Dental Practice Transitions – DSO Trends, Seller Options and Best Practices – Brannon Moncrief: Ep #526

Brannon Moncrief:

At a liquidation event, they have the opportunity to convert that profit share into equity and participate alongside you financially as if they were equity owners. But if they're unwilling to participate, they forfeit that equity. It's designed to influence behavior. Otherwise, if you don't set it up that way and they own real equity and they block the sale, there's really no penalty. So it's much easier to stand in the way of a transaction than if you have something at risk that you could potentially lose.

Dr. David Phelps:

Today we're diving back into dental practice transitions. If you're a dentist, contemplating the next step, whether selling to a private buyer affiliating with a DSO or just holding steady. This episode is packed with insight on best practices for each Brennan re CEO of Dental Transitions Group and an expert in dental transitions with an unmatched pulse on market trends breaks down the latest shifts in DSO acquisitions, the impact of interest rates and how dentists can strategically plan for a profitable exit. Expect to hear the current trends in DSO acquisitions, the three main options today for selling your practice and how to make the most of each. Why DSOs prefer practices with multiple providers and strong management teams. The challenges of transitioning when minority owners or associates are not aligned. How to position your practice for a premium valuation in today's marketplace. How vetting DSOs and other buyers before negotiating creates the best possible outcome and much more. Please welcome Mr. Brennan. Brennan. It's been a little while since we've spoken. I think it was last year sometime and since that time we have had an election. November 5th we had the big election, then we ran into the holidays and then we got New Year's and resolutions and people like starting out the year with like what's in the goal sheet? What needs to happen? How did that portend into your world of practice transitions? What did you see during the latter part of this year as we rolled into the fall elections and then from there?

Brannon Moncrief:

Yeah, so last year, 2024 was a very busy year for us. Really a high watermark as far as the number of transactions that we closed. Now, I think that's a product of the fact that it's been kind of a choppy market. There's been some very robust success stories in the DSO world and there's been some horror stories, right?

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Brannon Moncrief:

So I think doctors understand that they need to have representation if they're going to go down the DSO path now more than ever. But it was interesting going into that election cycle because things really came to a grinding halt in November and December. Not a lot of cell side activity in those two months, and I think that was a product of the fact that people were not making major life decisions until the election was over. A lot of people were just paralyzed and waiting to see how the election went before they made the decision whether they were going to monetize their business or not.

And then by the time the election was over, everybody was a little exhausted from that event. The holidays were here, Christmas and New Year's both fell in the middle of the week, so you lost two weeks of activity and it seems like everybody just wanted to disconnect, enjoy the holidays, and I did that as well because I know what that means. It's amazing that it's kind of a herd mentality. Everybody does the same thing. At one time, I knew that come January 15th, the phone was going to start ringing, the emails were going to start pinging, and that's exactly what's happened. I would say that today we are busier than we've ever been from a sell side activity perspective. I enjoyed the holidays, caught my breath, and now we're back at it grinding away 24 7

Dr. David Phelps:

Makes total sense. Let's start with what's the ratio selling through A DSO private equity versus private sale? What's changed? Is it about the same as it's been? Has that changed much at all in the last year?

Brannon Moncrief:

I don't think that's changed remarkably from my business perspective. We still do traditional private practice sales doctor to doctor transitions. We closed 38 of those practice sales was 38 to 40 practice sales in that realm last year, and we closed 32 DSO transactions, so a total of around 70 practice sales, and they were split damn near 50 50.

Dr. David Phelps:

Let's kind of dive into which plan, which pathway applies to which doctors, and I know we had a little prior conversation about also what DSOs are looking for, so you've got to marry and match the seller to what maybe they want to, what's available for the market. So why don't you take us down that road a little bit and I think that'll help define for people where they sit today and maybe how they think going forward.

Brannon Moncrief:

Yeah, absolutely. So let's talk about the sell side first as far as what our clients are evaluating in order to make the decision, do I either keep my head down and keep doing what I'm doing? Do I monetize the business by selling to a private buyer or do I go down the path of affiliating with A DSO? Anytime a client comes to us, those are the three most viable options. Do nothing private sale DSO affiliation. First, it comes down to your defining what your goals are. Is this an economic decision? Is it succession planning? Are you looking to eventually exit your business for one reason or the other, or are you looking for administrative and operational support? For a lot of our clients, they're looking to de-risk. They've built a large valuable business and it is their most valuable asset. It represents the bulk of their net worth, and they've got the bulk of their net worth tied up in a relatively illiquid business that has a ton of key man risk and they're looking to diversify.

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Brannon Moncrief:

And the way to diversify and to de-risk is to take some chips off the table, take that cash and invest it in other asset classes outside of your business. Anytime you're talking to someone in the financial advisory world, diversification's the name of the game. So I think a lot of our clients don't realize how much risk they have tied up in their business because it does represent the bulk of their net worth and their one heartbeat away or one ski accident away from their business being virtually worthless. So I think first and foremost, you need to identify your why, and then we need to take a look at an economic illustration to quantify the global economic implications of all three of those options, keeping your head down and hanging on to the business versus selling to a private buyer versus selling to A DSO. And depending on the size of the business and the way that it's engineered economically from an overhead and profit perspective, there could be a pretty sizable gap between selling in a traditional sense to another clinician comparative to selling to A DSO. Now, selling to a clinician in a more traditional practice sale environment is going to have less strings attached, right? It's typically a hundred percent cash at close and a relatively a short post-closing commitment. The DSO deal is going to have far more strings attached and some structure to it in a post-closing commitment, but if we're talking about a valuation that's two or three times what it would be worth in the private world, sometimes the DSO option can be significantly more compelling.

Dr. David Phelps:

Talk a little bit about what the DSOs are looking for because I know that falls in line with what you and I both know a lot about, and that is interest rates, inflation, interest rates, what's happening there in the markets that's changing the dynamic of all the capital markets. How's that playing into what the DSOs are looking for today as opposed to what they were maybe looking for or would approach from a buy-side 2, 3, 4 years ago?

Brannon Moncrief:

So obviously we were in an increasing interest rate environment with very tight capital markets, very tight debt markets for about 24 months, and that was painful for DSOs and many of them were on their heels and not being aggressive from a buying perspective. I would say that given the way the election went and given that we're now in a declining interest rate environment, hopefully TBD, there's still a lot going on that could play havoc with that from inflations tariffs, things of that nature. But I think Trump getting elected as well as entering a period of time where hopefully we're going to be in a declining interest rate environment long-term, that has brought some optimism back to the DSO and private equity side of the table. So we're starting to see some recaps occur at good multiples. We're starting to see some buyers that have been on pause, not buying practices over the past 24 months, coming back to the table and beginning to acquire offices, but they are being more selective.

So what's happening is they've had to sharpen the acts and really start to pay attention to what are the institutional investors that buy DSOs at recap events looking for. And the name of the game right now is organic growth, year over year practice level growth. Great. You can acquire ebitda, but that is not itself enough to be compelling for an investor to invest in your business. It really comes down to are you an effective operator? Can you increase the top line revenue and bottom line EBITDA of the practices that you acquire over time? And many DSOs have had to, like I said, sharpen their acts and build their infrastructure, focus on integration, focus on the same store sales growth as far as how that's impacted their buying behavior. Many DSOs have pivoted to looking for larger practice acquisitions where there's less key man risk, multiple doctors, a group practice that's operating at good margins that has been growing year over year for the past few years and still has some low hanging fruit from a post-closing growth perspective.

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Brannon Moncrief:

So where we see the most demand, where we see the highest multiples, the highest valuations, we're talking about those types of practices, practices where right now we have multiple clients on market where their biggest issue is they're having trouble managing their growth. They've got to build their team, they've got to recruit more doctors, they've got to develop better systems to accommodate the massive number of new patients that they're seeing and the growth that they're experiencing a high class problem to have, but a problem nonetheless. And many DSOs are salivating to buy practices of that nature versus we've seen a little bit of pullback in demand and valuations for those single doc super producer practices that have been relatively level from a revenue and EBITDA perspective or maybe even declining slightly over the past few years. And that's been a big change.

Dr. David Phelps:

We're holding a private gathering March 28th and 29th in Washington dc. This is where we reveal our freedom blueprint That's helped hundreds of other doctors and their spouses create the replacement income that's allowed them to have the freedom and choice about how they practice their career, escaping the chair, diversifying from Wall Street, becoming your own best financial advocate. This is not any kind of event. It's a transformational event. We keep a few guest seats available you'd like to see if you qualify, just schedule a discovery call. We'd love to see you there to create your freedom path. The deadline to apply and see if you qualify for a guest seat is today. So go to freedom founders.com and apply today.

We've seen exactly the same thing. Same thing in the tangible real estate markets for years with low interest rates, low cost of capital. It was all about financialization, the arbitrage. You buy an operating facility and you maybe add a little bit to it, but it wasn't really about really adding a lot and you just flip it to the next person, the next buyer, because again, the next buyer's got the same low cost of capital. Now that's all changed and we are all looking at the same thing today. We're looking at good solid operators that can carry the load and we're not looking for the quick turns as people were. So I see the same thing in the DSO market. It makes total sense. I can also understand that the key man risk to me, if I was in that realm, I wouldn't want that either, because you're right.

I think looking at operations, the opportunity for organic growth is not going to be with that single high producing doc as great practice as they have. It's all on them. I think the big problem is whether it's a DSO buyer or a private sale who falls into that seat where that big producer has been, it's just too much risk, right? Does it work out? So I'm going to ask you this then with keyman risk, it sounds like, but correct me if I'm wrong, that you need one, two, maybe three docs, maybe one's the owner and two associates, or maybe there's a couple partners or three partners, whatever. But is there a multiple of numbers that they're looking for or does that factor in that much?

Brannon Moncrief:

I mean, it factors into some degree. I mean, the less dependent the practice is on one single provider, the better, right? So the more evenly the production is bifurcated across the providers, the better off you're going to be, the less key man risk, and typically the more demand on the buy side you're going to see and the higher the multiple is going to be.

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Brannon Moncrief:

Now, that doesn't mean if you're a single doctor, super producer practice or moderate producer practice that you can't affiliate with A DSO. It just means that those multiples and that demand has softened a bit, whereas those practices were trading for seven to eight times EBITDA from the back half of 21 through the front half of 23. Now they're trading for five and a half to six and a half times ebitda. Still compelling multiples depending on your why they haven't crashed through the floor, but they're not as robust as they once were. And if you want to see A DSO really lean into the multiple and give you a premium valuation, you've got to check more boxes via multiple doctor practice with top line revenue of at least 3 million and EBIT of at least 500,000 to fetch a premium multiple in today's marketplace.

Dr. David Phelps:

Brandon, walk me through a little bit of the puzzle, which I know you deal with all the time. When there is a Multid doc practice, it could be multid doc with one senior owner, doc owner and has a couple of associates, or it could be partners, senior partner, junior partner. There's already been some buy some equity transfer there. What I'm asking sits in front of these particular practices with different people at different time durations, look at older, right? As looking to take chips off the table and maybe doesn't want to work back so much, and you got younger docs who are saying, well, I still got 10, 15, 20 years ahead of me. Maybe I take a little more discerning look. How do you look at time durations and what's important for people to understand when they have that kind of a grouping that's working well now, but they're looking at somebody who wants an exit, right? Somebody who wants out.

Brannon Moncrief:

I love this question because we're seeing this more and more as dentistry has moved to a group practice model, the good news is a lot of practices check all these boxes that DSOs are looking for as opposed to 10, 15 years ago, you really didn't see a lot of these multiple doctor multispecialty, multimillion dollar rev practices, whereas today I feel like they're everywhere. This is the more common model and the growing model in dentistry, which is good, but it does bring about some challenges when it's time to monetize the business because a lot of times when it's a multi-doctor practice and the senior doctor is ready to monetize their equity interest, whether that's a minority equity interest or a majority equity interest, it's almost a no-brainer if their runway is less than five years or so to go the DSO route, especially in a practice that's high revenue, high ebitda because the gap between the traditional private buyer valuation, the DSO valuation is going to be significant.

But now we've got a middle-aged doctor and maybe a doctor in their thirties that are partners and or associates, and it's a much harder to convince them that it makes sense for them to go the DSO route because their runway is significantly longer than the senior doc. We deal with this on a daily basis, and the trend I'm seeing more and more is that the founder, the senior doc brings in minority partners along the way, and then when they're ready to finalize their succession plan and their ultimate exit from the business, they built this very large valuable business and they want to monetize it in the DSO world, even if they have a tag along drag along right, and a unilateral legal right to sell the business without the consent of the minority partners, there's no way you can get a deal done if the minority partners are major producers and they're not swimming the same direction because the DSO is going to come in and say, Hey, again, key man risk.

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Brannon Moncrief:

We want everybody to be on board with this transaction and if the youth, the future of the practice, those minority partners are not on board, you as the senior partner have a serious problem. And recently we've seen some associates and or junior minority partners hold the founder's hostage when they're ready to monetize the remainder of the business. So a few things you need to think about if you are that senior doctor is one, you need to be thoughtful regarding the conversations you have with your associates and your minority partners regarding equity and succession planning. And if your goal is ultimately to monetize a piece of the business in the DSO world, you need to make sure that that game plan is laid out from day one. And one thing you may want to consider rather than selling equity to associates, is give them some sort of profit share and gift it to them.

It's going to be far lower than the equity amount you would sell them, but net economically you can make the financial outcome congruent. But the way that profit share functions at a liquidation event is that if you have that tag along drag along, right, and you have that unilateral legal right as the founder and primary owner to sell the business to A DSO down the road, if for some reason your associates or minority partners aren't willing to participate, they forfeit that profit sharing interest. So that's a way to protect yourself on the backside. And one of the reasons we like profit share interest as opposed to gifting equity is because if you gift equity as a taxable event, if you gift a profit's interest, it's not, and you can set that profit's interest up in a way that it converts to real equity at a liquidation event. So we're trying to coach doctors on utilizing that strategy more so than selling equity or gifting equity to associates. But look, I think at the end of the day, what you need to understand is that all the major producers in the practice are going to have to be onboard if and when you want to pursue a DSO affiliation. And if they're not, you're going to have a problem. You're going to have to find a way to incentivize them to transact.

Dr. David Phelps:

It's a really great conversation to have. That's why I was interested in talking to you about it because I knew it was there. We hadn't really talked about it before, but in my many years of orchestrating a lot of different kinds of transactions, not so much in the dental practice realm like you do, but other transactions and seeing these variables come up. You said it's best for the senior doc to have this laid out in advance. Well, how many are going to do that? Realistically, we never know what we don't know,

Brannon Moncrief:

Right?

Dr. David Phelps:

I do agree just in my overall philosophy is I'm not a big fan of giving equity, but I'm a fan of profit share. He's been paying that profit share all along for some period of time, and then if the associates in this case don't want to go forward, they lose it. But this is not a vesting period.

Brannon Moncrief:

There is no vesting period. Typically, you would at the appropriate time when you feel like you would've sold that person equity rather than selling them real equity,

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Brannon Moncrief:

You look at, okay, well if I was going to sell them 20% equity, how would that be valued? What would the payment on that buy-in look like and what would be their net cashflow benefit after that equity payment is made? And then you can back into what the appropriate profit sharing alternative interest would be comparatively speaking, so that economically, it's essentially equivalent and yes, you immediately start paying that profit share. It might be 2%, 3%, 5% profit share, so they get 5%, let's say, of the ongoing EBITDA of the business, and then add a liquidation event, which could be a DSO sale or private equity partnership. They have the opportunity to convert that profit share into equity and participate alongside you financially as if they were equity owners. But if they're unwilling to participate, they forfeit that equity. I mean, that could still do damage, right? If they don't participate, they forfeit that equity. You lose a producer, what have you, but it's designed to influence behavior. Otherwise, if you don't set it up that way and they own real equity and they block the sale, there's really no penalty. So it's much easier to stand in the way of a transaction than if you have something at risk that you could potentially lose.

Dr. David Phelps:

So if they don't participate, they lose a profit share potentially converting to equity, turn it the other way, define participation. Okay, I'm in, but there's got to be a period of participation ongoing. What does that look like? How's the rest of that work out so that there is an influenced participation ongoing to make this whole transaction viable?

Brannon Moncrief:

So normally it works out in several ways. One, you have the option to convert that profit share into an equity position and liquidate it in the same structure that the senior partner is liquidating their equity. You can just retain the profit share interest if you'd like versus converting it into equity. But if you convert it to equity, all DSO deals involve a cash component and an equity component, so you're not converting that to a hundred percent cash. You're likely going to have some residual equity in the business on a go forward basis, so that's one way to incentivize them to stay on. Also, you're probably going to have to agree to at least probably a two year post-closing commitment as a minority partner, the senior partner, the founder's likely going to have to agree to some sort of longer term commitment because their cash at closing is going to be considerably higher and their ongoing equity retention is likely going to be considerably higher.

I think the main point of this conversation is you've got to think about these things in advance and make sure that everybody's swim the same direction. You can't just figure it out as you go or you are asking for problems when it's time to ultimately exit your equity. But look, it's no different than, let's say the DSO world didn't exist prior to, let's say 10 years ago, a lot of doctors entering into partnership, whether that's an equal partnership or allowing associates to buy a minority equity interest, and eventually the founder is going to liquidate the remaining equity likely internally. Well, don't you set all those parameters up from the beginning, right? How is the business going to be valued? When is that potentially going to occur? What are the different triggers? What are the different rights of the parties? You would put that naturally in an operating agreement, right? If it was a doctor to doctor partnership, I think you just need to do the same thing, but think about the fact that because there now is this other option out there that could be significantly more lucrative planning for what if that's the mechanism that you use to ultimately exit your business.

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Dr. David Phelps:

Last question, and you kind of seeded this earlier when we talked about the markets and the fact that in all markets, some have been operating very well and some have been just in the DSO markets, some have crashed and burned, that's everywhere. It's not just in dentistry. Based on that large size macro basis, how do you distill that down? I assume you just only set up the potential introductions to players that you know are strong and anybody else who's just outside the field, they don't even enter the arena. Is that kind of how it works or what do you do to

Brannon Moncrief:

Help? Vetting DSO buyers and private equity firms is a full-time job for us, and we have a couple of people in our firm to spend an insane amount of time doing just that. Onboarding relationships with new buyers, vetting existing buyers, keeping our ear to the street to know that water cooler talk, who's healthy and who's not. And that's why we go to all of these meetings. That's why at the DMA meeting this year, we'll have a private room and every 30 minutes for three days, we'll have a different DSO walk in and we'll meet with their leadership team to talk about who they are, where they're at, how healthy they are, what type of practices they're looking for when they're expecting a recap event to occur, and what the projections look like in regards to the financial return. We spend a lot of time vetting DSOs.

There's about 500 DSO buyers in the marketplace, and we work with about 70, so that's about what, 15% of the marketplace. We don't do business with 85% of the marketplace. Now, I would say that of that 85%, half of them are just unproven. They may turn out to be real players, but they're either too small, they don't have the proper capital structure, the proper deal structure, or the proper appetite to pay up for the practices that we represent. The other segment of that 85% are people that we don't feel good about. We either don't feel that they're financially healthy, we don't feel that they treat doctors respectfully. We don't like their equity structure or we don't believe in their management team and their investment thesis. They're kind of blacklisted, let's say 15% of the marketplace we trust. We've done business with, our clients have had good experiences.

We believe in their management team, we believe in their investment thesis, and they're backed by a sophisticated sponsor. 40% of the marketplace is blacklisted and the other 40 to 50% just relatively unproven TBD, right? Some of them may get a seat at the table over time. Others will probably fall onto that blacklist at some point. It's not easy to vet these players. Private equity is relatively secretive about their financial health and releasing their financials. But there are some poignant questions you can ask. I think given that we live in this ecosystem and play in this sandbox on a daily basis, really take pride in the fact that we vet these players before we allow them to sit and have a conversation with our clients. It's key to what we do in addition to obviously all the other value adds that we provide to our clients,

Dr. David Phelps:

It's always good to get an update. It is an ever-changing environment, and I think it's just really prudent that every doc, I don't care where you are in your practice, whether you're a solo and in a boutique and high profitability and love that, or you're looking to expand or scale, you have to enter these conversations and at least understand them.

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Dr. David Phelps:

Be aware. Be aware what they are, so that as you're making plans, you've got the structure in front because there's so much that goes into it, so many variables, no one person can figure it all out. You've got to have someone who's really understands the lay of the land. And I think that's really one of the great benefits obviously, that you bring to the table, your experience and the exposure you've had over many, many years. These are huge, huge moves when you are making some kind of transition. You don't have the margin to make a mistake in this world today. Any last comments you want to leave today?

Brannon Moncrief:

No, I think what you just said was well stated. I mean, get educated, right? And understand that there's a lot of bias in the marketplace. There's a lot of noise in the marketplace, there's a lot of misinformation. And you need to make sure that you build a strong team of experienced advisors around you that give you objective guidance and basically say, Hey, here's the lay of the land. And you have options, right? To say that selling to A DSO is the worst mistake you'll ever make. That's biased. That's bullshit to say that it's a no-brainer and everybody should sell their practice to A DSO that's also incredibly biased. You have options, and if you've built a large successful business that has a great reputation, a long-term sustainability, you're going to have some really, really high class options available, but you only have the opportunity to do it once. So take a pragmatic approach, build a great team of advisors, get educated. We'd love the opportunity, schedule a discovery call to get to know each other 30 minute low pressure confidential conversation with me to just see if it makes sense to do evaluation, do a deep dive, do an EBIT analysis, and quantify those options. And you'll never feel any pressure from me or my team to go to market or pursue one option over the other. So David, I appreciate you having me look forward to staying in touch.

Dr. David Phelps:

Yeah, we'll put your contact information in the show notes, but I'm going to go ahead since I happen to know them right off the top of my head since we were communicating. It's Brandon, B-R-A-N-N-O-N, at dental transitions.com. Cell phone number is okay?

Brannon Moncrief:

Yeah. Yeah. People can text me and schedule a call. Go ahead.

Dr. David Phelps:

6 6 0 8 5 0 5. I can say that I have referred a number of people that we work with and freedom founders to Brandon just for this very thing, consultation on what the options are. And I've never got anybody that came back and said, well, that wasn't worth my time. In fact, many have gone through and actually had very successful transitions on the backside. So if you don't use Brandon and find somebody, don't do this by yourself. Get educated, understand what you're doing. It's a critical move. And as you said, Brandon, there's a lot of options open today, which is a benefit, but also makes the marketplace very confusing.

Brannon Moncrief:

Absolutely. Thanks for having me, David. Always good catching up with you.

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Dr. David Phelps:

There's a new financial game being played today in the marketplace. And before I get into the details of it, let me just say that I am not anti DSO necessarily anti private equity. I'm not anti anything that is a good deal, a good transaction, a win-win for both parties. Bottom line, that's what capitalism is. And whether it's private equity, DSOs, private sales, whatever it may be, if it works for the benefit of two sides, the two parties, buyer sellers to the goals that each party respectfully wants, then it's a good deal. The problem is that many times what's promised on the front end doesn't happen on the back end, just to say it bluntly. And that has to do with performance. Look, we deal with pro performance all the time, and we're looking at potential real estate investments, particularly those on the equity side where we are taking a stake in the ownership of a particular asset property, a fund syndication.

And the promise generally is if the operator, whether that's you with your own property or that's the syndicator or the fund manager does a good job with the assets that they're going to drive value in the assets and drive the value up to a point where the asset can equity the profit, the capital gain can be harvested for a nice return, a capital gain return, along with possibly some distributions along the way. That's the play. And when the markets are going up, and we've had cheap capital for many, many years up until the last two years, this trend generally has worked very, very well because when you can roll debt over and over and over again at next to zero interest rates, it's not costly to do that. It's not high risk to do that. Things change when the markets change. And we've seen great disruption in the marketplace in the last two years when we had inflation coming back at historic highs, 9% back in September, 2022.

The Fed comes to the rescue, so to speak, and says, well, we're going to tamp down this inflation. It's just transitory. Trust us. We'll raise interest rates up. And so they did. And yes, inflation has come down. The problem is we still have high interest rates and we still have an economy that is suspect. So we've talked a lot about DSO and private equity sales and transitions, and how much one has to be aware of, in my opinion, how much capital investment that the seller might be you with your practice is leaving in the parent company, the holding company. That's always the play. The DSO backed by private equity will come in, make an offer, a total offer on the practice sale, and those offers in the last five, six years have traditionally been on a nominal basis. What I mean by nominal, the actual stated sale price has been a higher multiple number than generally speaking, the private market would pay a private practice sale to another practitioner.

Private practitioners have to come in with cash, hard money, and bank financing, and banks look at evaluation a certain way. Well, private equity plays a different game, and they've played this for decades. For decades. This has been going on in all industries. We've just seen it in the last 6, 7, 8 years. Pretty heavy into dentistry, veterinary medicine, many other industries. And so the play is we'll give you what looks like anomaly high valuation for your asset, your practice in this case, but we're not going to give it all to you upfront. We're going to give you a certain percentage upfront, and then the rest of it we're going to keep over here. And a side bucket, which is our company, our fund. And because we're really good at managing money and aggregating practices, you are going to likely get a four or five times more multiple on that retained equity that they're retaining over here on the side.

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Dr. David Phelps:

That's worked out in some cases, but not all. We're already seeing the headwinds in many of these roll-ups that are taking place where I think we're going to see more and more of the recap promises being extended out or may not happen. So now what's happening is a lot of this money that's been buying practices and doing these roll-ups are realizing that they've been overpaying for practices, and particularly with the higher interest rates that we have today, those practice valuations don't make sense. Even private equity, who thinks they can do no wrong? They're realizing that this does not have a run rate to it. Now, many of them, or some of them I should say, are moving to actually buying the real estate owned by the practice operator owner could be you. And that, again, that can apply to dentistry, to medicine, healthcare clinics, veterinary medicine in the past, usually those who buy the actual operating business, the practice itself, don't want the real estate because the real estate takes what A lot more capital.

You've got to go finance that and you've got to put hard money down, and your operations are really not in owning real estate. It doesn't make sense. It makes sense many times for the DSOs to buy the practice, and then they will lease the practice facility back from you, the dentist, and they'll create terms to make that work. So it's usually an either or. They'll either buy the practice or in this case, they're starting to shift to the real estate. Well, why the real estate? Well, the real estate by and large, is easier to fundamentally value than a practice. It's fundamentally easier to value. Now, that doesn't mean there's not fluctuations in real estate prices. There always are, but it's easier to put a valuation on them similar to what they've done with practices. They've now coming in and offering practice owners without buying the practice.

You own your practice, you like your practice. Hey, how would you like to capture some equity out of that building? And let's say you've got a building that got a lot of equity, you've paid it down over the years, you don't hold any substantial debt or maybe no debt at all. And let's say you've got a building that's worth $700,000. So private equity will come in and say, Hey, we'll pay you a million dollars for that practice building. And you're thinking, wow, a million dollars. And now you can have that equity and you can go make money on your equity and you can UNT trapp that equity. And that's always the game, right? Untrapped that debt equity, well, it's not debt equity if you're using it or somebody's using it in this case you're using it. It's not debt equity. So you have to compare and contrast.

And of course, if you give up and sell your billing in this case, get the million dollars, then you're going to have to pay rent to the new owner, right? Part caveat is, well, how much is the rent going to be? And you're thinking, well, they'll just charge me normal market rent, Uhuh, they're going to charge a higher rent. Trust me, they know what they're doing with the numbers so they can play games just like they do with the practices. And this maybe it gives a more clear insight into what they do with the practice. They'll tell you, they'll give you a million dollars for a $700,000 building and here are the lease terms we want you to sign like a 10 year lease. That's not uncommon. And there's going to be escalators normal, escalators tied to some index similar to CPI, but there's other indexes they'll tie it to.

So there's going to be increases along the way to keep up with inflation in a particular deal that I was helping someone look at because they had this actual opportunity to come up, and I'm actually giving you the numbers of their deal. It was a real estate practice building that was valued real time in the market for $700,000. And the private equity said, we'll give you a million. He thought, well, that's great. Well, here's how the terms work out. We're not going to give you the full million.

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We're going to give you half of that. We'll give you 500,000 in actual cash, and we're going to take the retain amount, the 500,000, and we're going to put it in our fund. We've got this real estate fund and we're aggregating all these medical, dental, veterinary practice optometric, and we've got this fund and we're going to manage all this real estate together and we are going to build up the NOI cashflow because that's what drives the real estate values.

It's like EBITDA in a practice drives the valuation for a practice. Well, it's NOI net operating income. We're going to drive that. We're going to add value and drive it, and particularly if they're charging you a higher rent amount. So here's the catch, pay this guy a million dollars, 500,000, you get to get 500,000 goes into the fund. So you don't get to get that. That's going to be in the fund and you'll participate in whatever that fund does over the years with the promises of the typical, we'll give you a four or five x on that half a million dollars in three to four years. You're thinking, well, why wouldn't I do that? I can't get in the marketplace. I can't get that anywhere else. But can they really drive it with interest rates where they are today with the fact that I think we're going to have a more of a stagflation, probably a recession correction in the overall economy, notwithstanding asset prices.

And you think in three or four years you're going to somehow get some big multiple. I think not. And of course, like anything, you've lost control. You've lost control of a really solid asset that in this case with your practice, you're using it. You've given up control. They wanted $8,000 per month on their leaseback rent. Now, I asked this person, I said, what's the market? I said, have you talked to commercial real estate broker in your market? What is a medical in this case, dental facility? What's the normal range for a lease? And he was told it's 4,000. Around 4,000. So basically they're asking the seller of the building who they're going to give a million dollars, but only half of it upfront. They want double the rent. Oh, and guess what? That $8,000 per month, that's net. It's a triple net lease, which means that that's a guaranteed amount that gets paid.

It's net to the fund owner. The buyer of the building, it's net to them means that you, the lessee, you're now leasing back your building, have to cover all the other stuff you normally had to cover anyway, taxes, insurance, common area maintenance, CapEx. I mean, you basically still have all the owner obligations of the building without owning the building. You carry all that stuff. What's happened to property taxes and insurance in the last year? Just ballooned? Well, guess what? In this kind of a triple net lease arrangement, you suck that up as the lessee, the lessor, the owner of the building doesn't bother them. You're guaranteeing to pay them 8,000 a month with escalators. So let's just do the math, and this is easy to do in my head. If they're saying the building is worth and they're going to pay you a million dollars, again, half upfront, half somewhere in the future, so that in my mind right there is not a full million dollar sale, but get this, if I'm paying out $8,000 per month in my head real fast, I can do the math.

That's $96,000 a year, and if the valuation on the building is a million dollars, quick math in my head, that's a 9.6% cap rate. That's extremely high. Who does that benefit benefits the owner of the buyer of the building, not use the seller. If you're a seller, you want a low cap rate. Probably that would be a cap rate of probably around, I'm going to say six and a half. They've boosted up to 9.6, so now you're paying a very high cap rate on a building you just sold and thought you got a million dollars for now over 10 years, 10 year lease. Let's see. Again, I can do this in my head. $96,000 a year times 10 years plus, there's going to be escalators. Let's just keep it at the flat rate, 8,000 without the escalators. That's $960,000. I will have paid guaranteed to the owner of the building over 10 years.

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In other words, they've recouped over 10 years. All the money that they paid out to acquire my building who benefited there, plus whatever there is in inflation, they capture all that. Basically, I've paid down whatever debt that they had to use to acquire that. I paid it down for them, and now I no longer have the asset. It's gone, but I got $500,000. What can I do with that $500,000? What are you going to do with that? You've always got to consider before you take cash out of anything, whether you refinance out, you refinance money out or someone buys you out, your practice, your commercial building, any other assets you have before you decide to grab the cash, you got to say, what am I going to do with that cash? And can I do better than my current position? That's always the key. Can I do better than my current position?

In some cases, it would make sense. Some cases, if you've got the right numbers, it could make sense to harvest equity out of an asset, which you've always got to consider the long game ramifications. That's what most people don't do. They can't perceive and look down the road or they take that high pro forma, oh, we'll give you a four or five X multiple on this retained equity that you're leaving with us and you're going, well, for sure, because that's what they've always done. No, no, no, no, no. You probably just gave up a lot of that equity, and as I said, you've tied your down to a high lease payment. What would that just do for you? Well, that just cuts your cashflow down for all those years. So it is a balancing act, and it's interesting that these companies, these private equity based backed organizations, DSO type are telling the potential seller of the AL building, well, we're flexible, we're negotiable.

If you want a little bit more for the building, we can do that. Of course, yeah. All I'll do is just fudge the lease back up. I mean, you can play these numbers all day long and play games with it. We'll tell you, we'll give you on a proforma a much higher multiple to juice it up for you. It's just all a game in math. And so it was fun to help this doctor look at the options because at first he was thinking, man, I can get a million dollars for my $700,000 building. Well, if everything's even, then, yeah, that sounds like a great deal, doesn't it? But you've got to consider all these other factors before you actually plunge in and say, I'll take the deal. Because usually in most cases, the big money, the private equity money is smarter than you are because they play the game with the numbers and you don't, and they know how to fix it in their favor.

It's what they've always done. So I thought it was a great way to kind of compare and contrast something that we know a lot about real estate and compare and contrast that to how private equity plays the numbers in any of the industry assets that they purchase with the, here's how much we'll give you upfront. Here's how much we'll give you later, and how they play the numbers to make it always work in their favor. Just be aware. It's just not a lesson to keep in mind. Most spend their lives optimizing for wealth, net worth and quantity, thinking them the accurate measuring sticks for success or the magical portals into the lives they want. I believe most people are optimizing for the wrong thing. Time is the greatest resource, and time is what we all want more of in the end. But it's not just about the quantity of time, it's about how you spend it.

How you spend your time is the most accurate measuring stick of the success of your life. So how can you optimize your life, business, and decisions for more time? And how can you upgrade where you spend your time to improve quality and the satisfaction of life? My new book, scaling Time Versus Wealth Lace, the groundwork for these questions that provides the lens to which you can filter your decisions to optimize for time and how you spend it. You can get your free copy at scaling time versus wealth.com. That's scaling time versus wealth.com, and thanks for tuning in. Be sure to click that subscribe or follow button and let us know what you want to hear more of in the future. I'll see you next time.