



Dental Practice Financing — Understanding the Options

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ABSTRACT This article provides insights into the process of financing a dental practice. It provides information on the different options, points out key considerations and potential pitfalls that can lead to a less-than-ideal experience.

Astute buyers know, or quickly learn, that there is more to a well-structured financing package than simply the interest rate. Thorough preparation, lender selection, and offer analysis are the critical components of a smooth buying experience and well-structured loan.

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Purchasing a practice requires — at minimum — knowledge in law, accounting, human resources, banking, and business. Dentists are experts in dentistry. Successful practice owners surround themselves with experts who can serve them well — accountants and attorneys who focus on dental practices; dental brokers who can help find, evaluate, and assist with the purchase; business associates who know human resources; real estate and practice management; and lenders who have expertise in practice finance.

Buyers can avoid many problems or surprises by asking the right questions at the right time and fully understanding the nature of the business relationships forged during a practice purchase.

Preparation

BUILDING A TEAM

Outlined below are some of the main team members and considerations that should be addressed when preparing for practice ownership:

- *Dental practice brokers/transition specialists* — assist buyers and sellers through the sale process. In addition to listing and selling practices, brokers will perform practice valuations and assist with the purchase/sale agreement. Since there is not a source to consolidate listings, buyers normally need to find practices by working with multiple brokers. Word of mouth, trade journals, Web sites, and dental suppliers also are sources to find a practice that is a good overall fit for the buyer.

- *Dental consultants* — also assist buyers with the purchase. Dental consul-

tants who represent the seller and/or buyer can assist with the due diligence analysis of collection ratios, scheduling, fee structures, chart reviews, and computer analysis to ensure the practice details are accurately represented. If due diligence discovers a previously undisclosed issue, buyers often times have new negotiating power to reduce the price or may even decide not to move forward with the purchase. Through their analysis, dental consultants can often recommend changes that the new buyer can implement to increase profitability and grow their business.

- *Dental-focused lawyers* — review the purchase/sale agreement to ensure all language is included to protect both the buyer and seller in the transition. They also review the lease and any other agreements required for closing the transaction.

- *Dental-focused CPAs* — analyze, assess tax impacts, and make recommendations on the buyer's financial options from a tax perspective. They are responsible for the overall financial analysis and tax planning for the practice and will complete the payroll and tax returns for the new buyer.

- *Lenders* — finance the purchase. Once a location has been identified and an offer has been made, the lender evaluates both buyer and seller information to make the final lending decision. Not all lenders offer the same financing terms and conditions, so it is important to evaluate lenders and offers prior to securing financing.

- ★ *Buyer due diligence*: Often times, one or more parties to a sale will offer to make a referral and be subsequently compensated for the referral. Buyers should not only perform their own due diligence on each member of their team, but since there are no disclosure requirements, should directly ask how/if they are being compensated for the referral.

ADDITIONAL PREPARATION AND QUESTIONS TO CONSIDER

- *Prequalify*: Lenders can prequalify the buyer to help streamline a buyer's search. This helps to avoid spending time on purchases that will not be approved.

- *Lease/purchase details*: The No. 1 reason transactions fall apart is the inability to secure space. Land purchases and lease negotiations are normally done simultaneously with the practice purchase. In the case of a lease, problems can arise if a landlord wants to increase the rent or is not willing to assign the lease

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or write a new lease for the new owner. If the space cannot be secured, the practice purchase cannot be completed. For that reason, it is wise for the buyer to ask if the landlord is aware of the sale and is open to new terms. If lease terms can be negotiated on the front side, buyers and sellers avoid undue costs and will not spend time on a deal that might fall through.

- *Risk tolerance*: Similar to making investments, risk tolerance comes into play when making financing decisions as well. The buyer's feelings toward factors such as interest rate variability will help drive a loan structure best suited to the buyer.

- *Cash flow comfort*: Will the cash flow of the practice and the buyer's level of cash flow comfort support higher payments for a shorter term, or would lower payments for a longer term be a better fit?

- *Accounts receivable*: Should the accounts receivable be included in the sale? If not, the buyer may benefit from including some working capital into the

financing. In most cases, buyers do not purchase accounts receivable. A/R is work the previous owner performed, is taxable as income, and may not even be collected. Working capital, on the other hand, is available Day One, is not taxable, but will be assessed interest. In most cases, the buying dentist collects A/R on behalf of the seller, and may or may not be reimbursed for time spent to do so.

Choosing a Lender

Buyers have two main options when looking for practice financing. They can use a lender who specializes in dental practice financing or they can go to a commercial lender at their local financial institution. A third option, using a seller's note, may be considered for all or part of the financing package.

- *Using a specialist in dental practice financing*: This type of lender will have a deep understanding of practice finance and will use the assets of the dental practice for collateral. Due to their experience, they can more easily identify strengths and weaknesses in a potential practice, and will usually be able to render quicker decisions and close the loan faster than a standard commercial loan. They typically are able to finance 100 percent of the purchase price, plus working capital needs that may arise.

- *Obtaining a commercial loan through a financial institution*: A commercial loan financed through a local bank will use the overall practice as collateral. In addition, loans of this nature usually require money down and alternative collateral such as a personal residence or other bank assets.

- *Financing with a seller's note*: A seller's note can be used in conjunction with one of the other methods of financing to provide further security or eliminate some risk. Instances where a seller's note can be of benefit include when the buyer feels that

a practice is overpriced but still wants to purchase the practice. In this case, the seller carries a note, subordinated to the bank, for a percentage of the financing. In another example, due diligence might bring a piece of information to light that causes the buyer to have reservations about the purchase. In this case, the seller can carry a note to guarantee what they are representing. Since the buyer has no leverage after the fact, this is a way to minimize the buyer's risk.

Offer Analysis

As previously mentioned, there are many factors to consider when obtaining financing, and what works for one buyer might not be the best approach for another. Buyers need to educate themselves on the process, know what questions to ask, and also know what is important to them and their unique situation. It is prudent to interview lenders and receive turnaround times, standards, and finance quotes in writing before submitting a credit application to each available lender. This minimizes the number of credit inquiries that will be reflected on the buyer's credit bureau. (See **TABLE 1** for typical credit requirements.) By receiving proof of verbal commitments, proposals in writing, and amortization schedules, buyers can submit their application to one lender versus multiple lenders and thus streamline the process.

INTEREST RATE

Interest rate is usually the first, and sometimes the only, question the buyer asks when selecting a lender. In most cases, interest rates are fixed and are not based off of the prime rate, but occasionally, a commercial lender will offer a variable interest rate and tie it to prime. Interest rates are usually tied to long-term treasury bills, swap rates that are set by the Federal Reserve or other cost-of-funds indexes set by the lender.

TABLE 1

Practice Acquisition Credit Requirements

The following checklist will assist buyers and sellers in compiling the credit information required to begin the review process.

Buyer Requirements:

- Completed credit application with personal financial statement
- Federal tax returns for the past three years. If currently practicing as an associate, average monthly production numbers and most recent pay stub may be required
- Curriculum vitae or resume

Seller Requirements

- Federal tax returns for the past three years
- Most recent year-to-date income statement and balance sheet for the practice
- Practice summary including personnel roster and tenure, hours of operation, number of active patients, current fee schedule, accounts receivable aging report, and practice specialization
- Cash flow statement if provided by the transition specialist/practice broker

These indexes provide a baseline of where the lender sets interest rates from.

WHAT IS IMPORTANT TO UNDERSTAND?

■ *Quoted rates can be misleading.* Lenders often do not quote the true annual percentage rate (APR) when quoting rates. When comparing rates, payment timing is a key differentiating factor. For example, if a lender asks for a payment in advance with the loan documents, they may or may not include that payment with the amortization when calculating the interest rate. Payment due on Day One vs. Day 30 changes the true APR. If the lender quotes 8.0 percent on a \$500,000 loan with no fees or costs and the payment due date is 30 days after loan closing your payment would be \$7,793.11. Now, if that lender asks for one payment due upfront with the loan documents instead of billing your first payment 30 days after closing and charges you the same payment (\$7,793.11) your true interest rate is 8.21 percent, not 8.0 percent as quoted. (See **TABLE 2** to review advance payments or without advance payments example.) Unlike consumer loans, it is not a requirement to disclose the true APR with fees included. Most lenders do not include the origination fees, documentation

fees or closing costs in the rate calculation, but it's important to understand what impact this has for evaluation purposes. These fees and costs can range from \$350 up to 3 percent of the loan amount.

■ *How interest is compounded.* Most of the time, interest is compounded monthly. In some cases the lender may use the exact days that could adjust the true APR.

■ *How the loan is being amortized.* Make sure the amortization matches how payments are collected. If the first payment is due 15 days postclosing instead of 30 days, make sure the amortization schedule reflects the earlier due date.

★ *Buyer due diligence:* Always ask for an amortization schedule. When comparing offers, compare true APR, monthly payment, and total out-of-pocket expenses to fully understand the true cost of the loan.

TERM

Standard loan terms of seven to 15 years are the most common, but if the transaction is small and cash flow is strong, a shorter term can be offered. Some lenders only offer a buyer one-term choice in their financing proposal, while others lay out multiple-term options, and allow the buyer to choose the term length

TABLE 2

Interest Rate Comparisons With No Advance Payment or With an Advance Payment

Compound Period Monthly, Nominal Rate: 8.00%

	EVENT	DATE	AMOUNT	NUMBER	PERIOD	END DATE
1	Loan	4/11/2008	500,000.00	1		
2	Payment	5/11/2008	7,793.11	84	Monthly	4/11/2015

Compound Period Monthly, Nominal Rate: 8.214%

	EVENT	DATE	AMOUNT	NUMBER	PERIOD	END DATE
1	Loan	4/11/2008	500,000.00	1		
2	Payment	4/11/2008	7,793.11	1		
3	Payment	5/11/2008	7,793.11	83	Monthly	3/11/2015

that is best suited to their needs. Before deciding on a term length, make sure to discuss the options with an accountant who can help evaluate the accounting and tax implications. While short terms generally have lower interest rates, there may be other factors to consider including depreciation and whether the interest rate write-off or increased cash flow would be beneficial to have for a longer time.

PAYMENT TYPES AND TERMS

While interest rate and term length are important, understanding the payment types and payment terms are crucial when making a decision. Often overlooked, payment and prepayment penalties can have a huge effect on the overall cost of loan.

Types of payments:

- *Equal payments* — when a standard amortization is used, the buyer makes equal payments over the term of the loan.

- *Step plans* — buyers make lower or no payments for an initial period of time. This payment approach can be used by buyers wanting to finance less working capital, need time to build up income, or can be used by a new owner wanting to have a cushion while they settle into all aspects of practice ownership. Interest-only payments will help to ensure the loan does not become negatively amortized, but it is a good rule of thumb when using step plans to make sure payments

are structured to get back to the principal balance by Year One of the loan.

- *Balloon payments* — buyers have a very low rate for typically seven years, at which point the loan “balloons” and needs to be refinanced at the current rate. Not only does this type of payment bring interest rate risk into the equation, it also requires the buyer to take the time to refinance the loan, bringing into question whether they would be better

served spending that time with patients rather than requalifying for financing.

Payment terms

Payment terms are a huge differentiating factor between lenders and are crucial to understand. Poor terms can cost a buyer thousands of dollars over the course of a loan.

- *Principal reduction*: Understand how soon extra payments can be made to reduce principal without a penalty. Some lenders offer this option starting at Day One while others may not allow principal reduction payments until after Year One or beyond. The ability to apply additional payments to principal without incurring a penalty can shorten the term and overall interest costs for the buyer (FIGURE 1).

- *Early payoff*: Similar to principal reduction, early payoffs often times carry a penalty and vary greatly between lend-

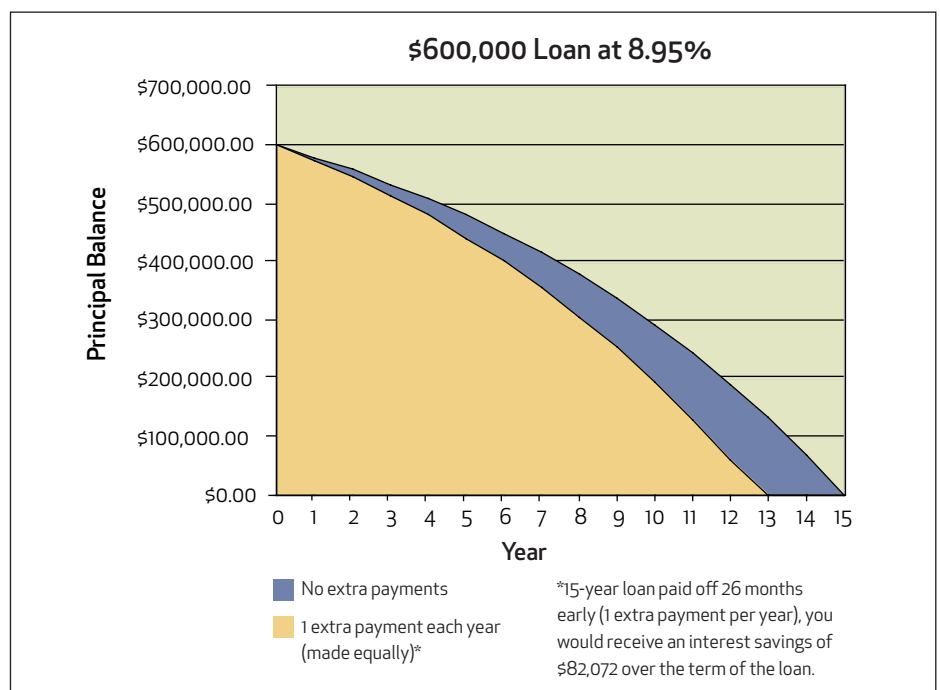


FIGURE 1. Impact of additional principal payments on term length and interest costs.

ers. Terms include no penalties starting Day One, no penalties after a certain number of years, or the ability to payoff the remaining principal plus a small fee.

★ *Buyer due diligence:* When comparing lenders, specifically ask what the prepayment penalty is and how it is calculated. It is prudent to request the answer in writing along with an example that covers at minimum, one-, two- and five-year scenarios. In certain cases, a loan could cost \$200,000 more than it would with more advantageous payment terms. When evaluating options, the question to ask is “Would the practice be worth paying another \$200,000 in the market?” Most times, the answer to that question is no.

COLLATERAL

The collateral that will be taken to secure the loan will also vary based on the lender. Generally speaking, specialized dental practice lenders will have a thorough understanding of the business, and will take the practice as collateral by establishing a first lien against the practice assets. If financing through a traditional commercial lender, they most likely will use the practice assets and will require additional collateral such as the buyer’s home, bank accounts, and other assets.

Some lenders may require assignment of the buyer’s life and disability insurance policies to protect themselves in the event of the dentist’s death or disability. This generally depends on the lender and the transaction size. It is always good to think ahead and have a plan if either of these scenarios would occur.

SERVICE

Often times, buyers don’t take into consideration the level of service they will get from their lender — both during the actual purchase as well as throughout the term of the loan. One of the main differ-

entiating factors between lenders is how well they know the dental practice finance business. If the lender is well versed in this area, they will be able to ask the right questions to ensure all of the alternatives are considered before finalizing the financing.

In addition, they most likely can help align the buyer with knowledgeable team members who can focus on the business, help protect the practice, and allow the dentist to focus on dentistry. Working with a lender who understands the business also helps speed up the turnaround time from application to closing, and most likely will be able to provide a level of customer service superior to a more generalized financier.

Conclusion

Buying a dental practice can be very exciting. It can also be overwhelming. That is why it is so important not only to be educated on the process but to be surrounded by a team of experts. A lender who has the expertise, stability, and commitment to help weigh the alternatives and analyze each unique situation will help to ensure a suitable practice for the buyer now and in the future. ■■■■

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