Buying and selling dental practices - 2013

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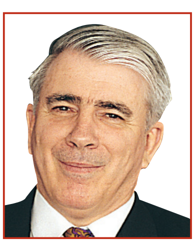

"For dentists to hold onto their practices in retirement and reduce their clinical involvement to zero, the results are likely to prove catastrophic..."

Buying and selling dental practices is a subject near and dear to most dentists' hearts, but too many seminars and utterances have been strewn with misinformation. This articles deals with common misconceptions and applies to contemporary dental practice sales.

Common fallacy #1

This goes along the lines of *dental practices are worth a fixed percentage of fees in respect of their goodwill.*

Fact: Looked at in terms of actual sales, there is a huge spread. In each case, all other things being equal, then:

- A practice in a desirable suburb of a capital city will be worth more than a similar practice in an unpopular suburb;
- A practice in a major capital, such as Melbourne, Sydney, Brisbane or Perth, will sell for more than one in a smaller capital such as Darwin or Hobart;
- A capital city practice will fetch more than one located in a regional city;
- A regional city practice will be worth more than one in a smaller town. The fact that regional cities have substantial hospitals and a mixture of public and private schools, visiting medical and dental specialists, etc, makes them more attractive to other professionals, including dentists;
- A practice situated in a single location will be worth more than one with similar fees but spread over multiple locations;
- A practice in suitable premises with either a long lease or with a purchase option will be worth more than one where the premises are either unsuitable or are unavailable for a long lease or purchase; and
- A practice in suitable premises with economical rent will be worth more than one in similar premises with much higher rent. Since rent is a fixed cost, varying it has an immediate effect on profitability and value. Some practices are virtually unsaleable in situ because of exorbitant rent. In such cases, all the owner can do is wait until near the end of a lease period and then offer to sell the patients to some other practice nearby, usually at a much lower value than the sale price of similar size practices in the general vicinity, with reasonable lease occupancy conditions.

Common fallacy #2

Practices sell for a set multiple of profit.

Fact: Practices sell for significantly different multiples of profit subject to location and other attributes. There is also a significant difference between sales to corporates, with their stringent conditions, and sales to other dentists.

It is important to observe that definitions of profit differ widely. If you ask three accountants to define dental profit, the chances are that they will come up with three different answers. Does profit mean your gross dental profit or your operating profit or your net profit after the owner and perhaps spouse's salaries and superannuation have been paid? Is profit before or after add-backs or personal expense items and in turn these items require careful examination against a database to ensure that the amounts added back are based on reality.

By some definitions, EBDIT (earnings before depreciation, interest and taxes) is treated as though it were profit, but EBDIT needs careful definition as well. When valuing practices, it is critical to adopt a consistent approach to valuation, consistent definitions of dental opportunity cost and a consistent approach to defining EBDIT. Only by arriving at a consistently accurate dental EBDIT and dental opportunity cost calculations, can we arrive at figures which can have a relative consistency.

Choosing capitalisation rates

Here, it's necessary to refer back to our earlier discussion of the relative attractiveness of practices. Practice location, as well as other attributes including suitability of premises, duration of premises lease, the nature of the work done in a practice and the consistency of its results over a period of several years all have a bearing on capitalisation rate. It's also necessary to dig deeper into profits to define whether some of the profit is temporary in nature, for example practices which have done a fair amount of work on the CDDS might have unsustainable profits arising from the 2012 and first half of 2013 financial years, while the cessation of that scheme will change profitability going forward.

Fixing your practice prior to sale

Most dentists contemplating selling their practices are locked into their existing location because of lease obligations or because the cost of relocation of a practice is so high. There are other issues which need to be identified and fixed if a seller hopes to achieve a sale of their practice at a good price.

It is important to have your practice benchmarked at least 18 months before probable sale in order that you can identify and correct the negative aspects. My experience is that most dentists don't make up their mind to sell a practice until about the last eighteen months of their career. By having the practice benchmarked, you can identify the relative efficiency of your practice compared with an accurate and very broad database of other dental practices and identify issues such as whether your non-professional staffing costs are badly out of alignment with the practice or, alternatively, whether your fee schedules have been allowed to erode to too low a point relative to other practices. There are other observations which come out of a benchmarking exercise. Having your practice benchmarked and identifying other issues which need to be in your mind prior to selling enable you to get the practice into good shape and presentation.

It will be important to the buyer of the practice that they look at a practice which is performing. This means that there is particular emphasis on the annual financial results leading up to sale and the post 30 June results for the current financial year, as measured by practice bankings and patient bookings.

While a well-located practice in inner city Melbourne will still fetch considerably more for equivalent profitability than would a practice located in Gunnedah, Penola or Goondiwindi, it is also true that in each case, the potential vendor wants to maximise the saleability of their practice and the potential practice buyer wants to buy a practice that is performing well, and which won't take a considerable period of time to rectify shortcomings.

Practice valuation prerequisites

Sellers need to ensure that valuations used to set their price or as evidence of value to put before buyers come from experienced and well-informed practice valuers. Valuers who don't have a large database of previous practice valuations or don't have a significant number of actual contracts of sale of dental practices on file, or who don't have an up-to-date database of practice financial performance against which to compare the financials of the practice being valued are likely to make significant errors.

Specific knowledge of dental practice is vital

While some valuers have experience in valuing newsagents or pharmacies, that does not carry over to dentistry. Associated with every profession and every industry are particular people who have expertise in that particular type of business or practice. Having the industry-specific knowledge required to value dissimilar businesses does not carry across into dentistry. Nor does having the ability to value dental or veterinary practices equip a valuer to value business consultancies or bakeries. Specific knowledge is required.

Recent practice performance important to buyers

Buyers want to know how the practice has performed in the most recent financial year and in the months and weeks leading up to the sale. Buyers should be wary of 'blue sky and roses' type practice valuations which project growth in fees and profitability at an annual percentile rate well above the rate of inflation. These types of valuations are misleading.

A common mistake

It is a mistake to forward either dental financials or valuation data to a buyer who hasn't inspected the practice. Buyers who take the trouble to inspect a practice are far more likely to become purchasers. Those who receive information in the mail invariably try to pick holes in the information without inspecting the practice and almost never buy. Visiting a practice, seeing and touching the equipment, viewing it firsthand, seeing parking and access, reception area and looking at current practice bookings with the owner are essential steps for the buyer. They also make the buyer begin to visualise whether or not they would fit into the practice.

Don't get equipment valued separately

The correct valuation technique used right across the business world is to value a business based upon its outputs. In the case of dental practices, this means its fee outputs and its profitability as defined. Consultants who value equipment in isolation and then attach some arbitrary percentage of fees as representing a goodwill valuation are failing in their examination of the financial outputs of the practice. It is necessary to view practice financials against the backdrop of dental practice database performance to determine its relative profitability and if it is insufficiently profitable, identify what the causes are.

It's also necessary to know the values and sales of practices of similar size and practices in roughly equivalent locations.

In the business world, no sensible buyer pays a significantly higher price for a business which has a lot more equipment than it needs to operate. Buyers are unlikely to pay a premium because your practice has a lot of stuff. If it requires three equipped surgeries to treat the patient base, buyers are unlikely to pay a lot more because it has two extra surgeries which are unused and which attract higher rent.

A second problem with people valuing equipment is that there is no discernible basis for the numbers they put down. The only time dentists buy a whole practice suite of secondhand equipment is when they purchase a practice. At other times, they replace individual items on an as-needs basis. Some functioning items of equipment in a practice can be many years old but still be useful, while other items which seemed like a good idea at the time have been found to have little use and sit on a shelf even though they cost a lot of money.

To the extent that some secondhand items of dental equipment have a market, the question arises as to whether the price a valuer puts down is that which a secondhand dealer would charge a dentist for the item, or that which they would purchase a secondhand item for from a vendor. There is a large gap between the two because secondhand dealers have to have a large margin to cover their cost of carrying stock for long periods of time and the risk that some stock may in fact not be on-saleable. Looking at the 'buy it now' price of a used CEREC machine on eBay only tells us the price that the seller wants, not whether it will sell at that price. The taxation concession for people buying new equipment as a result of the response to the global financial crisis meant that for a specific period, dentists were able to write off half the purchase price of significant new items of equipment in year one as well as the normal depreciation charge. As a result, many dentists significantly re-equipped their practices. The flow-on effect was to render still usable but discarded dental equipment to the scrap heap as having little value. In a market where dentists could gain a 50% immediate taxation deduction for buying a new item of equipment, there was little interest in buying secondhand items.

The business of a dental practice consists of a combination of goodwill attached to its active client list of patients and the equipment, furniture, fixtures and fittings needed to service those patients. In charging patients for dental services rendered, dental invoices do not differentiate between charges for goodwill and charges for use of equipment and patients would feel it strange if they did.

Why create a tax liability?

From the viewpoint of a dentist selling a practice, having equipment valued separately usually creates a substantial tax liability because the equipment is usually valued at significantly more than the depreciated value. Conversely, had the vendor charged the depreciated value of the equipment and charged the remainder of the proprietorship value as goodwill, they would have had better taxation outcomes; particularly if the goodwill was purchased prior to 20 September 1985 or if the sale of goodwill met the active business asset guidelines applying to the sale of small businesses.

The additional tax associated with selling equipment and goodwill at separate valuations can be substantial; perhaps $50,000 or more depending on the values.

Corporate price vs sale to another dentist

Dental corporates buy some practices, but they have rigorous criteria. The corporate requires a high level of profitability because of the way in which they structure their finances and balance sheets. They find high-end practices which do a large amount of cosmetic dentistry particularly attractive, whereas some dentists prefer not to overindulge in this type of work. Corporates also require the vendor dentist to work for them for a substantial period of time, typically for five years, on a demanding contract requiring them to achieve specific fee and profitability outcomes year by year. If they fail to meet these obligations, they can forfeit the deferred element of their practice sale price. In effect, corporates pay above the odds for goodwill, which appears as a capital asset on their balance sheet and during the period of employing the vendor dentist as lead dentist in the practice, they pay a salary far below that which the dentist was earning prior to the sale, which in effect pays them for the dental work they do but not for the managerial direction of the practice. What the corporates are doing is gaming the tax system, but there are only certain styles of practices which enable them to do it.

A dentist who sells their practice to another dentist on a straightforward contract with a limited handover period and with the buyer assuming responsibility for the financial outcomes of the practice from date of settlement, is engaging in quite a different deal with far less responsibility. The result is that the prices paid by corporates are and should be much higher than the prices paid in dentist to dentist transactions.

In the long run, there will always be privately owned dental practices, because no matter how hard corporates try they cannot buy equipment which will enable a dentist to use two drills simultaneously. Hence corporates will always be vulnerable to competition from privately owned practices.

Practice transactions from a buyer's perspective

The dentist buying the practice has to be satisfied that they are getting fair value and they will often employ an adviser to examine the practice and confirm or correct the vendor's asking price. The buyers should insist on a good handover, including having the vendor work in the practice for a suitable time, usually on a declining days per week or days per month basis. The buyers will also insist on the vendor leaving their nameplate on the practice for an agreed time.

The buyer will not be announcing the purchase but will be 'joining' the practice and the contract will require the vendor not to write to patients advising that they have sold. The buyer and the contract will expect the vendor to use their best endeavours to promote the buyer to patients as a competent dental clinician and to introduce members of important patient family groups to them if the opportunity presents. The buyer will be keen to have suitable conditions in the premises lease, both in respect of the overall rent and to have a good period of lease and lease renewal options. The buyer would be examining the lease and the practice financials to ensure that the rent that they are paying is broadly commensurate with practices of similar size. If the rent is much higher than normal, the buyer would be expecting the practice price to reflect this additional cost. There may be a variety of other conditions.

Don't continue practice ownership in retirement

Holding onto practice ownership in retirement is likely to prove to be a big mistake. Dentists selling their practices do so because their energy and ability to generate good fees has passed its zenith. They realise that once the enjoyment of practice that they once had has become a drudge, it's time to sell. We have long observed that dentists who reduce their clinical activity below four surgical days per week consistently see their practice gross fees and profitability decline substantially. Staff see a dentist who has reduced to a three-day week as being a boss who is less committed and once this occurs, inefficiencies begin to occur across the practice. This will be particularly so on the days when the owner is not in the practice.

For dentists to hold onto their practices in retirement and reduce their clinical involvement to zero, the results are likely to prove catastrophic.

We need to ask what occurs if a couple of years after retirement, with possibly declining health and having ceased registration and indemnity insurance, key staff suddenly leave the practice. It's a pretty horrible thought, because the dentist concerned is not going to go through the necessary steps to become re-engaged in practice and is faced with the urgent sale of a de-valued practice.

Overwhelmingly, dentists accept that if planning retirement they should sell their practices. It's better for an owner dentist to sell a practice a bit too soon rather than leave it to a point where personal fees, health and overall practice profitability are in decline.

It's also better that the buyer takes over the practice at near peak output than a year or two after patients have begun to walk in large numbers.

It's very difficult to disguise from buyers that a practice has gone into a significant decline.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 25 years, the last 18 as a 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 Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking and 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 the Synstrat Guide to Practice Management, 50 Rules of Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is also a long-term contributor to Australasian Dental Practice. 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. For more info, call (03) 9843-7777,see www.synstrat.com.au or email dental@synstrat.com.au