SYNSTRAT

Why Small and Simple is Beautiful

In 21 years of dealing with dentists and dental practices, very few business days have passed without analysing dental financials and contemplating business strategies. Many consistencies remain despite the substantial changes in technology and dental education which have occurred.

At Synstrat we have been extracting comparative data out of completed dental practice financials for many years. This provides us with a valuable basis on which to provide advice to our dental clients.

Myth Number One

Proponents of corporatisation and some academics argue that practices must consolidate and become bigger to survive.

Fact

Over at least the last ten years, as measured on a Dental Earnings Before Depreciation, Interest and Taxes (DEBDIT) basis, our database shows an improvement in DEBDIT per dollar of fee income. If there are reasons for corporatisation, profitability per dollar of fees is definitely not one of those reasons.

In the last year we've observed a well known corporatisation promoter seriously misquote dental profitability statistics to a share market professional investor group. He did not understand the elementary flaw in Australian Bureau of Statistics data related to dentists. The error should have been immediately obvious to anybody with a basic knowledge of business structures of dental practices. Clearly some of the corporatisers do not understand the basic facts as well as others.

Myth Number Two

Dental practices are becoming too difficult to manage. Therefore management needs to be contracted out to a corporate.

Fact

There are a multitude of well managed practices. The quality of individual who achieves entry to an Australian dental school was well performed in high school, literate and highly numerate. Invariably they work as employee dentists for several years before purchasing their own practice. We observe that they handle practice management as well as senior dentists did twenty years ago. While some things have become more complicated, there has been sufficient management education and software support to march in step. There will always be some lesser performed practices as there were twenty years ago. The majority of dentists run their practices to a standard which is better.

Myth Number Three

Bigger is better!

Fact

We acknowledge isolated exceptions, but generally highly efficient and profitable practices are limited in size. The evidence of the observation of the actual practice financial outcomes over many years supports this view.

Practices run by a dental proprietor become an increasing drag on owner dentists as second and third employee dentists plus hygienists are added. As human beings, we have a limited effective span of control without adverse impact on our own work. The proprietor's own surgery suffers. The newest and least experienced operatives require the most supervisory support. Most practice manager titles are, in reality, courtesy titles given to receptionists or senior chairside assistants. The proprietor dentist makes all the critical decisions and cannot avoid responsibility.

Traditionally five direct reports have been considered optimal for a senior manager. However this needs to be qualified. Where roles are professionally challenging or substantially different, demands on the manager are much greater than where subordinates carry out parallel tasks. The issue in dentistry is that only a dentist can successfully manage all aspects of a practice. Where non dentist practice managers exist they are more administrators than managers.

Since the highest profit in the practice is usually earned in the proprietor's own surgery, too high a management load creates a substantial "personal opportunity cost" in fee income foregone in that surgery. Therefore there are effective limits to efficient practice size. The efficient sizes remain as follows:

1. A well conducted solo dental practice.

2. One proprietor dentist plus one employed dentist.

3. Two good dentists practising as associates.

4. Two associated dentists plus one employee dentist.

Simple structures enable good dentists to get optimum performance out of their own surgery without being loaded down with too many management and supervisory problems.

Consolidating multiple practices into mega practices is rarely going to produce efficiencies of scale, unless an owner dentist is extraordinarily gifted in respect of the ability to harmonise all aspects of a busy practice without significant detriment to their own surgery. This is rare indeed.

Self Selection Is Not Replicable

Darwinian evolution is based on the theory of natural selection and is well proven by science. In dentistry the most successful dentists self select. Talented and ambitious graduates choose to purchase and develop their own practices because they can earn more over a career span, and because they enjoy the control factor of being their own boss. The most talented and ambitious dentists usually don't choose to work long-term for health funds or government clinics, nor would they choose a long-term career as a corporate. They will be seeking to work for well regarded, privately owned and operated practices in order to get the essential experience and feel for running a practice.

Practices purchased by corporates will have been selected because of their past income. They will generally have been conducted by dentists high up the Darwinian self selection model of success.

It is highly likely that as vendor dentists come to the end of their contracts the corporates will have no choice but to draw many of their replacements from the wider tier of dentists who, in the absence of corporates, would have been unlikely to develop practices to the level of the vendor dentists who preceded them. We predict that there will be a substantial reduction in overall performance.

We have already observed "Stockford Disease" with respect to a number of accounting consolidations. Pearl Healthcare and some medical consolidations also have this characteristic. There was a pronounced reduction in performance of practice vendors once they had become employees. Pearl Healthcare continues to make losses and is only able to continue to trade because of the ability of its directors to lend significant sums of money to the business. The dental corporate approach is to deal with the problem of Stockford Disease by building into purchase contracts elements of deferred pay and share scrip tied to escrow periods and performance levels. These measures can defer and slow the reduction in performance by vendors, but not eliminate them. Eventually vendors reach a point at which they have little or nothing to lose in continuation payments, and their interest at that point will plummet. In terms of motivation, there's nothing worse than a contractual "corporate release" day.

Risk

Taking substantial share scrip as a part buyout consideration from a corporate for your practice is a major risk if there are a large number of vendor dentists' contractual obligations which are due to end before your scrip will emerge from escrow. Any dentist considering a corporate offer would be wise to refuse share scrip and insist on cash. You would not consider a share scrip component unless you at first had been provided with a list of all dates at which contractual obligations with respect to existing vendor dentists expire. Does anyone but the most starry eyed corporate spokesperson believe that vendor dentists who have been paid out are going to continue the same high fee output? Or that they will have any interest in practice management problems? Or that they won't eventually be replaced by recent immigrant dentists who have passed the ADAC exams?

The true test for the corporates will occur at about five years after their initial practice purchases, by which time initial vendors' contractual obligations will have expired. These contractual obligations varied from one to five years, but are generally in the three to five year range. At this stage investment in a dental corporate, whether via the market or via acceptances of share scrip as part payment for practice is a high risk.

Interestingly, the Townsville based 1300 Smiles Ltd dental corporate has recently traded at about twice the price earnings ratio of the also Townsville based Greencross Ltd veterinary consolidation. Since the two companies are of roughly similar stature, it begs the question as to which is correct? In our view the Greencross share price is the more correct and 1300 Smiles Ltd is overpriced.

Dental corporates will only prove to be successful if they can maintain good profitability beyond the period at which vendor contracts have expired and demonstrate the ability to replace those dentists with employees who are equally successful.

Corporate Motivation

Did the Jesse James gang rob banks and trains for sixteen years because they wanted to imitate Robin Hood and redistribute wealth from the rich to the poor, or was personal greed their motivation? Alternatively, after the thrills of fighting the American Civil War as members of Quantrill's Raiders, was life simply too dull for the James and Younger boys?

Are the corporates trying to capture the dental profession because of their personal altruism? Or are they doing it because they believe they can make a killing on the stock market? One well known organiser for a corporate has been telling dentists that it's "all about the IPO". Unfortunately, stock market conditions are not friendly towards an IPO at this juncture. Does anybody believe that standard of dentistry will rise because of the corporates? Does anybody believe that the shareholders will care about the quality of dentistry?

What Should Younger Dentists Do?

Well motivated, talented younger dentists should aim to work in the best privately owned practice they can find. If, having gained suitable experience, they are unable to buy into that practice they should buy another or commence a practice. If, after having had a profitable career, they can find a corporate that wishes to buy them out a couple of years before retirement, well and good.

Where's the Best Place to Start a Practice?

Almost certainly the best place to start a practice will be in proximity to a corporate practice or, better still, between a couple of corporates. As the marketing of professional services is overwhelmingly connected to personal relationships and personal referrals, a good dentist who provides effective dental services and maintains good relationships with patients will steadily build a patient book and retain them long-term. Competing corporates working with employee dentists will always have the problem of regular staff turnover. Patients go to a practice where they can have a stable relationship with a long-term dentist of choice. Dentistry will remain the last great cottage industry.

Our Prediction

In ten years' time the corporate phase of dentistry will largely be seen as an historical oddity with one or two survivors having plateaued and the remainder fallen by the wayside. The structure of dental practice will look pretty much as it did in 2000, albeit that there will continue to be incremental advances in equipment and treatment.

By GRAHAM MIDDLETON, BA, MBA, AFAIM

Graham Middleton is a director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. 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. Graham Middleton personally has been an investment adviser to dentists located throughout Australia, and has been providing this service for 20 years, the last 13 as a partner and director of Synstrat Management Pty Ltd.

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