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Distribution Reform - What Is Left Undone

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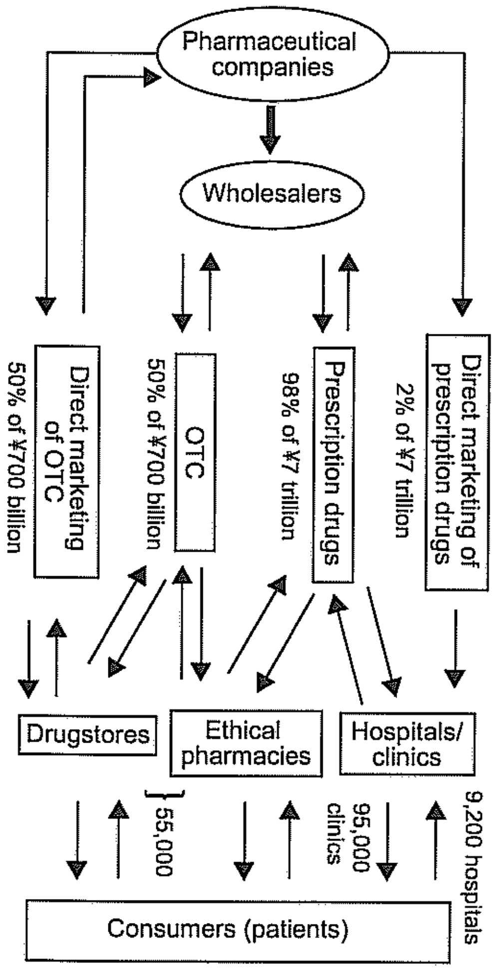
Talk about a shake out. When I arrived on these shores in 1970 there were over 1,200 pharma wholesalers. Today there are slightly over 100 names, but all align themselves into four groups through cross shareholdings.

This article will review the distribution channels in Japan, the process of wholesaler restructuring and consolidation, changes in the management parameters of performance, and conclude with reform measures that remain undone.

Distribution Channels

The diagram outlines pharma distribution channels in Japan.



Pharmaceutical Distribution Channels in Japan

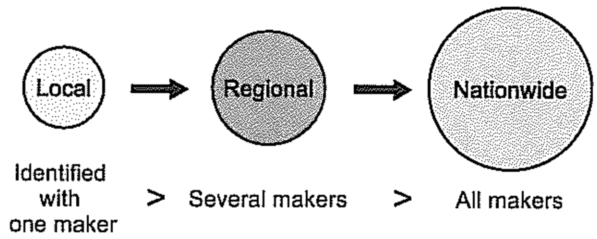
Obvious that pharma wholesalers distribute practically all ethical pharmaceuticals from manufacturers to hospitals, clinics, and pharmacies. However, they only distribute 50% of OTC drugs from manufacturers, and the percentage of generics is less as generic manufacturers distribute through *Hansha* or dealers. Medical devices and diagnostics are most often distributed by specialized wholesalers, typically with local coverage.

In summary, drug manufacturers are two steps removed from their consumers. Hospitals and clinics must use a variety of wholesalers to supply their products. Only limited attempts have been made to consolidate the purchasing function on behalf of users. Few buying groups exist to achieve economies of scale.

Wholesaler Restructuring

The diagram portrays the evolution of wholesalers over the past 40 years.

Implications of Distribution Reform



All wholesalers in 1970 were local, that is, their territory was limited to a city or one prefecture. Their business success depended on an exclusive arrangement with one manufacturer and there were four who had a lock on distribution, i.e. Takeda, Shionogi, Sankyo, and Tanabe. If a hospital wanted to buy a drug from each of these companies it had to go to four different wholesalers.

Wholesalers competed with each other not for customers, but for sales rights from manufacturers. They had to bow more deeply to their suppliers than to their customers.

In the first stage of consolidation wholesalers within a region merged and thereby had the sales rights from several manufacturers. They began to compete with other regional wholesalers for customers. During this time customers included clinics that dispensed their drugs rather than writing prescriptions to be filled at an independent pharmacy.

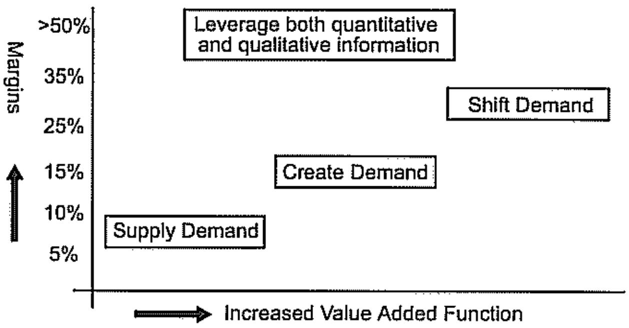
Coverage of dispensing doctors required an army of salesmen called MS or marketing specialists employed by wholesalers. The MS not only supplied demand but they created demand by promoting certain drugs. Medical representatives or MRs from manufacturers focused their promotion on hospital doctors rather than clinic doctors.

The next stage of consolidation created four merged wholesaler groups with nationwide coverage. They became full line wholesalers offering drugs from most, if not all manufacturers. They now bow more deeply to their customers than to their suppliers.

At the same time the customer base changed from clinics to dispensing pharmacies. MS had to spend more time in pharmacies where their function was to supply demand. Therefore, their function was less important to manufacturers and the MS army was downsized.

The next diagram describes the value added functions of wholesalers and corresponding margins.

Distribution Value Added Functions



Wholesaler Metrics

The dynamics of consolidation are reflected in the next chart that outlines the various parameters of performance in 1990 compared to 2009.

Wholesaler Management Index in Japan

Item	1990	2009
Gross profit (%)	12.4	6.8
Operating expenses (%)	10.8	6.4
Ordinary profit (%)	1.8	0.8
Net profit (%)	0.8	0.2
Payment terms (months)	5.7	4.0
Stock volume (months)	1.2	0.5
Account receivable (months)	4.0	3.0
Annual sales/salesman (US$000)	1,425	4,359
Annual sales/employee (US$000)	740	1,718
Number of employees	74,790	58,985
Sales force share	51.9	39.4

(Source: Crecon Research & Consulting Inc.)

The consolidated wholesalers became more efficient by several measures. However, these efficiencies could not make up for a reduction in their gross profit margin. Thus, the net profit percent of sales eroded to a perilous 0.2% in 2009.

Future Reform Measures

Perhaps the biggest challenge for wholesalers is how to add value to the function of MS employees. They would like to demonstrate that MS can create demand or shift demand from one drug to another to justify a higher gross margin. To do this they must have access to prescibers (doctors) rather than dispensers (pharmacists).

The MS have much qualitative information about drug usage, but how to justify charging fees for this information is problematic. Wholesalers do sell quantitative information, but not directly to manufacturers. They are akin to grape farmers who sell grapes to a winery who distil the grapes (raw data) into high valued wine. The real money is in the wine not the grapes.

There are only two outcomes for MS. Either they add value or they disappear. Wholesaler margins under the present business model would be respectable if the MS expenses were eliminated.

Wholesaler pricing policies remain archaic and are in urgent need of reform. Does anyone understand the rationale for rebates, back margins, and bundling of products into one discount basket? The same fixed margin percent for a ¥100 drug and a ¥1,000 drug makes no economic sense. These outdated policies for the supply-demand function are sure to attract other players into distribution of drugs.

Another area ripe for reform is the distribution of generic drugs. In the past this was small business that could be left to local dealers. Will these dealers merge and follow the same path as wholesaler consolidation? Or will wholesalers decide not to forfeit this business?

The same questions can be asked of medical devices and diagnostics. In other words, should wholesalers confine themselves to distributing ethical, branded drugs to pharmacies and not serve the broader healthcare market?

There is no doubt the consolidation of wholesalers was a remarkable achievement accomplished by strong leaders. But in retrospect it may have been the easiest phase of wholesaler evolution. Many tough and complex decisions lie ahead that cannot be solved by simply getting bigger.

P. Reed Maurer has had love/hate relationships with wholesalers for a long time.