Financial Markets Meltdown – Impact on Dental Corporatisation?

The state of the stock market has just made it a lot more difficult to float a new company of any sort; particularly one of micro or mini size.

The following is the situation concerning a number of listed professional services related companies, many of them in the health field plus some potential listings:

Vision Group Limited
Vision Group Limited, a company made up of ophthalmic surgeons, has recently traded at about one third of its twelve month high.

Capitol Health Limited
Capitol Health Limited, which previously tried to establish itself as a dental company, has since abandoned dentistry and is now a radiology company. The stock market has been unimpressed and it has recently traded at 4.5 cents per share, down from a year's high of 16 cents.

Greencross Limited
The veterinary services company Greencross Limited, which IPO'd with groups of practices in Townsville, Brisbane, the Gold Coast and Melbourne plus one practice in Adelaide, recently traded at 60 cents. After its initial IPO subscription of $1, it traded above $2 before market reality hit home. Lowering the share price makes it much harder to provide share scrip as part payment for practices. It is now a much more difficult climate, and its expansion plans may slow.

1300 Smiles Limited (Smiles)
Listed dental services provider Smiles, a Townsville based company which owns dental practices in a number of Queensland locations, has appeared to defy gravity. It recently traded at about $2.40 and a PE of about 20. On the surface that is laudable. It looks far better than a similarly sized Greencross Limited, on a PE of about 5.4. Both of them are managed by Townsville identities. However 75% of Smiles' shares are owned by its founder, and often many days pass without a stock market trade. There are too few shareholders and too little share spread to create a viable market. If a large parcel of shares was placed on the market, it is probable that the share price would plummet. If, hypothetically, these two companies' shares were the only ones available to invest in, then investors would sell Smiles and buy Greencross until their PE's aligned. The investment risk in both stocks is assessed as being equivalent but at this PE no dentist should contemplate receiving share scrip as part of a buyout offer from Smiles, but Smiles would be eager to use its scrip.

Pearl Healthcare Limited
Dental laboratory company Pearl Healthcare Limited IPO'd several years ago as a back door listing into an existing company which had already had a couple of rebirths. It was previously a dot com, a tyre company and a mining exploration company. Following its 25 cents subscription it finished day one at 19 cents and continued to head south. Eventually it consolidated on a fifty shares into one to make its share price look respectable. It's had a succession of losses, and along the way a change of board. Its directors had to loan money to the company to continue trading. Some of the

loans have been converted into shares because the company was in no condition to repay them. Its 2008 report indicated that it had been factoring its debtors' ledgers to get ready cash. The 30 June 2008 accounts also indicated that it had negative equity. It's being kept afloat by its directors providing loans.

OGL Limited
This company, which is a consolidation of leading orthopaedic surgeons, is yet to list. It has natural advantages in that orthopaedic operations are expensive. The referral power of the orthopaedic surgeons, enabling them to fill operating theatres and hospital beds in private hospitals, involves the placement of services which are worth a lot more than the actual orthopaedic surgery. By contrast with orthopaedic surgeons, the referral leverage of the average dentist is minor. Even so, OGL is yet to prove itself and at this stage there is no firm indication as to when it will IPO onto the stock market.

Independent Practitioner Network Limited (IPN)
This is a consolidation of medical general practices of significant size. It has struggled. Previously Foundation Healthcare Limited was folded into it. The issue with medical practices revolves around their referral power to pathology and radiology services. Technically the company cannot force doctors to refer patients to a particular pathology service or a particular radiology contractor. In reality by setting up practices in a particular way so that the referral forms are on the individual doctor's computer, and the easy or lazy way is to use the company's preferred pathology or radiology provider, the railway lines are greased and virtually all work ends up where the business wants it to. Without harnessing significant referral power, medical general practices are not worth owning. There are indications in IPN's annual report for 2008 that the company has improved. Its accumulated losses have fallen to $20,679,000 from $29,415,000.

ABC Learning Centres Limited (ABC)
Whilst ABC is not in the health field there are some similarities in the consolidation of child care centres and the consolidation of widely spread professional practices. There were few obvious synergistic benefits at the local level. ABC struggled to make an acceptable profit. Recently it has had to sell out of its American operations in order to placate its bankers, and has been suspended from trading on the stock market because of its inability to produce audited annual accounts by the due date. It had no obvious referral power. The board has dismissed founder Eddie Groves.

A report of 17 October 2008 in the Australian Financial Review indicates that an unlisted company, Bellaraphon, held 16 childcare centres in Adelaide and Melbourne. It had common directors with Primebroker Securities, which had some form of entitlement to it. Primebroker pledged the proceeds of the $14 million sale of the childcare centres to ABC as security for ANZ Bank refinancing. ABC put up a deposit of $1.5 million but hasn't been able to complete the sale. Now ANZ Bank has a problem.

The Accounting Consolidations
There have been three outright failures, all of which ended in liquidation, being Stockford Limited, Harts Australasia Limited and Knights Insolvency Limited. Their business models were disastrous. There has been one significant success, being the WHK Group Limited, but WHK really started as a consolidation of successful financial planners with high service fees and a proven and loyal clientele, and later became more accounting orientated. There were factors favouring its IPO which are generally absent from most other professional consolidations.

Given the various accounting failures, it may be a long time before another accounting IPO occurs. Following the Harts, Stockford and Knights failures, several other accounting schemes which were being shopped around accountancy practices failed to gain acceptance. Their promoters vanished into thin air.

Other Dental Consolidations

As all dentists would be aware, there has been a significant amount of corporate activity. A multitude of dentists have been rung up by somebody representing one of a number of companies. A number have also received letters. Usually the initial contact carries a much heavier promise than what transpires as a final offer. Usually too, many of the conditions are not acceptable to the dentists.

Primary Healthcare Limited
Primary Healthcare Limited has a dental arm, but it's really a healthcare conglomerate and its dental arm is dwarfed by its other activities. Its annual financials don't break out its dental activity.

Dental Corporation Limited
Dental Corporation Limited has a significant number of dental practices under its management, but it is yet to achieve a successful IPO. Financial markets may force a re-think of its strategy.

Any stock market induced delay in IPO is serious because it brings the conclusion of the vendor dentists' contracts closer to the point of IPO. That adds a significant risk to the company.

Vital Information

Vital information which must be sought by anybody contemplating investing in such a company, or accepting share scrip as part of a buyout consideration for a dental practice, must demand to see a schedule of vendor dentists and the dates on which their contractual obligations end.

A substantial risk revolves around replacing the vendor dentists with other dentists recruited as long term employees (as opposed to practice owners). Employee dentists are less likely to have the same ability or inclination to produce high levels of fees as do successful owners of dental practices, which is what most of the vendor dentists were.

Dental Partners Times Two!
There's actually been two companies called Dental Partners. The first, Dental Partners Ltd, including Dr David Dunn, a Sydney dentist, and Dr William Medland, a Gold Coast dental specialist, as directors. Both subsequently resigned. That company had sought to raise money prior to its IPO and had an interesting management team. Refer to Synstrat's website at www.synstrat.com.au

The second or new Dental Partners Pty Ltd, has the same CEO, Mike Timoney, who is the husband of a Gold Coast dentist. David Garofalo has also been a director of both companies. Dental Partners Pty Ltd reported that it has entered into a business arrangement with New Zealand group Abano to own 70% of its business.

Whichever of the two iterations of Dental Partners we view, there is little evidence to suggest that it has been significantly successful in the Australian dental market to date.

Platinum Outcomes – Dental Laboratories

Mr Glen Gaudet of Platinum Outcomes Pty Ltd has approached dental laboratory owners, seeking to buy them out. He was previously associated with the Greencross Limited IPO (see above). The experience of Pearl Healthcare Limited suggests that consolidating a large number of dental laboratories into a profitable company, then listing it on the Australian Securities Exchange (ASX Ltd) is a daunting task. Again Pearl Healthcare's experiences indicate that they may find it even more difficult operating as a profitable listed company. The dental laboratory owners who previously accepted a substantial amount of share scrip when selling their businesses into Pearl Healthcare's IPO could only watch helplessly while the share price plunged over the next year. They couldn't sell because of escrow conditions.

Platinum Outcomes Pty Ltd is a company with $2 of paid up capital. Its shares are owned by Francis Gaudet. Its directors are Glen Gaudet and Justin Broad. Glen Gaudet was instrumental in the establishment and IPO of Greencross Limited (see above).

All vendors contemplating offers for their businesses should insist on 100% cash payment up front. Given the recent state of the stock market it could be a long wait for IPO to occur. Vendors should insist that contracts of sale are not dependent upon an IPO occurring.

If Platinum Outcomes wants a quick way into the dental laboratory business it could make a takeover bid for Pearl Healthcare Ltd, which has negative equity.

Impact of Global Financial Conditions

Events have moved rapidly. Hence any comment made in this article needs to be checked carefully against the current state of the market. At time of writing, world stock markets have suffered one of the most traumatic collapses in history, and the world is headed for recession.

World governments have handed effective control of the financial world to the governors of the major reserve banks in Western economies. Politicians have been reading the lines given to them by their reserve bankers and regulators. Regardless as to whether markets have stabilised or remain volatile, it is unlikely that there will be any stomach for capital raisings to enable the float of small professional consolidations. Even the largest companies are having difficulty in raising capital on the stock market in current conditions. Stockbrokers will be reluctant to recommend small floats to their clients.

The wave of consolidations and attempted consolidations was an attempt to cash in on buoyant stock market conditions existing prior to this year. Often the types of businesses being consolidated were unsuited to the model. The failure rate has been extraordinarily high and it would be a very brave person who would put money into the float of a new dental company, dental laboratory company, veterinary services company or medical services company in this environment.

Raising Capital for Floats (Initial Public Offers)

After the longest period of economic growth in Australia’s history, our financial markets became complacent about raising capital. During the past two or three years some bizarre businesses have been able to raise capital via listing on the stock market. Bankers too have offered easy credit, mobile mortgage brokers have been knocking on doors offering to procure loans. Low doc and no doc loans (liars’ loans) found their way into the menu.

That has ceased. Australians are just beginning to understand that low doc loans have been removed from the menu and Australia’s banks, which source about one third of their funds from overseas, are now having difficulty raising those funds overseas. Home loan applications will undergo a lot more scrutiny. Borrowers who can put up substantial deposits and have good incomes will be preferred. Credit is now being rationed to worthy borrowers.

Banks who provided venture capital to throw at investment schemes will be a lot more discerning. Bank senior management will ration the capital allocated to this type of activity. Investment schemes will require rigorous assessment.

Investment Bank Margins Will Shrink

Stockbrokers have been charred by the experiences of the last year. They are wary of recommending second tier stocks to their clients and afraid to associate with the float of third tier mini stocks at IPO. These include professional consolidations when there have been so many failures and disappointments. As Australia’s share market has sunk lower there have been many larger companies with household names which appear safer yet which are now trading at much more attractive prices to buyers. As a result the price earnings ratios on which small professional consolidations are able to float will shrink. Investment bankers' margin between the price to earnings ratio at which they can buy professional practices and the ratio at which they can float is narrowing dramatically; if indeed they can find a broker who is prepared to put their name to an IPO or an underwriter who is prepared to underwrite the float. Even Top 20 companies carefully canvass among institutions to gauge support before they tentatively seek to raise capital through issues of additional shares in the market. A year or so ago they would have had no hesitation.

Number of IPOs Declining

The number of IPOs on the Australian share market has fallen dramatically when compared with the number a couple of years ago. Investors now want stability, and that suggests investing in major companies which are household names and which have ownership of strong brands and a long history. Those companies appear to be safer and potentially offer a lot of upside in an eventual recovery from the bear market.

Advice to Dentists and Dental Technicians

In the current climate, do not accept share scrip in lieu of cash. If you are thinking of selling your practice, insist on cash.

If the organisation approaching you is not yet listed, insist on being told the date its IPO is planned for. Be careful to contract yourself to work in your old practice for the shortest possible time. Don't agree to a deferred settlement at IPO. The IPO may never arrive or be delayed by years.

It is essential that you insist on receiving a company document which sets out a schedule of all of the vendor dentists or vendor laboratory technicians, as the case may be, who have sold their practices and laboratories to the corporate and the date to which the vendors are contracted to work for the new company. There is a significant risk of future income and profitability plummeting once the vendors have left their former practices. Will vendor dentists be replaced by recent immigrant dentists? Will their replacements have equivalent skill sets? Will they be able to maintain and build patient loyalty if regular changeover of dentists is occurring? Will falling company profitability impact on your ability to work in your old practice? For example, will corporate head office place restrictions on the ordering of consumable stock? The employment of essential staff in the practice? Or delay authority to have equipment repaired? It is likely that there are substantial risks in dental corporatisation which are not yet fully apparent.

Avoid ownership of shares in a professional services company unless you are clear as to the average length of contractual period remaining for the vendors of the professional practices involved.

Dental Practice Valuations – Corporate Buyer

In a valuation of a dental practice, a critical issue is that a sale of a practice to another dentist for cash with a limited handover period is quite different to a sale to a corporate involving a lengthy employment period, which effectively precludes involvement in other activities of choice and ongoing management responsibility of the practice. The consideration must also differ significantly if there is a deferred payment or a share scrip component of the deal. If any of these restrictive elements are in place then the price will be higher. If all of these restrictive elements are in place then the price would be much higher. These issues should be discussed with Graham Middleton or Lorraine Arousi on (03) 9843 7777.

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