Determining PRACTICE VALUE

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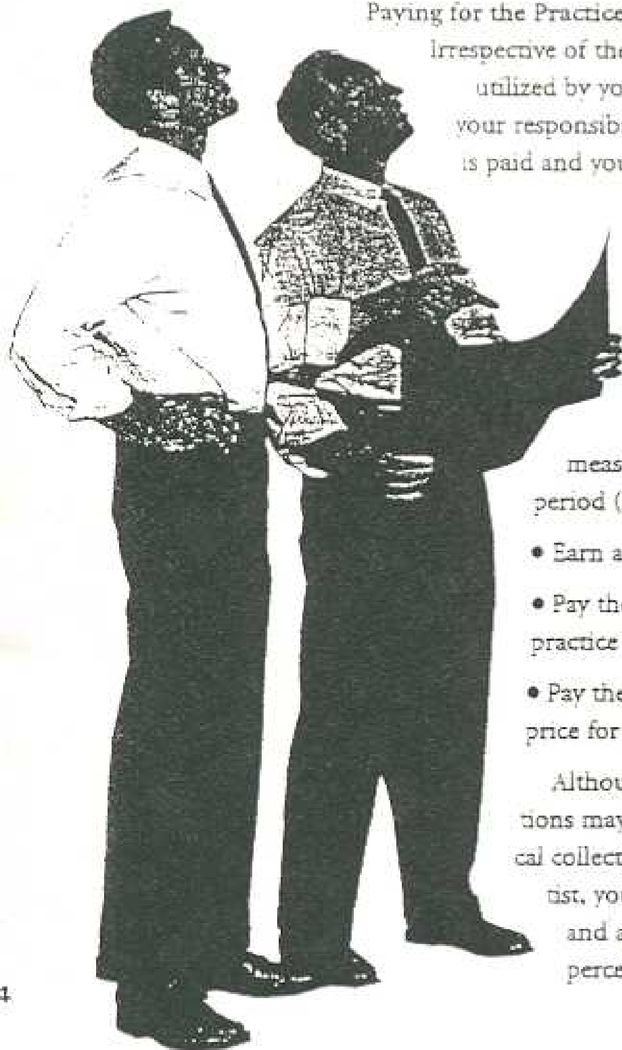
This article is not intended to provide specific legal advice. For solutions to legal matters, consult your legal counsel.

Purchasing a dental practice can seem overwhelming. Not only are you making a critical move as far as your career and practice are concerned, but it is a financial investment that carries important ramifications for your future's security. Therefore, many significant steps are taken before an actual purchase takes place, one of which is the valuation of a practice.

The purpose of a dental practice valuation is to determine its fair market value. As a purchaser, it is important for you to know that appropriate methods are being utilized to determine the fair market value of the practice being acquired.



Paying for the Practice Within a Reasonable Time

Irrespective of the practice valuation method utilized by you and/or the seller, it is your responsibility to ensure that the seller is paid and you can meet your obligations within a reasonable time period. This means that you must project the annual collections of the acquired practice with you as its owner and do the following within a measured or predetermined time period (e.g. five years):

- Earn a reasonable living
- Pay the operating expenses in the practice which you will incur
- Pay the lender(s) the purchase price for the acquired practice

Although your projected collections may be identical to the historical collection rate of the selling dentist, you should assess, calculate and attempt to determine the percentage of the seller's patient or referral base which will remain with the practice after its sale. Additionally, it is critical to review all patient charts and records prior to the acquisition taking place.

A reasonable time period to pay the lender(s) for a practice would be five years. This time period measures the degree of risk in the operation of a dental practice as an investment and provides for a capitalization rate of twenty percent.[1,2] The lower the capitalization rate, the higher the value of the practice and vice-versa.

The compensation (reasonable living) which you should earn while paying for a practice should be slightly less than that which you would be earning as an associate dentist (e.g. twenty-five percent of production as a general dentist; thirty percent of production as a specialist).[3]

Annual Operating Expenses

To determine the annual practice operating expenses you will incur, add the selling owner's compensation in all forms (including, but not limited to, retirement plan contributions and fringe benefits to the owner), as well as interest, depreciation and one-time expense.[4] Subtract this sum from the annual collections of the practice. The remaining sum will be your estimated, annual operating expenses.

From your projected compensation, you must pay the lender(s) for the acquired practice. Often, practice valuations do not consider that the purchaser pays for the acquired practice in after-tax dollars—as opposed to pre-tax dollars. Remember, if you cannot earn a reasonable living while paying for a practice, the acquisition should not proceed. To the extent that you anticipate initial equipment purchases, leasehold improvement costs, relocation or other capital expenditures of any nature, such expenditures would reduce the available cash flow (owner's compensation) to you to earn a reasonable living and pay for the practice simultaneously. Therefore, to the extent that these expenditures would reduce your cash flow, the fair market value of the practice would be correspondingly reduced.

Other Considerations in the Fair Market Value

Additionally, to the extent that the seller would continue to render services in the acquired practice (except to assist in its transfer), such renderance of professional services by the seller should also be considered in the valuation process. However, in a shared solo-facility or multiple owner arrangement, the existing practice owner would continue to render professional services in the practice and the valuation process would account for such multi-doctor/owner arrangements.

Generally, you would not purchase the accounts receivable of the practice being sold. This is because you would typically be borrowing *cash* to pay for *cash* that you may or may not receive, depending on the historical collection rate of the practice. Alternatively, where an associate buys into an ongoing professional corporation, the associate is acquiring an interest in accounts receivable, unless such value is considered separately in addition to the acquisition price.

Also, when determining practice value, *the production associated with managed care* should be considered. In short, the intangible goodwill value of the practice being valued would be reduced by the percentage that the managed care revenues relate to the total practice revenues.[5,6]

Joint Ownership

With regards to valuing a practice for purposes of joint ownership arrangements and associate buy-ins, the valuation process should be approached as if 100 percent of the practice were being acquired. Thereafter, the actual percentage of the practice being sold and acquired would be considered. For example, if the fair market value of a multiple owner practice was $630,000 and the acquiring dentist was purchasing a one-third interest in the practice, the fair market value would be $210,000. However, the fair market value may be further reduced by some amount to reflect the purchase of a minority interest, as the purchasing dentist/specialist, as best, would retain a one-third voice in the operation and control of the practice.

Furthermore, the fair market value may further be reduced to account for a lack of marketability, in that the new owner's interest may be restricted by the operating agreements of the practice and it is more difficult to sell a partial interest to a third-party dentist/specialist than it is to sell a 100 percent interest.

High Revenue Producing Practices

High revenue practices tend to be more difficult to sell than average sized practices. This is because it generally takes two or more purchasers to produce the revenues that one or more high revenue producing dentists can generate. To the extent that two or more compatible dentists/specialists are needed to acquire a high revenue producing practice, it is more difficult to find such a combination of compatible talent in the pool of potential purchasers than it is to locate one dentist/specialist. For this reason, a *lack of marketability* discount is sometimes applied to high revenue producing practices.

So remember, when acquiring a practice it is important to assess and determine a practice's fair market value based on a number of varied criteria, each critical in its own right. In addition, consider whether or not the practice can be paid for in a reasonable amount of time and take into account all operating expenses. Acquiring a practice should be a conscious step taken with all the necessary precautions.

1. *Successful Valuation of a Dental Practice*, Dental Practice Library, American Dental Association, 1993, p. 23
2. *Business Legal & Tax Planning for the Dental Practice*, Pennwell Publishing, 1994, William P. Prescott, E.M.B.A., J.D., p. 244
3. *Associates, Partners & Appraisals*, Pride Institute, 1.9, 2.9, 1992
4. *Associates, Partners & Appraisals*, Pride Institute, 1.7, 2.9, 1992
5. *Journal of the California Dental Association*, June, 1995, The Law and Managed Care Plans, William P. Prescott, E.M.B.A., J.D., p. 37
6. *Journal of the California Dental Association*, June, 1995, Impact on Practice Appraisal, Patty Moyer, p. 55

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