Canaries in the DSO Coal Mine - Analyzing Trends in the DSO and Private Equity Marketplaces – Alastair MacDonald: Ep #464

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. On this podcast today, I'm going to share with you some insights into an actual conversation in a kind of a group setting where a good friend of mine and I, you've heard from him before, Mr. Alastair Macdonald and I were hosting a group discussion, small group discussion that pertained a lot to the current conundrum, (I'll call it a conundrum) about the DSO private equity exit options.

The model is changing rapidly, and we took a case study of one person in the group who recently went through it and discussed really a little bit about how best to structure negotiate at a professional level, these transitions, or transactions if you care to go down them.

Specific contract terms that are important to focus on when negotiating with DSOs. How to conduct due diligence when evaluating DSOs, the difference between operators and aggregators, big difference in the DSO world today.

The impact of rising interest rates on DSO recaps and financing, how DSOs are shifting the burden of risk more so to the selling doctors, buyouts versus a traditional practice sale. Big difference here again, and it's not well-defined in the offers being made.

What happens when DSOs overpay for a practice and how to become a more sophisticated deal maker. Very important constructs in this conversation, which I'm happy to provide for you to give you insights. Take a listen and we'll do a follow-up next week on the podcast. You'll want to catch both, talk to you soon.

Alastair MacDonald: It's good to see you, my man. It's been a while.

Male: Sure. Yeah, it was really good to be joining the group again, I apologize for my absence to the last couple of months, but things have been going really well. I mean, we're approaching six months into my transition to the DSO group and things have been going pretty well for the most part.

They have followed through on most of their promises that they made at the beginning. We've had four new associates join my practice, with a fifth one joining in January. We have removed and replaced three team members who are no longer aligned. And our production is going well, collections are going well.

Overall, we have a very good feeling in the practice. And so, I still count my blessings every day. For me, it was the right decision. I heard one of the recent sessions and we were talking about what's appropriate for someone. And for me this was definitely the best decision that I made.

I get reminders of that every day, not only in the practice, but even outside the practice. My stress level has decreased tremendously. And basically, all four quadrants of my four futures are just exploding.

My relationships with my friends, my family, my health, opportunities that are arising, doors that are opening, my outlook on my future is very, very different. And so, yeah, I think for me so far so good.

Alastair MacDonald: Congratulations, mate. I got to say, not only was this a good move for you, it was a good move well executed. And actually, you're a great example of what can happen if you do hold the line and if you do structure and negotiate at a professional level which is what most of these DSOs are not used to and you've done that.

And I know there's a couple of other sovereigns here that are doing that exact work themselves. I'm still a fan of it as I've shared, I'm not anti DSO, I'm anti bad deal. And I love the one that you crafted for yourself and that you feel good about and really appropriate is … suitable and fitting for the time and place.

This is amazing. Onboarding of new associates is a radical, this is going to go a long way for you hitting those targets that you have on the EBITDA earnout as well, isn't it?

Male: That's right. Yeah.

Alastair MacDonald: Huge, huge. Congratulations. What do you put that down to? How is it that you guys were so successfully able to snag not just a doc, but so many right now? Because so many of us are floundering there.

Male: I think it's really their constant recruiting efforts. Of course, just like most DSOs, they have a permanent recruiting team. In fact, they have a separate recruiter for general dentists and a separate recruiter for specialty docs.

And one of the things that I mentioned to them was that my practice still has a large opportunity within perio and oral surgery as well as pedo. We have a lot of patients calling in asking for pediatric services.

And that's just something that been on the back of my mind, but I just was never really able to implement because we were doing so many other things and they heard that and they're like, “Absolutely we already have several candidates in mind.”

And it was just basically a matter of them coming to the practice and as long as there was a good culture fit. And I think for them too, part of it was just them knowing that they're part of a larger network.

That they're not just associating in a single practice, that they have the opportunity to work in other offices within the organization and they get their full benefits package associated even though they're working at different offices. I think those were some of the things that really attracted the people that ultimately joined us.

Alastair MacDonald: So, I know we spoke about it a lot at the time, but remind me, what percentage of production are they paying you?

Male: 35%.

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Alastair MacDonald: Okay, great. I wanted to grab that because it's what I'm seeing more of lately is DSOs coming back and saying, “Okay, we'll give you 70% of close instead of 60, or we'll give you 60 instead of less. But what we ask for is, oh, we'll pay you 25 or something like that.”

And it's just a good reminder what happens when we hold the line, when we know we've got something valuable, we know we're the prize, we hold the line. David.

David Phelps: Based on what you're saying, your DSO operations are more in, sounds like they have an intent of playing more of the long game than many DSOs who want to get in and get out.

You talked about the fact that they have a strong recruiting arm. Obviously, I know you did a lot of due diligence before you selected who you were going to “partner” with.

How much of that aspect of their infrastructure operationally did you look into? And I assume that was one of the major piece of the decision matrix that you used to go with them. Could you tell us a little bit more about that?

Male: Yeah, I didn't specifically ask about their recruiting efforts or the details within each of the departments, but I had the opportunity to meet with a lot of people on their business development team during the time that we were getting to know one another. And I met with the founders, the CEO, and their business development team.

And every single person that I interacted with inclusive of a lot of the partner docs that I spoke to just had this culture of inclusiveness, of growth, of supporting the clinicians, being a little bit more kind of in touch with the doc and the offices that they serve versus some of the larger DSO groups that were very cold and had a corporate feel to it.

So, this group, because it's a regional DSO and they have about 60 locations right now, they're still able to maintain that close touch with each of the offices. And I think people get a sense of that both from like docs who are looking to partner with them and also associate docs who are kind of vetting the organization themselves.

David Phelps: And last question, I'll stop. When are they predicting or when have they talked to you about their next recap? What's been communicated?

Male: They've said two or three years, but a lot of their deals are not centered or around a recap because they buy out the practices at a hundred percent. And from what I found, and I think this is true of other offers that they've given too, but they give a lot of their cash up front.

So, usually it's about 70 to 80% upfront for the deal and then the rest is earnout and a very small portion of parent level equity. Which we don't really have control over or I don't think it's really dependent on the recap. So, yeah, I think there's less of a focus of that on the partner docs.

David Phelps: So, Alastair, do you see that structure as being a DSO that is more focused on writing things through saying they're not looking at a recap per se, versus many that are promising their docs hooking them with we'll recap in 18 months or 24 months based on what we've done in the past?

Alastair MacDonald: And just the deals that I'm seeing and looking at and working on, most of them need a recap and the vast bulk of them, but well over three quarters of them. And by that, I mean they've either got a balloon payment or they're operating with some form of mezzanine financing, they've got a line of credit and they're going to need to refinance at some point.

I think it's almost easier if we use the word refinance because everybody gets that. It doesn't sound so mystical as recap, and it doesn't sound more sophisticated than it should. So, most of them need to and not just because as I say, they've got balloon payments, and the runway is only so long.

We've spoken about this in the past, but this is the difference between an operator and an aggregator. An operator it sounds like and looked like even from early days of those conversations, I mean they were operators.

The interesting thing is the bad news is they have also overpaid. The good news is that having brought in this revenue, these value creators here, the docs it's going to comfortably offset, I should think, any downside risk to your specific practice.

So, you're in a good spot because you're sitting on an opportunity and you're participating in it. A lot of docs, they just kind of take the check and go and that's fine too, isn't good or bad, it's your business. Get to do whatever you want with it.

At this point about retained equity in the mothership versus in the home practice, this is something that needs to be spoken about. And I'm going to use this as an example of this kind of what happens when it's going well.

But I want to shine a light on something critical that came up in a very powerful conversation with David and Candace and I the other day. And I want to really tip the hat to Candace on her contribution here.

As we were thrashing through the various scenarios of why is it that private equity has shifted from 60, 40, 40% of the mothership to 60, 20, 20 cash your clinic mothership to 60, 40 cash your clinic.

This has happened over the last two years. If nobody notices this, it's just probably not … if you're not actively doing deals which you shouldn't be doing, you should be running a business you wouldn't notice this.

So, we have to ask ourselves what is it just as I've been asking for three years is why nobody's pointing to the fact that used to get a check for a hundred percent. And as interest rates have risen that upfront amount has dropped to 90, 80, 70, 60 as interest rates have risen, that's a clear as day, obvious de-risking of private equities situation given interest rate risk.

Why is it that now this newer wave of moving you from being entirely in the mothership down to being entirely in your practice? This is directly connected to the articles and links that we shared; it came out this week.

And what's happening, I've been using Apollo as a critical canary in the coal mine because they account for it literally as much as 15 to 18% of the entire private equity group, universe is just them. They're huge. So, as they go, so goes the marketplace.

What we're seeing here is KKR and Apollo, two of the largest in the world are moving assets into their distressed asset department, it's almost easier if I draw. Imagine a molecular map here of five different practices or four different practices.

Stick with me on this because there's a very important concept here for all of us, whether we're engaged in a sale right now, and I know I'm in conversations with many, several that are.

But for those of you that are looking to use this as a learning experience for your long game and really getting a better sense of how deals are structured and why they are offered this way, this is very important.

My intention is for everybody to become more sophisticated deal makers and of course happier practice arms. So, we've got a universe of the DSO and the parent organization, let's call it the mothership with four practices underneath just as a universe.

And I'm breaking it to four because 25%, if they've been around, whether they've been around a long time or short time, they have overpaid for the first quarter of this practice, they've overpaid. That means these ones are going to have really crappy return.

The last trench, number four, they've underpaid, these are the winners, killing it. Growing, more revenue coming online, more providers coming up, they're doing great.

So, one they've overpaid, or they've underpaid. Number two and three, we've got a practice that's really floundering and a practice that's doing really well. So, number three is really carrying everybody together with the fact that number four was underpaid for.

Where am I going with this? Why is it that Apollo and KKR in this article are moving certain assets to distressed assets? And what has this got to do with you having more ownership in your practice than the mothership?

If I am the parent DSO, the last thing I want is I have to make hard decision. Just like you've had to in your practice. There are people that have to be let go because overhead is out of control or they're bad fit or an associate who's not producing, we have to let them go. It's no different with me with my DSO.

I'm going to have to get rid of tranche number one because I've overpaid for them. The returns are going to be terrible and they're dragging everything else down. They're dragging down ROI that I could get elsewhere.

So, I take all of these dysfunctional, either those practices that are underperforming in terms of revenue, all for which we've overpaid and created unreasonable expectations. I can break that practice out and put it inside a pool of other practices that will go for a distressed asset sale. That's exactly what Apollo and KKR are doing in this article.

When you get a chance, read this article, it's very instructive. We'll put the link as CT always does inside the notes of today's meeting.

By moving you, you four practice owners, imaginary practice owners out of my parent DSO, I reduce the risk of disgruntled practice owners that are in tranche number one, forming a class action lawsuit.

I don't want four practice owners upset saying, “You promised us all of this stuff and we're expecting big check,” I don't want that. So, instead I say, "I'll drive this, you drive that," and if I need to trim you off and send you to a distressed asset pile, I will.

We need no better evidence of this strategy in play than looking at the other day where Dental Group is now the victim of a cross action lawsuit from 140 of the 280 doctors, that is a legal nightmare.

Now as you read in that article, these docs are forming a contingent and they're suing just for information and it's fascinating. They need time to recap, to come up with more money because they'd grossly overpaid for all of them. We knew this, we spoke about it two months ago when they stopped their distributions and canceled their recap.

Now these docs have been able to form an alliance and say as shareholders we are coming back after you. You can't do that if you are just a shareholder in your practice. The man at the top of the mountain didn't fall there. That's what private equity is doing.

They don't follow Warren Buffet's strategy, which is time. They try to get as faster return as quick as they can as opposed to a large return over a longer time or an average return consistently of a long time. They look for a rapid return as quick as they can get it.

But they do follow his first rule, don't lose money. And this is how they do it. By breaking off the dogs of the full practices, pushing them off. They clean up their balance sheet. It's now easier for them to go and get recap. It's easier for them to go to market and try to sell and get the multiples that they claim.

This is a critical strategic step and I'm really thankful to Candace for the conversation that catalyzed exactly this revelation. This is connected, of course, to what we're discussing here. And what he's done of course, is he was of that prior tranche that was able to do both. Increasingly what I'm seeing is 60, 40, not 60, 20, 20 or 60, 30, 10, I'll stop there.

Critical point, we have to understand that these are the things no one's paying attention to. Just like they didn't pay attention to cash up front going from 100 to 90 to 80 to 70 to 60.

Why were they doing that? The same thing here. They've gone from mitigating interest rate risk to mitigating liability risk, legal risk. So, lots there, these are truly fascinating. Anything more to add anything on your side there?

Male: I would say that's interesting what you're saying. And what David asked, if I have access to the information of their balance sheet, I don't. I've been trying to figure out a way to get that information directly or indirectly.

But yesterday actually we had a member of their integrations team come by the practice. When we converted from open dental to Dentrix, there was a team of about three to four people that came to help with that transition and then they come back after two or three months just to see if there's any questions or follow up or whatnot.

So, I was talking to him and at the time that I sold the practice they were closing about two to three practices per week. And so, I remember him really frazzled at that time because he was like, “I don't know how we're going to do all these integrations. We just don't have enough people.”

And yesterday when I saw him, he was so relaxed, I was like, “Hey, so how's everything been going?” He's like, “Well you know, it's been great because they actually slowed down.” So, now they are only acquiring about two to three practices a month.

And from what he said was that the practices that they've been integrating, it's been easier also because the docs that he's working with are younger and savvier with the technology as opposed to earlier as mostly senior docs, and the conversion to Dentrix was extremely difficult.

And so, what it seems like the strategy here is they're becoming a lot more choosy with the practices that they are acquiring and it seems like they're targeting younger docs that have a longer runway with practices that are already going so that they can add value right away and drive the return.

Alastair MacDonald: Very valuable input and feedback and perfectly sensible and logic. What they've done has gone from overpaying for older practices clearly that do not have the gross profile that a younger docs practice does. And by that, I mean a younger practice.

This came up in conversation yesterday with one of the sovereigns who's looking at an exit themself and pointing to this when we say, “I'll give you 60 cents on the dollar and I'll give you the remaining 40 in three years,” we talk about quality of interest rates they will either fall, stay the same or rise.

Again, most of this funding was secured with lower interest rates, which is exactly why its group is slowing down their purchases because they're probably using up their cash they got at a lower price. More likely than not it's just follows.

So, if we assume two of these three scenarios are 66% of the chances, interest rates will stay the same or they rise, they've been rising for three years, reasonable assumption.

If they come back down, they have to fall back to or below the level they previously secured the financing, which is likely to have been tuned to three years ago, which was the trough in interest rate. So, their slowing down of acquisitions matches perfectly with the steepening of the interest rate curve.

But the critical point that I want to make here is when you are assuring individuals of very large recaps or multiples or exits and two of these three scenarios play out, which is interest rates stay the same or they rise, you are going to need a significant growth rate on the practices revenue and net profitability to justify even just getting the same price from someone else.

This is important because a practice that's been around for 25 years is not going to double in three years. It's not, it's extremely rare. A practice as we all know, many of us here or — Gunners that started Denovo, we see that type of growth in years one through five for sure.

So, it makes sense that they're changing their risk profile collectively on the macro and then on the micro by looking for those more rapid growth practices because they're just younger. Equally, they will also be paying less for them.

Every one of us knows that if I was buying a practice two or three years in, I'm paying a heck of a lot less than us paying at year five or year six just because of the steepness of the kind of hockey stick growth that we experienced in those first five years.

So much here that I love, it was great to see you and also great to get these updates because it puts so beautifully into the grand scheme puzzle that we're all collectively deconstructing here.

David, please some thoughts. I know because the same canaries are dying in the different coal mine over in commercial real estate.

David Phelps: Everything's in tandem, that's why I love these conversations because they're relevant to all of us. I mean, everybody here has a practice and has the opportunity to do what they want with a practice. You get to steward the way you want to, but understanding the marketplace is so important.

Same thing in real estate, which is the area I love, but we're seeing the same thing play out. Actually, this week, I had the opportunity to spend some time with a good friend of mine who is a — been a longtime syndicator in a certain equity market in real estate. Very, very good.

I trust him implicitly, but he's dealing with the same headwinds that we all are and looking at the rate hikes and the cost of capital. And one of his lenders from which he's had a good long-term relationship was actually in his offices in Denver this week, and it's actually KeyBank.

KeyBank is a pretty robust regional, based out of Cleveland I think around 200 billion in assets. So, good size, good size bank. And my friend asked him, he said, just for out of interest, they weren't looking for any debt financing right now because the rates are too high, and the margins are too slim.

Just like with the private equity looking at dental offices, they said, “Well, what's the term sheet look like right now?” And the rep from KeyBank said, “We haven't offered any term sheets to anybody since April.”

KeyBank, big player, big player. We have offered no term sheets to anybody since April. I said, “And the previous quarter Q1, we were winding it down.” So, I asked my friend, I said, “Well, what are they looking at on their balance sheet?” They're into a lot of different things.

Offices has got the biggest problems right now in commercial real estate and those are going to move off to distressed asset management is what will happen to those. But the whole idea of all these operators having to refi these short-term rich loans, we're just on the front end of that whole issue playing out.

And I see it playing out very, very heavily over the next six, eight quarters at least, and well into 2025. I think we're going to see this play out. And again, back to private equity DSOs, same thing.

I think we're just on the front end of seeing this, the initial signs of what's happening and what we have to foresee and make the best decisions that we can. That's what I love about this group is Alastair, you're leading people, and giving them the insights that nobody else talks about.

Nobody else talks about this stuff and you and I and everybody else here, we've heard plenty of podcasts on how the multiples’, heard practices are still way up here and there's still huge demand and it's all good.

And yeah, some of the players have changed, but don't worry that they're filling the gap and I'm just thinking, “You're betting odds that are not going to be in your favor. Unless you're doing some offsets wherever you can to mitigate those downside risks.”

Alastair MacDonald: A big contribution, David, thank you. This absolute mania that we're experiencing right now is going to, as it did with the lag time show up in the veterinary space in the next two years.

So, today's mania where I'm being contacted as I did, I said I would on Tuesday. I followed through my word. I met with this third year. He's just beginning his third, he's got two more years. And he's already planning on building a DSO and he's hoping to start now.

He's going to plug in associates, he's going to bring in a specialist just to really crank on growth and EBITDA. And he's going to do this of course with multiple practices and he's never owned a business in his life. He has yet to have an employee, and this is what he's doing. So, we are absolutely, in my opinion in a mania.

There is a saying about a mania that everything that we're hearing in the news right now in the news, I say the news in the industry, which I think is relevant. And I share it with everybody with the same glee that I first learned it 20 years ago. When it comes to the investing and capital markets finance and economy, a person doesn't have an idea, an idea has a person.

And that idea is that we can be a student and already be thinking about how we're going to direct specialists to do work in a profession we're not even yet qualified to nor have we ever even owned an employee, had an employee who owned a business.

David Phelps: Alright, I hope you enjoyed this conversation that we had today. A lot of insights that are great for provocations in your own right.

Next week we're going to continue some additional conversation that we had on the same topic. Discussing a little bit more about what gives permission to a doctor to take the move to exit his or her practice earlier than the industry norm or societal norm would be?

Bringing in associates, building the right team, the power of collaboration, releasing yourself to a higher level of contribution, investing in the right infrastructure, building the roads to build the city first and then again, the mindset shift.

So much relief when that permission is there. And you have what I call recurring revenue, passive income that covers your basic lifestyle needs. It opens the door to making all kinds of new options and considerations in your life. That's next week, join me there.

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