

Chapter 8

SELLING TO OR WORKING FOR A DENTAL SERVICE MANAGEMENT ORGANIZATION — THE ECONOMICS AND THE FUTURE

Some doctors did well in the dental service management company ("DMSC") market through initial public offerings. Others did not and, in fact, may be or have been placed in a position to reacquire their practice. It is also possible that the DMSC which purchased your practice may want out of the business if its acquired practices have not performed well. This also results in your reacquiring your practice, and possibly some or all of the debt which the DMSC incurred relating to your practice, e.g., a relocation and new equipment in a large facility. The "unwinding" or the working relationship and sale to the DMSC are difficult issues which should be discussed and negotiated prior to the working relationship and sale. Notwithstanding the success or failure of the DMSC, you also want to be paid for the practice you just sold.

The DMSC business is a difficult one in that there are often insufficient profits to pay both the required management fee to the DMSC and pay the doctor for his or her practice and for professional services rendered on a continuing basis. And if the DMSC does not deliver on the management services and systems promised, profits will not sufficiently improve to meet the economic obligations.

A typical DMSC model may be as follows. Twenty to twenty-five percent of the purchase price is paid in cash, while the remainder is paid in promissory notes not personally guaranteed by the DMSC owners, and the initial public offering. Management fees are often twenty percent and are payable to the DMSC through a multiple year management contract entered into with the acquired practice. The DMSC usually acquires the assets of the practice it purchases, irrespective of the tax consequences to the seller if the seller practices as a C corporation, and not its capital stock. Thereafter, the practice incorporates or retains its corporate status, whereby the seller is the shareholder(s) of the newly formed or existing professional corporation, which enters into the management agreement with the DMSC.

Notwithstanding the risk of not being paid for the practice to the extent that you are not paid in cash, a significant reason why typical DMSC models have failed may be due to the difficulty in payment of the management fees to the DMSC. Often, the management fees are twenty percent of practice collections, not owner profit or compensation in all forms. You are fortunate if your profit or owner compensation is forty percent. In the following example, assume that practice collections are \$400,000.00, profit/owner compensation in all forms is forty percent and DMSC management fees are twenty percent of collections.

<u>Category</u>	<u>Amount</u>
1. Collections:	\$ 400,000.00
2. Profit Percentage:	<u> x 40%</u>
3. Owner Compensation without Management Fees:	\$ 160,000.00
4. Collections:	\$ 400,000.00

5.	20% Management Fees:	<u> x 20%</u>
6.	Subtotal — Management Fees:	\$ 80,000.00
7.	Collections:	\$ 400,000.00
8.	Less: Management Fees:	<u><\$ 80,000.00></u>
9.	Collections, less Management Fees ("Adjusted Collections"):	\$ 320,000.00
10.	Adjusted Collections:	\$ 320,000.00
11.	Profit Percentage:	<u> x 40%</u>
12.	Revised Owner Compensation after Payment of Management Fees:	\$ 128,000.00
13.	Owner Compensation, without Management Fees:	\$ 160,000.00
14.	Less, Revised Owner Compensation with Management Fees:	<u><\$ 128,000.00></u>
15.	Reduction in Owner Compensation Without Practice Growth:	\$ 32,000.00

Increase in Collections Necessary to Account for Management Fees:

1.	Collections:	\$ 400,000.00
2.	Calculation to Cover Management Fees of 20%:	<u> ÷ .8</u>
3.	Increased Collections to Cover Management Fees of 20%:	\$ 500,000.00
4.	20% Management Fees:	<u> x 20%</u>
5.	Management Fees:	\$ 100,000.00
6.	Increased Collections:	\$ 500,000.00
7.	Less, Management Fees:	<u><\$ 100,000.00></u>
8.	Collections After Payment of Management Fees:	\$ 400,000.00
9.	Profit Percentage:	<u> x 40%</u>
10.	Compensation to Former Owner:	\$ 160,000.00

The above illustrates that with management fees of 20%, collections of \$400,000.00 and profit of 40%, a \$100,000.00 increase in collections is required for you to earn the same compensation with payment of the management fees than you would earn as practice owner prior to the DMSC sale.

This analysis does not consider facility relocation, expansion, additional equipment or staff costs. Those additional costs can be quantified in the same manner as described above to determine the additional collections necessary to earn the same compensation.

To illustrate the above further, please note the following:

1.	Owner Compensation with Payment of Management Fees and No Increase in Collections:	\$ 128,000.00
2.	Divided by Collections without Collection Increase to Cover Payment of Management Fees:	÷ \$ 400,000.00
3.	Revised Profit Percentage:	= 32%

4.	Owner Compensation with Payment of Management Fees and Increase in Collections to Cover Management Fees With No Reduction in Compensation Amount:	\$ 160,000.00
5.	Divided by Collection Increase to Cover Payment of Management Fees:	÷ \$ 500,000.00
6.	Revised Profit Percentage:	32%
7.	Profit Without Payment of Management Fees:	40%
8.	Less, Payment of Management Fees of 20%:	<20%>
9.	Revised Profit Percentage:	<32%>

In the example above, the problem is the revised profit percentage due to the required payment of management fees.

If you desire to earn \$200,000.00 in the above example the calculation would be as follows:

1.	Desired Compensation:	\$ 200,000.00
2.	Divided by Revised Profit Percentage:	<u>÷ 32%</u>
3.	Required Collections for Former Practice Owner to Earn \$200,000.00:	\$ 625,000.00
4.	Less, Management Fees of 20%:	<u>x 20%</u>
5.	Management Fees:	\$ 125,000.00
6.	Required Collections for Former Practice Owner to Earn \$200,000.00:	\$ 625,000.00
7.	Less, Management Fees:	<\$ 125,000.00>
8.	Collections After Payment of Management Fees:	\$ 500,000.00
9.	Profit Percentage:	<u>x 40%</u>
10.	Desired Compensation:	\$ 200,000.00

Stated Differently

1.	Required Collections for Former Practice Owner to Earn \$200,000.00:	\$ 625,000.00
2.	Revised Profit Percentage:	<u>x 32%</u>
3.	Desired Compensation:	\$ 200,000.00

In this example with management fees of 20%, you would not earn 40%, but 32%. Therefore, a small percentage reduction in profit has a tremendous impact upon the addition of collections needed to earn the same compensation. The bottom line? If you spend money on any expenditure, in this case management fees and selling your practice to the DMSC, you need a return on investment for the expenditure or it should not be made. So, if the management services do not correlate to the management fees paid, your relationship with the DMSC probably will not be long-term, you will probably not be paid for your practice and you will not be too happy with your new employer.

What about these tremendous savings in dental supply costs touted by DMSC's? As a former dental equipment and supply person of 17 years, the calculations could be as follows.

Using the same example as above, let's assume a 20% savings over what you can negotiate as the practice owner from the dental equipment and supply dealer.

Let's say your practice prior to the sale of the DMSC had supply costs of 6% of collections. Note that 6% of collections is a relatively low percentage of practice collections and represents negotiated discounts of probably 15% to 20% off retail prices. Traditionally, dental supply dealer margins had been 40% or maybe higher with the recent supply company mergers. Nevertheless, it is unrealistic to think that a DMSC can save your former practice an additional 20% discount over and above 6% of collections. Dental equipment and supply company margins are not sufficient to accomplish such ends. But let's say this happens and we run the numbers.

1.	Collections:	\$ 400,000.00
2.	Dental Supply Cost Percentage Prior to the DMSC Acquisition:	<u> x 6%</u>
3.	Dental Supply Costs Prior to the DMSC Acquisition:	\$ 24,000.00
4.	20% Dental Supply Cost Savings Percentage:	<u> x 20%</u>
5.	Dental Supply Cost Savings:	< <u>\$ 4,800.00</u> >
6.	Total Dental Supply Cost with 20% Savings, Items 3 less 5, Above:	\$ 19,200.00
7.	Total Supply Costs With 20% Savings, Divided by Collections:	<u>\$ 19,200.00</u> \$ 400,000.00
8.	Revised Supply Costs as a Percentage of Collections:	4.8%
9.	Additional Compensation to Former Owner:	\$ 4,800.00

Does a \$4,800.00 increase in compensation cover a 20% management fee of \$80,000.00? Probably not if you need to collect an additional \$100,000.00 to earn the same compensation.

Management fees of 20%, or 15% or 22% are simply too high, particularly if the DMSC does not provide the management services promised. Alternatively, the DMSC's which do provide the management services promised are probably doing fine. If you sell your practice to the DMSC and the management services are not what you anticipated, what can you do? Very little as you have sold your practice and you are now an employee of a new employer. In essence, you are stuck with an undesirable "partner."

To make matters worse, the DMSC practice location occupied by the former owner may relocate, expand the facility and/or make significant capital expenditures. Thereafter, if the DMSC sale unwinds, somebody is stuck with the cost of the relocation and/or expansion. This means that the former practice owner will be required to work with the creditors and lending institutions of the DMSC in order to release liens on the practice assets. This will probably be complex, time consuming and expensive.

Unfortunately, the DMSC typically does not want to discuss unwinding the transaction when it is entered into. The idea is, if you are going into the transaction with the DMSC and you have to think about your exit strategy, why enter the transaction? However, not having the unwinding provisions in effect up-front creates a lot of confusion if the transaction does not work out at a later date. Unwinding the transaction with a DMSC is truly a matter of negotiation and depends upon the reason(s) for the unwinding, e.g., lack of profitability, insufficient capital, state or federal regulatory violations or bankruptcy of the DMSC. However, the more precise the initial documents relative to the unwinding provisions, the better off you are.

Perhaps in the future, we won't see DMSC's attempting initial public offerings. I predict, however, that the dental profession will continue to see non-doctors operating dental practices.