Ep #379: Practice Transition Panel (Part 2)

Full Episode Transcript

With Your Host

Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

David Phelps: Hi, David here. This week on the Dentist Freedom Blueprint Podcast we are doing a continuation of a conversation with a panel that I hosted on practice transitions. Jump right in today, but also go back to last week's episode to pick up on where we started, how we got to where we are today.

This week, we'll be talking about taking chips off the table. If you are considering selling a part or full aspect of the equity in your practice, how to look at that, what are the options today, and really importantly, where do you potentially invest the money that you're taking off the table. Jump in today and I know you'll enjoy this particular segment.

What are their options today? I mean, doctor to doctor, as you said, Brandon. So a private sale. And then can you guys break down the DSO market into some additional tranches, or do you want to keep that as a whole? Brandon and Mike Abernethy probably you guys maybe talk about that a little bit, so we can identify the players so we can elucidate what these options are and then some of the caveats. As Alistair said, there's always a trade. So why don't you guys start and let's go down that rabbit hole.

Brannon Moncrief: In the private buyer marketplace, we essentially have two different types of buyers. We have the traditional doctor that's four or five years out of school, 250,000 to $400,000 in student loan debt. They're going to buy a practice from another individual and that's going to be their baby and they're going to work there full time. Those transactions are still happening every day.

David Phelps: And Brandon, that would fit what valuation range for that, we need to know what that looks like. So give us that, if you would.

Brannon Moncrief: So that's going to be somewhere in the range of, let's say, 70 to 90% of annual revenue. What's a better metric for buyers to use is let's call it one and a half to two times net cashflow.

David Phelps: Got it.

Brannon Moncrief: And those transactions are still happening every day, while my company is doing more DSO transactions than we've ever done, the amount of doctor to doctor transactions that we've done over the past 35 years has been relatively consistent from year to year. So we're not seeing a drop off in doctor to doctor transactions, we're just seeing another side of the market evolve and become viable. And that's the DSO private equity side.

The other type of private buyer that's out there is the entrepreneurial dentist that owns multiple locations. You could call it an emerging DSO, whether they're legally structured as a DSO or not. And that type of buyer is a fit for a seller who may have a practice that's not large enough or profitable enough to sell to a larger DSO buyer, but they want to sell, they want to unload some management responsibilities and stay on post close. The

valuation in that world is going to be almost identical to what it is and the more traditional doctor to doctor sale.

And then on the DSO side, I really see three different types of buyers and deal structures out there. There's the more traditional Heartland style model, where they have robust infrastructure, they're going to buy 100% of the practice. They're going to give the doctor, call it, 70% cash at close and put them on a three to five year earnout paid contingent upon them fulfilling their employment obligations and possibly the practice maintaining the revenue level that it was at when the practice was sold.

So that's one type, I'll call that the traditional DSO model, because Heartland was really the first big DSO buyer that came to market. And their growth was fueled by the fact that they were operating in an environment where there weren't a lot of other options at that point in time, that's obviously changed now.

The second model is we'll call it the MB2 model, where it's a JV model. So that's where the DSO buys a 60 to 70% interest in the practice, the seller maintains 30 to 40% JV interest in their own four walls at the local practice level. And then they have the opportunity to enjoy obviously the management infrastructure that the DSO provides so they can upload some of that burden. They get ongoing pro rata net income distributions after overhead and the management fee of the DSO is paid.

And then typically they have tag along rights where when the parent company has a recapitalization event, they're allowed to liquidate a portion of their JV equity at the parent company given a multiple. So there's multifaceted benefits from that type of DSO buyer.

And then the third is 100% practice sale with an equity rollover. So rather than retaining equity in your own four walls at the local practice level, you have the opportunity to sell 100% of your practice and roll typically up to 25% of the sales price into holding company equity. So into equity of the parent company. And that equity is typically liquidated upon recap, either in part or full.

And then I'd say that's probably the top three. And then we've seen some hybrid models, where you have the opportunity to sell, let's say you cash out 70% of your practice, have a 15% JV equity interest at the local level, and then a 15% equity role into holding company equity. So those are the four DSO models that are most prevalent and there's different iterations of each of those models. And each DSO has its own culture, personality, infrastructure. If you've seen one DSO, you've seen one DSO.

David Phelps: That's right. Exactly. That was a great framework. I'll let anybody else jump in. Mike, you want to add any definitions to what I thought was a pretty good layout.

Mike Abernathy: That was good. I mean, but we are talking when you make those descriptors of the buyers and not the sellers or the downside to the number two and three. I mean, the reason that they're doing such a great favor at letting you be a partner with them, and so they can get into the deal for less money, for money you're never going to see.

And so I'm sitting here just getting mad as I'm going, it's like you're betting on the comp. I mean, if you're going to leave 20 or 30% in the company, just assume you're loaning this to your worthless cousin and you're never going to see it. And so it still makes sense if that 60 or

70% is more than you could get on the independent buyer market.

And then there is the possibility, but in a way, now this is the old guy sitting at the table here going, "Your practice while any business you start should be designed to sell at some point." I think it's foolish to use the sale of your practice as a wealth building strategy without learning how to save and invest money and have passive income.

And you're waiting till the ninth inning and you can't even take a pitch and it's got to be three people on base and you hit a home run. And so I think because the people are going to be listening to this and I'm hoping that they're not thinking like a dentist. In the worst possible description, you can think of thinking as a dentist, because they see that life preserver thrown to them and it's really made out of hard sugar that's going to melt in the sea of financial ups and downs.

I want Alistair to comment on this because I love when he talks about debt being the taxes on future earnings. And you look at if you're going to sell for one and a half to two times net, "Why the heck can I just work a year and a half more?" Or why don't you just learn to live on the money that you have and stop your lifestyle suck.

I mean, all these things will happen, but getting in bed with the DSO, it's much harder to extricate yourself from these contracts, these managed management service agreements that you're signing than it ever was to get in bed with them. And often times there are great companies out there that I respect what they do, but I have yet to see a DSO that has purchased an office, a good office, because generally they start out buying the best offices. They don't want something with no E and EBIDA.

And so they've never purchased an office where they've been able to increase the earnings or decrease the overhead. These companies are built on Fiat credit money, they're built on mergers and acquisitions, not on actual performance and ownership of a business. And that's where equity money at some point will go, it'll be that Dr. Phil moment, where they go, "What was I thinking when I did that?" So I'm curious, I want to hear Alistair say something.

David Phelps: Hi, Dr. David Phelps here. I started my real estate investing portfolio back in 1980. Inflation was running at 14.8% and the federal fund rate was at a high of 20%. This after a decade of hyperinflation, along with a very anemic economy called stagflation. Now look where we are today, we have hyperinflation again, interest rates going up, possibly triggering a recession, could be back to the 80s.

I know how to navigate these times. I've done it. I built my whole portfolio during times of a lot of volatility. I'm proud to announce the release of my newest book, Inflation: The Silent Retirement Killer. I've packed it full of information about how Fiat currency can undermine the hard work and the wealth that you've tried to create. You've got to do things differently to protect that wealth going forward and the wealth generation you hope to pass onto your heirs. You can download a digital copy of my book for free at inflationbook.com. That's inflationbook.com.

Author Venita VanCaspel once wrote, "Inflation takes from the ignorant and gives to the well-informed." You want to be well-informed in this case, this is what I call a great wealth transfer. Be sure you're on the receiving side, not the giving side. Download a free copy of my

book at inflationbook.com. Okay, Alistair we want to hear you say something.

Alastair Macdonald: Thank you, Mike. We're just so aligned. It's kind of comical. The couple of things come up for me that as you say, if that's your plan for your grand exit and you're all in on that, it's very much like choosing to grind it out and defer joy until when you retire. Well, you're all in on that planet, better work because when you hit 65 and you've trained yourself to be miserable, the chances of you suddenly finding joy is a low probability outcome.

And the same with being all in on the practice, this is what I'm going to sell. Likewise, to these, what I really think of as interlopers, we're all familiar with the term greater fool theory. The idea that I'm willing to overpay for this asset, knowingly do so because it is a greater fool than I, that I'm going to be able to sell this too in the future.

By any other term, this is really hustling. This is what we're doing. We're hustling with practices. There's a lot of hustling going on right now with vet practices. The notion that I can pay 10 times it'll work out. I mean, just take my own vet hospital for example, if they're buying it from me at 15 times EBITDA, and this is bumping up, it breaks through any historical precedent. What are the chances of them finding a fool greater than that? They can have a hard time finding a buyer.

And then finally, to Mike's point about, you better be right. And this is not to say the trends can't stay in place longer than we would expect. I think it's all the beautiful old saying, the market can remain irrational longer than you can remain solvent. I think it was Keynes who said that.

So as the crusty old guys, we get to be frustrated in the sense of when is this madness going to end so that we can get back to the real business? Which is what Mike's pointing to, which is value creation, not moving things around on the desk and trying to find a greater fool than I.

And the last point is really about this kind of MB2 model, very prevalent, very popular right now, as Brandon pointed out. I think speaking to our friends who will hopefully find some thoughts to reflect on in our time together here. One of the most dangerous things is a kind of disequilibria or a breakdown in the ratio between responsibility and authority.

This is crucial. What so many docs don't realize is by selling to a DSO, they are yielding authority, but retaining responsibility. This is a trap. This is quite literally how somebody gets caught on the wrong side of a trade.

The ratio between responsibility and authority has to be one to one, whether it's, we're doing it for our practice manager at location number five, or we're doing it to somebody who's going to be head of hygiene. You have to make sure that whatever responsibilities is matched by an equivalent level of authority.

When we sell to a DSO, particularly one who, say is based in Texas, but I live in Washington. I am on the ground. I am the one who has to listen to that front desk person disrespect a patient on the phone. I have all of the responsibility of dealing with that in real time, but none of the actual end authority that the parent company has to superimpose their own philosophy of what do we do with disgruntled patients, for example. That's just a really small example, but that's what they're doing.

In the service of hot, quick money, they're yielding the most valuable thing that they have in their practice, which is at the root of everything they've grown, which is the authority to make the changes needed in a dynamic work environment, which is what a practice is. And I would encourage everybody to pay all the attention you can to keeping that ratio at one to one.

David Phelps: Well said. Bill and Jared, jump in, insights into the conversation.

Jared Duckett: I'll just jump in there real fast. I mean, going, Brandon, you laid that out perfectly, all the different structures in your spot on is if you've seen one DSO, you've seen one DSO. Because they're all different regarding we mentioned the JV MB2 model, regarding coming in and buying 100% of the practice and an earn out. The culture, the economies of scale and the infrastructure they bring with it. So they're all different.

I talk to some people and they're like, well, DSO is their four letter work. And some people are like, "No, I love DSOs." It's just, there's a lot in between. And so when you're looking for that exit, rewind this and listen to Brandon and all the different options he mentioned. Start with the end in mind, think about what you want out of a potential exit.

Is cash your number one priority? Upfront cash. Is it you're willing to stay on for X amount of period? What's the culture? What's the infrastructure? Think through all that and then piecemeal through what makes the most sense to you. So you got to think with the end in mind and look at all the options, because they're all just totally different.

Bill: And I'm going to jump in and take the track of Mike talking about people looking at their exit as their investment strategy. That's how they're going to fund their future cashflow. And we do see that and I do think that's very dangerous. And the problem we tend to see is people who have that mindset, their practice is typically running into the ditches right now.

And so what they've done is they've shot themselves in the foot on that strategy because their multiple is going to be much lower because there's no profit—what you're saying. When I look at this, I don't think that's a bad strategy to have the end in mind at how you want to exit and you'd like to get a good multiple. But I think what you have to do is look at that and say, "Well, what am I going to do in my practice now to set myself up for that potential, knowing worst case scenario, I maybe don't have the exit I want, but I've had a very profitable practice kicking off cashflow allow me to put money to work and do what I need to do to replace my income stream," like you say, David, "and I've had a practice that now is a high performing profitable practice, which dental practices still can be in this environment."

So I think that we see people get too trigger happy. They're wanting to move, they're wanting to get this thing done and they don't stop to think that, "Hey, maybe with a little intentionality, I can get my head right, get back in the game, start making some profit." And a lot of times we see that we'll get people's timeline shifted out a little bit, where they can get the runway back and have a profitable practice along the way.

Jared Duckett: Well, to jump in, build your spot on. And I always use the car analogy in this regard. Because if you're going to go

sell your car, you're going to go clean it first, right? Most people don't sell their car to another person or trade it in. If you get your kids French fries shoved in the car seats, you go clean it up, vacuum it, detail at everything. Same thing on a practice, that's what Bill's talking about. What's your runway start cleaning that car up is you're going to get more out of it on a trade in or potential sale than you would if you just sold it now.

David Phelps: And that concludes the second session of the conversations on the practice transition panel. Next week will be our third and final week in which we'll jump into considerations for those who are younger in practice. What the current model is, what you have to look forward to, how you can assess your debt situation. And really looking at the trends, what's happening in the model going forward. This will help you ascertain whether or not you even want to be in a practice owner, why you should or shouldn't and what to do if you're not.

And if you are in a position where you are going to sell your practice, you need to understand what our younger docs are thinking about, so it'll be relevant no matter where you are in your practice. See you next week.

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