

# **THE VALUATION OF MEDICAL BILLING COMPANIES: FACTORS INFLUENCING THE VALUATION MULTIPLE**

Historically, most shareholders of a privately held, third-party, healthcare billing company recognized the significance of such an investment from an income-production standpoint. Few owners, however, realized that such an investment had value as a tradeable commodity over and above its income potential. The events of the last decade have educated many shareholders and potential shareholders, both young and old, that both the income stream and capital gain potential of such an investment need to be considered. Industry consolidation demonstrated quite clearly that shareholdings in billing companies had equity value as purchase prices far above historical buy-sell type values were paid.

For years, partners in medical billing companies, or revenue cycle management companies, lived by the traditional shareholder agreement, or buy-sell agreement, whereby ownership was achieved at a price equal to some pro rata share of cash, accounts receivable, and equipment, less debt. Upon retirement, a shareholder would trade in his or her shares using the same formula. If the entity had grown during the tenure, increasing A/R and equipment, than maybe the payment received upon retirement would be slightly greater than the payment made upon admission as a partner.

Times have changed. Existing shareholders, seeing their older colleagues sell their companies to larger entities, began to chafe at the concept of receiving less than a year's salary upon retirement. Existing partners began to question the financial logic of allowing young managers to buy into such a potentially lucrative investment for a nominal fee set by a shareholders' agreement that was thirty years old. Young shareholders began to balk when such buy-sell agreements were changed. And as the healthcare entities served by the billing companies grew in size, as the practice of billing for healthcare became ever more complex, as the IT infrastructure requirements became ever more challenging, and as the scope of services offered by medical billing companies expanded into comprehensive revenue cycle management, larger and larger billing companies were created. As billing companies grew in size, the potential for conflict between shareholders increased proportionately with the larger number of young and old owners.

As the twenty-first century unfolds, it is inevitable that sooner or later, the owners of a private healthcare billing company (an "HBC") will need to determine the value of their business. The need may arise when evaluating strategic alternatives in light of industry dynamics, such as competitive changes, reimbursement changes, or IT changes. Such strategies could include merging with another billing company, selling to a larger company in the current industry consolidation, or selling to private investors. The need for a valuation could arise in conjunction with shareholder transition issues, such as when it becomes necessary to buy out a

retiring partner, to sell interests to new partners, or for estate planning purposes. The need for a valuation could arise from litigation, such as the involuntary termination of a partner or a marital dissolution matter. Ultimately, the alternatives can only be thoroughly examined after the owner(s) understand the factors influencing the value of his or her HBC.

### ***Factors Influencing the Valuation Multiple***

The valuation multiple utilized has a tremendous impact on the resulting value indication. The valuation multiple is time-specific, meaning that the appropriate multiple today might not be the appropriate multiple six months ago or six months hence. Various factors impact the multiple, including:

*Percentage Interest Acquired or Sold* - as has been discussed, on a per share basis, a buyer will pay more for a controlling interest than for a minority interest. Generally speaking, the larger the percentage interest being transacted, the higher the multiple.

*Growth Potential / Historical Growth Rate* - what are the HBC's opportunities for revenue growth, from existing clients (both from volume trends and reimbursement trends experienced by those existing clients), new marketing, new services, new specialties, new locations, and subsequent fold-in acquisitions? How do recent trends translate into future growth patterns?

*Size* - what is the size of the HBC in terms of revenue, earnings, number of clients, number of billers, etc.? Generally speaking, all else being equal, the larger the company, the higher the multiple. It takes a potential buyer as much effort to evaluate a large target as a small target, so allocating the fixed costs of a large acquisition can lead to a larger return on the up-front efforts.

*Profitability and Cash Flow* - are the costs under control, or would a buyer have to exert time and energy improving the profitability? What are the near term capital requirements for upgrading software, IT equipment, adding specialties, or adding locations?

*Stability and Quality of the HBC's Revenue Stream* - is the revenue stream sustainable? What is the nature of and quality of the underlying clients' businesses? Is the financial and operating data verifiable? Is the revenue stream diversified or concentrated across the customer base? The buyer's perceived risk of achieving projected cash flows in the future will impact the valuation multiple which they are willing to pay.

*Customer Relationships* - what is the quality of the relationships with the major customers? What is the nature of the written contracts with the customers? What

are the provisions of the contracts with respect to exclusivity, length of term, termination provisions, compensation, and change of control? What is the retention rate amongst the client base?

*Depth and Composition of Professional Staff* - how many billers are owners and employees, and what are their ages? Do they have sub-specialties? What is the revenue per FTE biller? What are their reputations and relationships within the medical community? What is the quality of the management personnel?

*Specialties Served* - what types of specialties are served, and who is the competition for each type of specialty? What are the opportunities and threats facing each specialty served?

*Information Technology* – what is the quality and robustness of the information technology utilized by the billing company? Are significant capital expenditures required in the near term?

*Synergies and Motivations* - what potential operating and financial synergies exist? Are there economies of scale available through a combination? Why is the seller selling, and the buyer buying? What are the parties' specific motivations?

*Form of Legal Organization* - the manner in which a billing company is organized, i.e. a C corporation vs. an S Corporation vs. a Partnership vs. a Limited Liability Company, can directly impact the purchase price paid. The objective is to achieve capital gain tax treatment for sellers, while balancing the desire of buyers to purchase assets as opposed to stock.

*Timing* - at times, due to external economic and industry factors, it could be a buyer's market, while at other times it could be a seller's market. Valuation multiples change based on external factors as well as factors inherent to the HBC.

Understanding these factors which influence value will greatly help the owner of an HBC make the critical, strategic decisions.

Kirk A. Rebane, ASA, CFA is a Managing Director of Haverford Healthcare Advisors, a firm which specializes in providing valuation advisory and merger and acquisition consulting services, with a specific focus on healthcare and healthcare-related entities, including third-party, medical billing companies. We provide financial valuation services. We also represent and assist shareholders during the process of selling their companies, during the process of merging or partnering with other companies, or during the process of growing through acquisition. It should be noted that this article does not represent legal, tax, or financial advice.

Kirk A. Rebane, ASA, CFA

Managing Director  
Haverford Healthcare Advisors  
[www.haverfordhealthcare.com](http://www.haverfordhealthcare.com)  
43 Leopard Road, Suite 102  
Paoli, PA 19301  
(610) 407-4024, ext. 11  
fax (610) 407-4028  
[krebane@haverfordcapital.com](mailto:krebane@haverfordcapital.com)