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PHARMACY SERVICES
FALL 2016

THE ABSOLUTELY, POSITIVELY, NO DOUBT ABOUT IT, NUMBER ONE REASON PHARMACY SERVICES TRANSACTIONS FAIL

Having completed more than 280 transactions, we're like Farmers Insurance – "We know a thing or two because we've seen a thing or two." So, when it comes to developments that trash a transaction, we've seen it all (except for the next thing that will pop out of nowhere like a visit from your mother-in-law).

In most health care service businesses, done deals become undone on compliance failures in regulatory matters, billing, documentation, licensing, wage and income tax comp, and the like.

But not so with pharmacy services.

Sure, there are compliance shortfalls in some of these deals. But more often than not, these deals come tumbling down on matters of accounting, as **the pharmacy services sector is uniquely susceptible to reporting miscues that can turn a seemingly slam-dunk EBITDA into EBIT-no way.**

Consider the number of therapies a provider may offer. Now consider the number of payors, contracts, insurance companies, government agencies, employers, third party adjudicators, etc. in the mix, each likely to have different formularies, dosages, dispensing amounts, and chargemasters.

With so many variables in play – and regularly in flux – simple **revenue recognition – the foundational element of financial reporting – is anything but simple.**

It doesn't get much easier with cost of goods sold. You have to match up the right drugs with the right formulary, at the right amounts, at the right cost. What about volume rebates that may not be known until the end of the year? You could limit your exposure by conducting regular and frequent inventories. But when you're fighting an insurance company for payment, your drug supplier for better terms, and your employees for control of the thermostat, well, regular inventories are anything but regular.

So rather than fall into the GAAP, many providers opt out of accrual accounting and opt into some measure of cash basis accounting. Sure, with variations in timing of inventory purchasing, drug dispensing, billing, and final reimbursement, the financial statements may be a bit, uh, wobbly. But hey, cash is king.

In an M&A situation, the cost of such financial faux pas can be fauxnormous.

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One Way EBITDA. Right off the bat, you should know the Rule of the One Way EBITDA. That is, when a buyer attempts to verify the seller's earnings as presented, their computations are one-directional – and that direction is south. Even the best financial reporting reflects certain discretionary applications of accounting principles which makes precision a matter of opinion. Add to this a financial incentive to chip away at EBITDA to wrangle a price concession or two…or three - suffice to say at the get-go, your numbers will ***never look better*** when scrutinized by a buyer.

Now, if well-constructed numbers are going to suffer the torture of the damned, imagine what is going to happen if you knowingly, and admittedly, go into a deal with "soft" or cash basis numbers and cede the task and control of ***creating*** the financials to the buyer.

Talk about a fox in the Yen house.

The Time Value of Risk. You know the Time Value of Money – the notion that the further out in time you expect to receive a dollar, the lower the "present value" of that dollar, given lost investment opportunity and interest. Well, we've come up with an M&A corollary to this concept – The Time Value of Risk: The further out in time it takes for a buyer to get your numbers in order, the lower the present value of the company given a buyer's and lender's heightened perception of risk, not only in the numbers themselves, but in the management and operation of the company as well.

But wait. There's more.

Perhaps the worst – and overlooked – consequence of having inaccurate financials is the extraordinary amount of extra time – and hence, exposure to risk – it adds to the deal cycle. Time in which "unknown unknowns" – like the loss of a contract, a cut in reimbursement, an increase in drug cost, or even a change in the buyer's strategy or performance – can sabotage a deal.

Experience has shown us repeatedly that nothing good can happen between the signing of a letter of intent and close. Consequently, once there is a meeting of the minds, it is literally and figuratively, a race to the closing table.

So what's the potential seller of a pharmacy service business to do?

Quite simply, it is essential to invest the time, money, and human resources to get the most accurate, accrual-based financial statements as possible. Graduate from a bookkeeper. Find another job for your brother-in-law and employ an HTG (Honest to Goodness) accountant. Invest in the best-in-class billing software; ideally one that is fully integrated with your pharmacy (can you say bar codes?) and general ledger. Even if you're using a perpetual inventory system (and good for you if you are), conduct regular physical inventories – ideally quarterly - annually at a minimum – to insure that your cost of goods sold doesn't wander too far off into the land of rainbows and unicorns.

And if your company is sizeable at all – let's go with $20M in revenues or more – consider getting an audit (or at the very least, upgrade from a simple compilation to a review by an outside accountant). No, don't just consider it. Go all out Nike and "Just Do It."

Yeah, it can be expensive ($50-100k). And yes, you may prefer a simultaneous colonoscopy and root canal.

But neither is nearly as costly, unpleasant, and disheartening than a cut in price or a failed transaction…and then having to explain it all to your significant other.

Really.

No, **really.**

FOR MORE INSIGHT INTO THE M&A MARKET FOR PHARMACY SERVICES AND WHAT IT MAY MEAN TO YOU, CONTACT OUR PHARMACY SERVICES TEAM:

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