Deferred Consideration & Deal Details

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DISTINCTLY DENTAL, DISTINCTLY DIFFERENT

Approaching Deferred Consideration & Considering the Minutiae of the Deal.

We have now established how valuations are constructed and how sometimes there can be benefits in merging a dental practice's goodwill with another existing practice to achieve full value as opposed to marketing as an outright sale. In this guide we aim to explain how sometimes how a deal is structured can be just as, if not more important than what the ultimate purchase price is.

Deferred & Additional Consideration are increasingly common in dental transactions as buyers seek to mitigate some of the risk of an acquisition by ensuring that a vendor bears some responsibility for the business' performance post-completion. However, this should not be confused with a Vendor Loan which is actually quite different. To explain the terminology;

Additional Consideration – This is where you negotiate that if the businesses' performance improves post-completion as a result of the Vendors efforts pre-sale that an additional sum is paid provided that agreed parameters have been met. An example of this could be uplifts in NHS Contracts or the introduction of a Foundation Dentist Training Contract. In private practices this is now a common deal component if the vendor commits to assisting in growing the practice's turnover post-completion. E.g. if the Turnover increases by £100,000 annually based on a three-year average then the buyer agrees to pay an additional lump sum of £120,000 at the end of Year 3.

Deferred Consideration – This is where an element of the purchase price is retained only released in the event that the businesses performance is maintained at an agreed level post-completion. We have seen deals where this has been linked to a practice or individual turnover target or the business' post-sale EBITDA or sometimes on as soft a terms as that the Vendor agrees to keep working three days a week for a year post-completion.

Retention – In some respects this is similar to deferred consideration but retentions are very rare in the dental practice transactions. This sum is related to a component of the business purchase agreement and normally released based on the outcome of pre-sale events. The most common is where there is a Limited Company Sale and it is known that the business has liabilities such as Associate Pay / Corporation Tax for which there is insufficient liquid assets in the business to cover such liabilities. In this instance the retention is calculated on the basis of a Net Asset Adjustment which will explain in a later guide. However, retentions are often sought by purchaser's solicitors if they feel it is likely that the vendor will breach one of the warranties within the sale contract if they have a pending GDC hearing for example or if it is known that the Vendor is emigrating post-completion and as such it would be tough to recover funds in the event of a breach of warranty.

Vendor Loan – An increasingly common occurrence in the dental practice transactions as practices become more expensive. The difference with this method of holding back the purchase price is where a purchaser cannot (or doesn't want to) borrow the full funds to finance the purchase so the Vendor effectively loans them the balance of the purchase price to be repaid either over a number of months / years or as a lump sum on an agreed date e.g. the Anniversary of the Completion Date. The key difference with a Vendor Loan is that this payment isn't linked to future or previous performance within the business.

So now we have established the differences in the terminology this guide will focus primarily on deferred consideration. Whilst in a perfect world every vendor would like all of their purchase price to be paid at completion in large private practices or practices with short-term orthodontic contracts, a deal without deferred consideration may be unattainable. Similarly, you may be presented with a number of offers – so how do you decide whether a deal of £2.4m to be paid entirely at completion is better than a deal of £2.5m with £450,000 to be paid over the three years following completion based on the business' performance?

Aside from the financial computations below you must of course consider other factors, such as what the deferred consideration is linked to? We would always strongly advise that where vendors accept a deferred element that this is linked to their own individual turnover as opposed to the practice's combined turnover or EBITDA as once the practice is sold they will have little control over the associate's retention and performance and also the cost structure of the business.

You will also want to consider whether you want to remain working in the business for three –years post-sale? What happens if you underperform? I have seen dental corporates impose tough tapering clauses where by for every £1 in turnover lost £1 of the consideration is lost but bear in mind they will not have lost £1 in profit as they would probably have paid you 45p in the £ to deliver the treatment. Similarly, if the same thing happened three years running you would have been penalised £3 for every £1 loss and at the moment they are not paying that much for practices in the first place.

Further, they seek to impose clauses where if the income falls below a certain level the tapering stops and none of the consideration I paid whatsoever. Therefore, you will need to consider the likelihood of this happening and how near to the target this 'collar' is.

Once you have consider these factors we also recommend our vendors consider an accounting principal of Net Present Values (the Time Value of Money). This is to say that because of unearned returns as you will not have the money invest and owing to inflation £10,000 in your bank account now is worth more than someone paying you £10,000 in a years time. The Discount Factor you apply to the income over a period of time is largely down to opinion but in our example below we have used 7%, a typical yield on property at this time.

	Offer One		Offer Two	
	Consideration to be Paid	After DCF Applied	Consideration to be Paid	After DCF Applied
Point of Completion	£ 2,400,000	£ 2,400,000	£ 2,050,000	£ 2,050,000
Y1			£ 150,000	£ 140,250
Y2			£ 150,000	£ 130,950
Y3			£ 150,000	£ 122,400
Total	**£ 2,400,000**	**£ 2,400,000**	**£ 2,500,000**	**£ 2,443,600**

As you can see the value of the higher offer was significantly eroded over the three years. Imagine if you had a deal with five years consideration? Or if you felt that 8% or 10% was a more appropriate discount factor.

<u>Consideration not Remuneration</u>

Another important point we ask all vendors to consider is whether they should take consideration (i.e. purchase price) over remuneration. The answer is almost certainly always to take purchase price over remuneration. Lets consider the table below again;

Based on £250,000 Gross, £1m Business Valuation						
Fee Split	Annual Pre-Tax Earnings	Impact on Valuation Based on 5x Multiple	Income Tax on Income Over £120k	CGT on Addit Purchase Based on ER	Total Pre-Tax Earnings / Gain Over 5 Years	Addit Tax Based on LH Columns
40%	£ 120,000	£ 1,150,000	£ -	£ 15,000	£ 1,750,000	£ 15,000
45%	£ 135,000	£ 1,075,000	£ 6,750	£ 7,500	£ 1,750,000	£ 41,250
50%	£ 150,000	£ 1,000,000	£ 13,500	£ -	£ 1,750,000	£ 67,500

This is Based on a Sole Trader Trading Structure, this should not be considered as Tax Advice as all individuals situations are very individual. You should always take specific advice from your own accountants.

As it is demonstrated is very non-specific terms above, if the seller were to stay on five years it is undoubtedly beneficial to take a higher purchase price instead of a higher fee split, this position is further re-enforced if the seller is only planning on working for a shorter period post-sale. You should also remember that a purchase price cannot be changed post-sale whereas there is potential that remuneration can be on as little as three months notice.

Other Minutiae That is Often Forgotten

- If a Seller is staying on as a Foundation Dentist Trainer with the reward of an enhanced Trainers Grant, always try to negotiate this to be Additional Consideration.
- Negotiate the structure of the deferred consideration so that the purchaser does-not gain if it is not paid. All too often the terms end up making it advantageous for the purchaser if the patient list of the Vendor goes into decline.
- What happens if you get ill? If someone is covering your appointment book, ensure you get an input as to who this person is and that you don't forfeit consideration is the business has not suffered. Pain and Reward should always be shared!
- If your spouse is also staying on as a Practice Manager or Nurse, remember to think about ways of splitting your incomes to use both tax allowances in full post-sale.
- Negotiate Annual Leave entitlements before you sign Heads of Terms. Do you really want to go back to just six weeks?
- If the purchaser is an Independent Dentist, have they considered how they will fund the additional / deferred consideration as, when and if it becomes due?

The next Guide in the series discusses the sale process in detail. If you have any questions in the interim or would like us to value you practice on a free and non-commital basis please contact us on 01788 545900. Once we have completed a practice visit we can provide you with a Healthcheck Report which demonstrate exactly how we have calculated your practice's value and perhaps more importantly how we feel it could be improved.