Five Steps in Practice Transitions

How you can avoid the common pitfalls in each

By Chris Bentson

If you are a practice owner, the chances are very high that you will experience the transition of adding a new doctor, either for partnership or buyout, at least once in your practice's lifetime. Some of you will buy and sell multiple practices or add multiple partners, but most of you will go through the process of transition just once. As a singular event, it is not one in which you can rely on past experience. Additionally, most practice owners deal with a transition as the sun is setting on a long and successful career, so that the issues tied to the process are often new and can be emotional—issues such as retirement, timing, and wondering, "Do I have enough money saved," "Did I pick the right successor," and "What will I do now?" This article will explain five common steps in the transition process and discuss some of the pitfalls I've seen occur during each of the steps.

Step 1) Gathering Information

How long it takes: 2 to 3 years prior to a planned transition

How it works: Learning about the mechanics of the transition process is a good starting point. As you consider the idea of transitioning a new doctor into your practice, be it for partnership or a buyout, understanding how these transactions occur; the math; the tax effects; the time and money involved; who to ask for help; the role of your spouse, CPA, and attorney; what to do with the real estate; when to tell the staff, patients, and referring parties; how to find a doctor; what to pay a new doctor; and changes to the physical plant are all common concerns that doctor/owners will have.

Typically, orthodontists first gather information from colleagues who have "been there, done that." This is not a bad place to start, but a better place to start is usually with your spouse and the people who help you manage your money. Why? Because they will likely have the most influence on when a transition will occur. I like the spouse to be "all-in," as the saying goes, on the process. Likewise, you will need the wise counsel of your wealth management person(s) to help you define when you are financially able to make a transition, based on your expected future lifestyle expenses. So, the place to start is usually with the people who will tell you when a transition is able to occur.

Common next stops on the information-gathering tour include speaking to colleagues who have already gone through the process, gathering literature written on the topic, meeting and discussing the process with the companies that specialize in the area of practice transition, and attending seminars and webinars on the topic. The AAO hosts a full-day annual transition conference the day before the official opening of each Annual Session. You can also call the AAO office and ask for a list of transition companies, which it is happy to provide.

Pitfalls: An opinion of one is generally not a good idea. Talk with enough colleagues, read enough literature, attend and meet transition specialists at enough meetings, and examine enough testimonials to allow for an informed decision of how the process works and who you want to work with on your transition.

Not starting early enough is the other major pitfall in this phase. Gathering information on the process several years in advance of an expected transition is a "best practice" approach. Knowledge of the process and trust in who you are dealing with will help minimize the emotional ups and downs common to the transition process.

Step 2) Practice Valuation

How long it takes: Allow 90 days

How it works: If you're selling your car "by-owner" you at least get a quote from the Kelley Blue Book. When selling your home, an appraisal is always required prior to the transaction. When selling your practice, a valuation is performed so that the recent financial and operational results of the practice can be accurately reviewed by a potential new doctor. As you might expect, there are a number of options of "who to use," and the degree of detail and expense involved varies widely. To help you through the decision process, here are some questions to ask regarding how to choose a valuation company:

- Have they done this before? How many? For how many years?
- What data is required?
- What valuation methodology is used? Why is it used?
- Do they visit my practice?
- How long does the process take?
- Can they provide me with data on industry norms?
- How much will it cost?

In general terms, most orthodontic practice valuations will look back at the last 3 years of practice performance as well as the partial year at the time the valuation takes place. Discretionary expenses will be examined and, ultimately, the true operating overhead of the practice will be determined. This will leave the valuator with the current income stream from which a valuation determination will be made, usually by an accepted accounting methodology using a profit multiplier or capitalization rate.

The valuator will seek to determine present patient flow (how any new patient exams, starts, etc) and then examine the systems in the practice. Are patients paying on time? How many active patients are there? How many of those have a zero balance? What is the recall system? Most valuations will also include a discussion of the tangible assets, supplies on hand, local demographics, competitive environment, and referring patterns.

Lastly, the physical plant will be discussed, along with an appropriate lease rate or purchase price.

Pitfalls: To ensure that a thorough review has been done and is accurately portrayed to a potential candidate for partnership or purchase, the valuation needs to avoid the following things:

• Relying solely on a few industry rules of thumb (for example, multiples of production, collections or net profit, or ratios of contracts receivable). These can be right if the practice is within industry norms, but can be off materially if certain aspects of the practice have not been examined. A valuation must thoroughly analyze all data.

• Skipping the site visit. Would you list your house with an agent who had never walked through it? More to the point, would you spend hundreds of thousands of dollars on a business you've never visited? Likely not, and in my experience much more is learned on the site visit than can be determined by just looking at the numbers.

• Ignoring trends. Just looking at this year's performance is risky for a buyer. If the practice is up or down from previous years, it is important to understand why. You can count on lenders examining near-term annual trends as part of the underwriting process.

Step 3) Finding a Partner or Buyer

How long it takes: 1 day to several years

How it works: It's worth noting that sometimes this step happens before Step 2 (you've found the buyer and then get the practice valued), but orthodontists seeking to find and attract a partner or buyer have usually decided to transition, have gone through Steps 1 and 2, and are now ready to discuss the potential transaction with a candidate.

The good news for those seeking a buyer is that, at the moment, there are more young orthodontists looking to buy than there are opportunities. As of December 2011, the AAO Practice Opportunities Service listed 464 doctors looking for opportunities, and 143 opportunities available. This ratio of approximately 3:1 seekers to opportunities coincides with Bentson Clark & Copple LLC's market observations, and I believe it accurately represents the current environment.

Residents tend to gravitate to coastal states and states with high population densities. So if you are located in

a rural or more landlocked area of the United States, it can take more time to find a candidate. Other avenues for finding a candidate are alumni associations, transition companies, AAO annual and component regional meetings, and vendor representatives.

Pitfalls: Confidentiality is crucial in the transition process. The last thing you want is for patients or referrers learning of your plans before you tell them. Make sure a nondisclosure agreement is in place with all potential candidates. Be careful whom you share information with: Orthodontics is an amazingly tight network, and you need to stay in control of who learns about your planned transition and when.

Another pitfall is getting down the road with a candidate who can't complete the transaction. Beware of candidates who don't have the right credentials for licensure, haven't discussed the transaction with a spouse who won't agree to the area, can't get money from a lender, or can't exit their current work situation on your time frame.

Step 4) Transition Negotiations

How long it takes: Allow 60 to 90 days

How it works: This is where the rubber really meets the road. You've identified the candidate; they have seen the valuation and visited the practice. You want to move forward. You have likely discussed the transaction at a high level, and you are now delivering the terms of the proposed transaction to your candidate. The terms are typically delivered in a document called a "terms sheet" or "letter-of-intent." This is usually a five- to seven-page document that outlines the asset allocation of the purchase price (for tax purposes), association periods and compensation for both doctors before and after closing, remedies for breach, noncompetes or liquidated damages, how retreatment issues will be addressed, real-estate matters, financing terms, and certain representations and warranties by both buyer and seller. This document will be the road map for the attorney to draft legal, definitive documents. Typically, a cash-flow pro-forma is presented in conjunction with the terms so that both parties have a financial illustration of how the transaction relates to their expected income over a period of years.

Some back and forth is common in this stage as the details of the transaction are agreed upon. I suggest having knowledgeable representation in this phase for both parties. Some firms are successful with the idea of representing both parties, but as a general rule, both parties should seek separate counsel, as there are definite financial conflicts on almost each deal point in a transaction.

Pitfalls: A "my way or the highway" attitude: getting everything you want in a transaction of this size would be nice, but likely not practical. The fairest spot or win-win most commonly occurs with both sides feeling a similar degree of discomfort.

On the other hand, giving too many scenarios or too many different ideas of how to get to agreement often confuses one or both parties to the point of not being able to make a decision. Paralysis by analysis can happen on both sides of the transaction. Careful is good, but if you miss seeing the forest for the trees, the transaction can die, and an opportunity for both buyer and seller could be missed.

Step 5) Ownership Transfer

How long it takes: 2 to 4 weeks, followed by a closing

How it works: After Steps 1 to 4 are complete, an attorney will draft the legal documents that allow the ownership transfer to take place. With all the hard work it takes to get to this point, you would think a big closing with lots of fanfare would be in order. However, done properly, this phase is nothing more than the signing of the papers, often without an attorney or notary in sight. Both parties can feel a bit "underwhelmed," but the real work for the new owner now begins in earnest.

At the closing, assets or stock are transferred from one owner or corporation to another. Personal goodwill is often purchased as part of the transaction. Employees are often simultaneously dismissed and rehired under a new owner's corporation. Both buyer and seller enter into noncompetes. Names on stationery, doors, and signs are likely to change, if they haven't already. If it has been properly planned, however, the ownership transfer will seem like just another day to patients, employees, and referrers.

Pitfalls: Don't let the attorneys renegotiate the agreed-upon transaction—this gets expensive for both parties.

Use an attorney who understands the transaction. Experience is a great teacher, and paying for experience is often less expensive than paying someone to get experience.

These steps can be rearranged and altered to some degree, but each of the steps will occur in almost every planned orthodontic transition. The general descriptions of each step are not inclusive of all the matters at hand, but are meant to give an idea of what is involved and serve as a planning tool. It is usually true that selling doctors work harder preparing for and going through a transition than they have in the years preceding a transition. Often, I find that they are reenergized as a new doctor enters the practice. Transition really is about change, and, in most cases, is inevitable. Proper planning and understanding the steps in the process will help every doctor prepare for a successful transition. **OP**

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