ADS®

Practice Transitions Made Perfect™

Newsletter Article Reprint

Avoiding a Tragic Transition

Roger K. Hill, ASA - ADS Carolinas

November 2010

A common deal-breaker for some practice transitions is a misunderstanding about determining practice value. The tragedy is that this need not occur if the issue is properly addressed.

Among the most common misconceptions about practice value is what percentage of a year's income is appropriate for determining value? It is very common to hear that the appropriate value is a standard, fixed percentage of a year's collections. This is a surefire prescription for heartache.

Suppose two practices have identical income and overhead rates, but vastly different amounts of (capital) equipment. On the other hand, suppose two practices have the same income and (capital) equipment, but vastly different overhead rates. Establishing the value of these practices using a single percentage will invariably lead to a faulty assumption in one, or both, of these events.

Instead, the most reliable way to establish the value of a practice is to first determine the intangible value, and add to this the value of the fixed assets, supplies and receivables (if applicable, such as with an orthodontic practice).

While determining the value of the tangible items is more of a mechanical process, the value of the intangibles is driven by the same factors that govern a purchase decision. For example, considerations such as location, growth rates, profitability, sufficiency of the facility and similar items are important in determining the intangible value, as well as making a decision to purchase. In short, the same set of variables that are important to a valuator are important to a purchaser.

The correctly determined value (i.e., the sum of the independently established tangible and intangible value) can then be divided by the practice collections, and stated as a percentage for purposes of convenience. However, applying the collections percentage without
first establishing the value of these two components will invariably be disadvantageous to either the seller or the purchaser.

Likewise (and this is no small item), a more reasoned approach using proven valuation methodology will carry more influence with a lender.

Understanding these key principles may well be the difference between success or failure in your practice transition.