McGuireWoods

THE CORNER SERIES

Episode 96: The Joint Venture Model Revolutionizing DSOs, With Justin Puckett

Episode Summary

"If you don't have a proper alignment model," cautions MB2 Dental President Justin Puckett, "it's really hard to win in this game." Speaking with McGuireWoods partner and host Geoff Cockrell, Justin explains why most dental service organizations (DSOs) struggle with provider retention and growth.

He also unveils MB2's groundbreaking joint venture approach in which dentists maintain local ownership while receiving monthly distributions — a model that has propelled them to nearly 800 practices nationwide. Tune in for insights about the future of large DSOs, acquisition strategies and how MB2's pioneering approach reshapes the dental industry landscape.

Transcript

Voice Over (00:00):

This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods Partner Geoff Cockrell as he and specialists share real world insight to help enhance your knowledge.

Geoff Cockrell (00:20):

Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell. Here at The Corner Series, we try to bring together deal makers and thought leaders at the intersection of healthcare and private equity to discuss current trends, where the market is going, and lots of other aspects of that intersection.

(00:36):

Today I'm thrilled to be joined by my longtime friend Justin Puckett. Justin is from MB2 Dental. Justin, if you could give an introduction of yourself and MB2. With that, we can jump into some questions.

Justin Puckett (00:47):

Yeah, happy to connect, Geoff, as always. Again, Justin Puckett, president of MB2 Dental. I joined MB2 and our founder Dr. Villanueva coming up on 11 years ago. No DSO world existed really back then and it's truly a provider-driven alignment model. You look today and we are closing in on 800 practices throughout the country. We employ a joint venture model that's based on provider autonomy. It's been a fun ride. We started out private with basically no money, very scrappy. We're now on our third financial sponsor, and still trying to grow and solve problems every day. Happy to jump into any other topics and look forward to it.

Geoff Cockrell (01:27):

Justin, you mention joint venture model, local provider autonomy. There's a lot of different ways that businesses like yours have thought about these questions. Both from the perspective of how do you attract and motivate people, how do you connect them to what's happening in spheres that they can control. Some folks answer that question with leaning heavily into top co level equity as being one of the big drivers of alignment.

(01:55):

The alternative, of course, is among other levers that you can pull, is a joint venture model where their equity ownership is connected at a lower level that's closer to something that they can impact. How do you think about that spectrum, and why have you built your model the way you've built it?

Justin Puckett (02:13):

Yeah. I think for us, the local level ownership, it's very simple. I think dentistry, it's different than medical, optometry, for example. Every dentist in every market and even sub-markets have their own little niche, their own little way to do things. We've found our owners like to control what they can control. A lot of them are entrepreneurs, that's why they picked dentistry over medicine, for example. They focus myopically on that one office. They can drive four-wall EBITDA, they can drive same store sales. If everyone does that, it goes into the old adage of "rising tides lift all ships."

(02:48):

Dr. Villanueva, our founder, his idea was simple. He's like, "I want them focused on that specific practice." Because if something happens, when we have three or four practices, he was just concerned about a provider there. He's like, "I don't want to have to go, I couldn't work two places at once." That's how it started. We do have a small slug of we want them to have to hold co equity as well, so they care about the global entity. But we have just found, again, it's just they can understand and they can drive change in their local office in their local market. For us, it's obviously worked really well and I think it's resonated with so many of our doctor partners.

Geoff Cockrell (03:23):

One of the aspects of equity ownership is the idea of second bites at the apple. On the top co philosophy, and I know that you split yours, the providers would be owners either through rollover or other programs, owners perhaps at the top co level and a joint venture level. At the top co level, obviously in most businesses, that top co equity is not cash flowing. As money lands at top co, it's being used to satisfy enterprise-level debt, it's doing other expansion initiatives. Whereas the joint venture aspect of it, where a provider owns at a sub-DSO, that often is cash flowing.

(04:02):

How do you think about the impact of current cashflow from an alignment perspective versus additional bites at the apple in a sale process?

Justin Puckett (04:10):

Yeah, I think it's the differentiator. I always use the example, at the end of the month, after even paying our partners' chair side and we pay their rent, every kind of expense, there's 10 bucks left over for that practice. They own 40% call it, they get 40% of the 10 bucks. For us, it's the best driver of alignment.

(04:31):

I always use the example, people are like, "How do you give so much autonomy to your doctor partners?" I say it's because we're aligned. They want to order a new, make it up, a new scanner. Obviously, it's our job at the DSO level to go secure the best pricing, give them options, work with the manufacturers or the distributors. But at the end of the day, if they feel confident enough that they're going to put up their portion of that money, it makes our job so much easier. It's almost like why would we say no? Because if they feel that strongly about it, they are doing that because of the longterm, their distributions. We do ours monthly. That will grow. We do ours monthly and not quarterly. I think our financial team still hates us for doing that, because it's an administrative burden.

(05:11):

We want them to feel the changes monthly, good and bad. If they take a two-week vacation, many times, they have to put in a capital call for that month. Obviously on the inverse, if they implemented some new type of strategy, they tried a new marketing campaign, or whatever example you can come up with, it results in increased volume or increased pricing, they get to feel that effect very quickly. That's something we've done since office one and we still do today. Versus the bites at the apple, we've found ... Again, we obviously believe in that too, but there's so much of that not even just outside of their control, but it's outside of our control. It's market driven, it's DSOs' interest rate. There's so many different variables there that it's so one moment in time, versus this is an everyday focus for them because they know they're going to see those results financially.

Geoff Cockrell (06:01):

How do you balance the local autonomy from an economic perspective against having some form of uniform culture and connectedness to the overall business? Or do you think that that is less important, as long as you answer the first question right?

Justin Puckett (06:17):

Yeah, I think if you nail the first question, you'll have success, which people like. If everyone's a hold co investor, they like that. Now that said, we still focus very heavily on the culture piece. We do and have done since the beginning of time, numerous owners' trips a year. That is purely designed of how do we bring people who have different local cultures into one big MB2 culture? Which again, ours is how do we change the dental industry by giving this autonomous model? How do we put best practices in place? Because so many of our owners, they're competitive. They already have phenomenal practices. They're joining us to get better.

(06:54):

I would say in the past five years, we've even seen an additional shift of they want help, they want best practices, they want to know what everyone else is doing. We have an internal app on their phones because we found they check their phones more than they check an actual email. It's constantly going back-and-forth together, whether that's clinical. Whether that's, "How's this vendor? Here's my ROI. Is anyone else seeing anything?" We want basically our partners helping each other, competing with each other in a positive way, but it's very intentional.

(07:22):

We spend a lot of time and a lot of money on small regional events to encourage a specialty share. Large national events, we do two a year, which all the owners are invited to. Even down to specific sub-markets of the East Valley of Phoenix about once a quarter to get everyone together. We want them to feel like it's still a small organization, but at the same time be able to take a step back and appreciate that we're now a massive organization.

Geoff Cockrell (07:45):

When you think of growth, how do you balance Denovo versus doing acquisitions? What's your thought process on that?

Justin Puckett (07:53):

We try to be agnostic and just say, "What is appropriate for that specific owner, that specific market?" This year, we'll probably do about 20 Denovos. I think we did 15 to 18 last year, and did about 100 acquisitions. Denovos, we've found were more recently, we are solving for something. Meaning, maybe it's a satellite office or a second office for one of our owners. If we have 20 GPs in an area and an oral surgeon wants to open an oral surgery office, we'll build it right there. Or just frankly, a market we've been trying to get in, but haven't been able to find the perfect partner. Because it's not just acquiring an office, they've got to fit the provider piece. Are they a good partner? Are they top-of-class clinically? Do we have the same morals, values, beliefs, and longterm vision of dentistry?

(08:39):

We always want to be able to do both. I think the market will change and do both as well. There will be times when the multiples were crazy, crazy high on an acquisition of, maybe Denovo makes more sense from an ROI. We're also seeing construction costs are way up, no different than if you're remodeling a home or building a new home. It's constantly weighing those pros and cons, but we always want to be able to do both if needed.

Geoff Cockrell (09:00):

The growth and acquisition market for larger than those small, individual ones that would be selling to a consolidator, the mid-size DSOs gotten stalled. I think a lot of that stall is related to them looking up-market at larger DSOs, like yourself and others, a handful of others that are much bigger. There's a lot of uncertainty as to where that upstream market goes, because ultimately if there's not a successful path forward for the largest DSOs, the consolidation idea breaks down below it.

(09:35):

How would you describe what the future of large DSOs looks like?

Justin Puckett (09:40):

Yeah, I think you're exactly right. We're obviously very close with one of our current private equity sponsors, Charlesbank. When we were recently talking with larger sponsors when we got a deal done last November, they were commenting on how many of the mid-sized groups on the PE side were calling them with that exact thing of, "Where does it go from here?" Because a large buyer, if they're going to buy a mid-size group, it's got to know how they're going to exit.

(10:04):

I think, obviously if you look at the top four, Heartland, us, Aspen, Pacific. Heartland is owned by KKR. You look at the top 10 private equity firms in the world on size, a lot of them are in dental now. We're with Warburg Pincus. You have so many that are already in dental. Where do you go from here? I think the obvious one is do these go public? I think you will see those at some time.

(10:28):

I think there are other vehicles that are emerging, whether that's in a private IPO or continuation funds with these other large LPs. All these KKR, Warburgs, Blackstones of the world have massive LPs, and sometimes they're co-investing now, we're seeing that. We always just try to focus on if we are successful, and cash flowing, and growing, we will have options. But eventually, you are going to see these companies go public. Someone's got to be able to write that check of that size and it's got to be a public market.

Geoff Cockrell (10:59):

With that backdrop, as we're moving further into 2025, do you see the market for mid-size platforms opening up, or is that going to take a little bit longer?

Justin Puckett (11:09):

If you had asked me six months ago, I would have thought we would have seen a lot of transactions by this time, but we're just not seeing it. There are quite a few in market right now, but so many are in this long hold period. It does seem like everyone is waiting on the other shoe to drop. I think the lack of dropping interest rates is for sure playing a factor in that. But yeah, you're just not seeing transactions. There's some great examples of guys going to market and they pull out, there's no buyers. You have a lot of people sitting on the sidelines that something has to happen.

(11:41):

I know we're, I would say in the past three months, we've probably been approached more than the past five, six years by smaller platforms about could we do anything strategically. Because they're at that unique point of, "Do we put equity in to grow the business? Do we put equity in to grow the management team?" But I do think it's going to be a slower '25 than we'd thought. For all of us, we hope it starts to open up at the end of the year.

Geoff Cockrell (12:03):

From your perspective, given that the future of what happens for platforms like you all is still evolving, do platforms like you all feel like buyers of those mid-size platforms, or if there's a right opportunity? Or are you still doing your acquisitions on the small side? How do you think about that?

Justin Puckett (12:22):

We definitely will be involved and we are getting involved in some of these smaller mid-size platforms. I think we have a great reputation from our providers and our partners, so a lot of the dentists know us, they have friends with us. They've talked to, whether that's their executive team or their sponsor. You are going to see more, I think you have to. Some of these guys have to get creative.

(12:40):

Now for us, it's always balancing. We looked at 2800 practices last year, so the pricing has to still make sense for us. I think that probably has to be a little more reality checks as to what the exit multiple is going to be for those groups, but you are seeing that get closer. We even, I think last week, Smile Doctors did a transaction with myOrthos. Those were very, very rare, but you are going to see more of those just because a lot of these, they're at seven, six, eight year hold periods. They've got to do something at some point. I think once, a little more time from now, whether that's the lenders or the private equity firms have accepted, I don't want to say their fate, but in a way it is, I think you're going to see more and more of these happen.

Geoff Cockrell (13:22):

Yeah. You see a lot of continuation vehicle deals, which that can make sense and it buys time in that sequence. We may see that as a stop-gap here for a while, but that only takes you so far.

(13:35):

Maybe looking down market again, to your eye, what does the smaller side of the market look like? I know you do a lot of acquisitions at that stage as well. Is there still room for more consolidation, especially in a market where you happen to be? Or does it run its course and you run out of room for it?

Justin Puckett (13:51):

We always wonder that. Are you going to see a drop-off? We look at our funnel, the top of the funnel, it's still extremely healthy compared to all the other years. I think there's just less buyers out there right now. A lot of groups are sidelined with, whether they're up against covenants or just lack of capital.

(14:07):

I think we see a little bit still, of I would say pricing shock. No different than the residential real estate market of, "Well, I was told a year ago, a year-and-a-half ago, two years ago, I was going to get," and we hear the craziest things. We hear a one-off location that's got $400,000 of earnings, "I heard I was going to get a 10X." You're like, "Well, no, that's not the market." I think there's a little bit of pricing shock that still is causing a little bit of a slowdown, especially on the broker deals that we see. But there's still so much consolidation left. We are still, in my opinion, call it the third, fourth inning. We are in the early innings and the industry as a whole has still a healthy runway ahead of it.

Geoff Cockrell (14:45):

As I look at the market, setting aside some of those macro dynamics, I see lots of platforms and some of them are doing well. The M&A market can be uncertain, but within their business, they're doing well, and others that are pretty dramatically floundering. What's the through-line on some of those that are not doing well? Is it leadership, is it structure? What would you attribute that to?

Justin Puckett (15:11):

Yeah, I think typically it's one of two things. It's if you don't have a proper alignment model, it's really, really hard to win in this game. At the end of the day, it is do your providers and your doctor partners, are they motivated? Are they aligned?

(15:24):

I think secondary, we see a ton of those groups that were simply put in this market as a financial arbitrage play. We always tell everyone and we tell ourselves daily, "We've got to create value for our owners." Which means we got to make their lives better, we have to make the best place to work. Then obviously, we have to financially benefit them. So many of these groups were just going to gobble up 20 practices, 30 practices, 40 practices, duct tape it together, and sell it. "We're going to buy these practices for eight, we're going to sell for 12." Interest rates doubled, performance, maybe volume dipped, and they never built out a proper infrastructure to actually provide that value, so they're stuck. I think the groups who purely relied on that financial arbitrage, which I guess goes into lack of leadership, are stuck. Those are the ones you're seeing get turned over back to the lenders and the banks.

Geoff Cockrell (16:13):

Yeah, I'd also say that a number of practices didn't remain laser-focused on the basic economics of the proposition to the providers. In the sense of it's business school 101 in negotiation, and retention is a negotiation just like acquisition is a negotiation. The basic business school is always know what your negotiating partner's BATNA is, their best alternative to a negotiated agreement. By that I mean not having laser-focused on what the current compensation take home of your providers is, visa vie what they could do elsewhere. If you lose track of that for a second, then there's not enough culture to carry you for very far. In some of the deal structures, it became conventional wisdom that, "Oh, you can scrape 30% of whatever they were making and slap a multiple on that, and everything's going to be great."

(17:05):

Well, maybe, maybe not. The maybe not is if you scrape that much economics out, because that's going to be your go-forward comp, if that has landed everybody at a non-competitive spot, you're going to be in trouble. I saw that play out time and time again.

Justin Puckett (17:20):

Totally agree. We lost out on a ton of deals, especially in the hey-day of post-COVID, call it '22, early '23, when we would see doctor compensation underwritten at the lowest, way below market values. We always struggled with that.

(17:34):

Two reasons. One, you touched on it. Eventually, they're going to be like, "I went from making X to X-minus a lot." Over time, that gets old. I think the second thing was if something happens to them, we couldn't go out and hire someone at that rate. We knew what was happening. Yeah, they were juicing EBITDA. We know the game. But to be sustainable longterm, we have to be very steadfast. Again, like you said, are we the best alternative? We have to be the best place for them throughout all times. That was a frustration for us and now you're seeing it come full-circle. They're seeing the effects of that.

Geoff Cockrell (18:10):

Justin, it's always fun to talk to you. You guys have been a market leader in so many ways. You pioneered, and I've done a little bit of work with you on this, pioneered the whole joint venture model that has been the real driving force in the industry. You guys are a beacon on a hill in a lot of ways. It's been great to watch your guys' ride. This has been a ton of fun having you on the show.

Justin Puckett (18:31):

Appreciate it greatly and look forward to the future.

Voice Over (18:36):

Thank you for joining us on this installment of The Corner Series. To learn more about today's discussion, please email host Geoff Cockrell at gcockrell@mcguirewoods.com. We look forward to hearing from you.

(18:49):