



FINDING THE RIGHT PRICE

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Analyzing the formulas used in determining equitable selling and purchase prices for independent community pharmacies

As many independent pharmacy owners approach retirement age, much thought is given to transferring ownership. Most owners would like to make sure that their independent pharmacies stay independent, and transfer ownership to an individual instead of a chain. The first step in the pharmacy's transition is determining an equitable selling/purchase price.

Determining such a price for a community pharmacy is difficult for most owners. For many, it is a once in a lifetime experience for which they have received little or no formal education or training. Therefore, it behooves the pharmacy owner to be as knowledgeable as possible regarding the factors associated with determining an equitable selling price.

Business value is usually determined through a negotiation process between the buyer and the seller. A business valuation is far from an exact science. It is based on an assessment of facts about the business, judgment and some common sense aspects. Several formulas have been developed to

estimate an independent community pharmacy's equitable selling price. For a complete description and examples of using these formulas, see "Maintaining Our Independents," in the October 2002 *America's Pharmacist*.

CHOOSING A FORMULA

There is no single formula that is best for all pharmacies, and not all formulas are valid for a particular pharmacy. Several should be used, providing for a range of valuations. The valuations derived from these formulas may then be adjusted according to subjective factors to arrive at an equitable valuation.

It should be pointed out that these formulas (which do not specifically take net profit into account) are for an "average" or typical pharmacy, operating at an average net profit of approximately 4 percent of sales. In those pharmacies that have an unusually high or low net profit, some formulas that do not take net profit into account would yield excessively high or low valuations and would not be valid.

Some adjustments ("normalizing") may need to be made in the data provided on the financial statements before being utilized in the valuation formulas. For example, several of the

formulas use net profit in their calculation. In some situations, an owner may be taking an unusually large salary, thereby creating an inordinately small net profit. In this case the owner's salary would need to be adjusted to a more "realistic" figure and the net profit adjusted upward for use in the valuation formulas. In addition, since depreciation is not an "out of pocket" expense, it is usually added to the net profit in those formulas wherein net profit is used in calculating the selling price. If the owner owns the building and pays himself an "abnormal" rent, an adjustment also would need to be made.

Formulas described in this article are for the outright sale of the business (as opposed to a stock sale), yield a valuation that does not include cash, accounts receivable, accounts payable or notes payable. These would be the responsibility of the seller and would not be transferred to the buyer. Obviously cash would not transfer. Accounts receivable is difficult to value, but it may be negotiated separately. Accounts payable would not be transferred, inasmuch as the inventory has already been factored into the selling price. Notes payable also would not be transferred, but would be responsibility of the seller and, as with accounts payable, paid off with funds from the business' sale.

FACTORS AFFECTING VALUE

The fiscal condition of the business as determined by a financial analysis is an important consideration in determining an equitable selling price. In addition to providing extra information related to the pharmacy's valuation, a favorable financial analysis will assist the seller in the negotiation process. By pointing out those business aspects, such as profitability, solvency, and efficiency, the seller may be able to negotiate a better price. Of course, to be certain, an astute purchaser would be quick to point out negative financial statistics in an attempt to negotiate a lower acquisition price.

There are several other factors, mostly subjective, which would affect the value of a business. An assessment of each of the following would be important in adjusting the valuation of a pharmacy as determined by various formulas described later in this article. Important factors include:

- Physical appearance and pharmacy condition (Are certain fixed assets in need of repair or replacement?)
- Cash flow (Examine past cash flow records and make future projections.)
- Competition (How aggressive are pharmacy and other non-drug outlets and is expansion planned?)
- Inventory composition and condition (Does inventory reflect needs and demands of physicians and customers and is it saleable or shopworn?)

- Economic trends in the community (Is the community stable with high employment?)
- Future projections for retail pharmacy (What are the national trends?)
- Managed care (What percentage of prescriptions are third party and what is the outlook for the future?)
- Lease terms
- Location (About 65 percent of the pharmacy's sales can be attributed to its location and about 25 percent to the store layout.)
- Image of the pharmacy in the community
- Terms of sale

OBJECTIVE

The purpose of this study, funded by the NCPA Foundation, was to validate, revise and determine the accuracy of existing formulas used to determine an equitable selling/purchase price for an independent community pharmacy.

METHODS

Questionnaire Development. A questionnaire was developed to obtain financial data from independent pharmacies that had been sold to either chain or independent pharmacy buyers. This questionnaire was used to obtain data such as the selling price, pharmacy demographics, inventory, net profit, and owner's salary. The questionnaire was adapted from annual surveys conducted for the *NCPA-Pfizer Digest* (will be mailed with the November issue).

TABLE 1 - RULE OF THUMB VERSUS STUDY RESULTS

Valuation Formula	Rule of Thumb	Study Results	N
1. Percentage of Sales	25%	22.7%	19
2. Return on Investment	20%	20%	19
3. % Sales plus Inventory	15%	12%	19
4. Net Income	1.5	1.8	22
5. Net Profit	5	4.9	21
6. Itemization	1-2	3.5	19
7. \$ (Annual Prescriptions) Inventory	\$3-\$7	\$4.85	20
8. \$ (Annual Prescriptions)	\$10	\$9.16	20
9. Direct Assessment	Various	10.6% over-statement	11

PHOTOGRAPH: ROSS ANANIA

Data Collection. Participants for the study were obtained from three different sources. The first was a list of contacts provided by NCPA through the NCPA Independent Pharmacy Matching Service, which included individuals who had posted their pharmacy for sale. The second source was state pharmacy association executives across the United States who were asked for names of pharmacies that had been for sale or sold within their state. The final data source came from a pharmacy appraiser (one of the investigators) who routinely values pharmacies.

Due to the lack of response from mailed pre-test questionnaires, the investigators recognized the need to telephone potential participants to determine their willingness to participate in the study. The telephone call allowed the investigators to explain the study's purpose in greater detail, especially because financial information was being disclosed. Once the potential participant was contacted by telephone and provided a verbal agreement to participate, the questionnaire was mailed. There was then a follow-up phone call to determine if there were any questions about the questionnaire's details that prevented its timely return.

RESULTS

From a total of 70 questionnaires mailed to pharmacists that were obtained from NCPA, 10 usable responses were acquired. From 22 questionnaires mailed to pharmacists identified by state association executives, six were usable. Nine of nine pharmacies for the appraisers files were used. In all a total of 25 pharmacies that were sold between 1999 and 2003 were evaluated in the study.

The average financial data for the pharmacies in the study breaks down accordingly:

ANNUAL SALES VOLUME	\$2,056,000
NET PROFIT (% of sales)	4.1%
ANNUAL PRESCRIPTION VOLUME	50,920
SELLING PRICE	\$538,132

PERCENTAGE OF SALES FORMULA

The selling price rule of thumb formula for percentage of sales is 25 percent of annual sales. In the current study, 19 pharmacies were examined. As may be determined from Table 1, (at left) not all 25 respondents submitted complete data for all analyses. The average pharmacy in the sample was sold at a price equal to 22.7 percent of annual sales. Those sold to an independent versus a chain showed little variability.

It should be re-emphasized that the formulas used for valuation purposes that do not specifically take net profit into account are for an "average" pharmacy and do not ap-

TABLE 2 - SELLING PRICE AS A PERCENTAGE OF SALES BY NET PROFIT (% SALES)

Net Profit	% Sales
< 3%	20%
3 – 4.9%	23.5%
5 – 10%	24%
> 10%	60.9%

ply for those that deviate from the "normal" profitability of approximately 4 percent of sales. As the profit percentage increases, so does the selling price as a percentage of sales (see Table 2, above). Therefore, for those pharmacies with an exceptionally high net profit the value of that formula would not be valid.

RETURN (NET PROFIT) ON INVESTMENT (SELLING PRICE) FORMULA

As seen in Table 1, the return on investment formula for the determination of an equitable selling/purchase price uses 20 percent. The median return on investment for the sample pharmacies was 20 percent. In other words, the net profit for the sample pharmacies averaged 20 percent of the actual selling price.

TABLE 3 - SELLING PRICE AS A PERCENTAGE OF SALES PLUS INVENTORY BY NET PROFIT %

Net Profit	% Sales
< 3 – 4%	7.4%
3 – 4.9%	13.8%
5 – 10%	15.1%
> 10%	22.8%

PERCENTAGE OF SALES PLUS INVENTORY FORMULA

The percentage of sales rule of thumb formula used in valuation for an average pharmacy is 15 percent of sales plus inventory. As may be determined from Table 1, the percentage of sales plus inventory was 12 percent.

Breaking down the pharmacies by net profit as a percent of sales reveals that the percent of sales used in the formula increases as the net profit as a percent of sales increases (see Table 3, above).

NET INCOME (OWNER'S SALARY PLUS NET PROFIT) FORMULA

The rule of thumb formula using the net income approach is a multiple of 1.5 times net income (owner's salary plus net

profit) plus inventory. As may be determined Table 1, the pharmacies in the sample sold for approximately 1.8 times the net income of the pharmacy plus inventory.

NET PROFIT FORMULA

The traditional formula used for valuation purposes using net profit is to use a multiple of five times net profit (see Table 1). The pharmacies in the sample sold for an average of 4.9 times the net profit.

ITEMIZATION

Itemization involves simply adding the value of the inventory, fixtures and equipment and goodwill to determine a selling price. Traditionally, the value of goodwill was estimated at 1-2 times the net profit. Assuming a value of \$50,000 for the fixtures and equipment, the pharmacies in the sample sold for the value of the inventory plus fixtures and equipment plus 3.5 times the net profit.

PER ANNUAL PRESCRIPTIONS (\$3-\$7) PLUS INVENTORY FORMULA

Compared to the accepted rule of thumb valuation formula of \$5 per prescription filled annually plus inventory, the pharmacies in the sample sold for \$4.85 per prescription filled annually plus inventory (see Table 1).

TEN DOLLARS PER ANNUAL PRESCRIPTIONS

The annual prescriptions rule of thumb formula uses \$10 per prescription filled annually. The pharmacies in the sample sold for an average of \$9.16 per annual prescription (see Table 1).

DIRECT ASSESSMENT

Many mathematical manipulations are used in this procedure. Pharmacies varied widely from a 31.6 percent understatement to a 49.7 percent overstatement. Use of this procedure produced an average 10.6 percent overstatement of the actual selling price.

DISCUSSION AND CONCLUSION

With the exception of the itemization formula and direct assessment, the results of this study indicate that the rule of thumb formulas used for determining an equitable selling/purchase price for an independent community pharmacy provide a reasonably valid indication of the actual valuation for average or typical community pharmacies. The itemization formula tends to understate the value and the direct assessment tends to overstate somewhat. This is probably, however, due to the study's small sample size, and one or two extreme values can markedly affect the average value in

the collected data. However, as stated earlier, not all formulas are valid for all pharmacies. When using several formulas, it is usually obvious that some valuations are outliers and would not be used for that particular pharmacy. As a very important caveat, it should be reiterated that these formulas are more valid for the "average" or "typical" community pharmacy with a net profit as a percent of sales of approximately 4 percent.

The best indicator of the value of a business is its earning power as reflected in its net profit. Therefore, for those pharmacies with an exceptionally high or low net profit, the formulas that do not factor in net profit would not be as accurate as those that do. However, they could be adjusted to allow for a deviation in net profit from average. For example, for a profitable pharmacy with a net profit of 8 percent, the multipliers and percentages would need to be adjusted upward. Of course, those that utilize primarily net profit such as return on investment, net income and net profit formulas would not need to be adjusted.

These rule of thumb formulas may provide a useful starting point for negotiations and deliberations between the buyer and the seller. Other factors, which are more subjective, would then be considered and through negotiation the valuation as determined by the formulas would be adjusted upward or downward. ■

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