VALUING A COMMUNITY PHARMACY AND OTHER FINANCIAL CONSIDERATIONS©

The process of valuing a business, large or small, can be a complex one. There are numerous approaches to the process, many variables and a wealth of published material from which one can get input on how to perform the process. This material ranges from lengthy, hardcover books to many, many magazine articles and other source material that discusses, delves into and deals with the process.

There are many in the pharmacy world, academics, business owners, outside professionals and lenders who constantly declare that evaluating a pharmacy is a process that requires special skills and knowledge, and the many of the premises on which the valuations are based are special and unique to the world of pharmacy. While there is some truth to this premise, much of the valuation process of any business, large or small, public or private, depends on sales, profits and what I term “free cash flow.” Simply put, free cash flow is money available from gross profits to meet a buyer’s three most important needs:

1. The need to pay him or herself a decent managerial salary for running the business or, in the case of an absentee owner, to pay a manager to run it for them.
2. The need to get a reasonable return on any cash investment they make in the purchase, since they are putting out money at risk.
3. The need to service any debt incurred in the course of the transaction.

The first two of these are definitely variable. One person’s idea of a “decent” salary may not be another’s. Depending upon what the current earning power of the buyer is, where they are or are not employed, what their needs and expectations are, this figure can vary widely. Many people are willing to work for little or no salary for some period of time, in order to build a business, grow the sales, investing the profits back into the business, what otherwise might be their salary. They may have the support, financial and otherwise, of a spouse or partner while doing this. Others may need to draw a salary as soon as they purchase a business, in order to support themselves or their families, or both.

On the matter of return on investment (ROI), that, too, is a variable. One simple premise that might be applied here is that a buyer’s return on his or her cash investment should be at least TWICE what they might expect from some sort of very conservative fixed income investment, T-Bills, municipal bonds or the like. When one considers that investing in a business is always a risk, no matter how minimal, I like to apply this rule of thumb in order to make sure that if a buyer is investing significant dollars in the acquisition of a pharmacy, their expectations in the way of return on that investment are reasonable. But to reiterate the earlier premise, this is definitely a variable item. A buyer might be willing to settle for NO return on his or her cash investment in order to make an acquisition work from a financial standpoint.

The third item, debt service, is definitely NOT a variable. When a buyer signs a note for money borrowed to purchase a business, regardless of the source of funds, they MUST have the free cash flow to service this debt in a timely manner, or else risk losing everything they have invested in terms of time and money. Accordingly, when evaluating a pharmacy acquisition, it is critical that the prospective purchaser have a clear understanding of what the debt service will be and, to the best of their ability, ascertain that the free cash flow of the business can support that debt service, as well as all the expenses required to run the business.

It is important for prospective buyers (and sellers) to keep these premises in mind when evaluating a pharmacy for purchase or for sale, either way. For buyers, the ability to meet these criteria will be important to their economic and professional future. For sellers, the ability to correctly value the business will enable them to hopefully sell at a fair price, one commensurate with the stated value in the market. This issue comes into play in two areas, one where the seller may be the lender on the transaction, holding some portion of the purchase price in a note of some kind, the other where the seller owns the property the business occupies and, regardless of financing considerations, will still be a landlord to the new owner.

Last but not least, I am definitely NOT in favor of applying so called “rules of thumb” or formulas when valuing a pharmacy, particularly if they are keyed to sales in any way. With all due respect to the many of my colleagues, financial professionals and academics as well as other consultants, who may suggest using some sort of percentage of annual sales or multiple of daily or monthly sales when valuing a pharmacy, my experience over the years tells me that these formulas rarely if ever address the three issues I have raised earlier in this article. The same holds true for multiples of net worth. To use these as anything more than a rough guideline is, I believe, doing a disservice to a buyer, a seller, or both, when evaluating a pharmacy prior to its sale.