Issues in Buying, Selling and Valuing Dental Practices

Following is a pot pourri of observations based on our experiences, rather than a cohesive article. Those interested in buying or selling practices should read carefully, as there's something in it for everybody.

Buyers usually say that practices are over-valued, and vendors usually say that they are under-valued. The less dental clients that vendors' or buyers' accountants have on their books, the more likely it is that they are prone to provide exaggerated views on value with a bias towards the interest of the client that they are advising.

Misperceived Value – Too High?

Invariably, when a dentist seeking to buy a practice consults an accountant who does not have a significant number of dental clients, that accountant advises the young dentist that the value is far too high, knowing full well that that's the message the younger dentist wants to hear. In actual fact the price may be quite fair. When an opportunity to purchase a good practice is passed up on that basis, and the young dentist later hears that the practice has been sold to somebody else, it's too late. They may then have a frustrating wait of several years trying to find another practice for sale which was as good as the one that they passed up. The accountant concerned did them a serious disservice.

Misperceived Value – Too Low!

The reverse situation occurs when an accountant, again without many dentists among their clients, advises an older dentist wishing to sell that their practice is worth far more than market-based valuation indicates. By seeking an unrealistic price, potential purchasers are burned off. Ultimately the practice may take on a shop-soiled image in the marketplace and other potential buyers, knowing that it has been on the market for a long time, bypass it, thinking that it's got a serious problem.

Accounting Qualifications and Dental Valuations

The training of neither chartered accountants nor certified practising accountants equips them to value dental practices unless they also have an extensive dental client list and are therefore in a position to observe regular sales. Valuation textbooks as to method do not overcome the lack of market knowledge of other sales, or of capitalisation rates applying to dental practices as distinct to those applying to newsagents or postal agencies when capitalising profit to determine market value. There is no substitute to using a valuer with regular ongoing dental valuation experience as well as good financial knowledge.

Unusual Ownership Structures

When buying part of a practice as an associateship there may be traps in acquiring ownership of various structures, including companies and trusts, particularly where several structures are involved in the running of a practice. A potential issue is who or what owns the goodwill, since purchasing within structures may result in significantly greater capital gains tax bills far into the future.

Buying a Dental Practice Inside a Company

It's invariably a mistake to buy a practice company or part thereof, where the goodwill is recorded as belonging to the company via an entry on the company's balance sheet. Buyers may either:

a. End up with a greater tax liability than they assumed when the practice is on-sold in twenty or thirty years' time; and

b. In the case of being part of a company with several other dentists also being shareholders, when an individual wishes to sell what they regard as 'their' associateship, other well advised dentists will refuse to buy a share in a practice company. It can make a practice very difficult to sell.

In certain cases, a company operating a practice where there is only one dental owner involved may be able to be wound up and the dentist concerned claim the various small business capital gains tax concessions at sale.

Whether or not it is appropriate to own the goodwill of private practices via companies should not be confused with companies listed on the stock exchange where ownership via shares and management are divorced. The underlying stock market assumption is that a listed company has an indefinite life. Furthermore, small business capital gains tax concessions don't apply to the sale of shares in listed public companies.

Incorporation Doesn't Add Value!

We have periodically been asked to advise on a situation where a dentist has to be advised not to buy shares in a dental practice company, yet the practice owners had been advised to incorporate, sometimes combining the goodwill of several previous practices into a large company on the misplaced assumption that they would enhance its value. Even where a practice is turning over several millions of dollars, incorporating the 'ownership of goodwill' into a company is not a great idea if the practice is likely to be sold in parts to several dentists. Those several dentists purchasing in isolation would hope to be eligible for the capital gains tax concessions applying to active business assets when they sold their associateships at some future date, and are advised to buy goodwill personally rather than take part ownership of a company. It's also not a good idea because when trying to sell their part of the practice, it's near certain that the buyer's accountants will advise them against purchasing into the company structure, and therefore it can seriously damage the possibility of on-selling the practice.

Ownership structures of existing practices are a snake pit of potential problems for intending buyers.

Size and Value Additions – Hitting the Wall

We observe instances where practices become too large for the owners to maintain tight management. We acknowledge that there are rare exceptions. What typically happens is that a proprietor dentist building up a practice gets beyond the capacity of their own efficiently-run surgery, and having the flair for marketing a practice they employ a second dentist, who builds up another profitable surgery and contributes a modest profit to the practice. In due course a third dentist is employed and builds up a surgery, but is less profitable than the second dentist and so on. With each additional dentist the owner finds themselves doing more administration and more supervision of other dentists; and dealing with more personnel problems. Periodically a younger dentist leaves and some dental treatment has to be redone at the owner's expensive. Profit per dentist and profit per dollar of fees tend to decline with practice size. At a certain point the practice owner hits an invisible wall and is unable to grow profit further. They simply end up with a complex practice structure of too many dentists, too many receptionists and too many chairside assistants, with quite a few of them being part-time. To bring order into the chaos they create an additional layer of management and expense.

The hidden wall is far more common than dentists perceive. In almost every successful practice the busiest and most profitable part of the practice is the owner's personal surgery. Overwhelmingly the most successful dentists have limited the size of their practices and are visible proof of our observation that all successful small businesses are run by control freaks! Putting on a full-time practice manager usually absorbs more profit than it creates.

Associate Not Willing to Buy
When two or more dentists are associated in a practice it is usual for their associateship agreement to require that each has to first offer their associateship to the other dentist(s) before selling to a third party.

The situation can have tricky side effects, particularly if two dentists do not have an agreeable relationship.

In some instances the continuing associate decides to sit out an increasingly anxious vendor associate in the expectation that they will capitulate and lower their asking price substantially.

In other situations, when the vendor starts the process several years in advance of the intended retirement date, they are able to maintain a high fee level and let the continuing associate contemplate the gain they could be making by owning the whole of the practice.

In these situations, bargaining power favours the associate with the greatest patience.

Associate Says No To Purchase – But!
In this situation a departing associate has a right to sell to an outsider. This becomes very tricky if they can find a buyer perhaps via international advertisement. If the new associate turns out to be a cultural misfit and alienates the practice staff and many patients, how does the continuing associate deal with the situation? In extreme cases, a continuing associate has been forced to move and undergo the substantial cost of fitting-out new premises in order to escape a toxic environment; having already lost many of their patients to other practices.

Good Associateships
Fortunately there are many stable associateships where the dentists work harmoniously. It's more normal for each in turn to sell their associateship to a third employed dentist, and for a practice to maintain a consistent working relationship. The key issue for the dentist buying an associateship it to recognise that two sets of arrangement are being negotiated:

1. The purchase of an associateship; and
2. They are entering into a continuing relationship with the other associate(s). If there are any concerns they need to be negotiated before buy-in, as the day after buy-in everybody will regard the matter as having been settled.

Warehousing an Associateship
It's fairly common for a younger associate to buy out a departing one, not because they necessarily want to own a bigger practice but because they wish to control the succession plan in the practice and choose the future associate with whom they will be working and who may in turn be the person to whom they on-sell their remaining part of the practice.

Corporate Price Not Applicable for a Dentist to Dentist Sale
The arrangements vendor dentists enter into with corporates are quite onerous. They may receive a substantial sale price, but they are also usually required to contract to work for the corporate and produce specified outcomes for the next five years, with clawback provisions applying in the contract. The corporate is paying extra in order to persuade the vendor dentist to contract their services and guarantee certain profit outcomes. This in turn enables the promoters to bring their overall dental business to an IPO and stock market listing because they hope to profit on the transaction prior to disappearing with a substantial bankable profit.

Corporate deals with their onerous contractual conditions cannot be compared with the much simpler dentist to dentist sale whereby the vendor hands over the practice to the buyer, and sometimes works on a part-time basis for a limited time. The vendor receives less but is free of the practice after a short time.

Dentists who seek a corporate price for a simple dentist to dentist transaction are likely to burn off potential buyers. Again, after their practice has been exposed to the market for a while, there's a natural tendency for those dentists who are looking to assume that it has significant problems because it has been for sale for a period. At a certain point it can become very difficult to sell.

Practice Plus Premises in Combination?
A practice located in suitable premises with guaranteed long-term occupancy at a realistic cost (related to fees) is more saleable. It's also true that dentists will pay a little more than market price in order to control both their practice and their premises. Not only does ownership of the premises guarantee their practice longevity, but it also makes future renovations and alterations simpler if they don't have to negotiate with an external landlord.

Under-Appreciating the Cost of Fit-Out - Hidden Infrastructure
We've seen accountants argue that a completely serviceable fit-out has negligible value because it's been depreciated to a negligible value, yet if confronted with having to re fit-out new premises from scratch with all the necessary plumbing and wiring, we've rarely seen a dentist complete the job close to budget. There are always, it seems, additional items and charges. The newcomer rarely appreciates the amount of red tape in arranging for inspections of plumbing and electrics, fire department inspections, special arrangements with respect to the installation of x-ray equipment etc, and this is a very simplified list. Council permits invariably specify car parking and in many areas insist on expensive alterations to conform with local amenity (often as defined by local government bureaucrats). A vast amount of time can be spent in queues and form-filling, and in waiting for permits and inspections, as well as having to pay out fees at every turn. In an overall sense this creates an 'economic opportunity cost'. Aside from this fit-out, practices have at some point had telephones installed, they have arranged Yellow Pages listings, and these days increasingly have websites. Even simple matters have a cost, like having electricity connected, arranging for medical waste disposal, installing alarm systems and having well-installed practice management software on which staff are trained. They have also paid for fees to employment agencies to source staff, registered practice names and paid signwriters for attractive signage. The dentist deciding whether to buy or squat and start a practice would do well to comprehend the amount of hidden infrastructure, much of it seemingly having little, if any, tangible value which has been established in order to make even a modern sized practice function. All of this hidden infrastructure contributes to the goodwill value of a practice or, to put it another way, try running a practice without it!

Overvaluing Equipment
In many respects equipment is the most easily replaced element of a practice. Whilst some items of dental equipment may have a second hand value, the only time in which all of the equipment of a practice changes hands is when a practice changes hands.

However, individual items of equipment are usually fairly easily replaced.

The correct way to treat equipment is to assign an overall value to the practice proprietorship rather than to try and value individual items of equipment item by item from large item down to very small item.

The approach long adopted has been to value the practice proprietorship.

Dental practice proprietorship = goodwill + equipment

Equipment in turn includes all of the fixtures, fittings, furniture and equipment necessary to the running of the practice. This overall approach is similar to that taken when valuing the assets of major companies for the purposes of merger or acquisition and stock market listing.

The fact that dentists invoice patients for treatment items rather than for 'use of goodwill' and 'use of equipment' illustrates the point.

Attempts to value items of equipment separately confront the problem that only some items are readily saleable on a second hand market at any time. Furthermore there is a wide margin between what a second hand dealer might pay for an item, and that which they would charge when on-selling, because the dealer has to factor in having a significant amount of capital tied up in second hand equipment, some of which may have to be stored for a long time before being saleable. Furthermore, some items of equipment are not easily on-saleable.

We observe valuations from persons who are incapable of analysing the financials of a dental practice and identifying strengths and weaknesses from benchmark data, but who have listed the equipment and values down to minor items, and arbitrarily assign a percentage of fee turnover to goodwill without analysis of the practice financials. We also observe that they use widely different percentages of turnover for essentially similar practices in essentially similar locations!

Losing the Receptionist from Heaven

Many years ago I knew of a veterinary practice run by a very gentle vet, but one with an ability to produce good fees. The vet had a receptionist with wonderful interpersonal skills. Let's call her Rosie. Kids begged their parents to take the family dog or cat to the vet at 'Rosie's'. Everybody from toddlers to age pensioners adored Rosie. Rosie and her boss also had a wonderful relationship; based on that rare ability where people can, at the merest glance across a room, exchange a question and answer without speaking. Rosie was also very efficient.

The vet sold his practice for a good sum. However Rosie and the new owner, who were both nice people, didn't gel. Soon after, Rosie left to work for a group of surgeons and the new owner of the vet practice was never able to achieve the success of his predecessor.

Having the right person can sometimes make an appreciable difference to a practice.

Waiting Too Long to Sell

Dentists' practice lives have well-defined stages:

- There is the initial period when recent graduates search for employment. During this period they often find part-time work in two or three different practices, each for a day or two or session or two per week.
- Most dentists eventually achieve a stable position as a full-time employed dentist and work in a practice as a full-time dentist for several years.
- The next stage is normally that of buying a practice or a dental associateship. In this phase they work up the existing patient list and, through careful nurturing of patients and referrals, build their patient base.
- Several years after they purchase into their practice, they reach their high production period which typically lasts for ten to twelve years. During this phase of their careers, they maximise the fees that they generate and maximise their profit per dollar of fees.
- The next phase is the period in which they reduce personal pressure. In this phase dentists slip back to a four-day working week but maintain a consistently high throughput.
- The definite slow-down period toward retirement.

Dentists should consider selling their practice before they get to the definite slow-down period, since this period is typically marked by reducing fees and reducing profit per dollar of fees. The value of a dental practice can plummet during this period. Practice owners who reduce to a three-day working week consistently experience a substantial erosion of practice fees and profitability.

It's far more satisfying for a dentist to sell near their peak and perhaps exercise a choice to work for a new owner for, say, three days per week, gradually reducing until retirement. Dentists who do this are usually happy, because unlike young dentists who haven't yet bought a practice, they have nothing left to prove with respect to their profession.

Do Professionals Know When to Retire?

Long experience in dealing with professional clients, including dental, medical and veterinary specialists and GPs indicates that most of them achieve high levels of personal satisfaction from their work. When older ones are asked when they intend to retire, their most typical response is along the lines of:

"I'll think about retiring in a year or two"

This means that:

"I haven't contemplated doing so at this time"

Lo and behold, one day a blinding light flashes in their brain and they decide that they want to retire as soon as possible. Contrary to the impression that one would get reading the financial press, the decisions by professionals to retire are often sudden rather than carefully planned many years in advance.

Most busy professionals, despite being attentive to their financial situation, actually don't make up their mind to retire until they are very close to the actual event.

Predicting the Future Market for Dental Practices

- **The sweet spot of near equilibrium**
  The best market and hence best price for practices occurs when the market is near equilibrium with potential buyers slightly outnumbering sellers. Of course, the market in various capital cities can differ one to the other, as well as the market differing between coastal centres and inland towns.

  If the number of buyers swamps the number of sellers, there will be a tendency for many dentists to start up new practices rather than buy, and this will in turn lead to a danger of fee erosion. With the number of dental schools now operating in Australia, plus the rate of dental immigration, this situation may not be many years away. Right now, demand to buy practices is probably near its zenith.

  Alternatively, if the number of sellers was much greater than the number of buyers, the buyers would pick and choose and practice prices would fall.

  There is a medium term danger of many practices acquired by corporates spilling back onto the market; particularly as some corporates have had to delay their IPO and stock market listing, winding down the employment period that many of their vendor dentists are contracted to.

- **Value of country practices**
  Right now, country dental practices have value and buyers should note that they are much more profitable on average than are metropolitan practices. We currently observe that immigrant dentists have spread across country Victoria and have also spread well into country areas in a number of other states.

- **Reliance on health fund and third party schemes**
  Health insurance funds offer both hospital cover and general cover (ancillary health benefits tables). The latter tables are about 50% dental related. However health funds ration their benefits in respect of general cover, making substantial profits which are then invested in their reserves and used to underwrite the risk in providing hospital cover, which is much more difficult to ration. Many persons with health insurance would be better off dispensing with general cover and simply buying their hospital cover.

  The issue for dentists is that health funds are continuously trying to re-jig their tables, benefits and payments to lessen the amount that they actually pay to dentists. The associated risk is that dentists who sign up as 'preferred providers' increasingly concede control of their practices to health funds. Once health funds have a substantial representation of 'their' clients among a dental practice's patients, they are in a position to exert third party controls and effectively interfere with dental patient relationships. Other types of schemes, where patients pay an annual fee to an organisation which promises to provide them with cheaper dentistry and then signs up dentists on the basis of building their practice, also introduce third party influence.

- **Profitable dentists don't have third party schemes**

The most profitable dentists we observe refuse to be preferred providers, and they also refuse to join other third party schemes.

Our advice is simple: keep third parties out of your practice. Other things being equal, a dental practice which has no third party obligations is worth more to a buyer.

- **Non dental owners?**
  As dentist legislation has changed state by state, regulation has centred upon the individual dentist, who must maintain current registration and professional indemnity insurance rather than regulating practice ownership. This opened the door to corporate ownership, but it also raised a wider question as to whether non dental owners can successfully run practices. The same observation applies to medical, veterinary and allied health professional practices.

  We've seen examples of dental hygienists, dental technicians, former practice managers and widows of dentists running practices, but on what we've observed to date it's a tough road fraught with risk. Employed dentists don't like taking direction from non professionals, even in non clinical matters, and they refuse absolutely to take direction in respect of clinical matters.

  On a practical level, a dentist owning a practice knows that if their employed dentist is absent through illness they can at least treat that dentist's urgent cases and keep the situation under control until either the dentist returns to work or they can obtain a locum. Dental practices owned by non dentists rarely achieve acceptable financial outcomes and never achieve profit levels remotely approaching that of successful dentists who own practices.

- **Buy in opportunity but the practice is bursting at the seams!**
  Sometimes we value a practice which has outstanding outcomes per dentist, but is constrained by the physical limitation of its premises. They've got too many patients for the number of dental surgeries, and are working at capacity.

  Generally we would advise employed dentists to purchase an associateship in such a practice, but to negotiate an understanding with respect to the expansion of the premises or the purchase of adjoining property and extension of the practice, or even a future split into two practice in order to accommodate what in reality is the practice's most valuable asset – a large number of loyal and profitable patients.

- **Overstated opportunities!**
  There is a tendency for marketing people to only see upside and overstate the potential of practices. They also tend to see dental marketing in terms of selling a product, whereas successful dentists who have built practices over many years know that dental marketing is overwhelmingly based on building strong relationships with the patients, and thereby generating personal referrals.

Big Not Always Beautiful
Efficiency per dollar of fees often overrides size. Some practice owners have assumed for years that their practice was far above average, but are shocked when actual benchmarking and/or valuation reveal that they rate poorly. Purchasing an associateship in a smaller but more efficient practice may be a lot more profitable and involve less management and administrative trauma.

Driving Buyers Away
Practice vendors should seek to obtain a fair price for their practice. Those who seek to obtain a price beyond market value compared to equivalent dentist-to-dentist sales face the risk that the buyers will go elsewhere. If those potential buyers have been reliable dental employees, they face the risk of not only losing the sale but also losing their employees. Once negotiations stall, employed dentists nearly always move on within a short time.

Buyer Beware – Forensic Accountants and Dead Data
Be wary of persons claiming to have substantial experience of valuing dental practices who quote figures from databases which no longer exist; or which haven't been updated for years; or who quote Australian Bureau of Statistic data on dental incomes dating from 1997/1998. Additionally that ABS data was obviously wrong as it mixed input from both incorporated and non incorporated practices, did not correct the fees earned by auxiliaries and hygienists, and exhibited no understanding of the workings of dental associateships.

Corporate Spruikers
We are aware of a prominent figure in one of the corporate organisations who quoted IBISWorld business data as the definitive word on dental profitability at an investment seminar. When examined closely, IBISWorld had in turn quoted the ABS data on dental profitability from 1997/1998 (see above). A case of rubbish in and rubbish out. If you are able to sell your practice to this person's organisation we wish you luck, but we'd advise you against accepting share scrip in lieu of cash.

Dental Divorce – Property Settlement Valuations
In any family court property dispute there is a danger that even when the parties have agreed upon a choice of valuer that having received the report, one of the parties or their solicitor will go and seek a second opinion.

It's also often the case that one party is searching/hoping for a higher value and another party is searching for/hoping for a lower value.

There is a tendency for forensic accountants who provide legal support services to take on valuation of dental practices even though it is apparent that in many cases they have never valued one before. Unless they specialise in a particular industry, which hardly any do, most forensic accountants attempt to value all types of businesses, and these may range from restaurants and rock bands to panel beating workshops and bakeries. Such an accountant might have had a fleeting experience of hundreds of different types of business. When they stumble across a dental practice it's usual to have them make statements which can't be backed up by data.

On occasions where Synstrat valuations have been challenged by a forensic accountant, our approach has been to write back to that forensic accountant about the perceived differences, pointing out that various conclusions were drawn from our database. We in turn suggest that if they, in their research, have come across other evidentiary data which could validate their conclusions as to value, for example evidence of other dental practice sales, we ask that they provide us with the names of the practices and the contact details in order that we can verify their conclusions. Inevitably that is the last we hear of the matter, and we must therefore conclude that their statements were made without back-up evidence.

Do Specialist Dental Practices Have Value?
The answer is some do, but some have little market for their type of practice and hence little value.

Can Orthodontics Practices Have Significant Value?
Yes, dependent upon size and profitability and the constancy of the number of contracts in hand, they can.

Do Periodontic Practices Have Significant Value?
Some do, dependent upon the nature of their practice. A periodontics practice with a substantial recurring client base, with the treatment being of a regular maintenance basis, certainly has a transferrable economic value.

What About an Oral Maxillofacial Surgeon's Practice?
It's going to depend upon the size of the market (often thin), whether the surgeon concerned has significant in-house surgical capacity, including private operating theatres, or whether they do virtually all work in a hospital theatre. Being part of a referral group may help. Naturally

profitability will come into it but the real issue is do they have a transferable economic benefit and is there a market in which that benefit can be transferred?

Transferable Economic Value

The overriding consideration in valuing a practice is whether and to what extent there is a transferable economic benefit between a seller and a buyer. Many lawyers, accountants and others assume that goodwill is something that can be put in a bottle and labelled. That's untrue. Rather, the situation of each practice and type of practice must be looked at in detail and economic value assessed.

Data Driven Valuations

It is critical when doing a dental practice valuation to have a sound knowledge as to how the various facets of the operation benchmark against a sufficiently large database of contemporary practice performance in order to draw valid conclusions. For example, if considering the appropriateness of an addback for unusual insurance costs, it is necessary to know what the average practice pays as a percentile of its fees, or when making an observation as to whether greater profit can be achieved per dollar of fees, it's worth noting not only what average practices can achieve but that which practices in similar locations with similar rentals can achieve. At Synstrat we are mindful of these key ratios, as we spend endless hours wading through dental financials.

Benchmarking

Without reliable practice benchmarking data, many dentists operate their practices as remote little islands in a sea of dentistry. They don't know how their practice performance compares to all the other dental islands. Valuation of dental practices without reliable comparative data is also highly inaccurate.

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