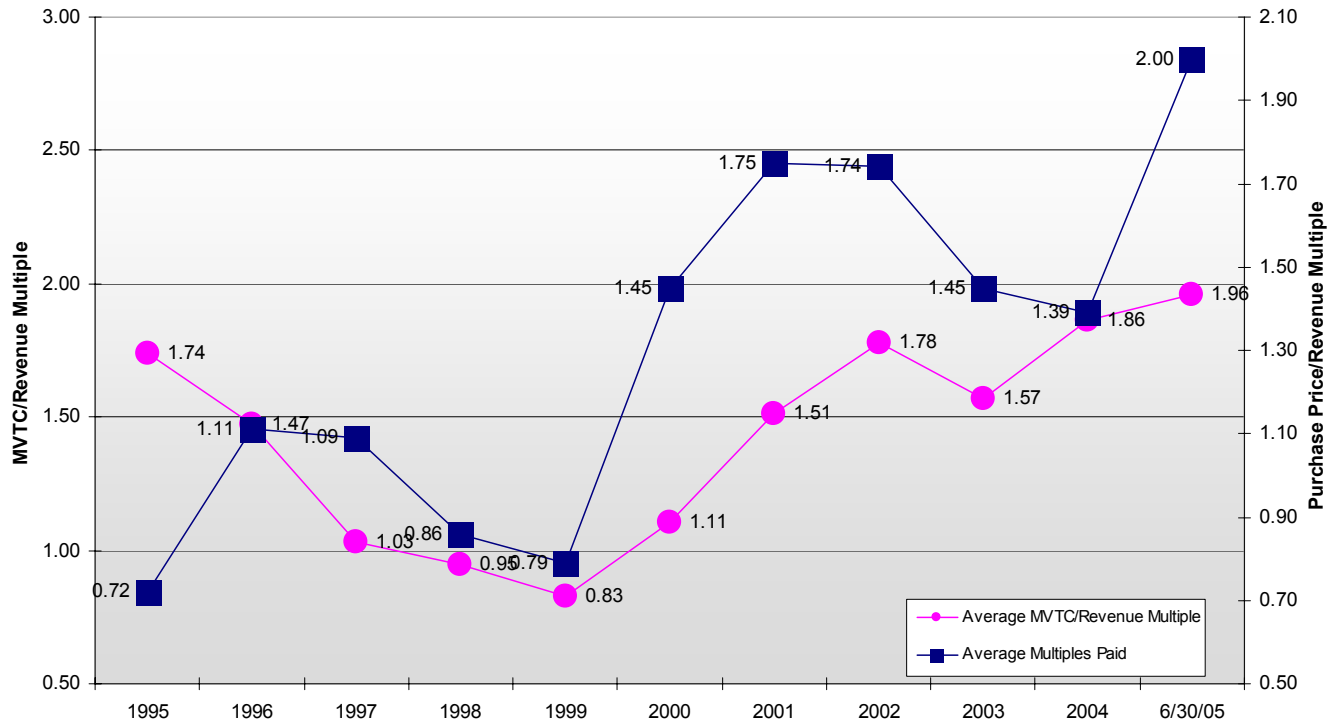
# VI. How the National Labs Can Justify Their Valuations

- An intelligent buyer will make an acquisition only if it adds to the value of the acquiring company. Such acquisitions are said to be “**accretive.**”
- Lab buyers can afford to pay *more* for an acquisition as the relative value of their own company *increases*.
- A direct relationship between laboratory acquisition valuations and publicly traded laboratory valuations has been clearly exhibited over the past 20 years that Haverford has been following the lab industry.

## VI. How the National Labs Can Justify Their Valuations

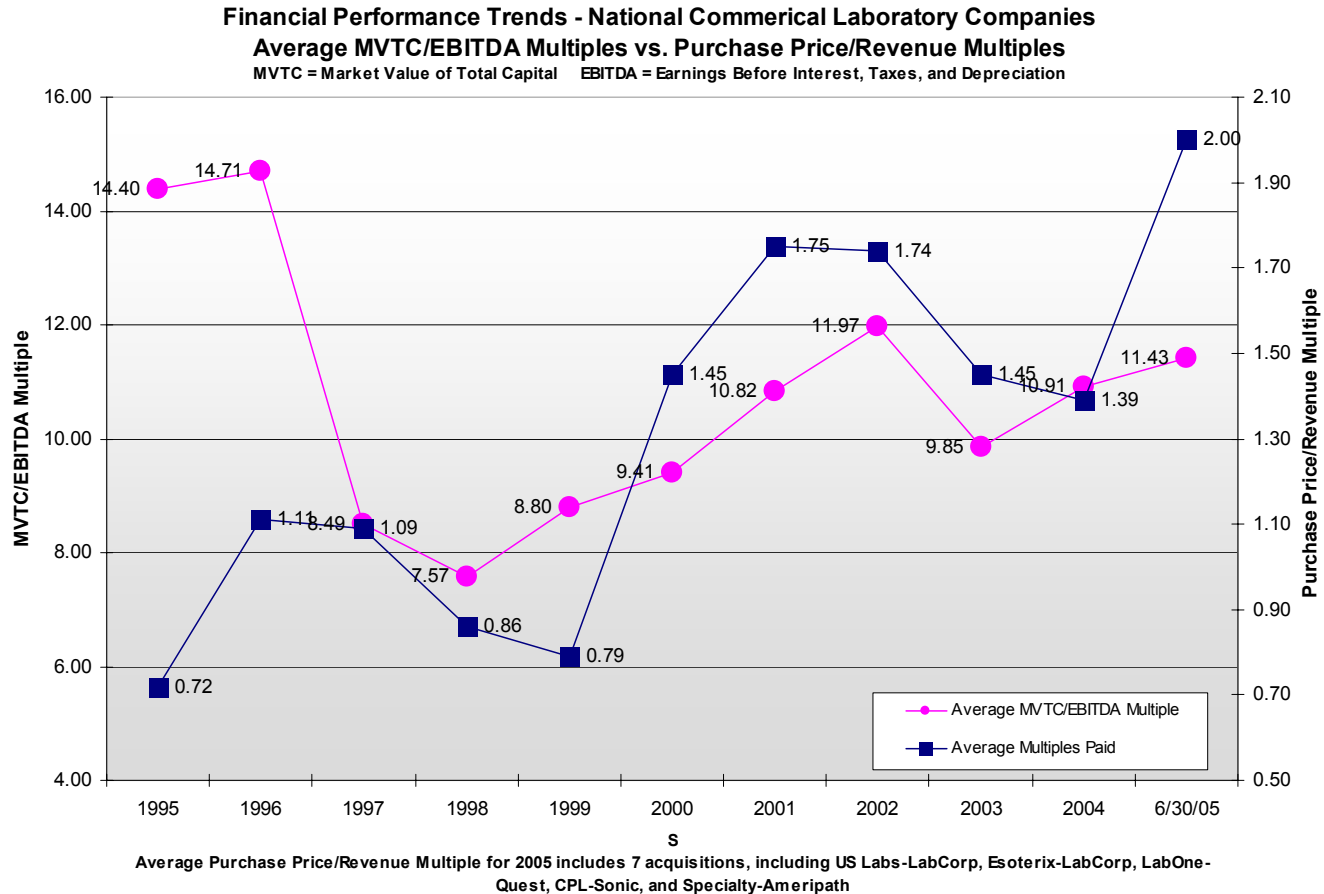
**Financial Performance Trends - National Commerical Laboratory Companies**  
**Average MVTC/Revenue Multiples vs. Purchase Price/Revenue Multiples**

MVTC = Market Value of Total Capital EBITDA = Earnings Before Interest, Taxes, and Depreciation

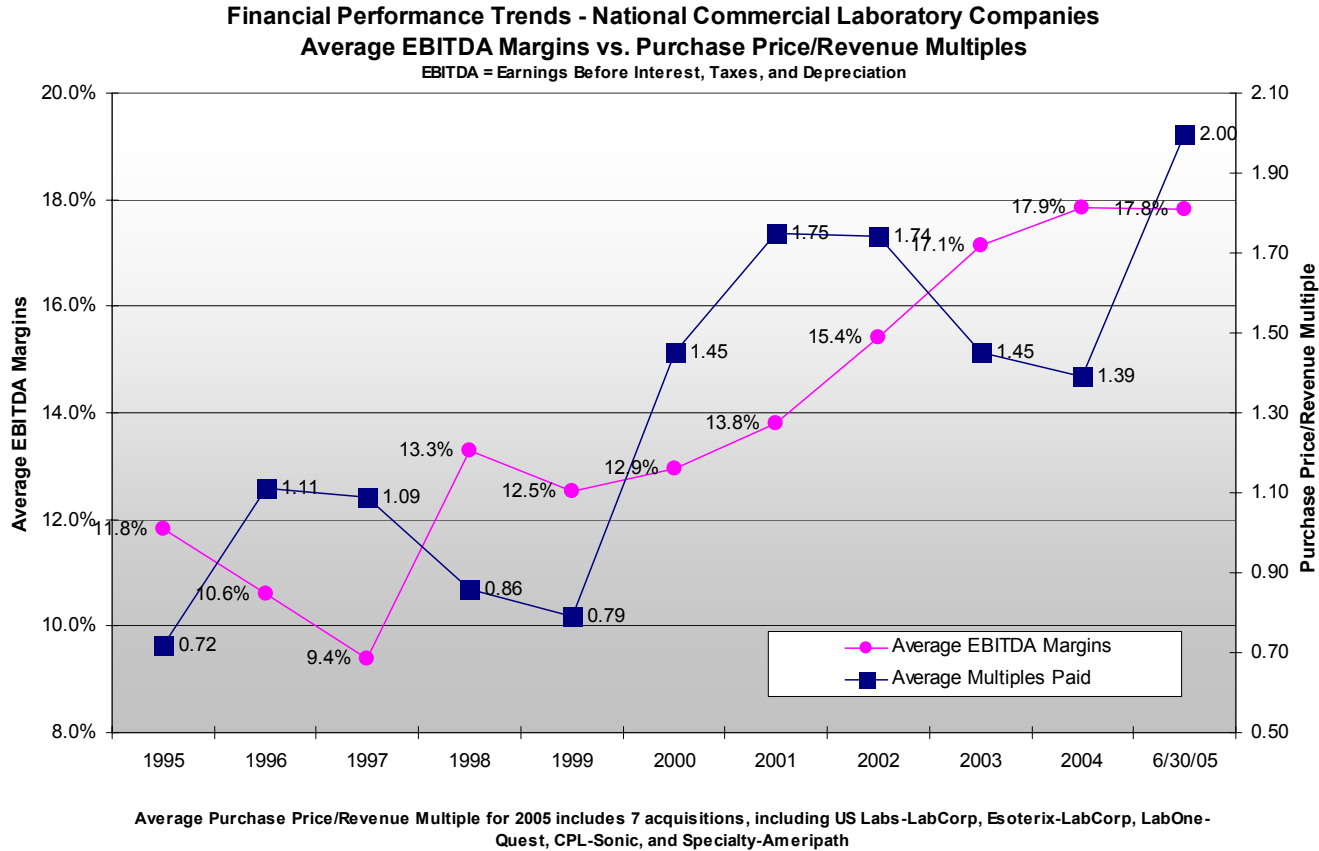


Average Purchase Price/Revenue Multiple for 2005 includes 7 acquisitions, including US Labs-LabCorp, Esoterix-LabCorp, LabOne-Quest, CPL-Sonic, and Specialty-Ameripath

## VI. How the National Labs Can Justify Their Valuations



## VI. How the National Labs Can Justify Their Valuations



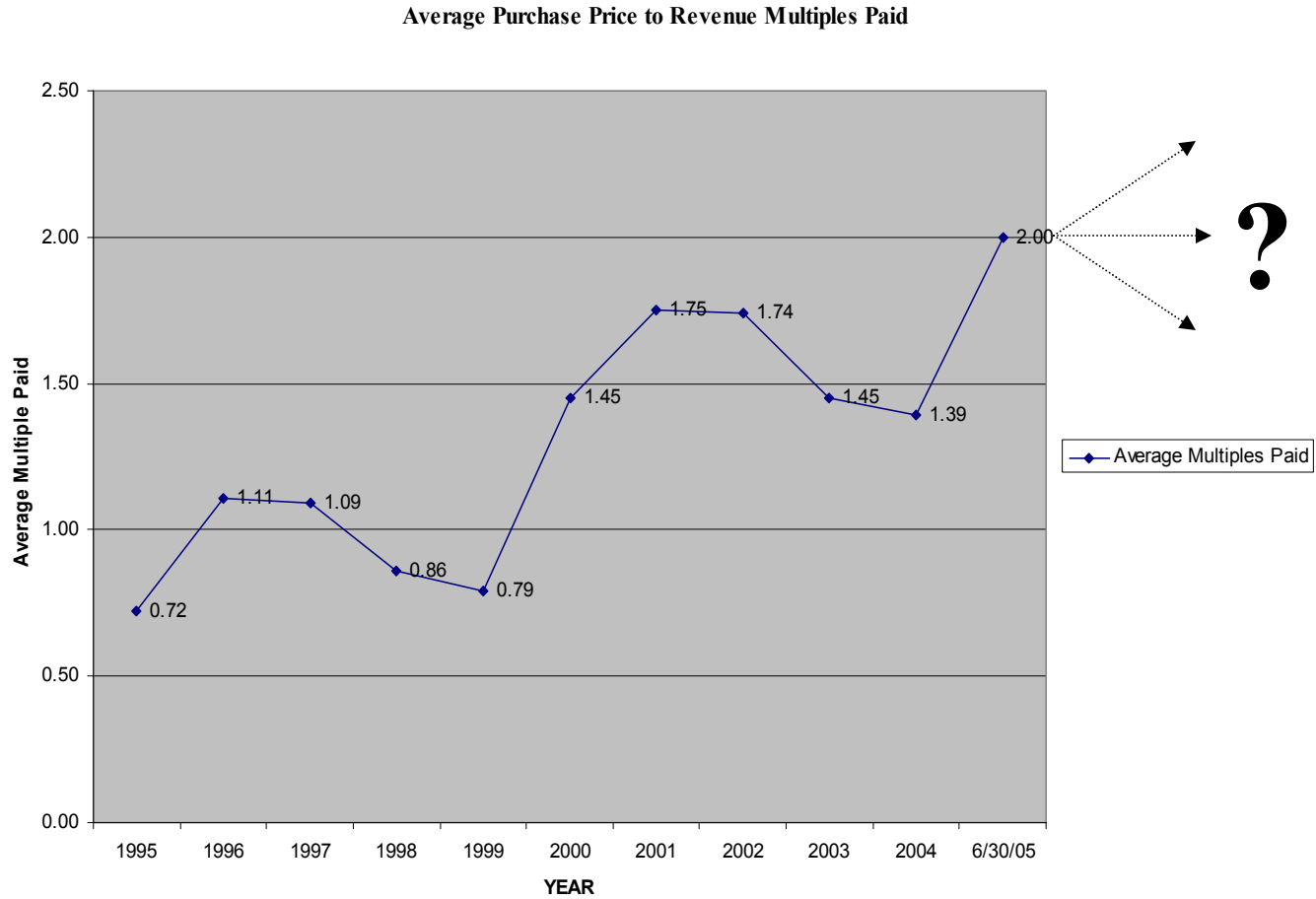
# VI. How the National Labs Can Justify Their Valuations

- How can the same laboratory or pathology practice be worth more today than it was a year ago?
- It depends upon how badly the buyer wants to do the deal.
- Before completing a major transaction, a public company requires the approval of its Board of Directors. Frequently, the Board will seek the advice of an investment banking firm to confirm the reasonability of the terms of the transaction.
- In order to justify the purchase price paid in certain transactions, buyers and their investment bankers will take into account the **synergies**, or cash flow enhancing benefits, that will *potentially* result to the buyer post-transaction.

# **VI. How the National Labs Can Justify Their Valuations**

- The buyer expects to rationalize the target's operations and to realize synergies in the following areas:
  - Laboratory Capacity
  - Esoteric Sendouts
  - Supply Savings
  - Infrastructure Improvements
- The buyer expects to realize incremental EBITDA.
- If one considers the buyer's projected synergies, their effective valuation multiple for the target declines.

## VII. Where Are Lab Valuations Heading?



## Haverford Healthcare Advisors

Haverford Healthcare Advisors specializes in providing valuation, merger and acquisition, and corporate finance advisory services to healthcare companies, with a specific focus on clinical laboratories and pathology practices. We represent and assist physicians and other healthcare company owners during the process of selling their laboratories, during the process of merging or partnering with other laboratories or companies, or during the process of growing through acquisition. We also provide lab valuation services, typically in connection with lab transition issues such as admitting new partners and retiring existing partners, and with the formation of joint ventures.

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