

## Why rules of thumb don't work

Dental Economics JULY 98

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### Practice Transitions

#### Why rules of thumb don't work

One-half gross production or net income plus equipment -- what an easy way to value your practice! If only either was accurate. However, as an owner/doctor knows, a practice can never be summarized so simplistically.

Aside from a home, in many cases, the dental practice is the most significant asset a doctor owns. By placing a value on a practice based on a simple rule of thumb, the owner/doctor runs the risk of either overvaluing or undervaluing the practice. A quality practice is made up of many complex elements. All of these components should be taken into consideration when valuing a practice.

We often are asked what we, as professional practice appraisers, look at when we value a practice. One of the elements that must be evaluated is the practice's tangible assets. It is easy enough for a doctor to get a value for equipment, leasehold improvements, or supplies from either the appraiser or his/her equipment/supply company. The intangibles in a practice, however, are difficult to value. Such factors include location, telephone numbers, parking, accessibility from major streets, quality of patient base, quality of staff, organization of office systems, number of competing dentists in the area, fee schedule, financial arrangements, size and appearance of the office and building -- to name a few. These factors, combined with many others, make up the "goodwill" (the intangibles value, blue sky, economic going concern) value of a practice.

In the past, a common rule of thumb was to value the practice at an amount equal to six months of average production. The problems with this formula arise when you start comparing two very different practices that are producing similar monthly production:

The rule of thumb formula described above would not take any of these factors or differences into consideration, but would look only at the average monthly production. Each factor adds to or detracts from the value of the practice and should be evaluated. A formula based solely on monthly production would value "Practice B" greater than "Practice A," even though it is obvious that "Practice A" is a higher quality practice.

Fifteen to 20 years ago, valuation of professional practices was characterized by less science and more art. What little valuation that was done was derived primarily from rules of thumb published in various professional journals, and was generally performed by representatives from dental-supply companies.

#### Practice A

-

\$23,500 average monthly production

-

New, updated equipment

-

5 operatories: 4 equipped, 1 for hygiene

-

1,800 sq. ft. w/one operatory used for storage

-

Located in medical/dental complex in suburbs

-

100% private/insured

-

Rent \$1.50/sq. ft.

-

3 years left on lease with a 5-year option

-

Stable staff; no turnover in last 24 months

-

Computerized front and back office

-

Excellent referral base -- 15-20 new patients/mo.

-

40% adjusted net income

Practice B

-

\$24,300 average monthly production

-

Older equipment, with minimal updates

-

3 fully equipped operatories

-

1,400 sq. ft., fully utilized

-

Located in downtown medical/dental building

-

70% private/insured; 30% capitation

-

Rent \$2.95/sq. ft.

-

1 year left on lease with no option to renew

-

High staff turnover

-

Pegboard office systems

-

25-30 new patients/mo. (50% are capitation)

-

30% adjusted net income

Over the years, dentistry has changed dramatically. Payment systems through third-party carriers, Independent Provider Organizations, and Preferred Provider Organizations have affected dental practices in terms of fees, size of practices, the necessity for accepting assignment, completion and complexity of insurance forms, and endless other operational burdens. Marketing techniques, internal and otherwise, are the order of the day. The cost of opening a basic office with minimum equipment and leasehold improvements has escalated significantly.

Just as the ability of new practitioners to easily open their own offices has disappeared in most areas, simplistic rules of thumb in valuation technology no longer are considered valid. Few would disagree with the fact that it takes much more than "gross receipts" to make a quality practice. Therefore, to value the practice using "gross receipts" as the only criterium of that value doesn't make good business sense.

Likewise, "net income plus equipment" appears on the surface to be straightforward, but in reality, poses several obstacles in the valuation process. The biggest difficulty lies in making the proper adjustment to the net income for personal discretionary expenses that most owner/doctors expense through their business, but that actually are personal expenses.

The above examples illustrate how a mere "rule of thumb" can provide an inaccurate value for a practice when information is not adequately analyzed and proper adjustments are not taken into consideration.

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