

Economic technologies to increase the profitability of the
pharmaceutical market. Easy. Logical. Profitable

Economy of interaction of pharmaceutical manufacturers and pharmacy chains on the Russian pharmaceutical market

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Economy of interaction of pharmaceutical manufacturers and pharmacy chains

Presentation plan

Part 1. Economics of pharmacy chains;

Part 2. Difference between front and back margin;

Part 3. Reasons for reducing front margin;

Part 4. Sales Management in pharmacy chains;

Part 5. Economic profile of the product;

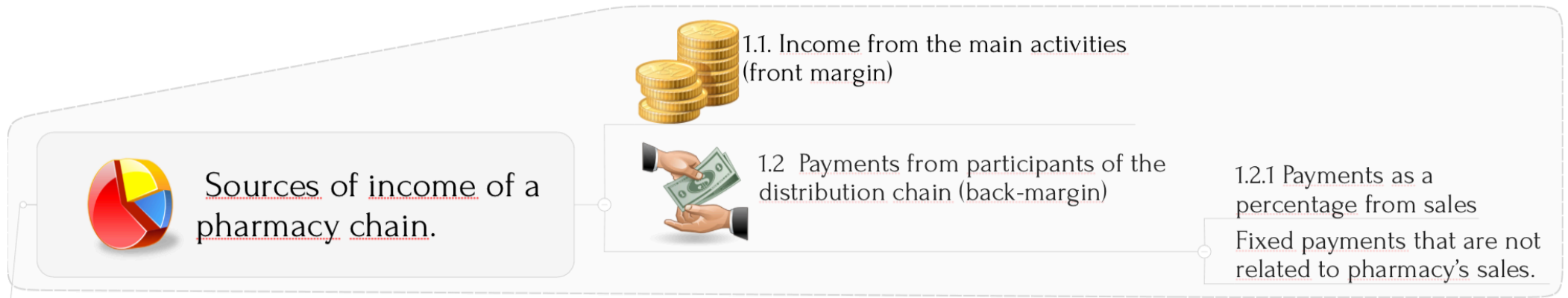
Part 6. Strategies for interaction of pharmaceutical manufacturers with chains;

Part 7. The phenomenon of Private Label and the fight against it;

Part I. Economics of pharmacy chains

Sources of income and relation between front and back margins

Sources of income for a pharmacy chain



1. Which source of income is more important?
2. What kind of marketing payments is better, fixed or flexed («volume»)?
3. What is the optimal balance of income types?

Ratio of front and back margin

Back margin is always under the share of gross profit

Ph. chans	turnover, rub.	Gross margin, rub	marketing payouts	Total income	Share of front margin	Share of back margin
system discounter	3.801.850.200	304.148.016 (8% of TO)	190.092.510 (5% of TO)	494.240.526	61,5	38,5
Big classical PhChain	1.537.800.000	276.804.000 (18% of TO)	61.512.000 (4% of TO)	338.316.000	81,8	18,2
Typical middle	576.700.100	112.320.100 (19,5% of TO)	17.301.000 (3% of TO)	129.621.100	86,7	13,3

There is a legend about possibility of making zero mark up and get income from manufacturer. But this business model is short term.

Psychological importance of back margin factor is at the peak

1. The quantity of contracts in each major chain: from 100 and above;
2. The share of marketing payments for the whole contracted and non-contracted assortment is about 3 to 6%
3. The marketing payouts for the several SKU can be 5 to 50%.

Front margin - how to calculate?

Front margin – is the difference between the turnover in retail prices and wholesale prices.

$$fm = TOr.p. - TOw.p = (retail\ price - wholesale\ prices) * number\ of\ items$$



wholesale price	mark up, %	Retail price	front margin per item.	Sold, items	Gross margin, rub.
220 rub.	30%	286 rub.	66 rub.	1.000	66.000 rub.

Back margin - how to calculate?

Back margin – is payouts of additional remuneration to the pharmacy chain for the fulfilment of the sales planes

$$bm = P(sip) * x\% * (\text{number of items sold (or bought)})$$



SIP, rub.

investments,
%

retail price,
rub.

back-margin
per items

Sold, items

Summary, back-
margin, rub.

200 rub.

20%

286 rub.

40 rub.


1.000 it.

40.000 rub.

Front+back margin - is it correct?

Does the total profit of a drug equal the sum of front and back margin?

It may be an erroneous calculation.



retail price, rub.	Front margin per item.	back-margin per items	Sold, items	Gross margin, rub.	Summary, back- margin, rub.
286 rub.	66 rub.	40 rub.	1.000 шт.	66.000 rub.	40.000 rub.
				106.000 rub.	

Total income of pharmacy chains

Front margin + back margin

~~=~~

total income

Part 2. Difference between front and back margin

Which source of income is the main? How to calculate it correctly?

How to calculate? Front and back margins are not equal

Income from the customers is more important than payouts from the manufacturer:

1. Pharmacy receives front margin in any case, but to receive the back margin a sales plan has to be completed;
2. Pharmacy receives a mark-up as soon as the drug has been sold, without delay;
3. Different taxes. VAT on medicines is 10% however on services is 20%.

Incorrect Indicators => Incorrect Conclusions
=> Wrong Decisions

How to calculate? Front and back margins are not equal

$$Bm' = 0,5-0,7 * \textit{Front margin}$$

Part 3. Reasons for front margin going down

Marketing payouts heat up price war on the pharmacy market

Reasons for front margin going down

Pharmaceutical manufacturers pay for the increase in sales of drugs.

Pharmacy can fulfil a sales plan in one of three ways:

1. By opening new pharmacies.
2. With help of other products of the same category, i.e. at the expense of other drugs.
3. By attracting additional customers from other pharmacies.

Why pharmacy chains are to blame for price war

Vicious circle of price war:

1. First step: Sign marketing contracts with a large number of manufacturers;
2. Second step: Get a sales plan for almost all products in the product category
3. Third step: Try to fulfil all sales plans at once;
✓ Try to increase sales by reducing prices;
4. Next step: Another pharmacy chains also get a sales planes and they also want to fulfil them, so they also reduce prices. Who will make them lower?
5. Final step: Front margin is over? No problem! You can reduce the price due to back margin.

and one more trouble...

Pharmacy chains have one more trouble. There is no guarantee that they fulfil sales plans.

This means that the pharmacy chains may not receive back-margins.

Why manufacturers are to blame for price war

1. Lack of control over the level of profitability of their products on the market

For example, a pharmacy chain can use back margin for price war or “overflow” of drugs to other market participants.

2. special price offers with several chains

Special price offers lead to front margin going down at first in one chain, and then other chain join not to lose the price war.

Reasons for profitability going down

Preconditions of two last decades:

1. Predominantly external source of growth of the pharmacy market;
2. «Try and guess» method of management;
3. The previous growth of the market hid inefficient business models;
4. Weak economic methods, lack of resources and experience in overcoming the crisis;

Conclusion. What is more important front or back margin

All participants of the distribution chain prefer drugs which have

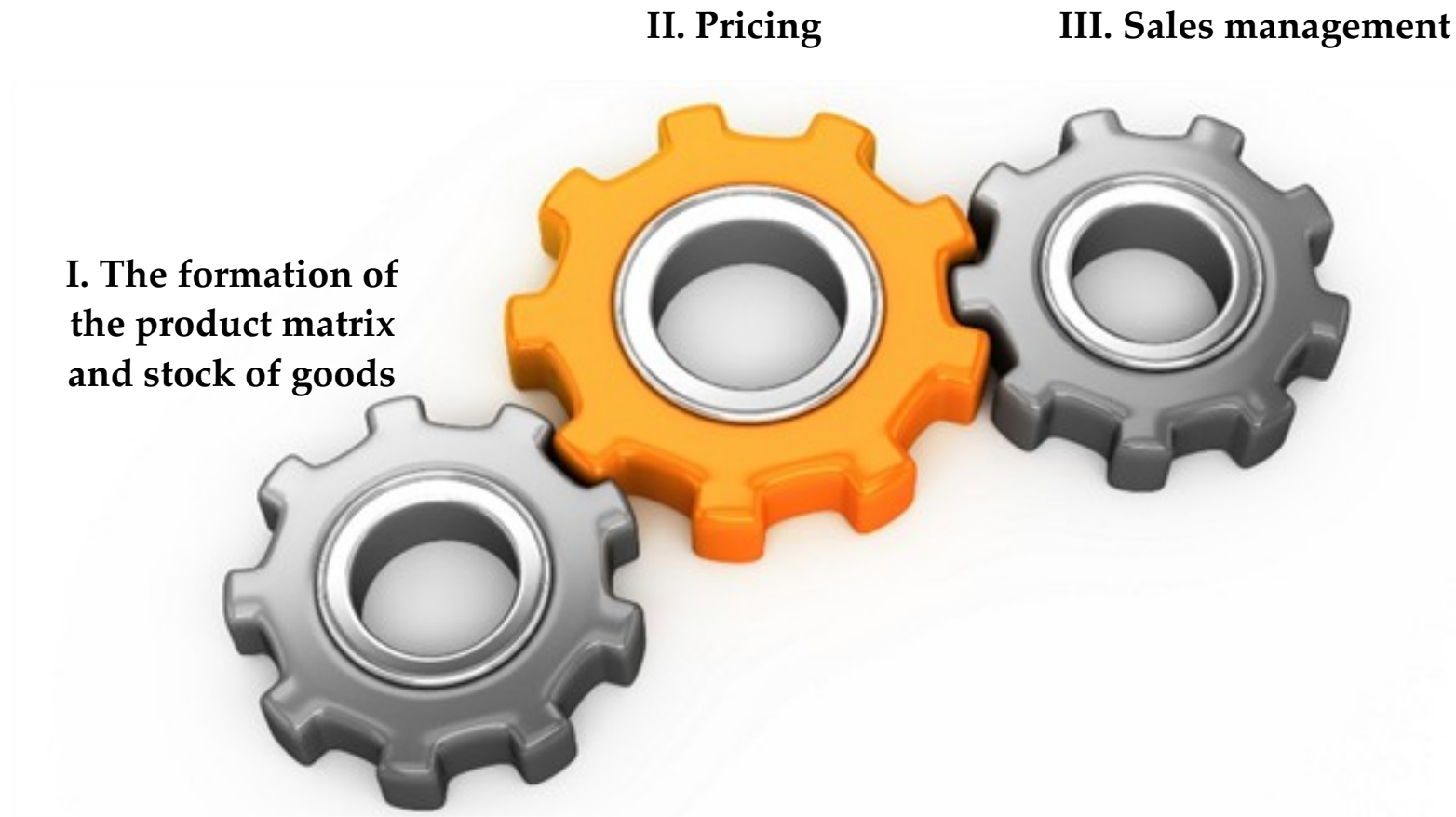
- high stable demand;
- and good profit from the item;

In the long term: High front margin is the key to the pharmacy's interest in products.

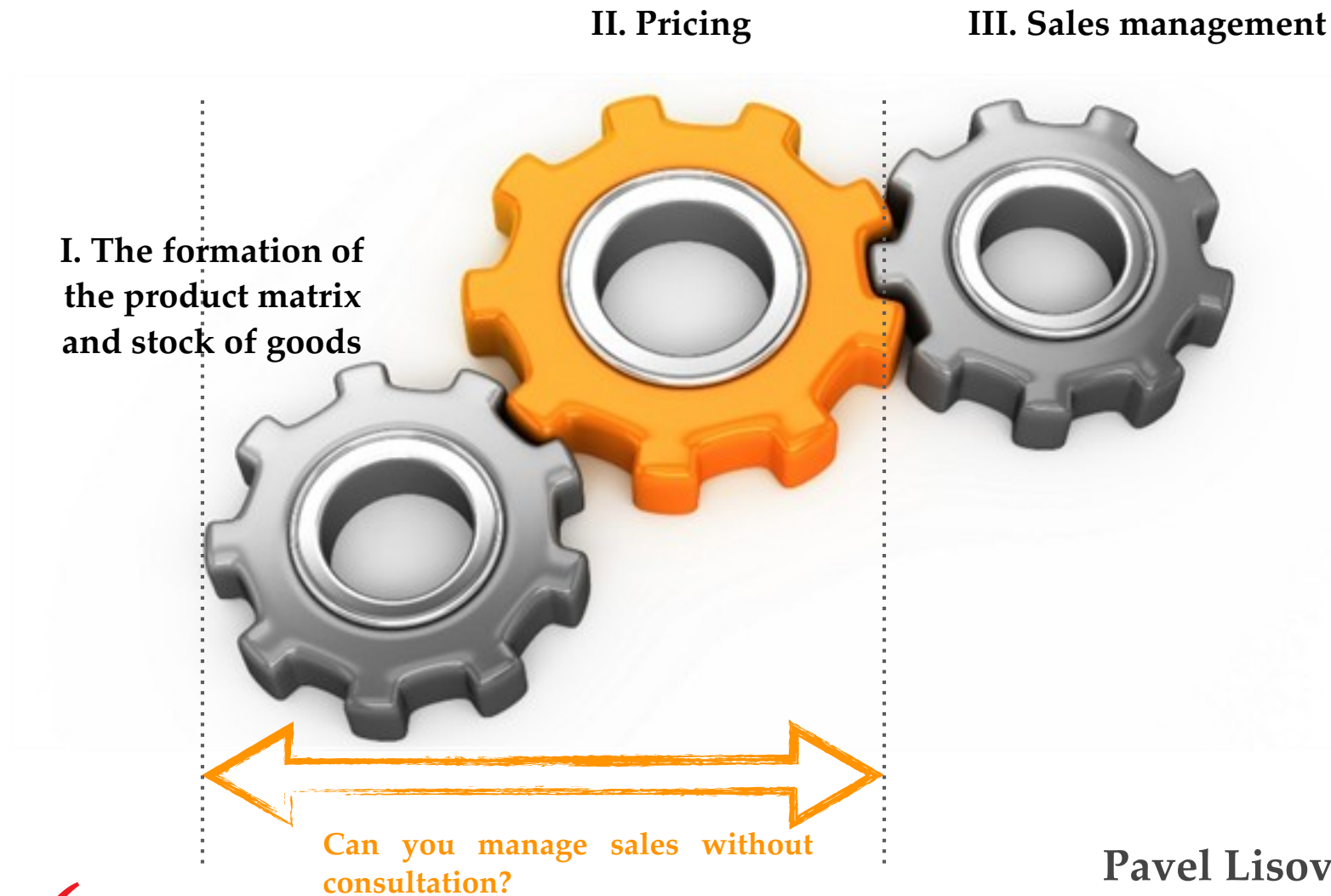
Part 4. Sales Management in pharmacy chain

How the chain can help or impede the manufacturer with promoting his portfolio of drugs.






Three main business process of retail business



Three main business process of retail business





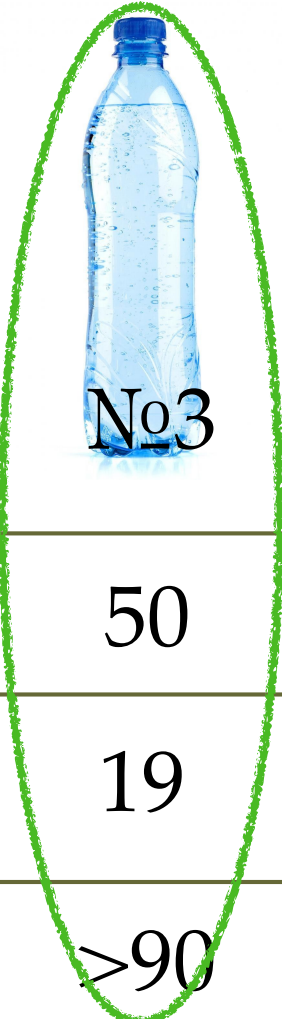


Sales Management in simple product category

						Total
Price	50	50	50	50	50	
Front margin /item	10	10	19	10	10	
Number/ sold	120	80	90	110	100	500

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Sales Management in simple product category

						Total
Price	50	50	50	50	50	
Front margin /item	10	10	19	10	10	
Number/ sold	0	0	>90	>110	0	500-?

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The basis of Sales Management






Relation of the processes \Leftrightarrow and Sales Management

1.Reducing the width of the category:

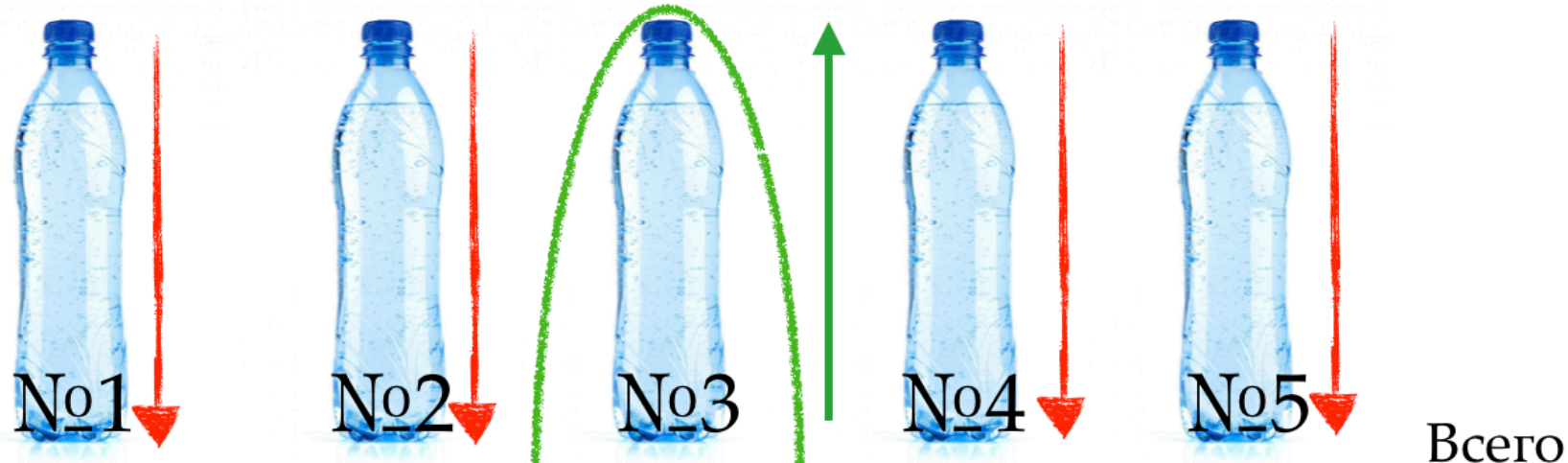


- increase the probability of selling the remaining goods
- correctness of sales forecast
- refuse to buy any product in category;
- improvement Sales Management

Sales Management in simple product category

	 No1	 No2	 No3	 No4	 No5	Bcero
Price	50	50	40 ↓	50	50	
Front margin /item	10	10	9	10	10	
Number/ sold	95	105	>90	110	100	500

Sales Management in simple product category



	No1	No2	No3	No4	No5	Bcero
Price	58	55	50	59	57	
Front margin / item	18	15	19	19	17	
Number / sold	95	105	>90	110	100	500

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The basis of Sales Management

Relation of the processes \Leftrightarrow and Sales Management

1. Price reduction for selected item:



- increase the probability of selected item at the expense of product category;
 - improvement Sales Management;
-



- decrease in the correctness of sales forecast;
 - reducing of profitability;
-

2. Price increase for selected item:

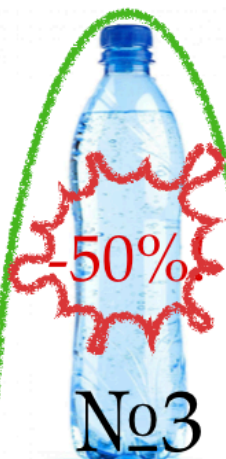


- increase the probability of selected item at the expense of product category;
 - increase the probability of refusal to purchase
-



- decrease in the correctness of sales forecast;

Sales Management in simple product category



Bcero

Price	50	50	90 45	50	50	
Front margin /item	10	10	14	10	10	
Number/ sold	95	105	>90	110	100	500

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Part 5. Economic profile of the product

Which level of profitability is optimal? How much to pay?

How to calculate it correctly?

Less money more share. Is it possible?

The rate of the profitability of an item for chain

Comparison of turnover and average profit per item in the pharmacy and product categories.

	Average pharmacy indicators	Product's parameters
Average turnover (days)	20	10
Average profit per package (rub.)	30	40

The rate of the profitability of an item for chain

Comparison of turnover and average profit per item in the pharmacy and product categories.

	Average pharmacy indicators	Product's parameters	Average indicators of Product category
Average turnover (days)	20	10	1
Average profit per package (rub.)	30	40	50

Profitability level of an item for a pharmacy chain

Key point:

1. Profitability of an item should be compared with profitability level of the product category;
2. It is beneficial for the pharmacy chain to increase sales of a SKU if this leads to an increase in the profitability of the entire product category in which it is included.

The general logic of the work with the product category lays in increasing sales of more profitable products and reducing the sales or excluding the less profitable positions from the category.

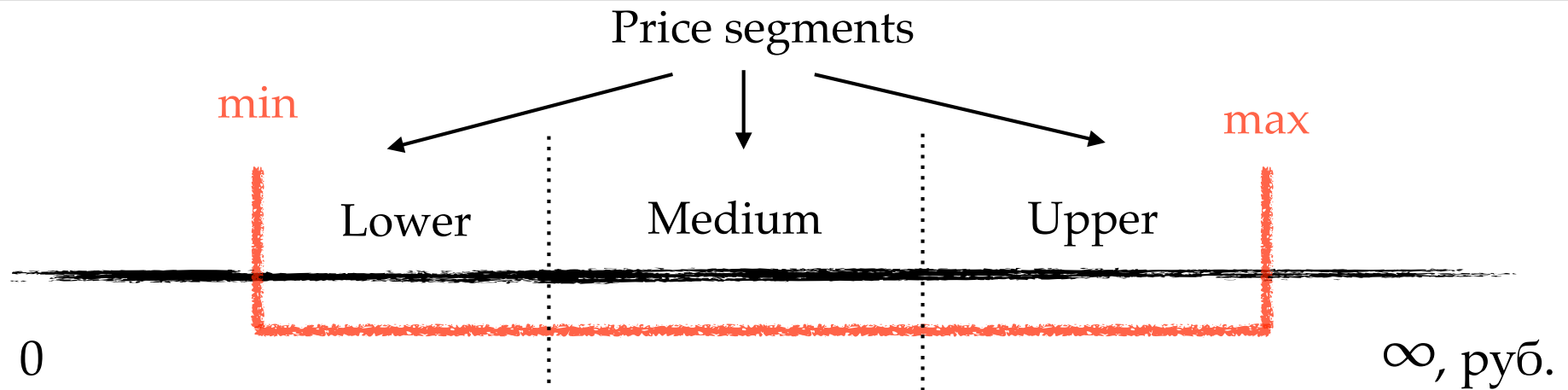
What about strategy?

Which level of profitability is optimal? How much to pay?

Competitive landscape of a drug

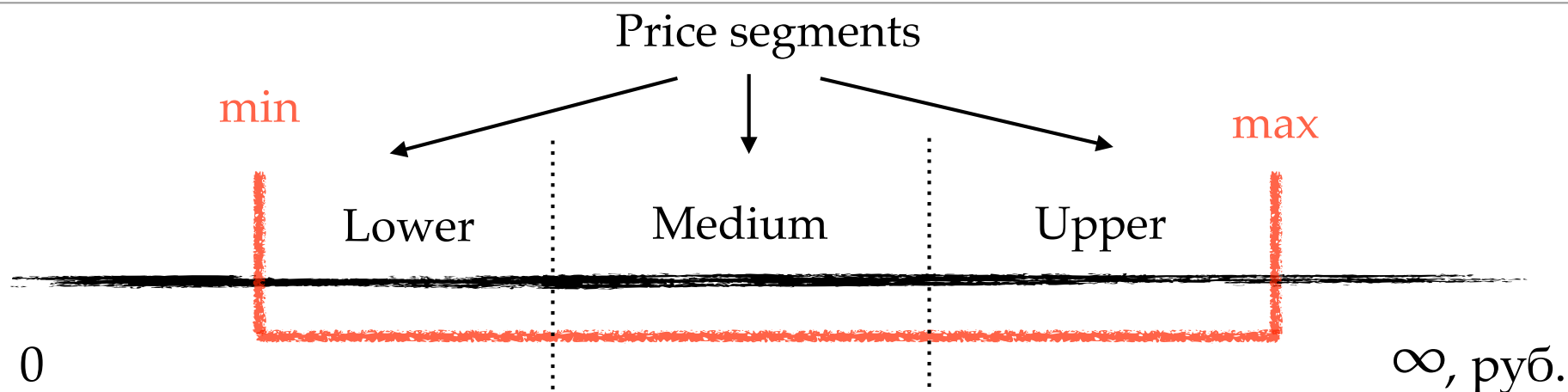
1. **Profitability of an item should be compared with profitability level of the same price segment of product category;**
2. **The profitability of a product is calculated by 3 main indicators:**
 - Quantities of items sold;
 - Front margin per item;
 - back-margin (profit per item from pharmaceutical manufacturer's payouts).

Assessment of economic profile of the product



	profitability per item	Quantity sold	Economic profile
1	↑	↑	Priority, Priority Candidates
2	↑	↓	New Items, Private Label, Typical
3	↓	↑	KVI, Negative Leaders
4	↓	↓	Withdraw
5	≈	≈	Typical

Evaluation of the competitive landscape of a product



	front margin per item	Quantity sold	Economic profile
1	↑	↑	Priority, Priority Candidates
2	↑	↓	New Items, Private Label, Typical
3	↓	↑	KVI, Negative Leaders
4	↓	↓	На вывод, «ИММУНИТЕТ»
5	≈	≈	Обычные

What about strategy?



1. Information about the level of profitability and the economic profile of the drug allows the manufacturer to choose the strategy of interaction with the pharmacy market.
2. Manufacturer has not one, but many drugs in its portfolio, it should correctly prepare drug packages and correctly calculate the financial conditions for them.

Economic types of the drugs determines strategy of manufacturer.

Part VI. Strategies for interaction of pharmaceutical manufacturers with chains

Economic types of the drugs and its packages determines strategy of manufacturer

What does a Chain want from a marketing contract with Manufacturer?

The Profile of an “ideal” contract (chain’s point of view)?

What does a Chain want from a marketing contract with Manufacturer?



- 1. Minimum or no increase of the sales planes;
- 2. Guaranteed fixed payments;
- 3. High level of payouts, increasing from year to year;
- 4. Counting the organic growth of the pharmacy chain as a basic growth;
- 5. Payment only for advantageous positions, ideally payment for each drug, no portfolios/packages;
- 6. Minimum transparency, take everything at face value.

What does a Manufacturer want from a marketing contract with Chain?

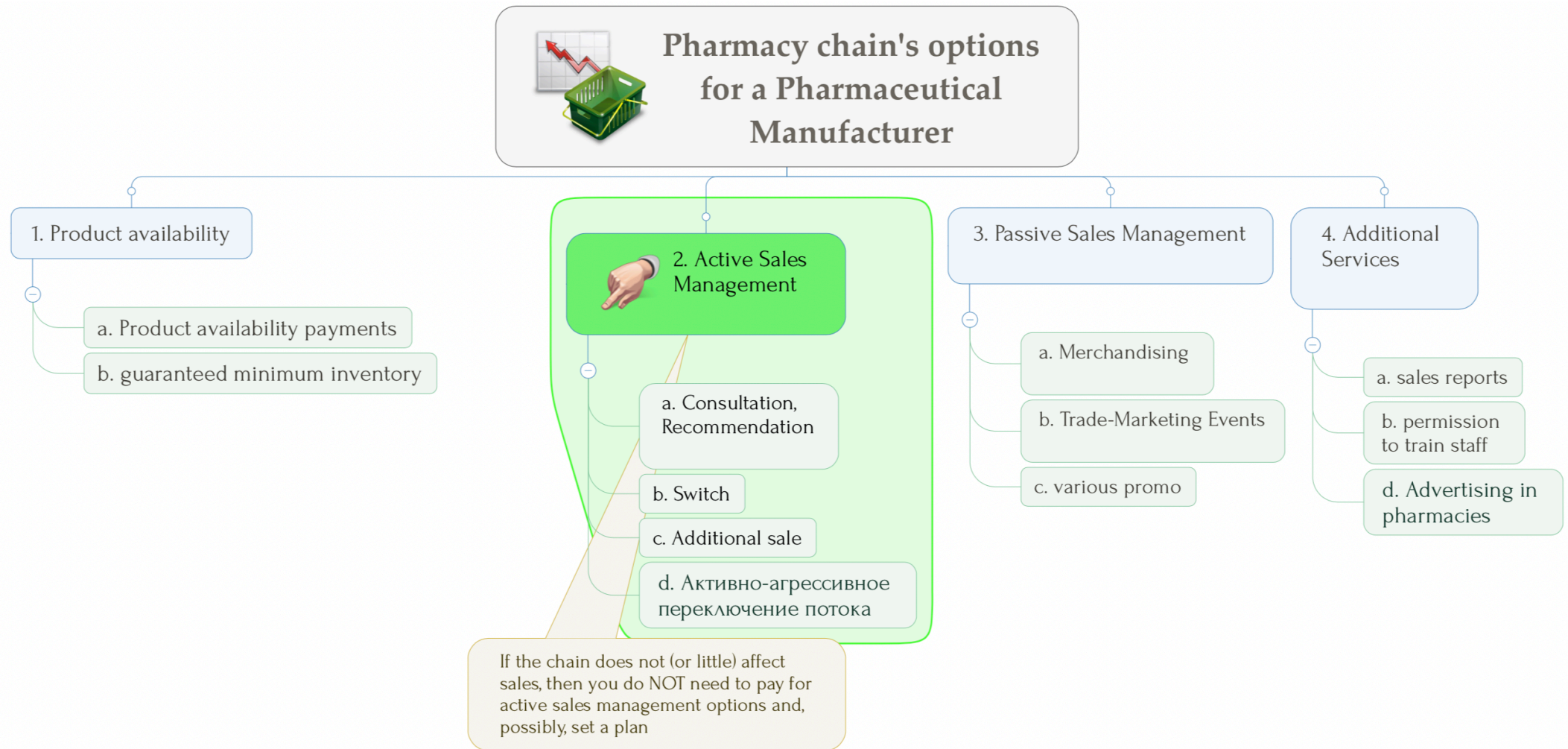
The Profile of an “ideal” contract (manufacturer’s point of view)?

What does a Manufacturer want from a marketing contract with Chain?



1. Work on the whole portfolio, it is desirable on all the pharmacies of the chain;
2. Availability of a standard minimum supply of all the items;
3. No fixed payouts, payments only for the growth;
4. Full transparency of the pharmacy chain;
5. Growth only like for like (excluding the organic growth);
6. Payments in the form of a percentage for the increment in the whole or part of the portfolio.

Marketing options of a pharmacy chain





Manufacturer's options for a chain



1. General market

a. Good product

1.1.1. Pharmaceutical Characteristics

1.1.2. **Economic Characteristics**

1.1.3. Good public opinion

b. Demand creation

c. The ability to create and control profitability at every level of distribution

d. Ability to plan stocks at all levels of the supply chain



2. In Pharmacy chain

a. Fixed payments for non-sold options

1. Reports

2. Trainings

3. Listing fees, payment for the availability of goods

b. Payment for passive sales management

1. Guaranteed minimum inventory

2. Merchandising

3. Trade-Marketing Events and Promo

b. Payment for active sales management

a. "Push" (product pressure)

b. Offer – Switch

c. "Take the stream", Parasitism

c. Super-Option

a. exclusive, limited exclusive

b. overpayment (conditional PL)

c. Private Label

Methods of contract payments, calculations

	Number, sold	% without plan	V(%) open plan 1000 items	Vc(%) «closed» plan 1000 шеуыы	Vst(%) step plan 1000, 1100, 1200
AC-1	1085	109	109	100	- (by 1100)
AC-2	1120	112	112	100	110 (by 1100)
AC-3	1301	113	113	100	120 (by 1200)
AC-4	1205	121	121	100	110 (by 1100)
AC-5	970	97	-	-	-
AC-6	1005	101	101	100	100 (by 1000)
AC-7	890	89	-	-	-
AC-8	1095	110	110	100	110 (by 1100)
AC-9	1089	109	109	100	- (by 1100)
AC-10	1021	102	102	100	100 (by 1000)
Total	10.781	1.063	877	800	540

Павел Лисовский, к.э.н.

Увеличение прибыльности бизнеса



Simple classification of contract payment methods.



1. Fixed



2. "Flexed", payments as a percentage from sales

2.1. Percentage from sales without plan, %

2.2. **Open Plan (bonus)**. % for achievement of sales plan with open or increased payments growth for over-performance $V(\%)$

2.3. **"Closed" Plan (bonus)**. % for volume during plan achievement. Over-performance are not payable V_c

2.4. **Step plan (bonus)**. Percentage is one of the options of the plan. Over-performance by Step is not payable. (V_{st})

2.5. % for sales volume, with a guaranteed fixed payment if the plan is not achieved

Strategies for interaction of pharmaceutical manufacturers with chains

I. Demand Creation

Type of Drug: Narrow product category, unique pharmaceutical characteristics, steady demand, high profitability (Priority, Priority Candidate economic profile), a disease requiring medical intervention, Rx-status

Payments: Fixed or Nothing

Strategies for interaction with chains: training, profitability protection, demand generation, expansion of indications for use (if possible)

Support from Pharmacy Chain: Proper recommendation, goods availability, display, additional sale (if OTC).

Resistance from Pharmacy Chain: recommendation of a different product category, suboptimal inventory => reduction in market power.

Strategies for interaction of pharmaceutical manufacturers with chains

II. Sales plan, indirect sales stimulation

Type of Drug: high total profitability including back-margin (priority, priority candidate), wide product category, pharmacies actively influence sales, OTC or “light” Rx

Payments : Fix + any type of flexed payments (payments for the fulfilment of the plan);

Strategies for interaction with chains: training, protection of profitability, demand generation, product pressure, sales plan, which indirectly influences sales.

Support from Pharmacy Chain: Offer, switch from competitors, proper recommendation, product availability, display, additional sale

Resistance from Pharmacy Chain: Withdraw from Stock (“to withdraw” or “common”), switch, replace, suboptimal inventory.

Strategies for interaction of pharmaceutical manufacturers with chains

III. Take the stream, Parasitism

Type of Drug : low share in the category, low cost, high front-margin, a little-known drug;

Payments: the most share of the income remains in the chain (it may be front or back margin);

Strategy for working with Pharmacy: minimum interaction with pharmacies, It is believed, that great profitability should stimulate active sales and switch form the competitors.

Support from Pharmacy Chain: Active sales, Switch from Competitors, proper recommendation, Product availability, additional sale

Resistance from Pharmacy Chain: Withdraw from stock.

Part 7. The phenomenon of Private Label

and the fight against it

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Why chains launch Private Label

Retail business launches a PL to solve following tasks:

1. Ensure the availability of products;
2. Ensure the quality of products;
3. Increase customer loyalty;
4. Increase profitability.

Why chains launch Private Label

Pharmacy chains launch a PL to solve following tasks:

1. Increase profitability
2. Increase the negotiating power in negotiations with the pharmaceutical manufacturer

Thus, in the pharmacy market, the key goal of the implementation of the PL is to increase the profitability of the product category and, as a result, the pharmacy chain.

Pharmacy problems of using PL in Russia

1. Strong dependence of the pharmacy market on generating traffic from outside;
2. Unreasonably high price for such quality of PL.
3. The problem of difficult recommendation and replacement original drugs.

Pharmacy problems of using PL in Russia

