Understanding Orthodontic Transitions

The Value, Pitfalls and Associations

2018 AAO Transitions Meeting
Washington D.C.
May 4, 2018

by
Ken Alexander, M. Div.
Director, Alexander & Sons Consulting

30+ Years
Transitions Consulting &
All Aspects of Practice Management
Consulting exclusively with orthodontic practices,
in North America & Europe

Ken Alexander is Director of Alexander & Sons, (formerly Millenium) and is joined by his son Ryan, Consultant/Broker, and son Steven, Orthodontist. He is considered one of the top consultants in practice management and transitions working almost exclusively with Orthodontists for more than 30 years. Few possess his knowledge and expertise, and fewer yet have the ability to understand every part of an Orthodontic practice and be able to move each practice to its maximum potential. Ken is an intelligent deal maker, often working with both Buyer and Seller to ensure a fair transaction and a smooth transition. He is a polished lecturer and effective consultant having worked with well over 700 orthodontic practices in the US and Europe, all of whom he calls his friends.
I. **A Brief History of Orthodontic Practice Valuations:**

1980’s – Practices had little salable value as a start-up could provide as much or better return without having to complete another doctor’s cases. Practices were sold for tangible asset value of facility and equipment with a big “thank you” to the Buyer for their willingness to move to the area and take over the case work and retention.

1990’s – With the advent of practice management and many innovations that made treating cases much easier and less doctor intensive, there were larger practices with greater profits and less work. Most practices were sold for mainly the tangible asset price for facility and equipment, but the main way to get value from the practice was to take on a two-year associate who then bought into the practice as a 50-50% partner. The goal was to bring in an associate/partner three to seven years before retirement, with the Buyer usually buying in by way of a “management fee” or “sweat equity.”

The top 10-20% of the profession were leveraging innovations and practice management to create the $2 - $3 million mega-practice. Many of my clients grew to $3+ million-dollars with 50-55% profitability and Contract Balances of 80-90% of yearly collections. Few banks would lend on a practice purchase beyond the tangible asset value, so Seller financing over five years was the norm.

**Martin “Bud” Schulman**, a retired businessman was talked into becoming the president of DCA, a retainer and custom band manufacturer. During his tenure he became friends with many of his clients coaching them on sound business strategies. For Bud, as for me, it became natural to coach our clients as to how to transition out of practice. Bud decided that orthodontic practices should be valued at 1 x Yearly Collections. It seems that number fit well with the “sweat equity” approach where a Buyer could own half the practice in the first five years of partnership, then pay off the second half by way of deferred compensation to the Seller the next five years.

Somewhere in this time period, Practice Solutions (now integrated into B of A), a private Dental/Medical lending group, began heavily lending for orthodontic practice purchases. Often a carry back of 20% was required, but 100% of gross became the norm.

2000’s – Practices continued to be very successful as innovation and demographic growth started to steadily increase the size and profitability of most orthodontic practices. What used to need two doctors now only needed one as Doctor Time Scheduling and self-legating brackets, along with other innovations made seeing 60-90 patients a day much more commonplace. Many doctors began to shy away from bringing in partners after hearing the horror stories of bad break-ups and disappointments, mainly due to poor communications when bringing in associates. With the advent of the Letter of Intent there was much more clarity and fewer upsets.

Ziegler Practice Transitions, Bentson Clark & Copple, and Roger Hill of the McGill Group and Ken Alexander provided a more unifying structure for transactions that had not existed before, especially by providing Term Sheets prior to the legal docs.
What seemed to universally become true was a greater focus on the Contracts Balance and its value, using a sufficient C/R Balance to mitigate the issue of “paid in fulls” and “paid in advance.” Dr. Ziegler showed exactly what a Contracts Balance should be with a routine of 25% down payment and 24 monthly payments.

2010’s – Much of disruption began taking place in the Orthodontic industry resulting in a wide divide in private practice between the “haves and the have nots,” and the significant increase in corporate dentistry/orthodontics. New grads have far less choices for buying a private practice yet doing a start-up often seems impossible with all the school debt. The Corporate entities are enticing the new grads with greater associate pay, and for some it is a good fit, but for many others they long to eventually be in their own private practice with complete control and no longer losing out on the business investment aspects of ownership.

Orthodontists began working longer into life, most for the pure pleasure of their hobby, and others because their career practice success and spending habits left them with a sense that they must keep working into their 70’s. When they want to sell their retirement practices there is sometimes little or no real value left for a Buyer so creative means are necessary to allow them to step-out.

Practice values began declining as overhead rates squeezed profit margins and C/R balances fell. Lenders began to get aggressive in competing for the loans on orthodontic practices which rarely ever defaulted. The norm was 100% financing on 10 and 15-year loans.

2018 – Orthodontics remains one of the best professions for both quality of life and income. It is especially true, as it always has been, that those who have the best personalities, a strong desire to be successful, and use practice management effectively, will have the biggest and best practices in the area. The profession could be cut almost in half and the Orthodontist will continue to be in the top 1% of wage earners in the US. Hence part of the reason why corporate dentistry has begun to enjoy 35-50% of the orthodontists’ profits while trying to keep associates relatively happy.

The C/R Balance vs. Paid in Fulls has begun to reach a critical status in many transactions where what was once 80-90% of yearly collections remaining behind for the Buyer has dwindled to 35-50%. This creates a deficit to traditional value that should be resolved by a reduced sales price if one wants to value practices “apples to apples.” Unfortunately, the major appraisers are not yet on the same page with this important potential pitfall.

What should the Contracts Balance be?

75% of Last Year’s Production = 25% down and 24 monthly payments
50% of Last Year’s Production = 30% down payment and 18 monthly payments

The C/R should be at least one year’s expenses (53-58%)
if average treatment time is two years.
II. **Key Considerations for Determining an Orthodontic Practice Value:**

1. **Practice Profitability:** The Almighty Determiner of Orthodontic practice value.
   
   Determine the Net Adjusted Profits by removing all “Elective” expenses and adding them back as Adjusted Profit. Be sure to leave enough expense monies in each cost category to reasonably pay for the ongoing expense of the operation.
   
   **Ideal Targets** = 55% for expenses & 45% are profits and free cash flow

   *What should be most important to value is understanding how the profits are generated and will they be duplicated in the future by a new Buyer!!!*

2. **The Number of New Patients and Starts:**
   
   Low NP Exams with high Start % = Be careful
   
   High NP Exams with low Start % = Could be good
   
   Heavy Phase 1 & Buyer does little Phase 1 = Be Careful.
   
   What is the quality and diversity of the Referral Sources? (50% from one Pedo?)

3. **Facility and Equipment:**
   
   Nice facility and low debt = increases value.
   
   Nice facility and high debt = is often problematic.
   
   Poor facility & equipment = should decrease value.

4. **The Location of the Practice:** Location, Location, Location
   
   California, Florida, Arizona, and Texas are the hot spots, and on what street corner?

   *The Too Often-Neglected Considerations for Orthodontic Practice Value:*

5. **The Staff and Management Team:**
   
   The Seller must disclose which team members may be leaving.
   
   Will top talent continue with the practice after the buyout?
   
   You need the necessary pillars of the practice and familiar faces to keep the Goodwill!
6. **ARE THE TREATMENT FEES TOO HIGH OR UNSUSTAINABLE FOR THE AREA?**

   *High fees may be a blessing or a curse for a Buyer.*

7. **TREATMENT TIME AND QUALITY OF RESULTS:**

   Check at least the last 20-30 Debonded Cases for Quality and Treatment Time.
   Up to 2-3 months over on average treatment time is usually not a problem.

   *For practices with many cases over treatment time, consider having the Seller complete cases at a discounted per diem or no compensation.*

8. **GROWTH MOMENTUM:**

   Growing practices deserve higher multiples on 2-3 years data.
   Declining practices should get lower multiples on 1-2 years data.

   *It’s all about Exams, Starts and Net Production in evaluating if a practice is up or down.*

9. **THE QUALITY AND QUALITY OF THE REFERRALS AND THE PATIENTS ON OBSERVATION:**

   Ideally a good split of 50% patient vs. 50% dentist referrals.

   The more Observation patients and Phase 1 patients the better for hidden value.

10. **TOTAL PRACTICE YEARLY NET PRODUCTION AND CONTRACTS RECEIVABLES BALANCE:**

    **Net Production** (New Charges) is a better indicator of practice success than income.

    Has the Net Production kept up with Collections or has it lagged causing a decline in C/R?

    **Contracts Balance** (C/R) (often confused with A/R) and is:

    *All monies owed to the practice past, present and future.*

    *The C/R balance should equal a minimum of 45-50% normal yearly collections.*

    There is potential extra value in a C/R that is over 60% and deficit value under 45%.
III. **THE POTENTIAL PITFALLS WITH BUYING AN ORTHODONTIC PRACTICE:**

11. **Financial Pitfalls:**
   
   a) A Low Contracts Balance that cannot adequately cushion a possible initial decline.
   
   b) Credit Balances still on the books at Closing and Refunds. (Who is responsible for them?)
   
   c) Losing Invisalign or Delta Dental status, Sure Smile, Damon, Adults, Lingual Braces, TMD, and many Surgical Cases. Can the Buyer sustain the Seller’s work and reputation?
   
   d) Differences in early treatment philosophy and fees that cannot be sustained by Buyer.
   
   e) Referrals are too concentrated in too few Dental / Pedo offices and you lose some.
   
   f) Dwindling Exams & Observation base with cases started too young the past few years.
   
   g) Capitation / HMO’s plans, Medicaid, and No Down Payments.
   
   h) Too many locations that generate too little income.
   
   i) Special concessions to key staff members to keep them on board until after the sale.

12. **Facility & Equipment Pitfalls:**
   
   a) Facility too large or too small, outdated, poorly designed, or no adequate TC Room.
   
   b) Outdated Equipment, X-Ray, Chairs, Units, Sterilization or Instruments.
   
   c) Needs new computer software, server, computers and or no charting at the chairs.

13. **Treatment Pitfalls:**
   
   a) Differences in overall treatment philosophy, especially extraction and non-extraction.
   
   b) Over-Due Treatment Time and a Seller unable to effectively complete his/her cases.
   
   c) The Seller who “checked out” of his practice a year or two before he sold.
   
   d) Poor record keeping or poor-quality records and charting.

14. **Resistance to Change Pitfalls:**
   
   a) Seller will not let go of management, final treatment decisions and has special, even emotional affections for the old logo and old ways of doing things.
   
   b) Staff who were given extra time off, extra holidays, benefits, and bonuses.
   
   c) The patients, parents and team will not let go of their attachment to Seller.
   
   d) Inheriting a team resistant to change, inexperienced or incompetent.
IV. HOW ARE ORTHODONTIC PRACTICES VALUED?

A DEFINITION OF FAIR MARKET VALUE

The IRS says that a business must be valued at fair market value. That is "the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both having reasonable knowledge of the relevant facts."

“Willing buyer and a willing seller”

“Both having reasonable knowledge of the relevant facts”

15. THE MAIN DATA USED TO CREATE THE VALUATION MODELS:

1) Three years of Total Revenues (Collections) averaged; 2015, 2016 & 2017.
4) Consideration for any perceived shortfall or surplus in the Contracts Balance.
5) Consideration for any facility or equipment deficits or extra value.

16. THE TWO MAIN VALUATION MODELS USED IN ORTHODONTIC VALUATIONS:

1) A COMPARATIVE MARKET APPROACH: (Much like real estate comparables.)

This Method of Valuation seeks to compare the practice being valued to similar other practices taking into consideration all of the key components that create practice value.

2) SOME FORM OF CAPITALIZATION OF EARNINGS: Pre-tax and/or Post-Tax Models.

This approach tries to standardize valuations to make them similar to how many dissimilar businesses are valued. It is the model most accountants prefer, even as it is difficult for most doctors to understand.

The "formula" approach may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for making the determination; A.R.M. 34, A.R.M. 68, O.D. 937, and Revenue Ruling 65-192 superseded.
17. **CAPITALIZATION OF EARNINGS (SOME FORM): THIS IS THE PRIMARY VALUATION MODEL:**

\[
PV = \frac{E}{C}
\]

(Earnings / CAP rate)

1) Earnings = Net Adjusted Profits – *minus* appropriate Dr. Compensation.

2) Net Adjusted Profits = The true business free cash flow after paying all necessary bills.

3) Capitalization Rate: The fraction or % used as the divisor of E to determine value.

- A Capitalization Rate of 15% means a PE (Price to Earnings) of 6.77;
- or
- It will take 6.67 years of Ownership income to pay off the purchase price, not counting the cost of interest.

4) Expected Ownership Income divided by the selected Capitalization Rate = Present Value

18. **PRE-TAX & AFTER-TAX CAP VALUATION MODELS:**

The **After-Tax Model:** Calculates value using After-Tax dollars and a lower CAP Rate as the assumed taxes have been removed by the formula prior to applying the CAP Rate divisor; or a CAP Rate value set at 5-7 years of after-tax Earnings (Expected Ownership Income).

The **Pre-Tax Model:** Calculates value using Pre-Tax dollars with the taxes assumed to be built into the higher CAP Rate; Generally, 27-33% in Orthodontic Transactions; or a CAP Rate value set at 3-4 years of pre-tax Earnings.

19. **A COMPARATIVE MARKET APPROACH:** The best approach 😊.

A Market Approach should be the most preferred method and model for Orthodontic practice valuations because those of us who are in the Orthodontic Transitions Business know the relative Multipliers that are found in average private Orthodontic practice sales:

- **80% of Collections = The current Average Collections Multiplier**
- **1.80 x Net Adjusted Profits (Earnings) = The current Average Net Profits Multiplier**

Determine appropriate value multiples for the practice: **Above or Below Average?**

Add or subtract from the preliminary value any negative or positive adjustment for Contracts Balance and / or for Facility and Equipment to arrive at final value.

*Many Orthodontic Practice sales contain significant areas of EXTRA Value!*
V. THE VARIOUS TYPES OF PARTNERSHIPS AND ASSOCIATIONS: What do I get out of the deal?

20. The Long-term Associate: Keep them happy with higher compensation and maybe give a promise for ownership when the senior doctor is ready to retire.

21. The 50-50% Partnership: (Partnership of Corporations): After a one, or two-year associateship, the Buyer is offered 50% ownership which is paid by a loan from the bank. The senior doctor may or may not be given the benefit of being able to work fewer days or receive an extra management fee to help mitigate any extra value that he/she is perceived to bring to the partnership the first 3-7 years.

22. The Fractional Partnership: Buyer is allocated a fair % of profits that corresponds to their individual contribution to the practice as a whole. Days worked and ownership share may or may not be allocated 50-50%. The goal is to arrive at a fair transaction that both Buyer and Seller will enjoy. In most transactions 60% for Senior doctor and 40% for Junior doctor is fair for the first 5 years.

23. The Graduated Fractional Buy-in: Buyer buys in at 10% a year for five years and then split of profits is 50% for days worked and 50% for ownership share. Essentially, assuming same number of days worked, Junior partner receives 30% year 1, 35% year 2, 40% year 3, 45% year 4, and 50% year 5+, and is responsible for paying the purchase loan from his/her allocations.

24. The Associate/Owner – Owner/Associate Transaction: The Buyer works as an associate for 3-5 years for X amount of dollars and then Owner sells and works back for a similar, or lower pay, than what the associate was paid. Effectively the same dollars can be achieved as a the 50-50% partnership.

25. The Partner Associate: The Seller sells 100% of the practice to Buyer and then works back for 50% of the profits after all expenses, including the practice purchase loan payments. Essentially the Seller has sold but gets the benefits of a partnership after they pay their fair share of the loan payments, and Buyer gets a portion of the Sale’s price paid by the Seller each year they stay on.

26. The Associate Partner: The Owner pays the associate a salary or per diem for working in the main office, but sells part or all of a second location, or the two parties form a 50-50% joint venture in a start-up or practice purchase.

27. Partnership by Practice Merger: Two practices merge for the purpose of the future retirement of one of the doctors, or to better utilize a facility, or to share staff and facility.

27. Group Practice & Pedo/Ortho Partnership: Many different forms of partnerships exist for group practices and with pediatric dentists. Be sure to have a knowledgeable consultant advise you on this.

Conclusion: Buying and selling an Orthodontic practice can be a daunting experience, but if you seek the right help you can gain valuable insight into practice value and get a glimpse of the potential difficulties faced in the transition. It is vital that the Buyer and his/her advisors ask the right questions and do due diligence to assure that the answers provided are accurate. Having an experienced transition consultant evaluate the practice is a small investment to help ensure a fair price and fair terms, but most importantly the assurance that the future anticipated stream of profits is highly probable. Orthodontics is still golden for those who wisely work towards excellence in treatment quality, take care of their customers, and apply sound management principles to their businesses.