How Much Debt Can Your Business Afford?

Below are a few examples of formulas we use to determine whether or not a veterinarian and the animal hospital they are looking to purchase can afford to take on the debt to do so. While these formulas can help give you a general idea of how much debt the practice can afford, we always recommend speaking with a loan officer to determine debt capacity.

CASE STUDY:

A DVM (buyer) who has been an Associate DVM for four years following college has uncovered a practice 25 miles away he is interested in purchasing. The practice produced revenues of $507,000 and $490,000 in the two years leading up to listing the practice for sale.

The agreed upon sales price was $430,000 for the practice assets. After including working capital, furniture, fixtures, equipment, etc., the buyer will borrow $525,000 to finance the purchase of the practice.

Payment to Live Oak Bank will be approximately $5,600 per month or approximately $67,000 per year.

Can the buyer afford to purchase this practice?

EXAMPLE:

Calculating Net Operating Income (NOI):

1. Net Income + Addbacks (non-cash expenses and money going back to the business owner) = NOI

2. We then take net income and add back several non-cash expenditures in order to accurately calculate the Net Operating Income or the true cash flow of the business. This is the money left to pay the owner, pay the business debts and invest back into the business.

3. These addbacks include:
- Depreciation Expense
- Amortization Expense
- Interest Expense
- Rent (if Real Estate is owned)
- Officer Salary

Once we add these expenses to the net income, we have derived the NOI, the true cash flow through a certain period of time. We divide this NOI by the amount of debt the business must cover over that time period to obtain the debt service coverage ratio (before owner's compensation). This is an SBA calculation that identifies a business' ability to pay its debt.

In the stated case above the NOI for Seller Year A was $180,000 and for Seller Year B was $122,000.

Calculating Annual Debt Allowance (Payment):

1. (NOI – Reasonable Officer Compensation (ROC)) / 1.25 = Maximum Annual Debt Payment the Practice Can Afford (for all business debt)

2. An ROC is determined by the personal debt load of the buyer. A rule of thumb is taking the buyer's personal debt from the buyer's credit report, doubling it and then annualizing it. We use this figure or $75,000 for ROC, whichever is greater.

In the above case a decision was made to use $61,000 as the ROC. This decision was based upon the extreme low personal debt and because the city where the buyer was relocating had an extremely low cost of living.

Debt Allowance Equation Example:

(NOI – ROC) / 1.25

Seller Year A

($180,000 – $61,000) / 1.25 = $95,200

Seller Year B

($122,000 – $61,000) / 1.25 = $48,000

Seller Year A

The estimated Live Oak annual debt stated above is $67,000.
Cash Remaining ($95,200) – Live Oak Bank Annual Payment ($67,000) = $28,200 left to reinvest in practice or take as added salary.

Seller Year B

The estimated Live Oak Annual Debt stated above is $67,000.
Cash Remaining ($48,800) – Live Oak Bank Annual Payment $67,000 = - $18,200 = shortage to pay the annual debt.

Live Oak Bank was able to get comfortable with Year B's shortage because we understand the seller did not practice full time in his (or her) final year as owner. In addition, the buyer was going to continue adding services in-house that the previous owner had referred out.

Calculating Monthly Debt Allowance (Payment):

Annual Debt Allowance / 12 = Maximum Monthly Debt Payment Business Can Afford (for all business debt)

Seller Year A

$95,200 / 12 = $7,933.33 per month

Seller Year B

$48,800 / 12 = $4,066.67 per month

Seller's Final Two Years Compared to Buyer's First Year:

	Seller Year A	Seller Year B	Buyer Year 1
Revenue	$507,000	$490,000	$742,180
NOI	$180,000	$122,000	$314,526
ROC	$61,000	$61,000	**$100,000**
Cash Flow Available	$119,000	$61,000	$214,526
LOB Debt	$67,000	$67,000	$67,000
Excess Cash Flow	$52,000	- $6,000	$147,526
Cash Flow Coverage	1.77	0.90	**3.78**

As a new practice owner, you will face some challenges you may not have anticipated. Just like your clients want an experienced veterinarian for the life of their pets, you'll want a lender who is seasoned in practice acquisitions and dedicated to your long-term success. Live Oak will guide you through the loan process and provide resources to ensure a successful transition—even after the loan closes.

Learn more by downloading our Veterinary Practice Acquisition Guide or contacting a loan officer to learn what financing can do for you.

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