Solo to Group to DSO - Which Path Is Right for You? - Perrin DesPortes (Part 1): Ep #453

Full Episode Transcript

With Your Host

Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

Solo to Group to DSO - Which Path Is Right for You? - Perrin DesPortes (Part 1): Ep #453

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, all David here, this week and for the following week, I have had a conversation with Mr. Perrin DesPortes of Polaris Healthcare Partners. This conversation was so good and so relevant to where we are in the marketplace today in regards to practice exit transitions that we went long and I decided to break it up into two weeks so you don't have to consume it all at one time.

So, this is week one of my conversation with Perrin. We're diving into what I consider the state of the industry today in terms of the exits and the DSO mania as I see it, which has been good up to a point but it's changing rapidly.

What those changes mean in the marketplace, what doctors, where they are in their career need to look at in terms of the game plan, the pathway forward. You want to build a group practice or have a DSO exit. Well, when should you do that? How do you do that? Who is right to do that? And who shouldn't do that?

These are the common puzzles that really have to be looked at. And so, I'll lead you right into the conversation today with Perrin, and next week we'll follow up with the second half of the conversation, enjoy.

Good day everyone, this is Dr. David Phelps of the Freedom Founders and Mastermind Community and the Dentist Freedom Blueprint Podcast.

Today, a conversation that I have been looking forward to for weeks and probably some months, and that's with someone who's become a friend, a colleague in our industry, and someone who actually we have some affinity in some other areas of life and exploration and adventure, glad to have Mr. Perrin DesPortes with us today.

Perrin, thanks for being with us.

Perrin DesPortes: David, thank you so much for having me. I too have been looking forward to this, well ever since we first met in person back at the DSI summit and then our subsequent conversation. So, I think this'll be a lot of fun today. Thanks for having me on.

David Phelps: Absolutely. Just to give people a bit of background, Perrin, you come from a family lineage of being in the dental space. I believe it was your grandfather, Perrin Thompson founded the Thompson Dental Supply Company. Did I get that right?

Perrin DesPortes: Great-grandfather, actually … eneration in that business, and it was started in 1899 of all things. And my grandfather was chairman of the board, my father was president and CEO when I came into the business in 1995 and ended up making the decision to sell that business to Patterson Dental Supply in April of 2002.

We can talk about equity transitions and family businesses, all kinds of fun stuff today.

David Phelps: Well, yeah, I mean, you obviously had experience with that, and I think if I recall our previous conversation, the reason to sell to Patterson wasn't because you needed to. It was the equity position of other members of the family that wanted to be liquidated, and that's where it made most sense. Is that correct?

Perrin DesPortes: That’s right. The company was growing quite quickly. It was on a run rate to about a hundred million in revenue and had 12 or 13 sales branches that covered Baltimore all the way down through Virginia, the Carolinas, Georgia, and all the way as far south as Orlando, Florida.

And business was profitable, operationally very well run, and was growing quite nicely and had a lot of diversified revenue streams beyond just your core consumables and capital equipment.

But my father, I said, was president and CEO, he has two sisters, neither of whom worked in the business, nor did their husbands, nor did any of their children. And my grandfather at the time was about, I think 84-years-old.

My grandmother had passed away and my grandfather's estate was set up to be share and share alike. And 84-years-old you're getting up there, nobody's going to live forever. And the more successful the company became was the more valuable his estate would become and the less my father owned of it.

So, you can kind of do some quick math and see that if you're set up to be a third, a third and a third in terms of estate planning and two thirds of the people want their money out of a fairly illiquid bank funded high inventory type of a business, tough to reconcile that on some type of a leverage buyout.

So, the company was growing quite nicely. Patterson being a Minnesota company, Minnesota nice meets with Southeastern values and everything like that. So, it was a nice complimentary fit philosophically and geography and a lot of the people at Patterson say that was their most successful acquisition in dental through all of their years.

And I was fortunate to be able to stay on with the company for 15 years. So, it turned out pretty good for me as well.

David Phelps: Yeah, it went very, very well for you. And then just to give us ground at your background history, you are a Washington and Lee University graduate, you got your MBA from the Darla Moore School of Business at the University of South Carolina.

And today with your partner, your co-founder of Polaris, let's talk a little bit just briefly about what Polaris does. We'll give obviously the opportunity for people to connect with you where it makes sense, because we want to do a deep dive into specifically what your focus is in dentistry.

And that'll lead to the conversations I want to have with you today because you've got a lot of perspective on the market. So, let's talk about Polaris just for a moment. We'll come back around on the back end to talk about it a little bit more.

Perrin DesPortes: Sure, sure. So, my co-founding partner is Diwakar Sinha, and he is what I call a recovering healthcare banker. He spent his prior career in healthcare lending, most of it being around dental.

And the most recent position he had was VP of sales for East West Bank out of Pasadena. And they were the preeminent lender in the group practice space.

As I was kind of coming toward the end of, or the late stages of my Patterson career, this was mid 20 teens, the proliferation of group practices was in full swing, and we saw it at Patterson through a lot of our best customers wanting to own more than one location. And Patterson started getting into the enterprise level DSO space as well.

And it wasn't the traditional sort of cottage industry that dentistry had been single dentist in a single location for 40 years. And that this was much more entrepreneurially driven.

And the proliferation of group practices was doctor founded in debt funded group practices, meaning the entrepreneurs who happen to be dentists who want to own more than one location and they're using bank funds to do it, that was the fastest growing segment of the space.

And Patterson discovered that through a study they did with the McKinsey Consulting Company. Diwakar saw it from a healthcare lending standpoint. I saw it from a Patterson standpoint.

And as we kept looking and looking and looking at this space, there weren't a whole lot of people providing consulting type resources around growth strategy.

Like how do you build a group practice? How do you acquire practices? How do you integrate them? How do you bring in associates into the business and create opportunities for them to become owners in the business? How do you really grow and scale a multi-location healthcare group?

And then if you do, do that to some degree of success and you want to take some chips off the table, how do you transact it? And in the world of traditional dental practice management consultants, those men and women are great at an operational level, a clinic level, scheduling efficiencies and hygiene retention and case acceptance rate and all that. That's dental practice management to a tee, and we don't do any of that.

We are growth strategists on how to build bigger businesses and how to maximize EBITDA, how to build a more valuable company. And then when you get it to some level of success and you want to transact it, that's far beyond the complexity of a traditional dental practice broker.

So, we saw this confluence of a rising tide of interest as it relates to building group practices. We saw a lot of people doing it wrong, candidly, and there weren't any resources to help them on either side. So, we decided to launch a business that became Polaris.

Polaris Healthcare Partners, guides entrepreneurial dentists to build and exit successful group practices.

David Phelps: Excellent. Let's talk about what you see as the big picture state of the industry today. You mentioned a moment ago the industry coming from a long lineage of being a cottage industry. That's certainly the way it was when I was practicing in the 80s and 90s.

There was maybe the inkling of what we would refer to as group practice, maybe even some private equity DSO, but it was very out there, and it certainly has evolved a lot today.

So, what do you see the cottage industry that we've known for many, many decades going back in time, and then the movement we've seen today to more consolidation group practices, whether it's private equity based, whether it's debt funded, as you said in groups, and where do you see things going if you can, again, I know a crystal ball is something none of us possess, but what do you foresee?

Because you're in that mix, and you have to have some ideas and we're not going to hold you accountable if you miss the mark a little bit because I put out prognostications all the time, and I'm not saying that I have it all right either.

Perrin DesPortes: That's right. Well, I mean, we all have opinions, right David, so I'm happy to share those. If we think about business, generally speaking, not even a healthcare services business for a second, we think about the name brands we all know and love that maybe aren't tech companies, but traditional brick and mortar type companies, most of the name brands we all know and love I mean, you can be like, on either end of the spectrum.

You can be large with economies of scale like a Walmart or a Lowe's or a Home Depot or something that's usually lower price, proliferation of stores, availability of products and services and all that kind of stuff.

Or you can be a unique boutique type of a customer experience driven business. Usually, it's hard to scale a customer service experience type of business. Disney does it great. Ritz-Carlton does it great. They're kind of the outliers.

But usually, when you think about bigger businesses that are more low cost driven and have a wide variety of goods and services, they are consolidator type businesses. You see it in banking from a service standpoint.

I mentioned two hardware stores. Lowe's is headquartered here in Charlotte, so we know them very well. There are a lot of others. I mean, grocery stores are the same.

So, you're really trying to build a business that at some level gains efficiencies due to economies of scale. That's buying ability to buy things at a lower cost, usually to drive costs out of the business through efficiencies and sometimes even to take headcount out of the business, to gain efficiencies through internal technologies that don't require human input. Because wages are the biggest driver of cost in most businesses.

So, when we think about that type of a principle of how you build a more efficient, larger business that generates more revenue and more profitability, now we start thinking about healthcare services businesses and healthcare services businesses are no different, principally speaking than any other.

If you can create a larger business that has more productive capacity like associates that can be open more days and hours and take advantage of the fixed cost of the business, be more convenient to the consumer to access when they're available, not just through traditional eight to five, Monday through Thursday type of a service offering.

And you can do it at more low cost and even with greater marketing 6pull through it, everything I just described that's applicable to a group dental practice of five locations or 500 locations is the same for an enterprise level bank or a dental distribution company or hardware services type of a business.

So, those principles of economies have scaled a lower cost typically take some level of headcount out of the business and reduce wages and grow convenience and productive capacity are all the competitive advantages that a group dental practice can generate.

And you don't have to have private equity backing to do that. You don't have to have multi-hundred locations to realize that.

You can start to realize some of those economies of scale and in a couple of locations if that's all you want to buy or bill.

And I can also make a really good, at least academic case that in the world that we live in today, right here, right now, today, the ADA cites a lot of studies about declining insurance reimbursement rates for their core audience, which is still that traditional, usually single dentist, single location. They don't have a whole heck of a lot of bargaining power.

And when you think about declining insurance reimbursement rates and that kind of creates a roof or a ceiling on the revenue generation of the business, and we're dealing with higher wages and an increase in cost of lab supplies, professional services, whatever else, now you have a rising cost environment and a declining revenue environment, well that hits the owner in his or her back pocket.

So, sometimes the proliferation of building a group practice is almost akin to a defensive strategy. I would like to build a multi-location group that I can still manage, but it's not dependent upon my clinical skillset alone for its existence.

And that's not a bad way of looking at the next decade to two decades if you're a mid-career dentist. That was a little bit of a wandering answer for you, but hopefully that gave clarity around some aspects of that for your audience.

David Phelps: Right. Very helpful. So, then going back to your last statement for the mid-career dentist, so do you feel like the mid-career dentist is at age 40 to 50, 55 ish, give or take somewhere in there?

Perrin DesPortes: Yeah, I would say so. Like late 30s to maybe early 50s, big chunk of real estate. If you're three to five years from retirement, I have people that are 60-years-old and they come to me and say, "Hey, I'm interested in building a group practice."

I'm like, "Hold on cowboy. I don't know that you need to take on the debt, the headaches, the anxiety, or anything else at this stage of life if you're planning on transitioning out in three to five years."

On the other hand, if you've got a successful solo practice and you're 40 to 45 and you've got a decade or more to go, I think we got to be honest with one another about how long you think you can sustain that level of success in terms of income for you and your family unabated for the next 10 to 15 years.

And I just don't have the confidence. I know it's getting harder to run small businesses of all sorts.

David Phelps: Right all sorts, yes.

Perrin DesPortes: Yeah. Dental practice or any other, so you got to think about, "Okay, the revenue that I generate, the cost that I have, the income that my family is dependent upon," realistically facing the mirror, strengths, weaknesses, opportunities and threats analysis, how long can I sustain that? And if I've got 20 years to go, that might be a challenge. So, I think we got to be eyes wide open about that.

David Phelps: So, maybe this is where we can differentiate a little bit more the group practice, doctor founded, debt funded as you stated versus equity funded, private equity. I think there's a lot of misnomers and people think, "Well, multiple practices that's got to be the DSO."

We kind of have had … my term is kind of a DSO mania in the last number of years. It seems like in a lot of circles the push has been get a practice, build it up, multiple practices, and then make the exit.

This kind of early exit to me where, as you said, we have … I know a number of docs who have exited with private equity in their late 30s. I think the average now is like early 40s if I have the stats correct. So, that's an exit.

And then the other side which I think where you help focus is it's more of a cashflow or income play, a multiple stream that you're not necessarily looking for the exit now, but you're just building up more optionality and more diversity in your income and you're going to potentially hold onto this practice.

You may bring in partners the right way and that kind of thing along the way, but you're not looking for the private equity exit. Do I have that kind of right?

Perrin DesPortes: Yeah, so you got a lot of points in there. Let me try to hit on most of them. So, first and foremost, if I have two concerns, David-

David Phelps: I bet you do have two concerns.

Perrin DesPortes: I got a couple more than that, but we're going to limit this podcast at two. So, for one, I think we have had, coming out of COVID when bank funds were dirt cheap, all time low, fed funds rate, all that kind of stuff, and everybody's taking on more debt leverage.

We had coming out of COVID, the specter, the possibility of a long-term cap gains, tax rate adjustment that was threatened to calibrate to ordinary income tax rates. It didn't happen but that was the threat of the new administration.

So, you had a lot of people with a lot of value built up in their business that said, “Oh God, I'm going to stare down two times the tax impact if I wait and sell my business for a year versus selling it now, I need to sell it now.”

Now I think there were a lot of people fanning those flames that can be for another podcast. But I think there were people driving this, the seller mentality at that point, coming out of COVID.

You had all time low lending rates or borrowing rates technically, and you had a bunch of business development people in enterprise level DSOs that were private equity backed, that had been sitting on the sidelines for nine months or more, hadn't done any deals, and they get paid to do deals.

So, you had a lot of highly motivated buyers with low cost of funds driven by a seller mentality of a looming tax rate impact. It was the perfect storm globally, not just in the world of dentistry, but in all the world of M&A.

We've never seen anything like it. And sure enough, it blew the doors off of dentistry and every other industry around.

What you also had was this proliferation of equity rushing into healthcare services because it's always in the top three investment criteria of all private equity funds. And dentistry is arguably the prettiest girl at the ball due to lack of consolidation up at this point or upside potential of the industry.

So, there are a ton of private equity groups who want to get into healthcare services businesses, and the one healthcare service business they'd love to be in is dental. So, you have this rush of private equity groups looking for a cornerstone, a flag to plant in dentistry coming out of COVID or in COVID.

And so, now you've got a heavily weighted interest of a ton of buyers with fewer and fewer assets to buy. So, what happens? The buy side pays more and more and more. And you get relatively irrational valuations of average businesses unabated for about an 18-month continuum.

And with that comes this what we call aggregation play. You get a lot of people who are backed by private equity trying to acquire dots on a map, getting to certain levels of EBITDA.

The idea is that once I reach a certain level of EBITDA, I'm going to flip it to another private equity bar that's going to take out my position and I'm going to cash out in a couple of years.

And as long as the industry continues along these lines, it's going to be kind of musical chairs, it's going to be ever expanding valuation multiples or more and more even. That communicated a lot to younger dentists.

And when you mention the average age being in the late 30s, early 40s, I would even go further south than that. I would go almost into dental school right now.

I have the opportunity to do Zoom sessions with dental school study clubs and things like that from time to time. And they're all interested in building group practices and they're all talking about exiting group practices.

And I'm thinking to myself, “Holy moly, when did we go to dental school to not practice dentistry?” Didn't we go to dental school to help patients because we wanted to become a healthcare services provider in one of the best industries there is.

And so, now you've got this mentality of, “I don't really want to be a dentist, I got to have my license to buy practices. I'm going to buy practices, flip practices, and I'm then I'm going to go buy an island at the Caribbean.”

And this is not a healthy thing. And what has happened in the last couple of months with the rise of interest rates as fast as they have, is that all of these private equity backed groups that are borrowing money to make their equity investment dollar go further, that's the way private equity works. They use debt leverage to do it.

They use a variety of structures and a lot of them are interest driven structures, variable interest rates like think interest only loan for your and my mortgage or something like that. Well, what happens when the rate corrects fast?

Well, now all of a sudden it puts stress and strain on the volume of cash flow that these enterprise level businesses are spitting out just to cover the debt service. So, if there's equity being created and the rise of debt service eats up all the equity on a flip, there's no equity to be gained.

And so, now we're seeing something called workouts at the top end of the food chain. And a workout is where the value of the equity is not materially greater than the cost of the debt, and private equity isn’t thrilled about that.

And so, the aggregation play, which is dots on a map, let me just acquire practices, let me borrow as much money as I can to buy as many practices and flip it. The aggregation play is yielding less than stellar results.

Those that are true operational businesses disciplined about acquisitions, operationally efficient, understand marketing, revenue generation, profitability, expansion, all of that, they're building great businesses.

And these are going to be the group dental practices that are usually private equity backed that are going to win in the end.

I'm sorry for going long-winded, but the reason I wanted to unpack that is if your audience is in the doctor founded debt funded camp, which I gather that most of them aren't and they're contemplating building a group practice, it may be that the time is right for them to do that if they have a horizon long enough to justify it.

But if I can impress one thing upon them, do not build a group practice with a quick flip mentality. Build a group practice because you believe you can create revenue opportunities and practices you acquire or cost containment opportunities, ideally both, which yield more cash flow and be happy being methodical, not in a hurry.

And if you happen to transact it at some point in the future, if you build a great practice, there'll always be a buyer for it that I can guarantee you. But don't rush into it with an exit mentality from day one.

David Phelps: Alright, that concludes week one of my conversation with Perrin DesPortes, hope you enjoyed this week.

Next week we're going to dive into more on the backend of this and really look at the rising cost of capital, how that's changing the marketplace, not only in dentistry, but in all sectors of the economy, including what I love to do is real estate.

Solo to Group to DSO - Which Path Is Right for You? - Perrin DesPortes (Part 1): Ep #453

We've seen this coming for quite some time, that the rising interest rates are changing the dynamics of the equity plates that goes for real estate, that goes for DSOs in dentistry.

How has that changed the format and the structures and the negotiation that you need to be aware of before you jump into the mix? This is very important critical information wherever you are in your game plan, hope this brings relevance to you because it did to me. Enjoy the conversation. I'll see you next time.

You've been listening to the Dentist Freedom Blueprint Podcast. If you're tired of trading time for dollars and you want to create more freedom in your life, I encourage you to visit my week blog, freedomfounders.com/blog. I post weekly hard-hitting videos about creating more freedom in your life. Check out my latest book on Amazon, *What's Your Next?: The Blueprint for Creating Your Freedom Lifestyle*, or visit freedomfounders.com to learn more about how we help high income earners create the freedom to buy back their time and create more impact.