Your Step by Step Guide to Calculating Your Practice's Value Using the Exact Same Method Most DSO's Use

EVERYTHING DSO

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Every dentist has an abiding curiosity about the value of their practice, and most are completely perplexed by knowing how to calculate that value. Until now. In these pages I will show you step by step how to do those calculations yourself using virtually the same methodology that most DSO's use. How can I be sure? Simple... because I have either done it myself or seen it done by others countless times as I worked with dentists as they affiliated their practices with three different DSO's (with whom I was employed).

Once you master and understand the underlying concepts it is actually fairly easy. I understand you may not want to take the time to learn and do it yourself. If that's the case, I will do it for you simply as a reward for visiting my website. Just shoot me a quick email to stan@ everythingdso.com and I will tell you what information I will need to get it done.

Why is knowing the value of your practice important? Because knowledge is power and who doesn't want to be more powerful?

That last comment was a little "tongue in cheek". The real reason is that as the DSO phenomenon continues its march consolidating the profession and it will serve you well to understand how you and your practice might fit into the DSO universe.

As you begin to consider a potential sale of your practice – no matter the reason – it will be helpful for you to understand your practice's value to a DSO buyer. This guide is intended to help you do that.

If I can answer any questions for you as you digest the information provided please don't hesitate to contact me at the email address above.

I hope you find the content useful – if you have any thoughts on how I can make it more so I would be thrilled to receive your opinions. Fair warning... I may not take your advice, but please know that I am happy to have it!

Sincerely,

Stan Kinder

Understanding the Concept of EBITDA

EBITDA is an acronym that stand for Earnings before Interest, Taxes, Depreciation, and Amortization and is commonly used by the financial and investment community as a measure of a business' free cash flow on a pre-tax basis.

EBITDA allows analysts to focus on the outcome of operating decisions while excluding the impacts of non-operating decisions like interest expenses (a financing decision), tax rates (a governmental decision), or large non-cash items like depreciation and amortization (an accounting decision).

By minimizing the non-operating effects that are unique to each company, EBITDA allows investors to focus on operating profitability as a singular measure of performance. Such analysis is particularly important when comparing similar companies across a single industry, or companies operating in different tax brackets.

Private Equity funds universally use EBITDA to evaluate the companies they invest in and given the vast majority of DSO's are backed by private equity the methodology rolls downhill and most DSO's use EBITDA to value practices.

Valuation analysts use adjusted EBITDA to arrive at a more accurate assessment of a practice's operating performance. What does this mean – adjusted EBITDA?

Standardizing EBITDA by removing anomalies means the resulting adjusted or normalized EBITDA is more accurately and easily comparable to the EBITDA of other companies, and to the EBITDA of a company's industry as a whole.

KEY TAKEAWAYS

- The adjusted EBITDA measurement removes non-recurring, irregular and one-time items that may distort EBITDA.
- Adjusted EBITDA provides valuation analysts with a normalized metric to make comparisons more meaningful across a variety of companies in the same industry.

Adjustments to EBITDA are simply steps to make the number and any resulting conclusions more accurate. Don't worry... I will show you how to manage the adjustment process and share some real world examples so that you fully understand.

As you go through the exercise with your own practice, if you have any questions, by all means please contact me or if you would like me to review your work, I am happy to do so.

Understanding the Concept of Multiple – the Other Half of the DSO Valuation Story

Adjusted EBITDA gives an accurate measure of a practice's operational results and an assessment of the expected pre-tax free cash flow. But this is only half the story and not sufficient by itself to determine practice value. Generally, buyers of businesses, and in this case, your dental practice, are prepared to pay a multiple of adjusted EBITDA. Multiples are often expressed as a number and times or a number and x, thus a five times multiple is expressed as 5x. This means that the buyer is willing to pay five times the adjusted EBITDA in purchase price, or at a minimum, to ascribe that figure as the enterprise value of your practice.

Depending on deal structure, the buyer may not be paying all of the enterprise value in cash. Perhaps they will be buying a fractional interest with you retaining some interest yourself post transaction, or perhaps they ask you to hold a seller note for some portion of the purchase. The important thing to remember is that the term enterprise value refers to the total value of your practice – and I will teach you how to calculate it in this guide, Actual offers for your practice from DSO's will have variable deal structures in their proposals. The structures will play an important role in determining how the purchase consideration will flow to you.

Back to the concept of multiple. Multiples vary across industries based on profitability, performance in recessionary climates, need for CAPEX investment, and countless other factors. The average multiple across all industries is 3x. Fortunately, for dental it is higher. Individual practices have been acquired for the most part for multiples ranging from 4 to 6x – sometimes lower and in rare instances higher.

There are a number of factors that influence where a particular practice falls in the prevailing range for dentistry. The first is scale, the larger the practice and the higher the adjusted EBITDA then usually, the higher the multiple. Another factor is whether or not there is an expected requirement for capital investment; how old is the equipment, will the facility need to be renovated/upgraded. The greater the investment required the lower the multiple. Other factors may relate to expectations around margin improvement and growth. If the DSO believes they have a clear line of sight to EBITDA improvement then they will be more likely to pay a higher multiple.

Every transaction is a balancing act between perceptions around value and perceptions around risk. The logic is straightforward – higher perceived value results in a higher multiple and the higher the perceived risk results in a lower multiple.

Examples of issues that drive perceptions of risk include a high concentration of Medicaid patients. Government reimbursement can change with the stroke of a pen plus there have been many examples of Medicaid fraud within the profession and most DSO's would rather not deal with it. Other examples of risk factors may include the recent departure of a high producing associate or problems with regulatory compliance or quality of care issues. It is easy to see how a buyer would be influenced by these concerns.

The schedule below gives you a rough idea how a DSO thinks about multiples.

ADJUSTED EBITDA RANGE	MULTIPLE RANGE
$250K - $400K	4x-5x
$500K - $700K	5x-7x
$800K - $1,000K+	6x-8x
$5,000,000+	8x-10x

Multiples are influenced by the competitive landscape as well as broad changes in the macro environment. For example, with the impact of the recent pandemic multiples have declined modestly and many DSO's are putting a portion of the purchase price into an earnout to insure that future performance measures up to the historical – this is simply a way for the

Step 1 – Calculating Unadjusted EBITDA

You will use either a Profit and Loss statement or your most recent tax return for the purposes of this calculation, both can work equally well. You will use one or the other and avoid mixing numbers from different sources as you complete your calculations. When a DSO performs this analysis, they prefer to use what is commonly referred to as either a LTM or TTM P&L. This simply means the trailing twelve months (TTM) or the last twelve months (LTM) – these are the same thing. Using LTM numbers gives the analyst the most current snapshot of your practice's financial performance and this is the best predictor of near term, future performance.

E – Earnings

For this number you will simply enter the bottom line net income number from the P&L or tax return. I will give you an example at the end of this section.

B – Before

This simply means that the earnings number is before the following line items, interest expense, taxes (income), depreciation, and amortization are added back to earnings to give you your EBITDA number.

I – Interest

If your practice had any interest expense in the P&L, or in the tax return if you are using thar you will enter that number as a positive value. If no interest expense has been recorded then enter zero.

T – Taxes

This refers to any income taxes paid – it does not refer to payroll taxes or any personal property taxes. given that most dental practices are pass through entities this is usually zero.

D – Depreciation

If there is a depreciation expense recorded then you will enter it as a positive value. For example, if there was $25,000 of depreciation expense then you will enter $25,000 here. If there is no depreciation recorded, simply enter zero.

A – Amortization

If there is amortization expense recorded in the P&L then you will enter it as a positive value. If there is no amortization expense recorded then enter zero. It is not uncommon that depreciation and amortization are not calculated until your tax accountant does the tax return for the practice. If that is the case it is not a problem because having the expense for these recorded and hen added back is the same as not having recorded them in the first place.

The final step is to sum the total of all of your entries, and you will have completed the calculation of your unadjusted EBITDA. It is really quite simple.

Here is a quick example.

$423,000	Earnings (net income)
$23,421	Interest
0	Taxes
$12,346	Depreciation
0	Amortization
$458,767	Unadjusted EBITDA

I think you will agree, this part is easy.

Step 2 – Calculating Adjustments to EBITDA

This can be a little more complex. The primary purpose is to make the EBITDA conclusion more accurate by accounting for anomalies in the numbers that skew the results. Examples of some of the most common adjustments include expenses that accrue to the personal benefit of the practice owner that will be non-recurring in the future such as auto expense, meals and entertainment, and travel among others.

Another common adjustment is to normalize the earnings of the seller post transaction to the terms specified in the employment agreement. The best way to do that is to add back any salary paid in the TTM period and then create a negative adjustment for the salary that would have been paid in the future based on the collections in the TTM period. You can see how this works in the example below.

Adjustments can be either positive or negative in value – a positive adjustment adds back any expense that will be non-recurring going forward and a negative adjustment subtracts any expense that represents an increase over and above what was recorded in the TTM P&L.

Think about adjustments as a series of pluses and minuses that will make the EBITDA number more accurate as a projection for the next 12 months.

A you go through your P&L you should examine every line item and ask yourself if this expense will be the same next year assuming the collections remain constant and in the alternative, will this expense go away in a partnership with the DSO.

This sounds daunting but it really isn't. And as always, if you would like my help with this, just shoot me a quick email to stan@everythingdso.com.

I have included below an actual analysis for a particular practice.

Revenue	$	1,956,929.00	
Earnings	$	820,726.00	
Interest	$	-	
Taxes (income)	$	-	
Depreciation	$	-	
Amortization	$	-	
Preliminary Unadjusted EBITDA	$	820,726.00	
Adjustments			
Total Dr. Comp Actually Paid	$	366,911.00	Includes owners and associate
Total Employer FICA Paid	$	27,738.47	Calculate at 7.65% of Dr. wages
Charitable Contributions	$	12,544.00	Non-recurring
Legal	$	2,183.00	Non-recurring
Business Meals	$	10,284.00	Non-recurring
travel	$	1,495.00	Non-recurring
Gifts	$	3,000.00	Non-recurring portion
Dr. Comp to be paid	$	(460,949.61)	Based on total Dr. collections of 1,396,817 @33%
Employer FICA to be paid	$	(35,262.65)	Calculated at 7.65% of Dr. wages
Less 30% of labs	$	39,749.82	Added back as a reduction to DR. comp
Adjusted EBITDA	$	788,419.04	

In this example I added back the comp paid and then created a negative adjustment for the comp going forward and eliminated (by adding back) a series of non-recurring expenses. The net effect of all of these changes was to reduce the EBITDA from the P&L of $820,726 to $788,419. This is derived by totaling the Unadjusted EBITDA with all of the adjustments to resulting in a final Adjusted EBITDA figure.

One other adjustment that most DSO's will make is that they will adjust for the change in costs of moving from your benefit plans to their benefit plans. These adjustments are DSO specific and impossible for you to know in advance. Don't worry... the purpose of this exercise is to give you a reasonably accurate ballpark estimate of your practice's value to a DSO buyer. The final, most precise number will be the product of the DSO's own internal analysis.

The Final Step – Plugging in the Multiple

You have arrived at a calculation of the adjusted EBITDA for your practice – now you need to select the multiple. Repeated below is the schedule of EBITDA ranges and the corresponding multiple ranges reflecting current DSO thinking. My recommendation is that you find the multiple range that fits your adjusted EBITDA number and select a multiple in the middle of the range – this will give a reasonably accurate value for your practice in today's world.

ADJUSTED EBITDA RANGE	MULTIPLE RANGE
$250K - $400K	4x-5x
$500K - $700K	5x-7x
$800K - $1,000K+	6x-8x
$5,000,000+	8x-10x

For example, if you have adjusted EBITDA of $525,000, select a 6x multiple (the middle of the range) and you arrive at an enterprise value of $3,150,000 for your practice.

There you have it -you have just calculated the value of your practice using the same method that DSO's use.

Again, if you need my hep or would like me to review your calculation just shoot me an email at stan@everythingdso.com. I will be happy to help.

Understanding the Difference in Traditional Approaches to Practice Valuation and the DSO Approach

Let's start by understanding how banks value practices in the event of a dentist to dentist sale. This is the other option available to dentist selling a practice – if you are not transacting with a DSO then you are selling to another dentist – these are the only buyers in the marketplace. There are no other alternatives.

In today's environment banks are generally willing to loan 60 to 80% of topline revenue of the target practice to a creditworthy borrower. If you were to examine practice sales to dentist buyers over the last twenty years you would find that the vast majority fell within this 60-80% of revenue range. There are occasional exceptions that exceed this range, but they are few and far between.

Factors that influence where in the range a practice might fall include profitability, trend (growing or shrinking), need for capital investment, fee levels, and new patient volume.

Practice appraisers' valuations independent of valuation methodology used almost always resulted in values that fell within this range. Why? Because that is the most that a dental buyer could borrow to fund the purchase. The limiting factor historically has been the limits on available bank financing.

If you are selling to another dentist, it is highly unlikely that it will be for more than 80% of your topline revenue. This ceiling is driven by the artificial, but very real, limit of available debt from a bank.

The ultimate driver of practice-value in a doctor-to-doctor sale is: how much a bank will loan.

The ultimate driver of practice value in a DSO transaction, has nothing to do with what a bank will loan. DSOs don't need banks; they have virtually unlimited capital to buy good practices and are incentivized to do so. Their imperative is to drive investment returns. More on that in a minute.

The private equity investors in DSO's look at the acquisition of a dental practice in the same way that they look at buying a manufacturing business, or a distribution business, or any business for that matter – as an ongoing enterprise.

The valuation approach used by private equity is a **Multiple–of–Profit Valuation Model**, and profit is measured as adjusted EBITDA. EBITDA is an accounting term for earnings before interest, taxes, depreciation, and amortization and is a measure of free cash flow that a business generates. DSO buyers will pay a multiple of that number when affiliating with a practice.

An important fact – the higher the adjusted EBITDA the larger the multiple that a DSO is willing to pay. Your bottom line matters greatly.

This valuation approach not uncommonly results in values equivalent to 100 to as much as 150% of topline revenue.

I have been directly involved in several transactions that resulted in enterprise values of 150% of topline revenue.

In one instance it meant an additional $2.2 million in purchase value above the 80% of topline figure. In another case it resulted in $9.8 million of additional value above the 80% of topline number (this was a multi-location group practice).

Those examples are not hypothetical but actual transactions.

Oh so you have just finished reading this report and you are probably thinking "Stan, what do I do next". If you are serious about looking at the option for your practice, I am offering a no cost, no obligation Free Practice Evaluation (valued at $2,500). Just click here to schedule your appointment or go to www.everythingdso.com/talk and set up a time.

During our time together, I will, with COMPLETE CONFIDENTIALITY:

1. Determine the value of your practice
2. Discuss your goals
3. Structure the kind of offer you would like to receive
4. Match DSO buyers with your desired terms
5. Help you present the offer
6. Negotiate price and an employment agreement
7. Navigate pitfalls... and more

I only have a few FREE slots open, so make sure you schedule your FREE evaluation (a $2,500 value!) while it's on your mind. I look forward to helping you achieve . . .

Sincerely,

Stan Kinder

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