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Valuation of Healthcare Service Sector Enterprises for Purposes of Private Equity Investment: Valuation Considerations (Part 2 of a 3 Part Series)

As discussed in the first installment of this three-part series, *private equity* (PE) is a capital funding source that is not available through a public exchange and is often utilized to: (1) expand a business; (2) fund new technology; or, (3) supplement an established entity's working capital.[1] Although the global economic insecurity throughout 2016 resulted in a sharp decline in overall PE deals, the volume rebounded in the U.S. healthcare industry and hit a decade high in 2016, reaching $36.4 billion.[2] In addition to the traditional PE firms investing in PE funds, numerous healthcare organizations have been investing in PE funds as well; the main reason for this seems to be the perceived necessity to adapt to the changing healthcare industry to maintain a strategic advantage and remain relevant.[3]

The first part of this three-part series set forth an introduction to the current PE activity in the healthcare services sector. This second installment will discuss the valuation approaches utilized to develop an opinion as to the fair value of a target for the purposes of PE investment, specifically as it relates to the healthcare sector.

The best practice guidelines state that the most acceptable way to value investments by PE firms is at *fair market value*. The *International Private Equity and Venture Capital Valuation Guidelines* are issued with an objective "*to set out best practice where private equity investments are reported at 'Fair Value'*."[4] Additionally, the *Private Equity Industry Guidelines Group* set forth U.S. Private Equity valuation guidelines, and as their 2007 update states, "*The Guidelines seek to have all investments in portfolio companies reported at **fair value** on a consistent, transparent and prudent basis*."[5] [Emphasis added.] *Fair value*, as defined in accordance with *Generally Accepted Accounting Principles* (GAAP), is "*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*."[6] It is important to note that the standard of *fair value*, as defined by GAAP, is nearly identical to the valuation standard of value of *fair market value*.

The *Financial Accounting Standards* (FAS) No. 157 states that the three generally accepted approaches to be used to develop an opinion as to the *fair value* of a target are:

(1) Market Approach;
(2) Income Approach; and,
(3) Asset/Cost Approach.[7]

While FAS No. 157 allows for an analyst to use a single technique, it is prudent, and in conformance with professional valuation standards, to consider all applicable valuation approaches.[8] The most common approach used by PE firms is the *Market Approach*.[9] Valuation methods available to an analyst under the Market Approach include: The Guideline Transaction/Mergers and Acquisition Method; and, the Guideline Public Company Method.[10] Under the Guideline Transaction Method, transactions of companies exhibiting sufficient badges of homogeneity with the target are researched to use as guidelines (i.e., benchmarks) to value the target.[11] The Guideline Public Company Method values the target by using the valuation multiples of the freely traded, minority interest registered shares of publicly traded companies.[12]

The other methodologies that may be appropriate in certain circumstances, i.e., under the Income and Asset/Cost Approaches, include the: Discounted Cash Flow Analysis; Net Asset Valuation;[13] and, Leveraged Buyout Technique. These methodologies are not always feasible for PE firms since most of the targets are privately held and reliable financial information is not readily available. Often, PE firms invest in enterprises that might be in the turnaround stages or which typically do not have audited financial statements, such as family owned businesses, making it difficult to rely on their financial reports or to quantify any intangible assets that may be owned by the business.

The PE share of ownership varies in each investment made. A PE firm may own a majority share or a minority share in the target. Typically, the majority holders will have a control interest in a business; this should be taken into consideration when valuing a target, either through the application of a *control premium*, defined as: "*…an increase to the pro rata share of the value of the business that reflects the impact on value inherent in the management and financial power that can be exercised by the holders of a control interest of the business,*

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usually the majority holders,"[14] or through changes to the projected cash flows of the target reflecting the ability of a control position to alter the operations of the target. Likewise, if the PE firm is valuing a minority interest, the projected cash flows should be reflective of the lack of control available to a minority shareholder, or a minority discount or a discount for lack of control should be applied to a valuation of the target based upon cash flows arising from a control position. A *minority discount* is inversely proportionate to the *control premium*, and hence, is a reduction in the pro rata share of the value of business that reflects the minority shareholders' absence of control.[15]

As discussed above, there has been a surge in PE activity in the healthcare sector of late. Traditionally, PE firms invested in less complex healthcare entities, mostly driven by private insurance or private pay as those enterprises offer high-reimbursement potential, such as; dermatology, dental, and pain management practices.[16] PE firms continue to have tremendous interest in these areas, but have also begun investing in the primary care space as well.[17] Motivation for this interest may be due to the fact that specialty practices are becoming more expensive relative to primary care practices.[18] In the first quarter of 2017, the physician medical group segment was the largest healthcare sub-sector, with a total deal value of $3.3 billion.[19] Physician practices require the constant attention of the practice physicians to efficiently run the business and ensure positive income growth for the practice. When a PE firm invests in a physician practice, it involves the rollover of equity, which allows the physician shareholders to own a significant share of the practice.[20] Equity rollover is typically an exchange by the seller of a percentage of its equity for stock as full or partial consideration for the selling of the stake in the company.[21] This ensures the physicians' share of the profit from future growth opportunities and incentivizes the physicians to remain involved in the business.[22]

With the acceleration of large healthcare mergers and acquisitions, PE firms typically pay higher valuation multiples, as they have to compete against strategic investors seeking synergies.[23] The limited supply of, and increased demand for, primary care practices has led to increasing multiples being paid for practices in recent years.[24] However, the average health services *enterprise value/earnings before interest, tax, depreciation, and amortization* (EV/EBITDA) multiple decreased slightly, by 0.2x, in the first quarter of 2017 to a level of 12.3x.[25]

The average holding period for PE firms has traditionally ranged between three to five years, although recent trends suggest that this may be changing.[26] In the past decade, the average holding period for PEs has increased from 4.5 years in 2006 to 5.8 years in 2016.[27] A PE firm's objective is to realize returns on their investment by the end of the investment horizon. A successful exit is the culmination of this process. There are several methods of exits available to a PE firm, including:

(1) An initial public offering (IPO) – The first sale of a private company's equity to the public;[28]
(2) A secondary buyout – The sale of investment companies by a PE firm to another PE firm;[29]
(3) A management buyout – The acquisition of a business by its core management team;[30] and,
(4) Merger/acquisition – The merger or acquisition of the business with a strategic buyer to purchase the PE.

In the first two quarters of 2017, mergers and acquisitions and secondary buyouts dominated the healthcare PE exits.[31]

In addition to the myriad valuation considerations related to healthcare service sector enterprises for purposes of PE investment, the complex regulatory environment necessitates the consideration of the impact of various laws specific to the healthcare industry, with which such laws PE firms may not be intimately familiar. For example, most fee-splitting arrangements in healthcare, i.e., compensation or other financial arrangements based on a percentage of charges or revenue, are not legally permissible, potentially presenting a challenge for those PE firms that typically structure deals based on a percentage of revenue.[32] Additionally, PE firms generally may not own or directly invest in medical practices due to state *corporate practice of medicine* (CPOM) laws. While CPOM laws vary by state, they typically assert that only licensed providers (physicians) may employ other licensed providers, presenting a hurdle for PE firms seeking to directly invest in physician practices.[33] Many PE firms have been "*side stepping*" CPOM laws by establishing a *management services organization* (MSO) to purchase the assets of the physician practice, and provide management and other non-clinical services to the practice in exchange for *fair market value* compensation.[34]

Traditionally, PE firms operating within the healthcare industry have tended toward sub-sectors such as healthcare technology, pharmaceuticals, or durable medical equipment. However, PE firms increasingly are entering the healthcare services sector, investing in dialysis centers, infusion services, home health, and directly in physician professional practices. This provides an alternative route for those physicians who may be dissatisfied with private practice to divest of their ownership without aligning directly (through an employment arrangement) with a health system, which may be more attractive to some practitioners. From an industry-wide perspective, the expansion of PE investment should continue the trend of consolidation within the healthcare sector, albeit not through the traditional route of acquisition by a large health system. Although, with a PE firm's limited investment horizon and demand for short-term gains, PE firms can only be thought of as intermediaries in the consolidation project, seeking to quickly consolidate a market service area and capture any realizable synergy gains. In short, PE firms are not in the business of running a healthcare enterprise; instead, they are attempting to reap the rewards of removing inefficiencies from the healthcare industry through both horizontal and vertical integration.

It is, as yet, indeterminate as to the long-term effect of the trend of increased PE investment in the healthcare

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services sector. While, in the long run, consolidation may have beneficial effects to the healthcare industry, the short-term perspective of PE investors may lead to perverse results or unexpected consequences. Regardless, the investment of PE firms in the healthcare services sector will continue to drive competition for the acquisition of various healthcare service provider organization, which is a key factor to consider when performing the valuation of a healthcare entity or when advising a client regarding a potential merger and acquisition transaction.

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