Funding a pharmacy acquisition is probably within your grasp

By Ed Webman, RPh

You have chosen to become a pharmacy owner, and decided to acquire an existing practice. However, still unanswered, is the $1 million question: *How do I get the million to buy a pharmacy?* Surprisingly, funding a pharmacy acquisition is achievable and within the grasp of many pharmacists.

First, consider the ownership opportunity. The *2012 NCPA Digest*, sponsored by Cardinal Health, explains that there are approximately 23,000 independently owned pharmacies nationwide. With the average pharmacy owner about 60 years old, it's expected that more than 1,000 pharmacies will be acquired annually over the next decade. Further, as the *Digest* states, the average gross revenues of an independent pharmacy are $3.83 million. Most importantly, the *Digest* shows that most pharmacies have sufficient cash flow or net operating income (NOI) to provide the owner a pharmacist salary and have monies left over to service debt and provide a return to the business. The opportunity is ripe; a prospective owner just needs to be shown how to get the money.

Changing Times

Historically, pharmacy acquisition financing was primarily provided through seller financing, drug wholesalers, and less often, bank financing. Times have

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changed. Some banks have begun to recognize the value of an independent pharmacy as a borrower and customer. Pharmacy acquisition loans are usually more than $1 million, and pharmacies enjoy a low default rate. In fact, of the hundreds of major industries tracked by the Small Business Administration (SBA), pharmacies rank as the eighth lowest in default rate. With deposits from the average pharmacy nearing $4 million, and considering the variety of financial services required by pharmacies: merchant services, short-term loans for autos and equipment, as well as the personal financial services that pharmacy owners may utilize, independently owned pharmacies are good bank customers.

When considering a pharmacy acquisition loan, the lender and buyer first need to structure an acquisition loan budget to sufficiently fund the project. At the outset of the budgeting process, the lender and buyer must fully understand the nature of the project, its scope, and size. One of the first things to determine is whether the project is a stock purchase or an asset purchase.

Example Pharmacy Acquisition: 2012 Income Statement (Total Sales $4,200,000)		
Cost of Goods Sold	$3,200,000	76.2%
Gross Profit	$1,000,000	23.8%
Owner's Compensation	$120,000	2.9%
Interest	$50,000	1.2%
Depreciation	$35,000	0.8%
Amortization	$22,000	0.5%
Selling & Gen. Admin. Expenses	$630,000	15.0%
Total Expenses	$857,000	20.4%
Net Income	$143,000	3.4%

NOI (net operating income) = EBITDA (earnings before interest, taxes, depreciation, and amortization) + owner's compensation ($120,000+$50,000+$35,000+$22,000+$143,000) = $370,000

The owner is working half time as a filling pharmacist. The pharmacy's inventory is $300,000. The accounts receivable is $250,000. The pharmacy fills 65,000 prescriptions annually.

In a stock purchase, typically the buyer is acquiring all of the assets and liabilities of the pharmacy, or simply the entire the balance sheet, including: the stock, inventory, furniture, fixtures, and equipment (FF&E), accounts receivable, accounts payable, and equipment leases, to name several. Most often, the seller keeps the cash in the bank.

Asset Purchases

More commonly, pharmacy acquisitions are asset purchases. In an asset purchase, generally the buyer acquires only the assets of a pharmacy. These include goodwill, inventory, and FF&E. In an asset purchase, the seller generally retains the cash and accounts receivable. Consequently, the buyer will need a significant amount of working capital included in the project budget. It is imperative that there is ample working capital to operate the pharmacy while the buyer is awaiting payments (typically 21 days sales outstanding or days sale outstanding) from the third-party payers. Buyers often underestimate the working capital needs of a pharmacy acquisition and may quickly run into financial difficulty if the amount of working capital allocated to the project is insufficient.

As the vast majority of pharmacy acquisitions are asset purchases, our example acquisition is an asset purchase. Based upon a formula of 3x *normalized* NOI + inventory, our example pharmacy is selling for $1.23 million. (An article in the November 2012 edition of *America's Pharmacist* more fully explains the valuation formulas.) The buyer has $50,000 to make a cash down payment. In this example, equity requirements from the bank require the buyer's equity to be at least $235,000, so the seller has agreed to hold a note of $200,000 with terms allowing it to be considered as "equity."

First, we will review the money the seller will be paid, or the "seller proceeds." In the budget listed above, the total project cost is $1.55 million. The buyer brings $50,000, or 3.23 percent to the project. The seller is holding a note of $200,000, or 12.9 percent, and there is a bank note of $1,3 million, or almost 84 percent, to complete the project financing. At closing the seller will receive: $50,000 + $980,000 from the bank ($680,000 goodwill and $300,000 for inventory) plus the accounts receivable as they flow in, for prescriptions filled before closing, or $250,000, for a total of $1,23 million. Additionally, the seller will hold a note payable from the buyer for $200,000. Generally, these seller notes are eligible to be refinanced or paid by the bank after two years, so in this case the seller will receive $1.43 million (plus interest on the seller note) for the sale of the pharmacy.

At closing, the buyer will own the pharmacy, and be obligated by a note to the bank for $1.3 million and by a note to the seller for $200,000. Included in the bank note is $280,000 in working capital that will be deposited in the buyer's operating bank account at closing, to fund the pharmacy operations while awaiting payments from the third party payers for Rxs filled after closing. Also included is $40,000 to cover loan closing costs such as legal, accounting, and any bank fees.

The Underwriting and Credit Process

When examining a pharmacy acquisition loan request, a lender will examine the 5C's: credit, character, cash flow, collateral, and condition. The lender needs to ensure that the buyer/borrower has a history of good personal credit, professional and financial integrity, and the necessary background and skills to run the pharmacy. The lender will require a personal financial statement of the buyer to best understand the buyer's financial commitments and needs, and to examine any collateral that may be pledged toward the loan. The lender will examine at least three years of the pharmacy's financial statements. Additionally, the lender may request a business plan including three years of projections to better understand the condition of the industry, the business, and its potential.

Acquisition Loan Budget

	Buyer's Cash	Bank	Seller	Total
Goodwill	$50,000	$680,000	$200,000	$930,000
Inventory		$300,000		$300,000
Working Capital		$280,000		$280,000
Soft Costs		$40,000		$40,000
Total	$50,000 (3.23%)	$1,300,000 (83.87%)	$200,000 (12.90%)	$1,550,000 (100%)

The 5 C's

1. **Credit:** As history is the best predictor of the future, a lender will examine the personal credit of all borrowers and guarantors. Good personal credit is a must. Lenders are generally seeking a FICO score above 700. Any problems must be thoroughly explained.
2. **Character:** Lenders need to know the borrower and guarantors are honest and have integrity. Have they had any issues with their pharmacy license? Have they had any issues with Medicaid, Medicare, or other payers? In addition, the lender needs to be confident the applicant has the background, education, experience, and industry knowledge to successfully run the business.
3. **Cash Flow:** The business should have cash flow to support its business expenses and debts while providing the principals sufficient salaries that will support their personal expenses and debts.
4. **Collateral:** A lender will consider the value of the business's assets and the personal assets of the guarantors securing the loan as a secondary source of repayment if the loan cannot be repaid. Collateral is a very important consideration for most conventional loans but not as significant with an SBA-guaranteed loan.
5. **Condition:** The lender will need to understand the condition of the business, the industry, and the economy. Are current conditions likely to change, deteriorate, or improve? A local or large lender will need to better understand the independent pharmacy space and local market. A lender who specializes or focuses on pharmacy will understand the industry and should only need to understand the local market and opportunity.

Once a lender has sufficiently vetted the prospective borrower to ensure the borrower meets the bank's requirements for credit, character, and collateral requirements, the bank will focus on cash flow. The bank must fully examine the pharmacy's financials to understand the pharmacy's business trends and to ensure there is sufficient cash flow to support the borrower's salary requirements and the pharmacy's debt obligations. The following is a three-year cash flow analysis of the example pharmacy, as well as the proposed debt structure for an acquisition loan set to close in 2013.

Using the example shown in the Three-Year Cash Flow Analysis chart, in 2012 the pharmacy generated $4.2 million in gross revenues and $1 million in gross profit. The owner paid himself a salary of $120,000, and there was $250,000 in EBITDA (earnings before interest, taxes, depreciation, and amortization) totaling $370,000 in cash flow (EBITDA + owner's compensation). The net operating margin of 8.9 percent ($370,000/$4,200,000) is typical of a well-run pharmacy.

The bank note is a 10-year self-amortizing note (the note will be fully paid in 10 years) at prime rate plus 2 percent, or 5.25 percent with payments of $167,760 annually. The seller note is to be amortized over 10 years with an interest rate of 7 percent and a balloon after five years (the outstanding balance will be due in five years). Payments on the seller's note total $27,864 annually. *(As stated previously, banks are often able to refinance the balance due the seller after two years of successful payments by the borrower. It is feasible for the seller to be paid-in-full in two years.)*

Cash flow generated by the pharmacy is $370,000 and total debt service is $195,240, leaving $174,760 to compensate the owner and provide a return to the business. After allocating $120,000 for an owner's salary,

Three-Year Cash Flow Analysis			
	2010	**2011**	**2012**
Revenue	**$4,000,000**	**$4,100,000**	**$4,200,000**
Cost of Goods Sold	$3,100,000	$3,150,000	$3,200,000
Gross Profit	$900,000	$950,000	$1,000,000
Gross Margin	22.50%	23.17%	23.81%
Officer Compensation	$120,000	$120,000	$120,000
Interest	$65,000	$60,000	$50,000
Depreciation	$45,000	$40,000	$35,000
Amortization	$22,000	$22,000	$22,000
Net Income	$90,000	$110,000	$143,000
Net Operating Income (NOI)	**$342,000**	**$352,000**	**$370,000**
Net Operating Margin (NOM)	8.55%	8.59%	8.81%
Bank Note	167,376	167,376	167,376
Seller Note	27,864	27,864	27,864
Total Debt Service	**$195,240**	**$195,240**	**$195,240**
Available Cash Flow after Debt Service	$146,760	$156,760	$174,760
Officer Compensation	$120,000	$120,000	$120,000
Excess Cash Flow	$26,760	$32,760	$54,760
Debt Service Coverage Ratio (Pre-OC)	1.75	1.80	1.90
Debt Service Coverage Ratio (Post-OC)	1.14	1.19	1.28

Proposed Debt Structure			
Bank	**$1,300,000**	**Seller**	**$200,000**
Maturity	10.00	Maturity	5.00
Amortization	**10**	**Amortization**	**10**
Interest Rate	5.250%	Interest Rate	7%
Payment	$13,948	Payment	$2,322

there is $54,760 left to provide a return to the business, to be used as a cushion, as well as to provide for growth.

Most borrowers are familiar with debt-to-income ratios used by residential lenders for home mortgages. Similarly, in commercial lending, banks consider *debt service coverage ratios*, or DSCR. In the previous example, the debt service coverage ratio before owner's compensation is 1.9 ($370,000/$195,760) or the cash flow of $370,000 will cover the debt 1.9x. Most important is the DSCR after owner compensation. In this case, ($370,000-$120,000)/$195,240, or $250,000/$195,240 equaling a DSCR of 1.28, or the cash flow after the owner's salary, will cover the debt 1.28x. A DSCR of 1 is break-even and a DSCR below 1 signals a net operating loss, based upon the proposed debt structure. A DSCR of 1.28 is generally acceptable given that the other lending criteria are strong.

Structuring and analyzing a financing request for a pharmacy acquisition is not simply gathering tax returns, FICO scores, personal financial statements, and calculating a DSCR. An experienced lender needs to understand the borrower, the guarantors, and the business. Lenders should fully discuss the acquisition project with a prospective borrower, so the lender may best understand the project and the borrower may best understand lending requirements and financing options. Many pharmacists misunderstand that banks need and want to lend money, just as pharmacists need and want to sell medicine. Much as pharmacists need to ensure they are dispensing the right medication, for the right patient, banks need to ensure that they are financing a qualified borrower, and a viable project. aP

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