



OMS practice valuations and the pandemic

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During the pandemic, the utmost concern to OMSs is the safety of patients and the health and well-being of employees. Another concern these doctors are being confronted with is the possible loss of value in their practice. At press time, OMS practices were reopening to provide their normal array of services with most work referred by dentists with whom they had a prior relationship.

It appears there exists the same or near the same level of business that was available prior to the pandemic. Some elective procedures were scheduled but had to be delayed due to the pandemic. So as practices move ahead, they may or may not be able to see as many patients per day as they did prior to the pandemic, but they will adjust to continue operating at previous production levels.

Consequently, the concern is what effect did the pandemic have on practices' value and how should the valuation be accounted for? The prior methods of valuation, market method, excess earnings and capitalization of earnings should continue to be utilized, but two distinctive differences should be assessed.

Differences to assess

One difference to assess is how the financial statements are normalized or adjusted to fairly represent what expenses are typical for such practices. The second would be the marketability discount, or the discount in value, due to a potential lack of buyers.

In normal valuations, substitution or elimination of expenses are adjusted to provide OMS practice average costs. For example, considering the effects of the pandemic in valuing a practice in January 2021, part of the analysis should include financial information from the prior five years – including 2020.

But subsequent to the OMS practice being closed for a portion of 2020 due to the pandemic, the 2020 annual financial data for valuation purposes could become misleading. The data's effect could show a decreased value in the capitalization of earnings method of valuation. It

is recommended to use five years of financial data in the capitalization of earnings method, and it is important to note the most recent year typically gets the most weight.

To alleviate this financial distortion due to the pandemic, the process to further analyze the data is to remove the financial data related to the period when the practice was closed until normal production resumed and replace it with data from the same period during the prior year.

For example, if the practice was closed for six weeks and it took another four weeks to return to normal production, 10 weeks of financial data from the same period in the prior year should replace the financial data in the current year. This transfer of financial data assumes the prior year was representative of the practice's normal production and collection. It should be noted the capitalization of earnings method also is typically the heaviest weighted valuation method utilized in valuing small businesses. That is because the method is based on a practice's profitability. IRS Revenue Ruling 59-60 also recommends the method.

The second difference that needs to be considered is the lack of marketability that should be applied to the capitalized earnings value. Marketability is the ability to convert property to cash quickly with minimum administrative and transactional time. The valuation analyst applies the lack of marketability discount to the capitalized earnings value to facilitate the seller having a high degree of certainty of receiving the expected amount of proceeds. This is where the valuation analyst has the most latitude in determining the capitalization of earnings method's value.

Marketability discount

Typically, small business marketability discounts range from 23 to 45 percent. Recently, the marketability discount has been on the high end of the scale for OMS practices. To determine the marketability discount, a valuation analyst considers several quantitative and qualitative factors.

The first (and probably most important) factor is having a buyer. One must be an OMS to own an OMS practice. That fact alone constrains the array of possible buyers. OMS programs in the United States produced 225 graduates in 2017, 245 in 2018 and 242 in 2019. That number creates a strain on the market for associates and buyers. Empirically,

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a trend shows more OMS graduates want to be associates or institutional employees rather than practice owners.

In the last few years of difficulty finding associates and buyers, the discount for marketability has typically been in the higher range of the 23 to 45 percent discount. It has become more difficult in previous decades to find possible buyers. That fact is “baked in” to the marketability discount on the high end of the scale. Furthermore, the pandemic may have impacted qualitative factors that need to be considered when applying a marketability discount.

One very important factor is the trained staff. Did the practice retain its well-trained surgical and clerical employees? Typically, a well-trained staff is the practice’s best asset.

Another factor to consider is OMS practices have practice management software systems that can provide important information regarding patient referrals from local dentists. Referral information should be reviewed both pre- and post-pandemic to detect any loss of referral sources. The beneficial changes seen in the OMS practice’s prevention of sickness related to the pandemic must be implemented whenever possible in ways that do not affect operational efficiencies. Obviously, it would be beneficial if those preventative changes are well-communicated to referral dentists and patients.

There also remains the likelihood some patients may have some level of reticence visiting the office for elective procedures. This issue may well be handled on the practice’s website and can be part of the initial patient contact.

Extending the discount

After normalizing the financial statements with regard to the pandemic and assessing the mentioned marketability factors, the practice’s value will be affected if it is unable to keep production up to pre-pandemic levels. It may well be prudent to extend the marketability discount to 50 percent or more. To better appreciate this issue, industry

financial data report OMS practices had business revenue of approximately \$1.3 million for 2018. This level of practice income correlates well with the practice revenue per surgeon published by several other organizations.

As a market guideline, it is noted OMS practices sell for about 60 percent of their annual revenue. On average, a practice would sell for about \$780,000. That sale number is typically a weighted combination of three methods of valuation. Those methods are individually based on the valuation methods’ inherent characteristics related to the business valued. Typically, the method given the most weight derives its value on earnings.

Therefore, if the marketability discount is increased, it lowers the capitalized earnings value. Then, when the capitalization of earnings value is combined with the other two mentioned methods to determine the final value, the effect of increased lack of marketability is diluted or decreased.

Three possible outcomes

Post-pandemic, there are three possible outcomes for OMS practices:

- If practices can fully recover to pre-pandemic production, only then would the financial data need to be normalized in a valuation with the pandemic in mind. There should be no change in value.
- If the practice does not fully recover, the lack of marketability should be considered, and the practice’s value could decrease.
- If the practice recovers its productivity but takes longer to produce, there should be no effect on the practice’s value. ■

At the 2020 Virtual AAOMS Annual Meeting, the author will present a session on Tax and Finances after the Pandemic.



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