FIXER UPPER

January 2019

Have you ever purchased a "fixer-upper", maybe a house or a car or a piece of antique furniture? If you did, you undoubtedly paid a relatively low price with the hope that some good old fashioned "elbow-grease" would result in something much more valuable that you could keep or sell for a much higher price!

This scenario makes a lot of sense when you can "buy low" and "sell high" but how would you feel if the purchase price actually wasn't all that low? What if the buyer said to you that "this old table would be worth so much more if it was refinished, so I am going to charge you more for it because of its potential value"? Would you still consider that a fair deal? It probably depends on how much they are charging and how much future value you perceive there is to be gained. But isn't it your work in refinishing that would make the table more valuable? Should you have to pay a higher price to the seller because of the future benefit of your hard work?

This scenario certainly plays out in the veterinary field. Sellers of hospitals will often hope to get a higher price for their practices by convincing the buyers that there is tremendous potential for future growth. As a buyer, should you seriously consider this possibility or should you run away from this deal as fast as you can?

Unfortunately, this is not a hypothetical situation. In many cases, large corporate consolidators purchase practices for prices that are higher than typical, non-corporate buyers would pay. This is due in large part to the consolidators' ability to see the future potential earnings they can derive from the practice. In other words, they know they can make the practice more profitable and they are willing to pay extra as a result.

If you hire an appraiser to tell you what your practice is worth, the value usually is based on the past proven performance of the business. In some cases, however, the appraiser will assume that certain changes will be made by the seller and those are factored into the value. In other cases, the seller simply wants or needs a higher price than the appraised value. Are you willing to pass up a potentially good opportunity because of a somewhat higher price?

Generally speaking, we would caution anybody against paying now for "potential" future earnings. If a practice has so much potential, why hasn't the current owner taken advantage of some of that? Why isn't the practice already generating higher profits? If you are able to buy the practice and improve the revenue/profitability, shouldn't you be the one who benefits, rather than the seller? Furthermore, it is unlikely a lender will finance a loan based on "potential earnings" rather than existing earnings. Unless you have a big bag of cash at the ready, the lender may limit your ability to pay a higher-than-market price. This is where the corporate players have a real advantage. They have the financial resources to pay now for what they expect to be higher profits down the road. This makes it tough for the average veterinarian to compete against a corporate for the right to purchase a practice. As a result, we are seeing many associates lose out to corporates when their boss is ready to sell and they are hoping to buy.

The reality is that many low-profit veterinary practices do sell for higher multiples than high-profit practices. This is because lenders realize that poorly performing practices will often improve once a new owner is in place and they have found that veterinarians generally are a good risk from an investment standpoint. Therefore, in many cases, it is possible to get financing for a low-profit practice when the price is based to some degree on potential future earnings.

Before entering into any purchase, however, you will want to have good financial advisors. If you are depending on practice improvements in order to be able to make your loan payments, then you better have a very clear picture of how much you need to improve the bottom line and what steps you need to take to accomplish that goal. For example, if there is a realistic potential to improve a practice from a 5% to a 10% profit margin, you should not pay based on the assumption that it WILL be a 10% profitable practice. If you do, that means that in order to "break even" you are now REQUIRED to get the practice to 10%. If you don't, you will be taking home substantially less money in order to make your loan payments (or you may not even be able to make your loan payments). However, if you pay a price that is based on a 7% profitability and you feel there is real potential to get to 10%, then it may be a price that still gives you a lot of upside potential.

There are many practices out there with the potential to be worth much more than they are now. If you are a savvy business person and have good financial advisors and a supportive lender, you may find that you actually can, and should, consider a practice purchase, even if some of the current value is based on "potential". Just remember that every practice purchase has some degree of risk. The more you are paying for potential earnings rather than proven earnings, the more risk you assume. The last thing you want to do is end up with a loan that the practice cannot support!

If you are considering a practice purchase, be sure to have a qualified veterinary practice appraiser help you understand whether the current earnings of the practice support the asking price, or whether you will be required to improve the practice in order to meet your debt obligations. As always, buyer beware!