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Golden goose or stuffed chicken?

A *BRW* article (30 Jan–5 Feb 2003) titled 'Chemists take a clinical approach to sick sales' is a timely reminder of the incredibly rapid changes retail pharmacy is undergoing right now. Yes, that's right now!

Fearless borrowers

Having spent almost 20 years working with pharmacists buying pharmacy businesses, it has never ceased to amaze me how fearless they are when it comes to borrowing huge sums of money which, of course, must be repaid. Thanks to continued government regulation, growing demand and new blockbuster drugs, the pharmacy 'golden goose' has continued to lay golden eggs in the form of growing net profit dollars, sufficient to fund loan repayments, taxation, living costs and working capital needs.

It's pleasing to see that the smart buyers, before signing a purchase contract, look more carefully at what they can do post acquisition to grow net profit dollars. But the great majority of buyers don't!

Unfortunately, many buyers still believe that the pharmacy will grow no matter what and, provided they pay the market price, that the loan will look after itself.

Growing net profit (cash flow)

How wrong that assumption is can be found in the *BRW* article which contains a dose of good old reality. It points out that pharmacy is losing market share in retail categories to supermarkets and discount department stores, particularly beauty. It also identifies that pharmacy is relying more heavily on prescription sales—the volume and profit of which are controlled by the Federal Government—and that pharmacy must find other health-oriented income streams to ensure net profit dollars continue growing.

As I have been saying for years, traditional retail pharmacy must find new retail health category income streams. This is to make up for falling dispensary profitability caused by lower margins, Government attempts to claw back generic discounts (February 2003) and rising overheads (salaries and shopping centre rents), to create a strong retail healthcare niche that will differentiate pharmacy from grocery and other competitors.

> Those who do have constructive growth plans, and apply them, create pharmacies that continue to lay golden eggs

These categories include cough and cold, analgesics, flu, hay fever, children's medicines, quit smoking, nutrition (not just vitamins), weight loss, wound care, home healthcare, skin care and so on. I have seen several of our client pharmacies flourish by concentrating their retail effort on these categories.

Of course, that sounds easy and most pharmacists tell me that they're doing it too. But they simply aren't because most only stock the product without adding much value or adopting retail strategies to drive up volume.

Message to borrowers

Those buying, or buying into, pharmacies via succession plans must understand the importance of this argument because their loan repayments will only be funded from future profits, not past. Furthermore, these must grow significantly. That's the reality!

Also, if net profit doesn't grow there won't be much, if any, capital gain (investment reward) achieved when the store is sold. So what's the point?

Unfortunately I have seen many paying premium market prices for businesses that don't achieve net profit growth for several reasons. First, the store lacked inherent growth opportunities. Second, the buyer didn't possess the necessary retail business skills (common). Third, the majority partner wouldn't permit the required changes. The third point is of great concern because many older owners sell minority equity to over-eager young pharmacists at unaffordable premium market prices.

So, the message for those buying pharmacy equity funded by high debt levels is to look very carefully at how much the business will grow and how that growth will be achieved, rather than simply assumed.

Growth versus repayment term

The importance of the relationship between pharmacy market prices, future net income growth and repayment term is best demonstrated by example using our Loan Payback Period Ready Reckoner model.

Assume:

Current net profit (after owner wage)	$180,000
Cap rate applied	18%
Market price	$1,000,000
Borrow (incl. acquisition costs)	$1,060,000

At 7 per cent interest, the business net profit dollars will need to grow by almost 8 per cent every year in order for the loan to be repaid over 10 years, income taxes paid and some funds left in the business to fund working capital.

If we vary the numbers slightly by assuming that net profit will only grow by 4 per cent per annum, the loan will take nearly 12 years to repay, which is normally well outside bank pharmacy lending policy. But if there's little or no

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