The Ins and Outs of a Practice Buy-in or Buy-out

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For anyone who is not a career employee or beholden to the US government, there will eventually come a time during which the issue of a practice purchase or sale will be addressed. This time may come in the dawn of a practice career, with the prospect of 30 or more years ahead. It may come in the middle of a practice lifetime, with 10 to 20 years behind you and a similar number of years ahead. For some, it may come at or near the time of retirement. The reasons are varied and encompass nearly every imaginable scenario.

What is a constant is the careful analysis and consideration of the personal, social, and economic factors involved in the transaction. For every dermatologist who has ever contemplated or completed buying, selling, or merging a practice, there is a well-known dichotomy between tangible and intangible variables to assess. These variables are typically broken down into those that can be appraised, valued, or somehow given a "hard" number and those for which a simple accounting approach is insufficient. Examples of the former may include real estate, equipment, furnishings, and, to some degree, economic goodwill; the latter may include practice reputation, patient loyalty, or provider dedication and may even extend into philosophical issues, such as dedication to the altruistic aspects of medical practice. These "soft" factors are, fundamentally, at the core of the personalities of the parties involved, reflecting moral, religious, familial, political, racial, or socioeconomic traits, among others. In corporate mergers, we refer to the melding of these traits as the "merging of corporate cultures," the challenges of which are the domains of career organizational and social psychologists. Because these "soft" factors encompass nebulous areas of thoughts, feelings, loyalty, and, ultimately, morality, and because these issues are so intensely personal and unique to each transaction, they are not the subject of this article beyond acknowledging that they exist and that they can become a veritable Gordian knot of vexing frustration in the buy-in and buy-out process.

Instead, we will focus on the "hard" side of the equation, the tangible or at least predictable (to some degree) aspects of a business transaction in which there is a willing seller and a willing buyer operating without coercion. This does not mean that there is an absence of an urgent or even emergent, compelling reason to negotiate and complete a transaction. What it does mean is that the parties involved are willingly doing so without fear of reprisal if they choose not to complete the sale or purchase.

The terms *buy-in* and *buy-out* are really 2 sides of the same coin and represent the opposing perspectives of the parties involved, namely, the buyer and the seller. Even in practice mergers, there is typically one party that acquires, disposes of, or transfers a disproportionate share of the equity involved, sometimes referred to as the "senior" partner (or the bigger fish in the ocean!).

The Hard Assets

The process of valuation in a medical practice is really an exercise in appraisal—of the furnishings, supplies, inventory, and equipment present and intended to be conveyed in the transaction. It also includes the appraisal of real estate (if owned) or the value of the lease (if applicable and transferable). Finally, it may include the valuation of economic goodwill or the value in having an ongoing business concern that provides both patient and cash flow, with the attendant advantages of market presence.

Inventory

Beginning with *inventory* as a catchall term to describe the contents, tangible and intangible (think software licenses), of the practice, there are classically 4 very disparate methods of valuation. These methods assess, from top to bottom, the replacement, fair market, depreciation, and liquidation values ascribed to the inventory.

Replacement value usually refers to what it would cost to replace the "stuff" in the practice if you had to purchase it all again. Imagine you had a house fire and you had to start all over again; this would be very expensive. The same thing can happen to a dermatology practice. Typically, replacement value does not take into account

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the depreciation, condition, wear and tear, or obsolescence of the inventory. Needless to say, this replacement value is exceptionally good for the seller and a poor value proposition for the buyer.

Fair market value describes the valuation of inventory as it exists as of a certain date, based on a mutually agreed-upon valuation process, usually by a third-party appraiser. Fair market value has a certain equitability to it because, in the perfect case, it accurately measures the true value of the inventory without a bias toward either party, buyer or seller. Fair market value is also used by most lending institutions to make their financing decisions. In the most common method, there is one appraiser retained by each party or one mutually agreed-upon appraiser who is knowledgeable in the industry. An appraiser may make an on-site visit and physically inspect the inventory or use a standard formula to calculate the value of items based on factors such as age, reported condition, and quantity. If there is a significant valuation difference between 2 appraisers, an average between them may be taken, or a third appraiser may be retained to settle the question. Think in terms of buying or selling a used car. There is a value range for which the bank will make a loan and a price that reflects the current market conditions of supply and demand. Typically, when dealing with used cars, there is the feeling expressed by the sales manager that a certain car is a loss leader and by the buyer that it is a steal.

The depreciation value of equipment is really an accounting and tax calculation that has little bearing on the value of a sale other than to calculate tax liability. It is typically not used in buy-in and buy-out transactions unless there is a tax advantage (usually to the seller) in doing so, and then it is usually used as part of a tax equalization calculation relating to tax-deductible and nondeductible components of the sale globally. Think of the tax-depreciated value of a rental home versus the actual market value.

Liquidation value is the calculation of value that a wholesaler would give for the inventory if you had to sell it today, regardless of the cost of the loss. This is the so-called fire-sale price and is what the inventory would be worth to someone, frequently sight unseen, who takes it off your hands immediately. Believe it or not, this value is sometimes calculated by gross weight of the inventory, as in so many dollars per ton. This represents an extreme loss to the seller and is something of a risk to the buyer, who may have to warehouse the inventory for some length of time before disposing of it. This is similar to the "grab bags" that hardware and sporting goods stores sometimes sell at ridiculous discounts. Buyers purchase items sight unseen because they are so cheap, usually pennies on the dollar. Have you ever wondered what the stores did with all that unsold fishing tackle? Now you know what "buyer beware" really means.

Real Estate

Real estate, as part of a practice sale, can be a very simple or a very complex issue. Issues surrounding the sale of a leased practice location are different from those surrounding an owned location.

The location of a practice can be, and usually is, critical to the success of a practice, especially when considering the type or style of a practice, such as a cosmetic dermatology practice or a pediatric dermatology practice. In the lease scenario, a lease may be an asset or a liability, depending on the unique needs of the practice and the advantages and disadvantages of the leased location. Imagine a leased location for an aesthetic practice characterized by high crime, poor parking, and outdated improvements. Although there may not be another dermatologist in 20 square miles and medical patient demand may be crushing, this may not be the best location option. In fact, it may be a liability in the transaction. Conversely, a lease in an ultra–high-demand location, such as Park Avenue in New York City, may be worth more than the inventory of the practice itself.

Calculating the value of a lease should be similar to leasing a residence, with the same questions asked: Is this where I want to live? Do I want my family to live here? For how long? What are my other options? What is the cost to relocate? How long until I have the choice to do so? Will I have to leave if I don't want to? Where could I go? How hard will it be to find a similar location? What impact will this have on my business, positive or negative? Is more space available, and at what cost and time factor? Who are my neighbors? What does the future hold for this location—a Wal-Mart Supercenter or a new hospital campus? If I like it here, can I buy the space to preserve and protect my business interests? These are all very reasonable questions to consider before assuming or negotiating a practice lease.

There very well may be times when it is better to move the practice prior to sale or purchase to address these concerns. There may also be times when it is of paramount importance to secure a future in the existing location prior to closure of the purchase or sale.

Purchasing real estate is similar to evaluating a lease, except that a separate valuation based on the highest and best use of the real estate should be undertaken as part of the due diligence process. We know of a situation in which the sale of a practice that included real estate was accompanied by a parcel of land that was of much more value with a commercial office building than a medical office. The buyer elected to move the medical practice several blocks away, develop the land, and pocket a handsome return in the process. The opposite may also occur—the value of the land may be inflated by the presence of the medical practice. Declining to buy the real estate may be a wise financial decision that allows the seller to separate the 2 business interests and the buyer to obtain the practice without the added burdens of financing real estate.

Additionally, the time horizon and exit strategy of both the buyer and seller will impact the decision-making process with regard to any real estate purchase. Longer time horizons to amortize the costs of purchasing and maintaining real estate are generally helpful to buyers. Finally, tax considerations should be carefully evaluated with an accountant to determine if a real estate purchase will support or hinder your practice purchase and investment portfolio.

Economic Goodwill

The last hard asset component of a dermatology practice transaction is the concept of economic goodwill. Frequently thought of as comprising reputation, efficiency, number of patient charts, annual visits, and overhead, economic goodwill is ultimately a financial analysis, both retrospective and prospective. The positive concept of goodwill is that there is value in the business as it currently exists that can be transferred and that this value can be calculated and a price affixed to it in the process of negotiation. The negative concept of goodwill is that there is a liability in the business as it currently exists and that this liability can be calculated and deducted from the price during the process of negotiation.

Another concept of goodwill value is that of opportunity cost. Ask yourself, what is the cost to start a practice from scratch, and how much income is lost when compared with purchasing a practice that is already operational? In some ways, this is a value ascribed to the practice's address and phone number.

For example, if a practice generates a net profit of $500,000 per year and the average net profit of similar practices in similar locations with all other things being equal is $300,000, you could say that the goodwill value is $200,000 per year. That $200,000 of excess earning capacity has a value. Maybe it comes from better insurance contract negotiations (unlikely), or more efficient operations (doubtful, but maybe), or more private-pay patients (likely), or more cosmetic procedures (bingo!). The value is real and may be maintained postsale by the new dermatologist. Or it may be lost if the buyer does not perform those same procedures with as nice a smile. The problem arises when the excess earning capacity is compounded (usually by a factor of 3, resulting in a total goodwill value of $600,000) and is added to the sale price. The seller vacates the practice, and the private-pay patients, desirous of trying someone new somewhere else, leave the practice for the new medispa down at the mall. The excess earning capacity evaporates, and now there is discontent and ill will between the buyer and seller.

One way to ameliorate this potential minefield is to risk band the goodwill. What this means is that if the excess earning capacity drops below a certain level, a reduction of the goodwill purchase price occurs. Conversely, if an increase in the excess earning capacity occurs, there is a corresponding increase in the goodwill value. Typically, there is some dampening on both sides of this equation. In addition, the risk banding may not be symmetric and usually favors protection for the buyer.

Opportunity cost is a related, although fundamentally different, concept from that of excess earning capacity. Opportunity cost is a value added to the practice sale cost to reflect the true value of an ongoing operational entity versus that of starting from scratch. For example, if a practice generates a net profit of $500,000 per year as an ongoing concern, and a new practice produces net profits of $300,000, then the opportunity to start a new practice from scratch is $200,000, all other things being equal. Opportunity cost is sometimes compared with sunk cost because there typically is no way to recover the lost revenues. One hopes for a brighter, more profitable future because the new practice has more upside potential than the existing practice. This, however, is debatable in most real-life situations. It is like trying to justify buying a new car rather than a used one because the new car will last longer and cost less in the long run.

One area that we have not covered is the sale and purchase of accounts receivable. These billings are the outstanding collections of the seller and are typically not conveyed in the transaction unless they are a method of financing the sale and providing for immediate cash flow needs. The problem with accounts receivable is that there is always a discount rate applied to the accounts for factors such as bad debt, denied claims, and time value of money. It is our recommendation that accounts receivable not be a part of the transactional process of a buy-in or buy-out. Financing can and should be done with the buyer's equity or financial institution (bank) debt.

Summary

The process of buying, selling, merging, or otherwise transferring ownership of a dermatology practice can become quite complex. By identifying and understanding the various components of the transaction, both buyer and seller can consider each component separately and on its own merits. This allows for a more methodical analysis than simply considering a purchase price and helps to ensure the satisfaction of both parties as well as to minimize the risk of both buyer's and seller's remorse.

The various hard and soft components of the valuation process represent the objective and subjective sides of the decision, respectively. It is important to note, however, that in nearly every circumstance, the final outcome is determined by the establishment of a trusting relationship between the parties involved. When trust is established, the transfer of ownership is a much more simple and gratifying process. If the parties are not mutually determined to help support each other's efforts, then, unfortunately, litigation is commonly the end result. ■