



NAHC '09 Valuation Presentation Q&A

The 28th Annual Meeting and Exposition of the [National Association for Home Care and Hospice \(NAHC\)](#) in Los Angeles, CA on October 12th, 2009 was an opportunity to discuss opportunities and issues of interest to homecare providers. The primary topic of discussion was healthcare reform and what impact it might have on Medicare providers. The darkest cloud is that significant budget cuts are probably unavoidable, but the fact that cuts will be gradually introduced over ten years could be seen as a silver lining by some. The good news is that hospitals and other institutional providers appear to be as opposed to service-bundling at least as much as homecare providers, making the industry safe for smaller independent providers for the time being. This seems to reflect the cost report data that indicates that most independent providers are far more efficient than their institutional counterparts. More good news came in the form of the CLASS Act of 2009 as the federal government has finally acknowledged that chronic care addressing the activities of daily living can not only improve quality of life, but also save payers huge amounts of money. It remains to be seen if the politicians can effectively act on their good intentions.

Our session was well attended (in spite of its proximity to happy hour) as we reviewed practical elements of company valuations of homecare agencies in [Today's Market](#) and discussed almost a dozen examples, including several [ResCare transactions](#). Some very good questions were asked that further clarify some recurring issues, so we thought we would share some of them here.

Top Ten Questions Answered during Session 506 at NAHC 2009 Annual Meeting

1) Q: How can we calculate Enterprise Value if we don't have EBITDA?

A: Within the context of other value drivers like business mix and management depth, EBITDA and Gross Margin are the most important financial variables that impact Enterprise Value. In the absence of EBITDA and Gross Margin, buyers determine value by considering the replacement value of the assets (the cost of creating similar assets from scratch) and the opportunity cost of waiting (how much business will they lose while creating similar assets from scratch). Once a general range is established by the market, the "flinch system" is used to settle on a final number.

2) Q: Where can we find comparable sales to help estimate Enterprise Value?

A: Because most transactions are not publicly reported, there is no authoritative source for comparative data. Websites like [MergerNetwork.com](#) and [BizBuySell.com](#) list dozens of healthcare firms, but they provide zero operational, financial, or historical transactional data. What few transactions are publicly reported are usually not truly comparable because transactions with large, publicly traded companies are radically different from transactions with small, private companies. The only way to learn about truly comparable transactions (if there are any for your transaction) is to

speak with knowledgeable professionals such as M&A advisors, attorneys, and CPAs who have exposure to many unreported transactions.

3) Q: Given current [market conditions](#), are buyers still interested in providers who predominantly bill Medicare and Medicaid?

A: Yes. Due to market fundamentals associated with demographic trends, many [buyers](#) are capitalizing on short term uncertainty in preparation for long term growth. Buyers are actively searching for Medicare certified home health agencies, Medicaid homecare agencies, and Private Pay agencies, especially those utilizing the W-2 employment model. Top performing companies can expect to sell for a premium while weaker companies should expect to sell for a discount.

4) Q: Whether buyer or seller, how do we know if we're getting the best deal?

A: The only way to know for sure is to try to get a better deal. You can either try to negotiate a better price and terms with the party you're negotiating with or try to identify another party who will be more amenable to your wishes. Of course, the more you test the market, the more you give the other party an opportunity to do the same thing.

5) Q: How large does an acquisition candidate have to be to qualify as a "platform" investment?

A: As with beauty, size is in the eye of the beholder. Generally speaking, private equity groups rely on debt financing to consummate platform investments so size parameters are defined by what is financeable. Most lenders want a minimum EBITDA of \$1.5 - \$2 Million, thus most providers must be at least that large to qualify as a platform investment. That being said, when ResCare entered the homecare industry, they acquired a relatively small platform that has now grown to be over \$325 Million in annual revenues.

6) Q: Does ResCare ever end up with excess assets after consummating a transaction?

A: Yes. Although all buyers avoid paying for assets that they don't need, on occasion any prolific buyer will need to include unwanted assets in order to consummate a transaction. Unwanted assets can be carved out later if another buyer makes a compelling offer.

7) Q: Which expenses should be classified as "direct" and which expenses should be classified as "administrative" when calculating gross profit margin?

A: Gross profit margin, as defined by net revenue minus direct expenses, is one of the most important financial variables to consider in a valuation. Direct expenses are all expenses that are associated with the direct provision of care: Administrative expenses are all expenses that are not associated with the direct provision of care. Caregiver salaries, caregiver payroll taxes, caregiver workers' compensation and any other expenses (such as medical supplies, uniforms, and caregiver mileage, etc...) that are associated with the direct provision of care are considered to be direct expenses. Administrative salaries, administrative payroll taxes, administrative workers' compensation, and any other expenses (such as rent, advertising, and travel & entertainment, etc...) that are not associated with the direct provision of care

are considered to be administrative expenses. We highly recommend that all providers use accrual basis accounting, breaking out direct and administrative expenses in order to calculate gross profit margin.

8) Q: What is added and/or subtracted to net income to calculate adjusted EBITDA?

A: EBITDA is Earnings Before Interest, Taxes, Depreciation, and Amortization. For many homecare providers, the pre-tax net income and the EBITDA will be identical if the provider does not have a line of credit outstanding with interest, does not own any real estate to amortize (and real estate would be excluded from most M&A transactions anyway), and does not have any significant expenses to depreciate. Adjustments to EBITDA are made to reflect nonrecurring expenses that do not impact future margins and non-recorded expenses that must be assumed by the buyer. Nonrecurring expenses that are commonly added back to pre-tax net income in order to calculate the adjusted EBITDA include excess owners' compensation (*excess* compensation only, normal compensation for performing material job duties is *not* to be added back), significant one-time expenses such as lawsuits, IT investments, and unusual workers' compensation claims, and personal expenses such as travel & entertainment, personal autos, and nonproductive family members on the payroll. Non-recorded expenses that are commonly subtracted from pre-tax net income in order to calculate the adjusted EBITDA include market rate salaries for owner-performed job duties for which no salary is recorded (such as in a pass-through of an S-Corp), multiple job duties performed by an owner-operator that will be assumed by the buyer, and any expenses related to maintaining legal, regulatory, and/or company policy compliance. We highly recommend that all providers use accrual basis accounting and that net income, EBITDA, and adjusted EBITDA be considered and presented separately when calculating the adjusted EBITDA.

9) Q: Is the market functional during unstable periods such as the conversion from Reimbursement to the Prospective Payment System, the implementation of Competitive Bidding, and other market-changing transitions that inevitably occur?

A: Yes. What is a crisis to some is an opportunity for others. Transitional periods of instability separate the diehard professionals who are committed to the industry for the long term from the dilettantes who only dabble when times are good. Of course more buyers are present in stable markets and valuations are more volatile in unstable markets, but healthcare service economic fundamentals are driven by demographic conditions that supersede temporary transitions and operators who are committed to the industry for the long term will capitalize on M&A opportunities whenever and wherever they are found.

10) Q: Are homecare valuations going up, going down, or staying the same?

A: Economic fundamentals point towards growth for the healthcare services industry. Different industry segments and different individual providers will fare differently depending on market conditions and company performance, but demographic trends will continue to drive growth across the board. DME/02 valuations are at their nadir due to Competitive Bidding, rate cuts, service caps, accreditation requirements, and so on. Private Pay valuations (at least for companies utilizing the W-2 employment model) are at their peak and stand to increase further as the recession ends and the economy recovers. Medicare valuations remain high as the industry will probably dodge the service-bundling bullet, but will still have to absorb gradual cuts over the next ten years.

The Annual Meeting and Exposition of the [National Association for Home Care and Hospice \(NAHC\)](#) in Los Angeles was a great opportunity to discuss issues pertaining to homecare M&A valuations in a face-to-face environment. If you couldn't make it to the conference, we invite you to review our [presentation](#) and contact us if you have any questions and/or comments.

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