Value judgments

As consolidators hover and prices spike, the decision to sell your practice comes down to more than dollars and cents.

By Leslie A. Mamalis, MBA, MSIT, CVA

There has been a lot of buzz lately about the so-called corporate practice-buying frenzy and how long it might last. What started with VCA, National Veterinary Associates and VetCor is now a market flooded with consolidators from within and outside the industry. More than 30 consolidators of various sizes are active in the veterinary market, each with its own criteria for identifying practices of interest.

Many hospital owners, whether or not they are of retirement age, are cashing out and selling their practices to the highest bidder. And who can blame them? Sales prices are the highest in recent memory. Multiples of four and five times earnings have morphed into multiples of seven or eight, with reports of higher multiples for standout practices.

Practice owners have expressed genuine concern about whether we're in a price bubble and when it will burst. Does it make sense to sell now, assuming a high sales price, or is it better to hold on for several more years and hope that high values will be in effect still?

Multiples Defined

What are multiples and what is being multiplied? Addressing these in reverse order, practice earnings, sometimes defined as profits, are multiplied. Earnings refer to the money available to the business owners after all appropriate expenses have been paid. (For more on how to calculate practice earnings, check the VetPartners report "The No-Lo Practice: Avoiding a Practice Worth Less" at http://bit.ly/2DpaKRD.)

For owners with no immediate plans to sell but who are worried about missing a potential financial windfall, the decision is a little more complex.

If earnings are multiplied by "X," how is X defined? X, or the multiple, reflects the risk or uncertainty related to generating similar levels of earnings in the future, with higher multiples indicative of lower levels of risk. This means that the better shape the hospital is in, the more confident the buyer can be that the hospital is a good investment. Some elements of risk, such as employee training and turnover, can be controlled by the business, while others, like the local economy, reflect the general environment in which the business operates. Sales prices increase with higher earnings, higher multiples or both.

Consolidators have their own formulas for calculating earnings and assessing risk. The high multiples that some corporates are willing to pay are related to internal strategies, economies of scale and other factors that are proprietary and difficult for us to predict. Not all veterinary practices will rate these higher multiples; there must be a real strategic benefit to the corporate buyer to lead them to offer a generous price.

Sell Now or Hold?

It is easy to be caught up in the idea that the practice may command a higher price now than it would later when the owners are truly ready to sell. But is that true?

And even if it is true, when is it better to hold on to the business? The VetPartners Valuation Council, a group of experts on veterinary practice valuation, recently discussed this question. They agreed that taking advantage of a corporate offer now makes sense for a specific group of owners. The group includes owners who:

- Are at or near retirement age
- Do not plan to work more than two or three additional years.
- Do not have a private buyer in mind.
- Are in declining health or have family members who are.
- Are tired of the management mantle and just want to be a veterinarian.

This group of owners must consider several factors in addition to the sales price. First is the requirement to work for several years after the sale. Typically, the smaller the practice, the longer the seller is expected to work.

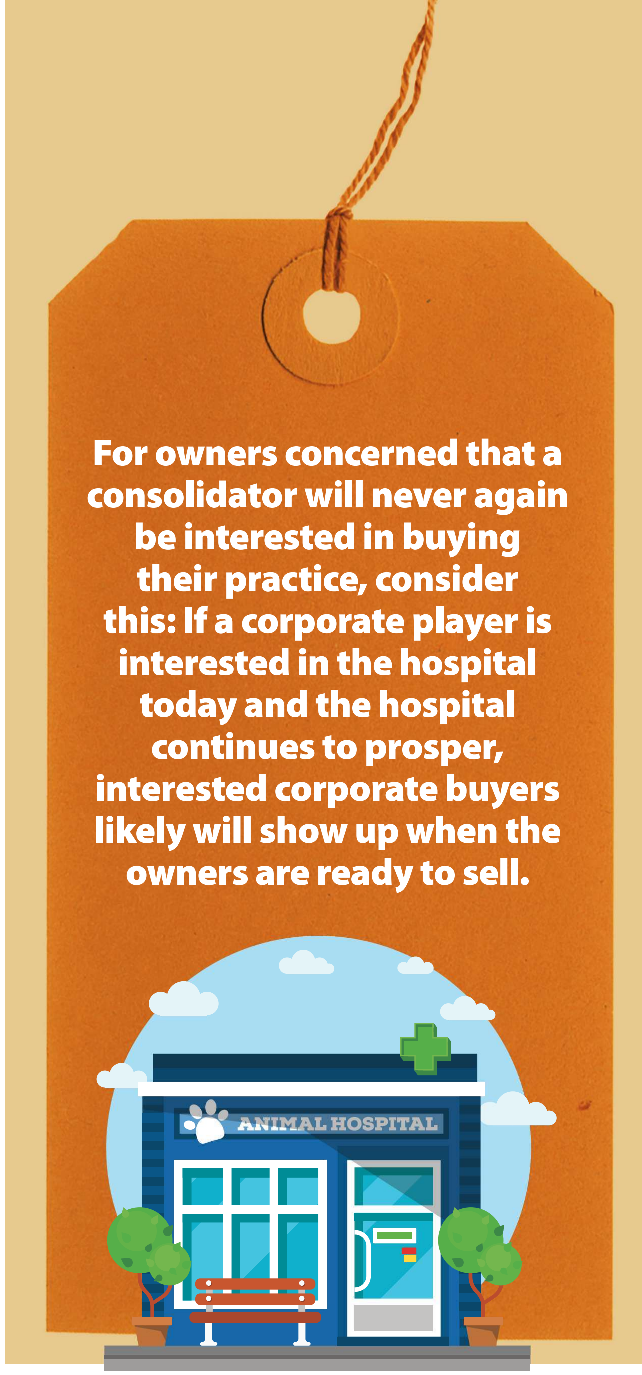
These owners also must evaluate the compensation and benefits package provided by the corporation. In some cases, there may be significant differences in personal production requirements, health and life insurance benefits, vacation time and other perquisites. Owners must understand the impact of a sale on their lifestyles.

A better financial decision usually involves remaining a practice owner because owners receive profits in addition to compensation for the work they do. However, the chief motivator for many hospital owners is not financial. Owners who don't plan to retire soon but who want relief from the stresses of ownership may opt to sell a majority stake to a consolidator. This option allows sellers to reduce their management responsibilities while continuing to receive a share of practice profits.

Remain an Owner

A sale makes less sense for a different group of owners. They:

- Truly enjoy ownership.
- Expect to practice for five more years or longer.
- Have financially healthy practices that provide regular earnings.
- Enjoy the clinical and managerial work.



These owners may have a much harder time transitioning to the role of associate, relinquishing decision-making and losing the financial advantages of ownership.

For owners with no immediate plans to sell but who are worried about missing a potential financial windfall, the decision is a little more complex. In a financially healthy practice, earnings should grow every year as practice revenue grows. Owners who keep their practices for an additional five years theoretically have a five times earnings return on their businesses. If the practice is sold in Year 6 for a multiple of five, the owners have effectively received a 10 times return.

However, there will be years when earnings are spent on equipment upgrades, doctor and staff education, or unexpected repairs and the earnings are not available for the owners to withdraw. In those years, the hospital owners' return may be X, half of X, zero or even negative, meaning a cash infusion is necessary. Earnings are never guaranteed.

What About the Bubble?

Are there risks to passing up an offer today? Absolutely. Competitors will enter the market, a recession may occur or an owner's health may fail. Hospital owners who wish to retire in the next three to five years should consider entertaining a corporate offer now to reap the benefits of the high multiples of earnings. For hospital owners who plan to work for five years or longer, the rewards for selling today may be less than the earnings generated by the practice in the years before a sale.

Owners who continue to operate the practice profitably will continue to receive a strong earnings stream. Years from now, the multiple may be lower, but the number being multiplied will be higher. In addition, these sellers maintain the ability to use or invest the money as they wish.

For owners concerned that a consolidator will never again be interested in buying their practice, consider this: If a corporate player is interested in the hospital today and the hospital continues to prosper, interested corporate buyers likely will show up when the owners are ready to sell. Certain hospitals will always demand higher multiples because of their location, size, profitability or some other feature attractive to consolidators. These practices will still demand a higher multiple in the future. Great practices will always be valuable to someone.

Some industry pundits predict that large multiples are here to stay. Other predictions are more tempered, suggesting the trend will last another 12 months at most.

Almost nothing in life is a sure thing. There is no way to predict what will happen next week, let alone several years from now. But of this we are certain: Financially healthy practices are good investments, now and in the long term.

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