Dentists financial decision making 2020 with lessons from the 1980's and the global financial crisis?

By Graham Middleton, BA, MBA

"Dentistry remains a labour intensive business... No corporate is able to find technology that enables a dentist to drill the teeth of two patients simultaneously..."

Dental corporatisation in Australia has fallen far short of what has occurred in the USA and it is unlikely to catch up. The recent unfolding disaster of Smiles Inclusive Limited is a lesson as to the dangers of investing in professional consolidations whether they be in accounting, dental, dental laboratories, medical or veterinary practices. The number of failures and the number of disappointing outcomes points to the reality that these types of companies have much higher risks than their promoters identified. The failures and disappointments are just too numerous to avoid. The next would-be entrepreneur wishing to make their fortune out of a dental corporatisation may find that convincing investors to put up cash based on a creatively presented prospectus might prove to be a much harder task.

To some extent, these consolidations can be regarded as miniature editions of some of the things that happened in the 1980s.

The 1980s entrepreneurs

In the 1980s and early 1990s, a collection of colourful characters graced the business pages who were briefly thought of as corporate heroes. A largely gullible financial press with the notable exceptions of Trevor Sykes and Terry McCrann wrote of them as though they were the financial equivalents of Greek gods but in reality, they were financial manipulators and asset strippers who preyed upon the gullible but often bought businesses for far more than they were worth based on the assumption that they could find greater fools to buy the assets off them at even higher prices. They also shamelessly exploited the naivety of their minority share holders while in many cases auditors looked the other way. It appears that many years after failed entrepreneur Alan Bond gutted the cash from Bell Resources, that the liquidation may be ending after numerous expensive court battles and enormous legal fees.

In 2020 non-bank depositors may be at high risk

It does seem that every generation has its own version of "Tulip Bulb Mania" but it takes different forms. Sometimes, the underlying weakness is interest rates which have become unsustainably high. And other times the problem is caused by interest rates on deposits becoming far too low, causing savers to put their money into non-bank related deposits offering higher interest rates. However, those offering higher interest rates on deposits are also likely to be making risky loans; being loans that the major banks are not prepared to provide and hence, the non-bank providers of those loans will be charging higher interest rates. However, there is a much higher risk of financial failure among businesses which have to pay higher interest rates to get loans and therefore in due course, the depositors risk losing their money if placing their money with higher risk lenders.

The 1980s/1990s failures of Rothwells, Tri-Continental, Estate Mortgage, Farrow Corporation and Pyramid Building Society come floating back when I see no-name lenders advertising loans on television to small businesses which can settle on the same day! The advertising offer to those desperate for a cash loan are not guaranteed but do suggest risky business models.

By contrast, bank hybrids do rank ahead of ordinary shareholders and hence, the larger banks cannot pay dividends to their ordinary shareholders if they are unable to meet their obligations to their hybrid holders. To my mind, that suggests that getting a grossed-up dividend yield on a bank hybrid of 5% or more might be a lot safer than a deposit offering 5% in a non-bank financier!

Reading financials

Stock market analyst reports don't always provide an accurate picture. Indeed, it's not uncommon for analyst reports from different brokers to offer differing buy or sell recommendations depending, one suspects, whether the analyst's broking house has been active in a placement of that company's stock or not. And indeed, in the days when the infamous Bond Corporation was visibly breaking down, there were still particular analysts recommending that stock as a buy.

Smiles Inc Offer Document

It is necessary to spend time in direct examination of a company's financials. The same goes for the prospectuses of companies making their initial public offer (IPO). Smiles Inclusive Limited's prospectus was such a document where Synstrat's conclusion was that the profit growth predicted by the investigating accountant was in our view unachievable. There were also doubts as to whether all of the 52 practices financials used by the investigating accountant were in fact exactly the same 52 practices eventually purchased by the company. There is some evidence to suggest that some of the practices used were replaced by others. The stockbrokers pushing the IPO may not have got into detailed client discussion but offered it to their client list on the basis that a percentage of them would invest. The fact that Smiles Inclusive Limited rapidly developed into a disaster demonstrates the weakness of the financial analysis at the basis of its IPO prospectus and the weakness of its management following the IPO capital raising and purchase of practices. A $1 per share acquisition fell down to a low of 2.9 cents per share at one stage and it has had a capital raising at 5 cents per share. Despite capital raising and the sale of a couple of the better practices to 1300 Smiles Limited, it has a huge challenge to avoid eventually sliding into liquidation if its lender, National Australia Bank, whose loan covenants have been breached, decides that that is its best action.

The contrast of a good company

When I look at a company that I have followed closely for years which has maintained steady growth in turnover and profit, has low debt and I find that there are three analysts saying "buy", two analysts saying "hold" and one analyst saying "sell", it tells us more of the standard of the analysts and whom they work for than it tells us about the company.

Skase's Quintex Group

Christopher Skase, an ex-financial journalist briefly rocketed across the sky, but he mixed ownership of companies with operating businesses with large resort developments - two in Australia, one in Hawaii and one in California. The developments took time, soaked up capital and importantly, created large interest payment obligations which the companies that Skase controlled had insufficient profitability to pay the dividends necessary to cover the interest payments. When legal retribution loomed, Christopher Skase fled from Australia to exile in a farmhouse in Spain, aided by a bankruptcy trustee who never should have handed his passport back. Skase avoided legal retribution in Australia but died in Spain.

I tend to shudder when a dentist who has not had a history of property development in their family wants to become a one-off property developer. A problem with property development is that the big developers always have a priority call on all of their sub-contractors. It's not unusual for a one-off developer to suffer significantly because tradesmen cannot or will not turn up at their site on time. The reality is that the sub-contractors concerned have to protect their long term by prioritising their biggest clients.

Getting into financial difficulty

When dentists have got into financial difficulty, in my experience, it has almost always been due to issues outside of their practice. The fact is that overwhelmingly, the dentists who finish up in a sound financial position as they approach or enter retirement are dentists whose principal real estate investments were their home and their practice premises, and who ran good practices and made sensible financial decisions.

As I review the financial situation of dentist after dentist what stands out is that with the rarest of exceptions the successful dentists have drawn most of their income from hard work in a well-run practice. Very few had substantial inherited wealth from particularly early in their careers and even much later most are still generating good profits. But there are older dentists who have long owned practices who are much worse off than they should be.

One issue is the wide variation in accounting and business advice standards. As a valuer of practices, I regularly view financials prepared by other accounting practices from across Australia and ask questions of the practice owner. It is clear that the standard of advice to dentists about initial structures and profitability and obvious problems varies enormously.

"Ponzi" like eucalypt schemes

From the 1980s and well into the 2000s, health professionals were targeted by promoters of plantation investment schemes, firstly pine trees and then eucalypts. The schemes were deeply flawed from the beginning but were heavily marketed through some accounting practices. I can recall various approaches asking me to sell to my clients all of which I refused despite the huge commissions on offer. However, many high profile accountants "sold" huge investments in these schemes to their clients, pocketing an upfront commission plus volume bonus if they reached a certain sales target. In many cases, the documented "Statement of Advice" was signed off by an inhouse financial planner after the accountant had given an elaborate whiteboard explanation to their client. The whiteboard presentations invariably confused their clients but breached the trust of the client who assumed that their accountant was providing proper advice.

Bit by bit, the schemes got into trouble and they became reliant on new sales to finance the plantings that they had previously sold. Bit by bit, some of the schemes turned into Ponzies, a term associated with an individual who promised high returns to investors but used the money coming in from later investors to pay back the deposits of early investors. One of the most prominent forestry companies set up a subsidiary to "buy" harvested products and then used their price to give an impression that all was well.

Eventually, the schemes imploded but some of the high profile accountants who had sold them are still in business and were able to blame everybody else for the failure except themselves. Many health professionals have had nasty shocks as the schemes were in reality tax deferral rather than tax write offs and there are nasty loan repayment demands. Many are probably unaware as to the extent that their accountants profited at their expense. Commissions of 9% including volume bonuses were being earned on huge sales of eucalypts financed with borrowed money - possibly there were higher commissions on offer, but I was certainly aware of 9% being offered.

Adsteam's debt on the banks

In July 1990, Westpac had become deeply worried about the wider market concerns towards the Adsteam Group, presided over by the mysterious entrepreneur John Spalvins. Spalvins had built up control over a group of Australia's biggest companies as well as having a share in many others in a complex web of cross ownerships and largely hidden borrowings. However, a combination of the Australian recession, the 1987 stock market crash and some risky decisions had exposed the group. He had allowed himself to be outplayed by Robert Holmes à Court in a BHP options deal and had invested in Bell Group, which Alan Bond's Bond Corporation had effectively stripped of money through a loan of its cash based on such a low ranking security that effectively the money could never be repaid.

Spalvins had made several other errors and his internal intricate financial engineering had severe weaknesses which would eventually prove fatal. Westpac, who had become very worried about its exposure, decided to consult the other three major banks and to their joint horror, the four banks discovered that between them, they had loaned the Adsteam Group $4 billion and that the group had overall debt of $6.4 billion! The four banks took action and eventually got most of their money back, much of it from the refloating of Woolworths onto the Australian Stock Market. A vast number of small shareholders in the various Adsteam companies suffered big losses.

A lesson arising was that financial markets are now very suspicious of conglomerate groups which are heavily geared, particularly if a group, like Adsteam, has invested in a variety of unrelated industries.

Real estate cons

Most dentists are aware that it's normal for developers of high rise units to budget up to 20% of the project costs for sales and marketing. As a result, many "investors" are shocked to find that when their bank, who they expect to finance the remaining 90% of the acquisition, having themselves paid 10% deposits, come to have the property valued at completion and value it well below the sale price!

I am reminded of the late Alan Bond's scheme to persuade enough buyers to invest in building blocks on a scruffy bunch of sand hills at Yanchep north of Perth. One day, Bond drove John Bertrand, the helmsman who won the America's Cup for him, to the potential resort that he was trying to sell. As they approached, Bertrand was stunned to see that the barren coast had suddenly turned green and made an exclamation along the lines that Bond had put in irrigation. "No" replied Bond, "I painted the sand hills to make the brochures look better".

I am also reminded that about 40 years ago, a construction that looked like a railway station appeared on some vacant land on the north side of Melbourne. Apparently, it was part of a real estate scam inviting people to buy cheap blocks of land on the basis that a railway line was about to be built!

New legislation brought forward by the Victorian government creates serious difficulties for residential landlords. Not only must a tenant be 14 days in arrears before a landlord can take action on their outstanding rent, but they, in fact, have 14 days to pay, having 14 days catch up and in fact, can repeat the exercise four times in a year. This, together with draconian tenants' rights concerning urgent repairs - with tradesmen being able to be called out in the middle of the night at expensive rates - means that landlords who have borrowed to buy residential rental investments can suffer severe cash flow problems and a tenant can take them to the brink of late payment of rent arrears four times per year before they can be kicked out. Given that the net yield on most residential rental property, after paying compulsory landlord expenses, is poor anyway, it begs the question as to why anybody would be nuts enough to invest in residential rental properties in the state of Victoria. This is particularly true of high rise rental apartments because the truth about housing is that the part of the value which accrues over the years is the land content and there is no land content in a high rise apartment. Potential investors should stop and ask themselves how could they possibly do an extension in an apartment?

The great weakness of all of the dental corporates

Large companies have been able to substitute technology for people, examples being:

- Large mining companies which have progressively replaced the pick and shovel with ever larger machines to the point at which they can ship vast quantities of iron ore or coal with very little human effort;
- Large supermarket chains are progressively automating the checkout process; and
- Airlines, which used to have a pilot and co-pilot flying an aircraft with perhaps 30 or 40 passengers in the early post war period, now fly aircraft loaded with several hundred passengers.

By contrast, no dental corporate is able to find technology that enables a dentist to drill the teeth of two patients simultaneously. Dentistry remains a labour intensive business; and skilled labour at that. Furthermore, dentistry is very much a relationship business. Coal mining is totally de-personalised, supermarkets have been progressively de-personalised and airlines are dependent on brand, but nowadays many passengers simply book to the lowest fare. Since dentists working for dental corporates, except for recent vendors, may have little long term relationships with patients and many will move on when they find a practice to buy or a better situation, the corporate grip on patients has nowhere near the impact of a dental practice owner with good interpersonal skills who becomes the long term dentist of choice for patients.

The big lessons from the Global Financial Crisis

The global financial crisis had its first tremors in late 2007 and reached its bottom around mid 2009. As far as Australians are concerned the biggest lessons were:

1. Corporate entrepreneurs who had used margin loans to leverage their control over companies caused those companies to implode once short sellers discovered how they had financed themselves and short sold shares forcing the share prices down which in turn forced margin calls from banks which in turn caused further share price falls breaching bank loan covenants.
2. A business called Storm Financial persuaded thousands of investors to double gear by first of all borrowing against their homes to get capital to invest then advised the same clients to take margin loans to augment their borrowed capital. Its clients were put in a position that when the stock market correction occurred, margin calls quickly threatened continued ownership of their home. In fact, large numbers of investors lost their homes.
3. Those who hung onto good companies got to participate in rights issues priced below market near the bottom of the GFC and their superannuation funds recovered quickly. In mid 2009, our big four banks, plus Wesfarmers, Macquarie Group and Rio Tinto, as well as other companies, all massively strengthened their balance sheets and were able to maintain normal business and in the case of the banks, normal lending activity which helped maintain employment. It also led to the rapid recovery of the superannuation funds that took up the heavily discounted rights issues. Those who had panicked and sold out of good stocks early in the financial crisis had no entitlements to these rights issues.

Synstrat's position regarding margin loans as stated in "50 Rules for Success as a Dentist" was and remains:

Margin loans

Margin lending schemes pushed heavily by many financial advisors are inefficient because:

a. The interest rate is usually a bit on the high side;
b. The restriction imposed by margin lenders on where you can invest the money means that the investment returns will usually be below average; and
c. There are always better financial options available as a dentist.

These days, many advisory organizations have restrictions imposed on margin lending, but nevertheless, the risks remain.

Tolerance to risk

Conventional financial planning wisdom suggests that as people move toward and into their retirement years that their investment approach should become progressively more conservative. However, if somebody suggested that an aging Warren Buffett or a Rupert Murdoch should sell shares in their enterprises and place the money into government bonds they would be laughed at.

Several things are apparent

- People of the same age - even the quite elderly - have different tolerances to risk. Those who have owned real estate all their life remain wedded to it and those who have long owned shares continue to do so;
- There is a wealth effect - those with assets above that which would be expected to maintain their desired standard of living in retirement are more likely to stay invested in growth assets and are prepared to accept market fluctuations because in the long term, share markets outperform fixed interest investments; and
- Those with modest assets need to draw down a superannuation pension to fund their lifestyle in retirement are naturally drawn to more conservative investments even though that will generally mean that over a long period, their income is less.

The tipping point

Individual dentists will have quite different views and spending patterns in retirement. It's not a case of a one size fits all model of the capital required to fund lifestyle. However, if a retired dentist's capital situation is such that it continues to grow despite funding their retirement, then they are in the right side of their tipping point. As their capital accumulates, they are more likely to accept investment recommendations to purchase good growth stocks. One common mistake is to purchase listed and unlisted managed investments with high internal management expense ratios (MERs) into a self-managed superannuation fund (SMSF). The reality is that many of the more recently listed as well as unlisted managed investment funds are so loaded with internal charges that their high MERs mean that over a period of time, ownership will significantly drag down the performance of a SMSF. Some of the very old listed investment companies such as ARGO do have much lower MERs. If you have a financial advisor who advises lots of managed funds be put within your self-managed superannuation fund, its time to change advisors. Warren Buffett exploded the myth of hedge funds with his famous bet of USD$500,000 on the basis that the S&P 500 index would outperform any four hedge funds that the hedge fund proponent wished to nominate. The winner to donate the winnings to a nominated charity. The result was that Buffett's charity won easily. Hedge fund proponents bragged that they could make money in a falling market but in fact, a large proportion of them were wiped out during the GFC as investors withdrew their money and they had no funds to buy stocks in a falling market.

Naturally, I must state that advice in this article is general in nature and dentists should take their own professional advice.

Regards to all dentists

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@synstrat.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.