April 27, 2006

American Dental Partners, Inc. (*ADPI*)
A Business with Strong Regional Economies of Scale

This is the write up I did <u>before</u> I bought additional shares. If my analysis is faulty at least I can go back and see my reasoning to learn from mistakes and omissions. This is a major position so this write-up is for your improved understanding of one business that you own.

Summary:

ADPI: A good business with high and sustainable ROIC. The Company has good reinvestment opportunities to grow within its niche of serving Dental Groups within prescribed geographic regions. The price of the business is being overshadowed by current litigation, and the price does not account for the sustainability of high returns and growth. Hence there <u>may</u> be an opportunity here. Prices at or below $12 would offer excellent prices to buy because the earnings yield would exceed my15% threshold for no growth businesses. You could have a free option on ADPI's future growth.

1. *ADPI* has excellent pre-tax returns on invested capital that have averaged over 35% for the past four years **(2005 ROIC was 60% +) so this is a <u>good</u> business.**

2. The current price at approximately $13 per share gives an (EBITDA-MCX)/EV **"owner's earnings" pre-tax yield of $26 million/$200 million or 13%. Perhaps, the yield is OK if there is solid growth.** I typically prefer a pre-tax earnings yield of 15% or higher. However, the business economics are very <u>steady</u> (see last page for operating and financial history), their service is not very price sensitive and its 5 year CAGR of sales, earnings and cash flows are in double digits, and I expect that to continue even allowing for a margin of safety of the growth slowing. Estimating a long term growth of owner earnings of 6% to 8% brings my pre-tax return to approximately 18% to 21%, a good price relative to alternatives (6% long bond rate).

3. I will continue to hold ADPI, but be sensitive to selling near IV of $18 to $22.

Introduction:

The company is significantly <u>underleveraged</u> since its target debt to capital goal is 40% while currently under 26% and the company has unused credit lines of $70 million to expand, make affiliations or buy back stock. With a <u>minimum</u> average 5%-6% to an average 8%-10% growth in owner earnings to allow for a margin of safety in estimating growth rates (currently averaging 25% annual growth) over the next 5 years brings my return up to the 18% to 23% range without any expansion of the multiple or lowering of the cap rate.

There are <u>no comparables</u>. The other public DPM, *Birner Dental (BDMS)* has less than 2.6 million shares outstanding and a different model entirely. Incidentally, *BDMS* has had minimal growth a 6 year CAGR of 3.5% with revenues growing from $29 million to approximately $36 million in 2005. Meanwhile *BDMS's* share price rose from 38 cents to $21 while management bought back stock and made minimal capital expenditures. *ADPI* has 6 times the patient revenues of *BDMS*.

More importantly, management has an ownership stake and financial decisions are driven by ROIC not EPS growth. They measure their capital cost for equity at 25% pretax. This is unusual for a small company. Management seems astute at allocating capital and they have purchased stock at advantageous times in the company's history. They seem to balance growth and return issues very well. My criticism is that management seems too liberally blessed with stock options.

Currently, *ADPI*'s share price is depressed by the uncertainty of a lawsuit brought forth by one of their larger affiliates, Park Dental—the downside of their partnership model. I believe this lawsuit is a one-off event, highly specific and unusual and not indicative of *ADPI*'s service to its affiliates. (It would take many pages to support my thoughts on the lawsuit, but my files are available). Since the filing of the lawsuit/complaint in MN, *ADPI* has announced a new affiliation, so *ADPI* doesn't seem constrained by this lawsuit. Even if the suit takes time to be resolved, profitable growth will continue and if there is a resolution or compromise, then expect a much faster revaluation upward.

Finally, as a backstop to value, private equity firms are paying more than nine (9) times EV/EBITDA for lower quality and slower growing DPM firms. ADPI would trade on an equivalent valuation at approximately $19 to $21 per share. *ADPI*, with 10 years of operations, is a business partner to dental groups where clinical excellence is the norm. *ADPI*'s affiliated groups have higher fees and attract patients through patient referrals rather than retail-oriented dental practices which might attract patients through advertising.

To grasp *ADPI* you must distinguish their unique affiliation structure from the many Dental Practice Management (DPM) companies that became private, disappeared or went bankrupt such as *OCA, Inc.*--though over-leverage, unprofitable growth, fraud and mismanagement were additional factors for the troubles in the DPM industry. Fortunately, most on Wall Street do not do the work to distinguish between DPM models.

An investor has to understand that *ADPI*'s incumbent competitive advantages rely on its strong regional economies of scale where the company can negotiate better rates from dental payers, recruit dentists and staff more efficiently, procure services & supplies more cost-effectively, spread management talent over higher density regions and leverage its infrastructure better. And most important of all, management is aware of its competitive advantages and works to deepen the moat by growing organically or peripherally in its geographic regions *(Think Wal-Mart in its early days growing outward from its enclave in Ark. and the South Central Western US)*.

In this age of global competition and rapidly changing technologies, I find in service industries, where a firm can achieve local dominance that company can build a defensible moat within their niche market.

(1) The first question I ask is whether *ADPI* is a good business?

YES. My threshold is a minimum 30% ROIC defined as either EBIT or (EBITDA – Maint. Capex) divided by (Net working capital + Net Fixed Assets)

ADPI	**2002**	**2003**	**2004**	**2005**
EBITDA – MCX	$13,967	$15,214	$20,110	$26,196
ROIC using (EBITDA – MCX)	***36.5%***	***38.9%***	***54.4%***	***60.1%***

Or

Total Tangible Invested Capital	**$38,269**	**$39,132**	**$36,946**	**$43,613**
EBIT or Operating Income	10537	12988	15702	18,689
Pre-tax ROIC using EBIT	***27.5%***	***33.2%***	***42.5%***	***42.9%***

Either way *ADPI* is averaging 35% ROIC though EBITDA – MCX is preferred, because true Maintenance Capex (MCX) is closer to steady state owner's earnings. Depreciation is much higher than MCX because operatories (dentist chairs), buildings and leasehold improvements will last much longer than their depreciation schedules. For proof one can look at a small "competitor" *Birner Dental* which has minimal capex and has not been growing either through new facilities or affiliations for the past five years has ROIC > 100%. Amortization charges should be added back, and the company does add back after-tax amortization charges to compute actual cash earnings because once the long term contracts are amortizated there is no more investment required.

(2) Is this a Good Price?

Growth in Owner Earnings		*8.9%*	*32.2%*	*30.3%*
After Tax	$8,380	$9,128	$12,066	$15,718
After Tax FCF/Sh. (EBITDA-MCX)*(1-40% Tax Rate)	***$0.75***	***$0.80***	***$1.00***	***$1.22***
Current Price to After-Tax Owner Earnings @ $13			***13x***	***11x***

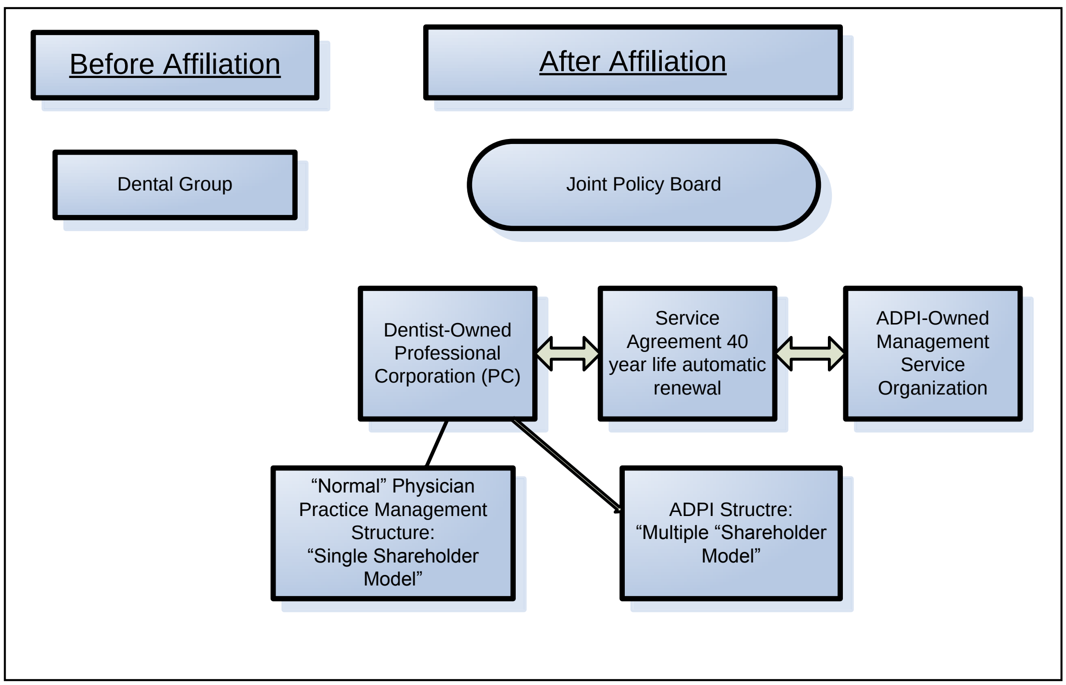
FD Outstanding Shares	11,177	11,358	12,102	12,900
Debt			$28,014	$32,039
EV with $13 per share price			**$185,340**	**$199,739**
Pre- Tax Earnings Yield (EBITDA-MCX)/EV			**10.9%**	**13.1%**

Pre-tax owner's earnings to EV is currently about 13% or about 8% after-tax. I prefer 15% and up but I will trade off depending on my certainty of profitable growth. In other words, if I capitalize the $1.22 in after tax FCF per share at 10% to 12% I get a $10 to $12 share price. Therefore, I don't have to pay much for future profitable growth as long as the probability is quite high (>80%). Owner earnings have grown at a 20% CAGR for the past five years. Management believes it can grow same market patient revenues in the 8% to 10% range over the next decade from a $300 million patient revenue base--so with a 10% EBITDA margin five years out (yet more mature facilities will have higher margins since incremental returns to capital are high—adding an operatory to an existing facility is more profitable vs. entering into a platform affiliation), you get to $3.00 to $3.50 per share of pre-tax owner earnings or more than $2 in after-tax cash flow per share in five years.

This is not stupendous but I don't take into account more operating leverage the company can improve on to raise the EBITDA margin. If affiliations slow and instead of growth being 8% to 10% then if growth is 5% to 6% or about market growth in dental services, then cash can be used to buy back stock which management has shown a willingness to do in the past at opportune times.

Growth in Owner Earnings	6%	8%	10%	12%
For five years starting with 13% pretax return	17%	19%	21%	23%

ADPI's affiliation model



Affiliation Structure is unique part of _ADPI_'s model

Almost all practice management companies use the corporate structure shown above but *ADPI* uses a multi-shareholder structure. Rather than the dentist-owned professional corporation having a single dentist shareholder of the PC under the typical "single-shareholder" model (like the structure *Birner Dental* uses), *ADPI* uses a multiple-shareholders" model in which ideally the PC is owned by 50% or more of the dentist in the PC.

ADPI does not control the medical practice or the Dentists, *ADPI*'s regional offices and teams provide management services such as procurement, insurance, payment services, scheduling and administration to the dental groups.   It is a partnership and management model—it has always been in *ADPI*'s model to share profits with the Doctors so as to give incentives for improving performance.   There have been some in the industry who, in essence, have bought practices. *ADPI* shares the profit incentives with the Dentists. Before affiliation, some dentists who were earning $150,000 to $200,000 are now earning $350,000 to $400,000. As the CEO of *ADPI* said, "When the dentists can do as well in one of our affiliated dental groups as on his or her own while not dealing with the admin headaches, you have a successful mousetrap."

Of the three original dental affiliations entered into in 1997 per annum patient growth has averaged 11%.

Growth Drivers

Patterson Dental in its 2005 10-K mentions a 6% expected growth rate for dental services over the next decade while *ADPI* expects 5%, but *ADPI*'s management believes with new affiliations, organic growth and platform growth its target patient revenue same market growth will be in the 8% to 10% range. Returns on capital should improve as new dentists become more experienced, regional density increases and growth capex moderates—thus, growth in owner earnings should be even better than the 8% to 10% revenue growth rate.

Current US spending on dental services is over $80 billion.
Demand is driven by population growth, more public awareness over health, more cosmetic dentistry and an aging population. Demand is outstripping the supply of dentists.

Supply is driven by changing demographics. More women are graduating as dentists and graduating dentists leave school with over $200,000 in debt while the costs of going into solo practice are climbing. There is a bubble of dentists aged 50 to 65 starting to retire. More new dentists seek a lifestyle choice to practice in groups

Platform affiliations are new affiliations in new marketplaces where we don't have dental groups. Incremental growth comes from adding new dentists, support staff, and operatories to existing facilities. Platform affiliations: *ADPI* has 19 dental groups.

Management has identified 125 metro areas out of the 316 metro areas in the US which are ideal markets. The following are the size of the targeted Dental Groups

290 Dental Groups: $1-$4 million in revenues.
25: $5-$9
15: $10-$20
4: > $20

At around $5 million, the dental groups have to make an investment in accounting and data systems and a lot of dental groups do not want to make that investment to get to the next level. Then somewhere around the $10 million revenue mark, the next hurdle – fee for management payment plans, they have to hire financial and operational expertise.

Strategic Initiatives—Incremental. *ADPI* bought a few dental labs a few years ago to serve its dental groups. .

<u>Components of same market growth:</u>

Providers (dentists or hygienists) selling time: Hours worked x Productivity (or the provider's clinical skills on a per hour basis) = Gross Production x Effectivity (some type of discount based on payer plan like PPO or traditional indemnity plan) = Adjusted Gross Revenue (Our collectible revenue). These are the components *ADPI*'s management focuses on in managing their business.

<u>Internal metrics of growth.</u>

Effectivity: *ADPI* helps its affiliates reduce the discount that dental groups are taking from the insurance company. 1) No insurance company will give a discount unless asked. *ADPI* wants better reimbursement rates from the insurance providers.

Effectivity is currently contributing 1.8% to growth. Management is seeing less of a discount from greater fee increases from the dental insurance plans that *ADPI's* dental groups are participating in than from our overall fees.

Secondly, if you don't have a market presence in a local geography, then you won't have success in negotiating better terms/rates with an insurance provider. ADPI's management wants to be deep in a particular area/market. There is not much synergy in being a national organization.

# of Doctors or Hygienists	Hours Worked	Recruiting and Retention
Clinical Skill Level	x Productivity per Hour	Retentions and Mentoring
	= Gross Production	
Discount based on negotiation with Insurance provider/payer plan.	X Effectivity (	Mkt Presence and Active Negotiation of Reimbursement.
ADPI's Collectible Revenue	Adjusted Gross Revenue	

How does ADPI achieve consistent growth? Retention and recruiting of dentists. *ADPI* drives recruitment by its reputation with dental groups.

ADPI's growth and profitability is driven by local market presence.

Demand:

- Dental Benefit enrollment
- Aging population
- Aesthetic Dentistry—growing pop of vanity in America.

Enrollment: 1996 to 2007 dental plans number of people has grown 2% pa with Dental benefits. Not unlike medical world shift from capacitated plans toward PPOs. Dental Plan Payers have shifted away from traditional plans to PPO plans. The consumer gets a card and goes to a dentist and get a discount of the services.

Demand for services – aging of US repair old dentistry work. Over 65 have lost 5 or fewer teeth.

Supply

Graduates vs. retirees: In 1970 about 4,000 dentists graduating per year. Then increased enrollment. Then cutback in the 1980's. Enrollment fell off. In 1970 Dentistry was a male dominated profession--now 40% are females.

Grad indebtedness—dental schools no longer supported by govt. so the dental students have to pay for their schooling. Average dentist has almost over 200,000 worth of debt. With the changing gender profile or new dentists wanting the flexibility group practice is becoming a more prevalent form of practice. There are 122,000 practicing solo Dentists. 34,000 non-solos or Dental Groups. Dentistry has a fragmented delivery system

Retirees outpacing new grads in 2010 through 2020.

RISKS:

- Rapid growth might lead to poor platform affiliation and overleveraging of the balance sheet. Management seems prudent.

- Loss of an affiliation. This risk has never been evident until the current lawsuit brought forth by Park Dental. Though this is a risk, validating the contracts through the judicial process might lessen risk in the future.

Dec. 31		**1997**	**1998**	**1999**	**2000**	**2001***	**2002**	**2003**	**2004**	**2005**
Same market Patient Revenue Growth						3%	2%	6%	10%	8%
Number of dental facilities						154	168	171	177	187
Number of dentists						358	383	396	398	435
Steady Economics										
Patient Revenues		$64,492	105,438	$151,965	$194,572	$207,736	217020	$245,609	$272,239	$302,982
Net Revenues		$53,270	84,090	11,7352	143,644	147,410	146,810	163,707	178,554	196,928
Earnings from Operations		1,633	7,098	12,041	14,763	9,642	10,537	12,988	15,702	18,689
CFO		4,581	9,510	9197	10203	10253	16979	21806	25405	25,452
CAPEX		3,212	5,074	11,166	9,391	6,801	5,607	7,381	9,657	11,000

Debt/Total Capitalization		76%	19%	44%	49%	48%	43%	37%	25%	24%
2001* Three affiliated groups received contract termination from Cigna Dental and 1 group from Protective Life. These contracts represented										
$24 million in patient revenue. The termination was strictly economic and affiliates did not wish to participate at lower reimbursement rates										

- Lack of qualified dentists and/or hygienists which would crimp growth.

Operating and Financial Summary

WORK SHEET

ADPI	**2002**	**2003**	**2004**	**2005**
(in $000s)				
Current Assets	23850	23882	21574	22,309
Current Liabilities	-17506	-19966	-23880	-23,880
Net PP&E	31925	35216	39252	45,184
Total Tangible Invested Capital	**$38,269**	**$39,132**	**$36,946**	**$43,613**
EBIT or Operating Income	10537	12988	15702	18,689
Pre-tax ROIC using EBIT	***27.5%***	***33.2%***	***42.5%***	***42.9%***
Good Business if ROIC > 30%				
EBITDA	19574	22595	26044	30,696
EBITDA Margin as a Pct. Of Patient Revs.	*8.7%*	*9.0%*	*9.6%*	*10.1%*
MCX*	-5607	-7381	-5934	-4500
Capex	5,607	7,381	9,657	11,068
Depreciation Expense	4,990	5,378	5,934	7,001
EBITDA - MCX	**$13,967**	**$15,214**	**$20,110**	**$26,196**
ROIC using (EBITDA - MCX)	***36.5%***	***38.9%***	***54.4%***	***60.1%***
Growth in Owner Earnings		8.9%	32.2%	30.3%
After Tax	$8,380	$9,128	$12,066	$15,718
After Tax FCF/Sh. (EBITDA-MCX)*(1-40% Tax Rate)	***$0.75***	***$0.80***	***$1.00***	***$1.22***
Current Price to After-Tax Owner Earnings @ $13			***13x***	***11x***
Net Earnings			8,519	10,291
Add back: Amort. Of Intang. Assets, net of taxes			2,662	3,049
Cash Net Earnings			11,181	13,340
Cash Net Earnings per share			$0.92	$1.03
Pre-tax ROIC using EBITDA - MCX	36.5%	38.9%	54.4%	60.1%
FD Outstanding Shares	11,177	11,358	12,102	12,900
Debt			$28,014	$32,039
EV with $13 per share price			**$185,340**	**$199,739**
Pre- Tax Earnings Yield (EBITDA-MCX)/EV			**10.9%**	**13.1%**
After-tax Earnings Yield with 40% taxes			6.5%	7.9%
CFO	16,970	21,806	25,405	32000
Net CAPEX	5,607	7,381	9,657	11000
Free CF from Operations	11,363	14,425	15,748	21,000
Per share FCFO	$1.02	$1.27	$1.30	$1.63
Growth in Owner Earnings	6%	8%	10%	12%
For five years starting with 13% pretax return	17%	19%	21%	23%
Total Patient Revenues (Unconsolidated for GAAP)	**223,781**	**252,058**	**272,369**	**302,982**
Net Revenues	**146,810**	**163,707**	**178,554**	**196,928**
Total Reimbursement of Expenses				
Salaries & Benefits	53,184	58919	63020	83,638

Lab and Dental Supplies	23,923	27793	30340	31,638
Office Occupancy Expenses	16,968	18389	19326	23,013
Other Operating Expenses	4,174	12096	13,044	18,372
Depreciation Expense	10,751	4508	5,016	7,001
Total	**109,000**	**121,705**	**130,746**	**163,662**
Business Service Fees	31,049	35,553	42,714	
Other Revs.	6,761	6,449	5,094	5,007
Total Operating Expenses	136,273	150,719	162,852	178,239
Earnings from Operations	10,537	12,988	15,702	18,689
Earnings Bef. Inc. Tax	7,590	10,396	14,110	16,885
Total Patient Revenues (Unconsolidated for GAAP)	100.0%	100.0%	100.0%	100.0%
Net Revenues	**65.6%**	**64.9%**	**65.6%**	**65.0%**
Total Reimbursement of Expenses				
Salaries & Benefits	23.8%	23.4%	23.1%	27.6%
Lab and Dental Supplies	10.7%	11.0%	11.1%	10.4%
Office Occupancy Expenses	7.6%	7.3%	7.1%	7.6%
Other Operating Expenses	1.9%	4.8%	4.8%	6.1%
Depreciation Expense	4.8%	1.8%	1.8%	2.3%
Total	48.7%	48.3%	48.0%	54.0%
Business Service Fees	13.9%	14.1%	15.7%	1.7%
Other Revs.	3.0%	2.6%	1.9%	
Earnings from Operations	4.7%	5.2%	5.8%	6.2%
Earnings Bef. Inc. Tax	**3.4%**	**4.1%**	**5.2%**	**5.6%**

END