



# *Value* Added

# Use your pharmacy's valuation as a management tool

by Ed Webman, RPh

Pharmacists and pharmacy owners are resourceful and entrepreneurial professionals. Despite the many challenges that independent owners have faced over the years—such as increased chain competition, mail order, preferred networks, and manufacturer limited distribution networks—independent pharmacy has thrived. The approximately 23,000 existing independent pharmacies have been successful in finding opportunities to provide products and services to their communities and have built valuable businesses. These owners have accumulated assets: home(s), investments, and retirement accounts, and most have a good idea of their personal net worth. Yet many owners struggle in valuing what is generally the largest asset in their portfolio, their business.

Of course, every owner wants to understand the value of his or her pharmacy when it comes time to sell, but the value of the business should be used as a tool to manage the business as well. A business valuation helps an owner plan for the future and prepare for emergencies. In addition to selling, there are many reasons to calculate the value of an on-going business, including:

- Understanding the business' value will help your family deal with the sale or disposition of the business in the case of an emergency such as death or disability.
- You may need to separate from partners and/or shareholders (death, disability, divorce, partnership breakup), and you need a valuation to divide up the business.
- A business valuation can assist owners in calculating and working toward their retirement goals.
- A business valuation can assist an owner with estate planning.
- The existing business' cash flow and collateral may be used to finance expansion or an acquisition.
- A business valuation is a crucial first step in creating an exit strategy. Planning should occur 3-5 years before the owner intends on exiting the business.

The independent pharmacy industry is a varied marketplace including a number of business models. Today's independent pharmacists provide a broad spectrum of services, including retail, long-term care (LTC), compounding, specialty, infusion, clinical education and management services, and durable medical equipment. All of these pharmacy services have varied gross margins and operating expenses. For example, \$1 million of gross revenues in specialty pharmacy and \$1 million of gross revenues in compounding pharmacy have very different cost of goods sold, very different operating expense structures, and contribute very differently to earnings. To understand and compare the profitability of various pharmacy business models, we will use earnings before interest, taxes, depreciation, and amortization (EBITDA) and net operating income (NOI).

To calculate EBITDA, take the net income of the business from the income statement, sometimes called the profit and loss statement (P&L), and add-back the interest, taxes, depreciation, and amortization expenses (EBITDA = net income + interest + taxes + depreciation + amortization). Additionally, when evaluating privately held businesses, it is important to normalize the expenses and also add-back to EBITDA any personal, non-business related, or above market expenses that may be run through the business. Common examples are an owner paying themselves an above market salary, unnecessary payroll such as family or friends, or possibly paying themselves above market rent if they own the building. This normalized EBITDA is one of the metrics used to compare and value pharmacies. Next, net operating income (NOI) is also used. In this case, NOI is EBITDA plus the owner's compensation. Again, NOI needs to be normalized for the amount of time the owner staffs the pharmacy. For example, if an owner

works as a staff pharmacist half time, his normalized salary would be reduced by half. Half of his salary is as a dispensing pharmacist and half as an owner. A new owner would have to replace the hours that the owner works as a dispensing pharmacist, so that would be an expense. The normalized NOI reflects the cash an owner has available after reasonable or normalized expenses, to pay themselves, service any debt, and receive a dividend or distribution from the business.

## PHARMACY ASSETS

A pharmacy's value is the sum of its tangible and intangible assets. Tangible assets are those which you can see and measure, such as inventory, furniture, fixtures, and equipment (FF&E), and accounts receivable (A/R). The tangible assets are counted and totaled when valuing a business. The intangible assets are those which cannot be seen and include goodwill, prescription files, customer lists, and non-competition

Bill's Retail Pharmacy		
Gross Revenues	\$3,900,000	
Cost of Goods Sold (COGS)	\$2,983,500	
Gross Profit (GP)	\$916,500	23.50%
*Owner's Compensation (OC)	\$120,000	3.08%
Interest Expense	\$20,000	0.51%
Depreciation	\$20,000	0.51%
Amortization	\$30,000	0.77%
Selling & Gen. Admin. Exp.	\$546,000	14.00%
Total Expense (TE)	\$736,000	18.87%
Net Income (GP – TE)	\$180,500	4.63%
EBITDA	\$250,500	6.42%
NOI	\$370,500	9.50%
Inventory	\$245,000	
Annual Rxs filled	63,500	

\*Owner is working half time as a filling pharmacist; see #6 normalized example.

agreements. For valuation, these intangible assets are generally combined and collectively referred to as goodwill. The value of the intangible assets may be calculated, often using the formulas and methods described in this article. Each formula provides the owner or buyer a different lens to view a pharmacy's value.

We will consider valuing the three most common types of independent pharmacy services: retail, compounding, and LTC. For these examples, we will assume that the FF&E is fully depreciated and has no residual value. The working capital assets (cash, accounts receivable, accounts payable, and all liabilities) are not included. We are simply valuing the goodwill and inventory.

## RETAIL PHARMACY VALUATION

Most of the formulas commonly used in pharmacy valuations are related to retail pharmacy. To best understand the use of pharmacy valuation formulas, let's consider the income statement of the well-run Bill's Retail Pharmacy at left.

Along with profitability, the efficiency of a pharmacy must be considered. As the largest asset in a retail pharmacy is generally inventory, its carrying cost must be factored in. Inventory turnover is the metric to measure efficiency; 12 inventory turns is often used as the benchmark for a well-run pharmacy. This can be calculated by dividing the total cost of goods for the year by average inventory value. The multipliers used above are for a well-run retail store. If the business is not as profitable or efficient, the multiplier would be less; likewise, if the business were exceptional, they may be higher.

## COMPOUNDING PHARMACY VALUATION

Compounding has become the most prevalent pharmacy specialty among independents. Approximately 65

### Retail Pharmacy Formulas

1. **Percentage of Sales + Inventory:** Multiply the pharmacy's gross revenues by a percentage, in this case, 15 percent, and then add inventory:

$$\$3,900,000 \times 15 \text{ percent} = \$585,000 + \$245,000 = \underline{\$830,000}$$

2. **Net Income:** Multiply the pharmacy's net income by a multiplier, in this case 5x (this assumes the buyer will get a 20 percent return on sales):

$$\$180,500 \times 5 = \underline{\$902,500}$$

3. **Gross Profit:** Simply take one year's gross profit:

$$\underline{\$916,500}$$

4. **Price per Prescription Filled + Inventory:** In the example, we'll use \$12 per prescription. Chains commonly utilize this method when acquiring an independent pharmacy.

$$63,500 \times \$12 = \$762,000 + \$245,000 = \underline{\$1,007,000}$$

5. **Net Income + Inventory:** This is similar to formula 2, except we use a multiplier of 4 and add inventory.

$$\$180,500 \times 4 = \$722,000 + \$245,000 = \underline{\$967,000}$$

6. **Normalized NOI + Inventory:** The net operating income (NOI) is normalized to reflect the amount of time the owner is working as a filling pharmacist, as they would need to be replaced or at least their salary would be; in this case, half time. This normalized NOI is then multiplied by a factor. With a net income above 3 percent, this is a well-performing pharmacy; we'll use 3.5x:

$$\underline{\text{Normalized NOI}} = \text{one-half owner salary of } \$120,000 + \text{EBITDA } \$250,500 = \underline{\$310,500}$$

$$\$310,500 \times 3.5 = \$1,086,750 + \$245,000 = \underline{\$1,331,750}$$



percent of the nation's independent pharmacies provide compounding services. In the past 10 years, the number of compounding-only pharmacies has grown dramatically and the valuation of these pharmacies is somewhat different.

According to Creighton Maynard of Healthcare Business Solutions, a consultant for compounding pharmacies and an expert in their valuation, "The valuation multipliers use 20 percent EBITDA as a benchmark. The multipliers increase with EBITDA above 20 percent; likewise, they decrease below 20 percent."

Consider the income statement of Will's Compounding Pharmacy (at right) and the formulas that follow:

The multipliers and factors used in valuing a compounding pharmacy are somewhat higher than those used in retail pharmacies. Compounding pharmacies have greater gross margins, higher labor costs, and very low inventory compared to retail pharmacies. The value-add in compounding decommoditizes the business, contributing to the increased valuation.

### LONG-TERM CARE PHARMACY VALUATION

The long-term care pharmacy business is divided into three major categories: skilled nursing facilities (SNF) commonly referred to as nursing homes, assisted living facilities (ALF), and intermediate care facilities (ICF) commonly referred to as group homes. The SNF business has become highly specialized and is largely reimbursed on per-diem rates with carve-outs. Though many independent pharmacies still service SNFs, independent pharmacy owners have increasingly focused on ALFs and ICFs. With the advent of Medicare Part D, most ALF and ICF patients are covered through Medicaid or Medicare and they may be dual-eligible.

Will's Compounding Pharmacy		
Gross Revenues	\$995,500	
Cost of Goods Sold (COGS)	\$155,000	
Gross Profit	\$840,500	84.43%
*Owner's Compensation (OC)	\$120,000	12.05%
Interest Expense	\$0	0.00%
Depreciation & Amortization	\$25,000	2.51%
Selling & Gen. Admin. Exp.	\$456,000	45.81%
Total Expense	\$601,000	60.37%
Total Expense (TE)	\$736,000	18.87%
Net Income	\$239,500	24.06%
EBITDA	EBITDA	26.57%
NOI (EBITDA + OC)	NOI (EBITDA + OC)	38.62%
Inventory	\$35,000	
Annual Rx's filled	16,500	

ble. This expansion of coverage and demographic changes have created a growth opportunity for LTC pharmacy.

According to Michael Cammeyer of Harbor Healthcare Consultants, a pharmacy M&A firm specializing in LTC, "The days of pricing solely on a price per bed are gone. Buyers of LTC pharmacies, large and small, strategic or financial, use a financial model. The larger and more profitable the pharmacy, the higher the multiple; the range is from 5 to 6x EBITDA." With that in mind, consider the income statement of William's LTC Pharmacy on page 32.

As with compounding pharmacy, valuations in long-term pharmacy are somewhat higher than those seen in retail pharmacies. LTC pharmacies generally have greater gross margins, higher inventory turns, and increased labor costs compared to retail pharmacies. The value-add services in LTC pharmacies (such as packing, consulting, and delivering) decommoditizes the business. Also, LTC clients tend to be sticky and recurring revenue is more predictable.

### CONSIDERING VALUATIONS

In years past, many pharmacy owners relied on relatively simple back-of-

## Compounding Pharmacy Formulas

1. **Percentage of Sales:** Multiply the gross sales by a factor; in this case, we'll use 135 percent, as the pharmacy's EBITDA is approximately 35 percent greater than the benchmark EBITDA of 20 percent. The multiplier is increased 5 percent for every 1 percent greater than 20 percent; in this case, there is a difference of approximately seven percentage points.

$$\$995,500 \times 135 \text{ percent} = \underline{\$1,343,925}$$

2. **Percentage of Sales plus Inventory:** Multiply the gross sales by a factor and add inventory. In this case, we used 127 percent; 20 percent would be 100 percent, 27 percent is 127 percent.

$$\$995,500 \times 127 \text{ percent} = \$1,264,285 + \$35,000 = \underline{\$1,299,285}$$

3. **Net Income (EBITDA):** Multiply the EBITDA by 5x; this is the same as #2 in the retail example, except we use EBITDA:

$$\$264,500 \times 5 = \underline{\$1,322,500}$$

4. **normalized NOI + Inventory:** The NOI is normalized; in this case, the owner is not working as a filling pharmacy, so their entire compensation is included in NOI. A multiple of 3.5x is used as before.

$$\underline{\text{Normalized NOI}} = \$120,000 + \text{EBITDA } \$264,500 = \underline{\$384,500}$$

$$\$384,500 \times 3.5 = \$1,345,750 + \$35,000 = \underline{\$1,380,750}$$

streams, and earnings need to be valued, not simply on revenue and prescription counts.

When utilizing a financial model to value a pharmacy, it is most important to thoroughly normalize and recast the financial statements and cash flow. Along with normalizing the expenses as was discussed earlier, normalizing also includes ensuring the financials accurately represent the revenues, cost-of-goods-sold (COGS), gross profit, and ultimately the net income. In pharmacies, common concerns are: Is the P&L done on a cash or an accrual basis? Does it accurately reflect COGS rather than purchases? Are all rebates included? Are the inventory figures accurate? Are the accounts receivable (A/R) figures accurate? Are the accounts payable figures (A/P) accurate?

You need to fully understand a business' income statement or P&L, and balance sheet, to comprehend its value and earning potential. When financial statements have to be significantly recast and normalized, there is often a discount to the valuation of the business. Clear and accurate financial statements will help ensure that pharmacy owners will get the highest possible valuation for their business.

the-envelope formulas to value their business. At the time, the pharmacy business model was much simpler and the gross revenues far less. Pharmacy is now a sophisticated business, with the average independent pharmacy generating approximately \$4 million in gross revenue, and earnings of approximately \$250,000. The value of a business is tied to the expectation of future earnings and

cash flow. A financial model focused on the earnings, EBITDA and NOI, with a multiplier most fairly values the business. A financial model rewards owners for the historical cash flows they have built. Banks utilize a financial model focused on cash flow when considering a loan request from a buyer. Additionally, most independent pharmacies are not monoline businesses, but have diversified revenue

## Other Things to Consider

- How are the pharmacy revenues and profits trending? A pharmacy that is increasing in profitability should command a higher multiplier than one that is level or declining.
- How are the prospects for growth in revenues and profits?
- How is the competition? Are there other independent pharmacies in the market?
- Is there a concentration risk? Is the pharmacy reliant on one customer such as an LTC facility, a large employer, one product (such as pain creams), one prescriber, or one payer such as Medicaid or an insurance company?
- What is the transition risk? How involved is the owner? The less the owner is involved in day-to-day activities, the fewer the changes in transition, and the more a buyer may be willing to pay.
- How are the facilities? Will the new owner need to remodel?
- How is the technology? Will the owner need to invest in new equipment and change workflows?
- How are the inventory levels? Has the seller let the inventory levels run down, requiring the new owner to beef up and invest in additional inventory?
- How is the staff? Are they professional? Will the new owner be able to utilize the existing staff or will they need to build a new team?

William's LTC Pharmacy		
Gross Revenues	\$5,675,000	
Cost of Goods Sold (COGS)	\$3,975,050	
Gross Profit	\$1,699,950	29.96%
*Owner's Compensation (OC)	\$120,000	2.11%
Interest Expense	\$85,000	1.50%
Depreciation & Amortization	\$84,500	1.49%
Selling & Gen. Admin. Exp.	\$1,258,050	22.17%
Total Expense	\$1,547,550	27.27%
Net Income (GP – TE)	\$152,400	2.69%
EBITDA	\$321,900	5.67%
NOI (EBITDA + OC)	\$441,900	7.79%
Inventory	\$235,000	
Number of beds serviced	940	
Annual Rxs filled	107,000	

\*The owner is not working as a filling pharmacist.

LTC Pharmacy Formulas	
1. <b>Net Income (EBITDA):</b> The pharmacy above falls into the 5x EBITDA range.	
	$\$321,900 \times 5 = \underline{\$1,609,500}$
2. <b>Normalized NOI + inventory:</b> As with the example in the compounding pharmacy, the owner is not working as a pharmacist but running the business. The entire owner's compensation is added back. A multiple of 3.5x is used as before.	
	$\$120,000 + \$321,900 = \$441,900$
	$\$441,900 \times 3.5 = \$1,546,650 + \$235,000 = \underline{\$1,781,650}$

## FOR BUYERS

When evaluating a pharmacy acquisition, the buyer must consider not only the acquisition price of the pharmacy, but the project cost. The project cost includes the pharmacy acquisition and the working capital needed to fund the A/R and operate the business. Buyers should always pay for historical financial performance, not the potential. Buyers need to fully understand how the prospective pharmacy will impact them financially. The cash flow of the new pharmacy must be able to support the debt, the normalized expenses, and provide a salary and/or a return to the buyer.

The same pharmacy is not worth the same price to all buyers. Are they an associate in the pharmacy? How will things transition? Buyers may be willing to pay a bit more when they fully understand the business and the market. If buyers already own an existing store, are there synergies? Is their pharmacy in same market? Will they possibly combine the stores? When a buyer combines stores, many of the existing store's expenses will not recur, creating more value to the new owner. Is the seller willing to finance a large portion of the acquisition? The structure and the terms of a deal are important, and the price is often dependent upon on the terms.

When valuing a pharmacy, formulas should be used as a guide, as they provide a starting point and a range for the negotiations between the buyer and the seller. Of course, individual situations vary, and it is prudent to consult professionals such as an accountant and/or an attorney. However, a business is ultimately worth what a buyer is willing to pay and the seller is willing to accept. ■

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