The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies

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Pembroke Consulting, Inc., and
Drug Channels Institute

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About the Author

Adam J. Fein, Ph.D., is the president of Pembroke Consulting, Inc., a management advisory and business research firm based in Philadelphia. He also is the CEO of Pembroke's Drug Channels Institute, a leading management educator for and about the pharmaceutical industry.

Dr. Fein is one of the country's foremost experts on pharmaceutical economics and the drug distribution system. Top manufacturers call on Dr. Fein's insights and judgment to create successful commercial strategies and make better strategic decisions in our evolving healthcare environment.

Dr. Fein's popular and influential Drug Channels website (www.DrugChannels.net) is the go-to source for definitive and comprehensive industry analysis, delivered with a witty edge. He has published hundreds of academic and industry articles, and is regularly quoted in such national publications as *The Wall Street Journal, The New York Times, USA Today, Pharmaceutical Executive*, and many others. He serves on the editorial advisory boards of Pharmaceutical Commerce and Drug Benefit News.

Dr. Fein earned his Ph.D. from the Wharton School of Business at the University of Pennsylvania and a B.A., summa cum laude, from Brandeis University. He lives in Philadelphia with his wife, Paula, and their two children.

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ABOUT DRUG CHANNELS INSTITUTE

Drug Channels Institute (DCI), a division of Pembroke Consulting, Inc., is a leading provider of specialized management education and computer-based training for and about the pharmaceutical industry.

Drug Channels Institute combines Dr. Fein's expertise and cutting-edge analysis—such as *The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies*—into online e-learning modules that offer a thorough grounding in crucial industry topics, all in 45 minutes or less.

These online learning tools mix the latest industry data and cutting-edge analysis with highly interactive elements that engage and entertain. They educate a wide variety of learners: from sales reps and field teams—who need immediate, easily digestible industry concepts for their key accounts—to internal teams who need to better understand customers and channels.

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To learn more about how Drug Channels Institute can help your business, please contact:

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Introduction and Guide to This Report

In 2015, amid significant growth, the $364 billion pharmacy industry began to transform its fundamental structure. Healthcare reform, for instance, is reshaping drug benefits but remains politically contentious. Specialty drugs and specialty pharmacies are booming, as the generic dispensing rate plateaus. Meanwhile, major mergers and acquisitions among pharmacies, health plans, and PBMs will leave the industry more consolidated than ever before. Given these and other changes, understanding the implications of the industry's evolution is crucial.

The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies—our seventh edition—remains the most up-to-date, comprehensive, fact-based analysis of the pharmacy channel and its interactions with other participants in our healthcare system. I have synthesized a wealth of statistical data, research studies, financial information, and my own unique business consulting experience into a definitive, nonpartisan resource.

This report is your ultimate guide to the complex web of interactions within the pharmacy distribution and reimbursement system. It helps pharmaceutical manufacturers, wholesalers, pharmacists, pharmacy owners, benefit managers, managed care executives, healthcare policy analysts, investors, consultants—anyone who wants to understand and benefit from this ever-changing industry.

About the Report

Thousands of companies operate in the U.S. pharmacy distribution and reimbursement system, ultimately enabling more than five billion equivalent prescriptions to be dispensed and paid. The table below highlights the major public companies operating in the pharmacy distribution and reimbursement system. The 2016 edition of this report contains the latest financial and industry data about the strategies and market positions of the largest public companies: CVS Health, Express Scripts, Rite Aid, Walgreens Boots Alliance, OptumRx, Walmart, and others.

Major Public Companies Operating in Pharmacy Drug Channels

Company	Stock Ticker	Primary U.S. Role
CVS Health	CVS	Chain Drugstore/Pharmacy Benefit Manager
Diplomat Pharmacy	DPLO	Specialty Pharmacy
Rite Aid Corporation*	RAD	Chain Drugstore/Pharmacy Benefit Manager
Walgreens Boots Alliance	WBA	Chain Drugstore
Walmart Stores, Inc.	WMT	Mass merchant with pharmacy
AmerisourceBergen Corp.	ABC	Pharmaceutical Wholesaler
Cardinal Health, Inc.	CAH	Pharmaceutical Wholesaler
McKesson Corporation	MCK	Pharmaceutical Wholesaler
Express Scripts, Inc.	ESRX	Pharmacy Benefit Manager/Mail & Specialty Pharmacy
OptumRx (UnitedHealth Group)	UNH	Pharmacy Benefit Manager/Mail & Specialty Pharmacy

* In October 2015, Walgreens Boots Alliance announced its acquisition of Rite Aid.
Source: Pembroke Consulting research

This complex system, illustrated below, contains three key channel flows that we discuss in *The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies*:

- **Product movement**, which traces bulk shipments from pharmaceutical manufacturers to the drug wholesalers that supply pharmacies. A pharmacy marks the final step in which a prescription is dispensed to a patient.

- **Financial flows**, which transfer money from third-party payers to Pharmacy Benefit Managers (PBMs), who in turn reimburse pharmacies. Funds flow to manufacturers via pharmacies, which purchase drugs from wholesalers. Funds flow from manufacturers in the form of rebates to PBMs, which share a portion of these payments with plan sponsors, reducing net prescription costs. Manufacturers' rebates to PBMs and other third-party payers do not flow through wholesale or retail channels.

- **Contractual relationships**, which govern the relationships between: 1) payers and PBMs; 2) PBMs and pharmacies; 3) pharmacies and wholesalers; 4) wholesalers and manufacturers; and 5) manufacturers and PBMs.

The U.S. Pharmacy Distribution and Reimbursement System for Patient-Administered, Outpatient Brand-Name Drugs

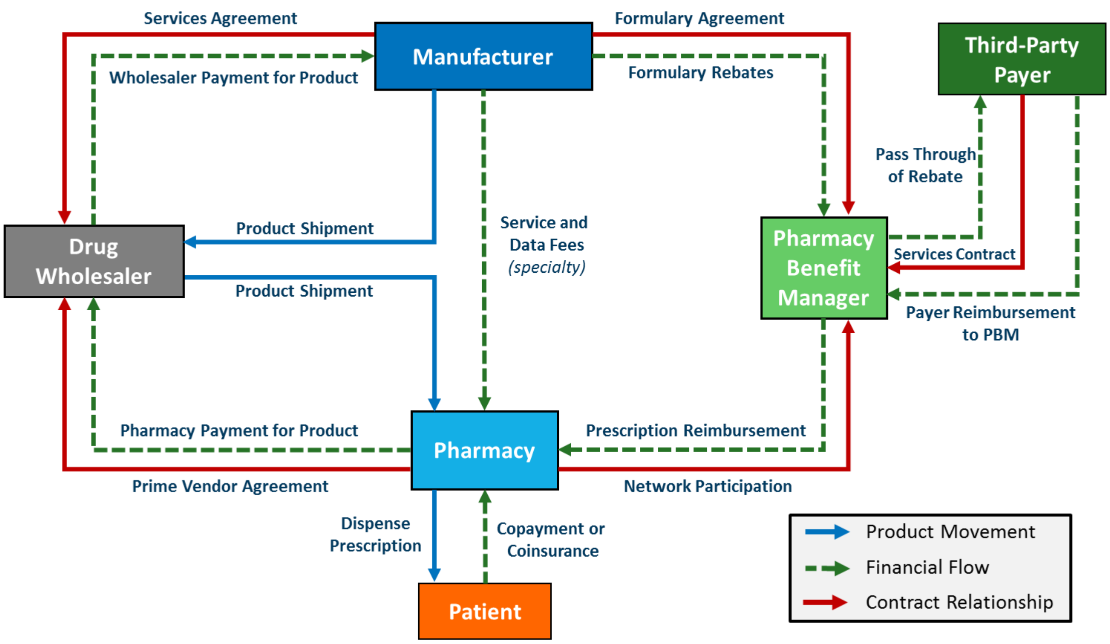

Chart illustrates flows for **Patient-Administered, Outpatient Brand-Name Drugs**. Please note that this chart is illustrative. It is not intended to be a complete representation of every type of financial, product flow, or contractual relationship in the marketplace.
Source: Pembroke Consulting research

Structure of the 2016 Report

To better reflect the changing industry, this year's edition has been completely updated, reorganized, and expanded. Therefore, the chapters and sections do not correspond to those of previous editions. *The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies* analyzes the industry in three major sections, comprising ten chapters. In addition to updating all market data and information, this 2016 edition includes many new elements. We have also integrated the trend and outlook material into the main chapters. This provides a more unified analysis of key industry issues.

Section I: The U.S. Pharmacy Industry

- **Chapter 1: Industry Overview** (page 2) defines the industry and its regulatory framework, explains different pharmacy industry participants, and quantifies differences among outpatient dispensing formats. Section 1.3. provides an integrated overview of industry trends and crucial topics, with links to relevant sections within the full report.

- **Chapter 2: Pharmacy Industry Market Structure** (page 16) analyzes the industry's prescription and revenue growth trends. It identifies the biggest pharmacies based on prescription revenues. It then analyzes recent market share trends for each dispensing format and the major national companies. This chapter also updates our analysis of retail clinics and pharmacist-provided clinical services, including medication therapy management services.

- **Chapter 3: Specialty Drugs and Specialty Pharmacies** (page 41) provides a comprehensive overview of specialty drugs and the pharmacies dispensing these medications. The chapter discusses the various definitions of specialty drugs and specialty pharmacies and summarizes the top specialty therapy classes and average prescription costs. We present our exclusive analysis of national market share for pharmacy-dispensed specialty drugs and provide a competitive analysis of the various organizations that compete to dispense specialty medications. Chapter 3 also reviews the channel strategies that pharmaceutical manufacturers use for specialty drugs.

Section II: Third-Party Payment and Pharmacy Benefits

- **Chapter 4: Payment and Spending for Prescription Drugs** (page 68) has been significantly expanded for the 2016 edition. We examine the primary payers for prescription drugs at retail, mail, and specialty pharmacies. Chapter 4 also analyzes recent changes in the payer mix and spending on traditional vs. specialty drugs. We also present the outlook for net prescription drug spending, gross spending changes on traditional and specialty drugs, and the future payer mix

- **Chapter 5: Pharmacy Benefit Management** (page 82) identifies the PBM industry's key participants, explains the services provided by PBMs to third-party payers, reviews the crucial role of PBMs in pharmacy economics, describes the relationship between PBMs and pharmacies that participate in a PBM's network, and reviews how Pharmacy Services Administration Organizations (PSAOs) intermediate between retail pharmacies and PBMs. This year's edition also includes new material on how payers compensate PBMs for benefit management services.

- **Chapter 6: Consumer Copayments and Coinsurance** (page 103) analyzes the benefit designs and plan structures that determine out-of-pocket spending for the major third-party payers: employer-sponsored health plans, Health Insurance Marketplace (HIM) plans, Medicare Part D, and Medicaid. We also explore the growth of plans with prescription deductibles and manufacturers' copay offset programs.

- **Chapter 7: Narrow Pharmacy Networks** (page 115), which is new for the 2016 edition, analyzes the structure, utilization, and economics of narrow network models. We explain the use and economics of narrow networks for retail pharmacies in commercial health plans and Medicare Part D. We also review the use of mail pharmacies as preferred and restricted options. This chapter explores how narrow networks affect pharmacy profits and describes the development of new performance-based narrow networks. We also evaluate payer-defined networks for specialty drug dispensing.

Section III: Drug Channel Economics

- **Chapter 8: Prescription Reimbursement by Third-Party Payers** (page 131) explains the latest formulas and methodologies for computing a pharmacy's revenue from brand-name, generic, and specialty prescriptions. This chapter compares and contrasts traditional list price methods with acquisition cost reimbursement approaches. We also review the economics of mail vs. retail pharmacies for payers and consumers. This chapter concludes by illustrating how prescription reimbursement, formulary rebates, and consumer copayments affect a plan sponsor's net costs for a prescription.

- **Chapter 9: Relationships with Pharmaceutical Wholesalers** (page 152) explores the interactions of pharmacies with their primary suppliers of drugs. It explains wholesalers' channel roles and services, identifies the largest wholesale suppliers, and analyzes wholesalers' role for specialty drugs and specialty pharmacies. This chapter also analyzes wholesalers' changing relationships with retail chains.

- **Chapter 10: Pharmacy and Prescription Profitability** (page 178) unites the reimbursement and cost discussion from Chapters 8 and 9 by presenting the latest data on pharmacy and prescription profitability. This section documents overall drugstore profitability, pharmacy margins for prescriptions, profit differences between brand and generic prescriptions, and PBMs' per-prescription profits from network and mail pharmacies. Finally, we consider pharmacy profits in the 340B drug pricing program.

Using the 2016 Report

The chapters are self-contained and do not need to be read in order. We include extensive internal references to help you navigate the entire document and customize it to your specific needs. There are also nearly 400 endnotes, most of which have hyperlinks to original source materials.

Please note that highlighted internal references are clickable hyperlinks in the PDF document. After clicking a link, use the following shortcuts to return to your previous location in the document:

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- Windows: **Shift+CTRL+F**
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As always, I welcome your comments and feedback. Please contact me if you have any questions or comments about *The 2016 Economic Report on Retail, Mail, and Specialty Pharmacies*.

Adam J. Fein
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P.S. You can find post-publication errata here:
http://drugchannelsinstitute.com/files/2016-PharmacyIndustry-errata.pdf

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LIST OF EXHIBITS