MEDI-DISPLAYS INCORPORATED

Elizabeth M. A. Grasby revised this case (originally Medi-Supply Inc. –author unknown) solely to provide material for class discussion. The author may have disguised certain names and other identifying information to protect confidentiality.

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In mid-April, George Robson was in the midst of preparing a report for his new employer, Medi-Displays Incorporated (MDI). As the firm's new controller, Robson had been asked by Matthew Tullen, the owner of the company, to evaluate a recent request to break a two-year-old contract from an important customer, Pharmacy Mart. Pharmacy Mart had been responsible, to a great extent, for MDI's growth. After showing Robson around the company's operations, Tullen left Robson to his task with the following words:

> We've relied on Pharmacy Mart's business for 15 years and they are an important customer to us, but I don't want to do anything that will prove unprofitable to MDI. I want you to investigate every facet of this decision and have a full report with recommendations to me by the end of the day tomorrow!

THE PHARMACEUTICAL RETAIL INDUSTRY IN CANADA[1]

Background

Over the past decade, the Canadian retail pharmaceutical industry had responded to many industry pressures. These pressures included but were not limited to an unprecedented expiration of patents (often referred to as the patent cliff) for many "blockbuster" drugs, a dramatic growth in the number and sale of generic drugs, the growing adoption of more expensive oncology, biotechnology and specialty drugs market segments, and on-going cost containment measures from both public and private payers. As a result, the industry experienced several mergers and acquisitions among pharmaceutical manufacturing and retail companies in order to consolidate their cost base, expand research pipelines and broaden their geographic market. Many pharmacy operators benefited from economies of scale with this increased merger and acquisition activity.[2]

Industry Characteristics

The pharmacies and drug stores industry (pharmacies) was the most highly regulated retail sector in Canada. Licensed pharmacists had to have earned a bachelor's or doctor of pharmacy degree from one of 10 Canadian universities, pass a national board examination, complete an internship program and be fluent in either English or French.

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[1] BISWORLD http://clients1.ibisworld.ca/reports/ca/industry/default.aspx?entid=1054
https://csca.ryerson.ca/products/corporate-concentration-in-the-canadian-retail-pharmacy-industry
http://pharmacyu.ca/2016/12/28/analysis-what-does-the-mckesson-rexall-deal-mean-for-canada/
INDUSTRY CANADA:
https://www.ic.gc.ca/eic/site/lsg-pdsv.nsf/vwapj/PharmaProfileFeb2014_Eng.pdf/$file/PharmaProfileFeb2014_Eng.pdf
https://www.ic.gc.ca/eic/site/lsg-pdsv.nsf/eng/h_hn01703.html
https://www.ic.gc.ca/eic/site/lsg-pdsv.nsf/eng/h_hn01703.html

[2] For example, major player McKesson Canada acquired Rexall Health in late 2016, adding almost 500 pharmacies to more than 2,500 stores nationwide.

Currently, there were more than 9,500 pharmacies in Canada serving more than 35 million Canadians. Many of these pharmacies were franchises managed independently while also relying on a distribution and support network. Of the major four pharmaceutical companies with franchisees, Shoppers Drug Mart and McKesson generated more than 50 per cent of the total revenue in 2017.

Demand for pharmaceutical products was directly related to total public and private health care expenditure. Demand for pharmaceuticals also increased with an aging population since the incidence of health ailments (like chronic illness increases) stimulated demand for pharmaceutical drugs. Seniors (65 years and older), accounted for approximately 56 per cent of government prescription drugs expenditures in 2016. The number of seniors was expected to continue growing as a percentage of Canada's population. While many provinces and territories covered prescription costs for the elderly and individuals on social assistance, many individuals still incurred out-of-pocket costs for prescription drugs; as a result, many Canadians moved toward more generic drugs (rather than brand name drugs) to cut their healthcare costs.

In 2017, pharmacy product sales included prescriptions (47.3 per cent)), non-prescription pharmaceuticals (19.9 per cent)), and general merchandise (32.7 per cent). The general merchandise category included cosmetics, toiletries, confectionery goods, infant care products and eye care. Demand for this market segment had risen steadily due to marketing, pricing and promotional activities, and pharmacies enhancing their product portfolio with private-label products to develop a loyal customer base.

Technologically, retail pharmacies had introduced electronic data interchange (EDI) internally. This technology has improved efficiency for pharmacies and had reduced labour costs. Other technological developments included the ability to place prescription refill requests electronically, and gave patients and care givers access to a patient's medication and immunization record on their smartphone. These applications also provided refill and dose reminders and contact information for prescribers and pharmacies. Other advancements included pharmacy support software that enabled pharmacists to update customer records allowing all pharmacists within a store to access this information to better serve consumers. The ongoing shift to internet sales, in particular e-commerce, had helped propel the industry into the digital age, selling medications, toiletries and beauty products online to meet shifting consumer preferences.

Industry Financial Performance

Total pharmaceutical sales (including non-patented over the counter medicines) in Canada had doubled over the past 15 years, with 87.5 per cent sold to pharmacy operators and 12.5 per cent sold to hospitals. Government payers accounted for 42 per cent of drug expenditures and private payers (private coverage and individuals) accounted for the remaining 58 per cent. In 2017, brand-name products accounted for 77 per cent of sales and 34 per cent of prescriptions. Generic brands accounted for the balance of sales. Representing 16 per cent of total health care expenditures, pharmaceuticals were the second largest component of total health care expenditures by Canadians. In 2017, profit, measured as earnings before interest and taxes (EBIT), was approximately 5.8 per cent of industry revenue and had risen steadily over the past five years.

Industry Pressures

Historically, many pharmacies had received financial incentives (rebates) from pharmaceutical manufacturers to stock their drugs (thus allowing pharmacies to reduce their invoice prices for prescriptions). This action bolstered pharmacies' profit margins; however, more recently, many provinces and territories governments had restricted specific generic drug prescription rebate rates by a percentage of the patent drug equivalent, curbing generic drug manufacturers' rebates to pharmacies. The restrictions by governments on generic drug rebate rates given to pharmacies by drug manufacturers had resulted in pharmacies looking for other cost saving or revenue generating measures. As pharmacies contended with fewer rebates, more chain pharmacies had emerged to lower the pharmacy's operational costs through the resources of the parent corporations.

Pharmacies were also experiencing mounting external competition from supermarkets and mass merchants, which typically offered low prices for industry products and the convenience of one-stop shopping. Pharmacies also competed with online retailers that offered similar or identical industry products at lower prices. In response to this competition and in an effort to develop a more loyal customer base, many pharmacies had diversified their product portfolio with private-label brands, emphasized customer convenience with longer hours of operation, drive-through pharmacy windows, and drug delivery. Other value-added service offerings had also been added to include renewing long-term medications for patients, administering injections like flu shot vaccines, customer consultations, diabetes monitoring, writing prescriptions for minor health ailments and viewing laboratory results, demonstrating the industry's movement toward providing more value-added healthcare management services alongside its traditional product offerings.

Industry Outlook

The pharmacies and drug stores industry in Canada was in the mature stage of its economic life cycle, characterized by slow growth rates, industry consolidation and market acceptance. Research and development expenditure was anticipated to increase over the next five years, providing additional drug prescription sales opportunities. The increased prevalence and treatment of certain diseases, as well as changes in treatment guidelines, were also expected to contribute to the average annual growth in drug spending. As well, the proliferation of biologic drugs, which were higher-margin products, were expected to further bolster spending on both cancer drugs and immunosuppressant drugs.

Over the next five years, pharmacies' sales were expected to grow at around 2 per cent annually to total CA$47.6 billion[3] in 2022 and industry profit (EBIT) to rise to 6 per cent by 2022. The number of pharmacies was also expected to increase. Most of this growth was projected to come from the additional preventive health services provided by pharmacies, an increase in over-the-counter (OTC) nonprescription drugs (sunscreens, aspirin, acetaminophen, ibuprofen, antibiotics, etc.),[4] pharmacies producing or expanding their own brand name version of generic drugs, and other merchandise sales as more pharmacies and drug stores enticed consumers by enhancing their front-end product offerings.

[3] All currency in Canadian dollars unless specified otherwise.
[4] Many OTC drugs were subject to regulation, depending on the OTC drug's schedule classification.

Medi-Displays Incorporated, located in Oakville, Ontario was a manufacturer and national distributor of retail shelving and display cases. MDI was a private company wholly owned by Tullen. Tullen had founded the company 20 years ago and, since then, had built up the firm's reputation for quality and dependability.

Since its inception, management had focused exclusively on drug stores and pharmacies as a customer base.

MDI's largest customer (25 per cent of MDI's sales and the only chain MDI dealt with) was Pharmacy Mart, the third largest national pharmacy chain with more than 400 Canadian locations. Over the years, the two companies had developed a friendly and trustworthy business relationship. There was no doubt that MDI's relationship with Pharmacy Mart, which had recently informed Tullen of its decision to undertake a major expansion program, had proven to be a major catalyst for MDI's growth.

THE REQUEST

Two years ago, MDI had developed a specialty narcotics security cabinet. To manufacture the product, $2,000,000 was invested for specialized equipment with an estimated useful life of 10 years. Most of the machinery had a production capacity of 600 units per year; however, the process was currently limited to 300 units because of limited plating capacity.[5] At the time the cabinet was developed, MDI and Pharmacy Mart signed a contract in which Pharmacy Mart had guaranteed to purchase a minimum of 120 units each year for 10 years at a price of $4,200 each. Robson gathered cost information on the cabinet (see Exhibit 1). This contract had an exclusivity clause stating that, although MDI held the patent rights to the product at Pharmacy Mart's request, it could not sell the cabinet to any other company than Pharmacy Mart for the duration of the contract. Although such an arrangement was rare, MDI agreed to this clause because Pharmacy Mart was such an important customer. Pharmacy Mart had fulfilled its part of the bargain by purchasing 120 units each year for the past two years.

Robson met with Aaron Flandon, the marketing manager, at MDI. Flandon told Robson that last week he had received word from executives at Pharmacy Mart that a similar cabinet made by another company had come onto the market at a lower price. Pharmacy Mart asked if MDI would match the market price. In return, Pharmacy Mart was prepared to drop the exclusivity clause and allow MDI to sell the cabinet to other customers. If MDI agreed to this proposal, Pharmacy Mart informed Flandon that Drugs Plus, another very large national pharmacy chain, might be interested in purchasing MDI's security cabinets. Flandon had called Drugs Plus's purchasing manager and learned that Drugs Plus would, in fact, be willing to purchase MDI's cabinets for $2,650 per unit. Flandon explained to Robson that there was little likelihood of getting any other additional business aside from the cabinet sales from Drugs Plus over the next eight years.

During Robson's discussion with Flandon, Flandon had gone into more detail about security measures taken by pharmacists:

> Federal and provincial bodies have legislated increased security measures for pharmacies over the years. The rise of drug abuse has made this necessary because pharmacies had increasingly become the targets of drug-related theft. In fact, a 2013 investigation reported that more than 90.0 per cent of pharmacists reported drug shortages at least once during the previous year. Narcotics and barbiturates were the main targets, as they could be illegally sold on the street at prices 20 to 30 times their usual selling price. These shortages were the result of either internal or external theft.

[5] Plating ensures a smooth, corrosion-proof interior to the cabinet.

The thieves were usually the dealers or addicts themselves. Although most had technically unsophisticated methods, more of them had become technically savvy. Once in the dispensary, thieves had less than 10 minutes before they ran the risk of being seen, heard, or security or police had arrived on the scene. This was ample time to break into the metal cabinets many pharmacies had currently in use.

In March 2017, government legislation mandated public reporting of drug shortages and discontinuances. Most security precautions were either too expensive or ineffective. Alarm systems connected to police stations were expensive, as were security guards.

The narcotics cabinet that MDI developed provides an excellent answer to the industry's theft problems. It is 24 inches high, 18 inches deep and 18 inches wide. It is made of one-quarter of an inch steel and has a deadbolt lock system. Operated by a hinge, this lock system drives four deadbolts in four directions to totally lock the cabinet door. The lock cannot be picked and can withstand 10,000 pounds per square inch of pressure. Although it also comes with an electronic keypad, most pharmacies choose not to engage it (the code had to be shared with employees); instead, they preferred the security provided by the mechanical lock.

Each pharmacy usually requires two to three units to meet its storage needs. We originally worked with Pharmacy Mart executives to develop the cabinet and in the Pharmacy Mart outlets where the cabinets are in place, they have been totally effective. Losses due to narcotics theft have dropped to zero dollars!

THE COMPETITION

When asked about the competitor's product, Flandon noted that, while it did the same job as MDI's cabinet, it had a much less sophisticated lock system, was not made of as thick a metal, and it did not have the proven track record of MDI's cabinet; however, Flandon explained to Robson that the competition was known for its aggressive pricing policies.

THE CUSTOMERS

According to Flandon, MDI could sell the cabinet to chain pharmacies (chains) and independent pharmacies (independents). The biggest difference between the two customers would be their purchasing process. Independents, of which MDI had a customer list of 1,200 stores, required an individual selling effort and were time consuming considering the volume of sales that could be generated. On the other hand, the chains had centralized purchasing departments so that only one intensive selling effort was necessary (rather many visits to smaller independents), which could result in larger sales volumes.

Flandon thought that by compensating sales people with a commission of 15 per cent on a selling price of $2,650, MDI could achieve total sales of 600 units per year for the cabinet: 120 to Pharmacy Mart (as in the past two years) and 480 to Drugs Plus and independents. No commission would have to be paid on any Pharmacy Mart order. For either customer, Flandon indicated that most accounts would be collected in 40 days.

Apart from Pharmacy Mart and Drugs Plus, Flandon thought it was unlikely that MDI could get sales from the other chains. He had done some preliminary investigations and discovered that other major chains had already developed their own security programs.

Flandon also had other ideas for marketing the cabinet. On a national scale, he thought hospitals, doctors, dentists, and various clinics that carried narcotics, could also be a potential market. Flandon concluded:

> I didn't like this original deal two years ago—it was too restrictive. Here is an opportunity to tremendously increase sales volume for the cabinet. I think if we really expanded our sales efforts and, with a 15 per cent commission, our salespeople could sell another 480 units per year. This would certainly give us better exposure in the marketplace.

PRODUCTION

Having learned all he could from Flandon, Robson then spoke to Carl Shuster, MDI's production manager. Shuster was surprised to hear of Pharmacy Mart's request but agreed to review production costs with Robson, based on a potential volume level of 600 units each year (see Exhibit 2).

Based on current purchasing and production schedules, Shuster concluded that MDI would have to maintain the current raw materials inventory level of 30 days of purchases. Due to the manufacturing process used, there was rarely any work-in-process or finished goods inventory. Shuster summarized:

> If we have to increase production, it means hiring more people and, heaven knows, there is a shortage of skilled labour in the job market. Besides, I've got production schedules laid out for the next five to six months. It would be a hassle to try and fit in extra production. I think we should take our smallest loss and sell only to Pharmacy Mart at $4,200 per unit.

As Robson returned to his office, he decided that he would glance over MDI's past financial performance. He found that current cabinet sales to Pharmacy Mart represented approximately 3 per cent of total MDI sales of $18 million last year; however, all of Pharmacy Mart's business totalled approximately $4.5 million of MDI sales. Also, at fiscal year-end, January 31, MDI had $51,600 in cash and $147,000 of marketable securities (short-term investments) on its balance sheet.

Robson glanced at his watch as he sat down at his desk and discovered he only had a couple of hours left to evaluate the information. Tullen was expecting his report and recommendations by the end of the day and, since this was Robson's first assignment, he wanted to produce a coherent report that presented everyone's thoughts, needs and expectations.

REQUIRED

As George Robson, make a decision regarding Pharmacy Mart's request. Prepare a report for Matthew Tullen, outlining your analysis, decision and action plan using relevant information from the case.

Exhibit 1

TOTAL MANUFACTURING COSTS PER YEAR
120 Unit Volume: Narcotics Cabinet

Materials[6]	$ 57,510
Labour (including benefits)[5]	104,460
Plating[5]	30,144
Supplies[7]	4,320
Overhead—fixed[8]	10,352
Overhead—variable	2,328
Depreciation[9]	200,000
Total manufacturing costs	$ 409,114
Selling general and administration cost[10]	52,279
Total costs	$ 461,393
Revenue per year ($4,200 × 120)	$ 504,000

[6]Varies directly with the number of units produced.
[7]Brackets, bolts, etc. used in the construction of each unit.
[8]Charged on the basis of 18 per cent of direct labor.
[9]Units of Output $2,000,000/10 years = $200,000/year
[10]Allocated at 25 per cent of manufacturing costs excluding depreciation. Rounded to the dollar.

Exhibit 2

NOTES FOR PRODUCTION COSTS AT A 600-UNIT VOLUME

1. Material costs will decrease by $10 per unit at 600-unit volume due to volume discounts.

2. At a volume level of greater than 120 units, a production supervisor must be hired for $72,000 per year (includes benefits).

3. If volume exceeds 300 units, an additional plating machine must be purchased for $120,000. The plating machine could be delivered within two weeks.

4. At a volume of 600 units, the investment in working capital would increase from its current level of $24,870 to $124,350. Working capital is a one-time investment in accounts receivable and inventory and a one-time source of cash from accounts payable.