



## **Does My Equine Practice Really Have Value?**

I first met Dr. Barry, the owner of an ambulatory practice in Virginia, in 1998 at an AAEP Summer Management Conference when I was speaking on valuation and transition issues for equine practices. Working with Dr. Barry over the course of the next year, I found that he was very receptive to changes in his fee schedule, inventory management, and staff and associate compensation levels. A more difficult discussion for him was understanding why another veterinarian would pay 'good money' to buy his practice when he retires in 2008.

For sellers and buyers of equine practices, there are two main factors that determine whether or not a practice has value to a successor owner:

**Does the practice pay the current owner a return on investment? And...  
Will the return on investment continue under new ownership?**

### **Does the practice pay the current owner a return on investment?**

Return on investment is the compensation you receive for the risk you take in owning a veterinary practice. It's the earnings remaining after all practice operating expenses have been paid including fair market compensation to owners and associates for their veterinary and management services.

In the valuation of a veterinary practice, the owner's return on investment (called expected earnings) is the primary component of goodwill value. As goodwill typically represents 70% to 80% of a practice's total value, expected earnings are critical to anyone buying or selling a practice. Here's how expected earnings and goodwill value are determined.

The calculation starts with taxable income for the prior three years. Then we make adjustments for:

- Income or expenses listed on the tax return that we don't include in the calculation of earnings such as the gain on the sale of equipment and local income taxes.
- Nonrecurring expenses such as repairs due to natural disasters, employee theft, litigation costs.
- Expenses not listed on the tax return that we include in the calculation of profit such as nondeductible entertainment expenses and owners' health insurance premiums.
- Rent expense, if the rent paid isn't the fair market rent.



- Under spending on facility repairs and maintenance, continuing education for all team members, and the true cost of services provided by the owner or the owner's family at little or no cost to the practice.
- Economic depreciation as a cost of maintaining the current level of investment in medical and office technology and equipment.
- Veterinary pay and owner-level, management pay if current compensation does not reflect the fair market value of services provided.

The adjustments for veterinary and management services are two of the most critical. Here, we don't count bodies or even full time equivalents. We look at the total dollar value of medical services provided at the doctor level and determine the fair market cost for providing these services. We want to know what it would cost a new owner to provide the same medical and management services you offer.

Fair market cost is calculated as a percent of doctor generated revenue. In equine practices, the percents used depend on how doctor services are provided. For fieldwork, the common range is 24% to 28% depending on your practice radius, staff assistance with farm calls, and the level of off-the-truck dispensing. For outpatient services provided at the facility, the range is 20% to 25% depending on your technician-to-doctor ratio and the investment in medical technology and facilities. For surgical services, it's 16% to 22% depending on staff support, investment in medical technology and facilities, and the reputation of the senior surgical team.

We base the fair market value of management pay on a percent of total revenue (2 percent to 3 percent), or on the amount available to pay associates and owners for their veterinary and management services and to reinvest in the practice (6% percent to 10%). The total cost, plus payroll taxes, replaces amounts actually paid. Paying on the amount available, a truer measure of the owner's/manager's management skills, does require consistent record keeping and adherence to owner approved budgets.

Once we make these adjustments, we determine the practice's expected earnings for each of the three years considered.

To finalize the calculation of goodwill value, we use a weighted average to arrive at one expected earnings number. For example, we would count your 2004 earnings three times, 2003 earnings twice, and 2002 earnings once and divide by 6 to find the average. This approach bases half of the earnings value on the most recent year's earnings and helps make sure the final practice value reflects the most recent growing or diminishing earnings.



A practice may pay a working owner quite well for his or her services as an employee of the practice. However, if there is nothing left after the bills are paid to pay the owners an investment return, a potential owner weighing different investment opportunities may decide to invest elsewhere rather than pay 'good money' for an investment that has no payback.

Next, we reduce this weighted average expected earnings number by the current annual return on investment on the net working capital and tangible assets. This gives us our final number for excess expected earnings. Next we multiply that number by a capitalization multiple to figure the total goodwill value.

The capitalization multiple reflects the return on investment required to attract an investor considering the risk associated with owning the practice. Several factors weigh into this equation including the practice's expected revenue and profit growth; competitive position; management systems; staffing; revenue from dispensing; ancillary services and products; ability to cover expense and debt payments; extent and condition of facilities and equipment; and the transferability of owner's earnings to the new owner.

Net assets make up the balance of a practice's total fair market value. The net assets include such working capital as cash, accounts receivable, and drugs and supplies. Net assets also include such tangible assets as office supplies, medical and office equipment, and vehicles.

We obtain the values for working capital assets from the practice's balance sheet and the values for the rest of the net assets from estimates, appraisers, or accounting formulas, and then adjust them to reflect fair market value—the price a buyer would pay for each item given its current condition. Then we subtract the balance of all outstanding debts and leases from the fair market value to arrive at net asset value.

In 1998, I valued Dr. Barry's practice. It was generating about \$30,000 in expected earnings, had a goodwill value of \$100,000 and a net asset value of \$70,000 for a total fair market value of \$170,000. In addition to recommending changes to improve practice earnings, Dr. Barry and I worked through the following process starting with questions pertinent to Dr. Barry's future sale:

1. What are the practice's earnings today?
2. What do the earnings need to be to produce your targeted practice value?
3. If your owner earning's aren't on track, what changes are needed to reach your target by the time you're ready to sell?



4. Using a Management Statement™ format (one source: wellmp.com), track owner's earnings by month or by quarter.
5. Are there management decisions that will decrease earnings in the short run (for the benefit of greater long term earnings)? If so, how will this affect the timing of your sale?

#### **Will the return on investment continue under new ownership?**

Dr. Betty was hired as an associate in 2000. Within two years, Dr. Barry could see that she had the skills and interest in ownership. So, as part of the revaluation of the practice in 2002, I discussed the valuation process with her. One of her first questions was, "How can I be sure that the earnings I buy will continue when Dr. Barry leaves the practice?"

Whether or not owner profits continue under new ownership is significantly affected by the seller's ability to transfer client loyalty. When an owner leaves a practice, will clients remain or will they go to another practice seeking better client service, lower fees, or a broader range of medical services? In the calculation of an equine practice's goodwill value, the risk of transferability is key in determining the capitalization multiple.

In an ambulatory practice with limited facilities, the transfer of client loyalty may be the most important factor in evaluating the transferability of owner's earnings. To preserve a strong capitalization multiple, plan the transfer of client loyalty at least two to three years before a sale to give the buyer time to prove himself or herself to the departing owner's clients. Can the transfer span less than two years? Yes, but the capitalization multiple may be reduced. If the departing owner is known for special talents or skills such as reproduction, lameness, etc. the transfer will take longer.

In referral practices, the issue of transferability may reach its highest risk if the production of owners' earnings are tied to the reputation of one specialist. Here, the transferability of client loyalty may require a four to five year plan to preserve a strong capitalization multiple.

As Dr. Barry's practice is primarily ambulatory, we established an exit strategy for securing the transferability of his owner's earnings to Dr. Betty. Adopt as your own or modify as needed to fit your practice:

1. Establish standard operating procedures in medicine and management throughout the practice. A new owner inheriting existing, smooth running systems (employee management, client management, medical management, etc.) will enjoy an easier transition than if the departing owner practiced seat-of-the-pants management. And, their clients will, too!



2. Bring in associates with the potential for ownership or merger partners several years before you plan to sell. This is a wise decision even if it means you become the part-time or seasonal veterinarian for a short period.
3. Prepare future owners. Don't wait until a week before the sale to expose your associate to the sale process. This includes educating about the valuation process, the benefits of ownership, financing options, etc.

This year, I again revalued Dr. Barry's practice. As a result of solid management, the expansion of ambulatory and in-house services, and the addition of another doctor, his owner earnings are up to \$110,000, goodwill is \$470,000 and net asset value is \$110,000 for a total fair market value of \$580,000. With four years before retirement, growing earnings and a transition plan, Dr. Betty and the practice's clients will be well prepared for the change in ownership.

#### Questions and Answers:

The following questions and responses were published in the 2004 Well-Managed Practice Associate Management Guide.

1. **What are the top three benefits of practice ownership?**

- Voice in the direction and growth of the practice; ability to set the standard of care and mold the practice culture.
- 2. Greater earning power and financial return
- 3. Long-term financial security; and investment that not only pays dividends now, but provides value when ready to sell.

**What are the top three disadvantages of practice ownership?**

- 1. Personnel-related issues – hiring and retaining qualified employees; developing a strong, cohesive team; resolving conflicts, etc.
- 2. Financial responsibility and risk; management responsibility
- 3. Time commitment required; balancing medicine, management, and family commitments

**Knowing what you know now, would you choose to own a practice again?**

Yes 98%                      No 2%

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