The Myth of the Multiple

Understanding the Real Meaning Behind Valuation Multiples

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The Most Common Question . . .

" What are current valuation multiples for ASCs?"

Valuation Multiple - Definition

- **Simple Definition**:

"A valuation multiple is a numerical figure, which when multiplied against a measure of earnings yields an indication of value for business (or asset) generating those earnings."

Example: 3.5 X $1,000,000 = $3,500,000

Valuation Multiple - Definition

- **Market Approach Definition:**

  "An observation of relative pricing derived from market transactions, whereby the observed purchase price is divided by a reported measure of earnings."

A multiple cannot be applied to a subject interest as a method of valuation without an understanding of the math and financial theory behind the multiple.

Valuation Multiple - Definition

- **The Finance Definition** (a.k.a. Appraiser speak)

  "A mathematical expression of risk and growth, which when applied to a perpetually recurring earnings stream results in an indication of value"

  A multiple is mathematically expressed as follows:

$$\frac{1}{(K-g)}$$

  - Where, (K) represents the rate of return (risk), and
  - (G) represents the growth rate of the earnings stream

Valuation Multiple - Example

- The risk of the investment warrants a 15% rate of return
- The growth of earnings is expected to be 5% per year
- Formula: $\frac{1}{(K-g)} = \frac{1}{.15-.05}$ = 10.0x multiple

1) How are risk and growth determined?
2) 10.0x What?

Key Components of a Multiple

- Before we can truly understand valuation multiples, we need to understand three key components:

  1. Definition of the **Earnings Stream**
  2. Estimation of **Risk** (K) measured as a rate of return
  3. Estimation of the rate of earnings **Growth** (g)

Valuation Multiples - Defining "Earnings"

- Typically measured as Earnings Before Interest Taxes and Depreciation ("EBITDA") but can also be stated as cash flow, net income, distributions, etc. When using EBITDA, debt must be subtracted from value.
- Single Period or Average? May be most recent year, trailing twelve months, 2-year average, etc. The appropriate measure is the one that is most indicative of future earnings capacity.
- In some instances historical earnings measures must be normalized to remove the effect of non-recurring income and/or expense items.

Multiples derived from market data must be applied to the subject entity using the same measure of earnings.

Market Multiples - Estimation of Risk

- Risk is defined as the degree of uncertainty as to the realization of investment returns (*i.e.,* the earnings stream).
- Risk is measured as the required rate of return necessary for an investor to commit funds given alternative investments.
- **It is very important to match the risk to the measure of earnings being multiplied.**
  (*e.g.*, Pretax/After Tax, Levered/Unlevered)
- For mature in-network ASCs the required rate of return on equity is generally in the range of 18-22% (WACC of 15-18%), however, this can vary significantly from entity to entity.

Market Multiples - Estimation of Growth

- A valuation multiple is a "perpetual" valuation model.
- Because of this, there are limitations regarding the growth assumption that can be built into a multiple.
- Generally the growth assumption should not exceed the growth rate of the overall economy, which when measured as GDP, is less than 5%.
- Because of this limitation – valuation multiples should only be applied to stable businesses.

Recap - Key Components of a Multiple

1. **Earnings Stream**

   The next time you hear that Dr. Jones sold his interest for 5x, ask yourself "5x what?" Most cases the answer is 5x EBITDA less debt.

2. **Risk**

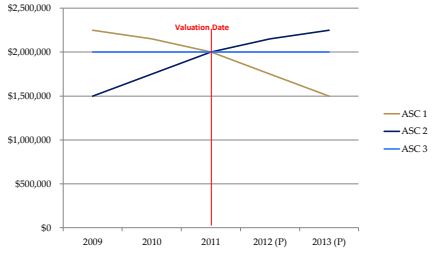
   Not all earnings are the same! Two ASCs with $2.0M of earnings may have completely different risk profiles.

   Higher Risk = Lower Multiple

3. **Growth**

   All things equal, **Higher Growth = Higher Multiple**.

Three ASC's with $2.0M EBITDA



Market Multiples - Misapplication

Examples:

- Assuming all ASCs trade in a narrow range of multiples
- Not adjusting EBITDA for one-time revenues or expenses
- Failure to consider future changes in earnings
- Applying multiple to an ASC with a high proportion of out-of-network commercial payor revenue without normalizing revenue to sustainable levels
- Not subtracting debt from derived enterprise value
- Applying control multiples to minority interests

Controlling vs. Minority Interest

- Interests providing absolute control are worth more.
- Control typically granted by the governing documents.
  - Which matters require **board majority** vs. **board supermajority** vs. **member vote**?
    - Determine distributions
    - Approve new investors
    - Approve redemption of units for retiring/relocating investors
    - Approve new contracts or operating agreement changes
    - Sell the company or dispose of assets/assume debt

Marketability Concerns

- **Marketability:** the ability to quickly convert property to cash at minimal cost.
- **Discount for Lack of Marketability:** deducted from the value to reflect the relative absence of marketability.
- Most minority investments in ASCs tend to be reasonably marketable, and discounts tend to be lower than other entity types.
  - Local market factors are key, including pool of potential physician investors, competing ASCs, Hospital employment, etc.
  - Provisions set forth in governing documents may have significant implications.

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