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Life Sciences & Health Care M&A Transaction Services Issues Brief #8

Understanding and Evaluating Deal Considerations in the Dental Practice Sector

An update for private equity investors

This issue explores certain financial and tax issues that private equity investors should consider when making investments in dental practices.

Financial Considerations

Health Care Reform Impact – Health care reform has had a significant impact on the dental industry, and is expected to drive additional revenue opportunities for dental practices. The Affordable Care Act requires insurers to offer dental care for children (but not adults), increases funding for dental education and training, and establishes dental pilot programs intended to expand the reach of dental services to areas in need. In response to research showing the benefits from good dental health practices, the number of people with private insurance is expected to increase, and the number of states offering Medicaid dental programs may also increase (currently only half of the state Medicaid programs include dental coverage). These trends are expected to drive additional volume to dental practices.

Revenue Recognition – Dental practices are typically reimbursed on a fee-for-service basis from commercial and government payors. Understanding historical billing and collection practices is a key focus of the dental provider due diligence process. Revenue recognition for dental practices is complex, as there are variations between gross amounts charged and contractual rates with insurers. Significant judgment is required to estimate future expected cash collection and the value of accounts receivable. Changes in historical trends related to payor mix and timing of collections may affect the accuracy of estimates, resulting in a financial impact to EBITDA and working capital. Investors should consider performing additional procedures related to accounts receivable to assess whether historical accounts receivable estimates have been realized through subsequent cash receipt and whether historical trends indicate current accounts receivable are collectible.

A large portion of dental patients are self-pay, and certain long term dental procedures, such as orthodontics and dentures, may be paid by patients upfront or in installments. While the dental practices have received the cash, they have continuing obligations to provide services. As a result, payments may not match the timing of costs incurred, resulting in deferred revenue. Additionally, self-pay patients may participate in payment plans or financing, resulting in accounts receivable. Investors should gain an understanding of payment arrangements during due diligence.

Retail Considerations – Often, dental practices are organizations comprised of several small practices that may have characteristics similar to a retail model. Investors should consider same store sales analysis, which can help identify performance metrics by location. Additionally, a vintage analysis can be used to analyze the timing of when practices transition from start-up to profitability, understand historical trends, and assist in the development of future expectations. Financial results should continue to be analyzed in periods subsequent to achieving breakeven results, as certain dental practices, particularly those with a focus on Medicaid patients, may experience a short term increase in revenue when the practice opens. Patients, who previously did not receive dental services, may have a higher number of procedures performed initially, but normalize over time. Under a retail model, investors should analyze a target's growth and operations by assessing base, de novo, and acquired entities' growth trends.

Cash Basis Considerations – Many dental practices use a cash basis of accounting, and are not subject to a financial statement audit. When performing financial analysis and developing a financial model, investors should consider utilizing accrual basis financial information, as there could be significant timing issues in the receipt or disbursement of cash that do not reflect the economics of transactions. Additionally, upon exit of the investment, accrual basis financial statements may be required. Investors should tailor due diligence to include cash to accrual adjustments. In instances where companies are not subject to a financial statement audit, investors should be aware that due diligence procedures may not identify material misstatements that audit procedures could identify, and financial results may be subject to adjustment at the completion of an audit.

Ownership Structure – Dental organizations often have complex organizational structures. Dentists may own portions of practices, holding companies, or parent companies. Due diligence procedures should be designed to understand the ownership structure, including any non-controlling interests, and the financial impact related to the consolidation of any variable interest entities. These ownership structures can be complex and may not be reflected in unaudited financial statements. Additionally, investors should understand the contractual relationship between the dentists and any related entities, as these relationships may have financial and regulatory ramifications that could impact deal value.

Tax Considerations

Tax Structuring – Certain states require dental practices to be owned by medical professionals who are duly licensed or otherwise legally authorized to render professional medical services. This requirement is often referred to as the corporate practice of medicine doctrine. To comply with the corporate practice of medicine doctrine, investors may need to form legal entity/ownership structures, whereby a private equity-owned management company and the existing dental practice operate under the governance of various agreements. The formation of these structures, the ongoing operations, and the exit from these structures can have adverse tax implications for both buyers and sellers if not carefully structured and reported.

Prior Acquisitions – Certain dental practices have previously acquired assets/practices from other parties, including dentists themselves. Often, tax due diligence has not been conducted in connection with these acquisitions, and the acquiring dental practices may receive varying degrees of contractual protection for pre-closing tax matters. As such, it is important to understand a dental practice's prior acquisitions, analyze the nature and extent of any tax indemnification provisions, and evaluate whether such tax indemnification provisions will carryover in a contemplated transaction. Furthermore, it is important to understand whether sales/use taxes and transfer taxes in connection with these acquisitions had been remitted to the applicable tax authorities depending on the form of the acquisitions. Otherwise, any unpaid sales/use taxes and transfer taxes may be inherited by investors in contemplated transactions.

Independent Contractors – Dentists who sell their assets/practices to dental practices may enter into independent contractor agreements with the buying entity. The dental practices then treat these dentists as independent contractors. The proper classification of an individual as an independent contractor vs. an employee is highly dependent on the facts and circumstances. Dental practices that misclassify certain individuals as independent contractors may be subject to income tax withholding exposure and payroll tax exposure, which could be sizable depending on the number of independent contractors and the lengthy statutes of limitations. Underpayment of payroll taxes could also impact a dental practices' quality of earnings.

Tax Accounting Methods – Many dental practices also utilize the cash method of accounting for tax purposes. Depending on the tax structure that investors pursue, dental practices may be required to report taxable income using the accrual basis of accounting during post-closing tax periods. The conversion from the cash basis of accounting to the accrual basis of accounting may trigger taxable income, creating adverse tax implications for buyers and/or sellers. As such, investors should address these tax implications in the letter of intent so that the parties clearly understand who is responsible for the taxable income that may have been deferred as a result of the cash basis of accounting. Additionally, if required to use the accrual basis of accounting for tax purposes, the dental practice will need procedures in place to substantiate its revenue recognition generally based on contractual reimbursement rates at the time of services and billings. If the dental practice has not historically implemented such procedures, additional post-acquisition system implementation costs may be required.

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