Determining the value of your dental practice

By Graham Middleton, BA, MBA, AFAIM

"A practice in run-down mode conveys an aura of gloom and despair. Key staff may leave and accelerate the rate of decline. A busy, vibrant practice with good presentation conveys a positive message to buyers..."

It is insufficient to look at practice purchases in isolation. It's the ability to look at what happens subsequent to many purchases which is the real determinant of practice valuation. Where brokers do not engage in detailed analysis of figures and do not use the subsequent financial performance of practices, they may be guessing at a value based on gross figures. Much deeper analysis is required to determine whether Dental Earnings Before Depreciation, Interest and Taxes is adequate, and where it is inadequate, to examine the causes. In turn, this provides an indication as to how much change is possible in the particular practice. From a valuer's perspective it is imperative that we're able to look at the accounts of a substantial number of practices we have valued and determine what the actual performance was post-sale in the hands of the new owner and whether the price they paid was merited. This leads us to constantly fine-tune our methodology and particularly, the capitalisation rates applied.

There's simply no substitute for being able to deal with practice financial outcomes and practice benchmarks on a regular, daily basis. Sellers want to receive a fair price and buyers don't want to pay more than market value.

Some people offering advice on sales never see the financial results of practices after the sale and have no benchmarking data. Some don't even see the actual contracts of sale, whereas having access to a large pool of actual contracts of sale of dental practices bought or sold by clients is vital background information to a valuer as to the real state of the market for dental practices. Contracts of purchase and sale are foundation documents in the accounting records of clients.

Preparing to sell a practice

It is vital that the owner(s) continue to run the practice as though they are planning to remain in it for much longer. A practice which is in a run-down mode conveys an aura of gloom and despair. Key staff may leave and accelerate the rate of decline. A busy, vibrant practice with good presentation conveys a positive message to buyers.

A key determinant of profitability

Since the key determinant of profitability is the output of the surgery/ies of owner dentists, it is vital to both the ongoing sense of purpose of practice staff and the financial outcomes which will be examined by buyers and their accountants that practice proprietors continue to maintain good personal clinical output.

While owners can reduce to a four-day clinical week, dropping to three clinical days usually leads to a substantial deterioration in overall practice performance. When a practice owner is out of a practice more than they are in it, it conveys the message to staff that they are switching off dentistry. Staff tend to switch off as well. In a short while, employed dentists are being urged to finish up early so that DAs can clean down surgeries and be out of the practice spot on knock-off time, or a little earlier, and vacant spots magically appear in the practice book at times convenient to staff. Pretty soon there's a general air of 'easy as she goes' about the practice. Whenever the owner walks out the door, the whole practice relaxes. Practice profitability plummets and the figures that you have to produce to present to a valuer or potential new buyer look grim.

It is imperative that you time your sale to occur before you reach this stage and if you're contemplating the sale of the practice, you remain busy and fully engaged. Regardless as to the other dentists in a practice, it is important that a vendor dentist have substantial patient lists to hand over to buyers, as it will smooth the transaction. Generally the vendor will continue to work part-time on a declining basis to smooth the handover. However, where too many patients have been spilled to employee dentists (being non-buyers), it becomes difficult for the subsequent purchaser to treat those patients without causing staff disharmony. Nobody likes the boss interfering with patients that they've been treating.

Don't announce the sale

Where a vendor is a widely respected dentist, it is unwise for the buyer to announce that they have bought the practice. Rather, patients of the vendor are advised that 'Dr John Smith' has joined the practice and they extoll the buyer's attributes. If a letter is sent to the vendor's patients, it introduces him as having "joined" the practice.

If the retirement of the vendor is announced it is destabilising, as many patients who were loyal to that dentist may take the announcement as an invitation to break the tie with the practice and attend a dental practice nearer to their home.

Getting the practice benchmarked

A vendor should have their practice benchmarked at least 18 months prior to the sale in order that they can have an objective measure of the financial performance of the practice and, importantly, identify areas where they are falling short. Without this information, many dentists operate their practices as isolated dental islands, unaware as to how their practice will compare to other practices. The vendor must have time to address those weaknesses and have improvements reflected in annual financials, prior to having the practice valued when it is ready for sale.

Seeking buyers

We estimate that over 80% of our dental clients purchased their practices from a dentist who was personally known to them previously. It is apparent that, overwhelmingly, the best practices and the best associateships within occur in this manner. If selling, you first need to decide whether your employed dentists are likely to be buyers. If that is unlikely, then perhaps there is a dentist in your study group or a dentist known to a close friend who may be a buyer. The vast majority of well-performed practices change hands in this manner. Understandably, listings of practices for sale will contain a significant number of practices which present problems to potential buyers. Often this can deter potential buyers from continuing to inspect practices when all the practices they've seen to date have obvious and significant problems. Our advice is to explore other avenues before listing a practice for sale publicly.

Obtaining a practice valuation

Practice valuation is a complex task. There are many variables which affect value. Some common observations are that all other aspects of a practice being equal, then:

- A practice located in an attractive suburb of a capital city will be worth more than a similar practice in an undesirable suburb;
- A practice in a major capital such as Sydney or Melbourne will be worth more than one in a smaller capital, such as Canberra, Darwin or Hobart;
- A capital city practice will be worth more than a regional city practice;
- A regional city practice will be worth more than a practice in a smaller town;
- A practice situated at a single location will be worth more than one spread over multiple locations;
- A practice in suitable premises with either a long lease or a purchase option will be worth more than one where the premises are either unsuitable or unavailable for long lease;
- A practice in suitable premises with economical rent will be more profitable than one in similar premises with high rent. The value of the practice with the cheaper rent will be higher;
- An untied dental practice with a good fee base will be worth more than one with an equivalent fee base which is significantly tied to health fund preferred provider arrangements;
- A practice which is more general in nature will be worth more than a practice with equivalent fees and profit which is heavily orientated towards special interest dentistry, and so on; and
- A practice which has not relied on EPC work will be worth more than one which has.

The value of practices relates to the sale of other practices; particularly those with similar characteristics.

Corporate vs non-corporate buyers

Some practices are too large and too specialised to be readily saleable to other dentists, yet have proven to be popular with corporate buyers. The corporates are running at significant risk that they may not be able to maintain those fee bases long-term. Nevertheless, we note that they have been buying these types of practices.

Some practices which are not quite large enough to interest corporates find ready buyers among dentists.

There are of course many practices which are of interest to both corporates and dentists. Whereas the corporates, generally, make the purchase conditional on the vendor dentist agreeing to work for them for five years, it is normal for a vendor selling to another dentist to work for a limited time on a diminishing clinical time basis. Nor does the vendor continue in a managerial role post-sale. That's the purchaser's problem. Other differences are that part of the corporate price is deferred and depends upon the performance of the practice under the vendor dentist's management. Basically, part of the consideration of the corporate purchase is subject to a clawback arrangement. Additionally, from time to time corporates have insisted on part of the purchase price being paid as share scrip.

The differences between a corporate sale and a private sale to another dentist are so substantial that the value of a practice being sold to another dentist cannot be equated to the value if sold to a corporate. Generally, the dentists who sell practices to other dentists are not prepared to work for a corporate for five years, or subject themselves to onerous conditions.

Looking at practice sales from a buyer's perspective

It's always helpful to look from a buyer's perspective. Buyers will achieve their greatest certainty where the vendor of a successful practice is actively involved in handing over patients over a reasonable period. Goodwill value is not something you place in a bottle, label and place on a shelf. Rather, it is the ability to transfer patients in an orderly manner which gives goodwill a value and hence I define it as an economic value given to a transferable asset.

What a practice buyer wants most of all is a high degree of certainty with respect to income and that is what a well-nurtured and carefully transferred, established patient list provides. That raises the issue of communication to patients. Announcing that a long-established and respected dentist has sold their practice is destabilising to the loyalty of patients, many of whom may take it as a signal to move to other practices. Dentists who are sensible buyers contract to the vendor, giving the message that they have joined the vendor's practice. This conveys a much more stable message and enables a graduated and orderly transfer of patients to occur. The vendor quietly fades out after a period of working for the new owner on a gradually declining basis.

Generally better to buy

Younger dentists would generally be better off purchasing an established practice in an established area. An attempt to establish practices surrounded by new housing developments confronts the problem that most of the owners of the new houses took out heavy mortgages, as well as having to furnish their new home. It may be many years before they have significant discretionary spending power to afford high quality dentistry.

Associateship better than partnership

Overwhelmingly, buyers prefer dental associateships to dental partnerships. There are sound reasons why associateships have long been preferred by the vast majority of co-owners of dental practice groups. Attempts to force buyers into partnerships or into complex ownership structures often deter buyers and can make it difficult to attract and retain dentists who are potential owners of a practice.

Where an associateship is sold, the purchaser needs to be aware that not only are they entering into an agreement with the vendor but that they'll be subject to a separate agreement with the vendor's associate. It is important that any issues requiring renegotiation be addressed at this point before signing the purchase agreement. Continuing associates are unlikely to be sympathetic for requests following settlement to make significant decisions concerning re-equipment, changes in facility or staffing if these have not been addressed and agreed prior to the new associates entering the practice.

Complex ownership structures

Where a buyer is presented with a complex ownership structure, they need to obtain expert advice before proceeding. Once a buyer has settled a purchase, they may be hooked into a bad structure which can be difficult and expensive to undo. This structure may impede buyers of their practice in the distant future and result in capital gains tax concessions being given up.

The most common buyer mistake

The most common mistake buyers make is seeking advice from an accountant who does not have a significant dental client list, and who doesn't pick up on key issues nor realise that the asking price may be well above market. Without lots of exposure to dentists' financials and dental financial decision-making, advice as to the reasonableness of price or the appropriateness of practice structure is often dangerously inaccurate. It is too late to realise that you have paid too much or that you have entered into an inappropriate agreement after you have borrowed and paid the money and settled contracts.

You be the judge

Practices A and B have identical gross fees.

- Practice A shares a waiting room with several allied health professionals and is located at the wrong end of a medical centre complex. Any changes are subject to complex negotiation. Practice B is located in separate premises with its own waiting room.
- Practice A has rent which is substantially above dental benchmark. Practice B's rent is in line with the benchmark.
- Practice A's landlord will not provide more than a three-year lease with a three-year renewal option. Practice B has a four-year lease with an additional two four-year lease renewal options.
- Practice A is a preferred provider, whereas Practice B has no third party restrictions.
- Practice A is poorly situated in respect of its entrance being at the wrong end of the medical complex. Practice B is visible, with good access.
- Practice B is significantly more profitable than Practice A.

Which is correct?

One valuer simply estimates a practice's worth on a gross fees basis and hence both are the same. A second valuer assesses the financial details and practice characteristics. This valuer also compares key costs and dental EBDIT to benchmarks and looks for reasons for variation. He notes the unsatisfactory characteristics of Practice A relative to Practice B. This valuer determines that there is a significant difference in value. Which approach is correct?

The lesson to be learnt

The above example demonstrates why it is important to rely on proper valuation advice from experienced valuers with reliable benchmarking data and an overview of many buy and sell contracts, as well as the subsequent performance of many of the practices purchased.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 24 years, the last 17 as a partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer, and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of the Synstrat Guide to Practice Management and of 50 Rules of Success as a Dentist. He is a long-term contributor to the Australasian Dental Practice magazine. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed Dealer owned by its directors who work within the Synstrat Group. Tel: (03) 9843-7777 Fax: (03) 9843-7799 Internet: www.synstrat.com.au Email: dental@synstrat.com.au