New Zealand pharmacy benchmarking survey 2014

MOORE STEPHENS MARKHAMS

ACCOUNTANTS AND ADVISORS

Serious about Success

Changing market provides challenges

The Moore Stephens Markhams group works with over 115 community pharmacies located throughout the country (approximately 12 percent of the total number of pharmacies in New Zealand). We assist those pharmacies with a broad range of services, including but not limited to, the preparation of financial statements and income tax returns, valuations and due diligence assignments, other accounting and taxation services, restructures and acquisitions, financial forecasts and financing assistance, business consultancy and advisory.

Our dedicated experience with the sector and the resulting relationships and information gained, place us in a prime position to provide prompt, accurate and useful information to assist pharmacies with their business planning and analysis.

This is the second consecutive year we have prepared our survey report, enabling us to compare some trends over the two year period. The data used in this benchmarking report has been captured from the 2014 financial statements prepared for 95 Moore Stephens Markhams pharmacy clients around the country (which represents around 10 percent of New Zealand's pharmacies).

We believe the pharmacies included in our survey represent a reasonable sample of the full population of New Zealand's community pharmacies in terms of size, type and geographical range. We share this data with you as we believe the information may be useful to your business. If you have any queries regarding the information in our report, please contact your Moore Stephens Markhams advisor.

Overall results

Overall KPIs

Overall Key Performance Indicators	2014 Average %	2013 Average %
Number of pharmacies in survey group	95	89
Gross Profit	38.7	37.1
Mark up	63.9	59.6
Dispensary sales	74.8	72.5
Retail sales	25.2	27.5
Advertising	0.6	0.5
Computer expenses	0.5	0.5
Interest expense	1.1	0.9
Occupancy costs	3.9	3.4
Salaries, wages and locums	19.5	18.9
Subscriptions and licences	0.4	0.4
Other expenses	4.8	4.0
Net Profit	7.9	8.5

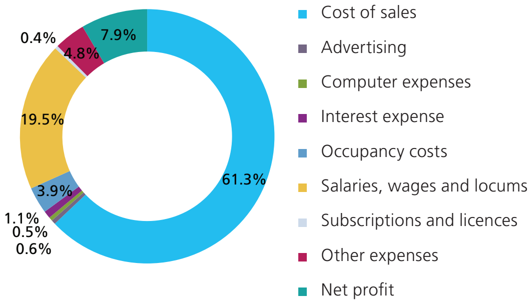
The KPIs referred to above provide a starting point for some aspects to consider when monitoring pharmacy performance. Other than cost of goods sold, which pharmacies often have very little control over, the major expense incurred by a pharmacy is the labour cost. This is the area that business owners have the largest discretion over and is usually the most important when determining how well a business has performed from year to year.

The results show that despite an increase in gross profit percentage in 2014, the overall net profit percentage has decreased. This tends to suggest that costs are rising faster than income. The other thing that stands out is the declining retail revenue stream that made up 27.5 percent of total sales in 2013 and only 25.2 percent in 2014.

Note - Any wage paid to owners and directors has been removed from the results and an average owner's wage has subsequently been added in as a wage expense on a pro rata basis for the amount of time the owner spends working for the business. On average, owners paid themselves $100,000 per year. On this basis, an owner working an average three days a week would have a salary of $60,000 factored into their results.

Overall results continued

Average expenses and profit as a percentage of revenue



2014 was the first complete financial year under the terms of the new Pharmacy Services Agreement (PSA) and whether this was a factor or not, it was a year that resulted in disappointing financial performances for many businesses in the pharmacy community.

More pharmacies than ever before have recorded decreases in gross profitability. Those that have been able to maintain or improve gross margins, have often not been able to maintain the same level of overall profitability due to other costs, such as rent and wages, rising quicker than income levels. The survey also shows that the retail portion of the business is being hit and this can have a significant impact on the bottom line.

Significant changes 2014 over 2013

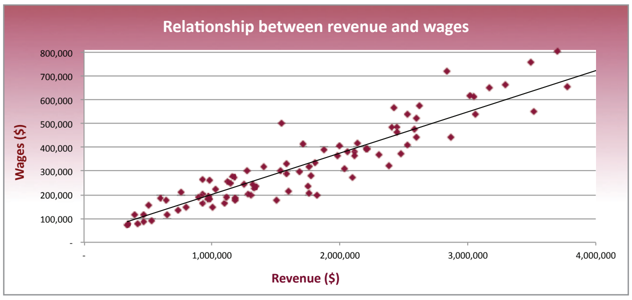
Average decrease in total revenue	- $27,762.96
Average increase in gross profit	$7,742.81
Average increase wages	$16,091.74
Average increase in occupancy costs	$1,832.66
Average decrease in profit	- $6,127.52

With the changes the PSA has brought to the way pharmacies are remunerated for their services, we have begun breaking down the various revenue streams in the profit and loss reports as shown below.

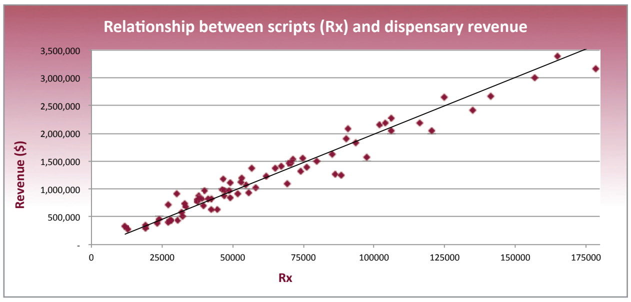
Breakdown of revenue derived in 2014 income year

Retail Sales	25.2%
Dispensary Sales	42.0%
Transition/ Advance/ Core Services	15.1%
LTC Payments	2.7%
Patient Charges	15.0%

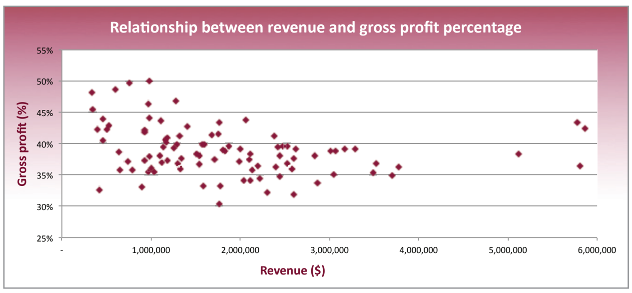
Results by turnover



This graph shows the relationship between labour costs (often the most important for a pharmacy) and total pharmacy revenue. Those below the trend line have been able to achieve their total revenue while spending lower than average totals on their wage bills. As referred to previously, these businesses often perform better overall than those pharmacies above the line.



This graph shows the relationship between the total dispensary revenue and the number of scripts dispensed. This shows a fairly consistent relationship and those below the line seem to have recorded a higher portion of repeat scripts as opposed to new scripts. This data has been extremely useful for forecasting purposes. A total of 4,857,668 scripts were recorded in the survey.



You can see that gross profit percentages can vary significantly for pharmacies that recorded similar revenue. A number of factors can play a part in this including, but not limited to, breakdown of retail vs dispensary sales, selling with a higher mark-up percentage, discounting goods, charging for additional services such as deliveries, blister packs or faxed prescriptions, and receiving discounts from drug suppliers such as prompt payment discount.

Results by region

Region KPIs

Important Key Performance Indicators	Auckland %	Other North Island %	South Island %
Number of pharmacies in survey group	57	22	16
Gross profit	38.9	38.4	38.4
Mark up	64.7	62.7	63
Dispensary sales	76.4	73	68.5
Retail sales	23.6	27	31.5
Cost of sales	61.1	61.6	61.6
Advertising	0.6	0.7	0.7
Computer expenses	0.5	0.5	0.4
Interest expenses	1.0	0.9	1.8
Occupancy costs	4.0	3.6	3.6
Salaries, wages and locums	18.9	20.2	20.7
Subscriptions and licences	0.4	0.3	0.4
Other expenses	5.0	4.7	4.4
Net profit before tax	8.5	7.0	6.5

Similar trends to last year have been identified when examining the results based on location. The standout remains the higher labour costs for pharmacies outside of Auckland. An important variable not evident from the table above is that the pharmacies outside of Auckland often have a larger turnover, so even if the net profit percentage is less, the overall dollar profit is not necessarily smaller. This is presumably due to the saturated Auckland market where many pharmacies are located in such close proximity to each other.

Occupancy

Occupancy KPIs

Important Key Performance Indicators	Alone %	Mall %	Medical Centre %
Number of pharmacies in survey group	49	9	37
Gross Profit	38.3	40	39
Mark up	62.8	67.3	64.7
Dispensary sales	71.2	52.5	83.6
Retail sales	28.8	47.5	16.4
Cost of sales	61.7	60	61
Advertising	0.8	0.9	0.3
Computer expenses	0.5	0.2	0.5
Interest expenses	1.2	2.7	0.6
Occupancy costs	3.6	5.5	3.9
Salaries, wages and locums	19.3	18.8	19.9
Subscriptions and licences	0.4	0.3	0.4
Other expenses	4.9	4.7	4.8
Net profit before tax	7.6	7	8.6

The results by occupancy type also showed similar trends to last year. Mall pharmacies had a higher portion of retail sales, higher occupancy costs and lower wage bills, while medical centres had the highest portion of dispensary sales, and highest wage costs.

Increases in perceived value of pharmacies

We have performed a large number of due diligence assignments for pharmacies that have been sold over the past year. We have noticed an increase in the perceived value of a pharmacy business and this has put a lot of pressure on younger buyers particularly. It is important for a buyer to remember what they are getting when purchasing a business. The purchase price will include stock on hand, fixed assets and the remainder will be termed 'goodwill'.

As the asking prices have continued to rise, larger portions of the purchase prices are made up of goodwill. There are risks involved with any business purchase and a number of things can have an impact on the outcome including, but not limited to, the lease of the premises, the location of local doctors and the continuity of key staff members.

A good due diligence can help limit as many of these risks as possible but it is important to factor these in when determining an appropriate purchase price. One key measure that should be considered when purchasing a business is the expected payback period – how long is it going to take me to pay back the purchase price? If you project that it is going to take five years to earn enough profit to repay the purchase price and the business has only has a five year lease (with no guarantee that this will be renewed), then you could end up having not made any actual return on your investment, and without a lease, you would likely have no business to sell at the end of the lease term. These risks need to be weighed up against the potential return when calculating the value of the business.

The increased values at which pharmacy sales have been taking place has also lead to increased focus on bank lending requirements. Despite the new LVR lending criteria, many banks are still interested in lending money in situations where they believe the business is viable, however often with greater covenants than would previously have been in place. Overleaf are covenants we are aware that banks look at for their customers. These conditions are often reviewed annually or quarterly and if the requirements do not continue to be met, this can lead to an 'event of default'.

Ratios

Ratio	Interest cover	Leverage cover
Formula	EBIT/EBITDA / Interest = X	Bank loan / EBIT/EBITDA = X
Common bank requirement	X must be > 2.5	X must be < 3
Median survey result	6.18	1.71

Some of the effects of the increased purchase prices and drop in business performance can be seen by looking at the movements in the ratios below.

Ratio	Return on assets	Current ratio	Stock turn ratio
Formula	Net profit / Total assets	Current assets / Current liabilities	COGS / Closing stock
Median 2014 result	22.13%	0.92	8.99
Median 2013 result	27.18%	1.20	9.60

Stock turn ratio

Another key ratio that we look at when examining a pharmacy is its stock turn ratio. A large portion of a pharmacy's working capital is tied up in items on shelves so getting this right is key to optimal cash flow. Too high can be a result of the pharmacy not holding enough stock and may not have the item a customer requires, too low can mean too much money is sitting on the shelf gathering dust. The median for the year was 8.99 times per year. This is slightly less than the 9.6 times that were recorded in last year's results.

Points of interest

- Approximately one third (31 out of 95) of the pharmacies in the survey were Green Cross Health pharmacies.
- 36 of the 95 pharmacies had more than one independent owner.
- 53 (56 percent) of the pharmacies in the survey were owned by shareholders that hold shares in more than one pharmacy.
- No unexpected performance differences were identified between pharmacies in these categories.

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