

By **GRAHAM MIDDLETON, BA, MBA, AFAIM**

Dental Practice Valuations – Facts and Fantasies

Every dentist would like to think they can walk away with a large bag of gold when they sell their practice. The realities often differ. At Synstrat we have been valuing dental practices for many years, as well as observing the purchase and sales of practices by dentists who utilise Synstrat Accounting Pty Ltd as their accountants. Many of the actual sale contracts end up in the records of our clients. There are also a multitude of general enquiries and discussions about potential transactions which might not get to contract.

Myth Number 1

This myth is that if a practice carries out lots of advanced techniques, including expensive restoration or cosmetic dentistry, that it will be highly sought after and worth more. However, it is often the case that if fees are being pushed to the absolute edge, or if the practice has relied heavily on the charismatic selling technique of an exceptional proprietor, or if some of the procedures are beyond the capacity of most younger dentists, that the market for such a practice may be quite limited. Proprietors of such practices are often disappointed.

Myth Number 2

This is the belief that the best practices are located in attractive inner suburbs or CBD locations of major capital cities. In truth, there are many outstanding practices in regional centres and outer suburban areas, while a relatively small proportion of CBD and close to CBD practices are as profitable. Where a CBD practice has insufficient patients, it can be much more difficult for it to build up numbers than for a practice in the outer suburbs or in the country.

Myth Number 3

Other accounting practices and dentists often ring Synstrat and enquire as to “the formula for valuing dental practices”. The reality is that each practice has characteristics that make it more or less unique. These characteristics make a practice more or less saleable, and hence reflect the likely prices that a dentist will pay. We have to take into account many factors including gross fees, practice efficiency, practice profitability, the suitability of premises, practice location, and the nature of treatments of the particular practice as well as whether or not a practice is a health fund preferred provider. This list is not exhaustive. Some practices will sell readily for a significant proportion of gross fees, whilst others are a drag on the market. A practice in the Hills District of Sydney is likely to sell for a much higher proportion of gross fees than one in Broken Hill, all other things being equal.

Large Associateships Versus Simplicity

In dentistry there is a premium for simplicity. Large complex dental associateships with four or five associate’s practitioners plus four or five employed dentists and two or three hygienists as well as a substantial number of support staff and the practice manager are usually less efficient when you drill down to the facts. They can also imprison associates in a complex business relationship and can make decision making extremely difficult when

major decisions like moving to another premises or contracting for substantial renovations or setting fee schedules are discussed.

Health Fund Preferred Provider Practices

Over time, practices which derive a substantial portion of their fee base through being a preferred provider to a major health fund are going to lose their goodwill value. This goodwill value gets transferred to the health funds that often profit from dental ancillary cover and use it to cross subsidise hospital cover. Because of the imperative of health funds to control dental fees and the difficulties dentists face in withdrawing from preferred provider schemes once their practice has been embedded, it is a fact that potential practice buyers are increasingly shunning such practices.

Synstrat is also aware of an instance where a health fund refused to transfer the preferred provider arrangement to a potential practice buyer because the health fund wished to transfer it to another dentist, who coincidentally had a second practice in a suburb where the health fund was not represented by a dentist. There appears to be no guarantee that health funds will respect the dentist's patient base. Synstrat's advice to dentists is that if they wish to wreck the potential future sale price of their practice, they risk doing so by becoming a preferred provider to a health fund.

Country Practices

These are generally more profitable and offer the ready availability of cheaper premises, but they are less popular than inner city practices in Sydney, Melbourne, Brisbane, Adelaide or Perth. However, it is wrong to think that they have no value. We have witnessed a steady stream of country practices bought and sold, but sometimes the sale takes much longer than would be expected of a well located capital city practice.

For younger dentists with limited resources, buying a country practice and working it efficiently is a fast track towards maximising potential dental income.

This lesson also applies to the smaller capital cities that do not have their own dental schools including Hobart and Darwin.

Marital Breakdown and Practice Value

Often the non dental partner assumes that the practice has an inflated value, whilst the dental partner points out all of the reasons why their particular practice is not worth much at all. Not surprisingly, the truth invariably lies between the two opposing views.

These days, the family courts have adopted the process of requiring the two parties to jointly engage an expert to value the matter outside of the court. Stripping away the emotion and taking a thorough look at the practice financials, number of dentists and hygienists employed and the conditions therein, security of tenure of the premises, location, parking and whether or not the practice has a speciality component; all have a significant bearing on the value. Often both parties have started out with a rigid view, but there is no substitute for getting the valuation done by somebody who has valued a multitude of practices.

Peculiarly, there is a widespread belief that all accountants are qualified to value dental practices. This is quite untrue. The actual truth is that in every profession or industry, there are a tiny group of consultants and accountants who have built up lots of knowledge of that particular profession over a long period and whose work is authoritative. Asking somebody whose client base consists of a range of unrelated businesses to value a dental practice, is a bit like asking a farrier to provide endodontic treatment to a human being.

In the situation where a practice has been valued for the parties jointly and the valuation demonstrates knowledge of dental practice value, it is usually the case that settlement is hastened.

In situations where the parties are entrenched in their attitudes towards each other and towards processes involving clarification of asset values, it is often the case that disputation is prolonged by an argument over choice of valuer. In these circumstances, there is little choice but for one of the parties to proceed to get a well rounded valuation. The other party will invariably shop for a valuer, and at some stage, legal processes will determine a joint arbiter who will decide between the valuations. Invariably, an independent third party will come down on the side of the valuation which has demonstrated significant knowledge about dental practice.

At the end of the day, the whole process is designed to get to a value which is as close as possible to the value the practice would fetch if exposed to an orderly market for a reasonable period of time and a normal amount of negotiation between potential buyers and vendor occurred.

Complex Premises

The best situations occur where the selling dentist has suitable premises which they are also prepared to sell to the purchaser of the practice at a fair price. The worst situations are where a large practice occupies several adjoining strata titles with separate owners and the lease periods do not coincide. Each separate landlord uses their leverage to force up the rents on the practice at review time. In order to relocate to a better situation, a practice has to pay at least one landlord a significant sum as compensation for breaking a lease as well as undertaking expensive relocation. These situations have a significant impact on practice saleability, and hence, practice value.

Internal Tension

Nobody buys into a hostile partnership or a hostile associateship. The buyer of a dental associateship is negotiating two things:

1. They are negotiating their working arrangements with the continuing associate(s). Whilst there may have been a pre-existing agreement, it is foolish to simply assume that it will carry on. Rather, the potential incoming dentist should go through the working relationship issues very carefully with the continuing partners, in order that they are comfortable with the way the practice will be run after they join. Those who sign off a purchase without being happy with these arrangements usually find it practically impossible to make changes the day after they have bought in.

2. The purchase agreement from the retiring associate should only be signed after the practice buyer is satisfied with the working relationships with continuing associate(s). Complex arrangements in an associateship inevitably deter buyers and have a negative impact on practice value.

Dental associates who squabble amongst themselves need to be aware that if not resolved quickly, internal tension in a practice can render it unsaleable.

Dental Associateship Versus Dental Partnership

In dentistry, associateships are far more common than straight partnerships. Dentistry differs from many other professions whose practice conditions favour partnerships. However, we are aware of some healthy partnerships within dentistry.

Buying into a Chain of Practices

The situation of buying shares in a large chain of practices and working in that chain as a dentist is likely to have little appeal to most dentists' long term. There is too much risk of future changes to the corporate strategy, which impacts on the individual dentist who holds a minority shareholding. We deal with many dentists, and we see no evidence that dentists are clamouring to get into such arrangements. Of course, there will always be the odd dentist from whom the corporate operator might offer to purchase practices as a buyer of last resort facility and contract them to work for a limited period until retirement.

We also view such chains as being high risk investments. Therefore, we would strongly advise any dentist selling a practice into them to insist on being paid in cash, and not accept share scrip. There are many dismal outcomes spread across a range of professions where practices have been consolidated in Australia. Those who ignore history are doomed to repeat it. Inevitably, there will be periodic attempts to capture practices in this manner. Some of these practices may have promising beginnings as listed entities. However, so did some of the past failures in other professional consolidations in accounting and medicine. There is also the dismal example of Pearl Healthcare Limited, which consolidated a number of dental laboratories, and whose share price has recently been under 5 cents. In respect of dental consolidations, we would anticipate that there is strong risk of companies which have been carefully prepared for listing on the stock market to be in a worse state a couple of years after listing.

We have observed periodic attempts to corporatise medical, dental, veterinary, accounting and other professional practices. If recent history is any guide, we expect attempts to continue, but we do not anticipate any of the organisations involved having significant success long term.

Practices with Multiple Locations

We are yet to see a dental practice which utilises multiple locations which is even nearly as efficient as the better single location practices.

Size and Efficiency

Practices of any significant size require much more management. Usually, this manifests itself in at least one layer of additional management in the form of a practice manager often supported by a bookkeeper and generous staffing at the reception desk. Our widespread observation indicates that many practice managers are “profit destroyers”. Practice managers often lead to additional staffing costs because they have a tendency to add a few hours employee time amongst chairside assistants and receptionists to ensure that they personally don’t get “pinned” to help out in those roles in busy times.

Dentists buying into large practices need to tread warily. If you make a mistake, it may prove difficult, if not impossible to sell out quickly without making a substantial loss. The reality is that it can be quite frustrating trying to wring efficiency out of your investment in a complex practice due to the fact that such practices tend to turn many variable costs into fixed overheads for the individual associate.

Improving Practice Saleability

Many older dentists have a tendency to curtail the investment in their practice and let other aspects of practice management slip. Unfortunately they are often the last to realise that value in their practice is draining away. While many of these types of practices have untapped potential in the hands of the right buyer, this is sometimes not recognised by potential buyers. If, as is likely, the potential purchaser takes advice from an accountant who is not well versed in dental practices, it is often the case of their being advised against a purchase which may in fact have been their best option since often these type of practices have significant untapped potential. These situations are a tragedy for both vendors and purchasers.

If selling your practice, the time to get proper advice about it is several years in advance of the event. If left too late, there is a danger of a large decline in fees. Timing is important, as is a proper business plan during the last few years of ownership.

Supply and Demand for Dental Practices

If there are many buyers and few sellers of practices in a particular location or type of locations, then practice values are bid up. If there are a number of sellers and few buyers, prices decline. If the population per dentist rises, then the profitability of practices should increase, but not necessarily the value of practices because demand for dental services and demand for dental practices by dental buyers are quite different. Where the ratio of the population to dentists is too small, practices tend to be less profitable and less saleable. Where there is a healthy balance between the population and the number of dentists, dental practice sales can occur at good prices. Where there is too high a population per dentist, practice prices again tend to decline because other dentists can set up new practices in the knowledge that they will be able to secure patients.

Buying Versus Start Up

Unless patient demand is badly skewed, most dentists prefer the security of buying a practice and securing a flow of patients immediately. If a practice is badly run down, then a proper business plan will include the necessary

expenditure on renovation and equipment. In reality, there are few bargains to be had in the market.

Where a practice start up is contemplated, then considerable expenditure is required. In a consumer aware society, patients would expect the new dentist practice to be presented to them properly furnished and equipped.

Tips for Buyers

Emerging patient demand for dental services in Australia is such that it is likely to favour practice buyers over sellers in the majority of cases. From a buyer's perspective, there is no substitute for doing your homework. It pays to remember that advertised lists of practices for sale are going to contain most of the practices that nobody else wants to buy. An agent listing practices for sale has the same difficulty in advising on the value as does a real estate agent who notoriously gives the vendor a higher indication of price and the potential purchaser a lower indication in the hope of luring them to an auction. The agent hopes through the auction process or negotiations thereafter to draw the parties together with both making a significant compromise. In this way, the agents earn their commission, but often both buyers and sellers are dissatisfied with the process.

The lesson is that you can't be both a seller of practices and an objective valuer and adviser. At Synstrat, we are valuers and professional advisers to dentists, but we do not act as agents for practice sales, as that would destroy our objectivity.

Buyers relying on accountants to assist in valuation should take particular care to ask whether the particular accountant has other dental clients, and how many. Ask how many practices they have valued, and what the profitability of a good practice should be. If you get vague or inconclusive answers, then you have the wrong person. Similarly if the accountant says something along the lines of "*all businesses are similar*" this should be treated as an alarm signal. There are sound economic reasons why profit ratios and valuation multiples vary enormously across a wide spectrum of industries.

We have built up a constantly updating database of dental practice performance as well as a large stock of practice valuation and practice sale price history, precisely because we found that there was no publicly available information source concerning dental practice performance or practice value with data that we could trust.

Many dentists have walked blindly into new practices not realising that the person who advised them was comparing the financial conditions of the dental practice with the outcomes of a post office or a bread shop. The knowledge of business consultants, advisers and accountants is a reflection of the client base that they deal with.

Advice to my Son or Daughter

If, hypothetically, one of my sons or my daughter were a dentist I would be advising them to take a lot of time looking for a practice to buy and to be prepared to consider buying a country, regional or outer suburban practice where the supply of patients per dentist is above average. I would be advising them to seek locations with affordable premises, but with an appropriate socio

economic grouping in the population. They would be prepared to make offers on slightly run down practices with a healthy patient base. They would be advised to give priority to a solo proprietorship or perhaps dual associateship in preference to buying into large complex practices. I would advise them against corporate share arrangements and against buying dental practices located in medical centres and be cautious in respect of practices which are tenants in large shopping centres. Naturally I acknowledge the occasional exception. I would advise them against complex buy in arrangements or contracts of employment and purchase spread over several years. These tend to be drawn up in favour of the vendor over the purchaser. Naturally I would pull the financials apart and advise a realistic value, be anxious to advise in respect of immediate capital investment in the practice and to construct a realistic budget and business plan.

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