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Associate to owner transition: When should a dental practice be valued?

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Acrimonious controversy often defines the question of **when** a general dental practice should be valued if a new associate has a clear future intention to buy-into or buy-out the practice. In fact, the importance of valuing a dental practice was previously identified as one of the potential "mines" in situations where associates seek to work successfully in a general dental practice [1]. This editorial explores the basic options of when a dental practice should be valued in an associateship.

Obviously, other equally important and related issues arise regarding a practice valuation, including **how** the valuation should be determined—that is, what methods of valuation can and should be employed in isolation or in combination [2-3]. Similarly, other pivotal questions relate to the business form/entity of the dental practice [4] and how dental hygiene income may or may not be shared with an associate who supervises dental hygiene [5]. How to value tangible assets of the practice (such as chairs and other equipment) also has to be addressed, though typically a fair market value would be determined at the time of practice purchase in order to equitably establish the value of tangible assets. The purpose of this editorial is to focus on the **when** of practice valuation, especially the

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intangible or goodwill assets (including a patient base and reputation), knowing that an associate intends at some future point to buy or buy-into the practice.

The following diagram (Figure 1) depicts the most commonly utilized options regarding **when** a practice may be valued and the relative advantage-position for the owner and for the associate.

Option 1 is most advantageous for the owner. The associate's future revenue for the practice is included in the process of valuation—typically, 1 – 3 years after the associate begins working. If the associate buys or buy-into the practice and averaged $350,000 in revenue during the previous three years, then that revenue would be included in the calculations for determining practice value, along with all other practice revenue. For example, a practice valuation without counting associate revenue might be $600,000, but with associate revenue added would likely be approximately $800,000 +/-. Some consulting firms apparently value a practice in this way with the associate revenue included in the valuation formula. Other consultants and brokers do not think it is ethically appropriate for an associate to pay for the "sweat equity" that s/he has helped to build in the practice to be purchased.

Option 2, a "middle" ground or compromise position, aims to balance the interests of the owner and those of the associate. The practice is valued based on historical performance from the previous 3 - 5 years before the associate begins working in the practice while excluding the associate's future generated revenue. In addition, however, the valuation incorporates the reasonably expected revenue growth of the practice or adds an inflationary benchmark such as the consumer price index [6]. For example, if a practice has realized an average of 5% revenue growth without an associate, then the valuation would be calculated based on this 5% average growth for the future date/year the associate buys into the practice. Thus, an associate who buys into a practice after two years when the practice was originally valued at $600,000 would pay approximately $661,500 ($600,000 x 1.05, twice). Alternatively, a $600,000 practice purchased after three years with a built-in inflation index of 3% would be approximately $656,000 ($600,000 x 1.03, three times).

Option 3 is clearly the most favorable approach for the associate. The practice is valued before the associate begins working for the owner and includes in the valuation historical revenue from the previous 3 - 5 years without accounting for normally expected practice growth, an inflation index or the associate's future revenue. For example, a practice is valued at $600,000 when the associate begins working for the owner and then the associate

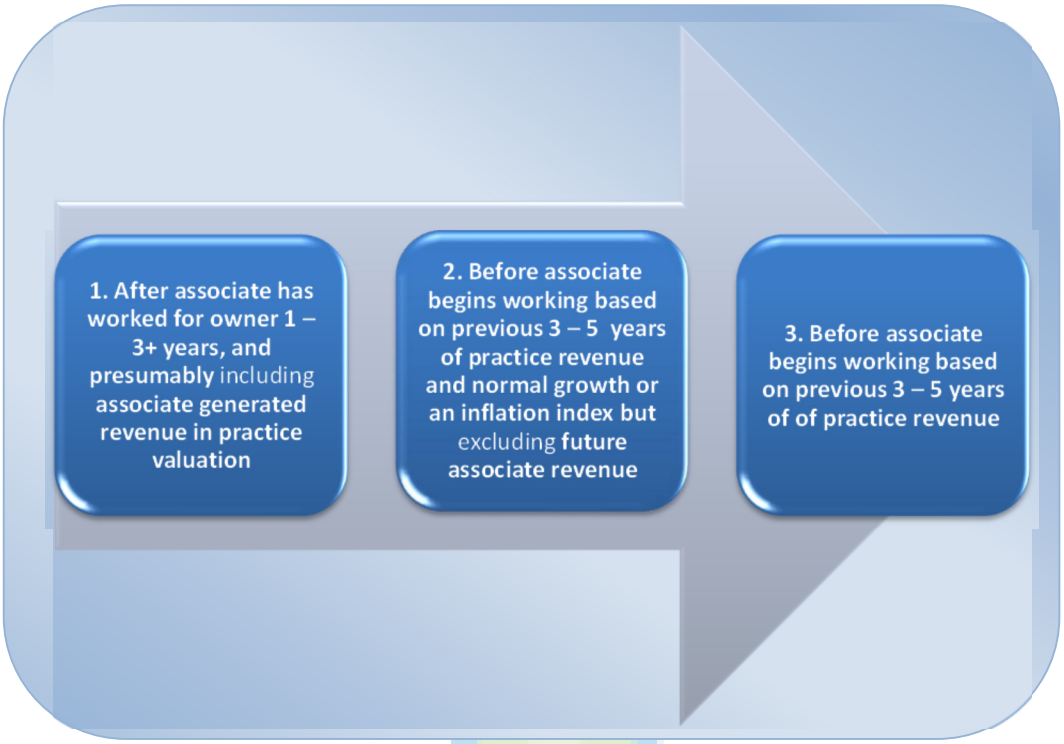

Figure.1 From more favorable for owner to more favorable to associate.

buys or buys-into the practice after three years for the original $600,000 valuation.

Of these three options, when is the most fair, equitable, ethical option, and why? These answers depend on the person whose opinion you seek. It would appear that either the second or the third option is the most fair, equitable and ethical. Option two focuses on historical practice revenues while **excluding** the sweat equity of the associate. Providing added protection of the owner's business interests, the second option also allows for some increase in practice value which may develop without an associate generating more revenue for the practice. Of course, would-be and new associates in a practice typically view option 3 as the most fair, equitable and ethical option, and with good reason. Clearly, practice growth is not a certainty, especially in difficult economic times such as the recent recession in which 10% of practices reported no revenue increase and 32%, a revenue decline [7]. In a climate of flat or declining revenue, practice

value could be adjusted to reflect the practice's most recent performance.

Based on my experience in assisting dental students and alumni seeking to purchase practices, the vast majority of consultants and brokers utilize some variation of the second or third option. As has been stated elsewhere, it is incredibly important for the owner and the associate to discuss in detail the process of valuation, preferably deriving an actual practice value, before the associate begins working [1, 8-10].

Failure to have this discussion will significantly increase the likelihood of a failed practice sale. In fact, Dr. Heller suggests that 75 - 90% of future practice purchases by an associate will fail without a clear understanding of the practice's value when the associate begins working [10].

Conflicts of interests

The author declares that he has no competing interest. He is a co-editor of the textbook cited in the references. He also has editorial involvement with Dental Hypotheses.

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