Pharmacy Buy-Out Offers: File Acquisition vs. Continuing Operations

Introduction

The quickest way to grow a pharmacy business is to buy prescription files and incorporate them into an existing location. Close behind is growing business by buying files and moving them to a new, nearby location or operating in the same location under the new owner's identity. These two strategies are most commonly seen when a chain buys an existing pharmacy; it is generally less complicated for a corporation to acquire files without all the other parts of a pharmacy business. But while this may be relatively simple and efficient for the buyer, the seller may have a complicated purchase agreement to evaluate that is written with maximum return on investment for the buyer in mind.

When an offer to buy-out a pharmacy is made solely on prescription volume, one risk the buyer must account for is that patients are not obligated to keep their prescription business with the new owner. Purchase agreements from large chain pharmacy companies are written with many terms intended to keep the prescription volume or compensate the buyer for lost volume. It may not be readily apparent to a pharmacy seller how all of these terms affect the final selling price but it is critical that sellers understand what they can control and the need for aggressive negotiation.

While believed to be accurate at the time of publication, the information in this article is not intended to constitute legal advice nor serve as a substitute for the engagement of qualified professionals (attorney, certified public accountant, etc.) as to the matters discussed herein.

Prescription File Acquisition

Script Count

The initial offer from most buyers who are interested in an asset purchase is based off the prescription volume of the pharmacy. Data analytics give large chain pharmacy companies a good idea of the number of prescriptions in a given community that they are not filling and thus an informed initial offer. The final purchase price will be adjusted to reflect the prescriptions the buyer will actually be able to incorporate into their business model. This means that the script count may be reduced based on the volume of compounds, long-term care beds, and urgent care or other non-refillable files. Sellers with long-term care contracts should carefully evaluate how this could affect the final purchase price since a not insignificant portion of script volume may be attributed to these patients. The final purchase price will further be adjusted by the ability of the buyer to retain business associated with the files acquired. It is not unusual to see an initial payment to the seller made at closing and one or more additional payments made based on the percent retained at specified milestone dates. For example, a seller may receive 50 percent of the agreed purchase price at closing, the next 25 percent after three months if 90 percent of the volume is retained and the final 25 percent after six months if 80 percent of the volume is retained. Percentages and milestones will vary for individual sellers. The retention payments could likewise be held in escrow or be clawed back from a seller who received 100 percent up front.

There are a number of tools and purchase agreement terms that a buyer may use to minimize lost volume. Some of these are no-brainers and painless for the seller to agree to. Others are completely out of the control of the seller and may cause him or her to reconsider the offer entirely.

Employment

The seller, especially if the seller is an owner-operator, staff pharmacists and technicians are important threats or assets to the success of the buy-out. A buyer may offer or go so far as requiring pharmacist staff to work in their pharmacy for a specified time. Technician staff may be particularly desirable when they are a key to communicating with patients, for example when technicians speak one or more languages other than English or are part of a culture that incorporates complementary medicine. It may even be advisable for the seller to work in the buyer's pharmacy for a period of time to help the retention rate and thus the final price received for the pharmacy.

Non-Compete Agreement

Sellers should expect to be asked to sign a non-compete agreement. It should be a separate document from the purchase agreement but may be combined with an employment agreement. This agreement would prohibit the seller from engaging in a similar pharmacy business for a reasonable, specified time period, limited to a reasonable geographic area. For example, the pharmacist who sells a pharmacy might be asked to sign an agreement that they will not engage in a pharmacy business that would compete with the buyer for two, three, four or even five years. The agreement also has to have a geographical limit that might range from one to ten to twenty miles or more depending on the pharmacy location. The more urban an area the less reasonable greater distances become. Now, while the seller has ultimate say over whether to work for the buyer, the seller has no control over whether a staff pharmacist or technician will. Some buyers won't move forward without a non-compete agreement with key pharmacy staff. A seller could advocate for an assignable employment agreement that includes a non-compete clause and would serve two purposes. First, it would satisfy a buyer's interest in acquiring key staff to transition patients. Second, an employment agreement may allow key staff to maintain steady income if the seller is unable or unwilling to give them notice that the store will close on a specific date. Sellers should have a clear understanding of how future employment with the buyer or working for a competitor against the buyer will affect the final purchase price. An offer of $1.6 million could have a significant portion tied up in non-compete agreements that the seller may or may not be able to provide. It would be devastating to a seller for one or more staff pharmacists to refuse to sign a non-compete agreement and then open up a "back-fill" pharmacy in a nearby location and recapture patients.

Communications

Any pharmacy buyer, whether buying common stock, all the assets or just the prescription files should take steps to ensure that patients and other health professionals who need to contact the pharmacy reach the buyer with minimal effort. A business's telephone number, fax number, website and social media profiles have some value to a buyer…especially when they can forward or redirect a customer to the buyer's business. Sellers who shared a dedicated phone number for prescribers should consider the value of that phone line as well. Pharmacies may be obligated by the state board of pharmacy to notify, patients where they will be able to fill prescriptions after the seller closes. Some states require this notice well in advance of the closing date and others permit notice to begin the day the buyer takes possession of the files.

The buyer may require or request joint marketing activities or blanket permission to use the acquired business name and logo for a period of time to get the word out to patients and underscore that the seller wants patients to keep their prescriptions at the buyer's pharmacy. The buyer may display a sign with the seller's logo welcoming transferring patients, may display an announcement on the seller's website or front door, or co-brand a flier or bagstuffer to help patients transition. Assuming the purchase agreement assigned the seller's website URL, phone and fax number to the buyer, these will eventually redirect to the buyer's pharmacy or go out of service.

Pharmacy Management System

The buyer may request or require access to prescription records in electronic format for a period of time necessitating that the seller make arrangements with a pharmacy management system vendor to support access for a period of time. The cost of this should be addressed in the purchase agreement unless the buyer will make arrangements with the system vendor.

3rd Party Receivables

Sellers who are party to an asset sale should pay attention to third party receivables. It may be in the best interest of the seller to keep third party receivables to have income to pay off current liabilities such as the wholesaler's invoice. Chains generally don't purchase receivables but sellers and their advisors should read the purchase agreement carefully and account for disposition of receivables.

Inventory

Some buyers will account for a certain amount of inventory to be acquired in the per-script price, others will finalize an offer with the inventory as an additional asset to be purchased. There may also be a price cap on the value of inventory a buyer is willing to acquire regardless of the quantity. Most often, a buyer will acquire un-opened, brand inventory with more than 90 to 180 days dating that will be used to fill the prescriptions they are acquiring or already dispense. Only somewhat less common is a buyer who will pay for short-dated inventory and generic inventory that isn't in short supply or matches what is on the shelf. Non-prescription inventory including over-the-counter drugs, durable medical equipment, gifts, and greeting cards and fixtures are rarely purchased buy chains and it would be in the best interest of a seller to reduce or liquidate this inventory.

Accounting

Tax planning will go a long way to preparing a seller mentally and financially. While they are not mental health professionals, making an appointment to talk about positioning the pharmacy business for sale is a significant milestone on the way to closing the deal. Meeting with an accountant is necessary to maximizing purchase price and minimizing taxes after the sale. Proceeds from the sale of the assets are typically taxed either as ordinary income and/or capital gains and the buyer and seller can be at odds over determining the portion of the sale that gets attributed to each. Poor tax planning can result in tens if not hundreds of thousands of dollars of lost on the take home from the sale of a million-dollar plus business.

Real Estate

Occasionally, chain pharmacy buyer will use prescription file acquisition to start a pharmacy in a new market. Leasing the seller's property or transfer of the lease may be a contingency of the sale or full offered price. This lease may be only for a limited time while the buyer builds out their location. If the seller is the landlord, the purchase agreement should address leasing the building to the buyer. The lease should be a separate document, drafted and reviewed by an attorney, to ensure that it is legally binding independent of the purchase agreement.

Going Concern Acquisition

Pharmacists and other buyers whose intent is to operate the pharmacy as a small, closely-held business will approach valuation slightly differently. The valuation will rely more on future cash flow and growth of the existing business and a little less on the prescription count for a given period of time. A pharmacist buyer is has more reason to be interested in the reputation and growth potential of a business and is more likely to continue compounding and servicing long-term care beds

Employment

A pharmacist buyer is also going to ask the seller to sign a non-compete agreement but may also offer an employment contract for a specified period of time and keep the door open for the seller to do relief work. If the pharmacist buyer will be staffing the store, the financial projections may be on the lean side with regards to salary and wages in order to make aggressive loan payments. In that case the time the seller works might be more limited than if the buyer is acquiring an additional location that would need its own pharmacist-in-charge and other staff.

Third Party Receivables

In the case of a common stock acquisition the buyer acquires all the assets and liabilities of the corporation. Sellers who are party to an asset sale will generally want to keep the receivables to pay off current liabilities. A seller should seek the advice of an accountant before agreeing to sell the receivables.

Inventory

A buyer who intends to operate the store in the same location is more likely to want to acquire the inventory and thus less likely to mark-down the final price by the value of inventory deemed unusable, particularly the non-prescription inventory.

Fixtures, Furniture and Equipment

Likewise, if the store is going to continue operating in the same location without immediate, drastic change, the seller may be able to transfer the fixtures, furniture and equipment in the pharmacy. Depending on the terms of any leases in place for these items, the lease could be transferred to the buyer rather than the seller having to buy the lease out. This might apply to computers, printers, copiers, greeting card displays and dispensing automation.

Real Estate

Ownership of the real estate where the pharmacy is located brings up a few things to consider. First, the seller needs to determine if he or she wants to own the real estate after the sale is complete. If the real estate is an asset of the pharmacy company, rather than a separate entity, quick action may be required to sell it to the individual or a different business entity. Owning real estate may provide regular rental income into the future – plus eventual proceeds of sale, but does require active management to retain or attract desirable tenants. In addition, if the buyer has an SBA-backed loan he or she needs to have a lease, which may include options to renew, for at least the term of the loan and the typical SBA-backed loan term is at least ten years. On the other hand, buying real-estate may permit a lender to offer a longer term on the loan. This is good for the buyer's cash flow and gives the buyer better control over the location and condition of property

Valuation

The purchase price a pharmacist or other non-corporate buyer pays may be dictated in part by what a bank or other lender determines it is worth. Banks usually value businesses by multiplying its earnings before interest, taxes (only applies to C Corporations), depreciation and amortization, or EBITDA, by some number, typically 3X – 3.5X for the pharmacy industry today. EBITDA will vary depending on the net income of the pharmacy and any "recasting" of expenses that will no longer be a part of the pharmacy once the seller is out of the picture. EBITDA will vary depending on cost of goods, staff wages, rent, utilities, prescription reimbursement rates, non-prescription sales volume and sales based on pharmacy services.

Conclusion

Large corporate pharmacy buyers are primarily interested in buying prescription files and, like any buyer, getting the lowest price possible. The allocation of the sale price should be written into the purchase agreement and match what the buyer and seller each report to the IRS on Form 8594 "Asset Acquisition Statement". A seller, In order to improve the tax situation following the sale will want as much as possible, typically, allocated as goodwill which is taxed at the lower, capital gains rate. Other allocations which are taxed as ordinary income and at a higher rate that depends on the buyer's income tax bracket include inventory, fixtures, furniture and equipment (if fully depreciated), and the non-compete agreement. The sale of land, prescription files and goodwill are taxed at capital gains rates. There is no right or wrong way to sell a pharmacy or allocate the sales price, but it is important that sellers know the typical differences between chain buyers and pharmacist buyers and use that knowledge to get the best price possible for years of investment in the business.