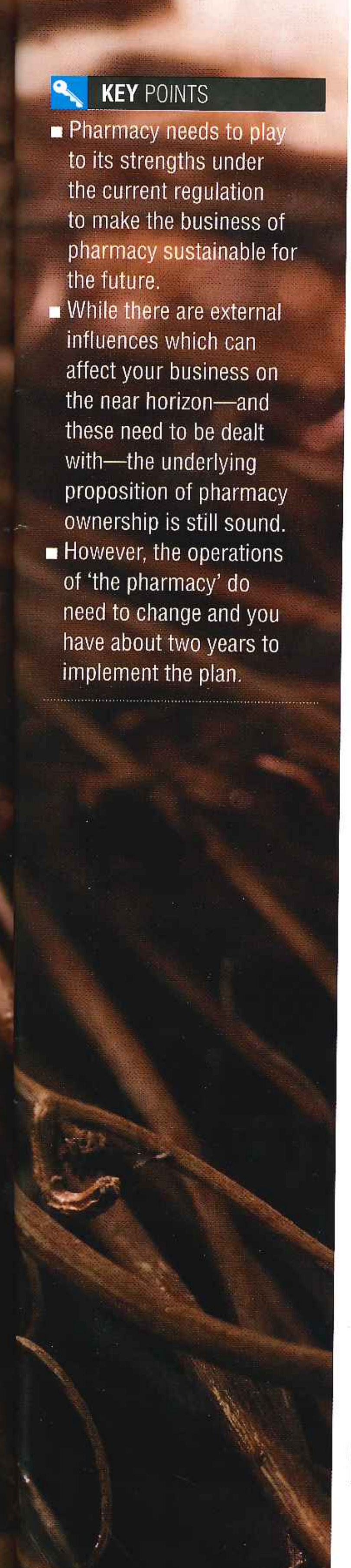
PLAN AND PROTECT YOUR WEALTH

PHARMACY OWNERS CAN SPEND THEIR ENTIRE LIVES WORKING IN THEIR PHARMACIES BELIEVING THE CAPITAL SUM INVESTED WILL PROVIDE ENOUGH CASH FOR A SUPERANNUATION NEST EGG, OR MAYBE EVEN ENOUGH FOR THEM TO BUY ANOTHER PHARMACY AND EXPAND. WHILE THIS IS THE CASE FOR MANY PHARMACISTS, FOR SOME THE GOAL POSTS ARE BEING MOVED, SAYS **NORMAN THURECHT.**

KEY POINTS

- Pharmacy needs to play to its strengths under the current regulation to make the business of pharmacy sustainable for the future.
- While there are external influences which can affect your business on the near horizon—and these need to be dealt with—the underlying proposition of pharmacy ownership is still sound.
- However, the operations of 'the pharmacy' do need to change and you have about two years to implement the plan.



The concept of wealth creation/management is about taking a systematic approach to growing net worth. This occurs via the building of assets by means of careful investment, usually over a long period of time so as to achieve a desired outcome. You can often achieve this by making investments outside of pharmacy. That said, my focus in this article, however, is going to be around the investments you can make back into your business to grow/protect your asset. We won't be focusing on the internal business model, rather we'll be looking at the external influences which can affect your business/asset and, ultimately its value to you the owner.

REGULATION CREATES SUSCEPTIBILITY

There are many benefits to operating in a highly regulated environment. For instance, there's protection around location and the amount of competition that can exist within a given area; some competitors (and we mean supermarkets) are locked out from the bulk of pharmacy's product range; and the government is the largest customer.

However, recent actions place into sharp focus the fact that pharmacy needs to play to its strengths under the current regulation to make the business of pharmacy sustainable for the future.

RECENT EFFECTS ON VALUES

Since changes to the pharmacy location rules in October 2011, the value of the PBS number has fallen and is now effectively worthless (unless there were some strategic relocation opportunities for a pharmacy within those redefined relocation rules).

The demise of some large consolidators in the market has also seen the 'heat' come out of the market as there has been a reduction in access to capital (bank and wholesaler funding) continues to tighten. As a result, the value of pharmacies is now more likely to be a function of the net profit and 'opportunities' for that pharmacy than ever before.

The issue affecting net profits now, and in the medium term, is the continual effects of the Weighted Average Disclosure Price (WADP) mechanism which was first introduced in 2007, and amended in the Memorandum of Understanding in 2010 to be the Expanded and Accelerated Price Disclosure (EAPD).

To date, the effect on pharmacy net profits has been limited due to high volume, large dollar value molecules coming off patent allowing for substitution opportunities in the pharmacy. In other words, generic trading terms have been temporarily supporting the net profit of any given pharmacy.

The overall effect on pharmacy net profits will be varied due to a number of factors, including:

- **pharmacy molecule mix;**
- **dependency on dispensing PBS medicines;**
- **overhead structure (i.e. cost of space and staff);**
- **ability to engage with customers on something other than product sale in the pursuit of other income (whether Government funded or not);**
- **the ability to change the business model they current operate within the next two years.**

The Federal Government's 2014 Budget suggests they are expecting $3bn of savings from the price reductions over the next three years. While not all of this will come out of pharmacies' net profit, pharmacy will be affected.

Some may perceive the above as negative. The reality is, however, that there are many opportunities for pharmacy you just need to look for them.

1ST OPPORTUNITY—MERGING

As we [JR Pharmacy] travel around the country visiting pharmacies we see many locations where there are simply too many pharmacies operating within close proximity. And very few of them have any real point of strategic differentiation. So, while they may be making acceptable levels of net profit in the current environment, future price reductions in the dispensary mean, unless they do something now, they stand to make little or no profit in the future.

These circumstances are not limited to capital city metro areas. And we see these (stagnant) stores as merger opportunities to protect wealth and earnings.

While personality and ego often get in the way of a good partnership, the key in a merger is to focus on the business and what is best for the business. By way of example: two pharmacies located in a city strip location both with total overhead expenses of approximately $700,000 will benefit from the merger. Key expenses such as the duplication of rent, some wages (note key employees should be retained for customer loyalty), advertising, electricity, stationery, and so on, will mean that the merged pharmacy is more robust and sustainable but more importantly the cash-flow will then be available to implement the changes required to engage the customer and become a healthcare destination in the frontline of preventative healthcare—something that both the customer and government wish for.

Therefore, assuming the same multiple of earnings (or

TABLE ONE: **Advantages of succession**	
Seller	**Buyer**
Contemplation of selling 100% worse than small %	Outright purchase can be out of reach
Get $$ for super fund	Affordable purchase
Re-organise work/retirement life	Learn the 'ropes' /business management
Injection of new ideas/business support (5th CPA initiatives)	Grow responsibilities over time
Ready future buyer	Commercial salary
Satisfaction of remaining in ownership & contributing to customers/community	Finance secured by pharmacy assets

capitalisation rate) is applied, the combined value is higher for both participants than if they had stayed separate.

You may find that one owner takes out the other through the process of merger, or alternatively they will come together as one with the view to one exiting the business in the near future. This leads me into the second opportunity.

2ND OPPORTUNITY—SUCCESSION

Many pharmacy owners are overwhelmed by what is required to implement the necessary changes to their business model to protect profits and value. As a result, many just bury their heads in the sand. Waiting... A great example of this is the time it took pharmacies, on mass, to engage with the clinical intervention program.

Maximising the sale of a pharmacy in the current environment will take some work and having another owner with 'skin in the game' should help the changes to be realised.

The advantages of a succession are different for both parties and summarised in Table One, above.

In addition to the above points, depending on your age and circumstances, selling now may not be your best wealth-creation strategy. For instance, the current prospect might be to sell now for a higher price and accept lower investment earnings, or sell at a date in the future for a lower price but enjoy higher earnings in the meantime. In other words, the return on investment able to be achieved by pharmacy will exceed some other investment asset classes in the future despite the fact that pharmacy earnings will be reduced in the near future and may not all be replaced by other sources of income. See Table Two, below.

Therefore, assuming the pharmacy is robust, management can make changes to the business to cope with the current environment, and therefore the earnings can be managed. Staying in ownership for three or more years will yield a stronger return than selling out now and trying to match that return in the medium term.

Nevertheless, each person's decision making and circumstances will differ and you will need to seek advice before acting.

TABLE TWO: **An example of pharmacy earnings from selling now vs selling later**		
	Sell Now (invest outside pharmacy)	Sell Later (retain capital in pharmacy)
Net Capital Invested	$1.0m	$1.0m
Invested with income @ average 5%	$50k	
Investment return decreases to average of 15%		$150k
After tax earnings p.a. (Tax @ average of 30%)	$35k	$105k

3RD OPPORTUNITY—MEDICAL CENTRES

If the decision is to stay in ownership (whether as a merged business, 100% ownership or under a succession arrangement), there may be the need to consider alternative use(s) of space within the pharmacy, as pharmacies are experience shrinking sales and profit per square metre through competitive forces and deflation in dispensary sales.

An alternative use of the space and an opportunity to supplement possible shrinking pharmacy net profit is to consider converting some of the space into a medical centre either by yourself or in collaboration with a doctor/s

There are specialists to assist with locating the doctors but the core proposition is getting easier as a result of higher numbers of graduating and emigrating doctors. Similar to the increase supply of pharmacists, there has been an increase in the number of graduating doctors due to the initiatives of the Howard Government.

In our experience with clients undertaking such activities, we are starting to see that increased supply in the marketplace which is in turn is starting to place pressure on their remuneration levels. From a business perspective this should translate to more doctors working and wanting ownership opportunities in the future.

While there are business risks associated with this option, they may outweigh the cost of doing nothing. This therefore represents the opportunity for some pharmacy owners who want to drive their pharmacy and investment dollars harder by diversifying.

IN THE END

While there are some issues on the near horizon that need to be dealt with, the underlying proposition of pharmacy ownership is still sound. That said, the operations of 'the pharmacy' do need to change and you have about two years to implement the plan.

The questions you must ask yourself are:

- **What is your own motivation and drive over the next five years;**
- **If it is wanning, is a merger or succession opportunity available;**
- **If not, how do you maximise your exit now because the return on investment outside of pharmacy may be too low to justify the sale in a low interest rate environment.**

The core underlying driver must be to create and protect your wealth through the process. ■

At JR Pharmacy we assist our pharmacy clients through these processes and once eventually sold we have a wealth management division which assists with maximising non-pharmacy investment returns. Should you wish to discuss your opportunities, please call Norman Thurecht on (07) 3222 8444.