Solo to Group to DSO - Which Path Is Right for You? - Perrin DesPortes (Part 2): Ep #454

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: Alright, this is week number two of my conversation with Perrin DesPortes of Polaris Healthcare Partners. This was a conversation we started last week, so if you are just jumping in today, you'll want to go back and catch the first half of this conversation, where we really get into the different considerations that one needs to make today in the dental industry in terms of your business model, your pathway, your potential exit or transition out plans.

All the models have changed primarily due to the rising interest rates and the credit contraction that we're seeing probably rolling into a recession before the end of this year. This changes everything and you need to be aware that whatever you knew in the past is not going to be the same in the future.

It doesn't mean it's bad, it just means that you need to be more on the forefront of how you're planning your plans, your business, your model, to make sure that you don't get pummeled by the onslaught for those who don't understand what's happening.

Enjoy the conversation, love your feedback, see you next time.

We see, as you would know, the exact same thing in the real estate markets. In Freedom Founders, in our group, we have all … anybody's invested in the capital markets and the equities of multifamily and self-storage. And you name the equity play and it's all been good, it's all been good.

Until, as you said, the fastest rise in rates that we've ever seen from near zero to five and a half federal funds rate has changed the dynamics completely.

And to your point, those that are operationally efficient, who have fixed rate debt, not short-term variable rate, bridge construction, which is all part of the development, ground up construction, the high-level value add renovation that takes 18, 24, 36 months, that's the scary stuff today.

But back when the cost of capital was zero, you could roll that, roll that roll that, and you had all the time in the world, and the marketplace really took care of you because there was always another buyer.

There was always another buyer who would come and say, “I'll take it. Whatever you got, I'll take it and I'll pay you more for it.” And a lot of operators, well, maybe I should call them flippers …

Yeah, they really don't operate, they're flippers. And so, you're saying the same thing in the space today in dentistry, same thing. You have good operators that are foundationally solid.

They've got a game plan to ride through this higher cost of capital. They'll be the ones as I call last man standing or last company standing. And the others will, as it happens anytime there is a correction in the marketplace, it's like a forest fire. It just takes out all the underbrush and you restart.

But it's not pretty for those that are caught in that underbrush trying to figure out what happened; where do my plans go awry? Well, even with your doctor led group practices that utilize debt funding, that's got to be changing the dynamics there.

Can you give us a little bit insights into what that looks like? Because again, I know the cost of capitals has gone up for anybody who's borrowing today.

Perrin DesPortes: It certainly has, and it's affected, well, every sector of the economy. I think it has made our target audience much more, they've had to sharpen their pencil a lot as it relates to both buying and building additional locations.

We talk a lot about buy from an acquisition standpoint, but this applies equally well to those using a de novo strategy. And we're big fans of the build strategy or a complimentary strategy at least. So, what you have to do is understand the difference in income versus EBITDA, versus free cash flow.

For one, if you're going to acquire a practice, like I see, you need to be able to forecast, you need to be able to predict where you're going to generate revenue beyond what the seller was able to do.

It could be additional days and hours from an associate, it could be recapturing referred out treatment, simple ortho or routine-guided implant surgery, or if there is such a thing as simple endo or something like that. There's always the ability to recapture some level of specialty treatment in a general dentistry group at least.

And then some of it could be negotiated insurance reimbursement rates, but you got to have some confidence

around buying a practice to improve that practice. And that's through revenue generation, and then some level of cost containment, supplies, lab, professional services, employee benefit costs, et cetera.

So that when you acquire that practice and you understand the amount it's going to cost you and monthly debt service to do it, now you're confident that you can generate enough operating income to satisfy the monthly bank note that leaves positive free cash flow at the end of the day. And you can do that every month like clockwork.

So, when debt funds cost you more, you have to be more hyper-focused about your ability to integrate and execute. Now, on a build strategy standpoint, it's a don't take the strategy of hope and pray. If you build it, they will come, we're not in that business, alright.

If you're going to have a build strategy de novo, you need to be able to forecast operational break even when your revenue cover your monthly operating costs, and obviously, when you're able to cover the cost of debt funds, and you need to know that from a patient revenue generation standpoint. So, we do forecasts for our clients that are using the de novo strategy all the time.

I think the credit markets, generally speaking, have contracted to a degree. Solo dentistry is still one of the lowest default rate risks in all of banking. So, your traditional single location, single dentist, even though they're seeing and experiencing a rise in rates like everybody else, it's still relatively cheap for them just because those men and women don't default.

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When you start moving into a group practice context, the default rate risks certainly go up and banks know that. And what we see is that somebody uses a national lender for location one or two, and then the national lender says, “We're going to stop there, Dave. We're good at two locations.”

But when Dr. Phelps wants to have locations three and four, he goes to bank number two, that's maybe a local lender, and they'll lend on those two locations at a higher rate because it’s a subordinated debt.

And then that lender says, “Hold on Dr. Phelps, we're probably good on three and four,” but Dr. Phelps wants five and six. So, they go to an SPA type of a lender or something.

And that's kind of the musical banks type thing. You run out of credit relatively quickly because banks ultimately won't take on the subordinated debt risk. So, lower middle market lending is business to business lending that is for group practices.

These are not the relationship managers that we all know and love through retail banks, but they are the banks and some even non-bank lenders that are the right source of capital for somebody building a group practice.

Maybe not four to five locations, but for those that want to go 8 to 10 to 20, and do it with one lender, which you should do, a lower middle market instrument is the right one.

And it might cost you a few points more, but you typically have some level of credit commitment from the institution to fund your growth strategy. So, banking is one thing, not just an arising rate environment — but banking is one thing that is the true Achilles heel of building a group practice.

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David Phelps: So, interest rates aside, what is the typical term for the banks that you're using for going beyond the four to five practices? Is it amortized? Is it interest only? Is there a balloon? I'm not in that sector, so I'm just curious what that looks like today.

Perrin DesPortes: It's still usually 7 to 10-year terms, and term and arm, you can match them up or you can have a balloon payment at the end. It kind of depends on … I could answer every question with "it depends."

So, when we take a client and try to source a bank debt funding commitment for them, we build an analysis of their business. Predominantly around where their existing debt resides and what it looks like, what it's going to take to possibly recapitalize it, but also maybe more importantly what their growth strategy is.

So, how do they want to draw upon this commitment of funding? Is it one practice a year they're going to build, or two practices they're going to buy? Or what's the forecasted outlay of funds that they need to draw upon?

And here is where we're trying to balance the loan structure with cash on balance sheet, and understanding the cash flow generation of the core business. So, structure can be a negotiating point as well as leverage ratios.

Most of your traditional retail banks use something called debt service coverage ratio for a traditional borrower in a traditional single location, your personal debt, your business debt, your cashflow well enough to satisfy those, yes or no? It's pretty straightforward. All the banks can calculate it differently at times.

When you move into a group context, they look at debt service coverage ratio, but they also look at funded debt to EBITDA from overall leverage. And that's usually in the high two and a half, three times debt to EBITDA, up to as much as four times debt the EBITDA depending on the size and scale of the business. These are all still personal guarantees I would add.

So, you're not going to get out of that to a corporate guarantee until probably 4 to 5 million in EBITDA. But like I say, depending upon the case of the growth strategy, really that can be the right instrument for them.

David Phelps: Let's dive into who this is for, because I know this is a big part of what you do. I know you offer discovery days, which I think is a great thing for anybody exploring any change in model of whatever they're doing.

I think it's so important to understand what this looks like because we know that the very successful solo owner who has built a practice primarily based on their good clinical skills and their ability to communicate, lead, build culture, communicate treatment plans, all the things that go into making that single location very successful, the thought occurs to many that well, just rolling out a second and a third, that's going to be easy.

I just need to find a location and again, kind of build it, they will come, and this will all be good. And we both know, and you're smiling as we're talking about this, because expanding anything notwithstanding the debt load, which you mentioned you have to take into account, but expansion eats up cashflow.

And for the doctor who's used to making a good living off of his work chairside is now thinking about expanding, which it means

more chairs, which means more associates, other doctors, because that's the whole goal here.

I want to become more of the CEO of my practice, I don't want to put all the time in the chair. So, now I'm going to bring on these other doctors, and it sounds like it's a good plug and play model. Just have the chairs, do the marketing and it's all going to happen, and you know that it's not that easy.

Can you talk about some of those issues and then how you maybe on a top-level scale help a doctor who's very successful today, maybe that mid-career doctor aged 37 to 52 who's hearing this and going, “I better get on the ball here. I better make something happen.” Which ones should, and which ones shouldn't? Is it that clear cut or is there more involved?

Perrin DesPortes: Good question. And I would preface this answer by saying that the reason that I don't have two kids is because I have one, alright.

David Phelps: Very good.

Perrin DesPortes: And I think for all those parents in your audience, whether you have one or more than one children, you know that, or at least I have it on very good authority that going from one to two kids is not just twice as complicated, it's geometrically more complicated as one of my best friends once told me.

And I think the same can be said for going from one location to more than one. And I'll give you a couple of pointers and some things for your audience to think about here. Everything you just preface is a hundred percent correct.

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You build a successful practice through your ability to do the dentistry, your ability to have a high case acceptance rate, your ability to create a culture in your staff in those four walls under that roof. You're really, really good at it and the team takes its cue from you and you're the orchestra conductor and everything like that. And it's a great, great business.

Then when you want to start going to multiple locations, obviously, you can't be everywhere at once. Most people choose to build a group practice through acquisition.

They are going to buy a practice from somebody, maybe the seller's going to retire, transition out, or maybe they want the seller to stay on board, but they can't be in both locations at once.

And when you acquire a practice, one of the biggest challenges is change management. And when I say that, I guess you're buying a successful practice, however you define success, but there're going to be things that you want to change.

You're going to put your systems and processes or what have you in there. And sometimes, if that staff has been around for a while, they're not very adaptable to change. And that's not the way Dr. Smith did it when he or she was here.

So, now change management, you start getting resistance and that erodes culture very quickly. And when culture gets eroded and you get resistance to change management, that's typically bad for revenue and profitability as well.

So, when we see this, one of the other challenges is that usually when you acquire your first practice, you're not really sure around what valuation is or what you should pay for a practice.

And a broker has it represented one way and you got to employ an associate to work in there. And when you pay the associate to do all the clinical work, there's not a whole lot of profitability left that, oh, by the way, you borrowed money and the bank's going to get paid.

And now, that great practice that you had that you built over 20 years is funding the one that's starting to fail on you. And so, this is the drain on cash flow immediately. So, what happens?

Well, to fix that, they go out and buy a third: “If it's not working well in location two, let's double down and go to location three” and that tends to exacerbate the scenario. But as the founder of the business, you want to start building a larger group. So, you're also undertaking a personal transition.

You used to work four days a week clinically in your core business, and now, if you're going to lead other locations and acquire other locations, you got to find them to buy, and that's going to take time. And you can't do that from behind the chair.

So, maybe you go from four days a week clinically to two days a week, but the workload doesn't go away. You got to pay an associate to do the work you're no longer doing.

What happens, the dirty secret to this — and if you ask 10 people and they're all being honest with you, I got to believe 9 out of 10 will say, “When I first started to build a group practice, I didn't realize it, but I took an income hit to do it.”

And this transition from, we call it clinician to CEO, should happen gradually. Some people are in a rush, and those that are in a rush tend to experience an income hit. And if their lifestyle is calibrated to 100% of the income level that their

primary practice used to throw off, now they're on trouble on the home front as well as on the professional front.

David Phelps: Yes.

Perrin DesPortes: And this is a horrible position to find yourselves in because you have no margin for error on either side. And Sue, you mentioned discovery day and a discovery day is a one-on-one, you can call it a consulting day.

It's group practice fundamentals. I teach probably 50 to 60% of them that the clients come to Charlotte and spend a day with me or one of our advisors or my partner. And we kind of go through the fundamentals of group practices.

“Hey, I don't know what I don't know, what should I know about building a group?” And what we find is that people come and spend a day with us, and they have two or three questions they got to get solved.

They know who to ask, they want to have the answer to at the end of the day. They walk away with two or three questions … they had no idea. It was never on their radar; they had no idea to even ask it. And we spent an hour or two digging into a lot of that together.

And now, they're more eyes wide open about the journey at hand. And I would tell you that for every four people that come and spend a day with us, one of them walks away saying, “Hey, loved the day, thanks for the time. It was worth my investment dollar. This isn’t for me.” We actually talk them out of building a group.

David Phelps: That's the decision. And it's made with clarity, best decision they can make.

Perrin DesPortes: 100%. Because we probably talked them out of making a mistake if they would've stepped on the landmine that everybody else does. If you get caught in a cash flow crunch, it's really tough to get out of that quickly. And I think there's a right way of building a group and there's a wrong way of building a group.

And when you're leading with ego or not doing your homework before you start that journey, I can usually tell you how that's going to end upk, and it's usually not very well.

The last thing I would say is, a group, like I kind of opened up by saying — a group can be three or four or five locations, it doesn't have to be 500 locations. If you want to build a three or four or five location group, that's probably what I would call a lifestyle business.

Again, you want to build a business that's not dependent upon your clinical skillset. You're probably going to acquire those additional four locations over 5 to 10 years or something kind of slow and methodical.

It's a cash flow business. And you can cash flow wonderfully as long as you're not in a hurry to do it. And you can be really methodical about it, those are great businesses.

If you want to build a 10 to 20 or more location business, that's a business where you're going to recycle cash. The cash that those businesses throw off, instead of taking it out as income, you're going to reinvest in the growth engine of the business. It’s a wealth play.

You're creating equity on balance sheet. That's a different business than a cash flow business. So, when I ask people, “Hey, what are you trying to build and why are you trying to

build it?" That's what I'm trying to ascertain because those two are completely different strategies with different mindsets, and a different pace.

David Phelps: Yes, and very good. It seems to me that the linchpin in this whole dynamic, Perrin, is the associate doctors. And I'm enough in the mix to hear the stories of those who had the aspiration, even within one facility, expanded, added the chairs and the associate conundrum just causes all kinds of havoc.

I know you spend, invest a lot of time with your doctors in consulting about how to overcome this. And it can be overcome, but again, it's not a plug and play: "I'll build it, just put associates in there."

Anything you want to add to that piece here, just so that people understand that that can be done, but it's not as easy as it sounds.

Perrin DesPortes: Associate turnover is the biggest problem of any group practice. Again, 5 locations, 500 locations, 1,500 locations, if you can't truly solve it, you're going to be a hamster on a wheel. It's just a never-ending treadmill and it's also really not good for continuity of care for patients either.

So, when it comes to recruiting associates, I think there are a couple of things to kind of keep in mind with this. One, you are more than likely competing against enterprise level private equity backed DSOs that are professionally managed.

And they have an HR department that has a recruiting team that does nothing other than recruiting dentists. This is their sole reason for being, and they are professional and they're extremely good.

So, you are competing not against your dental school colleague down the street or study club colleague down the street, you're competing against a lot of name brands. If you are recruiting based on need, you're already behind the eighth ball.

And when I say need, an associate presented you with you with their resignation notice and they're going to work out a transition of couple of weeks or a couple of months — how long does it take to recruit a dentist, onboard a dentist, credential a dentist and get them kind of combat effective in your business? Four to six months maybe?

David Phelps: Yeah. Right.

Perrin DesPortes: David, there aren't many people in your audience that are getting a four-to-six-month notice, I don't think.

David Phelps: No.

Perrin DesPortes: So, what we try to impress upon people who are building a group is as you transition into a leadership role, recruiting has to be one of the top three things you do all the time — not when you need it, all the time.

If you're building a growing business, guess what, you're going to have available days and hours you got to build, you're going to have turnover, somebody's going to quit, you're going to fire somebody, they're going to move out of the area. You're always going to be recruiting. So, don't take your foot off the gas, this is constant.

Even when you don't have an opening, you should have a list of 8 to 10 potential candidates that may be gainfully employed somewhere else, but if they're not an owner in that business somewhere else, it doesn't mean they're going to stay forever.

So, recruiting is something I learned early on at Patterson that if you're not in the discipline of really doing it all the time, you're playing the wrong game. What I would also say is that you got to put yourself in the shoes of the young associate.

They're usually coming out of dental school or residency or maybe a first associateship that might not have gone well. What are they looking for? They're looking for certainty.

They want to be part of a winning team. They want more than a clinical compensation rate. They want to understand potential income earning for sure, but that's different than 30% of collections or 35% of collections.

What does that mean in terms of income at year one, two, and three for them? And they also want to become masters at their craft. So, if I join your group, what are you going to do to make me a better clinician? How am I going to learn more complicated treatment? Do you want me to fund part of that CE and you fund part of it? What does that look like?

I mean, if I'm going to be here for the long haul, how am I going to be a better teammate and a more capable clinician? And the last thing I would say is if you intend to retain them for the long haul, you absolutely have to have an ownership track for them.

Buy in or earn in, or a hybrid of both — but if you're simply just going to pay them as a hired gun, you're going to turn over more of them than you should. So, creating an ownership potential for them is really the key.

David Phelps: Last question for you Perrin; how much could I build out diversification of my income and do something similar to the goals we would have maybe in a multi-location?

Could I do that in a single location if I had the facility? I mean, I know there would be a limit to the scale of that, sort of that would reduce some risk. Is there enough upside?

Again, I know it's based on what do you want, what does the doctor want? What are you looking for? But is that an option or is that something you look at with certain consulting clients as something they might do rather than go multi-location?

Perrin DesPortes: Great question. We have the privilege of working with a lot of what I call large footprint, solo practices. These are 12 to 20 some odd operatories. I've got one that's like 38 shares all under one roof that are multi-specialty businesses, core business being general dentistry, usually not with pediatrics, but all the other specialties or potential specialties.

And the great thing about that is you get a lot of cost containment synergies, efficiencies, and still are able to maintain that culture piece all under one roof. So, I think it's a 20 location, multi-specialty type of a business, sort of operates like four to five practices in one, from a revenue generation standpoint, marketing synergies, brand awareness, days and hours, taking advantage of capacity and all that kind of good stuff.

So, we absolutely love those businesses and we're also starting to see some of our group practices that are having to either expand or renovate existing locations, going to an 8 to 10 operatory standard operating type of a model that may be four or five locations, but having 8 to 10 ops per location.

So, these are much larger businesses in fewer locations and less drive time between them. So, I think those can be diversification plays ultimately within the core services.

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If you think about diversification, the way you probably think like several steps down the road in terms of investment or asset mix or something like that — I would tell you it's prudent not to have all your eggs in one basket for one, whatever the diversification play is.

The one thing I would tell your audience, sometimes we hear about people wanting to diversify by allowing an associate to buy into a location and become like a 25% partner or something and they're going to borrow 500 grand or something to buy into that location and be your anchor dentist, and you're going to take that 500 grand and put it in real estate, stock portfolio, whatever else.

Frequently, a bank's loan covenant will specify any material change of ownership of a business where the proceeds of the buy-in need to be allocated. And that's usually to pay down principle of existing debt.

Just a word of caution, sometimes people think, “Well, I'm going to take the invested dollar and put it somewhere else, your bank may have something else to say about that.”

David Phelps: Always partners that we have to deal with. And there's that-

Perrin DesPortes: That's right.

David Phelps: That you need to look out for you.

Perrin DesPortes: That's right.

David Phelps: A great conversation today. Best way for people who are interested in some follow up with you? Again, I'm not here to sell anybody, but I just think anybody who's looking at what

their options are, you provide a landscape of discovery in the consulting you do and I'm a fan of that. So, what's the best way to get in touch with you?

Perrin DesPortes: Thank you, David. So, our website is www.polarishealthcarepartners.com. I like to tell people we searched for the longest unclaimed URL, and I think we found it when we launched the company.

I can get you all of our social media handles, website and my email address directly is perrin@polarishealthcarepartners.com. You can book a call with me off the website if you want, I think, and there's tons of educational resources.

Our podcast is called Group Practice Accelerator. So, if you like some of this wonky business stuff, you can consume a ton of it there. We speak at a lot of conferences. There's white papers, blogs, videos, more content than people can probably digest off of our website. Appreciate you letting me plug that.

Thank you so much for allowing me to be with you today. This has been a fun conversation and really appreciate the partnership and the faith and trust, and getting to work more closely with you too. I value it very much, David.

David Phelps: Well, Perrin, thank you. I know this will be valuable to our listeners and I hope those that are considering what their options are, will definitely gain access to some of the materials and perhaps even a follow up with you would be a good idea.

So, thank you so much. We'll come back again in the near future and talk about where the market's going. Because I think that's where everybody has their eyes on it, and I know you're right in the middle of the changes, so we'll come back.

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Perrin DesPortes: Oh, yeah, they'll be plenty to talk about as we roll through the end of 2023, my friend. I look forward to it, thank you.

David Phelps: Thanks Perrin. Take care.

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