



Valuation Essentials for Veterinarians

Long Term Aspect of Ownership - Practice Value



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Veterinary Valuation Resource Council of VetPartners™

Introduction and Purpose

Most owners operate their practices from day to day without much focus on an important long term aspect of ownership — practice value. We know this because as valuation analysts, we see the results regularly when we prepare practice valuations for owners who are surprised and disappointed that their practice does not appraise at the price they expect. Just as it is vitally important to help practice owners understand the significance of managing their hospitals effectively and profitably, it is equally important to educate practice owners specifically, and the veterinary profession in general, toward a greater understanding and appreciation for how practice valuations are prepared and reported.



The purpose of this valuation primer is to provide an overview of valuation theory and practice to help those who use valuations (owners and prospective owners) be better consumers of valuation services. Buyers and sellers of practices often seek shortcuts or rules of thumb to determine practice value. Convenient though that would be, there is no single method, no standard cap rate, and no single valuation approach that is always appropriate and consistently accurate in every situation.

This publication will emphasize the primary approaches and methods used to determine veterinary practice value and discuss their differences, so that readers can recognize the method used and understand why that approach or method is (or might not be) appropriate for their valuation circumstance. An added focus is to help valuation consumers understand the difference between asset valuations and equity valuations.

Glossary of Terms

Throughout this paper there are several valuation terms used. Words or phrases italicized and underlined "*like this*" can be found in the Glossary at the end of this article, which includes a short definition. Use this appendix to aid you in better understanding the language of valuation.

Q: When should I have a valuation done?

A: Veterinarians understand the use of a valuation for buying and selling a practice, but are unaware that a valuation can also be an important tool in strategic planning. A practice appraisal not only indicates to owners what their practice is worth, but can also highlight areas in need of improvement by comparing a practice's operations and spending habits to industry averages. Improvements in these areas may translate to greater cash flow in the short term and higher value when it comes time to sell.

Valuation Is an Art Form and Not a Science

Valuation of a closely held business with limited marketability, such as a veterinary practice, is more an art than a precise science. A valuation for purchase, sale, merger, partnership, estate planning or divorce may offer greater flexibility in methods than those used in the federal tax area. When valuing any veterinary practice, it is important to seek an overall view and to consider as many of the contributing factors as possible in arriving at an estimated value.

Even with that much flexibility, in reality the seller of a practice is selling what has already occurred, and the buyer is buying a stream of future benefits (income) *discounted* to its value today. A valuation is based on real information, investigation and analysis. Using established procedures will ensure that the value finally determined is based on a rational methodology, accurate information, and sound judgment.

Choosing a Valuation Professional

Veterinarians often ask what to look for in assessing the qualifications of a practice valuator. Currently, a number of professionals in the industry offer business valuation services, and they are not all equal. To determine if a valuator is “qualified”, you should look at both experience and credentials. Also consider if the format of the report you will receive will provide the amount of information you need for your purpose.

The following factors will help you choose a qualified appraiser:

Experience. Inquire about the appraiser’s prior experience in valuing veterinary practices. Does the valuator understand the veterinary practice environment, both for the profession overall and for your practice in particular? How many veterinary valuations have they completed? If valutors do not have prior experience in the veterinary industry, it may be difficult for them to gain enough data from outside the profession to produce an accurate valuation, since there is not a lot of public information available about veterinary practices. The vast majority are privately owned and do not share information with other practices, nor do they have an obligation to submit operating results to outside agencies.

Accreditation and credentials. Several business valuation organizations provide advanced valuation courses of study. Those individuals who successfully complete the required course of classroom study and pass testing requirements receive special designation or credentials.

The most common organizations and their designations are:

The American Institute of Certified Public Accountants (AICPA), which offers the ABV (Accredited in Business Valuation) designation, which appends to the CPA designation.

The American Society of Appraisers (ASA) with the Accredited Member (AM) or Accredited Senior Appraiser (ASA) designations.

The Institute of Business Appraisers (IBA) with the Certified Business Appraiser (CBA) and Accredited with the Institute of Business Appraisers (AIBA) designations.

The National Association of Certified Valuation Analysts (NACVA) which offers the Certified Valuation Analyst (CVA) and the Accredited Valuation Analyst (AVA) designations. CVAs must also be CPAs.

Although accreditation does not guarantee competency, it does demonstrate that the member has obtained additional education in the valuation field and passed a qualifying exam.

Report writing competence. It is difficult for the potential user of valuation services to assess the appraiser’s competency in report writing. However, you could ask to see the Table of Contents from reports previously prepared by your potential appraisers to determine if there is sufficient detail in the report to make it useful for the reader.



Basic Steps in the Valuation Process

At any point in time, a practice has a number of different values, each of which is correct, depending on the purpose of the valuation. For example, if you are selling the entire practice, your buyer can make changes in the fee schedule, staffing levels, equipment in use, etc. after becoming the owner. By purchasing the entire practice, this buyer has total control over future operations. Buyers of entire practices generally buy assets, i.e., they purchase your inventory, equipment, receivables, and goodwill but they don't generally agree to pay off your debts. Contrast that with an associate who is purchasing 20% of the practice. An associate has limited ability to make changes in operations, including owners' compensation, facility rent, staffing, fees, etc. In addition, associates generally purchase a piece of the equity, i.e., a piece of the existing legal entity, which means they are buying an undivided interest in the assets and assuming an undivided portion of the practice's debt.

Because the value depends on the purpose of the appraisal, every valuation process should start with a discussion about how the valuation will be used. Here are the steps the appraiser will take:

- (1)** Establish the purpose of the valuation and the valuation date (effective date): Discuss the reasons for requesting the valuation and what the client hopes to get from the process.
- (2)** Gather information: Typically, the bulk of this information comes from tax returns, financial statements and practice management software reports.
- (3)** Evaluate the data and identify necessary adjustments to the financial statements.
- (4)** Develop an opinion of practice value, using established valuation approaches and methods, and
- (5)** Report the results of the process in an appropriate and understandable way.

Because of the number of variables that must be taken into consideration, the scope of the valuation can be enormous, and every practice is a case study of its own. It is the task of the practice valuator to take into consideration all of the relevant historical, financial and practice management data, as well as future prospects, and process them by applying his or her knowledge and experience to produce an opinion of value.

Single Value versus a Range of Values

Some valuers prefer to use a single valuation method and/or arrive at a single number, while others feel strongly that there is no single valuation method or number that is totally accurate and will look at and report on various methods. Both a single value and a range can be appropriate, depending on the purpose of the valuation.

Types of Valuation Engagements and Reports

Although standards vary slightly among the certification organizations listed above, there are different types of engagements which require different levels of analysis and result in different reports.

Calculation of Value

In a Calculation of Value Report, the valuation analyst and the owner agree in advance to develop the practice value based on a single valuation method and an agreed upon set of assumptions. The value developed is called a "calculated value" as it is "calculated" based on the agreed method. Other methods and assumptions are not considered. Because it represents a limited approach, the Calculation of Value Report typically costs less and can be appropriate for strategic planning purposes. However, since most practice owners and buyers have little or no

experience in choosing a valuation method and don't know what assumptions are reasonable, they need to understand what the valuation analyst is recommending and why. They should also understand that there may be other methods and other assumptions which could be used and which could produce a different value. In other words, do not accept a Calculation of Value report that does not set forth the rationale behind the method used and the assumptions agreed on in advance so that you can evaluate their reasonableness.

Conclusion of Value

For this type of engagement, the valuation analyst considers and develops a variety of approaches to determine the value for the practice. There is no agreement at the outset to limit the method or assumptions. Using his/her professional judgment, the analyst reaches a conclusion of value by selecting the most appropriate result for your practice out of a variety of approaches. The process to develop a Conclusion of Value Report is more comprehensive than for a calculation of value and is required for Gift and Estate Tax filings. Furthermore, this type of report is generally the most appropriate for matters involving litigation.

Finally, because the engagement is more comprehensive, the resulting report will have a more complete discussion of the practice's history, the analysis done, and the reasons why a particular method or methods were chosen.

Q: Why can't you just give me an estimate of what my practice is worth?

A: Because we would be doing you a disservice. There is no quick and easy way to look at a practice and know what it is worth. Your financial statements are designed to minimize your income tax liabilities, not to calculate true profits. Without digging into the numbers, there is no way to determine its real value. Rules of thumb and popular formulas don't work, and if you rely on them, you will either overestimate the value (to the buyer's detriment) or undervalue the practice (which harms the seller). Even if the purpose is strategic planning, not a change of ownership, you should be making decisions on the basis of accurate information, not just an estimate.

Other Report Formats

It is also possible to issue an oral report in some situations, though there must be a statement made that an opinion in a formal report might be different and that the difference might be material. Because of the likelihood of misunderstanding in oral reports, most valuation analysts provide written reports. Some valuers issue a Letter Form Written Appraisal, although the same cautionary statement must be included. These reports do not provide the reader with underlying data, however, and focus only on the resulting specific value, range of values, or preliminary estimate. Finally, expert testimony related to litigation can result in different report formats, depending on the jurisdiction involved.

Q: What should I expect to pay for a complete valuation report?

A: It varies, based on the purpose of the valuation and the type of report to be produced at the conclusion of the valuation. Expect to pay somewhere between \$6,000 and \$12,000 for most valuations performed by qualified valuation analysts.

Valuation Date

The value of any business changes over time. Therefore, you and the valuator must select the effective date of the valuation, which is especially important in litigation cases. Generally, this is a date that has already passed. For veterinary practices, it is frequently the last day of the prior taxable year, because better data is generally available at the year end than at any point during the year.

Premise of Value

Before determining the appropriate valuation method, the valuation analyst must determine the appropriate *premise of value*. The premise of value describes the assumed market conditions under which a buyer and seller will meet

and transact. These conditions can be broken down further into the following subsets: Net Book Value, Going Concern Value, Liquidation Value, and Replacement Value. The valuation analyst selects the appropriate premise

of value based on the purpose and objective of the appraisal and the most likely form of the ultimate sale of the practice. Going concern value is the most common premise in veterinary practice valuations.

Standards of Value

As stated previously, there is not a single value for any business, even at a single point in time. Therefore, the purpose of the valuation dictates the appropriate Standard of Value. The choice will be different depending on whether the valuation is being conducted for an acquisition, litigation, buy-in/buy-out or outright sale. Common standards of value encountered in veterinary valuation include: Fair Market Value and Investment Value. Fair market value assumes a pool of hypothetical buyers, while investment value assumes a specific buyer who may have special strategic objectives. Therefore, the standard of value for an associate buy in, for example, is generally investment value, since the buyer is usually purchasing a non-controlling interest with an eye toward buying the controlling interest when the owner exits the practice in the future. Fair Value is less common for veterinary practice valuations and is generally limited to shareholder disputes.

Valuation Approaches and Methods Used to Determine Practice Value

There are three general approaches to determining value – the Market Approach, the Asset Approach and the Income Approach. Each has several methods which the valuation analyst can employ to establish practice value. For each assignment, the appraiser must determine which of the approaches and methods are the most appropriate. The choice is based on the judgment of the valuation analyst (or agreed to by the parties for a calculation of value engagement) and is determined by the characteristics of the business to be valued, the purpose and use of the valuation, the pattern of historical performance and earnings of the company, the company's competitive market position, experience and quality of management, the availability of reliable information necessary for the various valuation methods, the marketability of the ownership interest to be valued, and other relevant factors.

A brief description of the approaches follows:

The Market Approach

The Market Approach determines the value of a business by comparing it to similar businesses that have been sold in the open market. The comparable businesses must be substantially similar but not necessarily identical to the business being valued. The challenge, of course, is finding data about veterinary practices that are substantially similar and have sold recently. Since most practices are privately owned, data about their sales is not generally public knowledge. Consequently, the Market Approach is seldom used in valuing veterinary practices.

The Asset Approach

The Asset Approach derives the value of a practice based on the current value of each asset it owns. With the exception of valuing liquidating practices, this approach is seldom used to establish veterinary practice value for one very important reason: its methods are unable to develop a value for the intangible, or goodwill, asset. This is a major shortcoming because goodwill is by far the most valuable asset of healthy practices.

The Income Approach

The Income Approach is the most common means of appraising a professional service business like a veterinary practice. The methods used view the practice as an investment: the income the practice is forecasted to produce is the return the practice owner receives for making the investment. Logically, the greater the return, the more valuable the practice. The Income Approach provides a way to value intangible assets in veterinary practices. Since these intangibles customarily make up between 60-85% of the value of a veterinary practice, these expected earnings are critical figures in determining practice value. If goodwill is not taken into consideration, the practice will have little value beyond that associated with the hard assets like equipment and inventory.

To use the Income Approach, the valuation analyst must make astute decisions concerning:

- The appropriate capitalization rate or discount rate (discussed below)
- The real economic earnings or cash flow for the practice
- The expected growth in the practice's economic earnings or cash flow

If the valuation analyst incorrectly estimates any of these, it could result in a significantly under- or overvalued practice.



The Income Approach considers the “true” or adjusted earnings, which could be based on profits or net cash flow as well as the perceived risk of those earnings continuing in the future. Because profits and net cash flow are not the same, the valuator should be clear and consistent about which earnings stream is being used. The valuation analyst determines adjusted earnings by evaluating the past financial statements and tax returns – usually 3-5 full years. The adjusted earnings reflect adjustments for income sources or costs that may affect the value of the practice and are likely to be different in the future.

There are typically two income methods plus a hybrid method (Excess Earnings, containing elements of both the Income and Asset Approaches) which are used in veterinary practice valuations. These methods are listed below:

Capitalization of Earnings/Cash Flow Method—This method is also referred to as the Single Period Capitalization Method. The methodology estimates future benefits which are then capitalized using an appropriate capitalization rate. This method assumes all of the assets, both tangible and intangible, are indistinguishable parts of the business and does not attempt to separate their values. Therefore, the critical component to the value of the business is its ability to generate future earnings/cash flow. It also assumes that the future benefit streams will be fairly even and predictable.

Discounted Earnings/Cash Flow Method—This method is based on estimates of revenue and expenses in the future and must also take into account changes in staffing or equipment that will be needed as the practice grows. It is based on the principle that the total value of a business is the present value of its projected future earnings, plus the terminal value, since businesses do not last forever. A present value for the projected earnings and the terminal value are determined by using an appropriate discount rate rather than a capitalization rate. Although these rates are similar, they are not interchangeable.

Excess Earnings Method—This method was designed to quantify the value of the intangible assets of closely held businesses in those circumstances where goodwill, an asset notoriously hard to quantify, is considered to be a major component of the business value.

The concept underlying the Excess Earnings Method is that, logically, part of the practice's earnings is the direct result of the investment in

Q: How does a valuator determine the value of medical/surgical, computer and office equipment?

A: It's hard to get accurate values for these items. Using original cost doesn't work, because in many cases several years have elapsed since the equipment was purchased. Neither is it accurate to use “depreciated” value as shown on the financial statements, because often the current value of the equipment is greater than the amount reported on the balance sheet. Additionally, it is not accurate to use the cost to replace it with new equipment, because most, if not all, of the equipment is used. The most accurate approach is to have a qualified personal property appraiser estimate the value, though that increases the cost of the valuation.

tangible assets, like equipment or inventory. So if the total earnings (profits) are reduced by a fair return on the tangible assets, the remaining earnings can be construed to be a result of (or a return on) the intangible assets, like goodwill. By applying a capitalization rate, these “excess earnings” can be converted to a value for the intangible assets. That value is then added to the value of the tangible assets to determine the total value of the business.

A major shortcoming of the Excess Earnings Method is that it is heavily dependent on the accurate determination of the value of the tangible assets. This requires valuing such items as the inventory, equipment, drugs and medical supplies on hand. These tangibles are difficult to evaluate without performing a thorough personal property appraisal, and even then, none of the typically used methods of tangible asset appraisal is consistently applicable to the veterinary industry. Inaccurate values for these tangible assets can lead to significant misstatement of practice value.

A second shortcoming is that it is difficult to determine what the fair return on tangible assets should be. In other words, what level of financial reward do you expect to receive as the result of buying a piece of equipment or a stockpile of inventory?

Discount Rates and Capitalization Rates

Once the valuation analyst has arrived at the expected earnings (benefit stream) as described above, the next step is to apply a capitalization or discount rate in order to estimate the practice value. Collectively, capitalization and discount rates are called the cost of capital, and they represent the expected return that an investor or buyer would demand in order to take on the risk associated with owning a specific practice. Higher risk demands a higher rate of return; otherwise, the buyer will look for alternate investments. There is no standard capitalization or discount rate for veterinary practices, since that would imply that all practices are equally risky. Common sense suggests otherwise.

The most common way to determine the discount rate is to use the Build Up Method, which takes into consideration the current return on 20-year treasury investments (“the risk-free rate”), the amount by which investors expect the return on equity investments to exceed the risk-free rate, the expected industry risk, the risk of the size of the business and the Specific Company Risk.

The Specific Company Risk premium (or discount) is the factor that distinguishes your practice from other practices in the industry. Factors which influence this risk include:

- **Trends in profitability**
- **Trends in gross revenue**
- **Ability to effectively transfer goodwill**
- **Location**
- **Quality of staff**
- **Demand for services**
- **Facility**
- **Demographics**
- **Practice stability**
- **Influence of locally competing veterinary practices**
- **Lease terms**
- **Effective management systems**
- **Desirability and marketability**

The sum of all the risk factors becomes the discount rate appropriate to use when applying the Discounted Earnings Method. If the expected growth rate is subtracted from that percentage, the result is the capitalization rate for that practice.



Personal (Professional) Goodwill versus Practice (Enterprise) Goodwill

One of the specific company risk factors listed above is the ability to effectively transfer goodwill. How difficult that transfer is depends on whether the goodwill belongs to the individual owner, to the practice, or some combination of those. In a one-doctor practice where the owner knows all the clients and treats all the patients, the reputation of the practice is highly related to the doctor. Therefore, if you were to buy that practice, it would be critical that the owner introduce you to the clients, speak highly of your qualities as a veterinarian and as a manager, and work to convince the clients that they will continue to be in good hands. This is an example of personal goodwill.

Contrast that to a multi-owner and multi-doctor practice where clients are routinely scheduled to see various doctors based on available slots on the appointment calendar. Those clients understand that doctors and staff all practice quality medicine and are all representatives of the practice itself. If one doctor or owner leaves, the odds are good that clients will continue to patronize the practice. This is an example of practice goodwill, which is generally considered to be easier to transfer to a new owner and less risky for a prospective owner to purchase.

Special considerations in valuing equine, referral, food animal, or emergency clinic practices

People outside the profession tend to view all types of veterinary practices as being the same, even though those of us within the profession know there are significant differences. Since the majority of practices are small animal general practices, some appraisers may try to value all practices using the same assumptions and methodologies. Of course, that doesn't result in a meaningful valuation for all practices.

Part of the analysis the valuation analyst must do is determine what makes each practice unique, including the niche in which it operates. You have a right to expect the valuator to understand your kind of practice and to make the appropriate adjustments and assumptions. For example, compensation dollars and methods for doctors vary depending on the kind of practice. Expectations for the dollar amounts of annual production by doctor depend on the type of services offered. Also, rent as a percent of gross practice revenue will vary, depending on the practice type. These variations in rent are smaller for emergency and specialty practices than for equine practices, which may or may not have a fixed location. Finally, food animal practices have different kinds of clients with different economic objectives, so that tracking the number of transactions or average transaction charge is not easy and likely not meaningful.

Therefore, be sure the valuator you choose is familiar with your kind of practice, and review carefully the assumptions and adjustments included in the report.

Q: How long does it take to prepare a full valuation report?

A: The timeframe typically ranges between 4 and 10 weeks, once the valuation analyst receives all the necessary information.

Where your valuation might fall in the range depends on how complete and accurate the information is when it's submitted and the timeliness of responses to queries for clarification.

Glossary

Asset (Asset-Based) Approach – A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets.

Assets – Economic resources owned by business or company. Simplistically stated, assets are things of value that can be readily converted into cash (although cash itself is also considered an asset).

Capitalization Rate – Any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.

Discount – To purchase or sell (a bill, note, or other commercial paper) at a reduction equal to the amount of interest that will accumulate before maturity.

Discount Rate – A rate of return used to convert a future monetary sum into present value.

Equity – The owner's interest in property after deduction of all liabilities.

Fair Market Value – The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Fair Value – With respect to a shareholder dispute, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

Going Concern Value – The value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

Goodwill – That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

Income (Income-Based) Approach – A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

Investment Value – The value to a particular investor based on individual investment requirements and expectations.

Intangible Assets – Nonphysical assets such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities, and contracts (as distinguished from physical assets) that grant rights and privileges and have value for the owner.

Liquidation Value – The net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced".

Market (Market-Based) Approach – A general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

Net Book Value – With respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise.

Net Cash Flow – A type of cash flow used by the valuator that is a measure of a company's financial health. Generally equals cash receipts minus cash payments over a given period of time; or equivalently, net profit plus amounts charged off for depreciation, depletion, and amortization. Also called cash flow and may be adjusted or refined appropriate to the specific valuation purpose and method.

Premise of Value – An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; for example, going concern, liquidation.

Present Value – The value, as of a specified date, of future economic benefits and/or proceeds from sale, calculated using an appropriate discount rate.

Profits – A company's total earnings, calculated according to Generally Accepted Accounting Principles (GAAP), and include the explicit costs of doing business, such as depreciation, interest and taxes.

Replacement Value – The value of an asset as determined by the estimated cost of replacing it.

Standard of Value – Identification of the type of value being utilized in a specific engagement; for example, fair market value, fair value, or investment value.

Tangible Assets – Physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, etc.)

Terminal Value – The value as of the end of the discrete projection period in a discounted future earnings model.

Valuation Essentials for Veterinarians



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