HAVERFORD HEALTHCARE ADVISORS

Valuation Basics for Independent Laboratories: Developing a Reasonable Expectation of Deal Value for Your Lab

2011 Executive War College

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Overview

No Conflicts to Disclose

Overview

I. Valuation Fundamentals

II. Factors That Influence Value

Valuation Fundamentals

Future Cash Flow!

Valuation Fundamentals

The two most common descriptors when discussing lab valuations are:

- Net Revenue
- EBITDA, or Cash Flow

Valuation Fundamentals

Income Statement Terminology

Income Statement		
Gross Charges	$150	
Less: Contractual Allowances	50	
Net Revenue	100	100%
Cost of Sales	50	
Gross Profit	50	50%
Sales, General & Admin. Expenses	25	
EBITDA (a) or Cash Flow	25	25%
Depreciation and Amortization	5	
EBIT (b)	20	20%
Interest Expense	8	
PreTax Income	12	12%
Income Taxes	4	
Net Earnings	8	8%

(a) EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization
(b) EBIT – Earnings Before Interest and Taxes

Valuation Fundamentals

The two most common descriptors when discussing Net Revenue and EBITDA are:

- Pro Forma
- Sustainable

Valuation Fundamentals

Pro Forma Income Statement

- Typical Adjustments
  - Excess officers' or physicians' compensation
  - Real property lease
  - Non-recurring revenue
  - Non-recurring expenses
  - Run rate in revenue
  - Run rate in expenses
  - Excess professional, management, and billing fees

Valuation Fundamentals

- 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

Valuation Fundamentals

Sustainable Income Statement

- Typical Adjustments
  - Non-recurring revenue
  - Non-recurring expenses
  - Run rate in revenue
  - Run rate in expenses
  - Which clients are at risk?

Valuation Fundamentals

WARNING: We're here to discuss the

Value of 100% of the equity of a lab in order to assist in strategic planning and to facilitate the outright sale of a lab

NOT the value of a minority interest in the equity of a lab

NOT for shareholder transition planning

NOT for divorce

Valuation Fundamentals

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

Valuation Fundamentals

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

Valuation Fundamentals

Value Based Management

- In addition to providing assistance in selling your lab, knowledge of the factors that drive value and knowledge of how to value a lab allows shareholders to practice value-based management

- A good manager who practices value-based management seeks to:

  1. Maximize sustainable value,
  2. Monitor performance on a fairly real-time basis,
  3. Understand and monitor the direct correlation between actions and value creation
  4. Manage the internal factors which can be controlled
  5. Anticipate the external factors which cannot be controlled

Valuation Fundamentals

Standards of Value

- “Fair Market Value” is the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and 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.

- “Investment Value” is the value to a particular investor based on individual investment requirements and expectations.

Valuation Fundamentals

Three Basic Approaches to Valuation:

- The Income Approach
  - Discounted Cash Flow Approach
- The Market Approach
  - Public Market Comparable Approach
  - Comparable Acquisition Approach
- The Cost Approach

Includes Intangible Value

Excludes Intangible Value

Future Cash Flow!

Valuation Fundamentals

- **The Discounted Cash Flow Approach**

  Most financial theorists believe that the best measure of going-concern value is the present value of expected future cash flows from an investment.

  - 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 Earnings

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 Enterprise Value
  - Subtract the Face Value of Interest-Bearing Debt From the Total Enterprise Value, Yielding Equity Value

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

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 multiples of
    - Net Revenue
    - EBITDA
    - Equity
    - Some unit of production

  – Subtract the Face Value of Interest-Bearing Debt From the Total Enterprise Value, Yielding Equity Value

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

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 and EBITDA
  - Subtract the Face Value of Interest-Bearing Debt From the Total Enterprise Value, Yielding Equity Value
  - The Comparable Acquisition Approach is Typically Only Utilized to Value 100 Percent Interests

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

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

VIII. Valuation Fundamentals

Cost Approach

=

Market / Income Approach

Future Cash Flow!

Valuation Fundamentals

Value = Present Value of Future Cash Flows

What factors will impact future cash flows?

Valuation Fundamentals

- Valuation Theory
  - $V = \frac{CF_1}{r_1} + \frac{CF_2}{r_2} + \ldots \frac{CF_t}{r_t}$

    Value = Sum of CFs into perpetuity

  - Time Value of Money: $PV(CF_1) > PV(CF_t)$

  - But, CFs after the first five years typically comprise > 50% of value

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Factors That Influence Value

Factors That Influence Value

- Management should understand the internal and external factors which drive value.
- Whether a tangible exercise listed on the manager's to-do list, or whether an implied responsibility within a job description, a manager should be practicing value-based management.

Factors That Influence Value

- A true organizational leader should be managing a laboratory with the goal of creating value for the stakeholders, including equity value for the shareholders.

- Understanding the correlation between actions and value-delta is critical to success, and can serve to optimize the planning process.

Factors That Influence Value

Internal Factors:

- Pro forma sustainable financial performance
- Historical growth trends
- Growth potential – proactive or reactive
- Size (net revenue, EBITDA, number of accessions, etc.) – There is a scarcity of large acquisition targets!
- Profitability and cash flow
- Stability / reputation

Factors That Influence Value

Internal Factors (cont'd):

- Composition of Revenue – Clinical Lab
  - Price per accession
  - Specialty vs. routine test mix
  - Physician office clients vs. nursing homes
  - Medical testing vs. substance abuse testing
  - Hospital outreach vs. in-patient
- Sustainability and quality of Revenue and EBITDA
- Billing compliance and payor mix

Factors That Influence Value

Internal Factors (cont'd):

- Location and competition
- Verifiability of financial and operating Data
- Customer relationships
- Hospital contract terms
  - Exclusivity
  - Term and termination provisions
  - Compensation
  - Change of control
  - Quality of relationship with administration

Factors That Influence Value

Internal Factors (cont'd):

- Depth, quality, composition, and versatility of management staff
- Information technology
- C-Corporation vs. S-Corporation vs. Partnership vs. LLC
  - Objective is to achieve capital gain treatment for sellers
  - Buyers prefer to buy assets
- Level of working capital or net asset value to be delivered at closing

Factors That Influence Value

- **External Factors**:
  - State of general economy
    - Availability of patient funds for healthcare
    - Credit market for buyers
    - Government stimulus plan
      - preventive medicine and diagnostics
      - EMR
      - volume impact from broader health insurance coverage
      - capital gains

Factors That Influence Value

- **External Factors (cont'd):**
  - Industry demographics
    - Reimbursement trends
    - Paradigm shift from inpatient to outpatient setting
    - Rapidly aging population
    - Increased incidence of cancer
    - Shift from prognostic and monitoring tests to preventive medicine
    - High growth in new technology, new test development, and implementation

Factors That Influence Value

External Factors (cont’d):

- Opportunities for the buyer, (i.e., “Synergies”)
  - Revenue growth from existing clients
  - New marketing
  - New services and offerings
  - Subsequent “fold-in” acquisitions

- Taxation and finance theory factors
  - Benefit from the lower tax rate on capital gains
  - Conversion of future earnings to lump sum distribution today
  - Value protection and asset diversification

Factors That Influence Value

External Factors (cont'd.):

- Industry demographics
  - Paradigm shift from inpatient to outpatient setting
  - Rapidly aging population
  - Many screening tests are performed based on age
  - Increased incidence of cancer
  - High growth in new technology and tests, such as molecular
  - Strong fundamentals continue to attract investment from large consolidators and private equity
- Industry Demographics (cont'd.)
  - Esoteric testing fuels growth of industry players
  - Shift from prognostic and monitoring tests to preventive medicine

Haverford Healthcare Advisors

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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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