Case Consortium @ Columbia
Columbia University

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Merging Two Worlds?: Reston Dental Arts and American Dental Partners Teaching Note

Case Summary

In the 1980s, dental practices in America began a process of consolidation that for medical practices was already well advanced. General dentists had traditionally worked in solo practices on a fee-for-service basis, referring patients to specialists as needed. But several factors drew some into group practice. First, in 1979 the Federal Trade Commission dropped its ban on advertising by dentists. Advertising was a promising way to attract new patients, but it was more affordable and effective to market as a group than as a lone dentist.

Second, dentists with different specialties in a group practice could keep referrals in-house, boosting revenue and making care more convenient for the patient. By joining a group practice, new dentists, often carrying debt from student loans, could enter the field without having to invest heavily in equipment and office space. There was greater collegiality within a group and more flexible working hours, both of which seemed to fit changing expectations of the workplace.

For all these reasons, 10 dentists in 1987 came together to found Reston Dental Arts (RDA) in suburban Virginia. Overall, the group's business was successful. Patients were happy with the arrangement, the dentists earned more while enjoying greater flexibility, and there was considerable camaraderie among the partners and office staff. There were, however, some signs of disquiet. Personality differences, the strain of having to reach consensus among all 10 partners on every business decision, and grumbling over some partners' ownership of the group's office building created some tension.

It was in this context that RDA in 1998, a decade after its formation, faced a second decision: should it accept an offer by a dental management company, American Dental Partners (ADP), to buy and manage its business, leaving the dentists to focus solely on their clinical work? The partners had already reaped the benefits of becoming a group practice—sharing the costs of

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equipment and office staff, for example. Bringing in a professional management company could lead to even greater efficiencies and higher profits. ADP offered to take on all management tasks; it could also purchase items in bulk, and cheaper, for its many dental groups. It could be a good time to sell to a company like ADP.

This decision point is the focus of Part A of the case. There were clear advantages to affiliating with ADP, especially for older dentists who could retire early on the proceeds of the sale. There could also be opportunities for further gain, both monetary and professional, if ADP, as promised, was able to expand RDA's operations across the region. But there were risks. The dentists would lose some control over their own practice, and the culture of the business could change. Moreover, the terms of the deal were up for debate. What was the right price? How should ongoing revenue sharing be structured? ADP had devised similar arrangements with other group practices, but how could RDA be sure that those terms would be in its own best interest? The case ends as the partners debate whether to accept or reject the ADP offer.

In Part B, RDA has affiliated with ADP, and the early results are mixed. By late-2000, a mini-rebellion has resulted in the angry departure of three partners (a fourth had left for unrelated reasons). The practice is losing money, and RDA and ADP are accusing each other of breach of agreement. The RDA partners are tempted to shutter the practice, but ADP says it will sue if they do so. Part B focuses on the remaining partners' options for salvaging the business.

Teaching Objectives

This case highlights the challenges of working in a group, both for individual dentists within the RDA partnership and for RDA within the management structure of ADP. What are the benefits and downsides of affiliation? What are the pluses and minuses of solo practice? The case touches on several factors that students should consider when, in the future, they are faced with the choice of affiliating with others or maintaining their independence.

One consideration is money. The case explores numerous business concepts: how to valuate a practice, what constitutes goodwill, formulas for sharing future earnings, and how a group practice may acquire other offices and get a cut of an expanding pie. It looks at the potentially lucrative role of real estate ownership in a group practice, and the advantages of building an on-site laboratory. It also discusses the significance of insurance, both in attracting patients and in adding complexity and cost to the business. The case delves into financial considerations that affect individual dentists: the costs of starting a solo practice, how age and anticipated retirement may make an outside offer more or less attractive, and weighing up-front payment in a buyout against long-term revenue-sharing responsibilities.

Another consideration is the office environment and work-life balance. Which arrangement offers more flexibility, camaraderie, security, and opportunity for advancement? Does affiliation allow dentists to focus on clinical work, or do new distractions inevitably interfere? How does affiliation affect the non-partner members of staff—the dental associates and the office workers—and should the partners take their views into account? Students can discuss the meaning of an organization's "culture" and the forces that shape it. In particular, the case illuminates the outsized impact of individual personalities on the success or failure of a group endeavor. Is there such thing as a partnership of equals? How can decision-making be made fair if some partners are more aggressive or outspoken?

Finally, there is the question of industry trends. Several are noted in the case: growth in group practices, the move to in-house referrals, and increased advertising and marketing. Dentists are starting to sell their businesses to large management companies. Patients increasingly carry dental insurance, and are demanding appointments outside of traditional office hours. The protagonists often wonder whether they should be adapting to the future, or holding on to tradition. What are the risks, or rewards, of bucking such trends?

Students can discuss the affiliation decision from various points of view: a recent graduate with student debt and no established patient list; an older dentist who has invested heavily in a group practice; a successful solo practitioner being courted by a managed-group practice—to name just a few. The case may be particularly useful in helping students understand valuation methods. Because each method has limitations, companies commonly employ several of them, allowing the parties to "triangulate," or cross-check the validity of the valuations. Students may come to regard valuation as being an "art" as much as a "science." At least four methods are touched upon in the case:

Market Value Approach. A company's worth is determined by the going rate of similar businesses. In determining its offer to the RDA partners, ADP "used as one element national numbers for a traditional purchase from one dentist by another."[1] This approach can provide a handy benchmark, but it relies on comparable and frequent sales for accuracy. The sale of a dental practice is relatively uncommon, and the context of a sale is rarely comparable. For example, one dentist's business may have been driven into the ground over years of mismanagement and patient attrition, while another's is on an upswing in a booming market. Patient demographics, geographic location, the condition of equipment, and a dentist's reputation are among the many factors that make comparing practices a complex endeavor.

Gross Revenue Multiplier Method takes the previous year's gross revenue and multiplies it by a certain factor, known as a "revenue multiple." The revenue multiple is based on an

[1] See Appendix 1 of the case.

observation of the marketplace and an analysis of revenue multiples used in other, similar deals. ADP's cash/stock offering to individual partners is based on "his most recent production numbers during the last year in practice."[2] But last year's figures many not be typical of a given dentist (e.g., if he or she was new to the practice or needed to take parental leave), nor does it take into account a dentist's value to the overall business apart from individual revenue figures (e.g., a dentist's leadership qualities, mentoring of younger colleagues, or reputation in the community). A particularly lucrative year does not guarantee future performance at the same level. In deriving the revenue multiple, moreover, this method (like the market value approach) suffers from the incomparability of sales of dental practices. A multiple that works for one deal may not work for another, because geography, demographics, etc., make each practice unique.

Asset Summation Method adds up the current value of all hard assets (real estate, equipment, furniture, non-returnable supplies, etc.), monetary assets (cash, accounts receivable, liquid inventory, etc.) and intangibles (goodwill, patient lists, non-compete agreements, etc.). There are established accounting conventions for calculating the book value of fixed assets, as well as the cost of collecting on (or writing off) accounts receivable. But that is the essential limitation of this method: it is an accounting view, not a market view. A dental practice's book value may differ considerably from its market value (the difference is referred to as "goodwill"), because potential buyers place value on intangibles, such as a dentist's reputation or the location of the office.

As the case notes, RDA's hard assets had depreciated. But ADP wanted to make an attractive offer, so it upped its goodwill assessment: "Since physical assets, once used, had relatively little value, ADP essentially purchased the goodwill of the practices with which it affiliated, and allowed the dentists tor realize the equity value they built up in the practice over the years."[3] The dentists calculated the group's goodwill to be $4 million and ADP agreed to this assessment when it made its second offer of $8.1 million. It was an inexact figure, only "accurate" insofar as both parties agreed it was worth buying—and selling—at this rate.

Capitalization of Earning Method estimates a business' future profits, and discounts them at a specified rate to take into account the risk that profits will not materialize as predicted. The smaller and more distant the expected profits, the higher the discount rate. Dental practices are typically discounted 20-45 percent. ADP's first offer of $6.1 million discounted at 25 percent: "[ADP's CEO] calculated that ADP's annual share of RDA's profit would come to $1.6 million. The first offer was about four times that—an approach ADP had used for previous purchases."[4] The limitation of this approach is that the discount rate is fairly arbitrary (consider how wide the "typical" range of 20-45 percent is!). Future earnings are volatile and not assured.

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[2] Ibid.

[3] See case subsection, "A proposal."

[4] Ibid.

Students can also compare two formulas for sharing future income. First, ADP proposed a formula that it had used in previous acquisitions:

> RDA would earn 30 percent of monthly revenue off the top (which would be used to pay the dentists). ADP would pay all expenses (staff salaries, equipment, etc.), estimated to be 50 percent of revenue on average. The remaining 20 percent (estimated) would be split 85/15 between ADP and RDA.

In some ways, this was a good deal for both parties. The dentists were guaranteed a salary, and ADP was incentivized to keep costs down in order to realize a larger profit. But it didn't sit well with Dr. Kirkpatrick, for whom it appeared that ADP would be getting an undeservedly large share of profits. He proposed an alternate formula:

> Expenses (estimated at 50 percent) would be taken off the top. The remaining revenue would be split 30/70 between ADP and RDA.

Students can test the formulas. What would happen under each scenario if there was a significant dip in revenue one month, or if expenses were unusually high? Does ADP's incentive to manage costs differ under the two plans? Part B of the case reveals the failure of the two parties to keep to the formula agreed upon: the dentists continued to take their salaries off the top, without covering expenses first and without abiding by the 30/70 split. They accused ADP of not managing expenses and collecting on receivables. Students should argue whether this breakdown was due to inherent problems in the formula, personality issues, or other factors.

Class plan

Use this case in a class/course on dentistry professional practice, medical management, mergers and acquisitions or human resources. It can also be used as a history of dental business in the US, including trends in managed care and insurance.

There are two parts to this case. Students can access Part A online. **Part B is visible to faculty only**, after sign in, and is coupled with the epilogue. Should you choose to use Part B, please print and distribute in class, or forward the pdf to students in advance of class. You will have to separate Part B from the epilogue.

Pre-class: Help students prepare for class by assigning the following questions:

1) Should RDA accept ADP's proposal? (Part A)

2) How should the remaining RDA partners salvage their business? (Part B)

Instructors may find it useful to engage students ahead of class by asking them to post brief responses (no more than 250 words) to questions in an online forum. Writing short comments challenges students to distill their thoughts and express them succinctly. The instructor can use the students' work both to craft talking points ahead of class, and to identify particular students to call upon during the discussion.

In-class questions: The homework assignment is a useful starting point for preliminary discussion, after which the instructor could pose any of the following questions to promote an 80- to 90-minute discussion. The choice of questions will be determined by what the instructor would like the students to learn from the class discussion. In general, choosing to discuss three or four questions in some depth is preferable to trying to cover them all.

a) What are the attractions to individual dentists of coming together in a group practice? What are the disincentives?

b) What are the attractions to a group practice of selling to a management company? What are the disincentives?

c) Both RDA and ADP wanted an accurate picture of RDA's present and future value. They employed various appraisal methods (including market value approach, gross revenue multiplier method, asset summation method, and capitalization of earning method). Why did they employ multiple methods? What are the limitations of each?

d) List the methods of valuation on board. For each method, what financial information would ADP/RDA have needed to conduct a useful analysis?

e) A large but amorphous piece of ADP's offer constituted "goodwill." What did this include? How is goodwill quantified?

f) Two formulas were proposed for sharing future earnings, one by ADP and a second by RDA. What were the shortcomings of each formula? What might a compromise have looked like?

g) Personalities affected the way the dental partners communicated and made decisions. The most outspoken partner seemed to be the *de facto* leader. Was this avoidable? Discuss how, or if, a partnership of equals should be "led."

h) Real estate became a bone of contention among the dental partners. How could the group have addressed the disagreement?

i) Older dentists at RDA were more enthusiastic about the ADP deal than younger ones. Why? Could the deal have been structured so that both younger and older dentists viewed it favorably?

j) Associates and office staff were excluded from the decision on the ADP offer. Would their views matter? Why/why not?

k) The case provides examples of positive and negative motivation. Seeing colleagues' monthly revenue figures, for example, pushed some dentists to work harder and earn more. How was the ADP deal designed to motivate the dentists? What factors may have demotivated them (and associates and office staff) after the affiliation with ADP went through?

l) The deal was supposed to incentivize ADP to manage costs, collect on accounts receivable, and expand the business through new acquisitions. Why were these objectives unmet? Did the structure of the deal have anything to do with it?

m) Imagine you are a new dentist joining a group practice. How might your experience differ in an independent organization compared to one under a dental management company? Consider compensation, opportunity for growth, office culture and other salient factors.

n) Accountant John Smithers prepared a balance sheet[5] for RDA covering the first four months of 1998. How could this have been used by the dentists to help make a decision? What other information would have been useful?

Suggested Readings

Aegis Communications, "Flying Solo? Understanding the Trends Driving Large Group Practice," *Inside Dentistry*, Vol. 7, No. 8, 2011.

SYNOPSIS: This article provides a concise history of group dental practice in the US, and the impetuses toward consolidation. It describes different group structures, including those reliant on dental practice management companies like ADP. While generally focused on the advantages of group practice, the article also discusses the downsides of consolidation and why many dentists choose to remain solo practitioners.

https://www.dentalaegis.com/id/2011/09/flying-solo

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[5] See Appendix 3 of the case.

"Park Dental History," Park Dental website

SYNOPSIS: This webpage summarizes the history of Park Dental in Minnesota, one of the first group dental practices in the country and an inspiration for the dentists who formed RDA.

http://www.parkdental.com/about/park-dental-history (accessed June 2, 2014)

"American Dental Partners Inc. (ADPI) IPO," Nasdaq.

SYNOPSIS: The site provides key data, financial records and other background information for ADP's Nasdaq listing in 1998. (Part of the filing is also presented in Appendix 2 of the case.) The Overview section analyzes trends in the dental industry, such the expansion of insurance plans, which have resulted in a growing demand for professional management companies. It lays out ADP's strategy for fulfilling this demand.

http://www.nasdaq.com/markets/ipos/company/american-dental-partners-inc-2517-4492 (accessed June 2, 2014)

ADA Health Policy Resources Center, *A Profession in Transition: Key Forces Reshaping the Dental Landscape*, American Dental Association, 2013.

SYNOPSIS: This is a comprehensive industry report looking at trends in dental care use and expenditure, patient demographics, insurance and the Affordable Care Act, dental school capacity and the cost of education. It is published well after the timeframe of the case, but provides some useful context.

Scott Becker et al, *Investing in Dental Practice Management: Key Issues and Notable Transactions* [Virginia: McGuireWoods, 2012].

SYNOPSIS: This white paper, produced by consulting company McGuireWoods, advises on legal and business issues that management companies and private equity firms investing in dental practices should analyze before entering into a transaction.