Randvard Animal Hospital Case Study

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In early 2021 Dr. Ajax was preparing to meet with consultants from Simmons Inc., a veterinary brokerage firm. Dr. Ajax owned two animal hospitals: Randvard and Boulevard Animal Hospitals. He had been planning to sell one of them for 7 years and decided to undertake a valuation in 2021. The meeting was scheduled, and Dr. Ajax planned to ask the consultants to value Randvard Animal Hospital under two different scenarios.

The Corporation:

Dr. Ajax owned and operated both the Boulevard and Randvard clinics as Boulevard-Randvard Animal Hospital PC Inc., an S corporation. As an S corporation, there are no income taxes for the corporation. All of the company's profit passes as income to Dr. Ajax, as the owner, and is added to his adjusted gross income and he pays the taxes on it as an individual.

Randvard has an 86-year tradition of innovation in animal science. It was founded in 1935 and run through WWII. At that time Randvard Farm was an operational Jersey only dairy farm. Jersey cows had the highest milk fat percentage. Customers loved the milk for its taste. The dairy pasteurized but did not homogenize the milk, which meant that the fat would come up to the top so customers could pour it off for cream. The dairy farm was also home to a dairy parlor and inn that not only made super-creamy ice cream, but also featured huge display windows where customers could watch one of the cleanest, most advanced milking parlors in the world. In 1965, Dr. Ajax's father, Dr. Ajax senior – also a veterinarian – bought Randvard Farm.

Dr. Ajax senior bought the farm for $100,000. He had wanted a farm for his boys, and he leveraged everything, including his home and his business, to buy the farm. He ran it for a year or two with the Jersey cows and was selling off the Jerseys for Holstein cows. He did this strategically because he recognized that although the Holsteins' milk was homogenized, it made more volume.

Dr. Ajax senior ran the farm until about 1977. The dairy parlor closed from 1977-1978, and the farm housed horses in 1979. When Dr. Ajax finished vet school in 1983, his father suggested that he renovate the dairy parlor for his reception room and use the rest of the facility as his animal hospital. Dr. Ajax finished converting the dairy parlor and facilities into his veterinary clinic and started Randvard Animal Hospital as a DBA (doing business as) from 1984-1998. In 1986, Dr. Ajax expanded by purchasing the property for the Boulevard Animal Hospital from Simmons Motel, located 18 miles away, and converting it to an animal hospital that he operated with his father. When Dr. Ajax senior passed away in 1995, he bequeathed the entire Randvard Farm to 3 of his sons and Dr. Ajax bought the part with Randvard Animal Hospital in it from his estate. In 1998 Dr. Ajax formed Boulevard-Randvard Animal Hospital PC Inc.

Company Financials

The company does not allow customers to buy goods on credit as a policy, so it has $0 in accounts receivable. The company also does not pay its accounts payable more than 30 days late. The company is completely equity financed and has $0 long-term debt. Since the company is registered as an S Corp and does not have any income taxes at the company level, the taxes listed on the Profit Loss Statements are property taxes.

Dr. Ajax has been operating his animal hospitals since then as the sole veterinarian. He currently only works at each location for 3 out of a 6 day week. However, on the days that he is not at a given hospital, it is open and staffed for outpatient care and supplies to maintain visibility and a level of convenience to the clientele in that area. The clientele could support working a busy week with a veterinarian on-site all 6 days at each location. Both businesses have an excellent reputation, and their clients are very stable. This means that each location is capable of generating twice the revenues that it currently makes.

Dr. Ajax realized that by splitting time between both businesses he has not been able to fully maximize the potential of either business. He has many options. He could sell or lease each of the businesses together or separately, he could also sell or lease the physical properties, he could sell to a corporation buying up veterinary hospitals such as National Veterinary Associates (NVA), or he could merge with another veterinary clinic in the area. His initial plan is to begin winding down his workload by selling Randvard to focus more on operating the Boulevard. He would prefer to sell both Randvard and its property outright, rather than to lease the property.

He needs to calculate a fair value at which to sell the business. With the COVID pandemic, there has been large growth in the number of pet owners. During the work from home environment necessitated by the pandemic, people are spending more time at home and are investing time in increased outdoor activities, facilitating pet ownership. In fact, there is another local animal hospital already interested in buying both Boulevard and Randvard Animals Hospitals as part of a merger.

Transferring Goodwill

Goodwill is the brand name that Dr. Ajax has established in Randvard. Some clients may not know the doctor's name, but they know the business' name. New clients may just see the name Randvard Animal Hospital and stop by or may be referred to go to Randvard. The goodwill is also the standard of care that Randvard offers and that patients have come to expect.

It can be challenging to effectively transfer goodwill. If the new doctor does not have the same standard of care, the staff has completely changed, or the clients do not feel connected to the new establishment for any reason (either via a merger or a sale) the goodwill will not transfer. How difficult it is to transfer the goodwill depends on whether the goodwill is attached to the individual owner, the practice or some combination of the two. Since Randvard is the name of the business and not "Ajax Animal Hospital" for example, this will increase the ease with which goodwill can be transferred and could therefore enhance the value of the business.

In a single doctor practice, the owner knows all of the clients and treats all of the patients. Therefore, it is critical for the original doctor to introduce and endorse the new doctor to the clients. In a sale or merger, this would be done by writing a letter that gets sent out after closing to all clients instead of the postcards saying a pet is due for a checkup. The letter would be written by both the old doctor and the new doctor. The original doctor would say thank you very much. I enjoyed being your family doctor, I found an awesome new owner and I am excited to transfer the practice to her. The new doctor would also write part of the letter introducing herself, and saying, I am so excited to take over the practice and carry on the level of service that you deserve and expect. The letter would be sent out after closing.

For a merger, there would also be a new phone line set up special for Randvard's phone number at the new place of business. When the phone rang, there would be staff that answered the phone and introduced the name of the acquiring business and informed clients of the merger. Over the course of the year, that phone would ring less and less until the clients stopped calling the old number altogether and it could be discontinued. Dr. Ajax could also stay on staff a few days a week to enhance the transfer of goodwill.

Valuation

Dr. Ajax has decided that a valuation would be a good first step to see what the numbers are, and he decided to start with a valuation for Randvard Animal Hospital.

Word got around that Randvard was looking for a new owner, which caught the ear of the corporate development team at BorkBork, Inc. BorkBork, Inc is a corporation led by a group of aggressive industry experts who have been buying up veterinary clinics and animal hospitals. They use their industry expertise to drive operational efficiencies and integrate the target into their network of clinics and hospitals to generate additional sales and take advantage of economies of scale to receive discounts from suppliers. They are especially interested in Randvard, because they believe the clinic is understaffed relative to demand and can quickly scale up the revenue of the firm.

Your job is to value Randvard from two perspectives: from Dr. Ajax's perspective if he were to continue running Randvard (splitting time between both businesses), and from the perspective of BorkBork, Inc if they were to acquire the clinic. Your work will be split into 4 parts:

1. Financial Statement Analysis and Income Statement Forecasts
2. WACC
3. Net Working Capital
4. DCF Model

<u>Part 1 – Financial Statement Analysis (FSA) and Income Statement Forecasts</u>

Setting up the Financial Statements

Your job is to convert the Profit Loss statements (P&L) into the standard format for the balance sheets and income statements used by public companies. To do this, you can model the income statements that you create after VCA, a leading national animal healthcare company with 46+ animal hospitals operating in 46 US states and 5 Canadian provinces. You can create the balance sheet from the accompanying balance sheet template.

In 2016, VCA Inc.'s Form 10-K, operating expenses were classified as either Direct Costs (DC) or Selling, General and Administrative (SG&A). The classification criteria below was also adopted from VCA Inc.'s 2016 10-K.

- Direct costs are comprised of all service and product costs, including but not limited to, salaries of veterinarians, technicians and other hospital-based, laboratory-based personnel, and content-development personnel, transportation and delivery costs, facilities rent, occupancy costs, supply costs, depreciation and amortization, certain marketing and promotional expenses and costs of goods sold.

- SG&A is primarily comprised of costs incurred to support each of the company's business units. These costs typically include compensation related items for the accounting, legal, information technology, marketing, training, and medical operations departments and in addition, other shared costs such as marketing and rent for corporate facilities.

VCA's 2016 Form 10-K is available on SEC EDGAR under CIK code: 0000817366.

Financial Statement Analysis and Income Statement Forecasts

1. Calculate the 2019 Asset Management and Profitability Ratios for all the ratios listed in the "Ratios and Dupont" sheet in the excel file.
2. In the "Ratios and Dupont" sheet, calculate the Gross Margin and Profit Margin for 2017-2020. What trends do you notice through the years that are responsible for the firm's trajectory in terms of gross and net profitability?
3. On the "Ratios and Dupont" sheet, complete a DuPont ROE analysis of Ranvard's 2019 Return on Equity.
4. When looking at the ratios you calculated, the DuPont Breakdown, as well as the income statements, what can you say about the financial health of the firm?
5. As you can see from the balance sheet, Randvard does not use Accounts Payable, Loans/Debt, is fully funded by Retained Earnings, and no longer offers sales on credit (no Accounts Receivable). What are the strengths and weaknesses of the firm's financial policy? Should they implement any changes?
6. Forecast out the Income Statements through 2026 for two scenarios: Senario 1, if Dr. Ajax continues to own and operate the firm (S1), and Senario 2, if BorkBork were to acquire, own, and operate the firm (S2). Below are the assumptions you will need for the calculation.

Scenario 1 Assumptions

If Dr. Ajax keeps the business, he believes he can continue to grow the firm at a yearly 2% growth rate. This will serve as a conservative valuation for the business. 2020 was a strong year in regard to direct costs and SG&A. Dr .Ajax foresees the firm keeping both those costs at the same level going forward (as a percent of sales). Dr. Ajax's marginal tax rate on income earned from the business is estimated to be 30% for all the years during the projection period.

Scenario 2 Assumptions

If BorkBork where to acquire the clinic, they believe they can immediately double revenue in 2021, and then grow it at a 20% yearly pace through 2026. BorkBork would need to hire a veterinarian immediately to replace Dr. Ajax. The market rate for a vet is predicted to be $85,000 in 2020, and their salary is expected to grow 2% on an annual basis. Furthermore, BorkBork believes they will have to hire a second vet in 2022 to keep up with their demand forecasts. BorkBork believes direct costs as a percent of sale will remain the same in 2021 as they were in 2020 but are confident, they can reduce it by 5% every year until it reaches 40%. During the first year of operation (2021), BorkBork believes SG&A will increase to 30% as a percent of sales due to consolidation expenses, but for every year following it will decrease to 15%. BorkBork's marginal tax rate is 28%.

Part 2 – WACC

1. Calculate the Weighted Average Cost of Capital for both scenarios by using the assumptions below.
2. Just by looking at the two cost of capitals, who do you think will get more value out of the future cash flows of the firm, and why?

Randvard is currently funded through 100% equity coming from Dr. Ajax. Dr. Ajax does not know the firm's beta, nor the firm's cost of equity. However, if Dr. Ajax did not invest in this business, he would be instead investing the capital in his grandson's hedge fund, which has an 8% return on investment.

BorkBork's funding is a little bit more complicated. They recently issued $20 million worth of bonds at face value with a 3.75% coupon rate. They also have a $30 million outstanding bank loan with an interest rate of 6.25%. They have issued $20m worth of Preferred Stock at a price of $20 that pays a dividend of $1.25 on an annual basis. The market value of the equity is $30 million. The risk-free rate is 2%, the market risk premium is 6%, and the firm's beta is 1.5.

Part 3 – Net Working Capital

1. Project out the firms Net Working Capital through 2026 for both scenarios using the assumptions below.
2. BorkBork's management puts a lot of effort towards keeping Net Working Capital as lean as possible. What are the potential benefits of keeping NWC low? How does it impact valuation? What are some of the potential pitfalls of their NWC policy?

If Dr. Ajax continues to operate the firm, he believes he will have to maintain 70% of total annual expenses as cash. He will continue to not offer sales on credit, and he will continue to not buy on credit either. He predicts inventory will be held at 30 days worth of direct costs going forward.

BorkBork believes they will be able to drive a lot of operational efficiencies to keep net working capital down as they grow the firm. They will immediately cut cash to 30% of total annual expenses and hold inventory at 14 days of direct costs. In order to boost sales, they will begin offering sales on credit. They expect Accounts Receivable levels to be equivalent of 28 days revenue. Since the clinic will now be part of a much bigger firm, it will get to take advantage of their buying power to start buying on credit, and the accounts payable is expected to be 28 days' worth of direct costs.

Part 4 – DCF Model

1. Using the 3 previous parts and the assumptions below, create a DCF Model for each scenario and calculate the NPV of the firm under either scenario.
2. Suppose the maximum BorkBork can spend on the acquisition is $2 million. Should they go through and offer this? Do you think Dr. Ajax should accept this offer?

3. What is the NPV impact caused by the NWC changes that BorkBork expects to implement?

Scenario 1 Assumptions
Dr. Ajax expects to write down $10,000 worth of depreciation expense every year, from 2021-2026. The terminal growth rate of cash flows is expected to be 2%. Dr. Ajax does not expect to have any capital expenditures going forward.

Scenario 2 Assumptions
BorkBork plans to immediately spend $250,000 on a renovation of the facility and an expansion wing to increase capacity. They plan on writing down $20,000 worth of depreciation every year, from 2021-2026. They also expect the terminal growth rate of cash flows to be 2%.

- 4.3% cost of debt
- 8% cost of equity
- Perpetuity growth rate is 3-year growth average
- More assumptions are included on bottom of IS and BS forecast models on a year-by-year basis