Seven Steps To Buying a Dental Practice

You want to buy your own dental practice? Great! Proceed with caution and follow these seven steps to success.

By Mac Winston

Having spent the last eight years making over $100,000,000 in loans to dentists for 100 percent or more of the purchase price of existing dental practices, I’ve observed seven key steps that will ensure a smooth transition to ownership.

While acquiring or starting a practice of your own is a powerful dream, and one that easily can become a reality, a few words of caution are in order. First, you should beware of the allure of the sense of autonomy inherent in this dream. As any dentist who has borrowed money to become an owner of a practice will report, there is no such thing as absolute independence. Second, the dream of ownership quickly can turn into the nightmares of bankruptcy, overdrawn bank accounts, disrupted family life, and mental depression when you decide to purchase or start a practice before you are ready. Therefore, working as an associate for two or three years following graduation can be very valuable in terms of sharpening skills and gaining firsthand knowledge of the challenges, benefits, and drawbacks to ownership.

There is less risk in buying an existing practice than in starting one from scratch. So, while there are many situations where a start-up makes good sense, you should thoroughly understand the challenges involved in each process before making a choice between purchasing vs. starting a practice.

Now, assuming that you have decided to pursue ownership through the acquisition of an existing practice, let’s go through the seven steps to success in buying your dental practice.

1 — Check Your Credit

Obtain a copy of your personal credit report. You may request a report, free of charge, each year from one of the three major credit-reporting services: Equifax (800-759-5979), Trans Union (800-851-2674), and Experian (800-682-7654). You need to check the report carefully for derogatory credit notices that may impede your ability to borrow the money needed to purchase a practice. Most credit reports feature a credit rating called a “credit score” that ranks the credit profile of an individual borrower relative to the vast population of individual borrowers in the United States. Your credit score can be negatively or positively influenced by such factors as:

- Late payments
- Delinquent accounts placed with a collection agency
- The number of credit inquiries (i.e., the number of times a credit report on an individual has been ordered by prospective credit grantors during a given period)
- The total balance of credit-card and revolving credit available (it is wise to keep this below $35,000)
- The total balance of revolving-debt usage (this should be kept below $25,000)
- The existence of bankruptcy during the last 10 years
- The dollar amount and number of new debts incurred during the last 18 months
- Any civil judgments outstanding
- Disputed city, state, and/or federal taxes, etc., that have not been paid

If there are derogatory notices on your credit report, you should try to remove them by contacting the creditors in question or asking the credit-reporting service to attach a written explanation, giving your side of the story, to the report. You also might wish to ask the applicable credit-card companies to
terminate unused accounts. These efforts can enhance your individual credit score and your chances of obtaining practice financing. To make sure that your actions to improve your score have been effective, go back to the credit-reporting agency and order a new report.

2 — Select Your Market

Most dentists gravitate toward the heavily populated urban areas and closely linked suburban markets (e.g., the metropolitan areas of Chicago, Dallas, Atlanta, Denver, Phoenix, Los Angeles, and St. Louis). They do this to be close to high school or college friends, family, major entertainment and shopping centers, the dental school they attended, major airports, and the like. Rural markets are chosen less frequently because they are “out there”...where there might be few of the most desirable characteristics of metropolitan areas.

Many rural practices do, however, offer a significant investment opportunity not available in most urban and suburban practices. The cash flow of a dental practice generally improves (i.e., more money is made doing the same work), and the market value (sales price) generally declines as the practice moves away from an urban center. Cash flow improves because of reductions in rent and staff expense. Market value declines because there are fewer buyers for rural practices.

This gap between a dental practice’s economic value (i.e., the practice’s value as a generator of cash flow into the future) and its market value represents the investment opportunity that often is not available in the urban and suburban practice. Dentists in rural markets often realize a larger disposable income, a larger personal savings rate, and an earlier retirement than their counterparts in urban and suburban practices.

3 — Get Help from a Practice Broker

Since most dental practices are sold with broker assistance, serious buyers will want to get in touch with a broker active in the markets where they want to practice. Brokers typically work in limited geographical areas where they have a unique familiarity and understanding of the local dental market. They charge a commission or a fee, which is paid by the seller, for the sale of the practice. With the advent of the Internet, a dentist can shop broker listings of practices all over the nation. There also are listings of practices for sale in the major dental periodicals and local dental-association publications.

4 — Get Professionals on Your Team

Once the desired market has been identified and the ideal practice located, it is time to enter into an intent-to-purchase agreement. Before you sign that agreement, however, you should develop a relationship with an attorney and an accountant. These professionals need to review the agreement and assist you with due diligence on the practice.

5 — Obtain Insurance as Loan Collateral

You need to find a life- and disability-insurance agent experienced in working with dentists acquiring dental practices. Life and disability insurance is necessary at this point because most financiers will require this type of coverage as collateral for their loans. You will be able to deliver approved coverage as collateral to the lender more quickly if you submit an application for coverage and complete the insurance company’s medical exam in advance of your application for financing.

The most frequently used life-insurance product for loan collateral is term life. The most frequently used disability products for this purpose are income disability, reducing-term disability, and disability overhead. The number of disability-insurance providers has declined significantly over the last five years, so coverage is more difficult to find. Be sure, however, to select an agent experienced in structuring and procuring disability coverage for the purpose of collateralizing a business loan.
6 — Arrange for Financing

Brokers, accountants, and attorneys usually can make recommendations on suitable lenders to consider. Most lenders specializing in practice-acquisition financing will fund 100 percent of the practice-purchase price, plus all related working capital and transaction-cost needs. Lender policies can vary widely in the length of the approval process, the interest rate and terms of the loan, and whether there are penalties for early repayments.

After you decide on a lender, obtain a loan application. Complete it in its entirety and return it along with:

- A copy of each of your personal tax returns for the last three years
- A personal resume
- Copies of the last three years’ tax returns and most recent interim-operating statement for the practice in question
- Any information the broker may have produced in the process of valuing the practice
- An explanation of derogatory notations in your credit report
- A statement of your annual living-expense needs (if this is not included on the loan application form)
- A short narrative regarding your transition plans for the practice during the six to 12 months following the acquisition closing

Once the lender makes you a financing offer, review it very, very carefully – including the fine print. You will want to look for two things in particular:

- **The Annual Percentage Rate (APR)** – The APR is a measure of the total costs of the financing offer. Such costs include the interest rate paid over the life of the loan, any fees paid, and any interest to be paid on interest as a result of having no payments or graduated payments during the first few months of the loan.

- **Penalties for Early Repayment** – Many lenders will charge a penalty if the loan is repaid during the first few years of the loan or at any time prior to the scheduled maturity of the loan. It is not unusual for penalties of $30,000 to $40,000 to be levied on loans of as small as $150,000.

Another thing to check carefully is the amount of life and/or disability insurance required as collateral. (On life insurance, the requirement usually is an amount equal to the loan total. The disability requirement typically is no less than 80 percent of the loan payment.) Relay these amounts to your insurance agent as soon as possible, so that approval for coverage can be completed.

The lending offer should include an amortization schedule depicting the monthly payments of principal and interest over the life of the loan. Review it and make sure that your monthly loan payment will leave you with sufficient funds to live on, given the historical cash flow of the practice. A practice purchased within the typical market range of 60 to 980 percent of its historical gross receipts will support the repayment of acquisition debt in seven years while paying you a reasonable wage relative to the dentistry you perform.

7 — Negotiate the Purchase Agreement

So, you have accepted a financing offer. Now it’s time to team up with your accountant and attorney to negotiate the purchase agreement with the seller of the practice. You should arrange for your insurance agent to have contents, liability, and malpractice coverage in force for the practice following the closing of the sale. (Most dentists have malpractice insurance, but those who do not certainly will be required by the lender to purchase it.)

Once the purchase agreement is final, it’s on to the closing and, after that, celebrating the acquisition of your own practice!
The preceding article appeared in the May 1999 issue of Dental Graduate. The author, K.M. “Mac” Winston, is executive vice president and chief credit officer for Professional Practice Capital, a Texas-based lender that serves the professional marketplace nationwide. Mac has over 20 years of banking experience and has specialized in lending to dentists and medical professionals since 1992. He may be reached at 800-456-2779 or mac@ppcloan.com.