Putting a value on a practice

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Mark Ridout became a director of RA Valuation Services – business valuers specialising in professional and health care practices – in 2007. He graduated in business and information systems and worked in management software before concentrating on business valuation. He has written numerous articles for professional associations on how businesses can improve and maximise their value.

Calculating the financial value of a practice can be challenging and a variety of factors must be taken into account, including the current economic climate. Mark Ridout outlines the factors that affect the value of a practice.

Why value a business?

Business valuation for professional practices is a prerequisite for many circumstances, including partnership or director change, practice sale or purchase, incorporation, tax negotiations, divorce settlements, and so on. In this respect, veterinary practices are no different from any other business. Arriving at an accurate valuation is not easy and can be something of a perennial nightmare. It depends very much on the individual business and the intended purpose of the valuation. And, of course, it depends on the success or otherwise of the organisation. So, what is a realistic value? How do you pinpoint the value of a business and its so-called goodwill? How is the recession affecting values? What makes one practice worth more than another? How can undervaluing the practice be avoided in an economic downturn, and how can the value be improved?

What is goodwill?

Due to the vocational nature of veterinary practice, vets have traditionally undercharged for their professional time. Worse still, practice owners have then made the same mistake by underselling their business on the open market. During the worst economic downturn in recent memory, outgoing practice owners are now having to work harder than ever to justify a fair price for their business. Even then, when a willing buyer or investor can be found, bank managers and financial intermediaries are often unwilling to provide the necessary funds to finance the purchase.

It is perhaps worth establishing what is meant by business value. Values for tangible assets (eg, stock, equipment, property, motor vehicles) can be assessed through recent certified or audited accounts. The key component in most business sales is, however, the value of an intangible asset, namely, goodwill, which is not normally represented on the balance sheet. The value of goodwill is invariably greater than the combined value of the rest of the assets in the business and, therefore, forms the largest component of the business value. This means that an accurate assessment of goodwill is vital.

Technically, goodwill is the difference between the price achieved through a sale and the balance sheet value of the tangible assets in the business. It is intangible in that you cannot touch it or feel it like stock, equipment, premises and cash. Once a new business starts showing profits, goodwill comes into play in assessing the business value and the business starts to justify a higher value than the costs of setting it up and its day-to-day running.

Effects of the recession

Previously, the veterinary profession was considered almost recession-proof, with revenues for veterinary practices predicted to grow even during periods of economic downturn (Ackerman 2006). However, in general, although professional businesses such as veterinary practices have not suffered the knocks that other small businesses have, many have nonetheless taken a significant hit on their profits during the past two years. Overheads have risen against mainly static sales levels as customers strive to save money on pet care and dispensing charges.

The credit crunch is taking its toll too. Bottlenecks are occurring as purchasing parties struggle in their attempt to raise finance after an internal or open-market deal has otherwise been successfully agreed. Banks will continue to request firm evidence of a reasonable and achievable return on any investment well after the green shoots of recovery have genuinely sprung. As a result of this, common sense suggests that if a practice is going on the open market today, there will be fewer potential purchasers in its catchment area compared with a few years ago.

Lifestyle changes

The recession aside, changes in lifestyle show vets are sometimes likely to take an extended sabbatical after qualifying rather than take on the liability of full or

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even part ownership of a practice. But this won't stop an ambitious young vet from buying into a well-established, profitable, independent practice, or a corporate franchise that can potentially offer a lesser financial burden.

An economic downturn inevitably creates opportunities for shrewd investors, such as those seeking to buy up smaller practices to form a multisite business. However, ambitious owners of single-site practices seeking to build a group of networked practices should be mindful that the overheads incurred in running more than one site can be disproportionately high when compared to the enlarged revenue. Interestingly, although lower customer spend and increased overheads are major concerns in the current economic climate, it is changing regulations, red tape and litigation (all unrelated to the economic downturn) that practice owners fear as being the greatest obstacle to trading performance in the forthcoming year or two.

Determining the valuation figure

A market value is determined by valuation professionals as the price a practice should be able to justify and achieve on the open market, reflecting a justifiable return on investment (ROI), and what a willing purchaser is likely to pay and a willing vendor likely to accept in the current market conditions. Market value may or may not include a margin for negotiation. A fair price takes both ROI and market value into consideration to derive a pinpointed figure without a negotiating margin. This figure is typically used when no one party should perceive a gain from the value held within the business, for example, in the case of matrimonial litigation or partnership changes.

The days when an asking price was arrived at using empirical means such as a multiple of annual turnover (sales) are, thankfully, long since gone. It is rare for two practices having the same level of turnover to show identical levels of profit and, therefore, goodwill. The RA Valuation Services database contains many examples of this. Clearly, a practice having, say, £500,000 annual turnover and a surplus (or pretax profit) of £100,000, is worth more than another practice also showing £500,000 turnover but a surplus of only £50,000. That said, a practice with little or no surplus (or profit) may still have a useful market value and could appeal to a prospective owner not wanting the hassle of setting up an organic business from scratch. There is, however, no substitute in valuation for a recent set of trading accounts showing healthy profits.

Value of goodwill

- Goodwill usually represents the bulk of the business value and is, therefore, the most critical and influential figure affecting valuation;
- Goodwill valuation is a function of the profit – or surplus – that is left after taking account of all legitimate trading expenses and making appropriate adjustments necessary to arrive at a true trading value.

Other influences on goodwill

Other criteria can influence value and should be taken into consideration in the valuation process.

External factors

These include:

- The economic climate;
- Market conditions within the business sector;
- Location, demographics and the competition – both from other local practices as well as, for example, online medication suppliers;
- Regulation, red tape and the threat of litigation.

Internal factors

These include:

- Turnover (sales or income);
- Gross profit (sales minus cost of sales);
- Trading trends;
- Practice presentation;
- Premises and permanence of location – in our experience, clients prefer to know that their vet will stay close by in case of an emergency. In addition, they may not have the facility or willingness to travel further;
- Potential.

Owners

While it requires complete independence, expertise, experience and industry knowledge to value a particular business, it is the owners who, knowingly or not, exert the greatest influence on goodwill by the way they run their business. If they do it right, they could be enhancing their retirement plans. If they get it wrong, however, they could be in for a prolonged struggle to realise the full potential value of their business.

Increasing the value of a practice during an economic downturn

Although it may well be something as mundane as the availability of adequate car parking that determines whether potential customers within the local catchment area use the practice, there are steps that can

While the value of tangible assets such as property must be taken into account, intangible assets such as goodwill tend to form a large part of a business's value

Exit strategy

The words 'exit strategy' can be seen as emotive, but all business owners should have an exit strategy in mind. This may simply be a wish list reflecting the owners' desires, or it could comprise part of a detailed formal business plan. Either way, an exit strategy should, ideally, be planned at least three years ahead if a satisfactory valuation and successful sale or transfer are to be achieved. Those who feel they haven't got the experience or the time to develop a plan should hire a consultant or someone who can help – it will almost certainly be a sound investment.

be taken to maintain, or even increase, the potential value of the practice during a downturn.

Preparing the business for sale

There are many things to do, most of them simple, when planning to put a practice up for sale on the open market. For example, its physical appearance should be up to scratch; as with selling a house, so-called 'kerb appeal' is vitally important. When homeowners want to sell their house, they may paint it, fix a few things that have been waiting for repair during the previous few years, and polish the taps. Simple and obvious, but unarguably effective. Practice owners can improve the value of their practice by making a few changes along the same lines. First impressions count and can be the difference between a successful and unsuccessful sale.

Importance of profits and profit growth

Clearly, financial performance – and growing trading profit in particular – must validate that the practice is performing well. As an example of the dramatic effect of profit growth on business value, in a recent one-year update valuation of a health care business undertaken by RA Valuation Services for a client one year after the original valuation, sales had increased over the previous year by an insignificant 5 per cent, but purchases were maintained at the same level and overheads cut by 5 per cent. The resultant goodwill was valued at over 40 per cent higher than in the previous year solely as a result of these changes.

To illustrate this, the table below shows how trading profit can be doubled in three years by improvements of 7 per cent in three other areas, all under the owner's control – namely, sales, gross profit margin and reduction in cost ratio (overhead costs as a percentage of sales).

How to increase profits

In the day-to-day running of a veterinary practice, increasing profits equates in simple terms to a combination of:

- Increasing sales;
- Managing purchases;
- Cutting overheads.

Increasing sales

Existing loyal clients are far more valuable and less expensive to provide a service to than new clients. To increase sales in real terms – that is, to keep existing clients coming through the door and to maintain a respectable level of spend per visit – offer and promote services such as preventive health care schemes that bond owners and pets with the practice. Capitalise on the captive audience in reception by advertising offers through posters and update these on a regular basis. Keep water bowls for the pets and toys for children in the waiting room. Include and promote pet food and other accessories and any current offers. These are obvious, of course, but simple and effective examples. Be realistic with price-driven services such as neutering and prescription dispensing, and keep a sensible balance between consultation charges and dispensing. The ubiquity of online medication websites means that practices can no longer discount consultation charges in lieu of big prescription mark-ups. It is better for the business to have higher (but still reasonable) consultation charges and competitive dispensing fees – clients have already accepted that they will be spending money when they visit the practice.

Example of how trading profit can be doubled over three years by improvements of 7 per cent in sales, gross profit and cost ratio

Area	Year 0	Year 1	Year 2	Year 3
Turnover (sales)	£400,000	£428,000	£457,960	£490,017
Cost of sales	£200,000	£199,020	£195,800	£189,871
Gross profit	£200,000	£228,980	£262,160	£300,146
Overheads	£100,000	£99,510	£99,022	£98,537
Trading profit	£100,000	£129,470	£163,138	£201,609
Sales growth		7%	7%	7%
Gross profit margin (gross profit/sales)	50%	53·5%	57·2%	61·3%
Increase in gross profit margin		7%	7%	7%
Cost ratio (overheads /sales)	25%	23·3%	21·6%	20·1%
Reduction in cost ratio		7%	7%	7%
Profit growth		29·5%	26·0%	23·6%
Profit growth compared with Year 0		29·5%	63·1%	101·6%

Note, although the cost ratio has been reduced by 7 per cent year on year, actual operating costs themselves have only been reduced by a reasonable 1·5 per cent over three years, demonstrating that profits can be doubled without having to slash costs to the extent of damaging the business

Managing purchases

Keep purchases of medical products at sensible and pragmatic levels. Avoid a build up of worthless or obsolete stock and review and compare supplier prices and reliability of service. Most importantly, capitalise on the present economic situation with suppliers – there is unlikely to be a better time to negotiate price reductions and attractive terms from both established and new suppliers.

Cutting overheads

Keep a close eye on all overheads; use and review management information on a frequent and regular basis, and highlight any expenses that are becoming disproportionately high in relation to the level of practice income – watch the cost ratio (overheads/sales).

Manage the business

A veterinary practice is a business and, in difficult economic times, must be effectively managed. Budgeting and cash flow must be supervised consistently. As with all small professional businesses, the owners and a significant proportion of the payroll should be fee earners. Unnecessary management or administration bloat must be avoided and if the premises are leasehold, advice should be sought over rent reviews and lease terms. Utility suppliers can also be reviewed and compared for the best prices.

Be realistic

It is important not to underestimate the value of the business but to be realistic. Beware artificially inflated valuation figures suggested by a broker eager to sign a practice up to a sole-agency agreement; potential buyers will recognise an overpriced practice for what it is. Take advice from a professional valuer familiar with the industry – never use guesswork. Whether you are a purchaser or vendor, a specialist valuer could save or make you money.

Be a professional manager

When trying to value a practice, concentrate on the points listed above, enlist professional help to organise and plan, and listen to the experts. Most importantly, be prepared with clear, up-to-date accounts showing an attractive and well-documented track record of profitable growth. Like the homeowner, some polish and a fresh coat of paint will help with the kerb appeal. But remember the bank will want to see that the potential buyer can pay back the loan. Ultimately, it all comes down to profit. Get all of the above right and the financial figures will speak for themselves.

Reference

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