Collaborative Practice Models

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1. Introduction

There is an incredible flurry of corporation aggregators currently buying equine veterinary practices. At first these groups were focused on acquiring companion animal practices, but as more and more of the prime companion animal practices have been purchased they are turning their attention to other species. The acquisition of veterinary practices in North America is relatively new, but it has been going on for many years in Europe. Presently, 50% of companion animal veterinary practices in the UK and 60% of practices in Sweden are corporate owned.1 More recently consolidators are quickly buying practices of all species in the UK, Netherlands, and Germany. In North America, 25% of companion animal practices are expected to be corporate owned by 2023.2 Regardless of which region of the world is being targeted for corporate acquisitions, purchase amounts seem to be exceptionally high, and many veterinary practice owners wonder if they should jump in and be part of the bonanza of seemingly high valuations placed on practices. At the same time, selling a practice to an outside group can be the basis of many questions. Will things remain the same? Will the vets and staff be taken care of? Will our legacy be preserved? Most practice owners would prefer to sell to an associate, but the high load of student debt in the United States can often make a younger vet cautious about increasing their debt load to buy a practice. In addition, the purchase prices offered by consolidators are often far higher than what an associate could afford to pay. Many veterinary practice owners who previously thought they would never sell to a corporate aggregator are forcing practice owners to re-evaluate their opposition due to the absence of internal purchasers and the high price offered by these groups. Like any high stake transaction, it is helpful for practice owners to understand who they are selling to and if the promise of a high payout is actually what it seems to be. The purpose of this presentation will be to discuss the business model of these aggregators, why veterinary businesses are attractive to these corporate groups, determine if their offers to purchase are as lucrative as they appear to be and finally the pros and cons of selling to a corporate aggregator.

2. Business Models

There are three types of entities that are buying veterinary practices. The first are family owned private entities like Mars Inc, the owners of VCA, Blue Pearl, Banfield in North America and Anicura in Europe, and JAB Holdings, the investment vehicle for a German family that owns NVA, a large group of companion animal hospitals in North America, Australia, and New Zealand.2 The latter group has recently purchased many equine practices in North America over the past 2 years. Typically, they prefer to buy 51–100% of a practice so that they can have a controlling interest in the acquisition. These types of entities typically have a long vision for their portfolio companies and since they are privately owned do not need to respond to short term market forces facing public companies or private equity firms. Often, the
acquisition of veterinary hospitals is complementary to other assets. For example, Mars also owns Royal Canin prescription pet food as well as Sound/ Antech. The second type of aggregators are public companies that are listed on stock exchanges. The largest of these groups is CVS Group PLC based in the United Kingdom. They own over 480 practices and over the past 2 years have moved into the equine veterinary market. Like Mars Inc they have a diverse animal health care portfolio that includes diagnostic laboratories, crematoriums, and e-commerce. Like other public companies, it has to answer to shareholders and their expectations for financial returns that ideally outperform the market. The final group of aggregators are private equity firms. Their basic business model is to collect a fund of money from investors in order to buy a business, or group of businesses, and then sell them within 4-6 years for a much higher value than the original purchase value.3,4 Investors in a private equity fund can range from high net worth individuals to institutional investors like pension funds, hedge funds and insurance companies. The private equity company will identify a business or industry that is poorly managed or has undervalued assets. They develop a business case that tells these investors that they can acquire these assets and with proper management or consolidation of a portion of industry can sell them within 4-6 years for a far larger sum. In other words, they do an excellent job of buying at a low price and selling at a much higher value. Private equity acquisitions are often financed through debt. They do this by using a portion of the invested fund to make some purchases and then rely on debt to acquire the rest of the targeted businesses. The debt is held by the acquired companies and not the private equity company. In the case of financial difficulty or bankruptcies, the acquired businesses are liable for debt repayments. This was more pronounced years ago and was responsible for the bad reputation associated with private equity companies. Many business analysts think the downfall of Toys R’ Us was related to the enormous debt burden placed on it by a private equity firm. It left the company cash starved and unable to compete against the likes of Amazon since any excess profits were used to pay back their debt.5 The other relevant aspect about private equity firms is how they are compensated. Typically, they charge the fund 2% of revenue annually and receive 20% of the profit from the sale. In the case of vet practices that collectively gross $40,000,000 annually and are sold for $80,000,000, they would receive $800,000 annually as a management fee and 20% or $8,000,000 of the excess profit of $40,000,000 when they sell. In practice this means the private equity managers are incentivized to maximize revenue, through acquiring more businesses or raising prices and maximizing profitability through a combination of increased prices charged to the end user and minimizing expenses. A critical aspect to consider of the private equity business model is that to accomplish their end goal of selling their businesses for a higher value, they are actively working to sell their portfolio of veterinary practices to another company. The first 1-3 years of their plan will often be to acquire as many practices as possible. They will then spend years 4 and 5 nurturing these companies to increase revenue and profitability and then by year 6 sell the practices at a maximum value. The timeline may be a bit shorter or longer, but ideally the funds they are working with have a finite life span in order to get the expected returns. Private corporate groups will have a much longer horizon for their holdings and may keep them for decades, or until a more promising investment opportunity occurs. At such a time they will restructure their portfolios by selling some assets to finance the acquisitions for their new focus. Unlike private companies like Mars Inc and Jap Holdings Inc, acquirers of veterinary practices that are listed on stock exchanges or are private equity firms are in the business of maximizing shareholder value. Compensation of these companies are often dependent on meeting or exceeding market expectations, or what promised investors.

3. The Allure of Equine Veterinary Practices to Consolidators

Now that we know about the business model of the main types of companies buying veterinary practices, the obvious question is why are they so attracted to the veterinary industry? The simple answer is that veterinary practices are relatively recession proof and offer financial returns that are far higher than conventional investments like bonds, or equities in the stock market. In other words, veterinary practices are low risk vehicles that carry high financial returns. This is the goal for any investor. Fundamentally, these groups are buying future cash flows of a business. This is primarily determined by the EBITDA of a company, or earnings before interest, taxes, depreciation, and amortization. The latter two items are accounting terms that refer to how a business will spread the cost over time of large purchases, like digital radiology systems or leasehold improvements. According to a financial overview of 24 equine veterinary practices,6 the average EBITDA was 12.7%. This means if a practice has revenue of $1,000,000, they would have an EBITDA of $127,000. One way that veterinary practices are valued for sale is to determine the average normalized EBITDA over the previous three years. A normalized EBITDA accounts for situations where certain business expenses or revenues that are not directly related to the operation of the business for sale are added or deducted from EBITDA. To ensure that their investment in the future cash flows of company is secured, the buyer will assess how risky the investment could be. For example, a practice with three plus veterinarians with a broad range
of clients spread over a number of veterinarians is a safer investment than a one-veterinarian practice. Once the single veterinarian leaves the practice, there is a very good chance the clients would leave too. There is a greater chance that if one of the veterinarians left the multi-practitioner practice that the loss of clients would be minimal, thus the latter situation is a safer investment. Valuations of a practice will often include a multiplier that is directly related to the risk involved in purchasing future cash flows. It reflects the ability to recoup the investment on a yearly basis. The one veterinarian practice would have a multiplier of 1 or less indicating that the risk is high. The multi-veterinarian practice could have a multiple of 4 or 5 because there is less risk, and the buyer feels confident that their investment could be recouped in 4-5 years. Currently, corporate consolidators are using a multiple of between 6-10 EBITDA when purchasing lower risk large group practices. If they are planning on selling in 4-6 years, why are they paying a rate when they won’t see their return in 6-10 years? The answer is simple, if they can aggregate a large number of practices, they reduce the risk even more and can sell to a larger aggregator for greater than double the multiple they initially paid for the original practices. If they bought numerous practices with a combined EBITDA of $20,000,000 and used a multiple of 8 they would buy the group of practices for $160,000,000 with the hope of selling the aggregate for at least 16 times multiple, or $320,000,000. Ideally, they would also improve the overall EBITDA during their ownership by 1-3%. Going back to the original EBITDA of $20,000,000 a 3% improvement by the time they sell again will give them an EBITDA of $20,600,000, which when multiplied by 16 gives a selling price of $329,000,000, a $9,000,000 improvement. In addition, a consolidator will be paid 20% of the final selling price above the initial purchase price. If there was no improvement in profitability, they would pocket 20% of $160,000,000 or $32,000,000 and if they improved profitability by 3% they would gain an extra $1,800,000 from the additional $9,000,000 selling price. There are conditions that are often applied by the buyer. They will want the selling veterinarians to stay on for 2-3 years to help with the transition to newer veterinarians. They will hold back 25-30% of the sale price and pay that once this period is over. Associated with this may be performance metrics that once reached in 2-3 years allows the seller to get a bonus on top of the initial selling price. Some buyers will insist that this 25-30% of the selling price be invested into the group of practices. The payback to the selling owners will be when the aggregate of practices is sold to the next buyer. This could be a substantial reward to the practice sellers if the new purchasers are willing to pay a much higher multiple of EBITDA. All of these are incorporated to mitigate risk for the buyer. They don’t want a practice owner to sell the practice and then start up a new business in the area and they want them invested in the success of their own practice, but also that of a combined group of practices. Finally, many corporate consolidators will welcome an associate that owns a small percentage of the practice to maintain their ownership at the time of the sale, but there is often wording in the sale agreement that when the group of practices are sold that the minority shareholders have to sell as well. We can see how the veterinary profession could be so attractive to corporate consolidators because of the low risk and high returns. The questions then arises if they are offering a fair price to selling veterinary practice owners.

4. Are the Prices Paid to Purchase Equine Veterinary Practices Sufficient?

The reality is that the high numbers that are being offered to practice sellers seem lucrative but don’t necessarily lead to a pot of gold. There is a very good financial argument that practice owners with more than a 5-year horizon before they want to sell would receive less overall compensation compared to what they would recoup if they sold in 5 years or more. Consider the scenario where a practice is sold today. Let’s say, for example, the practice is valued at $2.5 million. They will ask the sellers to stay on for 2-3 years to help with the transition to the new owners. For the three years, the past owners will get a veterinary salary, but afterwards they are living on the proceeds from the sale. They may get a 5-7% return on their investment if they are lucky, but they will also begin to draw down on their nest egg for living expenses. Not a bad life for someone entering their golden years. A just reward for all of the years they are offering a fair price to selling veterinary owners. For the three years, the past owners will get a 5-7% return on their investment if they are lucky, but they will also begin to draw down on their nest egg for living expenses. Not a bad life for someone entering their golden years. A just reward for all of the years they are offering a fair price to selling veterinary owners. For the three years, the past owners will get a 5-7% return on their investment if they are lucky, but they will also begin to draw down on their nest egg for living expenses. Not a bad life for someone entering their golden years. A just reward for all of the years they are offering a fair price to selling veterinary owners.
profit and salary over the 10 years plus the ultimate sale. Even practices that have been offered 15 times EBITDA, can earn more money by selling in 10 years at a much lower multiple of EBITDA. Here is the uncomfortable question we have to ask ourselves when a corporate aggregator comes knocking on our doors. If they are in the business of making money, what about our practices do they like? The simple answer is that they are buying low and selling high. It’s obvious that if someone is about to retire and can sell to one of these groups, they would be wise to take what is typically offered. But if their career has a longer horizon, it is much more profitable to hold on and reap the rewards down the road. One should ask, would you like $2,000,000 now or $5,000,000 in 10 years? Warren Buffet states “Investing is laying out money now to get more money back in the future.” If you own your own business, you just need to invest time to get more money in the future. Your business is working for you to maximize your investment. Just like rolling a snowball, it just keeps getting bigger and bigger.

5. Pros and Cons of Selling to a Consolidator

Money is not the only reason why someone would sell a practice. Many would value some of the management services a corporate group can offer or want the security of knowing their retirement is assured. Let’s review some of the pros and cons of selling to a corporate aggregator.

Pros
- Ability to sell in the absence of internal prospects
- Administrative support with accounts receivables and accounts payables
- Recruiting of new veterinarians and support staff
- Human resource support
- Marketing support
- Equipment purchasing support
- Peace of mind that the sellers can retire
- Potential bonus when shares held in overall group are sold

Cons
- Reduced overall compensation if owners want to practice for more than 5 years
- Resistance of veterinarians to work for corporate owners
- Lack of control over management
  - Prices
  - Equipment purchases
  - Employee compensation
- Risk that performance targets are not met resulting in a reduced purchase price
- Potential new practice owners in 4-6 years
- Potential conflict of interest between patient care and financial return to investors
- Potential loss if final sale price is lower than expected

6. Conclusion

Selling a veterinary practice is a major life event. Owning a practice reflects many years of risk and sacrifice from building a practice, the long-term care given to clients and their horses, a sense of community, and responsibility to all employees. The practice stands as a legacy of an owners’ dreams and ambitions. Selling to an outside corporate group is fraught with risks for both the seller and buyers. It is imperative that the seller recognize the business model of the purchaser to ensure that they are compatible with the legacy that is important with the sellers. The money received for the sale may or may not be sufficient depending on the seller’s situation. It could be a lifeline for those at the end of the career or insufficient for those who have a longer horizon. The main thing for all sellers to be aware of is that the goals of the corporate groups are not necessarily the same as a veterinary practice. While it is important for an aggregator to treat the practices they purchase well, at the end of the day, they are ultimately responsible to their investors. As veterinarians, our goal is to care for our patients. Yes, we need to be profitable, but it isn’t the only thing. An investor wants to be known for caring for their purchased practices, but their reputation and livelihood depends on fulfilling the needs of their investors. The trade off with selling to an aggregator is that the selling practice owners can receive fair financial compensation, but in return there is a loss of control. Ultimately, it is up to the seller to be aware of the business model of the purchaser so that they can recognize the potential benefits and disadvantages of working with the new owners and determine if the price offered is worth it, especially if the sellers want to continue practice for more than five years.

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Declaration of Ethics
The Author has adhered to the Principles of Veterinary Medical Ethics of the AVMA.

Conflict of Interest
The Author has no conflicts of interest.

References


