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Winds of Change: How Valuation Methods Respond to a Dynamic Practice Environment

If "beauty is in the eye of the beholder," it might also be said that "value is the view of the vendor, in agreement with the spender and with the support of the lender." In this regard, the current climate provides a stress test for valuation methodology. The COVID-19 pandemic temporarily changed our profession's ability to practice and, at present, how we practice.

For a business to be appraised as a going concern requires that it will continue to operate into the future. For most, if not all practices in Ontario, 2020 has been a year where a quarter of the revenue was nearly eliminated, and at least half of the year's revenue was reduced. The assessment of fair market value requires an appraiser to evaluate market conditions comprehensively without fixating on one-time events (1). However, valuation of assets and a business are time sensitive (1). Depreciation of assets over time, trends and changes in practice financials and operations are considerations of value that are time dependent.

Despite these considerations, price paid and appraisal value are not synonymous terms. A purchaser's emotions can circumvent analysis and facts. The capacity for negotiation can be different between a vendor (or vendor's agent) and a purchaser (or purchaser's agent). When it comes to dental practices, tangible assets and leasehold improvements are easily valued based on their initial value, depreciation, and comparable commodities. But when external variables influence change in the marketplace, the way the intangible values are established requires capacity to reflect these influences in a way that communicates changes in value.

For example, dentists typically receive favourable lending structures from the major Canadian banks (both personally and professionally). In the case of a practice purchase in Ontario, dentists can often qualify for 10-year financing (or longer) at the appraised value or greater, with zero down at the prime interest rate. If this structure required a 20 per cent down payment from a purchaser, or greater security from the purchaser to reduce lender risk, the marketplace would yield fewer qualified purchasers. Similarly, if interest rates were double or triple their current value, practice cash flow would theoretically require relatively lower valuations to support comparable income levels.

In the authors' opinion, profession-specific valuation methods that can weather the changing tides in our provision of care and economy create legitimacy in the unregulated world of dental practice brokerage. In light of the state of change that we are experiencing in our profession and our economy, how should dental practice appraisal methodology respond in a way that accurately and transparently justifies practice value?

The perfect storm

A true perfect storm is said to involve a combination of meteorological factors that occur simultaneously to create a severe weather event. The COVID-19 pandemic and response to the pandemic have far-reaching implications of public-health measures, economic fallout and provision of health care that will be analyzed for years to come. This perfect storm has created ripple effects inducing waves of change in patient behavior, practice equipment considerations, access to personal protective equipment, and overall practice function. This was the first time in our lifetime that biology dictated the economy on a scale of this magnitude (2). This has required our profession to pivot and change course during a time when the costs of providing dentistry and creating access to care for patients was arguably already a challenge.

In biology and immunology, it has been said that the risk of acquiring an infectious disease equals the dose (of the disease) plus the time (of exposure) (2). The authors argue the extrapolation of this idea to practice values is also true when we look at lender risk and the financing of a practice. The risk taken on by a lender is equal to the effect on revenue (resultant from regulatory changes to the provision of dentistry) plus the length of the time over which the changes are in effect.

For example, a practice being completely shut down with no revenue for a period of two months may carry little risk if the practice responds with the ability to return to the same level of production after a shut-down. However, a practice being shut down for a period of two months and returning at a capacity of 50 per cent of the original production for six months, with increased costs to providing care, holds greater risk for a lender if pre-COVID-19 values are considered.

Put another way, risk is indirectly proportional to value. The lower the risk, the greater the demand, the higher the value. During a time when lenders are exercising greater caution and requiring more security against loans, values need to be accurate in order to bring as many buyers to the table as possible. The authors are aware of two major Canadian banks that presently consider vendor take-back financing as part of the purchase agreement on certain listings since the pandemic; something not every seller wishes to agree to. An appraisal that is met with the bank's agreement gives the seller the opportunity for the highest number of interested buyers and the most successful outcome.

Whether it is openly discussed or not, forecasting when historical revenues and cash flows may (if ever) return for a given practice is the current challenge for an appraiser (and a lender). Not all valuation formulas are created equal for dental practice analysis in an unstable climate. As such, we argue that those formulas that cannot transparently communicate value have the potential to be in greater disagreement with the intended audience (buyers and lenders).

The float plan

In chemistry, biology and pharmacology, it is a mechanism of action. Pilots call it a flight plan. Boaters call it a float plan. Regardless, how one gets from point A to point B requires step-by-step communication. In terms of valuation, the methods that determine value are the justified means that communicate between the parties involved in a practice sale (brokers, buyers, lenders and sellers). Many different mathematical and accounting models exist in the brokerage industry to state value for a given business. Without an attempt to objectively apply a model to a business, the appraisal is merely an opinion of value without a justified mechanism of valuation. The authors argue that if we can't explain how a mechanism causes an action or how a method responds to external changes that influence value without manipulating the measurement tool, then the validity of the tool has poor credibility.

Examining some commonly used accounting formulas in practice appraisals begs the question of how these models work in the current climate of establishing value. The Discounted Cash Flow (DCF) approach values a business based on placing a present-day value on the future cash flow expected to be generated (3). This model is based on two modifiable opinion-based drivers. One of these drivers is a projection of cash flow and the other is the discount rate, which is the rate of return in the marketplace for investments of similar risk (3). Both of these variables are readily manipulated, open to bias and when combined in a complex mathematical formula, create the potential for inconsistency. On top of this, considering our current challenge of practice cash-flow projections, we argue that the DCF model is highly subjective.

Models where forecasts of growth and potential for future earnings are subject to the same considerations as in the DCF model. Accurate projections require minimizing assumptions and variables. Our reality in dentistry is that we have some time before our return to pre-COVID-19 cash-flow practice predictability returns.

Weighted average approaches apply a multiplier or factor against the average of gross income and cash earnings to state a value for practice goodwill. The multiplier is determined based on the opinion of the appraiser and, despite the use of this method for decades, there is no known validity or rationale for its use in chartered business valuation principles (1). This model remains highly subjective, non-transparent, and open to manipulation.

Comparative sales approaches use hand-selected practices sold in the same brokerage as a comparison to justify appraised value. Data on practices sold is not shared amongst brokerages. As such, little transparency exists and those selected for comparison are at the discretion of the appraiser only. Vast differences may exist between the function of compared practices, making them less similar than they are presented to be. Again, in the current environment, which offers no comparison in our profession's lifetime, reliance on this method suggests comparison of practices in different eras of practice.

In a time where our profession is asking how we provide care to maximize patient and staff safety through evidence-based principles, it would seem logical to extrapolate this thinking to how we value practices. A model of valuation that can provide a "reader-friendly" rationale that is transparent and used by lenders to establish affordability, and has the capacity to respond to the environment we are in, may have the capacity to weather this and any future storm.

We're going to need a bigger boat

The goal in a practice appraisal should be maximizing value while attaining accuracy with the purpose of achieving lender acceptance. To do this, valuators must strive to minimize assumptions. For lenders and purchasers, trends in historical cash flow give the most important indication of overall practice health. An understanding of the rate of return to historical revenues is important to analyze as practices resume non-essential care. The increased cost of providing care through heightened infection-control measures and financing costs impact the cash flow of a given practice.

What kind of model has the capacity to respond to all of these external variables that are influencing change in our practice function, take-home income, and values? Moreover, what kind of accounting model can showcase a practice's capacity to respond to and recover from the challenges our profession has faced with as few assumptions as possible? What models might lenders use to evaluate risk when financing a practice purchase? We would argue that normalizing cash flow provides this insight and does so with simplicity. A normalized cash flow (NCF) statement transparently states where expenses are inflated, underreported or affected by one-time events. Different than other models reviewed here, a valuator's NCF statement permits adjustment for a buyer or lender to create a cash flow scenario of affordability if there's disagreement. To our knowledge, few dentists and lenders rely on complex accounting models to determine affordability but nearly all of us have the capacity to quickly understand how expenses affect revenue. Simplicity supports understanding and justification of value whether economic times are good or bad. And while understanding does not always result in agreement, it is more likely to do so than when there is confusion.

Cash flow statements for a dental practice are specific. Revenues reflect volume of patient care. Expenses reflect the relative costs of providing that care during times of consistency and during times of change. Appraisers can readily generate these statements at any given time using practice software in comparison with annual financial statements to yield justifications of value that lenders and buyers can understand without a master's degree in finance. At the end of the day, in a sellers' market, it is the financing structure offered by lenders that drives that market forward. Of course we need buyers, sellers and brokers, but lenders write the cheque. Accuracy, transparency and the capacity to adapt to a changing environment are paramount if we are to achieve lender agreement in practice valuations. And successful valuations, much like successful changes to practice post-COVID-19, can only truly have all of our interests in mind if we work together to develop methods that facilitate understanding and serve the intentions of all involved. Change is inevitable. Appraisal methodology should be built on the expectation of change and not the hope of riding a wave. OD

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