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Due Diligence and the Anatomy of a Failed Transaction

The Jaswal Institute was recently retained as legal counsel to advise a dentist on the purchase of a dental practice, which did not proceed to closing due to matters discovered by the transaction team in the due diligence phase. This article will present the transaction as a case study to stress the importance of due diligence and of assembling a professional advisory team to guard investments in dental mergers and acquisitions. For client confidentiality purposes, we have altered absolute values but attempted to keep relative values and percentages the same to ensure that the real-world nature of the case study is realized.

Table 1 summarizes the significant deal terms as ascertained from legal material, the appraisal, the lease, initial discussions with the selling dentist, and other relevant sources prior to undertaking more detailed legal and financial due diligence.

Financials		
Annual Revenue	$600,000	
Adjusted Annual Profit	$60,000	
Adjusted Profit Margin	10%	
Active Patients	900	
Average Annual Revenue/Patient	$667	
Legal		
Co-payments and Deductibles	No Issues Reported	
Effective Date of Demolition Clause (landlord's right to terminate the lease so that demolition, redevelopment or substantial renovation can occur)	Five Years	
Allocation of Employee Termination Costs	100% Liability to Purchasing Dentist	
Valuation		
Tangible Assets (equipment, instruments and supplies, leaseholds, software)	$250,000	33%
Goodwill (intangible assets)	$350,000	47%
Additional Premium	$150,000	20%
Purchase Price	$750,000	100%

Table 1.
Significant Transaction Terms Reported Prior to Due Diligence

Red flags

Observing Table 1, significant areas of concern can be identified.

Financials

The financial statistics were not impressive. Using 2015 data obtained from the Government of Canada, we analysed the available financial statements and financial performance of all dentists in Ontario and found that the average dental practice generated approximately a 33 per cent profit margin. Accordingly, though the selling dentist's profit margin of 10 per cent was concerning, it was not a deal-breaker since our client, the purchaser, had potential options for improving the profit margins of the practice.

First, as the practice was overstaffed, we suggested that employment levels be revisited. However, since the practice was comprised of long-term employees, the employee liability would be significant and the selling dentist would not renegotiate the condition that termination costs for any employee's employment period — prior to the closing of the sale of the practice and up to the effective date of termination — be paid solely by the purchasing dentist. Typically, and depending on market conditions, if a purchasing dentist terminates employees within the first few months after buying a dental practice, the selling dentist contributes to employee termination costs. In this case, the selling dentist insisted on allocating the full liability to the purchasing dentist.

Next, we examined the revenue-per-patient statistics available prior to our due diligence. As noted in Table 1, based on the appraisal, we calculated the average annual revenue per patient to be $667, which is in line with the Ontario average of $670, obtained by analysing historical deal data and data obtained from an accounting firm specializing in the dental industry. We advised our client, the purchasing dentist, that, after a review of service reports and billing codes, if the appraisal's active patient count held up, there was a potential that we could discover areas where the practice could be improved and where patients could be served more comprehensively to improve practice and patient outcomes.

Legal

As discussed, the selling dentist would not entertain the reallocation of employee termination costs. If the purchasing dentist wished to optimize the practice, the significant employee liability would be his or hers to bear. In addition to the employees, the demolition clause in the lease — which would allow the landlord to terminate the lease and demolish, redevelop or renovate all or part of the building — would be effective and enforceable upon the purchase of the practice. The demolition cause was a showstopper with respect to financing the transaction since, based on the financial information available, the bank requested that the demolition clause be delayed 10 years over the term of the loan. (In order to guarantee that the loan will be repaid, the bank must ensure the practice will exist for 10 years without being demolished, redeveloped or renovated.)

We advised the seller that this situation had to be resolved prior to us proceeding with the purchase of the dental practice. The landlord in this scenario refused to negotiate for 10 years, but agreed to an additional five years in exchange for a one-time cash payment from the seller, effectively forcing the seller to pay the landlord for a five- year extension to the demolition clause in order to make the practice financeable for a bank and ultimately sellable (initial, early and diligent lease negotiations could have prevented this situation for the seller, but that is a topic for another article). As the five-year extension was still not acceptable to the bank, since the cash-flow analysis indicated that practice revenues could not cover expenses and safely service the debt when amortized over five years, our firm negotiated an interest-free vendor take-back (selling dentist agreed to an interest-free loan in favour of the purchasing dentist), which positively affected the bank's credit metrics, allowing us to secure a business loan and line of credit to finance the transaction at 100 percent of the purchase price. To that end, as the intangible portion of the purchase price, including goodwill and the premium, accounted for 67 per cent of the purchase price, it was critical that the purchasing dentist, through due diligence, was satisfied with respect to the value of the goodwill. In the worst case, if the goodwill was not properly analysed via diligence and was ultimately not transferable to the purchasing dentist post-sale by virtue of being worthless, and if the landlord enforced the demolition clause in five years and decided to demolish, redevelop or renovate all or part of the building, the intangible assets that the purchasing dentist paid for would have no value, and our client would effectively have to relocate the practice and incur significant start-up costs in the form of new leaseholds and other relocation costs. In other words, our client would be forced to relocate and effectively begin as a start-up, even though he/she had paid a significant amount for intangible assets which were ultimately worthless.

Valuation

As noted above, the intangible portion of the purchase price, including goodwill and the premium, accounted for 67 per cent of the purchase price. Though intangible assets can consist of a variety of factors — including profitability and cash-flow potential, reputation of the seller, attractiveness of the lease, stability of the practice, innovation, technology and management systems, competition, quality and experience of staff, marketability of the practice, size and location of the practice and use of dental practice names — the patient profile and charts, the quality of patient records and the transferability of this goodwill, which relates to the degree to which patients will remain with the practice after sale, are the most important aspects of the intangible purchase price. To that end, it was critical that the purchasing dentist was satisfied with the profile of patients, number of patient charts, quality of these records and transferability of this goodwill. As previously mentioned, without this due diligence, there was a significant risk that the purchasing dentist could unknowingly participate in a transaction where 67 per cent of the assets being paid for were made up of intangible assets of no value.

Due diligence methodology

Based on the concerning results observed prior to due diligence, the transaction team advised the potential buyer to proceed with caution and consider not moving forward with this transaction. However, given the competitive market for dental practices and the fact that buyer had been searching for a practice for a considerable time, he/she wanted to move ahead with due diligence to analyse whether the practice had turnaround potential. As highlighted above, the transaction team was focused on the most critical indicators of goodwill — the patient profile and charts, the quality of patient records and the transferability of this goodwill, which relates to the degree to which patients will remain with the practice after sale. We examined the following:

- Active Patients: Whereas the appraisal included patients who attended the practice in the previous 12 months for any kind of dental treatment, we considered those who, in addition to having visited the practice in the past 12 months, displayed a pattern of visiting the practice. To that end, we analysed a 10 percent sample to form our conclusions.

- Production Reports: Reports were analysed to verify revenue numbers.
- Insurance Information: The appraisal and selling dentist had reported that co-payments were not an issue. We tested this through analysing notes, ledgers, payment history and accounts-receivable reports.
- Types of Treatment/Service Reports: We analysed billing codes to assess areas where the practice could be improved and where patients could be served more comprehensively. We further assessed whether the work was preventative or restorative, and if it was the latter, we could conclude that the patients were more reactive and thus not recurring active patients, by our definition.
- Appointment Book: This was analysed to verify upcoming patient visits and revenue.
- Postal Codes and Demographics: Postal code analysis provided us with an estimate of the proportion of patients who lived close to the practice since, on a transfer of ownership, it is likely that patients who travel longer distances to their dentist will relocate to closer practices. The demographic analysis helped us predict revenue from patients based on age models.
- Accounts-Receivable Reports: These were analysed to assess collection patterns and co-payment issues.

Due diligence results

With respect to the active patients, based on our sample, the practice had 400 active patients. Given the $600,000 revenue figure, this would suggest an annual revenue per patient of $1,500. As we considered this outside of our acceptable range, we analysed statistics of comparable practices and adjusted our sample results to conclude that the active patient number was closer to 600 (much lower than the 900 active patients represented in the appraisal), which suggested an annual revenue per patient of $1,000. As noted above, based on historical deal data and data obtained from an accounting firm specializing in the dental industry, the average annual revenue per patient in Ontario is $670. Given that the practice's annual revenue per patient of $1,000 was much higher than the Ontario average and than initially reported in the appraisal ($667), not only could we likely not improve the margin potential of the practice via the existing patients, but there was a possibility that our client would not be able to sustain the higher-than-average revenue per patient level, thus representing a downside in future cash flows and the value of the practice. This conclusion was buttressed by our analysis of billing codes, which found that many patients were reactive, as opposed to preventive, and thus potentially not recurring active patients, according to our definition.

With respect to the insurance, we found that co-payment was an issue historically. Though the practice did not actively promote not collecting co-payments, based on notes, ledgers and financial records, patients were not paying their required amounts. The co-payment issue was emphasized during our review of accounts-receivable reports, which suggested that the practice was regularly writing off uncollectable amounts. More recently, as financial records must include the date and amount of all payments received from the patient and the dental insurance provider, we noted that the practice had been attempting to collect a low flat fee from patients, typically representing a small portion of the co-payment amounts, which we concluded may have been a strategy to increase the sale attractiveness of the practice by attempting to improve the historical co-payment issue. More worrying, based on a detailed analysis of patient ledgers, we noted that the practice was losing patients as it attempted to enforce its co-payment strategy. Accordingly, patients who otherwise would have been counted as active, would not be producing any further revenue for the practice. Since the purchasing dentist was adamant about strictly enforcing co-payment collection, it was highly probable that he/she would lose a large proportion of the patients at the clinic, thus significantly diminishing the value of the patient charts and goodwill.

Based on our analysis above, the value of the intangible assets was significantly reduced due to the patient and co-payment issues. Similarly, the value of the tangible assets was significantly diminished due to the demolition clause, which would allow the landlord to terminate the lease and demolish, redevelop or renovate all or part of the building. The information presented by the seller did not pass our tests and thus, in conjunction with the limited turnaround potential of this practice, our client, the purchasing dentist, was advised not to proceed with the transaction.

In summary, this real-world case study is intended to emphasize the critical nature of due diligence and the value of retaining professional advisors to assist in protecting investments and sheltering them from assessable and unnecessary risks.

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