# Buying and Selling the Orthodontic Practice

## The Value, Hidden Costs and Pitfalls

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***by***

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

## *The Changing Face of Orthodontic Transitions*

The orthodontic marketplace has changed significantly over the past ten years and even greater changes are coming. Just when we thought the "Golden Era" of Orthodontics was over, we found a wealth of opportunity in Adult Treatments that now make up over 25-30% of many orthodontic practices. In spite of General Dentist's doing half of the Aligner cases, many Orthodontic practices have seen significant growth these past two years.

The profession is beginning to show a significant break between the "*haves and the have nots*," and between the private practice model and the corporate model. The days when all it took was Orthodontist, DDS after a name and a decent facility to be successful, now finds young Orthodontists wondering how they are going to pay off school debt while trying to make their way into the higher, more profitable echelons of one of the most lucrative businesses in the nation. Long gone is what used to be a handshake and *"welcome to my practice as a partner,"* with no real costs attached. Instead the new grad has to quickly become a business person, going further into debt to try to live out their dream.

This consultant sees four major issues muddying the transition landscape requiring caution to anyone who wishes to apply a "Rule of Thumb" approach to valuation without the help of an experienced transitions consultant:

1. Higher valuation multiples are being given to practices in the sunny and more desirable areas of the country at the same time that those areas have an increasing glut of orthodontists. Supply and demand in the more desirable areas often means many more years to pay off a practice purchase price while battling greater competition.

2. Contracts Balances are decreasing as payments are accelerated. If the appraiser is not intimately familiar with how each practice is collecting its revenues then an unsustainable profit margin may be assumed, resulting in an artificially inflated Sales Price. The double whammy of having both a higher sales price and a lower stream of revenue can sack a new Buyer with many lean years before financial success takes hold.

3. Capitation insurance plans (HMO's) are being routinely accepted by some practices. Let the "Buyer Beware" that some of what they may be purchasing may be just a lot of extra work with little reward, or little chance, that the full fee will be collected. The Buyer must understand "how" a practice books and makes its money.

4. Many older retirement practices are coming up for sale and these transactions pose some of the greatest challenges to forecasting a future stream of revenues and profitability. Far too often facility and equipment are dated and the Recall base has eroded. The Buyer should not be purchasing the past, but is instead purchasing an opportunity that can be clearly seen as extending into a bright future.

*The quote: **"Past performance is no guarantee of future success"** is not to be taken lightly.*

## I. *A BRIEF INTRODUCTION:*

I can imagine that for many of you here today the idea of a practice transition, whether a buy-in or buy-out, appears to be a complicated and confusing proposition. Having been involved exclusively in the business of orthodontics for more than 30 years, it has taken me almost twenty of those years to feel comfortable that I, the consultant, understand the many and varying aspects of buying and selling an orthodontic practice. So if this is your first or second time working through a practice purchase or sale, allow us who have worked on hundreds of transactions to try and make things as simple and as clear as we possibly can, given the time limitations and relative complexity of the subject matter.

***KEN ALEXANDER: MAKING HUNDREDS OF HAPPY SATISFIED CLIENTS FOR 30 YEARS***

For Ken Alexander it is all about helping others and developing strong relationships. Few orthodontic consultants possess the intimate knowledge how orthodontic management can make things simple and fun for doctors and staff while maximizing practice growth and profitability. Over 30 years ago, Ken took over the Millenium Society, the premiere orthodontic management firm of its time. He works with hundreds of practices large and small in North America and Europe, many of which are the most successful in the world:

***Practice Transitions Consulting:*** Coaching many new graduates and senior doctors for Associateships, Partnerships, Transitions, Buy/Sell, Mergers, Deal Making and LOI's.

***Practice Management Consulting:*** Scheduling, Patient Cooperation, Staff Management & Motivation, Doctor Coaching, New Patient Enrollment, Customer Service, Marketing.

***Orthodontic Office Layout:*** Space planning for offices in America & Europe.

***The CEO of a Large Orthodontic Practice:*** Bartlett & Alexander Orthodontics

***A Family Man:*** Father of four terrific kids and married to the best wife for 35 years.

## II. *PRACTICE VALUE: THE 10 MAJOR VALUE INFLUENCES:*

1. **PRACTICE PROFITABILITY: This is the single greatest determinant to 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

   ***It is vital to understand how the profit is generated and if it can be duplicated!!!***

**2. TOTAL PRACTICE YEARLY NET PRODUCTION REVENUE (COLLECTIONS):**

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

**3. THE CONTRACTS RECEIVABLES BALANCE:**

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

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

**4. THE NUMBER AND QUALITY OF REFERRALS, NEW PATIENTS AND PATIENTS ON RECALL:**

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?)

**5. THE LOCATION OF THE PRACTICE: Location, Location, Location**

California, Florida, Arizona, Texas are the hot spots, and on what street corner?

**6. FACILITY AND EQUIPMENT:**

Nice facility and low debt = increases value.

Nice facility and high debt = is often problematic.

Poor facility & equipment = should decrease value.

**7. 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!

**8. ARE THE TREATMENT FEES TOO HIGH OR UNSUSTAINABLE FOR THE AREA?**

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

**9. 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 is 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.***

**10. GROWTH MOMENTUM:**

Growing practices deserve higher multiples on 2-3 years data.

Declining practices 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.***

## III. *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"***

**11. THE MAIN DATA USED TO CREATE THE VALUATION MODELS:**

1) Three years of Total Revenues (Collections) averaged; 2013, 2014 & 2015.

2) Three years of Net Production/New Charges averaged; 2013, 2014 & 2015.

3) Three years of Net Adjusted Profits averaged; 2013, 2014 & 2015.

4) Consideration for any perceived shortfall or surplus in the Contracts Balance.

5) Consideration for any facility or equipment deficits or extra value.

## 12. THE TWO MAIN VALUATION MODELS USED IN ORTHODONTIC VALUATIONS:

1) **THE COMPARATIVE MARKET APPROACH:** Much like real estate comps.

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.

## 13. CAPITALIZATION OF EARNINGS (SOME FORM): THE PRIMARY VALUATION MODEL:

(Present Value) **P V = <u>E / C</u>** (Earnings / CAP rate)

1) **E**arnings = Net Adjusted Profits **– minus a**pproproite Dr. Compensation.

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

3) **E**xpected Economic Income divided by the selected **C**apitalization Rate = Present Value

4) **C**apitalization Rate: The fraction or % used as the divisor of **E** to determine value.

**A Capitalization Rate of 16% means a PE (Price to Earnings) of 6.25;**
or
**It will take 6.25 years to pay off the purchase price, not counting interest costs.**

## 14. PRE-TAX VS. AFTER-TAX CAP VALUATION MODELS:

**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 (Expected Economic Income).

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 Economic Income).

## 15. A Comparative Market Approach:

A Market Approach should be by far 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 Orthodontic practice sales:

**80.5% of Collections = The current Average Collections Multiplier**

**1.81 x Net Adjusted Profits (Earnings) = The current Average Net Profits Multiplier**

**Step #1:** Gather all the important data and study it carefully.

**Step #2:** Determine the true Net Adjusted Profits (Earnings) for the past 3-4 years.

**Step #3:** Lay out the key value data in the Appraisal.

**Step #4:** Tell the story of the practice, its strengths, weaknesses and concerns.

**Step #5:** Determine an appropriate value level for the practice: **Above or Below Average?**

**Step #6:** Determine if any one or more years should be weighted as most representative.

**Step #7:** Apply the appropriate Multiples to the weighted average yearly totals.

**Step #8:** Total the Collections & Production Values and divide by 2.

**Step #9:** Add the Collections/Production Value to the Net Adjusted Profits Value and divide by 2 to obtain a preliminary value.

**Step #10:** 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.

**An Illustration of the Average Practice Sale in 2015:**

Weighted Average 3 Years Col1ections $1,000,000 x 80.5% = **$805,000 Value**

Weighted Average 3 Years Net Adj. Profits $444,000 x 1.81% = **$804,000 Value**

Contracts Balance and Good Accounts Receivables **= $500,000 remaining balance**

Reasonable rent, nicely appointed facility and equipment and furniture is 10 years old.

**Many Orthodontic Practice sales contain significant areas of EXTRA Value!**

## IV. *The Potential Hidden Costs and Pitfalls to Buying an Orthodontic Practice:*

**16.** Facility: Too large or too small, outdated, poorly designed, or no quality Exam Room.

**17.** Outdated Equipment, X-Ray, Chairs, Units, Sterilization or Instruments.

**18.** Needs new computer software, server, computers and charting at the chairs.

**19.** A Low Contracts Balance that cannot cushion a possible initial decline.

**20.** Credit Balances still on the books at Closing and Refunds. (Who is responsible for them?)

**21.** Dwindling Exams & Observation base with cases started too young the past few years.

**22.** Over-Due Treatment Time and a Seller unable to effectively complete his cases.

**23.** Differences in early treatment philosophy and fees that cannot be sustained by Buyer.

**24.** Staff extra time off, extra holidays and benefits, and bonuses.

**25.** Special concessions to key staff members to keep them to stay until after the sale.

**26.** Losing Invisalign Status, Sure Smile, Damon, Adults, Lingual Braces, TMD, and many Surgical Cases. Can the Buyer sustain the Seller's work and reputation?

**27.** Incompatibility of Buyer and Seller personality, especially when in conflict.

**28.** 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.

**29.** The patients, parents and team will not let go of their attachment to Seller.

**30.** Poor record keeping or poor quality records and charting.

**31.** The Seller who "checked out" of his practice a year or two before he sold.

**32.** Inheriting a team resistant to change, inexperienced or incompetent.

**33.** Referrals are too concentrated in too few Dental / Pedo offices and you lose some.

**34.** Too many locations that generate too little production.

**35.** Capitation / HMO's plans, Medicaid, and No Down Payments.



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## VI. THE MOST IMPORTANT QUESTIONS TO ASK BEFORE BUYING A PRACTICE:

1. **Is the practice in a location where my family would enjoy living?** Obviously where you want to practice and live is a critical question to be answered before looking for a practice. Unfortunately, you must temper this question by realistically evaluating the competition. Often, the most desirable areas to live have many more orthodontists for the population than areas that are COLD! Buyer's should consider that they can purchase or create a larger practice in a less desirable area and retire earlier with its higher yearly net income, or sell back out in 5-7 years and purchase a practice in a more desired area of the country.

2. **Will the sales price and transaction terms create a livable wage for the Buyer?** The first and foremost concern for the Buyer must be anticipated free cash flow after expenses from which he/she will pay back the acquisition debt and still have enough of a livable wage to raise a family, and pay back their school debt. Not all of a new graduate's income must come from the practice he purchases, as he can go work in another practice or establish a second or third location. A Pro Forma must be created for the Buyer taking into consideration all of the anticipated aspects of the transaction that shows free cash flow and what a Buyer can be reasonably projected to take home as a salary with no growth, modest growth, or a 10-15% decline in the practice.

   **Targets:** In the past a good target for a Buyer was a yearly salary of $170,000 - $200,000 a year, or $1,200 - $1,500 a day after the servicing of the acquisition debt. Desperate Buyers appear willing to accept as low as $800 per day projected free cash flow which leaves little room for any decline, unless they work outside the practice during the pay-back years.

3. **Am I capable of handling the size practice I am about to buy?** Purchasing too large a practice just to watch it grow back to your level of abilities is unwise. Your personality, management savvy, and how you handle stress, are all important issues that need full consideration. Your approach to treatment and willingness to delegate are also strong considerations, but the biggest consideration may be "how hard do you want to work?"

4. **Is there growth potential in this area, and who is the competition?** Many orthodontists go home every night and lament to their spouse that their practice is not growing, yet they fail to realize that their area cannot sustain significant growth. Location will not guarantee a large practice, but it can guarantee a small one! The average orthodontist has 28,000 people to treat. Make sure you have your fair share and that a large number are not poor, military or retired.

5. **Are the vital statistics in the practice growing?** These statistics must include new production, income, new patients and starts. If the practice is on a slight decline or level, it may simply indicate a doctor who has been neglecting his referral base as he is on his way out. On the other hand, any significant decline in new charges and starts should be a warning sign that something may not be right with the practice. You cannot blame it all on the economy, nor expect to pay for past success more than the last year or two.

6. **What is the Practice's Total Contracts Balance?** This number is one of the least understood, yet vital to establishing practice value. The C/R is the amount of money owed to the practice; past, present and future. As orthodontics is one of the few professions that extends a monthly payment plan option, future monies owed becomes an excellent indicator of anticipated monthly income. Many doctors, brokers and even some consultants do not understand this important number and its effect on the future stream of revenues and profits.

   Low C/R Balances are usually the result of accelerated payments. Collecting your money faster may be a good idea for the Seller, but it can be disastrous for the Buyer. The lower the C/R Balance, the fewer monthly payments will be coming in over the next two years. Accelerated payments can create a huge problem as a payment in full goes 100% into profits with no allocation for future expenses past the start year for what the patient will cost the practice.

7. **Will the key staff remain with the practice?** There is no more pressing problem in managing an orthodontic practice than having the right staff. You will never have a perfect staff, but a good staff, without a lot of turnover, is vital to success and reduced stress. For some areas of the country it is relatively easy to find good quality people to hire. With other areas, especially those that require dental assisting credentials, it can be a nightmare to attract a good team at a reasonable wage. Understanding the skills and experience of the staff and their potential "burn out" levels, along with understanding any bonus programs in place, are important to buying a practice with your "eyes wide open."

8. **What percentage of patients are referred by dentists vs. patient/parent referrals?** Understanding this percentage will give you excellent insight into the marketing and customer service of the practice. If the practice is more than 60% referred by the area dentists, it is possible that the customer service needs improvement in on-time scheduling and the satisfaction of patient needs. If the practice is more than 60% referred by patients and their families, it is possible that the area dentists consider the practice to have a poor reputation or are locked into other orthodontists. Be careful to look at each referral source, as one or two large referrers, like a pediatric dentist, may not continue to refer in the future.

9. **How many patients are on Observation/Recall or Phase 1 Retention?** Practices that do a significant amount of early treatment usually have a higher exam to start ratio, but may have fewer patients left on observation. A low observation base can reduce the value of a practice, especially for a Buyer who chooses not to do early treatment. On the other hand, a practice that does little Phase 1 treatment and has a large observation base can be a gold mine of ready patients to a Buyer who does early treatment. Be careful to evaluate if the Seller may have started younger patients more aggressively to boost the starts and income numbers.

Evaluating this area of the practice can be statistically difficult as many practices fail to add and remove observation patients as necessary from their computer status counts. It is always best for due diligence to try and count each one of the Observation/Recall folders and the number of actual Observation visits seen each month. A clear understanding of the Seller's treatment philosophy can give the buyer critical insight into this important issue. Matching up a heavy Phase 1 practice with a Buyer who does little Early Treatment can be a financial disaster.

10. **What is the seller's treatment philosophy and quality?** Matching up treatment philosophies between buyer and seller is ideal, but not critical, IF there is a transition period of 1-2 years. A two-year transition would allow the Buyer to start all of the new patients in his/her method while the senior doctor finishes up most of his/her cases. Any transition time less than a year can create significant turmoil for both doctor and patient if treatment philosophies are mismatched. If the average transfer patient takes six months longer than estimated to complete treatment, imagine trying to finish up an entire practice of patients that have been transferred to you! Matching up treatment philosophies and treatment goals will make for a much smoother transition.

    Treatment quality is difficult to assess, but the average length of treatment time for full cases is not. A practice that completes its full cases between 22-26 months is within an acceptable norm. Anything over 27 months can be a red flag on practice value and future headaches. It is important to ascertain how many patients are in active treatment over 26 months and how many cases have completed paying on their contracts. Anything more than 10% of cases overdue in treatment can pose a significant hurdle to a smooth practice transition as customer dissatisfaction may occur even as the new owner tries to deliver a higher quality of result. ***Be sure to check the last 20-30 debonded cases to evaluate treatment quality and treatment time.***

11. **How much higher or lower are the fees compared to the area fees?** Some practices have fees that are a significantly higher than the area competition, and perhaps they deserve such a premium for the service and quality they deliver. But will the customers and area dentists perceive that the New Orthodontist deserves the higher fees? If not, the Buyer may be paying a huge premium as much of the excess profit being generated may not be able to be conveyed from Seller to Buyer without a proper transition time.

12. **What is the number of New Patient Exams and Exam to Start %'s?** This is a "mixed bag" for potential disaster or greater success. Some practices may have an excellent Exam to Start ratio yet the total number of New Patients is low for the size of the income the practice generates. Even a small drop off in the number of New Patients or a decline in the start percentages may severely impact the practice's future profitability. On the other hand, a practice that is perceived to be doing a poor job of starting its New Patients may be a gold mine for a Buyer who can identify what needs to be changed to increase the acceptance rate. There is little need for external marketing in a practice that has only a 50% start ratio if the New Orthodontist can figure out how to increase the starts from exams to 70% or 80%!

**13. What are the purchase terms, non-compete, and partnership terms?**
When buying into a partnership the terms can be more critical than the actual sales price. Creative partnership arrangements are becoming the norm instead of the traditional 50-50% transactions. Most transitions consultants will advocate that the buy-in be structured in such a way as to adequately compensate each partner for their anticipated contribution to the practices marketing, management and patient care. A mega-practice, for instance, might sell to a Buyer a 25% equity stake and ask the Buyer to work one more day per week than the senior doctor. On the surface this may sound like a terrible purchase, until one discovers that the offer is a 25% allocation of $420,000 for a 3 ½ day work week! Consider all aspects of a buy-in and look at the transaction as a whole to see if it is not a significantly better opportunity than owning 50% of a much smaller practice that may be more difficult to work, market, and manage.

**14. What is the anticipated transition period?** The ideal transition period depends on many factors, but usually ranges from six months to a year. Perhaps a perfect transition, if it can be afforded, would be to keep the selling doctor in the practice until 80% of the cases he started in his treatment technique and appliances are completed. A transition that requires the selling doctor to work two days a week the first year, and one day a week the second and third year, is excellent for maintaining the stream of new patient referrals and the transfer of goodwill. Unfortunately, I have watched a number of sales transactions fall apart on this one issue where the senior doctor wants to sell his practice and keep working for a number of years. A work back arrangement can be mutually beneficial, but be careful that the Buyer can both afford to pay the senior associate and that the two doctors are compatible in personality and treatment philosophy.

***Conclusion:*** Buying and Selling an Orthodontic practice can be frightening, but if you seek the right information you can gain valuable insight into practice valuation and get a glimpse of the potential difficulties faced in the transition. It is vital that the Buyer and his 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 insure a fair price and fair terms, but most importantly the assurance that the anticipated future stream of profits is highly probable. The golden era of orthodontics still exists for those who wisely work towards excellence in treatment quality and apply sound management principles to their business.

***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 insure a fair transaction and a smooth transition. He is a polished lecturer and effective consultant having worked with well over 600 orthodontic practices in the US and Europe, all of whom he calls his friends.