



ONE DESTINATION, TWO ROADS TO PHARMACY OWNERSHIP

Start a new pharmacy or buy a 'used' one? It's more challenging than picking a car—even one you've always wanted.

By Ed Webman, RPh & Brian Faulk

YOU KNOW YOU WANT A FORD MUSTANG, and that's a given (or maybe a Corvette, a Porsche, or BMW). But do you buy an older, classic model or go with the very latest? Either way, you want it.

It's the million dollar question for budding pharmacy owner: Do I buy an existing pharmacy, or do I start my own from scratch? Compelling arguments exist for both options. If you start from scratch, you do not incur a \$1 million or more debt obligation. If you buy an existing pharmacy, you have stable operating income on day one to support your debt obligation. From the bank's perspective, it is a relatively easy decision as historical repayment ability evidenced by an established pharmacy is much easier to finance than a start up operation where repayment is based on projections. It is a very daunting decision, but hopefully we can make it a much easier one by analyzing a startup investment and an acquisition investment.

As statistics in the 2010 *NCPA Digest*, sponsored by Cardinal Health, reflect, the average independent pharmacy generates approximately \$4.02 million in gross revenue, with prescription drug sales being the primary income source. This average pharmacy fills some 64,000 prescriptions per year at an average price of \$58. Now that we have this information in hand, we can begin the process of comparing a startup investment to an acquisition.

Experience has shown bottom line cash flow for a good pharmacy to be **approximately 7–12 percent of the gross revenue** generated by the pharmacy.

Buying an Existing Business

There are numerous methods to determine the value of the prescription records/goodwill/business of a going concern. These include a per script price, a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization), net present value of earnings, and several others. For simplicity's sake, we will examine a pharmacy's EBITDA and apply a multiplier to arrive at a value.

We determine the bottom line cash generated by the pharmacy that will be available to service the debt/loan incurred to acquire the pharmacy and still have ample excess cash to appropriately compensate you as the owner and operator. This bottom line cash figure is a cumulative of the following: seller's salary, depreciation, interest on the debt the seller was servicing, amortization expense, net income, and any non-recurring expenses that will be eliminated following ownership transition. If you are working as an associate at the pharmacy being acquired we would also add your salary to the bottom line cash figure.

Experience has shown bottom line cash flow for a good pharmacy to be approximately 7–12 percent of the gross revenue generated by the pharmacy. Likewise, a good pharmacy is often sold for three times bottom line cash plus inventory on hand at closing. Please note that

there are several factors that can change this multiple including sales trends (up or down), and other pharmacy services such as compounding, durable medical equipment, and/or long-term care services.

We will now examine the acquisition of a typical independent pharmacy. (Table 1.) Gross revenue is \$4.1 million and the bottom line cash being generated is approximately 9.5 percent. The store is generating about \$389,000 to service acquisition debt and compensate the buyer. (The owner is working three quarters FTE as the second pharmacist, so three-fourths of his salary may be deducted from the true business earnings.) Multiplying (\$389,000 minus \$93,750) by three gives us, \$885,750, and a goodwill purchase price of \$900,000 plus inventory, of \$300,000. We now have a total purchase price of \$1.2 million due to the seller.

We are not quite finished funding the project, as funds need to be allocated for working capital and loan closing costs. You will need working capital to sustain your operation while you await payment from your third party payers (the seller will retain the AR). Typically you should request a working capital figure 17–30 DSO (days sales outstanding) representing the time it will take you to collect your receivables from PBMs and other third-party payers. Additionally, you will need to have some cash in the bank to ensure you are well capitalized from the start.

Loan closing costs include legal fees you and the bank will incur, business valuation fees, accounting fees, and loan fees. Closing costs can vary greatly and you should allocate to the high side for this category to ensure you have ample funds to cover all transaction-related expenses without having to dip into the working capital allocation. The closing costs on a \$1 million plus transaction can run as high as \$50,000. Any savings realized in this category will be diverted to additional working capital.

We have now arrived at the total financing cost of \$1.55 million to acquire this \$4.1 million gross revenue pharmacy: \$900,000 for prescription records/goodwill/non-compete, \$300,000 for inventory, approximately \$300,000 in working capital, and \$45,000 in closing costs. A very typical loan structure would be as follows: borrower cash equity injection of \$75,000, seller financing of \$150,000, and bank loan of \$1.325 million.

The seller note is placed on complete standby for two

TABLE 1. ACQUISITION BUDGET**Acquisition Budget—Cost**

		EQUITY	LOB	Seller	TOTAL		
APPRAISAL	SC		\$2,500		\$2,500		
SBA GTY. FEE	SC		\$34,790		\$34,790		
LEGAL	SC		\$7,500		\$7,500		
INVENTORY	INV		\$300,000		\$300,000		
WORKING CAPITAL	WC		\$305,210		\$305,210		
GOODWILL	P	\$75,000	\$675,000	\$150,000	\$900,000		
TOTAL		\$75,000	\$1,325,000	\$150,000	\$1,550,000		
		4.84%	85.48%	9.68%	100.00%		
RECAP:							
Soft Costs	\$44,790		LOB	\$1,325,000		Seller (standby)	\$171,735*
Practice	\$900,000		Maturity:	10.00		Maturity:	5.0
Inventory	\$300,000		Act. Mat:	10		Amortization	10
Working Capital	\$305,210		Interest Rate:	5.250%		Interest Rate:	7.000%
TOTAL	\$1,550,000		Payment	\$14,216		Payment	\$1,994

*accrued interest

Prime rate plus 2.00% adjusted calendar quarterly

Acquisition Budget—Cash Flow

	2008	2009	2010	6/30/2011
Revenue	\$3,800,000	\$3,950,000	\$4,100,000	\$2,101,000
Seller's Salary	\$125,000	\$125,000	\$125,000	\$62,500
Interest	\$24,500	\$22,000	\$20,000	\$4,200
Depreciation	\$14,350	\$12,900	\$14,300	\$6,550
Amortization	\$12,000	\$12,000	\$12,000	\$6,000
Net Income	\$180,500	\$193,000	\$217,700	\$115,600
NOI	\$356,350	\$364,900	\$389,000	\$194,850
NOM	9.38%	9.24%	9.49%	9.27%
LOB Mtg	\$170,594	\$170,594	\$170,594	\$85,297
Seller Mtg	\$23,928	\$23,928	\$23,928	\$11,964
Debt Serv.	\$194,522	\$194,522	\$194,522	\$97,261
Available CF	\$161,828	\$170,378	\$194,478	\$97,589
Buyer's Salary	\$125,000	\$125,000	\$125,000	\$62,500
Excess CF	\$36,828	\$45,378	\$69,478	\$35,089
DSC (Pre-OC)	1.83	1.88	2.00	2.00
DSC (PostOC)	1.19	1.23	1.36	1.36

years, which means no payments of principal or interest are made. The seller's note accrues interest during this standby period and can be viewed very similarly to a CD investment by the seller. Request terms of two years standby followed by five years of principal and interest payments based on a 10-year amortization. The rate is normally around 7 percent and the loan matures seven years from original date of issuance. When payments due commence 25 months after closing, your payment would be approximately \$1,994 per month.

The bank loan of \$1.325 million amortized 10 years at prime rate (currently, 3.25 percent) plus 2 percent for a current effective rate of 5.25 percent would result in a monthly principal and interest payment of \$14,216. Please note that the majority of business loans of this nature are variable rate loans that adjust on a calendar quarter basis. Fixed rates are available in certain situations; however they are in the 7–10 percent range, and most have an early call or balloon provision.

We know the pharmacy is grossing \$4.1 million (or \$341,667 per month), and that it

TABLE 2. STARTUP BUDGET**Startup Budget—Cost**

		EQUITY	LOB	TOTAL
BUILD OUT	C		\$75,000	\$75,000
SBA GTY. FEE	SC		\$10,125	\$10,125
LEGAL	SC		\$7,500	\$7,500
FF&E	FFE		\$75,000	\$75,000
INVENTORY	INV		\$150,000	\$150,000
WORKING CAPITAL	WC	\$75,000	\$132,375	\$207,375
TOTAL		\$75,000	\$450,000	\$525,000
		14.29%	85.71%	100.00%
RECAP:				
Build Out		\$75,000	LOB	\$450,000
Soft Costs		\$17,625	Max Maturity:	10.00
Inventory		\$150,000	Act. Mat:	10
Working Capital		\$207,375	Interest Rate:	5.750%
FF&E		\$75,000	Payment	\$4,940
TOTAL		\$525,000		

Acquisition Budget—Cash Flow

	Year 1	Year 2	Year 3
Revenue	\$874,380	\$1,380,600	\$1,656,720
Officer	\$100,000	\$100,000	\$100,000
Depreciation	\$15,000	\$15,000	\$15,000
Amortization	\$4,980	\$4,980	\$4,980
Net Income	-\$77,725	\$14,841	\$66,856
NOI	\$42,255	\$134,821	\$186,836
NOM	4.83%	9.77%	11.28%
LOB Mtg	\$59,275	\$59,275	\$59,275
Debt Serv.	\$59,275	\$59,275	\$59,275
Available CF	-\$17,020	\$75,546	\$127,561
Officer Comp.	\$100,000	\$100,000	\$100,000
Excess CF	-\$117,020	-\$24,454	\$27,561
DSC (Pre-OC)	0.71	2.27	3.15
DSC (PostOC)	-0.97	0.59	1.46

is generating a 9.5 percent bottom line cash return of \$32,458. Subtract the monthly \$14,216 payment for the bank loan and the \$1,994 seller note (even though you will not make this payment for the first two years to stress

test repayment feasibility). You are left with \$16,248 in owner compensation, or \$194,478 annually. You can pay yourself an owner's salary of \$125,000 and have \$69,478 for a cushion.

Each year you accumulate considerable equity in your business as you reduce the principal debt obligation and in no less than 10 years, you have a \$1 million plus asset owned free and clear. This all assumes that you operate the pharmacy status quo with little to no improvement in the margins or sales generated by the retiring seller.

Starting a Startup

Now take your \$75,000 cash savings and invest it in a startup independent pharmacy. (Table 2.) To begin you need approximately 1,500 square feet. Minimal leasehold improvement costs at \$50 per square foot result in build out costs of approximately \$75,000; another \$75,000 for furniture, fixtures, and equipment; \$150,000 for opening inventory; \$17,625 for soft costs/loan closing costs; and no less than \$200,000 in working capital to sustain the operation while you build your script counts.

We now have a total startup financing cost of \$525,000 less your \$75,000 equity injection upfront, requiring a loan of \$450,000. A typical startup loan will provide six months of interest-only payments to accommodate building development and initial startup months of operation followed by 120 monthly payments of principal and interest. A total of \$450,000 amortized 10 years at the prime rate plus 2.5 percent for a current effective rate of 5.75 percent creates a monthly principal and interest payment of \$4,940.

To reach a break-even level of operation sufficient to service the loan payment and pay you an equivalent \$100,000 annual salary, you have to fill approximately 100–120 prescriptions per day (27,600 per year) or approximately \$133,333/per month and \$1.6 million in gross revenues, and manage a 10 percent bottom line cash return. With a net operating income of \$13,333 less the \$4,940 monthly loan payment, that leaves you with a monthly officer compensation figure of \$8,393 or \$100,716 yearly.

Comparing an Acquisition Versus Startup

Developing a pharmacy from scratch to dispensing more than 100 prescriptions per day is a daunting task.

This could take a several years. Let's consider your immediate ROI (total owner's compensation) based upon your investment of \$75,000 for each pharmacy. In the acquisition, if things remained the same as with the prior owner, in the first year ROI should be \$69,478 over and above your salary of \$125,000, or a return of 93 percent. In the startup example, the pharmacy can only afford a \$100,000 salary, and it would be two years before the store is cash flow positive. In the third year, there is \$27,561 over and above the \$100,000 salary, an ROI of 37 percent. If you use the same base salary of \$125,000, to compare, as in our acquisition, the ROI is then 3.4 percent.

You do have to consider your total debt obligation, and granted you have a much lower debt obligation on a startup after three years, which would be approximately \$341,000 based on a straight line amortization of your original \$450,000 note, but you have little to no business equity as your pharmacy has only just recently achieved a break-even status. You reduced your principal debt obligation by \$109,000, but you have little to no market for the sale of your pharmacy with prescription counts

just above 100 per day. In comparison, the acquisition opportunity has reduced the original debt obligation from \$1.325 million to \$997,500 million based on a straight line amortization, thus creating a minimum of \$327,000 in equity via principal reduction. Also, since the acquisition pharmacy generates revenue of more than \$4 million and has a substantially higher prescription count, it is much more marketable, thus providing you with an additional return on your investment.

Just like a classic cars (new or old), it all depends on your preference. With either choice, you know you'll love it and care for it. No two opportunities are alike as potential owners, practices, markets, and lenders are all different, but we hope this information will help you make your million dollar decision. **ap**

Ed Webman, RPh, is a former pharmacy owner, a longtime NCPA member, and loan officer with Live Oak Bank. Brian Faulk is a loan officer with Live Oak Bank and a professional practice lender for veterinarians, dentists, and independent pharmacies. More information is available at www.liveoakbank.com.