

New Study Shows Rule of Thumb for Practice Valuation is a Myth

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Many practice owners are counting heavily on the sale of their practice to finance their retirement. But how much is the practice really worth? A new survey conducted by the OVMA reveals that an often-heard rule of thumb for the valuation of veterinary practices – that value is equal to one times revenue – does not apply.

The OVMA recently conducted a survey of veterinary practice purchase and sale transactions. The survey, which was mailed to Ontario practitioners in late 1999, requested information pertaining to any practice purchase or sale from 1994 to 1999.

Responses were received for 44 separate transactions, setting out:

1. the year of transaction;
2. the purchase/sale price, in dollars;
3. the type of practice;
4. the location of the practice;
5. whether or not the transaction included a sale of real estate as well as the sale of the practice;
6. the annual gross revenues of the practice, in dollars; and
7. whether or not the subject practice had been independently valued prior to sale and if so, at what dollar amount.

The results were received and tabulated by the OVMA. To maintain confidentiality for all respondents, only data based on more than five observations are reported.

Summary of Key Observations

On Rules of Thumb

- Actual transaction prices suggest that practice value is not equal to one times practice gross revenue.
- The ratio of practice value to gross practice revenues is, in fact, generally much less than one-to-one. Hence this often-quoted rule of thumb needs to be re-examined and applied only with the greatest of caution, if at all.
- The ratio of practice value to gross practice revenues can vary quite dramatically, which means that practice profitability is a more important driver of value than revenues alone.
- Analysis of the underlying terms of these transactions might well highlight an even further reduction in the ratio.

On Maximizing Practice Value

- Real estate and the practice of veterinary medicine are two different businesses. While this may sound obvious, the survey highlights the need to separate the two and have a value maximization plan for both.
- Maximizing revenues does not necessarily also maximize practice value. Finding ways to increase the bottom line is at least as important as increasing the top line, if not more important.

Why the Survey Matters

The survey tells us how the prices paid in actual practice sales relate to the gross revenues of the practices being sold. This is important because comparable transactions are excellent indicators of value. However, the survey data also tells us that, even for practices with

the same gross revenue, transaction prices can vary dramatically - there is no one rule of thumb that fits all situations.

Comparability

Veterinary practices are generally comparable. While each has its own unique characteristics, their business models (how revenues are earned, ancillary business opportunities, the nature of the client bases, staff qualifications etc.) are similar enough from practice to practice that they can be considered comparable across practice types (small, large, mixed, etc.). This means that prices paid for practices that have been sold in the recent past are important yardsticks that should be considered in assessing notional¹ value or pricing a practice for purchase or sale. The data derived from the OVMA's survey is, therefore, very relevant.

Can Value be Assessed by a Rule of Thumb?

Do the results of the survey re-write the rule of thumb at a lower ratio than one-to-one? The answer is no. In fact, the survey highlights exactly what business valuers have always said about rules of thumb. While they are formulae that have come to be accepted as a measure of value in situations where value is thought to be a function of some other measurable characteristic, rules of thumb should only be used to test the validity of findings reached by other methods (usually earnings-based) and consideration must be given to the unique characteristics of the entity being valued.

In the case of rules of thumb that express value as a multiple of revenue, those rules are really just short-cuts. Value is really a function of future profitability, of which past results are often the best indicator. While reported profitability can vary dramatically depending on how it is measured,² if one could assume that all practices should yield a similar percentage profit per dollar of revenue, then the values of all practices could be calculated based on their gross revenues, and a rule of thumb could take shape. However, when actual prices vary widely at the same revenue levels (as seen in the survey results), there must be other factors involved. Profitability levels may be quite different in otherwise similar practices, and it is profitability that is the more important determinant of value.

- 1 Notional value refers to a value determined theoretically by a valuator (as opposed to the price in an actual transaction).
- 2 For example, is reported profit net of the practice owner's draw or not? Is that draw really an extraction of profits or does it represent market compensation for services rendered? Are there discretionary expenses recorded? Is there a deduction for interest expense that is only a function of the capital structure and not the underlying strength of the practice? Have income taxes been considered?

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Reportable Results

Survey responses were sufficient to allow categorization and reporting of respondent transaction information in the following categories:

- small animal practices with and without real estate included in the sale;
- mixed animal practices (small/large/exotic) with real estate included in the sale; and
- small animal practices with real estate not included, broken out into sales to an external purchaser (i.e. new to the practice) and sales to an internal purchaser (either an existing partner or an associate employed in the practice).

Key results are summarized in the tables and discussed below.

SMALL ANIMAL PRACTICES

Table 1 shows the ratio of the price paid for the practice (including the real estate) to the gross revenues of the practice. To eliminate the influence of extreme values at either end of the scale, the median value is presented rather than the average. "Percentile - 25" and "Percentile - 75" for all tables indicate the values at which 25% and 75% of the survey results, respectively, are lower. Also shown is the ratio of the notional value of the practice as determined through a practice valuation prior to the transaction to the actual price paid for the practice.

Table 1
Small Animal Practices
Purchase/Sale Transactions Including Real Estate

	Ratio of Price Paid to Practice Gross Revenues	Notional Valuation as % of Price Paid
Median	1.16 : 1	116%
Percentile - 25	0.96 : 1	100%
Percentile - 75	1.44 : 1	200%

Source: Reported information from 10 transactions

Observe from Table 1 that the ratio of price to gross revenues with real estate included is 0.96 at the 25th percentile and 1.16 at the median. It rises to 1.44 at the 75th percentile. While these results are not too far off the alleged 1:1 rule of thumb, these transactions **included** real estate. Real estate values can dramatically skew results, and therefore should not be combined with practice values in any meaningful analysis. Consider, for example, two practices identical in all respects except that one is in downtown Toronto and the other is in rural Ontario. Obviously the Toronto practice will have a higher value because the value of its real estate will be higher.

We can also see that the value determined through an independent practice valuation was equal to the actual sale price at the 25th percentile and was 116% of the sale price at the median. It rises to 200% of the sale price at the 75th percentile. This tends to suggest that independent valuations tend to be high, as much as double the actual sale price at the upper end of the scale. These valuations might have been

based on rules of thumb for the practices that were too high, or real estate appraisal estimates that were too high, or both.

The data in Table 2 is the most meaningful information derived from the survey. It presents the same information included in Table 1, except this data is for small animal practice sales in which real estate was not part of the transaction. My concerns about real estate skewing the data in Table 1 are alleviated in Table 2. Furthermore, not surprisingly, the data in Table 2 is based on a larger number of transactions.

Table 2
Small Animal Practices
Purchase/Sale Transactions Excluding Real Estate

	Ratio of Price Paid to Practice Gross Revenues	Notional Valuation as % of Price Paid
Median	0.61 : 1	100%
Percentile - 25	0.42 : 1	100%
Percentile - 75	0.87 : 1	107%

Source: Reported information from 23 transactions

From Table 2, we can see that the ratios of price paid to practice gross revenues are much below 1:1. The median is only 0.61:1. Is this the new rule of thumb? Not necessarily. The range indicated by the 25th and 75th percentiles, though also well below 1:1, is quite wide. In fact, the ratio of 0.87 at the 75th percentile is more than double the ratio of 0.42 at the 25th percentile; and each is about one third off the median.

This suggests that even using 0.61 as a rule of thumb presents some significant risk of both under-valuing and over-valuing a small animal practice (without real estate). As discussed below, if we really knew the terms of these transactions, that ratio could fall even further.

In any event, it is clear that prudent purchasers are considering more than just revenue levels in making pricing decisions. They must be looking further down the income statement to the "bottom line" to assess what they will pay. Actual historical profitability, not just what profits should be capable of being generated from a particular revenue level, must be a value driver.

This suggests that, while practices are comparable, they are only comparable to a limited extent. Given widely varying cost structures, some practices are and will remain more profitable than others of the same size in any geographic area. Hence value is really a function of earnings, not revenues.

We can also see that the independent valuations are very close to the actual price paid. What does this suggest? I would like to think that as valuers, we did a good job assessing value. However, is it possible that the transactions are being reported more so by the purchasers (who are still in practice and may have been more inclined to complete the survey) than by the vendors? Assuming that the purchasers drove the transaction prices (because as people tend to suggest these days, there are more sellers than financially-able buyers), and it is their valuations that are being referred to, then we're not seeing what valuations were put on these practices by advisors to the vendors. I suspect that they could be much higher and, with hindsight, turned out to be above what the market would bear.

MIXED PRACTICES

Table 3 contains data for mixed practice sales, including real estate. There was insufficient data on mixed practice sales without real estate to do any meaningful analysis on those sales. This may not be surprising, as most large animal practices are in rural areas, and I expect there would be a greater propensity to buy/sell the related real estate with the practice. While the inclusion of the real estate presents the same difficulty as it did in Table 1, at least one observation can still be made from Table 3 (although the data is based on only six reported transactions).

The main difference between small and mixed practices is that the ratio of price to gross revenue is lower for mixed practice sales. On its face, this seems to suggest that there is less commercial goodwill in large animal practices than in small animal practices. Perhaps in large animal practices the goodwill is more personal to the particular veterinarian, and hence less transferable to a purchaser. Alternatively, it may be that, aside from having fewer tangible assets, the large animal practices that were sold were less profitable than the small animal practices to which they are being compared.

Table 3
Mixed Animal Practices
Purchase/Sale Transactions Including Real Estate

	Ratio of Price Paid to Practice Gross Revenues	Notional Valuation as % of Price Paid
Median	0.39 : 1	208%
Percentile – 25	0.25 : 1	112%
Percentile – 75	0.79 : 1	336%

Source: Reported information from 6 transactions

INTERNAL VERSUS EXTERNAL BUYER

Table 4 shows that for the 21 small animal practice sales for which real estate was not part of the transaction (refer to Table 2) and for which we know whether the buyer was internal or external, the median price to gross revenue ratio was not materially different whether the buyer was an associate within the clinic or an external buyer.

Table 4
Small Animal Practices
Purchase/Sale Transactions Excluding Real Estate
By Internal and External Purchasers

	Ratio of Price Paid to Practice Gross Revenues (Median Values Only)
Internal Purchaser	0.61 : 1
External Purchaser	0.59 : 1
Total	0.61 : 1

Source: Reported information from 21 transactions; 11 with an internal purchaser and 10 with an external purchaser.

SOME FINAL THOUGHTS

How Important is Profitability?

The limitations of rules of thumb are confirmed by the wide range of price to gross revenue ratios seen in the survey data (Table 2). The reason for the variance is the range of profitability of the underlying practices. A current owner would be best advised to focus on enhancing profitability rather than growing revenue at the expense of the bottom line.

Does Size of the Practice Matter?

The survey data does not allow us to distinguish between large and small practices. It is possible that size does matter to value, not just in absolute terms, but proportionately. For example, might a larger practice be worth proportionately more than a smaller practice? Might the opposite be true? There are arguments both ways. A larger practice may be more stable and therefore have better “quality” earnings, however a larger practice may also be more difficult to sell because the market of financially-able purchasers may be smaller. I suspect that size doesn’t matter as much as people think. Value is a function of profitability and, within certain ranges, purchasers will require the same rate of return irrespective of the absolute dollar level of profits.

Real Estate

The survey shows that when real estate is mixed into the practice value equation, the true value of the practice is unclear. In my view, real estate of relatively significant value should be considered separately and apart from any practice. That’s not to say that it shouldn’t form part of any transaction. Rather, it should be assessed based on its own merits and value parameters. Real estate can also offer some attractive tax planning opportunities that should be considered with a tax advisor.

What Might the Underlying Transaction Terms Tell Us About Value?

Finally, how different would the survey results look if we knew the details of the underlying terms of each transaction? Consider that a dollar paid by a purchaser on closing is worth more than one paid at some time in the future. I suspect that the transaction prices reported by the survey respondents were “face” amounts of consideration paid that might vary at present value if one were to account for such factors as the timing of payment, interest charged on vendor take-backs, earn-out provisions and off-market lease terms for related real estate. If the risk and timing-adjusted purchase prices were adjusted downward, then the price-to-gross ratios derived above would also similarly decline. While knowing all of these details and making the necessary adjustments would make for a more complete picture, the survey data that has been gathered and reported in this article is very instructive about veterinary practice value.

In closing, I’d like to congratulate the OVMA on conducting this survey. As an advisor and business valuator, I can tell you that no matter what the industry context, there is no substitute for data derived from live transactions. While no transaction is ever perfectly comparable, I believe that the data gathered by the OVMA will be very helpful to both purchasers and vendors, and others with an interest in determining notional practice value for any number of purposes.

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