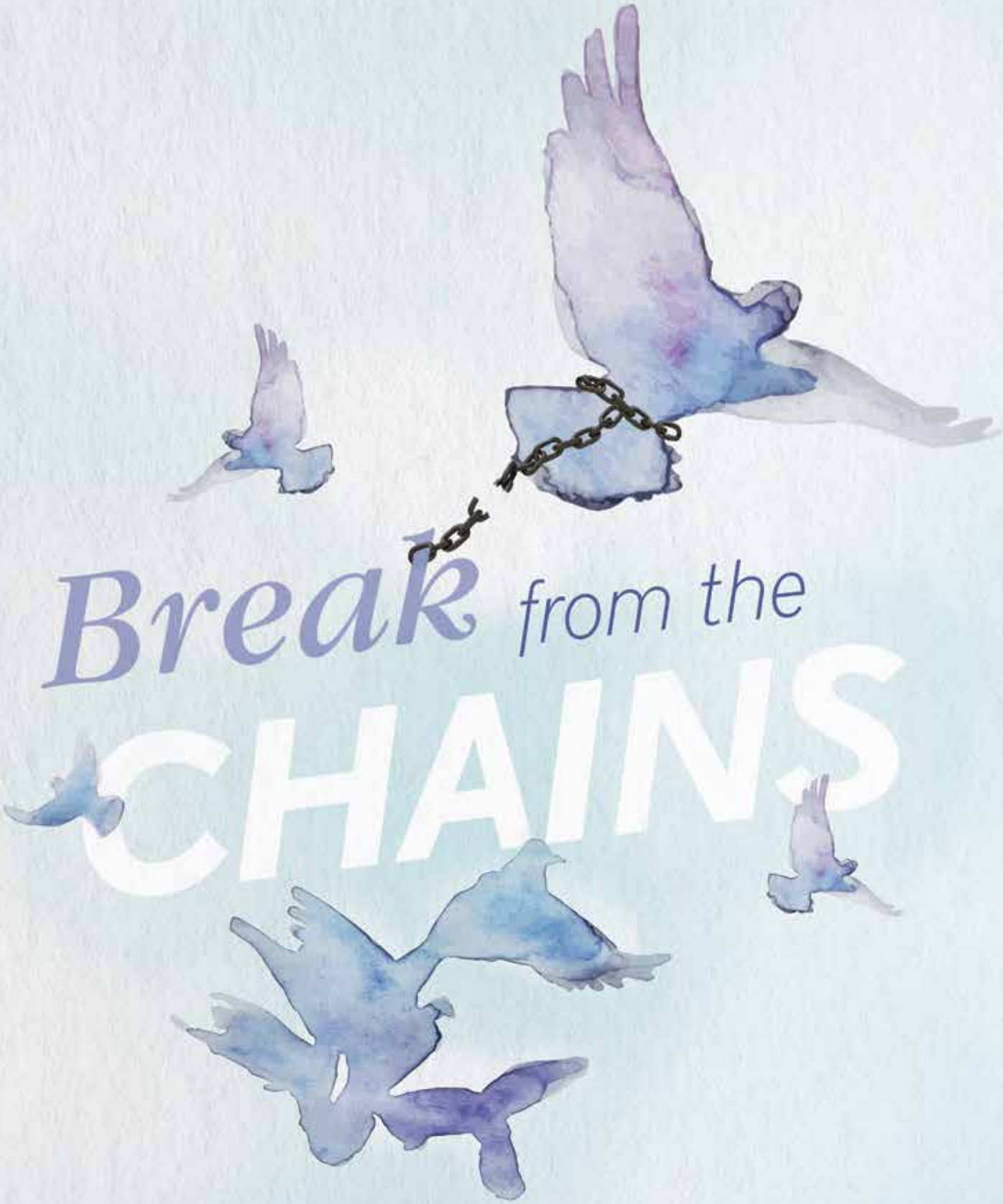

Break from the CHAINS

Selling to a junior partner can help independent pharmacies stay independent

by Richard Jackson

The establishment of a partnership or a "junior partnership" is an alternative to a direct and immediate sale. In this scenario, the sale of the pharmacy occurs over several years, with the new owner acquiring a gradually increasing total percentage of ownership in the pharmacy while increasing his or her share of the management.

For many owners, the transfer of ownership to an individual instead of a chain is difficult because the prospective buyer may lack the necessary capital to make the purchase. It is this problem that causes many independent owners to sell to a chain instead of an individual. The junior partnership in this description provides the owner and potential buyer with a practical guide of how the transfer of ownership of a community pharmacy may be accomplished in a situation wherein the buyer has little or no capital. Adjustments in the factors in the example, such as the timing of initial purchase, total time frame, percentage of purchase per year, and amount paid, may be adjusted to meet special needs of the owner or buyer.

In this description, the first 50 percent of the pharmacy is purchased over a six-year period at approximately 10 percent per year. After the sixth year, the junior partner could purchase the remaining 50 percent using a bank loan, owner financing, or the same procedure as for the first 50 percent. The junior partner pays for and receives the first 10 percent of the pharmacy after the second year of the agreement, which gives him two years to become familiar with the business and save for the purchase of the initial 10 percent. After years three, four, five, and six of the agreement, an additional 10 percent is purchased per year based on the valuation of the pharmacy at that time.

AGREEMENT ON PROVISIONS IMPORTANT

All provisions of the junior partnership should be agreed upon in writing by both the owner and junior partner. This agreement should be drawn up or at least reviewed by an attorney. Particular attention should be given to provisions that would allow the owner or the junior partner to terminate the agreement should particular situations develop. In the event a portion of the pharmacy had been purchased by the junior partner at the time of termination, provisions should be delineated to describe the disposition of the junior partner's share; in other words, whether the shares are bought back by the seller, or the buyer has the right to complete the buyout and the method for valuing the portion of the business to be sold.

This junior partner will receive a reasonable salary plus a bonus of approximately 15 percent of the annual salary. This bonus is used as an incentive for the junior partner to remain with the pharmacy and continue to participate in the junior partnership. Salary increases would be provided each year as allowed for in the junior partnership agreement.

Ten percent of the ownership in the pharmacy will be transferred to the junior partner beginning at the end of the second year and continuing through the end of year six. Therefore, the junior partner will obtain 50 percent of the ownership of the pharmacy in six years. In this particular example, the junior partner will actually pay for only 5 percent of the pharmacy at the end of each year in which a payment is due. An additional 5 percent will be

Special Considerations to Tailor a Junior Partnership

1. Percent purchased each year
2. Number of years
3. Bonus to buyer
4. Ownership share target
5. Discounting share price or gifting

Alternate A) 10 percent per year for three years and then conventional financing with 30 percent collateral.

Alternate B) 5 percent per year for five years and then conventional financing with 25 percent collateral.

Alternate C) Owner finances a five-year loan to buy 20–50 percent and then convention financing for the balance with acquired percent collateral. Consider growth rate of value of pharmacy versus interest rate on owner-financed loan.

Figure 1. Pharmacy Yearly Value in a Junior Partnership								
Line		End Y1	End Y2	End Y3	End Y4	End Y5	End Y6	Total
1	Pharmacy Value	$882,762.00	$909,244.86	$936,522.21	$964,617.87	$993,556.41	$1,023,363.10	
2	Percentage Purchased **End Of Year**	0%	10%	10%	10%	10%	10%	**50%**
3	Junior Partner % **During Year**	0%	0%	10%	20%	30%	40%	
4	Junior Partner $ Share of NP	$ –	$ –	$18,730.44	$38,584.71	$59,613.38	$81,869.05	
5	$ to Seller	$ –	$45,462.24	$46,826.11	$48,230.89	$49,677.82	$51,168.16	**$241,365.22**
6	Net Profit	$176,552.40	$181,848.97	$187,304.44	$192,923.57	$198,711.28	$204,672.62	
7	Seller % Owned **During** Year	100%	100%	90%	80%	70%	60%	
8	Seller NP $	$176,552.40	$181,848.97	$168,574.00	$154,338.86	$139,097.90	$122,803.57	**$943,215.70**
9	Total to Seller	$176,552.40	$227,311.22	$215,400.11	$202,569.75	$188,775.72	$173,971.73	**$1,184,580.92**

provided by the owner at no charge as an extra incentive for the junior partner. In essence, the junior partner would receive 50 percent ownership in the business in years 1–6 of the agreement, but would only pay for 25 percent. It is important for the seller and buyer to seek advice from a qualified advisor to understand the tax ramifications of stock incentives or discounting stock price.

During the first six years of the junior partnership agreement, wherein the junior partner purchases 50 percent of the pharmacy, the owner receives compensation in the form of his or her share of the net profit of the pharmacy and payment from the junior partner for the incremental 10 percent of the business beginning at the end of year two. During years one and two the owner owns 100 percent of the business and is entitled to 100 percent of the profits.

At the end of the second year, the junior partner purchases the first 10 percent of the business; therefore, during year three he receives 10 percent of the net profit and the owner 90 percent. At the end of the six-year agreement, the junior partner will have purchased 50 percent of the business. He may then choose to go to a lending institution and obtain a loan to purchase the remaining 50 percent at full value. He would then have 50 percent of the pharmacy to use as collateral. The seller may consider offering owner financing for the remaining 50 percent.

FIGURE 1 BREAKDOWN

Line 1: The value of the pharmacy is estimated to increase 3 percent per year in this example. The actual value of the pharmacy would be determined at the end of each year after normalization of the financial data and according to selected formulas agreed upon by the seller and junior partner. The value of the pharmacy as of 2013 was $882,762.

Line 2: Percentage of the pharmacy purchased at the end of each year in the six-year agreement. Ten percent is purchased at the end of years two through six. At the end of six years the junior partner owns 50 percent of the business and can borrow the funds to purchase the remaining 50 percent. The value of the pharmacy at the end of six years in this example is projected to be $1,023,363. Half of that value would be $511,682, which would be paid to the seller.

Line 3: These percentages represent the percent of the pharmacy owned by the junior partner during each year. It is this percentage that is used to determine the amount of the net profit which the junior partner is entitled to and is listed in Line 4.

Line 4: Multiplying the junior partner share of the business by the net profit provides the amounts listed in Line 4. The estimated net profit each year is provided in Line 6 and described below.

Line 5: The amount paid at the end of each year by the junior partner to the

Figure 2. Income from Bonus and Profits and Projected Payments of Junior Partner					
Year of Transfer Agreement	Income From Net Profit	Income From Annual Bonus	Net Profit and Annual Bonus of Junior Partner	End-of-Year Payment To Current Owner	Cumulative Surplus
1	$0	$25,000	$25,000	$0	$25,000
2	$0	$25,000	$25,000	$45,462	($20,462)
3	$18,730	$25,000	$43,730	$46,826	($3,096)
4	$38,584	$25,000	$63,584	$48,230	$15,354
5	$59,613	$25,000	$84,613	$49,677	$34,936
6	$81,869	$25,000	$106,869	$51,168	$55,701

seller in this example is determined by taking one half of the value of the percentage of the pharmacy transferred. For example, at the end of year one, the junior partner acquires 10 percent of the business. Ten percent of the value of the pharmacy at the end of year two is estimated to be $90,924. The junior partner pays one half of that or $45,462 (5 percent of the value of the pharmacy). The junior partner is responsible for the tax liability of the amount of the pharmacy that is "gifted" by the seller to the junior partner.

Line 6: The net profit of the business is estimated to increase each year by 3 percent in this example. Each year the financial data would be normalized and actually determined.

Line 7: The percentage of the business owned by the seller during each year of the junior partnership agreement is provided in Line 7. This is used to determine the amount of the net profit to which the seller is entitled at the end of each year. In the event a cash withdrawal is not made or is not possible to be made, a payable would be established by the pharmacy to the seller.

Line 8: The amount of the net profit to which the seller is entitled appears in Line 8. This is determined by multiplying the percentage in Line 7 by the net profit in Line 6.

Line 9: The total amount received by the seller each year is determined by adding his share of the net profit in Line 8 and the payment of the junior partner in Line 5. The total amount received during the six years of the junior partnership agreement is $241,365 for the first 50 percent of the business ($48,273 if stock sold at full price). Adding this to the $943,216 collected from net profits provides the total amount received by the seller to be $1,184,581. The selling price of the remaining 50 percent of the business is estimated to be $511,682 (50 percent of the value of $1,023,363 at the end of year six).

In this agreement, the junior partner would have to save personal funds to make the first three payments to the seller because payments are made primarily from the junior partner's share of the net profit and the bonus which, combined, don't exceed the stock purchase price until after year four. However, by the time the junior partner in this example makes the first payment, he or she would have received two annual bonus payments. Using these bonus payments, plus saving diligently from salary in the first four years, the junior partner could make the stock purchase payments. Beyond year four, the payments could be made totally from the junior partner's bonus and share of the net profit.

FIGURE 2 BREAKDOWN

Figure 2 provides a breakdown of the junior partner's income from his or her share of the business and the annual bonus compared to the end of year payment to the seller. The total of the bonus and junior partner share of the net profit covers the end-of-year payment to the seller beginning in the fourth year. For the second and third years, there is a deficit ($20,462 in year two and $3,096 in year three).

This procedure provides for the establishment of a junior partnership for an independent owner to transfer ownership to a prospective buyer who may not have the necessary capital to purchase the pharmacy outright. The procedure is financially beneficial for both the owner and the junior partner. Most importantly for many independent owners, it provides a mechanism to transfer the ownership of the pharmacy and keep independent pharmacy independent. ■

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