The Myth of the Multiple

Understanding the Real Meaning Behind Valuation Multiples

Presented By

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What is a Valuation "Multiple"?

- An approach to valuation?
- A price to earnings ratio (*i.e.*, a calculation)?
- A rule of thumb?

Valuation Multiple - Definition

- A valuation multiple is a calculated value derived from market transactions, where the negotiated purchase price is divided by some measure of earnings.
- By observing transactions above, valuation multiples can also serve as a rule of thumb to establish general "market multiples" for pricing transactions.

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

- A valuation multiple is appraiser shorthand for the present value of a perpetual earnings stream mathematically expressed as follows:

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

- Key components of a valuation multiple
  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 Multiple - Example

- Next year's earnings are expected to be $100
- Thereafter earnings are expected to grow 5% per year
- The risk justifies a 15% rate of return
- Formula: $\frac{1}{(K-g)} = \frac{1}{.15-.05}$ = 10.0x multiple

Next question - 10.0x multiple of what?

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.
- 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 is generally in the range of 18-22%, however, this can be significantly different if earnings are volatile or at risk.

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**

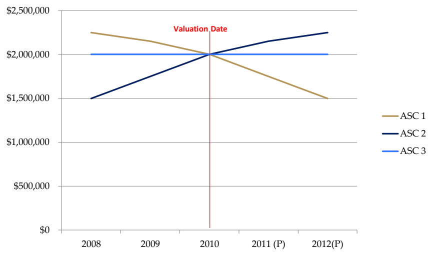
   The next time you hear that Dr. Jones sold his interest for 5x, ask yourself "5x what?" Most cases the answer is 5x EBITDA less debt.
2. **Risk**

   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:

- Not adjusting EBITDA for one-time revenues or expenses
- 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
- Not considering special marketability factors affecting the ASC

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
- Physician Investors may exert significant control regardless of share voting power.

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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