Buy, Sell or Hold
Orthodontic Transitions

Ortho II Webinar
Hosted by Dr. Bob Scholz
Monday April 15, 2013

by
Ken Alexander, M. Div.
Director, Millenium Management Services

25+ Years
Transitions Consultant &
All Aspects of Practice Management
Consulting exclusively with orthodontic practices,
large and small, in North America & Europe

“Relationships are the Most Important Things in Life.”

When all is said and done your relationships should remain strong forever!
The Changing Face of Orthodontic Transitions

The orthodontic marketplace has changed significantly over the past three years and even greater changes are coming. Practices that increased significantly in size for a decade have suddenly turned downward. The economy has soured and many older orthodontists have decided to ride into semi-retirement working their practices one or two days a week. The Orthodontic programs are graduating more orthodontists while at the same time fewer orthodontic practices are coming up for sale.

The future looks spotty for the newer orthodontist with fewer opportunities available, significantly greater school debt and senior orthodontists wanting a full valuation and sometimes more for their practices. The orthodontic practice is looking more and more like a small business than a profession and what used to be a handshake and “welcome to my practice as a partner,” with no down payment, has turned into an investment asset with much greater risk placed on the Buyer’s shoulders as a lump sum payment from the bank is often expected at the time of closing.

This consultant sees four major issues muddying the transition landscape requiring caution to anyone who desires 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 even greater competition.

2. Contracts Balances are decreasing as payments are accelerated and if the appraiser is not intimately familiar with the mechanism by which each practice is collecting its revenues a profit margin may be assumed that is unsustainable that will artificially inflate the sales price. The double whammy of 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 in some practices along with no down payment options. Let the “Buyer Beware” that some of what they may be purchasing may be simply a lot of extra work with little reward, or little chance that the full fee will be collected AND they may be paying a higher price for this extra work.

4. Many more “retirement” practices are coming up for sale and these transactions pose some of the greatest challenges to forecast the future stream of revenues or profitability, especially when the facility and equipment are dated. The Buyer cannot be purchasing the past, but is instead purchasing an opportunity that extends into the 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 25 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 25 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.

- **M. Div:** Four years graduate training in Communications, Human Relations and Psychology.

- **A Family Man:** Father of four terrific kids and married to the same doll for 32 years.

II. **Buy, Sell, Hold or Associate?**

It is vital that the Buyer’s and Seller’s needs and goals are identified early, and are realistic. In most cases a senior doctor should never take in a partner in order to make more money, as this dream rarely results in orthodontics. Partnerships are best for their other benefits, especially with a view to transition the junior doctor in and the senior doctor to retirement. Ideally the senior doctor takes on a partner for no more than 2-5 years before retirement or becoming the senior associate.

**The practice size often determines the type of associateship and/or partnership:**

Normally it is best if an associateship period lasts for longer than one, or maybe two years. The size of the practice and its profitability often determines the structure of a partnership as the income allocation should attempt to match the perceived contributions of each partner to the practice’s management, marketing and patient care. Partnerships may be formed on any basis or structure that makes sense to the partners in achieving their individual goals.
III. 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 affect 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 with 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 tx 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.

IV. **THE 10 MAJOR INFLUENCES AFFECTING PRACTICE VALUATION:**

1. **Profit Margin:** 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 category to reasonably pay for the ongoing expense of the operation.

   **Ideal Targets** = 42 - 45% profit margin and 55-58% for expenses

   *It is vital to understand how the profit is generated !!!*

2. **The Terms of the Agreement:**

   “*Can the buyer pay off the purchase in a reasonable number of years and survive or thrive on the remaining cash flow?”*

   Tax implications?  Stock transaction? = not deductible  
   Personal goodwill? = amortized over 15 years

   “*the time value of money*”
3. **TOTAL PRACTICE YEARLY REVENUE (GROSS INCOME):**

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

4. **THE CONTRACTS RECEIVABLES BALANCE:**

   All monies owed to the practice past, present and future.
   
   *The C/R balance should equal 45-50% normal yearly collections.*

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

   California, Florida, Arizona, Texas and what street corner?

6. **FACILITY AND EQUIPMENT:**

   Nice facility and low debt = increases value  
   Nice facility and high debt = often problematic  
   Poor facility & equipment = decreases value

7. **THE STAFF AND MANAGEMENT TEAM:**

   Seller must disclose who may be leaving.  
   Will top talent continue with the practice after the buy out?  
   You need the necessary pillars of the practice and familiar faces to keep the Goodwill!

8. **THE NUMBER OF NEW PATIENTS AND OBSERVATION RECALLS:**

   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
9. TREATMENT TIME AND QUALITY OF RESULTS:

Check the last 20-30 Debonded Cases
Up to 2-3 months over on average treatment time is usually is not a problem

Practices with many cases over treatment time have the seller complete cases at a discounted per diem

10. GROWTH MOMENTUM:

Growing practices deserve higher multiples on 2-3 years data
Declining practices get lower multiples on 1-2 years data

Factor in production numbers when growth momentum is significantly up or down.

Conclusion: Purchasing a 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 ask the right questions and then does 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.