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Corner pharmacies gain stature with drug-distribution giants

BY CARRIE GHOSE | BUSINESS FIRST

J.R. White, a second-generation owner of White's Pharmacy Inc. on Columbus' east side, has noticed a rise in competition among the nation's three largest drug distributors to serve small stores like his. They're offering deep discounts and better back-office services.

"They want our business because you can make money on generics. They can't make money on brand names," he said.

Independent pharmacies, unlike chains with warehousing operations, need to buy their drugs from distributors.

White has a cordial relationship with sales representatives from Dublin-based Cardinal Health Inc., but he and 400 members of a purchasing cooperative recently re-upped with competitor AmerisourceBergen Corp. of Chesterbrook, Pa.

"They get us a really good deal," he said.

The Cardinal Health sales force keeps track of when contracts expire, and they'll be back to woo White, said Steve Lawrence, senior vice president of retail independent sales. The \$100 billion health-care giant has thrown considerable resources over the past two years at winning neighborhood pharmacies as customers.

"I think we have done a very good job of articulating to them ... why they're important to us and what we can do for them," CEO George Barrett said in a transcript of a March investor conference.

Not all independent pharmacy customers are happy. Cardinal is facing a lawsuit from franchisees of its Medicine Shoppe brand over a 2009 restructuring.

Among independents, Cardinal trails AmerisourceBergen and San Francisco-based McKesson Corp., which franchises a chain of 2,000 stores.

"We are quickly closing in," Lawrence said, citing estimates the three each have 20 percent to 30 percent market share.

"We do more business with independents today than we ever have in the history of Cardinal," he said.

The record number of stores is higher than in 2007, he said, when all three distributors lost customers during U.S. Drug Enforcement Agency investigations into the resale of narcotics by certain customers. Cardinal likely was disrupted

the most because of the number of license suspensions for its warehouses and the time it took to resolve the case, said Helene Wolk, senior analyst with Sanford C. Bernstein & Co. LLC. Cardinal estimated then it would lose \$1 billion in sales to independent stores, but never released a final figure.

Recovery from the DEA mess is "a work in progress, but it's encouraging," said John Kreger, an analyst with Chicago-based William Blair & Co. LLC. The company appears to be making an earnest effort to become easier for customers to work with and help stores improve profitability.

"Those smaller pharmacies are much more important now for distributors than they were in the past," he said.

The 1990s was the age of blockbuster brands, such as Lipitor, for which manufacturers control price. Cardinal and McKesson concentrated on chain drugstores to gain volume. In 2009, Walgreen Co. accounted for 23 percent of Cardinal revenue, and CVS Caremark Corp. 21 percent. But profit margins from those so-called bulk customers are razor thin, about 0.5 percent for Cardinal. As a wave of patents expires, not many new brands are emerging, and generics are taking over. White says about 78 percent of what his store dispenses is generic, up from half two years ago.

Since distributors have many manufacturers to choose from, they have more say on price, Kreger said. He sees Barrett, recruited from a generic manufacturer, as key to Cardinal's strategy for generics and said he expects to hear more about it when year-end results are released Aug. 5.

Cardinal disclosed new business services for independents last week, including help in becoming a supplier to nursing homes. Existing services fall in four areas: creating new revenue sources, inventory control and friendly ordering software, improving insurance payments and customizing a marketing and ad-buying strategy.

The company has seen results over the past year in a steady increase of customers, but it won't release figures, and a higher percentage of generic drugs in orders. In January, a 2,000-member group that formed in the merger of two customer groups kept Cardinal as its supplier.

WHEN SMALL IS BIG

Revenue from Cardinal Health's distribution segment is about evenly matched between "bulk" customers – the national pharmacy chains – and "non-bulk," or hospitals, independent retail pharmacies and other care settings. More intense services to smaller operators mean higher, if still slim, profit margins:

	2007	2008	2009
Bulk revenue	\$33.9B	\$37.3B	\$43.7B
Profit margin	0.6%	0.5%	0.4%
Non-bulk revenue	\$42.4B	\$41.8B	\$43.6B
Profit margin	2.4%	2.1%	2%

Source: Cardinal Health Inc.

"Independents are under attack. Their reimbursements are being decreased, their margins are going down, they're being pressed by competition," Lawrence said. "When you see the energy of these pharmacists and the passion they have for their customers and their communities, it excites us."

From the standpoint of independent Medicine Shoppe owners, one of those pressures is Cardinal itself, said Stan Winters, owner of a store near Long Beach, Calif., and one of the lead plaintiffs in a federal lawsuit against Cardinal. Franchisees claim Cardinal locked stores that signed on to the restructuring plan into exclusive buying contracts but slashed promised services. With fewer stores, the group loses purchasing power and can offer fewer Medicine Shoppe-brand vitamins and over-the-counter drugs because manufacturers won't make them, he said.

"I am not convinced that Cardinal really understands independent pharmacies," Winters said. "The back office support is great. (But) why are you consistently determined to take your best customers and not listen to them and do things that keep them from growing?"

Cardinal has signed more franchisees to Medicine Shoppe under the new model than it did under the old, company spokesman Troy Kirkpatrick said.