

# Expert Advisor: Valuation Insight in a Changing Market

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## Disclosure

Jimmy Neil is the General Manager of Pharmacy with Live Oak Bank. The conflict of interest was resolved by peer review of the slide content.

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## Learning Objectives



1. Explain key data to gather in assessing pharmacy purchase.
2. Discuss trends in pharmacy valuation.
3. Review the proper instruments of negotiation.

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## Why Banks Finance Pharmacies



- Deposits
- Credit cards
- Low default rates
- Opportunity
  - › Average pharmacy acquisition project \$1.6MM

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## SHORT TERM FINANCING

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Lines of Credit  
Wholesaler notes/Inventory Buy-Ins

## LONG TERM FINANCING

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### CONVENTIONAL

Balloons  
Loan Covenants  
Collateral Requirements  
1-2% Origination Fee

### SBA

Full Amortizing - No Balloons  
No Loan Covenants  
Collateral is not part of decisions  
2.25% - 2.62% SBA Guaranty Fee  
GP vs PLP Lenders

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## Your Funding Timeline

START FROM YOUR **DESIRED FUNDING DATE** AND WORK BACKWARDS:

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## THE FIVE 'C's of PHARMACY LENDING

1. Credit
2. Competency
3. Cash Flow
4. Collateral
5. Cash

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## Credit



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# Competency



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## Collateral



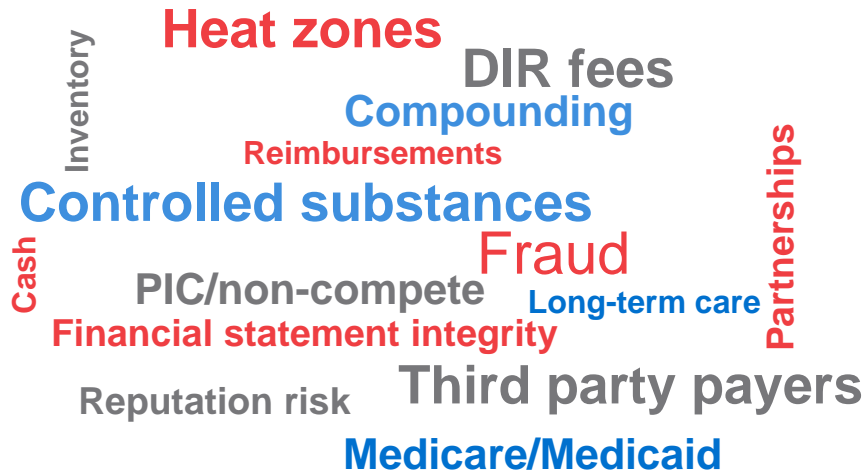
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## Cash



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## The Importance of Due Diligence



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## Commonly Used Terms in Lending



- EBITDA: Earnings before interest, taxes, depreciation and amortization.
- Add-backs: Expenses that are added-back to cash flow to normalize a profit and loss statement.
- NOI: Net operating income, often called cash flow. Includes EBITDA + add-backs + owner's compensation.

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## Terms Continued



- Loan Term: The period of time over which the loan is to be repaid.
- Loan Amortization: The period of time over which the loan payments are calculated.
- Balloon: A loan which does not fully amortize over its term. Since it is not fully amortized, a large single payment is required at the end of the term to repay the remaining principal balance of the loan.

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## Terms Continued



- Debt Service Coverage Ratio (DSCR) is the ratio of the cash available to service debt and the total debt service for all interest, principal and lease payments.

**Formula: EBITDA / total debt service = DSCR**

- Aim for a DSCR of 1.40 as a minimum.

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## Understanding the Income Statement

Revenue  
 - Cost of Goods Sold  


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 = **Gross Profit**  
 - Total Expenses  


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 = **Net Profit / Loss**



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## Normalizing Profit

### Simple P&L

Revenue: \$3,700,000  
 - COGs: \$2,850,000  


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**Gross Profit: \$850,000 (23%)**  
 - Total Expenses: \$660,000  


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**Net Income: \$190,000**

### Expenses Include:

Wages \$480,000  
 Rent \$35,000  
 Auto \$14,000  
 IRA \$40,000  
 Legal \$20,000  
 Other \$61,000  
**Interest \$5,000**  
 Depreciation \$5,000  
 Amortization \$0

EBITDA

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Traditional Add-backs		Discretionary Add-backs	
Interest	\$5,000	Auto	\$10,000
Depreciation	\$5,000	IRA	\$40,000
Amortization	\$0	Legal	\$15,000
<b>EBITDA:</b>	<b>\$200,000</b>	<b>Material EBITDA:</b>	<b>\$265,000</b>



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## Determining Available Cash Flow

Net Operating Income (NOI)

- Simple measure of cash flow available for owner's compensation and debt service
- NOI will identify the amount of cash available in the business based on historical performance
- NOI may include:
  - Officer compensation
  - One-time expenses
  - Interest
  - Amortization
  - Depreciation
  - Rent

NOI  
is  
different  
than  
EBITDA

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## Valuing Goodwill (Script Files)

➤ The most relevant method is the income-based method

➤ The multiple is  $(3.0 \times)$

➤ Material EBITDA  $\$265,000 \times 3 = \$795,000$

### 2 Additional Methods:

% of annual revenues

\$ times annual scripts

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## Types of Acquisitions

### STOCK PURCHASE

Buyer purchases the seller's corporation.

### ASSET PURCHASE

Buyer purchases only the pharmacy assets. Two types of assets:

1. **Tangible Assets**
  - ✓ Inventory
  - ✓ Accounts Receivable
  - ✓ FFE (Furniture, Fixtures and Equipment)
  - ✓ Commercial Real Estate
2. **Intangible Assets**
  - ✓ Goodwill
  - ✓ Prescription Files

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## Expansion Options

There are several options for growing your pharmacy business—through building a 2<sup>nd</sup> location, buying a second location or buying a competitor's files. Each has several risks and benefits.

### Build Location

- ✓ Distance
- ✓ Competition
- ✓ Customer base
- ✓ Projections/break even point
- ✓ Risks vs. rewards

### Buy Location

- ✓ Distance
- ✓ Competition
- ✓ Customer base/staffing
- ✓ Cash flow
- ✓ Assets vs. stock

### File Buy

- ✓ Increase Rx counts, increase margins
- ✓ Minimal expense addition
- ✓ Customer retention through transition planning

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## Deal Structure

If you accurately quantify EBITDA and use 3.0x multiple:

**1.8 debt service coverage ratio (DSCR) every time**



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## How Much Cash Do I Need?



Combination of:



**Aim to have a minimum of 10% down**



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## Take a Logical Approach



### Do:

- Understand the practice niche (how it differentiates from competition)
- Understand the practice cash flow
- Retain industry experts (CPA, lawyer, banker)
- Be prepared for the unexpected
- Prepare a budget for the future to gauge your performance

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## Take a Logical Approach



### Don't:

- Limit yourself to what is there - look for potential
- Pay for potential
- Be impatient - make a business decision
- Assume negative trends are easily reversed or that positive trends will always continue

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## Questions?

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