SYNSTRAT

More Pitfalls in Buying and Selling Dental Practices

The constant series of financials and contracts reveal that there can be many pitfalls when dentists are about to buy or sell practices, or part thereof.

Associate Structure vs Company Structure
Consider a practice with multiple owners with the goodwill owned inside a company. The company turns over $3-4 million of dental fees per year. One of the owners wants to sell, but he can only sell shares in the company as he doesn't own the goodwill personally. The company cannot be wound up because it has other dental owners continuing in practice.

A result is that the vendor, whose share of practice fees is about $1 million, cannot access the capital gains tax concessions available to small business owners because of the structure, but were he selling an associated practice with $1 million of fees he could!

Now consider the same structure, but the current shareholders want to admit an employee dentist into it as an additional associate, because they are the type of person that they want to work with long-term. The employee dentist's adviser tells her that the structure will disadvantage her in the long-term. She leaves the practice and buys elsewhere.

Who Owns the Equipment?

Dudded on Depreciation
Some dental associates share the ownership of equipment via a jointly owned unit trust. We've seen instances where a valuer valued the equipment separately, and listed the equipment as 'jointly owned'. The vendor's contract then listed as part of the sale 'practice equipment', whereas it correctly should have showed a transfer of 50% of the units in the unit trust which owned the equipment, as well as 50% of the shares in the trustee company of that trust.

The result was that the buyer could not depreciate the equipment at the acquired price because it was actually owned inside the unit trust and the trust could only depreciate it at its carry forward depreciated value within that trust. As a result the buyer misses out on a substantial tax benefit. Conversely, had the sale been correctly documented with the same overall acquisition cost, but the units in the trust had been transferred at their net tangible asset value, and the residual value of the deal was described as goodwill, the vendor selling the goodwill would in all probability have accessed the small business capital gains tax concessions and paid no tax, whereas by selling equipment at an inflated value their accountant booked a profit on sale of equipment which was taxable. Both sides missed out.

Misrepresentation of Data
Some persons buying, selling and valuing practices have misrepresented statistical data, sometimes quite deliberately, to achieve a sale of a practice at well above value. In other instances, some of the data has been quoted innocently by forensic accountants, not realising that the databases are hollow or contain wrong data.

a. Australian Bureau of Statistics Data

Not only does the published ABS data on dental practice profit date from 1998, but it contains a serious error in its sourcing. The ABS didn’t differentiate between incorporated dental practices, where profit was paid out in salaries to the dental owners, and non incorporated practices where no salaries were paid and profit at the bottom line was therefore magnified. Mixing the two together produced a meaningless outcome, yet valuations prepared by some accountants quote this data!

There are also issues in that the ABS statistics didn’t differentiate fees paid to hygienists, and appeared not to comprehend the workings of dental associateships. Not only is the published data years out of date, but it’s also meaningless.

b. FMRC Data

FMRC ceased providing comparative data to dentists in 2005, and even then the data was very thin. For example, data on Victorian dentists was for three practices only, being two country and one city practice! Quoting such data in support of a valuation related to a Melbourne practice was meaningless, but we’ve seen it done.

c. IBIS World Business Data

This source used ABS data to compile its own advice on dentistry. We’ve seen it quoted by a well-known figure associated with one of the dental corporates as part of a presentation to stockholders and investors on the profitability of dental practices! Certainly this was a case of the blind leading the unknowing.

Corporate Valuations vs Dentist to Dentist Valuations

Everybody wants to get a high price for the practice when they sell, and buyers want to get a low price when they buy. However if vendor dentists don't want to be bonded to a corporate for five years under onerous contracts, with clawback provisions if contracted performance targets are not met, then realistically they'll be selling to another dentist. Whereas the corporates who offer these types of deals are contracting to receive a series of profit for the next five years, over and above the normal residual goodwill value, the total value of the sale tends to be written up as goodwill, which usually gives the vendor dentist significant tax concessions.

Where a dentist sells a practice to a fellow dentist with only a brief handover and no ongoing performance guarantees, the contract is far less onerous on the vendor. Looked at from the buyer's point of view, the buyer isn't buying a guaranteed series of profits, as was the corporate, but is assuming the risk that profits may not be maintainable. Inevitably the vendor dentist is going to depart after a short handover period.

The economic reality is that what the corporates are buying is quite different to what the individual dentist is buying, and hence the valuations are quite different. When a practice owner says to an employed dentist 'This is my price because that's what a corporate will pay', the employed dentist's advice is along the lines of 'Tell him he's dreaming'.

Buying Practices Little by Little Schemes

Schemes where a dentist is offered purchase of an associateship or a partnership in a practice a bit at a time have serious problems and usually don't work. Selling half of a practice at 10% a year over five years involves tricky issues of differentiating dental earnings and profits. It also reflects an overt power and control situation, whereby the vendor is effectively saying to the dentist buying in 'I don't trust you, so I'm going to control you for the next five years'.

A related issue is that somebody who has only bought 10% and gets into a significant difference with their associate can take a decision that they haven't got very much invested in the practice, and they'll walk away with the best deal they can get. If dentists really want their employee to buy in and to work with them, then they'll offer them a proper associateship. If they don't trust the employee sufficiently to offer this, then they shouldn't offer a little by little scheme.

Often dentists who are offered these types of schemes leave the practice and eventually buy elsewhere.

Don't Establish Structures in Advance of Buying

These days companies and trusts are frequently not recommended for use by new purchasers of practices. However even when they are recommended, they can be set up within a few days. It is important to have negotiated a firm deal and have proper advice about the value you are paying, and have finance approval, before you begin to set up structures. The structure can be done close to settlement, and you therefore don't waste money on it if the deal falls through.

Sourcing Correct Advice

If you stop and think about it, only persons who are in a position to view a vast quantity of actual financials of practising dentists, and who have also been advising on practice valuations and on constructing deals between dentists, are in a position to provide properly informed advice concerning practice acquisition, valuation and structure.

Quite a few accountants who have never had a dentist on their books give inaccurate advice on value and purchase. Very few accountants have sufficient dental data to be able to give authoritative advice. Bank lenders are not particularly gifted at sifting good practices from bad, but we've seen situations where they have given gratuitous advice about practice structure and matters that, in reality, they know little about. ADA officers may give well-meaning advice, but they too are not in a position to view the financials of their members, and are not qualified by experience or knowledge to value or advise on structure of other dentists. Possibly the only dental financials they have seen are of their own practice.

Solicitors' Contracts

Solicitors often produce contracts with significant errors. Examples are:

- Contracting vendors to sell equipment, whereas the equipment is actually owned by a trust, which is co-owned by an associate.
- Contracts which don't comprehend where the goodwill sits in the practice, sometimes confusing a service company with a sole proprietorship.
- In a particular state, with strict conveyancing and stamp duty laws, we've seen a situation of a solicitor's contract which purchased practice premises into a company, which is a big no-no.

It's important to get these matters right at the outset, because the contracts become foundation documents in accounting records. In the case of vendors they can cause a nasty shock when lodging the next annual tax return. In the case of purchasers, the nasty shock may occur in 25 to 30 years' time when selling.

Smelly Transactions

Buyers stitched up with error-laden valuations and compliant bank lenders

Bank lending officers get rewarded by the quantum of loans they have executed, hence the more money that the particular bank loan manager has attached to their name, the greater their salary. The internal bank conflict is often between the need for compliance and the desire of bank lending officers to get lending proposals approved. Periodically banks develop compliance weakness. Over the years we have been consulted after the event concerning some smelly transactions.

Regrettably in every profession there are some practice owners whose personal ethical standards are poor, and who set out to profit by selling a practice or part thereof at a greatly inflated value to a young dentist, with the assistance of an accountant/valuer who is prepared to write inflated valuations (refer *Misrepresentation of Data)* and who then steer their targeted buyer towards a bank lender who is prepared to lend on that person/organisation's value. Subsequently the buyer discovers that they have paid far too much for the practice. The practice fee base and its unavoidable cost structure cannot produce the profits that they had been led to believe were available to them. As they didn't take proper advice themselves, their ability to seek legal remedy may be weakened. When they look closely at the valuation they'll find that it was addressed to the practice proprietor, not to themselves and the valuer will say the valuation was for the purpose of giving advice to the practice owner, and they had no indication it was going to be used by a purchaser. The bank lender will say that they relied on the valuation. Fighting a large bank which has a virtually bottomless legal budget is not easily recommended. The real issue is getting proper advice before buying.

Practices Tied to Health Funds – Noble Dentist etc

Third party agreements reduce the amount of control a dentist has in a practice and can be very difficult to unwind. For example, when a dentist withdraws from a health fund preferred provider arrangement, the preferred provide will write to its members and say that that dentist is no longer on their approved list, or words to that effect. The letter can be read as implying that there's something wrong with that dentist's professional standards.

Dental practices which are heavily reliant on these sources of patients are not as attractive to buyers as practices which manage to have direct relationships with patients and who rigorously avoid third party arrangements.

Minority Interests

We are aware of a situation where some sharp operators bought 51% of a group of veterinary practices. The sharp operator then turned around and sacked the 49% veterinary owner, alleging that he was not doing his job properly. The veterinary owner sought legal advice, but it was quickly made plain to him that the corporate backing the 51% ownership structure had a very large legal budget, and would have drawn the matter out until the 49% owner lost his home. As a result, he settled for a token sum and left. Beware of becoming a minority owner with a big brother with 51%.

The Legal Mediation Pitfall

Solicitors love writing into associateship agreements a clause to the effect that in the event of a dispute between dental associates, the matter will be referred for legal mediation. Such clauses are a recipe for a feast of fees by solicitors, barristers and forensic accountants. Whilst seemingly innocent, they invariably have the effect of widening and prolonging the dispute. I have regularly advised dentists on appropriate dispute resolution steps to be written into associateship agreements, which have the effect of causing most issues between associates to be resolved before they get into an expensive legal showdown. Mediations were supposed to save time by avoiding the courts, but have developed into another expensive legal feast, and disputes that end in mediation may have about the same costs as those that end in courts.

If you buy into an associateship it's vital to consider the associateship agreement in parallel with the buy/sell agreement. It's too late to ask for changes in the associateship agreement after you've signed the contract to buy the associateship.

Corporate Due Diligence Pitfalls

Where a contract of a dentist selling to a corporate has a clause to the effect that the purchaser's due diligence extends to the day before settlement, a corporate can renege on an agreement which they have signed and which the dentist has negotiated in good faith. If for example the corporate's bankers suddenly decide that they're going to tighten their rules, a corporate may be induced into pulling out of some contracts. In this situation, a vendor who has spent large sums on providing the corporate with all of the information it wants, and who has spent a lot of money on legal advice and provided the corporate with the contract that it wants, can then find themselves with a failed deal after they have told the staff of the imminent ownership change and the corporate's representatives have been in and out of the practice a number of times.

Valuing the Wrong Practice

I am aware of a valuer who valued a specialist dental practice as a general practice, quoting general practice data! Although he presented himself to the parties to a dispute as a well credentialed expert, it transpired that he had insufficient knowledge to identify the type of dental practice he was valuing.

It pays to ask specifically how many general dental (or specialist dental) practices a person purporting to be an expert (such as many forensic accountants) has in fact valued. Remedies are costly, and so are delays in process.

Falsely Assuming That There is Value in Business Names and Corporate Structures

Creating a corporate structure does not of itself enhance practice value. Indeed, if the goodwill is locked up in a company it reduces the value. Having an exotic practice name usually does not enhance value either. This is because most dentists still draw most of their new patients from personal referral. We acknowledge that some practices have attracted considerable patronage via websites. However the pulling power of a website must be weighed against the local effect of referrals.

Generally the best names for practices are either dentists' own names, i.e. Smith & Brown Dental Services, or location names which are easily recognised, such as 'Greensborough Road Dental' or 'Penrith Dental'.

Buyers should be wary of valuers who ascribe substantial value, not reflected in practice financials, to the practice having a corporate structure or an exotic name.

Double Dipping on Goodwill

Another trap for buyers is where a vendor's valuers ascribe separate substantial goodwill value both to the associated dental practices and at the same time ascribe a significant goodwill value to the service entity. Apart from servicing the administrative needs of a practice, a service entity may employ dentists or hygienists to do the overflow work not done by the associates. However it is the associates who own the goodwill and who can choose, if they wish, to work extra sessions or hours and do the work of the employed dentists and hygienists. The convention is that the goodwill is owned by the associated owners of a dental practice.

Breadth of Patient Base

In the case of specialist practices, it is critical to examine both their financials and the number of referral dental sources that they have. Obviously we should be wary about a specialist that draws most of their income from a too narrow band of referring dentists. It may be that with a change of ownership in a practice, the referring dentists switch their allegiance to other specialists. It's important in buy/sell contracts of specialist practices to have agreed protocols concerning personal introduction by the vendor.

In the case of orthodontics practices, many patients are drawn from the siblings of children who have already had or have in process an orthodontic treatment plan. Therefore a buyer of a practice would probably wish that the vendor would work for them on a restricted hours basis for a significant period of time, and would assist in introducing patients with lengthy treatment still to be completed to the new owner. They would also be careful to get introductions to referring dentists.

In particular situations where a group of specialists of like category (say a group of endodontists or a group of prosthodontists) practice together it is likely that to some extent referring dentists have formed a habit of referring to the group rather than to a particular specialist.

Two and a Half Times

Our observation is that when neither vendors' nor buyers' accountants have other dental clients, the vendors' accountants tend to grossly overvalue a practice and buyers' accountants tend to grossly undervalue. Our general observation in these circumstances is that the vendor's accountant's valuations tend to be about 2.5 times the purchaser's accountant's valuations. In reality neither accountant actually knows what the true value is, but they provide advice which is heavily biased towards the interest of their client. Such approaches help no one, and demonstrate why specialised valuation advice is necessary.

Lack of Clarity About Corporates' Plans

It is apparent that some of the corporates have been on a mission to bulk up their fees and get to an IPO and stock market listing. One well known corporate figure has openly said to vendor dentists 'It's all about the IPO'.

Where vendor dentists have been obliged to take part of their payment in share scrip, the absence of an IPO creates doubt as to the ultimate market for their shares. However where a corporate sells a significant shareholding to a foreign owned company, it then raises questions as to what the significant foreign shareholder's intentions are. Organisations which put substantial money into an Australian dental corporate aren't doing so out of a sense of altruism. They will have a long-term plan of their own which they aren't going to disclose until they have cemented their control over the company; polite assurances notwithstanding.

Punitive Rent

Where the percentage of dental fees paid in rent is very high, profit is permanently affected because rent is a fixed cost. Some persons who value equipment then assign a percentage of fees to goodwill value, fail to examine the financials in detail and fail to check leasing schedules and other costs of a fixed or semi fixed nature. As a result their valuations can be seriously misleading.

Mistakes by Vendors of Practices

1. Not maintaining tight fee schedules.
2. Not maintaining their own output. The most profitable and productive parts of most dental practices is the owner's own surgery. Where owners substantially reduce their own output, profit usually falls by a significantly greater proportion for the practice as a whole. Often the output of both clinical and non clinical staff suffers from reduced interest by the owner.

3. Not maintaining the appearance of their practice. Even when not prepared to invest in substantial new equipment, it is essential that the waiting room be redecorated regularly. Appearances are vital.
4. Not having a practice valued in order to gain a realistic appraisal as to a sensible asking price and a feel for the market.

Hints for Sellers

1. Have your practice valued.
2. Ensure that appearances are sound.
3. Sell before your own dental output drops.
4. Advertise your practice for sale via the ADA newsletter, giving an email address which is not obvious, and make the ad general, such as:

> ***Busy two-dentist plus hygienist practice in Sydney's southern suburbs. Premises are available for sale or rent. Contact [email address] and you will be contacted to arrange an inspection of the practice.***

5. Don't provide financials or other significant information to people who say that they are buyers until after they have inspected the practice. Those who receive information via mail rarely, if ever, buy, and can always find something wrong with the financials.

The Toorak Poor vs the Blue Collar Cash Rich

It's a mistake to think that because a practice is located in a prestigious suburb that it's going to be worth a lot more than one in a middle income suburb. The phenomenon referred to as the Toorak poor goes a bit like this:

Consider families living in multi million dollar houses with seven figure mortgages and two expensive European cars financed on chattel mortgages, with two or three children at expensive private schools. Such families may have impressive income but it's swallowed up in lifestyle costs to the extent that their actual disposable income is quite low, and they have to postpone consideration of expensive dental treatment plans.

Now consider the following:

Families living in traditional tradesman type suburbs with lots of homes having solid two-income families; say the income of a tradesman married to a secretary. Their homes have modest value and their mortgages are either low or have been paid out. Their children have a cheaper education and they have a significant amount of income available for discretionary spending. If they have learned to trust their dental practice, they have no difficulty in agreeing to desirable treatment options.

Practices in the second type of suburb are often more profitable than those in the Toorak type locations; particularly as their premises are much cheaper.

At Synstrat we have observed the financial performance of practices located across the CBDs of all of Australia's major cities, practices located in inner and outer suburbs, as well as practices in regional centres and country towns. It is evident that good, profitable dental practices are widespread. Some practices with high rent and limited space located in expensive suburbs are always going to underperform good practices in middle income suburbs, often by substantial amounts.

The Multi Million Dollar Trap

In terms of the capital which a dentist can build up over their working life, perhaps the biggest mistake they can make is to buy a high rent limited space practice in an exclusive suburb. Because of the compounding effect of their surplus income being reinvested, the difference in their long-term capital formation when measured over the typical working life of the proprietor of a dental practice will amount to many millions of dollars.

This, more than anything else, demonstrates why it is essential for those purchasing practices to get well informed advice concerning value and business plans.

Dr Right Practice vs Dr Wrong Practice

As with all these matters, the observations and case studies are virtually endless. While many dentists will end up owning homes which may be worth a lot more than the capital value of their practices, it remains a fact that for most dentists the most important financial decision that they will make concerns the purchase of their practice. Dentists who buy the wrong practice have a tendency to hold onto it too long and in relative terms their situation, vis a vis dentists who buy the right practice, diverges year by year. Eventually 'Dr Right Practice' has assets of several million dollars or more greater than 'Dr Wrong Practice'.

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