

Dental corporatisation - A corporate's perspective

By Dr Ray Khouri

Since the purchase of our first dental practice in October 2007 Dental Corporation has now completed the acquisition of 32 practices, has a further 17 dental practices under agreement and is actively in discussions and due diligence with many new practices about joining our group.

The 49 dental practices settled and under agreement represent annualised revenue in excess of \$105 million and forecast practice earnings under our operational structure in excess of \$28 million per annum.

Over the past 5 years there has been growing discussion and debate within the dental community in regard to the benefits (or otherwise) of corporatisation and the impact that it will have in the longer term.

We believe that the benefits for both practices and dentists who participate in a corporate model are significant and that these will flow to the industry as a whole as one or a number of consolidators achieve a scale increasing the investment in their business and the growth of the industry.

These benefits include:

1. Increased values for dental practices;
2. Improved and streamlined administrative functions allowing dentists and practice staff more time to focus on patient care;
3. Improved training and professional development for dentists and support staff;
4. Expanded career paths for young dentists;
5. Defined succession planning; and
6. Removing isolation and creation of camaraderie and a support network.

We also recognise that not all dentists will join a corporate group and the "private" industry will continue as a vibrant

and compelling choice for both dentists and patients alike. In the end, we do not believe that corporates will dominate the industry but would expect that over the next five to ten years up to 30% of practices will join a corporate group.

What is our approach and plans?

Dental Corporation is focused on acquiring top end dental practices with gross revenue over \$1 million which are run by practice principals (the previous owner) who are highly experienced and who are considered leaders in the field. These practices are well run with a good depth of management in support staff and have a consistent and growing patient flow.

Dental Corporation's business model is to maintain the autonomy of the dental practices and practice principals with us assisting in the administration of the practices through financial reporting and management, payroll and accounts payable, purchasing and material sourcing, and assisting the practices where requested in IT, HR and marketing. No Dental Corporation practices are changing brands and the practice principals in all instances retain control of the day to day management of their practice.

The Dental Corporation structure is in effect a partnership of like-minded dentists and all practitioners joining Dental Corporation receive a percentage (normally between 20% and 25%) of their purchase consideration in Dental Corporation shares. The ongoing interests of our founders, financial shareholders and dentists are aligned through their common share ownership.

Dental Corporation's primary intention is to build the best dental business in Australasia focusing on delivering the highest quality clinical services in the most efficient and patient friendly manner. If we achieve this then our other business goals will be delivered.

In the next 12 to 24 months we plan to undertake an Initial Public Offering (IPO) on the Australian Securities Exchange (ASX) as a means to provide the platform for our continued growth and allow all our investors and practitioners to share in the past and future success of the company.

Over time, and that time is not too far away, our practice principles will be the largest group of shareholders in Dental Corporation. The Dental Corporation infrastructure has been established to support our dental practices as they are the ones who provide the revenue and profits - head office is there to make the life of our dentists easier allowing them more time to see patients or for personal pursuits.

So why join Dental Corporation?

The first and most obvious answer is financial. As we value dental practices as on-going businesses the value we attribute to the practice is much higher than that traditionally applied to dental practices.

Our standard valuation normally equates to a value of between \$0.75 and \$1.25 for each dollar of gross annual revenue. Our valuation is based on a multiple of maintainable profits and the end outcome will vary depending on asset values, billing rates, costs and practice efficiency. Some prices have exceeded \$1.25 for each dollar of gross revenue.

Between 20% and 25% of the purchase price is paid in Dental Corporation shares with the balance paid in cash. All consideration is paid at the time of settlement and there is no deferred or performance component to the purchase price.

These values are substantially above prices traditionally paid for dental practices and we can do this as we value the practices using normal business methodologies and offer a longer term commitment from the vendor dentist than was normally available - this model is not necessarily suitable for dentists wanting a short term exit but can provide a long term succession plan.

All our vendor dentists must enter into a 5 year service agreement with Dental Corporation under which they continue to have full responsibility for the day to day management and clinical operation of the practice. In our service agreements the dentist has the automatic right to extend his tenure on expiry for another term and it is our desire to retain and reward all our principal dentists for many years to come.

Under the service agreement dentists are also rewarded for their direct patient income and the performance of the practice as a whole. These rewards come in two ways:

- A commission based payment (dental draw) generally between 40% and 45% of the principal's direct net patient billings. This is paid monthly.
- A profit incentive representing 40% of the increase in annual profits of the practice above the purchase level which is paid yearly.

We have a totally hands off management model and the dentist remains in control of the day to day management of their practice including purchasing, fee schedules, hours of work, staff selection and pay rates.

Given this independent management model we have incorporated into our service agreement a shortfall penalty whereby if the profit of the dental practice falls on a yearly basis from the level on which the purchase was struck the practice principal must make up that shortfall out of his/her dental draw payments in the following year. The shortfall penalty has been accepted by our practice principals as a natural commercial counterpoint to the operational freedom they enjoy.

Why the dental industry?

The dental industry represents an attractive market for consolidation given the following:

- It is a large growing market with in excess of \$4 billion in annual revenue;
- It has an attractive economic structure with high gross margins and strong cash flows; and
- It is highly fragmented allowing a consolidated business to deliver value to participants beyond financial benefits alone.

The dental industry is one of the few industries today that has had very limited consolidation. Many other professional industries such as medical doctors, accountants, radiologists, etc have had industry consolidation - some successfully and some not so successfully. Unfortunately some industry commentators only focus on the negatives and not the positives!

We believe that success or failure of individual consolidation within those industries can be attributed to two issues - the structure under which the consolidation was undertaken and the management undertaking the consolidation.

As with any business, if the consolidation is poorly managed or fails to retain the day to day management expertise and to provide an ongoing incentive to the vendors then it is doomed to failure.

We are sure that dentists when talking to Dental Corporation or others like us will assess the business model and management before agreeing to join and should get independent advice from their lawyers and accountants.

There are also a number of inefficiencies in the current dental industry which we believe consolidation can address:

- While the average age of our practice principals is only 48, over time Dental Corporation will need a pool of qualified and well trained young dentists to assume day-to-day management from our practice principals as they wind back their involvement and/or retire. Career opportunities for young dentists are presently limited with a lack of on the job training and mentoring available. Under our business model younger dentists can participate in training and mentoring program under the guidance of our practice principals who can

become involved in the program without the responsibility to take on and keep busy a new graduate on a full time basis. We are establishing a dental advisory group headed by a number of Dental Corporation practitioners to oversee this training and development program and the company as a whole has committed both financial and people resources to establish this program.

- Paper work and back office complexity has grown significantly in recent years. One of the common frustrations among many dentists is the time taken to oversee the financial operations of their dental practice. Under the Dental Corporation model all financial functions from payment of staff and suppliers to rents and equipment purchases is undertaken by the central management team with the dentist receiving monthly profit reports and analysis for their own practice. It is our experience that this has freed up a significant amount of time for our principals which can then be used for personal or business pursuits.

- The day to day operations of the dental practice can be insular and contact with fellow professionals outside one's practice can be limited. Joining a larger group provides the opportunity for the practitioner to be part of a growing business with a group of dentists who all share a common goal through their shareholding. Already, we have had a high level of interaction between our dentists including visits to each others practices to assess how they operate and what works and doesn't work.

Our model is all about growth, not cost cutting, and the Dental Corporation ideal is to work with our principals to grow their business rather than find ways to reduce costs. This also works in their own long term interest as it broadens the base of practitioners within the practice and provides for long term succession planning.

Dental Corporation has focused its efforts in building a group of highly experienced and well regarded dentists as the foundation for our business. This then assists in attracting new practitioners and also provides us with the skill base to undertake our training and mentoring program.

The common theme amongst all our dentists is that they enjoy being dentists and that they have grown their business through hard work, skill and sound business principals. Why should these dentists not be provided with a financial reward for having built this business?

Succession planning in all small businesses is a significant issue and in dentistry was one that was traditionally hard to solve. One of the imbalances in the industry is the current price being paid by associates and external dentists to take over what are successful and highly profitable operations.

Under the Dental Corporation model the principals who built the businesses are rewarded while the associate dentists wanting to move into practice management are identified and recognised, receive share options in Dental Corporation and are provided with a management and development program to give them the skills to take over the dental practices when the principal dentist wants to wind back his/her involvement. This program includes the associate dentist taking over the profit share arrangement put in place for the original practice principal under which they can earn an ongoing share of the increased profits of the practice over time.

The independence of the practitioner and all dentists working for us is enshrined in our legal contracts and the Board and man-

agement recognise that we can not run (nor do we want to run) dental practices any better than the person on the ground. As mentioned earlier this is a partnership model where we see benefits for both sides in joining one group as common shareholders in a business. While our model is about growth already we are seeing significant synergies being available in terms of savings in purchasing of supplies, insurances, telecommunications and other costs.

Do things need to change?

The most common comment we hear about the future of consolidation is about us coming in at a later date and changing the operations of the practices we have acquired.

Why would we do this?

We are only acquiring successful well managed businesses and fully recognise that the creation of those dental practices is due to the principals and their support staff. We believe our value-add come from the support we can provide in the areas previously mentioned rather than becoming involved in the day-to-day operation of the practice. Any savings made through our scale are shared with the practice principals through their profit share.

That is the primary difference between what we are doing and what has been done in the past in this and other industries.

What is our motivation?

The founders of Dental Corporation have invested significant time and in fact their own money into this business and like our dentists are focused on the growth in the overall value of the company.

We believe that this growth will come from assisting and rewarding our principals and their associates and staff to grow their dental practices rather than micro managing or cost cutting.

To date we have raised in excess \$20 million in equity of which approximately 20% has been provided directly by the founders and directors. The interests of the directors are therefore firmly aligned with our financial and dentist shareholders.

While it is our intention to achieve an IPO in the next 2 years we are under no pressure to do so and will only move to a listing when market conditions are conducive. We, as a business, are well funded and can continue to grow as a private business indefinitely. As in anything, economies and markets go up and down but Dental Corporation's aim is to build a long term sustainable operation that will continue to provide alternatives to successful dentists for many years to come in regards to how they run and operate their dental practices.

About the author

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