About Your Speaker - Roger K. Hill

- Nationally recognized expert among transition consultants since 1979
- Senior partner in the McGill & Hill Group
- Published a comprehensive textbook on practice transitions at the request of the ADA, with a special section on orthodontic practices
- Serves on the National Board of Smile for a Lifetime
- Hosts extensive presentations and webinars for the AAO
- Areas of focus: transitions, partnerships, associateships, and practice sales

Where Are We Now?

- Orthodontics undergoing major changes
  - Morphing to a digital age for clinical aspects
  - More efficient and proactive business methods employed
  - Some changes intersect on both clinical and business aspects

Why Do We Have to Change?

- What you practice is a profession
  - Changes are pervasive:
    - Self-ligating brackets
    - Digital imaging/modeling
    - Metal to plastic
    - Invisalign and its progeny
    - Nothing is static

- What you run is a business
  - Like clinical, it is never static
  - Migrates/mutates to meet patients’ needs-desires
  - Always seeking efficiency
    - Brownian movement
    - Filling a vacuum

Practice and business aspects different

- Practice is science based
  - Always an explanation
  - Zero sum; always nets to zero
  - Law of Conservation of Matter
Why Do We Have to Change?

- Business is not as tidy (maybe more fun!)
  - In short, more begats more
  - A quick tour of practice value:
    - Tangible + intangible = value
    - Which is larger and more precious?

Why Do We Have to Change?

- Answer: it is always the intangibles
  - Intangibles are analogous to business aspects
  - Key to thriving (not just surviving) is adaptation to:
    - Business/intangible aspects, and
    - Meeting the patients at their point of needs/desires

Where Are We Going?

- The Mega Trends:
  1. Consolidation
    - Equity and operational considerations
  2. Consumerism
  3. Reimbursement
- Trends are pervasive and here to stay
  The Key: Adaptation

Where Are We Going?

- The Mega Trends (cont’d)
  1. Consolidation
    - Increasing practice values
    - Total practice value more than sum of practices contributed
    - Ownership/equity concentrated

Where Are We Going?

The Mega Trends (cont’d)
- Operational efficiencies
  - “The 10 Red Roofs”
  - Marketing/branding
  - Increased profitability
  - Market space coverage

Practice Model Evolution
**Where Are We Going?**

- Practice models
  - Cross-specialty alliances:
    - Pediatric Dentistry/Orthodontics
    - Pediatric/Orthodontic/General
  - Concerns with general dental component
  - Office Sharing Agreement (OSA's)
    - Effect on value
    - Fee splitting and Stark regulations

**Where Are We Going?**

- Fewer solo practices
- Partnerships (1 to 4 doctors)
- Cluster practices
  - Necessity for owner to change mind set
  - Precursor to a roll-up
- Corporate Dentistry
  - Service model
  - Ownership model
- Hybrid model: large private practice with corporate efficiencies

**Where Are We Going?**

- Hybrid model: large private practice with corporate efficiencies
  - Owned by doctor(s)
  - Multiple locations
  - Multiple (non-owner) associates
  - Economies of scale for overhead
  - Area/market dominance

**Where Are We Going?**

- Hybrid model: large private practice with corporate efficiencies
  - Reduced fee pressure
  - Centralized/sophisticated marketing
  - Doctors relieved of management
  - Doctors relieved of compliance and HR

**Where Are We Going?**

The Mega Trends (cont’d)

2. Consumerism
  - Direct marketing
  - Consumer makes the decision
  - Reduced dependence on referring doctors
  - Less doctor-centric
  - Increased marketability for a practice value

**Where Are We Going?**

The Mega Trends (cont’d)

3. Reimbursement
  - Pressure on fees
  - Value perception critical
  - Marketing strategy and protocols
  - Total team involvement
Sweeping Changes in Orthodontics

A New Valuation Metric

The New Valuation Metric: EBITDA

• Commonly assumed value ranges:
  - General practices 65.0% to 75.0%
  - Specialties vary: Orthodontic 75.0% to 85.0%

The New Valuation Metric: EBITDA

• Targets for corporate acquisitions:
  - Solo practices with revenue $1.5 mm, or greater
  - Multiple practices in a single acquisition (Roll-Up)

The New Valuation Metric: EBITDA

• What does EBITDA mean?
  - Earnings Before Interest, Taxes, Depreciation and Amortization
  - Earnings is essentially free cash flow
  - What is free cash flow?

The New Valuation Metric: EBITDA

• What EBITDA is NOT:
  - $ Practice Revenue (Normalized Overhead)
  - $ EBITDA
The New Valuation Metric: EBITDA

- **What EBITDA IS:**
  
  -$Practice Revenue
  
  (Normalized Overhead)
  
  (Reasonable Doctor Compensation)
  
  =$EBITDA

The New Valuation Metric: EBITDA

- **Current state of EBITDA multiples:**
  
  - Solo practices: 5 to 7 times EBITDA
  
  - Roll-ups: 8 to 12 times EBITDA

The New Valuation Metric: EBITDA

- **Let’s look at a solo practice**
  
  - $1,500,000 Practice Revenue
  
  (900,000) Overhead
  
  (350,000) Doctor Compensation
  
  $250,000 EBITDA
  
  x6 Multiple
  
  $1,500,000 Value

The New Valuation Metric: EBITDA

- **And, for a multiple practice roll-up**
  
  - $15,000,000 Practice Revenue
  
  (900,000) Overhead
  
  (3,500,000) Doctor Compensation
  
  $2,500,000 EBITDA
  
  x10 Multiple
  
  $25,000,000 Value

The New Valuation Metric: EBITDA

- **Where is the traditional market as EBITDA?**
  
  -$1,500,000 Practice Revenue
  
  x 0.80 Assumed Percent of Revenue
  
  $1,200,000 Assumed Value
  
  $1,200,000 = 4.80 EBITDA
  
  $250,000

The New Valuation Metric: EBITDA

- **Recent transaction**
  
  -$2,121,026 Practice Revenue
  
  (1,060,513) Overhead
  
  (530,256) Doctor Compensation
  
  $530,257 EBITDA
The New Valuation Metric: EBITDA

<table>
<thead>
<tr>
<th>Purchase price</th>
<th>$3,000,000</th>
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<tbody>
<tr>
<td>EBITDA</td>
<td>$530,257</td>
</tr>
<tr>
<td>Price EBITDA</td>
<td>5.66</td>
</tr>
</tbody>
</table>

- Where is traditional market on this transaction?
- Assume 75.0% to 85.0% of revenue
- Likely range: $1,600,000 to $1,700,000

So, should I sell to a corporate purchaser?
- Answer is not just about value
- Answer is two-part:
  - Post-sale tenure
  - Personal financial status

Should I sell to corporate purchaser?
- Run comparative cash flow projections
- Corporate sale, reduced post-sale compensation for n years
- Own practice n years more, then sell to traditional market
- Own practice n years more, then sell to corporate purchaser

How can corporate purchasers afford this premium?
1. Revenue will be increased by marketing for new patients and negotiating strength with insurance carriers.
2. Overhead (as a percent) will be streamlined;
3. The acquisition cost will typically be recovered in 3 to 4 years.

The effect of NOT streamlining overhead

\[
\frac{1,500,000 \text{ Practice Revenue}}{\text{Difference in Overhead Rate}} \cdot 0.05 \cdot \frac{\text{Difference in Overhead Rate}}{75,000} \cdot 6 \text{ EBITDA Multiple} = \$450,000 \text{ Reduction in Value}
\]
The New Valuation Metric: EBITDA

Key Factors:
- First, most corporate purchasers will want, or require you to stay for several years post-sale. The length of post-sale tenure is important.
- You will be paid as an associate post-sale, and make less than as an owner.

The New Valuation Metric: EBITDA

- The longer the post-sale tenure, the greater the difference in lost ownership profit which, in effect, reduces the benefit of the EBITDA multiple.
- Second, your personal financial status will have a bearing on your willingness to sell. To the extent you are secure, there exists the likelihood you may want to sell at an earlier age.

Selling the Practice and Strategies for Reducing Tax on Gain

Full Sale: 100.0% of Practice

Tax Strategies for Full Sale: Reduce Ordinary Income Taxes on Proceeds
- Pay Sale Expenses Through Corp
  - Legal Fees
  - Commissions
  - Accrued Expenses Payable
- Maximize Retirement Contributions

Tax Strategies for Full Sale: Post-Sale
- Keep Corporation and Use Service Agreement
- Minimize Payroll Taxes for Both Parties
- Continue to Fund Retirement Plan
- Maintain Family “Perks”
**Full Sale: 100.0% of Practice**

- Selling Your Building
  - Parallel Proforma / Purchase with Practice, or
  - Right of First Refusal, or Option
  - Negotiated as Part of Global Transaction with Purchase at Lease End

**The Golden Window:**

**Why Now May Be the Best Time to Sell**

**Lenders Are Willing**

- Money Readily Available
- Current Standards for Borrowers
  - Experience: 0 Years for Orthodontists
  - Credit Score: 680 or Higher
  - Production Capacity: 65.0% to 75.0%
  - Relaxed Standards Compared to Other Commercial Loans

**Full Practice Sale**

- Strategies for maximizing value
  - Above all else overhead control/reduction
  - General guidelines:
    - Staff salaries: 18.0%-22.0% (W-2 only)
    - Occupancy: 5.0%-7.0%
    - Dental supplies: 12.0%-18.0%
  - 1.0% overhead reduction = 5.0% increase in value!

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**Capitalization of Income**

<table>
<thead>
<tr>
<th></th>
<th>$1,500,000</th>
</tr>
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<tbody>
<tr>
<td>Projected Professional Income</td>
<td>$1,500,000</td>
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<tr>
<td>Costs of Professional Services</td>
<td>(337,500)</td>
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<tr>
<td>Operating Expenses</td>
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<tr>
<td>Profit Before FIT</td>
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<tr>
<td>Estimated Taxes</td>
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<td>$219,375</td>
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<tr>
<td>Capitalize @</td>
<td>16.9%</td>
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**Fair Market Value** $1,298,100

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**Capitalization of Income**

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<td>$190,125</td>
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**Fair Market Value** $1,125,000
Full Practice Sale

- Strategies for maximizing value (cont'd)
  - Reduce pre-paids
  - Updated equipment
  - Active marketing protocols/systems
  - Current fees
  - Appearance of facility

AAO Donated Orthodontic Services (DOS) Program

- Introduced in 2009, the DOS program provides access to care for children in need. Access to quality orthodontic care is missing in many children's lives. The AAO DOS program mission is to serve indigent children without insurance coverage or that do not qualify for other assistance in their state of residence.
- The program has expanded and offers care to children nationwide in addition to the recognized state programs in Illinois, Indiana, Kansas, Michigan, New Jersey, North Carolina, Rhode Island, Tennessee, Texas and Virginia.
- In order to expand further, we need you to help us by volunteering to serve as a principal orthodontist or help identify orthodontists willing to lead efforts to establish a DOS chapter in your state.
- Stop by the DOS booth here in San Diego to learn more about the program or contact Ann Sebaugh at asebaugh@aaortho.org with questions.