Lending and Capital— Funding Your Future

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This year's **Practice Development series** is dedicated to **building today's veterinary practice**. The goal of this series is to describe the many elements that impact the growth and success of your veterinary practice. This second installment introduces the basics of financing and the veterinary lending process.

Read the first article in the series, **Moving Forward—Investing in the Future of Your Practice** (January/February 2014), at **tvpjournal.com**.

Almost 15 years ago, my wife and I took out a loan to buy our first practice, and like most new borrowers, we knew little to nothing about the process. Now spending most of my days working with practice owners as they invest in their businesses, I have tried to write the article my wife and I needed many years ago.

You can't watch TV or peruse the Internet without coming across a story about another debt crisis. Whether it's the evening news tracking the never ending federal debt, your favorite blog commenting on the dangers of unchecked personal debt, or an industry journal debating the merits of student debt, the message is similar—debt is choking many people in this country.

So am I really going to take the position that debt can be good for a veterinary practice? You bet I am.

The perils of the various debts mentioned above are very real. However, debt utilized intelligently, deployed conscientiously, and managed responsibly, can enable a veterinarian and/or their practice to achieve financial success.

DEBT FINANCING

Debt financing enables veterinarians to move their practices forward in many different ways. It can be the:

- Vehicle that makes purchasing your first practice a reality
- Jump-start that allows you to open a brand new practice
- Capital to expand your current building
- Funding to build a brand new hospital
- Means to refinance existing debt and reduce monthly bills.

While debt financing enables you to move your practice forward, it's not without risk and should be secured responsibly, with a clear understanding of future obligations. This article is intended to provide an introduction to the veterinary lending process, and will serve as a quick resource for any reader considering borrowing money.

FUNDAMENTAL ELEMENTS OF BORROWING

The 3 fundamental elements that drive the value and future obligations of a loan are the principal, term, and interest rate. Understanding the relationship between the 3 is critical as you consider loan options, because each can greatly influence your ability to repay.

1. Principal

Principal is the *total amount of money being borrowed*. Depending on the structure of the loan, principal can be used to:

- Fund an acquisition of practice assets
- Fund construction costs
- Purchase equipment
- Provide working capital.

TABLE. TYPICAL LOAN TERMS

LOAN TYPE	TYPICAL TERM
Traditional practice acquisition	10 to 15 years
Real estate purchase	25 years

2. Term

Term is the *period of time required to repay a loan*; it greatly influences the amount of your monthly payment. Extending the term of a loan enables a borrower to reduce the monthly payment amount in exchange for paying more in interest over the total life of the loan. The **Table** illustrates typical loan terms.

3. **Interest Rate**

Interest is the *cost associated with borrowing money*; generally stated as a percentage of the principal amount borrowed. In the veterinary lending environment, the interest rate can take one or more forms.

Prime rate. The prime rate is a benchmark defined as the *lowest commercial rate available to the most credit-worthy customer*. It is largely determined by the federal funds rate, which is the overnight rate at which banks lend to one another, and sets the base for lending rates for mortgage, small business, and personal loans.

Variable interest rate. Variable interest rates on loan products can change during the life of the loan usually based on the *prime rate*. As the prime rate changes, the interest charged on a variable-rate loan changes as well.

Because this type of loan is directly tied to a bank's natural lending costs, and because the current prime rate is very low, variable-rate loans in today's environment are often very attractively priced for borrowers.

Fixed interest rate. Fixed interest rates remain unchanged for the life of the loan. A fixed interest rate enables the borrower to plan their repayment schedule using an exact payment amount for the duration of the loan period.

Because the prime rate and costs of lending are fluid, it is more expensive for a bank to offer a fixed rate for an extended period. As a result, fixed-rate loans are often priced higher than comparable variable-rate products. The borrower is exchanging the security of fixed interest for a potentially more expensive total repayment obligation.

HOW TERMS & INTEREST RATES AFFECT MONTHLY PAYMENTS

Dr. Smith is considering expanding his hospital to accommodate future growth. Based on his current business, he does not want to commit more than $2,500 per month in loan repayment. Differing loan structures mean significantly different options for Dr. Smith.

CONSIDERATIONS	LOAN 1	LOAN 2
Principal	$310,000	$395,000
Term	20 years	25 years
Interest Rate (Annual)	7.5%	5.75%
Monthly Payment	$2,497.34	$2,484.97

LENDING AVAILABLE TO BORROWERS

For a veterinarian seeking financing to purchase a practice, build a new hospital, or refinance existing debt, there are several different types of loan opportunities. Following are some common lending products currently available.

Conventional Loans

Conventional loans are one of the most common loan products used for acquiring an existing practice. These loans can carry floating or fixed interest rates, which are influenced by the lender's assessment of risk of both the borrower and the practice.

These loans are commonly structured over a 10-year term, although newer term options for 15 years (or more) are making their way into the market. Conventional loans can be priced based on several different interest rate indices or internally by a bank, compared with Small Business Administration (SBA) loans whose interest rates are typically priced based on the prime rate plus a fixed percentage.

Small Business Administration Loans

The SBA (sba.gov) offers a government-backed lending program intended to help small business owners of all kinds. While the SBA guarantees loans through this program, funds are actually disbursed through individual banks, many of which will fund projects for veterinarians.

Benefits. Because the SBA is backing, but not directly lending, lenders have a higher level of discretion when creating a loan structure for an individual borrower. With this flexibility, SBA-backed loans may offer:

- Lower down payments
- Longer terms (7 years for working capital, 25 years for real estate)
- More flexibility than other loan products
- A pre-defined maximum interest rate that varies depending on the size of the loan (currently the SBA 7(a) Program's maximum interest rate limit is the prime rate + 2.75%).

Limitations. SBA loans have limitations that may present challenges in practice acquisitions. When a practice changes hands, the purchase price is based on the combined value of the tangible assets (eg, cash, equipment, inventory, and real estate) and goodwill (intangible assets—eg, client lists, medical records, and non-compete clauses). Because the SBA sets pre-determined limitations on the amount that can be borrowed specifically for goodwill, the purchaser may be required to come up with additional cash for a down payment, or the seller may need to agree to some amount of owner financing.

In addition, SBA loans are assessed additional fees, including a guarantee fee that can add over 3% to the government-guaranteed portion of the loan.

Owner Financing

Although not a regulated form of financing, owner financing is another option for practice acquisitions and buy-in opportunities. Once commonplace as a tool to fund associate buy-ins or as a means to allow a younger veterinarian to purchase an ongoing practice, owner financing enables transactions to occur when capital isn't readily available from conventional lending sources.

Owner financed loans are *private agreements between the seller and the buyer*, and interest rates and loan term are often negotiated as part of the purchase agreement. As a rule, owner financing is not advisable to a seller as it delays payment over an extended period and requires the seller to assume the risk of the the buyer's ability to pay.

As capital is more readily available today, owner financing agreements occur less frequently and are typically reserved for cases where bank financing falls short of a seller's desired price.

Lines of Credit

Although typically intended for short-term operating capital needs, some practices will use a line of credit for projects of smaller size and scope. Rather than completing a more involved loan process, a line of credit enables a practice owner to borrow (in prescribed increments) up to a certain amount of capital annually. Lines of credit are usually less than $200,000 and normally based on assets of the practice.

Remember, lines of credit should be used judiciously as the interest and late fees can compound rapidly, leaving a practice owner with an unexpected repayment obligation. If you are considering a project of any scope, it is most often better to pursue a traditional commercial loan.

CRITERIA INFLUENCING LOAN APPROVAL

A lender considers many factors when evaluating a prospective loan, but the most influential factors include:

1. **Cash Flow**

   The most important consideration a lender makes when funding an acquisition, construction, or renovation, is the ability of the borrower (practice) to reliably repay that obligation without compromising the daily operations of the business.

   Different lenders use different formulas and employ their own individual levels of tolerance, but all lenders will spend considerable time evaluating the following as part of the approval process:

   - Expense structure of the practice
   - Revenue growth trends
   - Likelihood of future growth
   - Bottom line cash flow.

   This cash flow analysis will set the limits on the total debt service and what terms the lender will be able to offer a prospective borrower.

> It's critical to keep your day-to-day obligations current as poor payment histories can negatively impact your business' credit worthiness for a long period.

2. **Practice History**

   Lenders only make money when a loan is repaid; therefore, they look to fund projects with the lowest perceived risk. The following histories will negatively impact your ability to secure further funding:

   - Late payments to vendors
   - Defaults to vendors
   - Poor credit history
   - Late or failed payments to other business debt.

3. **Personal History**

   Many potential borrowers are intimidated to apply for a practice acquisition loan due to their own personal debt obligations. While your total debt does come into play, what's more important is that you have demonstrated the ability to responsibly repay that debt over a period of time. Most borrowers in the veterinary lending environment have student debt, a mortgage, and a car payment. It is ***how they have managed*** these obligations that will determine how a lender views the risk.

EVALUATING LENDERS

While lenders evaluate your worthiness as a prospective borrower, it's important that any borrower apply the same critical eye in considering lending options. There are many lenders, loan brokers, and advisors in the marketplace, not to mention the many local banks that individual veterinarians will solicit for a business loan.

Some lenders have made a dedicated commitment to lend to members of the veterinary profession, while others may process only a handful of loans to veterinarians every year. It's important to understand whom you're dealing with. The following are key considerations when evaluating different lenders:

1. **One Size Doesn't Fit All**

   Some lenders offer only a single product line—either exclusively conventional or SBA loans. It's important to understand this dynamic as the products the lender offers ultimately work within the lender's own restrictions, not what is necessarily the best fit for your individual needs.

2. **Beware of 100% Financing**

   100% financing and 100% of a practice purchase price are not one and the same. Some lenders will advertise that they offer 100% financing but actually have cap limits on what they will lend (based on a pre-determined ratio of practice revenue to loan amount). A lender who has a blanket policy that caps all loans at 70% of gross revenues isn't very helpful if your purchase price is 85% of gross revenues.

3. **Interest Rate & Term**

   As described above, the interest rate and term of a loan define your repayment obligation. To create the best lending arrangement for your practice, understand:

   - What is most important to you
   - Your individual project needs
   - Capital required to meet those needs.

   Utilize interest rate and loan term to make your repayment structure feasible.

HERE IN THE REAL WORLD: A CASE STUDY

When my wife and I finally settled on a start-up practice as our next project, we evaluated several different options for funding.

We settled on a bank with a proven track record that offered start-up veterinary practice funding. Our previous experience as practice owners was helpful in bypassing several normal hurdles; we moved from an application to approval in a matter of days.

Based on our business plan, we secured a loan to renovate our chosen building, install new equipment, and seed approximately $50,000 in working capital at an annual interest rate just below 6%.

The funding process was moved along nicely and allowed us to begin the building renovation phase, although there were inconveniences along the way. As the bank set restrictions that required direct payment from the bank to all vendors, doing business with retail stores, like Lowe's and Home Depot, was more difficult as they are not traditionally set up to do business that way. For a do-it-yourself remodeler, this slowed down our process.

The greatest inconvenience came in the accrual of loan interest during the project phase of hospital renovation. Despite our ability to complete renovations and equipment installation within just 4 months from the opening of the loan, we accrued over $15,000 in additional interest, increasing the total repayment obligation by 4.5% due to a monthly project interest rate of 2.5%.

All in all, these were small issues in building our ideal practice. But without a bit of luck, and many evenings of personally installing flooring and painting, our loan balance could have been substantially higher.

4. Project Rates

For construction and start-up loans, many lenders issue a different interest rate for the project period during which funds are gradually dispersed; then lock in a final interest rate once the project is complete and the loan officially closes.

A borrower needs to keep these fees in mind as they may elect a loan with a 6% annual percentage rate for a construction project, but unknowingly accept a project rate of 2.75% **per month** during construction. The effect on accumulated interest can be thousands of dollars.

5. Fees

Make sure to understand all of the potential fees associated with a particular loan. If applying for an SBA loan, understand what the program fees are, what additional administrative fees your lender will impose, and how that will affect your overall obligation.

6. Penalties

What happens if you decide you want to pay down principal early? What if you decide to refinance with another lender? Before committing to a loan provider, it is important to understand the penalties and fees associated with principal reduction and early loan payoff because these fees can be significant.

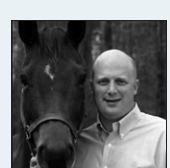
7. Secured Loans

A loan is secured against an asset of some value, typically the project it is funding (ie, the practice). The industry standard for a veterinary loan is to secure the loan against the assets of the practice, although a smaller local bank with little experience in this industry may seek to secure a loan against an individual's personal property. In today's market, there is no reason for a veterinarian to secure a loan with their home or personal property.

SUMMARY

As a profession, we are very fortunate that we all have the opportunity to be practice owners and to build the practice of our dreams. There is capital available to buy a practice, build a new hospital, or refinance existing debt, and there are many lenders providing capital for veterinarians. But it is important that a prospective borrower understands the details and their responsibilities, and works with a lender who can best meet their individual needs. ■

SBA = Small Business Administration



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