

Strategic Success: Growth Through Practice Acquisition

By Bruce Maller

Physicians are faced with a myriad of challenges when attempting to grow the bottom line of their practices. Downward pressure on reimbursement, third-party payer intervention and competitive influences make it increasingly difficult for most practitioners to think about seeing sustained growth in take home pay.

Practitioners employ a variety of strategies to combat these challenges. These strategies include diversification of service lines, addition of subspecialists, and the development of ambulatory surgical centers. For most practices the key to success is to make more efficient use of their providers, staff, and physical plant.

Many practices employ a wide array of marketing programs in an attempt to enhance revenue opportunities with existing patients and/or to pull new patients into the practice. Practices will generally spend between 3% and 5% of annual collections on practice marketing. Organic or internal growth can also come from the development of new practice locations. Suffice it to say, these projects will often entail significant capital expenditure. In some cases it may make more sense to acquire an existing patient base from a retiring optometrist or ophthalmologist. Growing a business through acquisition offers several potential advantages vs. building a new facility “de novo.”

First of all, the buyer of a practice will have immediate access to the charts and records of the acquired practice. There may be an opportunity to capture surgical referrals that may have previously been kept in-house or referred out to other practitioners. Availability of subspecialty cases may also help to augment the productive

capacity of the physicians of the purchaser. If the buyer has an ambulatory surgical center, there may also be an opportunity to improve the productive capacity and profitability of the facility.

On the flip side acquiring an existing practice can be a complicated and expensive proposition. This article provides an overview of the major issues that need to be

considered when acquiring another practice. In all cases the purchaser will need to engage the services of experienced legal and tax counsel in order to make sure the deal is structured within applicable regulatory guidelines and in a manner that maximizes tax advantages.

1. Structure of the Transaction: A buyer can acquire the stock or assets of the selling practitioner. Asset purchases are most common and generally preferred by the

buyer. In a stock purchase, the buyer will acquire the shares of the seller’s professional corporation. In doing so, the buyer will “inherit” all debts and obligations of the seller (known or unknown) as of the date of closing of the purchase. In addition, with a share purchase the buyer cannot depreciate or amortize any portion of the purchase price. In the case of an asset purchase, the buyer can depreciate acquired fixed assets and amortize any portion of the purchase price allocable to goodwill. Keep in mind under the terms of the asset purchase agreement, the buyer and seller will agree to treat the transaction for tax purposes on a consistent basis. As such the allocation of the purchase price will be an important point of negotiation between the parties.

2. Assets to be Acquired: All assets to be acquired by the buyer need to be clearly stated. Ordinarily assets

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would include all furnishings, equipment, leasehold improvements, inventory, supplies, patient records and lists, telephone numbers, trade names and practice goodwill.

3. Excluded Assets: Any assets that will not be sold should also be clearly indicated. This would generally include cash, accounts receivable, and those items of a personal nature owned by the seller. Unless otherwise agreed, the buyer will ordinarily acquire practice assets free and clear of any indebtedness. In other words, the seller will need to satisfy any outstanding debts of the practice prior to closing.

4. Terms of Purchase: In most cases the seller will have an asking price for their practice. In other cases a buyer may find that the seller does not have a good idea as to the value of the assets to be sold. In either case, a valuation of the practice should be prepared. Regardless, the purchase price and payment terms need to

be negotiated up front. In some cases the buyer will be paying all cash as consideration for the purchase. In other cases, the seller will carry a note for some portion of the purchase price. In this case, the interest rate and payment terms need to be negotiated. If the buyer is acquiring new debt in conjunction with the purchase, it will need to be clear that any seller carried note(s) will need to subordinate to any new financing. Any new lender will not sit in a “second” position to a seller carried note.

5. Restrictive Covenant: The purchase agreement will include language that will prevent the seller from practicing medicine, in any capacity, within an agreed upon radius of each office of the seller. This radius should normally cover a distance within which the vast majority of patients have been seen by the practice. The covenant should extend for a period of between two and five years. The attorney for the buyer should be consulted in this regard to insure the terms of the covenant are deemed reasonable under applicable state law.

6. Transfer of Practice: The purchase agreement should make clear that the seller will cooperate fully in communicating with practice patients and referral sources regarding the assumption of the practice by the purchaser. Inasmuch as the value of practice goodwill is dependent on a smooth transition of patient care to the buyer, the seller should be contractually bound to devote his or her best efforts toward ensuring such transition.

7. Assumption of Staff: It is generally not advisable for the buyer to commit to continued employment for members of the seller’s staff. On the other hand, the staff can play an important role in providing for a smooth transition of patient care to the buyer. This is especially the case with staff members that have been with the practice for an extended period of time.

8. Real Estate Leases: First of all it is important

for the buyer to obtain complete copies of all real estate leases. Careful attention needs to be paid to the lease rate, renewal terms and the assignment provisions. In some cases the seller owns the real estate that is occupied by the practice. When completing your due diligence careful attention must be paid to the terms of these leases. Oftentimes the seller has been charging the practice an above market rental rate. In these cases renegotiation of the lease terms would be in order. In other cases it may make sense for the buyer to acquire any practice “owned” real estate from the seller. Terms of this transaction would be documented in a separate real estate purchase agreement.

9. Equipment Leases: The buyer will want to review copies of all equipment leases that may be a part of the transaction. Ordinarily the seller will want the buyer to assume all practice related equipment leases. If the leases are to be assumed, this in essence amounts to an increase in the purchase price. The buyer will want to

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make certain the leases can be assumed. In some cases it may make sense to refinance the leases.

10. Employment of the Seller Following the Close of the Purchase: In many cases, the selling physician will want to remain on as an employed physician of the buyer following the close of the transaction. It is important these terms be negotiated on the front end along with the asset purchase terms. Generally the buyer and seller will execute an employment contract that will detail compensation terms, work schedule, duties, covenants against competitive practice, and other termination provisions.

11. Indemnification: In the case of an asset purchase, the seller will indemnify and hold harmless the buyer from all acts and omissions arising from the seller's practice prior to closing. These provisions are set forth more fully in the definitive agreements executed by the buyer and seller.

12. Due Diligence: It is customary for the buyer to request from the seller copies of all of the relevant documentation related to the operation of the practice. This would include, but not be limited to, tax returns, financial statements, practice productivity reports, space and equipment leases, payroll reports, accounts receivable and accounts payable aging reports, as well as files pertaining to insurance policies and capital expenditures. In addition the buyer along with his or her advisors will want to complete on-site inspection of the practice premises. The due diligence is ordinarily completed before the buyer makes a definitive commitment to close on the transaction.

13. Preparation of Cash Flow Forecast: In conjunction with performing due diligence it is strongly recommended the buyer put together a detailed cash flow forecast of practice revenue and expenses. The forecast should include a provision for compensation of the new

owner (or a physician in the employ of the new owner) as well as repayment of practice acquisition debt. Since accounts receivable will ordinarily remain with the seller, the buyer will also likely need to acquire additional funds to cover the working capital needs of the practice. Amortization of any additional debt needs to be incorporated into the forecast. The forecast is a tool that can assist the buyer in determining an affordable purchase price. It is recommended several iterations of the forecast be prepared with different assumptions on patient retention.

14. Standstill Agreement: In some cases the buyer will request from the seller that he/she agree to cease negotiation with any prospective buyers regarding the possible sale for an agreed upon period of time. A so-called Standstill Agreement will normally be executed at the time the parties enter into the Letter of Intent. Needless to say, most sellers will be reluctant to take the practice off the market unless they have a strong sense the buyer is serious about closing on the transaction.

From a process standpoint, if a buyer wishes to move ahead and make an offer to purchase, this is normally done through some type of letter of intent. The terms outlined above are normally incorporated into this letter. As noted, the buyer should consult with an experienced health care consultant as well as legal counsel before submitting the offer letter to the seller. This letter is generally non-binding. Assuming the parties can agree on the major business points, the seller's attorney will draft a definitive purchase agreement along with other pertinent documents, i.e., employment contract for the seller, promissory note and security agreement.

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For more information, contact BSM Consulting at 1-800-832-0609.