Evaluating the Dental Practice Purchase Opportunity

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Evaluating a practice for possible purchase is both an exciting and frightening process. Carefully considering the hard facts involved should eliminate most of the anxiety about a purchase, leaving only the excitement of owning your own practice.

Welcome to the Platinum Age

You are fortunate to be entering dental practice during a period of history that is quickly becoming known as the "Platinum Age." The 1960s through the early 1970s were known as the "Golden Age" of dentistry. Dental insurance had created an increased demand for and appreciation of what dentistry had to offer. Thus, the dental industry has become a financially profitable profession.

Today, the U.S. population is increasing, people are keeping their teeth longer, and the demand for care is skyrocketing. Pre-fluoride baby boomers want to look and feel good—and will spend the money required to accomplish that goal. All of this is occurring at a time when the number of dental school graduates has significantly decreased, resulting in an unprecedented opportunity in dentistry.

Marketplace opportunities and the future seem promising for the new dentist considering the purchase of a practice or building one from the ground up. Both options have their pros and cons. However, despite the favorable demographics, new dentists starting their own practices still lose productive years attempting to build a patient base. Acquiring an existing practice and patient base will put the existing practice from $300,000 to $500,000 ahead (pre-tax) after the first five years, which comes with significantly lower risk than "scratch start" offers.

The First Step

The first step in evaluating a purchase opportunity is actually unrelated to the practice. The decision as to whether you and your family will be comfortable living in or near the community where the practice is located must be determined prior to any other considerations. Ownership of a practice makes this decision a long-term commitment.

The personal needs of all family members must be met and include: spouse's career requirements, available education for the children, lifestyle options such as availability of sports and cultural activities, and basic needs such as availability of shopping areas.

The Second Step

The second step involves a determination as to how you want to practice—through a partnership or as an independent businessperson. There has been a growing trend toward group practices, but the solo practice has been and continues to be the primary method of practice for dentists today. New dentists often begin as an associate and later, buy the practice. The senior doctor then becomes the associate, retires shortly thereafter, and the practice returns to a solo practice.

Analyzing the Appraisal

The next step is an analysis of the practice numbers, and should be carefully reviewed. A well-done practice appraisal will provide an abundant source of information about the business side of the practice. The benefit in purchasing an existing practice is access to an established patient base and subsequent cash flow. The historical revenues and expenses of a practice can be accurately ascertained and used to project and indicate future results. Conversely, starting a practice from scratch, carries with it a host of unknowns, risks, and uncertainties, such as whether the practice will attract enough patients to make it financially successful.

The appraised value should be based on a 3–5-year average of a practice's historical revenues. The appraisal should not be based on possible income, but on demonstrated past performance. If the practice has been underproducing, this becomes the "buyer's advantage" and may be justification for purchasing the practice—but not for paying a premium price beyond what historical revenues can justify.

Questions asked about the appraisal process should include: the qualifications of the appraiser, the records reviewed to determine appraised value, and the methods used in determining that value. And, finally, does the appraised value, regardless of the appraisal method used, pass the required "sanity" test?

This parameter will help determine whether the final appraised value makes sense or specifically—will practice cash flow support the purchase price. Using the rule of thumb, it is indicated that the annual principal and interest payments required to purchase a practice should generally not exceed 12–16% of the practice's historical gross annual collections. The appraised value should already have been downgraded for old equipment/limited-use equipment. If major equipment upgrades will be required to make the practice functional for the new owner, these costs must be subtracted from the net to be certain that purchaser income requirements are met. Remember, the previous owner was producing the numbers with the existing equipment. Therefore, only needed equipment upgrades should be considered.

The appraisal process should also involve a determination of what the practice's operating expenses are, resulting in the actual net value. This should exclude the current owner's allocations for depreciation or amortization, interest, and/or items that have directly gone to the benefit of the present owner and are not related to the actual cost of production of services. A practice with a higher percentage of receipts for operating expenses should appraise for less than one with a lower overhead, given the same gross revenues.

Also, remember that the final allocation of assets for sale purposes frequently works to create the best tax result for the parties and rarely is directly related to actual values of the individual components.

Placing the Appraised Value in Perspective

In assessing appraised value, the actual appraised value is not as important as the bottom-line cash flow after paying operating expenses and debt retirement for the practice purchase. This bottom line should support the personal financial needs of the purchaser, including household expenses, personal debt repayment, and professional/school debt.

If it does meet the requirements, the only other question should be, "Is the purchaser reasonably capable of producing at least the same income that the seller has historically produced?"

There are a variety of reasons for choosing a healthcare career as the means of earning a living and providing for future retirement. A practice is a vehicle to get you financially to where you want to be at retirement. This determination comes down to an assessment of the bottom line. There will be other questions, but the outcome of the answers will not have nearly as much weight as these first considerations.

Additional "Disqualifying" Questions

If the practice is primarily or significantly dependent upon outside referral sources for new patients, the purchaser must carefully assess whether these referral sources will be transferable to the new owner. If not, then the purchaser must assess compensating sources.

A more sensitive issue relates to race and ethnic background considerations. The buyer must carefully consider the race, religious, and ethnic background of the patient base, the former dentist, and the neighborhood. Regardless of the buyer's race, etc., the purchase cannot legally be discriminated against relative to their personal beliefs and background. The buyer must ask, "Will there be a mass exodus of patients, the most valuable aspect of buying a practice, after I assume ownership because of my background?"

Another critical question regards the existing office space lease. Access to a lease of at least five to seven years—and, if bank financing is involved—it will generally be insisted that the lease is for the term of the loan.

The final major question is whether all or some of the key staff will remain during and after the transition process. Frequently, patients have as much loyalty to the staff as the doctor. Retention of the staff insures an almost total transfer of the patient base to the new doctor. Loss of the staff can be overcome—and should not be an automatic reason for non-purchase, but it can be a factor that should be carefully considered. Ideally as much of the old staff as possible should be hired initially by the new owner.

A Word of Caution!

All of the above represent logical, factual reasons to consider or reject any given practice purchase opportunity. The items that follow are issues and matters that may need to be addressed but are not necessarily "deal killers." If the numbers are acceptable and the patients are there, the business is sound.

NEVER FORGET THE MOST IMPORTANT THINGS YOU ARE BUYING ARE THE PATIENT BASE AND FUTURE INCOME FLOW THIS BASE WILL PROVIDE!

All other things become secondary, are cosmetic and generally replaceable/correctable in the future. The thing that is the hardest to replace, requires the most time to develop (years), is the most expensive to generate through advertising/marketing, and represents the practice's greatest asset, is the "patient base."

The majority of what follows are individual matters which can be changed and many times reflect the needs, professional training and perspectives, and personalities of the individual, whether buyer or seller.

While the answers to the questions should be researched to allow for anticipation of the need to address those issues and/or areas that are unsatisfactory to the purchaser, they are best addressed in the future and after the purchase. Unfortunately, on occasion we have observed a purchaser being overly critical and vocal regarding some of these issues. This has resulted in the loss of the purchase opportunity when the seller became offended, thus offering the practice to another purchaser.

While it is appropriate to ask questions and determine the answers, the purchaser is advised against expressing direct criticism to the seller. Concerns should be addressed to your practice transition consultant/advisor and if necessary forwarded to the seller through that individual.

Additional Business Related Questions

Assuming the practice has passed the above issues, there are several additional matters that must be considered relating to the business evaluation of the practice. Does the practice follow any specific practice philosophy? Is this a practice that is a holistic type practice that does not place amalgams? Is this primarily a cosmetic practice, extensive TMJ practice, or does it provide ortho treatment and does the purchaser have the clinical skills to continue providing these services?

Other questions include: What has been the historical treatment mix provided by the seller? Has this been an amalgam or crown and bridge practice, fixed bridgework and implants or extractions, partials and dentures?

How efficient is the hygiene and recall (re-care) program? Are patients scheduled six months in advance, or must someone schedule each patient at recall time? How many active patients are there compared to the number of available hygiene appointments? Typical practices have an active patient base of 1.5 times the number of hygiene appointments available in a six-month period and the optimum number is at least 1,000-1,400 active patients. How many new patients are seen monthly and what are their primary sources? Ideal is 15-25 per dentist, excluding any "plan or discounted" dental program.

Does the practice participate in any capitation/HMO programs? Are these contracts transferable and how much of the practice revenue is derived from these programs? Does the practice accept and/or treat medical assistance or welfare patients and what percentage of revenues is derived from them? If the new dentist does not plan on carrying these plans and providing care to these patients, the practice price to the new dentist should be carefully re-considered, because the practice has been appraised including the receipts these programs provide.

Office Space

The present and future status of the office lease and/or building ownership needs to be addressed. As previously discussed, the unavailability of an adequate lease and subsequent need to move a practice may be one of the specific reasons to not purchase a practice. Will the building be available for purchase, on what terms and when should this be addressed? Will it be in your best long-term interest to own this real estate?

When considering building your own future "Taj Mahal" style building, remember that one can produce the same amount of services in a building costing $200,000 as one costing $500,000. The difference is whether you want to pay the additional principle plus two times the principle amount in interest, or whether you would rather have a functional building and put the extra interest money to work in your pension plan. While it is the dream of many practitioners to have their own building, will this building service your needs at a considerably reduced price for the years to come? Is the present office location desirable? Is the neighborhood stable or in decline? Will this be a suitable area in the immediate and long-term future?

Evaluation of the Physical Plant

The cosmetics of a practice are changeable. This is an area to plan for if needed, but generally is not a reason to refuse a specific practice. Granted, outside building esthetics are much more difficult and expensive to correct, and problems here should be carefully considered. Another consideration regarding the current office space is whether there is room for future expansion.

The age and condition of the present equipment should be noted. Is it right-handed or left-handed, is it functional and usable for the new buyer or will certain items require immediate replacement?

Remember again, a careful evaluation must be made as to whether an item is being replaced because it is absolutely necessary or because one simply "prefers" a more ideal item. If the office is computerized, an evaluation needs to be made regarding the computer system.

Evaluation of the Clinical Practice

In evaluating the clinical considerations of a practice, there is only one consideration that again may be classified as a "deal killer." Your consultant will help you evaluate whether there may have been a recent increase in revenues or some other indication in the treatment mix which might indicate that the selling doctor has aggressively and recently done an unusual amount of major revenue-producing procedures, thereby using up the normal backlog of work found in the practice of a retiring doctor. If this has been the case, a careful determination must be made to insure that the patient base can still provide the level of production anticipated by the new owner.

A consideration that needs to be recognized and identified is whether there may be a major difference in philosophy of practice between yourself and the current owner. Patients who have come to expect a non-amalgam, holistic approach to treatment will quickly leave the practice if offered conventional amalgam restorations. This is not a reason to pass on purchasing a specific practice, but rather must be recognized and an appropriate response planned. Another consideration is whether there is a personality difference between yourself and the present owner. If the present owner is a laid-back sort of individual who never recommends ideal treatment, and you are an aggressive, outgoing individual who does, a softer approach to case presentation will be necessary.

One of the ever-present concerns of the new owner is, "What if there exists an abundance of sub-standard work?" This is not a major concern that should result in a decision to pass on an otherwise acceptable practice. The new owner will not be expected to replace work at no fee, and with the proper communication skills, the needed replacement meets little resistance from existing patients and can actually be turned into a positive for the new owner. However, criticism of the prior treatment, when not tactfully and properly presented, will be a problem if you attack the previous dentist who was loved by patients, despite possible sub-standard care. While the dream of most new dentists is to have a high-end cosmetic/crown and bridge practice, dollar for dollar the low-end, sub-standard-care practice represents the better value and best future profit opportunity.

It is the prospective new owner's responsibility to verify the approximate number of active patient files, how often the files are purged for inactive patients, and when files were last purged. Actual record content is not critical to the purchase decision. Records can be upgraded with new forms, X-rays can be updated, and the new owner is not responsible for the completeness or lack of completeness of the prior owner.

The level of OSHA and HIPAA compliance needs to be identified, but again is correctable if not up to standard.

Another important factor is the present recall system effectiveness. How many patients are actually actively involved in recall? How many hygiene appointments are available in a six-month period? How full is the available hygiene schedule? How much of the practice revenue involves X-rays, recall examinations and prophies? These answers will give the clearest indication as to how many active patients are truly available.

Future Plans of the Seller

There is some level of controversy regarding the benefits of the selling doctor remaining for a period to introduce the new doctor. Our experience has been that, in cases where the total departure of the selling doctor will occur in less than one year, a better result is obtained if he/she leaves immediately. In that case, the patients will generally give the new doctor at least one chance out of respect and trust for the recommendation of the departing doctor. All that is required is a letter from the departing doctor announcing his/her departure and introducing the chosen successor.

If the departing doctor remains, and, especially, continues to treat patients, there is a tendency on the part of patients to get all work needed completed by the retiring doctor, subsequently buying time before the patient seeks out the services of their "neighbor's doctor." When faced with an on-the-spot decision regarding the scheduling of an appointment, whether it is a recall or emergency appointment, most patients will try the new doctor. However, when given time to investigate alternatives because their treatment has been completed and they have had the opportunity to say "goodbye," patients frequently leave.

Financing

The final area that must be considered is financing sources. Will the seller carry all or part of the financing? Will you need to consider SBA financing? Will a combination of lease and loans be in your best interest? Is there anything in your credit history that might interfere with your ability to obtain financing?

The re-payment term will relate to the gross purchase price. A practice with a higher gross (supported by an appropriate net) will require a longer re-payment term. This will provide a more comfortable level of available compensation after operating expenses for the purchaser. This also means, however, that the purchaser is building a larger equity position as the reward for higher productivity, and once paid off, the practice will provide a higher net to the owner. Typically we see a purchase price of less than $200,000 re-paid over five years, $200,000-$700,000 over seven years, and over $700,000 seven-to-ten years.

In today's marketplace, 100% non-owner financing is readily available. The rates are competitive and the terms reasonable. Non-owner financing has several significant advantages over seller financing. Which type of financing to take should be carefully discussed with your transition consultant.

Conclusion

This article has attempted to deal with the multitude of questions surrounding whether the practice you are considering purchasing is the right practice for you. The past accomplishments including receipt and expense history will give the necessary information as to whether this is a sound business decision. It will further indicate whether the after-debt cash flow is reasonable and will meet your personal needs. A careful analysis by experts has proven that after five years in practice, the party who buys an existing patient base and cash flow will have netted two to three times what a similar individual in the same geographic area has done while beginning a practice from scratch.

While a state-of-the-art, recently-modernized and equipped practice may be more appealing, it will also be priced higher to compensate for the capital expenditures made by the present owner. Therefore, older but functional equipment will usually work until the new owner makes his/her own capital improvement expenditures. A new purchaser only needs to be aware and plan for these future expenses while enjoying the lower purchase price, to which the "antiquated" equipment has contributed.

The most important thing purchased is the patient base. All other areas should be viewed in their proper perspective as secondary factors, many of which can be dealt with later. Whether you will need to spend the money for equipment now or later should not be the reason for you to pass up a good patient base in the area in which you would like to live.