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## Retail Drugstores – Appraisal Factors

### Introduction

In 2005, retail prescription market sales topped \$230 billion. Chain pharmacies accounted for nearly 63% of that volume, and now represent the largest segment of pharmacy practice with nearly 22,000 traditional chain drugstores and 18,000 pharmacies in supermarkets and mass merchants. Increased prescription prices — average cost rose from \$62.46 (2004) to \$72.71 (2005) — are confronting an aging American population. The number of Americans aged 55+ is expected to reach 76.4 million in 2010 (a 14% increase from 2005). Many of those Americans are covered by Medicare Part D, a federal initiative subsidizing prescription drug cost. The program, effective January 2006, will likely increase the volume of prescriptions filled by U.S. pharmacies, but also reduce reimbursement rates for drugs covered. As the number of people requiring healthcare rises, drugstores and pharmacies will fight for consumers who demand convenience and low prices.

The traditional chain segment of the industry is dominated by four retail chains (Walgreens, CVS, Rite Aid and Brooks-Eckerd), which represent about one-half of the segment store count. These and other traditional chains have recently experienced a wave of consolidations and mergers due to increasing competition from non-traditional retail formats (i.e., mass merchants and grocery stores) and shrinking margins on pharmaceutical sales.

The increased competition has caused some drugstores to reposition traditional front-end goods, namely cosmetics. In an effort to draw consumers from department stores and specialty retailers, many chains are focusing on upscale European cosmetics. In addition, chains are considering adding medical clinics, which promise affordability and convenience and offer select medical services, within stores. Locations with clinics expect increases in pharmacy and related front-end sales.

An expanding share of pharmacy business is controlled by third-party reimbursement plans, which set the reimbursement rate for many pharmacy-sold drugs. Retailers are battling against gross margin erosion by offering customers lower priced, higher margin generic drugs. Further cost savings are available through automation and technology, which have increased the number of prescriptions that can be filled by a single pharmacist and allowed companies to use central fill locations for customer prescriptions. Making a shift to integrated providers may also affect how drugstores do business and create new growth opportunities. (For example, the recent merger of CVS and Caremark Rx, Inc., a leading Pharmacy Benefit Manager (PBM), allows CVS to offer more choices at lower costs.)

Despite the drugstore industry's recent growth, retail chains continue to be threatened. The primary danger to retail drugstores may be Wal-Mart, which offers 300+ generic drugs at \$4 (30-day supply). Wal-Mart, with 3,800 pharmacies nationwide and over \$11 billion in 2006 pharmacy sales, ranks third in U.S. pharmacy sales volume. Other threats are a chronic pharmacist shortage and PBMs who require prescriptions to be filled via mail order.

Based on recent liquidation and appraisal experience, Tiger Valuation offers the following factors for consideration.

### Appraisal Factors

- o Prescriptions – The ability to fill prescriptions draws the public into a pharmacy. Revenue from pharmacy and other services must be excluded to evaluate merchandise-only sales.
- o Front-end sales – Non-pharmacy inventory such as convenience store goods have high inventory turns and recovery values, but due to high sales volume, sell through quickly in a GOB sale.
- o Special discounts – Stores often sell certain products as loss leaders or through customer loyalty programs, and advertise them in circulars. Discounts could be affected by a GOB event.
- o Strict plan-o-gram – Goods no longer carried by the chain due to plan-o-gram changes must be properly tracked. Discontinued items tend to become shop-worn and aged quickly.
- o Seasonal goods – Many retail drugstore chains pack away holiday merchandise until the next year. Recovery values must be adjusted if the GOB sale is to occur in the off-season.
- o Aged Inventory – Liquidators do not buy product near or past sell-by date. Retailers should have programs in place to track and move any product nearing expiration.
- o Script list – The company's customer prescription list ("scripts") can have significant value. Each list should be appraised separately, and competition analyzed on a store-by-store basis.
- o Pharmacy inventory – Sales of script lists to competitors are usually negotiated prior to a GOB event. Any remaining pharmacy inventory is typically sold to the buyer with the script list.

### Conclusion

Typically pharmacy sales have not been included in liquidation results, and therefore, should not factor into an appraisal. However, pharmacy financial data such as sales and gross margin should be monitored to understand their impact on script values. In addition, script lists must be appraised based on analyses of local and regional competition. For front-end items, historical initial markup, gross margin and net sales should be reviewed to understand the factors driving sales. In a distressed situation, some high-volume front-end items and reward card products sell quickly, causing inventory in a GOB sale to become weighted towards slow-turning merchandise, which would require heavier discounting later in the sale. The pharmacy and front-end components of a drugstore should be valued separately and then combined for an accurate overall valuation.