specialty DENTAL BRANDS

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Excerpts from Discussion with Fernando De Leon

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What investments are you pursuing at Specialty Dental Brands?

I'm looking for exceptional partners. I'm looking to partner with businesses typically run by founders that have a performance that is clearly better than their peers. We can typically see that exceptionalism in their financial performance. But we've developed a muscle memory that allows me to identify these partners.

Most of these partners usually live in strong family structures, have substantial positions in their communities and they're always focused on the long term. They're not looking for short term cash. They're looking to partner with other exceptional people and reinvest their capital, their talent and their relationships into a worthwhile endeavor.

Picking the right partners also takes time. Before buying a business, we typically sit down with founders and aim to understand not only the fundamentals of the business, but the people working there and the strategy, hoping to answer: "What might be the challenge here, what might be the opportunity?"

We want businesses that are going to be around for the long haul. We want businesses that are strong and have some sort of market positioning that allows them to create above-average returns on capital. They tend to be founder-owned businesses. We have a lot of conversations with business owners who want a partner, who want a longer-term home, but don't really think that a private-equity firm is the right fit for them.

What value do you bring to a partnership?

Over the years, I've talked to a lot of founders, doctors and owners, some of whom wanted to sell a part, or all of their company. What I found is that most small and midsize companies struggle with the same things: how to hire the right people, how to develop them, how to incentivize them, how to help them to grow, how to build a strategy. So what we did, is we built a business system to help in those areas, and that really allowed us to create immense value at a company like Specialty Dental Brands.

All businesses are different, therefore we don't impose ourselves at all in the integration process. We must know who our doctor partners are. First and foremost, we must listen to our doctor partners so that we can decide where to be most impactful. Whether it's accounting, billing, human capital etc, our partners are typically *already* very successful, so it makes very little sense for us to try to disrupt that.

I also don't allow our organization to create undue bureaucracy, with executives that are trying to justify their existence by creating undue work for anybody. That happens a lot in private equity-owned companies—there are a lot of vice presidents at private equity funds that have never run anything and the same culture permeates the companies they acquire. We try to stay small and nimble, with no drama.

We don't micromanage, and whereas other groups are trying to homogenize practices, we enable our doctors to maintain their own team culture. They're already successful, so why would we try to change that.

That's why our doctor partners give SDB the highest Net Promoter Scores in the dental industry. And our doctors generate on average 20% more revenue in our partnership than anywhere else.

What is the biggest challenge you see out there for Specialty Dental Brands?

People and culture are always—in my view—the number one issue that any company has. In the current world, labor and recruiting is the absolute most difficult part of any business, and we've honed a process that allows us to recruit associates nationally.

How do we attract really great talent to my company? Perhaps I am based in a part of Montana or Idaho, so how do I help people understand why they want to join my business that they've never heard of?

Then, once I have them in the organization, how do I develop them? Because it's not like I've got, you know, hundreds of thousands of jobs. We've got probably a couple hundred jobs. And so I need to get the right people, but show them a career path.

Part of our success we owe to our partners, because they're already successful and have a great reputation in their market, so it makes our job easier when we seek to find new recruits for these businesses.

What are the biggest differences between you and Private Equity?

A lot of founders and business owners don't want to sell to traditional private equity. They don't want to see their business bought and sold, or chopped up, or their employees fired. We could provide them a longer-term home, and help them build in the right way.

The fact is that almost every single DSO in America is owned by a private equity fund. A fund usually has hundreds of institutional investors, that in turn have thousands or millions of stakeholders. These funds usually acquire 20-40 companies in each mid-size fund. And those anchor companies then each acquire another 20-40 "bolt-on" acquisitions. So now a fund has 400-1600 individual companies that constitute the fund's holdings. And as a business seller, decisions about your equity future are being made in the context of timelines and agendas that have nothing to do with what you want to accomplish.

On top of that, the managers that manage these funds have an insignificant amount of capital in each fund, and they have 2-5 funds that they're investing concurrently at any given time. If they don't have 2-5 funds, then that means that their first funds were terrible performers. So their initial success is in fact their worst enemy. Think about that: 2-5 funds, with 400-1600 companies each—that means these geniuses have to properly manage 800-8000 companies at any given time.

I always recommend to prospective doctor partners that they ask the person they're speaking to about any transaction, to please explain how much of their own capital is invested in that company or fund. Usually, the fund managers don't even talk to individual sellers. They're making decisions in their office in New York about your future in Gilbert, Arizona.

The people that we partner with understand this mess and want to avoid it altogether. The ones that are just interested in the short-term, they'll never really care who their partner is. And that creates a perfect self-selection process for us. We only get the doctor partners that want to create real value over sustained periods of time, and therefore create real wealth.

How does your operating approach differ from private equity?

One, is just how long we hold companies. Most private-equity firms own businesses for three or four years. Because funds are legally obligated to sell their assets based on their fund bylaws. So the result is that doctor partners and owners are punted around like a football. If you're going to own a company three or four years, the minute you buy it, you're thinking about selling it, and every decision you're making is focused on: What am I going to do to sell this business?

A lot of investments you make in businesses don't pay off in three to four years, and so I think having that longer-term horizon makes all the difference in the trajectory of a partnership.

There are also questions around leverage and capital structure where the private equity folks create undue risk. Decision-making is usually so fragmented across these convoluted layers that it creates unnecessary problems and usually hurts business owners and doctor partners.

Also, most people in private equity typically have financial backgrounds. But I'm a founder like our partners. I think we can make better decisions from that vantage point. I understand what's possible in a business, what's needed. And then we can relate with a doctor partner, because we've been in their shoes and we know businesses aren't run on spreadsheets and PowerPoints.

So we spend time looking at a lot of different investments and really saying: Do we think that this is a really great business? Do we think that it's going to continue for 10, 15, 20 years and not be disrupted by someone else or by technology?

What's the long-term plan for Specialty Dental? Will you do a recapitalization event?

We don't have a specific outcome in terms of what we want to achieve via a recap event or otherwise. We need to create value along the way, and that value has to be demonstrable to our doctor partners in their net worth, but there are a lot of ways to do that.

Above all it really is about: How do we build it in the right way? And then how do we add value to the companies, to our team, to our partners, and help support everyone in doing that?

How have you funded Specialty Dental to date?

It's my capital as well as our doctor partners' capital. We're in the trenches together and that's it. We have several billion dollars of our net worth in this business. There are no fund managers with no skin in the game, calling the shots. Every bad decision we make hurts a lot, but conversely, every good decision pays really well and allows us to compete better.

It appears there are a lot of similarities between Leon Capital and Berkshire Hathaway—a long-term focus, partner alignment, best in class partners with a competitive advantage, etc. How does it differ?

Berkshire is very successful, so being similar to Berkshire is a good thing by and large, in my mind. I'd say we differ on two dimensions. The biggest is size. We can focus on much smaller businesses. That's where I think the biggest opportunity is because creating these partnerships takes a lot of work. The market for large deals is extremely efficient and difficult to navigate, that's why Buffet has had difficulty investing in the last decade. The second differentiator is we're more hands on with our management team. We support them with corporate development and establishing partnerships. Berkshire famously is very hands off, but we have a muscle memory that serves both our management team and our doctor partners very well.

Finally, what would you say to prospective partners?

I'd say focus on the power of the long term. Everybody underestimates sustainability. Short-termism is plaguing our economic system, because everyone wants instant gratification. But there is immense power in finding high-quality businesses, partnering with high-quality people over long and sustainable periods of time. When those three things are done in the right way, you can build something really extraordinary.