# Value, valuing and valuations

A REALIGNMENT IN THE MARKET VALUE OF PHARMACIES IS IN THE INDUSTRY'S LONG-TERM INTERESTS, WRITES **MARK NICHOLSON.***

Over the past 20 years the market for pharmacy businesses has proved to be more liquid, resilient easily financed, active and highly valued than any other Australian small business sector.

Pharmacy is also emerging from a period of active consolidation where acquisitive groups were pump-primed by wholesalers and banks, fuelling the market with easy finance and extended credit terms. Now that all three participants to this process have withdrawn to a more normalised position, pharmacy business values are slowly retreating.

This article sets out to explore some of the risks, outlooks and valuation anomalies associated with pharmacy businesses to assist all industry participants in making more informed decisions.

### MARKET PRICE VS VALUE

International Valuation Standards defines market value as: '...the estimated amount for which a business should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.'[1]

These Standards also consider market value as being distinct from market price, which is 'the price at which one can transact', while market value is 'the true underlying value' according to theoretical standards. The latter concept is more likely to happen in inefficient markets or disequilibrium situations where prevailing market prices are not reflective of true underlying market value.

Pharmacy owners, brokers and sometimes even bankers can be critical of independent valuations where the assessed market value is less than the perceived or eventual market price. Yet for market price to equal market value, the market must be informationally efficient and rational expectations must prevail. This is rarely the case in a highly liquid and active sharemarket, let alone the small-to-medium business market for Australian pharmacies.

### VALUATION METHODOLOGIES

Discounting future cash flows (DCF) is a valuation method used to derive the intrinsic value of a business. It is universally accepted as the preferred and most appropriate business valuation method.

DCF is complicated though and requires:

- **the estimation of future profits;**
- **translating those profits into cashflow forecasts; and then**
- **converting the future cashflows into a value which will deliver the required return on investment (ROI).**

There are short-hand valuation methods which are less accurate but more easily understood as they simplify all future variables and assumptions into one multiplier which is applied to an estimated maintainable earnings.

The term capitalising earnings describes this process as it converts future profit estimates into a capital sum. This is done via the use of a capitalisation rate. For example, a future cashflow of $100 per annum capitalised at a rate of 20% converts to a purchase price of $500. Hence a purchaser would hope to get a 20% return ($100/$500) p.a. on an investment of $500.

### ROI VS CAPITALISATION RATE

ROI and capitalisation rate are often used interchangeably by investors yet are two different concepts.

ROI is the required return an investor requires over the life of an investment and is used as the discount rate to adjust for the time value of money within the DCF valuation method. A capitalisation rate is a multiplier as described above.

The two figures will line up where future annual cashflows are expected to equal the projected profit that is being capitalised, but this is rare for Australian pharmacies. In fact capitalisation rates over the past 15 years have fallen from about 25% down to, in some circumstances, 15% but have recently returned to 17%+.

In contrast, purchasers' required rates of return will not or should not have altered significantly. Why? Because a ROI is the required rate of return for taking on the risk of a particular investment relative to the alternative investments available (eg. bank deposits, shares, property etc). Hence, over the period when capitalisation rates reduced, ROIs should have kept delivering the historically achieved 20%+.

So how is the gap between capitalisation rates and expected ROI explained? While purchasers may be potentially ignorant of the theory, the gap is sustained so long as business profits are growing. For instance, a first year return of 16% (using a capitalisation of 16%) on a purchase price can grow into a return exceeding 20% in future years through growth strategies, industry trends and so on. This optimistic view has been the reality for many owners who purchased their business during the 'Nineties' and 'Naughties'.

This decade, however, now has medicine price reductions driven by weighted average disclosed pricing (WADP) to contend with. Therefore, buyers, banks and valuers are now adjusting their expectations of future cashflows and incorporating these views into the capitalisation rates used when assessing market value.

### THE MARKET

In normal circumstances a seller of any business (especially those worth more than $1m) has to: be patient; have adequately prepared their business for sale; and be subjected to a substantial due diligence process involving legal, banking and operational considerations.

The Australian pharmacy market (assuming it is one market) may be efficient but is certainly not perfect—pharmacy sale transactions usually occur on short timeframes due to excessive demand, relatively easy finance, a very efficient broking market and short due diligence timeframes. This is due to the largely homogenous nature of pharmacy businesses where income streams are prescription/government-dominant and operational expenses, largely comprising rent, wages and advertising, are easily understood.

Due to this relatively consistent business model, the valuation methodology has evolved over time to one which capitalises the most

recent 12 months profit (before interest, tax, depreciation, leasing and amortisation). Assuming access to reliable POS and dispensing reports, agreeing on a profit figure is generally not difficult.

This is a somewhat crude methodology (by comparison to the DCF method) and generally does not reconcile an investor's expected ROI with the implied capitalisation rate. But it has not necessarily mattered greatly until recent years as pharmacies have generally enjoyed rising profits and most pharmacy owners' current ROI in dollars will exceed the profit expectation upon purchase.

However, it is possible many pharmacies will make less profit in 3-5 years than they do now and it is therefore worth understanding the valuation process and the relationship between market value and market price.

### WHAT IS BEING VALUED?

If what is being valued is 'the pharmacy business', then the key assets ordinarly being purchased are the stock, goodwill (including the right to have a new Medicare number issued to receive PBS income) and equipment, fixtures and fittings, together with the right to occupy the premises, staff and so on. Other assets (eg. amount owed at settlement by customers and Government) and liabilities (eg. amounts owed to suppliers) are normally retained and remain the responsibility of the seller.

Incumbent in considering value is the premises lease and the ability to occupy a site that is in suitable condition (not necessarily the business' current site) for the foreseeable future. Moreover, if the business being acquired requires a new fit-out (or a renewal), then it may be appropriate to adjust the investment valuation required by the purchaser. This has historically not occurred but should be increasingly considered given not all fit-out investments prove to be self-funding (especially ongoing refits required under shopping centre leases).

### MARKET DISTORTIONS

All markets can be distorted by a range of factors and one of the most common is access to capital. Between 2004 and 2009 the Australian pharmacy market enjoyed a highly competitive banking environment where access to cheap finance was comparatively easy compared to many other business sectors. It was not unusual for preferred lenders to purchase pharmacies on initial 90% + interest-only debt terms.

Wholesalers also provided unprecedented support during this period to preferred owners on an acquisition trail. Extended credit terms of 90-180 days on initial purchases, and 60 days for ongoing purchases, was not unusual.

These two factors effectively pump-primed the market prices (distinct from market value) of pharmacies which has left a legacy that is only now beginning to unwind itself via reducing market prices, bankruptcies and bad debts for banks and wholesalers.

### SINGLE OR MULTIPLE MARKETS

Market prices in various locations for similar style pharmacies with similar projected profits and cashflows can vary significantly due to localised factors that produce different levels of demand for a similar asset.

Accordingly, as an investor there is a need to consider where the greatest return on your investment can be generated. In a perfect market, all factors would be equal and market price would equate to market value. But this is not the case if considering, for example, country pharmacies which usually have lower purchase prices for the same profits as capital city pharmacies, despite often carrying lower earnings risk and more growth opportunity.

Despite the requirement of the owner to be registered as a pharmacist in the state where the pharmacy is located, Australia is a single homogenous market. Until recently, this was not the case with former WA law requiring an owner to be resident in WA.

Price variations driven by supply and demand factors, or purchaser's lifestyle preferences, are contributors to market price variations but not market value. Market price does, however, need to be considered by a valuer and purchaser because sometimes market prices may be lower than market value. This may occur, for example, in remote locations or areas that provide difficult work conditions. Where this is the case, then whichever price is lower—market value or market price—will prevail when determining value for financing and acquisition purposes.

**...BUYERS, BANKS AND VALUERS ARE NOW ADJUSTING THEIR EXPECTATIONS OF FUTURE CASHFLOWS...WHEN ASSESSING MARKET VALUE.**

### THE OUTLOOK

As noted above, the industry outlook for earnings has shifted in expectation of the impact that ongoing WADP mechanisms will have. Earnings may increase initially for some pharmacies as medicines come off patent (eg atorvastatin) but eventually, in the absence of script and/or retail sales growth, medicine price reductions will reduce net profit. Therefore, industry net profits are expected to reduce in 2015 and continue for a year or two thereafter until WADP effects are fully realised.

Coincidentally, 2015 is the year that should see the execution of a Sixth Community Pharmacy Agreement with perhaps an increased focus on the delivery of services and associated remuneration. Overlaying these industry expectations is an impossible-to-predict global and local economy that continues to depress retail sales but in turn is offset by an ageing population and a Government incapable of funding their medical services needs.

Translating these expectations into profit and cashflow forecasts to support a valuation is accordingly fraught with difficulty. Earnings volatility risk has increased and is arguably greater than it has ever been before. Yet capitalisation rates and price multiples continue to be supported by a market where prospective buyers significantly exceed sellers. It is unlikely that this situation will change in the near future and may even increase, given the pharmacy graduate growth and declining wage rates.

Pharmacy values are a function of earnings and a capitalisation rate. Values have reduced recently as capitalisation rates have begun increasing in response to the future income pressures. Capitalisation rates may come under more pressure if banks tighten lending policies and increase lending interest rates. Therefore, having a clear and achievable growth strategy that can maintain or increase earnings is the key to ensuring today's pharmacy values can be maintained or even increased into the future.

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1. IVS 1 Market Value Basis of Valuation, 7th ed: p4.