Dental practice strategies

By Graham Middleton, BA, MBA

"Very few people casually walk into a dental practice and make an appointment in the same way they would walk into a shop and buy a product on sale..."

Various sources indicate that corporatisation of dental practices represent about 8% to 9% of dental practice capacity in Australia, which is much lower than in the United States and certainly far lower than was predicted by early movers in Australian corporatisation. I have been privileged to provide advice to dentists for 32 years and have watched as many dentists' financial wellbeing has evolved. This has provided a clear model from which to judge what has made many dentists successful while others have done silly things and struggled.

Sale of practices

Some aging dentists have achieved significant amounts from corporates for their practices and it made sense because they were close to retirement, but still had sufficient work left in them to satisfy a corporate earn-out requirement. The corresponding situation for most younger dental practice owners is that sale to a dental corporate often generates a poor outcome when considered in an overall financial context. Nor are the experiences of dentists working for corporates during the contractual earn-out phase universally happy ones. Nor do dentists necessarily find that they are working for whom they expected to work. Dentists who sold to Dental Corporation who were strong individuals who had rejected preferred provider arrangements for their practices found that the company was on-sold to Fortis Global which in turn was on-sold to BUPA, a health fund!

Dentists who sold to Dental Partners found that the company was sold to a New Zealand company, Abano, which has since rebadged Australian practices under the Maven banner. It has recently ceased buying practices in Australia due to disappointing outcomes.

1300 Smiles Limited, in contrast to the others, has followed a cautious strategy and bought relatively few practices, most of which have been sound acquisitions.

Pacific Smiles has been closely tied to health fund NIB and appears to be well over its period of actively seeking acquisitions, preferring instead to open an occasional badged practice.

Ekera has learnt from its experience and tightened its practice selection criteria, probably realising that there were significant pitfalls in paying too much for practices overly dependent on an individual dentist.

The acquisition of 52 practices by Smiles Inclusive Limited, which subsequently grew to 56, and their subsequent operation has proven to be disastrous thus far. The fact that those original 52 practices were touted as having 61 chairs which were claimed to be totally vacant and available for new patients indicated that, in fact, many of the practices acquired were in a rundown state. Subsequent announcements to the Australian Securities Exchange concerning legal difficulties, breach of banking covenants, disputes between directors past and present and financial losses have seen the share price plummet. It is unlikely that anybody who was persuaded to buy its shares at $1 in the initial public offer through share broker Morgans will recover their losses anytime soon, if ever.

Optimum dental strategy #1

Harry, a dentist, married to Angeline, a school teacher, bought an associateship in a three associate dental group when about seven years out of dental school. He retained ownership for 30 years before selling to a dentist jointly employed by the associates. In Harry's case, there was no chance that the other associates of significantly different ages were minded to sell to a corporate. However, he achieved a fair price for his equity in the practice and premises, worked for the associates for a short period and retired.

Along the way, Angeline had helped Harry with bookkeeping and within the tax guidelines, he employed her part-time and topped up her superannuation from school teaching.

Harry had maintained debt on the practice and his share of the premises long-term, periodically renewing it on an interest only basis and over the years, the net after tax cost of his debt was below the non-tax deductable debt repayments on his home loan and well below the average performance of their superannuation fund. Harry and Angeline's joint debt was maintained on a safe ratio, well below one-third of their assets, on a long term basis. Harry and Angeline paid off their home at a sensible rate but did not do so at the expense of making realistic superannuation payments. In addition to their tax deductable amounts of superannuation allowed over various superannuation changes through the years, Harry and Angeline had been able to make "non-concessional" (i.e. non-tax deductable) superannuation payments to build their fund.

As the value of their superannuation fund increased, the debt on their home diminished. The home itself grew in value, as did the value of the practice and premises and as a result, their overall asset to debt ratio significantly improved.

At the time of the sale of his dental associateship and sale of their part of the premises, Harry and Angeline were able to access the small business capital gains tax concessions and topped up their superannuation fund, as well as paying out residual debt, which by retirement, was a tiny proportion of the overall value of their assets. These days, Harry and Angeline enjoy a great retirement with a large superannuation fund separately invested, a nice home and spare cash that couldn't be squeezed into their superannuation fund, invested. Their superannuation fund is significantly larger than the joint pension accounts of $1.6 million each and hence, they also have additional accumulation accounts in their fund.

Their situation compares favourably to that of some dentists who sold to corporates at an earlier age and gave up significant elements of their tax planning opportunities, including splitting income and superannuation payments with a spouse.

These days, while some aspects of our tax regime are harder for dentists, in other ways they have opened up opportunities. A critical element of dentist planning is to set out at an early age to achieve the small business capital gains tax concessions on their eventual retirement. This is not as simple as it sounds and requires specialised advice and structuring of assets and debt from an early stage.

Optimum dental strategy #2

Derek, who was married to Karen, bought a small solo dental practice about 25 years ago and wondered whether he had acquired a lemon, albeit that it had sufficient patients to fill about three days out of five. On seeking advice, it was discovered that the practice had no toilet facility and patients had to use facilities up the laneway out the back door. He was advised that as space was available, he should add a facility and even though he didn't own the premises, he should treat the cost as a marketing cost. While he was at it, he should have his practice professionally painted. He also had a professional signwriter do his signage. All of this was helped by his chair-side manner and the personality of his receptionist. Almost immediately, patients starting referring family and friends and his practice achieved a pleasing profit level. Even though his practice had two other competing practices within a short distance, Derek thrived. His practice was located in an area where incomes were a bit above average and his practice was now better presented than those of his nearby competitors. Derek refused to become a preferred provider and it was evident that his patients enjoyed his style of laconic communication.

Along the way, his landlord offered to sell him the premises at a relatively stiff price, but Derek bought it in order to maintain control over his practice. In due course, this enabled him to achieve a good sale price for his practice and premises. Derek had upgraded his first home into his second, long-term family home, the debt of which had been paid off and he and his wife have an impressive superannuation fund of about $4.2 million as well as other assets. He too has taken advantage of the small business capital gains tax concessions on the sale of practice and premises. Derek and his wife have moved to an alternate coastal location to enjoy a happy retirement. His practice was always the type of practice which would be much more attractive to a good solo dentist than to a corporate; nor was Derek the type of person that would have been happiest in a corporate culture.

Optimum veterinary and dental strategy #3 - The Toorak cash poor v the Clayton cash rich

A now long retired veterinary client of mine had once been involved in a veterinary partnership in Toorak, regarded as the most expensive suburb in Melbourne. They had struggled to survive and their partnership had ended. Some years later, on becoming a client, he purchased a small veterinary practice in the Melbourne suburb of Clayton, which was a working class area and thrived. He drew my attention to the parable of the Toorak poor. In Toorak, lots of people lived in hugely expensive houses with large mortgages. They often had two expensive European cars acquired on leasing finance and it was quite normal for them to have their children in expensive private schools, basically because all their neighbours lived in expensive houses, drove expensive European cars and had their children in expensive private schools. The result had been that not only did lots of the Toorak people not own pets, but those who did, were reluctant to spend money on them.

Years later in Clayton, my client thrived. He noticed that a typical household in Clayton was a two-income house with perhaps a tradie married to a secretary or fairly similar income occupations, their children went to the local state school, their house mortgage was modest and they drove Holdens or Falcons. If their dog got hit by a car and required expensive spinal surgery, they had no hesitation in paying for it. His experience was that the people in Clayton were cash rich whereas the Toorak people were cash poor.

Recently, we valued a dental practice in a well-established working class suburb of Sydney. The practice had three partners including one almost retired, five dental chairs and lots of clients of many years standing. It was long-established and while lots of new dental practices had opened up nearby, the established clients of the practice had stayed loyal. Importantly, those long-established clients were most likely to be the inhabitants of the suburbs whose house mortgages had been paid off or paid down to a low level so they too had good household cash flow. Overwhelmingly, they stayed loyal to the dentists who had refused to be preferred providers. The owners of the practice indicated that while some patients were diverted by a health fund, invariably, lots of them came back after inferior experiences elsewhere. Many existing patients referred in their family and friends and because people tend to associate with people of similar age and assets, their practice had stayed quite profitable. Indeed, measured on a classic DEBDIT (Dental Earnings Before Depreciation, Interest and Taxes) assessment, their practice was well above the national average in its efficiency per dollar of fees, as well as being profitable overall.

By contrast practices in far more exclusive suburbs typically have lower gross fees, high rents and lower profits. It is a classic case of a repetition of the fable of the Toorak cash poor versus the Clayton cash rich.

Highest achievers

The highest achieving dental practices will always be privately owned and conducted practices. Dentists who own their own practices have both the necessity and an incentive to improve their practices. A necessity because they have to cover their costs and earn a living and an incentive to make surplus income to put into their superannuation fund, pay down their home mortgage and increase the value of their practices.

A dentist working inside a corporate practice usually on a contract basis needs to make enough from contractual payments to pay their living costs and mortgage, but has no incentive to improve the overall practice. By contrast, a dental practice owner is concerned about all clinical and non-clinical staff's productivity and is keen to see them all employed to the best advantage and to see that the most profitable dental work streams into the owner's personal surgery. The employee/dental contractor has no concerns beyond earning a percentage of their own production. They are certainly not minded to improve other aspects of the practice. This reminds me of the American expression that "nobody checks the oil in a rental car".

Corporate spin

No amount of corporate spin and MBA management baffle gab about "stakeholders", "empowerment" or "KPI's" is going to overcome the underlying force of employee/contractor self-interest. Corporate spin doctors usually lack dental experience and even where they have it, they may be insufficiently engaged on dental matters to significantly influence employed/contracted dentists.

The best of corporate dental companies remain small in size and have a dentist as a key management figure, but even so, it is unlikely that the best of the practices they have bought can achieve the same level of efficiency as measured by DEBDIT as the best of privately owned practices once vendor dentists complete their earn-out obligations and depart. Organisational behaviour and human nature indicate otherwise.

It is likely that some of the corporates only exist to acquire a group of practices and on-sell them as a parcel to a larger corporate buyer. This is a miniature edition of the much bigger games played by national and international corporate giants but on occasion global economic conditions arise to wreck the plans of the corporate giants, and indeed, economic conditions in Australia periodically make life a lot tougher.

Back to the 1980s

Back in the mid-1980s, Australia had a number of corporate entrepreneurs, each of whom was buying assets with borrowed money at then high interest rates. As global stock markets rose ever higher, the apparent wealth of these entrepreneurs climbed and they were being extolled as corporate heroes in the press. Then Prime Minister Bob Hawke spoke glowingly of the deal when America's Cup winner Alan Bond paid $1 billion of borrowed money for Kerry Packer's Channel 9 TV network.

"The best of corporate dental companies remain small in size and have a dentist as a key management figure, but even so, it is unlikely that the best of the practices they have bought can achieve the same level of efficiency as measured by DEBDIT as the best of privately owned practices once vendor dentists complete their earn-out obligations and depart. Organisational behaviour and human nature indicate otherwise..."

The down to earth Packer told his mates that he expected to buy it back in a few years for about one-third of what he had received.

Simultaneously, a company called Adelaide Steamship, which shortened its name to Adsteam, came under the management spell of John Spalvens and went on a debt-funded spree acquiring David Jones, Tooth & Company Brewing, Woolworths, Clark Rubber and a variety of interests in other businesses including slices of our major banks, all funded by a massive amount of debt, some of it on its own balance sheet and much of it on the balance sheet of subsidiaries. In a particular case, one of its companies owned a little under 50% of another company and another of its companies owned a little under 50% of the same company.

Under the accounting rules at the time, neither equity accounted for their ownership but the group effectively controlled the subsidiary which was laden with debt. To complicate the matter further, many of the companies in the Adsteam Group had cross shareholdings in each other, also debt funded. In truth, its accounts were a mystery to outsiders.

In this economic environment, John Elliott had grabbed control of Elders IXL, while Robert Holmes à Court, via a company he controlled - Western Australian company Bell Group - was making takeover bids on BHP. Elliott's Elders in turn started to buy BHP shares, as did Spalvins Adsteam Group. There were a host of others playing similar games.

Suddenly the world changed and in October 1987, the world suffered the biggest stock market collapse since 1929. The debt laden entrepreneurs and the debt laden companies that they had controlled could no longer find buyers willing to pay ever higher prices for their debt laden assets.

The quickest of the entrepreneurs to realise that the financial world had changed and worked quickly was Robert Holmes à Court who almost instantly sold his controlling shareholding in Bell Group to Alan Bond's company which stripped it of cash assets. Holmes à Court was able to reduce his own enormous debts but exposed Bell Group's minority shareholders and the sale hastened Bond's collapse. In the aftermath, Spalvins Adsteam was broken up, Alan Bond went to jail, John Elliott descended into bankruptcy, Christopher Skase died in Spain following the collapse of Quintex, Robert Holmes à Court died leaving a depleted estate to his wife, Abe Goldberg fled to exile in Poland, Western Australian wheeler dealer Laurie Connell died in jail and others went to jail, were bankrupted or disgraced.

The late Kerry Packer did indeed buy back his television empire for a fraction of what he had received for it and observed that "you only get one Alan Bond in your lifetime". Packer had had the bank process the $1 billion cheque he had received from Alan Bond, then return it to him, whereupon he had it framed and hung on his corporate bathroom wall. Whenever he sat on his loo, he would gaze upon it with a smile.

Key lesson

Debt, when used judiciously to fund good assets producing reliable income is good, but must be kept within bounds.

Too little experience

Many of the 1980 entrepreneurs had little experience of the businesses that they bought, believing that they could hire managers to look after the actual running of the businesses while they used, what they thought was their superior skill, to acquire more assets with ever higher gearing at interest rates which were much higher then than in recent years. They believed that they could on-sell those assets at still higher prices. The truth was that the entrepreneurs mostly knew very little about what made the businesses they were buying work.

Richard "Tiny" Rowlands destruction of Alan Bond

Richard "Tiny" Rowlands, a British entrepreneur, controlled a company called Lonrho. Alan Bond had parked his yacht near Rowland's yacht at the marina at Antibes in the Mediterranean where Rowlands had the prime spot. The two had drinks on each other's yachts and later, Bond's company started buying shares in Rowlands Company Lonrho in the belief that it was vulnerable to take over. When Bond moved past 20% and looked like he was attempting to take over Rowlands empire, the ruthless Rowlands took action. He vowed to destroy Alan Bond and had financial analysts dredge through an enormous amount of detail with considerable difficulty in a pre-internet world. He produced a report titled "The Bond Group of Companies - A Financial Analysis by Lonrho PLC". The report was a savage 93-page analysis of Bond's finances, replete with a ruthless commentary on why Alan Bond was a financial fraud. Copies of the report were flown to Australia in Robert Holmes à Court's private jet. Holmes à Court had apparently not anticipated that Bond would strip the cash out of the Bell Group after he had sold it to Bond and was enraged by his action, which effectively robbed its other shareholders. Copies of the report were sent to financial journalists and analysts throughout Australia.

The penetrating analysis of Bond's problem and private business affairs came to the devastating conclusion that "Bond Group Companies are technically insolvent, the commercial existence of which is through extraordinary bank support".

The Lonrho report ignored defamation laws and openly attacked the biggest corporate name in Australia at that time. While Bond's official reports were glowing about Bond Groups financial health, Lonrho argued that Bond's accounts were works of fiction and that his businesses were drowning in debt. Bond's corporate empire never recovered from the penetrating analysis and following the body blow of the Lonrho report, was cracked, boxed and buried over two awful years.

> "We sometimes come across start up practices where, often immigrant dentists, have acquired and fitted out dental premises in the hope that dental patients will flood in the door... Some of these new start-ups survive after struggling for several years, while others disappear quietly into the night, swallowed up by their inability to cope with the essential practice running expenses and repayments on their debt..."

Banks

John Spalvins of the Adsteam Group was undoubtedly a very intelligent person, but the group became so diverse that even he made major mistakes and eventually the four major banks got together and jointly discovered to their horror that their debt exposure to the Adsteam Group, including all of its subsidiaries, was much greater than any of them had individually realised. They forced a sell down of assets and removed Spalvins from a number of company boards. The Adsteam Group was liquidated and lots of its companies refloated or sold. The ordinary shareholders in those companies received nothing. Companies like David Jones and Woolworths were refloated onto the stock market by the banks in order to reduce the debts owed to them by the Adsteam Group.

The 1980's revealed that top managers were incapable of overseeing so many diverse industries simultaneously and that when large financial corrections occur, it is those with far too much debt and too little ability to generate profits which are exposed. Simultaneously, all the persons whom they had hoped to sell assets to at a profit found themselves also exposed and unable to fund acquisitions. The Australian corporate world spiralled into a significant black hole within two or three years after the 1987 stock market crash but slowly emerged as common sense returned to markets and more realistic valuations were placed on assets with greater emphasis on actual profit making rather than corporate wheeler dealing.

Dental and veterinary practices survived

By contrast, those dentists and veterinary surgeons who had practices back in the 1980s but who continued to maintain them at a steady level earned reasonable profits and survived quite well. Indeed, once interest rates started to fall as a consequence of the economic recession, which then Treasurer Paul Keating described as "the recession we had to have", they emerged in a generally much stronger position. In today's dental scene, we regularly come across practices which are well run, have avoided the pitfalls of being preferred providers and built up and maintained long term patient relationship who continue to produce good profits and run their practices in a stable manner.

High risk start ups

By contrast, we sometimes come across start up practices where a dentist, or sometimes a dental partnership, often immigrant dentists, have acquired and fitted out dental premises in the hope that dental patients will flood in the door. However, it is usually the case that the population of the particular area mostly have relationships with existing dentists to whom they return when they require treatment. Some of the new start-ups survive after struggling for several years, while others disappear quietly into the night, swallowed up by their inability to cope with the essential practice running expenses and repayments on their debt. I often wonder who it was that advised them to do the start-up, or whether they falsely assumed that people would walk into a dental practice in the same way they walk into a new coffee shop. The essential difference is that one is offering a service which is usually based upon a network of long-term relationships, while the other is selling a product. The marketing of professional services and the marketing of products are quite different, albeit that a good coffee shop owner might build some relationships but many customers will see little difference between competing coffee shops, whereas many dental patient relationships are long term in nature and appointments are made by telephone or internet connection. Very few people casually walk into a dental practice and make an appointment in the same way they would walk into a shop and buy a product on sale.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, financial, valuation and conflict resolution processes for 32 years, the last 25 as a founding 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 Management of the Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He 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 Synstrat Dental Stories, the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. 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 financial services company. Both Synstrat companies are owned by the same directors who work within the Synstrat Group. Call Tel: (03) 9843-7777, Fax: (03) 9843-7799, visit www.synstrat.com.au or email dental@synstrat.com.au..

Synstrat Publications

If you would like to obtain copies of Synstrat's publications, Synstrat Dental Stories: Strategic Thought & Business Tactics for Dentists; Buying and Selling General & Specialist Dental Practices; or 50 Rules for Success as a Dentist, we ask that you make a charitable donation to the Delany Foundation. See Synstrat website under Synstrat Dental Publications, or email dental@synstrt.com.au for details on how to do this.

General Advice Warning

The information contained in this article is unsolicited general information only, without regard to any investor's individual objectives, financial situation or needs. It is not specific advice for any particular investor and is not intended to be relied upon by any person. Before making any decision about the information provided, an investor should consider the appropriateness of the information in this article, having regard to their objectives, financial situation and needs and consult their adviser. Any indicative information and assumptions used here are summarized, are not a product illustration or quote, and also may change without notice to you, particularly if based on past performance. This notice must not be removed from this document.

Smiles Inclusive

While some dental corporates appear to be travelling soundly, namely 1300 Smiles and Pacific Smiles, one wonders about the future of Smiles Inclusive Limited, which having breached its bank covenants, descended into open hostilities between its directors as indicated in its reports to the Australian Securities Exchange. After plummeting to as low as 10 cents, at time of writing, its share price had increased to 15 cents. One year earlier, its IPO price was $1.00.

Some of the Lessons

- Dental corporatisation is no longer the panacea to wealth creation perceived by some of its promoters and the rate of practice acquisition is stalling;
- The performance of the best privately owned and operated dental practices will always be better than that of corporate practices;
- To be in the strongest financial position at the time of practice sale or retirement, key financial strategies need to be understood and followed from the time at which practices are purchased;
- The best performing dental practices are not large. There are many excellent practices with from one to three chairs. There are also poor performed practices with more chairs. Top performing dentists who own practices must spend the majority of their time generating clinical output in their own surgery. They don't have the time to supervise lots of other clinical staff and this explains why the best performed practices are small in the number of chairs;
- The best/most profitable dental practices are rarely found in the most exclusive suburbs of capital cities. Rather, they are located in long-established working class to middle class suburbs with good household incomes;
- Dentists should be wary of corporate spin doctors; and
- Just as in the 1980s, entrepreneurs got themselves and their companies into serious trouble. Dentists need to be wary of persons trying to involve them and their practice in co-ownership schemes. If the company with which they are engaged fails, they too can be dragged down.