Value PROPOSITION

You can't always get what you want, but you do have to agree

by Jimmy Neil

“How much is a pharmacy worth?” It’s a question that I’m asked multiple times every week. The answer is simple: “A pharmacy is worth what an individual or company is willing to pay in cash.” The value placed on a pharmacy must be found in the common ground of what range the seller has in the back of his or her mind, and how much a bank or other type of lender (such as a wholesaler or seller) is willing to finance. But how either gets to that number is often debated.

I’ve been involved in all stages of pharmacy transition over the past 15 years, and when it comes to selling a pharmacy to another independent owner, the buyer is keenly interested in the earning power of the business. In short, the pharmacy must make enough money to repay a loan.

While percentage of sales, direct assessment, and dollar per annual prescription count are all relevant and important, they don’t account for earnings. These methods are used when earnings aren’t evident or when the company is underwater. It’s a riskier attempt to try to quantify what “could be.”

DETAILS MATTER

Typical due diligence consists of looking at the most current three years’ business tax returns and the most recent set of financial statements. Buyers also want to look at prescription counts, types of prescriptions, and concentration risks (PBMs, LTC contracts, business recently lost or in jeopardy).

Lenders want to know if they will be repaid. It starts with the historical performance of both the buyer and the business. This means documented good credit and good earnings. If borrower credit and business earnings are acceptable, it's all algebra at that point. The lending industry has used a multiple of earnings to determine the value of the goodwill, or the value of the customers who patronize the pharmacy each month. Some owners and buyers attribute the value of the goodwill to the prescription numbers generated. The result is that the buyer is paying for a business that makes a quantifiable net income.

> ***A pharmacy is worth what a seller and buyer agree upon.***

The income-based valuation method is the most accurate way to determine the value of a small business with historical earnings. The most difficult task when valuing a pharmacy is determining the normalized EBITDA (earnings before interest, taxes, depreciation, and amortization). This number is net income from the business tax return or profit and loss statement, plus nonmaterial expenses or intangible expenses to normalize free cash flow. Interest is expensed and, usually, reflects late payments to wholesalers or interest on a loan. These expenses are added back to earnings since the buyer won't incur them. Taxes are income taxes, not payroll or real estate taxes. Rarely are these added back as they are a "below the line" deduction. Depreciation and amortization are not tangible expenses and are based on asset life expectancy, so these deductions are added back to earnings. Last, identify any non-material operating costs that can be normalized. In pharmacy, the most common expense lines are extraordinary pension distributions to the owner, excessive auto payments, business travel, one-time legal or consulting expenses, and labor expenses.

Normalized EBITDA includes expensing the owner's compensation as part of the labor costs. Most experts use $125,000 a year for a pharmacist/owner who works at least 40 hours per week. In other words, don't include the owner's compensation to EBITDA. Once EBITDA has been determined, use the multiple 3x to determine a value of goodwill. This is based on thousands of acquisitions in which I've been involved over the years. Some have used higher multiples, and others lower, but the average is 3x.

A PRACTICAL EXAMPLE

If EBITDA was determined to be $225,000, then the value of the goodwill would be 3x that amount. Goodwill is then valued at $675,000. The tricky part is complete at this point; now just add the value of inventory. Prescription inventory is typically negotiated at what the seller paid suppliers. This includes any generics rebates. The non-prescription product is also negotiated, with scrutiny given to aged/used inventory. Typically, no additional value is given to furniture, fixtures, and equipment. In our example, let's value the total inventory at $225,000. Now, with the projected cost of $900,000 ($675,000 plus $225,000), the total for goodwill plus inventory is determined. This is referred to as the Total Project Cost.

As a buyer, you will also need some working capital to pay for replenished inventory and expenses for about one month. To continue the example, estimate this to be another $300,000. Add the Total Project Cost to the working capital needs, and the capital requirements of acquiring the pharmacy are calculated to be $1.2 million.

VALIDATE THE VALUATION

If 100 percent of $1.2 million is financed, at a rate of 6 percent for 10 years, the annual debt service requirement would be $160,000. Remember, EBITDA was normalized at $225,000, so the pharmacy made 40 percent more than is required to service the debt. Bankers refer to this as a debt service coverage ratio of 1.4.

Of course, lenders want buyers to inject cash, so 10 percent of the Total Project Cost ($90,000 in our example) is a good benchmark and is almost always followed with a seller carrying an additional note.

Industry factors affect values. Look at what the industry has been subjecting a pharmacy to in recent years. What have been the impacts of DIR fees, narrow networks, inflationary and deflationary drug prices? There is continued consolidation in the industry: chain mergers, exclusive partnerships with PBMs, and some chains simply exiting pharmacy altogether.

Pharmacy numbers are still strong, and I can offer assurance that lenders see some fantastic operations. These pharmacies innovate, specialize, vaccinate, deliver adherence solutions, offer medication synchronization, provide LTC services, and participate in 340B. They are doing more than just reliably and accurately filling prescriptions. These pharmacies are valued the same using a multiple of earnings at 3x; it's just that the earnings are higher.

A pharmacy is worth what a seller and buyer agree upon. However, for those looking for financing, the value of the prospect opportunity must demonstrate consistent earnings and have the ability to reasonably repay the loan. That's also something to consider for sellers looking to preserve their legacy. ■

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Understanding Valuation Terms

- *Add-backs:* Expenses that a new owner would not have to continue to pay, such as personal expenses, excessive rent, or labor.
- *Annual gross sales:* Revenue before deducting any returns, discounts, and allowances.
- *EBITDA:* Earnings before interest, taxes, depreciation, and amortization.
- *Nonmaterial expenses or intangible expenses:* Typical items such as equipment depreciation, excess owner pensions, auto expenses, travel, or one-time legal, consulting, or labor services.
- *Debt service coverage ratio:* Debt service amount required as a percentage of predicted earnings.