Dental Focus

DRIVING LIFELONG PROSPERITY

Winter 2020

SPOTLIGHT ON DENTAL MARKET CHANGES

HAZLEWOODS

DRIVING LIFELONG PROSPERITY

Insight into dental practice values, what has changed and where is it going next?

In recent years UK dentistry has experienced significant market growth and substantial increases in practice values, which has been accompanied by a rise in the number of practices selling. There are often many myths about the selling process and in this article, we will cover a bit of background to the market, the affect of COVID-19, future outlook and next steps if you want to sell.

WHAT HAS BEEN DRIVING PRACTICE GROWTH AND ACQUISITION ACTIVITY?

Like other sub-sectors of the UK healthcare environment dental practices have been able to expand, largely as a result of:

1. **Population growth, particularly in the over-60 age group.** According to the Office for National Statistics, the UK's population is growing at 0.6% a year. More significantly, the over-60 age group is expanding at a faster annual rate of 1.8%. An aging population typically requires more varied and complex dental treatments, such as removable prostheses, crowns, and implants.
2. **Private pay upgrades. The majority of dental practices have NHS contracts and also provide private dental care.** Many dental practices have been upselling private treatments to NHS patients as part of their dentistry care plan.
3. **Cosmetic treatments.** Pre-COVID-19, as disposable incomes rose, private sector dentistry benefited from the increasing popularity of cosmetic dentistry and facial aesthetics, hygiene services and other specialist treatments.

In combination with the hard work and entrepreneurial spirit of practice owners and their teams, these drivers have all helped the dentistry sector show what can be achieved in terms of earnings growth. This, in turn, has continued to attract corporate, private equity (PE) and institutional investors who have all contributed to a wave of consolidation across the UK with strategic acquirers backing the concept of national and even multinational chains.

HOW HAS DENTAL PRACTICE SALES ACTIVITY BEEN IMPACTED BY THE PANDEMIC?

Deal activity paused

Much the same as in other sectors of the UK economy, practice sales slowed down in the face of uncertainty and business disruption. While a small number of practice sales carried on, many of the deals that were set to close in the coming months were suspended until there could be more visibility and clarity around a path to emerging from lockdown and a return to less volatile operating conditions (Fig 1).

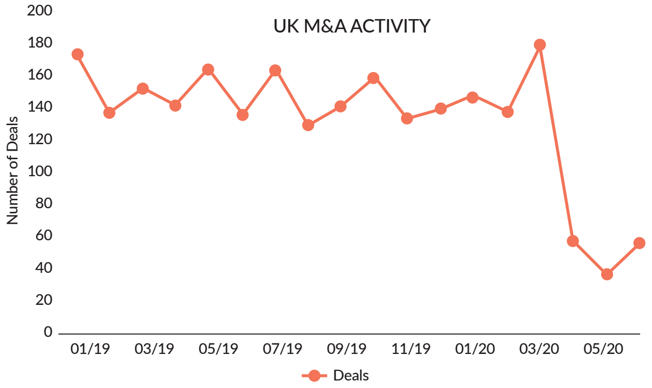

Figure 1: UK M&A Activity (Source: Office for National Statistics)

From the perspective of buyers, strategic corporate acquirers and PE have had to contend with the impacts of COVID-19 on their own businesses and existing portfolios. They needed to conserve liquidity, which then made it difficult to finance transactions with cash on hand. The lending environment also tightened, making it more difficult to finance 'bolt-on' and platform acquisitions using the same level of third-party debt that they had previously used.

Creative deal structures

Across the UK business sales scene, and including the dental sector, many of those deals that made it to the finish line were able to do so with a good bit of restructuring to help solve the added risk and financing issues that emerged as a result of COVID-19.

Accordingly, different creative structures were propagated to allow the deals that had been in process, many for several months under terms that were negotiated pre-COVID-19, to move forward at the same valuation albeit with some structural changes, such as:

1. 100% buyer funded, which eliminates the need for third party debt financing.
2. Seller-financed transactions where the seller defers a portion of the purchase price which is then treated as an interest bearing loan, the intention often being that when the business stabilises, it will refinance that debt and pay out the sellers.
3. Deferred payment structures – nothing new, but with a larger slice of the overall proceeds deferred and with an emphasis tied to profit performance metrics, rather than income performance, of the practice returning back to pre-COVID-19 levels.
4. Increased use of warranties, indemnities and retentions relating to specific COVID-19 risks and uncertainties.

We think these structural elements are likely to feature in deals for some time to come, with a particular emphasis on deferred consideration linked to future performance.

WHAT HAS CHANGED AS A RESULT OF THE PANDEMIC?

Practices closing as a consequence of the first lockdown instigated business disruption and significant uncertainty across the dental sector. Although there was some financial respite, particularly for those practices and groups where the majority of income is with the NHS, trading conditions have been challenging and the impact on dentist and staff wellbeing cannot be overlooked.

Despite all of this, and notwithstanding the inherent uncertainty around how the NHS contract might work in the future, the fundamentals of UK dentistry remain intact, particularly those relating to demographics and patient needs. These key drivers for growth and sustainability will provide the bedrock for the continuing evolution of treatment activity across the country.

Since re-opening their doors on 8 June this year, practices have contended with the higher costs of elevated hygiene and infection control standards, rigid patient vetting, regular testing of all practice staff and additional infection control measures. Procedure times have become longer, leading to capacity reductions, while operational costs have increased, ultimately resulting in lower levels of earnings.

Whereas many reopened practices have been inundated by work, some of the 'bounce-back' activity has resulted from accumulated patient backlog and/or market share drawn from those practices yet to reopen; work which may or may not be sustained. This issue could be exacerbated by the fact that many NHS practices are reporting an improvement in associate recruitment, reversing the recent trend of associates leaving the NHS to focus on private practice. While this will mitigate one of the many challenges faced by NHS practices in recent years and will be seen as a positive development by many owners, it may present challenges in sustaining the private treatment levels currently being experienced post lockdown.

How all of this translates into individual practice performance and earnings growth will depend to a large extent on how practice owners choose to respond to the changing ways in which dentistry is performed.

OUTLOOK

Since reopening following the pandemic peak, many dental practices are showing impressive resilience to the challenges presented by COVID-19, and thankfully for now at least, can continue to operate during the second lockdown. Despite there being some obvious factors that in theory could lead some observers to expect a downturn in practice valuation metrics, it is equally likely that these factors will be mitigated by the fact that most buyers will take a more medium term view and look beyond COVID-19 (whilst seeking to build in downside protection in the form of deferred consideration); and buyer demand bouncing back to pre-COVID-19 levels. One of the key aspects buyers will be looking at when evaluating the quality of practices (and therefore its value relative to its earnings), is how well sellers prepared for the reopening and how well income levels have bounced back, relative to pre-lockdown.

Notwithstanding the generally-held view that the impact of the pandemic may be felt for many months to come, with the potential for continuing regional lockdowns, prolonged economic uncertainty and dented patient confidence all being reasons for some concern, dental practice sales have started to gather pace over the last few weeks and there are good reasons to believe this trend will continue to accelerate.

Access to funding and the types of deals

In the current environment, corporate and PE-backed buyers with access to larger revolving credit facilities are likely to have better access to the capital markets and ultimately to financing, and so may be a little more active than smaller acquirors relying on raising new bank debt in order to finance acquisitions. That said, there are plenty of smaller groups and would-be acquirors out there with cash funds available to fund acquisitions.

Furthermore, the nature of operating costs post-acquisition may have an impact on the type of deals done over the coming months. Whereas the PE model leans heavily on investing in the infrastructure of a business that they can grow and scale, corporate acquirers will have already developed their corporate infrastructure and will likely realise synergies from a deal that can end up cutting overall costs. It therefore makes sense that more bolt-on deals are likely to be completed compared to new platform launches over the coming months. On the other hand, PE is sitting on record amounts of funds and will still be looking to do new deals. (Fig 2)

So, despite a backdrop of continuing uncertainty presented by COVID-19, most strategic acquirers are now back in the game, looking to build their pipelines with quality acquisition opportunities. These buyers are in the business of building their groups and are keen to pick up where they left off.

What has changed is that buyers have become increasingly cautious, enhancing their due diligence while pursuing deeper engagement with sellers to obtain a fuller understanding of the sustainable profits and growth opportunities a target practice might provide. Historical earnings are still highly important, but how a practice is responding to the current environment will form a critical element of how a buyer assesses each acquisition opportunity.

Being ready to go to market

Now the practice sale wheels are rolling again and buyers have become more engaged, barring any steep setbacks this pent-up demand should lead to a return to high transaction volumes, but it is important that the buyers' confidence to invest is matched by sellers recognising that they really need to focus on being ready to go to market and understand what the buyers are looking for.

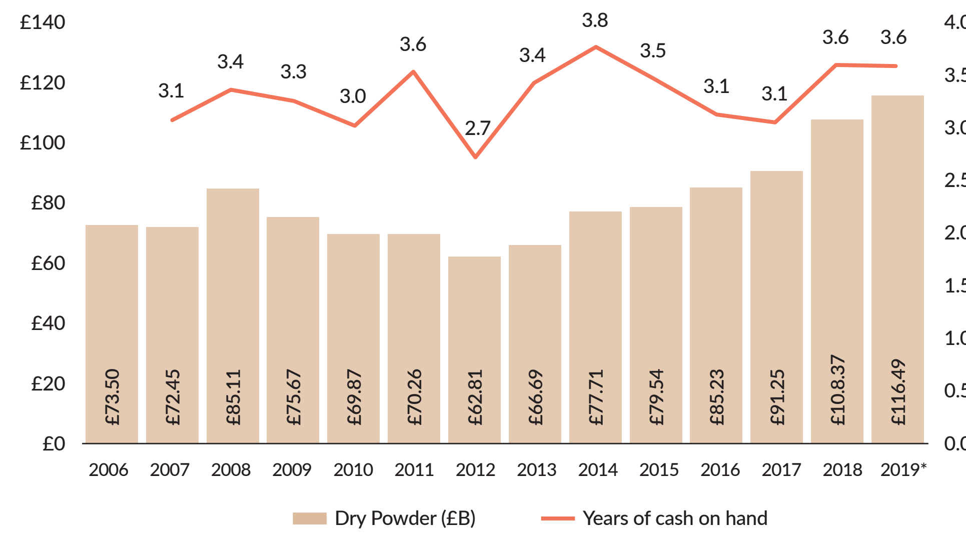

Figure 2: UK PE Funds for investment, known as Dry Powder (Source: Pitchbook)

Is now a good time to sell?

There are a variety of reasons why owners decide to sell their practices to a larger group, for example retirement, lack of succession options, de-risking tied up value or a desire to refocus on dentistry rather than dealing with the stresses and strains of running a business, and many more. Many practice owners who may have deferred their decision to sell during the initial lockdown period are thawing out their plans: some driven by a desire to take advantage of pent-up demand, some by worries about where capital gains tax rates might go and others who simply want to enjoy the fruits of all their hard work and just want to get on with it. For many owners, it will be a combination of all these things that drive the decision to sell.

In the current environment, it is more important than ever for would-be sellers to prepare diligently and substantively for a sale process. At Hazlewoods, we have many years of experience working with practice owners who are either considering an imminent sale, or looking ahead to selling in the near future. From our unrivalled experience of working on dental transactions, we have also developed a deep insight into what the buyers are looking for. We bring this experience to bear in advising sellers on how to maximise value and ensure a professional process in which both sides of a transaction can have complete confidence.

WANT TO FIND OUT MORE?

We are running a virtual dental practice sales day on **14 January 2021**, where we will provide an overview of how the sales process works, what buyers are looking for and how to prepare; but importantly to answer any questions. It is not a decision many owners take lightly but having professional advice and the right planning to hand can make a marked difference when the time to sell comes. For more information and to sign up, visit **https://bit.ly/dental-sales-21.**

If you would like to find out more before our sales day or would like a private, confidential and complimentary meeting, then please do get in touch by emailing **james.morter@hazlewoods.co.uk**. These are being conducted on video for now.

Tax changes

SELLING ASSETS – IS NOW THE TIME TO ACT?

As the cost of government support for the coronavirus spirals ever upwards, it seems inevitable that taxes will have to rise to pay for it. While the November budget has been cancelled, delaying any immediate changes, the timeframe to take advantage of current rates may be limited. What are the risks and opportunities?

CAPITAL GAINS TAX

Capital gains tax applies if assets are gifted or sold. For gifts of assets qualifying for Business Property Relief (BPR) it may be possible to holdover the capital gain, deferring any tax until the recipient of the gift sells it. However, for investment assets such as rental properties this will not be possible. If residential property is gifted and tax is payable, the gain must be reported to HMRC and the tax paid within 30 days.

The current rate of CGT for residential property is 28% and 20% for all other assets (the rates are 18% and 10% respectively for any part of the gain falling in the basic rate tax band). There is talk of these rates rising to the same level as income tax, so possibly up to 45%, making the current rates look very favourable.

On top of this, there is also talk about what might happen to entrepreneurs' relief. The lifetime limit on gains qualifying for business asset disposal relief (BADR), formerly known as entrepreneurs' relief, dropped from £10 million to £1 million in March 2020. Gains which meet the qualifying conditions are taxed at 10%, so this was a significant reduction in available relief.

This lifetime limit could be dropped further, or the relief abolished altogether. It may be beneficial to bring qualifying practice sales forward or pass assets on to the next generation to take advantage of the relief.

The March 2020 changes were accompanied by anti-forestalling legislation to catch transactions which were done purely to capture the higher levels of the relief and there is always a risk that the government could implement something similar with future changes.

Given that most dental practice sales can take several months to complete, immediate action would be required to try to beat any tax rate changes, depending on when the budget will be held.

INHERITANCE TAX

In July 2019 the office for tax simplification (OTS), published its second report into IHT. The report made several recommendations including:

- Remove the capital gains tax (CGT) base cost uplift that arises on death where an asset passes under an exemption (e.g. inter spouse) or is subject to a relief (e.g. business property relief (BPR)
- Aligning the trading test for BPR, currently wholly or mainly (i.e. more than 50%) with CGT which is substantially, widely seen as 80:20

In January 2020 the all-party parliamentary group for inheritance and intergenerational fairness published its report, 'The Reform of Inheritance Tax'. The main recommendation from this report was to replace the current IHT regime with a tax on lifetime and death transfers of wealth, with very few reliefs and a low flat rate, likely between 10% and 20%. The CGT tax-free uplift on death would be abolished.

The common theme from both is the removal of the CGT rebasing on death and, at best reform and worst abolishing BPR. While both these reports are a long way from becoming law, they highlight the potential direction of travel if IHT is reformed.

For dentists who have significant assets, for example from the sale of their practice, careful IHT planning is essential, which our specialist tax and financial planning teams will be happy to offer professional advice on.

STAMP DUTY LAND TAX (SDLT)

To encourage movement in the housing market SDLT on the first £500,000 of consideration has been reduced to nil, subject to the 3% higher rate for additional properties applying, up until 31 March 2021. This can give rise to a saving of up to £15,000 per property and may tip the balance in favour of proceeding now if planning a house move or residential property investment.

CONCLUSION

The current CGT rates could be at an all-time low and generous IHT reliefs may be at risk. Whilst the tax tail should not wag the dog (and there are many factors at play when considering whether to sell your practice), if you are thinking of passing assets on, now may be the time to act.

RESEARCH AND DEVELOPMENT TAX RELIEFS: COULD YOU MAKE A CLAIM?

Research and Development (R&D) tax reliefs provide an opportunity for companies to claim additional corporation tax relief for certain costs in order to reduce taxable profits and their corporation tax liability. The relief is only available to companies and cannot be claimed by partnerships or individuals.

R&D comes in many forms, for example, developing new products, systems or capabilities. In a dental/health context, non-routine work that aims to improve patient outcomes by developing or trialling new techniques and approaches may therefore qualify. Because of its broad nature, and the fact that many people often do not realise their practice is doing R&D because what they are doing is often seen as part of their 'normal' clinical practice, it could be the case that a dental practice company is already undertaking activities that qualify for relief. It may also be possible to structure future activities and documentation to improve the prospects that relief can be claimed.

The relief works by increasing eligible expenditure of say £100,000, which already receives 100% corporation tax relief, by a further 130% of this amount (£130,000). The company therefore reduces the profits chargeable to corporation tax by £230,000. With a tax rate of 19% the tax reduction is £43,700, rather than £19,000 on the £100,000 spent. In the above example the cash benefit in a profitable company is 24.7% of the amount of R&D spend.

If the company is loss making, the R&D eligible costs can be surrendered for a cash payment. In this example, if there is a taxable loss of £230,000 and the full amount is surrendered, then a cash payment of 14.5% (£33,350) can be claimed.

Eligible activities relevant to a dental practice operating through a company could include:

- development of new/improved patient treatments
- development of new pain management procedures
- trialling new techniques to improve clinical results
- evaluating new materials and processes
- development of practice management systems to create a solution that cannot be purchased off the shelf

Any R&D project should aim to improve existing technology and overcome any technological challenges. Because there are no boundaries to what type of activities might qualify, so long as they meet the over-arching criteria around innovation, it is impossible to list all of the potential areas that might be relevant to a dental practice. It is often only when the practice engages in discussion with an R&D expert and potential opportunities drop out of the conversation, that qualifying expenditure is identified.

Costs can be eligible even if you pay someone else to undertake the research and development for you. However, most claims include a significant element of staff costs that relate to the proportion of time spent by employees on qualifying activities together with 'consumable' costs, such as materials, software, water, fuel and power, that can also be attributed to relevant activities.

To support a claim for the enhanced tax relief, records should be kept of the activities undertaken as well as the results of the project. It does not matter if the outcome of the project means that the activities are not implemented in the future.

If you have any questions or would like to discuss R&D tax reliefs, please contact David Clift on **01242 680000** or email **david.clift@hazlewoods.co.uk**.

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ARE YOU SELLING YOUR DENTAL PRACTICE, OR EXPECTING TO IN THE NEAR FUTURE?

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