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Veterinary Transition Partners

Custom Veterinary Transitions & Valuations

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This paper will give you a large amount of information on what is occurring in the veterinary practice sale market today, and I look forward to potentially working with you to create a customized transition. Please also note that 90% of my work is corporate transactions, and while we will do planning work on sales to associates or other veterinarians, the bulk of the transaction and valuation material discussed will reference current veterinary corporate sales. Because I do much tax deferral work on veterinary transactions, and tax issues usually arise in larger transactions, most of these transactions are corporate, thus the primary focus of this discussion.

In most situations and potential transactions, customizing would be potentially helpful. Basically, the goal for any seller in a sale transaction is to find "the right buyer, at the right price and the right terms."

- "Right price" is self-explanatory, and routinely we see sellers take offers that are not the highest, because the fit and the terms are better with other offers. Our job is to think about all of those in advance of pricing, to come to some conclusions as to what you might like to see in a transaction (based upon your particular situation and needs), and then ask for them from a buyer in a reasonable and acceptable manner.

- The "right buyer" is the company that is going to fit best with your current business model, doctors, clients, staff, culture, and many other things. It also addresses what might change with a new owner, including computer systems, laboratory systems, vendors, branding, website, social media, and many other things.

- The "right terms" are more subjective, but definitely include terms of you and your other doctors' employment agreements, staff and doctor benefits, differing partner terms (if needed), future growth and revenue participation for doctors and staff, real estate lease or purchase (and associated terms), contract holdbacks (amount of purchase price reserved from initial payment to cover contingencies), earn outs (future profit participation for fast-growing practices), joint venture terms (if desired), private equity access (if desired), and multiple other items.

These obviously will vary from company to company, and the goal is to find the best mix of terms, pricing, and fit. What I am certain you will find interesting is, just as there is a lot of variation among veterinary clinics, there also is a lot of variation from company to company. You also need to include your personal needs in the consideration. <u>A transaction typically combines business and personal exit planning, retirement planning, tax planning, and estate planning all wrapped into one.</u> Practically speaking, you should be doing this along the way, but this transaction takes it to another level as it is so material to future outcomes for you, as well as your family, staff and clients.

PRICING

Pricing is the easy thing to discuss on these transactions, so we will begin with that and then work on to additional customization of the transaction. In the current market for corporate transitions, pricing drives from two variables, EBITDA and the multiple of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).

EBITDA simply relates back to how well you are managing for profitability. Generally, the earnings that we see for tax purposes are not the normalized EBITDA, because of the amount of personal/family income or one-time expenses in the company that a potential purchaser would not assume. Ultimately, we look to what a purchaser would have to pay in the way of salaries for appropriately-compensated professionals (based upon production and need), and which current expenses might not be assumed by a purchaser to reach the normalized EBITDA number, rather than one generated for tax purposes with optional quasi-business expenses. This is a reasonably straightforward process and will obviously influence what can be paid for the practice, and the most recent 12-months numbers will be the most important.

The significant factor in today's market is the multiple of EBITDA a company will pay for an individual or a group of practices. We have seen multiple numbers vary widely across the board, as it is negotiable! Obviously, multiples for larger practices, or groups of practices, have been higher than multiples for smaller practices.

As I'm sure you know, the historical valuation multiple (based on an appraisal perspective) has been 4-5.5X EBITDA. Many of the recent corporate sales have been between 6X and 8X EBITDA. In the last 12 to 24 months, for larger practices we have seen up to 9-10X, and for the extremely large practices or groups, we have seen aggressive multiples approaching 11-12X EBITDA.

To get in those higher numbers, you generally need to bring to the table around $5-$10M of EBITDA, or $20M+ of gross income. Recently, there has also been “pooling” of individual practices into a bigger group and offering the group to some of the companies interested in a group acquisition. Our groups have had multiples of 10-13X EBITDA for unrelated practices, which is significantly above what can usually be done on an individual basis (other than very large practices).

As you can see, it is quite a wide spread from appraisal to actual transactional price, and the more EBITDA you can bring to the table in a possible transaction, the better multiple you will likely get. For some perspective, of 80+ practice sales in the last three years, we have seen only a couple of individual sales that hit 200% of gross as a sale price; more typically we have seen values of approximately 125%-175% of gross on *individual* corporate sales. Recent *group* transactions have averaged 250% of gross as practice sale price and over 10 times EBITDA. Size is a significant factor, as smaller practices may average 9-10X EBITDA and very large practices may hit 11-12X EBITDA. As you can see, price is a direct reflection of EBITDA times the multiple. Because larger practices are typically more profitable, smaller practices may push 200% of gross as a value and larger practices could easily exceed 300% of gross. These are all generalizations.

TERMS

The corollary piece which go with pricing considerations are the terms. There are so many variables to consider that it can be extremely confusing (but also individually important) to customize. Obviously, you can simply have a cash sale and exit ownership entirely. That being said, many owners want to continue some business participation via future profit sharing in the business. In particular, when there are multiple partners to consider, or associates who would like to buy in, exit timelines could easily vary with different parts of the practices being sold at different times.

What we have been able to do in these situations is several different things. The simplest approach is a partial sale of the practice, with the owner (or partner) retaining a portion and having a guaranteed buyout price (typically a multiple of future EBITDA) at a defined time in the future. A similar approach to this, which has had significant appeal and discussion lately, is divesting the entire practice with a tax-free rollup of a portion of the practice proceeds into the private equity entity which is purchasing the practice (the majority of the purchase would be for cash). This basically allows the veterinary owner to exit entirely, but also allows an investment of a portion of the proceeds on a tax-free basis in the veterinary private equity entity. This is being offered extensively in the market now, and we have done substantial analysis on many of the companies and their offerings, also integrating the suitability for the individual doctors who are considering investing (based upon their financial situation). This needs to be an appropriate investment for a seller (who may be in retirement), and *significant due diligence* needs to be done on the operating and profit terms of the entity which owns the practices. For more information, please request my Veterinary Private Equity Summary.

While many of these veterinary companies profess their equity is appropriate for everybody, and the best veterinary investment available, I would beg to differ on both the amount that should be rolled over and whether it should be rolled over (due to the financial situation of the company or terms of the pooled entity). All of these veterinary companies are significantly leveraged, and have a majority private equity backer that basically rules the roost, so any contributor is along for the ride (i.e. you should know exactly what you're getting yourself into).

Some of the more interesting transaction terms are the other situations which we have been able to customize.

- Some sellers and companies will finance for associates to buy in at the same time they are purchasing, possibly with nonrecourse debt to the associates. This is basically a gift, can be a potential boon to the associates, and aligns the interest of the joint venture partner, company and the associates. Offering this has also been extremely helpful for sellers who have associates who would like to buy in, but don't want to sell at the lower sale price that would generally occur with the sale to associates (versus corporate pricing).
- We have also been able to craft transactions where there is a defined exit price for a portion of the practice now, with the seller retaining up to 49% of the practice and having the right to tag along with the private equity at a future sale (and receive a similar multiple of EBITDA on their retained portion as the private equity entity is receiving for its equity at the future sale of the company. Historically these company sales have been 17-19X earnings, with recent minority recapitalizations between 13-17X. While hospital lover valuations are slightly lower (2-4X), this is an extremely attractive situation because it allows the owner to take some chips off the table at a very attractive valuation, continue to receive their portion of the income on the practice for another 2 to 5 years, and then exit the remainder approaching a corporate valuation instead of an individual or group practice valuation (which could easily be another 30%-50% higher). This also works quite well for associates desiring ownership. This is something which has proven to be more attractive going forward for bigger practices or groups. This also has great potential to fit with some estate plans to facilitate passing some future income or growth to your heirs (rather than retaining to be subject to estate tax), which is more individualized planning.

BUYER

The right buyer is material to the discussion, as ultimately, even if you get the right price and the right terms, you also need to have the right fit. This is a critical piece and goes to how a specific buyer will fit with the character of your practice. Ultimately, a buyer may change your branding, computer system, laboratory system, vendors, pricing, benefits, and many other items which provide the current comfort zone for you and your employees. Change in these areas will happen but is not comfortable, no matter who your buyer is. We have tried to collate transition information on the majority of the buyers so you can understand exactly what will occur in these areas, but realize that we are looking for the buyer which is the best fit with how you operate. We usually find many times that the last little bit of price (especially at the currently high valuations) matters not as much as the terms or the fit of the buyer, as over 50% of our transactions do not go to the highest priced offer, but rather the offer with the best combination of price, terms, and fit.

TAXES

If we do a respectable job in creating value at the time of transition, another key consideration is taxes on the practice sale. We are doing a large number of tax-deferred transactions currently through family LLCs and trusts. Ask for our handout entitled "Business Transition Tax Considerations" to explore further. There is a reasonable opportunity to defer taxes at the time of the transaction, or to set up family entities in advance of the transaction that will spread the taxes over multiple generations.

This is simply good personal planning and needs to be done on an individual basis, and is more beneficial the higher your state tax rate is. Tax deferred planning simply makes sense and will include all types of planning from joint venture retention to private equity contribution to installment sales. Ultimately this may provide 25 – 50% more income than a comparable taxable cash sale. Since (other than valuation) taxes are the biggest surprise on a sale, to further evaluate early in the process we will ask your CPA for a tax estimate for your sale (based upon estimated numbers I can provide), as this is material to appropriate sale planning and any personal financial decisions you make.

Getting past the actual transition, we have been able to craft very customized terms inside of employment agreements and leases (if the real estate is owned by the seller). Employment terms are definitely variable, and many sellers who are big producers will have a longer required employment timeline, so its material to start this process earlier. In addition, many sellers are also the owners of the real estate, and the terms of the future lease are extremely critical, since this will be your future commercial real estate investment for retirement, not your veterinary hospital building.

The bottom line is there is a lot of competition in the market, and if you take the time to figure out exactly what you would like in an exit plan, many times you can achieve that plan if you know what to ask for. What I see happening in the market today is (1) many of the sellers are not fully aware of valuations in the current corporate market, (2) sellers are not sure how flexible companies can be related to various terms, and (3) sellers don't know enough about private equity investing to fully evaluate what they are investing in. The goal is to look at each owner on an individual basis and see what the practice transition is supposed to do for them, and then negotiate the best terms and price with the company they would like to marry. It takes a little bit longer, but definitely gets more customized and appropriate transactions.

THE PROCESS

What I initially do with most clients is look at their business numbers and their personal numbers to make sure a transaction fits from both perspectives. We want to look at the business to make sure the profit is at a reasonable level to consider a sale, and to get some familiarity with your financial reporting to make sure it conforms with what buyers expect to see. From a personal perspective, we typically look at your personal financial situation to ensure retirement readiness, since your income is likely to be changing significantly. Since we integrate the sale with personal financial planning and tax planning, this is simply to ensure that what we are recommending for you on your practice side is doing the appropriate things for you on the personal side. Both should be in sync to consider a sale, as the potential terms of the sale (especially if there is any tax mitigation, joint venture, earn out, or private equity participation) may influence your personal situation years into the future.

Initially we review the last two years' profit and loss statements on the business. I will also discuss whether this fits with your personal and financial plan. We would perform an eValuation for you as to your practice value on a corporate transaction. After review I can give you a quick summary as to whether both business and personal situation are prepared, followed by any areas about which I might have concerns and an estimated sale price for discussion with your CPA. Ultimately if you are ready to proceed with marketing the practice, we will also discuss whether you might fit with one of our group transactions, as that would likely add 10-30% to your sale price (but potentially decrease your company selection versus marketing individually).

While I know this is a lot of information, I wanted to give you our views on the market and how we work with clients. Most of what I do initially is a discussion of your goals, in combination with your personal & business snapshot, and then discuss options. We invest a little time for us to get educated about each other and about the market, so then educated decisions can be made.

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