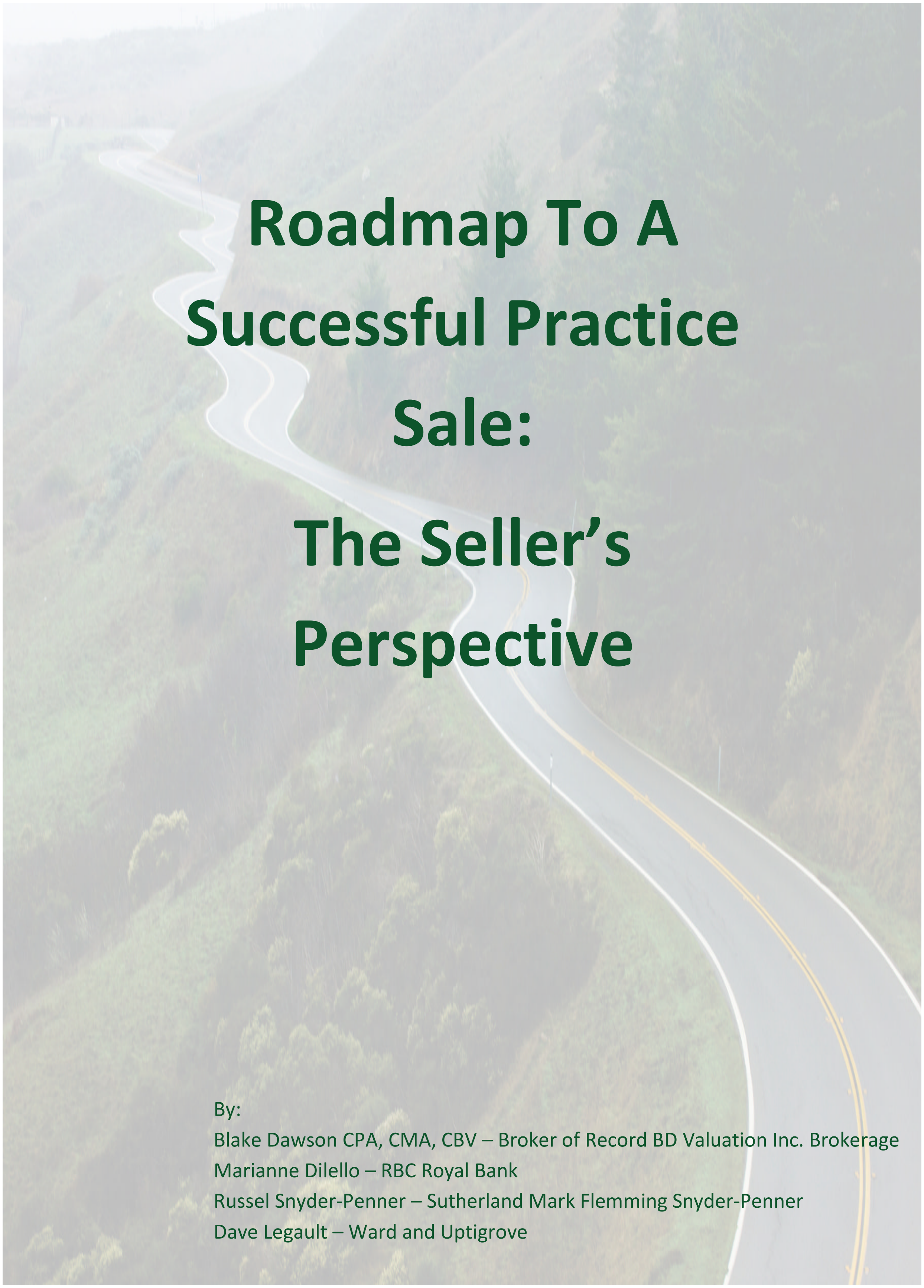

Roadmap To A Successful Practice Sale:

The Seller's Perspective

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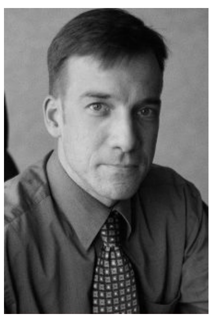

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Introduction

The authors of this article had found that current information regarding the sale process of veterinary practices lacked cohesion between the disciplines required: appraising, accounting, legal, and financing. This led to disjointed, and often conflicting, information. As a result, we decided to make this document, a road map to a successful practice sale, to outline the process right from the planning stages to the transition date, to incorporate all disciplines required in the process, and to do so in a comprehensive way. We hope that it helps to shed a little more light on the process for veterinarians contemplating a transition.

Retirement/Transition Planning Horizon (3-5 Years Prior to Transition)

Many veterinarians procrastinate financial decisions in the latter part of their career. This is not common only to veterinary owners, but is endemic of many small business entrepreneurs. It often stems from people's avoidance of processes they are unfamiliar with. However, three to five years before a targeted transition veterinarians should be paying particular attention to:

- Their Financial Planning
- Their Succession Plan

Financial Planning

Before the contemplation of transition, it is important that the veterinarian understand their financial needs post transition. Will you and your family be able to enjoy the lifestyle you expect or does your transition timeframe or lifestyle require a restructuring?

During this planning horizon it is prudent to meet with your financial advisor to discuss. Your advisor will be able to discuss the "net worth" you will need post transition, taking into account your lifestyle hopes and timeframe.

To get a full understanding of your capital worth it is also prudent to have a preliminary business appraisal performed, as this is often a large source of an entrepreneur's net worth.

The appraisal will benefit you by:

- Giving you a realistic expectation of what the practice is worth.
    - Rule of thumb approaches, such as a value as a % of gross revenue are extremely unreliable, as are online DIY calculators.
- Highlighting areas that could use improvement to allow for higher profitability in the years to come and ultimately resulting in a higher practice value upon the eventual sale.
- Helping you plan in the unfortunate case something should happen to you.

The valuation is strongly influenced by the investment value of the practice. In more general terms, higher cash flow and lower risk results in a higher valuation.

Succession Planning

This represents another area that veterinarians, and many other small business owners, also often overlook or procrastinate. Who's going to purchase the practice when you are ready to transition?

Having a solid succession plan can help secure a purchaser when the time comes, and removes some of the financial risks, thereby increasing the practice value.

When hiring an associate as part of the succession plan it is wise to spell out the intentions of the parties in a comprehensive employment agreement. This can save much confusion and frustration later. Many veterinarians still prefer to operate without employment agreements and non-compete agreements with their professional staff. While this is admirable, it is ill-advised and has been the reason for many lost transaction opportunities and practice value deteriorations.

Of course hiring an associate is not a realistic option for every practice, but this does not preclude the benefits of contemplating other succession plan possibilities.

The Tax Planning Horizon (2+ years Prior to Transition)

Once you have obtained a realistic expectation of the value of your practice you need to consider the income taxes that would be payable on the sale. For the majority of practices the most significant component to the total value of the practice is the value of "goodwill" (defined as the value in excess of the tangible assets of the practice). Assuming your practice is unincorporated, the income taxes payable on the sale of your goodwill could be as high as 23%.

By incorporating your practice and selling the shares of your Professional Corporation (PC), the gain on the sale of the goodwill is converted to a gain on the sale of the shares of your PC. With proper planning, up to $750,000 of the gain on the sale of the shares of your PC could be exempt from income tax through the use your lifetime capital gains exemption.

However, conditions must be met by the PC in order to be (and remain) eligible for the capital gains exemption:

• A full 90% or more of the PC's assets must be used in an active business at time of sale, and

• During the 24-month period leading up to the sale, at least 50% of the PC's assets must be used principally in an active business or to finance a connected active business.

Because PC's are permitted to invest surplus funds, it is a common practice to leave these funds in the PC, thereby deferring personal income taxes. As a result non-practice assets can accumulate within the PC over the years to the point where the capital gains exemption eligibility can be threatened.

If you or your PC cannot meet one of the above conditions, your accountant and lawyer may help develop appropriate strategies to allow you to access and preserve the capital gains exemption, including incorporating your practice or "purifying" your PC by moving out the non-active business assets.

Contacting your professional advisors as soon as possible will ensure that you are, not only positioned to take advantage of this lifetime capital gains exemption if it is available to you, but also to benefit from other tax planning initiatives.

Final Year

The final year is the most time consuming for the selling veterinarian in relation to the transaction. During this time the following activities need to be completed and each is discussed in turn:

- Appraising
- Marketing
- Negotiating
- Agreeing
- Finalizing
    - Financing
    - Legal
    - Accounting

Appraising

The appraisal is almost always required at this point to set the basis for the transaction price and for buyer financing (discussed later). It should be done by an appraiser that is both bank approved and experienced within the veterinary industry.

The process is very similar to that of the valuation in the retirement planning stages although it is often more exhaustive. It will use and reconcile between three valuation methods: asset approach, income approach, and market approach to arrive at a final opinion of value.

Marketing

Depending on the succession plan this may or may not be required. If the potential buyer is already known this step may be unnecessary.

The goal of the marketing process is to expose the practice to as many serious potential purchasers as possible while ensuring the sharing of sensitive information to buyers who are unlikely to furnish serious offers is minimized.

The marketing process can be done by the seller or with the help of a representative. The representative may help by being able to confidentially expose the practice to more buyers, preparing relevant packages for potential buyers, and answering questions about the process the seller may not be familiar with. These are often attractive propositions to many sellers, and can also help obtain a higher purchase price.

Depending on the location there will undoubtedly be differing levels of interest. The current market in Ontario could be classified as a seller's market in urban areas and buyer's market in the more rural or Northern areas. This is a function of the location preference of potential buyers and means certain locations require additional time on the market.

Negotiating

Once a potential buyer(s) is(are) identified, the next step is to negotiate the terms of the sale.

There are many aspects to consider, the following being a sample:

- Share or asset transaction?
- Is the seller to remain?
- Are all crucial staff remaining? And do they have non-compete agreements in place?
- How is the sale being financed?
- When is the sale to occur?
- What assets are included, and which ones are excluded?
- How is inventory to be dealt with on closing?
- Is real estate included? How is it to be dealt with? If not included, what is the expectation for the lease arrangement?
- Is there to be a deposit?
- Who pays severance if the buyer does not want to assume some staff?
- Is the offer to be conditional on some future event such as financing or other?
- What financial risks are assumed and which are indemnified by the seller?
- What is the financial consequence of each of the above terms to the seller?

Each term should not be negotiated in isolation as they are all interrelated and will have a significant impact on:

1) The value of the practice
2) The tax implications for both parties
3) Legal and financial risks

It is only the rare veterinarian that understands the impact of the sale terms in relation to each of these three areas, and understandably so. In school veterinarians are trained to be good practitioners, not accountants and lawyers. Many vets would benefit from the help of professionals. Deals often fall through due to misguided negotiations for a number of reasons related to these areas.

Agreeing

The final result of the negotiations is often a signed document called a "letter of intent". This is a non binding document agreed to by both parties that spells out the crucial terms of the sale such that the buyer's and seller's lawyers can draw up the binding purchase and sale agreement. The letter of intent should cover all of the questions above as well as practice specific ones. Before it is signed by the parties, it is wise to have it reviewed by a lawyer.

Finalizing The Deal – Finance, Legal, and Accounting Perspectives

Finalizing The Deal: Financing Perspective

Years ago much of the financing of a purchase was from the seller in the form of a "vendor take back" loan. In other words the seller would have to be paid the purchase price directly from the purchaser over a period of time. However, within the last few years banks have become significantly more interested in lending to purchasing veterinarians, allowing the vendor to obtain much of the purchase price upfront, thereby reducing his/her future risk.

The banks are typically willing to lend up to 100% of the appraised price to qualified purchasers. Premiums offered above appraised value are often not financed.

The interest rates and terms the banks are offering have also become very competitive in the last few years, such that the majority of purchasers are using bank financing over all other forms.

Besides requiring financial information of both the practice and buyer the banks will also require the following to be in order:

- An appraisal by a bank approved appraiser.
- If facility is leased:
    - A lease document securing the facility for at least the term of the financing (7-10 years).
- If real estate included:
    - A real estate appraisal by a bank approved appraiser and an adequate environmental questionnaire
- The executed purchase and sale document

It is the purchaser's responsibility to secure financing, but the seller will be required to furnish much of the needed information.

Finalizing The Deal: Legal Perspective

When the *Ontario Business Corporations Act* was amended in 2000 to permit professional corporations, few would have predicted that the most enthusiastic early adopters of this new form of practice organization would have been veterinarians. Karen Gamble, the Administrator for Registration of Incorporation at the CVO, recalls that originally the College expected only a couple of hundred practices would ultimately incorporate. However, by the end of the first year, there was already that amount and by the spring of 2010 there were almost eight hundred Veterinary Professional Corporations open. There are a number of reasons for this, one of the most important being the substantial tax savings a veterinarian may attain by transferring the goodwill of his or her practice by sale of shares. As a result, the vast majority of practice transfers in the veterinarian sector are now Share Purchase Transactions.

Ironically, in many other business sectors, Share Purchases are viewed with increased skepticism. This is due to the fact that when you acquire a corporation by transfer of share ownership, you acquire not only its goodwill, but all the "skeletons in the closet" as well. This has not discouraged veterinarian buyers, perhaps because veterinarian practices are less likely to contain the substantial hidden liabilities as you might find in purchasing a manufacturing business (such as environmental and employee-related risk) or a legal or medical practice (which have potential for large professional liabilities). Nevertheless, corporate transactions, Share Purchases in particular, are technically complex, even for veterinary practices, and the risk of undisclosed liabilities leading to future litigation between buyer and seller can be substantial. Accordingly, the buyer ought to engage in careful due-diligence. The seller needs to be just as careful to ensure that he or she is not signing a document that exposes the seller to an inappropriate risk allocation. The taxes saved through exemption on sale of shares will be quickly expended in litigation if a disgruntled buyer chooses to rely on representations the seller erroneously provided in the Share Purchase Agreement.

Given that Share Purchase Transactions are legally and technically demanding , it is important to approach a transaction systematically to manage the inevitable surprises and minimize headache. Some key considerations are as follows:

<u>Letter of Intent</u>

As discussed earlier, the Letter of Intent will be your guide to a successful closing. In general, it spells out the most important components of the purchase such that it can be more clearly drafted by the lawyers. It should be written in mostly ordinary English, so that the key components of the deal can be fully understood by the buying and selling veterinarians. The lawyers have enough work to do with the technical aspects of the transaction, so it is important that the "bones" of the business deal are clearly understood prior to drafting the final binding agreement. This is done so the parties do not get dragged into time-consuming and expensive legal negotiations about the basics of the transactions during the sale agreement drafting process.

However, as the letter of intent will need to be translated by the lawyers into effective legal documents, it will save much time and expense if the lawyers have input into the drafting of the letter of intent as well. Typically, standard format letters are used so that the parties can merely "fill-in the blanks" in order to tailor the transaction to their particular expectations. Usually, the letter of intent is not legally binding. Its purpose is to ensure that the buyer and seller are on common ground before they direct their lawyers to expend substantial time on document preparation.

<u>Due-Diligence and Representations & Warranties</u>

The task of the buyer's lawyer is to ensure that the buyer is getting what he or she expects and that there are no undisclosed surprises that will detract from the value of the practice. Accordingly, the buyer's lawyer will engage in legal searches, review legal documentation of the corporation and advise the buyer as to other investigations he or she may wish to undertake. The buyer's lawyer will also draft a large number of Representations & Warranties to be given by the seller to the buyer, who relies on these documents as assurance that the business he or she is purchasing is legally and financially sound. If the representations and warranties turn out to be false, the seller will be responsible to compensate the buyer accordingly. It will be the responsibility of the seller's lawyer to ensure these Representations & Warranties are reasonable under the circumstances. Some of the most important risks that are covered in this way relate to assurances that a corporation has properly filed and paid up on all tax returns and that there are no potential claims against the corporation, especially from longer-term employees.

<u>Non-Competition and Non-Solicitation Covenants</u>

It seems to be a commonly held view among many veterinarians that it is difficult to enforce a non-competition agreement. This may be true with respect to such covenants given by employees. However, a non-competition covenant given by the seller of a practice, if properly drafted, is definitely enforceable and absolutely essential from a buyer's perspective. Clearly no one will want to pay a substantial amount of money to purchase a practice and discover that he or she has inadvertently funded the seller's move across the street. Because of this, very careful attention must be paid to the drafting of an agreement by the seller not to compete with a purchased clinic or to attempt to solicit away its clientele and employees. It is just as important from the seller's perspective not to give away more than is reasonable.

Life goes on, and most selling veterinarians prefer to keep some opportunities open to practice a profession to which they have dedicated a career. Frequently, non-competition provisions of a transaction are subject to the most intense negotiation and should be outlined in detail in the letter of intent.

Post-Closing Financial Statements

Typically a buyer and a seller of a veterinary practice will agree on a purchase price for the shares based on a valuation made as of a particular date in time. However, the corporation that carries on the veterinary practice will not come to a standstill until the completion of the transaction, nor should it. In other words, neither party will know until the very date of closing, and even later, to what extent the value of the shares will have increased or decreased as a result of the ongoing business activities of the practice. Because of this, the vast majority of Share Purchase Agreements will include a procedure for determining precisely how much of the purchase price for the shares is to be paid at closing, and a procedure for preparation of closing date financial statements by the accountants representing both parties. This allows the final value of the shares to be settled post closing.

Organizational Issues

Either or both of the seller and buyer of the veterinary practice may wish to use a more complex corporate organization to maximize the value of the transaction. For example, the CVO took the lead a number of years ago by amending its by-laws to permit veterinarians the use of holding corporations to acquire and hold shares in professional corporations (the CVO is one of the few professional governing bodies to have been this pro-active). Taxation and financing considerations may lead the purchaser to use a holding corporation to acquire the purchased shares rather than obtaining them directly. Similarly, a seller, in speaking with their accountant, may wish to re-organize the corporate structure and ownership of a clinic shortly before closing. If these considerations apply, they should also be permitted by the letter of intent. In addition, where there is a partial buy-in to an existing practice, or where the purchasers are made up of more than one veterinarian, it will be essential for the parties to think about how they wish to share in management of the practice and a Shareholder Agreement/Partnership Agreement should be negotiated and implemented as soon as possible.

Legal Summary

All parties would prefer a simple and straightforward share purchase transaction. The reality is that legal and business considerations involved in the purchase and sale of a veterinary professional corporation are complex and to a certain extent, unpredictable. It is an unusual sale that does not include a few surprises and detours. However, perseverance, a pragmatic outlook and the directions recommended in this "road map" will enable you to address unanticipated issues as they arise and arrive at your ultimate destination.

Finalizing the Deal: Accounting Perspective

Accounting for your practice, prior to a transition in ownership, whether you are retiring or succeeding your practice, is an important aspect of proper practice management. A well designed practice accounting system including sales/receivable/collections, purchasing/payables/inventory and payroll/employee management provides accurate information your accountant will utilize to prepare annual financial statements and prepare and file annual income tax returns. The financial statements will be utilized by a potential purchaser to:

- analyze the financial health of the practice,

- provide financial information to a valuator to assist in determining a fair market value of the practice including tangible assets (equipment and working capital) and intangible assets (goodwill),

- provide financial information to a potential lender to determine the viability of financing the purchase of a practice.

Once a fair market value is agreed to between a potential buyer and potential seller and the letter of intent is signed, your lawyer will draft a purchase and sale agreement, including a clause which will allow an adjustment to the purchase/sale price based upon changes to the working capital (current assets less current liabilities) on closing from that of the last published fiscal year end financial statements. Your accountant will ensure there is no deterioration of the practice's financial position between the effective date (when a buyer agrees to purchase from the seller) and the closing date (when the purchase and sale transaction is completed). In addition, the purchase and sale agreement will provide that all practice debt of the practice that is being purchased will be paid out at completion such that the practice is acquired free of all liens and encumbrances (free and clear).

Properly prepared financial statements will allow both the buyer's and seller's advisors to ensure a purchase and sale agreement will be executed in full confidence that the financial condition of a practice has been fully disclosed. This reduces the risk of the deal falling apart and/or post-closing litigation.

For the seller, the financial statements will also allow for the proper tax planning discussed earlier. For the buyer, the financial statements will provide valuable historical information to grow their new practice, and allow for easier budgeting and cash flow management.

Why Deals Fall Apart

Below is a short list and description of the most common reasons deals, that otherwise made sense, tend to fall apart:

1) The lawyers involved

When choosing a lawyer you should be looking for someone who has experience with share purchase agreements, is pragmatic, and if at all possible has some experience in the veterinary industry. Pragmatism is crucial. It is unrealistic to think that one party is going to rid themselves of all risk.

2) DIY negotiating

If the parties understand all the legal, tax, and value implications of each term of an agreement then negotiating/facilitation help may not be needed. This is rarely the case though, and such misunderstanding can introduce badwill into the process. In fact, using a representative frequently enables the parties to negotiate in a more business-like fashion.

3) Unable to finance

The two most common causes of the inability to finance are:

i) The buyer, due to past financial history, represents a risk to the banks and will not be approved. This is relatively rare.

ii) More commonly, financing applications are rejected because the offer to purchase does not represent a realistic value: either the offer is significantly above appraised value and may not be feasible, or no appraisal exists.

Tips for Success

Below is a short list of tips that may help a smooth transition

1) Where needed, surround yourself with the right representatives (legal, value, and accounting). This will ensure that your interests are protected.

2) Focus on Win-Win. The deal will only work if both parties see a benefit. Focusing on win-win is critical to the negotiation process.

3) Remove your emotions. The process can be a long and often challenging one. Frustration will only add to that.

Time Commitment

The transition process is requires many steps. Often, veterinarians are surprised by the large time commitment it requires. From all our experience, we cannot stress enough that both seller and buyer should be prepared to expend a significant amount of time. Unrealistic expectations of the process and time requirements can lead to unnecessary frustration. An estimation of effort for each step of the process can be discussed with your representatives.

Conclusion

We have presented the basic information we believe is crucial for any selling veterinary entrepreneur. It by no means covers all aspects however. We urge you to discuss the specifics and ask any questions you may have with your personal representatives or alternatively feel free to contact any one of us to discuss further.