Maintaining the net profit gap

Bruce Annabel, pharmacy business adviser and Adjunct Professor of Pharmacy Management, QUT. bannabel@jr.com.au

CHANGE THE WAY YOU DO BUSINESS TODAY TO BUILD A FUTURE TOMORROW.

As discussed in my past two *AJP* columns, the average gross profit (GP$) per script is about $14. Deduct the average dispensing cost of $9.56 and the dispensary section bottom line net profit is $4.44. Based on this $4.44/script gap, the dispensary on average contributes just over 89% of community pharmacy total net profit (EBIT).

It's therefore vital that owners fully comprehend the importance of maintaining this $4.44 gap.

If this gap falls during the next two years by, say, $1.00 due to the twin impact of weighted average disclosed pricing (WADP) cuts attacking the $14 GP$ and inflation increasing the $9.56 average dispensing cost, 21% of EBIT disappears in the absence of pre-meditated corrective action to build alternate income sources and replace what will be lost.

INDUSTRY REACTION

Most owners and managers realise there are competitive (attracting customers) and financial (maintaining and growing profitability) issues confronting them and they need to react.

Common *GP$ management approaches* are:

1. **making the most of the generic substitution opportunities from 1 April 2012;**
2. **improving supplier deals maximising trade discounts; and**
3. **forcing up generic substitution even when some customers resent it.**

These have worked well enough in maintaining the gap, even increasing it, but for many pharmacies this is now no longer enough.

Common *cost control* approaches are:

1. **cutting wages by reducing pharmacist wages and entrenching the pharmacist's role as a fast script-processing robot;**
2. **trimming sundry overheads and waste;**
3. **improving rostering efficiency; and**
4. **introducing appropriate drug stock storage systems aimed at saving picking and replenishment times.**

Unfortunately approach number 1 is the most common because cutting wages is easy.

Those who rely on maximising generics and cutting wages as the panacea to maintaining the gap ignore the real solutions needed today. They're in danger of realising too late the fundamental changes required to confront their out-dated business model.

THE DISCOUNTING TRAP

In confronting the competitive conundrum it seems every second pharmacy has adopted a discounting model. In doing so they have already given away part, some a lot, of the $14 GP$ earned per script by price-cutting anything that is not a PBS script.

Many of these pharmacies mistakenly believe they are competing with the warehouse pharmacies when in fact they aren't and can't possibly. Their GP$ per script is commonly around $12 and $13 with dispensary margins of 30–33% instead of 36% or more, where they should be. In the absence of ameliorating factors, such as massive sales per m^2 that brings huge cost efficiencies, their bottom lines and viability will be hit harder than the rest by the looming WADP cuts. Pharmacies with skinny (usually single-digit) EBITs (net profit before interest and tax divided by total sales) caused by unnecessarily low GP%, and some with unsustainably high overhead structure, will be hit hardest.

In a competitive sense these pharmacies have lost any point of difference they may have had by resorting to price. Current profitability from generics has made the discounting more affordable in a financial sense but can it last?

There is little doubt that those who struggle to increase the top line (customers/scripts/sales) and net profit have failed to radically overhaul their business model. Some try to combine price discounting with some sort of service value-add but it's not possible to do both well, particularly the latter. And this will become more evident as the price cuts bite in the future.

CURRENT PROFITABILITY FROM GENERICS HAS MADE DISCOUNTING MORE AFFORDABLE IN A FINANCIAL SENSE BUT CAN IT LAST?

DODGING THE DISCOUNT TRAP

For those who have maintained high margins and not resorted to discounting my recommendation is to hang in there and work furiously on continuing to overhaul your business model, focusing on delivering differentiated customer health experiences as the priority. The word 'experience' is the key and is a much higher level goal than 'service' as it emphasises valued health outcomes instead of just being nice to people and being efficient in meeting requests and processing—traits of a transaction-based model.

These pharmacy owners know that the customer sees value in two components: '…the benefit received and the price paid. Value increases as benefits are added at the same price point or as price is reduced for the same benefits'.[1] Therefore, all their efforts/innovations are aimed at increasing benefits in lieu of cutting price… and the financial benefits are significant.

Some smart community pharmacies are trying to edge up prices and, hence, margins upon recognising the risky financial and commoditised competitive position they have placed themselves in. They are also trying to introduce value-add services in order to lift the customer experience.

Because adjusting up margins is a very difficult thing to do successfully it's far better not to fall into the discounting business model trap to begin with. Instead implement strategies founded on maintaining the dispensary gap for as long as possible by not discounting, work on innovations that enhance the customer health experience and look at all the opportunities available to build leveraged income sources throughout the whole pharmacy. n

1. Inside Retail, Bird on retail. The new value equation: Proof that price alone doesn't add up. 24 February 2012.