Episode 1: Spotlight on Brian Colao, Dykema

COREY JOHNSON: Thanks for joining the initial installment of Call Box Dialed In. On the phone with me today, I have Brian Colao who's the director of Dykema's DSO industry group. He's widely regarded as one of the foremost authorities in the US on corporate practice of dentistry. He currently works with clients in 46 different states and has appeared before 37 separate state dental boards. So suffice to say, Brian knows DSOs. Brian, thanks for joining me today.

BRIAN COLAO: Really, really glad to be here. I will correct you. We've now been in front of all 50 state dental boards, just by way of an intro on there. But it's my honor to be here and thank you for having me.

JOHNSON: That is awesome. Who were the last ones to get involved?

COLAO: North Dakota and Alaska were the last two. And in 2018, well here we are in 2018. Earlier this year, I had the privilege of going in front of the Alaska dental board and also the Hawaii dental board.

JOHNSON: That's awesome. That is great. Well congrats!

COLAO: Thanks!

JOHNSON: So tell me more about your background. I know you began as a litigator, why this transition into dentistry?

COLAO: Well I was hired about, let's see none of us are getting any younger here, now it's about 15 to 20 years ago. I was hired to represent a group of orthodontists against Orthodontic Centers of America and OrthAlliance. The very first generation DSOs. There was a lot of litigation and a lot of problems. Ultimately, Orthodontic Centers of America ended up filing for bankruptcy due to their inability to really, I think, effectively run a DSO program from a regulatory standpoint. I represented the plaintiffs in those actions. We had a lot of lawsuits going, because you alluded of course to my background as a litigator, that's how I got my start, and we ended up being a part of the case. I think we ended up having 36 lawsuits in 18 states. We made the law as to what is a regulatory compliant DSO relationship and what is not a regulatory compliant DSO relationship. I was personally a part of all of those cases that made the law in this area.

After those cases sort of concluded, my phone began to ring with all of the investors that were interested in continuing to invest in the DSO space. They thought it was a great business model; it just wasn't executed in a compliant manner by the first generation. But they wanted to see if there was a way to do it in a compliant manner and they thought I knew a little something about that, and I did. I gradually, in the early 2000's, picked up 5, 10, 15, 20 clients. Now, as we sit here in 2018, I think we have 372 DSO clients in all 50 states.

JOHNSON: Wow, that is interesting. So group dentistry and the trend of consolidation - it seems like this is booming. What do you think for a solo practice has the landscape changing?

COLAO: For a solo or small group practice or an emerging practice, what I always say is we're undergoing the Great Evolution of Dentistry, the Great Consolidation of Dentistry, and the Great Opportunity for solo and emerging practices. You've got those three things. You have the Great Evolution, and that's the industry evolving from solo offices to group offices to DSOs. Then you have the Great Consolidation, in as much as the solo offices and the group offices are being bought up by DSOs and private equity investors and other investors. And then you have the Great Opportunity; this is the best time ever if you are a solo dentist or an emerging group owner. This is a once in a generational-type opportunity to roll up your business for way above historical market return.

JOHNSON: So tell me more about the opportunity. As I'm sitting here putting myself in the shoes of a solo practitioner, it seems scary. Where do you start?

COLAO: I mean, it can seem... I don't like the term scary; nobody should be scared. I think it seems overwhelming, maybe, because there's so much activity and so much opportunity that where do you start? What do you do? I definitely agree with that. Nobody should be scared. In fact, if you play your cards right, there's such tremendous opportunities. I think it's going to end up positive for most folks. Scary would not be an emotion I would encourage, but it can be overwhelming.

I think you have to figure out what your organization is. You have to figure out what your EBITDA is. If you don't know, that's earnings before income, taxes, depreciation, and amortization. It's the gold standard that the industry uses to calculate value of organizations. You have to start with your EBITDA, and you have to take a profile, almost like a selfie if you will, of your organization. For example, what does your payer mix look like? Are you heavy on medicaid, or do you have no medicaid, or something in the middle? What type of infrastructure have you had? Have you invested in the latest and greatest accounting reporting software and billing and collecting? Or are you still operating with dusty boxes in your attic? Because all of these things can affect the opportunity and the value of your organization. The lower the medicaid, the higher the return you're going to get. The more infrastructure you have in place, meaning if you were a house, are you move in ready or are you a fixer upper? If you're a fixer upper, you're going to get a lower return. But if you make some investments and you're move-in ready and you modernize everything, you're going to get a higher return.

Also, do you have a sustained plan of growth? Can you replicate the success of your office into many other offices? There's not really a wrong answer. If you can't replicate it, then there's somebody who will still buy your office and an opportunity still exists for you. But if you can replicate it, I don't want to use the term cookie cutter, but if you've got a clear vision and a clear methodology for opening up offices and it's pretty clear that you can replicate that, then there's going to be even a greater opportunity for that. But even a solo office has plenty of opportunities right now in this marketplace.

JOHNSON: And that goes hand-in-hand, I guess, with why there's such an opportunity and an eye from outside investors and management groups. Is it almost just implementing these systems to start getting that return that everyone is looking for?

COLAO: Well dentistry has proven to be virtually recession-proof. When we had the Great Depression of the 2007, 2008, 2009 timeframe, dentistry did very well, despite the extremely difficult market conditions. It's continued to do well, there's a shortage of dentists and there's an abundance of supply or demand for dental services. All of these market forces make dentistry very, very attractive and a segment of the healthcare industry that I think is going to continue, most commentators agree, is going to continue or is likely to continue to yield above market return into the next ten years or so. All of these reasons have captivated the investment community and there are tons and tons of private equity groups, family funds, big DSOs, and other money that want to invest in dentistry. For the solo or the emerging group, this presents a once in a generational-type opportunity.

JOHNSON: That is excellent. Walk through, just for somebody who might be new to this idea, some of the advantages of joining a DSO versus staying solo or staying in a group?

COLAO: The first thing you have to consider is there will come a time that you're not really going to have a choice in the matter. And I don't frighten anybody; today you've got lots of choices. Nobody who listens to this little podcast or our discussion here today needs to feel pressured that they do have to do something today or tomorrow. I mean, you can take your time and make your decision. But that being said, there will come a time in the next few years where enough of the industry consolidates that it becomes difficult to compete if you're a solo office. Think about it, when you're a DSO you get massive volume-based buying discounts. Likely you've negotiated superior terms with providers… not providers… payers, insurers. You've got more money coming in, less money going out. Lower overhead. It's going to become more challenging and more difficult for the solo or the small, emerging group to compete in this marketplace.

So it's not necessarily even a question of should I do this. It's a question of the market is driving this consolidation and I think most folks are going to find when they do an individualized financial analysis of their situation, that they're going to be better off affiliating either with a DSO or a private equity group, and long term that's going to be the best option for them. I think it's more a question of if the market is shifting that becomes something that really has to occur. You don't have to do it, but it's going to be much more difficult to compete long term if you don't. And for specialties, they're going to lose a lot of their referral sources. For example, if you're an orthodontist right now or an oral surgeon and you rely on referrals from general practitioners, as those general practitioners continue to affiliate with DSOs, the DSOs are going to want to keep that specialty work in-house and they're not going to refer to you anymore. There are lots and lots of market forces that make it really the most appropriate and the most viable course of action for solo or emerging groups right now.

JOHNSON: At what point in the practice's lifetime would you typically recommend they consider the DSO structure? Are there certain checklists or checkboxes that you look for?

COLAO: Really anybody that wants to expand beyond one or two offices should be reorganized as a DSO in this marketplace, because it's the only structure that will allow for non-dentist participation as an investor. That's the first thing. With respect to when is the right time to do some type of sale or equity event, I've got clients in their 30s that start practices in their 20s, grow them to a couple offices, and then sell them in their early 30s. Obviously they're nowhere near retirement age, but the practices have hit a certain amount of critical mass and are profitable and there is interest in people that want to buy them, so they do it.

Obviously if somebody is their 50s or 60s and they're looking to exit the industry or they're looking to be relieved of the responsibility to run their own office, but they want to work. Maybe you're 59 years old and you want to work until you're 65, but you're tired of running the business side of your office; that's an obvious transition right there. You should affiliate with some kind of DSO, and you can continue to work until you're ready to retire, but you'll take some money off the table and not have to basically run the business side of your dental practice anymore. The people that are more senior, I think, it's an obvious choice to start to do that. But a less obvious choice and one we see all the time, are dentists even in their 30s, young folks with lots and lots of working life yet, but they've built a successful organization and they simply can't turn down some of the offers they're getting.

JOHNSON: How long does that process take from courtship to joining on?

COLAO: That's one of those… I always like to say it's like marriage. Imagine you just asked me the question how long does it takes to marry somebody from courtship. What would your answer be? Your answer would be some people do it in two weeks in Vegas, other people could be engaged for years. And it's funny, the same applies to the dental industry. I've seen courtships where it's love at first sight, and within 30-60 days after the people are introduced we're doing some type of transaction. And then I've seen folks that talk to each other on and off for a couple years before we ultimately close the deal. It's really specific to the individual.

JOHNSON: And there's not necessarily any correlation to the success of those partnerships from that length of courtship?

COLAO: No there's really not. How many folks in life have you seen that got married in 60 days and shockingly they're here 30 years later. And then you see some folks that dated for years and got married and they got divorced after six months. There's no correlation. What I tell people is you have to pick the right partner, however you do that. Some people know right away, some people it takes longer. But you have to pick the right investment partner. If you pick the right investment partner, then you're going to have a long... I say long... these things are turning in three to five years. It's not like you're getting married for life. I want anybody that listens to this to understand what the play is. You get into a courtship, often, if it's a private equity investor, you may only be with that person another three or five or six years before they turn the business again to another investor. Now, if a large DSO is acquiring you, yes, that will be more of a lifetime partnership until you retire. But you've got to understand, you're going to be doing business with these folks typically well after the equity event. So you've got to pick the right partner and somebody that's a match and a good fit, and you'll be able to get along with, whether that's three to six years, or whether that's ten or fifteen years.

JOHNSON: So what's involved in that, we'll keep using that word courtship, what should a solo practitioner or a small group be looking for?

COLAO: Everybody's got a little different interests, right? The buyer is going to want to look at the EBITDA and the financial figures and they're going to want to see the payer mix and the infrastructure; they're going to want to see mechanically if the office is a good fit. That's what they're going to look at.

For the seller, for the solo or emerging group, they're going to want to see what's life going to look like post-closing when I've sold all the assets of my practice, I now have a management agreement in place, and I've got an employment agreement with my new office. I don't really own my office anymore, there's another licensed dentist that is loyal to the DSO that owns my office and I basically have an employment agreement. What is it going to look like? You should talk to, in advance, who the new owner of your office is going to be in that scenario and make sure that's a good fit.

Sometimes people just look at the money, and the money seems like it's good, and in fact is good. But then they get up in a work environment that doesn't work for them, that's very unpleasant; it can create issues. The good news is you have taken some money off the table, but if you still got five or ten years to work and you realize suddenly, hey this was nice that I made money off this deal, but I can't stay here anymore because I don't like these folks or I don't get along particularly well or it's not a good fit, that can be a stressful situation. You've really got to do your diligence in advance.

You want to talk about clinically who you're going to be reporting to. In some situations, you can do an equity event and still own your office. It'll just be subject to management agreements, so you can continue to have complete clinical control over your office. That's usually a desirable situation. Other situations a new dentist will come in and own your office and you're going to have to report to that person and you'll need to understand is that's a good fit.

Also, you should figure out what it's going to look like post-closing on the non-clinical side. If it's a DSO, are they going to change all the policies and procedures and operations of your office? If they are, is it something you can live with? If it's a private equity investor, what's it going to look like? Who are going to be the non-clinical folks they're going to bring in to run the business? Do you share the similar philosophy with these folks? Or is it going to be difficult? Is it not a good fit or is it a good fit? These are things that you really should do your diligence on. Many folks, quite candidly, do not do their diligence on this and then they figure it all out post-closing and sometimes find themselves in undesirable situations and they wish they never did the deal. A couple times a year, quite candidly, we did about 83 of these types of transactions last year and we had two of them that we unwound after they closed because, the folks, it was such a rotten fit, the best thing to do was just to unwind the transaction.

JOHNSON: Well let's stick with the positive, can you share with us who's doing it well?

COLAO: I really am careful about that. I try not to, because we represent so many folks in the marketplace; it would be like which kid is your favorite. I really try not to do that. I do say this: obviously, if anybody on this call wants to have a private discussion about some of my views about certain organizations, I'll do that. But I really try not to do them on public podcasts.

But I will say this: not everyone does it the same way. And not every DSO operates the same way. There are pros and cons among everything. There are large DSOs that have, what I would call, well-defined operating procedures for how they do things. There are mid-level DSOs that have a little more flexibility in how they operate. And then there are emerging DSOs that are acquiring practices that are completely flexible for how they do things. So you just got to figure out which type of environment is going to work best for you. I can tell you though there are DSOs in every category, there are very large DSOs, mid-sized DSOs, and emerging DSOs that are doing these things very, very well. And then if we went back through those categories, unfortunately there are some large DSOs, and mid-sized DSOs, and emerging DSOs that are struggling. That's why in this marketplace, you have to pick the right partner.

JOHNSON: So it's safe to say, you'd recommend going on a couple dates before you make any long-term decisions.

COLAO: I absolutely would. The reality is, it's not uncommon for solo groups or emerging groups to get several offers and a lot of interest, depending on their situation. Sometimes it's very tempting to either jump at the first big offer, or if you have competing offers, to jump at the largest of the competing offers. I can tell you price is not always… sometimes the highest price is the best deal and that's what you should do, but it's not always. The best price is not always the best overall offer; sometimes a little lower price is a better long-term fit and that's going to be the best deal. I do encourage people to go on multiple dates and explore the options that are available. The reality is, some people don't. Some people just find it better to jump at the first offer. You have a higher risk of putting yourself in a situation that's not advantageous to you if you do that, if you don't do your diligence. I have to be honest, some people jump at the first thing and they're perfectly happy with it. But you have a higher risk of having a problem if you do that, if you don't do your diligence.

JOHNSON: A term that we hear a lot is "multiple." First… and I think that's part of the pricing you were just alluding to… first, talk to us about the idea of a multiple: what is it and then what are you commonly seeing in the industry today?

COLAO: It's a multiple of EBITDA, and I went over EBITDA a few minutes ago. Basically if your… we'll use easy numbers… if your EBITDA number is $100,000 and somebody pays a five multiple, you're going to get half a million dollars. That's just simple math. These are made up numbers. But that's what you'll get. If your EBITA is $100,000 and somebody pays 10 times, you'll get a million dollars. That's how it works. The buyers are going to pay you a multiple on EBITDA to purchase your office or offices.

What determines how big the multiple is, is first of all, the type of investor. If you're doing a deal with a large DSO, you're typically going to get four to six times a multiple because that's how the large DSOs do it. They don't pay super, super high multiples. If you're doing a private equity deal and you're large enough to get a private equity deal, they'll typically pay a higher multiple, but you're going to have to roll over a good portion of the purchase price; meaning if they pay you one million dollars, you may get $600,000 upfront and $400,000 rolled over and is redeemed for shares in the organization going forward. You have to hang around for three, five, six years and then when they sell it the second time, you can participate in a second equity event. That's the play with a private equity deal versus a DSO deal; there's a higher risk typically with a private equity deal.

If a very large DSO with many, many hundreds of affiliated offices acquires your practice, generally we know what will happen with a few exceptions. You're now going to be a part of that DSO, you're going to be a part of their standard operating procedures, and they know a little something about running dental offices because they have hundreds of them and we probably know what's going to happen. That's why it pays a lower return; because it's a safer investment. If a private equity group buys your three or four office group and says their goal is to grow it to 25 and then sell it and participate in a second equity event, we don't necessarily know that that's going to be successful. The industry is doing very, very well right now, and a lot of people are making a lot of money, but it's not a given. We don't necessarily know that's going to be a success and there's a lot higher risk. That's why they'll typically pay a higher multiple for the opportunity to do that.

So, one, to answer your question, it depends on who the investor is will determine the multiple, and then second, what you've done with your practice will determine the multiple. Like I said earlier, what's your payer mix? Are you heavy medicaid, no medicaid, or only a little bit? The lower medicaid, the higher the multiple. What type of infrastructure do you have in place? Do you have the latest, greatest software and reporting system? You'll get a higher multiple versus do you need a big upgrade, a costly upgrade. Second, what is your plan for growth? If you have a solid and sustainable growth plan that makes a lot of sense, you're going to get a higher multiple. How are you as an operator? If you're interviewing and they look at you and they say this person is an outstanding operator, that's probably going to get you a premium versus this person is not the best operator in the world, we're going to have to get some other people in here to help with the practice. All of these things go into the multiple you're going to get.

JOHNSON: That's great. So you mentioned your plans for growth and how growth fits in there. You know at Call Box we're all about the phone. How would you say that phone call management plays into that idea of growth and what these DSOs or private equity groups would be looking for?

COLAO: Yeah! If you have an industry leading... a lot of these phone answering or artificial intelligence component systems... where you're handling effective phone management, you're not missing calls, you're effectively selling the way you need to sell to the patients, and you're covering all the bases. This is going to be something that's going to positively influence the multiple versus:

Well who answers the phone? Oh Betty answers the phone. She's worked here for 20 years. She just picks up the phone.

What does she do? She just kind of answers the phone.

What are the policies and procedures? Well not really, she's just been doing it for like 20 years and she just does what she's always done.

That's going to be something that's going to need upgrading versus:

How do you answer the phone? Well we have industry leading software. We have tools. And this is what we do. And we make sure we answer every call. And we make sure the folks that are answering the calls say what they're supposed to say to maximize the selling opportunity with the patient.

That is going to generally be one of several things that will lead to a higher multiple than when we don't have anything in place.

JOHNSON: Excellent. And we'll wrap up after this one. What advice, from your chair, would you have for somebody who's either just graduating or getting into this space?

COLAO: If you're just graduating dental school, you have to understand the DSO marketplace. I've been invited to teach at a dental school and I'm considering that opportunity more for the educational value. I feel like our dental schools have not done the greatest job. Just like me being a lawyer, our law schools haven't done the greatest job of teaching the business of the law. Our dental schools haven't done a great job of teaching the business of dentistry. If you're just graduating and you're listening to this, you have to gain some understanding of the DSO industry, because if you're however old you are when you graduate... what 25 or 26 or something... your lifetime will be the DSO model.

If you're 60 years old right now, you can probably get away with burying your head in the sand and saying I'm just going to finish out my last few years and I'm not going to worry about this DSO thing. Although there may be a very good opportunity to sell your office, so I think you should be paying attention to it. But you've probably got some flexibility not to worry as much if you're in your 60s. But if you just graduated dental school, you need to understand everything you can about the DSO model and everything I said - the Evolution of Dentistry, the Consolidation of Dentistry, and the Opportunities in Dentistry. This will be your entire working career will be under this new paradigm shift of the industry.

JOHNSON: Great, well Brian thank you so much. If anyone has a question on anything they heard or they want to learn more about the DSO world, how can they contact you?

COLAO: I can be found at DykemaDSO.com. My name again is Brian Colao and my number also is 214-462-6409 or bcolao@dykema.com. Maybe when you list this podcast, maybe you'll list my contact information as well. I'm very happy to talk to anybody that wants to learn. We've got a very large team over here, and I'd be delighted to chat with anybody that's interested in learning more about the evolution of dentistry and the DSO industry and what the opportunities might be that are available to them.

JOHNSON: Great. You can find Brian at those sources. He's also really active on the conference circuit as well. I've seen him speak a couple of times and that's always great.

COLAO: If you'll give me one more second. I can't every leave any of these things without plugging our conference. We have an industry leading DSO conference. This year it's going to be July 10-13, 2019 in Dallas, TX at the Omni Hotel. You can find that at DykemaDSO.com. I think you guys are going to be there. You're going to be prominently featured. I'm excited you'll be at our conference, so I didn't want to leave this without at least plugging the conference, if you don't mind.

JOHNSON: No, thank you! We'll be there again. That was a great one! Really enjoyed that, a ton of great speakers and a lot of awesome content.