“Chase the vision, not the money. The money will end up following you.“

Tony Hsieh
Zappos CEO

CHAPTER 2

Should Buy An Existing Practice or Start One From Scratch?

The decision to begin your dental career comes down to only a handful of choices:

1. You may prolong your education process with a GPR or other postgraduate program
2. Start out as an associate, salary or commissioned base
3. Pursue a military career
4. Pursue an academic career
5. Buy an existing practice
6. Start a practice from “scratch”

In this chapter I will address the pros and cons of buying an existing practice as opposed to starting one from scratch.

Where to Look

In order to find an existing practice in your area of interest that is for sale, you have a variety of resources. Dental journals, web sites, dental supply reps or a local dental practice broker who specializes in in such transitions. Occasionally there may be some postings at your dental school from alumni practices that are for sale. Regardless of how you find put about a potential practice opportunity, the core of the ultimate decision to purchase an existing business comes down to representation and affordability. Who will assist you in determining whether this is a viable option and can you as a young dentist obtain the financing in order to purchase a practice.

Representation

Adequate financial and legal representation is a fairly good idea for any transition of any size. The only thing I want you to avoid are what is called “dual representation brokers” and people without any specialized experience with dentistry. The dental brokerage industry is fairly unregulated. What I mean by that is the concept of “dual representation” does not exist in the real estate industry. The concept of serving two people at opposite sides of a negotiation equally is a little naïve and is considered unacceptable in the real estate industry. As a buyer in the dual representation scenario, the chances of you coming up a little short at the negotiation table are real. Secure your own representative that has a fiduciary responsibility to you. On the accounting side, find a firm that specializes in dental practices and knows all the parameters of a dental p&l. On the legal front, avoid legal representation by someone not familiar with a dental practice sale transition. This can get extremely expensive in a hurry. Because they may not be knowledgeable about some of the intricacies of a dental practice, they will spend a lot of extra time on issues that are not really relevant. Time is money in their world and you need to be extra careful here.

Affordability

With student loan indebtedness at unprecedented levels, there are dynamics in place here that must be understood. It is not the normal supply and demand scenario. There are a growing pool of dentists who delayed retirement after the 2008 recession who are now ready to face transition so there is a growing demographic pool of sellers. State dental boards are increasingly relaxing their regulations that used to prohibit the corporate (non dental) ownership of dental practices. This has unleashed an avalanche of Wall Street money looking for a good return and believe me, dental practices are to them a gold mine. We are not talking about chasing 3 to 4% returns. We are talking 25% plus. So the bottom line here is this. Absent these corporate acquisitions, practice values would be in DECLINE. And I think substantially. But because the natural supply and demand balance that has normally been in existence does not apply anymore. Practice valuations are in my observation, very strong, and disproportionately strong. In the natural order of things your HIGH DEBT would yield LOWER VALUATIONS because you would be the only buyers. But that is not the case. You are competing with buyers with very deep pockets and as the saying goes, it has “lifted all ships”’

How Do You Evaluate A Practice For Sale?

Hard Assets

The hard assets also called chattel assets include the equipment, furniture, and fixtures. If a dental office has not been updated and maintained as to current standards, the value of the equipment is nil. I still come across practices that are so outdated they’re not only not digital, they have no computer management system. The operatory equipment that I am describing

has been fully depreciated by the owner dentist and in most cases to add insult to injury, you will have to pay someone to haul the junk away. It has a value of 0.

If an office is fairly current, it is a straight forward procedure to have a dental supply rep do an inventory and give you a ballpark appraisal.

Goodwill

The goodwill is that portion of the business value that is over and above its tangible assets. There is obvious value in the cash flow of an ongoing business, but it takes considerable skill to dissect the underlying value. Do not accept any cookie cutter formulas. They do not exist. You must have an evaluation prepared by someone with a thorough understanding of the overhead components of a dental practice and most importantly the fee and service mix that it takes to provide that cash flow. I recently evaluated a practice for a student with an exorbitant asking price. What was not identified by the practice broker was that the practice required nearly 3000 hours of production to reach the production figure. (the average dentist works in a range from 1600- 2000 hours annually) Could you imagine the disaster that was about to unfold to the buyer, the banker, and whoever was involved in the purchase of this practice because of the failure to understand the very basic components of productivity. In this case, specifically, the number of hours that were required to create the production.

With practice overheads today ranging from 60 – 80%, profitability and cash flow are the name of the valuation game. It takes an intimate knowledge of dentistry and financial analysis to get to the very heart of a practice's true value.

These are some of the factors I consider very important.

1. Number of active fee for service patients:

An active patient is someone who has received treatment in the last two years. A fee for service patient is a cash paying, non insurance patient.

2. Number of insurance/PPO plan patients:

Determine what percentage of total revenue is insurance related and what are the total annual write offs.

3. Number of active hygiene patients:

An active hygiene patient is someone who has received hygiene services within the last 2 years.

4. Production:

The total amount of clinical production from the last 12 months.

5. Insurance Write Offs:

Calculate the total of amount of insurance adjustments from all the participating insurance.

6. Adjusted Production:

Subtract the write offs from the gross production to get the true production figure.

7. Collections:

The total amount collected during the last 12months

8. Collection Ratio:

The collection ratio is the collections divided by adjusted production. You need this number to be 95%+ as a minimum. Many well run practices collect nearly all of their production. A poorly run practice will red flag here.

9. Overhead:

If you divide the annual total expenses by the collections you will get the overhead percentage. Most practices today are in a fairly wide range from 65 – 80%. Less is better and being at the higher end of this range can be problematic. When you read and understand the chapter on profitability, the importance of overhead will become apparent.

10. Accounts Receivable:

This is the money owed you or is outstanding. As a ruler of thumb, the accounts receivable ratio should not exceed more than 1.5 times one months average collections. In the transition process, I am strongly against the buyer purchasing the accounts receivable from a seller of a practice.

11. New Patients Per Month:

The number of new patients per month is a very important measure of the vitality of a practice. The amount of marketing dollars spent to attract those new patients is also very important. If a practice gets 50 new patients per month by word of mouth only and has no formal marketing campaign. It is much more valuable that a practice that spends 10% of collections on a marketing budget to achieve an equal number of new patients. This is why the acquisition value of each new patient should be calculated. Take the total amount of dollars spent on all marketing activities and divide by the number of new patients for that time period. This will give you that number. The other calculation is the production value of a new patient. Take the same period of time, total production from the new patients divided by the number of new patients. This is a really important number to help you determine the value of your marketing campaign.

Marketing budget/total number of new patients = cost of patient acquisition

Total Production per new patient/total number of new patients = production value of new patient

12. Number of Days Worked Per Year:

This is an absolutely essential piece of information. It allows you to calculate revenue per day and hour.

Total collections /days worked = revenue per day

Total collections / hours worked = revenue per hour

This also needs to be broken out for the hygiene department. Your hygiene department should always be looked upon as a business within a business and factor the metrics separately. The hygiene production should be 1/3 of the total production.

It is very easy to see how a practice that collects $500,000 on a 24 hour work week is worlds better than one that collects the same amount on a 60 hour work week. That is why applying formulas to the gross number will not work. You have to see the details as to how that income was created. The practice that creates a big number in a 24 hour work week also has one or more hidden values that will not show up in a valuation. There is a tremendous amount of unused capacity and is in my opinion worth considerable more money on that factor alone. These calculations are often overlooked in the valuation process.

13. Specialty Procedures Performed:

Do not overlook the breakdown of what the actual procedures were involved in the creation of the total revenue. If a doctor has $200,000 worth of income attributable to dental implants and you as a prospective buyer have no training or intention of providing that service, that needs to be addressed in some fashion. Look for other procedures by code that include, oral surgery, orthodontics, and complex endodontics. You do not want to pay for revenue that you are not capable or intend to offer. This needs to be addressed and negotiated. The converse is also true, if a practice is a straight filling/extraction practice, you can anticipate that by expanding services there is untapped revenue potential that you may not have to pay for.

14. Mix of Services:

Being able to get a feel for how progressive a practice is can be found by looking at codes that relate to a variety of services. On the cosmetic side, look at the number of bleaching and veneer cases. In Perio, look at the periodontal codes which should lead you to some impression as to how progressive the hygiene program is. There could be a considerable amount of upside potential hidden in the mix of services that is not apparent in the valuation.

15. Lab Fees:

This is an area that that can be extremely tricky to evaluate. You may have lab fees for a crown varying from 75$ to 300$. The only problem is you have no way to evaluate the quality of a doctor's crowns until after you have purchased the practice. The discount lab crowns might fit like "socks on a rooster" and you may not be satisfied using that lab. The point is that your lab fee could double overnight if a situation like this arose. This would significantly and adversely affect that portion of your overhead and this could be large dollars in a crown and bridge practice. Another example of why using a random math formula in valuations does not tell the entire picture. It is also not unusual for a practice upgrade to an E4-D machine at the time of transition and those numbers have to be carefully analyzed.

16. PPO's, Accounts Receivable:

If a practice is heavily reliant on PPO reimbursement, I would look very closely at it valuation. These patients are highly mobile and they can leave a practice at the drop of a hat for a better deal. This does not even address the write offs and much lower profit margins that theses patients generate. Fee for service patients are obviously the gold standard and they have more value from a valuation standpoint.

Carefully look at accounts receivable. If an older practice has a "bill me" mentality, you are in for a ton of hurt when you go in and change that policy as a new owner. A certain number of patients will leave the newly acquired practice based on that change alone. And **NEVER** buy the accounts receivable in a practice acquisition. That's a losing proposition on all counts.

17. Practice Location:

The real estate principles of location, location, location apply heavily to a potential practice acquisition. Because business training is not an integral part of dental school education, the majority of dentists have missed this lesson. I see all kinds of obscure locations for dental practices. Some almost seem as if they intentionally chose a hidden location. Take a very practical look at the location. If you buy this practice and end up having some patient or staff attrition, is this a location that you can easily grow a new patient base into without spending a fortune on marketing. Street visibility and being placed in an area of favorable demographics are a requirement. I will cover that in a future chapter.

Another observation has to do with real estate associated with a practice sale. Packaging a building with a poor location in a practice sale is a home run for an owner and a potential death trap for a buyer. Approach this very carefully. You are concentrating so many of your financial eggs in one basket I would only consider it if the location was outstanding. Otherwise pass on it and pay rent.

18. Availability of Money:

As of December 2016, the end of a very long period of economic stimulus seems to have come to an end. With a post election increase in interest rates of 50 basis points, (1/2%), the trend seems to be in place for a gradual trend to a more historical norm. Two to three additional points would not be out of the question. The other observation I see here is that there will be a shift away from the 100% finance option that has been available in many instances to younger dentists, back to a participatory down payment of ten or twenty percent. This may become a bit of a burden for the cash strapped new graduate and that is where owner participation may be required. I would do everything humanly possible to have the seller carry back some portion of the debt. One thing that will remain as a requirement is a stellar credit score. You must, as a student and new graduate, be very conscious of what it takes to build and maintain a good score.

Would I ever consider Buying A Dental Practice? The Hybrid Start Up:

There are really good opportunities for new graduates on a continual basis. There continues to be a large number of doctors who have, because of financial necessity, continued to practice after the 2008 recession. Many of these practices have diminished significantly in value. The doctor has continued to practice until many instances they become ill and have to close, or in some cases, die without a transition process in place. I think the distressed practice market is a growing niche that provides a lot of value for an aggressive savvy buyer. These transitions are under the radar because they don't fit the criteria of corporate or most other buyers. These are hybrid "startup practices". If you know how to fix something up, theses are often practices with thousands of patient records that need some new energy pumped into them. They can be bought for pennies on the dollar. The sellers are beyond desperate and often a deal that is structured with 10% down, a ten year owner financed loan with a three year balloon, will get the deal done. Also being willing to be within 60 miles of a metropolitan area is going to open up a world of opportunities. You will not have to live in the sticks but you also will not be competing with the log jam of practices in most desirable metropolitan areas which will be fully valued because your main competitor will be a corporate entity of some sort.

Here is an example. A practice collected 600k three years ago. The doctor became ill but continued to work part time. It is now down to 100k and 1 day a week. The practice is worth probably about 60k, 60% of last years collections. 10% down is 6k. Buying a practice that recently collected 600k for 6k interests me a lot. Often the doctor owns the building and is just pleased to get the continuation of the rental income from the practice. I would not buy the real estate too quickly, a lease option would be my preference here.