The Be-All, End-All on Practice Valuation

Before we get too mired in the details of practice valuation, I want you to do something, real quick.

- If you're selling your practice:

  Off the top of your head, what do you feel your practice is worth? What do you think you deserve?

- If you're considering buying a practice:

  Knowing what you know, what does you gut say the practice is worth? Not "how much can I afford," but how much do you believe it is worth?

Keep those numbers handy as you read through this article.

As you research medical practice valuation, you are likely to find that there are a number of "experts" out there who will tell you that they have a formula they use related to your income and expenses, and they may try to make the process opaque. They'll tell you that they have special certifications and patented methods that they would be happy to reveal and print up and put in a binder with your picture on it after you pay them a retainer.

But let's get right to the point:

> The true value of a practice is not the amount you think it is worth, nor the amount someone tells you it's worth based on gross, net, multipliers and the like. Rather, it's how much someone is willing to pay.

Practice Valuation Methods

There are many methods to consider in fleshing out the value of your practice. Some of the most common include:

<u>Using a Multiplier, or The "Rule of Thumb" Method</u>
Years ago, I ran and later sold one of the first medical billing and practice management software companies. At the time of the sale, there was this idea that one could value a company at anywhere from 1.5 to 3x the gross annual revenue of the business. And that's what we did. That 1.5-3x is the multiplier.

When it comes to medical practices, ten or fifteen years ago, the "rule of thumb" was that the value of a practice was 1.5-2 x revenues. But, given large-scale changes in healthcare, medical billing, back office costs, more physicians working in groups rather than solo practices, and a host of other causes, most practices tend to be sold for a price at or below their annual revenues.

The Market Approach

This is a lot like the way a house is sold: You compare your practice to what other similar practices in your area and of a similar size have sold for. You find "comparables" (comps). The thing is, there is no generally recognized source of medical practice comps. The exception to this is where selling a building is concerned. *When* selling a practice along with ownership of the office itself, we have very specific ways of valuating each, together and separately, and we'd be happy to discuss these methods with *you.*

The Income Approach

This income approach values the business based on the underlying asset plus the income it produces after expenses. So, again, with the house example, if you owned a house worth $100,000, but it rented at $5,000/mo, the asset (the house) is worth more than its base value of $100,000 because it also generates $5,000 per month. The higher the income stream, the more valuable the house becomes, and future earning potential (which really is goodwill) becomes part of the equation for valuating it.

While this seems an obvious, positive approach, in reality, it usually doesn't pencil out for medical practices, as the income from a practice is produced only at the time the practitioner performs the service, and is usually taken home as "profit" as soon as it's paid. There is no additional, residual, passive income generation from most medical practices.

The Asset Approach

This is the tact we most often prefer to take. It allows asset classes (tangible, intangible, goodwill) to be clearly separated out and assessed, and it also helps in the final accounting come tax time, as buyer and seller can divide up what assets are taxes in what manner. I'll go into more detail about what goes into the Asset Approach below.

More formally, this breaks down into the following subjects to consider in an evaluation of the practice's selling price. How much are the following worth?

Tangible Assets are the "stuff" in the office. The furniture, fixtures, medical equipment. Even the decorations, books, chairs in the waiting room. Whatever objects and equipment the seller intends to let go as part of the sale. As a seller, you would quite literally go through the whole office(s) and itemize everything. (The itemization of these assets has a significant tax implications. When I sold my practice, I was advised by my accountant to price each asset as if I would be selling it in a garage sale, not so much based on "what I thought it was worth." We highly recommend you speak with an accountant as well.)

Revenue is the amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income. How much does the practice bring in before expenses? For this number, most buyers will want to see consistency of both revenue and accounts receivable

Accounts receivable refers to the outstanding invoices a company has or the money the company is owed from its clients. The phrase refers to accounts a business has a right to receive because it has delivered a product or service.

Net Income is basically the business's profit, the amount left over when you subtract expenses and operating costs from revenue. Revenue minus Expenses = Net Income (Profit).

How you show expenses is a subject that gets a lot of attention. Assuming you are using some kind of finance software such as Quickbooks or somesuch, you should be able to generate a profit and loss / income vs. expense report. Better still if you can do this for the past several years. This way, a potential buyer can see the consistency of expenses and income.

The thing is, many of us have expenses that a buyer may not be inheriting, such as certain staff, equipment expenses, and stuff like continuing education that is put against the revenue for the purpose of reducing one's tax burden.

What's more, the numbers on one's tax return may not match up with the profit and loss statement. And, while we expressly do not advocate this, there are some businesses that do not report cash payments from patients. This presents complications as, in the end, a seller will want to show maximum net income (profit after expenses) and minimum expenses. Thus you may need to set up a theoretical profit and loss statement for a potential buyer that shows expenses they would be inheriting, leaving out the expenses they would not need to keep in order to keep the business humming along.

Dealing with these kinds of complications are what our consulting arm specializes in. If you're wondering how to rectify differences between your tax returns and profit and loss statements, give us a free call.

Goodwill

As one popular finance website (Investopedia) puts it, "The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill."

To further clarify, I'd add to this the value of your website, phone number, and any other intellectual property such as parked web domains your practice owns. It also includes your business's history, online reputation, and even its location.

Think about the goodwill of Nike, for instance. It's been around for decades, has a reputation for its technology and functionality where athletic clothing is concerned, a huge number of trained employees around the world, and a logo that most people recognize without needing to even see the word "Nike." This is all goodwill.

Now imagine that someone wants to create a new brand of athletic clothing to compete with Nike. They won't just be competing on the quality of their clothing; the hardest part may be going up against the goodwill of Nike. And if they wanted to buy Nike, the whole company, the value of Nike's goodwill would represent much more than their tangible assets—it would have to include the company's goodwill.

Just as a lot of goodwill is a barrier to entry for competition, and an asset for a buyer to inherit, it can also be an impediment to a sale if valued too highly. When Facebook first started getting popular, Yahoo, Viacom and others offered well over $1 billion for it long before it started to be a profitable company. As we now know, those offers were turned down. And now, at the time of this writing, Facebook is said to be worth half a trillion dollars. Too high a valuation for anyone to afford!

So while you may not be selling a practice that equates with the goodwill of a Nike or Facebook, you will need to be careful that you don't price your goodwill (and practice) higher than the market could possibly bear.

> Goodwill only exists and is determined when a business and/or its stock is being considered for sale. Otherwise, it doesn't really exist.

<u>Calculating Goodwill</u>

Given that goodwill is intangible (not a real thing you can objectively see or touch), it is often the part of the valuation equation that is most difficult to calculate. That said, with the sale of a medical practice, in the final analysis, it often accounts for the largest amount of the value of the business. This is something we specialize in figuring out, and we'd be happy to go through some scenarios with you.

These days, buyers are paying less for goodwill and basing most of the value of the practice on past numbers and perception of being able to continue or increase profit.

As you go through the subjects of your assets, revenue, goodwill, etc., keep in mind that the value of your practice will always be rooted in the specifics of the business aspects of your practice. In our experience, the way to give a buyer the greatest confidence that they will be able to replicate the seller's success (and retain its goodwill) is to put incentives in place to minimize attrition, as well as show that the practice can make even more through a few simple tweaks.

The "how to" of reducing attrition and maximizing and increasing potential future earnings for the buyer are subjects we love talking about, and we'd be happy to share some of our ideas with you.

Other Factors in Your Valuation

<u>The Economy</u>

Regardless of how or how much you calculate your business to be worth, the state of the economy will impact your final price and how easy it is to sell. I don't think I need to go into too much detail about why—quite obvious, this one.

<u>Terms</u>

The terms of payment you are willing to agree to as a buyer or seller will certainly have an impact on the final price. While the dream is to have your asking price paid in cash upfront, the reality in most cases is that it will be partially or wholly financed. The terms of the financing may help determine the price, as a motivated seller may agree to a discount in exchange for more cash at the time the sales contract is signed, or for a year or two of monthly payments instead of four or five years. As a seller, paying in installments may also benefit you from a tax perspective. And as a buyer, interest on a loan may also be a write-off. More on taxes below…

<u>Tax Considerations</u>

The way you justify your price will usually break down into the asset classes listed above, and the IRS has different ways of handling each. (Reference my article on tax considerations.) The amounts allocated to tangible assets, goodwill, and even a non-compete can all significantly impact the amount left in your pocket when all is said and done. For instance, in an asset sale, a buyer will usually want to max out on tangible assets they are buying as a percentage of the total value of a practice for tax reasons, whereas a seller will want to put more weight into goodwill. I won't go into great detail on the reasons why here, as I am not a tax professional. So when you get serious, find a good one. If you need help finding one, drop us a line.

<u>Timing</u>

The way a sale is timed can have a major impact on its valuation and final sale price. We recently helped a woman sell her acupuncture practice for about 1/10 of our assessment of its value due to her personal situation. While the business had been doing well for several years, her husband had just been informed that he was being transferred to another location in 6 weeks. She and her family had to relocate in that time span, and thus needed to sell as quickly as possible for whatever she could get. She was thankful to find a buyer at all, given the circumstances.

In another case, a large and very profitable complementary medical practice in the Bay Area suddenly had to shudder its doors when its owner and lead practitioner took ill and died three weeks after his diagnosis. His wife has been left to pick up the pieces, selling off each part of the practice as she is able.

While the above stories are extremes, the bottom line is that, the longer you have to prepare your practice for sale without a hard deadline, the more likely you are to get close to your ideal asking price. We are aware of many unique ways of preparing a practice for sale, and would be happy to help!

The Dangers of Overpricing

Think about selling something simple, like a bike. I recently had one on Craigslist. I had bought it for about $800, and a year later, after not having ridden it much, I tried to sell it for $599. Fortunately, Craigslist shoppers are a haughty bunch, and I was immediately assuaged by people telling me it was overpriced. So I had to keep lowering it until someone would take if off my hands ($380, if you're curious. Ouch.).

Of course, selling a complex business like a medical practice is a much more complicated proposition, and there's a lot more at stake. There are many reasons why you want to be sure to figure out a value for your practice that will drive demand rather than sit there and stale out on the market. Unlike an object on Craigslist, if a practice is overpriced, a seller will not necessarily be able to keep lowering the price until it sells.

Many professional appraisers like to compare themselves to appraisers of houses, so let's use that as a more a propos example. Much like a house, once you set your desired price, the marketing begins. Someone looking for a house like yours will see it when it gets listed, and their curiosity will extend only as far as their ability to afford it, and perhaps even more importantly, their feeling that it is worth the amount being asked for it. Anyone who has bought a home knows that, when you see a home advertised that appears to be what you're looking for, but has been on the market a long time and the price keeps going down… you'll think something must be wrong with it. It's shopworn. As a buyer, you'll either stay away from it, or lowball the hell out of it on the assumption that, by now, the seller must be desperate to sell.

At the beginning of this post, I asked that you pick a number quickly off the top of your head for what you feel the practice you are considering buying or selling is worth. Return to that number now that you have read this far. How does that number look and feel now? Still seem reasonable? Has it changed at all in light of the information you have taken in?

In the end, there are no set rules, only agreements. (quote) Price your practice in a way that it will lead to a sale, based on defensible assumptions. After all the work you've put into preparing your practice for sale, all the stress of talking to the relevant stakeholders, and planning your post-practice life, it could all be for naught if you stumble on this first, critical step.

In the final analysis, there are many ways to determine the value of a medical practice, and however complicated the analyses may appear, they usually boil down to the most important things that any buyer will be considering. (set this apart in its own content box) If you are interested in buying a practice, you want to be sure that it has a steady income, is profitable, and has a great reputation. Even more fundamentally, that in purchasing the practice, you will make money, and have the opportunity to continue to do so.

If you have questions about how to do this or want some assistance figuring out what a practice is worth, we're here to help. Reach out and let us know where you're at, and we'll be happy to share our knowledge with you.

In Summary

- There is no magic formula for practice valuation.
- We believe the Asset Valuation Method to be most appropriate for valuing a medical practice.
- Have a trusted accountant check your asset allocations before you sign a sales contract.
- Be careful not to overprice your practice so it does not get shopworn.
- The longer you have to make critical decisions around your practice valuation, the more likely you are to get a good price.
- The terms of your deal are a major negotiating point and can have a big impact on the final sales price of a practice.

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(Continued)

<u>Action Items for Sellers</u>

- List and value your tangible and intangible assets.

- See if there have been any recent sales in your area with which you can compare prices.

- Figure out ways that a buyer could increase their revenue if they wished.
- Consider whether the sales price and terms would allow a buyer to make a living from the outset of the purchase.

- Find a trusted accountant to go over final terms and their tax consequences with you.

We can help with any or all of the above. Simply reach out to us and let us know what kind of help you are looking for. The first call is free!