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The Dental Transition

NEWSLETTER

In this issue

Dental Industry Trends & DSO Buyers:

How current trends are leading to the consolidation of the dental industry & What you need to know about DSO buyers

As you are likely aware, the landscape of the dental industry has changed dramatically over the past decade and continues to evolve with each passing day. These changes present both opportunities and challenges for dentists of all ages. In this newsletter, we discuss how numerous trends in the dental industry have contributed to the meteoric rise of Dental Service Organizations (DSO's). We will then pivot to discussing what practice owners need to know when considering selling to or partnering with a DSO.

Recent Trends in the Dental Industry

1. Increase in Dental School Graduates. Less than twenty years ago, some were concerned that there would not be a sufficient number of dental graduates to replace the large number of Baby Boomer dentists that would be reaching retirement age by 2020. That concern has been alleviated by the fact that dental school enrollment increased by nearly 30% from 2005 to 2017, and the number of dental schools grew from 56 to 66 during that same time period (with talks to open several new dental schools, including TTUHSC El Paso, which is scheduled to open in 2021). The increase in dental school graduates ensures that the demand for dental practice acquisition opportunities will remain high in the near term and that DSO's will have a consistent flow of new talent searching for employment opportunities.

2. Shift in Demographics. There has been a major shift in demographics over the past decade, as approximately 30% of dentists are now female and nearly 50% of dental school students are women. While many female dentists will pursue practice ownership, a large number of female dentists will likely choose to delay or forego practice ownership and work as an associate in private practice or a DSO environment. Dentistry is also becoming more diverse, as many first-generation Americans have sought careers in dentistry, and a large number of foreign born/trained dentists have immigrated to the United States. It's also important to mention that most young dentists are moving to metropolitan/suburban areas (rather than smaller towns) following dental school graduation, leading to access-to-care issues in rural markets and a decline in the marketability/value of rural practices. Due to the challenge in recruiting and retaining associate dentists in rural markets, most DSO's have focused on growing their footprints in urban/suburban areas.

3. The Millennial Mindset. Many young dentists have a different mindset than those of previous generations, as they are more transient, focused on work/life balance, and have higher income needs/expectations than their predecessors. That mindset, coupled with increasing dental school debt (dentists have an average of $275,000 in student loan debt upon graduation) and the increasing costs of purchasing or starting a practice, are heavily influencing the career choices of the next generation of dentists. In fact, it is estimated that almost 20% of dentists under the age of 35 are affiliated with DSO's. All things considered, it's not surprising that some young dentists are choosing to work in corporate dentistry over pursuing practice ownership.

4. Shortage of Practices for Sale. For financial and/or emotional reasons, Baby Boomer dentists are practicing further into their careers than anticipated. This trend has resulted in a lack of supply of quality practice acquisition opportunities in rural/suburban markets to keep up with demand from the growing number of young dentists in these markets. The decision to practice further into their careers has also led some Baby Boomer dentists to sell their practices to

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Dental Industry Trends & DSO Buyers

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DSO buyers and continue working full-time or part-time in their own office until retirement.

5. Changes in Practice Value. Over the past few years, there has been a shift in regard to the methodology for determining the value of larger practices. Prior to the current economic state of the dental industry, practices with annual revenue of $1.5 million+ would sell for a lower percentage of revenue (than their smaller counterparts), because the buyer pool was much smaller for large offices and most dental lenders were not able to provide 100% financing for practices valued in excess of $1.2 million. While the value of practices in the private buyer market (doctor-to-doctor transactions) has remained fairly consistent at 65%-85% of annual revenue, the value of larger practices (potential acquisition targets for DSO's, multi-location groups, and ambitious private buyers) has increased dramatically. These practices are now being valued based upon a multiple of EBITDA (which stands for Earnings Before Interest, Taxes, Depreciation, and Amortization) rather than a percentage of annual revenue. Large, highly profitable practices can now command a price of 4-7 times EBITDA or 100%-150% of revenue in today's market, thereby influencing many practice owners to entertain offers from DSO's rather than offering to sell their practice to a private buyer. As a result of the high demand for larger practices by both DSO buyers and private buyers, coupled with the change in the valuation metrics discussed above, there has been a significant increase in the gap between the value/marketability of large, profitable practices with updated equipment (which have steadily increased in marketability/value), and smaller, less profitable offices with antiquated equipment (which have declined in marketability/value).

It's also important to mention that the marketability/value of dental offices located in urban/suburban markets has also increased, while the marketability/value of practices in rural markets has steadily declined. Both DSO buyers and private buyers are gravitating to urban/suburban markets where there is a steady supply of associate dentists, larger populations (higher demand for dental services), more employment opportunities for the dentist's spouse, and a perceived higher quality of life (despite the fact that practices in rural markets typically have higher profitability, less competition, and the cost of living is lower in those markets).

6. Growing Burden of Management. The burden of management has grown significantly over the past decade as a result of several factors; declining reimbursement rates from PPO's, rising overhead costs, an increase in regulatory compliance, HR issues, increasing competition fueled by the growth of "corporate" dentistry, and a large number of practice start-ups (due to the low supply of acquisition opportunities) that have occurred in urban/suburban markets in recent years. As a result of the growing management burden, there is no longer an assurance that being an excellent clinician will translate into owning a successful practice. Reducing the management burden is one of the leading reasons that dentists are choosing to exit practice ownership (many of them doing so earlier in their careers than expected) via selling to or partnering with DSO buyers.

7. Potential Issues on the Horizon. There are several issues on the horizon that could have a negative impact on the dental industry, including the above trends becoming more prevalent, continued consolidation of the industry via the expansion of DSO's, and potentially adverse changes in macroeconomic conditions, such as rising interest rates, fluctuations in the stock market, recessionary concerns, and political instability. Fear that these factors will have a significant impact on the dental industry, and the future of private practice, is driving some dentists to sell their practices prematurely (often to DSO buyers).

Many of the above trends have contributed to the advent and rapid expansion of DSO's, resulting in an ongoing consolidation of the dental industry. The ADA estimates that approximately 8% of all practicing dentists in the United States are affiliated with DSO's. However, that number is estimated to be much higher (closer to 15%) in states like Texas, Arizona, California, and Florida where the consolidation of the dental market has

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been occurring for quite some time and continues to grow at a rapid pace. DSO's have many economies of scale that provide them an advantage over the solo practitioner, including the ability to negotiate more favorable reimbursement rates from PPO plans, decrease overhead expenses via centralizing services and negotiating more favorable pricing with vendors (such as dental suppliers and labs), secure and retain associates, provide attractive benefits to staff, and offer selling dentists the ability to sell their practice for a premium and continue working until retirement. As a result, both young and older dentists find the DSO model to be appealing. However, making the decision to sell all or a portion of your practice to a DSO is a major decision that requires some serious thought. For better or worse, you need to know what you are getting yourself into. That is the focus of Part 2 of this newsletter….

What is a DSO?

Wikipedia defines DSO's as: Dental Service Organizations, also known as "Dental Support Organizations", as independent business support centers that contract with dental practices in the United States. They provide critical business management and support to dental practices, including non-clinical operations.

In a handful of states, you are not required to be a dentist to own a dental practice. However, in most states (like Texas), only a dentist can own a dental practice. The legal structure of a DSO is designed to comply with state regulations, as DSO's typically consist of a doctor entity (owned solely by a dentist) which owns the patient records (as required by state law) and the DSO entity which owns all of the tangible assets (equipment, furnishings, marketing collateral, lease, etc.) of the practice. DSO's are the fastest growing segment of the dental market and range in size from 1-10 offices (also known as "emerging DSO's") to 850 offices (Heartland Dental). Most sophisticated DSO's have centralized services, including: billing/collections, call center, marketing, HR, and legal/accounting. The dental practice contracts with the DSO to provide these services for a fee. The business entity also typically controls the net income of the practice after accounting for overhead (including the DSO's fee for centralized services).

While emerging DSO's are often backed by traditional banks or private investors, the growth of larger DSO's is being fueled by Private Equity. Wikipedia defines Private Equity as: investment funds, generally organized as limited partnerships, that buy and restructure companies that are not publicly traded.

Private Equity is particularly interested in the dental industry for several reasons:

- The dental industry has experienced consistent revenue growth over the past 20 years.

- Dental practices enjoy one of the highest levels of profitability of all niches in the medical space and typically sell for very reasonable multiples of EBITDA compared to other industries.

- The dental industry is highly fragmented, which provides investors with the opportunity to organize the market, optimize practices, and take advantage of the economies of scale previously discussed.

- There are a larger number of practice owners/potential sellers who are looking for liquidity and support from a business perspective.

- Demand for dental services is relatively inelastic in relation to changes in the economy.

Reasons for Selling to a DSO

There must be a compelling reason to consider selling to or partnering with a DSO buyer, as opposed to retaining ownership/control of your office long-term or selling to a private buyer. Here are several reasons why our clients have chosen to sell to or partner with a DSO buyer:

1. To receive a substantial premium on the practice purchase price compared to a private buyer (as discussed below)

2. To unload some or all of the management burden, thereby having less stress and a better work/life balance

3. To take advantage of the economies of scale and support a DSO can offer

4. To retire debt-free, and accumulate substantial liquidity/retirement savings

5. To fund future growth/expansion

Whatever your reason for entertaining offers from DSO buyers, you need to make sure that you choose the right buyer/partner that will truly enable you to accomplish your goals.

What Types of Practices Are DSO's Looking For?

While the appetite of DSO buyers varies, and there are many factors that are taken into consideration, most DSO's are looking for practices with the following characteristics:

- Annual revenue of $1 million +
- Updated facility with 5 + operatories
- Located in an area within 60 miles of a major population center
- Easily accessible or high visibility location (retail or free-standing building)
- Owner doctors (or associate doctors) who are committed to staying on for a minimum of two (2) years following the sale.

How DSO's Calculate Practice Value

For the most part, DSO's determine the value of dental practices based upon a multiple of EBITDA along with some consideration for the unique characteristics of the practice (location, quality and size of the facility, equipment/technology, patient mix, upside potential, etc.). As previously noted, EBITDA

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stands for Earnings Before Interest, Taxes, Depreciation, and Amortization and can be calculated as follows:

Net Income *(as it appears on your practice financials)*
+ Owner Compensation & Owner Benefits *(health insurance, retirement contributions, auto, meals, etc.)*
+ Associate Doctor Compensation
+ Interest
+ Depreciation
+ Amortization
– Doctor Compensation* *(30% of doctor collections)*

= EBITDA

** This compensation structure is based upon a general dentistry practice and will vary for multi-specialty and specialty practices.*

A practice with EBITDA in the range of $250,000 to $1 million will typically be valued at 4-5 times EBITDA, while a practice with EBITDA of over $1 million will typically be valued in the range of 5-7 times EBITDA. Large, multi-location practices with EBITDA of $2 million+ could serve as a platform investment for a DSO in a particular geographic area where the company does not currently have a presence. These practices often command a value as high as 7-10 times EBITDA.

The reason that DSO's typically target practices with annual revenue of $1 million+ is because offices with revenue below that threshold typically do not generate a substantial amount of EBITDA. A well run practice with an annual revenue of $1 million+ will typically generate EBITDA in the range of 20-25% of revenue.

As an example, a practice with annual revenue of $2 million, would hypothetically generate EBITDA of approx. $480,000. At a multiple of five times EBITDA, the practice would be valued at $2,400,000 (or 120% of revenue), which is a significant premium compared to a valuation of approx. 75% of revenue or $1,500,000 under the traditional private buyer model. The substantial premiums that DSO buyers are paying for highly profitable practices is one of the most prominent factors influencing sellers to consider offers from DSO buyers in lieu of selling to a private buyer.

Structural Elements of a DSO Transaction

While DSO buyers may pay a premium price for quality practices, the enhanced purchase price typically comes along with some strings attached. The buyer usually pays 70-85% of the purchase price at closing and payment of the remainder of the purchase price is contingent upon the selling doctor(s) continuing to work in the practice for a minimum of two years post-closing and/or the practice to hit certain revenue or EBITDA benchmarks post-closing. For example, a DSO buyer will purchase a practice with annual revenue of $1.5 million and EBITDA of $300,000 for a purchase price of $1.5 million (100% of revenue), with $1.2 million payable in cash at closing (80% of revenue, which is congruent with traditional valuations in the private buyer market). The remaining $300,000 would be payable in two annual installments, following closing, should the seller continue working fulltime at the office AND should the practice maintain revenue and EBITDA levels consistent with that of the trailing 12 months prior to closing.

Another common structural element of DSO transactions is the requirement of the selling dentist(s) to retain an ownership interest in their individual practice or "rollover" equity into the parent company. An equity retention/rollover structure is typically utilized in transactions involving large, multi-location practices or in a scenario where the selling dentist(s) is a major producer and/or plays a major leadership role in the practice. In this scenario, the buyer typically pays the selling dentist 60-80% of the enterprise value of the practice in cash at closing, and the seller either retains a 20-40% ownership interest in their individual practice or exchanges the remaining equity in their individual practice for a diluted equity position in the DSO. In both scenarios, the potential upside for the selling doctor is the ability to monetize their remaining equity at a much higher multiple of EBITDA at some point in the future via being part of a much larger enterprise (10-15 times EBITDA compared to 4-7 times EBITDA). The financial risk for the seller is that if the DSO is unsuccessful in re-capitalizing the business at a significantly higher multiple (if at all), it can leave the seller with a potentially unmarketable asset when he/she is ready to exit the company or retire. Therefore, it is imperative for sellers to understand the history and financial performance of the DSO, their past and current affiliations with investors/private equity, the company's future goals and expectations, and the variables at play when the seller is ready to divest themselves of their retained equity.

What to Expect During the Transition Process

The transition process in a DSO transaction is markedly different than that of a private buyer transaction. In a DSO transaction, the due diligence process is typically much more extensive than that of a private buyer transaction. The seller should be prepared to provide a DSO buyer with open access to all of their practice information, including their practice financials, bank statements, fee schedules, countless practice management reports, employee information, vendor contracts, etc. Given the amount of information DSO's require to complete their due diligence, it is often difficult for a distrustful or disorganized seller to make it through the due diligence process with a DSO buyer.

DSO's are typically required to have a certain level of consistency from transaction to transaction in regards to the deal structure and legal agreements. Therefore, DSO buyers typically require the parties to utilize their contracts (Purchase Agreements, Transition Agreement, Employment Agreement, etc.) and will be less flexible in the negotiation of those contracts than private buyers. Given the complexity of these agreements, it's imperative for sellers to engage the services of an experienced dental practice broker and dental attorney to facilitate the negotiation of the major deal points and review of the legal documents associated with the sale.

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What to Expect After the Sale

While you may be able to unlock a substantial amount of liquidity and freedom by selling to or partnering with a DSO, it's important to understand that you are exchanging autonomy/control and a portion of your personal income in return for those benefits. Not all DSO's are created equal. While some DSO's take a "hands off" approach and leave your practice culture, clinical philosophy, staff, patient/payor mix, operating hours, etc. intact following closing, other DSO's may take a more intrusive approach and look to substantially change your culture and systems immediately following closing or shortly thereafter. Therefore, it's vital for you to do your due diligence on your potential DSO buyer/partner. Ask for references from several doctors who have sold or partnered with the DSO, call those doctors to ask questions, and discuss how their experience has been following the sale. Here are a few questions that you may want to ask the DSO and their doctor references:

DSO Questions:

- What benefits do you offer to your doctors and staff members?
- Do you plan to retain my staff?
- Will you assert any influence on my clinical philosophy or treatment planning?
- Will I have the ability to choose the supplies we purchase and the labs that we utilize?
- Are you planning to change the operating hours of the practice? If so, what are your expectations regarding my work schedule?
- Are you planning to change the practice management software? If so, when?
- Are you planning to change my payor mix (PPO's, Medicaid, etc.)? If so, how?
- Are you partnered with a Private Equity Firm? If so, what is the name of the firm and when did they acquire an ownership interest in the company?

Doctor Reference Questions:

- Did the DSO make any significant changes to your practice that caused problems for you or our team?
- Were you able to retain your practice culture and clinical philosophy post-closing?
- Has the performance of your practice increased or declined since the sale?
- Did you meet the requirements of your post-closing holdback/earn-out and were you paid 100% of the total purchase price? If not, why?
- What are your thoughts regarding the DSO's management team on the corporate and local level?
- What do you like about this DSO? What would you like to change?
- If you were to go back in time, would you have sold your practice to this DSO?

It's important to mention that the culture of a particular DSO can change over time. If the company has yet to partner with a private equity firm, there could be shift in the company culture and/or operations following a liquidity event (the sale of a substantial interest in the company to a private equity firm). It's also pertinent to mention that private equity firms typically re-capitalize their investment (provide a return to their investors) by selling a portion of their stake in the company to another investor (often another private equity firm) every 3-5 years. While liquidity events may be lucrative for selling doctors who retained an ownership interest in their individual office or re-invested/rolled equity into the DSO, each capitalization event can lead to changes in the company's goals, culture, and operations.

Alternatives to Selling to a DSO

While most experts agree that the consolidation of the dental industry will continue for the foreseeable future, there will always be a place for private practice in the dental space. Patients who value personalized service and high quality dental care will continue to support private practices. However, it's important to touch on the fact that, in order for the next generation of dentists to experience sustained success, they will need to be more astute from a business perspective and adapt to industry trends and patient needs/wants as they evolve. This may involve several iterations of private practice models, including:

- Group practices where several dentists combine their resources and talents to form large multi-doctor offices that can take advantage of the same economies of scale that DSO's currently enjoy.
- Multi-specialty offices where all facets of dentistry are performed under one roof.
- High-end, boutique dental offices that focus on providing an unparalleled patient experience to fee-for-service patients who want the best service and dental care available in the marketplace.

While DSO transactions are currently generating a tremendous amount of buzz, doctor-to-doctor transactions are and will continue to be the most frequently utilized transition option, as the demand for quality practice acquisition opportunities is expected to remain high due to the continuous supply of young dentists who want to control their own destiny and are not interested in working in a "corporate" setting. These transitions take various forms, including walk-away sales (which are still very common), phased transitions (the gradual sale of a practice to an associate), partnerships, and practice mergers.

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3755 S. Capital of Texas Hwy • Suite 150 • Austin,TX 78704

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Regardless of whether you choose to sell your practice to a DSO buyer or are looking to do a doctor-to-doctor transition, don't go at it alone. It's critical for you to engage the services of an experienced dental practice broker who can help you evaluate your options, craft a transition strategy to meet your personal and professional goals, and represent your best interests throughout the process.

Contact us TODAY to schedule a free consultation!

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