

Chapter 9

UNDERSTANDING PRACTICE VALUATIONS

The IRS has defined fair market value as the price at which property would change hands between a willing purchaser and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. In order to meet the IRS definition of fair market value, the purchaser and seller would be considered to be dealing at arm's length, in a market based upon negotiation, supply and demand.

Seller's Perspective

From the selling doctor's perspective, he or she expects to be paid the purchase price and be succeeded by a worthy incoming doctor(s) to continue treatment of patients and retain referral sources in a specialty practice.

Incoming Doctor's Perspective

The incoming or purchasing doctor wants to have confidence that he or she is actually receiving the practice and its patient base and/or referral sources. The purchasing doctor wants "patients in the chair" to ensure that any acquired goodwill or intangible value has been transferred.

Declining Practice Values

There is a trend of declining practice values, both in general and specialty practices. First, dental schools and specialty programs are graduating fewer doctors than in the past. Second, an increasing number of doctors are retiring. Third, the population is increasing. Fourth, doctors want to choose where they practice geographically and do not desire to live in certain areas. For example, it is very difficult to find candidates who desire to practice in rural settings in any state. Finally, due to the supply and demand for dentists and specialty practitioners, the trend of doctors establishing their own practices is increasing. At this point, the incoming doctor has additional options of establishing a practice or becoming an associate in a busy practice rather than buying the practice of a retiring doctor; particularly if the requested purchase price is overly high. For these reasons, practice values are declining. However, quality practices with healthy profitability in desirable areas tend to retain value. And, practices with uncontrolled overhead, staffing problems, inadequate scheduling policies, poor collections and ineffective management systems in undesirable geographical areas are drastically declining in value. What's more, the doctors who own these practices have insufficient profitability to fund their retirement plans. These are the practices which need drastic operational changes and management training. These practices will be difficult to sell.

Verification Analysis

Irrespective of the valuation method used in appraising the practice, purchaser's accountant should complete a "verification analysis". This analysis should consist of four categories. That is, based upon what you project as the annual collections of the practice to be

with you as the owner(s), you must: (i) earn a living comparable to an "associate" doctor; (ii) pay the operating and capital expenses of the practice which you incur; and (iii) pay the lender(s) the purchase price for the acquired practice; and (iv) accomplish this within a measured time period, e.g., five years. This is the basis of the verification analysis which determines whether the purchase price is realistic, irrespective of the valuation method used.

Although your projected collections may be identical to the historical collection rate of the selling doctor(s), you should calculate and determine the percentage of the seller's patient or referral base which will remain with the practice after its acquisition and any growth. In other words, you cannot calculate your compensation and operating expenses without attempting to calculate practice collections or revenues. For example, if it is anticipated that the patient base will decline by 10%, the resulting reduction in collections will be significant to you, as the new owner.

The compensation which a purchasing doctor should earn while paying for a practice should be approximately that which would be earned as an associate dentist/specialist, e.g., 20%-30% of production as a general dentist/25%-35% of production as a specialist.¹ If you cannot earn an acceptable living while paying for a practice in light of the time period for payment, the purchase price is too high.

To determine the annual operating and capital expenses of the practice which the purchaser will incur, add the selling owner's compensation in all forms, e.g., retirement plan contributions and fringe benefits to the owner. This sum should be subtracted from the annual collections of the practice. The remaining amount will be the anticipated, annual operating and capital expenses of the practice for the purchaser.

From the projected level of purchaser compensation, you must pay the lender(s) for the acquired practice. Remember, interest will be included on the repayment amount. Additionally, the tax ramifications must be considered relative to the repayment obligations.

Importance of Practice Profitability

Figure 9-1 provides a three-page matrix, utilizing various purchase prices, rates of interest, with available owner compensation of 45%, 40% and 35%, respectively. It is interesting to note that small percentage changes in owner compensation greatly affect your ability to acquire a practice and pay for it within a measured time period.

Capitalization Rates

A reasonable time period to pay the lender(s) for a practice may be five years. This time period measures the degree of risk in the operation of the practice as an investment and provides for a capitalization rate of 20%. The lower the capitalization rate, the higher the value and vice-versa. An acquisition with a capitalization rate of 14%, would be paid in approximately seven years and a practice acquisition with a capitalization rate of 25% would be fully paid in four years.

¹ Valuing Your Practice, Associateships and Partnerships, 2-9, Pride Institute, 1992

When a practice is valued using a capitalization rate, such rate should include both the tangible assets and goodwill; an exception to this rule is the excess earnings valuation method.²

Capital Expenditures

To the extent that you anticipate, after the acquisition, equipment replacement costs, leasehold improvement costs, a relocation or other capital expenditures of any nature, such expenditures would reduce the available cash flow or owner's compensation to you. The extent that such expenditures would reduce the cash flow to the purchaser, the fair market value of the practice should be correspondingly reduced.

Post Retirement Services by the Seller

To the extent that the seller would continue to render services in the acquired practice except to assist in its transfer, those services provided by the seller should also be considered in the valuation process. However, in a solo group or co-ownership arrangement, the existing practice owner would continue work and the valuation process would also consider this matter. The services provided by the seller beyond a short one to three month period to assist the transfer of patients, directly affects the timing of the payment of the purchase price.

Accounts Receivable

The accounts receivable of the practice being sold are generally not acquired by the purchaser. Typically, the accounts receivable are collected by the purchaser and paid to the seller, less an approximate 5% administrative fee. However, there are times when the accounts receivable may be sold at their collectible value in order to provide the purchaser with non-lender working capital. Where an associate buys into an existing professional corporation, the associate automatically acquires an interest in the accounts receivable, unless specifically excluded. As a result, the valuation process should account for this. Irrespective of whether the accounts receivable are acquired or not, their disposition will have an impact upon the purchasing doctor. The value of accounts receivable after they are purged, would equal the "clean" accounts receivable, multiplied by slightly less than the historical collection rate.

Managed Care

Generally, the intangible value of the practice being valued would be reduced by the percentage that the managed care revenues relate to the total practice revenues. If managed care is assigned any intangible or goodwill value, carefully consider the ability of the seller to transfer this goodwill and the subsequent impact on your future profitability.

Co-ownership Values

In co-ownership, the practice value is usually calculated as if 100% of the practice is being acquired. Thereafter, the percentage of the practice being sold and acquired would be a pro rata percentage. For example, if the fair market value of a multiple owner practice is \$630,000.00 and

² Revenue Ruling 68-609.

the purchaser acquires a one-third (1/3) interest in the practice, the fair market value acquired would equal \$210,000.00. However, the fair market value may be reduced to reflect a minority interest if the purchasing doctor does not attain an equal voice in the operation and control of the practice as compared to the senior doctor(s). Additionally, the fair market value may further be reduced to account for a lack of marketability, in that the new owner's interest may be restricted by the operating or shareholder agreements of the practice. The rationale is that it is more difficult to sell a partial practice interest to a third-party doctor in a group practice than it is to sell a 100% interest for a sole practitioner.

Valuation Data

The more complete and accurate the information for which to value the practice or to assess the accuracy of an existing valuation, the easier it will be for you to make an informed decision as to whether to acquire a particular practice. Assuming that it is your intention to acquire a particular practice, it is critical to obtain relevant information relating about the practice in order to determine the purchase price and terms of the acquisition. The information contained in the chart in Figure 9-2 provides the basic information which should be provided by the seller's practice in order to prepare or confirm the valuation report. The information requested to prepare or confirm the practice valuation is a preliminary form of "due diligence" or homework. The purchasing doctor will review the valuation report and the corresponding information prior to making the decision as to whether to acquire the practice.

High Revenue Practices

High revenue practices tend to be more difficult to sell than "average" sized practices. This is because it generally takes two or more purchasers to produce the revenues that one or more high revenue producing doctor(s) can generate. To the extent that two or more compatible doctors are needed to acquire a high revenue producing practice, it is more difficult to locate such a combination of compatible talent in the pool of potential purchasers than it is to locate one doctor. For this reason, a lack of marketability discount should be applied to high revenue producing practices.

One problem with high revenue practices is that they are often burdened with unreasonably high overhead. High overhead definitely impacts value and makes it difficult to sell such a practice or admit an owner.

Seller Beware

Complete Sale

You spend your life and career building your practice. You are the practice and to you, it's worth a lot. You are ready to sell your practice so you have your practice appraised for what you believe it's worth. What if the practice is overvalued? For the purchasing doctor, the answer is obvious; the doctor can go broke or possibly be forced to find an additional job to meet outstanding obligations. For the seller? You may not be paid and be forced to return to practice, assuming you can. Possibly, your practice just won't sell; like the one retiring general dentist who wanted an extra \$20,000 for his practice which was valued at \$300,000. He "held out for more"

in what should have been a cash sale to a candidate practicing nearby. Two years later, the practice is still for sale.

Assuming that your practice is sold for cash, you have little to worry about if overvalued. Assuming that a purchaser bought an overvalued practice for cash, the purchaser may have lots to worry about.

Assume that you engage a broker to sell your practice and the broker completes the appraisal and overvalues the purchase price. The broker has found a potential purchaser who agrees to acquire your overvalued practice, but you are required to finance a substantial portion of the sale. Maybe the purchaser is told that both the practice and location have great potential; that fees can, on the average, be raised 10%; that you don't do root canals and the purchaser will; and that you only work a few days per week and that the purchaser will work 5-1/2 days; and that you can remain in the practice two days per week indefinitely because you have no plan to spend your time outside of dentistry after retirement. Sounds great? Maybe. But you are asked to finance some portion of the purchase price. This creates a substantial potential for default by a soon-to-be discouraged doctor who recently purchased your practice. You don't get the full purchase price and the incoming doctor fails. A lose-lose situation.

How do you protect yourself? Make sure that the contract you sign with any broker specifically provides for cash in full at closing.

If a practice broker's fee is based upon the sales price of the practice, it's obvious that the broker is representing the selling doctor. Therefore, it is imperative for the purchasing doctor to have an independent valuation of the practice completed, as well as the verification analysis of what the cash flow will be for the period of time when the practice is being paid for. Who does this analysis? The purchaser's licensed CPA; the CPA who will be retained by the purchasing doctor after the sale. Please note that there are many very good practice brokers who have your interests as a first priority and who maintain extremely high standards. The broker litmus test; require cash in full at closing.

The marketplace is changing due primarily to supply and demand for doctors. It is easier to establish a practice than any time since the late 1970's. As a result, practice values are now in decline. Doctors who are planning for their succession should: (i) plan for future economic needs by proper retirement plan funding; and (ii) commit themselves to the management training necessary to attain and maintain consistently healthy profitability. It is the healthy and profitable practices which will best retain value and act as a vehicle to allow the owner the freedom to retire.