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2017
EDITION 2

Examining issues confronting our pharmacy clients

What's in this issue?

A word from the editor...

By Mark Nicholson

WELCOME to the second edition of our 2017 Pitcher Pharmacy newsletter; keeping you up-to-date with ongoing community pharmacy industry changes and their impact on owners, while offering insights on business performance and improvement opportunities.

In positive news since our last update, the May Federal Budget confirmed ongoing support for the existence of Pharmacy Location Rules. More recently, wholesalers were granted an increase in government Community Service Obligation funding. Moreover, pharmacies now receive an increased Administration and Handling Incentive (AHI) fee to compensate for lower-than-projected Sixth Community Pharmacy Agreement (6CPA) script volumes, together with a remuneration improvement to the funding of dose administration aids (DAAs).

Meanwhile, the Review of Pharmacy Remuneration and Regulation was completed. It provides a list of recommendations which, in our view, reflected the contribution of the various interest groups that participated, but largely avoided any mainstream media focus that previous reviews have generated.

While this may be viewed as a 'win' in some quarters, the recommendation to consider replacing the current remuneration structure with a flat dispensing fee would be problematic. This is due to a simplification exercise likely favouring high-volume, low-cost dispensers (eg. discounters/warehouse) while also disincentivising the stocking of high cost drugs (the main reason behind tiered remuneration).

The AHI increase has returned some of the previously lost margin to pharmacy, although many pharmacies are only just beginning to realise the cash flow impact of price reductions that occurred during the financial year ending 2017 (FY17).

As discussed in our previous newsletter, margin loss has also been contributed to by the pricing decisions of pharmacies in response to discounters leading the market. For many businesses, this has been anything but beneficial. In contrast, those who have resisted the $1 discount, while also protecting their retail margins through mid-tier pricing strategies, have been able to maintain a retail margin in excess of 35%.

Inside this edition we explore the tightening market for pharmacies that service residential aged care facilities (RACFs), analyse the impact of robotics on the dispensing equation, and consider the case for DAA fees to be extended to aged care facility packing.

As always, please contact your Pitcher Partners adviser to discuss anything from this edition.

Robots and rosters...

By Mark Nicholson

Dispensing robots have operated in Australian pharmacies for some years. Anecdotally, we know that owners who invested significantly in a robot would be hesitant to work without one again. The owner-robot relationship is such that many have given their machines nicknames and consider them to be one of their most important staff members!

The reasons to invest in a robot are numerous and include an ability to:

- Pick stock from the shelf and deliver it to the pharmacist or technician (faster processing during peak periods).
- Keep greater amounts of stock in a smaller space compared to normal shelving (save space).
- Occupy the most inconvenient space within the pharmacy (save space).
- Reduce error rates (ie. risk).
- Put stock on its own shelves - chaotic version not channel (save time).
- Provide pharmacists more time with customers and staff (increase engagement).

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Packing it all in!

By Norman Thurecht

Dispensing continues to be the most profitable of community pharmacy activities, despite some contraction in recent years due to Federal Government efforts to reduce spending via Pharmaceutical Benefits Scheme (PBS) reform. In order to receive maximum return for effort, it is just as important to analyse and understand the financial performance of each component of dispensing activity as it is with the retail categories.

2017 – An overview

Based on the first cut of Pitcher Partners FY17 Pharmacy averages, gross profit dollars (GP$) per script has now fallen below FY14 (immediately before the introduction of the Sixth Community Pharmacy Agreement) – refer Table 1.

Table 1: Average GP$ per Script Trend

Financial Year ended	Average GP$/Rx
30 June 2014	$13.37
30 June 2015	$11.94
30 June 2016	$12.30
30 June 2017	$11.82

The 2017 financial year saw significant price reductions in both October 2016 and April 2017 to molecules that treat diseases and illnesses such as mental health, eczema, cholesterol, breast cancer and Parkinson's disease.

Further to the ongoing impact of price cuts, script volume declined by more than 2% for the financial year ending 2017 across our client base. Volume was impacted by:

- the increase in combination molecules;
- the continuation of items coming out of the PBS (eg. Panadol Osteo etc.);
- competition from warehouse pharmacies; and
- broader economic factors including the affordability impact from rising power costs, the threat of an interest rate increase and flat wage growth across the country.

On the positive side, the above situation has been counteracted somewhat by the Minister and Department of Health agreeing to a 'risk-share' arrangement requested by the Pharmacy Guild of Australia last year. Accordingly, dispensing remuneration rose by 32 cents per script on 1 July, 2017. As Table 2 outlines, this represents a 3% increase on the base fees for PBS funded scripts.

Ageing population

Despite flat script growth, Australia's population continues to age. This is confirmed within 2016 Census data (see Table 3). Note the population growth over five years for Australians older than 50. The increase in those older than 70 is the highest by percentage while the 50–59 bracket is highest by number.

Table 2: PBS Base Fee Components per Script

	Pre 1 July 2017	Post 1 July 2017
Dispense Fee	$7.02	$7.15
AHI Fee	$3.53	$3.62
Risk-share component	N/A	$0.32
Total Compensation	$10.55	$11.09

According to the Fifth Report on the Funding and Financing of the Aged Care Sector published in July 2017 by the Aged Care Financing Authority[1], the operational aged care place target ratio is being increased from 113 in every 1,000 in 2012 to 123 in every 1,000 by 2022. The provision of operational aged care places includes home care (increasing from 27 to 45) and residential care (decreasing from 86 to 78). The report explains that to reach these targets by 2021, an additional 62,000 home care packages (government-funded arrangements for elderly to remain at home) and 49,000 residential places will need to be made operational.

Table 3: Data Extracted from 2016 ABS Census

Median Age (Australia)	2016	2011	Change
0-29 years	9,017,598	8,523,733	5.79%
30-49 years	6,436,238	6,020,935	6.90%
50-69 years	5,466,279	4,870,083	12.24%
70 years and over	2,487,764	2,092,971	18.86%
	23,407,879	**21,507,722**	**8.83%**

Clearly, there will be a shortfall from 2021 in the number of aged care residential places available. Therefore, those needing some form of care will be forced to remain in their home. From a pharmacy perspective, the demand for medication packing is only going to increase for both facility and community patients.

Impact on pharmacy

From 1 July 2017, the Federal Government began paying some of the committed additional service-based funding from the 6CPA. This included raising remuneration from $5 to $6 per week to fund packing DAAs for community-based patients.

However, RACF customers do not qualify for any government remuneration.

This poses a significant commercial challenge for community pharmacies servicing RACFs; very few facilities allow their pharmacy service providers to charge a commercial fee to the facility or patient. In the absence of any additional DAA income under the existing Agreement, the profitability of providing packing services to aged care facilities therefore continues to decrease in line with the decline in GP$ per script.

Although the focus here is on aged care, we have clients providing similar services to other facilities caring for the disabled which will be similarly impacted.

Understanding the profitability

During the period from 2008 – 2014, the higher GP$ per script (underpinned by generic and wholesaler trading terms) ensured that packing for nursing homes was profitable without receiving a packing fee contribution from the patient or facility. However, the decrease in GP$ per script and, therefore profitability, since 2015 (outlined above) requires a considered understanding of the financial performance arising from each facility serviced.

Our recent analysis of pharmacies undertaking RACF packing services highlights that the GP$ per script generated is lower in almost every pharmacy when compared to the GP$ per script from what we have termed "general dispensary" (ie. walk-in script customers). The findings are summarised in Graph 1.

A significant cause for the difference in GP$ per script between community and facility patients is the higher percentage of private scripts in nursing homes and the pricing applied.

Graph 2A outlines the private scripts provided to the facilities reviewed as a percentage of total scripts. Graph 2B compares average GP$ per script for those private scripts.

In addition to facility patients generating less GP$ per script than community patients, the costs of supplying those scripts are significantly higher due to packing, delivery, administration, medication profile reconciliation and communication requirements.

Pitcher Partners finds that high care facilities are generally more profitable than low-care facilities. Nevertheless, some high-care facilities have a greater emphasis on deprescribing near life's end than others, highlighting the important point that every facility is different.

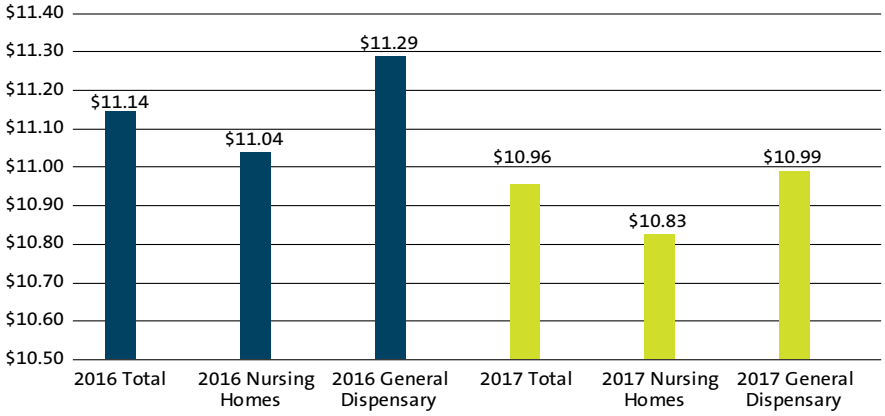
Insights from industry reinforce that non-fixed costs for packing (medication profile reconciliation, administration, delivery, communication etc.) can be as high as 70% of the overall service cost. This highlights the importance of having a granular understanding of packing service costs and being able to negotiate a fair and reasonable contract.

In our experience, many pharmacies that cease servicing aged care facilities have generated increased profits thanks to both refocussing their time toward core community patients and eliminating costs that can sometimes exceed the revenue from servicing a facility.

While the need for packing services is going to increase proportionally to the growth of the ageing population, there is a significant financial difference between providing the same service to a community care patient versus a RACF.

The ongoing reduction in GP$ per script (driven in part by the rising impact of lower pricing for private/under co-pay scripts) will require increased focus on the benefit of providing services to some facilities. Equally though, it should heighten pressure on facilities to agree to packing fees and government to fund remuneration parity between aged care and community patients.

Graph 1: Nursing Home vs General Dispensary Average Gross Profit per Script



The packing options available to pharmacy are:

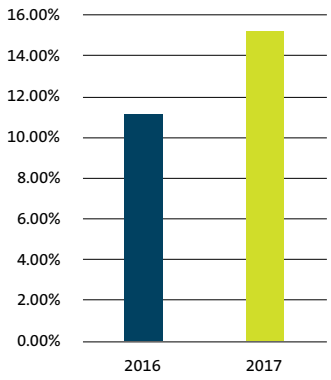
1. Webster packing – manually packing blister packs with each customer's individual medicines dispensed and maintained separately.
2. Webster packing with Medspro – same as point one but a virtual pill count.
3. Robotic packing in-house Webster/ sachet.
4. Outsourced sachet packing.

Different options have different costs. Specifically, anything done by the pharmacy has a material and labour cost while outsourced packing carries an inclusive fee per pack paid to the provider.

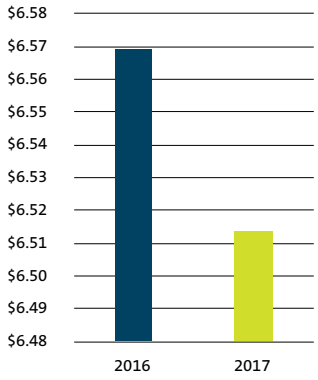
Clearly, it takes significantly less time to dispense a script to a customer who walks into a pharmacy because there is no packing required, nor a delivery cost. Packing only two or three medications per patient is significantly less profitable than packing four or more.

It is also difficult to benchmark operating costs for facility packing because each pharmacy has different operating procedures. The important point, however, is to analyse and understand the exact costs so that they can be matched against the total GP$ generated from that activity or facility.

Graph 2A: Nursing Home Only Private Scripts as Percentage of Total Scripts



Graph 2B: Nursing Home Only Private Scripts - GP$ / Rx



We see varying levels of financial performance in servicing RACFs. While scale can help, it too is dependent upon the size/ type of facility, the services required and the contract arrangements negotiated.

In the meantime all tendering for aged care contracts should be considered carefully. As always, Pitcher Partners is available for support and advice.

1. Sourced from: https://agedcare.health.gov.au/sites/g/files/net1426/f/documents/08_2017/design_version_2017_acfa_annual_report.pdf

Robots and rosters...(continued)

A robot's work is done without taking sick leave or holidays. Nor does it require pay increases or penalty rates. If not for the cost of purchase and annual maintenance, most pharmacy owners would already have a Robot.

However, once the expenses are considered, Pharmacies usually calculate whether wage costs can be reduced sufficiently (and/or sales/services increased) to cover the annual cost of maintenance, finance and depreciation (spread over, say, seven years).

In order to reduce wage costs it is incumbent upon an owner to actually change the roster and/or mix of staff. It is important to note here that it is the owner that has to change the roster if wages are to be reduced. Although robots can do many things, changing staff hours is not one of them.

So, on this important process of change management, we analysed the data from ten clients to determine whether:

- Wages reduced following the installation of a robot.
- Wages were discernibly lower in a pharmacy with a robot compared to manual dispensaries.
- Staff plus robot costs (maintenance + depreciation + finance interest) compared favourably to industry staff benchmarks in businesses where robots were not present.

Table 4 summarises the results for three different types of robots. From this sample, the evidence suggests that owners did not reduce wages or change processes sufficiently to cover the cost of the robot. This is not surprising as owners are often just as resistant to change as customers or staff.

Important points from the data to note about the sample average pharmacy employing a robot include:

1. 371 scripts per day are dispensed.
2. $936k of annual wages (excluding superannuation) are paid.
3. Store turnover is approximately $22k per square metre (PP client average – $16k).
4. Wages + robot costs / GP$ (gross profit dollars) were 42% versus PP client average of 40% where a robot does not exist.
5. The smallest pharmacy with a robot by script volume does 184 scripts per day. This is still larger than the PP average pharmacy once retail turnover is factored in.

Insights provided from the analysis include:

1. Pharmacies with higher space productivity (ie. sales per sqm) than average are more likely to consider employing a robot.
2. These will typically have higher-than-average turnover and script volume.
3. The goal of net profit growth and service differentiation does not rely solely on improving labour productivity (wages + robot costs : GP$)

Table 4: Robot Pharmacies — Select KPI Analysis

	Low	High	Average
Script Volume/Day			
- Pre	169	543	366
- Post	184	591	371
Total Wages (Excl Super)			
- Pre	$456k	$1,387k	$905k
- Post	$495k	$1,449k	$936k
Wages/GP$			
- Pre	28.5%	57.7%	38.9%
- Post	30.8%	47.8%	39.5%
- PP Average*			39.8%
Wages + Robot Costs/GP$			
- Post	33.9%	51.2%	42.0%
Sales/m²			
- Post	$11.4k	$30.5k	$22.0k
- PP Average*			$16.3k

** Based on PP Industry Average for all pharmacies in FY16*

It is clear from the analysis that many pharmacies employing robots have not offset their investment cost through wage cost reductions. Some of this will simply be due to management's inability to implement change.

This however does not imply that robots have been unsuccessful in transforming pharmacies for the future or improving the value of the business. As noted, businesses that have them would generally now not be without them as robotic technology will likely have generated increased space productivity and enhanced customer engagement – both of which are essential to future financial success.

Mark Nicholson
Partner | Pharmacy
mnicholson@pitcherpartners.com.au

Teresa Hooper
Partner | Consulting
thooper@pitcherpartners.com.au

Felicity Crimston
Director | Pharmacy
fcrimston@pitcherpartners.com.au

Norman Thurecht
Partner | Pharmacy
nthurecht@pitcherpartners.com.au

Annette Ivory-Barker
Director | Pharmacy
aivory-barker@pitcherpartners.com.au

+61 7 3222 8444

www.pitcherpharmacy.com.au

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