

# Practice Management Myths

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## Myth: No way a recent grad can afford to buy a practice

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### Abstract

There are several benefits to becoming an owner, including increased annual income and investment value. Understanding the financing landscape is important for veterinarians to understand in order to purchase the practice. Veterinary practices are typically valued as a multiple of historical earnings. To ensure maximal value of their business, sellers should be concerned with the profitability of their business for at least 3 years prior, and work with a business valuator to set the price of their practice. Industry specific third-party lenders have come to understand the veterinary landscape and the challenges inherent to our industry, such as the large student debt burden that recent graduates face. Fortunately, many cash-flow based loans allow for the transaction to still occur despite a collateral shortfall. The cash-flow analysis is at the core of the loan approval process to ensure that the new business owner will be able to pay the ordinary business expenses, pay the new proposed debt, pay themselves a sufficient salary to cover their personal obligations, and have some cushion left over. The strength of the veterinary profession and historically low default rates allow lenders to become comfortable lending to veterinarians to purchase practices.

**Key words:** practice management, practice value, financing, practice ownership

### Résumé

Il y a plusieurs bénéfices à devenir propriétaire incluant l'augmentation du revenu annuel et de la valeur d'investissement. Comprendre le paysage financier est important pour les vétérinaires qui pensent acheter une pratique. Les pratiques vétérinaires sont habituellement évaluées par des multiples des bénéfices historiques. Afin de s'assurer de la valeur maximale de leur entreprise, les vendeurs devraient prendre en compte la profitabilité de leur entreprise durant au moins les trois dernières années et travailler avec un évaluateur d'entreprise pour fixer le prix de leur pratique. Les tiers prêteurs spécifiques à cette industrie sont au courant du paysage vétérinaire et des défis propres à notre secteur incluant l'endettement étudiant élevé auquel font face les nouveaux diplômés. Heureusement, plusieurs prêts sur capacité d'autofinancement permettent de transiger malgré l'insuffisance de garantie. L'analyse des flux de trésorerie est au cœur de

la procédure d'approbation du prêt pour s'assurer que le nouveau propriétaire d'entreprise sera capable de payer les dépenses d'entreprise courantes, de repayer la nouvelle dette proposée, de se payer lui-même un salaire qui suffira à rencontrer ses obligations personnelles et d'avoir un certain coussin financier en fin de compte. La vigueur de la profession vétérinaire et le faible taux historique de défaillance sur les prêts rendent les prêteurs plus à l'aise d'accorder des prêts aux vétérinaires pour s'acheter des pratiques.

### Why Consider Practice Ownership?

To own or not to own... that is the question at hand. Let's examine why a veterinarian should even consider owning a practice.

Firstly, getting to be the boss has its advantages as you get to control your own destiny. Success lies in your own abilities and faculties, which can be equally invigorating and terrifying in the same moment. You have control over the medicine, the finances, the culture, team members, schedules, and the list goes on and on. Point being that you get to be in the driver's seat which comes with great responsibility, but also freedom.

Make more money. On an annual basis as an owner, you get access to another slice of the income pie that generally is not available to an associate. If you are in the driver's seat, you get to say how and where the money gets spent. Depending on how the practice is operated, generally the income for the new owner comes from a few different streams. Most of the time the new owner-veterinarian still seeing clients is entitled to the income they're generating solely for their work as the veterinarian. Then as the owner he or she would be entitled to a management fee as well as a return on investment for the business. If real estate is involved, rent is also another source of income for the owner. All of this increases the potential pool of dollars available to the practice owner rather than only having access to just an associate salary. Many veterinary owners tend to fail to recognize and manage these different roles separately, and instead lump all of their income into 1 stream, thus making it hard to decipher how each role should be managed for maximal profitability of the business.

One part of the story that tends to not get as much attention in the own or not-to-own discussion is wealth creation. One of Webster's definitions of wealth is "all property that has a money value or an exchangeable value". We typically think of millionaires as those who have a million dollars in

cash in their bank accounts, when millionaires are typically measured by having \$1,000,000 net worth, meaning their assets minus their liabilities is over a million dollars and all of it is not necessarily in cash. Assets are things of value that you own, and liabilities debts or obligations that you owe. Owning a practice, therefore, affects your net worth by coming into play as an asset that you own. And while yes, a large liability often comes with that, the beauty lies in how the income generated by the business is paying down the liability each month and is helping build your net worth. Investing in practice ownership allows for significant opportunity (over being an associate) to bolster your personal balance sheet.

Gaining entry into the veterinary profession is not a cheap endeavor, but a lot of money has already been invested to be a part of this profession. Classic investing advice is to invest in the thing you know best. When investing in the stock market you are owning a small piece of a business in an industry you may know little to nothing about. So why not also invest in the thing you know best, veterinary medicine? Typically, the response is “money of course, or rather the lack of it.” The barrier to entry to invest in the thing veterinarians know best is a much higher dollar amount than buying a small piece of a profitable company in the stock market. With recent graduates having high student debt and often little money to put down, investing in a veterinary practice may seem inaccessible. The amount needed to buy a practice can dwarf even the large student loan debts that veterinarians have accrued. Starting a practice can seem more accessible as a lower total cost to get going, but the long ramp-up period before breaking-even can make start-ups unfeasible for recent grads as well.

With the challenges and burdens that student loan debt has caused in the profession, it is easy to see why veterinarians may have a hard time imagining how more debt to buy a practice may be a part of the solution. However, obtaining a loan to purchase a business has some fundamental differences from many of the loans veterinarians may have previously dealt with. For most consumer loans, the income to make the payments on the loan is coming from a separate source. Yet, for a veterinarian purchasing a practice, the loan is approved based on there being historical or projected income from the business to pay for the debt being taken on. Therefore, the loan proceeds are purchasing an asset that is generating income that can pay back the loan. This is a fundamental difference than, for example, a personal home mortgage, where the debt being taken on is being supported by the person's income from their job (or other income streams unrelated to the house itself). In the case of a practice acquisition, the practice must have historical performance that demonstrates its ability to generate enough earnings each year to make the monthly loan payments, cover a reasonable salary for the new owner, and some cushion for savings. Therefore, the practice's performance and the purchase price are key components in addition to the buyer's financial position as to whether the practice is financeable or not. For start-ups, the financial

projections must demonstrate that within a reasonable time period the new practice will be able to financially support the debt and the new owner in the same way.

So, we have a highly responsible, skilled professional with low liquidity (predominately due to obtaining the education to become this responsible and skilled professional) wanting to purchase a valuable income generating but intangible asset. Examining this loan on paper using the traditional lending lens, it can look like a risky loan. While owner financing has and will likely always be around in this industry, third party lenders have become familiar with the challenges and opportunities that this scenario creates within the veterinary practice succession landscape. A collateral-based lender lends on a percentage of the tangible assets, but a cash-flow lender will analyze the cash flow of the practice to determine the amount of debt the business can support. If properly understood, what looks risky on paper can be a sound lending decision with the right structure. Each lender may assess and structure the loan differently based on their credit policy.

The transition of practice ownership not only allows young vets and longtime associates to become owners, but also allows retiring veterinarians the opportunity to realize the value of their practice. With proper planning, the sale and transition can be smooth and successful. One of the first steps is determining and agreeing on what is for sale, practice plus or minus real estate, and the selling price. Often the majority of the veterinary practice's value is intangible, as it is based on the business's ability to earn a profit. This ability comes from the practice's reputation, operations, client base, and employee relations. This intangible asset is termed the “goodwill” or “blue sky” of the practice and represents the dollar value set for how valuable this practice is. Working with a third party who understands the veterinary space to value the goodwill can help ensure the price is accurate. Ultimately the purchase price will be based on several sources including asset values, annual revenues, multiples of earnings, and other intangible assets. The building and land, furniture, equipment and inventory make up the value of the physical or tangible assets. It will be necessary during the loan process to have an appraisal done to value the real estate. This is important for financing because if the purchase is just for the practice but not the real estate, the loan term could be stretched up to 10 years. If both the practice and real estate and the real estate cost make up the majority of the loan proceeds, the loan term could be extended up to 25 years. Spreading the payments over 25 years allows for lower monthly payments, possibly making the loan easier to cash flow. Updates and equipment purchases can be included in the loan or bought later.

The lender will look at the full financial landscape, including both the business's finances and the buyer's personal finances, to make a credit decision. The process of purchasing a practice can look different depending on individual circumstances. To determine if financing is possible, the lender will need to assess whether this business will be able to support

this buyer and the new debt, which is based on the sell price and the buyer's down payment. The lender will need the practice's 3 years of prior tax returns and interim profit and loss statement, and balance sheet statements from the beginning of the fiscal year. From the potential buyer, they will need a personal financial statement, resume, and 3 years of personal tax returns.

The personal debt obligations of the buyer will determine the annual salary needing to come from the business. During the loan prequalification stage, the buyer's credit report will be pulled. A credit report is simply an individual's track history of owing and paying back borrowed money. It is an indication of how that individual performed in paying back debt in the past. How someone manages their personal credit is typically a good indicator of how they will manage the business's credit. Part of the analysis will also include looking at the payments owed other creditors, including a mortgage payment, any car payments, student loan payments, etc. The practice should be able to support the new veterinary owner's salary that is at least a 50% debt-to-income ratio. Thus, personal obligations influence the size of practice that can be purchased. Interestingly, this means that an individual may qualify to purchase a higher-priced practice and be denied for a lower-priced practice because the cheaper practice's performance is not large enough to support their debt and their lifestyle. Ultimately, the lender wants to know that the practice is bringing in enough money to cover the business expenses, business debt, and new owner's salary.

Veterinary student loan debt comes into to the equation in how much the new owner needs to take as a salary. Generally, their salary as an associate was enough to cover that debt obligation, thus the amount calculated into the cash flow analysis is similar to what they were making as an associate or close to the national average for a veterinary

associate. This number is a conservative estimate to ensure that the new owner-veterinarian will be able to continue to at least maintain their current lifestyle when transitioning to ownership, but with the hopes of being able to make more.

Once the loan has been approved by the lender, it moves into the closing stages. This is when all of the legal documentation and contracts are being drawn up, acquired, and signed. The day of closing is when money changes hands and ownership officially transfers.

Successful transitions happen when good communication and transparency has occurred between both parties around what will take place during the transition. Will the seller continue to work at the practice once the purchase is finalized? How will clients be introduced to the new owner? When will the staff find out about the sale? These are all important questions to the continued success of the practice. The staff is a key part of the practice being able to repeat the financial results that the new owner just paid for, so it is important that the team has a good transition as the buyer takes over. Losing key associates and valuable team members to a competitor will ultimately hurt the value of the practice. While fresh eyes can lead to improvements in the practice, the staff may be wary of a new owner. People tend to resist change, so it is best for the new owner not to radically change the experience for staff and longtime clients until he or she has gained their trust. Finding a doctor and practice that operates under a similar style of medicine will aid the success of the transition.

From selecting the right practice or startup business plan, to securing financing, and making a successful transition into ownership, acquiring a vet practice requires planning and patience, but becoming an owner is one of the best ways to maximize your degree and build net worth.