ARE YOU MAKING A PROFIT? ARE YOU SURE?

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Overview

Over the past several years practice appraisers and brokers have become aware of a growing and disturbing phenomenon in our profession. There has been an increase in the number of practices with values substantially lower than would be expected. Since practice value is closely tied to profit, the fact is that these practices have very low profitability. But, what is even more disturbing than low profit is that the vast majority of these practice owners are completely and totally unaware that a problem exists. Since, traditionally, many veterinarians have relied on their practices and real estate as the bulk of their retirement funds, this is especially alarming.

The Valuation Committee of VetPartners has decided to address this emerging trend of very low profit and, therefore, low valued practices and has dubbed them No-LoSM practices.

There is no practice or type of practice that is immune. However, there are two common threads that run throughout every one of these practices. The first is that they have very little profit. The second which is also almost universal is a complete lack of awareness of the problem by the owners.

So, what’s going on?

The Tale of Two Train Wrecks...

There have always been practices with little or no value, but these are typically low-grossing, and often rural, “mom and pop” practices. But recently, we have been seeing a new breed of low-value practices emerging. On the surface they appear to be excellent in all ways. And they are often model practices, but with extremely low cash flows, and, therefore, low values. Each has its story...

Train Wreck #1

Dr. Slim Pickens graduated in 1968 and has been practicing small animal medicine in a small town in Oregon ever since. He is a sole practitioner, takes his own emergencies, and is a pillar of his community. When times get tough for the locals, he readily extends credit (these are his good friends!), and he often trades for his services. Slim is a good guy. His kids are grown, he is debt-free, and takes a one-week cruise vacation every year. Otherwise, he leads a frugal, but very contented lifestyle on his $90,000/year income. The practice revenue has grown steadily over the years to $500,000.

When Dr. Pickens graduated, everyone knew what practices were “worth”: one year’s gross revenue plus the value of the real estate. Over the years that has given him comfort, assuming that he has planned adequately for his retirement. Thus, he has saved very little extra for his golden years.

Last year, Dr. Pickens decided it was time to hang up his stethoscope and sell his practice. His real estate was appraised for $400,000, so he figured he would have about $900,000 to use for his retirement, along with his social security income. When he had the practice valued in preparation for the sale, he was devastated to learn that the TOTAL value was little more than the value of the tangible assets. He couldn’t believe it and, of course, is now unable to retire. He will now need to work for the foreseeable future.

So, what went wrong? First, as a sole proprietor, his “net profit” of $90,000 is the total amount he takes out of the practice, which includes production pay, management pay, rent, and profit (if any). And, yet, because of his lifestyle, he is comfortable and wonders why a buyer can’t also live nicely on $90,000/year as he has done. He hasn’t really considered the fact that, in order to buy his practice and real estate, a buyer would have substantial monthly debt payments, something Slim hasn’t had for many years.
Sadly, he has not had the tools or guidance to properly analyze the true profits of his practice over the years, and he has not stayed abreast of current practice valuation methods. Why should he?

**Train Wreck #2**

Dr. I. M. Content owns the Taj Mahal of veterinary facilities. He is convinced it is in the top 1% of all practices in the nation, in terms of facility, quality of medicine, technician to doctor ratios, compliance, staff and client satisfaction, and community service. It just doesn’t get any better. How can you go wrong with a $1.9 million dollar, 10,000 square foot, state-of-the-art hospital, complete with VIP boarding and swimming pool for the boarders? It won the Veterinary Economics Hospital of the Year, enjoys four-year AAHA certification, a 35 hour work week for all employees, full benefits for everyone, including health/dental/eye care, liberal sick and vacation leave, fully-financed CE for doctors and ALL staff, profit-sharing, and a matching 401K program. He wants to be sure that there is never short-staffing, so there are plenty of employees available at all times so that nobody’s work schedule becomes overly demanding. He has all of the latest equipment including ultrasound, laser surgery, and digital radiography. There is simply is not a practice that can compare to his “Taj Mahal”.

Dr. Content is thrilled to be able to offer the very best to his clients and staff. He is “poster child” for generosity and wants to “share the wealth”, a noble goal, indeed. After all, his $1,500,000 practice is providing him with $325,000 every year and he is debt-free. Isn’t that enough for any of us?

As with his classmate, Dr. Pickens, last year Dr. Content decided it was time to think about the beaches of Hawaii and the fishing lodge in Montana. He has been making a very nice income and, when coupled with the substantial sale price he expects from his real estate and practice, he should be able to live quite comfortably and still be able to leave a healthy estate to his children. Imagine his shock and dismay when the practice appraiser told him his practice could support only a little more than $200,000 in value. Again, his entire career, he had assumed that one year’s gross was the average value of a practice. This came as a $1,300,000 shock. As with his classmate, he is now forced to work for several more years and delay his retirement.

So, what could have gone wrong with this model, award-winning practice? Let’s take a closer look. Dr. Content is a sole proprietor so his tax return reports a “net profit” of $325,000. Similar to his classmate’s situation, this $325,000 includes the TOTAL amount of compensation he receives. An owner should be paid four ways: 1) pay for producing income, 2) pay for management, 3) rental income (if he/she owns the building), and 4) profit simply for being an owner, and it is THIS piece that is the basis for practice value. If there is nothing left for #4, the practice has little or no value because there is no money available for a buyer to use to pay for the practice loan.

Let’s look at the details.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Gross revenue</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Real estate value</td>
<td>$1,900,000</td>
</tr>
<tr>
<td>Owner’s income</td>
<td>$325,000</td>
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1) Owner produces $400K, so, at a 22% compensation rate, he deserves $88,000.
2) Management compensation should total 3-4% of gross - $15,000.
(He has a full-time manager, so he gets only 1% of the gross)
3) Rental income on $1,900,000 @ 10% of building value is $190,000.
4) So, the remainder (profit) is $32,000.

**TOTAL TO OWNER= $325,000**

So, how much practice can the profit ($32,000) buy, assuming reasonable lender terms?

**Typical current terms for practice purchase:**
- Rate – 7.5%
- Term of loan - 10 years
- Monthly payment available ($32,000/12) - $2,667

This would be the payment on a loan of $225,000! This is the most the profit can support, but the actual practice value is probably even less.

Naturally, when Dr. Content is confronted with a practice valued at only 15% of gross revenue he is dumbfounded, shocked, and angry. After all, he is “making” $325,000. Unfortunately, almost none of that is profit (the money he takes home simply because he happens to be the owner).
These are examples of both ends of the spectrum of No-Lo practices, but ANY practice can fall into this category. It is our hope that we can begin to offer tools to diagnose and treat this problem before it “infects” more and more practices.

**Why do owners allow this to happen?**

Owner is “making enough” - The majority of veterinarians are highly compassionate and caring. They are not greedy. When they see that they are making more money than the others in their practices, they want to “share the wealth.” They don’t feel pressured to keep profits at an optimum level. Is that wrong? Of course not, but it needs to happen intentionally, not accidentally.

Even if the owners are satisfied, personally, there are other reasons to maintain profitable businesses. They have a responsibility to clients to reinvest in the practice to keep current with new equipment, CE, and staffing. They have a responsibility to their families. Since we never know when we will need to exit, it is important for the financial security of family and spouse to maintain a profitable, and, hopefully, valuable practice. And, finally, they have responsibility to colleagues. If they sell services for little or no profit, it will create pressure on surrounding practices to charge substandard fees. So, this is not just about “I am making enough for me.”

There are two reasons for low profit, either too little revenue or too many expenses.

Since it is often not possible to control expenses to the point of increasing profit substantially, the solution often rests with inadequate revenues. There are three areas to examine. (You already know all of these and are sick of hearing it again, but, here goes.)

1. Fees not high enough
2. Excessive discounting
3. Excessive (giveaways)

But, it is not all about revenue. It may be possible to increase profit by reducing expenses as well.

- **Employees are overly compensated and “over-benefited”** - This is a direct result of the owner’s need to share the wealth. It brings joy to owners to be able to pay top wages, provide top-quality health and dental insurance, send all staff to CE meetings, have a generous vacation policies, and to contribute liberally to employee retirement plans. But, again, there is a cost to the profit of the business. If it is impossible to undesirable to cut staff costs, then we go back to revenue issue---there is not enough revenue to support this level of staffing costs.

- **NO expense is spared** to provide the best possible customer and patient care - When there seems to be enough money to go around, it becomes very easy to add services and “extras” that don’t add to the ultimate profit of the practice. Some of these probably do enhance the business, resulting in more enthusiastic clients and more repeat business, but some of these, frankly, make little difference to clients. Once again, if you are unwilling to cuts costs here, you MUST increase the revenue to support this level of service.

- **Not managed for profitability** – Many owners receive their monthly financial statements, look to see if there is positive number at the end, and throw the statements in a drawer. Nobody ever showed us HOW to analyze for true profitability, so it becomes difficult to track if you don’t know where to look. In essence, most owners have not been given the tools to properly read their financial statements so that they can be used a management tools.

VetPartners has developed the No-Lo Threat Advisory Worksheet to assist practice owners and managers in calculating true profitability (not tax return profit). It is available for free at [www.vetpartners.org](http://www.vetpartners.org) as a free download. It is the first step in deciding if your profit is reasonable of dangerously low. We encourage you to go through this exercise to assess the financial health of your practice. Do it now before you are forced to exit your practice. Awareness of the problem is the first step to a cure.