Impact of the Current COVID-19 Pandemic on Dental Practice Valuations and Sales

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Never has the statement that we live in unprecedent times been truer. None of us knows how this pandemic will play out, in the short term or the long term. But even in times of unprecedented crisis, experience and basic principles can often help us draw reasonable conclusions about how businesses will likely be affected. As one of the oldest brokerages in Canada, with a very experienced team of valuation and transition specialists, we are getting a lot of questions these days. Here are our responses:

What is going to happen to dental practices in the short run?

Across the country, regulators and health authorities are strongly recommending that dental offices immediately stop seeing patients, except for emergency treatment. The key thing to keep in mind, is that, to a large extent, and unlike many other businesses, this will result in *deferral of revenue*, not the loss of revenue.

This is very different than many businesses. The revenue for the Uber ride someone did not take, or the meal they did not buy at a restaurant is lost forever. But COVID-19 does not reverse tooth decay or make impacted wisdom teeth go away. That filling will still need to be done, and those wisdom teeth will still need to be extracted. Apart from some hygiene revenue that will be lost, the revenue is delayed – not gone.

Fortunately, dentists are able to shed most, but not all, costs. The four costs which generally account for the vast majority of dental practice expenses are wages (25%–30%), rent (6%–9%), supplies (6%–10%) and lab (3%–8%). Most offices have already laid off all staff. Supplies and lab costs will not be incurred until patients are back. So, with the exception of rent, most offices can pare costs to the point that their economic survival is not threatened, even if the current advisories persist for a number of months. In addition, while the role business interruption insurance will play is still uncertain in many cases, most practice owners have sufficient assets to withstand business interruptions for longer periods than the vast majority of other small business owners.

What about practices with high levels of outstanding debt?

These practices should immediately reach out to their bankers. Many may be surprised by the cautious but positive, problem solving reception they get. Of the many types of small businesses that banks have loaned money to, dental practices will remain among the most secure loans the banks have. As noted above, in almost all cases, the survival of a dental practice is not in question. This is a timing issue, not an existential one. And banks are smart enough to know this.

Involving one's banker to help get through this will work far more effectively than avoiding the issue. In many cases, banks will be prepared to defer principal repayments and make other arrangements to keep practices going. They realise that much of a practice's revenue has been deferred, not lost. They will understand this is a timing issue – not a question of the practice's eventual ability to repay the loan.

In addition, the banks have a very strong economic incentive to help a dental practice weather the storm. Only those practices that get through this crisis will be able to eventually repay the loan. So, the banks have an entirely rational, economic imperative to help practices get through this.

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Just look at the facts. In most cases, 75% or more of the value of a dental practice is goodwill. That goodwill becomes virtually worthless if the dentist and dental team aren't there to treat patients. And even the 25% that may be tangible assets can't be sold at close to that value, in the absence of ongoing practice operations. So, in almost all cases, the best way for a bank to protect itself is to ensure continued operations of the dental practice – and that won't happen if they push the practice into bankruptcy.

All of the major Canadian banks have people who are health care and/or dental practice specialists. If you are dealing with your local branch or small business manager, they may not be as well informed about the factors in the preceding paragraphs, so it would be worthwhile for you to insist that your local banker contact those resources.

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What does the future hold, once current advisories are lifted?

As previously discussed, much of what is happening now is a deferral of revenue, not a loss of it. So, once current advisories are lifted and practices can return to normal patient treatment, there will be a surge in business at most practices. That surge in business will last as long as it takes to get caught up on the backlog.

In many cases, we think the only limitation on the magnitude of the revenue increases will be the availability of staff. Certainly, most staff that have been laid off in a practice will be eager to return and more than make up for lost time and wages. But before the pandemic hit us, the number one issue we were hearing from practice owners was their challenges in getting enough good staff. Prudent practice owners may want to make advance preparations to ensure they will have adequate staffing to deal with the substantial backlog, once they can treat patients again.

We are headed for an inevitable recession. How will this impact dental practices?

History has a lot to teach us in this regard. Readers will remember the major recession we went through as recently as 2008/2009. By many measures, it was the worst economic decline since the Great Depression. How did it impact dental practices?

For most practices, it had only modest, *if any*, negative impact on revenue and earnings. There were individual exceptions, but for the most part, dentistry is remarkably resilient in the face of economic declines. Indeed, that is often cited by the large institutional and private equity investors, who are backing the companies consolidating dental offices across Canada, as a primary motivator in investing in dental practices. That isn't going to change.

History teaches us that a recession will have far less impact on the average dental office than the vast majority of other businesses, small and large. While the exact impact will be determined by the magnitude and duration of the recession, we and, more importantly, many buyers remain confident that recessionary impacts are likely to be moderate, and an eventual return to normal levels of revenue and profitability will be forthcoming.

What will be the impact on dental practice selling prices?

Once again, history provides us some great guidance. For the duration that the current advisories remain in effect, practice sales, for the most part, will be substantially curtailed. But, once the advisories are lifted, what will happen?

First, the key thing to keep in mind is that prior to the COVID-19 pandemic, existing supply and demand forces had already driven practice values to unprecedented heights. We were in a strong "sellers' market" in most places across Canada. The key drivers of this – a significant oversupply of dentists making patients the scarcest resource in dentistry, the excellent economics of most dental practices, banks offering great financing terms on practice loans, and an unlimited supply of investment capital funding practice consolidators are all unlikely to change.

Second, we've already discussed the revenue rebound that dental practices will go through. That is going to make practices even more attractive to purchasers.

Third, those intractable forces of supply and demand are likely to get stronger, according to history. During and after the 2008/2009 recession, what happened to dental practice selling prices? They went up! Often considerably. That may sound counterintuitive to some, but not if you look at the factors driving supply and demand – the ultimate determinate of the price of everything.

The devastating drops in stock markets in 2008 meant that many practice owners who had been planning on retiring could no longer afford to. That resulted in a reduction in the supply of practices for sale. The Government responded to the recession by cutting interest rates to stimulate economic growth. We have already seen that again this time. Lower borrowing costs drove demand up then, and will again. With a reduction in supply, and an increase in demand, prices responded the way they always do when those forces are at work. They went up and laid the foundation of the present sellers' market.

And, what of the corporate practice consolidators? They all rely to some degree on institutional investors and private equity. In tough economic times, professional money managers look for safe harbours. Dental practices are high cash-return businesses, that have shown better ability to withstand recessions than most industries. That makes them far safer harbours than most alternatives for investment capital. While the corporate consolidators are not usually the "high bidder" on individual practices, they will continue to provide a solid floor to practice values.

With inevitable declines in revenue and earnings in 2020, won't that result in a lower appraised value for my practice?

Not if you have an experienced, data-based appraiser doing the valuation. A basic principle in valuing a business is to remove the impact of one-time events that purchasers are not going to factor into their assessment of future earnings potential. The revenue declines that practices will experience in March and April 2020, and quite possibly beyond, are just that kind of "one time" event.

It is straightforward to adjust for this in a practice valuation. The most common approach will be to substitute monthly revenue from 2019 for the months in 2020 that are affected by COVID-19 related declines, with appropriate consideration given to whether monthly revenue trends prior to the arrival of the pandemic were positive or negative.

Great care will need to be used to ensure this is done objectively, based on data, in a way that is easy for buyers to see and understand. But so long as that is done, neither appraised values, or buyers' perceptions of them, need be affected. The key will be choosing an appraiser that understands this methodology and who will approach it in this manner.

Are there any other risks to worry about?

Sadly, there will always be those that will try to take advantage of the fear, uncertainty and doubt that we all experience in a crisis. Just a week into this crisis, we have already begun to hear stories of buyers who are trying to panic practice owners into selling now, at prices below fair market rates, or with unreasonable conditions that hugely favour the buyer.

Practice owners need to take comfort in the fact that, despite everything going on, the fundamental laws of economics, led by supply and demand, have not been repealed, or even deferred. The one thing we know about all crises is that they end. The prospects for practice values remain strong. The key is to seek out experienced advisors you can count on, not yielding to buyers whose real interest is their own gain.

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Tier Three Brokerage provides dental practice appraisals, sales and transition services to dentists across Canada. More information can be found at www.tierthree.ca. To get more perspective on how the COVID-19 crisis may affect your practice, please reach out to any of the valuation and transition experts. You’ll find them on our website Team page. Or call 888-437-3434.