A *Primer* on Pharmacy *Financing*

Banks are actively seeking good projects to fund and that includes independent pharmacies

by Ed Webman, RPh

Independent community pharmacy is an evolving yet thriving industry, with many opportunities as well as some challenges. Among the challenges pharmacy owners often face is financing. As a pharmacist and former pharmacy owner, and a banker since 2009, I regularly hear pharmacy owners exclaim: "Banks don't understand pharmacies, they just don't get it!" Many times during my 20 years as a pharmacy owner, I felt the same frustration.

Independent pharmacies are often an enigma to bankers. Bankers are generally younger, healthier, and wealthier than the service-seeking demographic frequenting most independent pharmacies. There is often a fundamental disconnect with the industry. Those bankers don't understand why patients would seek out an independent pharmacy instead of a local chain, grocery store pharmacy or even mail order. These bankers consider an independent pharmacy as a quaint anachronism rather than the $4 million local health care provider. It is often frustrating, but pharmacy owners need to do a better job explaining their businesses, their opportunities, and their prospective financing projects to bankers. Bankers want to lend money to good businesses; independent pharmacies are good businesses. Of industries tracked by the Small Business Administration (SBA), pharmacies rank among the lowest in default rate.

Banks have a number of financing products, including long-term loans (both conventional and SBA-guaranteed loans), and short-term loans such as lines of credit. Pharmacy owners seeking to fund a specific project such as a business acquisition, expansion, real estate acquisition, remodeling, or large equipment purchases should utilize long-term financing or a term loan. Financing a project over the proper term is important. A project should be accretive, or create additional value to the business, while providing sufficient cash flow to service the debt incurred and an additional return to the owner. Short-term financing (such as lines of credit) should be reserved to shore up working capital and pay expenses during irregular cash flow cycles.

SBA VERSUS CONVENTIONAL LOANS

Most pharmacy owners are eligible for SBA-guaranteed loans that may offer some advantages to a borrower. In an SBA loan, the bank makes the loan, but the debt is partially guaranteed by the SBA. This allows the bank to provide credit for a borrower who may otherwise have difficulty obtaining a loan with favorable terms. SBA loans tend to be borrower friendly, flexible to equity and collateral requirements, and do not have loan covenants. SBA loans have longer terms with no balloons. For example, a conventional loan may have a 10-year amortization with a balloon in 3-5 years, while an SBA loan will have an amortization and term of 10 years. The SBA acts like an insurance company, allowing the bank to extend its conventional credit reach.

Not surprisingly, SBA lending requires numerous documents and can be tedious for borrowers when the lender is not a specialist. When considering an SBA loan, it is helpful to seek out a lender who is part of SBA's Preferred Lender Program. A PLP lender will know how to determine eligibility and properly structure the loan. PLP status allows the bank to approve the loan without waiting for the SBA's approval; the bank acts on behalf of the SBA.

When banks are reviewing and analyzing a loan request, a lender will generally request the following: three years of tax returns for the pharmacy and the borrower, a year-to-date financial statement for the pharmacy, a personal financial statement of the borrower, as well as a business plan complete with three years of financial projections. This information will help the lender understand the owner and the business, and determine creditworthiness.

WHAT COMPRISES A CREDIT ANALYSIS?

Credit analysis by a lender is determined by the "5Cs": credit, character, capacity, collateral, and condition.

- 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. Any problems must be thoroughly explained.
- Character: Lenders need to know the borrower and guarantors are honest and have integrity. Additionally, the lender needs to be confident the applicant has the background, education, experience, and industry knowledge to successfully run the business.
- Capacity (cash flow): The business should have sufficient cash flow to support its business expenses and debts comfortably while providing the principals salaries that will support personal expenses and debts.
- Collateral: A lender will consider the value of the business' 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 an important consideration for a conventional loan, but not as imperative with an SBA loan.
- 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?

ACQUISITION LOANS

With more than 1,000 independent pharmacies trading annually, and many banks now recognizing the value of an independent pharmacy as a customer, pharmacy acquisition loans through banks have become more common. A typical pharmacy acquisition exceeds $1 million, but is within the reach of many pharmacists as long as they meet the criteria of the 5Cs. The first step when evaluating an acquisition project is to develop a loan budget with a banker.

	SBA Loan	Conventional Loan
Term	10-25 years	3-5 year balloons
Collateral Required	Does not need to be fully secured	Generally fully secured
Equity	Can be a combo of cash and seller note	Cash
Loan Covenants	None	Yes, generally
Intangible asset/Goodwill Financing	Yes	Difficult
Prepayment Penalty	Generally none	Varies, could be significant
Fee	2.25%-2.625%	1-2%

Common Terms Used in Lending:

Add-backs: These are expenses that are assigned to cash flow to normalize a profit and loss statement. Normal add-backs include interest, taxes, depreciation, amortization, one-time expenses, personal expenses, and owner's benefits in excess of market such as compensation or rent.

Balloon: Term used when a loan which does not fully amortize over its term. Since it is not fully amortized, a large single payment is required at the end of the term to repay the remaining principal balance of the loan. For example, for a loan with a 10-year amortization and a five-year term, the loan will balloon in five years, requiring the remaining five years of principal to be repaid at the end of the term.

Debt Service Coverage Ratio (DSCR): The ratio of the cash available to service debt (NOI) and the total debt service for all interest, principal, and lease payments. (NOI/total debt service). For example, a DSCR of 1.5 indicates there is 50 percent more income than is required to repay all debt. Conversely, a DSCR of less than .90 would indicate there is only 90 percent of the income to repay all debt, thus negative cash flow.

EBITDA: Earnings Before Interest Taxes Depreciation Amortization

Loan Amortization: This is the period of time over which the loan payments are calculated. A loan's payments may be calculated over a longer (such as 20 years) time, while the loan term may be shorter (such as five years).

Loan Term: Period of time over which the loan is to be repaid

NOI: Net Operating Income is often called cash flow. This includes EBITDA + add-backs + owner's compensation.

NOM: Net Operating Margin is a measurement of profitability (NOI/ Net Operating Revenues). A typical NOM for a well-performing pharmacy will be 7-12 percent. This is dependent upon many variables, particularly the specialty of the pharmacy (such as retail, compounding, or long-term care, for example).

It is important that the lender fully understand the project to ensure that the budget is sufficient to acquire the business, transition the business, and run the business. Underfunding an acquisition project is a major reason for failure in pharmacy acquisitions. After developing a sufficient budget, a lender will utilize the previous owner's tax returns to determine if there is sufficient cash flow to provide the new owner with a salary, have monies left to service the debt as well as additional funds provide a return to the business. When reviewing a pharmacy's tax returns and financial statements, it is important to remember that they are likely to be prepared to be tax-efficient and may need to normalized and adjusted.

Bankers will often ask about add-backs or expenses that will not continue with new ownership. There are often many expenses that may need to be added-back such as rent, family salaries, and personal expenses. Only documented expenses will be added back by a lender. SBA-guaranteed loans are common in pharmacy acquisitions. As goodwill is often the greatest use of proceeds in a pharmacy acquisition project, (typically exceeding $1 million), there is generally insufficient collateral brought by the borrowers or associated with the project to secure a conventional loan, thus, making an SBA loan a good fit.

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EXPANSION FINANCING

Increasingly, entrepreneurial pharmacists are becoming multiple pharmacy owners. The *2013 NCPA Digest*, sponsored by Cardinal Health, shows that 25 percent of community pharmacy owners have ownership in two or more pharmacies. The average number of pharmacies in which each owner has ownership is 1.79, and that number is rising. Financing a second pharmacy (or third, or fourth, etc.), whether it is an acquisition or a startup, is easier than financing the first. First, an owner usually won't need to draw a salary from a second location, so all of the excess cash flow can be devoted to debt service. Second, a banker may be able to consider cash flow from all of the owner's businesses, or the global cash flow, when evaluating financing an additional pharmacy. Strong cash flows from the owner's existing pharmacies can support the acquisition or startup. For owners with a fair amount of equity in their existing pharmacy, a bank can often offer 100 percent financing for the expansion.

REAL ESTATE FINANCING

One opportunity for a pharmacy owner to best position the business and increase their future wealth is to own the building where the pharmacy is located. In recent years, commercial real estate values have reset and many commercial properties have become available and more affordable. Consequently, a number of pharmacy owners have taken advantage of the opportunity to become their own landlord. Purchasing an existing building, building a new facility, or remodeling an existing store are generally easily financeable and banks often provide 100 percent financing for such a project. It can be helpful to include real estate in a business loan, whether it is an acquisition, expansion, refinance, or a startup. Including real estate in a loan will allow the bank to lengthen the term. Real estate loans are generally termed over 20-25 years, making payments very affordable.

FINANCING A STARTUP PHARMACY

Many pharmacists become interested in starting a pharmacy from scratch with the idea that the initial investment will be smaller than acquiring an existing pharmacy for $1 million or more. In fact, properly funded startup projects can be close to $500,000. When considering a startup, it is important to budget for the full project, including initial startup costs, build out, fixtures, furniture, equipment, inventory, and sufficient working capital to carry the business during the ramp up until the pharmacy becomes cash flow positive. To fund a startup request, a bank will need a detailed business plan complete with realistic projections. Startup projects need to be properly funded from the outset. It is difficult for a lender to provide financing to a recently opened business that has been underfunded.

When approaching a bank to fund a project, pharmacy owners should consider the project from the banker's view. Is this a clear, understandable, and viable project? Are the pharmacy's financial statements and/or projections complete and reasonable? Do all of the owners have good personal credit? Is the loan request file thorough and organized? Many people believe banks are reluctant to loan money; in fact, banks are actively seeking good projects to fund. Of course, banks need to understand, and properly document the projects they are funding. Pharmacy owners who have spent the time considering a viable project and preparing a complete loan request will generally find a banker who is eager to fund their request. ■

Ed Webman, RPh, is senior loan officer with Live Oak Bank. Contact him at ed.webman@liveoakbank.com.