Practice Valuation – What You Need to Understand

The Following material was prepared to familiarize potential practice vendors and purchasers with the fundamental principles of the valuation process.

The most common reason for valuing a practice is the transfer of all or some portion of the ownership interest. The information presented in this article pertains to valuations performed for the transfer of an ownership interest. Marital dissolution and use as a management tool are other reasons that a practice valuation may be performed.

In almost every instance, a valuation done years before an ownership transfer can be very helpful. An early valuation provides the owner with knowledge of value before entering into discussions with potential purchasers. More importantly, if the valuation is done far before ownership transfer, the owner has the opportunity to make changes that will enhance the practice value.

No single method exists for determining the value of a business. However, there exists a generally accepted theoretical foundation to the process of valuing a business enterprise. The most critical assumption is that the value of an interest in a business to an investor is the future earnings, with the value of the future earnings calculated back to a present value at some appropriate rate that reflects the risks inherent in the business' operations.

In past years, many veterinary practices have traded with values set by using basic multiples of the practice's gross revenue. Although no veterinary industry standard for the multiple existed, frequently quoted percentages ranged from 60% to 100% of the previous year's gross revenues. On occasion, these rules also refer to a weighted three-year average of gross revenue.

A rule of thumb is a homemade recipe for making a guess. It is an easy-to-remember guide that falls somewhere between a mathematical formula and a shot in the dark[1].

Valuation determined by a multiple of gross revenue has not been used for the past twenty years. The following are the shortcomings of the Industry (Rule of Thumb) Method as it applies to valuing closely held businesses in general and more specifically to valuing veterinary practices:

1. This Method assumes that all veterinary practices are homogeneous and presumes typical or average entities. If this were true, buyers would have no preferences to purchase one practice over another, assuming similar gross revenues. Clearly, such is not the case.

2. The Method ignores a practice's true economic earning capacity, which experience has shown can vary remarkably from one practice to another. Additionally, the rules have no provision for assessing the risk factors. This is a major shortcoming.

3. Most rules-of-thumb are not derived from actual transactions in the market place. The absence of knowledge involving actual transactions results in distortions (due to differences in profitability, management, sale terms, existence of non-compete covenants with employed veterinarians, the ability to

---

[1] Tom Parker, *Rules of Thumb*, Houghton Mifflin: Boston, 1983, p. vii.

transfer goodwill to buyers, and/or other considerations) affecting what buyers would be willing to pay for a given business entity.[2]

In 1999, the Ontario Veterinary Medical Association conducted a survey to gather information on the sale of veterinary practices.[3] The conclusion of the authors was that there was no appropriate rule of thumb to value veterinary practices.

Like any other investment, the price a purchaser is willing to pay for a veterinary practice is determined by the size of the anticipated financial return and the risk associated with this return not being realized. The magnitude of the return, the potential for growth and the risk of return all drive the value of a veterinary practice.

The future earnings that an investor in an animal hospital is willing to pay for is some level of profit. The elementary measure of profit used in the valuation of veterinary practices is the adjusted operating income. Invariably, the adjusted operating income is different from the operating income recorded on the practice financial statements.

Accounting practices can vary widely across veterinary practices depending on management policies and tax strategies. Therefore, the income statement must be adjusted to reflect the true earnings stream of the practice.

Adjustments to the income statement exclude expenses that may be better considered a "perk" to the owner(s) and include expenses that may have been omitted. Examples of common adjustments to the income statement follow:

<u>Facility Rent Expense</u>
When a veterinary practice and practice real estate are owned by the same individual, the accounting for facility costs is often not at fair market values. The adjusted income statement records a rental cost at a fair market rate.

<u>Owner's Professional Compensation</u>
The income statement of a veterinary practice often does not record compensation for the professional activities of the owner at fair market value. The adjusted income statement includes compensation for the owner's professional activity at a rate commensurate to the owner's skill set and effort expended.

<u>Owner's Management Compensation</u>
The income statement of veterinary practices seldom account for compensation to the owner for managerial responsibilities. Industry norms for management expense range up to 5% of gross revenues and vary with effort expended and the level of practice gross income.

---

[2] J.E. Fishman, "The Problem with Rules of Thumb in the Valuation of Closely held Entities," *Fairshare*, Dec. 1994, p. 12.

[3] A, Scott Davidson, C.A., CBV & Ross Dawson, DVM, MBA, *New Study Shows Rule of Thunb for Practice Valuation is a Myth*, <u>OVMA Focus</u>, Ontario Veterinary Medical Association, March-April 2000.

Vehicle Expense
Most often the majority of the vehicle expense recorded on the practice income statement is considered discretionary. The adjusted income statement records the vehicle expense at a level consistent with the true needs of the practice.

The adjusted operating income measures the return to practice owner(s) after all veterinarians in the practice have been compensated for professional and management responsibilities and other expenses are recorded at fair market value. The adjusted operating income is a measure of true economic return to the owner(s) of practices. The adjusted operating income, expressed in terms of a percent of revenue, ranges across practices from 0% to 25%.

The adjusted operating income is a benchmark that should be monitored closely by practice owners. The adjusted operating income allows a fair comparison of profitability to the owner(s) of veterinary practices. Comparisons may be made from year to year or from practice to practice.

For the purpose of valuation, the adjusted operating income is used as a foundation in forecasting the future earnings stream that an investor is willing to purchase; the greater the adjusted operating income, the greater the practice value.

The value of the future earnings is determined by calculating its present value. Determining the present value of a stream of earnings is the exact opposite of compounding. Compounding attempts to answer the question,

"If I invest a dollar today at x% interest, what will it be worth in y years?"

Determining present value restates the question to be,

"In order to receive a dollar in y years, how much do I need to invest today if I earn x% return on the investment?"

The determination of the present value of the future earnings utilizes the principles of capitalization or discounting, depending on the anticipated stability of future earnings. For those who are mathematically inclined, a brief description of capitalization and discounting methodology follows. However, as a purchaser or vendor, it is not necessary to understand the methodologies. What is important is to understand those factors that will influence the practice value:

1. Magnitude of Future Earnings The greater the future earnings, the more valuable the practice.

2. Risk of Realizing Forecasted Future earnings The lower the risk, the more valuable the practice.

Capitalization is the appropriate methodology when there is a proxy for each and every future year's return (other than the long-term rate of sustainable growth). Capitalization has two underlying prerequisites:

a) Stable Earnings Stable earnings is a necessary assumption as the process prescribes that this earnings amount represents the proxy for each and every future year's return (other than the long-term rate of sustainable growth). If one does not have a single proxy that will work for the next year and each year thereafter, the method is inappropriate.

b) Constant Growth Rate The long-term sustainable growth rate is seen as a blend of the rates of growth over the coming years.

For a mature practice, it is often possible to determine a proxy for each and every future year's return (other than the long-term rate of sustainable growth). The return to be capitalized may be the adjusted operating income as discussed above. However, most appraisers will use the adjusted operating income as a basis to develop an estimate of net cash flow available to the owner(s) and thus capitalize the net cash flow that is determined to be a proxy for each and every future year's net cash flow.

The equation for capitalization is:

value = benefit stream ÷ capitalization rate

or, more specifically,

$$\text{value} = \frac{NCF_0\,(1+g)}{\text{capitalization rate}}$$

NCF_0 = Net cash flow expected in period 0, the period immediately preceding the valuation date

g = The projected growth rate in net cash flow for the next period

Under certain conditions, weighting of several years' earnings is performed. However, it would be inappropriate to weight the earnings without justification because the practice's forecast for earnings and the ultimate determination of value could be unfairly influenced.

While capitalization assumes a single proxy for each and every future year's return, discounting includes a mechanism which accounts for uneven or changing levels of future year's returns. The timing issue is important in practices that are expected to experience fluctuations in income. The most common need for discounting is rapidly growing practices whose income will grow through the initial years until such time that the practice is mature and will achieve an even level of income into future years.

A two-stage model is necessary to determine the value of a rapidly growing practice.

High Growth Stage
Year returns are forecasted and discounted to present value.

Future Even Return Stage
In this phase, it is predicted that earnings will become even into the future and the even earnings are capitalized and the value determined for the even cash flows is discounted back to present value.

Value = (PV Year 1 + PV Year 2 + PV Year3 . . . . .) + {PV of expected even cash flows in perpetuity}

Present vale calculations use a discount or capitalization rate, the size of which is influenced by the risk of realizing the future income stream. It is important to understand those factors that influence the risk for a purchaser.

The fair market value of the tangible assets of a practice (furnishings and equipment) may equate to as little as 20% of the appraised value of a practice. Conversely, the intangible asset (goodwill) may represent as much as 80% of the appraised value. In a worse-case scenario, amounts invested in intangible assets lack even a modicum of investment protection in the form of salvage value.

Future practice profits derived from existing clients of the practice comprise a purchaser's return on the intangible asset. The retention of clients is paramount for the purchaser to experience a fair return for the value paid for the intangible asset.

The retention of clients will vary for different types of buyers. The following scenarios illustrate differing ability to retain clients and thus different levels of risk for the purchaser. Keep in mind, the lower the risk, the greater the practice value.

<u>Associate Buy-In</u>

If an associate currently employed at a practice purchases an interest and the existing partners continue to work in the practice, there is no reason to believe that there will be any loss of clients. This is possibly the lowest risk for an ownership transfer.

If an associate currently employed at a practice purchases an interest and one or more existing partners will cease to work in the practice, one would anticipate minimal client loss.

If an associate currently employed at a practice purchases the entire practice and all the current owner(s) leave the practice, the risk of losing clients is much greater. However, the risk would still be less than that experienced by a third party who has had no relationship with the staff and clients of the practice.

<u>Third Party Purchase</u>

A third party purchaser has no previous relationship with clients and is at significant risk of losing clients. Thus the risk is much greater and the value to a third party is notable less than to an associate who has developed a relationship with some or all of the clients of the practice.

The risk for a third party purchaser is reduced by the retention of associate veterinarians and a competent staff who have a good relationship with clients.

In instances where there is a known buyer, the standard of value used is typically an Investment Standard of Value. In these instances, it is easier to assess the purchaser's risk than it would be for a sale to an unknown third party who has had no association with the practice. Fair Market Standard of Value is used for the valuation for an anticipated sale to an unknown third party. Typically, the discount /capitalization rates used in a Fair Market Standard of Value will be greater than that used in an Investment Standard of Value.

Planning for the sale of a practice is obviously important. Having an associate work in a practice and develop a relationship with staff and clients will afford the seller a better price and create a much safer endeavourer for the purchaser.

There are several other factors that may influence the risk for a purchaser of a veterinary practice.

Retention of Clients

The retention of clients is paramount for the purchaser to experience a fair return for the value paid for the intangible asset. It is desirable for seller(s) to cause a change of ownership unperceived by clients, or perceived as a neutral or a positive event, with an uninterrupted flow of services. Risk of losing clients is reduced by methods appropriate to secure the bonding of the clients to the new 'owner'. Continued involvement of the practice owner over a transition period is the most effective mechanism to allow clients to meet with and gain trust in the new owner. Letters of introduction to the new owner and testimonials by the vendor are also helpful.

The retention of clients is heavily dependent on the quality of and the retention of staff. The loss of staff will certainly decrease client satisfaction and loyalty. High quality staff that are committed to the practice are pivotal to the day-to-day operations after ownership transfer, including the organization of past schedules and routines.

It is imperative that the seller, associates and key personnel are bound by non-compete covenants or equivalent agreements. The loss of a key employee would certainly lead to the loss of clients. The threat that a key employee could become a competitor of the practice can erode most or all of the value of the intangible asset of the practice.

Analysis of the risk of losing clients to competitors should include both the quantity and quality of competing practices. One should assess if the veterinary environment is cooperative or antagonistic. Competition at the level of pricing adds significant risk.

Facility Lease

The current owner of the practice must be able to transfer/assign the current lease to the buyer or the buyer must be able to secure a new lease with favorable terms from the current lessor.
The terms of the lease must be analyzed for length of the lease, options to continue the lease, and the presence or absence of services/use restrictions.

An unfavourable lease, particularly the lack of security to maintain the facility for several years, can eliminate or erode the value of the tangible asset.

Revenue

The absence of historical growth in revenue represents risk for a purchaser and an analysis must determine the reason for the lack of growth. The analysis must evaluate the practice's fee schedule and the source of revenue. Low fees may represent an opportunity for a buyer to increase fees or represent risk of losing clients if there is excessive sensitive to higher fees. Revenue from product sales, boarding and grooming makes a practice more vulnerable to non-veterinarian competition. Abnormally high revenue from vaccines makes the practice vulnerable to changing vaccine protocols.

Demographics

Demographic factors can influence the risk for individual practices. Assessment of demographic factors must evaluate changes in population numbers, income levels, single sector or diverse economy, unemployment trends, movement of population in practice neighborhood as well as in community, levels of education attainment, the mix of household types and the presence of a significant transient/nonresident population (e.g. vacation community).

Personal Goodwill
In some practices, the vendor may possess an unusual degree of personal goodwill that is not transferable to a purchaser. Clients can become unusually attached to a charismatic individual. Clients of a single doctor practice are accustomed to seeing only one veterinarian. Unusual levels of personal goodwill also exist where the vendor has unique clinical abilities that a purchaser will not have. The services made possible by these unique abilities will cease to occur when the vendor discontinues practice activity.

All practice are not created equally. It is easy to see that some practices represent a much smaller risk to a purchaser. Practices with comparable historic income can value at significantly different amounts as is appropriate to the risk to the purchaser. It is most important for a vendor to understand these risks and minimize the risks to maximize practice value.

In summary, there are three basic steps in the process of valuing a veterinary practice.

Step 1. Forecast the future economic stream,

Step 2. Assess the risk for a prospective purchaser to establish the proper capitalization/discount rates,

Step 3. Calculate the present value of the forecasted economic stream.

Comprehension of these three basic steps will allow a potential vendor to enhance the practice value and allow a potential purchaser to assess the purchase opportunity.