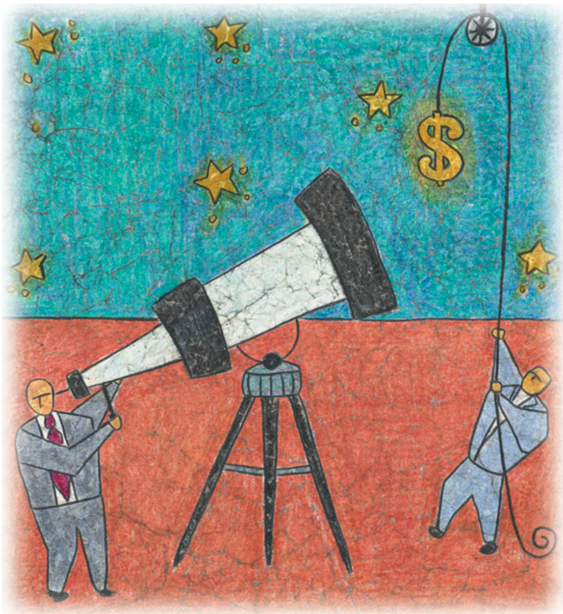
APRIL 2006 EDITION

Vision One CREDIT UNION

In Focus



BUYER REQUIREMENTS:

The Affect on Practice Valuations

As the leading financier of private practice transitions, Vision One reviews numerous private practice sales each year. We feel it is beneficial for sellers to understand a buyer's mentality when negotiating a sale transaction. Recognizing what is being sold, buyer requirements and how they affect a buyer's perception of practice value are critical to the successful sale of a private practice.

What is Being Sold?

Sellers believe they are selling their life's work developed through numerous patient relationships. Accountants suggest the sale involves physical assets such as equipment, tenant improvements and "blue sky" (the intangible value of a going concern). Buyers see that they are acquiring their professional dream. All of this is happening concurrently.

In economic terms (the language spoken by us bankers) what is being sold is a recurring stream of cash flow. With it comes the means of producing the cash flow which includes the physical location, improvements, equipment, inventory, human resources, patient records, etc. When viewed in economic terms we begin to understand the requirements of a buyer.

Buyer Requirements

Minimally, a buyer needs the ability to retain enough practice cash flow to:

- Pay practice acquisition debt service
- Provide a cushion for any revenue loss from:
  - Patients as a result of the sale (transition risk)
  - Mistakes made due to lack of business skills
- Fund reasonable personal / family expenses including student debt

Impact on Practice Valuations

How do buyer requirements affect a buyer's perception of practice value?

A knowledgeable buyer will only pay what they can afford. What they can afford is a price that will allow the buyers cash flow requirements to be met. Since most buyers do not have cash equity to put into a private practice purchase, most transactions are financed at 100% of sale price or greater. The amount over 100% generally comes from the need for working capital. Remember when you first purchased or started your practice; how much cash equity did you put in versus financing? In many cases financing was obtained only by relying on your relatives.

The buyer requirements coupled with the typical highly leveraged situation together establishes a natural upside price for private practices. In California, where we have seen the highest practice sale prices, prices tend to not exceed 2.5 times net cash flow. Over this amount, they generally become non-economic and too risky. Price ranges generally run from 1 – 2.5 times net cash flow. Practice appraisals will arrive at a specific value conclusion. Although many appraisal techniques are used as no standards have been set for our industry, responsible appraisals generally fall within the ranges indicated above. Where in the range a valuation falls depends on factors such as income growth trends, quality of the physical assets of the practice, etc. Prices outside California generally are somewhat less.

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(BUYERS PERSPECTIVE Continued)

Other factors can also affect prices of private practices by changing the supply or demand. One example is the salary level in commercial optometry compared to the starting net cash flow after debt service of private practices. Although we know the long term economics of private practice are much more beneficial than corporate optometry, some potential buyers are lured away from ownership, reducing demand for private practices. Perhaps this topic will be the subject of a future VOCU newsletter article.

When Vision One Credit Union underwrites practice acquisition loans, we derive a "net cash flow" which is based primarily on income before debt service and owner salary. The net cash flow is adjusted up or down for non-recurring revenues and expenses as well as other items (yes, this includes adding back everyone's favorite tax shelter - auto expense). Expenses can be increased for items such as additional landlord rent required. We then factor in the economic impact to net cash flow from transition risk. This risk varies and can be mitigated by a transition plan where the seller or existing associates continue to work in the practice for an agreed upon time (generally one or two days a week for 6 – 12 months). You can see this model favors selling to your associate who should already be familiar with your patients (less transition risk). The transition plan should include the seller introducing the buyer as their chosen successor, preferably with the buyer completing at least some portion of the exam.

The loss of cash flow from transition risk can be offset in part through creative financing. Our relationship with VSP has produced a loan for first-time buyers that can be used when adequate down payment funds are not available. The loan, which is part of the overall financing package, does not require any payments for the first two years. This provides ample time for the transition to occur and if necessary, for patient volume and revenues to recover.

As an optometric industry resource, Vision One Credit Union hopes to stimulate demand for private practice ownership by helping reduce risk for buyers and minimize the complexity of the acquisition process. A successful effort will help support practice prices. Our educational efforts are designed to help buyers and sellers understand each others needs in an attempt to alleviate impasses that can derail the negotiation process.

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Advancing Independent Optometry

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