Practice Purchase 101: Everything You Need To Know To Purchase Your First (Next) Practice

Mick Kling, OD
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Vision Source SIGNATURE EYE CARE

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Mick Kling, OD
Practice Management and
Transition Advisor
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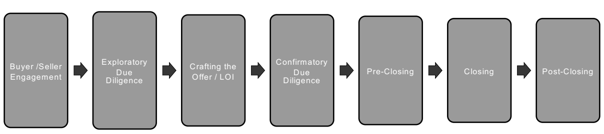
7 Steps to a Practice Transition



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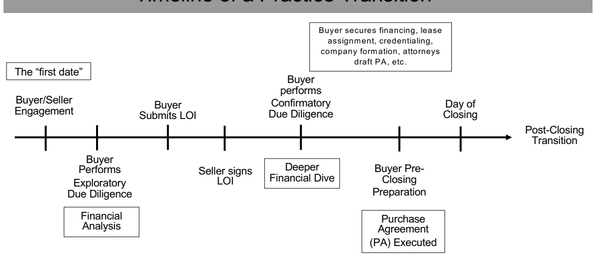
Timeline of a Practice Transition



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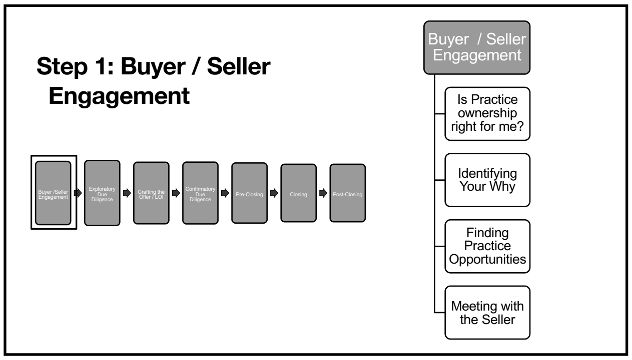
Step 1: Buyer / Seller Engagement
Buyer / Seller Engagement
Is Practice ownership right for me?
Identifying Your Why
Finding Practice Opportunities
Meeting with the Seller

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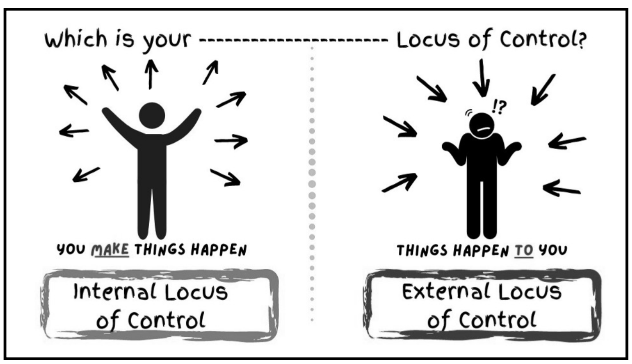
Which is your ---------------------- Locus of Control?
!?
YOU MAKE THINGS HAPPEN
THINGS HAPPEN TO YOU
Internal Locus of Control
External Locus of Control

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Is Practice Ownership Right For Me?

The biggest barrier to ownership is often a lack of knowledge and confidence.

“I don’t know what to do!”

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Rural vs. Urban Practice

	Rural Practice	Urban Practice
Practice Revenue	$1,000,000	$1,000,000
Cost of Goods	$280,000	$280,000
People Costs*	$220,000	$280,000
Occupancy Costs*	$60,000	$100,000
Other Operating Expenses	$120,000	$120,000
OD Compensation* (Fair Market Rate)	$170,000	$150,000
Practice Profit	**$150,000**	**$70,000**

*Assumptions: COGS same for both location types; lower staff wages and occupancy costs for a rural practice; higher OD compensation for a rural practice.

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Some Sellers Aren't Serious About Selling

- First time selling and don't realize how difficult it is
- They don't learn how much the business is worth until they've seen an offer
- The don't like the time commitment
- Uncertainty about life after the sale
- Concerned about their employees
- Loss of identity

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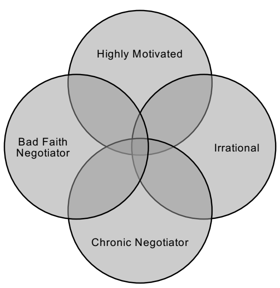
4 Common Seller Types



- **Highly Motivated Seller-** will do (just about) anything to get a deal done
- **Irrational Owner** - thinks he knows what his practice is worth, is anchored that number, and is sticking to his price without compromise
- **Chronic Negotiator** - finds any reason to drag out the deal. They often don't really want to sell.
- **Constant (Bad Faith) Negotiator** - wants to change the terms of the deal based on new information or circumstances.

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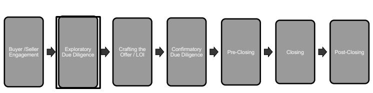
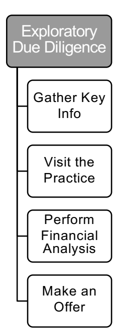
Step 2: The Exploratory Due Diligence Process





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Exploratory Due Diligence Information

- General Practice Information
- Operational Information
- Insurance Information
- Employee Information
- Equipment and Practice Debt
- Facility Information (Lease vs Building Ownership)
- Retail Data
- Financial Data

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Visiting The Practice

External Appearance:

- Location - parking, visibility, ease of entry, security
- Exterior Appearance
- Parking Lot location and size
- **Ease of Parking**
- Traffic into and out of the parking lot
- Busy intersections nearby?
- Office Signage
- **What kinds of businesses surround the office?**

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Visiting The Practice

Internal Appearance

- First Impression
- Office odors
- Entryway
- Size of optical
- Location of reception desk
- **Frame inventory and displays**
- Exam room layout
- **Type of equipment**
- **Functionality of equipment**
- Patient flow and efficiency
- Ancillary testing space
- Room for growth/expansion

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The Financial Analysis

- P&L for the last 3 years
- Current Balance Sheet
- **Tax returns for the last 3 years**
- Bank statement last 3-6 months
- Aging report for any outstanding A/R's (120 days or <)
- Create a practice Pro Forma

ABC Optometry
Profit and Loss
January - December

Income		
3000 Net Revenue		
3100 Professional Services		442,628
3350 Frames		212,214
3380 Lenses		390,804
3400 Contact Lenses		127,635
3600 Refunds & Other Adjustments		-1,355
Total Income	$	1,171,526
Cost of Goods Sold		
4000 Cost of Materials		
4031 Frames		117,292
4032 Lenses		69,898
4040 Contact Lenses		81,120
4050 Other Optical Supplies		2,198
Total Cost of Goods Sold	$	[illegible]
Gross Profit	$	[illegible]
Expenses		
5400 Employee Salaries		[illegible]
5405 Employee Bonus		18,842
5410 Employee Payroll Taxes		24,322
5500 Worker's Comp Insurance		5,384
5505 Health & Dental Insurance		[illegible]
5520 Retirement Cont		[illegible]
5580 Payroll Processing		2,801
5600 Rent		66,400
5720 Repair & Maintenance		[illegible]
5750 Security		288
5770 Storage		2,339
5790 Utilities		[illegible]
7000 Marketing		[illegible]
7240 Automobile Lease		[illegible]
7270 Bank Charges		[illegible]
7330 Credit Card Discount		16,440
7340 Computer Expenses		[illegible]
7350 Donations		1,450
7400 Dues & Subscriptions		3,299
7440 Seminars & Education		[illegible]
Total 7500 Insurance		7,481
7550 Meals & Entertainment		[illegible]
7560 Medical Supplies		1,655
7600 Office Supplies		13,680

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Creating A Practice Pro Forma

10-Year Pro Forma: Only enter data into cells with BLUE text											
INCOME	Year 1 Assumptions										
OD Clinic Days Per Week	5										
Exams Per Day	10										
Exams Per Month	208										
Exams Per Year	2496										
Projected Revenue Per Exam	$400	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Projected YOY Growth	5%										
PROJECTED ANNUAL REVENUE		**$ 998,400**	**$ 1,048,320**	**$ 1,100,736**	**$ 1,155,773**	**$ 1,213,561**	**$ 1,274,240**	**$ 1,337,951**	**$ 1,404,849**	**$ 1,475,092**	**$ 1,548,846**
EXPENSES											
Cost of Goods Sold (COGS)	28%	$ 279,552	$ 293,530	$ 308,206	$ 323,616	$ 339,797	$ 356,787	$ 374,626	$ 393,358	$ 413,026	$ 433,677
Gross Margin	72%	**$ 718,848**	**$ 754,790**	**$ 792,530**	**$ 832,156**	**$ 873,764**	**$ 917,452**	**$ 963,325**	**$ 1,011,491**	**$ 1,062,066**	**$ 1,115,169**
Non-OD Staff Payroll	25%	$ 249,600	$ 262,080	$ 275,184	$ 288,943	$ 303,390	$ 318,560	$ 334,488	$ 351,212	$ 368,773	$ 387,212
Occupancy		7.3%	7.2%	7.0%	6.8%	6.7%	6.5%	6.4%	6.3%	6.1%	6.0%
	Annual Increase	Annual Rent									
Rent	3%	$ 65,000	$ 66,950	$ 68,959	$ 71,027	$ 73,158	$ 75,353	$ 77,613	$ 79,942	$ 82,340	$ 84,810
Repair/Maint.		$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500
Security		$ 600	$ 600	$ 600	$ 600	$ 600	$ 600	$ 600	$ 600	$ 600	$ 600
Utilities		$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000
Marketing	1%										
Marketing/Advertising		$ 9,984	$ 10,483	$ 11,007	$ 11,558	$ 12,136	$ 12,742	$ 13,380	$ 14,048	$ 14,751	$ 15,488

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Creating A Practice Pro Forma

NET OPERATING INCOME ($)		**$ 255,172**	**$ 269,695**	**$ 284,984**	**$ 301,078**	**$ 318,017**	**$ 335,846**	**$ 354,610**	**$ 374,358**	**$ 395,140**	**$ 417,009**
		25.6%	25.7%	25.9%	26.0%	26.2%	26.4%	26.5%	26.6%	26.8%	26.9%
OD FM Comp	16.0%	$ 159,744	$ 167,731	$ 176,118	$ 184,924	$ 194,170	$ 203,878	$ 214,072	$ 224,776	$ 236,015	$ 247,815
NET +/- CASH FLOW (EBITDA)		**$ 95,428**	**$ 101,964**	**$ 108,866**	**$ 116,154**	**$ 123,847**	**$ 131,968**	**$ 140,538**	**$ 149,582**	**$ 159,125**	**$ 169,193**
Debt Service (P+I)**		$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639	$ 63,639
	Tax Rate										
Tax Liability	20%	$ 19,086	$ 20,393	$ 21,773	$ 23,231	$ 24,769	$ 26,394	$ 28,108	$ 29,916	$ 31,825	$ 33,839
NET CASH FLOW $ (After Tax + Debt)		**$ 12,703**	**$ 17,932**	**$ 23,454**	**$ 29,284**	**$ 35,438**	**$ 41,935**	**$ 48,791**	**$ 56,027**	**$ 63,661**	**$ 71,715**
NET % (After Tax + Debt)		1.3%	1.7%	2.1%	2.5%	2.9%	3.3%	3.6%	4.0%	4.3%	4.6%
Debt Analysis											
Total Cash Required		$ 82,725	$ 84,032	$ 85,413	$ 86,870	$ 88,409	$ 90,033	$ 91,747	$ 93,556	$ 95,464	$ 97,478
DSCR (Target > 1.25)		**1.15**	**1.21**	**1.27**	**1.34**	**1.40**	**1.47**	**1.53**	**1.60**	**1.67**	**1.74**
Pre-Tax Cash Flow (After Debt)		$ 31,789	$ 38,325	$ 45,227	$ 52,515	$ 60,208	$ 68,328	$ 76,899	$ 85,943	$ 95,486	$ 105,554
Pre-Tax Return		**3.2%**	**3.7%**	**4.1%**	**4.5%**	**5.0%**	**5.4%**	**5.7%**	**6.1%**	**6.5%**	**6.8%**
ASSUMPTIONS:											
Loan Amount	$500,000										
Interest Rate	5.00%										
Term	10										
Monthly Payment	$63,639.31										
Loan - Revenue	50.1%										

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Analyzing Key Performance Indicators (KPIs)

Key Metric	Formula
Revenue Per Exam ($)	Total Revenue / Total Comprehensive Exams
Exam Capture Rate (%)	Exams Performed / Exam Slots Available
Frame Capture Rate (%)	Frames Sold / Total Comprehensive Exams
Lens Pairs Capture Rate (%)	Lens Pairs Sold / Total Comprehensive Exams
Average Eyewear Sale ($)	Optical Sales / Lens Pairs Sold
CL Material Sales ($)	CL Sales / CL Exams Performed
Exams Per Doctor Hour	Exams Performed / Total Doctor Hours
Revenue Per Doctor Hour	Total Revenue / Total Doctor Hours

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Dealing with Debt

- Loans must be **retired** at closing.
- Some **leases** may not be transferable.
- Assumed debt will **reduce** the purchase price.
- **Pre-pay penalties** may apply.

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Office Lease / Real Estate Considerations

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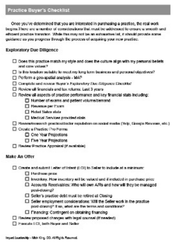
Additional Exploratory Due Diligence Considerations

- Professional and Retail Fee Schedule
- Assessing the competition
- Assessing the Practice Culture
- Insurance considerations
- Accounts Receivable Considerations
- Assessing the Reputation of the practice
- Doctor/Owner transition plans



Practice Buyer's Checklist

Once you've determined that you are interested in purchasing a practice, the real work begins. There are a number of considerations that must be addressed to ensure a smooth and efficient practice transition. While this may not be an exhaustive list, it should provide some guidance as you progress through the process of acquiring your new practice.

Exploratory Due Diligence

- ☐ Does this practice match my style and does the culture align with my personal beliefs and core values?
- ☐ Is this location suitable to meet my long term business and personal objectives?
- ☐ Perform a geo-spatial analysis - MAP
- ☐ Complete and review Buyer's *Exploratory Due Diligence Checklist*
- ☐ Review all financials and tax returns: Last 3 years
- ☐ Review all aspects of practice performance and key financial stats including:
  - ☐ Number of exams and patient volume/demand
  - ☐ Revenue per Exam
  - ☐ Retail Sales stats
  - ☐ Medical Services provided stats
- ☐ Review/research practice/doctor reputation on social media (Yelp, Google Reviews, etc.)
- ☐ Create a Practice Pro Forma
  - ☐ One Year Projections
  - ☐ Five Year Projections
- ☐ Review Practice Appraisal (if available)

Make An Offer

- ☐ Create and submit Letter of Intent (LOI) to Seller to include at a minimum:
  - ☐ Purchase price
  - ☐ Inventory: How inventory will be valued and if included in purchase price
  - ☐ Accounts Receivables: Who will own A/Rs and how will they be managed post-closing?
  - ☐ Seller's practice debt must be retired at Closing
  - ☐ Seller employment considerations: Will the Seller work in the practice post-closing? If so, what are the terms and conditions?
  - ☐ Financing: Contingent on obtaining financing
- ☐ Review proposed changes with legal counsel (if needed)
- ☐ Execute LOI, both Buyer and Seller

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Post-Exploratory Due Diligence Considerations

- ❑ Is this a good cultural and lifestyle fit for me?
- ❑ Is the owner serious about selling?
- ❑ Does this make financial sense? (Does the math work?)
- ❑ Is the landlord likely to cooperate?
- ❑ Am I comfortable with the risk?
- ❑ Am I ready to make an offer?

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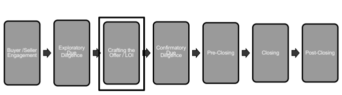
Step 3 (Part 1): **Crafting Your Offer** / Submitting the Letter of Intent (LOI)



Crafting Your Offer
- Assembling Your Team
- What is this practice worth?
- What am I buying?
- Valuation Considerations
- Engaging the Lender

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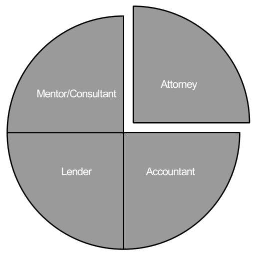
Assembling Your Team



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What is this practice worth?

Fair market value (FMV) is the **price** an asset would sell for (the practice) on the **open market**.

It is the price that would be agreed on between a ***willing buyer*** **and a** ***willing seller***, with neither being required to act, and both having reasonable knowledge of the relevant facts.

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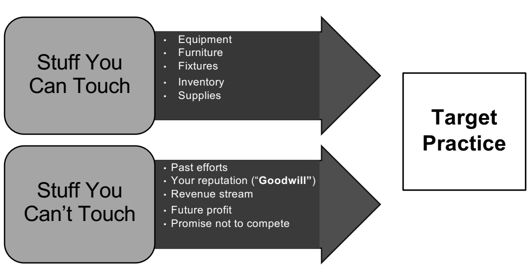
What Are You Buying?



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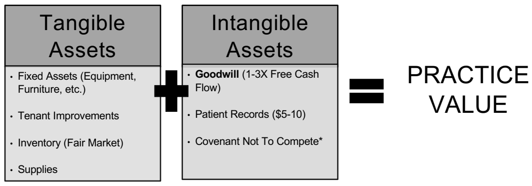
Understanding Practice Value



**"The value of a non-competition agreement is represented by the present value of the cash flows that would be lost if the covenanter were to compete, adjusted for the effective probability that the covenanter would compete, and compete successfully." Source: GBQ Consulting.com*

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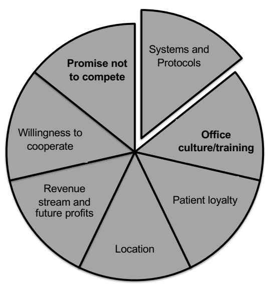
Intangible Assets

Goodwill. The "glue" to value.



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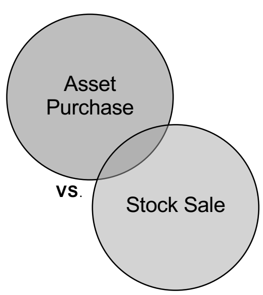
Transaction Types

- **Asset purchase** buys both tangible and intangible assets.
- **Stock sale** acquires the company's stock.
- Stock sale transfers **liability** to new owner.
- Most **healthcare** practices are sold as an asset sale.
- There are **tax advantages** to the **Seller** with a stock sale, and advantages to the **Buyer** in an asset purchase.



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Stock Sale vs. Asset Purchase

Stock Sale	Advantage	Disadvantage
Seller	Decreased liability; Tax advantages	May be some liability transferred
Buyer	Assumes third party contracts; TIN established; Simplified process; Avoids recredentialling	Increased liability; Lost tax benefits

Asset Purchase	Advantage	Disadvantage
Seller	Negotiating leverage?	Reduced tax advantages
Buyer	Decreased liability; Choose which assets to purchase; Tax advantages	Must reapply for third party payors and TIN

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Valuation Methods

- % of Revenue
- Summation of Assets
- Capitalization of Earnings
- Multiple of Practice Earnings
- Multiple of EBITDA
- Available Debt Service

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Valuation Method: Available Debt Service

- Value based on what's left to **service the debt.**
- This is what the **banks** care about.
- Practice size and **control of expenses** greatly affect what's left to service debt.
- Every expense bucket has a **HUGE** impact on practice value.
- It's all about **cash flow.**

Example:

Practice Revenue	$800K
Practice Net	$224K (28%)
OD FM Comp	$140K (17.5%)
Free Cash Flow	$84K
Available for Debt Service	**$67K (P+I)**
Amortization	10 years
Practice Loan	**$560K**

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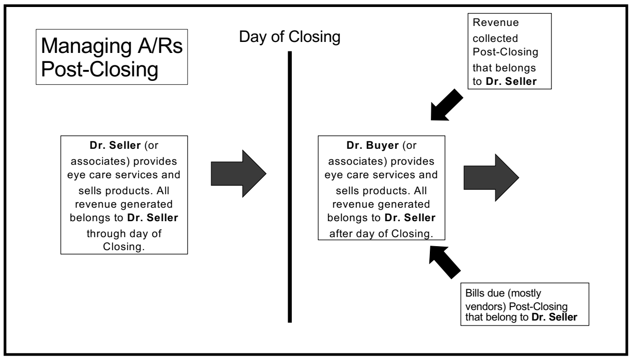

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Managing A/Rs Post-Closing

Possible Solutions	Advantages	Disadvantages
Include A/Rs in Purchase Price	Simple and easy for Seller. Transfers risk of collecting to Buyer.	Collectable A/Rs difficult to determine. May create a negotiation stumbling block with Buyer.
Buyer and Seller Track A/Rs and reconcile monthly	Clean and fair. Each party receives it's share of revenue and expenses it deserves.	Requires detailed recordkeeping, tracking and trust between the parties.
Buyer assumes both Receivables and Payables Post-Closing	Simple and easy to manage. Transfers risk of collecting to Buyer and avoids bookkeeping tasks.	If Receivables exceed Payables, Seller may be leaving cash on the table.

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The practice value must be based on past performance, not future potential.

A buyer should only pay what the **cash flow** will support.
Anything more rewards the Seller for the Buyer's **future efforts**, and potentially sets the Buyer up for **failure**.

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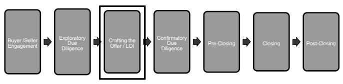
Step 3 (Part 2): Crafting Your Offer / **Submitting the Letter of Intent (LOI)**



Submitting the LOI
- What is the LOI?
- Elements of the LOI
- Engaging the Attorney

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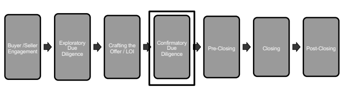
Step 4: The Confirmatory Due Diligence Process



Confirmatory Due Diligence
- Legal
  - Drafting the Purchase Agreement
- Financial
  - Finalize Funding
- Finalize the Lease
- Employment Agreement
- PM/Operational Considerations
- Create Purchasing Entity

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Due Diligence

3 types:

Financial Due Diligence
Legal Due Diligence
Practice Management Due Diligence

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RESTRICTIVE COVENANTS

- Enforcement
- Associate Employment
- Sale & Acquisition
- Associate Buy-In

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ALLOCATION OF PURCHASE PRICE

Tangible v. Intangible

CPA Role

Typical Percentages

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ACCOUNTS RECEIVABLE

Who collects it?

How long should it be collected for?

How do you pay for it?

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Don’t Ignore HR

18 documents

Beware of spouse

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The Lease

CAM
Full Service/NNN
New lease or extension

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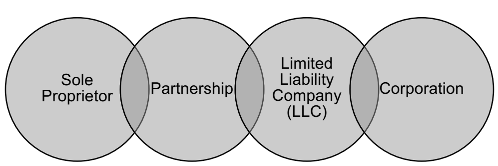
Creating the Purchasing Entity



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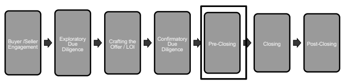
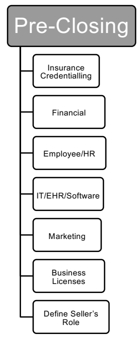
Step 5: Pre-Closing





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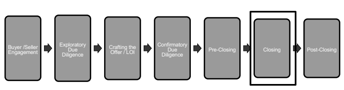
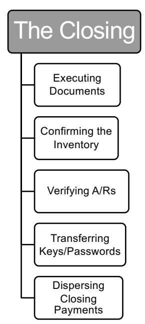
Step 6: The Closing





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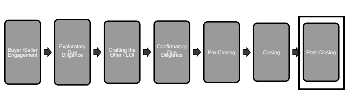
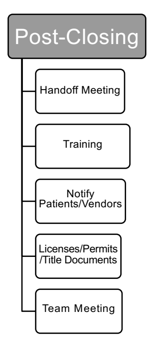
Step 7: Post-Closing





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Thank You!

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