KEY POINTS

- Increasing public sensitivity to price, along with a hyper awareness of price competition, is creating a downward pricing spiral.
- Any change in business model should consider: the pharmacy's values; loss in gross margin percentage and dollars; and the expected growth of the new model.
- Many owners of independents pharmacies have an opportunity to develop an offer that is relevant to the customer but visibly and experientially different to the discount model.

Fear thy customer

AN OBSESSION WITH COMPETITION, NOT CUSTOMERS, IS PARALYSING THE CHANGE PROCESSES REQUIRED IN MANY COMMUNITY PHARMACIES, WRITES **MARK NICHOLSON.***

A tap on the window interrupted a management meeting being held by a client. It was after trading closed one night and led to an exchange between the tapping customer and the pharmacy owner—one that is increasingly common and driving many owners to consider joining the discount model of community pharmacy.

The pharmacy is a seven-day trading business in a small shopping centre but accessible from the car park.

My client duly opened the door and attended to the customer's cough and cold requirements.

After being presented with the required product and then told the price, the customer noted that the nearby discount pharmacy was two dollars cheaper on the same product. The owner politely advised the customer that his position in a convenient shopping centre operating extended hours, seven days a week unfortunately necessitated slightly higher prices for some products. The customer begrudgingly accepted the explanation, paid and promptly left.

THE PRICE SPIRAL

All small businesses have these types of interactions with customers regularly and while these experiences are mostly in the minority, they often leave impressions on staff and owners that are disproportionate to the number of neutral or positive experiences that occur on a daily basis.

It is equally true though that customers across all retail sectors have become increasingly sensitised to pricing due to global economic circumstances, while reducing discretional spending. The response to this situation from supermarket, warehouses and chain groups is to emphasise price even more in an effort to entice consumers back into store and start spending again.

This behaviour creates a downward price spiral, like a domino effect, as each operator in turn responds to their competition until inevitably some businesses go broke.

This scenario is causing me to have more and more conversations with independent pharmacy owners about an appropriate competitive response to competitor price promotions.

Inevitably a pharmacist will start the discussion with an 'if you can't beat 'em, join 'em' mindset, accompanied by a desire to understand which of the 'discount operators' banners or brands will provide the ultimate protection with minimum margin loss.

THE SUSTAINABILITY OF PRICE

But is this knee-jerk response the right one? Will it develop a sustainable competitive strategy that complements the owner's professional motivations and ambitions while being responsive to customer needs?

As a starting point let's consider Table One which identifies the sales growth required to offset a margin reduction. For example, a reduction in GP% from 34% to 31% (ie. a 4.4% price reduction) would require a 10% increase in sales to maintain Gross Profit sales. The reverse situation is described in Table Two; that is, when GP is increased (eg. price rise) then it is possible to lose a certain amount of sales and still maintain profit levels.

So before any action is taken to switch models, the following questions need answering:

1. Does the model align with my own values and vision for the business?

2. What is my expected loss in gross margin percentage and dollars?

3. What is my expected growth from the new model?

TABLE ONE: Break-even sales increase required to maintain GP$ when reducing GP%

	Starting current gross margin					
	31%	32%	33%	34%	35%	36%
Target Margin						
33%				3%	6%	9%
32%			3%	6%	9%	13%
31%		3%	6%	10%	13%	16%
30%	3%	7%	10%	13%	17%	20%
29%	7%	10%	14%	17%	21%	24%

TABLE TWO: Tolerable sales decline to maintain GP$ when increasing GP%

	Current gross margin					
	29%	30%	31%	32%	33%	34%
Target Margin						
32%	–9%	–6%	–3%			
33%	–12%	–9%	–6%	–3%		
34%	–15%	–12%	–9%	–6%	–3%	
35%	–17%	–14%	–11%	–9%	–6%	–3%
36%	–19%	–17%	–14%	–11%	–8%	–6%

TABLE THREE: Percentage of GP$ lost from reducing GP

	Starting gross profit percentage					
	31%	32%	33%	34%	35%	36%
Reduction in GP						
1%	5%	5%	5%	4%	4%	4%
2%	9%	9%	9%	9%	9%	8%
3%	13%	13%	13%	13%	13%	12%
4%	18%	17%	17%	17%	17%	16%
5%	22%	21%	21%	21%	20%	20%
6%	26%	25%	25%	25%	24%	24%

TABLE FOUR: Growth converter: % to $ for turnover range $2–5m

	Growth % and $ Conversion					
	3%	5%	7%	10%	15%	20%
Turnover						
2,000,000	60,000	100,000	140,000	200,000	300,000	400,000
2,500,000	75,000	125,000	175,000	250,000	375,000	500,000
3,000,000	90,000	150,000	210,000	300,000	450,000	600,000
3,500,000	105,000	175,000	245,000	350,000	525,000	700,000
4,000,000	120,000	200,000	280,000	400,000	600,000	800,000
4,500,000	135,000	225,000	315,000	450,000	675,000	900,000
5,000,000	150,000	250,000	350,000	500,000	750,000	1m

For one of my clients, once we considered dispensary and retail price impacts, his expected margin loss was 3% and in line with the above GP movements first discussed. With a $5m turnover, this equated to an immediate $150,000 bottom line loss to hopefully be clawed back by growing customer and product volume.

Table Three states this margin loss in alternative terms. That is, a 3% reduction in GP for a business currently achieving a 34% margin equates to a 13% loss in total GP$. Further, if the $150,000 loss of margin was not replaced (and ignoring the refit costs) then approximately $750,000 of value (ie. 5 x $150k) would be wiped off the pharmacy's value.

For easy reference, Table Four is a simple ready reckoner that converts the required percentage growth for a specific turnover level to the actual dollar requirement. This simple maths is so often ignored by retailers when pricing decisions are made.

The final complications with pursuing such a fundamental shift by becoming a discounter are twofold:

1. It is difficult to retreat from a new pricing paradigm once it has been offered to new and old customers, even if you decide you do not like the model or it does not deliver the targeted growth; and

2. Your only choice when operating a price-based model and faced with competitors lowering prices to below yours is to reduce your own prices further (note initial comments regarding the downward spiral effect).

For these reasons, retail businesses that compete on price must have comparatively low costs as a percentage of gross profit dollars (ie. high rental costs make this not possible in Australian shopping centres). Further, the group must have sufficient buying strength and compliance to maintain sufficient margin to produce a profit.

Therefore, it is often easier for a pharmacy with a weak location and low turnover compared to their opposition (particularly in rural areas) to convert to a price-based offer as the value-destroying risk is low compared to businesses in strong (and usually higher cost) locations with higher profitability.

THE ALTERNATIVE TO DISCOUNT

If you establish that reducing prices and margins is more likely to destroy value than create it, then an alternative strategy that attracts and retains customers while growing average sale must be developed and executed. Just as good sporting teams are defined by their ability to attack while defending, then so too are good businesses.

There are many examples in retail of those who have overcome a product commoditisation process to develop successful niche businesses in mainstream categories (and personal health is not mainstream).

Kikki K and Smiggle are two examples within the stationery sector where, instead of focusing on selling stationery, they focus on providing solutions for the home office and school desktop environments. Both of these businesses are located in expensive shopping centres and succeed in a sector that is heavily commoditised by competitors including Officeworks, discount department stores, supermarkets and newsagents. I urge you to visit one to experience the difference.

Their success has been defined by developing formats, products and processes that ensure they are both visibly and experientially different to other retailers in their sector. Community pharmacies have the same opportunity as long as owners have the necessary drive and focus, and seek assistance as required.

Even the fitness industry is diversifying and segmenting via low-cost, 'self-serve' 24-hour gyms which convert customers from full service fitness centres.

The innovation component, which has reduced staffing and operational costs for operators (and, hence, price for customers), includes reduced floor area, swipe card entry and closed circuit television monitoring, as well as membership and administration systems hosted in the cloud.

Traditional fitness centres now have to grapple with how they retain customers who prefer to self-train, or maybe even combine the two offers to minimise costs, obtain service when required and maximise convenience. Sounds familiar doesn't it?

So what is an alternative strategy that attracts and retains customers in the face of competitors positioned as low-cost, low-price operators? (Note that many pharmacy surveys identify that this does not necessarily translate to low service in the customer's mind or experience).

The client referred to at the beginning of this article, armed with the information that a switch to a discount model which would immediately trigger a Gross and Net Profit reduction of approximately $150k per annum, concluded the better alternative, although potentially more difficult, was to:

1. Analyse customer and script trends (especially general and below co-payments). If they satisfy customers and leverage solutions with the associated retail categories, then customers should have too much to lose to defect.
2. Analyse what the pharmacy has lost in each retail department by comparing sales and customer numbers with the previous year.
3. Review the merchandising mix and alter it based on departments where pharmacy can compete by adding value.
4. Use value pricing as a tactic to reinforce a value proposition rather than as a strategy that destroys value.
5. Refit the pharmacy, enlarge the schedules area, lift skills of pharmacists and staff to specialise and focus on solutions (not transactions), while changing the workflow/processes to enable greater pharmacist engagement with customers, and technicians take over some pharmacists tasks.
6. Shift the culture to allow points 3–5 to succeed. Dispensary Loop by Feelgood Guide and Hilary Kahn helps many JR clients shift their culture and processes.
7. Employ an additional pharmacist during peak periods to ensure customer engagement does not wane when most required.
8. Ensure the pharmacist(s) are adequately trained and competent in engaging the customer and delivering valued health solutions (note: don't assume all pharmacists are equally proficient in servicing customers).
9. Develop a multi-channel customer strategy (including a store website, email database and Facebook page) with a clear strategy about content, repeat visit and so on that is designed to increase customer convenience, communication and engagement levels.
10. Ensure reporting and measuring systems are comprehensive, efficient and effective in delivering and maintaining strategic focus (including measuring health dollars (front of store) per script).
11. Develop a one-page strategy and action plan that covers merchandise mix changes, service quality, premises format, skill sets and marketing (internal and external) to reinforce what the pharmacy stands for.

My business associate Bruce Annabel noted in his January *AJP* column the following three community pharmacy examples where growth was achieved by focussing on customers rather than competitors:

1. A small pharmacy achieved a 38% retail sales growth (including S2/3) after removing the clutter, reducing open selling categories, tossing out the gifts and then significantly increasing all the healthcare, medicines and vitamins categories.
2. A provincial pharmacy installed two new health services, promoted them to the community, resulting in November sales increasing 27% compared with same period last year. Script volume grew 10% thanks to the additional customer traffic.
3. A suburban pharmacy ran a senior's week health promotion that included:

- *pharmacists checking blood pressure and glucose levels and answering questions about medications;*
- *guest speakers providing in-depth information on continence, home health aids and skin care;*
- *trained staff cleaning and calibrating glucometers; and*
- *providing a medication list pro forma supplied by NPS to all.*

This resulted in:

- *25 patients being referred to see their GP urgently;*
- *patients' delight with the pharmacist contact and their interventions;*
- *increase in sales and return visits; and*
- *many new customers being attracted to the pharmacy.*

OBSESS ABOUT CUSTOMERS, NOT COMPETITION

Obsessing about competition rather than customers and how to increase the level of engagement with them is paralysing the required change process in many community pharmacies.

The competitive power of an independent offer is yet to be felt by low price and banner group operators. This is because most independent owners are yet to develop their business vision into something visibly and experientially different for the customer (as compared to low price and banner competitors).

For those that do, the rewards from increased customer engagement are great. Those who don't may find they have every reason to fear thy customer and not their competition.

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