How Much Is It Worth?

Determining a pharmacy’s value from a lender’s perspective

By Ed Webman, RPh

With the average pharmacy owner about 60 years old, it is expected in the coming decade more than 60 percent of independent pharmacies, or same 1,000 annually, will trade or change ownership. While some of these pharmacies will be bought by chains as prescription file buys, an increasing number of young entrepreneurial pharmacists are seeking to acquire established pharmacies.

It’s easy to understand why a pharmacist would choose to acquire an existing pharmacy instead of starting from scratch. A successful startup pharmacy will generally take two years to reach break even, with the owner often having to take a reduced salary or no salary at all as business develops. As the average established independent pharmacy generates approximately $4 million in gross revenues, generally, there is ample cash flow after all expenses, to service debt and compensate the owner comfortably. The key of course, is finding a fair valuation for the buyer and the seller to make the transaction feasible for each.

A pharmacy’s value is made up of tangible and intangible assets. Tangible assets include inventory, furniture, fixtures, and equipment (FFE), accounts receivable (A/R), and sometimes real estate, which includes the land and building. The intangible assets, or those which cannot be seen, touched or measured, include prescription files, customer lists, and goodwill. The pharmacy’s value is the sum of the tangible and intangible assets less any liabilities.

**Tangible Assets**

The tangible assets are valued by a physical count. A physical count is usually taken just prior to closing of the sale to determine an accurate value for the pharmacy’s inventory. In an established pharmacy, the FFE is generally fully depreciated and given minimal value unless there is something new and significant, such as robots or clean rooms. In that case, the FFE may be valued separately. A pharmacy’s A/R is generally retained by the seller of the pharmacy, requiring the buyer to bring sufficient working capital to sustain initial operations. A pharmacy’s liabilities, any debt and accounts payable (A/P), are generally retained or settled by the seller at or prior to the closing of the sale. If the pharmacy sale includes real estate, a commercial real estate appraisal is generally ordered to determine an accurate value of the land and building.

**Intangible Assets**

A pharmacy’s intangible assets are by definition less exact to value. While the value of the intangible assets and ultimate selling price is determined by a negotiation between the buyer and seller, an initial valuation can be done through the use of a formula or a range of formulas to establish a fair value. These formulas take into account a number of factors, including the pharmacy’s gross revenue, net income, gross profit, number of prescriptions filled, and pharmacy inventory, evaluated either individually or in combination.
Additionally, other nonfinancial factors must be considered. (see box on page 28)

One of the first determinations in valuing a pharmacy’s goodwill is establishing a reasonable cash flow or NOI (net operating income), which includes the owner’s compensation. We do this by making adjustments to EBITDA (earnings before interest, taxes, depreciation, and amortization). Keep in mind, when evaluating a pharmacy’s financial statements, whether they are tax returns, internally prepared, or prepared by the seller’s accountant, they must be adjusted or normalized. Common examples of items that need to be normalized include owner’s salary, rent, and other expenses that will not be carried forward by the buyer so they may be added back.

For example, let’s assume the owner is working only half time as a pharmacist along with a staff pharmacist and will need to be replaced upon the sale (by either the buyer or an employee pharmacist). In this case, we would deduct one-half pharmacist’s salary from NOI to fully staff the pharmacy. If the seller owns the building, are they charging themselves a reasonable rent? If it is too high, rent will need to be added back; if too low, a deduction must be taken. Additionally, many owners include expenses that may be personal in nature, including memberships, auto expenses, and spouse’s salary. These expenses are generally added back to cash flow or NOI.

Other items to consider when utilizing formulas to determine value are the nature of the pharmacy’s business. Is the pharmacy a traditional retail pharmacy? Or, is the pharmacy obtaining additional revenue from services including compounding, infusion, immunizations, education, MTM, and 340B. If the pharmacy is providing a significant amount of compounding and infusion services, you would expect to
see a higher gross profit percentage with a higher labor cost. If the pharmacy is dispensing a large number of specialty medications, you would expect to see higher gross revenues but with a lower gross profit percentage. If the pharmacy is a large 340B provider, you would see low gross revenues as there would be no product reimbursement and only dispensing fees.

**Example Pharmacy**

To examine the use of pharmacy formulas, we will use the pharmacy example below:

<table>
<thead>
<tr>
<th>TOTAL SALES</th>
<th>$4,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>COST OF GOODS</td>
<td>$3,200,000</td>
</tr>
<tr>
<td>GROSS PROFIT</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>OWNER’S COMPENSATION</td>
<td>$120,000</td>
</tr>
<tr>
<td>INTEREST</td>
<td>$50,000</td>
</tr>
<tr>
<td>DEPRECIATION</td>
<td>$35,000</td>
</tr>
<tr>
<td>AMORTIZATION</td>
<td>$22,000</td>
</tr>
<tr>
<td>SELLING &amp; GEN. ADMIN. EXPENSES</td>
<td>$630,000</td>
</tr>
<tr>
<td>TOTAL EXPENSES</td>
<td>$857,000</td>
</tr>
<tr>
<td>NET INCOME</td>
<td>$143,000</td>
</tr>
</tbody>
</table>

**Pharmacy Formulas**

1. **Percentage of Sales + Inventory**: A simple method to estimate a pharmacy’s sale price is to multiply the pharmacy’s total sales by a percentage and then add inventory. In today’s market, 15 percent is used as the multiplier.
   
   Value: $4,200,000 x 15% = $630,000 + $300,000 = $930,000

2. **Net Income**: We simply multiply the net income of the pharmacy by a multiplier. In today’s market, 5x is commonly used.
   
   Value: $143,000 x 5 = $715,000

3. **Gross Profit**: We simply take one year’s gross profit.
   
   Value: $1,000,000

4. **Per Prescription + inventory**: This valuation is commonly used by chains in purchasing a pharmacy prescription files and customer lists. The range of prices paid per prescription varies widely. In this case, we will use $12 per prescription filled in the past 12 months. (Generally when a chain buys Rx files, 100 percent of the price per Rx is not paid up front, with the balance being paid as the pharmacy transfers prescriptions to the chain store.)
   
   Value: 65,000 x $12 = $780,000 + $300,000 = $1,080,000

5. **Net Income + inventory**: Similar to the method listed above, No. 2, except we use a different multiplier and add the inventory as well.
   
   Value: $143,000 x 4 = $572,000 + $300,000 = $872,000

6. **NOI + inventory**: In this method the NOI is normalized, multiplied by a factor and then inventory is added in. In this case, the owner works half time as a filling pharmacist so the NOI of $370,000 is reduced by $60,000, yielding an adjusted NOI of $310,000. The factor used varies, usually from 1.5 to 3.5. In this example 3x is used.
   
   Value: $310,000 x 3 = $930,000 + $300,000 = $1,230,000

Example Pharmacy To examine the use of pharmacy formulas, we will use the pharmacy example below:
 SOME NONFINANCIAL FACTORS AFFECTING A PHARMACY’S VALUE

- How is the pharmacy trending? Are sales increasing? Decreasing? Level? How are profits trending?
- Are the pharmacy’s revenue streams sustainable? Is there a concentration risk?
- Are they diversified? (retail, LTC, compounding, DME, other services)
- Is the pharmacy overly reliant on a single customer (such as an LTC facility)? A single referral source (clinic or physician group)? A single payer (insurance company, Medicaid, 340B)? A single employee (including the seller)?

Make certain to pay for a pharmacy’s historical performance, not a perceived potential. The physical appearance and condition of the pharmacy is important. Is it in good repair or is the pharmacy in need of a remodel and the replacement of fixtures and equipment? Is the inventory current or is it out-of-date and shop-worn?

How is the local community and local economy? Growing? Stagnant? In decline? How is local competition? Chains? Grocery stores? Other independents?

What are the lease terms? What are the terms of the sale? Is the seller providing a significant part of the financing through a seller note? Is the seller motivated? Is the buyer motivated? Does the acquisition provide a synergy for the buyer. Is the buyer a local competitor?

Final Thoughts
Today’s independent pharmacy marketplace is quite different from that of 30, 20, or even 10 years ago. Independent owners are filling a wide variety of niches unmet by larger providers and not contemplated by the corner drug store of yesteryear. Many of today’s most successful pharmacies are hybrid pharmacies providing a variety of services including retail, LTC, compounding, immunizations, education, and DME, with vastly different costs and profit structures. We see a range in valuations, again starting points, in the previous examples from $715,000 to $1.23 million. To account for the breadth of pharmacy practices, to provide an accurate measurement of a pharmacy’s value to its present owner as well as the value of the earnings potential to its potential buyer, we believe the last method (No. 6, NOI + Inventory), to be most reflective of an equitable pharmacy value. The adjusted NOI reflects the cash generated by the business regardless of the pharmacy’s gross revenues, gross profit, rent, labor, and other costs. After all, you pay your vendors, your employees, your debts, and yourself with cash. The value of a business is best reflected by its cash flow or cash generated by the business plus the tangible assets purchased, in this case inventory. 

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