# DRILLING DOWN

## What to Expect When Buying a Dental Practice

*A PNC Healthcare white paper exploring practice ownership*

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# DRILLING DOWN

The career path for new dentists is a wide one. Some newly minted docs join an existing dental practice. Others choose employment with a hospital or corporate dental chain. Still others opt to practice in a federal agency or public health setting.

Yet, at some point, the majority of dentists find themselves engaged in some form of private practice — either by themselves or in partnership with other dentists — according to the American Dental Education Association (ADEA).[1] In fact, one of the main reasons cited by dentists and dental students for pursuing a career in dentistry is the potential to be their own boss.[2]

According to the ADEA, most dental school grads begin their careers in salaried or associate positions in private practices — and then move to practice ownership within several years. Here, they traditionally follow one of two paths: They build a dental practice from scratch — or they acquire an existing practice.

The logistics of starting up a new practice are complex and varied, so, for the purposes of this white paper, our discussion will center on acquiring an existing practice.

## THE INS AND OUTS OF ACQUISITION

Many new dentists have found that buying an existing practice can get them up and running quickly, with a built-in base of patients and staff who already know the ropes. By purchasing an existing practice, the new dentist is purchasing an income stream — something with current and future value.[3] For example, assume that you pay $360,000 to purchase Main Street Dentistry, an existing practice with consistent revenue of $600,000. If the overhead you inherit is 65 percent and the practice grows at a steady 6 percent rate, you could enjoy pre-tax cash flow of $3,000,000+ over 10 years, even though you are assuming $360,000 in debt. Starting a new practice from scratch, by contrast, might require several years to hit the same $600,000 revenue mark. Ultimately, you might not achieve this level of earning capacity in the same 10-year period.

### UPSIDE

While the initial price tag of an existing practice can be higher than the costs of a startup, the practice purchase may be less costly overall if you are able to get up and running (and billing) faster.[4] Financing the purchase of an existing profitable practice may also be easier, as it has the proven track record that bankers like to see.

### DOWNSIDE

Finding the right practice to buy can be difficult. Is there one available in a community where you want to live? Is the practice financially stable? Is it growing? How many active patients does it really have (and how many are likely to remain)? Can you be added to the practice's payer networks? What equipment, furniture and computers need replacing? How many and what type of employees will you be inheriting?

## THE STAGED BUY-IN OPTION

Another option for acquiring an established practice is the staged buy-in. With this method, the new dentist buys a small percentage of an existing practice each year over a set period until becoming an equal owner with the senior dentist. At that point, the associate dentist buys out the remaining 50 percent of the practice. Associates are often offered the right of first refusal on buying the practice at which they work.[5]

### UPSIDE

In essence, you are getting paid to learn the practice, while you get to know the patients and the business. During the buy-in years, you are theoretically building up a patient base so that the practice is larger, stronger and more valuable than it was initially.

### DOWNSIDE

As the "new kid on the block," you may very well have to work the hours and accept the cases that the owner does not want. The owner also has control over patient flow and income. Further, negotiations on price can be difficult between a principal and an associate trying to maintain a working relationship.

## ARE YOU (REALLY) READY?

Whether it's an outright purchase or a buy-in over time, the decision to go solo entails some serious soul searching. Your answers to the following questions may provide the insights you need to determine your readiness to own a practice.

1. I have the necessary management skills to manage a practice (or am in the process of developing them).
   Yes ____ No ____
2. My clinical abilities and speed are at such a point that I will be comfortable in assuming this new role.
   Yes ____ No ____
3. My case presentation skills are well developed.
   Yes ____ No ____
4. Having a practice that is "my own" is attractive to me.
   Yes ____ No ____
5. Having more control over my work environment — and my income potential — is important to me.
   Yes ____ No ____

- More Yes than No: You may be ready to take some next steps and explore practice ownership.
- More No than Yes: You may need to critically appraise your readiness for practice ownership.

## THINKING IT THROUGH

If acquiring an existing dental practice seems like a good fit with your aptitude and abilities, you may want to spend some time defining what the "perfect" practice would look like. How big would it be? How many hygienists would it support? Would you lease or own the facility? In particular, these critical areas are typically important to think through:

**Yearly Production** What level of production are you capable of — and comfortable with? According to the *Dental Economics/Levin Group 7th Annual Practice Research Report*,[6] average gross production for the doctors surveyed was $649,839 ($162,113 for a full-time hygienist). That equates to an average daily production per doctor of $3,486 and $1,000 per hygienist.[6]

**Work Week** How many hours a week are you willing to work? The majority of dentists surveyed in the *Practice Research Report* worked 4 to 4.5 days a week, and only 15.8 percent of doctors reported working five days or more per week. How much time off for conferences, CDE and vacations do you desire?

**Desired Income** How much will you need to make to support your lifestyle and financial obligations? Dentist owners surveyed by *Dental Economics* reported annual compensation of $239,000 for full-time practices and $115,000 for part-time work.

**Patients** How many patients will the practice need to support your production and income goals? In the *Dental Economics* report, new patients totaled 27.9 per month for responding practices.

**Overhead** How much will it cost to keep the doors open? Responding practices reported average overhead of 61.2 percent of revenue.

**Additional areas to consider include:**

- Square footage
- Rent/mortgage/maintenance fees
- Staff size
- Insurance plans accepted
- Practice philosophy
- Age of equipment
- Number of treatment rooms
- Number of hygiene rooms
- Practice location
- Lease or own facility

## FINDING A PRACTICE FOR SALE

The next step after determining what a perfect practice would look like is to actually find one that matches your parameters. Fortunately, there are a variety of ways to find a practice for sale.

**Dental Practice Brokers** Establishing relationships with dental practice agents can help ensure that you receive details of practices coming to market. Brokers will typically provide a prospectus outlining the main financial aspects of the practice as well as details on turnover, equipment and location.

**Friends and Colleagues** Many practices are sold by word of mouth, so keeping your ear to the ground with colleagues and friends can certainly pay off.

**Local Dental Supply/Equipment Reps** Reps typically visit a large number of practices regularly and may be good resources for learning what practices might be available.

**Dental Associations** The "classifieds" section of state dental association websites and newsletters are another resource for identifying opportunities.

**It Takes a Team** The successful purchase — and ongoing operation — of a dental practice requires a team of competent, experienced advisors. These professionals can help identify business, financial and legal issues that could impact the purchase, as well as provide guidance on negotiating the best deal. Typical professional advisors on such a team include:

- Attorney
- Dental Lending Specialist
- Dental CPA
- Equipment Specialist
- Contractor
- Insurance – Commercial Agent
- Insurance – Life & Disability Agent
- Commercial Real Estate Advisor
- Dental Lease Specialist
- Practice Management Consultant

### LOCATION IS EVERYTHING

This truism of real estate holds true for dental practices. But it's not just about having a corner office with great parking on a busy thoroughfare. Other factors that help make a prime location include the demographics of the surrounding area — who your potential patients are and the types of services they need. Just as important is the presence or lack of competitors. You can learn a lot by analyzing existing practices in the area.

*The American Dental Association provides customized demographic reports to help dentists evaluate different market areas, which can be ordered through the ADA survey center at* 312.440.2568 *or* W **www.ada.org**.

## ESTABLISHING PRACTICE VALUE

Once a practice that meets your parameters has been identified, the issue of evaluating the asking price comes into play. Here, it's important to understand that an asking price isn't necessarily an accurate valuation (although it should be a realistic estimate of the eventual sale price). One way to get to the bottom line is to consider these key items that contribute to the overall value of a practice:

**Revenue and Profits** "Gross revenue" is often used as a rule of thumb in establishing practice value. Yet, as you can see in the example that follows, there is more to gross value than meets the eye. Example: Three practices each have annual collections of $600,000. Practice A shows a profit of $261,000, Practice B turns a profit of $198,000, and Practice C shows a profit of $167,000. Obviously, one of these practices offers more "value." The ADA's *Valuing a Dental Practice* booklet provides guidance for planning a practice purchase. You may also benefit from consulting an accountant or other professional expert for a business valuation.

**Profit Margins** Here, a clear understanding of practice overhead is critical. With overhead of more than 70 percent of revenue, Practice A will have a dramatically different profit margin and value than Practice B, which has overhead in the 50 percent range.

**Service Mix** Service mix is a key value driver. For example, assume you analyzed several years of a potential practice's production reports and saw that minimal perio and endo services have been provided. You might infer that excellent growth opportunities still exist in the practice. On the other hand, if the majority of the retiring dentist's production has been focused on complex restorative dentistry, the potential for additional clinical procedures may be limited. In this case, you may be purchasing more of a "maintenance" practice.

**Market Area** The right demographics for the type of dentistry you wish to practice can also add value. If you are interested in emphasizing aesthetic and complex restorative dentistry, you may need to practice in a community where the demographics will support it.

**Condition and Size of Facility** A cramped space with outdated fixtures and furnishings typically does not command as high a value as practices with recent renovations.

**Equipment** Newer equipment and state-of-the-art technology certainly bring value to a practice. If not already in place, it could cost tens of thousands of dollars to upgrade a low-tech practice with technology such as digital radiography, a high-end intra-oral camera system and cone beam CT technology.[7]

**Restrictive Covenants** Practice purchase agreements that include non-compete and/or patient non-solicitation covenants can help protect the value of a practice purchase.

**Accounts Receivable** If a practice's AR is included in the sale, a method must be developed to value them. One way is to apply a percentage based on the age of the receivables (e.g., 95 percent for current receivables, 80 percent for those 31 to 60 days, etc.).

## ASKING THE RIGHT QUESTIONS

A thorough due diligence process is typically the next step in assessing a potential practice purchase. This involves asking some pointed questions:

**Are current financials available?** As they progress in their evaluation, dentists typically request additional information[8], including three to five years of:

- Federal income tax returns and financial statements
- Annual production, adjustments and collections by provider
- Annual production, adjustments and collections by payer
- Annual totals of production by procedure
- Patient demographic information from patient management software (age groupings, ZIP codes, etc.)
- Fee schedule
- Copy of the space lease
- Copy of any employment agreements for associates
- Employee census information
- Current employee benefit programs
- Listing of furniture, equipment, computers and software, with age or year of purchase

Note that in order for these financial documents to be considered current under lending guidelines, they should be no older than 90 days.

**Is a deposit required?** In some cases, you may be asked to make a deposit or provide "earnest money" before you are allowed to look further into the particulars of a practice — typically when a broker is involved in the sale.

**Do I need to sign a confidentiality agreement?** Likewise, sellers may want you to commit to keeping their information confidential before opening their books. An attorney can help you analyze whether or not to enter into a confidentiality agreement and negotiate its terms.

## UNDERSTANDING YOUR FINANCING OPTIONS

The overall debt a dentist incurs in purchasing a practice can be significant — and finding the right financing structure is critical. Typically, financing a practice acquisition entails one of three options:

- A lender finances the purchase of an existing practice.
- The seller carries all or part of the financing.
- The purchaser utilizes a combination of lease and loans to fund the purchase.

Knowing how much to borrow is especially important. In addition to borrowing for the purchase price, some dentists borrow additional funds to support cash flow needs as collections ramp up. (It may take time to get revenue flowing, but expenses start immediately.) Here, the new owner may borrow enough to cover any capital expenses needed in the first year and request a line of credit to cover any cash flow shortfalls.

As you compare lenders, you'll want to know the terms, interest rates, life of loan, early termination penalties and flexible payment options of each lender. Evaluate their fees and associated expenses. Examine any differences in collateral requirements and who the lender will require to be a loan guarantor.

## PREPARING A BUSINESS PLAN

When it comes time to request financing, be prepared to look at it from a banker's perspective. Here, preparing a solid business plan can help answer all the questions necessary for the lender to make a decision.[9]

Start with an executive summary, which summarizes the purpose of the loan. Are you planning on a startup? Or are you buying the practice of Dr. Jones, which has been at 123 Main Street for 30 years? Outline the type of practice — general or specialty — and how the practice will be organized from a tax point of view (as an S-Corporation or LLC, for example). Consulting with a dental CPA can help determine which of these entities makes the most sense.

Then, introduce the members of your management team, which should include your attorney and your dental CPA, along with any key staff members who are going to help you run the practice. And explain where you are in the process. For example, has a letter of intent been submitted?

Next come the various elements that further tell your story and make your case for financing, which may include:

**Amount Needed and Allocation of the Loan Proceeds** Lenders typically want to see a narrative explaining the specific use for the requested funds (and how much you are requesting). Note that a qualified accounting professional can provide guidance on tax strategies related to the allocation of the sale price to the various assets involved in the transaction.

**Collateral and Their Values** If some form of collateral, such as a lien on equipment or even your home, will be offered to the bank, what is its value? Note that lenders may require a personal guarantee of the loan. This means that if a practice defaults on its obligations to the lender, the dentist is personally responsible for the unpaid balance of the loan.

**Repayment Plan** Include an amortization schedule outlining repayment. Do you intend to repay the loan over five, seven, 10 years or beyond?

**Business History** How long has the practice been at the current location, and how has it performed over the last three to four years? Is there any reason to believe it won't perform as it has in the past? Who is the current owner and what is the current legal structure (proprietorship, partnership, corporation, LLC, etc.)?

**Fee Schedule** Have you created a fee schedule by ADA procedures, or are you going to adopt Dr. Jones' fee schedule? Many dental CPAs have fee schedules by ZIP code that will allow you to be competitive in the current local marketplace.

**Insurance** Are you going to participate in dental insurance? If so, is it a capitation arrangement, or are you going to get into a PPO or other type of arrangement? Are you going to transfer the practice's existing insurance relationships to yourself?

**Patient Lists** Provide demographic information about your patients. Is it an aging population, or is it pretty well diverse?

**Market Area** What is the market area where you intend to practice?

**Competition** Who will be your competition within 1 mile, 5 miles and 10 miles of the practice?

**Advertising and Marketing Programs** What are you going to do that is unique to set yourself apart?

**Suppliers** Who are your major suppliers, and how are they going to allow you to pay — 10 days, 30 days, 45 days? Do they offer early-pay discounts?

**Office Space** Provide a description of the facilities and whether you will own the building (or, include a copy of the lease agreement if you plan to lease facilities).

**Improvements** If you're purchasing an existing practice, do you see ways to improve it? This might include installation of additional dental equipment, creating a more ergonomic office, or hiring additional assistants and hygienists.

**Risks, Costs and Rewards** What are the potential drawbacks — and rewards — of making these changes?

**Future Debt** What additional financing will be needed over and above the initial practice acquisition debt to fund these improvements?

**Financial Statements** You'll want to gather financial statements for the current business if they are available, as well as prior business tax returns.

**Cash Flow** Your lender is going to want to see an analysis of cash flow for at least five years. If you can, break the numbers out on a monthly basis for at least the first two years, and then on an annual basis for years three, four and five.

**Individual Tax Returns** Even if you just recently graduated dental school, you'll need to provide returns for the past two years.

**Personal Financial Statements** The lender will typically supply you with a template of the particular form it prefers.

**Accounts Receivable** If you are purchasing current receivables of the practice, you'll need to supply a current aging report.

**Copy of Your Credit Report** Of course, you'll want to address any outstanding issues with your credit history before providing a copy of your credit report.

## THIS WON'T HURT A BIT

Acquiring a dental practice is a major step — one that requires some guidance. By working with a bank that specializes in healthcare financing, you'll get the financing, business solutions and healthcare industry expertise you need to start out on solid footing. In addition, banks with a focus on healthcare financing typically have an intimate knowledge of equipment pricing, vendors and technology trends specific to the healthcare industry, and can deliver flexible financing options that help lower costs, conserve cash, and minimize clinical, technical and operational obsolescence.

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1 http://www.adea.org/dental_education_pathways/Pages/AfterDentalSchool.aspx

2 *Gender Differences in First-Year Dental Students' Motivation to Attend Dental School*, http://www.jdentaled.org/content/66/8/952.full.pdf

3 *Determining the Value of a Practice*, http://www.dentaleconomics.com/articles/print/volume-98/issue-5/departments/practice-transitions/determining-the-value-of-a-practice.html

4 *Points to Consider When Buying a Dental Practice*, http://dentalcpas.com/How%20to%20Buy%20a%20Dental%20Practice.steps%20to%20consider.pdf

5 *Associate Buy Ins: The Right of First Refusal*, http://www.dentistlawyers.ca/associate-buy-ins-the-right-of-first-refusal/26/

6 *Dental Economics/Levin Group 7th Annual Practice Research Report*, http://levingroup.com/pdf/desurvey/2013/Nov_DE_LGsurvey2.pdf

7 *Tips for Updating, Acquiring & Financing Dental Technology & Equipment*, presented by Angela L. Pratt, Contributing Advisor & Dental Practice Management Coach for Bender, Weltman, Thomas, Perry & Co.

8 *The ADA Practical Guide to Valuing a Practice*

9 *How to Run a Successful and Responsible Dental Practice*, webinar presented by Allen M. Schiff, CPA, CPE

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