



DRUG STORES AN INDUSTRY STUDY

Things you will learn from this whitepaper:

1. How does the government's healthcare policies affect the drug store industry?
2. What have advancements in technology done for the drug store industry?
3. Other than prescriptions, what other products are heavily merchandised?
4. How has consolidation affected the industry's landscape?

This whitepaper will have special interest to:

1. Attorneys consulting with drug store owners considering mergers or acquisitions.
2. Judges presiding over business disputes & corporate litigation cases
3. Business mediators & arbitrators.
4. Financial & income tax advisors.
5. Those concerned with the valuation of drug stores.

Notice & Disclaimer

In a forensic accounting setting, the purpose of an industry analysis is to allow a comparison of the subject company to its industry. This comparison is vital to assess the strengths and weaknesses of the subject company, as well as its industry and company specific risks.

The following study contains a brief, selected analysis of the specified industry. It is based upon a review of current economic statistics, articles in the financial press, reviews found in current business periodicals and information posted on numerous internet sites. It does not purport to be all-inclusive or to contain all of the information which a prospective investor or lender may require. Projections and opinions are based upon information provided by third parties. We make no representations or assurances that this information is complete or accurate. Neither Mark S. Gottlieb, CPA, PC nor any of its officers, employees, or representatives make any representation as to the accuracy of completeness of this report or its contents, nor shall any of the foregoing have any liability resulting from the use of the information contained herein or otherwise supplied.

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Industry Overview

According to the National Association of Chain Drug Stores (NACDS) there are over 55,000 drug stores operating in the U.S. today. Of these, 35,000 are operated by traditional chain pharmacies. The top four—Walgreens Co., CVS Corp., Rite Aid and Eckerd—claim about 66 percent of the industry's total market share. Supermarkets and mass merchant pharmacies round out the chain pharmacy category, helping chain drug stores claim over 75 percent of total industry sales. The remaining 20,000 drug stores are independents. It is estimated by the U.S. Department of Labor, Bureau of Labor Statistics that drug stores employ approximately 694,000 people.

With demand escalating, the drug store industry is growing rapidly, and sales have increased at an average rate of \$10 billion annually since the turn of the 21st century. By the 2010, total annual sales should surpass \$200 billion, with most of this growth claimed by chain pharmacies. Competition is fierce in the industry, and profit margins are thin. As a result, the last decade has seen a growing trend of acquisitions and consolidation, with the number of independent drug stores slowly decreasing. Mail order pharmacies have begun to establish a strong foothold in the industry, as well.

Operations

The drug store industry relies on four main product categories for a large percentage of total sales: prescription drugs, over-the-counter (OTC) medications, toiletries, and cosmetics. Other categories commonly sold in drug stores include: tobacco, consumables, stationery, photo-finishing services and housewares. Prescription drugs draw customers to the store, and a common strategy sees drug stores placing pharmacies toward the rear of the store in order to drag traffic through. Front-store merchandise typically yields higher profit margins than prescription drugs; sales of such merchandise accounts for 40 to 65 percent of total sales (and an even larger percentage of profits). Because front-store merchandise is not the industry's primary business attractor, however, drug stores tend to focus on the number of new prescriptions they fill as a gauge of overall success.

The average product mix for a traditional chain drug is as follows:

- Prescriptions- 48.4 percent
- OTC medications- 12.5 percent
- Consumables- 8.7 percent
- Toiletries- 6.2 percent
- Cosmetics- 3.8 percent
- General merchandise- 5.2 percent
- Photo-finishing services- 4 percent
- Tobacco products- 2.8 percent

According to the National Community of Pharmacists Association (NACPA), the average drug store has annual sales of about \$2.5 million and fills roughly 1,000 prescriptions per week. The average independent pharmacy has prescription sales of \$2.3 million, and dispenses 163 prescription drugs a day. Among retail pharmacy customers, 58 percent buy their prescriptions at chain drug stores, 15 percent at independent pharmacies, 12 percent at supermarkets, 9 percent at mass merchandisers, and 6 percent at other retail outlets.



Chain operators generally buy drugs and other products directly from manufacturers and distribute them to their stores through a warehouse system. Independent stores usually buy from a distributor or may participate in buying co-operatives that purchase from manufacturers. Large chains tend to get better prices from manufacturers by way of high-volume purchases, a key advantage as profit margins on many drugs are sometimes as low as 2 percent.

Among retailers, drug stores have fairly rapid inventory turnover, with inventory usually financed by cash flow. Chains frequently borrow capital to remodel and relocate stores, and to open new ones. Most sales of nonprescription items are transacted in cash. Third-party payers (e.g. insurance companies, HMOs, and other managed health care plans) usually pay drug stores within 30 days. More than 80 percent of all prescription sales are covered by third-party payers, as these provide prescription drugs to group members at reduced prices.

Government Involvement

The continuing success of over-the-counter products has prompted increasing involvement by regulators. Federal regulation by the Food and Drug Administration has been tailored to make OTC labeling easier for consumers to understand. New regulations also require OTC medicine manufacturers to revise product labeling to reflect the importance of consumers consulting with physicians and pharmacists on proper OTC usage.

Government attempts to control health care costs have also had a strong effect on the drug store industry. Although less than 10 percent of all health care costs are pharmacy related, pressure on drug stores to reduce costs and operate more efficiently have reverberated through the industry. While national health care policies have insured more Americans, thereby expanding the market for drugs, they have also decreased profit margins and galvanized the industry's competitive bent.

Workforce

While most drug stores have no problem filling "front store" positions, the industry currently faces an acute shortage of qualified pharmacists, pharmacist assistants and technicians. This shortage stems from: an aging population; a health care system that is increasingly reliant on pharmacotherapy; and the proliferation of chain drug stores. The pharmacist shortage is projected to increase as national demand for prescription drug therapy rises and the number of graduating pharmacists remains constant.

The number of future community pharmacists needed depends on the expansion rate of chain drugstores and the willingness of insurers to reimburse pharmacists for providing clinical services to patients taking prescription medications. With its emphasis on cost control, managed care encourages growth of lower-cost prescription drug distributors for certain medications. This is where mail-order stores have made their mark, easing the overall demand for pharmacists slightly.

Practicing pharmacists must be licensed, for which completion of an internship under a licensed pharmacist is required. Pharmacists must also graduate from an accredited college of pharmacy, and pass a state examination.



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Pharmacists' earnings are very high, with the median salary being \$95,252. They keep longer hours than other drug store employees, and may work nights, weekends, and holidays due to thin professional rosters and unyielding demand for services. The environment in which pharmacists usually work is clean, well-lit, and well-ventilated. When working with sterile or potentially dangerous pharmaceutical products, pharmacists must wear gloves and masks, and work with other special protective equipment.

Industry Trends

Generic Drugs — With a preponderance of prescriptions being covered by third-party payers, profit margins on name brand drugs are in constant decline. Therefore, many drug stores are shifting to sales of generic drugs. Generic drugs offer lower cost to consumers, but offer significantly higher margins to drugstores. This trend has also extended to nonprescription drugs, vitamins and supplements, and various health aids.

Expanding Role of Pharmacists — Increased government involvement has helped facilitate increased consumer care in pharmacies, as well as the involvement of pharmacists in consumer purchases. The NACDS reports that with "fewer hospitalizations leading to more and more procedures being performed on an out-patient basis, as well as the continued discovery of new and more complex drug therapy, there will be an increasing reliance on community pharmacy to educate and monitor patient therapy."

Litigation Concerns — In the past, pharmacists have been held professionally liable for errors made in prescription filling, and little else. With more drugs on the market every year, pharmacists and drug stores find themselves increasingly susceptible to litigation when prescriptions they fill harm a patient. This fact, coupled with pharmacists' expanding role as caregivers in the healthcare delivery system, has seen many pharmacists less eager to prescribe new drugs, potentially stunting sales.

Internet Sales — Internet sales of prescription drugs is a rapidly growing business that threatens the current drug store model of bringing customers in so they will buy other merchandise. Although most drug store operators oppose the Internet trend, some chains are capitalizing on their network of distribution centers by starting Internet operations.

Consolidation — Consolidation radically altered the drug store industry towards the late 1990s, leaving a handful of strong players. CVS acquired Revco and Arbor Drug; Rite Aid purchased Thrifty Payless, Marco, and K&B; and J.C. Penney bought Eckerd Drug, merging it into its Thrift Drug operations. This merger activity was caused by increased competition to offer a variety of merchandise at low costs, and by the availability of convenience in terms of pharmacy outlets. Consolidation continues as a basic industry trend, leaving independent drugs stores struggling to compete. In response, many have attempted offer better service, customer-friendly refund policies, knowledgeable employees, advice, and free home delivery.

Third-Party Payment — Prescriptions represent the largest out-of-pocket expense for consumers, and third-party payment has increased substantially over the past decade as part of the drive to control health-care costs. Third parties typically apply a discount of 20 percent to the average wholesale price of a drug, plus allowed dispensing fees (which cover administrative and labor costs of only \$3.00 per prescription as opposed to the actual cost of \$4.50). Although many drug stores take



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issue with the low margin sales and costly paperwork concomitant to third-party payers, such payers bring large prescription volume and are firmly entrenched in the industry.

Self-medication — The drug store industry has benefited from the general trend toward self-medication, and a more health-conscious attitude among consumers. Drug stores now control over 44 percent of the vitamin market, and many consumers purchase OTC medications, vitamins, and herbal remedies to treat their own symptoms.

Mail Order Drug Stores — Currently the fastest growing segment of the retail pharmacy marketplace, mail order drug stores comprise 19.1 percent of the retail pharmacy market. Sales from such stores escalated from \$13.4 billion in 1998 to \$43.93 billion in 2005. Much of this growth is due to the fact that by utilizing the mail order system, retirees have been able to avoid the usual 20 percent co-pay when claiming prescriptions under Medicare and Medicaid. Mail-order pharmacies are also thought to process prescriptions more efficiently due to automation and “assembly line” dispensing.

Increasingly, however, many plans adopted by employers, unions and other groups are adopting mandatory mail order rules. With mail order’s traditional economic incentives curtailed, and the inability of these stores to compete in the wide array of retail staked by traditional drug stores, it remains to be seen whether mail order drug stores can continue to win market share in the coming years.

Technology

Because pharmacists command high salaries, drug stores use various techniques and equipment to aid in dispensing prescriptions. Computer systems list potential drug side effects and aid in billing; pill-counting machines cut man-hours by performing a tedious occupational task; and 24-hour telephone lines allow customers to order at will. Electronic protocols, now standard, have eliminated problems in reading doctors' handwriting, while allowing pharmacies to bill third-party payers electronically.

With the discovery that some stores had been selling illegal prescription drugs purchased in Canada, digital tracking systems have become prevalent in the drug store industry since the turn of the 21st century. These systems also help combat sophisticated production laboratories that circulate sham pharmaceuticals, and drive down both price and profit margins.

According to the Encyclopedia of American Industries, other new technologies emerging include: AutoScript III, which integrates robotics, labeling, and pill counting into a touch screen system; QuickScript System, used for automating the entire filling process—including labeling, filling, and capping—and for streamlining the paperwork and inventory process to allow 90 prescriptions to be filled per hour; and RX-90 by Condor Corp., which simplifies the inventory process.

Following the lead of traditional retailers like Wal-Mart, many stores have instituted a satellite network to facilitate the filling of prescriptions anywhere in the U.S. Along this line, electronic data interchange (EDI) systems are an efficient way to share information with suppliers, who, due to intensified competition within the industry, have begun serving as key allies for drug stores.

Industry Outlook



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With an aging, health-conscious population, and increased insurance provisions by federal and state governments, the outlook for the drug store industry seems promising. The potential prescription explosion seems to be picking up steam through the first decade of the 21st century, thereby increasing overall demand for basic pharmacy services.

Unfortunately for traditional drug stores, many have begun to give ground to grocers, discounters and online retailers. Mass discounters in particular have made huge forays into both prescriptions and other health care products, shaking up the industry. By 2002, Wal-Mart had surpassed industry leader Eckerd with over 3,000 pharmacies, and five supermarket chains now post annual pharmacy revenues of over \$1 billion.

Truly, the drug store industry seems to be in a state of transition. The continuing consolidation of stores should be an effective method of dealing with razor-thin profit margins, and the proliferation of generic drugs could be another boon to profitability. If an adequate number of pharmacists can be found to provide basic pharmacy services, the industry may well emerge from its decade-long metamorphosis to capitalize upon a rapidly expanding market.



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