VALUATION OF NON-PROFIT CONVERSIONS

TECHNIQUES FOR DETERMINING THE VALUE OF HEALTH CARE ORGANIZATIONS CONVERTING TO FOR-PROFIT STATUS

During the past decade, the health care industry has faced a number of conversions of non-profit hospitals, health plans, and health insurers to for-profit status. The laws governing such conversions vary from state to state, but in most cases, state attorneys-general are required to conduct an economic evaluation of the value of such conversions to protect the public's interest. In exchange for permitting conversion to for-profit status, most states require non-profits to donate the fair-market value of their assets to an existing non-profit organization or to a newly established charitable trust.

These conversions raise a fundamental question for states, namely, how should a non-profit organization be valued? The answer to this question is of considerable importance to both the organization seeking to convert to for-profit status as well as to taxpayers who will benefit from the assets placed in public service as part of the conversion. The purpose of this memorandum is to summarize the generally accepted techniques for valuing non-profit organizations and to provide recommendations regarding the appropriate techniques for evaluating non-profit conversions.

Techniques for Economic Valuation of Non-Profits

There are three generally categories of economic valuation used in determining the valuation of nonprofit organizations[1]:

- asset-based analyses;
- comparable market analyses, and
- income or cash flow analyses.

Asset-Based Analyses

These techniques are based on the organization's balance sheet and include: (1) *book value* (i.e., total assets minus total liabilities = owners equity); (2) *tangible book value* (i.e., total assets minus intangible assets minus liabilities); and *economic book value*, where the value of assets, including intangible assets, and liabilities are agreed to by the buyer and seller.

[1] William O. Cleverley, *Essentials of Health Care Finance, 4th Edition* (Gaithersburg, MD: Aspen Publications, 1997); James J. Unland, *The Valuation of Hospitals and Medical Centers: Analyzing and Measuring Hospital Assets and Market Value* (Chicago: Healthcare Financial Management Association, 1993).

Book value is generally viewed as inappropriate for valuation because assets are recording on balance sheets according to their historical purchase price, which for most fixed assets does not reflect current value or replacement cost.

For *tangible book value,* the organization's assets must be inflated to represent current market value. The major disadvantage of this technique, however, is that it does not include any indication of organizational *performance,* and thus does not assess the value of the organization as an *ongoing concern*.

Economic book value does not seem appropriate for valuation of non-profit conversions, since the buyer and seller may have an incentive to undervalue the assets that must be assigned to the new non-profit organization or foundation after conversion.

Therefore, asset-based techniques are generally not appropriate for valuation of non-profit conversions.

Comparable Market Analyses

These techniques include: (1) *comparable sales,* which are similar to real-estate markets where valuations are based on recent sales of similar facilities or organizations, and (2) *market multiples,* which establishes market value of public companies relative to one or more of the following dimensions of financial status:

- cash flow or EBITDA, i.e., earnings before interest, taxes, depreciation, and amortization,
- revenues or sales,
- net earnings,
- book value of invested capital (i.e., debt plus equity).

Comparable sales analyses are possible in health care, but not necessarily reliable, since they require a large number of transactions to be reliable, and health care acquisitions and conversions do not produce a large set of comparable transactions.

Market multiples are commonly used as a quick and easy method to establish a benchmark for valuation, but market multiples are difficult to establish in advance, because market conditions can change for reasons related to general conditions in the stock market, which may or may not be directly related to the performance of the industry. For example, market valuations have dropped by more than 50 percent in many sectors of the economy since Fall 2000. Therefore, market multiples are subject to rapid change and can quickly become out-of-date. Any valuation analysis based on market multiples should coincide as closely as possible to the anticipated conversion date, and should be updated to accurately reflect current market conditions.

Multiples of EBITDA and revenues are most commonly used because organizations with negative net earnings generally have positive cash flows, and obviously all ongoing concerns have positive revenues. For these reasons, these multiples are particularly useful in establishing benchmark valuations for non-profit health care organizations.

Price-to-earnings (P/E) ratios are easy to obtain for publicly traded companies, and thus represent an easy method for establishing a valuation benchmark. The disadvantage is that if the non-profit organization currently is experiencing losses, it is necessary to project future net income after for-profit conversion in order to apply an appropriate P/E ratio.

Income or Cash Flow Analyses

These techniques include: (1) *income capitalization*, in which cash flow or net earnings are divided by a yield rate or capitalization rate (e.g., the weighted average cost of capital) to determine market value, and (2) *discounted cash flow or net present value (NPV) analysis*, in which future net cash flows are projected and discounted to account for the time value of money.

The advantages of these techniques is that they are based on the *performance* of the organization, although appropriate adjustments must be made to account for *future income or cash flow*, particularly for organizations that are currently performing poorly.

Of all the valuation techniques, *net present value (NPV) analysis* is widely recognized as the most appropriate method for valuation of organizations, both non-profit and for-profit, because it determines value based on a direct measure of shareholder or owner's wealth, namely, the present value of net future cash flows.[2]

NPV analyses are conceptually superior to all of the techniques discussed above, they are also the most difficult and timely to conduct because they require a considerable amount of information about both historical and future revenues and expenses. NPV analyses require assumptions and predictions about future performance of the non-profit after conversion, including: (1) sources of revenues and revenue growth; (2) major expense categories and rates of growth in each expense category; (3) rates of growth in fixed and current assets; (4) the appropriate discount rate, which should reflect the organization weighted average cost of capital. Therefore, the quality of the NPV analysis depends upon the quality of the assumptions that produce the projections.

[2] See, for example, Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance, Fifth Edition* (New York: McGraw-Hill Publishing, 1996).

At a minimum, states evaluating non-profit conversions should require a thorough NPV analysis be conducted by an *independent third-party* (i.e., someone other than the buyer and seller) who has complete access to the financial statements of the non-profit organization for a period of at least 3 years prior to the proposed conversion. Furthermore, the NPV calculations should be presented with all assumptions about future growth rates and discount rates presented explicitly, with accompanying justification for each major assumption in the analysis.