

A Closer Look at Practice Value

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Agenda

- Valuation Terminology, Literacy, and Examples
- Practical Acquisition/Valuation Implications
- Valuation Techniques & Fundamentals
- Other Considerations



Production

- **Gross Production:** The total amount of procedures performed and billed based on a practice's unadjusted fee schedule.
- **Adjusted (Net) Production:** The net amount a practice expects to receive after adjustments for items such as insurance payment reductions, discounts, or donated care. What you bill and intend to collect.
- **Note:** Production may be used interchangeably with "Revenue" which is often shown on profit and loss or income statements.



Collections & Adjustments

- **Collections**: The total amount of cash received from insurance, patients and third-party financing.
- **Collection %**: Percentage of Collections to Production. Can be benchmarked to both Gross Production and Adjusted Production.
- **Production Adjustments**: Payment reductions because of insurance payor contracts and adjusted fee schedules. Adjustments would also include reductions for one-time discounts or donated care.
 - For example, fee schedule for a crown is \$1,000 however practice has contract with insurance company to accept \$800 for covered patients.
- **Write-offs**: Unpaid amounts from insurance companies (usually due to disputes) or patients (usually for delinquent accounts).



Overhead

- **Adjusted Overhead:** The percentage of expenses excluding owner compensation in relation to collections.
 - Formulas for calculating overhead:
 - $(\text{Total Adjusted Expenses} - \text{Adjusted Owner Compensation}) / \text{Collections}$.
 - $(\text{Collections} - \text{Total Adjusted Expenses} + \text{Adjusted Owner Compensation}) / \text{Collections}$



Simple Valuation Examples

▶ Example #1

Practice A		Practice B	
Collections	\$1,000,000	Collections	\$600,000
Expenses	\$700,000	Expenses	\$300,000
Profitability	\$300,000	Profitability	\$300,000

▶ Example #2

Practice C (New Equipment, Nice location & operations)		Practice D (Old Equipment, Bad location & operations)	
Collections	\$1,000,000	Collections	\$1,000,000
Expenses	\$600,000	Expenses	\$600,000
Profitability	\$400,000	Profitability	\$400,000
Multiplier	2.00x	Multiplier	1.50x
Valuation	\$800,000	Valuation	\$600,000



Fixed Expenses vs. Variable Expenses

- **Fixed Expenses:** Expenses which do not change month to month. Includes: staff & employee costs (mostly fixed), rent, malpractice insurance, lease or mortgage payments, subscriptions, software, amongst other items.
- **Variable expenses:** Expenses which change month to month. Includes: production based compensation, lab costs, supplies, inventory, utilities, marketing, CE and other discretionary expenses.
- **Note:** As a general rule; the lower fixed expenses the better.



Expenses

- Primary Expenses Categories:

<u>Fixed Expenses</u>	<u>Variable Expenses</u>
<ul style="list-style-type: none">• Staff & Employee Costs (25% of Collections)• Rent or Mortgage (5-7% of Collections)• Other Operating Costs (Insurance, Phone, Internet, Practice Software, Etc.)	<ul style="list-style-type: none">• Equipment & Supplies (6-8% of Collections)• Lab Costs (5-7% of Collections)• Marketing Costs (varies)• Other Operating Costs (Repairs, Bank Fees, Professional Fees, CE, Training, Etc.)

- Staff & Employee Costs: Always the largest expense in a dental practice
 - Does not include owner compensation
 - Includes all other employee related expenses including: salaries, wages, bonuses, employee benefits, and payroll taxes
 - Highly profitable practices tend to keep payroll & employee costs at 25% or less as a % of Collections)



The “Other” Expenses

- **Lab Costs:** Typically range between 6% to 12% depending on the type of dentistry being performed and whether the practice has a milling machine.
- **Rent or Mortgage:** Market specific metric. In the Great Lakes / Midwest region, we like to see rent or mortgage payments to be 7% of collections or less.
- **Equipment & Supplies:** Items used and consumed in practice of dentistry. Typical range is 4-8%.
 - Includes: Composites, milling blocks, burs, consumables, impression material, sanitary products, disposables, patient giveaways, and much more.
 - ☐ Payment on equipment loans or equipment leases can be included within this expense category.
- **Operating Costs:**
 - ☐ Includes: Utilities, Telephone, Insurance: Business/Liability/Malpractice, Internet, Legal, Accounting, Consultants, Licenses and Permits, Maintenance & Repairs, Office Supplies, Care Credit Fee, Security, Website, Practice Software, Internet, Bank Fees / CC Charges, Training, Continuing Education and other.
 - Operating Costs can range between 5-15% depending on the practice and its needs & strategy.
- **Marketing:**
 - Not all marketing is expensive, however all good practices' have a marketing strategy.
 - ☐ Some practices spend less than 1% of collections on marketing.
 - ☐ Startup or growth practices expect to spend 5% or more of collections on marketing and advertising.



Valuation/Normalization Adjustments

- **Owner Compensation:**
 - Many practices payout all earnings to the owner doctor in the form of compensation.
 - Owner compensation needs to be adjusted to calculate the cost of replacing the owner with another dentist. Imagine as if an associate dentist performed all the dentistry. (For purposes of EBITDA)
- **Staff & Employee Costs:**
 - Are there family members working in the practice?
 - ☐ Are employee wages above or below market?
 - ☐ Will all the staff be retained? Will staff need to be added?
 - ☐ Are there profit sharing arrangements, fringe benefits, or other discretionary costs?
- **Rent:**
 - Is the office space is owned by the seller or related party?
 - ☐ Is the rent expense in line with the market?
 - Is the lease assignable, if not, what would be new lease cost?
- **Continuing Education:** Is the seller using CE trips in combination with personal vacations?
- **Auto, Travel, Meals & Entertainment:** Deductible for tax purposes but not required for the operation of the dental practice.



Active Patient

Active Patient: The number of individual patients which have visited a practice in the last 18 months.

- An “Active Patient” is not:
 - The number of patient visits
 - The number of patient records
 - The number of “Active Patients” in the practice management system (unless office monitors this very closely)

- “Approximate active patient capacity”
 - Formula: $(\text{Hygiene visits per day} \times \text{Total hygiene days per week} \times \text{number of weeks per year}) / (\text{number of patient hygiene visits per year})$
 - For Example:
 - ☐ Hygienists see 8 patients in a day
 - ☐ Practice has 7 hygiene days per week
 - ☐ Practice is open 46 weeks per year
 - ☐ Strong recall system (>90% of patients come every 6-months)
 - Calculation: $8 \text{ patients per day} \times 7 \text{ days per week} \times 46 \text{ weeks per year} / (2 \text{ patient visits per year}) =$ “Approximate active patient capacity” of 1,288.



Factors Impacting Practice Value

- Stability of historical and projected earnings.
- Ability and willingness to transfer practice
- ☐Overhead percentage
- ☐Size of practice
- ☐Number of active patients (range over time)
- ☐Number of new patients and degree of patient turnover
- ☐Stability of practice and community
- Competition
- ☐Fee Structure
- ☐Practice location
- ☐Demographics of patients
- Ability to expand
- ☐Collections / Gross and Age of Receivables
- ☐Parking
- ☐Recall System and hygiene production
- ☐Quality of records
- ☐Quality and experience of staff and degree of turnover
- ☐Effectiveness of management systems
- ☐Likelihood of staff will remain
- Ability and talent of staff



Factors Impacting Practice Value

- Facility design and square footage
 - ▣ Number of treatment rooms, age, conditions of equipment
- Overall appearance
 - ▣ Reputation
- Number of hours worked
 - ▣ Amount of time taken off
- % of patients covered by insurance
 - ▣ Assignability and terms of lease and availability for purchase of facility
- Legal and accounting records
 - ▣ Treatment mix
- Practice maturity
 - ▣ Practice profitability
- Associate/Dentist contract
 - ▣ Financial policies
- Technology
 - ▣ Dentist scheduling
- Patient Acceptance %
 - ▣ Treatment Acceptance %
- % of cases referred out



What assets are you purchasing?

- Assets typically included:
 - Fixed Assets, Equipment, Leasehold Improvements, Office Furniture
 - Patient Records
 - Certain contracts
 - Inventory and Supplies
 - Phone number, websites, signage
- Assets typically excluded:
 - Cash
 - Accounts Receivable
 - Personal items of the Seller
 - All Liabilities of the Seller



Fixed Assets vs. Intangible Assets

Goodwill &

- Goodwill & Intangible Assets: The value of a business which exceeds the value of the equipment and other fixed assets. The value of dental practices is typically 70%-90% made up of Goodwill & Intangible Assets.
- Why do buyers & sellers care?
 - Taxes
 - Fixed Asset Value (think eBay Pricing)
 - Sellers, lower fixed asset allocation is good for you.



Standards of Value:

- **Fair Market Value:** "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."
 - Most common standard for practice valuations
 - The universal standard of value for gift, estate, and inheritance
- **Strategic/Market Value:** The value to a particular investor based on individual investment requirements and expectations.
 - Something is worth whatever someone will pay for it.



Valuation Theory

Fair Market Value



FMV vs. Strategic



Information Requests

Data Requests for a Practice Valuation:

- Tax Return Filings
- Profit & Loss Statements or Income Statements
- Production by Provider by ADA code
- Payroll Reports (Annual Wages and salaries by employee for last 3-years)
- Production adjustments and write-offs
- Receivables report
- Balance Sheet
- Lease and other key contracts

Request data for minimum of the last 3-years and current YTD data.

Other Requests and Discussion Points:

- Why is practice for sale?
- Philosophy of the practice
- Information on the community & competition
- List of equipment and furnishing
- Pictures or video of office
- Types of Insurance Accepted
- Patient base demographics and changes over time
- Number of active patients
- Number of new patients
- Number of hours worked



Acquisition/Valuation Red Flags

- Valuation Report based primarily on Collections and not Profitability
- Variation in historical performance
- Declining trends
- High overhead
- Unprepared seller or broker
- Refusal to answer questions or provide requested materials
- Hesitation about working with your advisors
- Bad online reviews or poor reputation of with other dentists
- Lots of adjustments to the financial statements
- Practice has been listed for sale multiple times
- High amounts of debt on the practice
- Uncommitted or poorly trained staff



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