

## VIEWPOINT

### *Management service organizations in orthodontics: A paradigm shift?*

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Starting in 1996, I began an investigation into a new trend in orthodontic practice management called Management Service Organizations (MSO). I began to seek out as much information as I could from a wide variety of sources to learn about what I believe is a significant trend in orthodontics. In trying to summarize the function of MSOs I will speak generically instead of specifically about any one organization. I believe this is a fair approach. However, some of the items I will describe may be more applicable to one MSO than to the others. I have done this for the sake of brevity only. All of the details can be obtained from each MSO. It is my purpose only to give the reader a basis of understanding about MSOs.

There is no question that the health care market is changing. MSOs represent a change that may or may not prove to have lasting merit. MSOs are not new or unique to orthodontics. They have existed managing dentists, physicians, and even veterinarians. Frankly, it should come as no surprise to anyone in the orthodontic community that corporate America is looking for markets that have high income potential. Orthodontics is certainly an area of high margins in comparison with many other businesses. Also, orthodontists are treating less than 1/5 of the population who can benefit from orthodontic services. There is great potential for income and growth.

Over the past 30 years in American society, we have seen the franchising of almost everything. Hometown solo proprietors of every sort have fallen by the wayside as national chains and franchises have used deep pockets and extensive media marketing to create name recognition and perceived value. Americans have shown a significant propensity to herd into national chain stores of every kind. The proponents of MSOs are hoping to have the same effect on the American mind-set in regard to orthodontic care.

Who are the players in the MSO game?

Today the names include New Image, OrthAlliance, Orthodontic Centers of America, Orthodontix, Omega, Dento Facial Centers, and Apple Orthodontix. There will probably be more. Including letters of intent, there are, at the time of my writing, less than 450 (out of 8500) orthodontists who are involved with these organizations. That is 5% of the U.S. orthodontist population. There are fewer who are actually practicing in an MSO environment.

What does a management service organization do and what are they?

For the most part, MSOs buy established orthodontic practices, and once purchased the MSO owns all the tangible assets of the practice from brackets to computers to chairs in the reception area. Each MSO has a management protocol that it follows to run the practice. There are a few examples of MSOs creating orthodontic practices where there weren't any in the past. But establishing totally new practices has not been the primary thrust so far for growth among these companies. Once the MSO owns a practice, it enters into a renewable employment agreement with an orthodontist, usually for approximately 5 years (6 months to 7 years). During that time, the orthodontist is generally paid a base salary plus incentives based on gross collections and overhead expenses. The orthodontist also signs a noncompete covenant with the MSO if the orthodontist leaves the practice.

The practice (not the orthodontist) enters into an affiliation agreement with the MSO whereby the MSO provides management services, in return for a management fee, for a term not less than 20 years and for as much as 40 years. This assures the MSO continuity with the practice so that any orthodontist who steps into the practice to carry on providing services at the end of the first orthodontist's 5-year employment contract must still retain the MSO and continue to pay the management fee. The affiliation agreement is the heart of the "buy-sell" transaction, because owning chairs, brackets, and carpeting is not an orthodontic practice.

Management service is what you pay an MSO to do. You will probably do orthodontics differently once you contract with the MSO. When the MSO owns the practice, the orthodontist has less impact on control of the practice. However, the scope of management and the specifics and style of each MSO vary. What I am going to say next is speaking in broad, general terms—not specifics.

Once the MSO effectively owns the practice, the practice will run like a national "chain" company. The MSO will have a mechanism on how to schedule patients and how to perform new patient examinations. Also, standard recall and financing protocols exist. A founder of one MSO indicated to me that he wants to create a treatment database to determine exactly how to "best" treat each variety of malocclusion so that patients can always be treated in the most efficient manner. It would be like always making an "Egg McMuffin" exactly the same way every time. The MSO will use cost-based analysis, chairside computers, time and motion studies, and ongoing reevaluation to establish the precise, "cookbook" protocol to handle every aspect of client interaction. From the first phone contact to patting little Suzy on the back as she leaves the

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center for the last time, the MSO will have protocols and frameworks that the practice must follow to perform optimally. Surely, we'll soon find out whether single-phase or multiphase treatment is best. At least the MSO's orthodontists will find out. The potential to operate an orthodontic office "better" is really quite incredible, but perhaps serious concerns about the assumptions that are at the heart of "better" also need to be evaluated.

The MSO will have managers to oversee the practices from corporate headquarters who will be in close contact with the office administrators (office managers) in the various practices throughout the country. Daily operations and management decisions will be made locally within the context of the company framework. Information will flow to and from the corporate hub. Some of the MSOs have indicated that there will be a Board of Advisors comprised of orthodontists in the company who will guide the direction of the MSO. The board will at least consist of the founding orthodontists and some of the early sign-ups. The advantage to central administration is consistency and efficiency, and it frees the orthodontist from some of the management tedium that many would prefer to do without. However, it would be naive to think that many of the daily management decisions would be handled centrally. The stature and role of the office manager would likely increase as orthodontists come and go in a practice, but other key employees remain. This could have some very interesting effects on how orthodontics is practiced.

The MSO will provide uniform communication materials from letters to brochures to videos and CD-ROMs to promote the practice and improve communication. This is an area where a MSO could really shine.

The staff in the practice is employed by the MSO. The MSO is responsible for compensation, training, and continuing education. The MSO will provide the materials, but obviously the orthodontist and key local staff will actually do the hands-on training. The MSO will provide health, life, worker compensation, disability, liability, and other forms of insurance. They will use their size to negotiate price breaks, if possible. Staff incentive plans can be formulated. The company may offer corporate retreats to bring personnel from across the country to one location for en masse training and education from time to time. This way new information can be disseminated and uniformity can be protected. Of course, continuing education outside the corporate environment will be available.

The average orthodontic practice in the United States has supply costs in the range of 4% of total overhead. Bulk purchasing and uniformity of supplies can reduce costs. The MSO may potentially negotiate reduced supply costs with sufficient volume. But to have adequate volume, all the practices may need to be buying the same supplies, such as the same brackets, or at least purchasing from the same manufacturer or wholesaler. Volume savings can't be achieved if each practice in the MSO is buying different supplies from different sources. With supplies comprising a small component of the total overhead, the net result on the bottom line will be slight.

One definite advantage in the MSO is access to capital. Stock investors can supply a pool of money to make any number of possibilities occur. For example, new practices can be

established in especially lucrative areas. Also, and very significantly, the increased capitalization can be used to perform media marketing and name recognition. Increased marketing, it is hoped, will tap into the 80% of the U.S. population who can benefit from orthodontic treatment, but who presently don't pursue orthodontic care. The MSO will centrally develop a marketing program and action plan to advertise orthodontics, using whatever media the MSO chooses, from TV and radio to direct mail. The money should be available to do this especially in mid-sized markets. In large urban areas like New York or Los Angeles, where costs may be very high, and small rural areas, where there just aren't many people, the cost-to-benefit ratio of extensive media marketing may diminish the merit of these programs. I expect that middle-sized markets will see the greatest impact of the entire MSO trend.

One of the professed functions that the MSO can do for you is to negotiate service contracts with third-party payers or other reduced-fee programs (managed care). The MSOs say that they can do this if the orthodontist desires, but won't if the orthodontist doesn't want to get involved. I believe, for now, that this is true. However, it remains to be seen whether the MSOs will determine whether reduced-fee arrangements have a place in each MSO's marketing scheme. Remember, the MSO is now involved in the management.

Another place where MSOs can impact is in the area of practice transition. Transitions in and out of orthodontic practice can be facilitated by an MSO. The MSO will have in-house appraisers, and they have an established transition protocol that can be used over and over again to move orthodontists in and out of the MSO practice. I believe that practice transitions have been rather uniformly botched for any number of reasons historically in orthodontics. One only need look at the number of failed partnerships and associations that litter the orthodontic landscape. Personalities may perhaps have less to do with transition success in an MSO environment because the ego factor may be leveled out. Also there would be no "handshake," "wink-and-a-nod," "nothing-written-down details to be worked out later," "let's see how it goes," "power play" practice transition deals, which have been at the heart of so much transition failure. Significantly, the MSO can be the vehicle for transition financing, which is often a problem in traditional practice sales (whether it should be or not).

It is important to look closely at the transition issue because it is really the key to what is driving the MSO bandwagon. To a practice seller, the MSOs are offering established practices in desirable locations 85% to 120% of the last 12 month's gross collections depending on profitability and perceived ability to expand the practice as payment for the practice. The MSO will pay as little as 12% in cash, with the balance paid as stock or installment cash payments with interest. One MSO claims to pay as much as 100% cash in some circumstances. Realize, however, that you cannot take the money and run, because you must sign an employment agreement, which as stated before, is generally to provide orthodontic services in the practice for at least 5 years. Also, if one opts for a higher cash settlement, the ongoing monthly management fee will be higher.

It is debatable whether 100% of 1 year's gross collections

is a fair price for an orthodontic practice or whether it is high or low, although most practices being sold conventionally today are sold for less. But, as always, the “kicker” in this deal is the terms of the total agreement package. I will speak to this issue later when I lay out how MSOs make money.

It is interesting to note that the average orthodontist in the United States (1995 JCO survey) does approximately \$475,000 in gross practice collections per year and operates the practice with a 55% overhead rate. The “median” orthodontist in the JCO survey netted \$191,000 in 1995. At retirement, according to the Blair-McGill newsletter, the average orthodontist has put away approximately \$700,000 in retirement savings of one form or another. Also, approximately half the orthodontists in the United States have divorced at least once by the age of retirement, which impacts on a retiring orthodontist. Simply put, most orthodontists are not able to maintain the income and lifestyle that they have grown accustomed to when they retire and are looking for all the cash they can get their hands on when they sell the practice. Also recognize that the average orthodontist is 48 years old, up from 44 years old in 1986. Moreover, the number of orthodontists desiring to retire is growing at a rate greater than the number of orthodontists who are entering the profession. This means that it is a “buyers market” for practices. Some soon-to-retire orthodontists are going to have trouble cashing out of their practices. This reality is motivating some large practice sales to MSOs.

If an orthodontist has a busy, larger-than-average practice it also may be difficult to find a young graduate who can step in and run the practice at the same level it was going and pay the exiting orthodontist while still making a good living. It certainly can be done, but it can require a lot of effort and energy to find the right person to make it work. An orthodontist in this environment who has a reasonable retirement nest egg can take stock in an MSO and hope for significant capital gains from a sellout agreement. These individuals may get nothing for their practice anyway, so something from an MSO might be better than nothing. Also, the MSO can assist in finding another orthodontist to run the practice after the founder leaves.

This brings up another issue that is fundamental in the MSO landscape. A significant part of the story being promoted to orthodontists to sell their practice and join the MSO is the lottery mentality of making it big in the stock market when the stock in the MSO goes public. Good ol' greed and “pie-in-the-sky” have sucked many orthodontists into financial schemes in the past and I'm afraid that some things never change.

When Orthodontic Centers of America, Inc. (OCA) first went public in 1994, the stock price soared, as it so often does with initial public stock offerings of small companies. While the price has dropped since its peak, the founders of OCA did very well in the stock market—very well indeed. The thinking goes, “if they did it, so can we.”

Interestingly, an article in *The Journal of Finance* (December 1994) looking at the performance of small, previously privately held companies before and after their initial public stock offerings (IP) concluded that these companies in the long run have not performed as well after the IP as before,

and stock prices have not been maintained. As we have heard before, past history may not be a predictor of future results.

What kind of opportunity does the MSO offer to a new graduate entering practice?

Here is another interesting area. Today students graduate from orthodontic programs with significant financial debt. Debt of \$100,000 to \$150,000 is not unheard of before walking out the door of an orthodontic program. Then start-up costs for a new orthodontic practice can be significant, adding thousands of additional dollars needed with banks not always willing to offer financing. There is no guarantee of success. Purchasing an existing practice can, no doubt, get a new graduate up and running faster than a cold start. But there are countless stories of rip-offs and bad deals, which the orthodontic residents have heard about to the point of it almost becoming folklore. This is sad but true. But there are also certainly countless deals that have been mutually successful for both the buyer and the seller. The orthodontic graduate is facing a lot of debt and the great unknown when leaving school. These realities do color ones' perception of what to do.

Management service organizations can offer the new graduate a pretty nice package. For example, finding or establishing a practice for you and paying a salary of \$100,000 the first year, \$120,000 the second year, and \$140,000 the third year in practice is attractive. Also the MSO will have its systems in place to make the practice run well and provide capital for advertising as well. Of course, the orthodontist is now contracted to the MSO and paid according to the MSO's formula. This formula may be significantly less than what the orthodontist could net in a traditional private practice given the same gross income. There are several examples of success for new graduates or those recently discharged from the military setting up practice in an MSO environment. However, the other reality is that the vast majority of orthodontists who have graduated in the past have done very well. Also, the orthodontic marketplace is growing and improving as most all of the demographic and statistical indicators project. In my opinion, in spite of the debt, there has never been a better time to go into the practice of orthodontics.

### How do MSOs make money?

You can be absolutely certain that the individuals who are founding orthodontic MSOs have figured out how to make money doing it and it isn't all capital gains increases from soaring stock prices. Today MSOs are mostly in the business of buying up practices. Few MSO practices have been set up from scratch. The MSO uses their formula developed from their experience to evaluate the practice and they then provide the seller with an “in-house” appraisal, which sets the selling price. The seller can get another appraisal, if so desired, but will pay for it on his own and, in the end, the MSO (buyer) is in the driver's seat on price. The MSO is bigger than the seller is and they are only going to pay what they are willing to pay.

Today MSOs are paying generally approximately 20% of the purchase price for an orthodontic practice in cash when the deal is consummated, with the balance most often coming as stock. So for the average practice, the orthodontist is getting \$95,000 cash with stock priced at \$380,000. The stock