

Cur8 Pharmacy - Downside Protection Analysis

This is a short document talking through the risks to the principal of investing in the Cur8 Pharma Strategy.

Context

Cur8 will be acquiring UK pharmacies and embarking on an enhancements and improvements strategy by rolling out operational efficiencies, robotics, NHS and private services, as well as digital marketing to acquired businesses.

Cur8 is tapping into strong secular trends that are coursing through the NHS landscape today. Recent reports published by the Nuffield Trust and the Kings Fund¹ corroborate and echo what NHS England has itself stated² about the centrality of the community pharmacy in the future of the NHS.

A typical pharmacy acquisition comprises, *inter alia*:

- The pharmacy contract
- Goodwill
- Location
- Existing lease
- Existing stock
- Existing contracts with service providers as well as employees (together a "Pharmacy")

Let us model a typical pharmacy at £500,000 acquisition cost, with net EBITDA at 7% (£35,000).

What is the residual value of the pharmacy contract if things go wrong?

The vast majority of a typical pharmacy's revenue derives from the NHS contract it holds. However, if a business is very badly managed, it can turn unprofitable.

Let us assume EBITDA is no 0.

In these circumstances, the Pharmacy business can still be sold, as the NHS is no longer offering new pharmacy contracts, so the only way someone can acquire a pharmacy is by buying existing pharmacies.

¹ <https://www.nuffieldtrust.org.uk/research/a-vision-for-community-pharmacy>

² <https://www.england.nhs.uk/primary-care/pharmacy/community-pharmacy-contractual-framework/>

Location is a key factor to the residual price of a pharmacy.

For a site that is mismanaged but in a reasonably good location, one would expect to recoup £300,000 of the £500,000 invested initially.

The primary asset that will be bought for some pharmacies will be a robotics instalment worth £150k. In an exit scenario, either the incoming buyer takes over on the payments or the assets leased would be returned to the robotics company with a fee of £15,000 for removal of the assets. Each year one should expect a 10% depreciation of the asset after year 2.

So assuming a good location practice with robotics, exiting in year 3, total loss would be:

1. £200,000 on business
2. £30,000 on the robotics depreciation and removal

Total: £230,000

Value remaining: £270,000

Risk mitigations Cur8 will take to avoid this risk:

- **Buy cheaply.** Cur8 will look to buy in bulk where possible and distressed assets. This sometimes reduces the entry price by up to 20% - and therefore the downside.
- **Buy in the next 3-6 months.** Some larger pharmacy groups are exiting the market right now due to wider ownership dynamics, and as such there are appealing buy opportunities in the market that provide appealing turnaround prospects.
- **Buy in good locations.** Locations retain value and add to the growth story of the strategy.
- **Buy pharmacies that already sell 5000 items or more.** Pharmacies that have historically struggled and closed down are pharmacies selling less than 4000 items per month. These are usually smaller pharmacies and would not be appealing as a location to roll out services in most cases (which is the core Cur8 value add). They are also difficult to sustain as independent running businesses with the tighter NHS dispensing contract. Where Cur8 would acquire smaller pharmacies it would do so only as a consolidation play to add their sales and customers to a nearby larger pharmacy Cur8 already owns.
- **Strong management team with a track record of acquiring and incorporating new pharmacies into a group.** The core reason why a pharmacy would go this badly wrong is due to inexperience and poor management of the business. The Cur8 team have partnered with Everest, an experienced pharmacy operator running several profitable pharmacies today. They also have extensive experience acquiring and incorporating pharmacies into their group.

What is the value of the lease in the acquisition of a typical pharmacy and what are the powers a landlord has over the pharmacy at renewal?

A typical pharmacy lease is longer than 10 years and often over 20 years, with 5 year break clauses. Leases will have guidance on the increase in rent every year - usually linked to inflation indices - and will often have guidance (floors and caps) around renewal terms as well.

Given the state of the high street in the UK today, landlords are a lot more amenable to favourable terms than they ever were before.

The lease itself has relatively little value but the freehold would typically command a valuation equivalent to a 5-7% yield.

Risk mitigations Cur8 will take to avoid this risk:

- **Legal due diligence prior to purchasing pharmacy.** Lease issues are a common issue that usually gets picked up in legal due diligence. The rectification of these issues can be made a condition for completion.
- **Acquire the freehold through a sister healthcare property fund.** Cur8 has a separate fund that buys and hold long income healthcare assets. Where appropriate and possible, Cur8 will look to acquire the freehold of the pharmacies it owns.

How can the pharmacy contract be lost?

Pharmacy contracts are awarded to a business but must be operated by a licensed pharmacist. In the case of gross misconduct a pharmacist can lose his/her licence. In that instance, the business would still not lose its contract - it would however need to replace the pharmacist.

Risk mitigations Cur8 will take to avoid this risk:

- **Ensure robust training and oversight for staff.** Gross misconduct is a high threshold and Cur8 will be working with Everest to ensure the hiring of high quality personnel who Everest will further skill up in relation to service delivery.
- **But in place bad leaver provisions for Everest management.** Gross misconduct by the management team would qualify someone as a bad leaver, and they would lose most if not all their equity as a result.

What are the risks of the NHS reopening up the issuance of new pharmacy licences?

The risks of the NHS reopening new pharmacy contracts is low.

- You can open any private pharmacy (that does not provide NHS services) anywhere. However these are typically very rare as they only work in very affluent areas (such as Central London locations).
- NHS-contract based pharmacies - which are the vast majority of pharmacies - are no longer being awarded³. Only in rare cases, where there is a significant new development of 1000 homes or more, that also includes a GP practice, would a pharmacy contract become feasible for NHS England to offer. NHS England has a stated goal from 2016 of reducing down the number of pharmacies by 1000⁴. This has still not quite been achieved.

What is the typical acquisition cost of a pharmacy and how has that multiple moved over time?

Pharmacies are usually priced at 5-8x EBITDA, depending on:

1. What type of pharmacy it is (100 hours are usually not that popular and would command a 5x multiple, while normal 40 hour pharmacies would be 7-8x)
2. Location
3. Quality of the decor, assets, staff
4. Potential for expansion

This has broadly stayed stable since 2016 when the last changes were made to the NHS pharmacy contract. As this contract constitutes 90%+ of most pharmacies' revenue, valuations are closely linked to this for pharmacies.

Pharmacies that add:

1. Private services
2. NHS services
3. Retail item sales,

increase their non-dispensing revenue, increase EBITDA, and make their overall business much more defensible. Pharmacies that also add advanced robotics further enhance the efficiencies of their business as well as ease of staffing, again adding to the exit multiple.

³ The reason is that annually the Government conducts a survey of the UK landscape and looks at pharmacy density and spread and they aim at providing one pharmacy for every 5000 homes in an easily accessible location. However, today, pharmacy density is much higher than that, so even if pharmacies shut down today, the density is still too high in most cities to allow for new pharmacies to be opened. That is why existing pharmacy contracts even when loss-making are so valuable.

⁴ <https://www.bbc.co.uk/news/health-35418556>