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Can Corporate Disasters Engulf Dentistry?

A string of failures by companies which consolidated various types of professional practices highlight significant potential dangers for dentists.

A General Outline of the Schemes

Promoters wishing to get rich quick look around for a group of businesses or professional practices which have not yet been consolidated. The promoters then form a company with significant shareholding allocated to themselves at nominal cost before approaching the target practice or business owners concerned hinting that they wish to buy their practices at a healthy price. Usually no specific price is mentioned at this juncture, and the offers are careful to avoid any mention of cash. After a lot of smooth talking, the actual offer turns out to be a mixture of cash and share scrip (mostly share scrip). The practice owners dreaming of wealth sign a contract which is to be executed on the day after the initial public listing of the company concerned. The promoter then spins together a prospectus complete with pro-forma accounts suggesting healthy profits and the float is sold through a stock broking house. The pro-forma accounts do not take into account the changed behaviour and management problems introduced by consolidation. Unfortunately for the practice owners, the share scrip they receive is placed in Escrow for 12 months during which time they cannot sell, and therefore the actual price they receive for their practice is at the mercy of the stock market. Since the promoters invariably issued themselves a large number of shares at nominal cost, they expect to make substantial money regardless as to whether the share price of the company stays steady, rises or falls. For example - a company issues its promoter's 10 million shares at 0.1 cents each ($10,000 total). With that capital, they offer to buy dental practices with a theoretical value of $15 million on the basis of $10 million of share scrip (issued at $1 each) and $5 million of cash.

The day after the float, the company's share register has 25 million shares, being 10 million issued to promoter's for $10,000, 10 million issued to former practice owners at theoretical value of $10 million, and 5 million issued to the public at $5 million. The $5 million received has been paid to the practice owners and the company's balance sheet now has cash of $10,000 to spend and a theoretical asset backing of 60.04 cents per share is already looking a bit jaded, but in actual fact because the price paid to the practitioners was jacked up to get them over the line, the goodwill component on the balance sheet is inflated.

If in one year's time, with luck, the shareprice is 50 cents (only 50 percent down on IPO cost); the promoter's still have $5 million worth of shares for which they only paid $10,000. They are well ahead. The public who subscribed to shares are down by 50 percent and the dentists who thought they got good value for their practice are beginning to rethink. As their shares come out of Escrow, they ring their share brokers to sell and quickly find that there are hardly any buyers at the recent price. They then instruct their brokers to sell and find that the share price immediately falls to 27 cents. They only manage to sell a few at 50 cents, and actually average 30 cents. For simplicity, IPO related costs have not been included.

Management Failure of Consolidated Companies

Recent history indicates that forming the company and buying the practices is the easy part while actually running a consolidated group of a large number of professional practices of any kind is fraught with serious danger – particularly if they are spread over a large area of Australia. As a consequence, many individuals who have sold professional practice for scrip have seen the share price either fall disastrously during their period of Escrow, or worse still have seen the company go into liquidation and wipe out the value of their scrip entirely.

Are Accountants up to Giving Advice?

In numerous cases, individuals who have sold dental laboratories or medical practices received advice from accountants who didn't comprehend the shareholdings dilution which was occurring behind the scenes with the promoter's cheap shares, nor the dangers in trying to manage a consolidated practice. Indeed, three of the most spectacular failures have involved the consolidation of accountancy practices!

Failed Consolidations in Childcare and Dental Labs

At Synstrat, we have been advising dentists and veterinarians for many years, and in addition to the schemes that we have seen listed on the stock market, we have also alerted our clients to many other schemes which didn't get there because the faults in the scheme were advised to the professions concerned quite early in the piece.

- Several years back, the owners of a large number of childcare centres gave away nearly half their equity to the promoter's of a company which purchased their centres and then ran them disastrously.

- Many of the owners of dental laboratories, who sold into the Pearl Heathcare float, took much of the consideration in the form of share scrip whose value then melted down during the 12 months of Escrow. Pearl Healthcare continues to accumulate losses and has consolidated many of its labs. Perhaps its most recently appointed CEO might succeed in turning the business around. If so, it has a long way to go before it can absorb the accumulated losses and get its share price back to IPO price, i.e. from about 3 cents to 25 cents.

Failed Accountancy Consolidations

There have been three spectacular failures within the accountancy profession itself. Two of these, Harts Australasia Limited and Stockford Accounting Limited involved a consolidation of mainly medium sized general accounting practices. The third company, Knights Insolvency Limited, was a liquidation specialist. All three ended up in liquidation including the liquidation specialists! Curiously, a great many accountants couldn't see the dangers. My own experience of having The Synstrat Group approached by both Stockford Accounting and Harts Australasia, and knocking back participation in their consolidations, was that we were not able to comprehend how so many accountants believed that the concept could work. Needless to say, we quickly rejected both overtures. Harts Australasia went into liquidation at almost breathless speed, but Stockford Accounting had a long lingering decline. During this period, it continued to buy up other practices with as much scrip as possible, further diluting existing shareholders in the process. Each time they looked at another practice, its financials told them that the acquisition should be cash flow positive and profit positive. Subsequently, the partners of each acquired practice in turn who were now employees, discovered the merits of working normal hours rather than partner hours. They also stopped chasing new business and they were happy to let all management problems be passed on to Stockford's head office. Invariably they went from being profitable to unprofitable enterprises in a short period. As the group's wider decline became apparent, each former practice owner who was now a practice manager and holder of substantial Stockford scrip began to plot their own way out of the mess. There was no incentive for them to work hard for Stockford when approximately 99 percent of their efforts were going to go to others. Inevitably, Stockford Accounting ended up in liquidation, and the liquidator salvaged what little value he could by selling back the previously acquired practices to the former owners. In the meantime, most of the practices had lost many of their clients, and there was much damage caused in the process.

Knights Insolvency above all should have been aware of the risks because of the business it was in. However, it too ended up in insolvency, but not before its promoter's had managed to acquire a couple of significant payments along the way. Other share owners and creditors lost heavily.

In addition to the three failures of listing accounting practices, there were a host of schemes to get other accounting practices to consolidate. These schemes evaporated after the Harts and Stockford failures alerted the accounting professions of the dangers that they were in.

Failed Medical Practice Consolidations

Several years ago there was a rush of corporate buying of medical practices, including those purchased by Foundation Healthcare Limited. Foundation Healthcare's share price had a gradual slide towards oblivion, and the business was eventually subsumed into IPN Limited (Independent Practitioner Network). IPN's share price is itself dismal.

Attempts to Take over Veterinary Practices

At Synstrat, we have witnessed numerous attempts by a number of promoters to interest veterinary surgeons in selling their practices on the basis of scrip offers by dubious enterprises. The business plans of the various scheme promoters' were never very clear. The odd veterinarian had been burned, including a case of a veterinarian who sold 51 percent of his practice to a company which later sacked him and used its lawyers to force him to settle the remainder. The veterinarian concerned had been advised by his accountant to go into the arrangement! In any dispute between a wealthy entrepreneur with powerful lawyers and an individual relying on a contract, the odds favour the big money and the experienced lawyers. It is not only the wording of the contact that people need to be concerned about, but the relative bargaining power of the parties.

One lesson which is clear is that most accountants dealing with ordinary tax payers, small business and professional practices are used to a world in which the people they deal with have uncomplicated affairs. The majority are no match for the scheming of corporate sharks.

Will 1300 Smiles Limited Be Different?

Early this year we witnessed the listing of a company offering dental services known as 1300 Smiles Limited. At this stage, 1300 Smiles Limited seems to be doing a bit better than other corporate consolidations. Its share price is around $1.08 and it has announced a profit. We note that of the 18.25 million shares on issue, 15,787,539 are related to the promoter. 1300 Smiles operates in Townsville, with a branch in Cairns. Following the announcement of its 2005 results to the Australian Stock Exchange, we calculated its net asset backing at about 15 cents per share, which includes the goodwill of dental practices acquired.

Prior to listing, the company split 211,001 ordinary shares issued at $1, into 16 million ordinary shares (effectively issuing 16 million shares at 1.319 cents each). It then issued a further 1 million shares at 50 cents per share. At listing, it had 17 million shares against which a total of $711,001 had been subscribed. It then issued 1,250,000 shares at IPO at 80 cents each. Share splits and issues are of course legal. They illustrate what can happen in a company's balance sheet before its IPO. In the case of 1300 Smiles Limited, the number of shares issued in the IPO was in fact relatively modest.

1300 Smiles Limited's future intentions are unclear, but if hypothetically it is to go on the acquisition trail for more dental practices, then Synstrat's advice would be that dentists should insist on being paid in cash rather than accept the issue of new scrip as payment for their practices. Potentially we see a few business risks emerging:

1. An existing dynamic proprietor working in a practice in Townsville may be expected to have a strong hands on control of the enterprise, but if and when it expands beyond its present footprint, its management issues may then multiply, as occurred in Stockford Accounting, Harts Australasia, Pearl Healthcare, Foundation Healthcare, IPN etc.

2. The actual tangible assets supporting its balance sheet are modest.

3. Since listing, there has been scarce trading in 1300 Smiles Limited shares. In fact, often several business days go by without a single trade. This is a sign of an extremely thin market. Institutional and professional investors shun the shares of companies which are so thinly traded. The reason is that in a thin market, somebody wishing to sell even a modest couple of hundred thousand dollars worth of shares may find it near impossible without driving the share price, which they received for many of the shares, down substantially. It is difficult to see the share market retaining the existing share price if the principal were to sell the 15,787,539 shares owned by him. Indeed, it is probably that offering only a modest proportion of this number of shares to the market would drive the share price down dramatically given the existing level of trade.

Perhaps 1300 Smiles Limited's business plan will be successful long term, and if so, we predict that it will be on the basis of tight control of limited number of practices in a limited geographic zone, with high influence over dental pricing in Townsville and the gradual build up of shareholders equity through retention of earnings.

The Last Great Cottage Industry

The reality is that dental practice in Australia is the last great cottage industry. The numerous consolidation attempts of various professions indicate that running a horizontal consolidation of a large number of professional practices of any type spread over a large segment of Australia is dangerous and frequently ends in disaster. Nonetheless, stockmarket consolidation is one of the few ways in which somebody of modest capital but smooth tongue and quick brain can turn a negligible investment into capital of quite a few million dollars quickly. Hence these schemes will continue to be pumped out. A few may survive for a year or longer and a tiny few may turn out to be profitable in the long term, but only by extraordinary application of management and accepting severe limitations on where they can take the enterprise.

Until such time as technology can replace the actual dentists place in providing treatment, dentistry is going to remain a service which is most efficiently delivered in individual practices. Dentists approached to buy into large consolidated practice groups, whether listed or unlisted, or to sell their practices for scrip, must seek out experienced advice quickly.

Signs of a Great Con

Recently we came across a company writing letters to veterinary practices suggesting that they were interested in purchasing them. The letters hinted at good prices, but were silent as to the method of payment. When we did the company search, we found out that the company's share capital was only $10,000 divided into 10 million shares issued at 0.1 cents per share! Furthermore, we found that the majority of shares were held by offshore companies, several of them with addresses in Port Vila Vanuatu and one in Singapore! This masked the owners of the majority of shares in the company. Not only were the veterinary practitioners tantalised by hints of substantial offers for their practices, but they were being asked to deliver their financials to a group whose shareholders were disguised. For all they knew, the owners of the companies in Vanuatu could have been the major competing veterinary hospital down the road (indeed we would not be surprised if that was the case).

Some Lessons

1. If an offer looks too good to be true, it invariably is.

2. If the consideration for an offer is mainly in the form of scrip, don't believe the price.

3. Don't believe that the share price of a thinly traded stock can be obtained by the seller of a large amount of stock.

4. Don't provide any financial information to organisations unless you know who their owners are and on what basis they are proposing to deal with you.

5. In the long term, dentists who get the best out of their practices will be those who concentrate on running them profitably, and making their money from the provision of dental treatment rather than hoping for a capital gain to materialise from a mysterious buyer.

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