How To Value A Buy-In/Buy-Out

Given the array of important considerations when it comes to buying into or out of a practice, this author provides key insights into the pros and cons involved in this decision-making process.

By Steven Peltz, CHBC

Right now, many senior residents and fellows are facing the next step in their career, namely joining a practice. The idea of getting paid more than what they have received for the past few years along with working in a practice brings them a sense of excitement and foreboding.

After the interview process and mutual acceptance by each party, the discussion eventually turns to the topic of partnership. The owners only want to hire someone who will become an owner of the practice and will eventually buy them out. The owners explained in great detail the process of buying in for the new podiatrist and then explained buying out the owners. At the end of the evening, the new DPM has a headache and wonders if he or she went from the frying pan into the fire.

The owner of any business knows it takes time and energy to build up that business. These business owners create equity in their business, similar in concept to what you get as you pay off the mortgage on your home. However, the value of the equity in a business is not easy to quantify. The value of a business to the owner is usually much greater than the value of the same business to a potential purchaser. The value of an ongoing business supplies the owner with an income for his or her family. One problem that may surface is that the owner feels emotionally attached to the business. To the owner, starting the practice, building it and seeing it flourish results in an emotional attachment. This results in clouding up what should be an analytical, non-emotional process.

What One Will Hear During The Initial Buy-In Discussion

If you ask three valuation experts to value a practice, do not be surprised if you get three different values. Do not look for what is fair. Fair is subjective and what is fair to the buyer may not be fair to the seller and vice versa. If the seller feels the price is too low for the practice and the buyer feels the price is too high, the valuation may be close to an acceptable number. If everyone agrees on a valuation process and the process ends up with a price that the buyer decides is too high and walks away, no one wins. Start the process with an objective, open mind and then work to find what is acceptable to both parties.

The new DPM begins looking for a practice sometime in October of the year before he or she graduates. He or she finds a practice owned by a DPM, who

explains that he would like the buyer to work for three years as an employee and then begin the buy-in process. During the three years as an employee, the new DPM will receive a base salary that increases each year along with a productivity bonus if he or she meets certain benchmarks.

The seller explains that at the end of the potential buyer's third year (or earlier if he or she wants it), the practice's accountant will discuss the buy-in process and provide a number based on the latest financial information. The formula for the valuation of the practice will be equal to the collections for the past 12 months. For the sake of a discussion example, the selling DPM's gross collections total $650,000 before he or she hires the new podiatrist. Now let us consider a few key discussion points.

Why The Incoming DPM's Collections Should Not Affect The Valuation Of The Practice

The valuation of the practice should not increase due to the new DPM's efforts. If the new DPM generates another $500,000 a year in collections in his or her third year, the new DPM should not buy into **A PRACTICE NOW VALUED AT $650,000 (OWNER) PLUS $500,000 (NEW EMPLOYEE) OR $1,150,000.**

Keep in mind that the value of practices has decreased significantly from the high levels of the 1990s. Most of the "goodwill" has been replaced by participating with the insurance companies in the area. If the patient has a choice between going to a podiatrist and paying a co pay or going to a podiatrist and paying $100, 90 out of 100 patients will go to the podiatrist who accepts their insurance. The goodwill that has been established by publishing, expertise, teaching, being in the area for 20 years unfortunately does not transfer to the bottom line.

The valuation should be closer to the owner's net (his W-2 plus pension, FICA and allowances)as opposed to his or her gross revenue. In most cases, if there is an overhead factor of 50 percent, the net revenue will equal about one half of the gross revenue. Notwithstanding the previous sentence, there are times when a practice sells for much more than the net.

If the valuation of the practice is $650,000 and the new DPM is to become an equal partner, the new DPM agrees to a price of $325,000 when he or she buys into the practice. If the seller retires and the new DPM has to buy the rest of the practice, it is another $325,000. The new DPM will probably find a new podiatrist to work for him or her but the new DPM has now signed documents saying that he or she will pay the seller $650,000.

How To Determine An Appropriate Buy-In Price

The buy-in price should be less than what it would cost to start one's own practice. Many senior physicians remember the times of "UCR" (usual, reasonable and customary fee schedules) and selling practices for one or more times the gross, "goodwill" and other ephemeral phrases. While this time period is a thing of the past, some DPMs, for special reasons, try to sell practices based upon a relationship to gross collections.

The buy-in price is often close to what the buyer can expect to net in one year. If the buyer were to sit down and calculate what it would cost him or her to start his or her own practice, the total would probably be much less than $650,000. However, the new DPM would not have an established patient flow and the resultant revenue stream.

Any business has a value based on two components. The first is easy to measure. It is called the hard assets. For this discussion, we will use the value of the FFE (furniture, fixture and equipment) after the practice's accountant has considered depreciation of these assets. One can usually find the value of the FFE after depreciation on the tax return of the practice.

When a podiatrist buys into the practice, he or she is buying one half of all the assets (FFE), which is something the new DPM can take with him or her if the new DPM decides at some time to leave and set up a new office. In some cases, the practice has not purchased any assets in a few years and the value of the assets after depreciation is zero. In those cases, one can use the fair market value and have an appraiser value the assets.

For this example, let us say the value of the assets is $80,000. This means that the new DPM will buy into the assets by paying $40,000. One would usually purchase the assets with personal checks spread out over a three- to five-year period.

The second component is the intangible value. Perhaps the valuation of the intangible (good will, the value of an ongoing business, the value of getting a check…) assets is $200,000. In many cases, one would divide this amount by half (buying one half of the practice) and then spread the payments over three, four or five (years), and pay for it by crediting one's collections to the seller. Again, the process of the buy-in should be done over a three- to five-year period.

In this example, let us say the buy-in is over a three-year period. Accordingly, each month the buyer will write a check to the seller for $40,000/36. This is one half of the assets divided by three years (plus interest). The monthly check would be $1,111.11. Each month, the buyer will also have $2,777.77 **<u>of his collections</u>** credited to the seller for the intangible value of the buy-in.

The seller may be able to have the monthly check for the assets taxed at a capital gains rate (lower than ordinary income). He or she will probably have the

monthly check for the intangibles taxed at ordinary income rates. Only an accountant can determine how the situation determines the taxes.

The buyer will be on an increasing salary schedule each year. The new DPM's collections will cover his or her salary, share of the expenses and his or her buy-in. If there are funds remaining from his or her collections, a portion of them will be credited to the new DPM for a bonus or go toward his or her buy-in. The buyer should **eventually** have the same level of compensation as the seller unless it was agreed upon previously.

Why A Formal Partnership Agreement Is Essential

When buying into a practice, it is important to ensure there is a mechanism within process (not the amount) for practice valuation if one of the partners should die or become disabled. This will reduce legal and accounting expenses if an unexpected event happens later. One should have life insurance in place and the number of years of the buy-out should be easy to understand.

What would you feel comfortable paying your partner if he or she is disabled and over how many years are you willing to pay it? Then turn it around and say what would you feel comfortable being paid if you were disabled and had to sell your share of the practice?

When One Wishes To Leave The Practice

While we have discussed the buy-in process up to this point, you may have questions about buying out a partner who wants to leave the practice. Alternatively, it may be you who seeks to leave a practice. Here are a few points to consider.

The agreement that all partners sign must be in place before an event (death, disability, withdrawal or retirement) takes place that requires a buy-out of a partner.

If there are no signed documents in place, a partner who is ready to retire might tell her partners that she is retiring in six months and would like to receive her salary for the next three years as her buy-out. Her partner might ask why. No one has agreed on what to do before this event. In this case, the only certainty is that many dollars will be spent on legal fees.

How much should one receive when a DPM retires and sells his or her share of the practice to a new partner or partners? As a practice management consultant, there is one method I have used successfully a number of times in the past. While this will not work in every situation, it does provide insight into one method and the key issues that are involved.

As a guide, I start out by taking the net revenue, multiplying it by 0.5 and multiplying it again by 1.25. That is my initial range of values. I use this because it is close to what a new DPM can expect to earn. There are circumstances when a buy-out results in a higher or lower value than this guide.

In cases in which there is an opportunity to plan a buy-out over a period of time, one can use another formula. In that formula, the average of the last three years' W-2s is the buy-out value. This motivates a partner who is close to retiring to remain productive.

Finally, a number of practices feel there is no more value in a practice and only pay out the higher of the fair market value or the assets after depreciation as the value of the partner's share of ownership.

In most other non-medical businesses, formulas such as discounted cash flow and others are acceptable standards to use in valuing a business. However, because the government and managed care have significant impact on what you earn and do not impact other businesses in the same way, valuation has become more of an art than a science.

How To Prevent A Sudden Departure After One Achieves Partnership

Imagine that you have been practicing for 10 years and hire a new podiatrist. After five more years, he or she becomes a partner. Three years later, this DPM decides to retire and you have to buy him or her out. Something is wrong about this but you can't put your finger on it.

When someone becomes a partner, in order for him or her to receive the full buy-out, they have to work for (as an example) 20 years. With practice partnerships, we design a vesting schedule similar to what exists in a pension.

Here is an example. If a partner leaves in the first six years of partnership (excluding death and disability), he or she gets nothing. During the next six years, the partner vests 5 percent of his or her full buy-out value. If the partner leaves after 12 years, he or she gets 30 percent of his or her full buy-out. For each of the next seven years, the partner vests 10 percent a year. In order to be paid one's full buy-out value, you have to work three years as an employee and 19 years as a partner to qualify for a full buy-out.

Since it takes time to recruit someone to replace you, there is usually a required one-year notification when you decide to leave a practice. If you give less than one year, the value of your buy-out is decreased on a pro rata basis.

In all cases, the practice has to survive, especially if you want to be paid your buy-out. Your buy-out should not put financial stress on the practice. The practice

should start the buy out 90 days after you officially leave and then make equal monthly payments over three to five years.

You may not get as much as you want but then again your partners who are paying you may feel you are getting too much.

In Conclusion

This article is not intended to provide financial or legal advice. Hopefully, however, we have illuminated some key issues that podiatrists should consider when weighing the decision to buy into a practice or when to BEGIN THE PROCESS TO HIRE A REPLACEMENT depart a practice's partnership structure.

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This was published in the Podiatry Today December 2005 issue