

Are Practice Values Changing Over Time?

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Practice owners frequently wonder about how much their practice is worth. When contemplating this, owners may consider whether, in the grand scheme of things, practice values have changed over the years?

WHAT INFLUENCES PRACTICE VALUE

The value of a veterinary practice is driven by the return received for owning the business. When calculating value, there are two main variables that need to be assessed:

- Return on owning the practice (ie, profits)
- Risk associated with receiving those profits into the future (often referred to as capitalization rate).

Profit

Profit represents the revenues remaining after paying:

- All operating expenses of the practice
- Fair market rent (even if the practice owner owns the real estate)
- Fair compensation for the owner's work as a veterinarian.

What is left then—the profits—is the owner's return

for owning and operating the business. The greater the profits, the greater the value of the practice.

Capitalization Rate

Capitalization rate is a measure of the risks associated with earnings continuing and growing into the future. These risks include such factors as historic revenue trends and profit growth, demand for services, location, staff quality, competitive issues, demographic issues, and more. For a fair market value appraisal, the appropriate capitalization rate is determined by comparing the practice to other practices that have sold in the same market.

Financial Health

Of the two variables, profitability is the easiest one to influence by actively managing the practice. It is also the most significant indicator for overall practice health because profits provide the long-term foundation for all other elements of a practice's well being.

Unfortunately, though, few practice owners and managers focus on practice profitability—they manage for revenue growth, not profitability. A practice is considered financially healthy if it is 14% to 18% profitable.

Table. Practice Profitability & Capitalization Rates: 1996 to 2010

	Profitability	Cap Rate	P/G	Number
2006–2010	15.2%	21.9%	0.71	228
2001–2005	16.0%	21%	0.76	173
1996–2000	18.6%	20.2%	0.83	82

cap rate = capitalization rate; number = number of practices sold; P/G = price related to gross revenue

Industry data and data collected from colleagues indicate that the average small animal practice is operating with profitability levels 10% to 11% of gross revenue.

CURRENT TRENDS IN PRACTICE VALUE

Now that we've addressed what influences practice value, the questions arise: What are the current trends in practice value? Have there been changes over time in practice profitability, capitalization rates, and/or practice value?

The **Table** presents the means for practice profitability and capitalization rates based on data from SimmonVetStats (simmonsinc.com), which contains data from over 20 years of veterinary buy–sell transactions. The database includes several key variables, such as purchase prices, practice profitability, and capitalization rates.

Recognizing that the Table's numbers are means, the data do show a serious decline in practice profitability over the 15-year period. The average profitability of these sold practices dropped from 18.5% fifteen years ago to only 15.2%. *As profitability decreases, so does practice value.*

The capitalization rates also trended upwards over the same period, from just more than 20% to approaching nearly 22%. *The higher the capitalization rate, the higher the risk.* And when the risk goes up, value goes down.

P/G represents *price to gross ratio*—the practice's sale price relative to its total revenues (gross). The data show that the mean of P/G ratios is decreasing. This ratio is a good indicator that most practices are not worth "one year's gross." If "one year's gross" for practice value were to be true, the P/G ratio would be 1.0.

While some of the decline can be attributed to refinements in valuation methodology and improvements in financial analysis stage (eg, adjusting the income statements) and capitalization rate determinations, overall, the data indicate that practice values have declined over the last 15 years. Nontransactional data collected and information from colleagues confirm the trend.

A PATH FORWARD

The traditional focus for practice health has been on gross revenues. However, focusing on gross revenues obscures what is happening with practice expenses. The cost of providing quality veterinary care

VALUATION IN PERSPECTIVE

The valuation methodology that the authors describe is a product of many years' work and refinement. It is the benchmark that practices are measured against as well as a sound tool for providing a snapshot of financial well-being.

However, as the veterinary industry continues to evolve and buyers of varying backgrounds and business models enter the profession, other methods of determining practice value are influencing how practices are bought and sold.

Market Value: The least scientific of any method, *market value* is simply the value that someone is willing to pay; not the listed price or the asset's intrinsic worth. In desirable areas of the country or areas where the supply of practices is limited, market values can be driven higher than the standards described in the article. Conversely, in less desirable areas, a very profitable practice may have a depressed market value.

Lending Value: *Lending value* is the estimated value of an asset for lending purposes. Highly influenced by profitability, lending value is the amount/size of loan that can be paid from the earnings of a practice. In effect, it determines at what price the bank will lend money to the purchaser of the practice. Since most practice purchases are financed through banks, lending value can be very influential in determining the market value of a practice.

Strategic Value: *Strategic value* is based on a distinct advantage or benefit of the practice. The strategic value of a practice can manifest in many different ways: practices that purchase large volumes of goods or services, are in desirable locations, or complement other businesses of a buyer all have strategic value. The strategic value may or may not be calculated but can be very influential on the market value of a practice.

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For more information on practice valuation, see *Valuation Essentials for Veterinarians*, published by VetPartners Valuation Council, VetPartners.org.



is increasing and, for many practices, the economy is not helping. Practice owners and managers need to pay closer attention to the bottom line instead of the top line.

Focus on Profitability

To improve a practice's value, the owners and managers should focus on practice profitability. Determine profitability when constructing a budget. If you are not using a budget for your practice, it is time to start. If you want to have a financially healthy practice, you need to begin with the goal of developing a profitable practice.

Assess Financial Health

For ongoing practice financial health, we recommend

practice valuation every 3 to 5 years. A practice appraisal for management and planning purposes can be a powerful diagnostic tool for assessing the financial health of your practice.

A practice appraisal will focus on practice profitability, as recommended above.

- Cash flows associated with practice revenues will be checked, with a critical eye on revenues, associated expenses and, most important, resulting operational profits.
- If an element seems atypical or if profits seem low, your veterinary appraiser can help identify the reasons why. All too often, these issues can be creeping quietly in the background while owners/managers are unaware of their existence and/or unaware of what they mean to practice cash flow and value.
- This financial analysis can also be used to establish and review your operating budget.

IN SUMMARY

Keeping your practice healthy helps you, your team, your clients, and their pets. It also results in improved practice value when it comes time for exit from ownership. ■

Practice Owners: Explore Your Future Options



- Get Fair Market Value for your Practice
- Keep your Team Together
- Retain your Practice's Name, Image and Medical Direction
- Enjoy Collaborating with other Practice Leaders
- Continue Practicing on a Schedule that works for you

As you think about future options for your practice, please consider VetCor.



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