The Hidden Dangers of the DSO Zeitgeist (Part 1) - Alastair Macdonald: Ep #439

Full Episode Transcript

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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. Welcome back to another podcast conversation this week and next week, a great conversation with my good friend and mentor, Mr. Alastair Macdonald.

If you've listened to this podcast before, you know I bring Alastair back from time to time just to talk about current topics, either in the investing environment, the economic environment or dentistry specific.

And this week and next week, Alastair and I are going to refer to lightly in general, to an interview that we were able to pick up. An interview that was out in public regarding the current DSO and private equity in dentistry and where that's come from, where it's going, where it is right now, where it's headed.

So, we refer to a conversation, we don't need to make the parties public, but the conversation brought out some good cellular points and we dug into a lot of those this week and next week.

So, jump in, enjoy this conversation. I'll be back at the back end just to let you know what's going to happen next week, just a little bit. But I think you'll enjoy this conversation. Take some notes. It's good stuff.

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Alastair Macdonald: What this interview's done is really captured the current zeitgeist. It's captured so many of the narratives, so many of the fallacies, so many of the logical fallacies that it really serves as a great summary of where we're at in the collective belief and more dangerously the collective expectation.

I mean, like you, there so many of these conversations every week, they just tend to be more bite-sized than this.

To his credit, there were numerous diagnoses that he made that he was bang on than cautions and concerns and so forth, but talk about great diagnosis, misprescription. It's a shame.

Equally, I appreciated him kind of speaking truth to some of these fraudulent, that was really great. But there are still embedded assumptions that are so poor to his business model. He needs them to be true.

So, while he is wide open and clearly able to see the frailties in other business models, he doesn't seem to see the very Santa dress that he's built his own house on.

David Phelps: Well, this is so commensurate with exactly what we see in the real estate space. It's that, particularly the syndicators that need to keep a pipeline of syndications going because it's transactional on their part. That's where they aggregate acquisition fees, management fees and this supposed backend carrier promotes.

And they have to tell themselves the story, the narrative to rationalize why they keep going in. And again, if you have a relevant conversation with a syndicator who really will be authentic with the conversation, they will admit to some of the fallacies in their product.

And they will turn it around. And just the other day, I was talking to somebody, and we were talking about the fact that so many people believe “Well, just wait, the Fed is going to lower interest rates. We're at the peak right now. It's going to come down and you need to still jump in.”

And yet on the other side, they were talking about the fact that the risk premium for buying rate cap insurance was an all-time high.

I mean, the underwriters who actually priced that risk are saying “Huh.” So, I said, “How do you bring that together?” It's like, “I guess not.” But they have to tell themselves the narrative because they've got an incentive because their business is based on a certain model that's worked over the last decade plus.

Alastair Macdonald: It's probably worth … I think what's lost here is so much that's lost. But these are investment decisions. And historically speaking, docs and engineers are the worst investors. They just are because they come from this world of kind of physics and we're dealing with the world of biology, which is human budding instincts, mimetic desire, et cetera.

This is not at all the pneumatic system where you push down here and then it comes up.

And I say that because by way of qualification. I mean, I'd first stepped professionally into the investing world, I can't believe its 24 years ago. You've got even greater tenure.

I mean, what are we talking about in — because these are investment decisions that are being made here. They've got nothing to do with the dentistry. How many years have you been here?

David Phelps: 1980. That's four decades plus.

Alastair Macdonald: So, we're talking about accumulative of 65 years between us of diverse investment experience. And this is the key piece. We are of course living in a siloed world and we're sure this is about dentistry. No, these are investment decisions.

David Phelps: Alastair, we have the privilege of having numerous conversations, particularly over the last three years regarding the cycles, the business cycles. In fact, I would say we're even in a longer secular cycle change and yet we still see the markets in general, very exuberant, quite irrational.

People feeling like that things will return to a normalized period of time once we get through this recession and the higher interest rates and we'll all go back to this feeling frenzy that seems to push all assets up, up, up, up, up.

And in particular, we both have the privilege of dealing with, and helping people in the industry of dentistry, not unlike almost any other industry, the dentistry profession is a business.

And when people are talking about the opportunity in front of them to take the chips off the table, that is to sell part of the practice, which another term for that with many of the sales today would be a buyout, we'll get into some of that in a moment.

But looking at that as an opportunity and feeling this frenzy, the FOMO that we see so many times in the marketplace.

You said recently that this is not about dentistry, this is about investment decisions in which most of our graduate colleagues that are very, very astute in their clinical expertise and many are quite good in their business says, don't really understand

the crux moves that they're looking at when they're considering making a move to sell part or all of a practice, particularly so many at a young age today.

I'll say this too. We're also listening to different people at seminars, events, podcasts, interviews and again, this conversation comes up over and over again.

And we see that so many times the nuances or the stories, the narratives that many who are on the side of being incentivized to see these sales or buyouts go through, have to tell themselves a story about why this is a good thing. Even though they can probably diagnose exactly the pros and cons of the trade that's being made.

Alastair Macdonald: So accurate, as a settle. Out of the gates, I think it's worth pointing out as there always is, we are betrayed by the language that we use. And to that end, we can be betrayed by our own misuse of terms and there's a lot of that going on.

And there always is with new magical phenomenon. There's a lot of them. One example and I think a critical distinction is I don't have a problem with DSOs. I have a problem with bad private equity deals and they're very different.

What is old is private equity. What is new to dentistry is private equity, whether they're coming in through a DSO or using any sort of acronym you'd like, I've seen equivalent deals in the — space, PT, et cetera, et cetera.

So, the distinction here, that's important. This has nothing to do with DSOs effectively, it has to do with purchase structures and the money behind bank side. Equally, another critical distinction is the difference between a sale and a buyout.

A sale is, of course I take something from you, and I pay you for it. A buyout is where I kind of borrow it. I give you some money and I'm going to basically lease it back from you.

There's a big, big difference and how it manifests in the life of so many well intended, well intentioning docs is going to change their life.

And for too many, I'm afraid, as this goes on and as the hyperbole begins to escalate even more than it did a year ago, I'm now officially concerned that there are many, many people that are walking off the edge of a cliff of the quality of life that they have and the value of the assets that they think they're getting a good dealing on.

So, their language is crucial. It's no different than renting a home versus buying a home. It's quite literally that large a gap between a buyout and a sale, equally a sale that suddenly as we get through the LOI and the quality of earnings assessments and so forth, we suddenly go from language of purchase to partner.

In sleight of hand, is the stuff every magician uses. Look at this, look at this. Now boom, we've got something else. There's so many of these but I'm sure we'll get into it.

David Phelps: So, what we're really talking about is that term that many of us who have not been in the financial markets, we've heard it over and over again, the leveraged buyout or icon, who thought that we dentistry could participate in icon space?

But that's what we were talking about here, a leveraged buyout, as you said, leveraging the equity that a hardworking doc has built up in his or her practice, the private equity DSO leveraging

that on the buyout and leaving that buyout to whatever the market's going to bring.

And that's where the trouble begins, is it not? Because we can look back with recency bias as what we've seen in the last five or six years, perhaps. So, maybe not so much in the last couple of years, but there were those who were still singing the song that it's all good, it's all good, but what we've seen is not necessarily going to be what pertains in the future.

My experience has been in the real estate sector, but it's no different. Real estate typically, traditionally, particularly with the low interest rates, the hot, cheap money that we've had coming out of the 2008 great financial crisis has allowed for assets and leverage to be used to the max, way past the max.

And so, I see the same thing in real estate where we've had in the last decade, particularly the last bigger portion of this last decade, the quick turn. You just acquire an asset, maybe put a little lipstick on it, and you turn it to a seller who will pay a higher price because again, the cost of capital is still cheap. Who can lose? Who could lose? So, this goes over and over and over again.

I know right now in the real estate space, there are big problems and big headwinds that we see right now. Why aren't we seeing that or are we seeing that? Maybe I should ask that better question. Are we seeing that but it's just not being publicized as much through the narratives in the DSO dental space today?

Alastair Macdonald: The can’s being kicked down the road between three to five years from now, depending on when individuals bought. As a function of interest rates, which everybody in sure

has nothing to do with dentistry, that has everything to do with anything that money touches.

Interest rates are reflective of course of the risk premium. So, we've seen a significant rise in the pricing of the risk ever since the July 2020 lows in the long-term bond.

We are now entering a secular upswing in interest rate. And for those that are not clear, the larger trend has turned from down to up. This means money is going to get more expensive.

How can we say we're in the larger secular swing in interest rates? We will remain in a new upswing in interest rates until and unless new lows are made.

And this is a simple distinction and used in the financial markets. We consider us in a bull market provided that we continue to break new highs and we're in a bear market to the extent that we're making new lows, which is really not so much bull and bear as it is a rising or a falling, not as a slight distinction there too.

So, we can with confidence continue to act as if the larger trend has turned up and we should. Anybody that is not paying attention to that, is selling you a model that worked with falling interest rates, which right now unfortunately is about 98% of business owners and in particular in professional investors who are on the other side of the trade.

You're absolutely right. This is a leveraged buyout 2.0 actually, it's really 3.0. It's less about than anybody who cites performance in dentistry in the last three years. If anyone is advising you and using data of the last five years in dentistry, they are misinformed, to be kind.

What they would do better off doing is going back and studying the LBO boom of the 1980s. How it began, what's formed, the ERISA Act did, the failure of the 1977 Carter Tax Plan that caused a spike of capital to move into the space and created what we now know as the modern day leveraged buyout. Two types of private equity firms, they're venture capital and leveraged buyout.

These rarely began in the 1940s, but they didn't hit their stride until the late 1970s and the changes in taxation code by Reagan 1981, which spawned these icons as we know of that are now still prominent. You mentioned … icon, is a perfect example.

The irony is that because of the nature of how they went about the business that they were in, they were referred to as corporate raiders till the 1980s. You know this, I know this, but today they're activist investors. Now, I mean, what a beautiful whitewashing of an actual track record that destroyed far more businesses than it ever built, it just does.

Docs would do well to understand how it is that private equity makes their money. There's many, many different things about them. As well as the sense of privilege, which I hope it can come to.

The key piece is, to a large extent, in 1963, '65 was essentially running a private equity fund. It's changed dramatically over the years in that, he bought Berkshire Hathaway, a textile company and realized that he could borrow against these assets to buy other more profitable businesses, such that Berkshire Hathaway became the dregs on the balance sheet of Berkshire Hathaway.

Over time, he continued to use that leverage to acquire high cashflow businesses. The difference is where he diverged from most private equity groups is that he did not use excessive leverage and he actually cared about ongoing relationships with those businesses he bought. What has this got to do with us?

There are today a very, very different profile. These industries represent a very different profile than the standard subtitled conservative doc owners, while Warren Buffet and those of us that actually own businesses are playing the long game.

Warren Buffet as an example, is no longer a leveraged buyout guy and he really wasn't pretty much. Though his seeds were in there. Warren Buffett focuses on time. Private equity focuses on speed. They're less concerned about the size as concerned about the speed of the turn as they are the return they get. The antithesis of Warren Buffet.

So, to call them professional investors is a misnomer. They are professional speculators and they have developed a masterful movement to do it with other people's money, worked beautifully for them in the 80s. This is the nature of the beast.

It's worth remembering that in every transaction there's a buyer and a seller. The buyer believes that this asset could be sold in the future for greater value or it's going to spin off cashflow that suggests that. The seller believes that this price is as good as it's going to get. Only one of them will be right.

The grand irony of most private equity DSO sales today is docs actually think they can have both wings. They actually think that they can be both a seller and a buyer, which is to say, “I will sell you X percent of my practice clearly at an egregiously overpriced valuation or I wouldn't sell it.”

But I will stick around with some “Retained equity” in a business I have never seen the balance sheet of, with investors whose performance will never be known to me, roll 40% of my family's net worth into the hands of professional speculators.

Again, whose balance sheet I haven't seen, whose returns I don’t know, whose track record and system is unknown to me. We're going to do this and we're going to ride it out into the future. You cannot be a buyer and seller simultaneously; you have to pick a team.

But individuals are doing with no sense at all of where the money is actually going back to. It's critical that we realize this money is so sophisticated, it's going to go wrong. Where is this yield going to come from? We have to talk about growth and where this is all going to come from. So many misunderstandings here.

But there's one piece here, and I'll stop on this point, there's a lot more to it, is when I say, so I'm going to partner with you, “Oh, we'll get this beautiful multiple.” “No, we won't.”

We will be shown a high figure — I'll speak about this if we can. I'll be shown a higher figure, receive 60% of it and that 40% will be an ongoing investment in this parent company.

Not of the gates we've got. I'm agreeing to sell to you because you're overpaying. I wouldn't sell otherwise. I'm not going to sell you a dollar for 50 cents. I clearly believe that you're paying me $2 for $1 bill, meaning that you have already shown a track record of overpaying for a business.

If there's one thing that you teach all of the members of Freedom Founders that you and I are actively pointing to, the

surest way to get a great return is to pay less on the front end. The surest way to get a really bad return is to overpay.

So, out of the gates, docs are choosing to go all in with their family asset with an outfit that is known by a hundred percent their track record for overpaying for practices, and you're going to invest the rest of your capital with them. That's why I say you can't be a seller and the buyer simultaneously.

David Phelps: Okay, that's a wrap for this week. As I said, we all have a follow up. This conversation will continue next week with Alastair Macdonald, and we'll go back to the origins of where some of the hot money has transversed across different economic arenas even internationally before it came back and started finding housing in 2008 and then into the industry specifically in 2013 to 2018. And where it's moving now.

The fact is the money always moves. The environment today, the higher interest rates is making a big, big difference. So, jump in next week and we'll give you a little bit more of the overview of how all this money works.

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