The Danger of Market Cycles, Trends and Fads – David Phelps: Ep #455

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: Hey, it's David here. Well, you're going to get me as a monologue podcaster today, no guest. I'm hosting myself. I do this from time to time, as you probably know, when I feel the compulsion just to deliver my message without bringing a guest on.

When I do have guests, I have to be respectful of a guest. I bring a guest on, they're there to give their opinion whether I agree or not. Sometimes I just have to go hard with what I know I'm convicted about. And this is one of those times.

So, this is me in a relatively short rant, but it's about market cycles, trends and fads and the dangers within and how that affects both your investing opportunities going forward. And also, a big one today is your practice transition exits.

What you're looking at today and how things are changing and what some of the danger zones are that you probably are not aware of. It's an important time for you to be aware, and I hope you enjoy this podcast. Give me some feedback and I'll see you next time.

Hi, David here, CEO and Founder of the Freedom Founders Mastermind Community. I want to talk today about market cycle changes, trends, and fads, and the dangers incorporated within market cycle changes, trends, and fads.

What specifically am I talking about? Well, you can probably guess my take on market cycle. If you watch my video blogs, you listen to my podcast, get any of my communication, I've been speaking for quite some time about market cycle changes and what that portends for us as business owners, as investors.

And I want to talk to you a little bit more today. Focus mostly on the transition opportunities that you have in front of you with your business, wherever you are in your career. Speaking specifically about the trend or really the fad that we have seen in the private equity market space, not just for dentistry, but private equity has been everywhere in really the last 12, 14 years, but also making its presence well known in dentistry, most particularly heavily in the last six years.

These are all trends or fads that are based on the current market cycle. Now, current market cycle, actually we could go back and talk about a longer secular market cycle, which goes back 40 years. That's a long cycle. Many of you were not relevant. You were maybe born, but you weren't relevant in really life or business or investing 40 years ago.

I was on the front stage of that in my life in the 70s and 80s. And we can speak about that in a bigger term because the secular changes that we've seen over 40 years have been a reduction over those 40 years of a high of interest rates back in 1980 and ‘81 all the way down to a low in the summer August of 2020. And now we’re back on the uprise.

This is a secular change. What I'm saying to you is the dynamics that we've perhaps all enjoyed, or to a great extent enjoyed have been tailwinds, heavy tailwinds to low inflation, low cost of capital, investment opportunities everywhere, business, financial products, real estate alternatives, you name it.

We've had generally heavy tailwinds and with exception of fraud and corruption, which is out there in the market everywhere, anybody who had any decent intention and decent operating skills in any of these aspects should have done at least decently well, some extremely well.

This has been an opportunity, but it doesn't mean that it continues. And it doesn't mean that we're all geniuses because we did so well. If you have done well, great. Now your objective, and probably the key area of concern for you should be how do you keep what you've amassed?

If that's where you are, and some of you are younger in your life and say, "Well, how do I even get there, whatever there is, with the headwinds that David was talking about?" Look, I'm not a … this is not fear-mongering at all because I don't live my life that way. I'm very realistic.

I never get — well, I should say I never, I have probably been caught up in fads and trends earlier in life with maturity, time, wisdom, lessons learned. I'm pretty good at identifying what those trends and fads are and learning not to go all in, do something when I know it's got a short-term run rate. And if I do get in, it's more like trading or day trading. You need to know when to get in, when to get back out. That's not my investment strategy.

Generally speaking, I'm a long-term investor, but still with long-term investing, you can't just put your head in the sand and just keep doing the same thing you've been doing because there are market cycle changes, secular changes, those long 40-year periods of time.

And there's market cycle changes, which typically run an average of six to eight years. That's an average. But this last run has been extremely prolonged for various reasons, which I won't go into full detail to date, but we started coming out of the great financial crisis of 2008, '9, '10, '11, started coming out in 2012.

And since that time all the way through a year ago, we had this great bull ride market, even in the COVID downturn in early COVID where the markets froze and did a big drop, the fed and monetary fiscal policy came to the rescue. It's fake, it's subsidized. It is what it is.

But again, if you are involved with any kind of asset classes during this long period of time, or even the last three years, you know exactly what it's meant. It's felt really good. We feel like we've done well. We've had our investors planning anywhere there.

You should have done well unless you were just sloppy or you just invested very, very poorly. That's changing. Doesn't mean you can't still navigate and do well, focusing on the practice transition exits. So, there's different ways to exit.

The traditional way going decades ago was pretty much a private sale. One doctor selling to another doctor called a private sale. And those were based on constructs that are still relevant today. Typically, anywhere from 79% of annual collections will be the run rate.

Now, in the last six years or so, we've had private equity, which is I said earlier, has been involved in just about every other sector in the world. But healthcare in a big way, and certainly dentistry, veterinary medicine, I mean, they're into optical, they're into hearing.

I mean, private equity's been everywhere because they use leverage to arbitrage or make a spread over the business sectors or businesses that they buy. They've used the low cost of capital to leverage. I'll repeat that, low cost of capital.

When interest rates have been next to zero or fed funds rate’s been next to zero, which means the average run rate for general bank financing. Well, if you got some two or three years ago, you were probably well below 4%. Many people got below 3% on whole mortgages. That's low cost of capital.

Now, that's how private equity has done so well in the last many, many years. And they've rolled up a lot of industry sectors. Not always in a good way. In fact, if you go back to the 80s, that's when these private equity firms were doing the same thing. They're called leveraged buyouts. I'll say again, leveraged buyouts.

They use leverage. They bring very little of their own money to the table. They use other people's money, including the equity of the business sectors that they're buying. Get more on that later. Now, the cost of capital has changed dramatically in the last 16, 18 months, dramatically like not that we've seen before.

Not that the rates are higher than we've ever seen before. No, that's not the case. But the rate of rise is what is significant here. The rate of rise has never been seen before. We have not even begun to really feel probably even the midstream effects of this rate increase in interest rates.

I'm saying that over the next year, by this time next year, we'll start to feel more fully what this means. The marketplace is still very complacent about this, the financial markets. Even real estate there's still people out there syndicating real estate equities based on the model that worked so well in years past, but are taking into no account, really no account for what's on the backside of this. And that's where a lot of people get hurt. Back to your exit.

So, the fan or trend of private equity through DSOs aggregating dental practices and providing these bigger than like multiples over the last number of years has been a strong drawing card for a lot of you doctors.

And as it should be, it should be something to investigate. I'm not saying it shouldn't. I am not even against DSOs. I'm not really against private equity, except when I believe they're doing more damage and more harm than good.

Not everybody falls in that category, but in general, there's a propensity for these leveraged buyouts through private equity and DSOs to be really riding on the back of the seller and seller's business, riding the back.

Now, when the market's going up and the cost of capital stays low, there's really no issue. I mean, everybody still wins. You don't see problems in the marketplace. Why today are we seeing lawsuits and certain DSOs that are not even paying their bills right now, certain DSOs are throwing in the towel.

Certain DSOs are reneging on the “promises” that they verbally gave doctors. But when you go back and look at the fine print of the actual agreements, their attorneys are very, very smart and they build these structures to protect them, not you.

What I'm saying is, if you got in early on this trend, like any early trend, just same thing with real estate. If you rode the real estate early rise in the last 14 years up until about the last year and a half, and you rode that well as an operator or investor, you've done well, the model’s changing. Same thing with the DSOs and private equity.

That mall's changing drastically. The last two years has been changing. It's changing more so right now, what you have to do is understand that private equity is not stupid money. They know what they're doing and they're putting more risk on you, the seller, the doctor seller.

Yeah, they're still promising you these high multiples, or higher than you could get for the private sale. That's the inducement. But the backend, the constraints, the clauses, the things that you don't really understand or look at fully are what leads you potentially in trouble.

And I find very few of you and your advisors even look at the financials of the potential DSO backed by the private equity to see what their balance sheet looks like. I mean, we do that in real estate. We always look at the operators to see what their balance sheet is. I want to see what their cost of capital is, what their terms are, what their asset liability ratios are.

I want to know if I'm getting in bed with, in other words, investing with, what I'm dealing with. I mean, everybody can talk a great game, but I want to see what's behind that. And if you're not doing that with your potential DSO exits, with private equity where you are on the hook for your backend multiple, that big multiple they promise you, well, they're paying less and less than that upfront.

Did you know that? Used to be 80% and then went to 70, that went to 60, now it's going to 50. And they're also pushing back their “recaps” down the road. Well, same thing again, in real estate. This is the marketplace folks. They've been getting these recaps every 24 months.

Yeah, with a low cost of capital, you could keep rolling and rolling and rolling, but with a higher cost of capital today that cannot continue. It's a marketplace condition. It's not that everybody wants it that way. Private equity and the DSOs don't want it that way. They want to turn their money. That's how they make money. They don't want to turn it, turn it, turn it.

The longer they have to wait and actually operate the businesses they bought or operate through you, the worse it is for them because the high cost of capital is a drag on the profitability, it’s a drag on EBITDA, especially when they don't … Most of them, not all, but most of them are not good operators. They're good flippers. Yeah, they're good arbitrages. They're good financialization platforms.

Most of them are not good operators. And if you're in bed with one like that, what happens is your practice may be really, really good. You may be doing a great job or have done a great job, but you're now diluted with a bunch of other practices they bought that may not be as good as yours.

And operationally that affects their balance sheet, affects the DSOs profitability. So, when you're waiting for that recap, if their balance sheet doesn't look good, because trust me, the people that are going to loan them money or buy the next tranche, they're looking at the financials. If their financials don't look good, and you're in the mix with that, guess what, you're stucko.

Yeah, you got to ride it out now. You got to ride it out a lot longer if you want to try to even get a chance to get those back in multiples that have been promised.

So, why do I say all this to you? We get a lot of docs who reach out to us at different times during their career path, wanting to know what we do, how we do it, how we help our doctors and spouses create a game plan, a plan B, through investing in alternatives to create not just accumulation, but cash flow, predictable, sustainable, recurring income to replace your income. So, that's number one. That's plan B.

But also, they come to us because they're looking at these exits through some kind of sale of their practice, and they're going to get this equity back after taxes. They need to put it to work.

Because as long as you've had it in your practice, in other words, you've been operating your practice, you've been the operator of that, and you know how best, or you should know best how to maximize that equity. But once you take the chips off the table, now you hold that equity in cash, it's wired to your bank. What do you do with it?

You got to do something with it because up until now you've been directing that capital with your front-end finger on the pulse of that business or practice or practices. Now you're out. Now you're no longer one in charge, now you're just getting paid. If you're still there based on your production, just like an associate doctor is.

Now you've got this capital you've got to put to work, what are you going to do? That's where people reach out to us. Here's the mistake they make more times than not, and we have plenty of people in our group that make this claim.

"David, I only wish that I had, or we had investigated, found you or jumped on board with Freedom Founders before we went through the sale of our practice because what we learned from you and your group were some things that we could have done better."

Well, isn't that always the case? We just don't know what we don't know, if we're not involved in these kinds of financial transactions on a regular basis. Private equity, DSOs do it all the time. They do many of these every month. You do one, maybe one, what and how are you going to know?

Even with a good advisor, you don't really know what you don't know. CPAs are great with looking at taxes. Attorneys are great for looking at structural, but does anybody really understand how this model works?

We have a great board of advisors around us and realize the thing that makes Freedom Founders different, whether it's involving the assistants in guiding you through a exit of your practice sale, worry of investing in alternatives like real estate. We take no commissions, take no participation. There's no affiliate commissions like brokers take it.

I'm not demeaning brokers, I'm not demeaning people who sell syndications in real estate that are capital raisers, I'm not demeaning them at all. It's legal, it's okay. But you just have to understand where the incentives are. Who has the incentive to make this transaction work?

Who has the incentive to get your capital and put it to work in a real estate syndication? Whether it's appropriate or not, somebody else has at least as much incentive to get you to do it as maybe you do trying to figure out where to put your money.

So, when you don't have an unbiased perspective where you don't get all the information, it's what I call people are not lying to you but they're omitting information you should have. If you want to call that lying, maybe it is, but you're not always getting the information you need from anybody who's selling you anything.

I don't sell other people's stuff. I don't sell other people's services or products or investments. I don't sell any of that. I can't be bought, I'll say it again, I can't be bought. Other people, you have to look at their incentives and other people are being bought every day.

I see it in other groups that bring together investment opportunities or DSL roll-ups. Well, there's an incentive in there somewhere. Again, it’s nothing wrong with that. That's the capitalistic way the marketplace should work, but you have to understand where the incentives are.

Every time you go out in the marketplace, someone wants to sell you a product or service. They're getting paid somehow or the loaner's getting paid and that's okay. That's the way it works. But understand, you have to do the work on your end to understand if the potential prescribed benefits are number one real. Are they viable, are they predictable.

And what are the particular dangers of the complexity of you to get finally your full money back and with the return on. Again, I'm talking about real estate or exits of your practice, particularly when it's in multiple tranches over a number of years, I get people that knock on the door right when they’re close to the finish line.

“Oh, hey David, we talked to you a year ago and Janie and I are right now signing a letter of intent with X, Y, Z, DSO, and we'd like to jump in right now to the Freedom Founders.” I'm going, “Yeah, you can, I'm not saying don't go through with your sale, but you might want to just get a little more information to dial it a little bit.”

We've made and saved many of our members, hundreds of thousands of dollars by them just not knowing what they don't know by just making some tweaks and either not going in with a wrong real estate investment because they didn't have the background, the ability to vet and do to the due diligence or same thing on their DSO exit, just didn't know what to ask for, didn't know where they could negotiate, had no clue.

Had someone else driving the bus. They just took it like a good doctor takes advice from somebody else because they're told that it's too complex. Don't worry about it, we'll take care of you. Here's the term sheet, jump in, it's all good.

And that's typically, again, as I said the case when the market's running uphill, the market's on a bull run, unless someone's just totally incompetent, these deals generally work out. If you did a sale of your practice four or five years ago and you've gotten a couple recaps already, you may be close to being out completely good for you, you hit it right.

Same thing with real estate investments. If you got in a few years ago and you're exiting now, good for you, you probably hit it just right. If you're jumping into either of those arenas right now, without understanding the market cycle and the dangers of doing so without understanding all of the potential minefields involved, you're probably doing yourself and your family a huge disservice, that's not necessary.

My advice to you is get educated and find a place. It doesn't have to be us at Freedom Founders, but you've got to find people that that can give you real information that aren't trying to tugboat you in to doing deals with them, because that's how they put food on their table.

And again, there's nothing wrong with that. You just need to understand the difference between who's got your best interest at heart, in most cases, that's only you.

That's a little bit my rant for today, but I hope you take it with the meeting and the passion I have for helping guide my colleagues through the shark infested water that's out there. It's always out there. You just need help and guidance to know where the danger zones are, and I'm here to raise those red flags if you're willing to take a look. Hope to talk to you soon.

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