Pharmacies: The Right Prescription For Investors

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Prior to the effects of COVID-19, UK community pharmacies were already undergoing significant change as a range of factors converge to transform the role of pharmacists within the primary care system and generate opportunities in the market. The landmark five-year Community Pharmacy Contractual Framework ("CPCF") settlement, the longest yet agreed, has provided funding visibility and set the outlook for the years ahead. Its focus on expanding the range and scope of services that pharmacists are mandated to provide, and measures to encourage increased efficiency in the sector, with all designed to support the delivery of the NHS Long Term Plan.

Across Europe more broadly, 'bricks and mortar' retail pharmacy groups are succeeding in the face of competition from the emergence of online pharmacy platforms. Such platforms, which still represent a small part of the overall market, have experienced regulatory barriers and a slow pace of changing consumer behaviour, but are expected to increase their market share over the coming years, accelerated by the shift to deliveries necessitated by the response to the COVID-19 outbreak.

The ramifications of the COVID-19 outbreak have only served to highlight the importance of community pharmacies as part of the broader NHS critical infrastructure, with pharmacy employees designated by the government as "key workers". Amid simplistic negative press headlines in the sector regarding the disposal of underperforming stores by larger chains and the impact of the Category M clawback, Lincoln International believes the time is right for investors to give the sector a fresh look.

UK MARKET IN A NUTSHELL

The UK pharmacy market is valued at £11.3bn as of 2020 and is relatively stable, expected to grow at 0.9% CAGR between 2020 and 2025. The sector's revenue base is heavily linked to central government / NHS funding, which has been fixed at £2.6bn per year for the period 2019/20 – 2023/24 as part of the CPCF settlement. Despite headline funding levels being kept constant, underlying demand is rising significantly driven by an ageing population with repeat prescriptions and increasing levels of co-morbidity continuing to increase dispensing volumes.

NHS funding for pharmacies consists of three principal elements:

Dispensing fees: per prescription component, primarily the Single Activity Fee ("SAF") for each individual prescription dispensed

Retained buying margin: Gross profit generated through the difference between drug purchase costs and NHS reimbursement rate

Primary care services: Fees for delivery of a growing set of primary care services by pharmacists. Examples include testing for underlying health conditions and diseases, flu vaccinations and consultation services

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Pharmacies also offer a range of OTC / retail products which fall outside the central funding structure; these usually make up c.10% of an independent pharmacy's revenue base, rising to c.30% in the case of larger health and beauty focused chains such as Boots and Superdrug.

There are approximately 11,500 registered community pharmacy sites across the UK, with around half operated by large chains of over 100 locations, or supermarket groups, leaving a long tail of smaller chains and independent operators. There has been modest private equity involvement in the sector in the past, notably Bregal Freshstream's 2017 investment in Juno Health, since rebranded Avicenna Pharmacy, and Bridges Fund Management's portfolio company The Hub. Larger chains such as Boots, Superdrug, Lloyds and Rowlands tend to be held by overseas corporates.

There are also a limited number of UK online pharmacy groups operating at significant scale, the most notable of which is Pharmacy2U, which received a £40m investment led by G Square in 2018 and has been growing strongly, dispensing over 600k items per month as of November 2019, the equivalent of c.90 average community pharmacy sites. Pharmacy2U is the leading online player in the UK and we understand that it has seen strong growth in the last 12 months, which has accelerated with COVID-19.

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UNPACKING THE FIVE-YEAR CPCF SETTLEMENT

Historically, funding for UK pharmacies was agreed in annual negotiating rounds between the Department for Health and Social Care ("DHSC") and the Pharmaceutical Services Negotiating Committee ("PSNC"), which represents the industry. In July 2019, PSNC, NHS England and NHS Improvement and the Department of Health and Social Care ("DHSC") agreed a landmark five-year deal for community pharmacies, holding funding levels at £2.6bn per year until 2023/24 with annual reviews. This was the same as 2018/19 but still below the high-water mark of £2.8bn seen in 2014/15 and 2015/16. The new package foresees the following key funding arrangements:

SAFs and retained buying margin target fixed at £1.3bn and £0.8bn per year, respectively

Establishment payments, which have previously paid a fixed amount to each premises with no link to activity or performance, phased out completely during 2020

All other elements of the previous funding arrangements held broadly flat, including other activity payments (£97m), the Pharmacy Quality Scheme (£75m) and the Pharmacy Access Scheme (£24m)

Creation of funding streams (yet to be allocated), for future clinical services of up to c.£250m per year by 2021/22, taking the lead of the NHS Community Pharmacist Consultation Service and New Medicines Service, which have already been established. This is a reallocation of funds originally used (e.g. establishment payments) to support pharmacies as a collection destination for prescription medicines. This will now be used to fund specific national patient services

By fixing funding levels and setting out a path towards a developing role for pharmacists within the overall NHS system, the government has again signalled a desire to make the community pharmacy system more streamlined and efficient, and to allow pharmacists to deliver additional services by applying their clinical knowledge and skills in primary care, thus supporting the NHS in delivering its Long Term Plan.

In February 2020, funding levels for 2020/21 were confirmed as in line with those agreed in the CPCF, with a New Discharge Medicines Service to launch in July, alongside pilot projects in further "advanced services", through the Pharmacy Integration Fund, including blood pressure testing, point-of-care testing and referrals from hospitals to a pharmacy smoking cessation service during 2020/21. In the Scottish market, which has a system distinct to the NHS in England, funding levels have been

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increased for the third year in a row, and a three-year funding deal envisages above-inflation year-on-year increases through to 2022/23, alongside provision for a similar Pharmacy First primary care service. The opportunity for pharmacies to be a focal point for clinical services in the community is increasingly clear, with supportive policy and funding acting as a tailwind.

The dislocation currently evident in parts of the market is a direct, and to some extent intentional, consequence of the new settlement. Examples include:

Sites with lower item volumes (below the average of 7,000-8,000 items per month) are more likely to struggle financially without the subsidy provided by the establishment payment and the demands of a drive towards efficiency which leaves these sites at a comparative disadvantage to locations with higher footfall. These volumes, should smaller pharmacies close, will subsequently flow to nearby competitors, further increasing average site volumes and profitability

Groups will increasingly need to consider hub-and-spoke models for dispensing medicines in order to meet the demand for greater efficiency in the system with an increase in use of pharmacy automation. A law change proposed by PSNC in the next 12 months will facilitate this further

Premises must be fit for purpose to deliver the new clinical services, with appropriate space and layouts to allow for consultation rooms. Therefore, pharmacy chains are going through a process of rationalising their site portfolios and launching sale processes for sites which do not meet their new criteria (e.g. Boots, Lloyds, Well Pharmacy and Rowlands)

Operators must also ensure that their personnel have the requisite skills and knowledge to deliver the future clinical services and consultations. Independent owner-operated pharmacists may be prompted to sell up or exit the market, rather than going a period of adaptation and financial pressures

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The pharmacy bolt-on M&A market is likely to see increased activity post-COVID-19 as larger groups continue to shed underperforming segments of their site portfolios and the new settlement promotes a stable outlook; given the simultaneous increases in the supply and demand, bolt-on multiples are likely to remain relatively stable. In recent years, smaller groups of 2 to 10 sites have seen multiples between 5-7x EBITDA, held back by uncertainty regarding funding, while individual site multiples have been between 7-9x EBITDA, driven by the appeal of pharmacy ownership for individual owner-operators.

Overall, the CPCF settlement and the new environment for operators present several challenges for the UK community pharmacy sector. However, there are significant opportunities, particularly for emerging mid-sized consolidators with a blank canvas, to ensure that their site portfolios, systems and personnel are geared towards the challenge of adapting to the new services-led paradigm. In a sign of the times and the increasing demands on the clinical quality of pharmacies, General Pharmaceutical Council inspections are now generally unannounced and reports published, underlining the need for pharmacy owners to ensure they maintain high professional standards across their operations as the scope of their services broadens.

EUROPEAN COMMUNITY PHARMACY: DISTINCT SYSTEMS, SIMILAR ISSUES

Pharmacy markets across Europe are experiencing many similar issues, despite operating under sometimes very different public reimbursement systems and regulations. Across the continent, there is a sustained push towards expanding pharmacy services to relieve pressure on core primary care infrastructure and improving public health, a role that has already proved vital in the response to COVID-19.

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The traditional 'bricks and mortar' model of community pharmacy also faces a peripheral threat from online pharmacy models and the broader effort by e-commerce players to enter the market, which could create challenges as well as opportunities. As yet unproven on a wide scale, the remote pharmacy model has received a tailwind from the effect of the COVID-19 shutdowns, with many households, particularly those with underlying health conditions, needing to self-isolate and have deliveries made to their door. Whether this will change long-term patient behaviour and encourage greater use of online models remains to be seen, but it has provided a short-term boost to this trend and we suspect a portion of prescriptions will indeed stick.

There are a handful of scale consolidators with significant operations across multiple jurisdictions including Alliance Boots, McKesson and Phoenix Pharma, while private equity has made inroads in a number of markets, including Penta Investments' ownership of Dr. Max in Central and Eastern Europe who have also more recently entered the Italian market. In France, Five Arrows made a minority investment into Pharmacies Lafayette, while G Square invested in Boticinal. In France, as in common with several other European markets, directly owning a group of pharmacies is generally prohibited by regulation, but there are common loopholes to allow co-operation between pharmacies in areas such as systems and procurement.

European online players include the likes of publicly listed Netherlands-based DocMorris and Shop Apotheke, and Apologistics the largest privately-held online pharmacy group in Germany, owned by THI Investments.

COVID-19 SHINES A LIGHT ON THE ESSENTIAL ROLE OF PHARMACIES

Lincoln International's discussions with UK pharmacy "bricks and mortar" providers highlight robust trading both for dispensing and OTC. While patients bulk ordering of drugs has undoubtedly taken place, we suspect there will be wastage of various types by the patient, such that elevated dispensing item volumes will be also be incremental sales rather than purely 'pulled forward'. Like-for-like increases of 10-20% in dispensing item volumes and 50%+ in OTC products in recent months are not uncommon, as experienced by both Avicenna Pharmacy and The Hub, highlighting the 'essential' role of pharmacies.

The effect has been even more impressive for online pharmacies; Shop Apotheke confirmed in its recent results announcement that LFL Q1 2020 revenue growth was 29.7% and 58.6%, across their DACH and International markets respectively, with March highlighted as seeing significant COVID-19-related sales increases. Similarly Apologistics reported to Lincoln International a 40% increase in sales during March. The underlying strengths of online – lower cost, fast delivery to remote locations, convenience for elderly or housebound – have been key to driving its increased use during the crisis and online delivery capacity is likely to be seen as having strategic relevance going forward as part of a health crisis response system. While COVID-19 has the potential to see patients continuing to order their repeat prescriptions online going forward after experiencing the convenience of the service, to the detriment of "bricks and mortar" providers, Lincoln International believes physical visits to pharmacies will remain important for a large numbers of customers given their service element and role in the community.

CONCLUSION

The pharmacy sector is playing a pivotal role in supporting health systems through the COVID-19 crisis, as it does in many other aspects of healthcare, fulfilling critical needs for medicine, acting as a key point of access to healthcare advice and relieving pressure from the broader primary care service. Pharmacy has stood out as other forms of face to face healthcare have faced their challenges, with pharmacy's essential nature and accessibility clear strengths in these difficult markets.

Despite a number of potential challenges such as the drive towards greater efficiency, the need to deliver additional clinical services, and adapting to online delivery models, Lincoln International believes investors should look again at the pharmacy sector as it grows in stature, enhancing its position as a key part of the primary care system and offering significant untapped opportunities.

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