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EXCESS RENT CRIPPLES PRACTICE SALEABILITY

Susanne

Susanne purchased a practice with $350,000 of fees. There was a long-term rental agreement involving the premises and rent review conditions are reasonable. If all other aspects of the practice financials withstand criticism, then there is no reason why Susanne should feel uneasy concerning purchase of the practice. Ultimately, price is of course affected by a host of other issues including profitability, fixed expenses, location of the practice and composition of the practice clientele. However, In Suzanne's case there is every reason to believe that she will be able to on-sell her practice at a future date.

Thomas

Thomas had been working as an employed dentist for the past seven years, spending about 50 percent of his time in each of two practices and was no longer satisfied by the work conditions. He realises that each of his employers stream the better patient cases toward their own surgery with the employed dentist doing the leftovers.

Thomas is well remunerated, but as a long-term employed dentist, he has not developed a deeper understanding of dental practice financials. Thomas decided to look for practices for sale. Most of the ones he looked at were run down, whilst others were too far from his home. Some wanted obviously ridiculous prices. Finally, he came across a practice which was located in a prestigious suburb.

The gross fees were approaching $400,000. Thomas's fees had been comfortably above $200,000 working for his present employers with second choice patients, and he reasoned that by working the better patients he could stretch himself to manage the workload in the practice. The dentist wanted $230,000 for the practice. Thomas asked his accountant who had no other dental clients. He offered the opinion that it looked alright, but he was not able to evaluate the dental profitability correctly. Thomas rushed to sign, but later discovered to his horror that he had contracted to take over an assignment of the lease, with a monthly rental of $3,200. Worse still the lease was within one year of expiry and the landlord enforced a review of rent as a condition of renewal. Because of the location, the new rent will commence at $3,600 per month, with significant annual rental adjustments built into the new lease.

Before signing the lease renewal, Thomas considered moving his practice, but found there were no cheap alternative locations in the suburb concerned. Furthermore, the move of practice equipment involving a fit-out of new premises to modern standards with the associated plumbing, wiring, re-partitioning and the necessity of getting new cabinetry to fit would have introduced another major capital cost. Thomas found that he was effectively trapped long-term at a very high rent, and low profitability. He now realises that he paid far too much for the practice and has been advised that it is virtually impossible to sell it, except at a large loss.

Fred

Fred already owned a practice in a solid blue collar suburb. Fred's premises were rented for $22,000 per year and he grossed about $450,000 of fees. Fred noted that his current lease renewal was about twelve months away and that his current work environment was less than satisfactory. Other tenancies in his building had a grubby appearance and Fred was working in an environment which suggested that his practice was decidedly down market. Fred was fortunate to find a free standing building for sale for $200,000. Stamp Duty and legal costs added about another $10,000. It cost him $120,000 to fit-out the car park, replace some equipment, wire, plumb, renovate and paint. However, a year after he moved into his new premises, Fred's gross fees had grown to $540,000 and he was a lot more profitable. His patients now willingly pay a higher fee scale, but enjoy the convenience of proper parking and pleasant surrounds.

While Fred's occupancy costs (basically his interest bill) have gone up, the move have enabled him to run a considerably more profitable practice in happier surrounds. Fred has now got renewed vigour and it is likely that he will be able to on-sell his practice in the future, offering the purchaser rental and buy options with respect to the premises.

Lessons

One of the great fallacies in dentistry is that a practice is worth a fixed percentage of gross fees, regardless as to location and condition. The cost of occupancy of premises is a fixed cost of a practice and can have a dramatic impact on the future profitability and saleability of a practice. Where a practice is located in a prestigious suburb, it is normal to find both high rent and adverse rental review conditions. In some locations, dental practices are simply not profitable enough to justify the rent being asked. We are often surprised when asked to give a second opinion that an existing accountant or adviser has neither assessed the profitability of the practice concerned appropriately, nor identified critical issues including that of lease contracts on premises. For most dentists, the practice that they buy or commence will be their primary source of income during the best years of their working life. If the purchase decision is not correct, they suffer the adverse financial effects for many years.

Widespread observations of the valuation of dental practices by accountants applying general business principles in the absence of detailed industry, benchmarks or knowledge reveal many of them to be far removed from dental reality. Unfortunately, the individual who pays too much is unlikely to be able to find somebody else with the same degree of ignorance as to market conditions when they come to sell.

In some cases, relocating a practice into "owned" premises can facilitate a multiple benefit. This occurs because:

- the owner of the practice is making improvements to a building that they themselves own.

- the gross fees and profitability of the practice should rise in better surrounds; and

- they will be able to produce a saleable package to the market when it comes time for them to exit.

However, there is also cause for significant caution in that a detailed understanding of the right combinations of numbers are essential if overcapitalisation of premises is not to occur. The exercise should be commenced through a practice evaluation benchmarking exercise to ensure that a good fit between investment in premises, potential profitability and likely value of practice is maintained.

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