Pharmacy – Revenue Stream or Profit Drain?
Sherry Everhart BS, RVT & David McCormick, MS

One of the hot management topics this year is the pharmacy. Many practice owners are concerned as to the future of their pharmacy sales and whether they should even continue providing pharmaceutical services.

Industry data shows that as a percent of overall revenues, average product sales is beginning to show evidence of decline. At the same time, the average product costs are doing the opposite. Historically, it was common for the cost of drugs and medical supplies to fall in the range of 17 to 21% of revenues. This is no longer the case for most practices. It is increasingly common to observe these inventory costs exceeding 25%. Because inventory costs are the second largest expense for most general veterinary practices (behind labor costs), this trend has had a significant negative impact on practice financial health.

Should you keep your pharmacy?

Yes, for many reasons. If you can commit to actively managing your pharmacy inventory, it can play a positive role in your practice’s financial health.

‘Actively managing’ is the real issue here. Even though most practice management software systems include extensive inventory management capabilities, all too frequently they are not understood and therefore, they are under-utilized. Many practice owners are still using the same ordering, monitoring and pricing procedures for inventory that they used when they started their practice.

The veterinary product sales market is rapidly changing. In the midst of a challenging economy, veterinarians today are facing the challenges of increased internet competition, the expansion of veterinary products on super mart shelves and the highly advertised offering of low cost generics through human pharmacies. Failure in appropriately responding to these challenges has many veterinarians possessing a very inefficient inventory investment.

Below are some of the more challenging issues in inventory management that, when not addressed properly, are leading to pharmacy sales effecting a decline, rather than a boost, in a practice profitability.

Price Matching with the Competition

Many owners feel it necessary to offer products at the same price that clients can purchase them on the internet. When an owner chooses to go this route, they need to do it with the understanding and awareness that they are matching prices with a company whose likely biggest costs are shipping and advertising. These companies do not have the costs associated with keeping a highly educated staff, providing health care services with specialized equipment and maintaining a hospital facility with patient record oversight. They receive and ship. That is it.

If you decide to price match, dependent on your other costs, you may need to accept that very little or no profit from these sales will reach your bottom line. It is a service to the client that has no benefit to your practice. The decision to match prices should include an analysis of how much profit will you lose from the loss of sales to a competitor versus the profit lost from reducing prices on an entire product line.
As an example, let’s say a product line’s unit costs are $25,000 annually. After careful analysis, the practice appropriately decides to price the product to achieve $47,500 in sales revenues. This provides the practice $22,500 to cover the additional costs (see below) and to earn a profit. Later, to avoid losing sales to a perceived competitor, the practice owner chooses to reduce the product line’s price and now can achieve only $40,000 in sales. This adjustment leaves only $15,000 for the practice – the associated costs do not change. Only the profit is reduced.

In this example, if the practice did not change it original pricing structure, it would had to have lost 1/3rd of its sales in order to equal the consequence of the reduced pricing strategy. Would they have lost 1/3 to the competitor? Not likely.

If you choose to price match and you want to maintain your practice’s financial health and profitability, you should intentionally make up the shortfall somewhere else in your fee schedule.

Incorrect Ordering/Stocking Quantities

The ongoing pharmacy struggle seems to be deciding the appropriate quantity of each drug to have on hand. Being able to treat each patient’s health issue with immediacy often leads to having numerous product lines and larger stock quantities than what is truly necessary. Ordering habits are hard to change, especially when the person responsible gets caught up in their ongoing daily schedule of tasks and interruptions.

Your pharmacy has costs built into it that are on top of the unit costs of the drugs sitting on the shelves. Taxes, insurance, storage, and regulatory costs also are incurred. Inventory on hand is also tying up a significant amount of capital that otherwise could be invested to generate an income. When quantities on hand are in excess of managed levels, you risk additional costs that are associated with product obsolescence, expiration losses, and theft. These are referred to as “holding” costs. These hidden costs can frequently cost a practice an additional 8-20% of a product’s unit cost.

An in-house pharmacy also incurs “ordering” costs. These are the labor costs related to the ordering of products, un-packaging and stocking, entering inventory in the computer (and adjusting fees), payment of invoices, and any accounting costs. When a practice has too little inventory on the shelves, it incurs higher ordering costs. Employees have to place more frequent orders, shipping costs may increase, and there is an increase in the number of shipments and invoices that need to be dealt with. Over-ordering has other expenses and profit drains. Overall, the subtle ordering costs can add an additional 15-20% of a product’s unit cost.

On top of the holding and ordering costs, a practice may also experience lost sales due to stock outs and possible dissatisfied client if treatment of their pet is delayed.

Because holding and ordering costs are inversely related (as holding costs go up, ordering costs will decrease and vice versa), a balance is needed. Your practice will incur the least total inventory costs by ordering each product at a level where ordering and holding costs are balanced. This balance point is called the Economic Order Quantity (EOQ). The EOQ process is beyond the scope of this article but it is excellent for using on your top product seller and all high cost, low margin items. Many veterinary management texts provide EOQ details such as Practice Made Perfect by Marsha Heinke or Blackwell’s Five Minute Veterinary Practice Management Consult.

In most practices, 80% of your sales revenue will come from 20% of your products. At a minimum, these should be identified and their orders, stock quantities and pricing should be tracked regularly. Make the time to review what you are currently doing for your stock and ordering. Is it what you really want to have happening?
Inadequate Pricing Strategies

Pricing is a frequent frustration point for many practices and there has been much written on the “correct” method to price products. This has resulted in much confusion in the terms and their use: mark-up pricing, margin pricing, pricing minimums, prescription fees, etc.

Margin Pricing vs Mark-up Pricing
In Margin Pricing, the “margin” is technically the profit from the sale. It is not the difference between your cost and the client’s cost. Margin pricing involves setting a price based on the costs that should be included (professional and lay staff costs, administrative costs, etc.) plus the profit that you want/need to get from the sale. This can be a very effective method for pricing but the challenge to this method is knowing what costs need to be included in the calculation before adding on the desired profit margin.

Mark-up Pricing is simply adding a set percentage to the product cost to get to the selling price. For example, a product that costs $10.00 and it will be sold for $18.00 has an 80% mark-up.

The challenge isn’t in the method; both margin and mark-up pricing methods are fairly easy mathematically. The challenge is knowing what pharmacy costs must be accounted for in order to determine a sufficient margin or mark-up. It is not uncommon for practice owner to completely disregard the ordering and holding costs discussed above when deciding their pricing strategy for their pharmacy sales.

Insufficient Minimum Prescription Fees – (aka Dispensing fee)
Prescription fees are separate fees that are added to each dispensed prescription. This is intended to cover the fixed costs of maintaining an in-house pharmacy. A Minimum Prescription fee is a ‘practice specific’ fee that should be charged to each client purchasing a prescription regardless of how few pills are dispensed. Minimum Prescription fees vary greatly among practices and appropriately so. Determinants for a minimum prescription fee include pharmacy size and facility costs which are unique to each practice. Contrary to what some staff believe, prescription fees are not to cover the bottle that the pills are dispensed in - it should not be waived just because the client brought their previous bottle in for a refill.

The most frequent issue observed in most practices is not including enough of the hidden costs in their pricing. For example, a 100% mark-up is insufficient for most practices to cover costs (i.e., there is no margin left over) – especially if the item counts toward your veterinary production compensation. As a start, review how your top 20 products are priced. Is it a default mark-up or are you deliberately setting a fee to cover costs and include a margin – and possibly extra margin to make up for what you might be losing on other items?

Not Performing Inflationary Fee Increases

Many practice owners are pretty good at increasing a product’s price when they notice the unit cost has gone up (– which we hope was noticed right away and not a month or two later!) But what about the more subtle increases in cost of pill vials, syringes, applicators, reconstituting fluids, etc.?

How do you account for the increase in these foundational pharmacy costs?

Here is a relatively quick (and simple once it is set up) process to account for the inflationary creep:

• Keep a list of the top 50 disposable/consumable items used in your practice (e.g., syringes, gauze, pill containers, etc.) Also record the typical quantity ordered.
• At least annually or semi-annually, price check these 50 items and compare them in total to the previous check point. If/when it has increased, calculate the percent increase over the prior period.
• Apply this percent increase to all applicable services, treatments and products.
Making this a regular routine will keep your pricing current with your costs that are built into it. This is a fair and reasonable increase. Also, because it can be the staff that performs the analysis they learn that the costs increase so there is less pushback on the fee increase.

**Imbalanced Service / Product Sales Ratio**

Beyond the expense side, it is also good to look at where your revenues are coming from. How significant is your pharmacy revenue stream relative to your other revenue streams? If you find that a significant portion of your revenues are product based, it may be time to re-organize. For practices whose total revenues from referral lab, pharmacy, food, flea/heartworm products and vaccines exceed 40%, there is a good chance the practice’s financial health (i.e. profitability) could be compromised. Simply put, it is harder to be profitable if you are product centered as opposed to service centered. Product revenues come with substantial costs and less real margins relative to service revenues. It is also your products that tend to be more susceptible to outside and online competition.

Can you increase the service revenue portion of your practice? This may require a change in pricing strategy and team education to focus on pet health. Many veterinarians have an imbalanced Service/Product sales ratio because they are still guilty of undervaluing their services. This can also be a chance to investigate what opportunities are available to expand services. Efforts in improving compliance for services (dentistry, medical progress exams, etc.) will do much more at improving your bottom line than efforts in improving product compliance.

Wrapping it up…

Well balanced sales and effective inventory management is essential to the financial health of today’s veterinary practice. The foundation for management is collecting good data. Knowing what percentage of your sales is coming from pharmacy is imperative in recognizing how much risk the pharmacy poses to the practice if inventory is not adequately managed. It’s equally important to be tracking the costs of those sales. As the total of these costs increase into the 22-24% range, so should your attentiveness to your inventory management. As mentioned above, your practice management software may have tools that can help but have not yet been fully investigated. It may be worth taking a second look.

---

David McCormick and Sherry Everhart are veterinary practice appraisers and practice management consultants at Simmons Mid-Atlantic. They can be reached at 888.881.7084 and by email at DMcCormick@TMcCG.com and SEverhart@TMcCG.com.