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A publication examining the issues for our Pharmacy clients

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A word from the editor

By Mark Nicholson

WELCOME to the Pitcher Pharmacy Summer 2017 newsletter; keeping you up-to-date with industry changes and their impact on pharmacy owners.

Along with the rest of the Industry, we welcome Greg Hunt as the new Health Minister and wish him well in the review and completion of the numerous health portfolio projects inherited from the outgoing Sussan Ley.

While many view the change as positive (if only because an incoming minister is relatively free to reshape previous policy directions) we note that the current King review will provide independent recommendations in its yet-to-be completed report.

The Pharmacy Guild's concern about a potential conflict of interest regarding Deloitte who provided consultancy advice to the Review, certainly provides the new Minister a convenient "out" should he choose to shelve the report once tabled. Regardless, though, we note that it would only take one small change to the location rules (eg. moving the short relocation distance from 1km to 2km) to cause significant change and disruption.

Since the previous newsletter, our scepticism about the timing of the Federal Government delivering the proposed additional $600m spend (per Appendix B in the 6th CPA) towards Community Pharmacy programs by 2020 has only strengthened (especially now with a change of Minister). Strong advocacy from owners and industry bodies is essential to ensure these positive programs are enacted sooner rather than later.

Inside this edition, Norman Thurecht explores the October price cuts and the range of impact felt by different types of pharmacies. Variation between pharmacies is significant and confirms that there is no "average" that can be easily applied. Individual store analysis is therefore required to properly interpret the impact.

The price cuts, however, continue to pose challenges for all pharmacy valuations and reinforce the need for current information when assessing performance, value and outlook.

While addressing the management challenge this presents, owners should monitor KPIs and benchmarks by splitting out high cost/low margin drugs into a separate department to properly understand sales growth and margin performance.

Unsurprisingly, in the pursuit of growth, we are witnessing a downward trend in margins, partly driven by the belief of most brand head offices, that everyday low prices across an increasing range of products is essential to competing with industry price leaders. While this may be relevant for some stores within a group, for the majority of owners it does not appear to be producing the requisite volume increases to justify the exercise.

As a result, many banner group pharmacies are actually reducing profits through their own actions rather than customers. In addition, bannered pharmacy owners are typically incurring increased advertising costs (and increased discounting through loyalty promotions) without a discernible increase in average retail sale.

Consequently, some owners are reaching a point where brand/banner group membership viability is at risk, forcing them to consider operating as an independent. Inside I explore the responsibilities of owners to get the balance right and maintain a happy marriage with their brand for many years to come.

As always, please call your Pitcher adviser should you have any queries relating to the issues raised in this newsletter.

Retailing at the margins

By Mark Nicholson

Regular readers of our articles will be aware of the need to focus on growing margin dollars, which are a combination of both volume and the gross margin made on those products sold. Margin dollars (and by inference, net profit) is maximised by growing, or at least maintaining, customer relevance.

The downward pressure on pharmacy margins from government price cuts and broad-ranging competition has been evident for some time. This competition is fiercely led by Chemist Warehouse with more than $3bn turnover.

Fortunately, the majority of community pharmacies are in more convenient locations than Chemist Warehouse and/or are more than capable of maintaining relevance with a superior personalised/specialised range of services. While this doesn't always occur, community pharmacies are still capable of winning the battle for consumers when it comes to the value proposition.

As noted in the editorial however, since June 2014 we have witnessed a downward trend in margins (refer Table 1). This is often driven by brand and/or an owners' desire to pursue a discount-competitive, everyday-low-price position across an increasing range of products. Increasingly, this strategy or tactic is failing at store level as it is not producing the required volume growth in order to maintain or grow margin dollars.

Community pharmacies are still capable of winning the battle for consumers when it comes to the value proposition.

Moreover, we are also seeing an increasing separation of margins between similar stores within banner groups. This is explained by specific management decisions from owners about product pricing – whether this be at product level, general tier pricing, or a combination of both.

A happy marriage - it's not you it's me

The direction a banner group pharmacy chooses with respect to margins and value proposition is increasingly being assisted, or even driven, by head office decisions which are implemented via controlled POS systems.

It is imperative that stores consciously manage their in-store pricing processes in partnership with their respective head offices. The alternative risks forfeiting significant margin dollars without achieving the requisite offsetting volume increases. As discussed in our last newsletter, impacts to margins come from the buy price, sell price, bundle size and bundle mix.

Key store-level questions to ask yourself include:

1. Do I control the decision on how product pricing is set and maintained?
2. Are loyalty discount programs delivering total store margin dollar growth, or simply providing discount to the highest spend customers?
3. Are promotions driving an increase in store traffic, sales, average retail sales and the overall value proposition from a customer perspective?
4. Do promotions and pricing strategies/tactics assist with bundled product sales around solution-selling that grow overall margin percentage and margin dollars?

Generally, head offices only need to drive group volume to grow their own margin dollars as they tend to be able to fix their own margins before selling through to stores. Moreover, their margin usually enjoys compound growth on volume increase due to extra manufacturer-driven volume rebates.

The risk of potential conflict for a head office intent on driving group volume through lower customer pricing is somewhat balanced however by the need for the stores to grow profit and the group to attract new "franchise" stores. As such, head office performance should be optimised by firstly increasing store numbers and, in so doing, ensuring significant alignment between head office and store goals.

The price of defaulting decisions

Nevertheless, each store has to manage its own competitive landscape and is usually not best served by defaulting its pricing decisions and entire value proposition to head office. When this does occur, pharmacies will often incur increased group marketing costs and experience further margin erosion via increased loyalty program discounting without achieving a discernible increase in average retail sale.

In order to understand the impact of "head office" pricing strategies we analysed client data on a "like for like" sample basis and split the stores between brands where head offices control or lead pricing decisions, brands where owners control pricing and independents who were not members of brands. The results are detailed in Table 1 below.

Table 1: GP Comparisons *

PP client base subsets		FY14	FY15	FY16	YTD17
Pharmacy Brands H/O controlled POS	GP%	35.71%	35.24%	34.05%	32.68%
	GP$ Growth		-2.63%	1.90%	**-11.90%**
Pharmacy Brands Owner controlled POS	GP%	37.89%	37.61%	36.00%	33.77%
	GP$ Growth		-0.38%	5.80%	**0.38%**
Independents	GP%	38.46%	36.88%	36.51%	34.52%
	GP$ Growth		-3.15%	7.79%	**-0.95%**

The difference in results between the ownership categories per Table 1 is explained by differing strategies re private prescription pricing (driven in part by the $1 co-payment discount), and

(continued over)

Codeine measure analysis

On 20 December 2016 the Therapeutic Goods Administration (TGA) made an interim decision to up-schedule products containing codeine so that they become only available via prescription (Schedule 4). The decision is interim because the TGA is still receiving submissions from a wide range of interested parties.

If the decision is ratified, consumers will no longer have direct access to codeine-containing medicines via their local pharmacist. We expect this will have a negative commercial impact on Pharmacy businesses. Pitcher Pharmacy has started analysing the potential impact of this decision which we look forward to sharing in our next newsletter.

expansion/pricing of KVI (known value item) product lists.

Moreover the half year YTD17 results are enhanced by the first three months of trading prior to the implementation of the October price cuts while further price cuts for April are on the near horizon.

Unfortunately for many Pharmacies - in the absence of any reduction in expenses - the loss of 10%+ of GP$ can result in over 50% loss of net profit. As a consequence, some banner group pharmacies are reaching a point where their group membership is at risk due to reduced profitability and the alternative of operating as an independent may become a significant consideration.

However, before proceeding down this path it is imperative that owners consider the following questions:

1. What margin increases are possible within the current brand options?
2. Are loyalty programs being managed with the underlying purpose of growing gross margin dollars?
3. Is advertising spend being optimised at store level or maximised by head office?
4. Are promotional volumes being optimised at store level or maximised by head office?

Moreover, brand membership will be placed at most risk where rent is more than 7% of sales and/or sales are less than $15,000 per square metre. In these cases both head office and professional assistance is required to achieve the operating fundamentals that will deliver long-term success.

So if your branding marriage is at risk, first ask yourself: Is it me not you?

A script for dispensary efficiency - pricing strategy

By Norman Thurecht

Pitcher Pharmacy has previously highlighted a significant widening in the Gross Profit dollars (GP$) per script achieved by pharmacies, irrespective of location and brand. The most recent 1 October 2016 price adjustments continued the downward trend in PBS prices, with the impact of these reductions varied and dependent on the molecules being dispensed by each pharmacy.

Our analysis has also identified significant differences in the prices that some molecules are being dispensed for. This includes both PBS-reimbursed prescriptions and private/below co-payment items.

Table 2 below highlights the average GP$ per script movement experienced during 2016.

Table 2: Moving average GP$ per Rx *

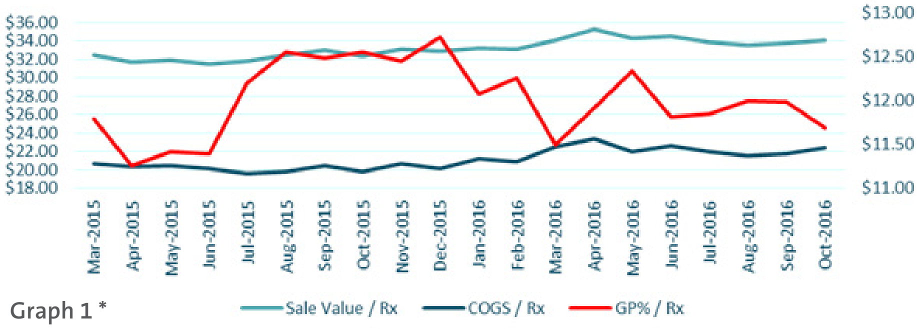
GP $ Rx	Average
Apr-16	$11.92
Jun-16	$11.81
Oct-16	$11.69

Interestingly, the reductions on 1 October 2016 were not as severe as expected. The average and spread of decline from the 1 October price reductions are detailed in Table 3.

Table 3: Variations in GP$/Rx *

GP$ / Rx	Average	High	Low
Oct-16	-$0.30	-$0.70	-$0.06

While there were significant decreases for many molecules already in price disclosure, we also identified a welcome change: price increases in some molecules each month which helped offset some of the reductions.



Graph 1 *

It is also true that because of the differences in molecules dispensed in each pharmacy, it is very difficult to define an "average" GP$ per script. In other words, you need to analyse and track the results of your own pharmacy/ies.

As mentioned previously, some of the variation in Pharmacy GP$ per script is resulting from the better performing pharmacies managing prices and ensuring that the dispensary team claims all allowable fees (eg. safety net recording fees). The latter is purely an administration task and can make a significant difference for a pharmacy with high numbers of safety net or entitlement customers.

In fact, for the month of December 2016 there were price increases for about 60 molecules, with four products experiencing increases greater than 100%. Such increases stem from the need to maintain a sustainable PBS given some manufacturers have experienced significant pressure as the reimbursement price for certain molecules has declined significantly during the last few years.

A win for pharmacy

This situation is a win for pharmacy as each increase in price will act to increase the GP$ per script as trade terms plateau for each molecule once it nears the end of the Government's price reduction process.

As a consequence of dispensing high-cost molecules and ongoing price increases, we predict the sale value per molecule dispensed will hold above $33 (as seen in Graph 1) – a level we initially thought would have been broken through on the downside by now.

Managing the customer

When it comes to managing prices, a large component of the profit equation is managing the customer. Optional discounting of the co-payment has been possible for more than a year now and when applied en masse it contributes to a lower-than-average GP$ per script.

Recently we have been advised of customers who took the co-payment in early 2016 and by late 2016 were querying why they were still paying for their prescriptions. There is a clear opportunity to work with these customers at the start of 2017 to ensure they get to their safety net earlier by not taking the discount and the pharmacy better protects itself against falling dispensary margins.

Disappearing wholesaler discounts

Pitcher Pharmacy's view is that Community Pharmacy is fast approaching the point at which wholesaler discounts become negligible or disappear altogether. Once this occurs pharmacies will need to streamline their ordering to one or two large orders per month, or suffer being charged for multiple other orders during the month.

The average dispensary stock turn of 24 times may therefore have to slow to, say, 12 to 18 times in the next 18 months. To do this, pharmacy needs to consider:

1. How much stock to hold? The cost of increasing stock in many lines is reduced given the price per box of many molecules; and
2. How much of the brand versus generic do you hold? This will influence the GP$ per script in a market where we are fast approaching price parity on many molecules and have brand price premiums.

The best performing pharmacies with the highest GP$ per script are currently managing the customer journey with respect to:

1. Product – brand vs generic;
2. Price – including not discounting the co-payment; and
3. Ensuring all claimable fees are included when dispensing PBS reimbursed scripts.

These pharmacies have already begun their journey towards optimising efficiency in the dispensary. Focusing on these items will ensure the customer stays front of mind.

These businesses are also optimising their stock holdings and ordering processes. This saves labour costs and may allow a reduction in the size (m^2) of the dispensary not only increasing its efficiency but, in many cases, improving profitability.

Pricing strategy trumps purchasing strategy

By Norman Thurecht

Pitcher Pharmacy has reviewed several commonly dispensed PBS items to better understand the degree of variation in market selling prices. Interestingly we found little variation in purchase prices but significant variation in sale prices.

Table 4 highlights the minimal variance in purchase cost (only a few cents difference) – note that box big pharmacy data is not represented in this data.

Despite the buy price being similar across the sample, the price at which these molecules are being dispensed varies significantly (up to 29%).

Table 4: Sample range of product purchase price variance and sale prices *						
Buy Price	**Alrpim**	**Coversyl**	**Endone**	**Nexium**	**Pariet**	**Ventolin**
Variance	**$0.03**	**$0.19**	**$0.03**	**$0.09**	**$0.13**	**$0.04**
Impact on GP	0.3%	1.2%	0.2%	0.4%	0.9%	0.52%
Sale Price						
Variance	**$2.66**	**$1.83**	**$2.89**	**$0.63**	**$4.16**	**$1.36**
Impact on GP	24.2%	11.8%	23.3%	2.6%	29.2%	15.5%

Table 4 comprehensively confirms that pricing strategy provides significantly more 'wriggle room' than purchasing strategy to positively impact dispensary profitability. The question must therefore change from "how much better can you buy the product for?" to "what is the appropriate sale price?"

There is clearly a point where price will influence volume. However, the customer is already aware that prices in community pharmacies will generally be higher than those of big box pharmacies.

We have seen various national banners broaden the Known Value Item (KVI) pricing strategy in the past six months with little-to-no movement in store unit volume across an extended period – certainly not enough to make up the difference in lost GP$. So, why try to aggressively differentiate on price if the customer does not recognise community pharmacy as a price leader but rates other components (eg. convenience, trust, service) higher in the value equation?

Balancing price, brand and stock

Habitual customers shopping on convenience represent a large cohort of community pharmacy customers and as such most will tolerate some price elasticity. Regardless, it is important to use product choice to help manage price or value expectations. Brand and generics are integral to this process.

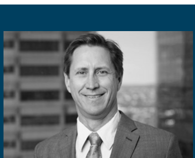
Some manufacturers apply Brand Price Premiums (due to the falling value of the molecule) which can benefit Community Pharmacy through higher margins while price-sensitive customers can be offered the generic equivalent.

Managing dispensary stock is becoming more complex as more patients fall below the general patient co-payment. This is in turn creating changes in both supplier and customer behaviours.

Future success will be defined by those that can efficiently adapt their business practices to meet these changing needs.

If you're ready to improve your dispensary efficiency and profitability, Pitcher Pharmacy would be pleased to support you on your journey. Contact us on 07 3222 8444.

** Note: All information has been derived from Pitcher Partners Pharmacy client base. Specific/individual client data is and always will remain confidential.*



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