

December 2010

## Are Australia's pharmacies recession proof?

**Australia was extremely fortunate to avoid the worst of the Global Financial Crisis. One sector that seems to have escaped particularly unscathed is the retail pharmacy sector: those community pharmacies involved in the sale of prescription drugs and patent medicines sourced either directly from upstream pharmaceutical manufacturers or from pharmaceutical wholesalers.**

In fact, the sector performed so well during this difficult time that it has left some questioning whether Australia's pharmacy industry is recession proof. Unfortunately it is not true: the reality is our pharmacy industry is as exposed to a recession as any other industry.



However, there have been a number of factors, not seen in any other industries (or countries), which contributed significantly to the ability of the pharmacy sector in Australia to avoid the very worst of the GFC.

■ **Support from suppliers was a critical factor.** Trading on credit terms of 90, 120 or even 150 days is very unusual in any industry, particularly during recession times when credit is tight and cash highly sought after. But for some Australian pharmacy groups, this was the "normal" trading environment they operated in prior to and during the GFC. The push from the two main wholesalers, Australian Pharmaceutical Industries Ltd (API) and Sigma Pharmaceuticals Ltd (Sigma) in particular, to expand their own brands into the retail pharmacy sector, placed Amcal and Priceline pharmacists in an enviable position. Not only were they offered generous terms for their trading accounts, but in many instances they also had their shops fitted out and their bank debt guaranteed. In other words, when everyone else was struggling to find the cash to pay their debts and had to cut down capital expenditure, the retail pharmacy sector was sitting pretty.

■ **The sector was also well supported by its financiers.** The GFC credit crunch forced the financial institutions to revise their existing credit and risk policies, which in turn saw a significant decrease in the volume of transactions, particularly with cashflow-based customers. Notwithstanding this environment

the retail pharmacy sector did not face the same scrutiny from its financiers. Historically, many banks lent 95 per cent or more of the value of a pharmacy business. During the GFC this fell to an average of 85%, which is still something that other cashflow-based businesses can only dream of. Why the special treatment? Banks setting lending strategy for the retail pharmacy sector were influenced by the sector's support from wholesalers (in most instances in the form of cashflow funding and debt guarantee), the regulatory environment, the reputation of the business and the certainty of cash collection from the Australian Government through the Pharmaceutical Benefits Scheme. For most pharmacies, obtaining funding during the GFC was still as easy as signing on the dotted line – and this at a time when most other businesses were being forced to reduce their debt level or simply refused rollovers of their facilities on maturity date.

### Things are changing

Despite the support pharmacies received during the GFC, there is change in the air. The two biggest financiers of the retail pharmacy sector, the wholesalers and the banks, are revising their strategies.

The wholesalers have had their own fair share of headaches over the last two to three years. Increased pressure from their financiers to reduce debt levels saw Sigma sell its pharmaceutical business to Aspen in August

2010 for \$900 million. API was also under pressure to improve its balance sheet and working capital position. With help from its shareholders through a capital-raising of \$146 million, API managed to avoid asset sales and negotiated an extension of its main facilities until April 2012. The impact of the GFC on these two wholesalers is clearly reflected in the movement of their share prices during this time. From an average price of approximately \$1.60 a share for each company in January 2008, they are now trading at around 40 cents – that is a 75% drop in the “value” of the businesses in three years.

And there is more bad news for the wholesalers. Recent changes to the PBS have led to Pfizer, one of the largest drug manufacturers, announcing recently that it plans to cut wholesalers out of the drug supply chain and sell directly to pharmacies. This is expected to cut the revenues of the main wholesalers by about 15%.

This is not great news for the retail pharmacy sector either. The wholesalers’ have focussed on improving their working capital position, primarily through “credit wind-back programs” which is reflected in new trading terms of 30 to 60 days being imposed on future supplies in conjunction with increased pressure for payment of the outstanding accounts. Demands for payment of large debtor balances are being issued to most pharmacies and in some cases legal action has commenced for the recovery of the debt. The good old days of full and unconditional support appear to be drawing to an end.

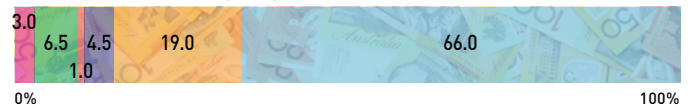
Financiers are also reassessing their risk appetite when it comes to lending into the retail pharmacy sector. What was once thought to be one of the safest businesses to lend to with regular Loan to Valuation Ratios (LVRs) of 90-95 per cent, is increasingly appearing on the banks’ industry watchlist. The applicable LVRs have been lowered to 70-75 per cent and some banks have gone as low as 60 per cent. The general perception that pharmacy businesses are overvalued is also impacting on the applicable LVR when current facilities are up for renewal.

The effect of these changes on the retail pharmacy industry can already be seen in the increased number of pharmacy businesses currently under review by the banks. We expect the proposed Government changes to the PBS scheme to have a greater impact on the performance and the value of the pharmacy business in the next 12 to 18

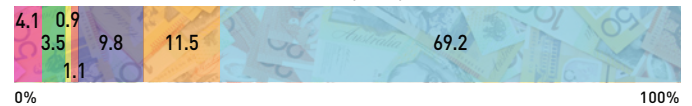
months. In particular, changes to the funding of generic drugs by the Government with a view to reducing the cost of the PBS scheme by approximately \$1.9 billion, will see generic medicines being subject to mandatory price cuts, which in some cases will be up to 25% off the current price. This will have a significant impact on the already small margins reported by some pharmacies.

### Industry costs and average sector costs

Pharmacy industry costs (2011)



Average costs of all Industries in sector (2011)



Source: www.ibisworld.com.au

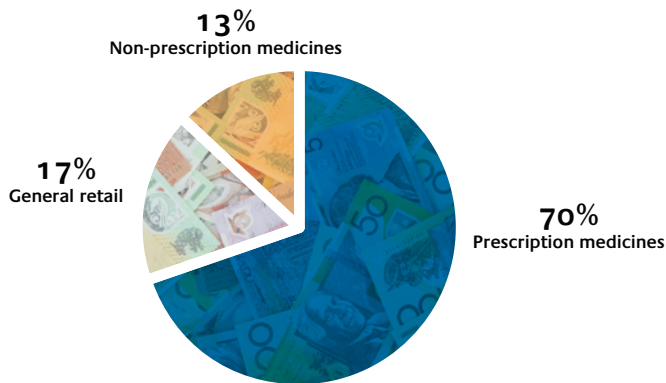
### Who will be most affected?

The additional financial pressure will be particularly felt by those businesses that relied on support from their wholesalers and financiers during the GFC. For some these changes could be the last straw. During the course of the GFC, Ferrier Hodgson has been engaged to review a number of pharmacy groups and provide advice on business viability, risks and turnaround strategies. It has become clear that the ones that will face the most difficulties will be those businesses displaying the following characteristics:

- Undercapitalisation as a result of rapid growth by acquisition.** There is nothing wrong with growing a business either organically or through acquisition when it is done in accordance with a well considered and realistic strategic business plan. However, the generous trading terms offered by most wholesalers combined with the continuous support from the banks made it possible for pharmacists or pharmacy groups to acquire businesses with little or no capital contribution. A number of pharmacists have grown their businesses exponentially over the last three to five years without a clear strategy. The inability to identify synergies, which

usually translates into high overhead structures, and the high level of debt carried on their balance sheets will have a significant impact on the performance of those businesses over the next 12 to 18 months, and in turn on their market value. This could lead to a “domino effect”: higher industry risk rating; higher prices on bank debts (currently the price is on average 3% above standard lending rates) and more pressure on an already tight cashflow.

Pharmacy products and services segmentation (2011)



Total revenue: \$12.3bn

Source: [www.ibisworld.com.au](http://www.ibisworld.com.au)

■ **Lack of retail experience.** There was a time when 80-90% of a pharmacy’s revenue was generated from prescription sales. This is no longer the case – the front-of-shop sales contribution has increased significantly over the last decade, in some businesses representing as much as 50%. This means it is no longer sufficient to focus on how many scripts are filled each day to ensure your business is performing well; pharmacists also need to develop retail skills. The ability to manage and control stock and space, two of the most significant costs in a pharmacy business, will become even more vital for the success of a pharmacy. Having the right stock and quantity at the right time and at the right price and making the best use of your space (eg: not having “dead corners”) could make the difference between success and failure. Pharmacists need retail knowledge to drive customer spending which will impact front-of-shop sales as well as prescription sales.

■ **Lack of focus on service.** The role of the community pharmacist is also changing. It is no longer sufficient to just fill in scripts at the back of the store: pharmacists need to demonstrate greater customer engagement and offer additional services. The Fifth Community Pharmacy Agreement provides the opportunity to share in government funding totalling more than \$500 million to pharmacies offering special advice and consultation to people suffering from things like diabetes and arthritis. Failing to provide these services will mean pharmacies will miss out on a slice of the funding pie and the opportunity to improve business performance.

■ **Poor management and management information systems.** Pharmacists need to be across the performance of all aspects of their business. The old saying – if you don’t measure it, you can’t improve it – remains true. Our clients often comment: “My prescription sales are going well, why I am getting so much pressure from my bank?” It is because banks no longer look at sales in isolation when measuring the risk on their investment. The quality of the management and the MIS are just as important. Failure to comply with the reporting covenants and produce timely and accurate financials can trigger an increase in pricing or even enforcement by banks as easily as a breach of a monetary covenant. It is therefore essential that owners understand how their pharmacy is performing, not just at the macro level, and that accurate information about all aspects of the business can be easily extracted to give the bank and other stakeholders confidence that their investment is sound.

■ **Poor cash management.** Another question that is regularly asked is: “My sales have improved, yet I still cannot pay my bills – where did the money go?” Our experience tells us that most pharmacists understand sales and scripts but don’t understand cashflow. The extended trading terms offered by some wholesalers have created a significant time difference between the cash collections from sales and supplier payments. Not having to pay bills for three months and sitting on three months’ worth of cash may prove too tempting for some pharmacists. Buying a new car or booking the next holiday may have seemed to make more sense at

the time than investing in a new POS system or staff training. But when wholesalers started reducing trading terms and banks began increasing prices, they belatedly realised the importance of cashflow management. For some it could be too late. Understanding the impact of the debt load on the business and taking steps to reduce that when extra cash is available is critical for the survival of any heavily geared businesses. Pharmacists take note!

## Conclusion

There is no doubt that what used to be “normal” for the retail pharmacy industry has changed. In addition to the changes discussed in this article, the Fifth Community Pharmacy Agreement between the Federal Government and the Pharmacy Guild of Australia is now public and it isn’t good news for pharmacists either. Further, the continuous threat of deregulation, the changes to the employment award for the pharmacy industry and some concerning trends in how landlords hand over tenancies, will add more pressure and make it even more challenging for pharmacies to protect business profitability.

Pharmacy owners and relevant stakeholders need to be aware of these changes and the likely impact they will have on their business. Recognising their shortcomings and expanding the management team by having specialist advisers in these areas could become critical for the survival of their business.

Ferrier Hodgson has a team of experienced pharmacy specialists that can provide independent, objective and timely assessments and recommendations to stakeholders. We can also provide business reviews with a focus on business feasibility, performance improvement, turnaround planning and risk identification and management. Ferrier Hodgson also has experience acting as expert valuers of pharmacy businesses in a number of court matters and pharmacy partnership disputes.



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Next year Ferrier Hodgson will be launching a regular electronic postcard about the pharmacy sector for distribution to those interested in developments in this dynamic industry. If you are interested in subscribing to our pharmacy postcard, please email [luci.palaghia@fh.com.au](mailto:luci.palaghia@fh.com.au)

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