How to Value a Health Care Staffing Company Amidst a COVID Run Up in Revenues and Profits

Let’s set the stage:
The shortage of health care providers was acute prior to COVID.

According to the Bureau of Labor Statistics, immediately prior to the onset of the pandemic in the United States, the gap between job openings and hires had reached 500,000.

But then COVID struck, and in less than two years, the gap rose to more than 1,000,000.

Paraphrasing one of our clients, “We were going to get here anyway, but the pandemic was like throwing a match into a bucket of gasoline. So welcome to 2029. The pandemic just accelerated the timeline.”

With such unprecedented demand, staffing companies have seen their revenues and profits double, triple, and even quadruple over this period. Not surprisingly, buyers have rushed the health care staffing market to establish a foothold in the market.

As a result, based upon proprietary data collected and analyzed by The Braff Group, the sector set a record for deal flow in 2021 with 47 transactions, up 236% vs. 2020 and 15% greater than the previous record set back in 2015.

Ah, but there’s a catch (and there’s always a catch). Amidst such rapid and unprecedented growth, buyers have been skittish when it comes to valuation. Because they wonder – or more accurately agonize over – how long it will last.

The Risk – and the Reality

The first thing is to thoughtfully assess where the market is headed over the next 12-36 months.

Will outsized demand and bill rates revert to pre-pandemic levels the day after a deal closes?

Of course not, (but you might be surprised how much such thinking plays in many buyers' proposals).
Will it peter out over the next 12-18 months?

Well, with (a) COVID likely to stick around in some form or another for the foreseeable future, (b) stalwart caregivers ready to bolt once they see a sustained lull in new cases, and (c) a backlog of elective surgeries that McKinsey and Company estimate could take as long as 20 months to work through, you’d have to be quite an optimist to think this crisis can be resolved any time soon.

What about bill and pay rates? Will they contract quickly?

Well, not if you believe in those pesky laws of economics that say when demand outstrips supply, prices rise. And then there’s the human aspect to consider. It’s easy to raise wages. But cut them? Quickly? When COVID has dramatically shifted the work/life balance decidedly towards life? Well, you get the picture.

What about economic sustainability?

Many suggest that such trends are simply economically unsustainable, and therefore by definition, short term. Perhaps. But the government has stepped in before to shore up essential industries and will likely do the same if necessary. Nothing like a presidential election two years down the line to avoid the enmity of those health care heroes the nation has celebrated, and, you know, a complete collapse of the health care system.

So, if it is the free market determining the clearing price to attract health care workers, allegations of price gouging by staffing firms seem wholly unwarranted. Now you could accuse the health care workers themselves of this, but, well, we wouldn’t advise it.

What about those investigations regarding price gouging?

As we wrote in our recently published Health Care Staffing M&A Year in Review,

A quick look at historical gross profit figures for publicly traded health care staffing companies show that despite their substantial growth, gross profit margins are the same or slightly less than historical averages. This means that the rate hikes are being passed down proportionately to the providers. And with signing bonuses averaging about $15k¹ and soaring to $20-30k² in some areas, it seems apparent that the caregivers are calling the shots in terms of wage requirements.

So, is there no risk out there for staffing companies? Will they continue to grow fast and flush unabated? Perhaps not. But can one reasonably conclude that the go-forward risk is substantially less than staring down a flying arrow with an apple on your head? You bet.

Nevertheless, what’s a nervous buyer to do?

Valuation Approaches (see accompanying illustrations)

An important caveat before we proceed.

Most vital here is an understanding of the key items and variables that can be toggled in one way or another to allocate risk fairly between a buyer and a seller. While we will illustrate these with specific numbers and models, this is not intended to be a definitive guidebook. Every buyer and seller brings unique needs and attributes to a transaction which, in turn, demand unique, equitable solutions.

The Base Case Normalized Multiple Range

First up, it’s necessary to evaluate what the range of valuation multiples would be for staffing firms if we peeled back the extra, extra, extraordinary growth that the industry has seen over the past 12-15 months.

One way to do so is to assess where staffing sits on the risk-return continuum of other health care service providers.

In this case, the reference group should include those sectors that are (a) at their peak in acquisition demand, as is the case in staffing, and (b) growing nicely, albeit not at 300-400%. Bearing this in mind, we believe the best comps are home health and hospice companies.

Most vital [in valuing a health care staffing company in the current environment] is an understanding of the key items and variables that can be toggled in one way or another to allocate risk fairly between a buyer and a seller.

In these spaces, "typical" multiples range from 6.0 to 8.0 times earnings, with larger providers well into the plus/minus 12.0 range (and higher).

Approach 1: Risk Adjusting the Multiple

This is far and away the simplest – and arguably no less reasonable – approach to valuing staffing companies in this market.

If you refer to the example illustrations included, you’ll see a summary financial statement for a generic staffing provider. The first column is where the company is today on a last three months run-rate basis, with all the COVID related hyper-growth in tow.

In this first approach, the buyer accounts for the market risk by applying a risk-adjusted multiple to the COVID-enhanced earnings (typically EBITDA – earnings before interest, taxes, depreciation, and amortization).

In our example, we applied a hefty discount of 30% to the base case normalized multiple discussed above, bringing it down from 6.0 to 4.2. If you apply the risk-adjusted figure to current run-rate EBITDA of $6,000,000, you get a value indication of $25.2 million. This figure is "purchase price certain" with no contingent, performance related adjustments. Therefore, subject to any hold backs as security against certain reps and warranties, the full amount would be paid at close.

Approach 2: Risk Adjusting the Earnings to Arrive at a Base Value Subject to Future Price Adjustments

This model is a bit more complicated, but once you understand the concept, it becomes clearer.

First off, we need to risk adjust the subject company’s financial performance.

In our example, we reduced the bill rate by 20% and the hours by 10%. This cuts our run-rate revenues by more than $8,000,000 resulting in a drop in earnings from $6,000,000 to $3,480,000 – a decline of 42%. Since we’ve essentially stripped the run-rate earnings of its COVID influence, we can apply the unadjusted base case normalized multiple of 6.0 to this figure to arrive at a base value of $20.88 million.

Since this value models that the contractions will happen in full and immediately the day after the deal closes – which is not going to happen – the seller is entitled to any value attendant to earnings above the risk adjusted figure. After all, the buyer did not pay for it. Notably, any growth above the non-adjusted earnings belongs to the buyer.

So, in our model, we compare the value attendant to the risk adjusted earnings to the value the seller would receive if feared market contractions do not come to pass – in this example, a target valuation of $36.0 million.

The difference between the target valuation and the base valuation then becomes the value subject to future price adjustments. In our example, $15.12 million is up for grabs.

The next question is how these monies should be distributed.

What is the measure that will be used? If targets are missed, will there be no payment, or a graduated scale? How long should the adjustment period last?

Perhaps the most important part of this puzzle is determining the basis for the payouts.

The de facto standard is EBITDA. But this can get very messy. The figure used to determine the original valuation is almost always an adjusted figure reflecting eliminations of one-time costs, investments, start-up expenses (if any), excess owner’s comp, and more. So, calculating this figure post-transaction can be very subjective. Plus – and this is a big plus (well, really a minus) – the seller generally loses control regarding how monies are spent, projects that are funded, and the like. So, a buyer could rightly embark on a de novo start-up strategy that’s good for the business.
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ILLUSTRATION OF POTENTIAL VALUATION APPROACHES

Disclaimer: Most vital here is an understanding of the key items and variables that can be toggled in one way or another to allocate risk fairly between a buyer and a seller. While we will illustrate these with specific numbers and metrics, this is not intended to be a definitive guideline. Every buyer and seller bring unique needs and attributes to a transaction which, in turn, demand unique, equitable solutions.

<table>
<thead>
<tr>
<th>Sample Health Care Staffing Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rate</strong></td>
<td>$125.00</td>
</tr>
<tr>
<td><strong>Annual Hours</strong></td>
<td>$240,000</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td>$30,000,000</td>
</tr>
<tr>
<td><strong>COGS</strong></td>
<td>21,000,000</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>$9,000,000</td>
</tr>
<tr>
<td><strong>% of Revenue</strong></td>
<td>30%</td>
</tr>
<tr>
<td><strong>SG&amp;A</strong></td>
<td>$3,000,000</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>$6,000,000</td>
</tr>
<tr>
<td><strong>% of Revenue</strong></td>
<td>20%</td>
</tr>
</tbody>
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Valuation Approach One - Simple - Risk Adjusted Multiple (No Price Adjustment)

| Market Multiple of EBITDA | 6.0 |
| Discount                  | 30% |
| Risk Adjusted Multiple of EBITDA | 4.2 |
| Valuation                | $25,200,000 |

Valuation Approach Two - Risk Adjusted EBITDA (Base Value Plus Price Adjustment)

| Risk Adjusted EBITDA | $3,480,000 |
| Target EBITDA        | $6,000,000 |
| Value Subject to Price Adjustment | |

| Base Threshold for Adjustment | |
| Target Threshold for Adjustment | |
| Threshold Differential to Earn Full Price Adjustment | |

Here, the multiple remains the same because if all the additional valuation is earned, it is because the multiple should not have been adjusted in the first place.

(a) With risk associated almost entirely with Bill/Pay rates, Gross Profit is the best basis for determining a price adjustment.

| Maximum Price Adjustment Ratio per Dollar Over Base Threshold | $6.00 [Ref 1] | |
| Price Adjustment Period (Years) | 3.0 [Ref 3] |
| Maximum Adjustment per Dollar Greater than Base Threshold per Year | $2.00 [Ref 4] |

(b) The price adjustment per dollar of gross profit greater than the base threshold if Target Threshold is achieved and the adjustment period was one year.

(c) To allow for more time for the market to settle, most buyers would want a multi-year period.

(d) Price adjustment per period; if actual gross profit is less than the target threshold, the maximum adjustment per dollar shall be reduced proportionately times a shortfall factor.
but can wipe out near-term earnings and hence contingent payments.

Accordingly, the rule of thumb for determining the basis of such payments is the further up on the income statement, the better. First up are revenues, then gross profit, operating income, EBITDA, and lastly, net income. The problem with revenue targets is a seller with a contingent payout on the line could be motivated to cut pricing to capture share and disproportionately boost revenues, despite the likelihood that reduced gross profit margins will yield substantially reduced EBITDA.

To eliminate this conflict, gross profit can be a far better volume driven measure. And since the biggest risk factors buyers are trying to hedge in health care staffing are hours billed and pay rates, GP is arguably the best measure to adjudicate future payments.

The rule of thumb for determining the basis of contingent payments is the further up on the income statement, the better.

If you take this entire amount ($15.12M) and divide it by the gross margin gap the seller is trying to make up ($2.52M), you come up with a payout of $6.00 for every dollar of GP greater than $2,520,000. This would work if the price adjustment time frame was just one year. But buyers would reasonably require a longer look forward. Our sense is that three years is long enough to generate market stability for the buyer, and short enough for a seller to await subsequent payouts.

So, to account for a three-year period, we divide the $6.00 figure by three, arriving at a new payout calculation of $2.00 for every dollar of GP over the base level.

If you’re still with us, 10 points for Gryffindor.

Now, for the nuance.

First off, the calculation can reasonably be capped once, and if, the entire gross profit gap is achieved. So, in our example, even though total gross profit in year one is greater than the $9 million target, the payout is limited to $5.04 million.

Now, what if there is a shortfall?

You could adjust the payout by $2.00 for every dollar below the target. So, if Year Two gross profit is $8 million ($1,000,000 short) you would cut the payout by $2,000,000 ($2.00 x 1,000,000), leaving $3,040,000

While opinions differ on this, some buyers argue that a shortfall from the target should reduce the multiple because...
it suggests more risk than that built into the base figure. We contend, however, that by agreeing to a three-year payout, the buyer has shifted risk to the seller, which, in turn, should increase the base multiple, with both changes offsetting each other.

Nevertheless, for illustration purposes, we created a factor that would reduce the implied multiple.

In our example, we applied a shortfall factor to the percentage of the gap, and applied this to the calculated price adjustment factor, thereby lowering the payout for each dollar of GP greater than the base margin. So, in our example, in Year Two the 11.1% miss is multiplied by the shortfall factor, lowering the payout from $2.00 to $1.33.

How did we arrive at a shortfall factor of 3.0? Essentially trial and error with a goal of coming up with a figure that would adjust the original multiple to a plausible figure (recall, however, that as stated above, we do not subscribe to this concept).

In our example, then, rather than the original multiple of 6.0, the shortfalls reduce the total value paid to total EBITDA over the period to a new multiple of 5.30.

Got all that?

Yeah, it can get a bit complicated, hence the reason to defer to Approach 1 and risk adjusting the multiple.

But forget the math for a moment and the concept is a bit easier to digest:

- Calculate the total amount of purchase price subject to adjustment
- Determine the basis for distributing the adjustment and the number of years it will be in place
- Calculate a payout ratio per year
- Determine a shortfall factor, if any, to reduce the implied multiple if gross profit targets are not achieved.

In the end, any thoughtful and reasonable model that incorporates these concepts can (a) provide a framework for buyers to hedge some of the risk attendant to COVID-related increases in revenues and profits while (b) protecting the seller’s value proposition should some or all these concerns not materialize.