Why do some dentists with similar practices retire millions of dollars better off than others?

With references to 1980s' entrepreneurs...

By Graham Middleton, BA, MBA

"Those who seek out higher interest rates in non-banking institutions have little or no idea as to how those institutions are lending the money..."

Those who start out with a good strategy and stick to it have a simpler and less stressful existence. Those who ride the high wire of unusual investment decisions or take bad structuring decisions from an ill-informed accountant, of whom there are many, set themselves down a far more stressful path and most end up much worse off than persons with similar size practices owned for a similar number of years. This writer has been advising dentists for 32 plus years and scarcely a workday goes by without examining dentists' financials and/or advising dentists. Regrettably, some leave it far too late to get good advice and their future retirement financial condition is far worse than it should have been.

The 1980's entrepreneurs - Short term players

In the 1980s, Australia spawned a significant number of get rich quick entrepreneurs who crossed the fiscal landscape like shooting stars and then imploded. They included:

- **Alan Bond** - Bond was an America's Cup hero who sank to being a financial pariah, was bankrupted and briefly jailed. Along the way, he caused major financial losses to many investors.
- **Christopher Skase** - Skase was a one-time financial journalist who massively geared up the Quintex Group until it imploded. He made a bad mistake of engaging in huge real estate resort developments taking years to develop and absorbing huge amounts of capital with no income, whilst the remainder of his empire could not produce the cashflow necessary to pay the interest as it fell due. Skase fled to Spain in exile where he lived out his life in an ordinary farmhouse pleading inability to travel to Australia on health grounds. He eventually died in there.

- **Abe Goldberg** - Goldberg stepped way beyond his core expertise in the rag trade, buying an inexplicable grab bag of heavily geared assets in businesses about which he knew little. When interest costs caused his temporary empire to implode, he fled to Poland in exile which had no extradition treaty with Australia.
- **John Elliott "Harlin"** - Elliott leveraged his way into control of Elders IXL. He and his inner circle of executives put their heavily geared shares into a private company vehicle "Harlin". When Elder's dividends fell well short of the interest cost to Harlin, his structure slowly but surely imploded. Elliott was eventually bankrupted. At his peak, he had been president of the Liberal Party, president of the Carlton Football Club and had even been spoken of as a potential future Prime Minister... and more. Two independent directors on the Elders IXL Board blocked Elliott's efforts to unwind Harlin at the expense of Elders IXL Ordinary Shareholders. One of those directors, Ian McLachlan, President of the National Farmers Federation and future Federal Minister, had too much personal prestige for Elliott to challenge.
- **Bank-like failures** - The failures of Rothwell, Estate Mortgage, Pyramid Building Society, Farrow Corporation and Tri-Continental. These were all organisations which offered unusually high interest rates to depositors but made horrible loans and in the case of Rothwell's, loaned vast amounts of capital to its CEO Laurie Connell who simply wasted the money. Connell died in jail.

The reality was that all of the above were essentially short term players who attempted to leverage themselves into assets but through a mixture of their own ineptitude, the 1987 stock market correction and high interest rates in Treasurer Paul Keating's "the recession we had to have" found themselves unable to recover from the mess that they themselves had got themselves into.

There were of course many other 1980's entrepreneurs who briefly flashed across the fiscal sky before imploding like dead stars.

The long-term players

There are many wealthy business people who played a long game working within industries in which they had close knowledge and who were prepared to plan many years in advance. There are a host of them large and not so large, but most lists will include:

- The Lowy family;
- The late Kerry Packer;
- Rupert Murdoch;
- The Gandel family; and
- Solomon Lew.

Whilst their results year to year may have varied, they kept one foot firmly on the ground, planned ahead and in the long-term, they and their type were the persons who ended up wealthy. The fact that the Lowy family has liquidated their interest in their former Australian Shopping Centre empire, Westfield, now re-named, suggests that other investors should now be careful about investing in it. Naturally, would-be buyers or sellers should seek their own investment advice.

Dental corporates

Dental and other corporatised professional practices turned out to have had far greater risks than their promoters have disclosed. The recent disaster of Smiles Inclusive Limited which crashed from a $1 IPO subscription price to as low as 3.1 cents and which has only been able to continue to trade at the mercy of National Australia Bank, whose lending covenants it has breached, sent a warning signal to potential investors in similar corporate roll ups. The list of failures and disappointing outcomes in the dental, dental laboratory, medical, veterinary and accounting professions is now substantial. Many of the corporate consolidations were put together by would-be entrepreneurs with more spin than business knowledge.

Residential rental properties not bright investments

32 years of observing financial outcomes for dentists and other professions has taught me that owner-occupied homes and dental premises are vastly better investments than are residential rental properties.

Misleading statistics

Investors have tended to rush toward residential rental properties based on statistics showing that overall housing has accumulated in value at a healthy rate. But has it? The reality is that homeowners look after the house they live in and are often renovating and extending, but owners of residential rental properties spend minimal amounts on them. The statistics of house price movements are extraordinarily misleading particularly in the more fashionable areas of major cities where lots of renovation, extension and indeed, knock down and rebuilds occur. The statistics of sale prices are taken from state Stamp Duty offices but those statistics only measure title transfers. They have no way of measuring capital inputs. For example, a knock down house on a well-located block of land in a good suburb sells for $1.2 million recorded at the state Stamp Duties office. The 60- or 70-year-old house is bulldozed and replaced by a modern two-story home with all of the contemporary requirements of a modern kitchen, modern bathrooms, ensuites, two car garage, landscaped garden and pool and then sells for $2.8 million. As far as the Stamp Duty office is concerned, the title transferred at $1.2 million and then again at $2.8 million but there was no record of the huge capital spend in between. It is this action which is occurring in some well-located suburbs which greatly distorts real estate pricing statistics.

Buying high rise off the plan is for suckers

High rise apartments are even worse. In order to gain bank finance to do the actual build, developers normally must demonstrate that they have 70% or more of firm Contracts of Sale off the plan. It's normal for developers to budget up to 20% of a project cost for the selling costs and apartments are sold through a combination of on-site sales offices and property spruiking organisations. It really is a hard slog. Eventually, when the person who had bought an apartment off the plan and paid a 10% deposit gets to completion and settlement, it is not unusual for the bank valuation to come in well below the off the plan price. To make matters worse, if they are buying it as a residential rental investment, by the time that they pay body corporate expenses, municipal and water rates, insurance, agent's rental management costs, etc., the net return is very poor, usually well below other returns in more liquid assets. The truly rich avoid residential rental property as investments. The reality is that the biggest purchasers tend to be public servants, police, nurses and schoolteachers who because of the relative security of their jobs, are looked upon favourably by banks when lending.

Poor superannuation strategies

Since the 2001 small business capital gains tax changes, which gave an advantage to many dentists, starting up SMSF's to purchase practice premises generally proved to be a far inferior strategy as many dentists will eventually pay no capital gains tax on sale of premises if not owned by a superannuation fund. Gearing property investment inside an SMSF is also for most a poor strategy. If an accountant suggests it, then it is time to seek other advice urgently. The reality is that a small army of accountants haven't yet caught up with reality. Limited recourse borrowing regulations mean that the borrowing is counted as a contribution and often precedes other non-concessional contributions which may have been appropriate to make.

Listed and unlisted investment companies and investment trusts

Most of these aren't suited for inclusion in self-managed superannuation funds because they have hidden high management expense ratios (MERs). Indeed, they shouldn't be invested in at all. While investment markets were such that funds were getting heady returns of 12% to 15%, these tended to be overlooked but in the current investment climate with extraordinarily low interest rates, very low 10 year bond rates and an Australian economy which is struggling for growth, the returns across all forms of superannuation going forward are likely to be much lower and in this environment having funds loaded with investments with high management expense ratios will hurt them badly.

There are exceptions such as Argo Investments which has a very low MER compared to the more recently listed investment companies.

There are particular exchange traded funds (ETFs) with very low MERs such as the iShares S&P 500 ETF which is based on the top 500 stocks on the New York Stock Exchange and NASDAQ, but those companies are global in nature. Its MER is at the bottom of the range.

The ultimate far-sighted investment story

The prize for this would have to go to Warren Buffett who heads Berkshire Hathaway and is a success story of 53 years. Buffett's very careful deliberative approach is an example to everyone, albeit that a big slab of what Berkshire Hathaway does is hidden from public view because over many years, it has purchased a number of well run substantial family-owned businesses on the basis that the family member running each successfully has been prepared to sign a contract to be long-term CEO while other family members have got their wish by being paid for their shareholdings and being able to depart.

The other hidden part of Berkshire Hathaway is its huge insurance float, which exists to pay possible future claims, but which is available to be invested. As an insurance giant with the visible means of paying claims in the event of a major disaster, Berkshire Hathaway's insurance arm attracts lots of lucrative business which it prices well above the general market because of the comfort that its huge wealth brings to the insured. In the event of a disaster, unlike many lesser insurers, they are confident that Berkshire Hathaway has the resources to pay out all claims. For this privilege, its subsidiaries charge higher premiums than their competition.

The Warwick Fairfax contrast

By contrast to Warren Buffett, Warwick Fairfax made a debt funded takeover bid for the Fairfax empire controlled by another branch of the family and almost instantly imploded when the interest cost far exceeded the income level.

Rupert Murdoch was content to wait for another opportunity

By contrast with the impetuous Bonds, Skases and Fairfaxs, Rupert Murdoch, who had been brought up pursuing his late father's newspaper interests, made a takeover bid for the *Melbourne Herald* in 1981. In those days, the Melbourne stock market was conducted by open outcry bidding on the stock market floor and the principal brokers had little boxes around the floor while their operators worked the floor and changing share prices were chalked up on the boards at the back. At a certain point during his buying, Rupert Murdoch realised that he was not going to succeed in his aim of gaining control. However, many of the shares he had purchased had been purchased at lower prices. He spoke to his broker and asked him to pass the telephone across to the broker in the next box. He then instructed the broker in the next box without making it obvious to tell his operators on the floor to sell. Other operators on the floor buying for other bidders were caught out, they all rushed to the new seller and a minute or two later everybody on the floor realised that there could have only been one seller of such a large line of stock. Rupert Murdoch walked away that day with a tidy profit and waited to pick up the asset on another day.

How leverage worked for the 1980's entrepreneurs - Until it didn't

Because many investors do not vote their shares, the rule of thumb is that effective control of a listed company occurs at 40% ownership. An entrepreneur controlling a company with 40% could then gear it up (have the company borrow) - have it purchase 40% of, say, two other companies, gear them up in turn and repeat the exercise. A bit of arithmetic shows that companies on the third line were being controlled with 6.4% of actual ownership flowing through to the top, but the entrepreneurs appointed their boards and created lucrative management agreements with themselves or their private management companies and milked the structures.

However, the 1980's and into the early 1990's were a period of strongly rising interest rates and a major stock market correction in 1987. This put huge financial pressure on the entrepreneurs and made many of their companies unprofitable. For a time, the entrepreneurs used their structures to sell assets to other companies under their control, often deliberately over valuing them in order to book what were phony profits and postpone their days of reckoning, but eventually their reckless behaviour led to a string of corporate failures. Tragically, many ordinary investors who had briefly regarded Bond, Skase, Spalvins, Elliott, Holmes à Court and others as heroes saw their investments wiped out.

Low interest rates - A warning for investors

One day, interest rates will rise significantly; it may be a year or two or much longer away but when they do, asset pricing will adjust because many speculators who have overvalued will find that they are unable to meet their interest payments and will resell assets. Imagine a mass of over geared high rise residential rental property investors all trying to sell their properties on the market simultaneously.

The lessons of the 1980's failures of Estate Mortgage, Pyramid Building Society and the Laurie Connell lead Rothwells are as valid today. Fixed interest investors rushed to put money into these institutions because they advertised interest rates above everybody else, but the institutions were fatally flawed because they were making bad loans to entrepreneurial characters and when those bad loans failed, the institutions failed and wiped out the savings of the investors.

In the current low interest rates climate, those who seek out higher interest rates in non-banking institutions have little or no idea as to how those institutions are lending the money. In particular, if they are lending long to relatively risky enterprises but paying good interest on shorter term deposits, they may have a mismatch.

It may well be that buying bank hybrid stocks in the four major banks which rank ahead of the ordinary shareholders of those banks are a much safe investment. Individual due diligence and advice is required.

Alan Bond vs Kerry Packer

In contrast with the get rich quick entrepreneurs, the late Kerry Packer was a long-term player. When Alan Bond pursued him to purchase his Melbourne and Sydney television stations (Bond already owned stations in Brisbane and Perth), Packer drove the price up to $1.055 billion. That price included $800 million in cash and a cleverly constructed $200 million convertible redeemable preference share parcel worth $200 million plus $50 million of options. The terms heavily favoured Mr Packer while Bond's floating of the overly inflated television network onto the stock market tanked.

The investors shunned the issue and it finished under water. The underwriters to the float were badly caught out. Bond still held most of the stock and the television network could not produce enough profit to pay dividends after paying the preference dividends to Mr Packer. As the share price fell, the number of ordinary shares for which the convertible preference shares could be exchanged multiplied. It rapidly became apparent that Packer was in the box seat to buy back the television stations at a future date at a very heavy discount which is exactly what happened. In fact, he sold Bond two television stations and bought four back. As Packer later observed *"you only get one Alan Bond in your lifetime"*.

Alan Bond vs Donald Trump

In October 1988, Bond bought New York's St Moritz Hotel from Donald Trump and there is no prize for guessing that Trump got the best of that deal.

Back to dentists - The plantation ponzi schemes

In the 1980s and since, dentists were among the self-employed professionals who were target marketed to by unscrupulous accountants intent on selling participation in olive groves, pine tree and eucalyptus plantation schemes. The schemes were sold on the basis of what werepresented as huge tax benefits but were deeply flawed.

Since the flaws in the scheme were apparent to this humble writer 32 years ago, it defies belief that the highly qualified accountants selling them were not aware.

For starters, the tax deduction up front was in reality a tax deferral rather than an outright tax deduction and those who participated got nasty shocks far into the future.

The accountants gave complex presentations of the benefits and got their clients to sign hefty loan applications to fund their so-called investments. The reality is that the schemes had many flaws. For a start, trees planted at the time of signing up weren't going to mature until many years in the future and there was too little incentive for the plantation operators to look after them properly. Indeed, it became apparent that the operators of the schemes developed cash flow problems and were continually relying on future sales to sustain their current plantings. They turned into massive Ponzi schemes.

There was no secondary market in which the buyers of a new plantings could on sell their three year old trees or their five year old trees, etc. The reality is that every sound investment has a secondary market. The absence of such a secondary market was a massive warning signal.

Ultimately the schemes collapsed. The accountants who had been the conduit for marketing them received commissions and volume bonuses, which rose to 9% or 10% of the upfront costs of the investments and those who persuaded professional clients to purchase several hundred thousand dollars worth at a time were richly rewarded.

Some of the best known accountants servicing the professions were involved in those schemes and are still dealing with the professions to this day. From its inception, Synstrat publicly advised its client list that it would not be participating in these schemes. Later, I was told by someone who was selling the schemes that my comments in Synstrat Dental Newsletters had made it impossible to sell eucalypts to dentists. I may be poorer for not indulging in promoting these schemes, but I am proud of the fact that I have never sold a tree.

On one memorable occasion, a surgeon was referred to Synstrat by a lawyer known to us and at his initial meeting produced paperwork for his $1.2 million investment in pine tree plantations! When quoted a figure for Synstrat to do his accounting, he remarked that that's more than my current accountant is charging. That is until we located the commission paid which was buried in the back of his pine tree plantation documentation on his $1.2 million pine trees and said that it looks like your accountant got richly rewarded for selling you this pine tree investment, whereupon he realised that he had been massively misled!

Importance of seeking advice

Before making investment decisions based on information in this article, it is important that readers take personal financial advice.

From the perspective of dentists who approach Synstrat/Graham Middleton for advice, any advice given will be contingent upon providing comprehensive information concerning their financial situation including performance of their dental practice, ownership structures, assets and liabilities, personal goals and risk aversion.

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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