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Advanced Transaction Strategies: What You Need to Know before Buying or Selling an Audiology Practice

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Advanced Transaction Strategies

What you need to know before buying or selling an audiology practice

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Contents

- Transaction Structures
- Key Points of Negotiation
- Valuation Strategies
- Case Studies

Asset v. Stock Sale

Most industry transactions – and most small business purchases in general – are structured as asset purchases.

Type	Definition	Pros	Cons
Asset	Buyer purchases the assets of the corporation (tangible & intangible), but does not purchase the corporation itself. Buyer establishes a new corporation with which to operate the business, and Seller dissolves existing corporation.	Limitation of Liability • Buyer chooses which liabilities to assume • Shields from risk associated with prior ownership (tax audits, fraud, lawsuits) Ability to select new accounting methods • Overall • Depreciation & Amortization	Double taxation for C Corps Portion of purchase price taxed as ordinary income (for all other entities) Difficulty in transferring contracts, licenses, leases, etc.
Stock	Buyer purchases the stock in Seller's corporation, effectively purchasing the corporation itself in addition to all of the assets.	Ease of transfer of licenses and contracts All purchase price allocated to stock is taxed as capital gains • Most, if not all, of price is typically allocated to stock • Some can be allocated to non-compete, training, or personal goodwill	All liabilities are assumed No change in asset basis – "tax basis" carries over Old depreciation schedules maintained Cannot amortize price allocated to stock

Price & Payment Terms

All Cash

<u>All Cash</u>

Buyer pays full purchase price in cash at closing.

<u>Seller Note</u>

Buyer and seller enter into promissory note and seller makes payments to buyer over time.

Seller Note

Deferred Payment

<u>Deferred Payment</u>

Portion of purchase price is deferred to a later date, but not contingent on performance.

<u>Earnout</u>

Part of purchase price has to be earned, based on future business performance

Earnout

Asset Allocation

We are not a CPA and this does not constitute tax advice. Please consult with your accountant if you have questions about your personal tax obligations.

Item	Seller	Buyer
Physical Assets (FFE)	Ordinary gain or loss	Capitalize and depreciate (usually over 5-7 years)
Accounts Receivable	Ordinary gain or loss to the extent allocated value differs from tax basis	Ordinary gain or loss to the extent collection differs from allocated value
Inventory	Ordinary gain or loss	Capitalize – can impact earnings in first year
Goodwill	Capital Gain	Capitalize and amortize over 15 years
Non-Compete Agreement	Ordinary Income	Capitalize and amortize over 15 years
Consulting / Employment Agreement	Ordinary Income subject to FICA	Current deduction
Other Intangibles	Capital Gain	Capitalize and amortize over 15 years

Balance Sheet Items

Most transactions involve an accounting cut-off at closing – the seller "owns" all income and liabilities until the closing and the buyer owns everything post-closing. Balance sheet items, however, can occasionally be negotiated.

Assets
- Cash
- Accounts Receivable
- Inventory
- FFE

Cash & A/R are typically excluded from the transaction. The seller keeps all of the cash and collects the A/R. Occasionally, some or all of each will be purchased. Cash should be purchased dollar for dollar while A/R may be discounted.

Inventory may be purchased if it is new and sellable. Depending on deal terms, it may be included in the price or added to it. FFE is almost always included in the price.

Liabilities
- Accounts Payable
- Salaries Payable
- Taxes Payable
- Credit Returns
- Debt

Liabilities are almost always excluded from asset purchases. Sellers should plan to pay off all accounts, salaries, and taxes payable with the current liabilities (cash & A/R) that they are retaining.

Debt is rarely assumed by buyers. Instead, sellers should plan to use the proceeds from the sale to pay off any debt.

Transaction Documents

Letter of Intent (LOI)

- What it is:
  - Document containing a formal written offer to purchase a business; typically non-binding
- What it contains:
  - Purchase Price
  - Payment Terms
  - Transition Terms
  - Employment Terms
  - Non-Compete Terms

Asset Purchase Agreement

- What it is:
  - The purchase contract entered into by the buyer and seller; primary document used in a transaction
- What it contains
  - Same information as LOI, only in greater detail
  - Restrictive Covenants
  - Representation & Warranties
  - Pre-closing conditions

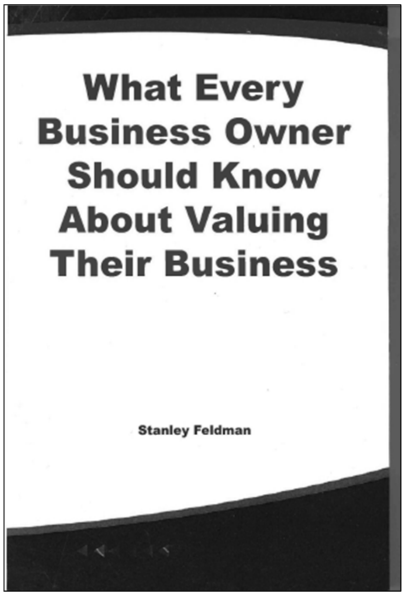
Non-Compete

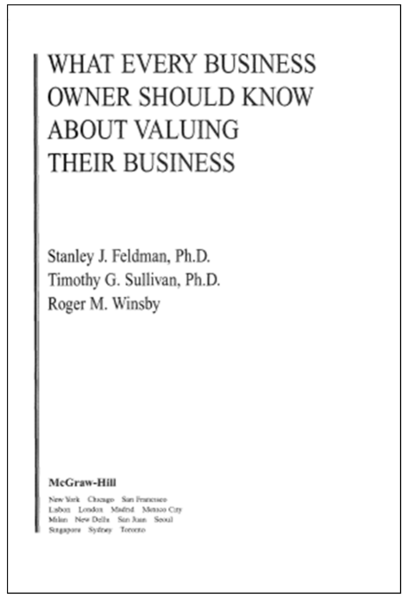
- What it is:
  - Restrictive Covenant barring the seller from competing with the new owner
- Key Elements
  - Term – # months/years non-compete is in effect (typically 3-5 years)
  - Geographic Scope – typically defined as a radius among office(s) being sold (25-50 miles)

The Deal Team

Selling a business is a team effort, and the team that puts the best players on the field usually wins.

	Decision to Sell	Prepare Financial Documents	Prepare Marketing Materials	Pricing	Marketing	Due Diligence	Negotiation	Closing
You	•	•	•	•	•	•	•	•
Accountant		•						
Attorney							•	•
Broker		•	•	•	•	•	•	•




WHAT EVERY BUSINESS OWNER SHOULD KNOW ABOUT VALUING THEIR BUSINESS

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Lisbon London Madrid Mexico City
Milan New Delhi San Juan Seoul
Singapore Sydney Toronto

Business Valuation

A business valuation is an analytical process for estimating the price a willing buyer would pay for a specific business and a willing seller would accept – without having to put the business up for sale.

The goal is to determine **"FAIR MARKET VALUE"**

Two Keys to Valuation

- The date of the process
  - This is a function the economic times
  - The process is only as accurate as the most current data
  - The most recent data (within a quarter)
- What is being evaluated
  - Usually this is the ongoing operations of a practice plus any non-operating sources of income or value, such as real estate

Transparency

- Is the feeling that everything is as is appears
- The higher the transparency
  - Easier to value
  - Lower the risk
  - Traditionally commands a higher value
- Private company versus a public company
  - Information is becoming more available since publicly traded are more transparent with financials regarding their corporate owned stores

Other useful pieces of information

- Have there been any significant changes in the financial market?
  - YES
- Have there been any significant changes in the industry in which the business operates?
  - YES!
  - Vertical Integration
  - Increase in 3rd party payers in the distribution system
- Have there been any significant changes in the numbers of business in that industry?
  - YES!

Typical Components Assessed

- Office and professional equipment
- Services and products provided
- Market analysis
- Competitive analysis
- Marketing budget and ROI
- Staff
- Contracts-insurance, provider, physician, etc.
- Patient flow or productivity
- Financials
  - Balance Sheet
  - P&L
  - Cash Flow

What should be analyzed?

What time frame needs to be analyzed?

- The previous three years
- The current year to date
  - Comparison to the previous years

What calculations are relevant to today's distribution model?

- Profit of Hearing Aids Sales
- Profit of Professional Fees
- Revenue by Payor
- Revenue by Referral source
  - Need accurate information regarding revenue by a practices different referral channels!

Valuation Process

- What are Traditional Valuation methods?
  - Asset-based approach
  - Value to owner's earnings/profit multiple
  - Value to revenue multiple
  - Discount cash flow
- What is the most common method used today our industry?

~~Revenue Multiple~~
or
Discounted Cash Flow

Traditional Valuation Methods

- Asset Value
- Revenue Multiple
- Earnings Multiple
- Discounted Cash Flow

Discounted Cash Flow	• Cash flow is based on the premise that a person buying a business is buying the opportunity to earn free cash flow of that business • It is the true analysis of the ability to pay back the loan and pay for fixed expenses "the value of a financial asset is the present value of the future cash flows to be gained from owning that asset"

EBITDA , SDCF, & Recasted Financials

SDCF =

Net Operating Income (Income before Interest & Taxes, or EBIT)

+ Depreciation & Amortization

+ One-time (unusual) expenses

+ Expenses not directly related to the operation of the practice

+ Owner's full salary & wages

EBITDA =

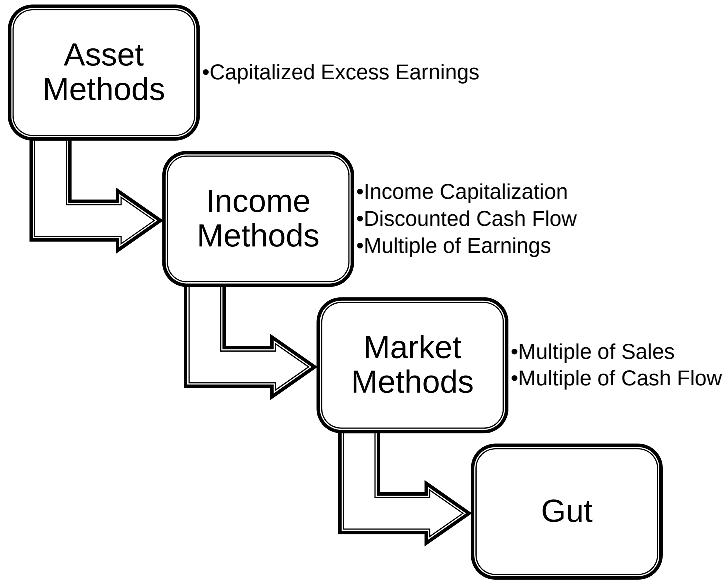
SDCF - Cost to replace owner (e.g. salary of owner during employment term, or cost of replacement Au.D. / Manager)

Add backs must be verifiable, and buyers may discount or disregard certain add-backs based on the quality of your earnings.

- Are your add-backs based on line-item expenses, or are they buried within categories?
- Do you have receipts?
- Can a new owner realistically expect to:
  - Pay themselves a reasonable salary
  - Cover loan payments

Which to use?	EBITDA should always be used for the purposes of valuing a business and determining debt servicing capabilities.

Caber Hill's Valuation Methods



"If you understood a business perfectly and the future of the business, you would need very little in the way of a margin of safety. So, the more vulnerable the business is, assuming you still want to invest in it, the larger margin of safety you'd need. If you're driving a truck across a bridge that says it holds 10,000 pounds and you've got a 9,800 pound vehicle, if the bridge is 6 inches above the crevice it covers, you may feel okay, but if it's over the Grand Canyon, you may feel you want a little larger margin of safety...."

-- Warren Buffett

Evaluating Customer Concentration Risk

Customer Concentration
- Exists when a small number of customers generate a disproportionate amount of revenue
- Payors & referral sources generate customer concentration risk

Payor Risk
- Occurs when a practice is overly-reliant on third party payors
- Assess type of payors and % of revenue
- Becomes significant issue when one payor contributes 20% or more of revenue

Referral Source Risk
- Occurs when a practice is overly-reliant on referral sources
- Assess % of business and likelihood of transitioning relationship to new owner

Case Studies

Referral Source Risk
- Profitable, owner-operator run practice rents space in a building owned by ENT's
- ENT's outsource all audiology services to audiologist, which represent 22% of annual new patients
- ENT's decide that they will not extend a lease to a new owner of the practice because they want to bring audiology in-house

Payor Risk
- Audiology practice serves as a VA provider, but does not have a contract (e.g. is registered as an approved provider)
- ~20% of revenue comes from VA patients
- Buyer is concerned about ability continue VA business

Valuation Gap
- Seller seeking a valuation of ~$400,000-500,000
- Buyer values business at ~$250,000-300,000
- Deal structure designed to close gap

Conclusion

- Always aim for a win-win outcome
  - There is a creative solution for every deal issue
  - Both buyer and seller should be satisfied with the purchase price and transaction terms
- There are several ways to calculate Fair Market Value, and each has an appropriate application
- End of Day Value must always be considered:
  - At the end of the day, a business is worth what someone else is willing to pay for it

Thank You!

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