By Leslie A. Mamalis, MBA, MSIT, CVA

Using EBITDA can be tricky

The popular financial metric is not the most accurate method for calculating profitability or a veterinary hospital's value.

You may hear about veterinary practice sales where the purchase price was some multiple of EBITDA. EBITDA (pronounced: ee' bit dah) is an acronym for earnings before interest, taxes, depreciation and amortization. In other words, EBITDA represents net income with certain accounting expenses, namely depreciation and amortization, income taxes and interest expense, added back in.

EBITDA is frequently used to gauge a business' profitability as well as its ability to repay debt. Some veterinary practice buyers, particularly national or regional consolidators, use a multiple of EBITDA as a method to calculate the price they are willing to pay for a veterinary hospital.

Why EBITDA?

EBITDA is a useful tool when applied to publicly traded companies, largely because such companies have financial statements that are regularly audited and are prepared using rigorous standardized methods (GAAP accounting). This allows potential investors to compare business to business and industry to industry.

GAAP (generally accepted accounting principles) is a complex, standardized method of recording a business's income and expenses. GAAP allows potential investors to compare investment opportunities on an "apples to apples" basis. There is no legal requirement for a business to utilize GAAP, and most small businesses do not use GAAP because the complexity creates additional accounting expense and does not contribute to higher practice value.

EBITDA is harder to apply to veterinary practices because there is no standard financial system or practice management software.

Therefore, EBITDA is harder to apply to veterinary practices because there is no standard financial system or practice management software, and setup varies from one hospital to the next. Of even greater impact is this: Veterinary hospital owners and managers generally make decisions designed to enhance patient care, client service or staff morale, not to increase profit.

By the Numbers

EBITDA is easy to calculate using an income statement or an income tax return. It involves simply adding together net income and four expenses: interest, income tax expense, depreciation and amortization. In the veterinary profession, more attention is paid to true profitability than EBITDA, but calculating profitability is not as simple as adding five numbers together. Every veterinary practice is unique, and every practice owner has distinct financial objectives.

In calculating the profitability of veterinary practices, the goal is to remove some of the variability created by decisions made to mitigate taxes, service debt, replace and upgrade equipment, or fund specific activities or charities.

WHAT TO FACTOR IN

	EBITDA	Profitability
Net income	✓	✓
Interest	✓	✓
Income taxes	✓	✓
Depreciation expense	✓	✓
Amortization expense	✓	✓
Equipment replacement		✓
Owner comp/benefits		✓
Family working in practice		✓
Facility rent		✓
Charitable contributions		✓
Other discretionary spending		✓

Equipment

One problematic aspect of an EBITDA calculation relates to adding back depreciation expense without subtracting an amount for routine equipment replacement. Depreciation is a method by which a business writes off major purchases. The cost of the equipment purchased from year to year can vary significantly, and since U.S. tax law has allowed first-year write-offs of as much as $250,000, it is easy to understand why adding back depreciation expense makes sense when evaluating a business.

What EBITDA fails to consider is the critical expense related to ongoing investment in equipment replacement and upgrades. While equipment purchases may fluctuate dramatically from year to year, a practice that does not regularly invest in new equipment and technology will struggle to achieve a competitive advantage in the marketplace. Veterinary hospital profitability calculations include an annual equipment acquisition allowance that varies somewhat based on practice type.

Owner Compensation and Benefits

Usually, hospital owners decide how much to pay themselves as well as what benefits they will receive, sometimes based on recommendations from their CPA. Due to the diversity of needs of these owners, as well as tax-mitigation strategies, owner compensation varies significantly from practice to practice.

EBITDA does not reflect what a different owner would pay herself, nor does it account for differences in benefits provided. Veterinary valuation experts always analyze owner compensation and may adjust that compensation up or down to reflect what another owner should reasonably expect to receive in compensation. This calculation is based on the substitution principle. At its simplest, this principle analyzes a situation by substituting a standard value for the actual value.

For our purposes, we want to replace the actual spending on owner salary and benefits with the amount that would be paid to an associate veterinarian or manager to do the same work that the owner is doing. If the practice owner is a veterinarian, an appraiser will substitute the owner's salary with the amount that would be paid to an associate with similar experience to generate the same level of production.

A substitution also is made for the owner's role in managing the practice and what a manager would be paid to do the same things. This adjustment will increase profitability if the owner is paid more than others would receive. Profitability will decrease if the owner is paid less than what others would earn for the same work.

Many small businesses hire members of the owner's family, and veterinary hospitals are no exception. Sometimes those family members are paid handsomely. Other times they are paid a pittance or not at all. Practice appraisers will adjust profitability to reflect what a third party would be paid to do the same work. EBITDA does not address family member compensation.

When a clear division between the owner's personal spending and the expenses of the business is absent, profitability will be artificially low.

Facility Rent

Facility rent is another area that may vary somewhat when the practice owner is also the owner of the real estate on which the practice operates. Again, largely dependent on tax-mitigation strategies determined by the hospital owner's CPA, the amount the practice pays for facility rent may or may not reflect the fair market value of the property.

Practice owners may pay significantly more or significantly less than what an unrelated party would expect to pay to rent the practice's facility. This is a common tax strategy employed by owner veterinarians, but it is not addressed by the EBITDA calculation.

Other Considerations

Several more areas that reflect a practice owner's personal values and interests can affect profitability but not EBITDA. Examples include discretionary spending on resort CE, charitable contributions, tithing, personal vehicles, or tickets to sporting or cultural events.

When a clear division between the owner's personal spending and the expenses of the business is absent, profitability will be artificially low. An appraiser will try to determine if personal expenses are mixed with business expenses and then adjust expenses where necessary. Even so, the owner should have the discipline and be mindful of paying personal expenses personally.

Today's World

Several buyers active in the veterinary market use multiples of EBITDA to determine the price they are willing to pay for a specific veterinary practice. As a result, the term EBITDA is becoming widely used in the media.

While EBITDA is a useful measure of business performance for publicly traded companies, it is more difficult to apply to privately held businesses that do not follow strict accounting guidelines. Your practice's EBITDA does not reflect true practice profitability.

Veterinary hospital owners make decisions every day with more emphasis on patient comfort and care and less regard to profitability and sales price. While EBITDA is used by more than one practice consolidator, it is not the most accurate method for calculating profitability or practice value. If someone offers to buy your practice for a multiple of EBITDA, you may be leaving money on the table. ■

Money Matters columnist Leslie A. Mamalis is the owner and senior consultant at Summit Veterinary Advisors. Learn more at www.summitveterinaryadvisors.com.