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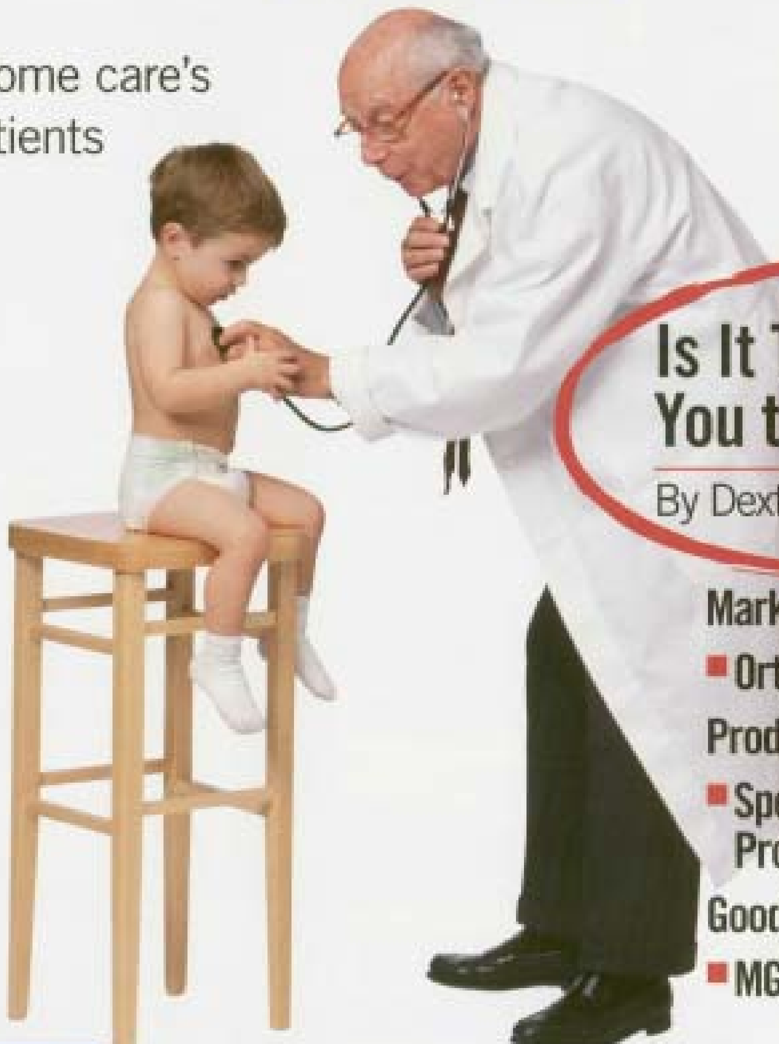

Is It Time for You to Sell? pg. 38

By Dexter W. Braff

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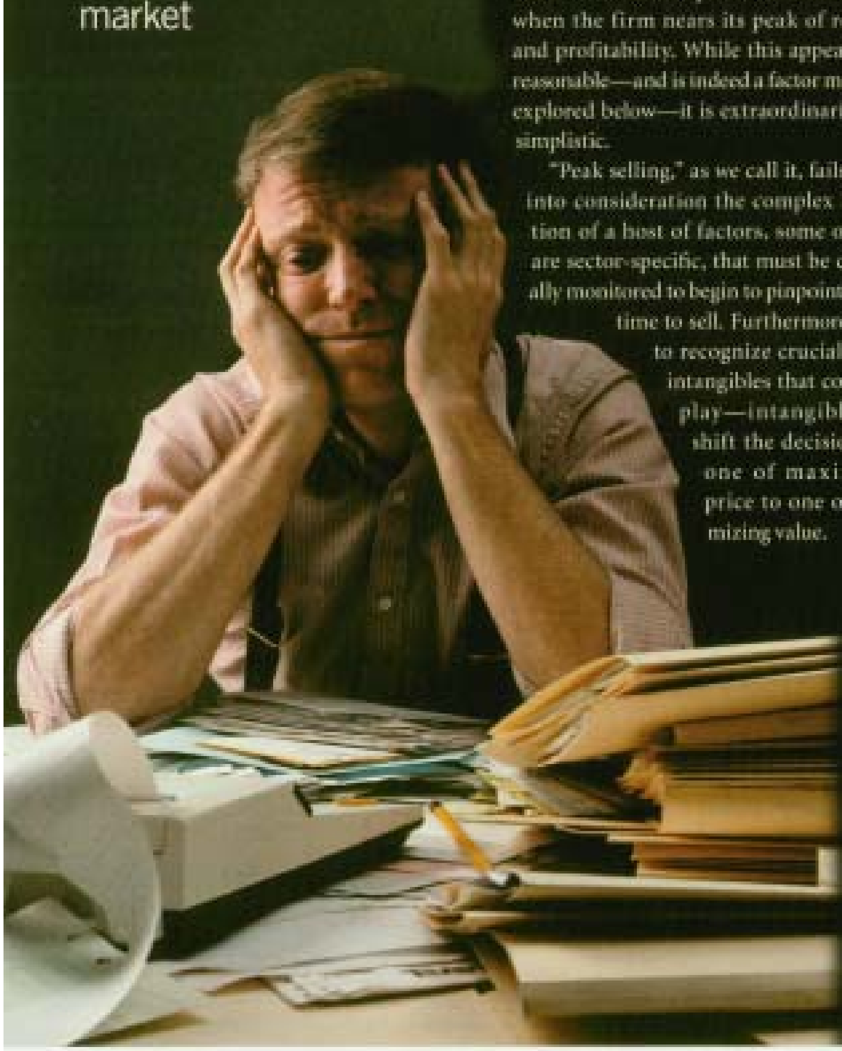
Is It Time for You to Sell?

A three-part construct for determining the best time to approach the merger and acquisition market



In determining the best time to sell a home medical equipment, infusion therapy, specialty pharmacy, home health care, hospice or health care staffing business—or any other business for that matter—the theory goes that in order to maximize price, one should divest when the firm nears its peak of revenues and profitability. While this appears quite reasonable—and is indeed a factor more fully explored below—it is extraordinarily oversimplistic.

"Peak selling," as we call it, fails to take into consideration the complex interaction of a host of factors, some of which are sector-specific, that must be continually monitored to begin to pinpoint the best time to sell. Furthermore, it fails to recognize crucial human intangibles that come into play—intangibles that shift the decision from one of maximizing price to one of maximizing value.

An Image of the Construct

To begin, we develop a mental picture of the construct. Consider a target in which the bull's-eye conceptually represents the best time to pursue a divestiture. Now consider that there are three "decision spheres" that hold a variety of related factors that should be evaluated.

Over the life of a business, these decision spheres drift toward—or away from—the center of the selling target. When all three are perfectly aligned and centered over the bull's-eye, the timing is ideal to maximize value. The key, then, is to define each decision sphere, the evaluation of which determines its current, and perhaps future, position on the target.

Decision Sphere One: Position on the Growth Curve

This is where the "peak selling" concept comes into play—and falls short of addressing the *subtleties* of growth. Somewhat perversely, once a firm reaches its peak of performance and the earnings number against which valuation multiples are applied has maxed out, those very multiples begin to fall as future upside potential begins to diminish.

Growth is important. But valuing it can be quite tricky. While buyers may covet firms in the "hyper-growth" stage of development—30 percent to 40 percent compound annual growth—in the real world they tend to undervalue it. Theoretically, in valuations of growing firms driven off of multiples (or capitalization rates), earnings should be based on an estimate of next year's earnings and beyond—what the buyer is actually buying—and a growth- adjusted multiple (or cap rate), albeit one that recognizes that periods of hyper-growth are relatively short.

In practice, however, buyers tend to rely more on historical earnings, often trailing twelve months, that substantially underpredict the go-forward performance of firms in the midst of hyper-growth. Furthermore, they tend to over-compensate for the temporal nature of hyper-growth and limit multiple adjustments to that more comparable with "mature growth" (10 percent to 15 percent per year), regardless of where the firm is positioned on the growth curve[1].

So from a divestiture-timing perspective, value is maximized not when a firm reaches its peak of performance, nor when it is in a period of hyper-growth. Rather, this decision sphere moves toward the bull's-eye as the firm enters "mature growth" where (a) earnings, while still growing, are approaching their peak, and (b) it can still take full advantage of what the market will allow for growth adjustments to multiples.

Decision Sphere Two: M&A Market Dynamics

One needs look no further than the nebulizer medication industry—and how the Medicare Modernization Act brought the market to a standstill as buyers and sellers awaited rulings on Average Sales Price—to see how market dynamics can (a) greatly influence the buying and selling decision and (b) turn in an instant.

■ **Reimbursement.** In government-funded health care, chief among the factors that drive these dynamics is reimbursement. At this point in time, buyers understand that when it comes to reimbursement, the best they can hope for are periods of relative calm and predictability.

Accordingly, sectors are often the most attractive—and valuable—when they are in the beginning or midst of these stages. That is why private equity groups are targeting hospice, which hasn't seen a substantial change in its payment system in 20 years, as well as Medicare home health, which, courtesy of the MMA, is in the middle of a period of scheduled reimbursement increases that ends in 2006.

Alternatively, while strategic buyers in the home medical equipment sector remain committed to acquisition strategies, with the prospect of CPI freezes, competitive bidding and the potential for nationwide cuts based on these results, these same private equity groups are steering clear of HME.

With regard to health care reimbursement policy issues, of special note are government initiatives to drive more seniors into Medicare managed care plans. If successful, these programs will have an enormous impact on the delivery of, and payment for, health care services. From an M&A market perspective, it already has spurred buyers across multiple sectors to begin targeting acquisition candidates with substantial managed care penetration and experience.

When it comes to determining the most optimum time to sell a business, most owners tend to focus predominately on whether offers are "fair" or "attractive" purely on a raw dollar basis.

■ **Shifting Operating Strategies.** Market dynamics are also greatly shaped by shifts in operating strategies within and across related health care sectors. Consider the following examples:

It wasn't until this past year, when specialty pharmacy providers sought to increase their "high-touch" capacity in order to be better positioned to offer therapies that require greater clinical intervention, that the market for home infusion therapy providers came alive after a long period of quiet. In an effort to create a continuum of care with multiple access points between the home and its institutional settings, long-term care companies are once again eyeing home health and hospice providers.

In health care staffing, initiatives over the past few years by hospitals to rein in the utilization and expense of temporary staffing has led to a decline in overall industry revenues, keeping the dominant buyers of the past focused inward to secure their businesses. But in anticipation of a market rebound as hospitals continue to struggle to meet clinically sound—and in some cases, legally mandated—nurse/patient ratios, a group of relative newcomers has taken advantage of a market in flux, driving acquisition volume to new record highs in 2004.

And on the horizon, once the rules for competitive bidding for HME are published and the top 10 MSAs identified, we anticipate companies will adopt and adapt acquisition strategies as necessary to round out their service capabilities. Similarly, if the managed-care initiatives described gain traction in the marketplace, companies may need to expand their mix of service offerings to capture these agreements, giving rise to diversified, rather than narrowly focused, acquisition strategies.

■ **Supply and Demand.** Another factor that greatly impacts M&A market dynamics is supply and demand. When merger and acquisition demand—driven, in part, by any combination of factors—exceeds the supply of acquisition candidates, values rise.

Such an imbalance is a key factor driving valuation in the HME sector, which, after nearly 15 years of uninterrupted acquisition activity, has seen the supply of large, respiratory-focused firms, decline. At the same time, in combination with reimburse-

As the decision spheres move toward the bull's-eye, the firm moves closer to the optimal time to divest.

ment factors, to supplement growth, this supply/demand inequity has led to a spike in interest in firms with lower respiratory mixes, including infusion therapy and supply firms serving patients with chronic conditions.

Similarly, with the potential to make profits under the prospective payment system still relatively new, many home health agencies are content with staying on the M&A sidelines. As such, for the reasons stated, numerous private equity groups are chasing after a relatively limited number of platform-size hospice and home health providers, driving up value. As more home health agencies begin to enter the market to capture these valuations, however, we may see the tide shift unless more strategic buyers enter the market in earnest, driving demand up further still.

Regardless of the reasons, as the M&A market in a particular sector becomes more vibrant, values often rise. These dynamics, however, tend to be just that—dynamic. So this decision sphere must be continually monitored to see where it is positioned over the selling target.

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Decision Sphere Three: Personal Goals and Objectives

Oddly enough, when it comes to determining the most optimum time to sell a business, most owners tend to focus predominately on whether offers are "fair" or "attractive" purely on a raw dollar basis. In doing so, they fail to evaluate M&A opportunities within the context of their unique personal goals and objectives, the consequences of which can substantially diminish the "value" they ultimately derive from a deal.

Passion vs. Burnout. For example, consider a prospective seller who derives an enormous amount of pride and professional and social enjoyment out of owning and operating a business. Even if the growth and market-dynamic spheres are perfectly positioned over the selling decision target, the loss of the psychic benefit of business ownership may significantly discount the value of a deal.

Alternatively, owners experiencing debilitating burnout may find the "cost" of holding the business until the other spheres move into perfect position is simply not worth the extra dollars that may accrue.

Alternative Investment Opportunities. If owners have plans for other business ventures, they should carefully consider the relative returns of holding onto their businesses vs. investing some or all of the proceeds from a sale in the venture. The added value that can be gained by holding onto a business as growth matures and market dynamics improve, while attractive, may not offer as great a return as what could be gained from the alternative investment—a situation that drives this sphere toward the bull's-eye.

The Psychic Value of the Marginal Dollar. Another critical personal factor that can substantially impact the selling decision is what we refer to as the "psychic value of the marginal dollar."

Drawing on the realities of behavioral economics, once the value of an owner's business reaches a certain level—a level that provides enough money to meet his own unique financial goals and objectives with respect to lifestyle, security, estate planning, etc.—the psychic value of the next dollar begins to diminish rapidly, as it offers little marginal benefit.

With a little introspection, most individuals can gain a sense of where their "marginal value breakpoints" lie. Armed with this insight, owners are less likely to expose themselves to unnecessary risks by chasing dollars that offer little incremental "value," an insight that greatly influences the timing of a transaction.

Many other personal factors can influence the position of this sphere, commonly, health issues or considerations regarding passing a business on to children or other family members. Whatever they may be, the best-informed sellers know that these intangibles are often just as important as growth and market dynamics in evaluating the sell vs. no-sell decision.

Final Thoughts. It should be noted that depending on the individual, one decision sphere may carry more weight than another. If so, the mental picture of that decision sphere should be larger than the others.

Furthermore, while the construct suggests that the perfect time to sell is when all three decision spheres are aligned perfectly over the center of the conceptual bull's-eye, it should be realized that rarely is the real world quite so cooperative. Rather, the point is to monitor the movement of the spheres and recognize that when enough mass begins to center over the target—and this is where the relative size of the spheres may come into play—the firm may be approaching an optimal point to divest.

While it may seem overwhelming to try and pinpoint the best time to sell amid so much uncertainty, by carefully and continually monitoring growth, merger and acquisition market dynamics and personal goals and objectives, the right answer—specific to each individual and business—frequently emerges. HC

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1. *Those familiar with valuation theory may recognize that to capture temporary periods of "hyper-growth," it would be more appropriate to use a discounted future cash flow method of valuation where the terminal period would be the point at which mature growth is reached. In practice however, home care buyers tend to put little faith in projections beyond a year, relying more on capitalization of earnings methods, which by definition assume long-term, sustainable growth rates.*