

DISCUSSION DOCUMENT

**Manhattan Smoke-Free Partnership  
Point-of-Sale Retail Reduction  
New York City Pharmacy Profit Analysis**

New York, NY  
May 2, 2011

*This document is confidential and is intended solely for the use and  
information of the client to whom it is addressed.*

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# Team

Matt McDonald –  
Team Lead

Matt McDonald is a strategy consultant with Booz Allen Hamilton, a leading strategy and technology consulting firm, in their commercial financial services practice. In this capacity, Mr. McDonald has focused on creating market entry strategies, identifying opportunities to expand market share, competitive analysis and organizational re-design. His clients with Booz Allen include Bank of America, Thomson Reuters and Fiserv. Past clients also include Duke Energy, Pepsi, Nestle and Toyota. Mr. McDonald holds a B.A. in History from Dartmouth College.

Lisa Cuesta -  
Co-Lead

Ms. Lisa Cuesta is a consultant with Booz Allen Hamilton's Strategy and Organization team. Ms. Cuesta graduated magna cum laude from the Wharton School at the University of Pennsylvania in May 2010 with concentrations in Finance and Global Analysis and a minor in Political Science. Ms. Cuesta has worked in the Advisory Practice at PricewaterhouseCoopers and the Investment Banking Divisions at Credit Suisse and Morgan Stanley. At Booz Allen, Ms. Cuesta has worked on a risk management assessment and improvement project for the Small Business Association, as well as the firm's pilot commercial finance intelligence program for a Fortune 100 company.

Greg Sans -  
Consultant

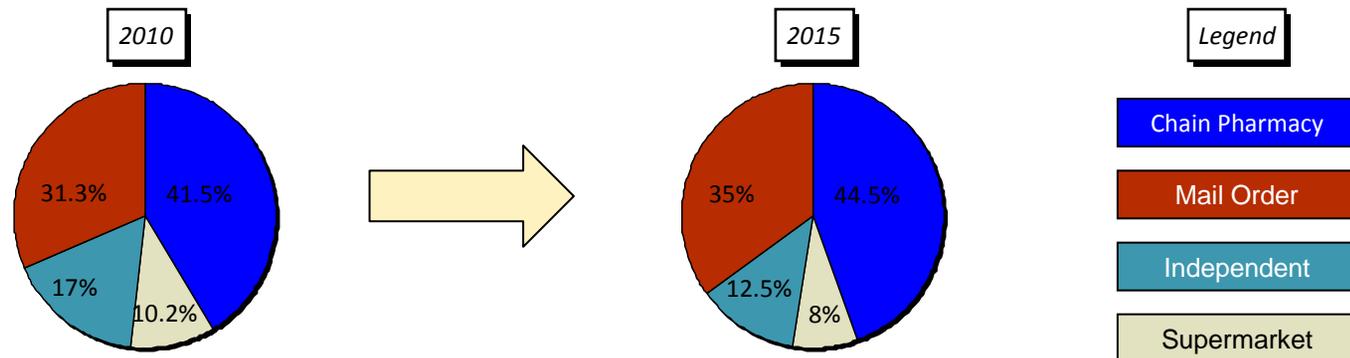
Mr. Sans is currently a Mailstream Consultant & Senior Sales Executive at Pitney Bowes . In this capacity, he focuses on marketing efforts and relationship management. He holds a B.S. from George Washington University.

David Loeb sack -  
Consultant

Mr. Loeb sack is a Senior Consultant with Booz Allen Hamilton, in the firm's strategic communication practice. Mr. Loeb sack's specialties include writing/editing, communications strategy and outreach marketing. Mr. Loeb sack holds a B.S. from Georgetown University.

# Prohibiting the sale of tobacco in pharmacies would reduce youth exposure to tobacco marketing and encourage smokers to quit

- ▶ In New York City, approximately 77% of the 11,006 licensed tobacco retailers are located within one thousand feet of a school perimeter
- ▶ It is a conflict of interest for pharmacies to provide health care and smoking cessation medications while profiting from tobacco sales
- ▶ Tobacco products are not currently sold at hospitals, medical clinics, retailers Target and Wegmans, and 85% of independent pharmacies
- ▶ However, over 50% of the large chain drug stores including as Duane Reade, CVS, Rite Aid sell tobacco products



Chain pharmacies receive over 65% of their sales through prescription and non-prescription drugs and market themselves as being part of the health care network

Chain Pharmacy	Key Findings	2010 Financial Performance
	<ul style="list-style-type: none"> <li>▶ Largest pharmacy chain in the US</li> <li>- Approximately 75% of the US population lives within 3 miles of a CVS store</li> <li>- Stores fill 1/5 prescriptions nationwide; #1 or #2 in 14 of the top 15 drugstore markets</li> <li>▶ A key focus is adding protocol-driven monitoring services for common chronic illnesses, such as diabetes, hypertension, and high cholesterol</li> </ul>	<ul style="list-style-type: none"> <li>▶ Revenue: \$98.7 billion</li> <li>▶ Operating profit: \$6.4 billion</li> <li>▶ Net income: \$3.7 billion</li> <li>▶ Same-store sales: overall - 5%, pharmacy - 6.9%</li> <li>▶ Net unit growth: 102 stores</li> <li>▶ Gained share in 82% of front of store categories</li> <li>- Private label and CVS exclusive brands account for nearly 17% of front-end total</li> </ul>
	<ul style="list-style-type: none"> <li>▶ Competing to be the largest pharmacy chain</li> <li>- Nearly 75% of the US population lives within five miles of a Walgreens</li> <li>- Enhancing stores through Customer Centric Retailing initiative</li> <li>▶ Leader in the New York City metropolitan area, the nation's largest drugstore market</li> <li>- In 2010, Walgreens acquired Duane Reade, the largest acquisition in Walgreens history</li> <li>- Converting Duane Reade stores in early 2011</li> </ul>	<ul style="list-style-type: none"> <li>▶ Revenue: \$67.4 billion</li> <li>▶ Net income: \$2.0 billion</li> <li>▶ Same-store sales: overall - 1.6%, pharmacy - 2.3%</li> <li>▶ Net unit growth: 550 stores</li> <li>▶ Front-end sales increased due to non-prescription drugs and convenience foods</li> <li>- Front-end sales were 34.8% of total sales</li> <li>- Drug sales account for 65.2% of total sales</li> </ul>
	<ul style="list-style-type: none"> <li>▶ Third largest retail drugstore chain in the US</li> <li>- Operates in 31 states and DC</li> <li>- Strategic alliance with GNC is a differentiator</li> <li>▶ The company is focusing on aggressive growth</li> <li>- Employ different strategies across stores</li> <li>- Improve sales by improving customer loyalty</li> <li>- Develop private brand offerings</li> <li>- Increase immunization offering</li> <li>- Expand GNC stores-within-Rite Aid program</li> </ul>	<ul style="list-style-type: none"> <li>▶ Revenue: \$25.7 billion</li> <li>▶ Net loss: \$506.7 million</li> <li>▶ Same-store sales: overall - (0.9)%, pharmacy - (1.4)%</li> <li>▶ Net unit decline: 121 stores</li> <li>▶ Offers approximately 25,000 front end products</li> <li>- Sale of 3,330 private label products contributes 15% of front end sales in areas where private brand products were offered</li> <li>- Drug sales account for 67.9% of total sales</li> </ul>

# Independent pharmacies provide tailored services and expert counsel on the treatment of health concerns to their communities

## Independent Pharmacy General Mission

- ▶ To be the primary provider of pharmaceutical services to their communities by establishing long term relationships with customers through effective disease state management, and superior consultative services in a compassionate environment
  - Ensure patients have access to quality care and pharmacy services in their community
  - Provide the highest customer service to both internal and external customers
  - Offer innovative ways of providing pharmaceutical care with knowledgeable and compassionate pharmacists
  - Continue to grow and be profitable in an ever-changing health care environment

## Industry Statistics and Current Status

- ▶ Represent \$93.1 billion of the \$206.3 billion total pharmacy marketplace
- ▶ Prescription sales in independent pharmacies represent \$86.8 billion, or 93.3% of total revenue, compared to 70% of chain pharmacy revenue
- ▶ 40% of all pharmacies are independent, down from over 24,000 in 2005 to 23,117 in 2010
- ▶ Earn an average of 3.2% pretax profit margin
- ▶ Offer a wide range of services, such as immunizations (76%), delivery (76%), diabetes training (69%), and blood pressure monitoring (67%)
- ▶ Serve smaller communities:
  - 51% of independent pharmacies are in areas of 20,000 people or less
  - 21% are in areas of 20,000 to 50,000 people
  - 28% are in areas of greater than 50,000 people

Number of Independent Pharmacies, 1998-2009



Sources: 2009-10 NACDS Chain Pharmacy Industry Profile; 2010-11 NACDS Chain Pharmacy Industry Profile;

Published on Drug Channels (<http://www.DrugChannels.net>), September 2010.

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# The pharmaceutical business model involves payment from third-parties, leaving pharmacies to compete over location and service

## Chain Pharmacies

### Strengths

- ▶ Operate nation-wide, providing brand recognition and convenience
- ▶ Diversify revenue streams with higher margin, front-end sales
- ▶ Possess pricing power due to large size and distribution network
- ▶ Utilizes advanced computerized technology to improve speed and quality of customer service
- ▶ Promote low-cost generic drug programs and other discounts
- ▶ Benefit from contracts with employer groups to acquire new customers
- ▶ Engage strong legal team to challenge local action and manage lobbying power in state and national legislation

### Challenges

- ▶ Rely on lean staff to keep overhead down, resulting in lower personalized, customer service and customer satisfaction scores, validated by forums filled with complaints from aggravated customers
- ▶ Face increased competition as purchasing prescriptions from mail-order, supermarkets, and other retailers becomes conventional
- ▶ Do not offer specialized services to further build relationships with customers, such as delivery for those who are homebound, special packaging for long-term care, or compounding for hospice patients
- ▶ Present an easy target that can attract a lot of attention

## Independent Pharmacies

### Strengths

- ▶ Garner highest customer satisfaction scores among pharmacies
- ▶ Offer superlative customer service, supported by clinically trained pharmacists who maximize medication adherence by answering questions and offering advice to patients face-to-face
- ▶ Provide customized services such as home delivery and specialized products such as diabetes shoes based on the population they are serving and the one-on-one relationships they developed
- ▶ Construct a setting that is familiar and easier to navigate
- ▶ Stay current on industry trends, products, and treatments

### Challenges

- ▶ React to changing dynamics in the marketplace, which could limit business expansion opportunities
- ▶ Compete with the buying power and cost-cutting efforts offered by chain and mail-order pharmacies
- ▶ Depend on prescription drug reimbursements for more than 90% of revenue, creating cash flow issues
- ▶ Face pressure from insurance companies and prescription benefit managers to cut reimbursement rates and profit margins
- ▶ Lack political clout and are underrepresented in producing legislation

# While selling tobacco products is inconsistent with pharmacists' responsibilities, pharmacies respond differently to bans

## Pharmacists Support Tobacco-Free Pharmacies

- ▶ Pharmacies are actively engaged in the health of their community: They have been granted exclusive control over the dispensing of medications and provide patient counseling, medication therapy monitoring, and help identify and resolve drug related problems
- ▶ It is a conflict of interest for pharmacies, providers of health care whose pharmacists can prevent and treat disease, to also profit from the sale of harmful products such as tobacco, known to cause disease
- ▶ Pharmacies sale of tobacco gives a false and dangerous credibility to cigarettes; displaying and selling cigarettes undermines the messages of other health professionals that tobacco products are uniquely dangerous
- ▶ In July 2009, the Pharmacist Society of the State of New York (PSSNY), House of Delegates passed a resolution supporting efforts to end the sale of tobacco products in pharmacies; PSSNY is the largest pharmacy association in New York

## Independent pharmacies have shown leadership in voluntarily banning tobacco products

- ▶ Highly value their reputation as health advisors, and focus their offerings to support healthy decisions for their patients
- ▶ Perceived as integral to the health care system, providing prescription medicines and other health services

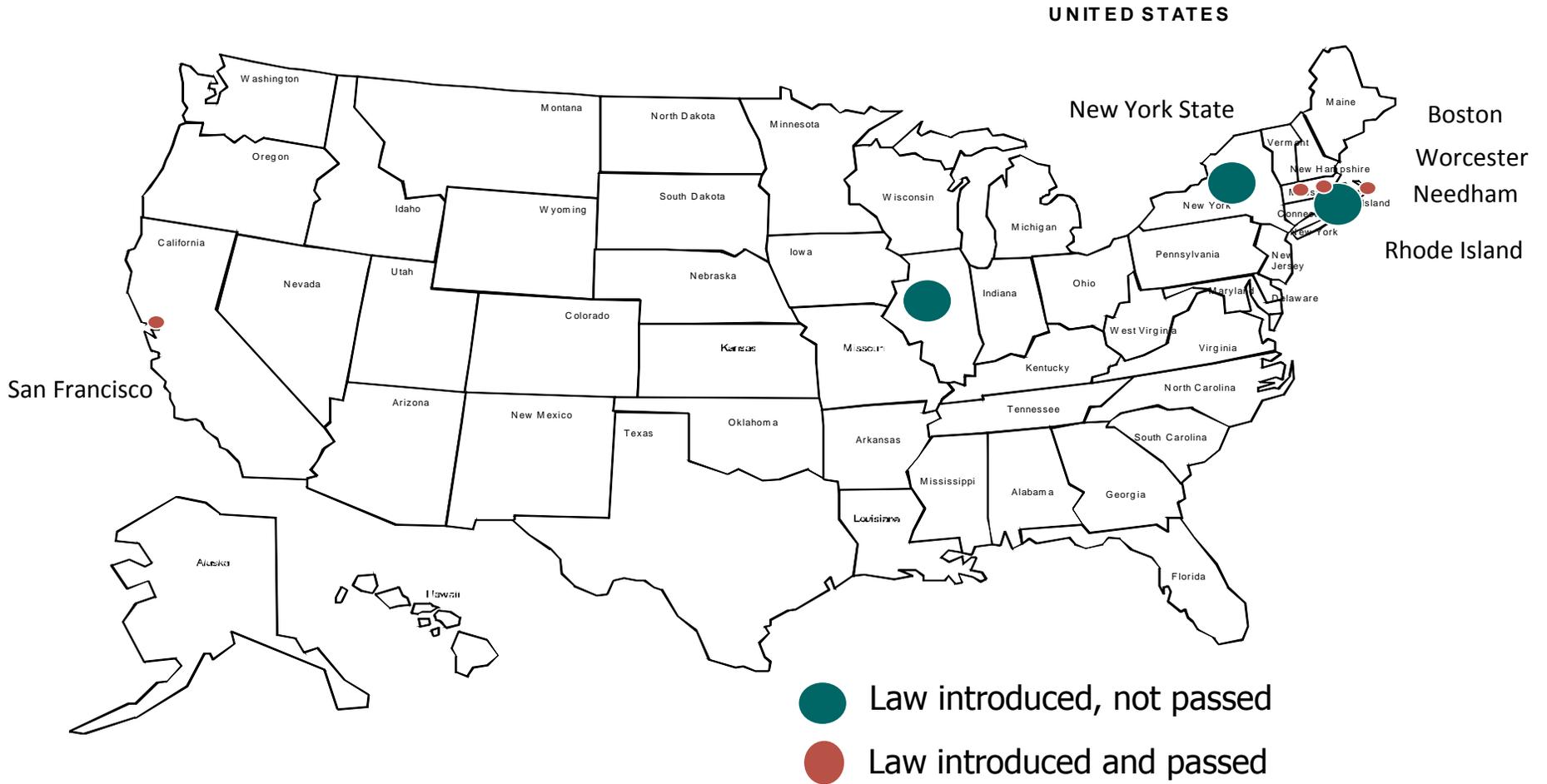


## Major chain pharmacies have yet to voluntarily stop selling tobacco products

- ▶ Benefit from selling both front-end and pharmacy products to smokers, and fear losing these customers by ending tobacco sales
- ▶ Only 1% of large chains and 40% of small chains in New York State are currently tobacco free pharmacies



In the United States, several jurisdictions around the country have brought laws to ban tobacco in pharmacies to legislature, with varied success



## Opposition to the tobacco ban has taken many forms, from philosophical to economic, but has primarily hinged on several factors

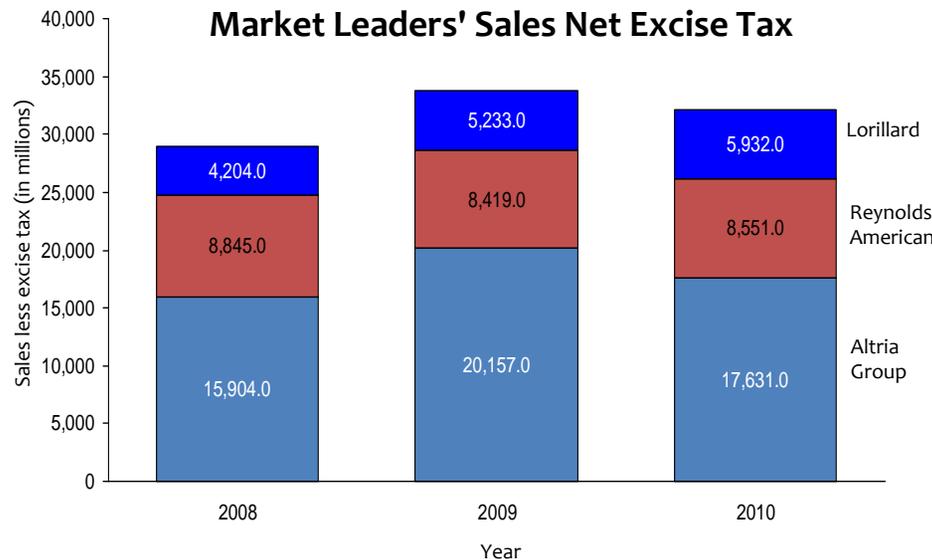
- Unwarranted government intervention
  - Laws relating to the restriction or outlaw of products have regularly come under fire due to the sense of perceived government intervention and over-regulation. With the tobacco issue, some have felt that the government has impeded smokers' rights and by preventing them from purchasing cigarettes through pharmacies – a supplier that is often omnipresent – that it severely restricts their access.
- Readily availability through other suppliers
  - Only 3.5% of tobacco is purchased at pharmacies. Consequently, many feel that targeting pharmacies solely makes little impact on the sale and distribution of tobacco and its affect on minors.
- Will hurt sales of pharmacies and retailers, perhaps resulting in closures
  - Smokers are a large constituency, comprising between 13%-20% of populations. Consequently, should retailers cease to sell cigarettes, they would be removing a product that is in heavy demand and therefore risk a substantial loss of revenue. The FTC took the position in the case of Illinois that portions of its proposed law to ban tobacco sales were anti-competitive.

...however, the belief that a ban will significantly hurt sales or induce store closures is largely unfounded

- Canadian Precedent Example
  - In the lead up to the Ontario Tobacco Control Act in 1993, several analysts predicted that a ban on cigarette sales would have a profoundly detrimental affect on the economy, including the closure of 119 pharmacies and a loss of \$550 million to the economy. Following the act's passage, there was a net gain of 70 stores over a two year period, with minimal loss to the economy.
- Wegman's, Target and Wal-Mart in Canada have voluntarily stopped selling cigarettes without harm
  - In the United States, Target and Wegman's have successfully offset revenue loss from voluntary cigarette bans through introducing new products, increasing supplies of high-demand, high-margin products (such as electronics) and in addition a bolstered brand due to the equity received through demonstrating health consciousness. In Canada, Wal-Mart has experienced "minimal" disruption from the various smoking bans in its sales.
- An analysis of tobacco industry sales and pharmacy sales of tobacco both indicate that ceasing to
  - In an analysis of the tobacco industry's trends and revenue movement's, Booz Allen Hamilton consultants concluded that the cessation of tobacco products would have minimal impact on pharmacies revenue figures, substantially less than the possible value brought by brand equity and a sound response strategy
  - In addition, when conducting an analysis based off the ban in San Francisco, our economic analysis confirms that pharmacies will have minimal loss due to the behavioral economics that come into play

# The domestic tobacco market consolidates, as the industry is increasingly challenged by increased costs and decreased volume

- ▶ Evidenced by recent mergers including Altria's acquisition of UST Inc. in 2009, consolidation has resulted in a domestic cigarette market that is dominated by three very large companies that have over 90% market share:
  - Philip Morris USA (50%)
  - Reynolds American (28%)
  - Lorillard (14%)
  - Other (8%)

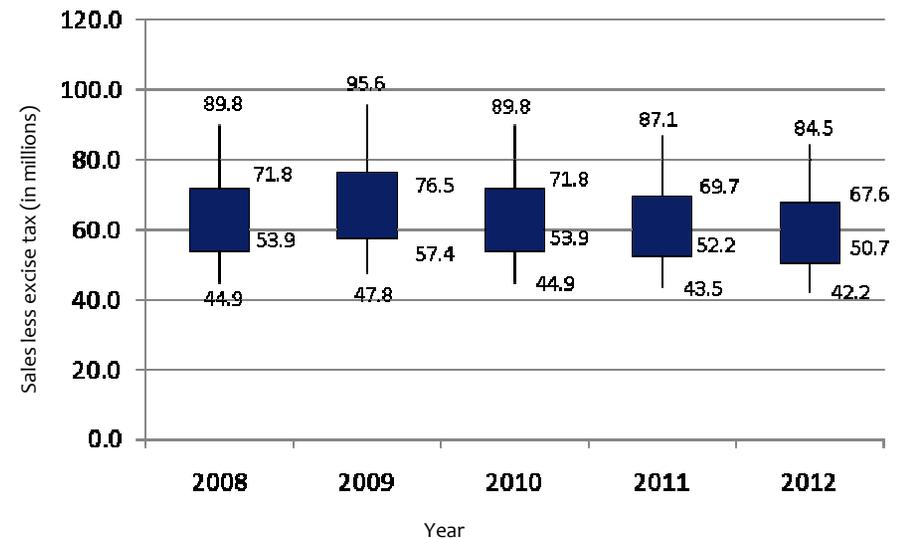


- ▶ Tobacco companies have pricing power that allows them to raise prices at least annually to more than offset increasing costs and decreasing cigarette volumes
- ▶ Increased costs impacting the industry include litigation and settlement payments and excise taxes, which decreased industry wide net sales over 40% between 2009 and 2010
  - In 2009, the combined state and municipal taxes ranged from \$0.07 to \$4.25 per pack of cigarettes
  - In 2010, the combined state and municipal taxes ranged from \$0.17 to \$5.85 per pack of cigarettes
- ▶ Volume has been steadily declining as a result of tax increase, smoking bans, health concerns and social stigma
  - The industry total domestic volume decreased from 345.3 billion cigarettes in 2008 to 315.7 billion in 2009 (8.6%)
  - The industry total domestic volume decreased from 315.7 billion cigarettes in 2009 to 303.7 billion in 2010 (3.8%)

# If unable to sell cigarettes, chain pharmacies will lose less than half of 1% of its sales per year

- ▶ Cigarette smoking has decreased over 9% in 2001 to 2009, but the decline has been erratic and inconsistent year to year
- ▶ The industry expects the volume of sales will continue to decline at least 3% a year
- ▶ In 2006, drug stores and pharmacies accounted for 3.5% of the industry's sales, trending upwards from 2.6% in 2003
- ▶ Tobacco outlets and supermarkets have become less significant channels for distribution during this same time period
- ▶ Most of the revenue is generated by chain pharmacies, as they have increased their market dominances and independent pharmacies have stopped selling tobacco products
- ▶ Cigarettes are sold at a markup that averages 6 - 8%, not factoring in the revenue generated by marketing offered by tobacco companies

**Estimated Drug Store/Pharmacy Revenue From Cigarettes**

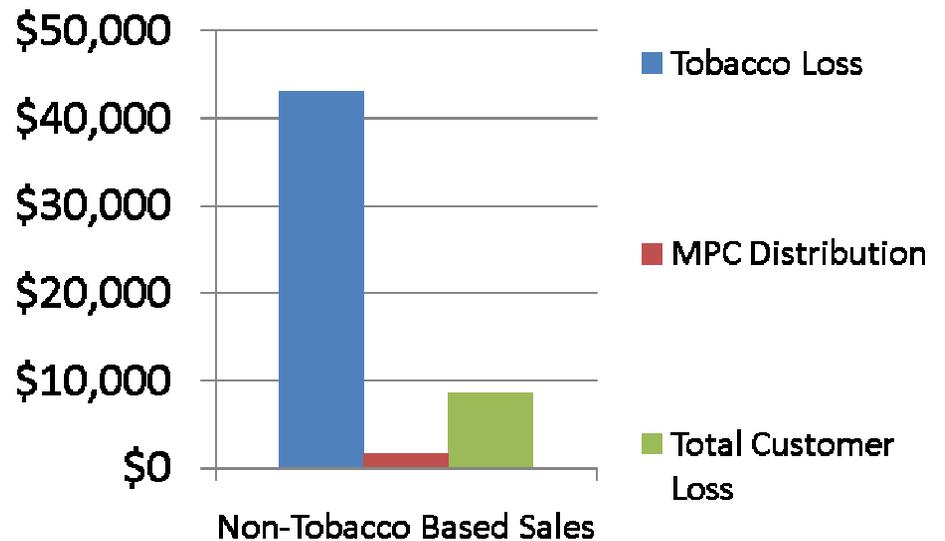
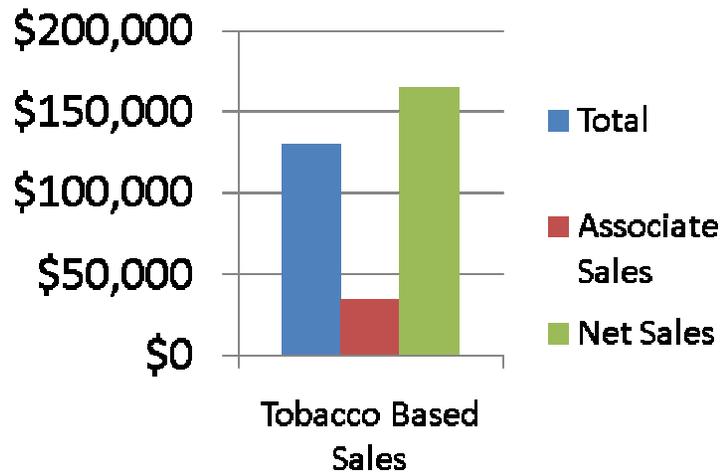


Margin	5%	6%	8%	10%
2008	44.9	53.9	71.8	89.8
2009	47.8	57.4	76.5	95.6
2010	44.9	53.9	71.8	89.8
2011	43.5	52.2	69.7	87.1
2012	42.2	50.7	67.6	84.5

## In San Francisco, analysis of Walgreens's legal case suggests that that company lost a net total of \$8.1 million from the cessation of tobacco sales

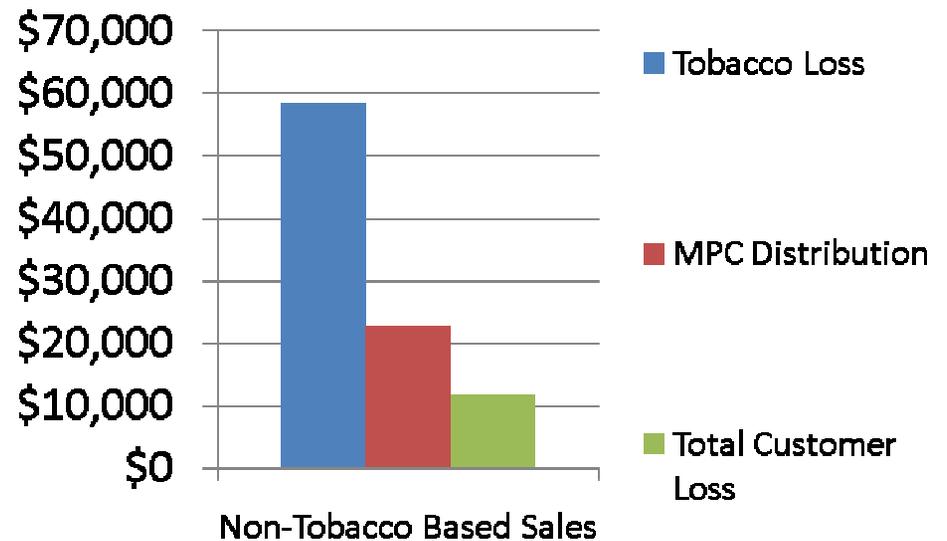
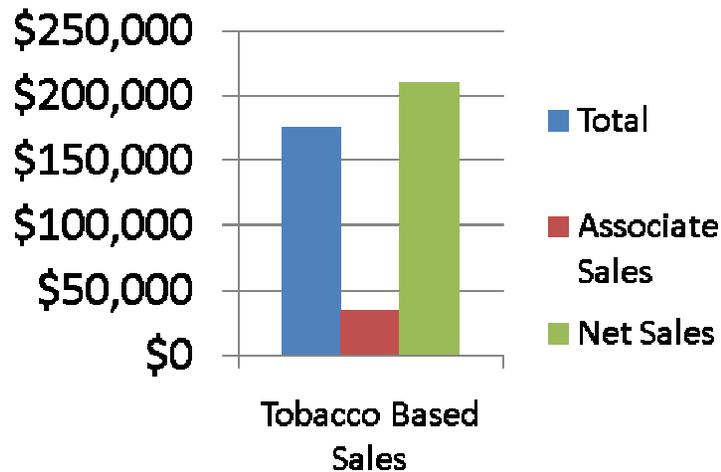
- ▶ Walgreens aggressively fought legislation to ban the sale of tobacco in San Francisco through lawsuits in the state of California
- ▶ In its suit, it claimed that it would lose \$9 million dollars in direct losses, and up to 9% of non-pharmacy sales to competitors due to product cannibalization.
- ▶ However, while product cannibalization will surely occur, like the analysts in Canada before them, Walgreens is grossly overestimating the effect on inter-departmental sales
- ▶ Booz Allen estimates that nearly 75% of tobacco purchases are made with tobacco being the anchor of the purchase. The psychology of the consumer who purchases tobacco to quell a craving leads them to primarily buy the product in isolation, or with other complementary products such as lighters, matches or gum.
- ▶ In San Francisco, this would amount to \$129.8K in tobacco per store. Assuming that for every \$1 spent on tobacco consumers spend \$.20 on associated products, this would yield an additional \$34.6K per store.
- ▶ For the remaining 25% in sales where Tobacco is not what brings the consumer to the store, a portion of consumers will go elsewhere due to unavailability (20%), a portion will re-distribute spending based on Marginal Propensity to Consume theory (60%) and a proportion will continue to shop without the purchase of tobacco (20%).

In San Francisco, analysis of Walgreens's legal case suggests that that company lost a net total of \$8.1 million from the cessation of tobacco sales



- ▶ Net Loss/Store: \$156,200
- ▶ Total Loss: \$8,122,500

For New York City, a tobacco ban would result in a loss of \$11.6 million, or .72% of City-Wide Revenue



- ▶ Net Loss/Store: \$198,900
- ▶ Total Loss: \$13,925,300

While retailers would see a .76% decline in revenue they can more than recoup their losses through several ways

- Steps to reducing revenue loss
- 1 Increase sales of smoking cessation aids and integrate smoking cessation into health plan**
    - All major retailers are currently adopting means to position themselves as centers of wellness in the wake of health care reform and the looming healthcare crisis in the country. With 65% of their profits coming from prescription and non-prescription drugs, pharmacies are well advised to strategically brand themselves as smoke free and investigate how they can increase both drug and OTC sales (many which fall under high margin private label brands) and counseling and workshops, similar to other programs in hypertension, diabetes and influenza.
  - 2 Recognize brand equity by being a first adopter**
    - As a first adopter of tobacco cessation, pharmacies could reap significant brand equity that will carry over into their other lines of businesses and their overall brand value. As retailers such as Wal-Mart has seen, increasing brand equity strategically is paramount in a competitive landscape, particularly with the continued consolidation in the highly-competitive pharmacy market.
  - 3 Diversify private label brand offerings and capitalize on increased square footage**
    - Increasing private label brand sales has been a key goal for all major pharmacies, due to their high margins and residual effects on brand loyalty and customer retention. With the added space in the stores, retailers should instead utilize that space for more private label brands or other high margin goods such as electronics, which has been a successful tactic for stores such as Target and Wegmans in Canada.

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