Starting out or winding down: How to value a practice

Daniel A Peters MD MBA FRCSC¹, Douglas R McKay MD MBA FRCSC²

Every time we attend the chief resident review course, we are asked about how to start a practice. There are all sorts of questions surrounding geography, practice type and academic requirements. One question, however, appears to come up over and over again: Should I start my own practice or should I join a more senior partner?

In many instances, colleagues seeking to transition a practice court young graduates. Younger surgeons may enter into a financial arrangement in which they 'buy' the practice. The details differ among cases, but the basic question from the young surgeons is always the same: How do I know how much to pay for someone's practice? Younger surgeons do not know whether they should financially invest, and established surgeons do not know what their practice is worth. This led us to explore the question of how to value a practice in plastic surgery?

VALUATION METHODS

We've all thought about this problem. Every surgeon has either been involved in these types of transactions or has discussed them.

The most commonly used method is intuitive. A surgeon looks at their 'patient list'. This method argues that a practice is worth the number of patients that can be transferred to the care of a younger surgeon. The argument in this case is that cosmetic patients continue to patronize the same practice. By acquiring the mature practice, the young surgeon gains access to a continuous stream of patronage. Another method is location based. Breaking into competitive geographical markets can be challenging and, sometimes, acquisition is the only means to break in. In some cases, senior surgeons control hospital privileges. In this scenario, established surgeons permit younger surgeons to enter the market only with a financial payment. The valuation in this case is the cost of circumventing a barrier to entry.

While these methods are valid, more rigorous alternatives exist. These formalize financial analysis. We gain insight into where value lies in a practice. More importantly, such analysis may offer insight into why some people pay too much and some people sell for too little. There is no question that mistakes can be made on both sides of this transaction.

Free cash-flow valuation

In this method, a business is treated like an annuity. This is a series of payments that are distributed on an annualized basis. To take the simplest example, consider the following scenario: A bond makes a payment of \$10 per year for the next 10 years. What is the value of that bond? A simple financial calculation would be required. The value of that bond is the value of $\$10 \times 10 \text{ years} = \100 ; however, it's not that simple. A payment of \$10 payable one year from now is not the same as \$10 payable today. It is worth less because you need to wait one year to receive the payment. The further out the payment is made, the lower it's value today. This is a concept termed present value. Therefore, the true value of that bond is the sum of \$10 payable in one year plus \$10 payable in two years, etc. There are simple annuity calculations that can determine the present value of a bond with a defined payment.

In the case of a plastic surgery practice, one performs a similar calculation. The question is which financial parameter is most important in determining the annualized payment. The most commonly used is an item on the income statement termed 'Earnings before Taxes, Depreciation and Amortization'. Basically, this is the total amount of profit that comes into the business before you pay your taxes and deduct noncash expenses. It requires that you project future cash flow by using forecasted financial statements.

The intrinsic method of valuation enables a young surgeon to think of a practice as buying a cash-flow stream. The value of the business is the value of the profit discounted for present value. In most cases, we stop at seven years because payments beyond this point face significant uncertainty. Sometimes a terminal value is added to this calculation.

Industry multiples valuation

This valuation requires a similar calculation of cash flow but does not require the complexity of discounting to present value. Many securities analysts are suspicious of the forecasted financial statements required to make predictions about future cash flow. They rely only on the present cash flow of the business and then compare that business with competitors in the same market.

Consider a software company that is earning an annual profit of \$1 million (M). The company may argue that they expect profits to grow by 20% annually. Using the above calculations, one would value the company at \$1M payable in one year, \$1.2M payable in two years, etc. However, if this growth never materializes, one would grossly overvalue the company.

The multiples method averages this uncertainty by comparing that company with its industry competitors. This method would say that software companies are worth some multiple of its cash flow. You may have heard someone say that a company is trading at five times earnings. That means that the company is worth five times its annual earnings. Otherwise stated, the company is trading at a multiple of five.

While we do not have data for these multiples for plastic surgical practice in Canada, some data do exist in the United States. These data are not reliable at present because most companies are not publicly traded. We mention this method here as a method of checking the price. If you are buying a practice for a price that is a low multiple of earnings, you are likely getting a good deal. If you're selling a practice above three times your earnings, you're getting a very rich pension!

REALITY CHECK?

Can we really think of a plastic surgery practice as a series of cash payments? What about growth, new innovations, cost of equipment and mentorship? Some argue that a surgical practice is too diverse to be evaluated in this manner. While, we concur with these complexities, please consider that if the cash flow is uncertain and unclear, is that really the kind of business that merits a serious investment? One should at least recognize the inherent risk introduced by ignoring the income stream. Such a purchase should be supported by some other financial argument.

¹Division of Plastic Surgery, Department of Surgery and Telfer School of Management, University of Ottawa, Ottawa; ²Division of Plastic Surgery,

Department of Surgery, Queen's University, Kingston, Ontario

Correspondence: Dr Daniel A Peters, PO Box 213, 1053 Carling Avenue, Ottawa, Ontario K1Y 4E9. Telephone 613-798-5555 ext 13712, fax 613-761-4025, e-mail dannyeters1@gmail.com

Asset-based valuation

A practice in plastic surgery may be difficult to value on the basis of discounted cash flow. It may be impossible to determine how many patients will actually be transferred to the newer surgeon. The person selling this practice has a strong incentive to argue that all patients could be transferred, while the buyer will be skeptical. This will require some judgment and considerations of risk tolerance. To reduce this uncertainty, a more concrete measure of valuation can be incorporated – this is an asset-based valuation.

In this scenario, the business is only worth the value of its assets on the balance sheet. For those of you unaccustomed to looking at a balance sheet, this document contains all of the assets as liabilities of the business. Assets include items such as cash, accounts receivable, equipment and real estate. Liabilities generally include accounts payable, mortgages and loans. The difference between assets and liabilities represents the equity or market capitalization of the business. In an asset-based valuation, you can consider the market value of the assets and subtract the liabilities to determine what the business is worth. This is very effective for situations in which the practice owns a surgical facility, equipment or a specific government license.

The problem with this method relates to a problem known as 'goodwill'. If you examine the balance sheets of many major corporations, you will notice this item. It usually represents the value of the entire enterprise, beyond the value of its physical assets. A prime example of this is Google. Consider that Google owns a series of computers, real estate holdings, patents, software code and copyrights. Each of these has a specific value on the balance sheet. However, it is

also clear that by combining these assets in a specific way, Google's value as a corporation vastly exceeds the value of its assets measured individually. The difference between these two calculations represents goodwill. This is very difficult to determine for a surgical practice.

For practices with measurable assets, such a method of valuation can be very illuminating and can clarify the purchase price considerably. However, for many mature surgeons selling a practice, the only item being proffered is the fidelity of patients. The assumption that these patients will continue to patronize the heir apparent represents goodwill. The uncertainty of this relationship makes an asset-based valuation very challenging in these cases.

OK, BUT I STILL DON'T KNOW WHAT TO DO...

These are three methods for formalizing valuation. There are many other ways; some are intuitive and some require formalized analysis. The underlying theme, however, is that we need to consider what is being sought and what is being received. Too often, young surgeons just pay the asking price or mature surgeons 'sell' their practice for pennies on the dollar without understanding its value.

In the end, a practice is worth what everything else is worth: it is what someone is willing to pay for it. Three rules of thumb may emerge: first, we should consider the income stream; second, we should evaluate tangible assets; and finally, however, the most difficult parameter will always be the valuation of goodwill and an estimation of how many patients can actually be transferred to the protégé. This requires judgment and trust, and the evaluation of these is significantly more difficulty to quantify.