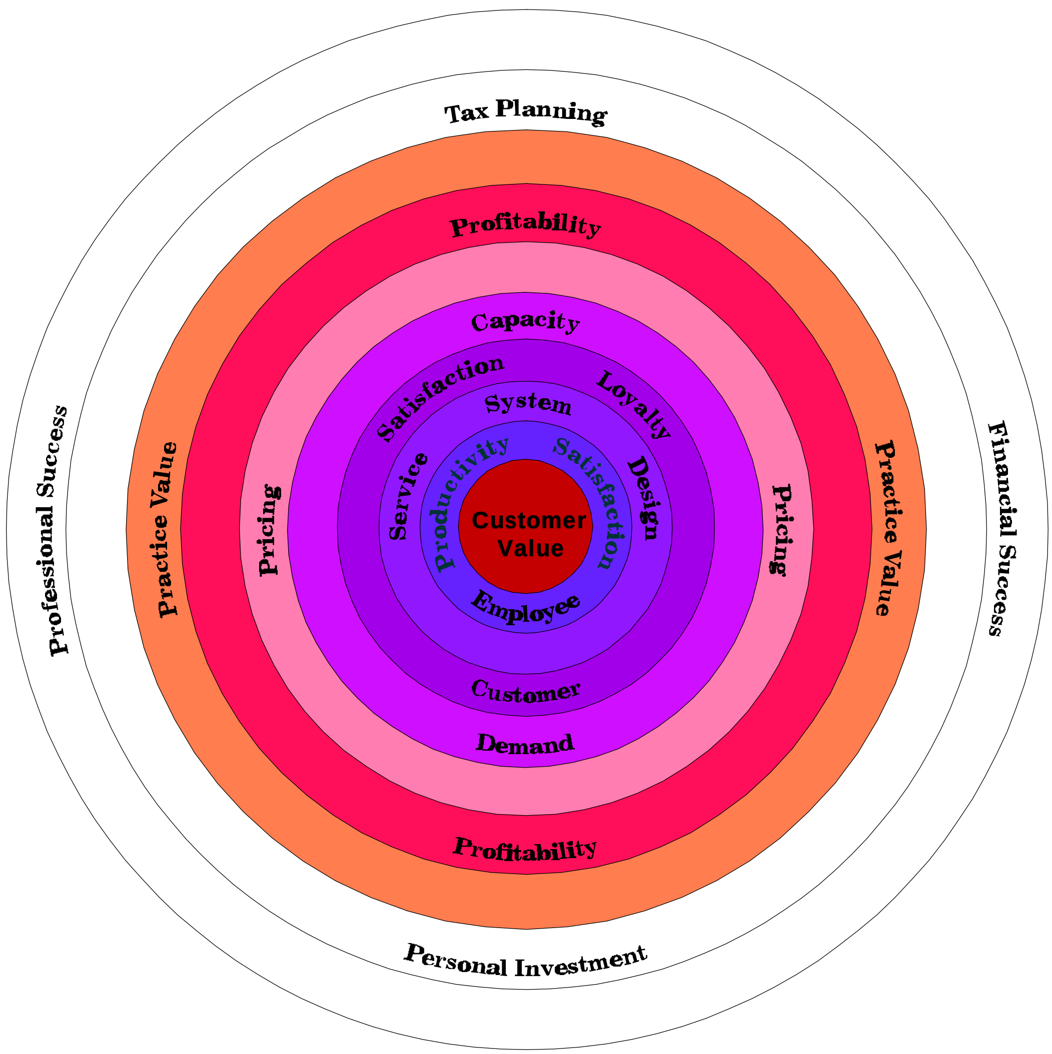
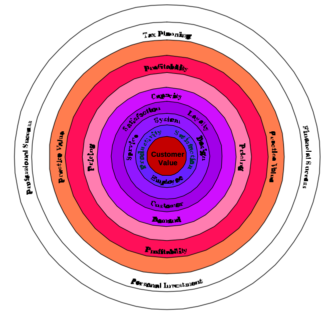
Deriving Value from the Practice





Deriving Value from the Practice

An investment in a veterinary practice is very different from an investment in a more conventional property such as equity or real estate. When one invests in these more conventional vehicles, there is an expected return on the investment. The investors hope to receive value that will represent the initial capital invested plus a compounded expected return that is proportionate to the amount of capital initially invested.

For most individuals, an investment in a veterinary hospital represents the purchase of a better job. In the present job market, it is unusual for an employed veterinarian to command a salary significantly in excess of $70,000 per year. However, as a practice owner, the annual net income that can be equated to salary may range from $30,000 to $400,000. This salary as a practice owner represents compensation for professional and management activity as well as a return on the investment. Attention paid to profit drivers can result in an extremely high return on the investment. The financial return has little to no relationship to the amount of money initially invested.

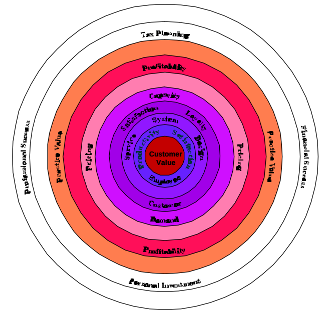
There are three stages to the investment in a veterinary practice. Whether establishing a new practice or purchasing an existing one, it will require 5 to 7 years to become established to the point of reaping high levels of income. Following the initial 5 to 7 years is a 25 to 30 year period of high income. The final stage is the sale of the practice.

Value is derived in different manners from each of the three stages of practice investment. .

Value from the Early Years - - Founding a New Practice

Establishing a new practice is a risky business. In today's market, a leased facility will require approximately $100,000 of leasehold improvements and $100,000 in equipment purchases. The annual fixed expenses, not including the owner's salary, will approximate $100,000, without a single client transaction.

Although it may be possible to reduce these costs slightly, they cannot be reduced enough to have a substantial effect on the associated risk. The risk of the new practice venture is the uncertain rate at which a satisfactory client base can be established to support the cost structure.

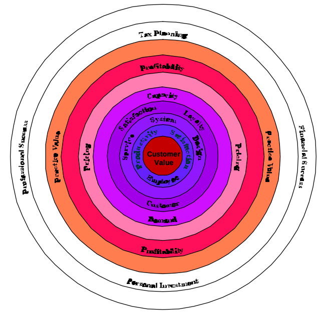


Diligence paid to providing value as discussed in previous articles will create a greater demand for the practice's services, but there is no magnet strong enough to attract clients within a market that is too small or too saturated with existing practices.

Determining the market potential through demographic studies, as discussed in the article pertaining to capacity and demand, is essential for the start-up veterinary practice. Establishing a practice in a market where a clientele can be established quickly results in a shortening of the initial, non-profitable period of the practice life. With rapid market penetration, high levels of income can be realized at an earlier stage. The time value of money has a staggering affect on this early income stream.

Conversely, developing a practice in a market where several years are required to establish a satisfactory clientele will lengthen the first practice stage and substantially reduce the lifetime return to the owner. Even worse is the establishment of a practice for which a satisfactory clientele can never be established and which perpetually gives poor returns. A strategy of divesting such an investment is far more profitable than accepting the very poor lifetime return.

An investment in an existing practice that has been fairly valued is much safer than an investment in a start-up practice. However, an entrepreneurial individual will take on the added risk of the new practice venture with expectations of benefiting from the greater returns that should accompany a riskier investment. This entrepreneur is banking on establishing a client base quickly and having high returns at an early point in the practice life.



Value from the Early Years - - Purchasing an Existing Practice

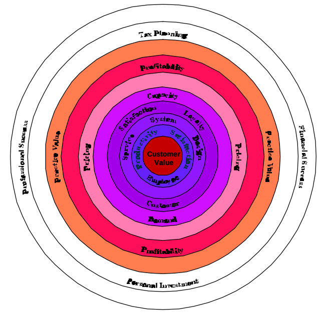
Purchasing an existing practice is a far safer investment than establishing a new practice. When fairly valued, a practice should have sufficient cash flow to provide the new owner with compensation for professional and management efforts and to retire the debt obligation associated with the purchase over 5 to 8 years. The length of the pay-back period is at the upper end of the range for very stable, low-risk practices and at the lower end of the range for riskier practices.

The risk of investing in an existing practice is less than that of investing in a start-up practice because the existing practice has an established clientele and a history of financial performance and resulting cash flows. However, the purchase of an existing practice affords little chance of cash flows greater than fair compensation before the 7th or 8th year of practice. As would be expected, there are lower returns for lower risk.

A fair valuation of the purchased practice is of paramount importance to the purchaser. Regardless of the valuation approach or methodologies used to derive a value, the purchaser must develop proforma cash flow statements to ensure that there is sufficient cash flow to meet the financial obligations of the practice after purchase.

Firms that appraise small, closely-held businesses and professional practices require no licensing from professional bodies. Membership in business appraisal associations is voluntary. Business valuation associations do offer designations following the successful completion of examinations and the demonstration of appraisal competency. Nevertheless, the most reasonable advice to the user of appraisal services is “buyer beware”.

Through the initial 5 to 7 years regardless of whether it is a startup or purchased practice, significant equity will accumulate, but very little value will be extracted for personal use. This equity has purchased a high-paying job and allows the practice owner to reap high income through the established years of practice. The equity will be divested when the owner sells the practice.



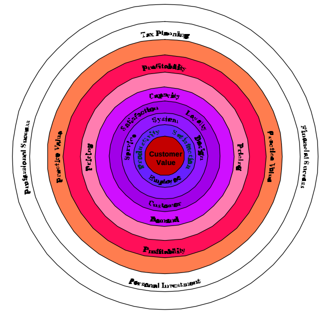
The Established Practice Stage

Whether a practice is purchased or founded, there should be significant financial stability by approximately the seventh year of operation. This should be followed by 20 to 30 years of stable and high personal income. It is during this stage of practice life that the majority of value is extracted from the practice.

Unfortunately, the value extracted during this stage varies widely from practice to practice. Practice owners must have a basic expectation of receiving professional and management compensation. Presently, owners should anticipate receiving approximately $65,000 for their professional activity, and, for a hospital grossing $400,000, a fair compensation for management at 3% of revenues equates to $12,000. Thus, the fair return to owner for professional and management activity is $77,000. Only income above this level of fair compensation represents value derived from the practice investment. Very conservatively, however, the annual return from the hospital could exceed fair compensation by $100,000. Following is a table that illustrates the future after-tax value of various levels of pre-tax income exceeding fair compensation, when invested at 8% for 25 years.

	PreTax Net Income Greater than Fair Compensation				
	$25,000	**$50,000**	**$75,000**	**$100,000**	**$125,000**
After Tax Value	$520,574	$1,041,148	$1,561,722	$2,082,295	$2,602,869

Over 25 years, a practice owner with an annual net income of approximately $200,000 can extract approximately $2 million dollars more from a practice than an owner with a net income of $77,000, an amount equal to fair compensation for professional and management efforts.



Practice Sale

Through the practice sale, owners will realize the remainder of the value of the practice. A brief explanation of the practice valuation process follows. On average, 70% to 80% of the practice value will be associated with the intangible asset, or goodwill, of the practice. The goodwill value will be proportionate to the earnings of the practice that exceed a return equal to fair compensation for professional and managerial efforts. Thus, the profitability of the practice not only affects the value extracted by the owner over 25 years of operation but also has a dramatic effect on the overall value of the practice at the time of sale.

Value Derived and Profitability

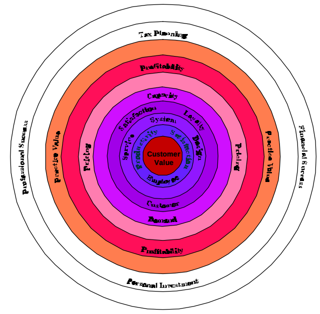
Many veterinarians believe that they participate in a low-paying profession and have low expectations of their earnings. Others within the profession enjoy very healthy and even high earnings. Failure to generate high personal income is not the result of constraints of the veterinary profession but of the inability of practice owners to provide value to clients and operate efficiently.

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.