

Sean Robertson
BHSc DDS

Michael Griffith
BCom(Hons) MBA

What's the Magic Number?

More than a year-and-a-half after dentistry across the world was severely limited in scope due to the COVID-19 pandemic, the dental practice marketplace is demonstrating resilience and strength. While our profession continues to navigate the challenges of the pandemic and its implications for delivering dental care in a safe environment, the number of dentists in our province and country increases. In the June 2020 issue of *Ontario Dentist*, we wrote an article that reviewed some of the potential considerations of the pandemic's influence on practice values in Ontario (1). With practice sales continuing to be active since returning to practice and "pandemic proofing" our offices, this article is a followup based on our sales since late fall of 2020.

In the current climate, prospective purchasers are faced with higher lender scrutiny in their ability to qualify for financing. Those qualification considerations from major Canadian banks include cash equity, years of practice experience, previous practice ownership, and a solid business plan to support a proposed purchase price for a given practice. Different than prior to the pandemic, many lenders now require a buyer to provide proof of enough cash equity to support another shut-down, should this occur. Additionally, many banks require an income-to-debt service ratio of 1.25. This means that for every dollar of debt repayment, there needs to be \$1.25 in income. Historical practice performance, pandemic practice performance/recovery, capacity for treatment, and current versus historical cash flow analysis must also be reviewed for a lender to consider financing. When a qualified buyer does "check the boxes," financing can often be achieved favourably with interest rates as low as prime less 0.25 per cent and interest on only 12 to 24 months of ownership in a 12-year amortization. Many major

Canadian banks still offer premiums on appraised values when the buyer can support this, but different than the pre-COVID-19 marketplace, the financing of a premium is often at a reduced amortization period relative to the appraised value.

With internationally trained dentists continuing to enter the Canadian marketplace, two dental schools in Ontario, and many practice owners working longer in their careers, there will continue to be a saturation of buyers relative to sellers. A buyer's ability to bring skill to and find opportunity in a given practice contributes to the possibility of ownership. But, as with any business, there exists a ceiling of value for a buyer to realize a reasonable income after financing the purchase and for a lender to feel secure in the risk of the practice loan. The COVID-19 pandemic has highlighted the importance of cash reserves in our practices and personal savings, but it has also shown us that we are a stronger and more resilient profession than we might have thought.

At a recent practice showing, a prospective buyer asked our team the question, "So, what's the magic number?" Unsure of what she was referring to, we asked for clarification. She said, "I've been looking to buy a practice for a few years now. I'm ready to be an owner. The last few practices I have put an offer on, I've lost out because of competition. I'm asking you, what's the magic number to get this practice?"

As we are all well aware, money isn't everything; providing dental care to our population is about caring for people. We are in a goodwill-based service industry and when it comes to goodwill value, we would argue that our clinical skills are as important as our chairside manner and team leadership abilities. The high demand for practices has created a marketplace where, quite often, the ideal fit and transition can be achieved for a seller in

combination with a very strong and competitive financial outcome. In an age where data is hard to uncover and not openly shared in the dental practice marketplace, we wish to share some of our “magic numbers” on practice sales since late fall of 2020, and what they have taught us about the current selling prices of Ontario dental practices in the era of COVID-19.

The market dictates the value

As with any commodity or business of going concern, the availability and demand drive the value... to a point. That point or ceiling reflects that highest price proposed for a given buyer to be comfortable with the affordability and expectations of the return on the investment. In our opinion, a practice appraisal should reflect a comprehensive and accurate review of the practice, patients, clinical and financial operations, opportunities, shortfalls, and strengths. There are many methods to arrive at a practice's stated value, and one buyer's opinion of value will often differ from another's. Similarly, one lender's opinion of a practice's value with a particular buyer will differ from that lender's opinion of the same practice with a different buyer. This is because different dentists bring different strengths, levels of experience and confidence to a given practice. This is why pre-approvals are not granted with major Canadian banks for a given dental practice. Mortgage pre-approvals consider a buyer's income and expenses to support affordability. Dental practices require the owner to manage and operate their business in a way that guarantees the lender will be paid. How one buyer approaches practice ownership of a specific practice will always have some differences from another.

Regardless of what the appraised value states, the demand, opportunity, historical revenues and buyer qualification for lender support will determine the true market value upon sale. As such, we view the role of the dental broker as the forensic practice accountant, facilitator, educator and transition support team. It is not the broker's opinion that determines the value; it is the market's opinion. An appraiser's role is understanding the market, and educating sellers, buyers and lenders on the current trends. Beyond this, the role of the dental broker is in highlighting opportunities of a given practice, and connecting the right buyers with the right sellers to maximize the transference of goodwill in a transition. The fact is, practices that are “over-appraised” typically sell for less than appraised value. Practices that are “under-appraised” typically see multiple offers over appraised value. The most important aspect of the dental practice appraisal is that the information contained within it is accurate, transparent and reliable.

Transparency trumps magic

Many buyers we speak to will ask us, “What's the EBITDA multiple?” for a given practice listing. This is in reference to the multiple of earnings before interest, taxes, depreciation and amortization (EBITDA), which is common convention in business valuation methodology. We have written about EBITDA and its evidence (or lack thereof) in the dental practice valuation literature (2). Before answering this question, it is always important to understand the enigma of EBITDA. How EBITDA is calculated can be vastly different between valuers and assessors. Are cash flows normalized with non-recurring expenses removed before EBITDA is stated? Is EBITDA before doctor's compensation or after? Is EBITDA taken from pre-pandemic cash flows? Understanding how EBITDA is determined is an important calibration step before an accurate assessment of reasonability can be made. After years of analysis, our opinion remains that EBITDA multiples should reflect a combination of operating cash flow and market demand.

Another favourite question from both sellers and buyers is, “What is the practice value as a percentage of gross revenue?” Our brutally honest answer is always, “Who cares?” We know there are practices that are extremely efficient, and practices that are less efficient. It is absolutely common to see two practices with the exact same gross revenue and very different valuations, both well supported by the historical cash flow and opportunity.


“The magic number”

In appraisal methodology, the concept of “intended use” refers to how the business will be operated and the intentions of new owners. For example, in a dental practice an investor dentist or practice owned by a large corporation will operate with the associates providing care and the management team assuming the business operations. In this scenario, earnings are after dentist compensation. Alternatively, a hands-on owner-operator may elect to pay more for a given practice and accept that, after financing, the net pre-tax income is less than the common convention of 40 per cent of dental billings. This is not a recommendation, but an observation that reflects why some practices sell for higher prices when comparing owner-operator purchasers versus investor practices.

In discussion with commercial health care lenders at major Canadian banks, it turns out that our business's numbers are reflective of the general marketplace. Those “magic numbers” that reflect recent historical general dental practice sales are as follows.

For our business, the average sale price of a general dental practice in the Ontario marketplace between

September 2020 and August 2021 was 4.5 times EBTIDA before the principal doctor's compensation. This represents approximately \$25 million in vendor-accepted letters of intent during this time frame. Removing 40 per cent of earnings for the principal doctor's compensation, the EBITDA after compensation was 6.4. Our brokerage has received letters of intent to purchase practices for EBITDA multiples after doctor's compensation for as low as five to as high as 15 in the post COVID-19 marketplace. Removing the outliers, however, gives a sense of where averages are falling at present. Not surprisingly, higher EBITDA multiples correspond to much higher cash flow and opportunity, quite often with a "special interest" buyer (or those willing to pay a premium for a specific practice).

In this ever-changing and exhausting climate for our profession, let us acknowledge and celebrate the fact that our practices continue to carry strong value and that we can continue to provide safe patient care in the midst of a global pandemic. 

REFERENCES

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Dr. Sean Robertson is a licensed dentist and partner with The Dental Broker Team, a full-service dental-practice brokerage and appraisal firm. He can be reached at Sean@dentalbrokerteam.com.



Michael Griffith is a partner and broker of record with The Dental Broker team. He assists dentists in the purchase and sale of dental practices. He can be reached at Michael@DentalBrokerTeam.com.

AD
Gardiner Roberts