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The Urge to Merge

HOW ATTRACTIVE IS YOUR COMPANY AS AN ACQUISITION TARGET?

By Ted Stack

If you're like most HBMA members, chances are that you have received at least one call from an unknown stranger in the last twelve months. The anonymous voice says, "I have been studying the medical billing and practice management market and am actively looking to acquire a company just like yours so I can take advantage of a highly fragmented market." If your company is over $5 million in annual revenue, you probably have received multiple calls. Why this renewed interest in the physician billing and practice management market, and what are these buyers really looking for in a medical billing company?

The Right External Conditions

We are in the midst of a "perfect storm" of positive external influences that are fueling this round of consolidation in the industry. These trends are not unique to the medical billing and practice management markets. You can't pick up a newspaper without reading about a significant mega merger. In fact, 2006 was one of the most active merger and acquisition (M&A) markets, and the first quarter of 2007 will likely be one of the top three most active M&A quarters ever. The medical billing market saw the announcement of several high-profile deals and many smaller quiet deals closed in 2006. We estimate that 2007 could be the most active M&A market in the medical billing industry since the early to mid 1990s.

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The external factors impacting these trends include:

- An abundance of private equity/venture capital money
- Aggressive debt lenders and the availability of relatively low-cost debt alternatives
- An accumulation of cash on many public company balance sheets
- A strong stock market that rewards growth
- A growing concern expressed by potential sellers over possible changes in income tax and capital gains tax legislation
- A renewed interest in the healthcare service sector
- The availability of new technologies and offshore labor alternatives to drive profit margin improvements

The New Acquirers

The most current round of M&A activity is quite different from the good old days in the early 1990s. Back then we had two or three companies already in the industry that were making proactive acquisitions of companies. Today, (continued on page 12)

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we have dozens of financial and strategic buyers actively seeking acquisition candidates. Most financial buyers (private equity and venture capital investors) are focusing on companies larger than $10 million in revenue. The strategic buyers (those companies that are already in the industry, or are in another industry) are looking to expand or enter the medical billing and practice management market. They generally will look at companies above $5 million in annual revenue. The market for companies with less than $5 million in revenue (which is the majority of the industry by number of companies) is also starting to become active as acquirers look for "add on" acquisitions to existing operations.

Today's acquirer is much more fiscally disciplined than the buyers of yesterday. Yes, valuations have improved over the last 12 months to levels not seen in many years. However, today's acquirers must be much more focused on the growth and profitability potential of a target acquisition in order to be able to make the economics work on a higher valuation. There also are "new" financial markets that did not exist ten years ago that can readily fund consolidation and or growth opportunities. These markets tend to rely on both debt and private equity, not a public security like in the 90's, to fund the growth and consolidation.

The Value Drivers

The discipline referred to above comes from the fact that much of the public market emotion is removed in financially sponsored deals, thus making the visibility to growth and earnings much more significant. Acquirers are looking for much more than just growth and profitability. One of the frequently asked questions at many of the HBMA meetings we attend is, "What is the current EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) multiple in the market?"

That is like asking a billing company owner/manager, "What is the reimbursement for a specific CPT code?" The answer to both questions is, "it depends," and yes, it is complicated. We can, however, give some guidance on the most important factors in determining the value of a medical billing and practice management company.

The following "value drivers," based upon our experience in the market, are listed in order of importance to the potential buyer:

1. **Profitability.** This is generally expressed in terms of EBITDA or "Free or Unencumbered Cash Flow." Potential acquirers will generally look at the 12-month trailing EBITDA and apply a multiple to arrive at a valuation. The multiple utilized is a function of the current market and how well the business "rates" based on the value drivers listed herein. If the business is growing more than 15% per year, a strong argument can be made to look at a blended 12-month trailing EBITDA and a forward-looking or run-rate EBITDA in determining value.
2. **Growth Rate.** A significantly higher value will be placed on a medical billing company that has a proven track record of consistent annual growth. Companies that have been in business over five years and have experienced growth rates over 20% per year will be a much more attractive business partner. Unfortunately, for those of you who are not growing, it is likely that your valuation, on a relative basis, is actually declining. Remember, growth and profitability are closely linked. Understand your fixed vs. variable costs.
3. **Management Team.** The strength and depth of the management team is a significant driver of value. Medical billing is a service industry where the relationships between customer/client and company are significant. If the management team has proven that it can manage service quality, hectic growth, and profitability, it will inure significant value to the company.
4. **Size of Company.** The larger the company in terms of revenue and earnings, the higher the value. The law of supply and demand works here—there are just not that many medical billing companies over $10 million in revenue.
5. **Recurring Revenue.** The higher percentage of revenue that comes from multi-year or evergreen contracts that have been in place over three years, then the higher the value. "Visibility" to future revenue and earnings is a key driver to value your company's "future" growth (i.e. forward-looking EBITDA multiple).
6. **Revenue Diversification.** Ideally, no one client or customer should make up more than 15% of annual revenue. Geographic diversification is a plus as well. It shows the ability to deal with billing issues in multiple states and with remote client service issues and it substantiates the company's ability to define a larger target market area for future growth. Being in a single specialty is (*continued on page 13*)

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not necessarily a negative so long as there are no significant legislative or payer issues that would adversely effect reimbursement in that particular sector.

7. **Client Retention.** There is no better gauge of quality service than customer retention. Low customer/client turnover speaks volumes about quality. Less than 10% of client (or revenue) turnover is acceptable.

8. **Infrastructure Investments.** The medical billing company that has made infrastructure investments in information technology platforms, data repositories for reporting on financial and clinical outcomes, administrative systems, financial systems, and expert human capital will be perceived as a more valuable "platform" company due to its ability to support growth.

9. **Market or Specialty Dominance.** If a company can demonstrate that it is the market leader in a particular geography and or specialty, this will help to improve value. With multi-year contracts in place, it is very difficult for competitors to penetrate a market dominated by an industry/specialty leader.

10. **Company Culture.** Culture is an intangible valuation metric. Medical billing companies with high employee satisfaction and retention, with professional working environments, with in-place compliance plans that are taken seriously, and where litigation is minimal, are considered to be better potential business partners.

These value drivers don't happen overnight. It takes years of careful business planning and thoughtful implementation to achieve high marks in all the categories. The businesses that are the most attractive to buyers are those that have a track record of performance and are in the midst of implementing their growth plans. Remember that an acquisition is usually a new beginning, not the end of your company's existence. Most business owners/management teams will remain in place for a minimum of three years after any deal closes (and often many years into the future).

These are exciting times of change for the industry. The good news is that there always will be a place in the market for well run, customer-service-focused companies, regardless of their size. ▲

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