



viewPOINTS

IN MERGERS AND ACQUISITIONS, MULTIPLES ARE WAY, WAY, WAY OVERRATED.



Health Care Mergers and Acquisitions



“Perhaps the most important problem with multiples is the tendency for buyers and sellers alike to fixate more on these, than the returns or dollars they are getting from a deal.”

You know those things in life that you desperately must have, only to find that when you finally get them, well, not so much?

You know, like Ralphie from “A Christmas Story” finally getting his “Little Orphan Annie” decoder ring, only to find out that the secret message was “Drink Your Ovaltine”?

Well, in mergers and acquisitions, everyone desperately covets “The Multiple” – the number that you can multiply against a company’s earnings to instantaneously determine its value.

Even when we know that it is often a quick and dirty rule of thumb that merely gets you in the right ball park, we’re just as sure that if we just knew it, we’d have pretty much what we need to confidently bring a company to market.

The problem, of course, is that those multiples that are tossed about like so much confetti on New Year’s Eve are in fact schtick and dirty, have nothing to do with thumbs, and even if they get you in the ball park, don’t give you a clue as to which section, much less seat.

Yup, in plain speak, multiples are way overrated – almost always misinterpreted and misused – and worse yet, in the hands of a shrewd buyer, can be weaponized.

Cue the theme from “Jaws.”

So why is the Holy Grail of M&A quite often a wholly fail?

Well, just how are these multiples actually determined?

They’re supposed to be calculated using the formula $1/(r-g)$, where “r” is the rate of return required by an investor to invest in an opportunity with equivalent risk, and “g” is long term, perpetual growth.

But in practice? Let’s just say that if you were to ask all but the most plastic pocket protector-cladded buyer, the closest you would get to “r” and “g” is that their multiple is **really good**.

First and foremost, required rates of return (“r”) are rarely rigorously determined. While they can be mathematically estimated based upon historical returns on investments with

similar risk patterns (often derived by combining risk-free rates of return based on government bonds with those derived from publicly traded companies – then adjusting these figures for company specific size and risk), buyers and sellers rarely consult such data.

And what is long-term perpetual growth (“g”)? Theoretically, it is growth that can be expected in perpetuity; akin in health care to long term (say, ten to twenty years) anticipated growth in utilization. What it is decidedly not, is near term growth above the norm, for which the simple application of a multiple is wholly inadequate (better to deploy a discounted cash flow model that separates periods of hyper growth from periods of lower long-term growth). And just like required rates of return, long-term growth is rarely explicitly evaluated.

At best, buyers and sellers adjust “base multiples” (more on this below) upward to reflect reduced risk and/or growth greater than the market, or downward to reflect heightened risk and/or growth below market – all based on little more than anecdote and “feel.”

OK, so, if these “base multiples” aren’t mathematically driven, where do they come from?

Well, it would be ironic if it weren’t so tragic.

Conceptually, they are derived from industry “comps” (similar acquisition transactions). But in truth, with extremely limited data available on comparable deals, base multiples are far more a function of “conventional wisdom” – and here’s the most important part – **driven largely by self-confirming industry talk and speculation.** In other words, those industry standards that buyers and sellers place so much faith in are formed almost entirely by self-fulfilling conjecture, with modest iterations up (or down) based upon the market consensus du jour.

What’s more, even when these comps are “known,” they often provide a distorted view of the imputed multiple because they are rarely based upon complete, or, well, “comparable” information.

Does the **numerator** (the price) include assumption of debt? Is it all cash, or does it include stock, contingent payments, or other illiquid remuneration? Are all the assets being acquired?



And as for the **denominator** – the earnings – is it earnings before interest, taxes, depreciation, and amortization (EBITDA), after tax, before or after synergies?

Each of these combinations yield very different imputed multiples. That is precisely why if you ask the buyer and a seller what the multiple was in a particular transaction, the answers are inevitably very different.

Another reason comps are unreliable: consider that, counterintuitively, sellers with the **lowest** EBITDA margins frequently sell for the **highest** multiples. Why? Because even the most underperforming companies – particularly those with size and infrastructure – have innate value. For example, in a competitive merger and acquisition market, a \$20 million, barely break-even company with \$200,000 in EBITDA could very well sell for \$5-10 million, to reflect a buyer's expectation of improving performance. The imputed multiple of 25-50x, however, **is not meaningful**. That said, it makes for good press and can contribute to a distortion of the market and value expectations.

One final observation. Because they are promulgated over time by a chorus of buyers and sellers alike, base multiples often become quite “sticky” and resistant to change, even when the risk-return fundamentals of an industry change dramatically (or were miscalculated in the first place). That's why, for example, it took a long time for buyers to fully price in the upsides in home health care when it moved from cost-based to prospective pay or to correctly reflect the annuity value attendant to group homes.

What exactly should these multiples be applied to?

In theory, multiples are supposed to be applied to the **representative** income stream for the period **immediately ahead**, i.e. next year's earnings. However, in practice, virtually all buyers reflexively use historical earnings as a proxy for what to expect in the coming year. This is particularly problematic for fast-growing firms where the trailing twelve months figures can be substantially less than even a conservative estimate of go-forward results based, perhaps, on the last quarter annualized.

And what, pray tell, is representative earnings?

Again, in theory, representative earnings are those earnings a buyer can reasonably anticipate in the coming year — a figure that “normalizes” unusual or one-time revenues or expenses, adjusts for excess owner's compensation and the like, and is

consistent with generally accepted accounting principles. But alas, while GAAP may seem to be a rigorous standard, **subjective** accounting treatment for items such as revenue recognition, accounts receivable reserve and write-off policies, depreciation schedules, and other accruals, to name a few, can have a profound impact on income. Moreover, one buyer's normalized, representative earnings can be substantially different than that of another buyer. And that's before we even contemplate the appropriateness, or lack thereof, of factoring in potential revenue enhancing or cost-reducing synergies into the equation.

The plain fact is that there is no real standard for calculating reasonable, go-forward, representative earnings. **And a miss in earnings has every bit as much impact on valuation as a miss in the multiple.**

Is it an all cash deal?

When a rigorously determined multiple is applied to a reasonable measure of normalized, go-forward, representative earnings, the resultant value indication is supposed to be **cash at close**. But quite often, this is not the case. To the extent that deals are structured with anything other than cash – contingent payments, notes below market interest rates, stock that is not freely tradeable, or any other deferred or illiquid compensation – such payments should be discounted to reflect risk, yielding an adjusted multiple that may be lower than it initially appears.

So, if a deal is priced at a 7.0 multiple, but part of the deal includes an earnout, or a non-interest bearing note, or restricted stock, the **effective** multiple is less – and in some cases, far less.

Who assumes what from the balance sheet?

When a multiple is applied to earnings before interest, taxes, depreciation, and amortization (EBITDA) – as it almost always is – the buyer is expected to acquire all the **operating assets** of the company. Additionally, the buyer is “entitled” to **adequate working capital** necessary to operate and sustain the business at its near-term projected level and includes not only the accounts receivable, inventory, and any other current operating assets, but also the buyer's assumption of non-interest-bearing working capital liabilities such as accounts payable and accrued wages. Lastly, non-working capital or interest-bearing debt is expected to be retained or paid off by the seller.

Upend any of these elements, particularly as it relates to working capital, and the “real” multiple may be different than that initially proffered.



For example, say a buyer is paying a 6.0 multiple against normalized, representative EBITDA of \$1,000,000 for all the operating and working capital assets of the business, but is not assuming \$500,000 in accounts payable and accrued wages. Instead of \$6M, the “real” value of the deal would be \$5.5 million, (\$6,000,000 less \$500,000 in working capital liabilities that the seller must pay off at close). So instead of a 6.0 multiple, the seller is really getting 5.5.

And then there’s that word, “adequate.”

Say that a seller’s accounts receivable are abnormally high due to the disruption of a particular payor source, or due to poor revenue cycle management that can be relatively easily cured. Or say a seller is particularly uncomfortable with debt and pays off payables immediately instead of when due. In both cases, the seller may have “excess” working capital. But if the excess is not explicitly carved out of the transaction or tacked on to the purchase price, the buyer is effectively subsidizing the deal with dollars that belong to the seller. And the multiple, once again, is less than it appears.

It’s easy to lose the forest for the multiples.

Perhaps the most important problem with multiples is the tendency for buyers and sellers alike to fixate more on these than the returns or dollars they are getting from a deal.

Sellers can receive what appears to be a high multiple of EBITDA, and yet an inappropriately low purchase price, if the earnings base is understated or the representative period is, well, not representative. Alternatively, the multiple might look low, yet the valuation high, if the earnings as presented exclude infrastructure expenses that a buyer might not have to duplicate, but are nevertheless necessary to operate the business independently or if additions in necessary personnel have been delayed to bolster earnings in advance of a sale.

And it’s not just sellers – buyers can just as easily be caught in the multiple trap.

This occurs most often when they are unwilling to pay more than “x” times earnings for synergies *they* bring to the table, even when these synergies can yield a *net* multiple far more attractive than alternative acquisition candidates.

Sure, we understand their reluctance.

But is a buyer better off acquiring a less synergistic company for a lower multiple – and lower anticipated returns?

The flaw almost always comes down to evaluating acquisition candidates in isolation. Rather than green or red light deals on whether they are at or below pre-ordained multiple limits, the most strategically successful buyers consider how each investment opportunity – and the returns they are expected to generate – compares to others available to them, all within the context of their near and long-term goals.

To be sure, we’re not suggesting that “generic” sector-specific multiples are useless. If nothing else, they can be extremely informative regarding where valuation is heading *directionally*, and at what *velocity*, critical factors in determining the best time to pursue a sale.

But in isolation, they are not nearly as meaningful – or definitive – as you may have imagined.

So the next time you overhear a seller (or buyer) mention how high (or low) a multiple they received (or paid) in a deal, don’t put too much stock in it.

If it helps, think of multiples as the Kardashians of M&A. They may be talked about all the time, but you can’t take them too seriously.



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