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“EBITDA, EBITDA, That’s All Folks” ... Or is it? Demystifying EBITDA as a Practice Value Determinant

Establishing value for a business requires detailed analysis of business operations, accurate accounting of inventory and assets, and careful consideration of how revenues are generated and expenses are controlled. Availability, opportunity for growth, cash flow and buyer demand contribute to marketplace conditions that, similar to real estate markets, impact purchase prices. Different from real estate, the purchase of a business is an investment in future cash flow, which is the common denominator and driver of business value.

If one examines an income statement for any business or dental practice and removes the interest expense, taxes paid, depreciation expense and amortization costs after earnings, one ends up with “EBITDA.” EBITDA, or “earnings before interest, taxes, depreciation and amortization,” is an accounting tool that can be used to reflect the efficiency of a corporation or dental practice, or its cash flow at a given moment in time or over a period of time, when evaluating change or considering reinvestment in the business (1,2). By removing interest, taxes, depreciation and amortization from the operating expenses of a dental practice, we can compare and evaluate a practice’s financial health in a standardized manner by neutralizing taxation differences, financing structures and accounting differences in depreciation since reporting depreciation does not always reflect actual asset deterioration (1,3).

Despite the usefulness of EBITDA as an accounting tool in the comparison of businesses and dental practices and as a measure of company efficiency, it has not received a great deal of attention in scientific or valuation literature

(1,3,4). Beyond this, EBITDA is commonly referred to and used in business valuation, including dental practice appraisals, in the form of a multiple (or multiplier) to establish, state and justify appraisal value (1-3). It is known that different industries have different tendencies in the use of EBITDA and EBITDA multiples to guide company value (1). The goal of this article is to facilitate an understanding of why EBITDA may be useful as a practice value determinant, how it may be useful in this milieu and under what rationale EBITDA can guide dental practice appraisal value.

Hindsight is 20:20

Many valuation strategies are used among valuers. Some of these techniques involve “pro forma” or forecasted cash flow. EBITDA can also be used to guide value, but it is not a “future earnings” model. Nonetheless, the concept of pro forma valuation deserves mention due to its prevalence in practice appraisal approaches, which the authors of this article are not in support of.

Very little exists in the literature that examines pro forma methodology used in business appraisals and the accuracy of these methods through follow-up analysis of predictions (5). Not surprisingly, there is no known evidence for pro forma methodology accuracy in the use of dental practice valuations. There is, however, evidence of the contrary demonstrating that pro forma techniques, like many commonly used valuation formulas, impose a subjective, inconsistent and assumptive statement of growth

or potential in the appraisal of anticipated business earnings (5). Often, these predictions are ad hoc and optimistic.

In consideration of goodwill and patient retention in a practice transition, it should be accepted that some patient attrition is likely to occur. Pro forma strategies are known to exaggerate the potential for growth and minimize or ignore the potential for loss of goodwill and revenue (5). The *2018 Economic Report to the Dental Profession* states that practice costs are rising in excess of the ability to pass these expenses on to the patient, and that the dentist-to-population ratio is rising (6). What this means is that a pro forma reporting that fails to accurately predict the potential for some loss of goodwill in a practice transition and account for the challenges we are facing as a profession has the potential to be falsely optimistic in its prediction and inaccurate as a valuation tool.

EBITDA, on the other hand, reflects practice efficiency, which is more important now than ever before, and existing practice operations, as our ability to recount the past is far more accurate and less biased than our ability to predict the future.

The enigma of goodwill

Why does one require valuation methodology to quantify value in a dental practice? Simply put, the “hard assets” of a practice have a fair market value that is straightforward to determine. Fair market value is defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts” (7). Dental equipment, leasehold improvements and supplies all have a fair market value that is relatively linear in determination based on cost paid, depreciation of the asset, condition of the asset and an understanding of similar assets that have sold in the marketplace.

But dental practices generate revenue through the provision of clinical care to patients, and the ways in which that care is provided. As such, there is intangible value in a practice, often referred to as “goodwill.” There is also “investment value” in a dental practice, which refers to the value the practice has to a hypothetical investor (the buyer) based on the investment required and anticipated ability to generate future cash flow (8,9). The financial literature states that businesses that have a relatively higher profitability, larger size and a greater proportion of intangibly held value (this includes dental practices) have greater unpredictability in their estimates of value (3). Consequently, the intangible value in a practice requires some methodology to determine a reasonable price to pay for a practice that includes the

revenue-producing elements beyond the hard assets, and this is where EBITDA is most useful.

A review of the literature reveals that when EBITDA is used as a valuation tool, the multiple and appraised value of a business is inversely proportional to the risk of the investment and directly proportional to the growth of the business. Put another way, a proven track record of low risk and stable increases in cash flow result in a justification of higher EBITDA multiples of value (1). Dental practices are in demand and lenders typically provide 100 per cent of financing at favourable rates of interest because default is low. As such, dental practices have low risk relative to some other businesses.

Normalized cash flow: the black box of practice value

Whereas cash flow reflects earnings after interest, taxes, depreciation and amortization, EBITDA reflects earnings before these other expenses are considered. When a buyer purchases a practice, the tax structure and take-home income will be different from that of the seller. The fees paid in interest will be different based on purchase price and financing arranged for the practice purchased and, consequently, the amortization of the financed amount and depreciation accounted for in the purchaser’s financial statements will also be different from that of the seller.

Normalized cash flow involves adjusting revenues and expenses where they are inflated or underreported in such a way that reflects realistic expected cash flow in a given scenario such as in the sale of a dental practice. When EBITDA is used, and interest, taxes, depreciation and amortization expenses are removed, this is a “normalizing” adjustment. Normalized cash flow takes this a step further to adjust expenses beyond interest, taxes, depreciation, and amortization when this is required and deemed accurate. For example, removing automobile expenses or adjusting travel and continuing education fees in a financial statement of a dental corporation may be done to give a more accurate account of cash flow when a potential buyer is evaluating a particular practice for purchase. Adjustment of the financial statement in such a way can provide insight into true net revenue expected before financing costs, taxes and take-home income, and is accepted common practice in business valuation methodology (8).

As such, if a practice appraisal includes normalized cash flow to demonstrate how net revenue is affected with the assumption that the gross revenue of the practice and practice operating expenses remain consistent while adjusting for any explained outlying expenses, the net result gives a buyer and a lender sense of what earnings remain for repayment of practice loans and income.

To establish a value for a business, one known technique is using a multiple of EBITDA for that business (1,2,3). The concern we have with this is that a chosen multiple of EBITDA is subjective unless it can be validated by another measure that is neither subjective nor assumptive. A commonly referenced multiple of EBITDA used to guide the value of a business to a seller is 4.0X-6.0X EBITDA (1). But again, too commonly the idea of an EBITDA multiple is arrived at without rationale. The use of EBITDA alone, without the evaluation of normalized cash flow, can contribute to inflated valuations (2). As such, EBITDA alone is not enough to accurately assess value, but when combined with normalized cash flow, an appropriate multiple of EBITDA can be determined and justified with a more transparent argument. It may be said that if cash flow is the driver of business value, EBITDA is the co-pilot and normalized cash flow is the black box.

When it comes to practice value, begin with the end in mind

For the most part, dental practices all operate with the same general expense categories. Equipment, instruments, leaseholds and supplies should have a generally agreeable value. Dental practices have a significant proportion of value in their intangible generation of cash flow or “goodwill.” To answer the questions posed of why EBITDA may be useful as a practice value determinant, we present a comparison of the statement of operations of two different practices (Table 1). For the sake of this example, it can be assumed that the equipment, instruments, leaseholds and supplies on hand are of the similar value in both practices. For illustrative purposes, only one year of operations is presented in a simplified manner.

In the comparative example shown in Table 1, Dentist # 1 owns the property where the practice is located with no mortgage in a region with a relatively low dentist-to-population ratio. Dentist #2 rents in an urban centre; a more saturated marketplace and, as such spends more on advertising the practice. As well, the expenses of supplies and wages differ significantly between the practices. Comparison between the two practices shows a more efficient practice run by Dentist #1, with less operating cost and a subsequently larger net pre-tax cash flow. The normalized expenses are explained as follows:

1. Amortization has been removed in the normalized comparable, as the amortization expense of a new owner will differ from that of the present owner.
2. Equipment leases are removed in the normalized comparable. Depending on the arrangement at the time of practice sale, the lease may be paid out by the lessee with the value of the asset being included

in the practice valuation, or the seller may elect to transfer the lease depending on the structure of the sale. For the sake of this example, the lease is assumed to be the responsibility of the seller and paid out before the sale of the practice.

3. Interest and long-term debt are removed in the normalized comparable as the amounts of these will be different for a purchaser.
4. Meals, entertainment, continuing education, travel and vehicle expenses are removed in normalizing, as these are personal expenses that are written off through the practice.

In our example, the EBITDA for each practice gives an idea of the cash flow when we remove the costs of interest, taxes, depreciation and amortization. Essentially, EBITDA presents a normalized cash flow limited to the interest, taxes, depreciation and amortization. As such, a multiple of this number can, in theory, be used to guide practice value, but must be based on the rationale of affordability. Affordability of a given practice must consider what a reasonable take-home income is for a buyer given the current practice operations in order to justify the valuation. Therefore, applying a multiple of EBITDA against a given practice can only make sense if doing so results in a net pre-tax income that a buyer and lender would deem reasonable.


Put another way, when a value is applied to a given practice, the cost to a buyer in the form of annual costs of amortization, interest and taxes must be considered to justify the price paid. In our example, the more efficient practice can justify a higher practice valuation since the normalized cash flow available to finance the practice and take-home income is much greater than the less efficient practice.

If we assume the equipment, leaseholds and supplies on hand are comparable for these two practices, based on the operations of the practice, there is approximately \$174,450 in greater normalized cash flow for the more efficient practice compared to the less efficient practice (\$535,700 — \$361,250 = \$174,450). For a buyer and a lender, the more efficient practice example with higher normalized cash flow reflects better practice efficiency, more cash flow for practice financing at a higher practice value, and the ability to have a more significant take-home income with the same revenue generated.

Any multiple of EBITDA used against the examples above illustrates how different valuations can be if this approach is applied, but it is normalized cash flow that determines what multiple of EBITDA is justified as a purchase price for a practice. Valuating a practice and establishing an appropriate EBITDA multiple begs a practice appraiser to employ the wise words of Stephen Covey: “begin with the end in mind” (10). When justifying a

Table 1 — Comparative Statement of Operations

	Dentist #1: “Efficient” Practice		Dentist #2: “Less Efficient” Practice	
	ACTUAL	NORMALIZED	ACTUAL	NORMALIZED
REVENUE				
Prof. Fees	1,000,000	1,000,000	1,000,000	1,000,000
Lab Fees	70,000	70,000	70,000	70,000
Net Revenue	930,000	930,000	930,000	930,000
Expenses				
Advertising	500	500	20,000	20,000
Amortization ¹	15,000	0	75,000	0
Bad Debt	1,200	1,200	5,250	5,250
Equipment Lease ²	0	0	36,000	0
Insurance	3,500	3,500	7,000	7,000
Credit Card and Bank	6,000	6,000	6,000	6,000
Charges				
Interest and Long-Term Debt ³	500	0	12,000	0
Meals/Entertainment ⁴	0	0	5,000	0
Office Supplies	20,000	20,000	29,000	29,000
Rent + TMI	N/A	N/A	60,000	60,000
Prof. Dues	2,600	2,600	5,000	5,000
Prof. Fees	6,500	6,500	12,000	12,000
Property Taxes	8,000	8,000	6,500	6,500
Repairs/Maintenance	18,000	18,000	25,000	25,000
Dental Supplies	80,000	80,000	92,000	92,000
Telephone	8,000	8,000	8,000	8,000
Cont. Ed. ⁴	2,500	0	4,000	0
Travel ⁴	1,000	0	2,500	0
Utilities	5,000	5,000	8,000	8,000
Vehicle ⁴	6,000	0	15,000	0
Wages/Benefits	235,000	235,000	285,000	285,000
Total Expenses	419,300	394,300	718,250	568,750
EBITDA (Before Dr.’s Compensation)	526,200		298,750	
Net Pre-Tax Cash Flow — Actual vs. Normalized	510,700	535,700	211,750	361,250

value for a practice, the normalized, anticipated take-home income is what gives a practice its value. Adding back the costs of financing at a given purchase price, standard rates of financing and amortization will guide practice value and determine what “multiple of EBITDA” is appropriate in the sale of a given dental practice. Although the stutter of Porky Pig had remarkable wisdom, “EBITDA, EBITDA” is not quite all, folks. 

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