

Lesson #4 – Buying a Cheap Practice



Many years ago, I received a phone call from a dentist looking to sell. He was an older gentleman in his 70's and believed the time to retire had arrived. He invited me out to his office. I made the trek to a small suburb just outside a major city. Upon arriving at the office, I found myself walking up what felt like 40 flights of stairs. As I entered the office, I noticed an elderly woman sitting behind a desk just below a ledge with two open operatories. Soon, the selling dentist walked feebly to greet me and invited me to join him and his wife for a discussion. Two operatories. No staff. Ancient equipment. Selling dentist who held on too long. The scenario in my mind could not have been any worse.

After a few minutes of reviewing declining financials and several low production practice analysis reports, I looked up and sadly told the dentist and his wife, "I cannot help you at this time". The dentist was shocked and said, "Don't you make money by selling practices?" With less than 400 active patients, and no room for growth, the practice was in a state of decline and was not a practice with value. There was no way I could ethically and morally spin this opportunity as a good one to a potential buyer. I could tell the dentist was quite upset as I had, in essence, called his baby "ugly." I shook hands with the couple and walked down the 40 flights of stairs out to my car and made the 60-mile trek back home.

Several months later I received a call from a young dentist asking for my help as he was about to close the doors on his practice. He had recently purchased an office and realized that there were hardly any active patients and very little revenue was coming in with bills due. I asked the young man to describe his practice to me. He said he practiced in a two operator office in a small town. "You park out front and walk up a long flight of stairs". I told him I am very familiar with

this practice and asked him, “What broker would sell this practice to you? What CPA and bank would support this purchase? And why would you buy such a poorly declining office?” His answer still lives with me today. He said, “The answer is simple....it was cheap.”

This dentist spent hundreds of thousands of dollars on his education. The first practice purchase he makes out of dental school is the cheapest practice money can buy. He got exactly what he paid for. With the elderly dentist leaving, the new dentist had purchased a few hundred patients who had aged with the dentist. It was not a practice with value. There was no long-term revenue stream. By thinking “cheap,” he was going broke.

Chapter 4. Does the Purchase Price of a Dental Practice Really Matter? (Advanced)

I am asked many times per week: "How is the value of this dental practice arrived at?" The answer should be simple, but it is not. Several methods are acceptable and credible in determining a dental practice's value. Some are quite involved and would require significantly more space than is available in this book.

I have learned over the past 20 years how dental practices are *really* valued by the experts in the industry, and it wasn't close to what I expected. There are various methods of valuing a business—discounted cash flow, multiples method, comparable transactions, market valuation, EBITDA method, and more. But which one should you use? For fun...Google the following terms: Valuing a Dental Practice. There are 42,700,000 results.

If you've seen a valuation number for a dental practice, it is a series of assumptions piled on imperfect information. The seller usually hired that CPA, in part, because the advisor convinced them that they could get them the most money for their dental practice.

So how do you know what a dental practice *is* worth? What is a fair price? While price is important, the most important number to determine is the true *net income* of the seller. *If* I could get you a loan for \$1,000,000 tomorrow and you would make \$400,000 - \$500,000 annually, the decision would be a no brainer. So why does everyone fight so hard over price when it's the net return to the seller that matters most?

I recently received a phone call from a buyer who had presented an offer of \$475,000 to a seller collecting \$950,000. There was no Medicaid in the practice. The seller immediately rejected the offer and terminated the negotiations. The buyer was asking me for guidance as to what went wrong. I asked the buyer how he came up with that \$475,000 offer. He explained that he had contacted a CPA from Iowa that had created the valuation. Iowa? Yes, not only did this buyer turn his decision-making power over to a so-called expert in Iowa, he also did not take the time to understand the metrics in the practice himself and ignored the true annual income and a host of

other benefits the seller received. By the way, the sellers actual net income in this example was \$475,000. A fair offer would have been closer to \$775,000-\$850,000.

You laugh, but I ask you: would you walk away from a career practice because an expert advisor, looking at a report from his office 1,000 miles away, told you the business was not a good investment?

How much you will offer to pay for the collections of a dental practice should depend on many factors, not just the financials, with the most important factors being the 1) true net income of the business and 2) the number of active patients calling the seller “their dentist.” Keep reading, we go deep on this topic.

Do You Want to Buy an Average Practice?

“How much will I pay for my first practice?” While the historical average purchase price, of “well-run practices” is \$0.60 to \$0.80 for every dollar of collections (without Medicaid); the trend of a higher purchase price began rising with the emergence of Dental Service Organizations (DSOs) in 2014, and the average changed dramatically to \$0.80 to \$1.00 for every dollar of collections. Or, if a practice collects \$1,000,000, then it sells for about \$800,000 and up to \$1,000,000. There are a few outliers up and down in price, but they are all relative to their location.

I know several people in the dental space that still say “the average rule of thumb for buying a dental practice, with less than \$1mm in collections, is between 65%-75% of collections. Not only is this “rule of thumb” twenty years old, but this statement will show just how amateur you are in the transition space or how cheap your thinking is regarding goodwill. My response is always “if you want to buy a below average dental practice than your rule of thumb formula may apply.” Let’s focus on the above average dental practice, with above average cash flow, above average staff, and above average selling doctor. I am going to steer you away from thinking “cheap” in this book. Any voice in your ear that quotes “average selling price for practices” is a person that is not very successful in this business.

Prepare to invest 80%-100% of annual collections towards the purchase of a dental practice with solid fundamentals. Remember, you want to invest in a practice with strong hygiene, spacious office, thousands of active patients, well-oiled team, and a selling dentist who is willing to support you to the community. You may pay \$75,000 - \$100,000 above the “average” selling price but earn several million in income over the life of the bank loan.

EBITDA

How do DSOs evaluate a practice? It’s Called EBITDA. In layman’s terms, take the overall