Understanding Practice Valuations

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There comes a time in most dentist's lives when they need to or should understand practice valuations whether they are selling a practice, buying a practice, or planning to exit the profession in the future.

Commonly Used Terms

EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) – This number is usually calculated after an allowance for dentist's remuneration typically 40% for a general dentist or 50% for a specialist.

Normalized Net Income – Refers to the income after non-recurring, unusual or discretionary items that do not affect the core business operations are removed. Example of items that would be normalized include, but are not limited to automobile expenses, travel, an excess number of conventions, personal insurance, interest, and bank charges that are out of the ordinary etc. It is imperative that you have someone on your team validate these normalizations.

Debt Servicing – Usually, the banks do a quick check as a rule of thumb.

They take the value of the practice, divide by the number of years of the term of the loan and add an interest factor. If a practice is valued at $1,000,000, they divide that by 10 or 12 years (depending on the institution). Let's use 10 years for easy math and 3% simple interest rate.

Then, the yearly principal would be $1,000,000/10 =$100,000 and the interest would be $30,000. So, the monthly payment would be $130,000/12 = $10,833 per month

This is how much profit you would need to generate before paying yourself a dollar.

From the vendor's perspective, if your practice is not generating enough profit to cash flow the debt servicing, you may not get what you want or what you think your practice is worth.

You can see that as interest rates rise, the debt servicing obligation increases the downward pressure on practice values in the future.

Demolition Clauses – To mitigate risk, banks will divide the purchase price by the number of years left before the demolition clause kicks in unless you have a back-up plan to relocate those patients to a nearby facility if the clause is exercised. It is highly recommended that you consult with a realty lease expert before you need to renew.

This clause increases your monthly payment so it may not "cash flow" to your lender's satisfaction.

Discounted Cash Flow – This is a valuation method used to estimate the value of an investment based on its expected future cash flows. This method projects the net income stream after deduction of an owner/operator's annual salary and professional corporate tax, for a prolonged period into the future. A salvage value is also estimated for the practice at the end of this period. These amounts are then discounted to today's dollars based on a rate representative of the perceived risk levels of investing in dental practices. The discount rate is a function of current economic forecasts in the area and prevailing interest rates achievable in other investments. Each practice has its own unique discount rate and a discount rate from one practice should not be applied to another practice to determine its value.

There are also several misconceptions about practice valuations which are, at times, overly simplistic or inaccurate.

"My practice is worth x% of my gross" – It could be but, in many cases, it could be too high or too low. There are fluctuations ranging from as low as 50% (some specialist offices) to as high as 250% (some startups). A hard and fast number just does not exist in the real-world. A range could be given for a certain subset of parameters, but the work needs to be done to narrow it down to get a true fair value.

"My practice is worth X times multiple" – What is included in the numerator and what is included in the denominator?

Multiple refers to the price/earnings multiple (P/E) and is the price or value of the practice divided by the normal-

ized net income or earnings (after tax) of the practice. Many people confuse the after-tax and the pre-tax normalized net earnings, so they are not comparing apples to apples.

The P/E multiple is an excellent starting point, but it does not reflect the true value of the practice and should not be used to value the practice. This number is derived after the practice is valued and can be deceptive. This number does not cause or create value.

Scenario – Dr. Jones knocks on your door and wants to buy your practice. He has you sign a non-disclosure agreement, does his/her own normalizations, and offers X times multiple of the number he came up with. This could lead to a huge discrepancy in the value of the practice.

"My practice is worth X times free cash flow" – This is normally the value of the practice divided by the normalized net income before doctors' remuneration, debt servicing and income tax. What items are included or omitted?

Goodwill equals one year's gross billings. A stopped clock is right twice a day – Each office is unique and has its own set of circumstances that can be compared to other similar practices and adjustments to the model can be made. Valuations are mostly objective but have some subjective elements. Objective elements are items that can be proven such as gross billings, # of active patients seen in the practice in a specified time, velocity (growth of production year over year), salary and rent percentages, remaining economic life of assets such as equipment, leasehold improvements, and consumable supplies, etc. In contrast, subjective elements address the Practice Specific Risk (PSR) of a particular practice. Some of these factors include location, volatility and trends of revenues and earnings, reliance on key personnel whether it is the principal dentist, office manager or other team members, competition, and procedure mix.

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Sustainability and reproducibility are also words often used to describe a practice.

Is the production and therefore, future net income reproducible and sustainable?

If the vendor dentist places many implants or does endo or ortho and the purchasing dentist does not, the revenues and therefore, the profits are at risk.

Conversely, if the vendor does not do these types of procedures and the purchaser is able to provide these other procedures, there is an opportunity to grow the practice organically from the existing patient base.

The bottom line: Do your homework, learn, and use multiple ratios to analyze a practice's worth.

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Gerry Crandles, Partner, Sales Representative, Gerry has spent 29 years in the Dental Industry focusing on Practice start-ups, relocations and high tech equipment, winning numerous sales proficiency awards across North America. Gerry holds a Bachelor of Arts (Economics) from Western University and has the proven business development skills to provide valuable advice and practical solutions for Dental Professionals. His extensive knowledge of the business aspects of Dentistry, coupled with his vast network of Dentists, accountants, lawyers, contractors and dental industry contacts will ensure he earns the trust and confidence of both Buyers and Sellers of dental practices.