



Easing the Buy-In Process

The number one question we get from an associate contemplating ownership is, "Can I afford to buy in to the practice? I don't have much left after paying my family's living expenses, so how will I buy in?" Owners who want to sell to an associate frequently ask the same question.

Most new buyers don't have a huge savings account that gives them the ability to pay cash for an ownership share of the practice. Therefore, they have to borrow the money from family, the seller, or an outside lender in order to buy in. The thought of an additional payment leaves them wondering, "How am I going to do it?"

Buying in to a veterinary practice is actually one of the best investments an associate will ever make – it pays for itself and with careful planning can guarantee future financial security. If this sounds too good to be true, let's look at an example to see how it works.

"Preparing Associates to Buy In", June 2003, outlined the four-year action plan Dr. Steve Bailey and Dr. Meg Jones developed to prepare for Dr. Jones' buy in. They've progressed as planned, and now Drs. Bailey and Jones have asked their valuator to prepare an affordability analysis (see **Table 1**) to determine how Dr. Jones' taxable income, tax liability, and cash flow will change after her buy in. Drs. Bailey and Jones agree they will receive compensation in three areas – veterinary, management, and owner return.

The current practice value is \$1,100,000. Dr. Jones plans to purchase 30 percent of the practice (\$330,000) with a 10 percent down payment (\$33,000). Dr. Bailey will finance the balance (\$297,000) over 7 years at prime plus two and one-half percent interest (6.75). The interest rate will be adjusted annually, on the anniversary date of the loan. Annual payments of principal (\$34,400) and interest (\$19,200) will approximate \$53,600.

With the guidance of their practice management consultant, Drs. Bailey and Jones modified their veterinary compensation formula to reflect current practice operations. They agreed veterinary compensation will be based on individual production, and will pay 25 percent for medical services and 6 percent for medical products. Drs. Bailey and Jones each produce \$291,400 of medical services revenue and \$72,900 of medical products revenue. Therefore, they will each receive veterinary pay of \$77,200.

Management compensation (3 percent) is based on total practice revenue (\$1,500,000) divided among the five key areas of management responsibility. Dr. Bailey will be paid 60 percent (\$27,000) of the management fee for employee development, financial management, and facilities,



equipment, and technology management. Dr. Jones will be paid 40 percent (\$18,000) of the management fee for client development and medical development.

Owner return is based on ownership share and is the amount available to owners after all operating expenses have been paid, including veterinary and management compensation. Based on the current practice valuation, the amount available to the owners is \$224,400. Upon Dr. Jones' buy in, Dr. Bailey will be entitled to 70 percent (\$157,100) of the owner return and Dr. Jones will get 30 percent (\$67,300).

<u>Owner compensation - year 1</u>	<u>Dr. Bailey</u>	<u>Dr. Jones</u>
Veterinary compensation	\$ 77,200	\$ 77,200
Management compensation	27,000	18,000
Owner return	<u>157,100</u>	<u>67,300</u>
Total owner compensation	\$261,300	\$162,500

Dr. Jones tax liability will increase because of the additional income from management and owner return. For purposes of the affordability analysis, the valuator assumed Dr. Jones' interest payments were a tax-deductible expense because the practice is an S-Corporation. The valuator estimated tax rates of 28 percent for federal, 5 percent for state and local, and 1.5 percent for Medicare. Dr. Jones' increased tax liability is estimated at \$22,800.

Dr. Jones' additional sources of cash flow in year one from management compensation (\$18,000) and owner return (\$67,300) total \$85,300. Her additional uses of cash flow for loan payments (\$53,600) and income tax (\$22,800) total \$76,400. This gives her a net increase in cash flow of \$8,900.

The analysis clearly showed Dr. Jones that the buy in was affordable. The management compensation and owner return would more than cover her loan payments and additional tax liability. Plus, she and Dr. Bailey had already developed a plan to ensure continued practice growth. Dr. Jones was confident her share of the profits would continue to grow (in dollars) while her loan payment would remain the same. Therefore, her "Net Source of Cash Flow" would continue to improve. Dr. Jones also knew the plan for growth would enhance future practice value, thus helping to ensure her long-term financial security.

For Dr. Bailey's personal financial planning, the valuator completed a feasibility analysis to project the financial impact of the 30 percent sale to Dr. Jones in 2006 and a sale of his remaining 70 percent share in 2015. Dr. Bailey wanted to project his after-tax, spendable income through 2015, along with



an estimate of the money available for investment purposes. He plans to use his veterinary and management compensation, interest from the loan to Dr Jones, and the rental

income he earns from leasing the facility to the practice for his family's living expenses. He'll invest his owner return and the principal payments from the loan to Dr. Jones.

The following assumptions were used for the feasibility analysis:

- Practice revenue, doctor production, owner return, and practice value would all increase by 5 percent per year.
- The real estate, currently appraised at \$500,000, will appreciate in value by 3 percent per year.
- Dr. Bailey will retain ownership of the real estate through 2020.
- The practice has a triple-net lease with Dr. Bailey that calls for rent increases at each three-year renewal period.
- Rent is calculated at 12 percent of the appraised value of the real estate.

The feasibility analysis clearly showed Dr. Bailey his annual spendable income, investable income, and the cumulative value of both through 2015, and indicates he's on track with his long-term financial plan. If all goes as planned, the value of his invested assets should approximate \$2,770,000 by the end of 2015.

Dr. Bailey was pleased with the results of both analyses. He was confident that Dr. Jones could afford to buy in and meet her loan payment obligation. He also recognized that even though he would now only receive 70 percent of the owner return, his income actually wouldn't change much over the seven-year term of the loan. He will just receive some of it in the form of a loan payment (part sales proceeds, part interest).

With a plan in place to ensure continued practice growth, Dr. Bailey knew his share of the profits would continue to grow (in dollars). He felt sure Dr. Jones' vested ownership interest (and loan obligation!) would further strengthen her commitment to the practice. And, as part of the Buy Sell Agreement, Dr. Jones is a guaranteed buyer of Dr. Bailey's remaining share of the practice when he is ready to sell – an integral part of his exit strategy.

Answering an associate's question, "Can I afford to buy-in to the practice?" is one key to making the sale happen. An affordability analysis helps answer the question with a resounding, "Yes!" If a sale is in your future, add an affordability analysis for the buyer and a feasibility analysis for you to your list of "to-do's".



**Table 1 – Affordability Analysis -
Additional cash flow for Dr. Jones – Year 1**

Veterinary compensation change	\$	0	
Management compensation		18,000	
Owner return		67,300	
Deductible first year interest		<u>(\$19,200)</u>	
Additional taxable income		\$66,100	
Estimated tax on additional taxable income			
Federal – 28%		\$18,500	
State - 5%		3,300	
Medicare – 1.5%		<u>1,000</u>	
Total estimated tax		\$22,800	
Additional sources of cash flow – year 1			
Management compensation		\$18,000	
Owner return		<u>67,300</u>	
Total additional sources of cash flow			85,300
Additional uses of cash flow – year 1			
Payments of principal and interest		\$53,600	
Estimated tax on increased income		<u>22,800</u>	
Total additional uses of cash flow			<u>\$76,400)</u>
Net source (use) of cash flow			8,900



Table 2 – Practice Value

What is the current value of your practice?

Less than \$500,000	6%
\$500,000 to \$999,999	47%
\$1 million or \$1,999,999	35%
\$2 million or more	12%

Source: The 2003 Well-Managed PracticeSM Study conducted by Wutchiett Tumblin and Associates and Veterinary Economics

This article is intended to provide the reader with general guidance in practice succession matters. The materials do not constitute, and should not be treated as, appraisal, tax, or legal guidance or technique for use in any particular succession situation. Although every effort has been made to assure the accuracy of these materials, Wutchiett Tumblin and Associates does not assume any responsibility for any individual's reliance on the information presented. Each reader should independently verify all statements made in the material before applying them to a particular fact situation and should independently determine whether the succession technique is appropriate before recommending that technique to a client or implementing such a technique on behalf of a client or for the reader's own behalf.

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