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How Drugs Are Distributed In Japan: Insider Analysis From International Alliances Ltd.'s Reed Maurer

A closer look at components of Japan's distribution system reveals a vastly improved network than previous years.

For years companies hoping to enter Japan complained of non-tariff trade barriers and a distribution system they viewed as nontransparent, inefficient, and saddled with high costs when compared to other markets.

The situation today is vastly different, particularly as experienced by companies doing business in Japan.

Forty years ago there were more than 1,200 local pharma wholesalers, all with limited coverage of the market, and most affiliated with one of the large Japanese pharma companies, i.e., **Takeda Pharmaceutical Co. Ltd.**, **Shionogi & Co. Ltd.**, **Mitsubishi Tanabe Pharma Corp.**, or **Daiichi Sankyo Co. Ltd.**

Wholesalers bowed deeply to manufacturers to secure sole sales rights in their respective areas. It was common for manufacturers to use 150-200 different wholesalers for distribution. The alternative was to assign distribution rights to one of the four companies mentioned above. To this day, IMS Health ranks companies in Japan into two categories, either as distributors or by their own product sales.

Foreign companies entering the market were confident of their ability to promote their drugs to doctors, but were unsure how to manage the relationships with 150 wholesalers. So they turned the distribution function over to Japanese companies.

Forfeiting distribution was a practical but short-sighted decision as it isolated the foreign company from the sales to pharmacists and dispensing doctors. They lacked vital information as to who was buying what drug when. In other words, they did not know their customers because they did not make the sales.

Wholesalers in the past, as well as today, distribute 98% of all drugs to hospitals, clinics and pharmacies. Direct sellers that try to bypass wholesalers do not prosper. One reason is the lack of space in Japan. A pharmacy does not have room to stock a large supply of drugs, so they expect and get a delivery once or even twice per day. What comes in goes out the same day, the ultimate on-time delivery system.

Consolidation Of Fragmented System

In retrospect, it was obvious the distribution system was fragmented, inefficient and ripe for consolidation. Once the process began, it proceeded apace. In 1970 there were more than 1,200 wholesalers, in 1980 that number dropped to 584, and in 1995 there were 251. Today there are 115 wholesalers in Japan, but practically all are affiliated with one of the four wholesalers as noted below:

Due to consolidation, the distribution system has gone from more than 1,200 wholesalers to four wholesalers. Of course, each of the four has national distribution coverage and they are full-line wholesalers versus being tied to one manufacturer. Therefore, they now bow deeper to their customers than they do to their suppliers.

Four Listed Drug Wholesalers' Business Results For FY2012

Company	Sales	Change, % year over year	Operating profit	Change, % year over year	Operating profit margin (%)	Change, % points
Alfresa Holdings Corp.	$23.6 bil.	2.3	$213.5 mil.	162.4	0.90	0.55
Medipal Holdings	$20.1 bil.	2.2	$146.1 mil.	89.1	0.73	0.34
Suzuken Co. Ltd.	$18.0 bil.	1.7	$36.3 mil.	-	0.20	-
Toho	$10.9 bil.	2.8	$117.3 mil.	26.0	1.07	0.20
Total	$72.7 bil.	2.2	$513.2 mil.	132.8	0.71	0.40

Current Characteristics

Consolidation for wholesalers provided an opportunity to restructure and rationalize their operations. The metrics outlined below indicate the progress made to reduce the number of employees, inventory, accounts receivable and payment terms while increasing sales.

Wholesaler Management Index in Japan

Item	1990	2011
Gross Profit (%)	12.4	6.0
Operating Expenses (%)	10.8	5.8
Operating Profit (%)	1.8	0.7
Net Profit (%)	0.8	0.3
Payment Terms (months)	5.7	4.2
Inventory Turnover (months)	1.2	0.7
Account Receivable (months)	4.0	3.0
Annual Sales/Salesman ($000)	1,425	6,171
Annual Sales/Employee ($000)	740	2,325
Number of Employees	74,790	60,349
Sales Force Share	51.9	37.7

Source: Crecon Research & Consulting Inc.

A unique feature of Japan's wholesalers is their army of sales representatives called marketing specialists. In the past, these people were basically couriers carrying small orders to pharmacies on a daily basis. As rationalization proceeded, the physical distribution of drugs was carved out into separate delivery companies, and MS were no longer necessary to take and deliver orders.

Consequently, expenses were reduced, sales increased but profit decreased. What happened? Simply put, the four wholesalers bought market share via low prices, thus eroding their margins. This was a good outcome for pharmacies, which were also consolidating, increasing their leverage over wholesalers and increasing their profit margins.

Manufacturers benefited at the same time because dealing with two wholesalers was obviously more transparent, efficient and more cost effective than dealing with more than 100 different wholesalers. Manufacturers became less prone to offer wholesalers substantial discounts for performing the sole function of supplying demand.

The distribution system today has many favorable characteristics. To name a few:

- The supply chain is short, so drugs do not sit on a shelf or get exposed to temperature extremes;
- The amount of counterfeit drugs entering the supply chain is practically zero;
- Drug shortages are rare;
- In the unusual case of a recall, the process can be carried out very quickly; and
- Costs have been reduced but are still high compared to the U.S. because of space limitations.

Future Challenges

The key future challenges for wholesalers are to improve profit margins and provide higher value-added services, particularly by marketing specialists who still number about 22,751. If the latter challenge cannot be met, the number of marketing specialists is destined to drop until they are an endangered species. Margin improvement will also require a push back against discounts demands by pharmacists.

Wholesalers Alfresa and Suzuken also have pharma development and manufacturing businesses. But in their present form, these business are not sustainable because they lack the research capability to discover new drugs. They might be restructured into contract manufacturers, contract sales organizations or divested to larger pharma players.

Another option may be to integrate into the pharmacy business, a strategy pursued by Suzuken and Toho. But the timing could be late given the consolidation that is rapidly taking place as "mom and pop" pharmacies become absorbed by the large chain pharmacies.

Although wholesalers are preoccupied with the challenge of efficiently supplying drugs at a reasonable margin, their most valuable asset is their mass of information. Information can be monetized to improve both revenue and the bottom line; in other words, software versus hardware. The future is not in warehouses, delivery trucks or buildings.

Reed Maurer came to Japan in 1970 as ***Eli Lilly & Co.****'s director of marketing. In 1971 he became vice president, responsible for Lilly's operations in Japan, and he later served as vice president at* ***Merck & Co. Inc.*** *Maurer was the first Japan Representative of the U.S. Pharmaceutical Manufacturers Association from 1987 to 1993. He is the founder of International Alliances Limited in Tokyo, Japan. He is the author of three books: "Competing In Japan," "It's Worth Doing: perspectives on the Japan Pharmaceutical Industry," and "They Do Well Who Do Good." Maurer is writing a series of articles for PharmAsia News; the most recent story appeared here: ("Defining Japan's Pharma Market: Insider Analysis From International Alliances Ltd.'s Reed Maurer" — PharmAsia News, Jun. 27, 2013 9:31 AM GMT).*