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PPD INDEX

GOODWILL – WHAT'S THE STORY?

Chartered accountant Alan Suggett has been preparing a quarterly goodwill survey since 2007 on behalf of NASDAL. Here he reports his findings and parts with some advice on buying and selling a practice

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On behalf of the National Association of Specialist Dental Accountant and Lawyers (NASDAL), I have been preparing a quarterly goodwill survey since October 2007. The survey originally started because members of NASDAL, as leading advisers to dentists, wanted something more than a subjective view about practice values. NASDAL members act for about 20% of the UK dental profession, so its surveys would be authoritative.

Over the period leading up to the 'new' NHS contract (which was introduced in April 2006) we had seen a change in typical practice goodwill values, starting from a rule of thumb of goodwill being roughly a third of gross fee income, values were rising, and we were seeing clients being caught out by this. We wanted to have our finger on the pulse, and be up to date.

NASDAL's first two surveys showed goodwill, expressed as a percentage of gross fee income, at around 75%, but from 2008 onwards the trend has been upwards, and nowadays regularly exceeds 100%. A good example of this was a client of mine who told in late 2007 that he'd agreed to sell his practice, and he'd got a good price! I asked for more details and he told me that he hadn't asked for my help as, rather than the expected third, he'd negotiated 50%. I told him I wasn't impressed and asked if I could help him increase the price. He was reluctant, but I offered to work on a fee based on 5% of any increase in value I could negotiate. The next week, after half an hour of discussion in a local pub with the prospective buyer, I'd increased the sale price from 50% to 75%, which represented £100,000 more! I was able to do this by reference to the NASDAL survey – I was sure of my ground.

At this stage I'll pause to dampen the fiery rage of some readers – particularly those who are sales agents. Sometimes when the NASDAL goodwill survey is published there's an interesting reaction from agents. Rightly, they want to reinforce the fact that there's more to practice goodwill valuation than a percentage of turnover. But this is simply a formula for the survey and not the actual methodology for valuing a dental practice. Perhaps they are keen to preserve their monopoly of the dark art of valuation! Then there are the vocal voices on dental forums who wax lyrically about ridiculously high values, and predict dental financial armageddon!

I get pleasure from the fact that, before qualifying as a chartered accountant, I spent three years at university gaining an honours degree in statistics, so I think I'm amply

TABLE 1: FACTORS INFLUENCING GOODWILL

- The size of the practice
- The nature of the practice (NHS, mixed or private)
- The location
- The value of UDAs in NHS practices
- The subjective value to the buyer.

qualified to present a statistical survey!

Any competent adviser knows that goodwill values depend on more facts than the percentage of fee income, but it's fair to say that this is the only simple measure that can be derived from limited data.

GOODWILL FACTORS

Straying now into more dangerous territory, what do I think are the factors influencing goodwill values in the marketplace? These are seen in Table 1. Large practices that have an NHS contract with fee income over £500,000 usually have a market value based on a multiple of profit, as they are attractive to corporates. Profit multiples vary between purchasers, but recent practice sales have been coming in at around five times adjusted profits. The word 'adjusted' is of critical importance, you can't just read the net profit from the practice accounts and multiply it by a factor.

The corporates usually don't depend on money borrowed from banks, they are using venture capital funding, and therefore can take more of a risk in their expansion strategies.

Smaller practices tend to have a value related to turnover, as the usual buyers are other dentists who will continue to work there. Other than the level of fee income, values are influenced by a number of factors, chiefly:

- If the practice has a NHS contract, what is the UDA value?
- If it is private, what is the proportion of patients paying into a scheme compared to those paying on a fee per item basis?
- The type of area and local circumstances.

NHS practices tend to have a higher percentage of goodwill to turnover, private somewhat less. In the April 2012 NASDAL survey average percentages were: NHS 107% and private practices 83%. Usually the value of equipment, fixtures and fittings is calculated (based on age and condition) in addition to the goodwill amount.

It's important to realise that this summary isn't necessarily how I think values should be derived, and is rather a commentary on what I see in practice. When I help clients buy practices I prepare a forecast of profitability and cashflow (taking into account tax payments and loan capital repayments) to determine what the practice is worth to the buyer. If it's worth more than the asking price, then my advice is to go for it — if not, negotiate the price down or withdraw. When acting for sellers I approach it differently, and use whatever tactics and arguments I can!

TABLE 2: PURCHASER DENTIST – PROFIT AND LOSS FORECAST

(All work by associates)

NHS income		Projected
14,000 UDAs @21		294,000
Private		10,000
		304,000
Direct costs		
Lab & materials	11.4%	34,656
Associate fees: 14,000 UDAs + Private		128,790
GROSS PROFIT		140,554
Overheads and expenses		
Wages & NIC		45,000
Rates		1,840
Light heat & fuel		1,450
Motor expenses		-
Repairs & renewals		3,100
Insurances		2,000
Bank charges		1,300
Accountancy		1,500
Printing, postage & stationery		5,450
Sundry, cleaning & laundry		10,900
Depreciation		-
Loan interest		28,000
Total expenses		100,540
NET PROFIT		40,014
NET EARNINGS CALCULATION		
Net profit as above		40,014
Less tax @ 40%		(16,006)
Deduct loan capital repayments (10 years)		(40,000)
NET DISPOSABLE INCOME		(15,992)

BUYING A PRACTICE

It is essential to prepare a financial forecast that shows what you will get out of the target practice if you acquire it. This forecast should not just be a profit and loss account, but should take into account income tax payments and bank loan capital repayments.

I recently prepared such a forecast for a client who was considering a £400,000 acquisition, as seen in Table 2. The financial forecast showed he would expect to make a net profit of £40,000 per annum. This was after paying bank interest, but before loan capital repayments and income tax. This was also to be his second practice, so he was already a higher rate tax payer. He could only borrow money over a 10-year period as his bank insisted on the use of a loan guaranteed by the government. The impact of this was to turn his expected £40,000 net profit into an annual cashflow deficit of £16,000. In this example, the value of the practice to my client was less than the asking price as he couldn't afford to buy it!

Economists summarise this concept by the assertion that the correct price for a commodity is equal to the economic value it brings to the purchaser. This explains why the large corporates are happy to pay (in some cases) more than 200% of turnover for the goodwill of larger practices. The value of the target practice to a PLC is more than five times adjusted net profit (sometimes called EBITDA), which is why they are happy to pay up to this amount.

In summary, Table 3 shows the important factors to bear in mind when a prospective purchaser is considering goodwill values.

TABLE 3: KEY POINTS

- **Percentage of turnover.** An interesting and simple statistic - more relevant to smaller than larger practices, and is not good enough on its own
- **Professional valuation.** Not particularly important in the early stages of a deal, but will normally be required by a lender
- **Value to you.** The most important consideration, for reasons outlined earlier
- **Multiple of profits (EBITDA).** Only of relevance on sale of a practice of interest to a large corporate (or an external investor).

For further information and advice on buying and selling a practice, please visit the NASDAL website on www.nasdal.org.uk

To ask a question or comment on this article please send an email to: PPD@fmc.co.uk