

## Confronting the brutal facts

By Bruce Annabel\*

ONE of the attributes of superior leadership and performance discovered by Jim Collins and explained in his book *From Good To Great* is the ability to 'confront the brutal facts'. So too must our leaders in Government—chiefly those political and bureaucratic leaders from Treasury, Finance and Health—and pharmacy owners.

Efforts by Government under a Pharmaceutical Benefits Scheme (PBS) reform agenda to strip costs out of the supply of medicines necessitates government and bureaucracy leaders to truly understand the brutal facts of how pharmacy operates within its regulated environment.

The Federal Government's proposals to improve the PBS, coined *Sensible Changes To Make a Good System Better*, would not, if implemented, achieve that aim as they would create significant hardship for those pharmacy owners who survive, and result in numerous bank debt defaults and pharmacy closures.

These points demonstrate the significant disruption to the PBS network and service offer, currently available to all Australians, by the Government's PBS reform agenda.

### An absence of understanding

The proposed changes have been created to further reduce the cost of the PBS, which was, until 18 months ago, growing faster than inflation.

However, these proposals appear to have been created in the absence of a clear understanding of the real impact on the financial and service capacity of pharmacies, whether they are:

- city suburban community pharmacies;
- rural/remote pharmacies;
- hospital providers;
- aged care providers; and even
- warehouse pharmacies.

That's understandable because the politicians and bureaucrats are exposed

only to macro industry data and bits of information that are sometimes correct, although often not.

Before explaining individual impacts I will first make some general comments about the brutal reality of the current economic environment and how it impacts on the financial performance of almost every community pharmacy. Then I will demonstrate the impact of the Government's PBS reform agenda proposals on five individual pharmacies (see box, Real pharmacies—five case studies, page 80).

This exercise will clearly highlight the damage wrought on pharmacy if the Government pulls back all pharmacy trading terms through PTP (Price to Pharmacy) becoming the NIS (Net Into Store buy price net of trading terms benefits).

I have also taken into account the impact estimated by M-TAG of the 12.5 per cent and proposed 5 per cent cascading claw backs upon listing of additional generic products.

In order to show that the proposals will impact all types and sizes, not just the small uneconomic businesses, pharmacies in different locations and with varying turnover levels were selected from the JR Pharmacy Services client base of more than 250 pharmacies. We act for all types of pharmacies in every state and territory.

### Current economic environment

It's a fact that almost all community pharmacy net profits and cash flow have been hit hard during the last two years by the triple impacts of:

#### Flat or negative PBS script growth

This has continued over the past 18 months due to Government initiatives including the 20-day rule, increased patient co-payments and the increased safety net qualification, both of which, according to our clients, are continuing to dampen script volumes and sales.

It is important to understand that when the PBS grows, so does pharmacy revenue. This has been the case until the past two years when the Government's successful efforts to halt PBS growth have also dampened pharmacy revenue.

The Fourth Community Pharmacy Agreement was negotiated on the basis of PBS volume growth estimates of up to 4 per cent to 7 per cent over the next four years. The actual growth in PBS cost to Government was only 1.7 per cent (approximately 5 per cent forecast in the Agreement) over the past 12 months while volume actually fell 1.1 per cent (approximately 1 per cent growth forecasted) for the same period.

Therefore, pharmacists have already been financially disadvantaged in the order of approximately \$125m sales and \$38m of net profit dollars when compared with Agreement estimates. This is also over and above that revenue pharmacy agreed to forgo to meet government objectives during the negotiations.

That's a lot when one realises that overheads continued to grow well in excess of inflation and, when combined, leads to net profit reductions, as we have seen.

### Rising overheads

Overheads, particularly pharmacist wages, are rising faster than income growth (gross profit dollars) as proven by our client base averages for the financial years ended 30 June 2004 and 2005. This resulted in net profits only growing 2.3 per cent and 3.9 per cent respectively.

Results so far in 2005/06 reflect an actual downturn in net profits for the majority of pharmacies despite the increased availability of generic drugs since 1 August 2005, substitution rate increasing from circa 18 per cent to circa 25 per cent and attendant superior trading terms compared with branded alternatives.

In fact the results tell me that net profit depends heavily on the improved trading terms, without which profitability deterioration would have been worse.

And while the Government clearly wishes to increase the rate of substitution as another mechanism to reduce the cost of the PBS, the irony is that if the Government gets its way, pharmacies will receive less margin on generics in general than branded medicines. This is an obvious disincentive for pharmacists to substitute, but the Government has this covered if it follows through with one of its flagged intentions—mandating the prescribing of a generic when it's available.

#### Extreme competition

This has come from the supermarkets and discount department stores taking market share from pharmacies in non-scheduled product lines, thus placing even greater reliance on dispensing and OTC schedules. For the last two years, according to *AC Nielsen Grocery Report*, 10 of the top 20 fastest growing categories were pharmacy lines including analgesics, vitamins, cough and cold, dental. Traditional community pharmacies have also lost market share to the ubiquitous warehouse pharmacies.

#### Biggest losers: the elderly and infirm

The result of these realities will be seen in the five pharmacy case studies, but first a comment on one service model which is not described below, but is a critical element of the overall service offer from so many pharmacies; the servicing of hospital and aged care institutions.

Unfortunately the impact of the PBS reform agenda on such services is easy to work out. As all their net profits are generated from supplier trading terms, the proposals would remove all net profits, plus more, leaving that part of the industry unable to provide services, unable to invest in new initiatives and deterring pharmacy operators entering or remaining in those sectors.

There is very little room to improve efficiency in provision of hospital pharmaceuticals while the oncology sector has become marginal because of the capped \$40 maximum mark-up on costly medi-

## Real pharmacies—five case studies\*

### Case Study 1:

#### Rural Pharmacy—single pharmacy town

- Turnover year ended 30 June 2006 \$3,679,605
- PBS script sales proportion 65.2 per cent
- Impact of proposals on EBIT—loss 76.5 per cent

**Result**—pharmacy would close after selling off its assets.

### Case Study 2:

#### Rural Pharmacy—one competitor pharmacy

- Turnover year ended 30 June 2006 \$1,702,406
- PBS script sales proportion 67.2 per cent
- Impact of proposals on EBIT—loss 56.3 per cent

**Result**—pharmacy would survive and struggle. Revert to maximise script throughput and little or no additional service or advice.

### Case Study 3:

#### City Suburban—Medical Centre pharmacy

- Turnover year ended 30 June 2006 \$3,646,331
- PBS script sales proportion 60.7 per cent
- Impact of proposals on EBIT—loss 76.3 per cent

**Result**—pharmacy would close or try to amalgamate. Or at least revert to a script factory with no additional service or advice.

### Case Study 4:

#### City Suburban—Shopping centre—low rent

- Turnover year ended 30 June 2006 \$4,124,326
- PBS script sales proportion 50.3 per cent
- Impact of proposals on EBIT—loss 50.8 per cent

**Result**—pharmacy would survive albeit with low capacity to reinvest. Would move total focus to driving retail product sales with very little or no advice available on prescriptions due to poor profit returns.

### Case Study 5:

#### City Suburban—Neighbourhood/strip location—very price competitive market

- Turnover year ended 30 June 2006 \$4,098,104
- PBS script sales proportion 68.1 per cent
- Impact of proposals on EBIT—loss 189 per cent

• That is, all EBIT is wiped out and results in a very substantial net loss!  
**Result**—pharmacy would have to close and the owner would suffer severe financial hardship.

\*These losses don't take into account any allowance for the loss of gross profit dollars and further loss of income from the impact of the lower mark-up base as a consequence of the Government's PBS Reform proposals.

cines, such as oncology drugs, which came into effect from 1 July 2006 and was negotiated as part of the Fourth Community Pharmacy Agreement.

#### Observations

These real examples emulate the very great majority of community pharmacies and demonstrate:

- like all retailers, including Woolworths and Coles and many other businesses, trading terms constitute a very large proportion of net profits;
- the proposals will have a huge negative impact on all pharmacies regardless of location, size of turnover or style of business;
- integrity of the whole PBS network

would be severely compromised and customer service levels significantly reduced;

- many pharmacies will have to close, although some may be able to merge with other similarly effected pharmacies; and
- those who survive will have to curtail existing free service levels and revert to a prescription supply-only function like that found in the UK, USA and other jurisdictions I have visited numerous times where price is the only determinant. Put another way, does the lowest price correlate with the best product, the best service and the best outcome? Clearly not when the paucity of service levels in these countries is experienced and observed!

### The importance of pharmacy's retail side

The examples also lead me inexorably to the conclusion that those owners concentrating on the retail sales area of their businesses will be the least affected. That's because it can deliver a separate source of income to fund the PBS remuneration cuts.

Conversely, those who have devoted their time to building a prescription-based pharmacy will lose out very badly or have to close down. The connotation is that the government proposals, if adopted in full, will eventually lead to only two types of profitable pharmacies:

- prescription 'sausage factories' churning out scripts with low-cost labour and infrastructure where consumer advice won't be affordable; and
- large mass merchant style pharmacies using the PBS script traffic primarily as a device to create profitable non-prescription sales.

### Message to pharmacy owners

However, it's not all one-way traffic. Current and intending pharmacy owners must face up to their own set of brutal facts whether the current set of government proposals are implemented or not:

- The days of assuming that PBS script volumes will just keep growing at a rate sufficient to drive net profit growth year in year out are now over.

**ABRIDGED PRODUCT INFORMATION RULIDE TABLETS (Roxithromycin) BEFORE PRESCRIBING PLEASE REVIEW FULL PRODUCT INFORMATION. INDICATIONS (Adults):** Mild to moderately severe infections in adults: acute pharyngitis, tonsillitis, sinusitis; acute bronchitis and acute exacerbations of chronic bronchitis; community acquired pneumonia; skin and skin structure infections; non gonococcal urethritis. **CONTRAINDICATIONS:** Known hypersensitivity to macrolides, including erythromycin; severely impaired hepatic function, concomitant therapy with vasoconstrictive ergot alkaloids, breastfeeding. **PRECAUTIONS:** Exercise caution in patients with impaired hepatic or renal function. Superinfection and pseudomembranous colitis may occur. Roxithromycin may elicit a lengthening in cardiac potential duration at supra-therapeutic concentrations. **USE IN PREGNANCY:** Category B1. **INTERACTIONS WITH OTHER DRUGS:** theophylline, terfenadine, astemizole, cisapride, pimozide, ergot alkaloids, disopyramide, warfarin, digoxin and other cardiac glycosides, midazolam, cyclosporin. **ADVERSE REACTIONS:** Generally well tolerated. Treatment discontinuation in only 1.2% of patients. Gastrointestinal: Nausea, vomiting, epigastric pain, diarrhoea (very rarely containing blood), anorexia, flatulence. Hypersensitivity: Urticaria, rash, pruritus, angioedema. Asthma, bronchospasm, anaphylactic-like reactions, purpura, glottic oedema, generalised oedema, erythema multiforme, exfoliative dermatitis, Stevens-Johnson Syndrome. Liver: Moderate increase in serum transaminases, AST-ALT and/or alkaline phosphatase levels. Acute cholestatic hepatitis, acute hepatocellular injury. Others: Headache, dizziness, paraesthesia, tinnitus, malaise, moniliasis, pancreatitis, disorders of taste and/or smell. **DOSAGE AND ADMINISTRATION (Adults):** 300mg daily at least 15 minutes before food for 5 to 10 days. Available dose forms: 150mg tablets, pack of 10; 300mg tablets, pack of 5. Streptococcal throat infections require at least 10 days treatment. Some patients with non-gonococcal genital infections may require 20 days treatment. Full Product Information is available on request from sanofi-aventis. AU.RUL.06.04.02

PBS Information: Rulide is listed on the PBS as a  
General Antiinfective for Systemic Use.

Reference: 1. Rulide Approved Product Information. sanofi-aventis. ABN 31 008 558 807. Talavera Corporate Centre, Building D, 12-24 Talavera Road, North Ryde 2113. \*Please refer to Product Information for specific organism coverage. TH RUL 2/3V 05/06 AJP 1



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# management

## management updates

- PBS gross profit dollar margins will continue to be clipped by governments of all persuasions while the costs of dispensing these scripts will continue growing faster than inflation.
- Owners must conduct a review of their business operations particularly the dispensary process and extract the efficiencies obviously available.
- Existing generic trading terms are obviously an area earmarked by Government as an opportunity to reduce cost.
- Embracing a total store Retail Healthcare culture/strategy including getting smarter about managing categories that add value and demonstrate strong customer relevant health outcomes will save many pharmacies from oblivion.
- The warehouse low-cost/lowest price pharmacy model will continue growing on an even more aggressive low price combined with higher turnover paradigm to overcome lower PBS income.

In other words just being there and maintaining a very high level of clinical competence won't by itself sustain a community pharmacy business any longer. So

pharmacy owners must make significant changes to the way they act and that means courage—the ability to let go of what you know, and reach out into the unknown.

### Conclusion

It's clear that if the politicians and bureaucrats introduce in full the proposals outlined in its document, *Sensible Changes to Make a Good System Better*, many pharmacies will close and those remaining will either contract to a low-cost, product-only supply model or use PBS prescriptions for the prime purpose of leveraging into retail sales—the same model found overseas.

The PBS supply network will be severely compromised, as will the service levels consumers have come to take for granted and that they currently receive from their convenient local pharmacy.

These are the brutal facts that the Government and bureaucrats must confront. While the Guild continues to educate the politicians and bureaucrats, it is most effective when its efforts are complemented by representations from individual pharmacists. Let your federal Member of Parliament know what your

business is facing because they are accountable for the political decisions being considered.

Having said that it's vital that pharmacy owners also confront their own set of brutal facts and understand that net profits from PBS dispensing are falling and will continue to do so. Therefore, they must have the courage to change their business approach and adopt the whole-of-store 'Specialty Retail Healthcare' strategy that embraces providing healthcare solutions and leads to customer healthcare outcomes.

Underlying that and to grow profits, they must significantly improve business and retail management, which at the moment is generally poor and certainly below that of the competition.

If both parties confront the brutal facts, work together and make the necessary compromises, Australians will continue to benefit from a workable and valuable community pharmacy sector and PBS network.

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