The Practice Valuation Process

The mechanics and details of practice valuation cannot be explored in a cursory manner. However, it is helpful to develop a concept of the general principles of practice valuation.

A business, including a veterinary practice, is a collection of physical assets, financial resources, and human resources that pursue an economic activity within a market place. The process of business valuation is that of determining the value of the property rights encompassed in the ownership of this collection of assets and resources.

Beyond bricks, mortar, and medical equipment, a very significant component of the value of a veterinary practice lies in the intangible asset often referred to as goodwill. The value of the goodwill is not found in the practice attributes of reputation, nor the client list, nor the geographic area that the practice has laid claim to. The goodwill value is determined by the net income that the practice generates. In other words, those practice attributes listed above may contribute to profitability, and thus to goodwill, but goodwill must be quantifiable in the profit that the practice generates.

Practices may be valued using one, or preferably, a combination of valuation approaches. Each of the **market**, **income** or **asset** approaches uses methodologies that are appropriate to the subject practice and data available.

Market Approach

The **market approach** determines the value of a practice to be comparable to that of practices of equal desirability and for which appropriate sales data is available. This approach has its limitations in the valuation of veterinary practices:

- There is a very limited database from which to source comparative data.
- The level of profitability of the practices within the database is unknown.
- The terms of the financing used to complete the transactions are unknown. As it is common for the vendors of veterinary practices to finance a large portion of the sale price, the terms of the financing can have a significant influence on the “real” price of the practice.

Asset Approach

The **asset approach**, which has been used predominantly to value veterinary practices for several years, determines value by summing the value of the practice assets. These assets include the tangible assets of equipment, inventory, receivables, and leaseholds, as well as the intangible asset of goodwill.

The tangible assets are priced at fair market value. Fair market value is usually determined to be the replacement cost of the subject asset times its remaining useful life. As an example, a 10-year-old x-ray machine with a life expectancy of 20 years and replacement cost of $20,000 would have a value of $10,000 [(20-10)/20 X $20,000].

The goodwill value is most often derived through the excess earnings methodology. Excess earnings are those earnings greater than what would be attributable to a fair return on the tangible assets, after the owner has received fair compensation for professional and managerial efforts. An estimate of the excess earnings that is felt to represent a reasonable proxy for the amount that will continue perpetually is capitalized at an appropriate capitalization rate to determine the value of the intangible asset.

The practice value is simply the sum of the values determined for each practice asset.

The asset approach has several deficiencies:

- It is difficult to determine the fair market value for the tangible assets. Getting this value wrong will, in turn, influence the expected return on fixed assets and the estimate of the appropriate level of excess earnings to be capitalized in the calculation of the value of goodwill.
- Some practices may be laden with assets that are seldom used and do not generate substantial income. These practice assets are valued similarly to income-producing assets and have the effect of inflating the practice value.
- The appropriate capitalization rate to be used in the excess earnings method is often difficult to determine. This rate must encompass a consideration for both the risk of future cash flows and practice growth. Many factors including competition and demographics must be collectively evaluated in determining a fair capitalization rate for a given practice.

Income Approach

The **income approach** bases value solely on the ability of the practice to generate income (profit). Fundamentally, this approach has the greatest appeal in that value is based on anticipated future returns. This approach pays no regard to the value of individual assets. The tangible and intangible assets are collectively responsible for generating the income upon which the value is based.

The value derived by the income approach is driven by the positive financial benefits produced by the components of a business's physical assets, financial resources, and human resources, all functioning within a market place. The income approach treats the business as a pure investment activity based on the return available to the owner. It is the achievement of earnings, not the possession of furnishings and equipment, that primarily motivates entrepreneurs - - the importance of assets being the need for same to generate revenues and earnings.

If future income levels and the growth rate of the income are determined to be stable into perpetuity, a single period capitalization method can be used. If the income levels or the growth rate are felt to be unstable, the appropriate income levels and rates of growth must be forecast and the resulting income streams discounted to a present value using a fair discount rate for the particular practice.

Reconciliation of the Practice Value

Each valuation approach will give slightly different values. The value derived by each approach depends on the appropriateness of its use and the data available for the associated calculations. Appraisers must use their judgment and professional experience in deriving a final opinion of value.

Justification for Purchase

Regardless of the combination of approaches and methodologies used to derive the value of a practice, a proforma cash flow statement must be prepared to ensure that the purchaser will have sufficient cash flow to operate the practice and satisfy financial obligations. The vendor should exhibit equal interest in this pro forma, since the vendor often finances a large portion of the sale price.