The No-Lo Practice

Avoiding a Practice Worth Less

Shoulders sagging, he grumbled, *"I just don't understand. Her practice is smaller than mine, her building needs updating, and she doesn't see as many patients as I do because she's always writing newsletters or speaking at schools. How could her practice sell for $2 million and mine doesn't get any offers?"*

The answer eludes many practice owners until they understand why this can occur and what they can do to recapture the missing value.

VetPartners™
For the good of the profession.

Valuation Council

To view this publication online, visit www.VetPartners.org

Executive Summary

Veterinary practice appraisers have always observed a relatively small pool of low-value practices. Often referred to as Mom and Pop practices, these generally consisted of solo practitioners delivering dated medical service from poorly equipped, marginal facilities and producing low profits each year.

But in recent years, appraisers have seen an increase in the number of practices with no value or an exceptionally low value (i.e., No-Lo Practices℠). Quite unexpectedly, appraisers are also observing a significant change in the mix of practices occupying the low-value end of the spectrum. In addition to the normally predominant Mom-and-Pop practices, this end of the spectrum is currently experiencing an increase in the number of practices traditionally expected to be profitable—practices that offer high quality, progressive medicine with the latest equipment; are located in new, state-of-the-art facilities; and offer above-average compensation packages to doctors and staff members. Owners in these practices may take home more than $200,000 per year but still have No-Lo practices.

The common thread linking all these practices is poor profitability in relation to gross revenue generated. To make matters even worse, most owners of these low-profit practices are not even aware of their perilous financial situation and discover the gravity of their situation only as they prepare to put their practices on the market.

If you are a practice owner or potential buyer, this publication is a must-read. It includes a discussion about how the trend developed and describes the common symptoms of a No-Lo Practice℠. The following pages also identify the underlying causes of having a low practice value. Finally, and most importantly, this publication provides practical information about how to restore profitability and recapture the lost value in a practice.

VetPartners is taking a leading role in educating practice owners about this highly debilitating trend in the veterinary industry. Now it is your turn to help reverse the trend. We need you, the practice owner, to become engaged and proactive about assessing your practice's true profitability. Reading this publication in its entirety is your first step in ensuring your personal financial security.

—VetPartners Valuation Council

ANSWER THIS QUESTION: *Do you view practice ownership as job security or as an investment?*

When this question was asked of both general and specialty practice owners who attended recent seminars, the answers were mixed. Those who saw ownership as job security praised the autonomy and control they gained by becoming owners. Those who viewed practice ownership as an investment reported varied expectations. Some said they were content to break even (i.e., just get the bills paid every month), while others said they expected returns on their investment as high as 25% or 30% each year.

Most owners want their practices to provide them with more than mere job security. They want practice ownership to act like an investment and to build wealth for their retirement or for their heirs. But for ownership to act like an investment, owners have to view their practices as investments. See **Figure 1** below to learn how.

If you own or plan to own a veterinary practice, you owe it to yourself to keep reading. The steps you take now can have a significant impact on your practice value and your ability to attract a qualified buyer. Even if your practice generates enough money to meet your personal and practice cash flow needs, would a potential buyer find that sufficient? Your needs are different from what a buyer may expect from your practice. After all, a buyer will be making payments on debt to acquire your practice and will expect the practice to generate those funds.

Just as you recommend regular exams for your clients' animals, you need to conduct a self-exam

Figure 1. How to View Practice Ownership Like an Investment

What is your risk of ownership? What reward do you expect to receive for taking that risk?

If you were to invest money in stocks or bonds, you would most certainly analyze the risk vs. the expected return. Is investing in Microsoft shares or Treasury bills more or less risky than owning a veterinary practice? Small businesses are almost always more risky. Why does this matter? Because to take a greater risk, investors need (and expect} to earn a greater return. Otherwise, they won't invest. The bottom line: You should expect a financial reward from owning your practice that is greater than the financial reward if you invested your money in a less risky product such as government bonds, stocks in stable public companies, or savings accounts.

What is your current return on your investment in your practice?

Now that you've discovered that small business ownership is a risky endeavor, you need to determine if you are being adequately rewarded for the risk you are taking with the money invested in your practice. What is your current return on investment? To determine this, you must step outside your practice and examine it as a potential investor. Pretend you are a silent partner. What money would flow to you while sitting at home if the practice continued to use your money but without your active presence? Your return from the practice is what you get sitting on your sofa at home while the practice carries on without you. All the functions you perform in the practice would have to be done by someone else who is fairly compensated for this work. All the expenses would have to be paid before you, as an investor, could get any reward. This amount can be compared to passively owning shares in General Electric or buying a Treasury bill. Your return on investment comes from:

- Distribution of your share of the current profits
- Long-term appreciation in the value of your practice, an amount you receive only when you sell.

on your practice's health. In particular, you need to examine your true profit, which is an important component of practice value. Unfortunately, that hasn't been easy to do. The accounting principles that drive the reports you see are largely tax-driven (i.e., your financial strategies are designed to minimize your profits to reduce your income taxes. Your statements then can't give you a snapshot view of your practice's financial health).

In the absence of a reliable method for knowing if your practice is financially healthy and thus building value, you may own a practice that has little or no value. In the last few years, the number of practices with no value or low value has increased—to the point where the VetPartners Valuation Council coined the term No-Lo Practice℠ to describe these businesses.

The biggest mistake made by practice owners is to assume all the money they take home from the practice (e.g., salary, management fee, rent) is their return on investment or profit.

This insidious disease is particularly dangerous because owners are often caught totally unaware until they try to sell the practice and a qualified practice appraiser gives them the bad news. That's much too late—by then the practice may be too infected and too diseased for short-term treatments to cure the illness quickly. As valuators, we don't like giving owners bad news, so we want to help you self-diagnose if you have a problem and show you how to fix it before it's time to sell.

What Got Us Here?

To a certain degree, historic methods employed to estimate practice value played an inadvertent yet causative role in the development of today's No-Lo Practice℠. Ever since the appearance of the first small animal practices, owners were in a quandary about what their practices were worth when it came time to sell. Gradually, over time, rules of thumb developed. These were deceptively simple, easy to understand formulas that allegedly provided a quick and dirty determination of a practice's value. The most common and most enduring of those rules used to be, "A practice is worth one year's revenue." This single rule governed the sale of thousands of practices during the last half of the twentieth century, and it lingers today. But common sense suggests that if two practices both gross $1 million, wouldn't you rather own the one that produces higher profits?

Despite common use, these rules were seriously flawed. Most of the rules' simplistic formulas were based solely on a practice's ability to generate revenues and totally ignored its ability or inability to generate profits. For example, a practice could sell at one times gross revenue, yet be barely profitable, leaving a new owner struggling to find sufficient profits to maintain operations, invest in staff and equipment, and pay down debt related to the practice purchase. These revenue-based rules of thumb could inadvertently establish the foundation for a No-Lo Practice℠.

Where Are We Now?

In the last 30 years, the veterinary practice marketplace has changed considerably. Appraisal methods have become more sophisticated and are based on a practice's profit-generating capabilities. These profit-oriented methods have almost totally replaced the old rules of thumb.

Current rules of thumb are more likely to be based on some multiple of net income or profit (the bottom line), though there are lots of variations in both the definition of the bottom line as well as the multipliers suggested. Multiples of 4-6 times profit were common, but with the advent of practice consolidators, the high end of that range has increased. See the discussion on page 5 concerning this trend.

Yet rules of thumb live on despite the advancements in the veterinary marketplace and despite the often-repeated warnings of the hazards of using quick and dirty formulas. Knowingly or unknowingly, when reverting to rules of thumb, owners effectively try to take precision out of the mix but instead may set their hospitals up to be future No-Lo Practices[SM] in the future.

Finally, a correlation may exist between the expectations of younger doctors and the increase in No-Lo Practices[SM]. Many owners have observed in the last 15 years that younger doctors are less willing to work long hours but have high expectations for compensation and benefits. There is an increasing emphasis on work-life balance, flexibility in scheduling, and attractive, well-equipped facilities as desirable places to be employed. That puts increasing pressure on owners to build and maintain those facilities, buy or lease the latest equipment, offer attractive compensation packages, and accommodate their associates' needs where possible.

However, a balance must exist between what the practice can afford and what it pays. Maintaining that balance seems to get lost in many No-Lo Practices[SM], where owners expect the practice to grow into a higher expense structure sooner than can actually happen.

Financing Alternatives

Financing has changed too. Years ago, the primary means for financing the sale of a practice was through the owner: the seller became the lender.

Today, commercial cash flow lenders are an integral component of the market, assuming the financial risks previously taken by the seller. These lenders understand the importance of profits as the source of their repayments.

Sometimes sellers offer to finance the buyer as a way to provide a steady stream of income in retirement. They should realize, however, that there is risk in being a lender. They should require that the buyer/borrower provides adequate life, overhead, and disability insurance to secure the seller's position, but there is no protection from a buyer's mismanagement or bankruptcy.

Occasionally, a practice owner offers to finance the buyer for a very different reason. That seems to happen when a practice appraiser or cash flow lender insists that a practice is worth less than the seller wants, so the seller goes for the quick fix: become the lender and finance the buyer. The hope is that by doing so, the seller will actually receive the inflated price. While that may ease the buyer's short-term cash flow issues, it doesn't address the underlying issue: it takes profits to generate the money to repay debt. If the buyer increases future profits, it's the seller—not the buyer—who is being rewarded for the buyer's efforts to operate and grow the practice.

The Role of the Corporate Consolidators

One of the major shifts in recent years has been the proliferation of corporate acquisition companies who now provide a growing pool of potential buyers, sometimes aggressively seeking target hospitals to purchase. Additionally, other companies, desiring to enter the veterinary profession, which they see as a good financial opportunity, have become buyers in a variety of ways by forming smaller consolidator companies. Currently, corporate ownership of veterinary practices in North America is approximately 10%, and growing, likely controlling a much larger share of the veterinary services market than this percentage might indicate. Some in the profession see this as a great opportunity for practice owners seeking an exit strategy, while others have negative impressions of the direction this is taking veterinary medicine.

Larger practices are generally most impacted by this trend. Rarely are No-Lo Practices℠ acquisition targets for consolidators, so veterinary hospital owners should not count on such buyers to “bail them out” if they are unable to sell their practices to an associate or to an outside buyer.

Practice owners should be aware of the types of conditions that corporate buyers seek. Much like the advice contained in this publication, these buyers target practices that are producing solid growth, have maintained steady financial performance and expense management, have low lease rates as a percentage of gross revenue (generally less than 6%), and produce consistent profitability. Often corporate buyers will turn their backs even if these conditions exist, if doctor compensation packages are considered too rich, and/or if support staff costs exceed the suggested industry norms noted in this publication. Generally speaking, corporate buyers are seeking hospitals generating fees of at least $1.5 to $2 million per year, although some of the newer practice purchase groups seek smaller practices to create a niche that the larger consolidators are ignoring.

Corporate buyers will often purchase practices based on a multiple of earnings (profits) higher than what has historically been a range of 4 to 6 times earnings. Some recent corporate consolidator purchases have seen these multiples increase significantly.

This may result in a higher sales price than a practice might command on the open market, depending on the buyer’s strategic objectives. There is clearly an impact on the willingness of sellers to forgo that bonus and sell to associates instead.

Clinical Signs of the No-Lo Practice℠

Imagine you are a practice owner a year before you plan to retire. You’ve spent the last 30 years building a small animal practice that is now debt-free and operates from a modern and attractive hospital facility you own. You feel your practice is very valuable because of the cash you are able to pay yourself each year—as the sole owner of this unincorporated business, you take home more than $275,000 per year. Your two very capable associates are interested in forming a partnership and buying your practice when you retire.

In anticipation of the sale, you hire a veterinary appraiser who asks you for data about your practice, analyzes the data, and gives you a report saying that your practice —which grosses $1.5 million annually—is worth only $210,000. You are stunned! How can that be? You say to yourself that the appraiser must have done something wrong, so you call her.

The appraiser then tells you that a primary determinant of practice value is the earnings the practice delivers to its owner. You remind her that your practice provided you a respectable $275,000 last year. She acknowledges this, but she further tells you that the $275,000 you drew from the practice actually represents several different payments (see **Figure 2,** above.)

Figure 2. Net profit: A striking example

Your profit? NO!

Your profit? YES! The basis for determining your practice value

Your take-home	$275,000
Your veterinary salary	— 75,000
Your management salary	— 30,000
Your fair market rent	—120,000
Your true profit	**$ 50,000**

First, because you are a sole proprietor and don't pay yourself a salary as an employee, part of that sum represents payment for your services as a veterinarian. Since you personally produce $375,000 annually, the appraiser tells you that 20% of $375,000 is a reasonable approximation of what it would cost to replace your production with that of an experienced veterinarian, so this $75,000 represents payment for your services, before payroll taxes. In addition, you were entitled to be paid for your management services. Owner management compensation in a practice this size would normally be 2% to 3% of gross fees. At 2%, your management compensation would have been 2% of $1.5 million, or $30,000.

Second, a commercial real estate appraiser valued the hospital property at $1.2 million, and fair rent on that facility was determined to be $120,000 per year. (Fair market rent in a veterinary hospital typically ranges between 8% and 12% of the appraised property value.)

Whether you continue to own the facility and charge the buyer a fair rent or sell the real estate now, the practice will have to pay a fair rent to someone to continue to use the facility.

Finally, the appraiser reminds you that the difference between the $275,000 you are drawing and these expenses (i.e., $75,000 for your veterinary compensation, $30,000 for management compensation, and $120,000 in fair rent) leaves only $50,000 as profit from this practice. But that suggests that this practice is not very profitable based on today's standards (i.e., a $50,000 profit on $1.5 million of gross fees represents only a 3.3% net profit, which is very low for the industry.)

The $50,000 doesn't provide the buyers with enough cash flow to service all the debt. Furthermore, the appraiser reminds you that your practice's growth in gross fees, the number of new clients, and average transaction charges are nominal, which you say is probably because you've been coasting a bit in anticipation of retiring. You have not adjusted fees regularly as costs have risen, and you haven't been as active in the community as you used to be.

Is this the kind of news you want to get just as you're ready to retire? You thought your practice was worth $1.2 to $1.5 million, based on gross fees. (Or if you multiplied the $275,000 "profit" you thought you took home by 5, you expected a sales price of $1.375 million.) How could you have been so far off?

The No-Lo Practice℠

Diagnosis

Unknown to you, your practice was showing No-Lo symptoms for several years. **Lack of profitability is the single most critical underlying factor resulting in a No-Lo Practice℠.** But the second most common factor was on display as well: a lack of owner awareness that the practice was poorly profitable.

A No-Lo Practice℠ is frequently either a mature practice owned by a solo practitioner approaching retirement age with no debt, or a larger multi-doctor practice with high fixed costs from a facility that's too large or too expensive in relation to its revenue. Surprisingly, a No-Lo Practice often is a high-quality, attractive, and well-equipped business. Some are emergency practices or even specialty referral centers.

Other symptoms can include:

•Large, new facilities that generate little growth in revenue or profits

•No or artificially low rent paid to the facility owner, who is also the practice owner

•High payroll costs as a result of being over-staffed or from paying high labor costs necessary to compete in a tight local labor market

•A practice location where client demographics are marginal—with limited discretionary income and/or a shrinking population

•Infrequent or inadequate fee increases as costs rise

•Periodic cash flow crunches characterized by a lack of cash reserves to cover the normal seasonality of veterinary practices

•Increasing client accounts receivable (i.e., clients don't pay at the time services are rendered)

•Excessive giveaways and service discounts

•Excessively high inventory levels and poor inventory management

•Lack of internal financial management systems (i.e., owners watching the bank balance but not the metrics)

•Major equipment acquisitions but minimal training and limited use of that equipment, resulting in inadequate revenue production associated with the equipment

•Continual reliance on debt as the means to finance or lease ongoing equipment and technology needs, rather than relying on cash from prior practice profits

•Inability to fund full retirement options for the owner/owners

To make the diagnosis easier, Vet

Partners has developed a worksheet called the No-Lo Practice Threat Advisory Worksheet. Any practitioner or practice manager can use this worksheet to arrive at an estimated level of true profitability for his or her practice. Further, based on profitability, it also forecasts the relative threat of being a No-Lo Practice℠.

Q: How do you know if you have a No-Lo Practice?

A: You score severe or moderate on the No-Lo Practice℠ Threat Advisory Worksheet.

Threat Advisory Worksheet

See **Figure 3** (page 9) for a copy of the No-Lo Practice℠ Threat Advisory Worksheet. On-line versions for general, ER/specialty, equine, and bovine practices are available at www.VetPartners.org, with instructions and guidance about where to find the correct information in your financial data.

The worksheets are updated annually, and have specific instructions imbedded in the tool for finding the appropriate numbers in your practice's financial data. You can also complete the form

Figure 3. No Lo Practice[SM] Profitability Estimator

VetPartners™ For the good of the profession.

The No-Lo Practice[SM] Threat Advisory Worksheet
(Practice Profitability Estimator for General Companion Animal Practices)

To complete this worksheet you will need the following items:
- Your most recent tax return
- Your income statement for the period covered by the tax return
- Production reports from your practice management software

Instructions for filling out the worksheet:
- Fill in only the yellow shaded boxes and green control boxes
- Click on the blue information icon after each box for instructions for that item

1 I file taxes as a:
- ● Sole Proprietor on Form 1040, Schedule C
- ○ Partnership on Form 1065
- ○ Corporation on Form 1120
- ○ S Corporation on Form 1120S

Gross revenue 2 [ ]

Net income 3 [ ]

Add back non-cash expenses
(plus) Depreciation expense (plus) 4 [ ]
(plus) Amortization expense (plus) 5 [ ]

Less economic wear & tear on equipment and furniture
(less) 1.2% of the Gross Revenues (less) 6 [ ]

Adjust owner(s)' compensation
(plus) Leave cell blank (plus) 7 [ ]
(plus) Est. employer payroll taxes on actual owner(s)' comp.(9% of Box 7); corps. only (plus) 7a [ ]
(less) Owner(s)' compensation

8 Choose production %: ● 20% ○ 21% ○ 22%

Enter owner(s)' production 9 [ ] (less) 9a [ ]

Choose management %: ● 1% ○ 2% ○ 3% ○ 4%

9b (less) Owner(s)' compensation for management efforts (less) 9b [ ]
(less) Estimated payroll taxes on estimated owner(s)' compensation (9% of Box 9b + 9c) (less) 9c [ ]

Adjust for reasonable rent on the practice facility
(plus) Actual annual rent paid (plus) 10 [ ]
(less) Reasonable annual rent (enter fair market value of real estate) 11 [ ] (less) 11a [ ]

Adjust for owner(s)' discretionary spending
(plus) Owner(s)' non-business expenses (plus) 12 [ ]
(less) Inadequate spousal compensation (less) 13 [ ]

Adjust for non-recurring income and expense
(less) Non recurring income (less) 14 [ ]
(plus) Non recurring expense (plus) 15 [ ]

Adjust for interest expense
(plus) Interest expense (plus) 16 [ ]

Adjust for equipment lease payments
(plus) Equipment lease payments (plus) 17 [ ]

Equals **Estimated Operating Earnings or Profits** 0

Estimated Profitability Calculation

Estimated Profitability (as a % of revenue) = Est. Operating Earnings / Revenue X = 0 / 0

Estimated Profitability

VC Interpretation of the *Estimated Profitability* Determination

If Estimated Profitability is		Relative Profit	No-Lo[SM] Threat Advisory
greater than	18%	Superior	NO THREAT
between	16% - 18%	Above Average	LOW THREAT
between	13% - 16%	Average	POSSIBLE THREAT
between	8% - 13%	Below Average (Pre No-Lo Practice[SM])	MODERATE THREAT
less than	8%	Poor (No - Lo Practice[SM])	SEVERE THREAT

IMPORTANT: This worksheet is intended to provide an approximation of the profitability of veterinary practices and to identify those at risk of receiving a low valuation if appraised. THIS WORKSHEET IS NOT DESIGNED TO DETERMINE THE VALUE OF A PRACTICE

www.vetpartners.org This Analysis Tool Developed by the VetPartners Valuation Council for prior years to track trends in your practice.

"The worksheet takes a complicated matter and makes it simple to get to the bottom line with a well laid out approach."

—Gary Glassman, CPA, Burzenski & Company, P.C., East Haven, CT

The worksheet requires that you enter only a few numbers to get a snapshot view of your estimated true profitability. Our goal was to make the worksheet as user-friendly as possible, which means that we have built in certain estimates and assumptions that could be different from those appropriate for your practice. But the worksheet will help you learn more about your practice's financial results.

Here's what one user told us: *"We found this to be an extremely useful and simple tool. It evaluates the critical issues without getting bogged down in detail, explains why adjustments are needed and where to find the numbers, and can be used effectively no matter how your practice is legally organized. Best of all, it comes down to a bottom line that explains where you stand. I appreciated its straightforward and easy-to-use format and instructions."*

—Diane S. Reeves, Northeast Veterinary Hospital, Seattle, WA

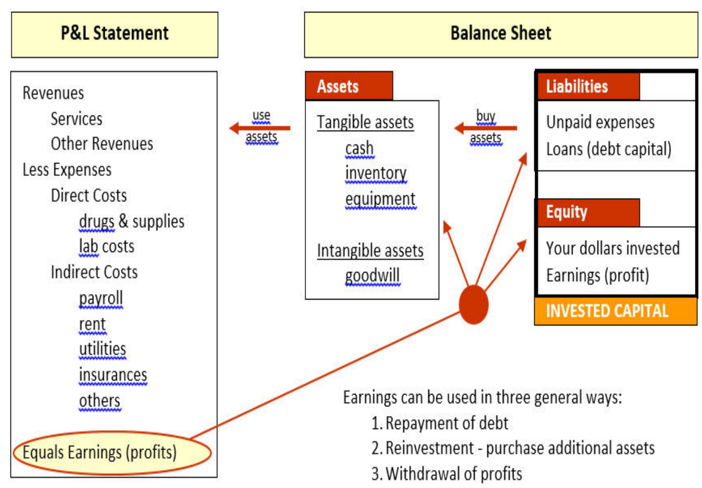
If your practice scores in the yellow, orange, or red areas of the worksheet, you need to do further analysis. Because the worksheet cannot cover all possible practice scenarios, yours might be a rare case where the worksheet presents an overly pessimistic or optimistic conclusion. However, the tool has been found to be quite accurate in identifying practices that have—or are becoming—low practice values. If the worksheet suggests your practice is threatened, what should you do?

Treatment

Keep in mind as you read this section: With adequate investigation into the underlying causes, almost all No-Lo Practices℠ can recover and become increasingly profitable once again. **This disease is treatable!** Remember, though, that lost profits cannot be recaptured, so don't delay treatment. Every dollar of lost profit represents at least $4 to $6 of lost value.

The first step in treating a No-Lo Practice℠ condition is acknowledging that profit is not a four-letter word. Practice profits enable owners to pay reasonable salaries and benefits, cover all operating expenses, reinvest in the practice by maintaining and upgrading equipment, and still earn a reasonable return on the owner's investment. If your practice scored poorly on the threat advisory, then the second step is determining why profit is low. To improve practice profit, you must either reduce operating expenses or grow revenue (or a combination of both).

Figure 4. How profits build practice value by creating goodwill



It is helpful to observe the cash flow that occurs in a successful and profitable start-up practice. **Figure 4** is a graphic representation of cash flow, how it relates to the practice's financial statements, and how profits create goodwill over time.

In the very beginning, a start-up investment is made. The funds for this investment originate from a combination of Equity (savings and similar funds from the owner) and from Liabilities (loans from banks or other lenders).

Using this Invested Capital, the start-up owner purchases various tangible assets such as inventory, equipment, and leasehold improvements. With these assets, the owner opens the doors and begins to deliver medical services to clients, generating the first revenues. In the process of providing these services, the owner incurs expenses that are paid from the generated revenues. In successful practices, revenues exceed expenses, creating earnings or profits. Profits can be utilized in one of three ways:

1. Paying down liabilities incurred in starting the practice
2. Reinvesting in tangible assets consumed in providing services, including building up the bank account
3. Withdrawing earnings for discretionary purposes, including owner's draw

Over time, successful practices develop a pattern of profits, creating a new intangible asset called goodwill. Goodwill represents the profits generated previously in excess of what would be expected from owning the tangible assets alone. In successful practices, goodwill is by far the largest asset, accounting for 70% to 90% of the practice's value

It is especially important to note that goodwill is a result of the practice's ability to generate profits. Further, the greater the profits, the greater the goodwill value and, thus, the higher the practice value. In practices with low profits, goodwill shrinks or even disappears.

As **Figure 4** shows (page 10), earnings or profits are a function of revenue generated and expenses incurred during the operations of the business. Attempts to correct a low-profit practice must focus on these factors.

Growing the Revenue

If revenue is low, the problem is either the fee side of the practice or inadequate client demand (or a combination). The importance of maintaining adequate revenue generation cannot be overemphasized. This is a major cause of little to no value in the vast majority of No-Lo Practices^{SM}.

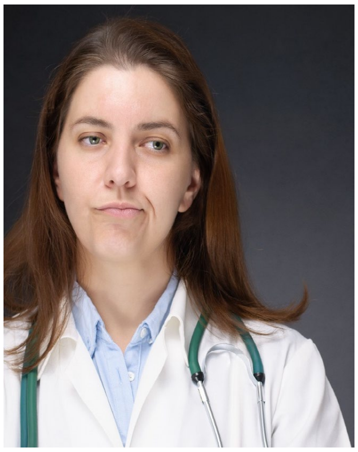
Fees and production

On average, small animal practices produce $500,000 to $600,000 of medical revenue per doctor and target an average doctor transaction of at least three times the exam fee. If your practice isn't at these levels, you have an opportunity to expand profitability by improving production. How might you do that?

- Reclaim missed charges (intentional and unintentional) and giveaways. Charging for the care doctors provide is critical to giving the practice the resources necessary to continue to elevate patient care, invest in new medical technology, give raises to the doctors and staff, and maintain profitability. Commonly missed services, such as fecal exams and medical progress exams, often amount to $20 to $30 of missed charges on 15% to 25% of outpatient cases. On hospital cases, $50 to $70 of missed charges on 40% to 50% of cases is common for items like inpatient exams, injection fees, and the use of fluid pumps. This can easily add up to tens of thousands of dollars of lost practice revenue.
- Analyze your revenue mix. On average, medical services (e.g., laboratory, diagnostic imaging, dentistry) represent 75-85% of medical revenue while medical products (including preventive medications) represent 15-25%. Practices with a service to product mix weighted more heavily towards products tend to have lower profits.
- Identify your medical philosophy. Do all doctors share a similar philosophy regarding the standard of care used to manage patients? If not, opportunities for optimal healthcare could be slipping through the cracks. Periodically conduct case reviews to determine whether the doctors have similar philosophies about patient care and charging for that care. Discuss

the results in meetings to enhance awareness and create consistency among the doctors.

- Gauge the doctors' availability. Does the practice have an adequate number of doctors and support staff to effectively and efficiently meet client demand? Is necessary healthcare slipping through the cracks because doctors rush through appoint-



ments to prevent long client waits? Alternatively, does your practice have enough technicians so doctors can focus on doctor responsibilities and not have to do everything themselves? Proper leveraging of doctors' time is often overlooked and can have a significant impact on profitability.

- Raise your overall fee structure. Ideally, you will evaluate fees every 3 to 6 months and make appropriate changes in a timely fashion. The time lag between when expenses rise and when owners actually increase fees can deal a deathblow to the practice over time. If your costs increase but you fail to raise fees, you have lowered your profits for the entire period until your fees rise enough to catch up. For many practices, that never happens—once costs rise faster than fees, owners are either unwilling or unable to increase fees enough.

Inadequate Client Demand

Perhaps your fees are set at reasonable levels, the other factors seem appropriate, but revenue is still low. In that case, explore whether your practice has correctly assessed and reacted to demand for your services.

- Recommend appropriate medical visits. Target client visitations average from two and a half to three times per year for small animal practices. As the patient advocate, always offer appropriate medical recommendations, even if those require a follow-up visit. Don't assume that a client can't afford a certain level of treatment. Be respectful of your clients' choices, but be sure to give them all the information needed to make an informed decision. Don't confuse and overwhelm them. Faced with too much information, too many options, and no clear recommendation, choosing nothing is the easiest path for the client to take.
- Increase demand. Is there untapped potential with existing clients? Can you increase the number of active clients by improving the scheduling rate for potential clients or by spending more on external marketing?

Managing Expenses

Next, let's look at the expense side of your operations. Keep in mind that revenue should cover expenses, including owner's compensation, and still produce a profit, as suggested in the No-Lo Practice Threat Advisory Worksheet. Normal operating expenses include the following:

- Variable expenses (direct costs). This includes items that change in direct proportion to the number of patients you see, such as drugs, medical supplies, laboratory expenses, food purchases, and credit card fees. This category increases in direct proportion to revenue—more patients equal more revenue and more drugs and supplies used. However, total variable expenses should remain consistent as a percent of revenue from year to year. Industry benchmarks suggest that variable expenses should represent 22% to 24% of revenue.
- Fixed expenses (indirect costs). This includes administrative overhead costs such as advertising, office supplies, continuing education, and health insurance. These expenses stay relatively stable over a wider range of revenue. For example, office supplies will likely remain consistent from year to year, un-

Figure 5. Controlling Higher-Than-Normal Expenses

Source: 2017 WMPB Study, by WMPB LLC.

Symptom	Remedy
Variable expenses (target = 23% of revenue – range 22% to 24%)	
Inadequate markup	The average markup on drugs dispensed in-house ranges between 140% and 175%. Exceptions – average markup on: HWFT products dispensed in-house, 90% and on-line, 75%; drugs for chronic conditions, 100% infrequently used drugs, 200% to 300%
Low Turnover or overstocking	Stock $10,000 to $16,000 of inventory per FTE doctor; target 10 to 12 inventory turns per year
Unbilled services or products	Institute internal controls and bill appropriately for all services and products provided
Fixed expenses (target = 7% - range 6% to 8% of revenue)	
Low overall fee structure*	Bill appropriately for services provided
Inadequate client demand*	Boost marketing efforts to attract new clients, look for untapped potential to provide additional necessary care to existing patients
Lack of budgeting	Plan ahead to avoid overspending or emotional purchases
Staff Compensation (target = 22% to 25% of revenue; includes wages, payroll taxes and retirement)	
Minimum-wage employees	Choose and offer competitive pay for a caliber of employees that will boost practice efficiency
Too many part-time	Hire more full-time staff members to enhance efficiency, effectiveness and productivity
Lack of supervision and training	Hire good team members, then provide adequate training and supervision
Turnover	Pay a competitive wage, provide valuable benefits and value team members' input and contributions
Facility Costs (target = 8% - range 5% to 8% of revenue)	
Underutilized facility	Expand practice hours or the number of doctors or staff members
Inadequate client demand*	Boost marketing efforts to attract new clients, look for untapped potential to provide additional necessary care to existing patients
Community economics	Investigate cost of living and other factors that may drive up your rent, utilities and taxes, but keep in mind that there's no real remedy (other than growing revenue) – you can't control this factor
DVM compensation (target = 20% - range 16% to 25% of doctor production revenue depending on type of practice/species)	
No relationship between compensation and production	Are the doctors producing enough to support their compensation and benefits?
Turnover	Improve selection process and provide consistent, quality care
Lack of supervision and Training	Provide doctors with adequate training and mentoring
Too many part-time and not enough full-time doctors	Hire the number of doctors and team members to meet client demand

**Expenses may be high as a percent of revenue not because of overspending, but because revenue is too low.*

Note: *Refer to the AAHA/VMG Chart of Accounts for definitions of what is included in each account.*

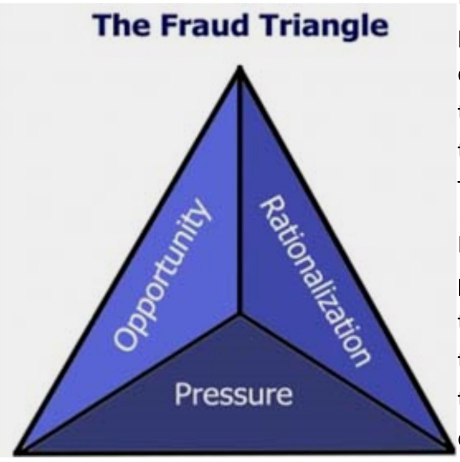
less you plan to print new brochures, letterhead, or overhaul your client educational materials. Target fixed expenses at 6% to 8% of revenue.

- Staff compensation. This includes wages, payroll taxes, and retirement contributions for non-doctor staff members. Normal ranges generally fall between 22% to 25% of revenue, depending on staff-to-doctor ratios and your community's economy (i.e., pay ranges and cost of living).

- Facility expenses. This includes rent, property taxes and insurance, utilities, cleaning, repairs, and maintenance. In all but brand new practices, rents should be around 4% to 6% of revenue, and the other costs generally add another 2% to 4%. If you divide your current rent by 6%, does the resulting figure approximate your gross revenue? If not, your facility may be too large or too expensive for the size of your practice. Unfortunately, this factor can be very difficult to correct, especially in geographic regions of rapidly rising real estate values or where an owner has built a Taj Mahal hospital in an area that can't pay the fees to justify this expense.

- DVM compensation. Target percentages will vary depending on geography, local economics and practice type. A typical range is 22% to 25% of doctor production, including benefits and payroll taxes.

- How do your percentages compare? If your expenses are higher as a percent of revenue, can you identify why? Only then can you take steps to improve. **Figure 5** (page 13) indicates why your expenses may be higher than normal and outlines remedies to address the problem. If your practice is at the high end of the range in one category, other expenses will need to be at the low end of the range to maintain a reasonable profit margin.



The Unthinkable Road to Low Profitability

Nobody wants to believe that their low profits could be attributed to employee theft. Yet as consultants, we see and hear these sad stories much too often. Veterinarians as a group are compassionate and trusting, and the notion that their staff could be stealing is unthinkable.

But consider this: Only the people you trust can steal from you. Whether it's bags of pet food walking out the door or personal charges on company credit cards, it's still theft. For these to occur, three conditions must exist, i.e., the Fraud Triangle.

First, the employee must feel **pressure** that creates a need to take your property. Second, there must be the **opportunity** to steal without expecting to be caught. And third, the person must be able to **rationalize** the act by feeling underpaid, overworked, unappreciated, etc.

As the owner, you only have control over one of these factors: the opportunity. By designing and implementing systems that reduce the opportunity, you can protect your practice. You cannot know if the employee perceives a need to steal and can rationalize it, so don't allow your financial systems to make it possible.

There is a checklist available at www.VetPartners.org that offers techniques and tips specific to veterinary practices for deterring employee theft. Many of the steps are quick and easy but still create barriers that can limit the opportunity to steal from your practice. Protect your business by reviewing and implementing the suggestions on the **Fraud Prevention Controls** checklist.

Even if you've never experienced theft, put these systems in place now. If your practice's bottom line jumps, you may have saved yourself not only a lot of money but also a great deal of time, trouble, and heartache. Now look backward — when did your profits start to drop? Why? What else changed at the same time?

The No-Lo Practice: No Permanent Immunity

The goal of this publication is to shed light on the distressing trend of no- to low-value practices in the veterinary industry. Ultimately, the goal is to reverse this trend. The veterinary industry has always been attractive for investment, and the rewards of ownership can be significant, both financially and personally. Although the percentage of practices valued at low to no value is small, it is growing. We must address this problem now, before it becomes more widespread.

VetPartners has taken the first step in this direction. Practice owners and managers must take the next step. It's your financial security and retirement that are at risk. You've already started by reading this publication. Don't stop now! Complete the on-line version of the Threat Advisory worksheet at www.vetpartners.org. If your practice's profitability is in the blue or green levels, congratulations! Keep up the good work and repeat the worksheet process at least annually.

But don't get complacent — circumstances can change and lead you down the wrong path if you don't maintain this level of vigilance. There is no vaccine that will give your practice lifetime immunity. Only regular checkups will keep you safe.

If your practice's profitability is in the three lower levels, you have some work to do. Take these results as a serious warning: begin investigating the underlying causes and institute corrective measures now. If you need assistance with completing the worksheet, identifying the underlying reasons your practice may be at risk, or improving your practice's profitability and value, you can find an appropriate consultant by accessing the directory on the VetPartners website at www.VetPartners.org. Together, we can reverse the trend toward the No-Lo Practice℠.

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For the good of the profession.

This publication was initiated and developed through the collaborative efforts of the members of the VetPartners Valuation Council. VetPartners is a professional organization consisting of members who consult to the veterinary profession and whose mission is to provide a community of networking, collaboration and integrity to serve our members, for the good of the veterinary profession.