

The Continued Role of Private Equity in the Dental Sector

By Maria G. Melone & Craig Castelli

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INTRODUCTION

Dental groups and dental practices have been – and remain – companies in high demand with buyers. For the past three decades, the dental sector experienced private equity-fueled consolidation, with limited slow-down during the pandemic. Dental groups are an investment highly sought after by investors for their recession resistance, market fragmentation, strong industry growth trends and healthy margin profile.

First a few basics on the private equity sector.

Private Equity Funds: Defined

Private equity funds are investment vehicles focused on acquiring privately held companies. As of mid-2021 there were over 18,000 active private equity funds in the United States, according to SEC data. Further, by analyzing data from Pitchbook and other sources, these funds invest in excess of \$100B per quarter into U.S. businesses. Recently, there has been tremendous growth among the lower middle market firms that are willing to acquire smaller companies.

Private equity investments typically take shape as either a buyout or an infusion of growth capital, with the distinction being the intended use of the funds and the percentage of a company acquired. Most transactions are structured as buyouts.

In these deals, the buyer acquires control of a company – at least 51% but oftentimes 75% or more – and the sellers or key managers retain a minority ownership position going forward. These deals in turn can be classified as either a platform investment or an add-on acquisition, largely based on the size and strategy of the investment.

Types of Private Equity Deal Structures

A platform investment is the firm's initial investment in a specific industry. Platform investments must meet stringent requirements and be of a certain size; most lower middle market funds look for companies with at least \$3M in EBITDA (earnings before interest, tax, depreciation, and amortization), stable cash flows, recurring revenue, and a promising outlook for the industry.

Add-on investments are acquisitions by these platform companies. There tend to be fewer requirements for add-on acquisitions, as size can be less relevant as long as the add-on is synergistic with the portfolio company.

Growth capital investments, on the other hand, also result in the creation of a new platform but can be structured as either control or non-control (minority) investments. Further, whereas in a buyout the majority of the cash component is distributed to the sellers, many growth capital investments are structured to fund growth and not pay out the sellers as in a traditional sale.

Types of Private Equity Buyers

The market for dental company acquisitions largely involves three categories of buyers:

01 Pure strategic buyers: groups lacking a private equity sponsor, like Mortenson Dental

02 Private equity platforms: groups aggressively pursuing add-on acquisitions, like Dental Care Alliance or GPS

03 New private equity entrants: groups seeking to capitalize and build their own platform

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Contact Maria directly at (339) 927-8882 or maria@caberhill.com.
Contact Craig directly at (312) 371-6920 or craig@caberhill.com.

Typical Timeline for a Private Equity Acquisition

PE firms manage money for outside investors, known as limited partners (“LP”), for whom they ultimately need to generate a return on their investment. In order to pay LPs a return, firms need to liquidate their investments.

Typically, a firm will hold an investment for 5-7 years, growing it rapidly during this time. Eventually, they will sell the company to another PE firm or a strategic buyer.

The Attributes Attracting PE to the Dental Industry as a Whole

The dental industry attracts PE investment because it aligns very closely with criteria common to PE firms high-performing investment criteria. One key reason: dentistry is a recession-resistant industry.

In addition, the dental industry is seeing and projected to enjoy moderate growth through 2032. According to Centers for Medicare & Medicaid Services, the US dental market is projected to grow at a CAGR of 4.2%.

Finally, the industry is highly fragmented, characterized by a few large operators and thousands of small and medium-sized companies. Heartland Dental, currently the largest DSO, accounts for less than 2% of dental locations and less than 1% of practicing dentists. Ultimately, this makes the industry ripe to streamline operations and maximize margins through consolidation.

The Attributes Attracting PE to a Particular Company

On a high level, below is a list of key attributes a dental business must have to attract the attention of a private equity buyer:



Experienced, capable leadership team



Low customer concentration



Highly recurring or reoccurring revenue



Strong customer retention



Above-market growth



Strong EBITDA margins

Investment Criteria

PE investors each have their own set of investment criteria. Typically, a company needs to generate at least \$15M in revenue and \$3M in EBITDA to be considered for a platform acquisition. However, a company may only need ~\$1M in revenue to qualify as an add-on investment.

Investors are looking for stable revenue streams supplemented by organic and acquisition growth. Revenue mix is of particular importance and a delicate balance to ensure patient flow and appropriate reimbursement. Most investors shy away from practices with a high concentration of Medicaid reimbursement, but there are those that welcome the opportunity to invest in practices with a focus on this patient population.

Geography

Most investors prefer geographic concentration of practices when considering a platform investment but have little preference for specific areas of the country.

Market Segments

The last several years have seen investors focused on platforms of dental specialties and it will be interesting to see if this morphs into a multi-specialty focus, or even brings in comprehensive healthcare modalities.

IMPACT ON COMPANY OWNERS

How Consolidation Drives Demand

Consolidation can create a more competitive market, and independent companies can expect increased competition when one or more large operators enter their markets. It also creates tremendous opportunity. The entrance of new players who have specific mandates to grow through acquisitions means that the demand to acquire may exceed the supply of companies for sale.

In other words, it becomes a seller's market.

When industries go through consolidation cycles, valuations increase as buyers compete with each other to purchase premier companies. Such cycles can last anywhere from 5-15 years, with owners who exit amidst the frenzy realizing massive premiums compared to the average valuations obtained during other cycles. Furthermore, the increase in the number of buyers in the market increases the options for a seller.



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Platform vs Add-On

There are major differences between selling as a platform and as an add-on, well beyond any perceived financial distinctions. Even companies that fit the financial profile of a platform may find themselves transacting as an add-on.

The Case for Platforms

A platform investment nearly always requires the company to come with a CEO who retains a significant equity stake in the business going forward. In the lower middle market, that often means the owner is that CEO. How significant the equity stake must be will vary by the individual PE firm and the capital structure of the business prior to a transaction, but 20% or more is common. Not all sellers want to make this large of a commitment of either time or money.

The upside, however, can be appealing. As with most investments, those who get in on the ground floor of something successful tend to reap the biggest rewards, and the same is true for those owners who create a new platform. Their rollover equity tends to appreciate more than that of any ensuing add-on.

The Case for Add-Ons

Add-ons, however, create a simpler path for the seller, as they likely involve a lower threshold for rollover and the potential for a shorter post-close commitment to the business. They may still be required to stay on for a few years if they are instrumental to either sales or operations, but that is usually a less intensive commitment than that made by one selling as a platform.

Further, their day-to-day is likely easier. Selling to private equity tends to be glamorized, and not enough is written about just how challenging it can be to operate a business owned by private equity and report to a PE-controlled board of directors.

Great challenges can yield great rewards, but they can also result in great failures.



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THE INFORMATION ASYMMETRY

The Information Asymmetry

First-time sellers face a significant disadvantage when selling to private equity or corporate buyers. There are a variety of reasons why, but it boils down to an information asymmetry between the seller and the sophisticated buyers on the other side of the table.

The main factors contributing to this information asymmetry are the opacity of the private capital markets and the relative lack of available information about private company transactions.

In such transactions, the more experienced buyer has access to proprietary off-market information about valuations, transaction structures, and deal terms that is only available to someone with vast transactional experience and an extensive network. They can leverage this information asymmetry to purchase companies for less money and on more favorable terms than if the playing field were leveled.

As a result, several sellers unknowingly accept a less-than-optimal offer.

The Value of an Advisor

An M&A adviser can generally help a seller identify and contact potential buyers, value the seller's business, negotiate with a potential buyer, and close a deal at a lower cost than the seller would incur on its own.

Several resources exist to support company owners in a sale, with the primary being M&A advisors. A sell-side M&A advisor acts as an exclusive advisor to the company owner, representing their interests in the transaction and managing the process from pre-sale

planning through to closing. A qualified advisor has a broad base of transactional experience, in-depth knowledge of an industry, and an expansive network of contacts among relevant strategic buyers and outside investors. While some firms specialize exclusively in the dental industry, company owners would be wise to retain a firm with broader expertise as they can draw from a larger network of potential buyers and contribute unique points of view to the process.

A sell-side M&A advisor will ensure that the company owner maximizes the sale process by eliminating the information asymmetry. Several studies have demonstrated that businesses sold through advisors receive higher prices than those sold by their owners, and the best firms align their incentives with their client's objectives to ensure all parties are focused on one goal.

One study analyzed nearly 5,000 transactions over 20 years and estimated that sellers who enlisted the guidance of an M&A advisor garnered valuation premiums of around 25%.

M&A DENTAL OUTLOOK FOR 2025 AND 2026

While we have seen a slow-down in transactions, it is still an excellent time to sell a quality dental group. There have never been so many platforms competing for add-ons, and every company that Caber Hill Advisors has taken to market has received multiple, competitive bids, allowing the seller to maximize value and choose a partner for reasons beyond economics. At the same time, there remains a strong thirst for attractive new platforms.

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The prospects over the next 12-18 months are very bright but trying to predict the market beyond 2025 is difficult. Presidential election years always present uncertainty for all financial markets, and even a recession-resistant industry like dentistry is not immune to macroeconomic factors like changes in interest rates and tax rates.

We still like the prospects for sellers over the next 3-5 years, as we expect demand to remain strong. However, predicting valuations beyond the near term is irresponsible.

Eventually, the ratio of supply to demand will flip. In the United States, an estimated 40% percent of privately held companies are owned by Baby Boomers. All of these owners will retire someday, and most are counting on the sale of their company as both their exit strategy and a critical element of their retirement savings. There will be a significant increase in companies for sale over the next 5-15 years.

We expect to see significant competition for sellers, with buyers having multiple options in most markets as the supply of companies for sale exceeds demand. There will still be buyers, but the shift in the supply-to-demand ratio will put downward pressure on valuations.

This dynamic is great if you're planning to buy a company, because your options will increase with each year. A company owner preparing for an exit, however, would be wise to evaluate supply and demand when determining when to sell, because those owners who sell at the beginning of this impending wave will achieve better results. Quite regularly, Caber Hill Advisors fields queries from dental groups eager to make add-on acquisitions or platform investments in the space. These frequent, ever persistent queries just reinforce our main claim: it is a seller's market.



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ABOUT CABER HILL ADVISORS

Caber Hill Advisors assists private company owners and prospective company buyers in the sale, purchase, or evaluation of a company, and has acted as the trusted advisor to hundreds of company owners across numerous healthcare sectors. Our team has in-depth knowledge of the dental industry and close connections with its leading investors. The firm utilizes a proven process for selling companies, bringing capabilities that are often only found at Wall Street investment banks to small- and medium-sized businesses. Our clients are our best advocates.

Maria G. Melone
Managing Director



MARIA G. MELONE, is a leading M&A advisor in healthcare, with deep knowledge of the dental industry. Her mission is to help both individual businesses and multi-site groups navigate the complex landscape of capital or strategic transactions.

Maria has extensive transactional knowledge and brings a wide breadth of skills to the table - particularly in valuation. As a Certified Valuation Analyst, she is an expert in helping clients understand what their business is worth. She determines value based on tangibles like equipment, actual cash flow, and profitability.

Here is what Eric J. Roman, the Co-Founder of Carolinas Dentist, had to say about Managing Director Maria G. Melone:



I would recommend working with the Caber Hill team for three primary reasons: it's an exceptional team and the resources they have at their disposal are top-notch; their support assures that they're not simply out to get a transaction done but care about what you want; and finally, the depth of their connections—they know absolutely every potential buyer in this industry. You need that level of knowledge, experience, and connections if you want to get the most for your transaction

A great advisor like Maria Melone would first want to get to know you. She is someone who you feel is completely on your team—there to support you, there to take your phone call quickly when something interesting (or uncomfortable) comes up. She does an incredible job of putting you at ease and building confidence that things are going the way that they should.

Don't consider doing this without a seasoned professional on your team. I'd make sure you have a strong trust relationship with the person you are working with. This isn't somebody who should be simply transactional or somebody just trying to get a deal done. Because anybody can get a deal done, and it takes a lot more skill and a lot more knowledge and wisdom to get you a really great outcome for your future. This isn't the end of your life, it's the beginning of a new phase.

- Eric J. Roman, Co-Founder of Carolinas Dentist



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