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Understanding Discounts in a Hospital FMV Appraisal

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For those tasked with reviewing and analyzing business appraisal reports, an understanding of key valuation terms and vernacular is key. This article will help the users of business appraisals understand the difference between a discount for lack of marketability (DLOM) and a discount for lack of control (DLOC), and when and how these discounts are commonly applied.

The *International Glossary of Business Valuation Terms* defines a discount for lack of control as:
"an amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control."

Stated differently, an owner/buyer of less than a controlling interest in an enterprise will demand an amount less than the pro rata share value because he/she does not possess the legal rights that a control owner has.

The Glossary further defines a discount for lack of marketability as:
"an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability."

A DLOC is commonly applied in determining the fair market value of a non-controlling interest in a hospital. A DLOM is sometimes applied to the valuation of privately held hospitals, because there is no ready market to sell an ownership interest. Where and when to apply these discounts is <u>highly dependent</u> upon the facts and circumstances of each case and the level of value produced from the valuation methods used.

To understand the concepts and application of DLOCs and DLOMs, one first needs to understand the three standard methods appraisers use to determine the fair market value of a hospital, as well as other types of private companies. The three methods business appraisers apply are: Asset Approach, Income Approach, and Market Approach.

Asset Approach

An asset approach to value is a method of valuing a business based on the value of its assets and liabilities. Very simply, a company's assets (tangible and intangible) and liabilities are adjusted to their fair market value and the difference represents the net assets of the enterprise. It is important to remember that a company's book value or cost-based values do not represent fair market value. The level of value produced from this approach is commonly referred to in the business valuation community as a *control, marketable value*. Only a control shareholder has the power to make decisions regarding the assets of the company/hospital. Therefore, if the appraisal objective is to value a non-controlling interest in a privately-held hospital, a DLOC is required. A willing non-controlling buyer would likely not pay a price equal to the pro rata share of the net assets that he/she cannot control. Hence, it is logical to assume that a hypothetical buyer of a minority interest would demand a discount, and a seller would likely accept such a discount. Finally, to sell a privately held hospital requires certain costs for legal fees, broker fees and accounting which represent an additional discount for lack of marketability.

Income Approach

The most common and fundamentally sound method to value a hospital is the discounted cash flow method (DCF). This method begins with the hospital's future cash flows and discounts the cash flows to the present value utilizing an appropriate discount rate. Developing an accurate, thorough and well thought-out financial projection takes considerable time and effort. If management has not prepared a forecast, the valuation analyst can assist in this task. It is essential for the appraiser to consider the character of the earnings stream used and whether they (earnings) are reasonable, attainable and on a normalized basis. The discount rate is derived from freely traded securities data and reflects the assumption of full marketability. Therefore, the resulting value is on a *marketable level of value*. Depending on the nature and character of the cash flows, a DLOC may be needed, and a DLOM is usually applied.

Market Approach

The Market Approach is premised upon the idea that the value of a business or business entity can be reasonably determined by reference to the prices paid at arms-length for similar interests in the open and unrestricted market. The key to valuing a business under this approach is to find transactions for interests in other similar type facilities. There are two methodologies under this approach: guideline company transaction method and guideline public company method. Again, depending on the method used by the appraisers, a DLOC and DLOM may be applied.

Under the guideline transaction company method, the appraiser obtains data from actual transactions of hospitals to calculate valuation multiples which can then be applied to the subject hospital. Valuation multiples are calculated on various measures of earnings (i.e. revenues, EBITDA, pre-tax earnings) and assets or size, such as number of beds. Because these transactions typically involve the sale of closely held businesses, it is generally accepted that this method yields a controlling, non-marketable level of value. Hence, the appraiser will normally apply only a DLOC if the appraisal assignment calls for a non-controlling interest valuation.

Under the guideline public company method, the appraiser refers to the trading prices of the common stock of publicly held hospitals, such as LifePoint Hospitals, Community Health Systems or Tenant. The trading prices are used to calculate valuation multiples which can then be applied to the subject hospital. Since the trading prices found on the public exchanges are for a single share of stock, it is commonly held that this method yields a minority, marketable level of value. As a result, a DLOM is often applied. Great care must be taken when relying solely on a guideline public company method to value a single location hospital. The publicly-traded providers are diversified in numerous markets where reimbursements are different. In addition, the public companies have multiple service lines, professional management, access to capital and buying power.

In conclusion, when and where to apply a discount in a fair market value appraisal of a private hospital depends on the method applied. The source and degree of discount is the subject of another article.