



GOT VALUE? FIND OUT NOW TO AVOID UNHAPPY SURPRISES LATER

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Drs. Jim McGraw and Fern Hill co-own a five-doctor companion animal practice, Smokey Mountain Animal Hospital (SMAH). The doctors are working with their financial advisor on their personal financial plan and determined their practice needs to be worth \$3,200,000 to meet their financial goals when Dr. McGraw retires in five to six years. The owners want to get their “ducks in a row” for the future sale, and approached Wutchiett Tumblin and Associates for assistance. Their goal: find out what the practice is worth today, and identify the steps to ensure they hit the target value.

Drs. McGraw and Hill aren’t alone. Even with so much riding on the outcome, many practice owners have never had their practice valued. While they may check the value of other investments on a regular basis, they neglect to pay attention to the value of perhaps their largest investment – the practice. It’s time to face facts – a practice’s value is not equal to one year’s gross, a practice’s mere existence is no assurance of value, and the owners’ management decisions control the practice’s value.

The excess earnings method is one method used to value veterinary practices. The principal components are the practice’s net assets and goodwill. Net assets include working capital such as cash, accounts receivable, and drugs, hospital, and retail supplies. Values from the practice’s Balance Sheet are adjusted to reflect fair market value. For example, the valuator adjusts accounts receivable to reflect only collectible accounts.

Net assets also include tangible assets such as office supplies, furniture, medical and office equipment, and vehicles. These assets are valued at the price a buyer would pay for each item in its current condition (fair market value). The total outstanding debts (accounts and taxes payable, notes, leases, etc.) are subtracted from the asset value to arrive at the net asset value.

In companion animal Well-Managed Practices®, the net asset value often represents 15% to 20% of the total value. The percent is higher in equine and food animal practices and lower in referral practices. Goodwill makes up the balance. The value of goodwill ties directly to the practice’s excess expected earnings - the earnings after all normal operating expenses and a fair return on the practice’s net working capital and tangible assets is paid. The calculation of excess

expected earnings begins with taxable income for the prior three to five years. Then, adjustments are made for:

1. Income and expenses included in the calculation of taxable income but excluded from the calculation of earnings, such as interest expense and the gain on the sale of equipment.
2. Expenses excluded from the calculation of taxable income but included in the calculation of earnings, such as non-deductible entertainment expense and owners' health insurance premiums.
3. Non-recurring expenses such as architectural fees, litigation costs, and repairs due to flood damage.
4. Rent expense if the practice doesn't pay fair market rent.
5. Under-spending on items such as repairs and maintenance to the facilities, continuing education for doctors and staff, and services provided by the owner or the owners' family at no cost to the practice.
6. Veterinary pay to reflect fair market compensation of the services provided by all doctors – owners, associates, contractors, etc.
7. Management compensation to reflect the fair market value of the owners' management services.

The adjustments for fair market veterinary and management services are two of the most critical. In a companion animal practice, veterinary compensation ranges between 16% and 21% of doctor-produced revenue. In an equine practice, compensation rates depend on where the service is provided - rates for fieldwork range from 25% to 28%; rates for outpatient services provided at the practice are 22% to 24%, and rates for surgical services are 18% to 22%. Management compensation typically represents 1% to 3% of gross revenue. The valuator includes the total of the veterinary and management pay, plus payroll taxes, as the normal operating expense in the earnings calculation.

Fair market compensation will be higher than the actual compensation if the doctors have been underpaid because of cash flow concerns. It will be lower if the owners include part of their owner return in their paycheck, or when associates receive a share of the profits.

Adding and/or subtracting the adjustments to operating income results in the valuator's estimate of the expected earnings for each year. Then, the valuator calculates a weighted average of the earnings. For example, if three years of practice operations are included, the

weighting will be 3, 2, and 1. This has the effect of basing 3/6 or 50% of the goodwill value on the most recent year's earnings.

Next, the valuator reduces the weighted average expected earnings by an investment return on net working capital and tangible assets, which results in the excess expected earnings - the earnings stream they capitalize to arrive at goodwill value.

The multiple used to capitalize earnings is the inverse of the return on investment in the practice's goodwill. It is based on several factors including general market risk, veterinary industry risk, and the specific risk of owning the subject practice. In recent years, required returns on goodwill have generally ranged from 16% to 33% resulting in multiples ranging from 3 to 6.

Why does one practice carry more risk than another? The valuator considers several factors including the practice's expected revenue and profit growth, competitive position, demographics, management systems, fee structure, staffing, revenue from dispensing, revenue from ancillary services and products, transferability of goodwill, ability to cover expenses and debt payments, and compliance with federal and state laws.

In summary, here are the key components of the excess earnings formula:

Revenue

- Normal, ongoing operating expenses
- Fair market value of veterinary compensation
- Fair market value of owners' management compensation
- = Expected earnings; calculated as a weighted average
- Investment return on working capital and tangible assets
- = Excess expected earnings
- x Capitalization multiple
- = Goodwill value
- + Net asset value
- = Total practice value

The value of SMAH is currently \$600,000:

Net Asset Value

Accounts Receivable	\$ 20,000
Inventory	50,000
Equipment	157,000
Liabilities	<u>(50,000)</u>
Total	\$177,000

Goodwill Value \$423,000

Total Practice Value \$600,000

Drs. McGraw and Hill are \$2,600,000 below their target of \$3,200,000 and want to learn how to improve the value and continue to raise the bar on their patient care. We take a close look at how their management decisions affect the practice's value. Since goodwill is the largest component of value, we start with an analysis of the excess earnings and capitalization multiple and find that earnings are negatively affected by the practice's fee structure, low client visitation, low new client numbers, and less-than-optimal inventory management.

Fee Structure

SMAH's exam fee is \$42 – a little light given the economics of the community and market research completed by their staff, and they increased it to \$44. The average charge per doctor transaction (ADT) is \$122. The Benchmarks Study of Well-Managed Practices® reports an ADT of 3.2 to 3.5 times the exam fee, which means SMAH's target is \$140 to \$154. We analyzed the practice's fee schedule and found the following opportunities:

- The medical progress exam fee is low; they increased it to 80% of the exam fee.
- They don't charge for electronic monitoring or hospitalized patient exams; we established fees for each of these services.
- Several of their laboratory service fees and non-elective surgery fees are low; they increased them in line with the Benchmarks targets.
- They are missing a significant number of charges for patient care; the doctors and staff collaborated to reduce the frequency of missed charges.

These adjustments improved the ADT to \$142 and provide additional cash flow for doctor and staff salaries and reinvestment in new technology. Here's the impact on practice value:

<u>ADT</u>	<u>Practice Value</u>
\$122	\$ 600,000
\$142	\$1,418,000

Action Step: Is your ADT 3.2 to 3.5 times your exam fee (4.0 to 4.4 for general equine practices)? If not, review your fee schedule and determine if any changes are warranted. Resources to assist include Benchmarks 2015: A Study of Well-Managed Practices® and the AAHA Hospital Fee Reference Guide. Do you bill for all of the services provided including IV catheters, fluid pumps, hospital exams and medical progress exams? Low fees and unbilled services hinder your ability to provide the best patient care, hire the best and the brightest, and keep up to date with medical technology.

Client Visitation

Clients visit SMAH on average 2.7 times per year for medical purposes - the target is 3 to 3.2 times. The Client Service Team explained that scheduling progress exams is usually left to the clients' discretion, and there's limited effort to follow-up with clients that do not respond to reminders.

The associates shared SMAH doesn't have a philosophy for ongoing, lifelong client education and clients aren't prepared for the changes to expect as their pet ages. They modified their protocols and now schedule the next appointment for progress exams and additional necessary care at the conclusion of the current appointment and now follow up on reminders for unscheduled care to increase client visits to 3 times a year. Here's the impact on practice value:

<u>Visitation</u>	<u>Practice Value</u>
2.7 times per year	\$600,000
3.0 times per year	\$788,000

Action Step: Low visitation is often caused by ineffective or limited communication and client education during outpatient and discharge appointments. Do you proactively schedule follow-up visits, or do you rely on clients to call if they perceive there's a problem? Do you spend a few minutes of every appointment educating clients about the next step in their pet's preventive and wellness care? Or, are you too focused on waiting clients crowding your reception area? The last thing clients want is to diagnose their pet's health – what if they guess wrong?

New Clients

SMAH's new client numbers are light given the owners' goal of hiring another doctor. Based on the results of the Potential New Client Caller market research project completed by the staff, we determined the practice enjoyed a robust number of potential client calls, yet the 40% conversion rate is low (target: 70% to 75%). Therefore, the staff embarked on a series of continuing education programs geared towards improving their customer service skills. As a result of their efforts, the scheduling rate improved to 50%, and they plan to focus on continued improvement in this area. Here's the impact on practice value:

<u>New clients</u>	<u>Practice Value</u>
1,020 new clients	\$600,000
1,275 new clients	\$807,000

Action Step: Low new client numbers can result from limited community awareness about your practice and ineffective or rushed communication by the client service team. First identify how many potential clients call your practice and how many become clients. If you have a high number of calls coming in, yet a low number who schedule an appointment, it's time to focus on client service education for your staff. If you have a low number of potential client calls and a high scheduling rate, then it's time to revisit your marketing plan.

Operating Expenses

The practice's operating expenses are generally in good order with the exception of their inventory management. In a review of inventory purchases, we found the time spent seeking the lowest price on each item eliminated the cost savings. Drs. McGraw and Hill decided to work more closely with fewer suppliers to negotiate lower prices on higher volumes. They also collaborated with their associates to eliminate some of the duplicate medications in stock to reduce the amount of inventory on hand. These changes reduced their inventory cost by \$20,000. Here's the impact on practice value:

<u>Drug and Medical Supplies</u>	<u>Practice Value</u>
18%	\$600,000
17%	\$693,000

Action Step: If your inventory manager spends hours seeking the lowest prices from 8, 10, or 12 suppliers, you've likely tipped the cost/benefit scale. Work with three or four suppliers to get the best price and service. Target \$10,000 to \$16,000 of inventory on-hand per full-time equivalent doctor.

Here's the cumulative result of the changes SMAH implemented:

Previous value	\$ 600,000
Increase the ADT	813,000
Improve client visitation	188,000
Increase new clients	207,000
Reduce inventory cost	<u>93,000</u>
Revised practice value	\$1,901,000

Drs. McGraw and Hill still have work to do in order to reach their target value of \$3,200,000, and now are in the midst of Phase II of their plan. They have a much better understanding of the relationship between their management decisions and practice value. You, too have considerable control over your practice's value. So, focus your attention on medicine *and* management to ensure you receive fair value for your practice.

This information is intended to provide the reader with general guidance in practice succession matters. The materials do not constitute, and should not be treated as, appraisal, tax, or legal guidance or technique for use in any particular succession situation. Although Wutchiett Tumblin and Associates made every effort to assure the accuracy of these materials, we don't assume any responsibility for any individual's reliance on the information presented. Each reader must independently verify all statements made in the material before applying them to a

particular fact situation and must independently determine whether the succession technique is appropriate before recommending that technique to a client or implementing such a technique on behalf of a client or for the reader's own behalf.

Common Questions Regarding the Valuation of a Veterinary Practice

1. What should I expect in terms of the valuation process?

At Wutchiett Tumblin and Associates, we have a 30- to 40-minute conversation with potential clients to understand their needs and gauge where they are in the planning process. Possible discussion points include: What is the purpose for the valuation? When do you want to retire? Who's buying your practice? These answers give us a better idea of how we can help accomplish their goals.

To begin, we send out an engagement letter and document request. The engagement letter states the purpose of the valuation, the valuation date, the assumptions and limiting conditions of the engagement, and the cost to complete the work. The client signs the engagement letter to confirm the intent of our work is clear to both parties. The document request includes items such as tax returns, financial statements, a depreciation schedule, an equipment list, and an employee census form. We try to make the document gathering process painless!

We estimate eight to twelve weeks to complete the report. The client controls the timeline and cost by submitting accurate and timely information. We begin the valuation analysis upon receipt of all the requested information. Our process includes two to three phone calls with the client to ask questions and gain an understanding about the current practice operations. These conversations are critical to the valuator's professional valuation opinion.

Once we finalize our analysis and valuation conclusion, the client receives a Draft Report for use during our discussion about the value. This conference provides an opportunity for the owner to ask questions about the report and the next steps in the selling process. After this conference, we make any necessary changes and send the final, Certified Valuation Report.

2. What does a Valuation Report include?

Introduction and Conclusion of Value

Identifies the property being valued (assets and liabilities or stock), the name and tax structure of the practice entity, the date of the valuation, the standard of value and a definition of the standard, purpose and intended use of the report, the primary sources of information, assumptions incorporated in the valuation, items that could impact the opinion of value, the valuator's opinion of the estimated value, a recommendation to update the net asset value as of the sale closing date, and a statement attesting to the valuator's independence.

Common Questions Regarding the Valuation of a Veterinary Practice (continued)

Financial Information Analysis and Adjustments

An overview of the valuation process and the practice history that describes common scenarios for the profession, ranges for expected earnings, a comparison of certain aspects of a client's practice to information published by industry authorities, and a reference to the balance sheet and income adjustments found later in the report.

Net Asset Value

Details the value of all assets and liabilities included in the conclusion of value. The valuator footnotes each asset and liability to explain the source of the information (for example, tax return, financial statement, representation of management) and any adjustments made to arrive at the fair market value of the assets.

Goodwill Value

The calculation of goodwill begins with taxable income and lists the adjustments the valuator makes to arrive at the earnings stream to capitalize. The valuator footnotes each adjustment with an explanation of why and how it was determined. This section also includes the calculation of the fair market cost of veterinary and management services, the return on asset calculation, and application of the capitalization multiple.

Valuation Approaches and Methods Considered and Used

Regulating authorities provide guidelines that require a valuator to consider a minimum of three approaches when valuing a business. This section explains the approaches and methods the valuator considered to arrive at the conclusion of value, then presents the calculated results of each method and explains the rationale behind the decision to rely upon or disregard each approach.

Qualifications and Certification

A summary of the valuator's qualifications and experience relevant to valuing veterinary practices, and the section where the valuator certifies the conclusion of value, his or her independence, the limiting conditions and uses of the report, and provides the names of individuals involved in preparing the report.

Assumptions and Limiting Conditions

This section details the limiting conditions on the use of the report and on the scope of the valuator's responsibility.

Supplemental Information

The remainder of the valuation report contains information the valuator used to value the practice, including a detailed list of the sources of information, historical revenues and expenses, an industry analysis and outlook, a description of the national economic

environment, local and regional demographic and economic environment, and provides an international glossary of business valuation terms.

Common Questions Regarding the Valuation of a Veterinary Practice (continued)

3. Does the Valuation Report need to be updated as of the sale date?

Yes. The fair market value of assets and liabilities should be updated as of the sale date. Goodwill value is constant for one year as it's based on a full tax year (12 months of operation).

For example, a practice valuation is completed as of December 31, 2014. The seller and buyer establish a sale date of June 30, 2015. The net asset value is updated to reflect fair market value as of June 30, 2015 – counting the value of inventory on hand, updating the value of the collectible accounts receivable, adding any 2015 equipment purchases, and subtracting the outstanding debt. This update usually takes one to two weeks.

4. Should I have my practice valued if I'm not selling right away?

Yes. A valuation is an excellent planning tool to identify opportunities to improve profits now and ensure a fair value for a future sale.

5. When are practice valuations mandatory?

- Buying or selling a practice
- Buying or selling a partial interest in a practice
- Writing or updating a buy/sell agreement
- Planning for financial security
- Retirement planning
- Estate planning
- Third party financing
- Mergers
- Property settlements

6. Why do I need hire to a professional appraiser to value my practice?

Professionals who specialize in valuing veterinary practices have extensive experience in and understand the specifics of operating a veterinary business. They perform their work with objective, unbiased, professional judgment. Valuation is scientific, yet it also includes an element of art. It is quite like a surgery - a veterinarian may follow certain procedures as he or she begins a surgery, yet the art of surgical skill and experience plays an important role in the outcome. No two surgeries are the same, and the same is true for valuations.

Common Questions Regarding the Valuation of a Veterinary Practice (continued)

The valuator must make many decisions throughout the valuation process, and it's not a task for the inexperienced. An inflated value is of no use when rejected by all potential buyers. An inflated value can easily result in a seller receiving less than the practice is worth, as overvalued practices that remain unsold for an extended period of time grow stale like overpriced real estate. An under-valuation jeopardizes you and your family's financial security.

If you choose not to hire a valuator and instead set your own selling price and the buyer relies on your representation of value, the liability for misrepresentation falls solely on your shoulders, which can lead to the potential for future litigation.

7. Is taxable income the same thing as excess earnings?

No. Taxable income is calculated for tax purposes and includes (and excludes) some items that are part of the calculation of valuation. Owners of C Corporations often express concern about their tax strategy of withdrawing all profits at year-end to eliminate taxes at the corporate level. Because of the adjustment process, they needn't be concerned. It is best to keep your practice financial records clean, though. Pay personal expenses from your personal checking account and business expenses from your business checking account.

8. What makes one practice riskier than another?

A variety of risk factors impact practice value including the quality and number of staff members, the makeup of revenue (medical services, medical products, and ancillary services), the condition of the facilities and equipment, and the transfer plan (or lack thereof). There's greater risk with high staff turnover, low staff wages, or inadequate or nonexistent training protocols, and large percentages of revenue from dispensing and ancillary services like boarding and grooming. Why? Clients have other options besides another veterinary practice – more resources for the client equals greater risk for that income stream. With facilities and equipment, owners face higher risk if the building is outdated or is at 100% capacity without the ability to expand. Transferability of goodwill is higher risk in one-doctor, niche practices that are sold to an outside buyer.