PRACTICE OWNERSHIP AND STUDENT DEBT: HOW CAN THIS POSSIBLY WORK?

David F. King, DVM, CVA, Simmons Southcentral, Scurry, TX

We often read about and hear from others that rising educational debt means that no recent graduate can buy a practice. Fortunately this is just not the case.

Student debt

About 89% of the students that graduated two years ago came out with some sort of student debt. The average debt among these graduates was around $150K. The full time salary for those in private practice started in the neighborhood of $65-$70K. This is among the highest (if not the highest) debt-to-income ratio among professionals. If you do the math you can start to see the big problem here! If the average recent graduate is making $5K-$6K per month and then has a student loan payment of $1750/mo, it does not take a math wizard to determine it is rough just to make ends meet. Also student loans are required to be paid off, they cannot be forgiven in bankruptcy. If payments are not being made, one could not only have credit ruined but wages garnished and other assets seized. When you have this large a portion of one’s income going to student debt it is almost impossible to save money; much less purchase big ticket items like a car, house or maybe even a practice.

This lack of extra income scenario may be true when it comes to a car or a house, but usually not a practice. The difference is that in the case of a car or a house YOU have to pay for it, when it comes to the practice the practice pays for itself. The only effect of educational debt on a loan application is the size of the monthly payment and its effect on a buyer’s after debt income. The lender looks at practice cash flow, subtracts the salary needed to support the buyer’s current lifestyle and personal debt service, subtracts a modest safety margin amount, and then subtracts the amount required to service the practice loan. If the remaining amount is a positive number, the loan is likely to be approved. In other words, student debt will not prevent you from buying a practice but it may dictate the size of practice. The practice will have to meet your needs, which includes your student debt, as well as pay the note payment. This means that smaller practices with smaller cash flows may not be attainable because of a student debt burden.

The “Three C’s” of lending

Most lenders will rely on the “Three C’s” when approving a loan. These “Three C’s” are:

- Credit
- Character
- Cash Flow

Notice nowhere among those “C’s” are the words “cash” or “collateral”. Most lenders understand that because of student loans and associate salaries, most buyers will have little to no cash or collateral. Therefore it is all about the other “C’s”. Credit and Character relate to the buyer. “Clean” credit does not necessarily refer to the size of (educational and mortgage) debt, but rather is a reflection of making timely payments on debt that exists. Most credit scoring agencies render a numerical score that is often referred to as a FICO score. If this score is between 650 and 700 or higher, the borrower is usually able to borrow for a practice acquisition. Character relates to most everything else in life. You manage your money well, have no criminal record, you are a licensed veterinarian, etc. Once a potential buyer gets past the “Credit” and “Character” hurdles it becomes all about the practice.

Cash flow, also called Owner’s Discretionary Cash Flow (DCF), is the amount of cash that flows to an owner after all the expenses have been paid but BEFORE being paid as a DVM/manager, note payment and taxes. It is essentially the “bucket of money” the owner gets to play in from which he/she pays all things of personal benefit (salary, note payment, perks, etc.). If a practice is priced properly then the DCF should be sufficient to pay ALL of the following:
• Owner’s fair market compensation for being a DVM/Practice manager
• Satisfy the note payment for the practice
• Have a “cash cushion” left over (lender required)

The ownership factor

As an owner you really should “take home” more cash versus being an associate simply from the increase in management duties and its compensation. The cushion is there for the lender’s peace of mind in case there is a dip in revenues. This cushion will remain in your pocket if there are no said dips. Also keep in mind, that part of your monthly loan payment is principle which adds to your equity in the practice. You cannot spend this in the same manner as take home pay, but it does increase your net worth. When you add your compensation together with the cushion you get your “after-debt” income. Mathematically it looks like this: DCF – practice note payment = after-debt income. This is the money you receive to take home to your family. What this means to you is that if as an associate you are able to pay your bills, you can do so as well (probably more easily) as a new owner because the practice pays for itself. When you factor in equity and net worth, it even becomes more obvious.

Let’s say you are an associate making $85/yr and you manage to pay your bills plus tuck away $8,000 into a retirement fund (nice job BTW). You invest well and are getting an 8% average return on this investment (again nice job). You are considering buying a practice for $800K (note terms of 6% for 10 years) that is grossing $1,000,000 and has a DCF of 25% or $250K. Your decision is whether to stay an associate or jump into ownership. Look into the future after the loan is paid in full and it might help you decide. It could look like this:

Well-Paid Associate
Salary: $85K/yr
Investments: $8K per year for 10 years at a return of 8%/year

After 10 years:
Savings: $212,000
Equity: $0
Net Worth: $212,000

Owner
After Debt Income: $144K/yr ($250K – note payment of $106K) plus future growth
Investments: $8K per year for 10 years at a return of 8%/year

After 10 years:
Savings: $212,000
Equity: $975,195* (assuming minimal 2% average growth/yr)
Net Worth: $1,187,195

When it is $212K versus $1.2M in net worth alone, is the decision getting easier? Also keep in mind, that after 10 years the $106K principle & interest payment is now coming to you and not the lender. That is $250K without any growth and you are a millionaire! Hopefully, at this point your student loans are paid in full as well.

Conclusion

The ever growing student debt is definitely a problem for our profession. Ultimately it will require someone higher up the food chain than most of us to slow it down. Meanwhile, all we can do is play the cards that we’re dealt and that means trying to produce as much income as possible to retire the student debt and provide for those we love. Practice ownership is just one path. Just know that student debt is not an insurmountable obstacle to practice ownership but practice ownership IS a solution to the burden of student debt which is the obstacle to everything else.