AN **ADS DENTAL TRANSITIONS** WHITEPAPER

NAVIGATING THE DSO MARKET

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What is a DSO?

Let's take a look at DSOs from several different perspectives. This should shed light on what DSOs are in different context. As you learn about DSOs, you will see there are conflicts among the different players in a DSO transition. You need to see clearly who is acting in your best interest and the purpose of DSOs.

Private equity firms dominate the DSO market; **27 of the top 30 DSOs are private equity owned.**

To circumvent laws regulating dental practice ownership, investors create separate entities — DSOs — to provide related practice management and business services, such as marketing, bookkeeping and financial services.

DSOs are an entity responsible for acquiring dental practices. Dental service organizations come in all different sizes, management philosophies and clinical philosophies. Next you need to understand they have different marketing strategies from nationally branded chains to regionally branded. They have various growth strategies from DeNovo to acquisitions to a hybrid of a mixture of growth from acquisitions and DeNovo.

DSOs Defined

SHORT DEFINITION: Dental Service Organizations, known in the industry as “Dental Support Organizations” or abbreviated to DSOs, are independent business support centers that contract with dental practices in the United States. They provide business management and support to dental practices, including non-clinical operations.

DSO DEFINITION: Dental Service Organizations are also referred to as Dental Support Organizations. They both are commonly abbreviated as DSOs, and at their core, their business models provide non-clinical functions for dental practices. In many cases, services can include things like human resources, payroll, marketing efforts, IT solutions and practice administrative support. For a dentist that seeks to focus primarily on their patients without the stress or worry that operations and administrative tasks can create, joining a practice that is managed by a DSO is an attractive option. DSOs generally promise greater mobility and work-life balance compared to practices who manage their own operations. Remember, this is the DSO’s definition or sales pitch; better check to see how accurate this statement is.

ADA DEFINITION: According to the ADA, a DSO is “a group practice that contracts with a dental management organization to conduct all the business activities of the practice.” In other words, all dental practices have two sides that must be constantly maintained to be successful: The clinical and non-clinical. DSOs manage everything non-clinical, allowing dentists to direct all their attention to the clinical side.

DSOs have the challenge of needing to centralize data and being able to share it across all locations, which is solved with a cloud-based practice management system. DSOs also need a practice management solution that will not only allow efficient management of dental practices but will continue to grow with them effortlessly and fluidly.

INVESTOR DEFINITION OF DSO: Dental support organizations (DSOs) offer potentially successful investment opportunities, but all opportunities are not created equal. To strike a successful deal, investors must identify DSOs that have strong alignment with dentists, provide quality support services on a consistent basis and have a clear and achievable growth strategy, whether driven organically and/or by acquisition. DSOs will continue to be an attractive opportunity for investments because they are essential to American healthcare. They provide another avenue for dentists to obtain access to capital and increase access to care.

ATTORNEY’S EXPLANATION OF THE DSO MARKET AND THEIR ROLE: DSO-focused legal practices are growing in the United States. They are comprised of a multidisciplinary team providing extensive counsel, with demonstrated accomplishments and proven experience covering the entirety of the unique business and legal needs of Dental Service Organizations. Practitioners — who handle mergers and acquisitions, patient finance, government investigations and regulatory litigation, tax, real estate, employment law, brand protection and corporate compliance — provide, both individually and collectively, top-tier legal representation and “go-to” strategic counsel.

WHEN IT COMES TO MERGERS AND ACQUISITIONS, NO TWO DEALS ARE ALIKE.

That's why it's important to select a seasoned legal team with a proven track record. The seasoned DSO team has worked with hundreds of clients in the dental space and have closed well over 1,000 transactions throughout all 50 states.

Law firms assist their clients in deals such as:

- private equity-backed DSO formations
- acquisitions
- mergers and sales
- equity capital raises
- lending transactions

Legal DSO teams also work closely with the firm's attorneys in other practice areas — such as IP, tax, environmental, real estate, labor and employment and benefits — all who have substantial experience in M&A within their disciplines.

Whether you are engaging in a deal as a buyer or a seller, you'll have a highly specialized team of attorneys experienced in all aspects of the dental organization space. They will be focused on getting your deal done.

DSO Differences

There are DSOs which identify themselves by other names, *e.g., dental partnership organization (DPO)* using a form of equity sharing more in the nature of a partnership for the parties. There are DSOs known as portfolio DSOs. These combine (or bring together) independent, privately owned dental practices into a portfolio to operate.

When the portfolio of practices is sold, the independent doctor-owned practices make the high returns and not the private equity firm/DSO that owns the dental practices. It depends on who you want to make the big bucks in the sale of your practice — you or the DSO.

History of DSOs, Who they are and how many DSOs are in the Industry.

What started in the mid to late 1990s as a cottage industry has since emerged to a large scale. The creation of the dental service organization has now become one of the most active areas of private equity investing in the healthcare industry. Although the earlier DSO model fit the definitions outlined above, the entrance of private equity funds has accelerated the growth of the DSO market. As of February 2021, there are over 70 DSOs that have private equity investors as partners. Of the 70 private equity DSOs, there are over 13 national DSOs with more than 5,887 offices in the United States and growing. The balance of the private equity DSOs is made up of multi-regional and regionally focused companies.

The cottage industry of DSOs focused on general dentistry. In recent years, specialty dental care has increased the number of specialty focused DSOs. The specialty has now expanded to multi-specialty, orthodontics, pediatric, oral surgery, endodontics and prosthodontics. Growth of specialty dental care has resulted in a significant contribution to the overall contribution in dental. In 2018, specialty dental care accounted for 22% of all DSO dental care. Specialty care is continuing to grow as a percentage of dental care provided.

Not only have we seen significant growth in the private, equity-driven DSOs, but there are also numerous small group dental offices. Group dental offices range from 2 offices to 20 offices and are led by entrepreneurial dentists with business skills to grow and build a dental organization. Generally, you will have such small dental groups made up of dentists in a partnership organization.

Exploring the Complexities of EBITDA and Multiples.

One of the most fluid and complex topics in the DSO industry centers on EBITDA and multiples in arriving at the valuation of a practice and its sales price. As you may imagine, computation of EBITDA and the corresponding multiple is the central theme in the sale and purchase of a dental practice by a DSO. Chapters could be written on this subject.

Suffice it to say that having a firm grasp and knowledge of where the industry is at the time of sale, is of paramount significance.

The Trials of Private Equity vs. Bank Financing and Expectations.

At whatever stage of growth and development a DSO is in, securing funding is the driving force behind leveraged scaling. Emerging dental group's primary focus is a clear understanding of what it takes to fund rapid growth with term debt financing. Banks have not been a good fit for DSOs because they are naturally hesitant to fund rapid growth. However, there is a movement by certain banks to now take a role in the DSO market and expansion. **Covid shutdown has practices coming out of declining revenues in 2020. Large requirements for cash and rapid growth are a challenge on many levels. DSOs must demonstrate they are prepared for such growth and have a proven track record.**

Cash flow is king and establishes the clear baseline.

DSO's models are required to grow revenue and increase profitability.

The private equity measures success by sustained and growing revenues with profitability as the key.

Private equity is an investor and they expect each office to perform and contribute to the bottom line handsomely to reward investors. Meeting the private equity expectations of growth and profitability is what matters and what drives the organization and practice and rewards its investors. If the DSO does not pass this measurement in each office, the impact has a significant effect on achieving growth. The DSO must demonstrate a well-defined, duplicatable process of growth; otherwise, your finance source will struggle to support your growth. The DSO must show maximized office utilization and steady revenue growth across all offices, or your process requires alterations or is subject to failure.

Forward thinking business plans are required to define how your vision will succeed.

Private Equity Firms Target DSOs Through Leveraged Buying.

The private equity firms orchestrate purchases in companies for its investors. These investors may be private individuals, corporate entities, and retirement funds. The private equity fund pools money from one or more investors to purchase dental practices. Such funds are generally not traded on public market exchanges like the New York Stock Exchange or NASDAQ. (Exceptions exist such as Palm Investors' control over Birner Dental Management, doing business as Perfect Teeth Dental, which is traded on the over-the-counter exchange.)

Direct ownership in the dental practices by a private equity group is not within their expertise or management resources.

Ownership of the dental practices is through a DSO, which serves as a management company for the DSO.

This also serves to mitigate possible regulatory or tort law liabilities. There are also tax advantages in the proper planning of the structure, which is employed as a fiscal pass-through vehicle.

The private equity firm generally will position itself as the primary creditor, via *collateralized loan obligations.*

This can take several forms

- **First-lien creditor**
- **Mezzanine financier**
- **Holder of very senior debt bonds**

In the event of a bankruptcy, senior debt gets paid first. Thus, those holding the debt usually have greater control than "owners," who hold unsecured stock or subordinated bonds.

Private equity firms purchase (technically they may not "own," but do beneficially own) DSOs through leveraged debt. That debt is a multiple of DSO earnings or earnings before interest, taxes, depreciation, and amortization (EBITDA). As a general rule of thumb, the higher the multiple of debt above a DSO's earnings, the greater the risk for investors.

The private equity firm establishes a leveraged buyout of a DSO by strapping the formerly independent DSO with substantial debt, which must be repaid to the private equity firm. Company profits are redesigned for accounting to pay out beneficial ownership in interest and principal sums, not as earned income or "profits." The private equity firms use this approach to grow its number of practices to satisfy its obligations to the private equity firms and prepare for a leveraged sale of its growth of practices.

Some Clues Regarding the Future of DSOs.

1. The DSO industry is not composed of a single structure or initiatives. It is composed of several or many different types of structures and initiatives. We have seen in recent years the expansion of the contribution of specialty dental practices into the mix of dental services provided. Some DSOs have entered Medicaid and regulated dentistry, while many still rely on PPO for dental patients.

2. There are evidences that DSOs are commonly at odds with doctor employees, which may result in civil legal actions or a revolving door policy, while other DSOs less so. Many DSOs represent a hands-off policy of non-interference in the doctor/patient relationship when, in fact, this is not the case. Most DSOs are fully unlawfully engaged in the doctor/patient relationship. The driving force is the growth of revenues and the additional pursuit to boost profits. This growth of revenue and profits is the key driver for private equity groups. The DSO is driven to grow revenue and increase profitability for the private equity. They like patients but are all about revenues per patient and growing patients to increase revenue and profitability.

3. Some DSOs utilize a branding tactic of being the neighborhood dentist. The DSO would like consumers of the dental clinic not to think of them as a part of a national chain. Other DSOs openly market their brand and trademarked logos nationally at their clinical facilities and in external marketing.

4. Business models, target demographics, management styles and strategies, and marketing vary throughout the DSO industry. Likewise, investment risk is not uniform within this industry. Both the leveraged loan markets and bond markets are swelling in volume.

A Close Examination of a DSO Transaction.

Which DSO or version of a DSO is right for you?

How to get the best deal from a DSO for the sale of your practice.

How many times have you heard and received solicitations from DSOs telling you they pay significantly more than selling to a private dentist? How many times do you hear from DSOs and wonder which of their representatives you can trust? How many DSOs are there in the marketplace? Do you think DSOs are all the same and offer the same terms? How do you know what's the best deal for you and what terms are important? Who is going to make the big money from the sale of your practice, the DSO, private equity group or you?

The right DSO can offer a great opportunity for the right dentist.

The process of selling to a DSO requires a knowledge of the multiplicity of terms that must be negotiated. The criteria of selling to a DSO involves many factors: knowing the value of your practice to DSOs and getting the best price for the sale of your practice to a DSO; work back arrangements and agreements; how much the DSOs can hold back of your sales price and what conditions are required for you to get the rest of your money; tax planning to put the most money in your pocket, knowing who you are really dealing with; and what is the DSO's track record. Above all, getting the right fit is essential. This is a partnership and not the time to make mistakes because a failed deal ruins lives. Undoing a bad deal or filing suit to get what was represented to you by a DSO can cost you tens of thousands of dollars and serious emotional strain.

There are so many DSOs or versions of a DSO, it is imperative that you make sure you are making the right decision and terms for you. Knowing the DSO marketplace and creating a competitive environment where you have multiple DSOs vying for your practice is one of the only ways you can make sure you are getting the best deal. You will never get the same deal from a DSO that has no competition for the purchase of your practice. You need to make sure you are getting in front of the best DSOs for you.

Experience, education, network and expertise provide you with the competitive advantages in dealing with DSOs. Remember, you spent many years building your practice and you need an advisor and counselor with the same kind of experience in the DSO market to give you the best representation to get you in front of the best DSOs. Money and price are important; however, there are many other terms and considerations that are just as important for you in the sale of your practice to a DSO.

A Dentist's DSO Experience.

A dentist gave his story below that may be helpful.

This dentist told his accountant he was going to take a break from dentistry. His accountant advised him to look at doing a transition soon because if he sold to a DSO, they would require a 5-year work-back. That fact, combined with potential tax charges and the current hunger for practices in the market made him seriously consider selling now.

He interviewed a few practice brokers and signed a listing agreement with his favorite, just to see what offers he'd get. Within 10 days of the listing, he had 35 interested parties, 20 of whom were well qualified. At $2.5M collections, he felt his practice was too big for a private party to finance, so all the qualified buyers were DSO groups of some sort. The broker interviewed the prospects and brought him the top 10, and the dentist interviewed the top 7 of those, resulting in 7 letters of intent to purchase. Some were local DSOs and groups. Some were regional to the west and some were nationwide. However, one was a group he knew! All the offers were generous, compared to the standard he thought of "65 percent of one year's collections" a private party would pay, but there was a very large difference in the size of the offers. The structure of the offers ranged from 100 percent buy-out to merging most of the equity into the parent company.

His decision of which DSO to partner with was based upon a combination of company culture, corporate influence in his practice, finances and future freedom.

"I wanted something profitable, but more importantly, something good for my team and a situation I'd be happy working in for the next five years. For me, DSO XXX was the best fit. I sold 70% of my practice to DSO XXX, picked up some corporate-level equity and kept 30% practice-level equity. It was not the highest offer, but it definitely feels right and has fantastic long-range financial potential."

He viewed DSO XXX as the type of entity that would be created if all my friendly docs partnered together. They have an annual owner's retreat resulting in fantastic company culture, strong connections among owner docs, wonderful opportunities to invest in the company, great vendor pricing, minimal intrusion into the administrative side of the practice and zero clinical intrusion.

"I'm only a few months into the partnership, but it feels much more like working with a coach with abundant resources than it feels like losing control of the practice. DSO XXX makes a big deal about being a Dental Partnership Organization (DPO) rather than a Dental Service Organization (DSO), and there is a lot of truth to that sentiment."

Although he is still in the honeymoon stage with DSO XXX, he doesn't expect things to change much in the future. He expects to sell his practice-level equity to an associate when he's ready to step away from the practice, thus leaving him completely untethered to a practice. He feels he is probably unique among DSO XXX in the plan to sell his practice-level equity. The average age of DSO XXX owners is 43 and they plan to be partners for a long, long time.

I think dentistry is at an inflection point in its business structure, and there is incredible financial potential in partnering with the right group while maintaining autonomy. So, he recommends even younger docs explore all the options available currently, even if you don't plan to exit dentistry anytime soon. In addition to the national 800-pound gorillas, there are some local groups building impressive momentum. You might be surprised at the opportunities in the market.

Although being in the honeymoon period all seems well, the test is in the long haul. This can be said about all DSOs — if the honeymoon starts off on the wrong foot, you know you have a problem. Even this doctor had some incorrect assumptions. He just hopes he made the right decision for his future. Who wants to hope they made the right decision for their future?

Final Thoughts about DSOs.

You should not make a decision to sell to a DSO because you received a flyer, letter to buy or have been contacted by a DSO sales representative to sell for some extraordinary sales price. There are far too many DSOs in the market to not weigh all your options.

Dentists want to know who they can trust, and what terms are important to the selling dentist. Knowing the pitfalls in DSO transitions is crucial in making the right decisions for a selling dentist. Understanding the value DSOs assign your practice and how much of the sales price is held back, how long, and what conditions must be met before the *selling* dentist receives all their money. What is the DSO's track record over time and (most importantly) finding the right fit for the selling dentist? You have heard a lot about the risks DSOs must assess in perpetuating business.

It is now time for selling dentists to assess the risks and understand with clarity what a transition with a DSO means to them. Knowledge of the DSO marketplace and creating a competitive environment in which you receive multiple DSO offers that fit you is critical to getting the best deal and price. You will never get the best deal and fit from a DSO that has no competition for your practice.

About the author.

Graduating with a Business Degree from Arizona State University, Brown went on to earn his law degree from the University of Arkansas. Brown continued his legal and business education by earning his Master of Law in taxation from Southern Methodist University School of Law.

Brown began his professional accounting career in the tax department at Peat, Marwick, Mitchell & Company, one of the big eight international accounting firms. He received a broad exposure to tax, accounting and business matters while at Peat.

Brown went into the private practice of law as a tax attorney where he handled his first dental practice transition in 1990. After several years in the private practice of law, Brown ventured out into the private business sector. He was involved in the transportation, insurance, finance and medical supply distribution industries. Active in these industries, Brown held positions as the Past Chairman of the premium finance division of the American Financial Services Association, Past President and Director of the Insurance Premium Finance Association of Texas, Past Chairman and Director of the Texas Motor Transportation Association Allied division, Past Director in the J. Rueben Clark Law Society Dallas/Fort Worth chapter and of the B.Y.U. Management Society Dallas/Fort Worth chapter. Brown is a licensed attorney in the States of Texas and Arizona.

Brown is the Past President of ADS, a national organization of 25 brokers across the country. ADS generated in excess of two hundred million dollars of dental practice sales this last year. Brown is a frequent lecturer at dental conferences, national seminars, and dental schools. He has published articles for the Texas Dental Association's Texas Journal, Dental Economics, Houston Dental Journal, and is a contributing author in the newly released dental practice transition book, "The Affluent Dentist."

Brown has worked extensively with local troops of the Boy Scouts of America in positions as Scoutmaster, Troop Committee Chairman and fundraising chairman for high adventure activities. Brown has enjoyed taking scouts to Philmont Scout Ranch, is an Eagle Scout and has two sons who are Eagle Scouts.

Brown enjoys family outings with his wife Jennifer and their five children. He plays squash and fits in an occasional round of golf. One of his real treats is to get out and wet a line fly fishing.

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