Truth check on the business of pharmacy

By Retail Management columnist, Bruce Annabel

THERE has been so much deliberate misinformation spread through the media by many parties in recent weeks (likely sources including government, government departments and the usual vested interests) attempting to 'scandalise' the business of pharmacy that it would be easy to conclude that the Federal Government is bereft of policy ideas and has reverted to mugging pharmacy in the hope that the public is dumb enough to buy it.

Given the Government's recent announcement that 'whoops—the Medicare safety net has blown out so, sorry, we'll have to change our election promise', one has to be sceptical of either the calibre of Government costing or their capacity to understand advice. Still, it was a rock-solid, iron-clad guarantee. So perhaps it's not surprising that it sank.

Few, if any, of these 'expert' commentators' truly understand the financial and retail realities of today's community pharmacy business and, by extension, the effects of a cavalier 'slash and burn' approach.

At JR Pharmacy Services we do have this knowledge thanks to 20 years' experience specialising in the business of community pharmacy and having a pharmacy clientele in excess of 250 pharmacies located in every state and territory. So much so that we are able to legitimately prepare our own KPI benchmarks and performance averages that have national relevance.

So let's talk truthfully about the of the real business of community pharmacy. The real business is not reflected in the 'shock-horror' reports from recent media commentary, nor the ignorant views attributed to some government Ministers who were apparently 'shocked' by the terms of an agreement negotiated by their Government. Wholesale and generic discounts are well known to the Government (otherwise how could they propose to adjust them?).

Sales growth

Sales growth in pharmacy has almost entirely been generated from prescription dispensing which, as a proportion of total pharmacy sales, comprised 67.3 per cent in 2001/02 and 68.1 per cent in 2003 (JR Pharmacy statistics). These figures exclude the sales of Pharmacy and Pharmacist-Only medicines. Our expert commentators' are unaware of the real drivers of this growth and the resulting impact on other aspects of pharmacy finances.

Health Minister Tony Abbott offered 'rock-solid' support for pharmacy at APP05

There have been three drivers of growth.

1. Expensive blockbuster drugs

Expensive blockbuster drugs are approved by the Federal Government appointed committee, the Pharmaceutical Benefits Advisory Committee (PBAC), which oversees the drugs introduced and maintained on the PBS.

The financial impact is firstly evident from the PBS statistics:

Year	PBS cost growth	Script no. growth
2001/02	9.9%	4.7%
2002/03	9.2%	2.6%
2003/04	9.3%	4.3%
2004/05 (March '04 versus March '05)	4.7%	0.7%

That means pharmacy sales have increased but not by as much as many would suggest. The trade-off has been the drop in the gross margins earned due to the largely fixed PBS remuneration on 'expensive' drugs (where cost is greater than $450), restraining the growth in gross profit dollars earned (these GP$s allow a pharmacist to invest in stock and staff for the dispensary activity). At the end of the day gross profit dollars must rise faster than (or at least equal to) pharmacy overheads, which continue to rise at an alarming rate (more on that later).

Before including supplier discounts dispensary margins have fallen alarmingly.

It's now common in our client base for pharmacies to see dispensary margins of 20 to 22 per cent. The many high-cost drugs being dispensed more often earn margins in the range of 4 to 8 per cent and that includes the supplier trade discount. This trend is likely to increase rather than decrease.

Private prescription margins, the subject of recent media misinformation, only earn circa 25 per cent (at least as reflected

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in pharmacy dispense reports that I have seen in recent years). That margin corresponds to a mark-up of 33 per cent! Woolworths Supermarkets' margin last financial year was 24.1 per cent, including liquor and petrol. That converts to a mark-up of 32 per cent and doesn't involve the sale of prescription medication.

If all supplier discounts, including generic incentives, are added then the real dispense margins have continued to fall in the last four years by between 5 and 2 per cent each year.

Pharmacy may be benefiting from a 'cash churn' from dispensing but dispensing is not the 'rort' that government ministers believe. So, it's just as well generics have been encouraged by the Government, manufacturers and pharmacy owners because, without the additional discount available, pharmacy net profit would have fallen significantly and pharmacy's capacity to provide professional service will have fallen commensurately.

Importantly the pharmacists' 10 per cent mark-up and the 4 per cent mark-up that cuts in for drugs costing more than $450 have been axiomatic to the survival of many community pharmacies in our client base. This is particularly so for pharmacies in remote areas and allows pharmacists the time necessary to counsel and advise where necessary. In countries such as New Zealand and the UK, where there is no mark-up, little if any time is devoted to much more than the process of simply getting through the volume of scripts.

2. Script numbers

Script numbers have grown and are a more accurate measure of real dispensary sales growth than pure dollar sales because the drug inflationary aspect is excluded.

The biggest area of PBS dollar growth has emanated from growth in the area of concessional and general safety net benefits referable to Government policy.

So, given that the growth of the PBS is referable to Government policy, not pharmacy-controlled factors, the Government's plan for a 'slash and burn' job on pharmacy looks intellectually bankrupt.

It's not as though community pharmacy doesn't have enough on its plate at the moment. Consider the following.

3. Competition

Competition to traditional community pharmacy from both within the industry (low-cost/low-price warehouse pharmacies, online and mail order) and outside it (supermarkets, health and beauty niche retailers, discount department stores and so on) have taken enormous chunks from the retail area which produces the highest margins. That includes OTC schedule and open selling lines. So, while our 2002/03 client base average shows retail gross margin was 37.9 per cent, sales only grew at the same rate as inflation.

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Evidence of the redistribution is obvious in the ACNeilsen supermarket data for the year ended 31 July 2004 that showed 10 of the 20 fastest growing categories were in traditional pharmacy lines (for example, cough and cold [29 per cent—first], analgesics [24 per cent—third], vitamins [19 per cent] and sun care [18 per cent].

These retailers, unlike the great majority of community pharmacists, are highly sophisticated merchandisers of product at a price and would be the beneficiaries of de-scheduling. Little wonder pharmacy retail growth is stagnant!

Overheads

In 2002/03 our pharmacy client base sales grew 7.4 per cent and total gross profit dollars grew by 6.6 per cent. That sounds okay until one realises that overhead dollars grew 11.2 per cent—an astounding figure! Very aggressive shopping centre landlords in city and regional locations have driven the increases, as well as rapidly increasing employed pharmacist hourly wage rates.

Our client base average rental has risen to almost 4 per cent of total sales (some up to 12 per cent) while wages, including commercial rate for working proprietor(s), have increased from 12.7 per cent of total sales to 13.5 per cent. But, the big factor is that wages (excluding super and on-costs) as a proportion of gross profit dollars rose from 39.1 per cent in 2001/02 to 41.8 per cent in 2002/03. That is, for every dollar earned after paying the wholesaler, owners in 2002/03 paid 42c to staff. If on-costs are included, that figure rises to almost 50c!

Supermarkets don't incur costs like that because they don't employ highly skilled professional pharmacists and allied health professionals to provide the high level of services that community pharmacy delivers.

Pharmacists are rarely, if ever, paid on the award basis these days due to the chronic shortage of pharmacists prepared to work in the traditional community pharmacy setting. In our experience the average rate has increased to $35 per hour with some demanding more, often up to $50, although that's unsustainable and rarely paid fortunately. Even $40/hr con-

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verts to an annual salary of $77,000, + 15 per cent on-costs, in return for a pharmacist working 40 hours for 48 weeks.

Net profit (EBIT)

The result of all this is that, what really counts, net profit dollars before interest and tax (EBIT) of our client base dropped by 5.7 per cent from 2001/02 to 2002/03. This is close to the 6.3 per cent average drop in EBIT identified by the Guild Digest for the same period for all pharmacies. These trends in overheads and net profit have not abated, as supported by my earlier review of our 2003/04 client base averages.

Debt

Whether we like it or not, there now exists a huge level of debt that is around the $2.5bn mark (that is, about $500,000 per pharmacy, although this figure is skewed toward the newest entrants/owners). This level of debt has been at least tacitly encouraged via the Government-initiated controls of the number of pharmacies authorised to dispense under the PBS, thus restricting supply. That's a lot for an industry with: sales of approximately $10bn; profitability under threat; and with a capital value of perhaps circa $4.5bn (that is, a debt to equity ratio of 55:45 which equals high risk).

So—what's likely to happen?

Let's suppose the Government decides (through whatever means) to cut remuneration by, say, $1 per script at the next agreement. That would be equivalent to reducing the wholesaler mark-up from 10 per cent down to 6 per cent, and wholesalers would have no choice but to pass this cut on to pharmacies in the form of significantly lower discounts. The impact would be to cut approximately 25 per cent or $60,000 from our client's average net profit (EBIT).

Some very profitable pharmacies, and those with little or no debt, could handle a hit like that. However, many pharmacies would become unviable very quickly. And that's not only the little pharmacy owners in the suburbs working hard for very little that constitute around 20 per cent of all pharmacies. There will also be many rural and city suburban pharmacies that would be seriously impacted because their sales mix is 80 per cent or more prescription-based and/or they have contracted very high debt levels to fund recent pharmacy purchases that largely comprised goodwill.

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The reality is, when a pharmacist buys a pharmacy funded primarily by borrowed funds, almost all the profits generated go to fund the loan repayments, interest, taxation and living costs. There's usually little left over as a buffer against big PBS remuneration reductions and to fund refits, new computers, new systems, training, additional specialist staff, and so on.

The point

What all this means is that pharmacy can't absorb a big remuneration hit.

Certainly there will be some offset through increasing volumes of generic substitution. But, in my view, that won't last long because of the 12.5 per cent clawback recently agreed to. And we must remember the impact will be felt on the returns that can be expected from the new drug, plus a reduction of income that had hitherto been earned on drugs in the same therapeutic category. Not to mention the savage impact on branded drug margins.

Having said that, there are possible efficiencies that can be found by intelligent restructuring in a collaborative environment. However, that won't automatically happen if the Government simply cuts remuneration on an 'ad hoc' basis while hoping that the pharmacies that do survive will be more efficient.

They may not be more efficient—they may simply restrict service.

Remember the industry realities at the moment: overheads are growing faster than income; competition is squeezing retail sales and margins; the level of debt is weighing heavily on cashflow; and the impact of the generic discount clawback.

In my view Australian pharmacy must not be allowed to go down the same road as countries such as the USA, UK and NZ. We have a unique opportunity to ensure that community pharmacy remains and extends its integral, value-adding role within the healthcare chain. To do this community pharmacy and Government must work together towards industry restructure and ensure savings will be delivered to Government while remaining financially viable to deliver services and contain/reduce downstream healthcare costs.

Australia leads the world with the Government-initiated and pharmacy-supported 'Quality Use of Medicines' program. This baby of a program is at risk of being thrown out with the bathwater of botched government policy.

Taking a reality check now to understanding the facts of what's truly going on in the business of pharmacy may pay huge dividends in the future for consumers, Government and community pharmacy owners. ■