G REPORT TO THE OFFICE OF FAIR TRADING PREPARED BY A.R. TOWNSEND, NATIONAL BUSINESS SALES MANAGER OF ORRIDGE BUSINESS SALES LIMITED

G.1 This study was commissioned for this investigation. It is the responsibility of the author and any views expressed in it are those of the author and not necessarily of the OFT.

Background to the market for pharmacy businesses

G.2 Pharmacies currently fall into two main categories – those under group (or multiple) ownership and alternatively, the independent sole trader. Occasionally, pharmacies have been established and run by consortia (often as part of a dedicated Medical Centre) which have usually been operated through reasoned rationalisation by 'affected' Pharmacists, i.e. a number of Pharmacy contracts have effectively been surrendered by neighbouring contractors, in the knowledge that only one efficient and profitable Pharmacy was required to adequately serve the neighbourhood/community from proposed new premises.

G.3 Pharmacies are run as going concern businesses at the expense and with the professional skill of the qualified Pharmacist. Pharmacies rarely survive on the NHS content of its throughput alone. Invariably Pharmaceutical services are proved through Pharmacy premises where the costs for these services are absorbed within the overall running costs of the business. The question arises, would the service continue to be provided without the back-up of the profit generated by the associated counter sales offered alongside the prescription medicines?

G.4 Around 300 independent pharmacies are bought and sold each year, with most of the sales going to private individual purchasers or to the smaller groups in the region. Not many sales were completed in 2001 with the major groups, such as Moss or Lloyds, and nothing sold to the supermarkets.

G.5 Over the last five to six years there have been some changes in the strategies of some national wholesale operators with new overseas 'parents' entering the arena, all with the ability to use 'buying power' to exert pressure on the independent owners trading conditions by offering pharmacy goods at substantially reduced prices as 'loss leaders' to encourage customers to their store to buy other non-pharmacy related goods; an advantage denied to the independent pharmacy contractor. With the exception of occasional bursts of activity amongst wholesale companies, there are marginally fewer sales taking place to independent contractors or smaller groups than there were five years ago. However, the trend towards multiple-ownership is increasing in certain areas and thus consumer choice is already diminishing.

The principles by which a retail pharmacy business is valued in mainland Great Britain

G.6 Anyone entering for the first time the seemingly complicated world of goodwill valuation as it relates to the Pharmacy profession could be forgiven for believing it was a unique place in the already specialised field of property valuation. FP34's; oxygen contracts; ESPS; dispensing doctors; the drug tariff; minor re-locations. These are all terms with which the valuer will be faced for the first time.

G.7 Outside pharmacy the valuer will have concentrated on the quality of investment and capital growth; alternative investment opportunities; factors which cause changes in the value of property (such as fashion, technology, planning control etc); the rates of investment and yields determined by stock market activity; and last, but not least, the effects taxation will play on the return on investment, net of finance costs.

G.8 The factors affecting the goodwill valuation of a Pharmacy business in fact differ very little from those relating to other retail outlets. The actual calculation is quite straightforward. In its most simplified form, it is an analysis of track record and projected performance, based upon known facts.

G.9 Major Factors Influencing Pharmacy Valuation include:

- **turnover** … and its constituent parts
- **gross profit**… and future achievability
- **overheads** … necessity, importance and reliability
- **adjusted net profit** … to reflect real income

G.10 These major factors can be sub-divided and analysed but there follows a précis of points which should be considered by a cautious purchaser:

- surgery/medical centre … movement and redevelopment
- G.P.'S prescribing habits
- Local authority/private enterprise development plans
- aggressive competition from stores and wholesaler groups

- availability and cost of finance
- costs of improvement to property and equipment
- suitability of existing staff
- necessity for longer opening hours
- changing consumer habits

G.11 A prospective purchaser will want to know how long the business has been established and will the profits generated by the business last long enough to repay the loan granted by the lender?

G.12 To assess the price the purchaser might be prepared to pay to the vendor, the experienced valuer will first turn to the evidence available to him from recent sales of similar opportunities and, of course, the age old rules of supply and demand will enter the equation at some point.

G.13 Given that the last three years trading performance is the usual starting point, the valuer will look at rising (and falling) trends in both turnover and gross profit and assess the likelihood of the trend continuing under new ownership. Falling trade might reflect recent changes in the location of doctor's surgeries (or their prescribing habits), new opposition in the area or movements (or spending power) in local population, due to adverse changes in employment.

G.14 Assuming there are no adverse considerations, the purchaser will look closely at the trade split between NHS business and associated counter sales. A Pharmacy biased towards prescription income will generally be of benefit to its saleability, if only that it reflects the community Pharmacists desire to practice within a caring profession. Pharmacy contractors have absorbed falling profits from the NHS sector by diversifying their business activities into more profitable lines open to them which patients/customers usually associate with the ''Chemist shop''. Over the counter medication will often be supplemented by household goods, photographic work, perfumery and even dry cleaning agencies, in an attempt to keep their outgoings as a sensible proportion of income generated. Pharmacies operating within the Essential Small Pharmacy payment scheme (usually located some distance away from major residential development areas) would fail to survive without this guaranteed income protection to supplement profits generated from counter sales.

G.15 Unless a proprietor can absorb rising overheads when faced with declining profit margins, his only recourse is to accept a reduced income for himself to safeguard the demise of his business.

G.16 Having already agreed that the business is 'sound', growing at a pace acceptable to the market and margins reflect industry standards, a purchaser will, generally speaking, pay a price calculated by reference to a multiple of adjusted net profit.

G.17 This multiplier invariably changes with desirability (e.g. location, NHS content/OTC ratio, rising trends), but often a higher turnover equals a larger multiplier. Between 4.5 and 6 times the adjusted net profit tends to be the market 'range', though in an acquisitive market place where there is limited availability of the most sought after type of Pharmacy (i.e. secure in relation to prescription source and in a stable community) multiples in excess of this level are sometimes achieved. Conversely, Pharmacies in deprived neighbourhoods might enjoy a substantial amount of business, though a less desirable environment in which to trade. Despite a pleasant location, those with a declining turnover and profits, dispensing fewer than 2000 NHS items per month, might not sell except at a substantially reduced price which would place severe strain on a businesses ability to remain viable. Its absence from the community might cause inconvenience and distress to the elderly and infirm patient.

G.18 Pharmacy Managers frequently command annual salaries of around £40,000, equivalent to an average hourly Locum rate of £17-18 per hour, and it is therefore accepted that the fixed costs to run a 'simple' Pharmacy will be around £80,000 per year. At this level approximately 5 per cent would pay salaries and wages, 2-3 per cent rent, rates and insurance and the balance to other outgoings. Given that the average gross margin generated will be in the order of 23 per cent, a turnover well above £300,000 is now required before any surplus 'profit' can be realised and thus the business would be considered to be under the threat of closure. Previously, a lower turnover business could remain profitable due to the higher gross margin then enjoyed. Final adjusted net profit produced following full appraisal is usually around 10 per cent of turnover.

G.19 A pharmacy already dependant upon a large proportion of its trade from counter sales for its very existence and now faced with new competition from one or more supermarkets within its catchment area, would immediately fall into the 'at risk' category. Initially goodwill value should fall to reflect potentially lower anticipated profits. Whether real or imaginary, a purchaser is likely to offer a lower price to safeguard future earning expectations. Whilst it is true to say some supermarket chains have paid over-inflated prices to secure NHS contracts in previous years the goodwill now offered appears to have fallen back in line with normal levels. Since the announcement that this inquiry was to take place, there have been no contract acquisitions by the supermarkets, pre-judging the possible 'free allocation' of NHS contracts in the future. The limited number of opportunities available in the market place for successful minor re-locations have no marked effect upon prices generally. They are isolated cases similar to 'special purchasers' i.e. an owner or group wishing to prevent a competitors introduction to the neighbourhood, who might bid higher than normal to ensure some degree of monopoly is retained.

G.20 Reducing profits will inevitably result in fewer Pharmacists wishing to entertain ownership, preferring the 'safer' prospects of Locum Pharmacy management, or working in Pharmacies which rely totally on NHS business for survival. Medical Centre situations, whilst offering lower margins than retail Pharmacies, present the devoted Pharmacist with the opportunity to satisfy his professional desires and caring ambitions to serve the community.

G.21 The main pressure recently has come from the abolition of Retail Price Maintenance, changes in Generic Pricing, the backlog in NHS payments which has now just recently been resolved and of course the announcement of the OFT enquiry into the current controlling of pharmacy contracts.

G.22 The 'market' by definition requires a number of players interested in making purchases. Internal policies dictate where the group operator will choose to develop. The acquisition of a wholesale supply organisation might lead to an increased level of competition for a pharmacy or group of privately owned pharmacies in a particular area. Equally, existing suppliers might increase their offer price simply to retain the wholesale margin which could be lost to the competitor.

G.23 Increasingly we see examples of smaller regional groups linking-up to counter the threat from multiples and supermarkets.

G.24 The formula for calculating pharmacy goodwill prices has remained fairly static over the last 5-10 years. The demand might have increased for a time in certain geographical areas, resulting in 'premium bids' from some operators, but, in general, prices will have moved up or down only in line with fluctuations in turnover and profitability, and, of course, the affect supply has on the market place.

An Illustrative Example of a Valuation

G.25 There follows a sample version of a calculation to arrive at the 'price' of a business i.e. the estimated sum a ready, willing and able purchaser might be prepared to pay for a Pharmacy Business with notes pertinent to each part which a competent Valuer might take into consideration.

Trading Details	Turnover	Gross Profit		Monthly NHS Items
Financial Year 1997	£543,968	£137,080	(25.2%)	3170
Financial Year 1998	£561,124	£138,036	(24.6%)	3180
Financial Year 1999	£587,072	£139,723	(23.8%)	3230
Projection	2000 £600,000 approximately			

G.26 This example shows that whilst turnover has increased year on year, its rate of growth (3.15 per cent, 4.62 per cent and (anticipated) 2.2 per cent) has hardly kept pace with inflation, and, in line with market expectations, the gross profit margin has fallen, whilst the dispensing trend has remained fairly static.

G.27 The turnover figures used in the analysis are extracted from the proprietors deposited accounts, which also show actual expenditure for the years stated, from which trends can be assessed. The lower a businesses turnover, the closer inspection of expenses becomes imperative. It is important to assess the *trend* of a businesses performance hence the need to look at the three years Accounts prior to the calculation, plus a reasoned projection of sales during the current year. It may be prudent to project turnover in an upward direction whilst conversely reducing the gross profit margin in line with market predictions. NHS margins vary between 15-21 per cent, whilst counter sales can vary between 25-35 per cent.

G.28 Against declining NHS margins, it is assumed a proprietor has worked harder to improve buying practices to restrict the fall to that currently declared. A less enthusiastic proprietor might have suffered a more dramatic decline

G.29 The 'NHS' content of a Pharmacy's turnover is calculated by reference to the monthly FP34's or statements received by the contractor from the Pricing Bureau/Health Authority. Comparison with the previous twelve months statements will either indicate a growth pattern or decline in dispensing habits.

G.30 Prospective purchasers indicate a preference for pharmacies dispensing over 3000 items per month (and on a rising trend) supported by counter sales (providing between 25 per cent and 40 per cent of total turnover), frequently the result of impulse buying rather than essential purchases, but from the proprietors point of view, these impulse buys could be essential to maintain the overall profitability of the Pharmacy.

G.31 Assume this business is now to be marketed in the present climate.

G.32 The proprietor (and the valuer) might expect a period of exposure to the market of between three and six months and thus it is reasonable to use the projected turnover of £600,000 at a notional 23 per cent Gross Profit as the basis for our calculation.

G.33 **Typical Trading and Profit and Loss Account:**

Turnover		£600,000
Apportioned £420,000 NHS (18%)	£ 75,000	
£180,000 OTC (34.6%)	£ 62,280	
	£137,880 (22.98%)	
Pharmacist & Locum Costs (i)	£ 42,000 (7%)	
Staff wages (ii)	£ 24,000 (4%)	
Rent & Rates (iii)	£ 12,000 (2%)	
Insurance	£ 1,800 (0.3%)	
Light & Heat	£ 1,200 (0.2%)	
Telephone	£ 1,000 (0.16%)	
Transport (iv)	£ 5,000 (0.83%)	
Post/Stat/Adverts	£ 2,800 (0.46%)	
Subscriptions	£ 1,200 (0.2%)	
Staff Training/Welfare	£ 800 (0.13%)	
Stocktaking	£ 340 (0.056%)	
Accountants/Audit	£ 1,800 (0.3%)	
* Repairs/Renewals	£ 2,000 (0.32%)	
* Bank charges	£ 1,500 (0.25%)	
*Loan Interest	£ 10,000 (1.6%)	
*Depreciation	£ 3,500 (0.58%)	
*Directors Fees	£ 20,000 (3.3%)	
	£130,940	
Declared Net Profit		£6,940

G.34 In accordance with standard valuation practice, items marked * would normally be removed from these costs and would 'adjust' the small profit of £6,940 to a profit of £43,940. This figure, falling well below the 'rule of thumb' 10 per cent Net Profit expected by the industry for a Pharmacy of this size, the valuer would look to see if further adjustments should be made. The following is offered for consideration:

- As this figure is relatively fixed for any Pharmacy dispensing up to, say 5-6000 NHS items per month, the 'percentage of turnover' would be highest for lower turnover Pharmacy and conversely, lower for a higher turnover. A higher dispensing Pharmacy might require attendance by more than one qualified Pharmacist at times, thus substantially increasing overheads. By way of contradiction, it is that part of the business that produces the lowest gross profit (in percentage terms) which requires the highest degree of qualified staffing, which is, inevitably, that part which commands the higher rates of pay. In order to secure acquisition of the business, an intended purchaser might be prepared to operate the business without expensive Locum cover, therefore he might accept a lower reward for his own personal Pharmacy duties to buy a conveniently located business, close to his home and family.

Within the formal Accounts, a proprietors income or drawings is usually expressed out of available net profits. For the purposes of the valuation the costs of full time attendance by a qualified Pharmacist is *added* to outgoings before arriving at the 'adjusted' net profit. Although there are minor regional differences in wage costs for both qualified and unqualified staff, these are generally insignificant to the overall analysis.

- The vendor might be approaching retirement and running the business with more staff than would otherwise be considered necessary, bearing in mind the number of opening hours traded by the business. A reduction to 3 per cent of turnover would 'save' a further £6,000 per annum.

  N.B. Family members are not normally engaged below normal rates of pay.

- Notice needs to be taken of rent review dates. Where the rent has recently been agreed, the current sum should be included in the calculation. A higher figure should be attached to the calculation where approaching a review, or the review date has passed without settlement. In the absence of a known rental figure, the valuer would apply a notional rental often between 8 per cent and 12 per cent of capital value, depending upon the desirability of the property, the availability of living accommodation and localised influences.

- As in the case of all expenditure, only essential costs required to maintain the present level of income and profitability should enter the valuation. A proprietor's desire to possess an exotic vehicle might unreasonably deflate net profit.

G.35 Having decided that the adjusted net profit (in this example, say, £50,000, being just under 8.5 per cent of turnover and falling within normally expected parameters) fairly represents the current state of the Pharmacy business and that there are no known changes to doctors surgeries, opposition or local population, and the property is deemed to be structurally sound and not falling within any detrimental town planning or development area, the Valuer must decide an appropriate 'multiplier', drawing upon his experience and knowledge of recent transactions of similar size, location and appeal. As mentioned earlier in this report, the adjusted net profit would usually be multiplied by between 4.5 and 6, except in exceptional circumstances, reflecting demand in today's market.

G.36 In conclusion, it would be fair and reasonable to assume the business would attract genuine interest from the market by inviting offers between £250,000 and £300,000 for the benefit of the Goodwill, Fixtures and Fittings plus an additional sum to be calculated for the stock in trade to be taken over at completion. Any interest in Freehold property would require separate valuation.