Understanding Your Valuation

dentalelite

DISTINCTLY DENTAL, DISTINCTLY DIFFERENT

Science or an Art?

How do valuers place a value on your dental practice? A set formula? A % of Turnover? Or a multiple of EBITDA? Why so much mystery in the formulation of a valuation?

In fact valuing a dental business is a more thought-provoking process than one might assume. Pre the 2006 NHS Contract and the relaxation of the Dentists Act 1985, demand was far more limited than the present market. The NHS contract change installed a scarcity value in NHS contracts, and everybody wanted to own a dental practice as competition was now heavily restricted. One of a business owners principal concerns was now removed. Entrepreneurial Dentists quickly realised this as did a number of organisations outside of dentistry and by August 2007 practice values had doubled if not tripled!

With the introduction of business-focused stakeholders into the profession and a more concerned credit team in lending banks the computations behind goodwill valuations were required to have more logic and quickly the secret that dental practices could actually be really profitable and could be acquired really cheaply was no longer so. The backs of fag packets were no longer fit for purpose!. The example below should demonstrate why using percentages of turnover as a method of calculation was plainly ill-conceived.

Practice	A	Practice	B
Turnover	£500,000	**Turnover**	£500,000
FPI	£100,000	FPI	£100,000
NHS Contract	£400,000	NHS Contract	£400,000
(UDAs)	20,000	(UDAS)	14,000
Associate Fees	(£250,000)	Associate Fees	(£190,000)
Staffing Costs	£70,000	Staffing Costs	£50,000
Rent	£30,000	Rent	£30,000
Materials and Labs	£70,000	Materials and labs	£50,000
Other Costs	£40,000	Other Costs	£30,000
EBITDA	£40,000	**EBITDA**	£150,000

For the illustrations above the practices are in a similar location with the same contract value and turnover. The Associate pay rates are the same for both practices at £10 per UDA.

At the time of writing practices are typically being sold for between 4 & 7 x EBITDA. Note, the illustrations above are based on an Assocaite led model. (This will hopefully make more sense to you by the time you have finished this piece.)

Using 5 x EBITDA to keep the maths simple. Practice A is worth £200,000 and Practice B is worth £750,000. Both turning over the same, both in a similar location but completely different market values. In this scenario Practice A would not be a viable proposition for an investor but practice B would.

Key Points;

- Practice B is paid £8.57 per UDA more by NHS England than practice A. That’s £119,980 more!
- Practice A has to recruit an additional member of staff to cover another full time surgery
- Practice A has additional running costs, a third surgery, uses more materials and a greater use of labs because of the increased level of activity required.

As a result the difference in profitability is £110,000. Multiply that figure by 5 x and it becomes clear why EBITDA is so important to your valuation. You’ve heard of the saying “Turnover is vanity but profit is sanity?!

Practice A as it stands is not a viable investment on an Associate Led model. We will now assume that 8000 UDAs and the private gross is performed by an incumbent purchaser. This leaves 12,000 UDAs at £10 per UDA to be paid to the Associates.

Practice	A
Turnover	£500,000
FPI	£100,000
NHS Contract	£400,000
(UDAs)	20000
Associate Fees	(£120,000)
Staffing Costs	£70,000
Rent	£30,000
Materials and Labs	£70,000
Other Costs	£40,000
Clinical Profit	£130,000
EBITDA	£40,000
Total Adjusted Income	£170,000

The EBITDA stays the same but the earnings for Full-Time Principal are now £170,000. Typically the multiple applied to an adjusted net income is lower, between 1 – 4 x. In this instance at 3 x bringing the valuation in at £510,000, a much stronger valuation than for an investment purchase alone.

The reason why a corporate or group buyer only buy certain practies is because of the return on investment. Practice A would not sell to an investor as a straight multiple of EBITDA as it doesn't offer as strong of a valuation as an incumbent purchaser, not only would a corporate not be competitive but most likely wouldn't be interested in the acquisition at all. However, as you may imagine for the purposes of this guide we have used extremes. In actuality most practices are far less clear cut.

As you can see from the table below, Practice A also works for a bank looking to finance a purchaser;

Cost of Lending	
Lending Required	**£408,000**
Stressed Interest Rate	6.5% abr
Amortisation Period	15 Years
Projected Net income	**£170,000**
Est. Drawings	£80,000
Tax on Drawings	(£21,245)
Tax Relief on Interest	£5,115
Net Cash Flow before Financing	**£68,755**
Loan Repayments at 7%	£44,007
Debt Service Cover	1.56

Based on an 80% Loan-to-Value the debt service cover will fit the lending criteria for a number of banks. It is not uncommon for a purchaser to have in the region of £100,000 cash deposit.

The above only touches the surface and your P&L EBITDA calculation will not be the same as buyers EBITDA. This is an important point to remember, EBITDA and multiples rely on each other to make the valuation work and equally can baffle you. 5 x P&L EBITDA might not be as attractive as a purchasers Adjusted Net Income at 4x. You should also remember that the EBITDA used may not be your actual EBITDA. It maybe that your spend on Associates, Materials, Labs , Staff etc is higher than we feel other buyers would assume so the higher valuation may come from lower valuation multiple, multiplied by a higher projected EBITDA!

EBIT What????

EBITDA is an accounting acronym which stands for Earnings, Before, Interest, Tax, Depreciation and Amortisation. In essence it is the true operating profit. Your accountant will / should know the tips and tricks for reducing your tax bill, or 'tax planning' as it's legally known and permissable. Not to be confused with 'tax evasion' or 'avoidance' which are different things entirely.

It a process where by we remove all of the non-cash costs in your accounts such Depreciation / Use of Home as Office etc and also those that a new practice owner would not continue to incur e.g. Spouses' Salaries.

Hopefully we have now demonstrated that neither a percentage of turnover or multiplication of practice's existing EBITDA serves as an accurate calculation of practice valuation. We will send you Guide 2 in this series next week but if you have any questions in the interim or would like us to value you practice on a free and non-commital basis please contact us on 01788 545900. Once we have completed a practice visit we can provide you with a Healthcheck Report which demonstrate exactly how we have calculated your practice's value and perhaps more importantly how we feel it could be improved.