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# The Utilization of the Market Approach in Appraising Outpatient Enterprises

Healthcare related outpatient enterprises provide services that do not require hospital admission and may be performed outside the premises of a hospital. Similar to valuation of any business, valuations of outpatient enterprises should include consideration of the three general approaches to valuation (i.e., the *income approach*, the *market approach*, and the *asset/cost approach*). The specific valuation methods selected under each engagement will be guided by the facts and circumstances surrounding the hypothetical transaction of the subject property interest (e.g., availability of data, nature of the current transactional marketplace). This article focuses on utilizing a *market approach* to value outpatient enterprises, while the other articles in this Health Capital Topics series address the use of an income approach and an asset/cost approach to value outpatient enterprises.

While no two companies are *identical*, *market approach* based methods are premised on the foundation that actual transactions of *similar* entities provide guidance to value the subject property interest.[1] Development of an opinion of value related to an outpatient enterprise using a *market approach* typically involves:[2]

(1) Identification of transactions of property that have *badges of homogeneity* (the same in type, size, structure, quality etc., i.e., similar; uniform) with the subject property interest;

(2) Calculating transaction valuation multiples (e.g., market value of invested capital [MVIC] to earnings before interest and taxes [EBITDA], price per physician, price per operating room, MVIC to revenue) for the transactions identified; and,

(3) Applying valuation multiples developed from the comparable transactions to the subject property interest.

Two widely utilized market approach based methods for valuing healthcare related outpatient enterprises are the *Guideline Transaction Method*, also referred to as the *Merger and Acquisition Method*, and the *Guideline Public Company Method.* Under both the *Guideline Transaction Method* and the *Guideline Public Company Method*, valuation analysts should develop a sense for the universe of typical purchasers (e.g., horizontal consolidators versus vertical integrators) of property interests similar to the subject property interest by reviewing industry newsletters (e.g., Irving Levin Associates' *Healthcare Deal News*, Definitive Healthcare's *Mergers & Acquisitions News*).

The *Guideline Transaction Method* is based upon the theory that an indication of value of the subject property interest can be derived from the valuation multiples of transactions involving *entire* businesses or *entire* company divisions.[3] A valuation analyst may utilize transaction databases (e.g., Irving Levin Associates, Mergerstat, Done Deals, Pratt's Stats, IBA Market Data, Bizcomps) to assist in the search for comparable transactions.

Identifying transactions of outpatient enterprises in which the target property interest shares *badges of homogeneity* with the subject property interest may be particularly difficult for valuation analysts because of the significant differences that exist between the valuation ratios for different types of outpatient enterprises. For example, many cardiology practices offer high margin diagnostic testing services and as a result may transact at higher valuation multiples than many internal medicine practices, for example which may not provide diagnostic testing services, and therefore sell for lower valuation multiples. Additional *badges of homogeneity* for physician practices include payor mix, number of physicians, and geographic proximity to hospitals.[4]

Another example that underscores the importance of identifying transactions where the target property interest shares *badges of homogeneity* with the subject property interest may be found by examining transactions of freestanding diagnostic imaging centers located within 35 miles of multiple hospital campuses. This proximity may allow the center to command a valuation premium over other freestanding diagnostic imaging centers because of their ability to bill as a hospital outpatient department when purchased and clinically integrated with a hospital.[5] Additional *badges of homogeneity* to consider regarding freestanding diagnostic imaging centers include services offered, utilization rates, and any state licensure requirements, such as certificate of need laws.

A key point of consideration when using the *Guideline Transaction Method* is that valuation analysts should

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adjust the transaction price for non-cash terms of the deal, because implicit in the definition of *Fair Market Value* is the requirement that *payment is made in cash or its equivalent*.[6] Therefore, if any of the transaction considerations in the guideline transactions was paid in company stock, management or consulting agreements, earn outs and/or notes, the reported transaction price may require an adjustment to reflect the true cash value.

The other widely utilized *market approach* based method to valuation is the *Guideline Public Company Method*, which is based upon the theory that an indication of value of the subject property interest can be derived through the valuation multiples of the freely traded, minority interest registered shares of publicly traded companies.[7] Identifying public companies is particularly challenging for valuation analysts appraising outpatient enterprises because, in many instances, public companies that with sufficient *badges of homogeneity* may not exist. For example, in September 2014, the Duff & Phelps *Healthcare Sector Update* reported that there were no publicly traded physician practices.[8] Also, the September 2014 Duff & Phelps *Healthcare Sector Update* reported that there were two publicly traded ambulatory surgery centers. A valuation analyst should use care when using databases of publicly traded companies (e.g., the *Companies by SIC Code* index in Ibbotson's *Cost of Capital Yearbook*; the SEC's *Electronic Data Gathering, Analysis and Retrieval (EDGAR) Database*, Yahoo! Finance's *Industry Center*, Bloomberg, S&P Capital IQ's *Industry Surveys*) to assist in the search for comparable public companies because companies within a Standard Industrial Classification (SIC) code may lack sufficient *homogeneity*. For example, SIC code 8011: Offices and Clinics of Doctors of Medicine is shared by many dissimilar companies from medical practices, to freestanding emergency departments, and ambulatory surgical centers (ASCs).[9]

A key point of consideration when using the *Guideline Public Company Method* is that valuation analysts should adjust the valuation ratios utilized in the analysis for the differences between the guideline public companies and the subject property interest (e.g., adjustments for expected growth, capital structure, or size).[10] A valuation analyst may want to adjust the valuation ratios for the differences in size between the subject property interest and the guideline public companies utilized because, historically, small companies have been perceived as more risk and, as a result have had lower valuation ratios than larger companies.[11]

In selecting which *market approach* based methods to employ, a valuation analyst should balance consideration of the sufficiency, validity, and efficacy of the available transactional data reported, as well as, the applicability of such indications of value as may be determined to arise out of observations from such distinct sources as historical transactional data of privately held companies and historical transactions of minority equity interests in publicly traded companies.[12]

The final installment of this five-part series will address the use of an *asset/cost approach* to value outpatient enterprises.

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1 "Valuing a Business: The Analysis and Appraisal of Closely Held Companies", By Shannon Pratt and Alina Niculita, 5th Edition, New York, NY: McGraw Hill, 2008, p. 63, 262-266, 310-311.

2 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services", by Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Hoboken, NJ: John Wiley & Sons, 2014, p. 96-98, 102.

3 Pratt & Nicultia, 2008, p. 310-311.

4 See October 2014 HCC Topics article titled "Utilizing the Income Approach to Appraise Outpatient Enterprises" for further discussion on the value drivers of outpatient enterprises.

5 "Requirements for a Determination that a Facility or an Organization has Provider-Based Status" 42 C.F.R. § 413.65(e)(3)(i) (11/6/2014).

6 See August 2014 HCC Topics article titled "Determination of the Appropriate Standard of Value and Premise of Value" for further definition of *Fair Market Value*.

7 Cimasi, 2014, p. 102.

8 "Healthcare Sector Update", Duff & Phelps, September 2014.

9 "Description for SIC 8011: Offices and Clinic of Doctors of Medicine", Occupational Safety and Health Administration, 2014, https://www.osha.gov/pls/imis/sic_manual.display?id=189&tab=description (Accessed 11/11/2014).

10 "Financial Valuation: Applications and Models", by James Hitchner, 3rd Edition, Hoboken, NJ: John Wiley & Sons, 2011, p. 291-308.

11 *Ibid.*

12 Cimasi, 2014, p. 105.

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