Don't believe corporate spin: Lots of privately-owned practices are thriving

By Graham Middleton, BA, MBA

"Established profitable dental practices have a remarkable tendency to remain profitable regardless as to whether practices nearby are owned by dental corporates..."

We can thank dentistry's latest "Smedley" in the form of Smiles Inclusive Limited for highlighting the fundamental weakness of dental corporates, albeit that each of the other companies would legitimately point out that they are very different. However, the performance of the stock market listed dental corporates in the 2019 financial year was poor, with only 1300 Smiles having a reasonable year. 1300 Smiles has been careful to expand only gradually and its small size means that its leadership is better able to maintain close contact with its practices.

Looked at across the corporate spectrum, 1300 Smiles had a profitable year but investors in its shares were cautious; Pacific Smiles struggled to satisfy the share market; Maven, owned by the New Zealand Abano Group, stopped buying practices because the strategy was not earnings accretive; while National Dental Care postponed its IPO and share market listing because it discovered accounting problems in a group of its practices. Recently, a venture by Dr Peter Hughes, which had offered a practice co-ownership scheme somewhat similar to Smiles Inclusive Limited, appears to have gone quiet. Ekera has also tightened up its acquisition criteria.

Smiles Inclusive, for which investors paid $1.00 per share in its IPO in early 2018, reeled from a series of disasters and at the time of writing this article was trading at 5 cents per share, having reported its "interim unaudited 2019 financial results" to the ASX after close of business on the last reporting day for companies having a 30 June balance date. If that wouldn't strike a warning signal in the stock market for a company whose shares had already plummeted from $1.00 at IPO to a range of 11 to 12 cents, it's hard to imagine what would. If it was solvent at 30 June, it was due to a sale and lease back of its property, plant and equipment and a fortunate capital raising from "White Knight" investors who contributed 14 cents per share for equity which quickly plunged to 6 cents! At the time of writing this article, Smiles' future looked uncertain.

Smiles replied to ASX queries concerning cash flow by referring to EBITDA rather than cash and appears to be significantly dependent on Bartercard Trade dollars. As at the 18 Sep 2019, it was unable to advise the ASX whether its auditor had yet formed a view as to the quantum of the impairment to be recognised by Smiles Inclusive Limited for financial year 2019. At the time of writing this article Smiles future looked uncertain.

The contrast of privately-owned practices

By contrast, a significant number of practices owned and operated by dentists remain demonstrably successful. I view the financials of many of them on a weekly basis. However, there are always a relatively few number of practices conducted by aging dentists and in some of these, the fees have declined to a point below the owners personal opportunity cost if assessed on the classic formula on which a large number of dentists are remunerated or contracted.

Hidden gold

Some practices conducted by older dentists contain hidden gold for potential buyers if the dentists buying them are capable of providing treatments beyond that which the vendors have provided.

We view the financials of many dentists who run steady practices and produce reliable income but to read the statements of some corporates about private dentists, the reader could be persuaded to believe that privately owned practices underperform corporates. This is quite untrue and is clearly an issue of trying to talk up their own performance vis a vis dental practice in general. The fact is that when analysed correctly, in many cases, privately-owned practices significantly outperform the average of corporately-owned practices in each of the major groups whose financials are available to us. Furthermore, there can be a significant reduction in corporate practice performance once the vendor dentists have satisfied their contractual earn-out conditions and have been replaced by employed or contracted dentists.

To a significant degree, the corporatisation of practices via Dental Corporation, Dental Partners, 1300 Smiles, Pacific Smiles and organisations which are yet to list have had the effect of prematurely separating a cross section of the most experienced dentists from ongoing dental practice.

Corporate spin: The IPO

A company that wishes to attract investors in its Initial Public Offer (IPO) and then list successfully on the stock market must first construct an offer document, i.e. a Product Disclosure Statement/ Prospectus which paints the proposed investment in the brightest light possible within the limitations of the regulatory requirements. It is likely to have a sponsoring share broking firm or firms and its CEO is likely to conduct a roadshow of investment groups organised by sponsoring brokers and talk to individual potential large investors. It will contain an investigating accountant's report and forecast which are likely to err on the side of optimism.

What is certain is that most of its audience will not understand the intricacy of dental practices and will be unaware of the fundamental weaknesses which have been demonstrated across a range of practice consolidations among the accounting, dental, dental laboratory, medical and veterinary professions. Failures are numerous but most of the brokers, advisors and investors attending presentations are blissfully unaware of the level of weakness involved in these corporate models.

If investors were aware of the following list of failures or poor outcomes, would they be enthusiastic to invest in a dental or veterinary corporate IPO? The following list is not complete but includes:

- Harts Australasia Limited - a consolidation of accounting practices – liquidated;
- Knights Insolvency Limited - a consolidation of accounting insolvency practices - liquidated.
- Stockford Accounting Limited - a consolidation of accounting practices - liquidated.
- Pearl Healthcare Limited - a consolidation of dental laboratories - liquidated.
- Smiles Inclusive Limited - consolidation of dental practices - its share price collapsed.
- Maven - the new name for Dental Partners which had passed to the ownership of Abano Corporation, a New Zealand company and which has ceased buying practices in Australia because they were not earnings accretive, or to put it another way, buying more practices was diminishing their profits.
- Foundation Health Care - medical practice consolidation - Google “Foundation Becomes IPN” and other information.
- Orthopaedic Group Limited - orthopaedic surgical group consolidation which foundered.
- Apiam Animal Health Limited - a veterinary practice group whose share market performance was extremely poor in 2019.
- National Veterinary Care Ltd - vet practice whose share market performance was poor during the 2019 financial year.

If investors were across the financials of all of these professional consolidations, would they be prepared to invest significant sums of money based on a prospectus of a brand new enterprise with nil or limited track record of operating as a consolidated professional practice company?

Do investors in professional consolidations understand the fundamental weaknesses across the professional consolidation spectrum which has led to so many failures?

Investigating accountants reports

These invariably paint an enterprise in a favourable light - indeed if they didn't, they wouldn't see the light of day. The Smiles Inclusive prospectus contained the following forecasts:

- Gross practice revenue would increase from \$51.948 million to \$57.641 million in the 2018 financial year.
- Net practice revenue (of 52 practices) would increase from \$35.988 million in financial year 2017 to \$41.362 million in financial year 2018, an increase of 14.9% in one financial year.
- Net profit after tax (NPAT) (of 52 Practices) would increase from \$3.988 million to \$5.832 million, an increase of 50.5% in financial year 2018.

Readers wishing to check up on this could refer to Smiles Inclusive Limited (Smiles Inc) forecasts stretch the imagination at www.synstrat.com.au.

Having issued its prospectus during its roadshow, Smiles Inclusive Limited's CEO pointed to the fact that 52 practices had 61 totally vacant dental chairs which could be filled with patients. A professional investor put this to me and suggested that this showed that it was a good investment. My reply was:

"I will rephrase that statement for you. They have 61 chairs which used to have patients but which are now empty. What does that tell you about the practices embraced by this prospectus"?

I will leave it for the readers' judgement to conclude whether Synstrat's comments that the forecast increases in respect of Smiles Inclusive for financial year 2018 which was almost over were of a magnitude which stretched the imagination! And that increases remotely approaching this magnitude don't occur in dentistry across a large number of practices in a single year!

The reality was that the numbers on which the financials were based were the 2017 aggregated results of the 52 practices and the forecast increases were little more than guess work. Indeed, it's not even clear that the eventual 52 practices purchased were exactly the same 52 practices on which the numbers were based!

Where to next?

Currently, the dental and veterinary professions each have significant issues which differ but each affect the long-term viability of the respective corporate owners.

Impact of surplus of dentists

In the dental profession, there is a huge surplus of dentists which means that those who cannot buy into a practice but who wish to own one set up new practices. A proportion of these fail to become viable and disappear quietly but a proportion gradually build a viable practice and in the long term, a successful practice. This means that the proportion of non-corporate owned practices is likely to remain at around the current percentage of practices long term. The penetration of the corporates into dentistry in Australia is far less than was predicted at the outset of dental corporate activity.

It remains a fact that there are many privately owned and operated dental practices whose individual performance is well above the average of practices owned by dental corporates in as much as we can calculate the averages from the annual financials of the listed dental corporates and compare them with our observation of dental practices for whom we provide accounts or perform practice valuations.

> "It is likely that corporate dental practices hoping to list may be subjected to far more searching analysis of their prospectus than has been the case in some previous listings. It will make little sense to pay a price above the average PE ratio of ASX 200 stocks. Why would you pay more for a dental corporate than for Macquarie Group, BHP, Rio Tinto or Wesfarmers?"

Impact of the mass of part-time vets

In the veterinary profession, a huge shift from male to female students in Australia's veterinary schools about 25 to 30 years ago has reached a situation whereby a huge proportion of today's vets are only available for part-time work, mostly within family friendly hours. This changeover has been accelerated by the activities of the corporates since vets who sold out to corporates have, in many cases, prematurely retired. Since most of the vets of that generation were males, it has accelerated the shift in the profession from being one of full-time predominantly male employed vets to one which has swung heavily toward mainly female part-time vets creating difficulty in filling rosters at unpopular times.

Vets owning practices near corporately owned practices regularly report that they gain a steady stream of new clients who previously attended the practice which is now owned by a corporate.

Their comments indicate a widespread corporate difficulty in staffing those practices with clients complaining that they rarely see the same vet twice, that there is too much staff changeover and that they are subjected to clumsy corporate upselling procedures.

In some instances, vets who previously sold to a corporate who then work out or wait out their required non-compete period have re-opened a practice nearby and quickly grown that new practice to a viable size.

In other cases, vets who have picked up on the weakness of the corporates have opened a practice near a prominent corporate practice and gained rapid growth in their clientele. It is evident that across the corporate spectrum of general practice ownership, there is widespread financial pain.

The lesson for vets prepared to work hard on a full-time basis is "start a practice near a corporate practice - the closer the better". Even better, if you could find a partner also prepared to work hard then a partnership of two hard working vets running a practice near a large corporate practice are likely to build a substantial business.

Recently, Greencross, which had been a listed corporate and was then bought out by a private equity firm, purchased a group of specialist practices/emergency centres, perhaps being more viable than its general practices.

Since the ownership structure is no longer listed, we have no direct observation of the group's overall financial performance but are constantly aware of evidence that practices near corporate practices are receiving a steady stream of new clients and that many corporate practices have visible staffing problems causing them to restrict hours and service. As our group deals with veterinary practices as well as dental practices, we are interested to see what transpires. It may be that this recent purchase is an attempt to change the footprint emphasis of the veterinary business in the hope that it can be relisted. We await the outcome with interest.

Questions potential investors in dental corporates must ask

- How many practices are still supervised by the lead dentist who is a former practice owner?
- What is the remaining average time from IPO date that each of the former owners/practice lead dentists are contracted to work for in their former practices in terms of years and months?
- What dental income are the former dental owners contracted to provide in the year following IPO? We would an expect offer document to specify this amount in the calendar year immediately preceding the IPO and in the expected calendar year and financial year following the IPO. For example, the year beginning 1 July 2020.

This type of data is far more important than some of the information routinely given in product disclosure statements/ prospectuses which can be misleading.

Personal relationships

Dentistry rates high among the list of the occupations whose success is heavily based on personal relationships. People have a strong tendency to be treated by the same dentist, attend the same hairdresser, take their pet to a vet that they trust and to attend the doctor of their choice. However, personal bonding to a dentist is stronger than to a medical GP because dentists carry out procedures, whereas medical GP's tend to refer a great deal more outward than do dentists.

Reliability

Established profitable dental practices have shown a remarkable tendency to remain consistently profitable over many years regardless as to whether practices nearby are owned by dental corporates.

Investors becoming wary of the corporate model

What is clear from the stock market performance of both dental and veterinary practices in the 2019 financial year is that investors have become wary of the corporate model.

It is likely that corporate dental and veterinary practices hoping to list or to re-list (in the case of Greencross) may be subjected to far more searching analysis of their product disclosure statements (prospectus) than has been the case in some previous listings.

Realistically, these companies should be measured carefully against the performance and PE ratios of companies in the ASX 200 list.

It will make little sense to pay a price above the average PE ratio of ASX 200 stocks, and indeed, there is a strong argument to suggest that if they list, they should sell on a PE significantly below that of the average of the ASX 200 companies. Why would you pay more for a dental corporate than for Macquarie Group, the major banks, BHP, Rio Tinto or Wesfarmers?

A lesson from Smiles Inclusive Limited

Above all, take a lesson from what can go wrong by dialling back through all of the stock market announcements by Smiles Inclusive Limited from the date of its listing to the present date and check its share price chart as a lesson as to what can go wrong. Investors should also take notice of the list of failures and disappointments in respect of accounting firms, dental laboratories, dental corporates, medical corporates and veterinary corporates to date. It is a sobering lesson.

As required I hereby state that the above consists of general advice only and any specific intention with respect to investment or divestment in any of the organisations mentioned should be based on proper analysis and advice from your respective professional and financial advisors.

Best wishes to all dentists.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, financial, valuation and conflict resolution processes for 32 years, the last 25 as a founding 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 Management of the 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 Synstrat Dental Stories, the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. 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 financial services company. Both Synstrat companies are owned by the same directors who work within the Synstrat Group. Call Tel: (03) 9843-7777, Fax: (03) 9843-7799, visit www.synstrat.com.au or email dental@synstrat.com.au..

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