Where’s the Value? Basics of Practice Valuation©
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Practice valuations are a tool by which veterinary practice appraisers take historical financial data about the business and convert it into an image by which others can look at the practice and arrive at a value. Because most of the value in a veterinary practice is in its “goodwill”, an intangible asset, such valuations are difficult to perform and require the expertise of an appraiser with experience in evaluating veterinary businesses.

Valuations of veterinary practices are performed for many reasons, including, practice sale, practice merger, adding an owner to the practice, estate planning and marriage dissolution. When done as part of a planned exit strategy, valuations 1) promote an understanding of how value is created and maintained; 2) help position the practice for eventual sale; 3) encourage owners to plan ahead so they can maximize value; 4) justify the purchase price to prospective buyers; 5) force owners to think about the business and legal issues involved in practice sales, and 6) force owners to closely examine the two main factors in determination of practice value: net cash flow and the risks associated with the practice’s ability to continue to generate cash flow in the future.

One of the most useful reasons to perform a practice valuation, however, is to get a physical examination of your practice. While, valuations are not frequently used as a management tool, when performed for that purpose, they can have a very significant impact on the profitability of the business. Using valuations as a management tool, 1) forces owners to look at aspects of the practice they might not have otherwise considered important; 2) encourages the use of management techniques that maximize profitability; 3) allows owners to focus on the hospital’s strengths and weaknesses; 4) provides a complete critique on the efficacy of hospital policies, and 5) encourages proper financial analysis and record keeping.

In a nutshell, the valuation process consists of gathering and analyzing objective data, adjusting the data figures as necessary, incorporating the data into one of several formulas, and arriving at a number that reflects the value of the business. A practice appraiser will perform a subjective and objective assessment of the foregoing information. Subjective factors that enhance practice value include 1) a competent and stable work force; 2) practice identity associated with high standard of care and practice ethics; 3) focus on customer service; 4) equipment and facility that is current and in good condition, and 5) clientele committed to pet care. The objective component consists of an analysis of practice statistics and financials and inputting the data in one or more valuation methodologies.
Only recently have practice owners begun using practice appraisers to look at practice value. In the past, the main method of arriving at practice value was through the use of “rules of thumb”. Rules of thumb are crude or unscientific methods of determining value that are based on tradition, word of mouth, sales persons, veterinary publications and other non-expert information sources. Examples of such rules include setting the value at “one year’s gross” or “a percentage of last three year’s gross”. There are many problems associated with using such cursory methods as these rules 1) assume all practices are homogeneous; 2) ignore true economic earnings; 3) ignore the terms of sale, and 4) ignore the details that distinguish one practice from another. Since practice value often falls between 65% - 125% of gross revenues, these rules of thumb should be avoided as they can result in sellers getting too little for their practices or buyers paying too much.

One of the first questions to address in valuing a business is determining what contributes to the value of the business. Veterinary businesses are comprised of tangible and intangible assets. Because veterinary practices are service-oriented businesses, the value of their intangible asset far exceeds the value of their tangible assets. Tangible assets are all the items that you can touch and easily transferable. For example, equipment, furnishings, inventory and supplies, medical records, cash, accounts receivable and real estate. The intangible assets are items that you cannot touch and are only valuable if their benefits can be transferred to a buyer. These include, the personal goodwill of the selling veterinarian(s), the good will of the business and non-compete covenants.

Goodwill is the intangible value that results from a practice’s good name, reputation, customer loyalty, employee satisfaction, hospital location, competitive advantage and type of services offered. The goodwill of a practice is directly related to its earning power. A practice that has a lot of goodwill that can be easily transferred to a third party is far more valuable than a practice that has goodwill that cannot be transferred. And this is true, even though these two practices may have the same annual gross revenue figures.

Determining a value for goodwill, involves three steps: 1) normalization; 2) capitalization and 3) feasibility testing. Normalization is the process whereby the appraiser carefully reviews the financial statements and adjusts them to reflect the norms of the industry. This will invariably impact the net earnings number that is derived from taking the practice’s gross revenue less its operating expenses. For example, appraisers often normalize rent for the property. A specific practice’s balance sheet may show no rental expense for the real estate because the owner does not pay himself rent as he also owns the real estate. This expense will need to be adjusted upward on the balance sheet to reflect fair market rent, thus, reflecting what a buyer would need to pay a landlord for the space of the hospital. This invariably will reduce the practice’s earning power, which will reduce its purchase price.

Capitalization is the process of determining the capitalization rate by which to multiply the normalized net earnings and is necessary to convert these earnings to a fair market value. Capitalization rates for veterinary practices usually range between 3 and 5 and represent the risk associated with the buyer’s likelihood of generating the same income stream in the future. Practices that have an uncertain future and greater risk will have a lower capitalization rate than practices that have consistently been profitable and continued to grow since their inception.

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Factors which affect the capitalization rate include, 1) expected future earnings; 2) years in existence; 3) surrounding competition; 4) recent growth in the area; 5) location and parking; 6) workforce in place; 7) work habits of practitioner; 8) fee schedule; 9) non-compete covenants with associates; 10) compliance with laws; 11) average client transaction; 12) demographics; 13) core competencies, and 14) quality of equipment.

Once the financial statements have been adjusted and a capitalization rate has been determined, the value of the practice’s goodwill can be determined. A simplified version of the formula most frequently used by appraisers follows (Capitalization of Excess Earnings Method):

\[ \text{Normalized} \times \frac{\text{Cap}}{\text{Rate}} = \text{Practice Goodwill} \]

This goodwill number then gets added to the total value of the tangible assets to arrive at a total practice value.

After calculating the total practice value, some appraisers will perform the third step and perform a feasibility analysis. Feasibility analysis is important because it helps confirm that the number obtained for the goodwill is realistic. For example, if the number is so low that it does not represent a fair return on investment for the seller or so high that the cash flow is not sufficient to service the debt on the buyer’s loan to purchase the practice, then it’s time for the appraiser to go back to the drawing board. It looks at the funds that are likely to be available to the buyer after accounting for the costs associated with operating the practice, paying the necessary taxes and satisfying your debt requirements. If, after all these expenses, there is not enough money left over for the buyer to lead a reasonable lifestyle, raise a family and buy a home, it would be an unwise and risky business decision to purchase the practice.

CONCLUSION AND THANKS

To increase practice profitability and sales price, sellers should give serious consideration to having their practices appraised by a qualified, experienced and trained veterinary practice appraiser at least five years before the anticipated sale date. It may take several years to implement the appraiser’s recommendations and increase the bottom line. An increase in the bottom line is directly correlated with an increased purchase price and the fees sellers pay for appraisals is often dwarfed compared to the increase in sales price which results from implementing appraisers’ recommendations.

From the buyer’s perspective, the best way to justify the seller’s offer price is by having a practice appraisal that substantiates that number. Buyers are looking for businesses that generate sufficient cash flow to service their debt and a purchase without an appraisal may mean the practice does NOT have the cash flow to fund the purchase payments. Net cash flow is derived from taking the practice’s documented gross income less normalized operating expenses. Determining what the normalized operating expenses are for specific practices is difficult and should be left to the number cruncher experts in the industry. If cash flow is insufficient to
service the debt, then the buyer will default on the payments and the seller will have to sell his summer home in Seville, Spain to return to the practice.

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