Veterinary practice consolidation demystified

Why private equity investors pay so much for clinics

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Commentary

Ever since the two largest veterinary practice brands, Banfield Pet Hospital and VCA Inc., began to grow 25 to 30 years ago, veterinary practice in the United States has been moving toward consolidated ownership. The pace was sedate at first. Today, it seems as if there are consolidators big and small around every corner.

Collectively, they control more than 4,000 veterinary practices and roughly 36% of the small animal market by total revenue. The majority of consolidators are owned by wealthy family entities and private equity firms.

Mars Inc. is the single largest veterinary practice owner in the world. Its family members are the descendants of Frank Mars, the company founder. Everyone associates the privately held international Mars company with candy — M&Ms in particular — but it's pet-related investments that are driving Mars' spending growth.

Mars operates about 50 different pet-related brands. Its practice brands encompass more than 2,000 clinics and hospitals in the U.S. and Canada, and a few hundred more in Europe. You won't find the Mars name on its clinics. They operate under other brand names — most notably in the U.S., Banfield Pet Hospital, VCA and Blue Pearl. Clinics run by the Mars-owned consolidators Pet Partners and CAPNA do not sport a chain brand name; they are indistinguishable by name from independently owned clinics.

Apart from those owned by Mars, most veterinary clinic consolidators obtain capital from private equity firms. Such firms manage money for a variety of investors, including endowments, state pension funds, insurance companies and wealthy individuals. Private equity firms are tasked to buy businesses in all types of industries, help grow them, then sell them in three to seven years.

In the veterinary sector, equity firms expect to make money — what is called "return on investment," or ROI — through a cascade of events: The hospitals they own bring in profits, enabling them to buy still more hospitals, amassing greater overall profits. Ultimately, the private equity owner sells the group of hospitals for (it hopes) a higher price than it paid.

Some equity firms don't bother to operate hospitals for any length of time. They simply aggregate practices, then quickly attempt to sell the collection for a profit.

Private equity firms' goal is to beat the average long run and quarterly return of the stock market, which is approximately 7% percent per year. Overall, consolidated veterinary hospitals easily are meeting, and in many cases beating, that target. Returns of 20% or more are not uncommon.

Even during bad times, veterinary clinics do solid business. Writing in Forbes in May 2018, Deborah Balshem noted that during the last recession, the veterinary practice revenue was flat to 1% down. That's great compared with most other industries, revenues of which were down by 10% to 50%, according to Balshem's report.

Some private equity firms invest in multiple veterinary consolidators at once, or at different times. They typically do not rebrand hospitals they acquire, which means employees and clients typically do not know who actually owns the business.

Beyond wealthy family and private equity investors, a third source of money for consolidators are specialty, non-bank lenders that offer what amount to interest-only loans. Borrowers make monthly interest payments, paying little to nothing on principal. This gives them more money in hand with which to buy more practices. Because they've been making little dent in the principal, the only way for them to repay a specialty lender is by selling the practices or refinancing the loan by borrowing from another lender. Thus the game continues.

Examples of specialty non-bank lenders are Ares Capital, Bain Capital and Golub Capital. Golub in particular finances many veterinary practice consolidators and often takes a small ownership stake. Golub is a publicly traded company that discloses its investment details in public filings.

Some consolidators, typically smaller groups headed by veterinarians, do borrow money from banks, which make loans comparable to mortgages. In the conventional lending market, veterinary hospital loans are paid off evenly over 10 to 15 years. Many veterinarians own multiple hospitals and have ambitions of owning and operating more, usually in the communities where they live. They tend not to buy at the same pace as large consolidators.

Strategies for exiting practice, sooner or later

Selling to a consolidator is only one of many options that independent practice owners have when they're ready to move on. Here is a list of options developed by Veterinary Study Groups (VSG), from its Consolidation Counterpoint Initiative. VSG is the umbrella organization of Veterinary Management Groups, which are made up of independent clinic owners who support and learn from one another by sharing business best practices. VMG plans to assemble a "transitions team" of experts to assist any practice owner with a transition.

Most of the options are aimed at helping sellers make money comparable to that paid by consolidators, albeit not in a lump sum. Because practice set-ups differ, the options are not equally applicable to every situation.

1. Internal sale: Sell to an associate or partner.

2. Passive ownership/phased buyout: Sell over time, retaining partial equity at outset, with no management responsibilities.

3. Lease to own: Lease practice to prospective buyer, giving option to buy when lease expires.

4. Employee stock ownership plan: Provide employees with a means to gain ownership shares over time.

5. Consultancy: Receive part of purchase price in fees for medical or managerial consulting in practice operations.

6. Practice occupancy: Maintain ownership of real estate and charge buyer higher rent to offset a lower sale price.

7. Early-purchase option on real estate: Sell practice while temporarily maintaining ownership of real estate for rental income. If the buyer wishes to purchase the property sooner than the owner prefers to sell, agree to sell in exchange for a premium price.

8. Earn-out: Sell to an independent buyer for a base price, with the potential for further payment dependent on future financial performance.

9. Estate sale: Maintain ownership, management control and practice income for lifetime, perhaps retiring from clinical responsibilities with the help of an able staff and management team. Upon death, owner's estate arranges sale.

10. Merger: Combine with one or more practices to raise practices' value for a future sale.

11. Roll-up: Combine with multiple practices and operate under a central management structure without a legal merger.

12. External sale: Sell to an independent veterinarian outside of the practice.

13. Consolidation: Sell to a large corporate buyer.

Veterinary medicine isn't unique in consolidating, of course. In most industries, market structure moves toward fewer businesses with larger shares, as owners aspire to gain economies of size. From a business perspective, this is not a bad thing. The strategy brings owners higher returns on their investments through technological innovation, lower costs and improved efficiency.

For example, consolidators presumably can achieve technical economies of size through improved labor efficiency by eliminating duplicate services in marketing, finance, inventory management and human resource management. In lowering its operating costs by centralizing such services, the company can afford to lower its prices, thereby potentially gaining a larger share of the market.

Consolidators also can save money by purchasing products and services in bulk at discounted per-unit prices and through their greater ability to purchase cutting-edge technology that improves labor efficiency.

What is a veterinary practice worth?

The way private equity investors determine the value of a veterinary practice is markedly different from how the veterinary community — and most banks — value practices. That difference has created rich hunting grounds for equity investors.

Independent veterinary practice owners generally focus on earnings alone. Banks drive that focus by lending at five to 6½ times the annual earnings of the practice being purchased. Investors, by contrast, focus on returns on investment (ROI).

We are seeing private-equity firms willing to pay 10 times a hospital's earnings or more. Why? Because even at this price, they can exceed their desired ROI. Remember, their goal is to beat the stock market average return of 7% per year.

Let's run the numbers. Consider a practice bringing in $1 million in gross revenue that is generating 20% profit, or $200,000. Using the common valuation calculation of five times earnings, the practice is worth $1 million. Buying this practice at $1 million would yield to the purchaser an ROI of 20% ($200,000 earnings on a $1 million investment).

Meanwhile, an investor seeking to beat a 7% stock market return could afford to pay more than $2.8 million for the practice. That's because the practice's annual profit of $200,000 is 7% of $2.8 million. A purchase price of $2.8 million would be 14 times the practice's annual earnings.

If a private equity firm, whose entire existence is focused on getting above-average returns on its investment, is willing to pay in excess of 6½ times earnings, why are practice valuators sticking to an antiquated way of valuing practices? (I have attempted to determine the origin of banks' rule of thumb for valuing practices, but no one seems to know it.)

Another advantage some equity firms have over aspiring independent practice owners is that they're undistracted by a goal of improving the practice's financial condition. Rather, their goal is to aggregate practices to gain a higher multiple by selling many practices to another consolidator.

Outlook

Is the consolidator feeding frenzy a bubble? We hear this question a lot. Our answer is no. Of course, there are a lot of possibilities. If pet owners don't like the services of large corporate medicine, or they simply don't like the idea of large corporate practice, consolidated practices could lose market share, resulting in lower profits, which would reduce investors' ROI and lower the incentive for further consolidation. But in general, while not impossible, it is extremely difficult for new independent businesses to compete head-to-head with large corporations.

Under current trends, consolidation of veterinary practices will continue until just three or four companies control 60% or more of the market. Across industries, the number of dominant companies is in the range of three to six, with three or four being the usual. This has to do with the maximum concentration allowed before triggering antitrust litigation. Oligopolies of three or more rivals can still demonstrate to the government that price competition exists.

Though diminished, independent ownership will not be eliminated, at least not in the near-term. While consolidators focus on small animal private practices, there remain independent rural mixed animal, food animal, equine and community companion animal hospitals.

Corporate veterinary entities are run by boards whose members are some combination of veterinarians, former executives of professional veterinary organizations, Fortune 100 health-care executives, and equity investors. These boards, like those of most corporations, are responsible for managing the CEO, determining operational policies and setting financial performance expectations for the company.

Understanding that the boards have a responsibility to maximize return on investment, the main question for practitioners is: To what extent will this impact veterinary medical service guidelines and veterinarians' freedom to make the best health-care decisions for their patients?

Veterinarians commonly put medical decisions above financial decisions. At best, these two interests will be put on par under most consolidators' roofs.

How to compete with equity investors

Private equity firms are in the business of making money. If the veterinary profession is to maintain independent hospitals as the heart of the profession, independent owners must integrate the financial prowess of private equity firms with their unique practices that respond directly to the veterinary medical needs of their respective communities. And they must do both tasks while being the hospital of choice for new graduate practitioners.

Brewing a revolt

Consolidation isn't irreversible. Consider the beer industry.

The U.S. brewing industry began at the end of Prohibition, when small brewers came out of their basements to local pubs. Consolidation took hold after World War II. By 1983, six brewers controlled 92% of the market. Beer had become a commodity, and price competition among the major breweries fighting for market share drove community brewers out of business.

Reintroduction of small breweries as entertainment establishments followed the success of local wineries. Today, small craft breweries have nearly 20% of the market, and growing. Craft breweries have been successful in marketing an experience rather than a commodity, thereby avoiding direct competition with the big breweries.

Gary Miller, CEO of GEM Strategy Management and author of a column titled Seven expectations if you sell your business to a private equity firm, provides a detailed account of practices that business owners must employ to match the financial savvy of private equity firms.

- Build and maintain a balance sheet, a profit-and-loss statement (also called an income statement) and a cash flow statement.
- Study clientele to create a map of the market, sketching out its size, its growth rate, its products and client segments, to answer the following questions:

    - Has the business reached all client segments?
    - What is the business's track record in retaining clients?
    - Where can services be improved to grow sales, increase prices or cut costs?
    - Can the business grow faster than the market's overall rate of growth?
- Examine the competition's business strategies, operating costs, finances and technological sophistication, pricing, market share, revenues and profits, products and customer segments by geography.

Private equity firms make these sort of analyses before buying a practice, and annually thereafter. They constantly are looking for new opportunities to make more money. They might acquire more practices or sell some if they can do so at a profit.

One way hospital owners can keep their businesses independent is by recruiting and retaining veterinarians who wish to practice medicine independently and wish to make more money than standard associates, nurturing their skills and motivation, and ultimately transitioning ownership to them.

Independent veterinary practices that mimic private equity firms' financial prowess; that continue to provide veterinary medical services specific to their community; and that plan for succession will prove sustainable even in the onslaught of consolidation.

Next: Veterinary labor's wild swings

About the author: Michael Dicks, PhD, established the veterinary economics division of the American Veterinary Medical Association in 2013 and was its director until 2018. Dicks earned a BS in biochemistry and animal science from California Polytechnic State University, taught chemistry in the Peace Corps in Kenya, then completed master's and doctoral degrees in agricultural economics at the University of Missouri.