



# How Much Is Your Dental Practice Worth?

3 Factors That Affect Valuation

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# INTRODUCTION

Buying or selling a dental practice is a major decision with lasting impacts. Dentists rarely turn over the keys and walk away from operations – the process is much more of a transition rather than a transaction.

It is important to remember that a transition must be financially rewarding to both parties. There are many deal terms to consider, and having both experienced advisors and motivated parties creates an environment conducive to a successful transition.

Selling a dental practice starts with answering the question:

 ***How much is my dental practice worth?***

The answer to this question is mainly a function of three factors: cash flow, growth, and risk.





# 1. CASH FLOW

Cash flow is closely related to profits, but they are not identical. Therefore, valuers most often convert anticipated profits to anticipated cash flows by making several adjustments. Another step in the valuation process is to review the historical financial statements to derive an “Adjusted Base Year,” which may include normalizations (owner compensation, occupancy expenses, and overhead) for one-time or discretionary expenses, among other adjustments. **For example:**

	12 Months Ended 06/30/20	Adjustments	Adjusted Base Year	12 Months Ending Year 1	12 Months Ending Year 2	12 Months Ending Year 3	12 Months Ending Year 4	12 Months Terminal Year
Net Revenue	\$1,500,000		\$1,500,000	\$1,600,000	\$1,700,000	\$1,800,000	\$1,900,000	2,000,000
Owner Compensation	-	400,000	400,000	408,000	416,160	424,483	432,973	441,632
Payroll and Benefits	650,000	50,000	700,000	750,000	800,000	850,000	900,000	950,000
Drugs and Medical Supplies	100,000		100,000	106,667	113,333	120,000	126,667	133,333
Occupancy Expenses	60,000	10,000	70,000	72,100	74,263	76,491	78,786	81,149
Overhead	115,000	(15,000)	100,000	102,000	104,040	106,121	108,243	110,408
Total Operating Expenses	925,000		1,370,000	1,438,767	1,507,796	1,577,095	1,646,668	1,716,523
Operating Margin	575,000		130,000	161,233	192,204	222,905	253,332	283,477
Other (Income) / Expense	-		-	-	-	-	-	-
EBITDA	575,000		130,000	161,233	192,204	222,905	253,332	283,477
Depreciation	25,000		25,000	25,000	25,000	25,000	25,000	25,000
EBIT	550,000		105,000	136,233	167,204	197,905	228,332	258,477
Income Taxes	-	(26,250)	(26,250)	(34,058)	(41,801)	(49,476)	(57,083)	(64,619)
Net Operating Profit After Tax	550,000		78,750	102,175	125,403	148,429	171,249	193,858
<b>Adjustments To Convert Profits to Free Cash Flow</b>								
Plus: Depreciation			25,000	25,000	25,000	25,000	25,000	25,000
Less: Capital Expenditures			(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(25,000)
(Increase) / Decrease to Net Working Capital			N/A	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Debt Free Net Cash Flow			\$93,750	\$112,175	\$135,403	\$158,429	\$181,249	\$188,858





## CASH FLOW CONTINUED

Often, dental practice owners do not draw salaries from the practice; however, for valuation purposes it is important to separate a dentist's clinical efforts and efforts as a business owner. Benefits such as health insurance may be added for owners, depending on circumstances.

It is also common for the owner dentist to also have an ownership stake in the building in which the practice operates, and thus, the rent paid between parties may be over or understated. Finally, any one-time or discretionary expenses are removed or otherwise adjusted.

The valuation of a dental practice includes the difficult task of projecting future operations and discounting these projections to a single present value using a subjective discount rate.

Valuations typically project each element according to its logical behavior. As such, a valuation requires reasonable assumptions to be made about future financial performance.

The valuation of a dental practice focuses on the amount of cash able to be distributed to owners after necessary re-investments are made to continue operations rather than the profits generated by the practice. Thus, a practice with higher anticipated capital expenditure needs or higher anticipated net working capital requirements will generate lower cash flow available for distribution.

Depreciation expense is added back to determine cash flow as this is a non-cash expense which is determined for tax purposes; and future depreciation is dependent upon the level of capital expenditures projected.



## 2. GROWTH

All else equal, higher risk is generally associated with achieving higher levels of projected growth. However, not all growth factors are created equal.

If growth is expected to be achieved through a recently hired staff ramping up, this growth would likely be viewed as less risky than growth projected from opening a new location at a yet-to-be-determined office at a yet-to-be-determined date, or expansion to offering new services to which no historical data is available.

Cash flow can also be generated through expense reduction, though not all reduction measures are viewed with similar risk. Certain overhead expenses may be easily controllable, whereas projecting cost saving measures in labor expenses might be much less certain.

Another growth element of a valuation is the long-term growth rate, which is a necessary simplification to avoid projecting a perpetual stream of cash flows. At some point a valuation assumes the dental practice has achieved a stable state of operations, and that the cash flow available to investors will grow forever. There are differing opinions on a reasonable long-term growth rate but most valuations use a range from 2% to 5%.





### 3. RISK

Risk can be addressed in different aspects of the valuation. For example, risk can be – and should be – addressed in the projected cash flows themselves by assessing the results of different scenarios into the analysis.

If competition is a major risk due to a new practice opening in the area, the valuation should consider the potential impacts of decreased revenues and offsetting cost savings efforts.

#### *Discount Rate*

Risk may also be addressed in the *discount rate*, which refers to the rate of return used to convert expected future cash flow streams to a single present value. These rates of return represent the percentage return on investment that a market participant would command for investing in the subject dental practice.

All else equal, a higher discount rate would result in a lower value because the analysis assumes that investors would

require higher rates of return to invest in a riskier cash flow stream.

Discount rates are subjective as there is very little empirical support for rate of return expectations in privately held businesses – let alone dental practices. In addition, some valuers may only consider equity discount rates as opposed to weighted-average costs of capital, which weigh components of debt and equity.

There is no right answer to this point, as long as the valuation follows the correct methodology for each discount rate determination. There is, however, a *reasonable range* for equity discount rates depending on the circumstances. Putting all elements of a discount rate together, a reasonable range is likely between 10% and 30%.

The adage of “higher risk, higher [expected] return” generally holds true, as markets are assumed to be at least somewhat efficient in the long-term.

# SUMMARY

To produce the valuation, cash flows are first projected and then distilled into a single present value using the discount rate. A greatly simplified example is presented below:

	12 Months Ending Year 1	12 Months Ending Year 2	12 Months Ending Year 3	12 Months Ending Year 4	12 Months Terminal Year
<b>Debt Free Net Cash Flow</b>	<b>\$ 112,175</b>	<b>\$ 135,403</b>	<b>\$ 158,429</b>	<b>\$ 181,249</b>	<b>\$ 188,858</b>
Partial Period Factor	1.00				
Discounting Period	0.50	1.50	2.50	3.50	
Present Value Factor - 20.0% Discount Rate	0.91	0.76	0.63	0.53	
<b>Present Value of Cash Flow</b>	<b>\$ 102,401</b>	<b>\$ 103,004</b>	<b>\$ 100,434</b>	<b>\$ 95,750</b>	
Present Value of Discrete Projected Cash Flows	\$ 401,590				
Present Value of Terminal Cash Flow	\$ 623,563				
<b>Implied Market Value of Total Capital</b>	<b>\$ 1,025,154</b>				

Terminal Value	
Free Cash Flow	\$ 188,858
Divided by Cap Rate (WACC- LTGR of 4%)	16.0%
Terminal Value at Year 4	1,180,361
Present Value Factor	0.528
Present Value of Terminal Value	623,563

One thing to note in this simplified valuation is that the present value of the terminal cash flow exceeds the present value of the discrete period cash flows. This is not uncommon, and clearly illustrates the importance of the assumptions surrounding the terminal period cash flows and discount rate. Small changes in these assumptions may have a disproportionate impact on the ultimate valuation. Therefore, the assumptions used in the valuation must be backed by sound logic and be reasonable.



# CONCLUSION: FOCUS ON THE TRANSITION

The valuation of a dental practice is but one piece of the overall transition. A successful transition begins with knowing the value of your dental practice and balancing the desires of all stakeholders to produce something mutually beneficial.

Likewise, the valuation of the practice will depend on the purpose. No matter the circumstance, it is common for the selling dentist to remain in a productive capacity after a transaction. Therefore, there is an inherent mindset shift during the transition from adversarial (sellers wanting high values and buyers wanting low) to cooperative, as the parties must work together after a transaction to achieve the intended goals.

A successful transition will involve the parties recognizing the importance of the post-transaction phase, and that an unsuccessful transition destroys value for all involved. The valuation is indeed a point of negotiation but should be considered in context of the overall transition.

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**Want to know the value of your dental practice?**  
**Contact us at [HORNE.healthcare@hornellp.com](mailto:HORNE.healthcare@hornellp.com)**  
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