Drug Wholesaling Moves to Fee for Service: Observations and Implications

Lehman Health Care Distribution & Technology Industry Expert Conference Call

Sector View: 1-POSITIVE

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We are providing a summary of our recent "Industry Expert" conference call, "Drug Wholesaling Going Fee for Service: Observations and Implications," with distribution consultant Dr. Adam Fein, president of Pembroke Consulting.

- On the conference call, Dr. Fein noted that he has already seen much movement by drug companies in altering wholesaler buying patterns through various inventory agreements, with a noticeable majority already having some agreement in place.
- Early negotiations in these inventory agreements have been characterized by wholesalers having much more information about their costs of delivery than do the manufacturers, creating some edge in discussion for the wholesalers, though the second rounds of negotiations could see changes in knowledge disparity, in his view.
- Dr. Fein continues to see forces at work that could push fee-for-service trends toward drug distribution. He is also cautiously skeptical about how successful these agreements may be, given the difficulties of measuring progress after the first rounds of inventory reductions.
- Dr. Fein believes that wholesalers will define themselves more as service companies in the future, characterized as more customer-centric, and perhaps selling more value-added incremental services to those customers.
- He does suggest that fee-for-service arrangements could change the relationship between manufacturers and wholesalers in the future, in some cases increasing the points of competition between the two parties.
- Lastly, Dr. Fein does not believe that traditional wholesalers have taken a leadership role in specialty dispensing and distribution thus far.
- We have available the contents of our conference call held November 12, 2002, "Crucial Forces of Change in the Distribution Channel" (see report dated December 12, 2002). Please contact us at (212) 526-5315 for a copy of the report.

Analyst Certification
I, Lawrence C. Marsh, CFA, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

January 14, 2004

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Drug Wholesaling Moves to Fee for Service: Observations and Implications

Introduction

We are providing a summary of the Lehman Brothers Healthcare Distribution & Technology Hot Topics Conference Call, December 11, 2003. The presentation featured Dr. Adam Fein, president of Pembroke Consulting.

There has been much discussion around drug companies amending their traditional wholesaler buying relationships toward fee-for-service agreements (most recently Merck in its public pronouncements) and with ongoing efforts by manufacturers to reduce inventories in the supply channel to address the issue of counterfeit products in the secondary market (most recently Johnson & Johnson in its public pronouncements). We therefore invited Dr. Adam Fein to provide his observations. Dr. Fein is the founder and president of Pembroke Consulting, Inc., a strategy and marketing consulting firm, and a noted expert in the distribution function for this and many other industries. He is the author of *Facing the Forces of Change: Future Scenarios for Wholesale Distribution* and the executive editor of *Facing the Forces of Change Outlook 2003*. The *Facing the Forces of Change* series, which dates back to 1982, remains the only report analyzing ever-evolving marketing channels and supply chains from the perspective of wholesale distribution. Dr. Fein was part of our November 2002 conference call, during which we previewed some of the important trends we are currently witnessing.

Below, we summarize the points from Dr. Fein's presentation. We note that these comments are our interpretation of his opinions; they do not necessarily reflect our outlook.

- **There has been real movement by drug manufacturers to change the profit models of their wholesalers through a de-emphasis on channel incentives.** The majority of larger manufacturers have moved in that direction. The traditional wholesaler compensation model revolved around the distributor being paid both by customers and by manufacturers through channel incentives (e.g., discounts, rebates, dating). In a fee-for-service business, the fee to the wholesaler becomes more transparent, with more evidence of what the wholesaler is delivering for that compensation.

- **The early negotiations of these inventory agreements have been characterized by wholesalers having great information of their costs.** Manufacturers, however, have been armed with little data on estimations of how much costs are involved in product distribution, and they have been extremely "close to the vest" in discussing costs. This may be working to the advantage of the wholesalers in these discussions. The second iteration of negations, though, could result in manufacturers having a lot more information about their delivery costs, which could create a movement toward greater transparency of fees. Moreover, wholesalers are marketing a new service to their suppliers—channel management—for which they want compensation.

- **There several reasons why we believe that the trends toward fee for service** will continue to evolve in the pharmaceutical wholesaling industry:

  1. **There is a concentration of health care buying.** The emergence of larger buying has shifted some margin "downstream," as it has effectively negotiated away the wholesalers' sell margins. This raises the question of someone having to pay for the wholesalers' services, given that these are legitimate operating expenses in the channel.

  2. **Wholesalers' costs continue to rise.** Compensation is the biggest component of a service company's expenses, representing 60%–70% of total operating expenses, and have been growing 3%–5% per year for the past 15 years.

  3. **There is an unhealthy component of some current channel incentives.** The "blunt tools" of incentives used by manufacturers to manage behavior by their distributors can create waste in the channel through inflating overall inventories. Dr. Fein did note that the "scandals" in other wholesaling businesses (such as food) were driven by a rebate structure that he defines as "incorrect incentives" (provided a temptation to maximize rebate dollars and show currently versus in the future).

  4. **The industry has some experience now of pharmaceutical wholesalers selling services.** This leads to less hesitancy by the wholesalers in adopting this change, according to Dr. Fein.

  5. **There is an increasing emphasis on "supply chain integrity,"** as manufacturers seek to shrink trading in the "secondary market," especially given the current concerns about counterfeiting. Dr. Fein notes that a challenge for drug manufacturers is that the building of global brands with differential pricing among countries creates a classic gray market challenge. Manufacturers in other industries overcame this issue through different names and marketing strategies by country.

- **Dr. Fein is skeptical about the sustainability of these agreements,** as it is very difficult to measure "what's next" once one comes off a base level. These agreements will continue to evolve, and the second iteration could be much different from the first. "We're going on a test run," stated Dr. Fein. He also noted that the wholesalers' appetite to carry certain amounts of inventory could change with a higher interest rate environment, making some of the points of these IMAs moot in the future. He suspects that these agreements could look much different in two years than they do today.

- **Seeking to go "downstream" and charging current pharmacy customers more is problematic.** As Fein noted, "Charging new fees for old services is a risky strategy," although he has seen success when fee-based services are viewed as new and valuable.

- **Dr. Fein suggests that wholesalers could lead from the middle—and there are some benefits from this new model.** One suggested response to fee-for-service shifts by wholesalers would be that they may no longer want to hold certain less profitable products in inventory, which would negatively impact revenues (fee-based) but expand operating margins.

- **Fee-for-service changes the relationship between the manufacturer and the wholesalers,** with the manufacturer increasingly being a customer, calling for more transparent fees. He believes that we could see a movement of wholesalers increasing defining themselves as service companies and being more customer-centric. He is of the opinion that fee for service could also move wholesalers into defining themselves as "service companies," to a model that's more customer-centric. To some extent, this could lead to instances in the future where wholesalers and manufacturers are competing for the same customer relationships.

- **Separately, Dr. Fein discussed the area of specialty distribution.** In some ways, the traditional wholesaler has been too focused on the scale economics of its core business and has missed a leadership opportunity in the delivery of biological products. A distinct channel has emerged where "disruptive products require disruptive channels."

In sum, Dr. Fein believes that much activity has already occurred in the movement toward fee-for-service. He foresees these inventory agreements as undergoing much change over the next two years, and he postulates that fee-for-service arrangements could change the relationship between the manufacturer and the wholesaler in the future.

Conference Call Transcript

Larry Marsh: Thank you and good morning everyone. We appreciate your being with us on this call. In November 2002, we featured Dr. Adam Fein on a similar call discussing initial movements to fee-for-service trends in the drug wholesaling industry. At that time, he provided his views of that trend in the pharmaceutical industry, and then compared and contrasted this industry to others. He noted what such a trend could mean, and how it could create disruption in the channel.

Needless to say, some of his thoughts from that call have proven prescient. So, today, with much discussion around drug companies amending their traditional wholesale buying relationships toward fee-for-service agreements, I thought it would be timely to have Dr. Fein back with us. And the topic remains timely; *The Wall Street Journal* recently discussed the ongoing efforts by manufacturers to reduce inventories in the supply channel and deal with the issue of counterfeit products, in this case discussing initiatives that Johnson & Johnson is undertaking to insure product safety and control.

Dr. Fein is the founder and president of Pembroke Consulting, a strategy and marketing consulting firm, and is a noted expert in the distribution function for this and many other industries. He is the author of many articles, papers, and books on this topic, including the issue of facing the force of the change in future scenarios for wholesale distribution. Adam is an expert in the supply chain with respect to wholesale distribution. I have known him for six or seven years and have found him to be a great resource. Today, I have asked him to address several topics: first and foremost, "What does the movement toward fee-for-service relationships imply for drug wholesalers and the entire channel? How might it work?"

Along with that, I have asked him to address the following: Is this trend being driven by manufacturers, customers, or wholesalers? And, who wins and loses in this "new world?" And then along with that, I have asked him to reflect on any other strategic directions that he foresees for distribution, comparing the drug industry to what he sees in other industries.

After his comments, we will address any questions you might have. Adam, it is great to have you back with us. We appreciate the time spent with us in your busy schedule. Let me turn it over to you for some observations.

Adam Fein: Thank you very much, Larry. It's a pleasure to be back with you.

As Larry mentioned, I am president of Pembroke Consulting, a management consulting firm working with senior executives from market-leading manufacturers, distributors, and B-to-B technology companies. Our experience includes working with manufacturers and distributors across many industries on executive-level initiatives such as profitable growth strategies, end-user and channel segmentation, market opportunity analysis, and channel rationalization and / or restructuring. We work across a range of industries and have extensive experience in the health care channel.

We recently completed a new distribution research study entitled *Facing the Force of* Change: The Road to Opportunity, which will be released in March 2004. I also want to mention that there are many articles on distribution-related topics available at our Web site [*www.PembrokeConsulting.com*].

As in my previous conference calls, I am not going to comment on the specific strategies of any of the health care companies that Larry covers. We work with a variety of companies that I may or may not mention. Instead, I am going to discuss general trends and highlight how these trends are playing out in pharmaceutical and health care distribution.

This morning, I will focus primarily on fee-for-service arrangements in the pharmaceutical wholesale channel. I will also offer a few observations and comments on specialty distribution and how it relates to the traditional channel.

Fee for Service

As Larry mentioned, I predicted last year that pharmaceutical wholesalers would shift from pricing based on a markup margin on product sales to a fee-for-service pricing model. We are now hearing more and more evidence of fee-for-service practices.

I want to address four issues:

1. How we define fee-for-service.
2. Factors driving this trend.
3. Inventory Management Agreements as examples of fee-for-service relationships between manufacturers and wholesalers.
4. Implications of fee for service for the pharmaceutical channel.

Fee for Service Defined

Intermediaries in a traditional wholesale distribution channel get paid by customers with gross profit dollars—the margin added to the cost of the product to cover operating expenses and profit. Support and other services are included in the customer's product price, making services appear free to customers. The economics of pharmaceutical wholesaling differ from other channels in two important ways.

- One, roughly 85% of wholesalers' gross margin dollars come from the buy side—the manufacturer. In other words, manufacturers support the legitimate costs of distributing their products with forward-buying opportunities, trade promotions, rebates, and cash discounts. In other words, customers pay almost nothing for the distribution of the pharmaceutical products in the United States.

- Two, pharmaceutical wholesalers operate on very slim gross margins yet retain very attractive return on total assets due to their phenomenal operating efficiencies.

Fee-for-service is really just a pricing strategy in which customers or suppliers pay directly for wholesaling services rather than having those services being paid for indirectly through gross margin and unseen discounts. A fee-for-service pricing model separates product costs and other operating expenses from the costs of providing services to either customers or suppliers. It provides a more direct and accountable way of measuring values and functions in the supply chain.

Factors Driving This Trend

Our findings are based on our research in this and other supply chains.

- **The growing concentration of health care buyers has shifted power downstream.** Large customers have negotiated away distribution margins. But someone still has to pay for the services and activities of pharmaceutical wholesaler. As a result, manufacturers rely on trade promotions, rebates, etc., to support legitimate business and operating expenses. Wholesalers can't pass these promotions or discounts on to customers without facing financial ruin.

- **The underlying costs of running a wholesale distribution business continue to rise.** Compensation and payroll expenses are the largest costs for wholesalers, representing 60%–70% of total operating expenses, even in this highly automated industry. These costs have been growing at 3%–5% per year for the past 10 years, driven in large part by benefits costs and health care insurance. Wholesalers have been growing the top line and gross margin dollars at a sufficient rate to cover up this pressure.

- **The current system of rebates and discounts is fundamentally broken.** When 85% of gross margin is being supplied by manufacturers, channel relationships become focused on supplier negotiations. Customers deny the value added by wholesalers, forcing manufacturers to step in and fill the gap. A vicious cycle ensues, as customers demand lower prices and wholesalers seek payments from the manufacturer to keep them whole.

  Cash discounts and trade promotions also warp incentives to lower supply-chain costs and are also unhealthy for both manufacturers and wholesalers. They lead to practices that add nothing beneficial to the customers or health care system. For example, the pressure to meet Wall Street expectations creates incentives for manufacturing executives to "rent" market share at the end of every quarter. These so-called channel stuffing situations have been in the news in this industry. Some companies are moving away from channel stuffing as a statement of strategy, such as cereal maker Kellogg.

- **Lastly, the fourth factor driving fee-for-service arrangements is the actual experience showing services can be more profitable than the core business.** No company illustrates this better than Cardinal Health. In an investor presentation they gave over the summer, they stated product distribution of pharmaceuticals and medical products represented 85% of revenue, but less than half of the company's operating earnings. Revenues from their two services divisions generated only 5% of company revenues yet contributed 26% to operating earnings.

In other words, a services business has a very different economic model. Revenues are lower because fee-based services do not include the pass-through cost of goods sold. Return on total assets rises because services do not add to inventory assets and add relatively little to accounts receivable.

Each of these four factors is probably not enough to trigger a move to fee for service. But put them all together and there are powerful internal and external incentives for both manufacturers and distributors.

Inventory Management Agreements (IMAs)

An IMA is a specific type of fee-for-service arrangement in the pharmaceutical wholesale channel. In a basic IMA, the wholesaler agrees to reduce or eliminate forward buying—purchases to stock not tied to demand. In return, the manufacturer provides a fee structure or payment to offset the wholesaler's economic losses from the discontinuation of forward buying.

Essentially, manufacturers are paying wholesalers not to speculate with inventory. This is a fundamental shift in the pricing model, especially since 85% of wholesale gross margin dollars come from the manufacturers. Rather than throwing money at wholesalers, hoping for loyalty and share, manufacturers can link fees and incentives to beneficial outcomes.

Both sides can benefit from IMAs.

Manufacturers have the opportunity to improve production efficiencies and overcome the traditional disconnect between marketing and operations. Too often in this industry, sales and marketing will use a trade promotion for strategic reasons, but fail to alert operations. All of a sudden, manufacturing is flooded with orders and must unexpectedly produce extra volume. In theory, wholesalers under an IMA will purchase to actual demand instead of channel stocking.

Wholesalers can benefit because they remove some risk from their business. Forward buying is just arbitrage across time. Even if the financial return under an IMA is less than forward buying, wholesalers have the opportunity to lower risk and return at the same time.

Implications of Fee for Service for the Pharmaceutical Channel

In my opinion, wholesalers have been the ones leading the supply chain here. They are thinking strategically about how to get paid for the value they add. Many manufacturers have been playing catch up on the operations side.

To a large extent, this is due to the historical emphasis on sales and R&D as the keys to success in pharmaceutical manufacturing. Operations are often considered to a backwater at big pharma companies; they don't know how to make operations into a strategic function for the corporation. Going forward, cost pressures and pipeline problems will force manufacturers to make the supply chain a strategic contributor.

Two, fee-for-service pricing will increase a wholesaler's accountability in the supply chain. Fees force wholesalers to deliver specific, measurable results – or risk not getting paid. In the case of IMAs, fee-for-service will change relationships between manufacturers and wholesalers by removing the smoke and mirrors around a wholesaler's promise not to forward buy.

The wholesaler is selling a service to the manufacturers. The manufacturer is now explicitly a customer and can hold the wholesaler accountable. Without an IMA, a manufacturer's only recourse is to switch wholesalers. That's not really a possibility in an era of three dominant wholesalers. We have not yet seen the full implications of this power shift yet.

Three, fees create more transparency and integrity in the drug supply chain. Fees can be reported as a cost of doing business on an income statement. In contrast, existing accounting standards and reporting requirements allow manufacturers to bury the distribution costs of their products and hide the profit contribution of vendor payments for wholesalers. Fees are an appropriate solution for today's new era of accountability.

Fees are an alternative to functional discounts given by manufacturers for performing certain activities (functions). Although functional discounts are an improvement over volume rebates, they still create a focus on vendor negotiations rather than fees for value.

In my opinion, the shift to fee-for-service is just one more step in the evolution of the health care distribution channel. Wholesalers have been moving to a customer-centric services business model for some time now. The largest distributors describe themselves as service companies not product distributors.

Specialty Distribution

I want to spend a few minutes talking about the specialty pharmaceutical distribution business.

My basic observation is straightforward: I think that traditional wholesalers have been so busy pursuing scale economies through consolidation that they have ignored the opportunity to take a leadership position in the fast growing, higher margin business of bringing biopharmaceuticals to market.

When biotechnology was first commercialized for human health applications twenty years ago, the technology was correctly perceived to be disruptive to traditional drug discovery processes. Since few people expected corresponding disruptions in downstream commercialization activities, most start-ups partnered with larger incumbents to access presumably complementary resources such as sales and marketing know-how, established distribution channels, and experienced management.

In fact, crucial differences between conventional drugs and new biopharmaceuticals have created wholly distinct marketing and distribution channels, leaving incumbent wholesalers poorly positioned in the commercialization of new biotechnologies.

With the benefit of hindsight, we can understand why biopharmaceuticals disrupted the traditional sales, marketing, and distribution channels handling mass-marketed, oral solids:

Biopharmaceuticals are extremely expensive, making reimbursement claims for both patients and health-care providers much more complex.

Products require complex handling, for which the conventional low-cost physical distribution channels are poorly suited.

Reimbursement risk and high product prices make providers or pharmacies unwilling to hold much product inventory.

Patient populations for many targeted disease states are very small, so there's low likelihood of purchase at any individual pharmacy dispensing location.

These challenges led to the evolution of a new group of specialty pharmacies and distributors, such as Accredo Health and Priority Healthcare. These companies operate in parallel to traditional retailers and distributors, delivering product to doctor's offices and clinics, drop-shipping product straight to end-users, or dispensing from distributor-owned specialty pharmacy networks. Leading manufacturers such as Biogen, Genzyme, and MedImmune have exclusive or highly selective marketing arrangements with these specialty distributors.

Operating margins for specialty distributors are four to five times as large as traditional pharmaceutical wholesalers due in large part to their many value-added services within the health care system.

In my opinion, the major wholesalers have missed this opportunity and face new long-term risks as a result. Other distributors are moving into the market, such as Henry Schein's recent acquisition of a specialty company. While acquisition seems like a logical strategy, I am not convinced that the large wholesalers understand how to run what is essentially a different business.

This is a major issue because the traditional oral solids market is shifting increasingly to generics and over-the-counter is shifting to mail order. The growth markets are biotech. There are over 400 biopharmaceuticals in the FDA pipeline. I believe this is a potential threat for the traditional wholesaler growth model over the next five years.

Let me stop there, Larry, and open it up to questions.

Q&A

Larry Marsh: Okay, we do appreciate the thoughts, as always, thought-provoking. Let me highlight two things before we turn it over to see what other questions might be on people's minds. First, what are your thoughts about compensation in a fee-for-service model? You addressed this over last year, but, what is the process of determining how a wholesaler is going to get paid from their customers in this model?

I think last year you addressed the customers being the pharmacy, the end customer, and the challenge of getting them to pay for something for which they are not used to paying. And, secondly, if we start to think about the customer as the manufacturer, how much of an educational process is involved if you really trying to drill-down to understand how much the wholesaler is going to get compensated for the services?

Adam Fein: "New fees for an old service" is a risky strategy. Customers resist paying for something that once was free, even if they acknowledge the economic logic behind the concept. Some customers will see fee-for-service as no more than self-serving behavior by wholesalers.

The biggest challenge in fee for service is getting customers to pay the true cost of their service requirements rather than getting services for free. Today, powerful customers can get the cost of the service deleted from the product price. The large GPOs want value-added services but don't want to pay for them.

The key to success is to offer a new service that provides something valuable to customers—something that solves the customer's pain and for which the customer is willing to pay.

Pharmaceutical wholesalers have also been at the vanguard of adding higher-margin services, ranging from on-site inventory management to technology consulting. Instead of struggling to get customers to pay for previously “free” services, they have built new fee-based services and acquired existing service companies. These services help hospitals and pharmacies provide better patient care and lower their operating costs.

In the case of IMAs, the customer is the manufacturer, not the health care provider or pharmacy. Manufacturers are now paying for a specific service—the elimination of forward buying. The actual price setting comes down to a negotiation. Most manufacturers are extremely close to the vest about these arrangements. That said, the benefit is probably much larger than the fee.

Wholesalers have a much better sense of their internal costs through activity based costing. I believe they will always be able to price the services profitably. I can’t talk about private negotiations, but I will mention that wholesalers come to the table armed with more facts about the cost structure. Nevertheless, the key to long-term success is to price based on the value delivered by helping a manufacturer runs its business better.

Larry Marsh: As a follow-up, how does the manufacturer think about this fee-for-service phenomenon? If they have already been compensating their wholesalers through subsidizing them these services, are they just paying the wholesaler in a different way?

Adam Fein: It is true that the manufacturers have been paying the wholesalers. However, this is a new service because manufacturers are paying wholesalers to change their behavior instead of paying them to provide physical distribution. Manufacturers had been paying indirectly for the fact that they didn’t have to actually do physical distribution to all of the hundreds of thousands of locations where their products are going to be consumed.

The difference is that the manufacturers paying wholesalers for something specific – not to forward buy. Here’s where accountability comes in. The manufacturers are giving something specific—money—for a specific outcome.

Larry Marsh: Another follow up question: have you noticed instances in other industries where their “secondary markets” (if they have them), have been subject to great change? And if there are other examples, do you anticipate there being a permanent- elimination or significant alternation in the secondary market in the pharmaceutical wholesaling business?

Adam Fein: To be perfectly honest, other industries have wrestled with this issue but none are at this stage yet. The political issues are bigger here – product safety, reimportation, supply chain integrity. There’s more money at stake, too.

Moving to a fee-for-service model will lower the volume of product being resold on secondary markets. Today's article in *The Wall Street Journal* points out that Johnson and Johnson has seen this happen in their business. With forward buying, wholesalers who guess wrong and overbuy can sell the inventory to secondary wholesalers. This practice, which is very common in the grocery business, is called diverting.

Reducing secondary supply is also a reaction to reimportation. Reimportation only works for identical products being sold at lower prices in another market at a different price. Pharmaceuticals are sold for different prices to different types of customers throughout the United States. IMAs should reduce some of the volume that can show up and undermine pricing practices.

Pharmaceutical manufacturers have compounded to their problems by creating global brands. Global brands create the opportunity for profitable reimportation because the same product is sold for different prices in different countries, creating a classical gray marketing problem.

Larry Marsh: Then your message seems to be that we could see some alteration but it is still early on to say exactly how it is going to manifest itself in the drug wholesaling industry?

Adam Fein: Yes. In fact, I see bigger changes in the retail channels rather than the wholesale channels. IMAs and fee for service are tweaks to the business model. It's not as dramatic as consolidating from 200 to three companies in 20 years.

Question: I had two questions. First on all of your work over the last year or so with respect with IMAs, just wondering if you have any better feel for the sustainability of the IMAs? Obviously, if all of the pharmaceutical companies are structuring these in the contracts with distributors, it is important to get a sense for the sustainability of those going forward.

My second question relates to the secondary market. And the article in the journal today speculates that it represents a very small portion of sales for companies like AmerisourceBergen and McKesson. But I would suspect that the margins are much higher than their typical margins.

I am just curious if you have any better sense of what percentage of sales for those distributors are in fact secondary markets. And what the profitability of the secondary market relative to the typically 3% or 2% to 3% operating margins we see from the core business?

Adam Fein: Most IMA agreements are less than two years old. Also, not every pharmaceutical manufacturer has even set up IMAs yet.

Like most channel arrangements, initial savings can be significant in the first few years, though, are often tied to one-time gains. In this case, the gains come from the reduction in forward buying. That becomes the new normality and they need something else.

The first round of IMAs are a kind of a test run. Future agreements are going to look different and I expect to see a greater level of supply chain sophistication by the manufacturers.

Turning to the secondary market, I don't have figures on the size the secondary market. However, I will say that the secondary market thrives for products that are near commodities or for which there are large differences between a contract price and the market price.

Question: Sure, for the wholesalers because you would think they could purchase the product at a lower price than they were even perhaps getting from the manufacturers.

Adam Fein: Most of the money is made by secondary smaller wholesalers, who are either brokers or local companies selling to a niche market. I do not believe that the larger wholesalers have made a lot of money from the secondary market, except to the extent they make margin on reselling products.

Question: I wanted to ask what the implications are for the long-term financial model for the wholesalers of this shift—first in terms of understanding the economics of the IMAs or the fee for service versus the prior arrangement. We have seen here a bit of gross profit margin pressure during this period of time. I just wanted to get a sense of how you think the all in economics compare.

Second, over the long term, the wholesalers did sort of benefit from riding the wave of revenue spend from pharmaceutical, not just volume but also pricing. And, what the implications are moving for a fee for service arrangement?

And, third, once the manufacturers do come back for renegotiations of these agreements how to think about the relative power of the parties and what that implies going forward.

Adam Fein: The economics are complicated by the shift to generics, which have a different margin structure for wholesalers. There are almost no opportunities for forward buying because prices are going down not up.

The financial statements need to be analyzed differently. As I discussed earlier, service fees add little to top-line revenue because they exclude the pass through cost of goods sold. Operating profit increases because of both the higher profitability of valuable services and the only incremental expense may be personnel. Return on total assets can grow dramatically because services do not add to inventory assets and add relatively little to accounts receivable.

Another possibility is that wholesalers could offer distribution services without taking title. Arrow Electronics, the largest distributor of electronic components in the United States, gives up gross margin on product parts in favor of service fees. In other words, Arrow will sell services even if the customer purchases the parts elsewhere.

Question: Second question was terms of the revenue growth model going forward—the wholesalers rode the full trend of drug spent and what they are selling going forward.

Adam Fein: Certainly, I would be a fool to predict drug spending going down given the Medicare bill. But I do expect greater scrutiny of product prices. IMAs could also be driven by expectations of lower price increases in the future, and therefore less opportunity to make money from forward buying.

Generics are gathering steam, reimportation is growing, and the major wholesalers are not well positioned in the specialty market, which is where the real price increases are happening. Put all these factors together and we may see overall revenue growth being much more muted going forward.

For many other distribution industries, product inflation rates are effectively zero and forward buying has ceased. In the economy, the inventory-to-sales ratio at wholesalers is an historic low. The wholesale channel in the United States has never been as thinly stocked as it is now.

In a separate research project, we found that inventory-to-sales declines were the result of wholesalers deciding not to hold inventory, instead of the conventional explanations related to supply chain innovation. Either wholesalers don't think they can sell products at a higher price or they don't want to take the risk of speculation. This is a deflationary mind set.

With regard to negotiating power, I think manufacturers went into these initial arrangements without a clear understanding of pricing and what their true economic value would be from ending forward buying. On the other hand, the wholesalers had a very good and deep understanding of their costs, but also limited understanding of the full value to manufacturers.

I think the next round of negotiations will be much more fact-based and linked to specific benefits. The issue of supply chain integrity will be more prominent.

I also think that manufacturers will want to rethink rebates as a channel support strategy. Rebate accounting scandals at several large wholesale distribution companies in the food industry are triggering new accounting rules and closer scrutiny of these transactions.

Question: My question is the entire focus on the IMAs is on the buy side. But the distributors have indicated that they are going to try to seek some pricing sessions on the sell side. And that historically they have priced along forward-buys or rebate dollars in anticipation of the profits they get.

As these contracts roll over that they may not be obviously raising prices. But they may not be gaining the same concessions. Can you comment on that? And then I have a second question is you mentioned a lack of strategy on the specialty side. Given the profitability there and the faster growth there do you anticipate these companies acquiring that expertise?

Adam Fein: Could you just rephrase your first question, because I didn't quite get what you were asking.

Question: The IMAs and the concessions are always focused on the buy side equation where the profits come. The distributors historically in contracts with customers on the sell side have in many cases given price concessions in anticipation of—for the rebate dollars or buy side profitability.

And they have commented that in future contracts that they will be firmer on price or not grant the same concessions because they don't have them. Do you think that is possible? Or in your work in the industry that the big buying groups are going to continue to want even greater concessions going forward.

Adam Fein: The reality of any distribution channel is that someone has to pay for the services of the channel. If no one wants to pay for it, then the service is not valuable and should be eliminated. But customers have been able to get the services of product distribution right to their doorstep on an as-needed basis in the right quantities. Manufacturers have supported this arrangement.

Fee for service is a way for the manufacturers to specify what they want and will pay for. Ultimately, wholesalers will be forced to go back to customers and let them know that the money has to come from somewhere. Either the customers don't want certain services or they have to pay. Therefore, I expect wholesalers to take a firmer stand on pricing. They are still by far the most efficient channel that is out there of any that I have seen. The middleman doesn't add much cost to this channel, so at some point they are just squeeze any more blood from that stone.

There are examples of hospitals getting together to self-distribute to save money. This usually has the opposite effect because hospitals are not good at doing these things. So, I expect that wholesalers will be able to get a little more price stability from the large customers.

Question: You mention that role of wholesalers and specialty pharma distribution—and obviously that is a faster growth area and faster profitability. So do you see these guys particularly as they tie up less capital in inventory given the IMAs that obviously your free cash flow is greater which means they could be more prone to acquiring a skill set here?

Adam Fein: Yes, the specialty companies are obvious targets, but they are pricey. I am just skeptical that the strategic mindset of executives at the large pharmaceutical wholesalers will truly allow them to succeed against the specialty model.

Larry Marsh: We should wrap up our discussion, as we are right at the hour. In sum, I want to thank you, Adam, for sharing your insights and observations on the market, and it was very well thought out and shows a lot of understanding of the market.

We look forward to continue to follow your work in the future and to keep up with your track record, which has been very good.

And as Adam said, there is a lot more information about his firm and the pieces that he has done on his Web site, which is Pembroke Consulting dot com. And so you can look that up. Once again thanks so much for your participation, Adam, and we will stop there.

Adam Fein: Thank you very much, Larry. As I mentioned, our strategy consulting focuses on marketing and channel strategy issues. Our Web site has a number of articles and resources on these topics (*www.PembrokeConsulting.com*). You can also reach me in my office at 215.523.5700.

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