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The upside in invisible DSO equity

Chip Fichtner

IF YOU HAVE NOT BEEN CONTACTED DIRECTLY by a dental support organization (DSO), don't worry, you will be shortly. We believe DSOs are growing at a 15% rate, as they consolidate the dental industry throughout the US via acquisitions and massive hiring of new dental school graduates. You will either join one or compete with many in the coming years. Guaranteed.

The word *transition* is often used in the dental industry to describe a doctor's exit plan. We believe that one of the best options for doctors is to partner with an invisible dental support organization (IDSO). When partnering with an IDSO, there is certainly an exit option, but it is not normally in the near future. It may be five, 10, 20, or 30 years distant. The future exit may entail gains for the doctor far in excess of the current practice value today if the right "silent partner" IDSO is chosen.

In the last six months, we have completed multiple transactions with IDSOs for doctors under the age of 40, over the age of 70, and everywhere in between. Frankly, the younger doctors achieve higher values. The IDSO business model is to silently invest in practices in which the doctor remains as an owner, operating his or her practice under the doctor's brand, team, and strategy for many years.

In a typical IDSO transaction, the doctor sells anywhere from 60% to 90% of the practice for cash now, but retains equity ownership of 10% to 40% in the practice, in the new IDSO partner, or a combination of both. The equity type retained depends on the doctor's goals and the transaction structure offered by the various IDSOs. Each transaction is custom, and equity of any type has varying levels of risks and rewards.

Younger doctors often retain higher levels of equity with the goal of increasing practice value over the ensuing years or decades with the silent partner's resources and assistance. In many cases, the retained minority equity position will be far more valuable in the future than if the doctor had kept 100% of the practice. A high-level of ordinary income is wonderful, but the potential to also build true long-term wealth at favorable tax rates is enticing. Many doctors with the right IDSO partners have made millions of dollars more than the initial value of their practices upon exit due to their equity ownership.

Younger doctors see an IDSO partnership as a mechanism to secure their financial futures with some cash now, but with the big upside long-term gains from retained parent equity. There are numerous examples over the last 10 years of doctors making three times, five times, and even 15 times the value of their retained equity when the parent has sold or recapitalized.

Older doctors see an IDSO transaction as a first step to a transition while continuing to operate their practices under their brands for three or more years. With an IDSO partner, a doctor of any age can have a known exit at a locked-in value in the future when a transaction is structured correctly.

If you believe practice values have peaked, now is a good time to lock in today's value

This article is the fifth in a continuing series by Chip Fichtner on invisible DSOs. Previous articles may be found on dentaleconomics.com. Search "invisible DSOs."

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levels for a future exit. If you believe that practice values will continue to rise, there is potentially more value in ownership of a larger, diversified group than in your practice directly. Older doctors still have the potential gains in the equity, but may have a shorter horizon in which to monetize the equity.

The upside equity gain potential for IDSOs, and thus for the doctors who join them, is fairly simple to understand. They attempt to create enterprise value with two basic strategies: growth through practice enhancement or acquisitions. Let's take a closer look at both of these strategies.

IDSO GROWTH THROUGH PRACTICE ENHANCEMENT

The IDSO business model is to acquire interests in growing practices that can benefit from the IDSO resources to accelerate internal growth and profitability under the doctor's leadership and brand. These resources may include lower product and team benefit costs, payer negotiation leverage, marketing expertise, and synergies with other local partner practices. A well-managed IDSO can even increase margins and send a doctor new patients.

IDSO GROWTH THROUGH ACQUISITIONS

While some branded DSOs grow primarily through new-office starts, most are creating rapid growth through acquisitions.

From a business valuation standpoint, bigger is better. A practice with $500,000 in operating income (EBITDA) may be worth five times EBITDA, but a group of practices with $100,000,000 in EBITDA will have a value of 12 times to 14 times in today's deal-hungry, private-equity financed DSO world. The arbitrage opportunity is obvious: buy at five times and sell at 14 times. The result is a significant value increase for the investors in your IDSO partner and for the doctors who take part of their purchase consideration in equity.

The key for doctors to successfully capitalize on their retained equity is choosing the right IDSO partner who can execute both internal practice improvement and acquisitions effectively. Not all can. The transaction structure you elect is critical. You can pick the right IDSO but not benefit due to a poorly structured initial transaction.

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CHOOSE WISELY AND CREATE BIDDING CONTESTS

There are dozens of IDSOs across the US that have been acquiring practices for decades and have returned billions to their investors, including the acquired doctors. On the other end of the spectrum, new IDSOs are being formed every couple of weeks with the same basic goals: buy, build, get big, and sell. It seems simple, but the dental landscape is littered with groups that thought this was easy. It is not. There are specific risks and rewards to be aware of in each IDSO, whether established or new.

In the process of choosing your IDSO partner, you will want to be exposed to many and hopefully create multiple quality and eager suitors.

MARRIAGE—NOT JUST A TRANSACTION

A partnership with an IDSO is more like a marriage than a one-time transaction. You will be living with each other for years. IDSO partners expect you to continue to run your great practice for at least five years, typically, and prefer that you stay until you die. While IDSOs can provide extensive resources, they are counting on you to continue as the leader of the practice. Unlike the branded DSOs, they are not in the business of micromanaging you, your practice, or your team. The owner doctor is critical to the overall strategy, and your associates will have a path to ownership to ensure continuity in the future.

In summary, an IDSO partnership is not appropriate for all doctors, but in many cases it can provide an opportunity to create long-term wealth that is far in excess of your practice value today. Doctors should at least understand the IDSO option. Those considering this path are wise to choose an advisor with knowledge of the current IDSO landscape as it will pay to "date" many prior to contemplating marriage! DE

CHIP FICHTNER is the founder of Large Practice Sales, which specializes in invisible DSO transactions for large practices of all specialties. The company has completed more than $100 million in transactions in the last six months. Learn more at largepracticesales.com.

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