MONEY MATTERS

Unpleasant Consequences

Your practice might not be worth what you expect if you don't plan for its sale and leave the clinic with enough doctors.

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Clients bring in their pets annually for vaccinations but decline your recommendations for preventive care, dental cleanings and lab tests. At some point, a number of those pets show up with fleas, a mouthful of painful teeth or a debilitating disease. While you want to tell the pet owners that neglect led to the problems, you bite your tongue and prioritize your patients' well-being. This is where your job and mine, as a consultant, are similar. I sometimes work with doctors who have had a nice career and are ready to sell their practice, only to discover that the clinic isn't worth nearly as much as they thought. A little planning could have prevented the disappointment.

Every practice owner should have an accountant, a financial expert who will help you pay minimal income taxes, recommend what to take home in compensation and what to pay in rent if you own the building, and tell you which personal expenses are business deductions. That's all great, but when you are within three to five years of selling, your emphasis needs to shift from avoiding taxes to maximizing the value of your practice.

Adjust Your Pay

If you want the best price for your practice, it must be profitable without you. Yes, you are a huge part of the operations, but the better the hospital does when you're away, the easier a buyer can step in. So, how do you do that?

First, stop paying yourself a minimal salary. Sure, your accountant advised you to take less in salary and more in draws or distributions to avoid payroll taxes on the difference. But remember that you're not focused on tax savings at this point. You want to demonstrate that buyers can pay themselves the market rate and still afford your practice.

Start paying yourself like you would someone else for the roles you take on. Pay yourself a percentage of your clinical production — 20% to 21% is typical. Then compensate yourself for managing the business. This amount generally is a percentage of gross revenue, but it also depends on the number and levels of managers you employ. To dodge a lot of calculations, pay yourself 1% of the gross fees. Can you get more? Of course, you're the owner. You can still take draws and distributions.

Where Did the Money Go?

Last year I worked with a practice owner who was quite productive but didn't take a salary of any kind. She owned the real estate, so she paid herself a fair rent instead of a salary. Because she

also took distributions, she thought the practice was doing well. Did this practice have a lot of extra cash? It should have, but it didn't. Drug and supply costs were extremely high. If the owner had paid herself a salary, she would have realized the practice wasn't profitable. Ideally, she would have investigated and fixed the problems. As it was, not only did she forgo compensation for years, but the practice was nowhere close to the value she expected when she sold it.

If you choose to pay yourself very little, or nothing in rent because the mortgage is satisfied, make sure your practice generates a lot of cash. Owner compensation and facility rent are significant expenses. A practice that doesn't pay one or the other should have plenty of money in the bank. If it doesn't, a problem of some kind must be addressed.

Once you confirm that your practice can afford you, prioritize filling the positions you will vacate. Losing a productive doctor will be a massive hit to the sales price.

Help Wanted

I had another client who planned to sell his practice in six to nine months. His associate veterinarian wanted to buy it, so the selling doctor told her to look for his replacement. He didn't want to spend any extra time or money on recruiting.

You know that hiring an associate veterinarian is very difficult today. Many practices don't find a suitable candidate for a year or more. So, in this example, you won't be surprised to hear that as the seller's retirement date drew near, no new doctor had been hired. If the seller left without a replacement clinician, the practice would go from a thriving two-doctor hospital to a single-doctor business that couldn't support its client base.

You might believe that replacing you is the buyer's job, and that is true to some extent. However, an outside veterinarian who buys your practice and plans to work there should be able to generate the same revenue without too much trouble. Or perhaps not. If you have specialized training in orthopedic surgery or rehabilitation, for example, and the buyer lacks the same expertise, the purchase price will reflect the loss of skills.

Why? Because all the revenue generated from those services disappears when you leave. If your practice can't absorb the work you do with its current complement of doctors, the income you generated will be gone along with the related profits and cash flow. In simple terms, the practice won't produce enough money to buy you out unless the sales price falls substantially.

The Downside of Downsizing

It is in everyone's best interest for you to champion your replacement in a two- or three-doctor practice. If you hope to ride off into the sunset the minute the ink is dry on the sales contract, make sure another doctor is ready to step into your shoes. If not, you will walk away with much less money than you expected.

Let's look at why that's so. The table below shows the changes that can occur when a productive owner leaves.

	2 doctors	1 doctor
Gross fees	$1,600,000	$900,000
Cost of goods sold	$384,000	$216,000
Doctor compensation	$302,400	$170,100
Staff payroll	$352,000	$198,000
Benefits	$48,000	$27,000
Rent	$80,000	$80,000
Equipment expense	$24,000	$18,000
Administrative expense	$144,000	$99,000
NET INCOME	$265,600	$91,900

Here's what you'll discover:

- Gross fees decline because the practice lost a doctor.
- The cost of goods sold is lower because fewer supplies are consumed when the activity is less. In both scenarios, the cost of goods sold represents 24% of gross fees.
- Doctor and staff compensation plus benefits remain the same as a percentage of gross revenue. But wait! The only way staff payroll falls is if team members are laid off. Let that sink in for a minute.
- Rent is a fixed expense.
- The equipment expense is lower but not proportionate to the gross fees.

HOW OWNERS GET PAID

According to AAHA Press's "Compensation and Benefits, Ninth Edition," 79% of owner-veterinarians are salaried. Thirteen percent receive a salary and a percentage of production, and 8% collect only a percentage of production.

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- Administrative expenses should be lower, but again, not proportionately. Advertising, business insurance and utility costs aren't affected.
- Net income is substantially lower.

Have a Game Plan

Regular readers of *Today's Veterinary Business* know that net income is not the same thing as profit. And while you might not agree with all the numerical assumptions I made, surely you agree that going from two doctors to one means a lot less money is available to cover a bank loan.

Having your practice valued by a professional three to five years before you expect to sell is critical. A valuation gives you a baseline. If the value isn't where you want it to be, you have several years to make changes and increase profits. Identify the soft spots and what needs to change.

Preventive medicine is much better than reactive medicine. When routine dental care is absent, the alternative is to extract a lot of teeth. If your unprofitableness isn't apparent until you are ready to sell, you won't have enough time to take corrective action and get a higher sales price. At that point, your only options are to settle for a lower price or work a few more years to improve the practice's financial health.

If you focus on preventive financial matters now, I guarantee you will be happy with the selling price no matter who buys your hospital. TVB

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Valuations are essential for assessing your practice financial health and determining your path to higher practice value.

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