

Pitfalls in buying a dental practice, becoming an associated owner, becoming a partner or selling a practice

By Graham Middleton, BA, MBA



"It is too late consulting an expert after you've discovered that the financial performance of the practice is far worse than you expected..."

The best dental undergraduates should make it their priority to obtain employment in a successful, well run profitable practice. There is no substitute for observing at close hand how a good practice functions. Dental lecturers and demonstrators have a tendency to spot the students who exhibit characteristics which would enable them to fit into a busy well run practice and to recommend them to their friends in the profession. On their part, top students should seek the advice of their teachers and mentors!

Experience

The first and best advice for an ambitious dentist is to get substantial on the job clinical experience in a good practice before contemplating practice ownership. Traditionally, dentists advance to practice ownership about eight years after graduation from dental school but there have always been early starters and late bloomers. Nobody learns to

run a practice at dental school and dental schools' best endeavours should be directed towards developing the student's clinical skills. Observing closely what happens in a good practice is invaluable and will tell you more about running a practice than you'd ever learn in your degree course.

Creating a buy in chance

Those dentists who are lucky enough to work in a quality practice conducted by a dentist approaching retirement age need to make themselves indispensable to the conduct of the practice. The tests which the principal of the practice will look for are:

- Do patients routinely return for follow up appointments?
- What is the number of personal referrals generated?

Employed dentists who demonstrate a reliable tendency to generate good levels of follow-up appointments and personal referrals are practice builders!

Their aim should be to turn themselves into the logical practice buyer whereas any potential external buyer would observe how vital they are to the running of the practice and be frightened that if they bought the practice, the indispensable dentist might leave.

However, this requires sustained good performance well above the average. Any successful practice can easily replace a mediocre dentist, but not a practice builder.

Looking for a practice

If you're not in a practice where succession to ownership is likely, then you'll be looking for a practice to buy. Don't wait to see a good one pop up in the advertisements of practice brokers. While it does make sense to check their listings, the reality is that most practice buy and sell transactions happen between dentists without broker involvement and most dentists who purchase practices have spent a lot of time looking and knocking on doors.

The importance of getting proper advice

Expert advice is essential particularly as many dentists use an accountant who has negligible knowledge of the dental profession or how dental practices compare. We've been consulted often after the event by dentists who paid ridiculous prices for practices because the valuer had an unrealistic expectation or a practice broker did a smart sales job and the accountant they checked the purchase with had no understanding as to the likely value range which should occur or what the conditions of handover of the practice should be.

It is too late consulting an expert after you've discovered that the financial performance of the practice is far worse than you expected and you have paid hundreds of thousands of dollars above true value.

In particular instances, we know of practices where a principal dentist had died and a "main chancer" has bought

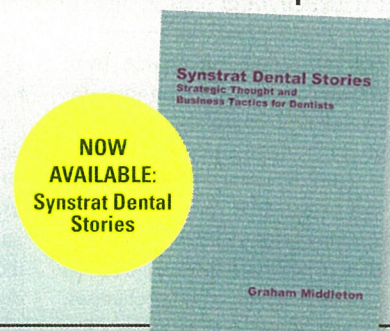
the practice, given its appearance a lick and a promise and run it temporarily with locum dentists then placed it on the market and achieved an outrageous price. The locums promptly departed leaving the practice with no dentist who knew the patients, many of whom then disappeared too. In this particular instance, the buyer of the practice consulted an accountant who should have known of the pitfalls but failed to see them. When the buyer realised later that they had been misled, it was far too late and they now face years of effort in getting the practice back to what they thought was its fee base when purchasing it. The key issue in seeking advice is whether the adviser has sufficient knowledge to guide you through the pitfalls and ask the right questions. Many weaknesses of practices are glossed over in the presentation of partial facts by practice brokers.

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Buying A Practice?

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- What changes should you make to the practice business plan?



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Buying into a dental partnership or associateship

There is a difference between partnerships and associateships. Most multiple owned dental practices are established as associateships because individual principal dentists can vary widely in their array of dental skills and in the fees that they produce. It's important to understand in detail how the financial structure of the associated practice impacts on a buyer's production and cost base. A critical document is the associateship or partnership agreement and there are a wide variety of them across the profession. Some are put together with care and proper consideration of how the owners would interact in the operation of the practice, while some are shockers. Often those documents have been drawn up by solicitors and some are copies of partnership agreements in totally alien businesses such as a partnership between two owners of a fruit and vegetable business.

Sometimes the associateship/partnership agreement is supported by a service agreement with a service trust and some practices are operating with historic structures which date from times which dentists couldn't incorporate or slightly later, when the Australian Dental Association still controlled incorporation, which is no longer the case.

Uninformed accountants and uninformed solicitors

Be wary of relying on advice from accountants or solicitors who are unfamiliar with dental practices who when negotiating to buy into a practice may not identify the pitfalls in the existing associateship agreement. It is too late to make changes the day after you have bought in as the other principal dentist or dentists will be uninterested in making changes. The only negotiating leverage a buyer has is prior to signing a purchase document.

The buyer's ownership structure - times have changed

Adopting the wrong ownership structure can mean that you miss out on all or some of the Small Business Capital Gains Tax concessions when you sell your equity in 30 years' time! By that

time, the accountant or solicitor who gave you wrong advice will probably be long retired and may not be still living.

Family considerations also apply, as in do you need to make your spouse a co-owner of your practice? This will often depend upon what their occupation and income is. Long ago, only a dentist could own a dental practice, but since the implementation of the Hilmer Report, regulation of dentistry is via the registration of dental providers, but anyone can own a dental practice. At times we have come across situations where accountants and solicitors have copied structures which were invoked 30 years ago without realising that Australian dentistry and indeed much of the tax structuring of yesteryear has moved on.

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Beware of "poly-filla" valuations

Sometimes persons who value other types of business drift into valuing a dental practice and often it's the only dental practice that they have ever valued. Not having access to proper facts about dentistry, they present information from Australian Bureau of Statistics to give the impression that they know a lot about dentistry but actually what they are providing is very broad and doesn't actually get them to a proper value of the practice that they are dealing with. Studies of dental numbers have dwelled inappropriately on the supply side of dentists, but neglected the demand for dentists and dentistry. We are not aware of any survey which identifies the spare capacity of dental practices Australia-wide. However, a recent announcement by the new stock-market listing of Smiles Inclusive Ltd that

it was purchasing 52 practices and those practices had 61 totally unused dental chairs gives a stark illustration. At some time in the past, all of those 61 chairs were installed because the practices concerned had reached the capacity of the remainder of their chairs. Subsequently, as dental numbers expanded beyond the demand for dental services and patients spread out, vacant chairs were created.

Valuers that cannot compare a practice's real numbers with average practice performance on the basis of dental earnings before depreciation, interest and taxes, as a percentage of gross fees, or cannot explain why these numbers vary from averages are deficient in knowledge. They tend to rely on statistics from the ABS which are so broad as to be irrelevant in the valuation of a specific practice. Additionally, there is a problem with the way data is gathered by the ABS which has difficulty in working through different types of practice ownership structures, etc. The real question to be asked of a valuer is - does the producer of that valuation have any meaningful data of their own to draw upon. Sometimes they're from accountants who don't have a single dental practice under their wing. Such valuations are a serious trap for the unwary.

Indeed, I recently dealt with a critique of one of our valuations where the accountant who had an impressive CV had no knowledge of:

1. The most common formula for employing experienced dentists in private practice; or
2. The current state of health insurance; or
3. No understanding of the surplus of dentists or the fact that a multitude of practices Australia-wide have spare capacity and who argue, despite contradictory evidence, that dental practices were becoming more profitable Australia-wide, whereas the truth is that taking into account increase in CPI with the percentage of dental registrations, the statistical evidence indicates that across Australia, dental practice income is falling.

Fraudulent valuations

Fraudulent valuations are rare but we have come across situations where very clearly, a dental practice owner in consort with an unethical partner in an accounting firm contrived a false valuation and a

friendly banker loaned a significant seven-figure sum to a dentist to buy a share of his boss's practice group at a greatly inflated value relative to its true worth. Eventually, the fraud was discovered when another dentist working in the same practice was offered a similar deal but sought our advice and after painstakingly working through the practice profit and loss accounts and balance sheet and checking various numbers with the practice accountant, came up with an unarguable value which revealed to the second dentist that his colleague, who had already bought a share in the practice, had been badly misled. The last we heard of that matter was that it was in the hands of lawyers.

The percentage of fees fallacy

Statements that a dental practice goodwill is worth x% of gross fees are demonstrably false.

On that basis, a practice in an outback town is worth the same amount per dollar of fees as a practice in an attractive suburb of a capital city. This is obviously nonsense.

OR

That a practice paying 4% of its fees in rent is worth the same per dollar of fees as a practice located in very expensive premises and paying 12% of its fees in rent is obviously also false.

OR

That a vibrant practice where there is a healthy profit margin above the dental opportunity cost of the owners is worth the same percentage of gross fees as a practice where the owner or owners do not cover their personal opportunity cost, i.e., the percentage of fees that they would be paid to generate the same level of production in somebody else's practice. Again, this is obviously nonsense.

Dental equipment fantasies

Overwhelmingly, dentists replace old equipment with brand new equipment and the fact that much of it can be written off in the first year, or rapidly depreciated, means that the market in second hand equipment has all but disappeared. The only time a full suite of second hand equipment changes hands is when a dental practice is sold.

Invariably, the equipment in a practice being sold has been heavily depreciated and any sale of that equipment above its depreciated value represents taxable profit to the vendor. By contrast, most vendors of practices selling in contemplation of retirement find that the profit on the sale of their practice goodwill is effectively rendered non-taxable through the application of the Small Business CGT concessions - however advice from vendors' accountants is critical in this area as there are pitfalls.

Valuation of practice proprietorship

In reality, what is valued is practice proprietorship. Practice proprietorship is

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the combination of goodwill plus equipment that would be sold to the buyer of a practice. The equipment in turn includes all the equipment, furniture, fixtures and fittings used in the operation of the practice. This definition excludes proprietor's motor vehicles or a work of art located in an owners private office since neither is necessary to the conduct of the practice.

Since dentists do not break up their invoices to patients into portions for the use of equipment and portions for the use of goodwill, the correct valuation technique is to value proprietorship. Once this is done, the convention widely adopted in the accounting profession is that:

1. Equipment is included in the sale at its depreciated value; and
2. Goodwill = Proprietorship value - depreciated value of equipment.

Practice buyers should be wary of attempts to ascribe separate values to second hand items of equipment as there are not large warehouses full of second hand items of dental equipment ready for sale at well-known prices to which prices of equipment in a practice can be compared. Where items are for sale on the internet, including eBay, there is often no buyer and the price at which something is listed does not indicate the value which can be obtained at sale, if any.

Individuals proclaiming themselves to be practice valuers who painstakingly come up with lists of second hand equipment and furniture with notional values against them and then arbitrarily add a percentage of fees as a goodwill figure are not valuing a practice correctly. Such valuations can be very misleading.

The slow dentist problem

Consider a dentist selling a practice which at face value looks pretty good. The vendor of the practice has deep clinical knowledge, personal empathy with patients but works quickly with good hands and produces slightly over \$1 million of fees per year in surgery number one.

Surgery number two is occupied by a plodder, who chats too much and has the unfortunate habit of having difficulty speaking and working at the same time. His chairside assistant also gets drawn into some conversations. He produces \$450,000 of fees per year, but uses the same amount of chairside assistant time, same amount of equipment, same amount of space as the practice owner in surgery number one. The reality is that his overhead cost per dollar of fees are much greater than those of his boss in surgery number one. He only generates a tiny amount of profit for the owner.

Surgery number three is shared by two part time assistant dentists. Between them, they occupy the surgery five days per week but are slow and have lots of gaps in their bookings. There are too many cancellations and follow-up appointments often don't occur. Between them, they struggle to do \$400,000 of fees. Their chairside assistant has lots of breaks. The profit to the owner in surgery number three is negligible and may be negative; looked at from a cost accounting stance, surgery number three is lucky to breakeven.

The practice owner may well have been better off putting up practice fees and insisting on having his own surgery fully booked. They could then tell the dentist in surgery number two to block up appointments into four days (or even 3.5 days) which could be readily achieved if they spent more time with hands moving and less time in idle chit chat. That would immediately reduce the need for chairside assistants for the day or day and a half that were saved.

He then restricts surgery number three to three and a half days between the two part timers but tells them that he will consider opening up more surgery time when their performance justifies it. In the meantime, the patients can be accommodated in three and a half days with one working two days and one working one and a half days per week. They will have to learn to work more productively if they wish to expand their time.

When looking to buy a practice, analysing the allocated surgery time of dentists and hygienists versus fees generated is helpful. This needs to be accompanied by self-analysis on behalf of the buyer as to the fees that they are capable of producing and hence what is the optimum allocation of chairs and chairside assistants which will produce the best practice output.

Practice performance benchmarks are critical tools

When valuing practices, we use an intermediate measure known as Dental Earnings Before Depreciation, Interest and Taxes (DEBDIT). This measure, which can also be referred to as Dental EBITDA or Dental Gross Profit tells us whether the practice is above or below average in its performance per dollar of fees produced. Where a practice is performing badly by comparison with the average, we are then readily able to identify whether this is occurring because of unusually high rental occupancy cost, unusually high non-clinical support staff costs, unusually high purchases and laboratory costs, which might reflect under-pricing of fees, or whether the clinical staff of the practice are efficient. These issues are the very basis of valuation of a dental practice, or for that matter, equivalent measures in any other form of business.

For practice buyers

How do you know that the practice you are buying represents good value to you? What are its figures telling you?

For practice vendors

How do you know what is the realistic price to ask a dentist wishing to buy your practice? Or, if contemplating a sale in a couple of years, have you identified the practice weaknesses that you need to correct in the expectation that buyers' accountants will look closely at the figures related to your practice's income and costs. Or are you simply unsure as to what you need to do and hence need to seek more facts to assist in arriving at a decision. It's quite normal to be unsure as to when to retire and many buyers have come to us for guidance to assist in arriving at a good decision before their practice begins to deteriorate.

The three day trap

Competent busy dentists who work five days per week initially routinely step back to 4.5 days with a half day for administrative matters once they are confident concerning their own surgery's bookings.

If their fees remain strong, they may then go to a four-day working week, which often means four long clinical days and typically they find that good production incurs both in their own surgery and that the remainder of their practice continues to function normally.

However stepping back to a three-day week can prove to be disastrous as fee levels and overall practice efficiency drops, sometimes alarmingly. Having four days out of seven away from work appears to signal to staff that the boss is on the way out. Efficiency of the practice suffers, even though extra patients are diverted to employed dentists and also it becomes increasingly difficult for an owner working three days a week to show sufficient interest in overall practice performance when they are spending four days out of seven away from the practice.

It is also the very opposite of leading a practice by example.

Hence, we would advise any practice owner wishing to reduce to three days or less that they should seriously consider sale of their practice and working part-time for the new owner rather than reducing their clinical time.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 31 years, the last 24 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.

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