

# Buying or selling a veterinary practice? The issue is affordability

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## Abstract

The biggest stumbling block in the sale of a practice can be the issue of affordability for the buyer. This program will show you how a practice purchase is structured, how your income will change once you become an owner, and where the cash comes from to make your loan payment.

**Key words:** veterinary purchase, practice value, practice buy-in, affordability

## Résumé

Le plus gros écueil dans la vente d'une pratique peut être le problème de l'accessibilité financière pour l'acheteur. Ce programme vous montrera comme se structure l'achat d'une pratique, comment votre revenu changera lorsque vous deviendrez propriétaire et la provenance de l'argent pour rembourser l'emprunt.

## Introduction

Dr. Laura Lars, a 2006 graduate, has been practicing in a 3-doctor practice for the past 6 years and has decided it's time to strike out on her own. Earlier this year, she prepared a list of requirements to help her narrow down the type and locations of practices she would consider for purchase. She's finally found a practice that fits her needs with 1 exception: the purchase price is \$600,000, excluding the cost of the real estate, which is \$200,000 higher than she originally intended to invest. "Can I afford to buy this practice?" asks Laura. She contacted her financial advisor for assistance and here are the steps they took to answer Laura's question.

### Step 1. Define affordability. What can I afford?

The affordability of a practice depends on 3 things: 1) the practice's excess earnings, the earnings available to the owner after all the practice's expenses have been paid; 2) the after-tax cost of the annual loan payments; and 3) the personal financial resources of the buyer.

If the excess earnings are greater than the buyer's loan payments, then cash flow from sources outside of the practice will not be needed to cover the buyer's payments; the investment will pay for itself. As Dr. Lars has limited personal

financial resources, this measure of affordability is the 1 that is most important to her.

### Step 2. Scrutinize the Valuation Report

A Valuation Report prepared by an experienced, professional valuator will contain most of the financial information that Laura and her advisor will need to assess affordability. From reading the report, Laura learns that the appraised value of \$600,000 represents \$100,000 of working capital and tangible assets and \$500,000 of goodwill value. The excess earnings available to her after all operating expenses have been paid will be \$112,000, assuming that the practice continues to produce the annual earnings that it has averaged over the past 3 years.

Laura's advisor explains that excess earnings is a crucial number in the determination of affordability. Excess earnings is the amount remaining after all practice expenses have been paid; it is the amount that she will have available to make loan payments and invest in new equipment. Practice expenses include all variable, fixed, staff compensation, associate compensation, and rent expenses and fair compensation for Laura's veterinary services and her management responsibilities. Laura looks closely at the amount specified as fair veterinary compensation. The valuator used a split-rate formula based on medical revenue produced by doctors of 22% of medical services and 6% of medicine dispensed. This is the amount that will be available to Laura and her associate as compensation for their veterinary services.

Laura knows that in the last 2 or 3 years, Split-Rate Compensation™ has become a common method of compensating doctors for their veterinary services, and she believes that a 22/6 split is reasonable. Management services were valued at 3% of total revenue. This will be Laura's compensation for her management responsibilities once she assumes her role as owner. After studying the practice's revenue, operation expenses, and fair compensation for veterinary services and management, she believes that the earnings remaining for her as the practice owner (her return on investment) will also be fair.

The report also documents the valuator's opinion of the risk and the investment return to be expected by the owner of the practice. Together, these factors significantly impact the valuator's opinion of value. In fact, all other variables being equal, the higher the risk, the lower the practice's value.

Laura will rely on this information in deciding if the risk in owning this practice is within her comfort zone.

### Step 3. Evaluate payment options

The down payment, interest rate, and repayment period determine the buyer's annual payments. Laura has several payment options. The following illustration is a sample of the options available to her for a \$600,000 purchase, and shows annual payments ranging from \$68,000 to \$144,000:

Payment options	A	B	C	D
Down payment	10%	5%	10%	10%
Term	7 yrs.	5 yrs.	10 yrs.	15 yrs.
Interest rate	8%	9.5%	8.5%	9.5%
Annual payment	\$101,000	\$144,000	\$80,000	\$68,000

While option D would give Laura the lowest annual cost, it would also mean that over the life of the loan, her payments would total \$1,020,000 versus \$707,000 under Option A. Her advisor has cautioned her to measure affordability based on payment terms that are most realistic for the type of investment she is buying. For a veterinary practice, that means a repayment period of no more than 10 years. Then, if she selects a longer payment term (and can do so without a prepayment penalty), she'll give herself a little breathing room but still have the option of repaying the loan faster. Laura decides to base her measure of affordability using the payment terms in options A and C.

### Step 4. Include the cost of taxes

How will income tax affect Laura's excess earnings and debt payments? Laura's advisor explains that tax liability can add significantly to her cost and must be considered in her calculation of affordability. The tax cost will depend on whether Laura buys assets or stock and, if stock, whether the stock represents a C Corporation or an S Corporation.

The interest she pays on the loan will be tax deductible if she buys assets or S Corporation stock. If she buys C Corporation stock, the amount of her interest expense deduction will be limited to the amount of her investment income. Laura, like many young veterinarians, has limited investments and buying C Corporation stock will result in little if any tax deduction for interest paid.

The second tax issue is the availability of a deduction for depreciation. When buying assets, all depreciable (or amortizable) assets such as medical equipment, office equipment, vehicles, and goodwill can be depreciated/amortized over the life of the asset and the annual depreciation expense is generally tax deductible. When buying stock, no depreciation deduction is available.

The following illustration shows the total cash required to cover the first year's payments plus tax associated with the payments when: 1) both interest and depreciation are tax deductible, and 2) when neither deduction is available to the taxpayer. Calculations assume an effective

income tax rate of 35%. Employment taxes have not been considered.

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#### Total cash required

Interest and depreciation				
Deductible	\$107,000	\$162,000	\$77,000	\$59,000
Interest and depreciation				
Non-deductible	\$155,000	\$222,000	\$123,000	\$105,000

Now Laura can compare each payment option, including taxes, with the practice's excess earnings of \$112,000. She sees that her original selection of Options A and C are still the most attractive provided she buys assets and not stock. And, where else could she make an investment that will pay for itself in seven years?

Dr. Lars has learned that there is much to consider in evaluating the affordability of a practice. However, with careful planning and assistance from her financial advisor, realizing her dream of owning her own practice won't keep her awake at night! As she re-evaluates her prospects as future owner, she is confident she is making the right decision.

### The Valuation Report

A valuation report typically includes the following:

- **The Statement of Value**  
The statement of value identifies the property to be valued (assets and liabilities or stock), the name and tax structure of the practice entity, the date of the valuation, the valuation method, the purpose and intended use of the report, the primary sources of information used by the valuator in arriving at value, items that should be brought to the attention of the reader that impact the opinion of value, a statement attesting to the independence of the appraiser, and the valuator's opinion of net asset value, goodwill value, and total value.
- **The Net Asset Value**  
This section details the values of all assets and liabilities included in the opinion of value. Each asset and liability is footnoted explaining the source of the information (for example, financial statement, computer report, representation of management) and an explanation of any adjustments made to arrive at fair market value.
- **The Goodwill Value**  
The calculation of goodwill begins with practice income and shows every adjustment made by the valuator in arriving at the earnings stream to be

capitalized. Each adjustment is footnoted with an explanation of why and how it was determined. This section also includes the calculation of the fair market cost of veterinary and management services, the return on asset deduction, and application of the capitalization multiple.

- **Assumptions and Limiting Conditions**

This sections details the limiting conditions on the use of the report and on the scope of the valuator's responsibility.

- **Qualifications of the Appraiser**

This is a summary of the appraiser's qualifications and experience relevant to valuing veterinary practices.

- **Certification**

The appraiser certifies the opinion of value, his or her independence, the limited conditions and uses of the report, and names those involved in the preparation of the valuation report.

- **Supporting Schedules**

Here, schedules and illustrations that provide further explanation of the methods, assumptions, calculations, and values used in arriving at the opinion of value are included.