PITCHER PROFICIES

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EDITION 1

Examining issues confronting our pharmacy clients

A word from the editor...

By Mark Nicholson

Welcome to the Pitcher Pharmacy Autumn 2018 newsletter, keeping you up to date with industry changes and tackling issues that we consider to be of high relevance to pharmacy owners.

Inside this edition, Norman Thurecht analyses the challenges of competing in a mature industry. He considers the ongoing effect of shrinking generic margins on head offices and whether the benefits from scaling and consolidation actually exceed the costs at store level.

Meanwhile, I review the ongoing decline of some Australian retailers and consider whether the related issue of hedge fund shorting of US mall owners will eventually impact future Australian shopping centre rents.

As always, please call your Pitcher adviser if you have any queries about the issues raised in this newsletter, or other business matters.

retail graveyard nod to shopping centre rents

By Mark Nicholson

An Australian retail graveyard might be a fun place to shop considering the variety of tenants it has accumulated. It is interesting how many have been buried due to the demise of an entire brand or even a simple management decision to eliminate unprofitable sites. The list could include some or all of the following:

Toys ‘R’ Us, Babies ‘R’ Us, Payless Shoes, Sizzler, Oroton, Brumby’s, Gloria Jeans, Donut King, Michel’s Patisserie, Pizza Capers, Marcs, David Lawrence, Herringbone, Rhodes & Beckett, Pumpkin Patch, Dotti, Just Jeans, Portmans, Top Shop, Dick Smith and any number of newsagents, bookstores and independent retailers which have closed their doors in recent years.

For most of this list, the changing face of retail (partly driven by fierce online competition – set to become more intense with the recent launch in Australia of Amazon’s Alexa) has resulted in unsustainable rent fees. A consequence of this competition has seen international retailers being allegedly enticed by shopping centre landlords with favourable rents in an attempt to maintain or grow shopper numbers. The inevitable side-effect is to heap even more competitive pressure onto existing tenants.

So with further reflection, and considering their loss of relevance in the face of online convenience and international competition, it is likely that the fun had long died for those Australian retailers now consigned to the graveyard. Nevertheless, the proposition that many large shopping centre rents are excessively inflated compared to other retail locations, or even other retailers in the same or similar centres, remains relevant.

International Trends

These centres carry increasingly higher retail vacancies and suffer declining customer numbers. Some have reasonably postulated that the Lowy family effectively identified ‘top of the market’ when agreeing to the Unibail-Rodamco takeover of Westfield Corp for $33bn last year.

Meanwhile, last year a number of US hedge funds began shorting US mall operators in the belief that the related share prices and dividend yields did not reflect the challenges being faced by their tenants. Moreover and similar to Australia, the flagship branded stores pay significantly lower rents per square metre (sqm) than other retailers. Because of this disconnect, hedge funds are betting on an eventual re-rating of values and rents.

So what does all this mean for Australian pharmacies? First, shopping centre landlords will continue to resist reasonable arguments to reduce excessively high rents. Second, shopping centre operators view pharmacies as no different to other retailers, irrespective of the additional regulatory burden of location rules which can impede negotiations and limit alternatives.

Some ground rules for success

As noted above, many retailers consigned to the graveyard had simply lost their edge and customers responded accordingly when offered superior products online, at lower prices and improved convenience. Fortunately, most consumers still desire a personal service connection when it comes to their health and this offers some protection for shopping centre pharmacies, providing a few simple ground rules are met. Change does not occur overnight so shopping centre landlords require ongoing education.

When reviewing the data (refer Table 1), large shopping centre pharmacies make less profit on average than pharmacies in strip centre or community locations. This is due, on average, to having more space than is optimal and paying higher rent on both a gross and per-square-metre basis. Moreover, the growth in rent costs over the past five years has been disproportionate in comparison to other pharmacies, and has occurred while margins have fallen due to medicine price reductions.

Other shopping centre insights from Table 1, which compares the same group of pharmacies from 2012 to 2017, include:

1. Rent per sqm was 1.35x small shopping centre rates and 3x other locations in 2012. In 2017 it was 1.4x and 2.6x respectively.
2. Growth in rent p.a. over six years (2012 – 2017) averaged as follows: Large 2.5%, small 1.7% and other 5.5%. Given the lack of customer and sales growth during that period, EBIT has been unable to absorb margin reduction and rent increases.
3. Off a large rent per sqm, continued rental growth will not be sustainable for some pharmacy businesses – especially when many require reductions.
4. Ignoring dispensary sales, rent expressed as a percentage of retail sales has grown from 16.6% to 19.6% for large shopping centre pharmacies. All other pharmacies have remained more stable at significantly lower levels.
5. Rent as a percentage of total sales in 2017 was more than double average community pharmacy levels and more than 30% higher than small shopping centre pharmacies.
6. Sales are, on average, similar on a per-square-metre basis. This is regardless of location. Hence it is evident that, on average, shopping centre pharmacies do not receive value for money for the space they occupy. Ideally, they need $25k+ per sqm of sales to be viable
7. EBIT for pharmacies in large shopping centres has shrunk from an average 8.4% of sales to 4.8%. This is unsustainable. By comparison, community pharmacies moved from 11.6% to 9.5% during the same period.

Table 1

(Note: rent includes outgoings)		Average Rent/sqm	Average Store Size (sqm)	Rent % of Retail Sales	Rent % of Total Sales (excl High Cost Drugs)	Total Sales/sqm (excl High Cost Drugs)	EBIT %
2012	Large Shopping Centre Pharmacy	$1,277	290	16.65%	5.67%	$22,521	8.36%
	Small Shopping Centre Pharmacy	$ 938	251	16.34%	4.88%	$19,245	9.77%
	Other Community Pharmacy	$ 417	213	9.68%	2.66%	$15,663	11.62%
2017	Large Shopping Centre Pharmacy	$1,471	289	19.56%	7.56%	$19,446	4.77%
	Small Shopping Centre Pharmacy	$1,035	262	17.50%	5.70%	$18,167	7.19%
	Other Community Pharmacy	$ 553	211	11.91%	3.33%	$16,604	9.54%

The increasing rent trend for pharmacies in large shopping centres is clearly unsustainable. This trend and consequent pain is being experienced by all retailers in the western world and is well understood by the owners of these centres. Understanding this is a useful starting point to commence negotiations.

However, as noted above, achieving a reasonable per sqm rent reduction is a difficult process. It generally requires time and sharing actual trading results to support claims. Pharmacies who remain profitable (despite being much less profitable than in the past) will usually have less leverage than those who have reached the point of unsustainability.

Arbitration may be required in difficult circumstances. In extreme circumstances, appointing an administrator may be the only way to drive a sustainable, long-term outcome. Ultimately, lower rent equates to higher value, so it is worth considering a specialist lease negotiator. But it is important to prepare and agree to goals, strategy and process before commencing any discussions with a landlord. National brands usually have their own negotiators who have access to comparative centre rent information.

It is always preferable to pay a premium if it means gaining the best location. But such a truism fails unless an optimal, and not excessive, amount of space is retained. Good centres charge premium rents because they ideally attract and grow customer numbers. Such tenants should therefore have less external advertising costs than pharmacies in less attractive locations. This does not necessarily happen, but will likely become a pressure point as profits continue to decline.

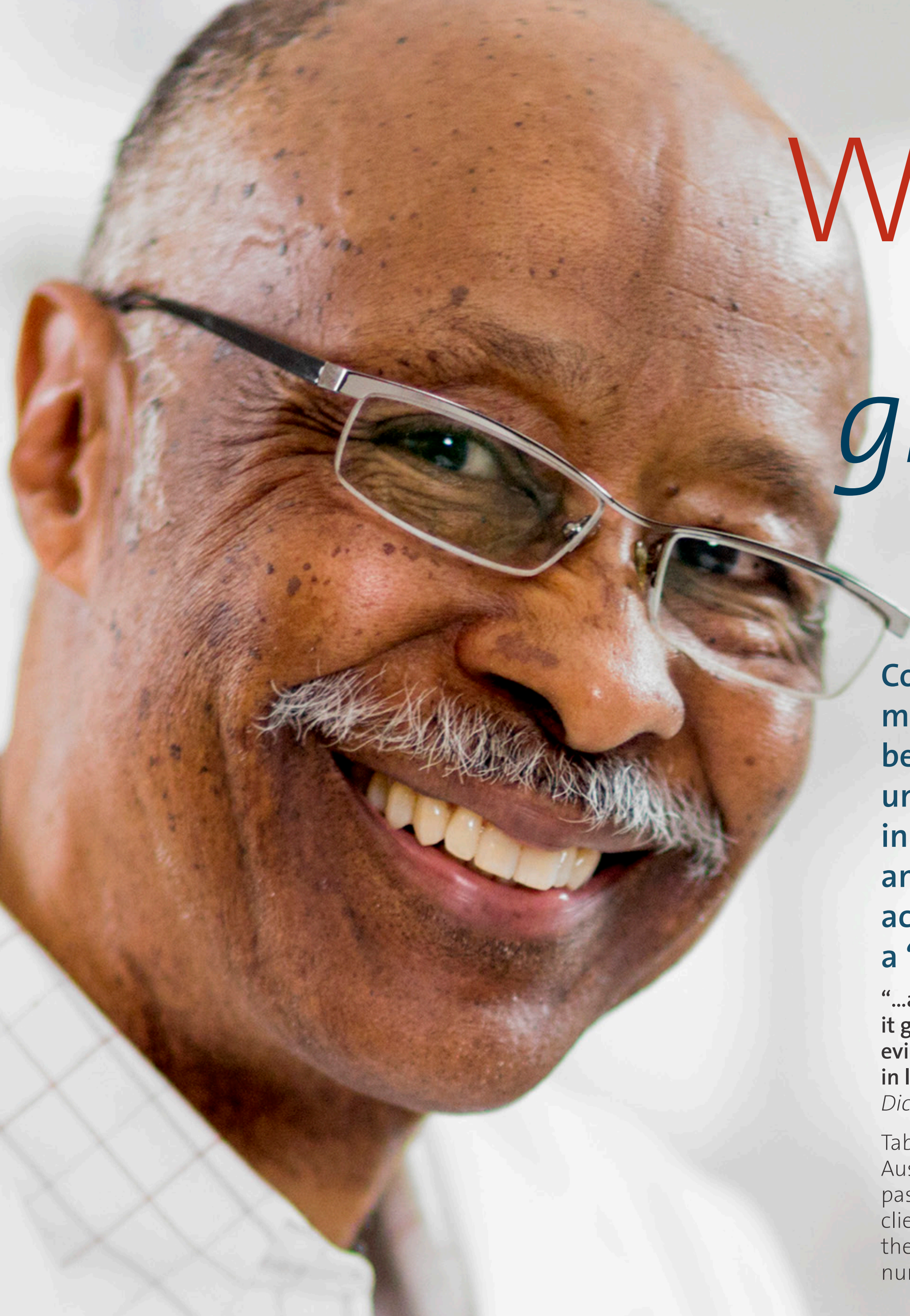
Finding the win-win

Any negotiation is infinitely easier when a win-win proposition can be identified. Shopping centre pharmacies with profit and rent difficulties usually occupy space excess to their needs. So a shopping centre may be able to maintain its rental rate if it cedes the amount of space it requires the pharmacy to occupy. Equally, and where appropriate, improving the location and access without increasing rent can improve outcomes for customers. Such an outcome helps both shopping centres and pharmacies.

To have any chance of reducing rents, pharmacy owners need to:

- develop strategies and be clear on the targeted outcome;
- start the process early;
- use professional support as required;
- document everything; and
- be prepared for continual change in landlord personnel throughout the process.

Importantly, times are changing and some of our clients have negotiated good rent reductions. Landlords can be influenced to realise that pharmacies represent a more stable, customer-drawing long-term tenant than many other retailers who continue to be highly exposed to online competition.



Will **you**... *mature gracefully?*

By Norman Thurecht

Community pharmacy is a mature industry and has been for some time. However, understanding how to prosper in a mature industry requires an understanding of what that actually means. One definition of a 'mature industry' is:

"...an industry at the stage in its life cycle where it grows at the rate of the economy at large, evidenced by earnings growth (or shrinkage) in line with the broader economy." (*Financial Dictionary by Farlex*).

Table 2 below outlines the growth in the Australian Community Pharmacy sector over the past six years and is based on Pitcher Pharmacy client base averages. What is most apparent is the flat or declining customer and script growth numbers.

Table 2

	2012	2013	2014	2015	2016	2017
Customer Number Growth	3.27%	-5.53%	-4.05%	-2.86%	0.96%	-1.88%
Script Growth	3.32%	-0.10%	-2.27%	1.99%	-0.51%	-0.15%
Net profit growth	13.40%	11.41%	-12.72%	-13.89%	3.72%	-22.52%

The net profit growth of pharmacy has generally followed the path of Pharmaceutical Benefit Scheme (PBS) reforms. That is, in 2012 and 2013, generic discounts were high as a proportion of total dispensing income, before being impacted in 2014 and 2015 by significant price reductions on many high-value and high-volume molecules.

This has therefore reduced the related trading terms. In other words, the net profit growth in 2013 and 2014 masked the underlying customer number trend.

> "... the net profit growth in 2013 and 2014 masked the underlying customer number trend"

In 2016, Community Pharmacy received a profit increase from the change in dispensing fees under the Sixth Community Pharmacy Agreement while 2017 was the worst loss of net profit for any year experienced by Community Pharmacy in Australia. The 2017 result occurred against a backdrop of reduced retail prices as pharmacies responded to competition and the pursuit of customer growth. But this was not achieved and, as Table 2 shows, customer numbers actually declined by almost 2%.

So aggressive price competition is a major characteristic (or resultant outcome) of mature markets. Another is an increase in the volume of consolidation.

Many readers would therefore not be surprised by our view that Community Pharmacy now operates in a mature market. More importantly for owners though, is to understand that this is a paradigm shift from the past. They now operate in a low-growth mature market and new tactics are required to lead, manage and operate.

The greatest risk to businesses in such an environment is that the 'pie' merely gets cut in a different way rather than the industry growing the total 'pie'.

Slowing down with age

Restricted growth rates and consolidation in the market confirm two main themes:

1. The industry has experienced a significant period of deflation in the dispensary due to PBS Reforms and unsustainable levels of retail discounting. The business model has to adapt so participants compete for customers on more sustainable terms (this requires a vision for the business and clear strategies to achieve it).
2. As net profit growth flattens the operating model needs to become even more efficient.

Does consolidation work?

Witnessing the ongoing consolidation of community pharmacy over the past ten years (accelerating recently), two concerning features stand-out to me:

1. An inability for most to deliver a differentiated and uniformly executed (compliance), customer-centric model.
2. An inability for most consolidator head offices to evolve and/or change the way they do business with the stores in their group.

That is, with deflation in the dispensary resulting in a reduction in supplier rebates, there has not been a commensurate decrease in the size of head office (or alternatively, improvement in the efficiency of the 'head office'). Nor has there been sufficient evolution of the business model to materially grow customer numbers and, therefore, profitability.

One or two of the larger chains are exempt from this observation due to their outstanding and relentless focus on systems, supply chain management and compliance at store level. We also note that their store profitability reflects this.

Industry consolidation usually generates larger synergistic benefits such as compression through store closures, single website, procurement and so on. However, in pharmacy the acquisition of new sites does not translate to consolidation of turnover and reduction in overheads. This is because site closures are often not possible due to competitive threats and location rules restrictions.

In reality, a decision to consolidate within Community Pharmacy is made mostly to achieve scale with the intention of improving buying terms, rather that enhancing customer outcomes through differentiation.

The ideal commercial consolidation should gain all or most of the following as synergistic benefits:

- Better trade terms.
- Better lease terms or closure of some sites to advantage others in the group.
- Fewer retail staff through the closure of underperforming or non-profitable sites.
- Greater consistency of service delivery in store.
- Fewer head office staff through consolidated reporting and so on.

With continual price reductions and flat customer/volume growth, supplier rebates will continue decreasing. They can't all be replaced simply via the usual retail product rebate. Without store number growth and product volume growth, head offices that rely on supplier rebates and other incentives (that stores ultimately pay for) will likely see their profit decrease because pharmacy members can't sustain increases in head office/franchise costs. Pharmacy is not alone with this quandary. This is a familiar trend experienced by retail franchises throughout Australia (refer to Mark's article on Australian retail graveyards).

Carrying excess overheads in store or at head office is simply unsustainable. Yet the opportunity exists to develop processes and systems that are essentially fixed price per site and easily scalable if you add or reduce pharmacy store numbers. We have achieved this in financial reporting and store wage processing for clients. There are also opportunities with stock control and marketing – some of the major variable costs in pharmacy.

CONTROLLING… *your destiny*

Although PBS Reform has hurt the bottom line of pharmacies, it has been good public policy by improving PBS sustainability and allowing new molecules to be listed. Other outcomes of recent decisions include the delisting of certain items from the PBS and, the up-scheduling of codeine. All of these changes, are beyond the control of pharmacy owners.

What can pharmacy owners control? I believe the list includes:

- retail space (quantum and quality);
- retail stock weight;
- retail stock mix;
- retail prices;
- staff mix and quality; and
- service/s defined as either government-funded, customer-funded or complimentary and which act to make customers 'sticky'.

Table 3

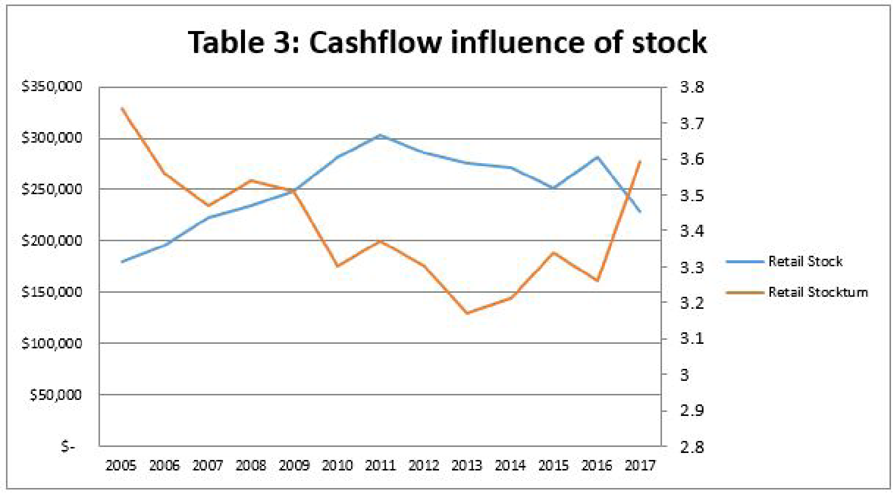


Table 3: Cashflow influence of stock

Focusing on the first three points, the PP client base data in Table 3 shows that, in 2017, retail stock levels decreased while sales did not. This meant that the number of times stock turned over in the year increased. The root cause was not a decrease in space (sqm) but rather a decrease in stock held per sqm. Some of this occurred as stores focussed on improving cashflow and lowering gondola heights where appropriate. Other reasons included cashflow pressure as profits fell and stock was 'thinned' (and sometimes not appropriately replenished).

Although PBS Reform has hurt the bottom line The risk is that the slow-movers are retained while the fast-movers (stock customers expect from pharmacy) are not managed properly. We know from the client base data that approximately 70% of retail sales come from what we define as 'middle health' categories – categories customers expect to find in pharmacy as 'first choice'. This stock cannot be compromised.

	2017	2016
Retail GP%	35.14%	37.36%
Average Retail Sale per Customer	$13.47	$14.12
Customer number growth	(1.88)%	0.96%

The issue of retail prices is always topical. It could be argued that price drops are relevant to retain customers. However, the data table above indicates that in general, Community Pharmacy decreased retail prices to customers during 2017 and this did not positively influence customer numbers.

Further analysis reveals that owner-operated pharmacies with control over their point-of-sale systems (ie. individual store-pricing strategies as opposed to a head office function) maintained a higher GP% (and net profit as an outcome).

	Owner Operated Branded	Owner Operated Non-Branded
Retail GP%	33.70%	38.71%

competing for the Customer

The 2017 results prove how difficult it is to compete for customers in a mature market where the offer is made up of largely homogeneous products. The ultimate point of relevance for most pharmacies is their convenience – easily accessible to the public with generally favourable opening hours.

It is easier to promote (or sell) into a new market by creating a vision of what the customer outcome will be. A great example of this was the weight loss category in the later 2000's. Opportunities like this, however, do not come along very often!

In a mature marketplace, differentiation becomes ever more important. While the large proportion of Community Pharmacy continues to rely upon catalogues with 'product at a price' as content, there is an opportunity to promote your ability to help customers improve their lives. I am suggesting marketing some services like Medschecks or DAA's (for example). However, they are pharmacy terms, so care needs to be taken with the terminology in marketing services.

The cost of marketing has remained fairly constant at 1.2% of total sales (including franchise fees and catalogue costs). Given the dispensary is not marketable (more of a traffic generator based on convenience), the marketing costs measured against retail sales jump up to 4%.

While not advocating a cut to the marketing budget, it is likely that a reallocation into specific marketing activities that are targeted to particular customers or conditions will produce better long-term outcomes. Pain management is a current example yet we see very little of it. Unless you have massive budgets and chasing the mass market, most professional marketers advise that targeted marketing strategies deliver far better returns on investment.

Some owners are aware of this proposition and are successfully heading down this path. For many others though, there exist two major gaps:

1. Perception – the gap between the definition of a successful service and what the owner believes is being provided.
2. Reality – the gap between the definition of a successful service and what the customer actually receives.

The up-scheduling of codeine is a good example of the ability for some pharmacies to differentiate. Examining the up-scheduling exercise in isolation, there is the potential for all pharmacies to lose most of the GP$ from the sale of codeine products (estimated to be on average $30,000 per pharmacy, but clearly there are some larger stores that will be impacted more).

We also know from benchmark reporting that Professional Pharmacy Incentive (PPI) income from Medschecks and Clinical Interventions is under-utilised in almost all pharmacies. We have determined this from the variance in income per script. When we analyse further we discover that the reasons are many and varied.

This source of income is, however, a significant missed opportunity, especially given the probable increase in future service income opportunities, as evidenced by the Health Minister's recent announcement of $20m to fund a trial of 'Pain' Medschecks until the end of the current Agreement in 2020. In our view, the up-scheduling of codeine coupled with the Medscheck is the first concerted Government step towards shifting some of the pharmacy income streams from specific product supply to specific patient/ailment management and outcomes.

While it is too early to fully assess the exact loss from the supply of non-prescription codeine, the total customer solution for pharmacies looking to create a differentiated business model will involve product alternatives and PPI income. Looking to banner the pharmacy or change banners is not easy either. Banners often provide a sound foundation from which to operate the pharmacy, but much of the in-store customer engagement (Government-funded or not) remains up to the owners to create and develop.

The strategy mix is therefore clear:

- protect margins;
- evolve the business model as the Government evolves remuneration directions;
- control stock (through reducing space and stock mix/ quantities); and
- manage costs (don't minimise them) to become operationally efficient in the process.

Mature model = mature value?

The alternate view to changing the business model and continuing to consolidate without a clear strategy or vision is to accept a lower return on investment from the pharmacy/ies.

Pharmacy value is inextricably linked to net profit. The capitalisation rate (or multiplier of the profit) has remained relatively constant in recent years despite the pressure (risks) being placed on the industry (generally as risk increases the capitalisation rate would follow). Yet the pharmacy market remains largely 'imperfect' with more buyers than sellers.

We have seen pharmacy valuations where head office and administration costs are added back with no suitable adjustment for cost inclusion for services such as payroll, financial reporting/bookkeeping, marketing and so on. It is difficult to argue that no costs will be incurred for the new purchasers but it is an indictment on the value added by a head office should the costs be eliminated under a 'break-up' sale arrangement.

The averages from our client base highlight that independently owned and operated pharmacies achieve a higher level of income from PPI activities ($30,702) than those stores that are under management ($18,430). This suggests that where pharmacies achieve the limit of 20 Medschecks per month and other clinical intervention income, customers receive a different experience. While this impacts value, the question remains whether a different owner could achieve the same financial outcome.

I note that owner-operated pharmacies, in turn, make higher net profit per customer at $3.05 per customer visit. This is compared to $2.90 per customer visit for managed stores despite the overhead structure being essentially the same at 26% of total sales. That is a 5% differential 'on average' and while it might not seem like much, every dollar counts in a mature market.

Consequently, we are seeing a trend for more owners back in their pharmacies and partnership opportunities for managing partners. This should lead to improved customer outcomes and sustainability to the pharmacy.

Community pharmacy is, in fact, exactly that – part of the Community. The best performers reflect this.

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