THE OPPORTUNITY FOR RETAIL DRUG STORE
DEVELOPMENT IN RURAL BRITISH COLUMBIA

by

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B.Sc.(Pharm), University of British Columbia, 1991

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In the
Faculty
of
Business Administration

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ABSTRACT

The drug store industry provides pharmacy service, cosmetic product and other health, beauty, and convenience goods to the population of British Columbia in urban, suburban and rural markets. Many different store formats compete in the industry using a variety of different strategic approaches. The mix of formats varies between urban and rural markets.

A review of the value chain and a competitive force analysis identifies key success factors for the industry. The impact on these factors of differences in the rural markets and in particular the small population base must be considered. This determines the essential factors for successful competition in rural markets across the province.

Over 25% of the British Columbian population lives in small rural communities. Development or expansion into these markets by companies who can achieve the key success factors will present the opportunity to increase market share and profitability.
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# Glossary

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIDS</td>
<td>Acquired Immune Deficiency Syndrome</td>
</tr>
<tr>
<td>CRM</td>
<td>Customer Relationship Management®</td>
</tr>
<tr>
<td>ELP</td>
<td>Everyday Low Price</td>
</tr>
<tr>
<td>GM</td>
<td>Gross Margin</td>
</tr>
<tr>
<td>GWP</td>
<td>Gift with Purchase cosmetic promotion</td>
</tr>
<tr>
<td>HBA</td>
<td>Health and Beauty Aids</td>
</tr>
<tr>
<td>KSF</td>
<td>Key Success Factor</td>
</tr>
<tr>
<td>MES</td>
<td>Minimum Effective Scale</td>
</tr>
<tr>
<td>Mix</td>
<td>Type and quantity of merchandise carried</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the Counter Medications</td>
</tr>
<tr>
<td>SKU</td>
<td>Stock Keeping Unit</td>
</tr>
<tr>
<td>ROI</td>
<td>Return on Investment</td>
</tr>
</tbody>
</table>
1 RETAIL DRUG STORE INDUSTRY

1.1 Drug Store Formats

The Canadian retail drug industry comprises three formats: independents, drug stores, and grocery/mass merchants with pharmacies. Independents are the "traditional" pharmacy with a dispensary and small front shop not affiliated with any larger chain or banner. Drug stores include banners, franchises and chains. Banners (Pharmasave®, IDA®, and Peoples Drug Mart®) are independently owned pharmacies that purchase an affiliation with a "brand name" and participate in a buying group while typically receiving a variety of central services. The franchise group (Medicine Shoppe®, Shoppers Drug Mart®, Jean Coutu®) are owned by individual pharmacist owners but subject to considerable direction from the franchisor corporations. Chain stores are groups of more than five jointly owned stores typically under a single banner (Rexall®, London Drugs®). Supermarket and Mass Merchandisers (Safeway®, Save-On®, Walmart®, Loblaw®) have pharmacy departments within the larger stores and are typically run by managers under the direction of central office personnel (Jennings, 2004).

1.2 British Columbia

Irrespective of the overall store format, every drug store in Canada has a pharmacy contained within it. The regulations that govern the practice of pharmacy in Canada fall primarily within provincial jurisdiction. As well, the provincial pharmacare programmes establish the reimbursement model for the province that largely determines
the economic potential of the pharmacies in the province. The differences between provinces are large enough to make consideration of a single province as a separate market worthwhile from an economic perspective.

In British Columbia, Pharmacy is governed by the Pharmacists, Pharmacy Operations and Drug Scheduling Act as administered by the College of Pharmacists of BC. The 2004 Annual Report for the College reports that there are 791 community pharmacies in the province and 3,649 practicing pharmacists. The provincial government in BC provides drug benefit coverage to all residents of the province through a province wide computer network based on family income levels. Negotiation with the provincial government is primarily achieved by the BC Pharmacy Association, an organization that promotes the economic and professional well being of its members.

The 2001 Canadian Census found that 41.8% of the BC Population live in rural regions. Slightly over one third of the rural residents live in “metro-adjacent” regions. These people shop and have prescriptions filled in the same markets as the urban dwellers they live adjacent to. The balance of the BC population (26.5%) lives in rural regions forming diverse markets that are serviced by several different drug store formats.

1.2.1 Market Survey

There are a dozen large corporate companies and many small independents operating in the province. This contributes to significant rivalry in the industry. Store count divided by company and market is listed in Table 1 for the BC market.
Table 1  BC Store Count by Chain and Market

<table>
<thead>
<tr>
<th></th>
<th>Urban Market</th>
<th>Suburban Market</th>
<th>Rural Market &gt;30,000</th>
<th>Rural Market &lt;30,000</th>
<th>Total Store Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independents</td>
<td>96</td>
<td>83</td>
<td>12</td>
<td>24</td>
<td>215</td>
</tr>
<tr>
<td>Medicine Centre</td>
<td>9</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>54</td>
</tr>
<tr>
<td>Katz Group</td>
<td>22</td>
<td>28</td>
<td>15</td>
<td>25</td>
<td>90</td>
</tr>
<tr>
<td>Peoples Drug Mart</td>
<td>5</td>
<td>6</td>
<td>6</td>
<td>26</td>
<td>43</td>
</tr>
<tr>
<td>Pharmasave</td>
<td>13</td>
<td>29</td>
<td>8</td>
<td>34</td>
<td>84</td>
</tr>
<tr>
<td>Shoppers Drug Mart</td>
<td>24</td>
<td>41</td>
<td>17</td>
<td>23</td>
<td>105</td>
</tr>
<tr>
<td>London Drugs</td>
<td>12</td>
<td>19</td>
<td>7</td>
<td>1</td>
<td>39</td>
</tr>
<tr>
<td>Canada Safeway</td>
<td>15</td>
<td>34</td>
<td>9</td>
<td>13</td>
<td>71</td>
</tr>
<tr>
<td>Costco</td>
<td>1</td>
<td>6</td>
<td>4</td>
<td>0</td>
<td>11</td>
</tr>
<tr>
<td>Loblaw Companies</td>
<td>5</td>
<td>17</td>
<td>12</td>
<td>16</td>
<td>50</td>
</tr>
<tr>
<td>Save-On Foods &amp; Drugs</td>
<td>3</td>
<td>29</td>
<td>16</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>2</td>
<td>8</td>
<td>8</td>
<td>9</td>
<td>27</td>
</tr>
<tr>
<td>Zellers/HBC</td>
<td>4</td>
<td>12</td>
<td>10</td>
<td>5</td>
<td>31</td>
</tr>
<tr>
<td>Total</td>
<td>211</td>
<td>327</td>
<td>139</td>
<td>207</td>
<td>884</td>
</tr>
</tbody>
</table>

Source: Compiled from College of Pharmacists of BC Website

Through a series of acquisitions and new store openings, Shoppers Drug Mart has grown to be the largest drug store chain in the province. The Katz group is the second largest in the market. They operate several different banners and formats in the province including Rexall, Guardian, IDA, and Medicine Shoppe. The largest grocery chain in the province is Canada Safeway followed by Save-On Food Group. Loblaw is the fastest growing grocery chain with four new sites opened in 2004. There are two mass merchants present in the market. The Hudson Bay Company (HBC) is the largest but its store count is declining. Wal-Mart continues to expand in the province. They opened three new sites in 2004.
1.2.2 Market Trend

Across the industry, there is a trend towards fewer independent pharmacies and more grocery and mass merchant pharmacies (Jennings, 2004). British Columbia is ahead of the grocery and mass merchant trend with 28% of pharmacies already in this format as compared to 19% nationally. A provincial difference from the national trend is the drug stores at 48% as opposed to 54% nationally. In BC, the independents have given up less market share than the drug stores have. Table 2 contrasts the provincial and national breakdown by store format.

### Table 2 Industry Store Count by Format

<table>
<thead>
<tr>
<th>Format</th>
<th>BC 2004</th>
<th>National 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Count</td>
<td>Share</td>
</tr>
<tr>
<td>Independents</td>
<td>215</td>
<td>24%</td>
</tr>
<tr>
<td>Drug stores</td>
<td>418</td>
<td>47%</td>
</tr>
<tr>
<td>Grocery/Mass</td>
<td>251</td>
<td>28%</td>
</tr>
<tr>
<td>Total</td>
<td>884</td>
<td>28%</td>
</tr>
</tbody>
</table>


The higher market penetration for the grocery and mass merchants in the BC Division is important to consider. As a group, these competitors offer a different value proposition and impact on different key success factors than do the independents. The challenge for the banner and chain drugs stores in the province is competition for market share against both smaller more differentiated businesses with core competencies in service and against the large low cost providers that have diversified into traditional drug store product.
1.2.3 Rural Market Opportunity

There are 72 rural communities in BC with populations less than 10,000 people (BC Stats, 2001). These communities are currently served by 104 pharmacies. These markets represent communities too small to attract the presence of mass merchants. The primary drug store competitors in these small British Columbia markets are Pharmasave with 24 stores, the Katz group with 22 stores, and Peoples Drug Mart with 20 stores.

Expansion within the small rural markets is a possible growth opportunity for these competitors. Expansion into these markets represents a growth opportunity for other competitors in the industry such as Shoppers Drug Mart who currently have only six stores in these markets. Consideration of the retail drug store value chain and competitive forces will identify the key success factors (KSF) for the industry. These factors must then be reviewed for any potential differences that may exist in the small rural markets.
2 INDUSTRY VALUE CHAIN ANALYSIS

Retail drug stores comprise the final link of value extraction for the pharmaceutical industry, the cosmetic industry, and many of the health, beauty, and convenience product industries. There are some minor differences between the industries but generally, they all develop and sell commodity goods to the end consumer. Production begins with initial product development and includes initial research and development along with all required and prudent product and market testing. Placement in the industry includes selection and procurement, followed by distribution, wholesaling, and shipping functions and culminating with the merchandising functions, which are essential to deliver the product to the customer. Promotional efforts create and sustain demand for the products, which are eventually sold through retail outlets to the end consumers.

The primary function of drug stores on the value chain is in retail sales and service to the end consumer. Drug store retailers are also involved to varying extents in each stage of the value chain with the exception of product development and production. Many of the key success factors for the industry arise from the placement portion of the value chain rather than the expected retail aspect. The involvement of drug stores in various places on the value chain is demonstrated by the shaded areas of the Industry Value Chain in Figure 1.
As is suggested by the significant involvement in most stages of the value chain, examination of the whole value chain is important to develop a list of key success factors (KSF) for the industry. While production is generally left to companies with core competencies in this area, placement and promotion provide KSFs that can be the source of significant competitive advantage. The retail environment is highly competitive and retailing must be a core competency for all companies in the industry. The mix of sales and service in the retail setting provides further KSFs that can offer a source of competitive advantage.

2.1 Production

Pharmacies are only peripherally involved in production, primarily in relation to private label brand product. The core competencies of the retail industry and the manufacturing industry are too dissimilar for vertical integration into manufacturing to be synergistic for a retailer. Even with respect to private label product, involvement is primarily limited to the creation of packaging. Increased focus on product innovation
with respect to developing private label products may change this in the future but currently no KSFs result from this portion of the value chain.

Product development begins with an idea for something that will be valuable to consumers. Typically, further development of the idea, extensive product development and testing, followed by market research is required prior to production. Regulations surrounding pharmaceutical products require that the testing and development process be more complex than is required for cosmetic or mass goods. An important part of the testing process required for all goods is to ensure that the conceived product will be valued by the end consumer market. Beyond contributing ideas for products to be developed, retailers participate minimally in these activities.

Final product design and packaging affect the consumers’ perception of a product. Design can include such variables as quality, variety, features, and branding of the final product. Packaging is used to present a product to the consumer and to suggest value consistent with the consumer’s needs and expectations. There are extensive regulations requiring the provision of information to consumers on the labelling of general, cosmetic and pharmaceutical merchandise in Canada. Retailer involvement is predominantly restricted to label design and determination of the package sizes for private label product.

Manufacturing is typically left to the large pharmaceutical and consumer goods companies for whom this stage of the value chain represents a core competency. Products, including private label, are typically sourced from outside manufacturers. Private label product is produced under contract by manufactures for the retail company.
2.2 Placement

Once produced and packaged, product must be moved from the point of manufacture to disseminated retail outlets where consumers can purchase it. The initial stage of this process is procurement when the decision on what will be granted retail-selling space is made. This decision is followed by distribution to the store network and eventually merchandising. While placement is essential, it is largely invisible to the consumer and consequently adds relatively little value. Efficiency and cost containment are essential for this part of the value chain. Economies of scale and market power can create significant competitive advantages on some of the KSFs of procurement, distribution, and merchandising which comprise this portion of the value chain.

2.2.1 Procurement

Managers are responsible for negotiating with suppliers to determine the selection of product that will be carried in retail stores. These negotiations determine the selection (also called the mix) and price or acquisition cost that will be paid for the goods offered by the suppliers. Significant revenues accrue to retailers in the form of listing fees, damage fees, volume commissions and display allowances because of the negotiation process. This process is essential for the financial success of a retail business and largely not visible to the end consumer.

Centralized negotiating is a key scale advantage. It is simply more efficient for the retailers and manufactures to have one category manager and one product manager determine the product mix for many stores than it is to have a store manager at each store work with one of a number of sales force personnel to determine the product they will carry. The labour savings involved in this scale economy improve financial performance.
of the retailer. In addition, the manufacturer has a reduced need for sales force personnel and captures labour savings. Companies that purchase centrally may negotiate for some of these vendor labour savings to be passed on in the form of a reduction in merchandise acquisition cost.

The primary financial advantage gained through central category management is the ability to leverage market power. To the extent that a category manager can take advantage of store count, store network distribution and market penetration when negotiating with suppliers, there is significant ability to garner reductions in cost and to generate fees for product listings, damage allowance, and display allowances. This is a KSF for the retail drug industry. In addition, broad market coverage assists in the negotiation for exclusive and new to market product from suppliers. Competitive advantage is gained through increases in store count and improved market coverage.

2.2.2 Distribution

In the drug store industry, distribution is achieved both through centralized distribution centres or wholesalers and through direct vendor shipment. Distribution is funded through mark-ups on the product sold through the wholesalers and from the volume commissions received from vendors for listing product for sale. Distribution, like all aspects of the procurement process, is a low value added activity to the end consumers so there is significant pressure to reduce costs. Due to the significant costs attached to distribution and the revenue potential from listing fees, many retail companies choose to exert extensive control over the distribution function.
The end-result of an extensive distribution process is the presence of product on the retail shelf. Service level is the term used to describe the presence of inventory on the shelf where it is expected. The value provided by retail outlets for the customer is that the products they want will be presented to them in a logical location and will be in stock when they want to purchase them. Keeping the store “filled and faced” is a core competency for any retail business. Maintaining good service levels then is a KSF for the retail industry but one that is a basic entry requirement rather than a source of competitive advantage.

2.2.3 Merchandise Mix

In the retail industry, mix is the term used to describe the type and number of Stock Keeping Units (SKUs) which are merchandised in the store. The products carried by drug stores are largely homogeneous and are available in many locations and from many different retail formats. By definition, a prescription must contain the product that the physician intended and cannot vary from pharmacy to pharmacy. An HBA item such as a bottle of shampoo is available from mass merchandisers, grocery stores, drug stores, local convenience stores and even hair salons. Cosmetic products within particular cosmetic lines are the same across different retailer formats.

What varies between different retail formats is the mix of product that a store carries. Of particular interest from a strategic perspective are the breadth, depth, and average line length of product in the mix. In addition, the penetration of private label product in the mix is significant. Management of mix is the true essence of retailing in a self-serve environment. It represents one of the most significant KSFs in the retail industry.
The market distribution of non-prescription product varies all the way from intensive to exclusive across the different areas of the typical drug store. The prestige lines of cosmetics carried in some stores maintain their high price points by limiting market availability. Biotherm®, Chanel®, Lancomb® and other prestige vendors limit the number of doors they are prepared to open and require the maintenance of high image and service standards along with mandating retail price integrity. The balance of the beauty product carried in drug stores and most of the health product is subject to selective distribution. The convenience product however, is intensively distributed and widely available on the market. Drug stores are constrained by the industry distribution modes of the product they carry but can differentiate within those constraints based on the mix of product offered.

For many large retailers, a floor map with corresponding shelf Planograms is developed, which dictates the SKUs that will be carried and exactly where they should be stocked in any given store. The Planograms are developed as part of management negotiations to maximize sales and gross margin within a category. Sales can be maximized by locating product on shelves between waist height and eye level consequently, suppliers must pay a premium to have product merchandised at this height. The majority of consumers are right-handed and unconsciously select SKUs located on the right-hand side. Gross margin can be maximized by locating higher margin product such as larger pack sizes and private label product to the right-hand side of lower margin product.

The breadth or width of product mix refers to the number of different product lines that a retailer carries (Kotler, 2003). Having extended breadth of mix offers the
consumers the convenience of “one-stop” shopping. The pursuit of a strategy of extended width led to inclusion of pharmacy departments and the accompanying OTC medications in grocery and mass merchant retailers. The primary constraint on breadth is size and more specifically the linear footage of shelf space available to stock merchandise.

A common trade off for product breadth is the depth included in the mix. Depth refers to the number of variations of size and type carried for a particular product line (Kotler, 2003). Given the space constraints of even the largest grocery and mass-merchant stores, product depth is often sacrificed to achieve breadth. In this instance, the most popular SKUs are carried across a wide breadth of lines. Having an extended depth of product mix available can be a source of differentiation and provide some competitive advantage particularly if consumers learn to expect good depth of product availability.

The presence of the product in the store at all can add some value, particularly if it is a rare product not typically carried in the large grocery and mass-merchant stores. Product length refers to the total number of items in the mix (Kotler, 2003). As was the case for product depth, the length is often traded off for breadth due to space constraints. Retailers can achieve competitive advantage by making available rare or less widely distributed products.

In addition to the mix of national brand product carried, having good penetration of a well-established private label brand is an important KSF in the drug store retail industry. Backward integration into package and label design, distribution, and promotion for private label brands reduce the acquisition costs for these SKUs. Private label products are used in the industry to provide customers with a lower price option while
improving margin performance for the retailer. The private label products both contribute to and profit from the company brand reputation.

Retailers with larger store formats are able to leverage some of the increase in store size into improved breadth and depth of mix. These larger stores may include a broader mix of cosmetic, household, convenience food, and natural health products. In addition, the increase in linear shelf footage may allow the retailer to include both some product lines not carried in smaller stores and a broader depth of product within the lines. Expanded product mix can be valued by the consumer as either a convenience or a service and either proposition allows collection of some premium over the basic commodity price of the SKU. Sales of the extended mix higher margin products improve total store profitability.

Having a wide depth of product in the mix is a possible differentiating strategy. The recent trend to larger stores seen in the industry has largely been driven by the requirement for extra linear footage to increase the mix available in the front shop (CACDS, 2004). Expansion of the cosmetic lines carried offers more product selection at a wider range of price points. Within the pharmacy department, where some competitors limit the number of drug molecules carried to those required for the more common disease states, a firm which carries higher inventory levels and will special order product to meet the needs of all prescription customers can develop a competitive advantage. By expanding the product mix within individual categories, drug stores may capture orphaned market share and develop competitive advantage.
2.3 **Promotion**

If retail sales can be accepted as the ultimate culmination of the marketing process, then promotion in the retail context will be understood to be essential. Considered from the perspective of the value chain, promotion is the process of communicating value to the consumer. At the firm level, promotion takes the form of building the brand through a combination of image and value statements, which may include private label lines and customer loyalty programmes. At the product level, promotion includes some combination of, merchandising, personal selling, and advertising.

2.3.1 **Product Advertising**

For the majority of products carried in retail drug stores, the vendors fund and undertake significant promotion through direct to consumer advertising. In Canada, direct to consumer advertising is illegal for pharmaceuticals so these products are promoted directly to the prescribers primarily through personal selling by the vendor sales-force. Cosmetic product is promoted extensively through advertising but it also requires extensive personal selling at the retail level particularly for prestige lines. Specific product advertising is an important competency for product manufactures but does not form a KSF for the retail drug industry.

Product promotion in drug stores ranges from extensive personal selling of prestige cosmetics and the high service and counsel available from the pharmacists on prescription and over the counter medications to complete self-selection for many of the convenience categories. Pricing is consistent with the amount of service required.
Prescription services and cosmetic product may be priced at a premium while the pricing for convenience product is not generally set at a premium.

Advertising spend is inversely correlated to service. There is no pharmacy product advertising due to Canadian law, which prohibits direct to consumer advertising. Prestige cosmetics are promoted through selective Gift with Purchase (GWP) offers targeted at loyal customers throughout the year. On the other end of the spectrum, many of the convenience, HBA, and paper products are extensively advertised through promotional store flyers, and through multiple media channels.

2.3.2 Sales promotion

Merchandise positioning is a self-serve form of sales promotion. Positioning refers to where a product is placed in the store both regularly and when it is being promoted or advertised. Moving product on to end aisle displays or high impact merchandising areas has the affect of drawing customer attention to the value available with respect to either product availability or price. This makes it more likely that the customer will purchase the product.

The most effective method of sales promotion is personal selling. In a drug store, personal selling may include a cosmetician explaining the benefits of an expensive skin treatment, a sales person demonstrating the savings available from a private label product or a pharmacist counselling a patient on the benefits of a particular over the counter remedy or nutraceutical product. Each of these activities increases the likelihood that a particular consumer will purchase the product.
Sales promotion through the combination of merchandise positioning and personal selling is the penultimate link of the value chain for an individual product prior to the exchange of money for the value contained therein. This is the essence of retail sales in the self-serve environment. Sales promotion is the primary function of any retail outlet and certainly a KSF with the potential to create significant competitive advantage.

2.3.3 Firm Branding

In the retail industry, the branding of a company depends significantly on image. This comprises not only the size and location of the stores but also the shopping experience within the stores in addition to the mix of product and services offered. For drug stores that offer value added prescription service and extensive cosmetic consultation, having appropriate space with good lighting and soothing décor are almost as essential to the service offering as is the product availability. As discussed earlier, space and layout also affect the mix of product available for sale, which affects significantly the brand image of the firm.

2.3.3.1 Value Position

Developing a value position is an important aspect of branding. In the retail environment, product pricing is the largest contributor to value positioning. There are two primary pricing strategies. High/Low pricing is the traditional system of setting regular prices with special reduced promotional pricing available only at intervals. Everyday Low Pricing (ELP) is the strategy of offering reduced prices every day in the hope of driving sufficient volume of purchases to maintain gross profit dollars on lower profit margins. This is the strategy introduced to the retail industry by successful mass
merchandisers such as Wal-Mart® (Slater, 2003). Retailers may choose to communicate a value message using either pricing strategy or through a combination of the two.

In the retail drug industry, high regular retails combined with low flyer pricing has been the traditional method. The high/low strategy is intended to attract maximum margin from pure convenience shoppers and relies on low flyer pricing to attract and generate high volume sales from price sensitive customers. Drug store flyers typically contain price promotion of product spread across the front store and cosmetic departments. Recently, many retailers have altered the flyer to include promotion of professional service offerings. Inherent in flyer promotion are the important variables of mix and positioning. In this context, mix refers to what is being advertised. Companies may advertise a combination of new products, selected to attract attention to their availability, with some base commodity products, selected to portray a competitive price message. Positioning refers to the inferred message on every day pricing that the flyer pricing conveys. Flyer pricing reveals to the price conscious consumer the mix of ELP and high/low pricing at a particular retailer.

New products to the markets present a different opportunity for drug stores. If a store can be “first to market” with a product there is the opportunity to make significant gross margin. Early in the product cycle, while distribution is limited, there is less price sensitivity in the market. This is an instance when the high/low strategy is not applied. These products are priced high at introduction and decrease over time. As the margins decrease due to increasing competition, the product may be added to the high/low mix or replaced with a newer product. Value to the consumer is derived from availability of the
product for purchase rather than from price. Access to “first to market” products is a potential source of competitive advantage in the industry.

2.3.3.2 Customer Loyalty Programmes

Customer loyalty programmes are increasingly important for their contribution to value perception and to firm branding. These programmes were originally launched as a means of collecting data for Customer Relationship Management (CRM) purposes and have become some of the most powerful marketing and sales tools available in the retail industry. The points awarded by these programmes to incent customers to provide personal sales information serve a similar function to price reductions in providing a value message to the consumer. In addition to the initial CRM marketing purposes, special promotions offered to loyalty programme customers can be used to increase sales during soft periods or to stimulate sales on particular days.

Awarding customer loyalty points on prescriptions, is currently allowed in British Columbia for all medications other than Methadone. Many provinces in the country have specifically banned this practice. The College of Pharmacists of BC has received complaints and has debated the ethical issues involved; however, it decided not to ban the practice. This is one of the few incentives or promotions allowed on prescription medications in Canada. Awarding loyalty points on prescriptions can contribute significantly to the brand impact of a drug store firm.

It can be argued that having a recognized “brand” is a KSF for the retail industry. It is certainly true that shopping patterns are positively impacted through consumer recognition of the firm. The notion of branding however is somewhat abstract and hard to measure. More important from a strategic perspective are the factors that contribute to the
brand and in particular the promotion of the firm. The KSFs then include the value position as portrayed by the promotional pricing and supported by the loyalty programme and sales promotion through merchandising and personal selling.

2.4 Retail Operations

Marketing is integrated throughout the value chain for the drug store industry from product design and packaging, through distribution and placement to promotion and pricing at store level. Product design and packaging are developed and market tested early in the process. Placement or distribution of the product is also a form of marketing. The amount of advertising, personal selling, and in store promotion required to attract the consumer’s attention to a particular product vary significantly by product type. Finally, and most importantly from the perspective of the value chain, the retail price must be set at the combination of the total input cost plus the margin of benefit that the consumer is willing to pay for the perceived value of the product or service.

2.4.1 Service

The service offered in drug stores varies by format and by department. Consumers do not expect the same service at a mass merchant retail outlet as they do at a small clinic pharmacy. Within the drug store, there are also differences in expectation between the pharmacy, cosmetic and front shop departments.

2.4.1.1 Pharmacy

Central to all drug stores is the pharmacy and the provision of advice and counsel from the pharmacists who staff it. Whether this is advice on selection of an over the counter medication, counselling on a new prescription medication, or prevention of a
potential adverse drug reaction through the prescription filling process, the service of the pharmacist is a differentiating feature from pure commodity sales for prescription and OTC items. As a point of differentiation, it can form the basis of a competitive advantage and is one of the KSFs for the drug store industry.

After the point of purchase, Pharmacists routinely provide counselling for patients who develop concerns once they have started taking their medication and many pharmacies schedule “call-backs” to follow up on a patient’s progress after they have been on a medication for several days. In addition to the essential medication advice and counselling services, there is an expanding role for pharmacist to play in providing disease and health information to the public. While this is valued by consumers qualitatively, there have not been many instances where pharmacists have been successful charging for these consultations, which draws the value to the consumer into question. Since these services are provided free, value from the customer’s viewpoint is only demonstrated through repeat business and verbal appreciation. It is unclear to what extent these services are required as part of the KSF of Pharmacy Service.

Delivery service is offered in drug store retail primarily as a convenience for prescription customers but also for other products when appropriate. In many stores, delivery is outsourced to a local delivery business. Delivery service can be a point of differentiation particularly valued by the elderly and shut-ins because many of companies do not offer this service. While delivery is known to add value to some customers, it is generally done at no charge. The pure business case for this service would require that there be some payment attached; however, the service is generally provided free.
At many pharmacy counters, the service offered meets or exceeds regulatory requirements. In many stores, the pharmacy manager is part of the dispensary team, actively involved in the practice and usually ready to provide back up and support as needed to maintain a high level of service during busy periods. The pharmacy computer systems, patient information handouts, and compliance monitoring combine to enhance the perception of pharmacy service in the consumer’s mind. The primary driver of pharmacy service and loyalty is the relationship that customers develop over time with a particular pharmacist (or pharmacy team).

2.4.1.2 Cosmetics

Service in the cosmetic department includes both the advice offered by the cosmetic staff and the breadth of product carried. The ability to purchase cosmetics from a variety of lines with a range of price points is a point of differentiation between drug stores and other channels in the industry. Consumers value the suggestions and recommendations of cosmeticians across a variety of lines when they are choosing cosmetic product. To sell cosmetics at full margin requires that the department be service focussed to add sufficient value to the consumer to overcome the margin cost of the service. Higher price point cosmetics in particular require service. Provision of knowledgeable helpful customer service in cosmetics is a potential source of competitive advantage.

In drug store cosmetic departments, a cosmetician is able to sell the customer a product that is well matched to her preferences and budget as opposed to the experience in the department store cosmetic counter where a cosmetician is constrained to the brand sold at her counter. Some drug store retailers have accounts with prestige cosmetic
vendors and are able to offer advice and service to customers of these lines as well as comparisons to other lines and mass cosmetics. Even in the stores that do not have prestige mix in their department, the service offered on the mass cosmetics available can be differentiated based on the knowledge and training of the cosmeticians available to assist in selecting appropriate product for application.

2.4.1.3 Self-serve

Outside the pharmacy and cosmetic departments, service in the self-serve environment involves little interaction with sales people. Aside from directing customers to the product that they cannot find, there is not a lot of direct service offered to the HBA and convenience based customers in most drug stores. Quick and easy check out, an easy refund policy and the presence of polite cheerful staff are the extent of the offering for the front shop area that is designed to be primarily self-serve. The inclusion of electronic merchandise and on-site photofinishing departments for roll film and digital picture development are areas where personal service can be added to the front shop offering. This can elevate the level of service offered in the front shop area to be more similar to the level offered in the pharmacy and cosmetic departments.

2.4.2 Sale

The final stage of the value chain is the completion of the sale. The exchange between a consumer and the retailer establishes the value of the purchased goods and service. This is in effect the market price. At the same time, the convenience offered to facilitate the exchange can affect sales.
2.4.2.1 Pricing

From the customer’s perspective, the communication of the price is very important. The customer needs to have the correct and current price displayed at the shelf when considering whether to purchase a particular product. That same price needs to ring in at the cash register when the customer is paying for the product. In cosmetics and pharmacy however, the communication of pricing can be more obscure and may even form part of either the service or convenience offering. Provision of products priced correctly is an essential aspect of retail operations rather than a source of competitive advantage.

Of strategic interest is what the price is set at rather than how it is communicated to the consumer. Transaction by transaction the consumer pays the margin that creates profitability for the retailer and flows back through the value chain. In other words, a retail outlet is the market where the price is ultimately established for a product or service. At retail outlets, consumers find products and exchange money for the value in the products. The value consists of the commodity price of the product and some premium for the convenience and service, which accompany the sale at a particular retail outlet.

Establishing pricing is clearly one of the KSFs for retailers. The price is partially determined by the acquisition cost resulting from the procurement function. Mass merchants have achieved and sustained competitive advantages through procurement efficiencies and their ability to achieve significantly lower acquisition costs than their competitors. This allows them to meet the demands of highly price sensitive customers for pure commodity type health and beauty items.
Drug store chains, banners, and independents do not typically pursue a low cost strategy. Reducing cost through scale advantages is necessary to help establish retail prices that will sustain market share. Consumers are prepared to pay a bit of a premium for the combination of convenience and service rather than just the sale price on commodity type items. If the premium is too large however, the consumers will balk and shop elsewhere. The incremental amount these consumers are prepared to pay represents the value attached over and above the commodity price.

To compete successfully with the low cost mass merchants, drug store competitors must maintain retail prices that reflect no more than the base commodity price plus the value premium while providing the mix of convenience and service customers expect. Cost efficiencies are needed to achieve the higher gross margins required to pay for the staffing needed to deliver a higher level of service. Cost reduction then is a necessary component of the competitive strategy; however, it is not pursued to the extent achieved by the mass merchants who achieve cost-based differentiation.

2.4.2.2 Cash out

In the self-serve retail setting, outbound logistics is primarily concerned with the exchange of money for product. The consumer locates the product then takes it away and leaves enough money behind to pay for the input costs of the product and only enough extra to cover the marginal value the retail format delivers to the consumer. Money exchange is only a value added activity in so far as it is relatively quick and painless. Cashiers are an essential or core function to any retail business. Provision of quick and efficient cashier service is a convenience differentiation point but not likely to provide any sustainable advantage because customers simply do not value the process of cash out
that much. Providing alternate forms of payment such as debit and credit cards are now so widespread as to be considered requirements rather than points of differentiation. In short, cash out is essential to perform adequately but there is little competitive advantage to be gained at this point in the value chain.

2.4.2.3 Convenience

Convenience factors begin with store location, availability of parking and ease of entrance to the store. Once in the store, the lighting, size, layout and ease of navigation affect how convenient the store is to shop. The product mix carried in a pharmacy retail outlet and in particular the breadth of product carried in addition to the prescription and OTC medications are important determinants of convenience and sales.

In the grocery and mass merchant stores, pharmacies providing the most popular prescription and OTC medications are included as a companion service to customers who are in the store to shop for required food purchases. In the small clinics, the products carried are primarily companion OTC’s and HBA products to prescription medications. For traditional drug stores, the mix of product carried includes more depth and breadth of prescription medication and the companion OTC and HBA product as well as an increased selection of health, beauty, and convenience items. Extended depth of product offering is both a convenience and a service for customers who require product outside the mainstream popular mix. Some of the new larger size drug stores allow for significant increases in product mix within the standard categories as well as the addition of more convenience food items such as milk, eggs, and bread.

Extended hours of operation offer the opportunity for customers to consult pharmacists outside of traditional business hours. As well, evening and weekend
shopping for required staples is more convenient for many people who work and otherwise lead busy lives. Operating-hours extensions to midnight and even 24-hour operation in some locations offer the customer extensive choice of shopping time.

Readily available and convenient helpful customer service is another differentiation points available to drug store retailers. Once merchandise selection is complete, the ease and speed of check out at the front cash impacts on convenience. The final contribution to convenience is ease of egress from the parking lot on the way home.

Location is not only a determinant of convenience; it is also the primary driver of pharmacy success and the most significant KSF for the industry. The most important factor for the pharmacy department is proximity to prescribing physicians. For the rest of the store, proximity to home and work are important aspects of the convenience offering. Stores located in the suburbs with easy access from commuting arteries on the home from work side of the road are more convenient to commuters than other locations. Having sufficient market penetration to offer store locations convenient to the doctor’s office, the work place, as well as close to home is the most convenient proposition. Achieving this strategic penetration should be one of the goals of the acquisition and real estate departments for larger drug store retailers

### 2.5 Value Chain Key Success Factors

The primary driver of pharmacy success has traditionally been location and specifically proximity to prescribing physicians. This is particularly important for capturing the high margin prescriptions for short-term analgesia or antibiotic therapy, which do not routinely require repeat trips to the drug store for refills. Small independent
Pharmacies are very often located in the bottom of medical buildings for this very reason. For chronic medications, repeat trips to the drug store are required and the convenience of location in relation to home and work in combination with hours of operation is increasingly important.

As demographic shifts increase the proportion of chronic medications, location as a point of differentiation remains important; however, some of the other KSFs contained within the industry value chain may have a larger impact on success. These include efficiencies in procurement and distribution, breadth and depth of merchandising mix along with private label penetration, merchandising and personal sales and service, pricing including discount sales and loyalty programme promotion, as well as professional service. The many competitors in the retail drug industry each present different value propositions based on their performance on each KSF found within the industry value chain. This contributes to rivalry in the industry.
3 INDUSTRY COMPETITIVE FORCES

A review of competitive forces is necessary to identify points of differentiation and KSFs, which may influence rivalry in the industry over and above those identified in the value chain analysis. There are relatively weak entry barriers to the industry. Supplier power is moderate. Consumers have little power over the industry and there is a low likelihood of alternate substitutes. The weakness of these forces contributes to the attractiveness of the industry in general.

3.1 Threat of New Entrants

The barriers to entry in the Canadian retail drug industry are low. Any licensed pharmacist can apply to the regulatory body in their province for a pharmacy license, which will be granted providing that the minimum statutory requirements are met. This process is used by many of the independents and by the grocery and mass merchants when they decide to add a pharmacy department to the mix available in their store. These are the most likely entry methods in the rural markets.

3.1.1 Economies of Scale

As was discussed in the value chain analysis, there are important scale effects in the drug store industry in procurement and distribution, which are industry KSFs. The costs of these functions do not increase linearly with incremental store count increases. Distribution is more efficient with increasing numbers of locations to share the costs with; however, the increased complexity and cost of maintaining a large delivery network
to service rural markets should not be underestimated. Similarly, the costs to design and implement a marketing or professional programme increase disproportionately with increasing size. In addition, there are scale economies in seasonal programme development, as well as in support and maintenance functions that can be shared across many locations of a chain or banner group.

3.1.2 Brand Differentiation

Strong brand identification is important in retail business because the basic merchandise sold is primarily commodity type items. The extent to which particular drug stores in the industry have well established reputations for provision of health care service and products contributes to the strength of their brands. It is more complicated to get the brand to "stick" in the mind of the customer than it is to package together an offering of product and service. Other KSFs such as the private label programme, a customer loyalty programme and the service offering contribute to the brand strength.

Branding makes entry by a new chain more difficult and expensive but not prohibitively so. Gaining market share requires significant lead-time to build trust as well as advertising expense to overcome the reputations of the established businesses. The establishment of brand recognition and strength for a new company is essentially constrained by how the service and product mix differentiates the company from the competition. No KSFs beyond those identified in the value chain analysis are posed by brand recognition.
3.1.3 Capital Requirements

There are significant capital requirements to open new retail drug stores. The required opening inventory combined with computer equipment and store fixturing costs can easily surpass $1 million per location. Even small medical clinic type pharmacies will require half a million dollars to open. To further compound the impact of the high opening costs, initial revenue is frequently low while reputation is developed and the net profit margins in the industry are low so additional capital will be required to support the business. If entry is planned to be on a large scale the capital requirements may pose an entry barrier.

3.1.4 Cost Advantages

Opening new drug stores can be a detailed and somewhat complicated process. Beyond the basic regulatory requirements required to get a pharmacy license, there are requirements for layout and efficiencies in process, which result in net reduction in cost and improvements in end operational effectiveness. In addition, the learning curve associated with the process of opening incremental stores reduces the cost of capacity expansion for companies, which regularly open new locations. The cost to open a store by a competitor new to the industry may be higher than for established companies.

3.1.5 Distribution Access

The distribution barriers to entry in the drug store industry are generally minor. There is only moderate chance of retaliation to entrance from established competitors. Professional courtesy generally constrains retaliation to entry of a new drug store. In the past however, price, professional resource competition, and real estate competition have
all been used to punish entry to the industry. This retaliation is a threat to entry but at most a minor one. Distribution for the retail drug industry is straight to the consumer so there is limited risk to the distribution beyond the competitive pressure in the market resulting from an incremental drug store.

3.1.6 Government Policy

Entry to the drug store industry is regulated entirely by the government; however, the government is generally bound to the protection of the public good in regulating the industry so it presents more of an administrative hurdle than a true entry barrier. More significantly, the government is one of the largest consumers of pharmacy services. In BC, the provincial pharmacare programme funds most prescription coverage in excess of certain income-based deductibles. Any changes to the coverage of certain lucrative programmes such as the BC Methadone Maintenance Programme or Compliance Packaging could pose entry barriers to businesses, which plan to establish initial cash flow through these programmes.

3.1.7 Risk from Entry

Traditionally, five sites has been defined as the minimum effective size (MES) for entry as a “chain” in the industry (Jennings, 2004). Practically, this would no longer be an adequate MES because the scale advantages would not be sufficiently strong to realized cost savings. A higher count of higher volume stores would be required to generate a reasonable ROI. Entry on a large scale by a new chain or banner to the industry would face greater barriers and require significant capital for acquisition and new store openings. Entry in this manner is certainly possible; it is however unlikely.
Entry by small independents to the industry poses little threat to established drug store chains beyond the impact on the local store profitability. Entry by a new chain with sufficient scale to be a threat is unlikely due to the higher entry barriers. No significant KSFs, beyond the scale and branding factors previously identified in the value chain analysis, are suggested by reviewing the low barriers to entry in the drug store industry.

3.2 Bargaining Power of Customers

Individual consumers generally exert low power over the retail drug industry. Consumers as a diverse group lack concentration and power. In addition, the purchases made from drug stores typically comprise a relatively small proportion of the consumers’ income and do not represent a large input cost. The aggregate impact of many personal buying decisions however, is the main determinant of retail sales.

Consumers will notice more variability in quality due to differences in product mix and service offerings in the cosmetic and front shop areas of the business than is found in the pharmacy. Pharmacy is a highly regulated profession covered by a combination of federal and provincial statutes designed to protect the health and safety of pharmacy consumers as well as their choice of practitioner. Health care and consumer advocacy groups have considerable influence on media coverage. The combination of these regulatory and public opinion factors ensures equal product quality and at least comparable quality service in dispensaries. This supports consumer bargaining power but does not influence the industry much beyond regulatory requirements.

The products available for sale in drug stores are primarily homogeneous commodities available across the industry and in many cases from other supply channels
so consumers can switch retail outlets easily and may tend to be price sensitive. The service that accompanies the commodity sale in the drug store industry can vary significantly. To the extent that consumers build trusting relationships with particular pharmacists and cosmeticians, consumer bargaining power is diminished because there are increased switching costs. This is a relatively weak factor because consumers are free to build new relationships with alternate pharmacists and cosmeticians should their perception of, or requirement for, service change.

The internet has drastically increased the amount of information that is available to consumers. This affects all segments of the drug store business. In pharmacy, medical and pharmaceutical information is widely distributed over the internet decreasing the dependence of consumers on the pharmacist for information but increasing the requirement for trusted expert advice on the information gathered. Similarly, product features and usage information is widely available for cosmetic products. Finally, comparative pricing information is available for front shop items. In each instance, the power of the consumer is enhanced through the decreased transaction cost of obtaining information relative to what the costs would be without access to internet information.

One group of consumers who exert power in the drug store industry are the insurance carriers of the high value prescription customers. Due to the significant dollar cost involved in providing medication coverage, the government and third party payers may exert cost control measures to contain rising expenses. This is a growing area of influence on the pharmacy industry as governments and insurance carriers reduce coverage to contain costs. In the Canadian Medical system, the patient’s right to choose their service provider has mitigated the impact of many of these measures; however, as
prescription medication cost increases continue, the pressure to decrease the pharmacy margin on the transaction will intensify. To insurance carriers, prescriptions are pure commodities and the trend is to cover the commodity and leave the payment for the service attached to the commodity to the consumer. This increases price sensitivity of the patients as a consumer group.

The importance of professional service as a KSF is enhanced by the cost containment efforts of government and insurance carriers. Other than this enhancement however, consumer power does not give rise to any significant KSFs for the retail drug industry.

3.3 Bargaining Power of Suppliers

There is moderate supplier power in the drug store industry. The supply of Pharmacists is the overriding supply factor consideration for the drug store industry. This concern overshadows the more typical retail industry factors of product and real estate procurement, which are present but do not represent as significant an impact on the industry.

3.3.1 Pharmacists

The drug store industry is dependent on the availability of pharmacists for the key pharmacy distribution process and for professional service offering. The base line regulatory requirement is that there be at least one pharmacist present at all times while the dispensary is open. As is the case with other health care providers, pharmacists are increasingly in short supply relative to the increasing size of the patient population. The shortage is particularly pronounced in rural markets (Jennings, 2004).
The shortage of pharmacists is one factor contributing to larger dispensary and store formats. Larger dispensaries with higher prescription volumes allow more efficient use of pharmacist hours than do smaller dispensaries, which may fill less than 100 prescriptions per day. As well, efficient workload management allows many prescriptions to be processed during the quieter periods in the stores with extended hours.

The emergence of lock and leave pharmacies has largely been driven by the pharmacist shortage. These dispensaries are typically found in mass merchant and grocery stores where there are inadequate pharmacists to cover the opening hours of the store. The pharmacy and the products restricted to sale in a pharmacy are “locked up” and the pharmacists and pharmacy staff “leave” while the rest of the store stays open for business. While this satisfies regulatory requirements, it is not great service for the customer who shows up to pick up a prescription or restricted OTC product when things are “locked”.

Changes in pharmacy practice such as increased usage of technology and reliance on pharmacy technicians have been stimulated by the recent shortage of pharmacists. These changes have mitigated the dependence on pharmacists somewhat. Improved supply of pharmacists through government funding of university spots and changes to the immigrant pharmacist licensing process will mitigate this further over the long term. In the short term however, the ability to attract and keep pharmacists is a KSF for the drug store industry.
3.3.2 General Labour Force

Outside the professional staff in the dispensary, drug stores are staffed by largely low skilled labour. With the possible exceptions of the product knowledge required of the cosmeticians and the management experience required for the front store managers, the skills required to work in a drug store can be taught on the job to new employees. There is a small locus of unionization in the drug store industry, which is not sufficiently strong to increase the bargaining power of the labour force. In British Columbia, the United Food and Commercial Workers Union represents workers in most of the grocery segment of the drug store industry as well as some of the Shoppers Drug Mart franchises in the province. General labour does not currently exert significant power over the drug store industry.

3.3.3 Real Estate

Access to commercial real estate is required for drug stores and is a KSF for the industry. Property owners maintain a position of relative power with respect to the drug store industry because it is still largely dependent on leasing space for store operations. Particularly in urban markets, access to locations proximate to physicians, with high residential density and convenient parking is increasingly difficult to get. Since the size of the retail space available determines the linear footage of shelf space and to a certain extent the mix of product that can be carried, there is a preference for larger format stores across the industry (CACDS, 2004). The requirement for larger formats, combined with scarcity issues and high competition for prime locations from non-pharmacy retailers, amplifies the difficulty of locating real estate and the competitive advantage that may be gained by retail drug stores on this KSF.
3.3.4 Pharmaceutical Suppliers

Drug Stores enjoy a close relationship with pharmaceutical suppliers. Quality issues are regulated by the Health Protection Branch and consequently are not a concern. To the extent that pharmaceutical companies can refuse to sell to drug stores (as was recently seen in the case of Canadian Internet Pharmacies) and have freedom to set prices, the suppliers have power over the drug stores. To the extent that pharmacists are able to influence the prescribing patterns of physicians, the pharmacies have power over the proprietary pharmaceutical suppliers. With respect to the generic pharmaceutical companies, the drug stores have considerable power and are able to attract significant volume commissions from the companies (Caicco, Wong, & Piticco, 2003). There are significant labour and customer relation costs involved in switching generic brands in a pharmacy. This mitigates the risk of switches for the incumbent generic brands. The pharmaceutical companies have power but it is limited practically by medical ethics constraints and the availability of generic and therapeutic substitutes for most products.

3.3.5 Cosmetic Vendors

Cosmetic vendors, and in particular the prestige line vendors exert power over the drug store industry by limiting the number of accounts that they will open. The artificially created scarcity contributes to the ability of the vendors to charge premium prices for their products. In addition, the strong gross profit margin performance of these lines cause retailers to accept constraints on image, sales volumes and staffing levels in order to attract and keep accounts with these vendors. Achieving the targets set by the prestige vendors can be very difficult in small rural markets. Having prestige product
available is a significant enhancement to cosmetic mix. The ability to attract and maintain prestige accounts is a KSF for the industry.

3.3.6 Diverse Vendors

There are many potential vendors for non-pharmaceutical products, which can be sold by the drug store industry. While consolidation in the manufacturing and wholesale industries has decreased the number of potential sources somewhat, there are still enough competitors in the market that drug stores are able to source adequate product to meet consumer expectation from a variety of suppliers. There is some competition for supply of branded product, which is in demand by consumers. In situations like this, the relationship of the large manufactures with the larger drug store retailers may exclude smaller retailers from gaining access to first to market or high demand product.

There are also sufficient suppliers of software for supply chain management and logistics and other required inputs to provide the drug store industry with sourcing options. Once a company has established software contracts for either the dispensary system or the supply chain, there can be significant transaction costs required to switch vendors; however, there are adequate options should there be a requirement to switch to improve functionality, productivity or cost position. The diversity in vendors decreases the bargaining power of these suppliers.

Three KSFs arise from consideration of the bargaining power of suppliers. Of primary importance is access to an adequate supply of pharmacists to open stores, to complete the dispensing process and to provide professional service (another dependent KSF). Access to prime real estate is another KSF particularly given the importance of
location as a determinant of pharmacy sales and profitability. Finally, access to prestige cosmetic accounts provides a competitive advantage in cosmetic mix and represents a KSF.

3.4 Threat of Substitutes

The threat of substitutes for the drug store industry is low. Medical advances, alternate methods of drug distribution and forward integration of governments and other payers into dispensing may influence the future growth potential of the business.

Medical advances in both the prevention and treatment of illness reduce the requirement for the dispensary and OTC components of the drug store industry. More disseminated availability of the “Flu Shot” for example, has had a measurable negative impact on OTC sales during the winter flu season. New alternatives to medication treatment may be distributed through alternate channels. For example, Quadra Logic Technology’s eye drop Visudyne® is dispensed not through pharmacies but rather by the Ophthalmologists who provide the treatments. Advances in cosmetic surgery may decrease demand for some cosmetic product.

The advent of mail order and internet-based pharmacies were widely thought to represent threats to the pharmacy business in Canada. Fortunately, the non-commodity portion of the business, that is the service and relationship with a pharmacist, reduced the anticipated impact of these substitutes on the drug store industry. More recently, tele-health initiatives that attempt to provide video linkage with automated dispensing machines are attempting to provide pharmacy service to remote areas of the province.
These represent distribution channels facilitated by advances in technology, which are potential long-term substitutes for the drug store industry.

Forward integration by government funding agencies into dispensing activity is another credible substitute for the drug store industry. A local example is the distribution of AIDS medication. A catastrophic new illness such as AIDS would be expected to have a significant regrettable but none the less positive impact on pharmacy sales. Along with this increase, corresponding increases in companion sales from front store and cosmetic purchases would be expected. The drug store industry was denied this benefit by the decision of the BC government to fund all AIDS medication through one central distribution point.

Substitute distribution channels remain a minor threat at this time.

3.5 Industry Potential

The Canadian drug store industry is very attractive and it should continue to experience significant growth. Suppliers to the industry hold only moderate power and the bargaining power of the customers remains low. The industry enjoys continued increased demand for the products and service offered and where not constrained by the shortage of pharmacists or the difficulty securing real estate, should continue to offer the potential for substantial profitability well into the future.

Compounding the overall attractiveness of the drug store industry are the incremental increases in demand created by the Baby Boom demographic and increasingly by their affluent offspring (Foote, 1996). A prime example is the explosion of demand for nutraceuticals a decade ago as the leading edge of the health conscious
baby boom generation sought to find "natural" and "herbal" products to counter many of
the bothersome symptoms that become prevalent in middle age. As the largely inevitable
progression with time has proven too much for the less potent nutraceuticals, the industry
is now experiencing very strong prescription growth count and a softening in demand for
nutraceuticals. The offspring of the boomers have higher disposable incomes than many
of the generations preceding them, which impacts positively on impulse, convenience and
high-end beauty items found in the cosmetic departments. These two segments of the
population offer the potential for even more significant industry profits from anticipated
growth in the pharmacy and cosmetic segments of the business.
4 KEY SUCCESS FACTORS

The primary success factors required in the drug store industry as suggested by both the value chain analysis and the competitive force analysis are real estate and pharmacist supply. Real estate contributes to merchandising mix, is a key driver of convenience, and is a significant cost factor. Pharmacists are the professionals that define the drug store industry as being different from general retail. An adequate supply of pharmacists is required for provision of professional service and can contribute to convenience. With out real estate and pharmacists there is no drug store.

The other success factors in the industry primarily influence brand differentiation. The basic product carried in drug stores lack differentiation. This contributes to competitive rivalry and increases the importance of brand differentiation and the consumers’ perception of the value offering of a particular retail outlet. Low pricing created by efficiencies in the procurement and distribution functions that can provide a cost advantage are the foundation of a price based value statement. Flyer promotion and customer loyalty programmes are KSFs that mitigate the price-based factor. The depth and breadth of merchandising mix including access to prestige cosmetic lines and a private label programme are key factors affecting brand differentiation as well. Equally importantly however, is the service and convenience offering in pharmacy, cosmetics and front shop. This service is dependent on the availability of pharmacists, cosmeticians and other employees and is both a minimum requirement for entry and a source of significant advantage. Promotion of a brand established through convenience, service, mix, and
price is essential to differentiate a drug store from rivals in the industry and to sustain a competitive advantage.

4.1 Real Estate

The factors that affect real estate for drug stores are location, size and cost. Leaving aside the in-clinic location advantage enjoyed by many of the clinic pharmacies, there is little consistent advantage enjoyed by any of the formats with respect to real estate. Competition for real estate is particularly intense in urban markets and exists not only between drug stores but with other retailers as well. In this respect, the grocery and mass merchants are at a disadvantage relative to the chains and banners due to the large footprints required to set up the stores.

In the rural markets, the real estate market is much less competitive and the advantage gained by favourable real estate is diminished due to the condensed geography and lack of congestion. Proximity to prescribers still creates some advantage and locations outside the core of town may be somewhat disadvantageous. Drug stores located outside the town core or adjacent to a large grocery or mass-merchant may not be able to compete well. The concern in these situations is that the convenience differentiation between drug store and the grocery/mass competitor is negligible once the customer has driven to their shared parking lot. Other service factors being equal, the low price position of the grocery or mass-merchant competitor may prove to be insurmountable.
4.2 Pharmacist Supply

The shortage of pharmacists that has affected the industry for the last ten years has been particularly intense in some rural communities and much less significant in the large urban markets. Stimulated by the high demand, the wage rates for pharmacist have nearly doubled in the rural markets. Drug stores strive to maintain a good professional reputation in the pharmacy community and network extensively with pharmacy students in an attempt to establish themselves as the employers of choice. Access to pharmacists in the rural communities enables the companies to maintain both store count and extended hours of service while other less successful competitors may have to adopt lock and leave formats, reduce hours or even close.

The independents format drug stores in particular have struggled with the shortage because they do not have the support of large central recruiting staffs and budgets and are often not able to offer comparable wages and benefits. One advantage that independents have maintained through the shortage however is their shorter operating hours. For the pharmacists who have to work the incremental night and weekend shifts, the standard day shift hours offered by the independents can be quite appealing.

4.3 Brand Differentiating Factors

In the drug store industry, competition on the brand differentiating KSFs tends to be primarily consistent with the store format with secondary minor variations between firms of a given format. A review of how the different drug store formats compete relative to one another on each of the industry KSFs is detailed in Table 3.
<table>
<thead>
<tr>
<th>Procurement &amp; Distribution</th>
<th>Clinics</th>
<th>Banners</th>
<th>Chains</th>
<th>Grocery</th>
<th>Mass Merch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mix</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>++</td>
<td>+++</td>
</tr>
<tr>
<td>Breadth</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>+++</td>
<td>+</td>
</tr>
<tr>
<td>Depth</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Private Label</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>+++</td>
<td>+</td>
</tr>
<tr>
<td>Convenience</td>
<td>++</td>
<td>++</td>
<td>++</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Location</td>
<td>+++</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Hours</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>++</td>
<td>++</td>
</tr>
<tr>
<td>Service</td>
<td>++</td>
<td>+</td>
<td>++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Pharmacy</td>
<td>+++</td>
<td>++</td>
<td>++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Cosmetic</td>
<td>-</td>
<td>++</td>
<td>+++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Front Shop</td>
<td>+</td>
<td>+++</td>
<td>++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Value</td>
<td>++</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>+</td>
</tr>
<tr>
<td>Price</td>
<td>+</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>+++</td>
</tr>
<tr>
<td>Flyer (discount)</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>+++</td>
<td>+</td>
</tr>
<tr>
<td>Loyalty Programme</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>++</td>
<td>+</td>
</tr>
</tbody>
</table>

Note: Industry leader on KSF shaded

4.3.1 Clinics

Clinic type pharmacies enjoy the key advantages of location in proximity to physicians and high quality service provided by the pharmacists. These advantages are significant and historically resulted in very profitable businesses. Clinic format stores are effectively constrained on most of the other KSFs because of small size. The convenience also overrides value considerations and these stores have traditionally been able to collect premium prices. Changes to the supply of pharmacists and pressure from insurance companies to reduce margins may change this with time.

4.3.2 Banners

The banner groups have been hampered recently by decreasing store count and smaller size. This combination with significant member autonomy and corresponding non-compliance with purchasing programmes weakens buying power for the banner
groups. This makes them generally less efficient than the less autonomous chain and franchise competitors.

The banner stores may enjoy some advantage with respect to service particularly in the front shop; however, service can be a hard variable to measure and compare quantitatively across different formats because customers expect different things from different formats. If the definition of good service for front store merchandise is the traditional drug store offering of an adequate mix of product, that is well merchandised, clearly priced, and supported by readily available staff, then the banners with higher staffing complements maintain an advantage over the larger format competitors. The banners are at a disadvantage with respect to cosmetic mix due to both the smaller footprint and the inability to attract prestige cosmetic accounts.

4.3.3 Chains

For chain drug stores, the breadth of inventory carried is a source of competitive advantage particularly with respect to the clinic and some of the smaller banner stores, which are constrained by physical space. The leadership positions in cosmetic service, combined with convenient hours and an extended depth of product mix add value that compensate for higher prices in the market. Effective leveraging of both flyer programmes and customer loyalty programmes may offset the dominant price position of the mass merchants.

Mass merchants are not space constrained however, the emphasis on inventory turns and the corresponding tendency to carry only the highest volume SKU’s result in a comparative advantage in SKU breadth for the chain stores. The recent focus in the
industry to increase the store size has been driven largely by the requirement for increased linear footage of selling space to further the development of mix opportunities and to maximize the margin opportunity represented by the demand for the incremental SKU's. Maintaining a sales volume high enough to improve the total margin dollar returns may be significantly more difficult for larger format stores in small communities.

The extension of operating hours by some chain drug stores from the traditional "bankers" hours of the clinic pharmacies to the current situation where some stores stay open 24 hours a day, seven days a week has been an evolutionary process. The market leader in extended hour service is Shoppers Drug Mart with a number of 24-hour stores located in the major urban centres. Many of the grocery stores also have extended hours of store operation; however, the pharmacy departments often have shorter hours with a lock and leave format dispensary.

4.3.4 Grocery

The primary advantage offered by the grocery stores is breadth of merchandise mix. This is not surprising given that pharmacies and OTC products were added to provide one stop shopping convenience. With respect to breadth within a particular category of traditional drug store product, the larger chain drug stores may maintain a SKU count advantage.

The grocery stores, in particular Loblaws, maintain a clear leadership position in the development of extensive private label lines. While other competitors have well developed private label lines as well, they do not enjoy the same market penetration as
President’s Choice does at Loblaw Companies. The Loblaw Companies’ 2004 Annual Report claims a 22.2% market share for what it calls control label products.

4.3.5 **Mass Merchants**

The mass merchants have built a competitive advantage based on supply chain management and low cost positioning. Wal-Mart is well known and respected in the industry for prowess in distribution efficiency. HBC is actually the largest mass merchant in the BC drug store industry; however, declining numbers of Bay Pharmacies and closure of some Zellers stores with pharmacies in response to entry from Wal-Mart diminishes the importance of HBC as a competitor.

4.4 **Competitive Advantage**

As is found in other industries, competitive advantage in the drug store industry can be maximized by developing the leadership position on different industry KSFs. Both low cost and differentiated strategies are possible. Differentiation in the drug store industry is created through a combination of convenience and service.

With respect to value, mass merchandisers and, to a certain extent grocery, have adopted a cost based strategy and positioned themselves as the low price providers in the market. Development and maintenance of central procurement and distribution systems have allowed chain drug store to maintain a slightly better price position than the clinics and banners and comparable to that of the grocery players. Continued improvement to contain cost will be essential to maintain position with respect to the mass merchants but will not likely provide a competitive advantage.
Differentiation strategies, based on convenience and service, have been adopted by the other formats in the industry. Many of the independents maintain an advantage based on their convenient locations and pharmacy service. The chain drug stores with their larger size, dominate on convenience factors related to pharmacy and cosmetic service combined with merchandise mix and extended hours. The grocery and mass merchants offer the convenience of one stop shopping, but primarily compete on price.

4.5 Rural Market Considerations

Success in the pharmacy retail industry requires three key factors: a supply of pharmacists to offer professional service, conveniently located real estate, and a strong promotional brand. As previously mentioned, the shortage of pharmacists is particularly acute in rural markets making this KSF even more critical to the success of a firm. On the other hand, real estate is more readily available in these markets and therefore less likely to result in sustained competitive advantage. Once these essential KSFs are met, successful competition in small rural markets requires a store format and cost structure that will address increased rivalry, reduced ability to differentiate and increased price sensitivity.

4.5.1 Increased Rivalry

There are several factors contributing to increased rivalry in the small rural markets. In these settings, the small population increases the relative buying power of each consumer. Rivalry in these markets in amplified by the relatively small customer base and the aggregate affect of each consumer’s shopping choice. This increases the
power of consumers from low to moderate because the effects on the businesses of independent buying decisions have a greater relative impact.

Population growth in rural markets is slow and declining in some places. This results in slow growth in the industry and increases competition for available market share from competitors with growth ambitions. In small communities, the competitors each have only one location. This may make capacity augmentation more difficult because the available option is to double store count in the market; which is unlikely given the small markets size. In less fortuitous circumstances, the exit barriers in small communities are higher because the chain will have to transfer prescription files to a competitor rather than to one of its own stores and they will be abandoning market penetration of the community. Each of these factors increases rivalry in rural markets.

4.5.2 Reduced Differentiation

Most of the products and much of the service offered by retailers in the drug store industry lacks significant differentiation. In rural markets, once mass merchants are present, each drug store must compete with other chains, banners and clinics for share of the less price sensitive market. Differentiation strategies of convenience, service and product mix are not as strong as they are in more urban markets.

In some very small rural markets, the presence of a drug store at all results in significant improvement in product mix available by virtue of there being a pharmacy in the town. In markets with more than one drug store competitor, a differentiation strategy based on mix may be difficult to achieve. The increased rent, labour, and inventory carrying costs required to achieve mix advantage may not be covered by the incremental
sales generated on the additional SKUs. The small size of the customer base produces insufficient sales volume to improve profitability significantly.

Service tends to be better in small market retail outlets than it is in larger urban centres. Part of the explanation for this is the fact that the customers are often being served by a friend or neighbour from their community. This familiarity encourages a more helpful and considerate level of service than is customarily found in the more impersonal urban markets. As well, the slower pace and lower customer traffic counts found in most rural communities allows for better service at basic staffing coverage levels.

In small towns, most of the retail space is located relatively close together, there is less congestion, and everything is easy to get to. Differentiating on convenience in these markets is more difficult. The service differentiation between retailers is less pronounced and the small population base results in less profit enhancement from increased mix. Pursuing a differentiation strategy to compete with a low cost competitor can be much more difficult in these circumstances.

4.5.3 Price Competition

The rural markets are served by more small independents and banners than other drug store formats. These stores are typically premium price providers that differentiate on convenience and service. When larger format stores enter the market, the cost advantages derived from scale efficiencies help preserve gross margin in the lower volume markets even at lower retail prices. The incumbent premium price position can be
a significant weakness as price conscious consumers quickly change their shopping preferences to the mass merchant or grocery stores where the value proposition is better.

Competing in small rural markets requires consideration of all the industry KSFs in addition to the special considerations that arise from the small population base and lack of congestion. Rivalry can be more intense and differentiation on service and convenience can be more difficult. This makes cost based strategies more powerful in these markets.
5 RURAL MARKET OPPORTUNITY

A superficial consideration of the rural market opportunity may suggest that this market should be avoided. The small population base increases rivalry and appears to decrease potential profitability. As Sam Walton proved however, the rural markets should not be ignored. In fact, Wal-Mart, Sam’s legacy, continues to expand into small communities across the province. With more than a quarter of the provincial population living in small rural communities, any drug store competitor with a growth strategy will ultimately need to compete successfully in the small markets as well as the larger urban centres.

Jim Collins, in his book Good to Great (2001) uses the American drugstore Walgreens® as the lead example for his hedgehog concept. He defines a hedgehog as:

a simple, crystalline concept that flows from deep understanding about the intersection of the following three circles:

1. What you can be the best in the world at.
2. What drives your economic engine.
3. What you are deeply passionate about. (p. 95, 96)

The hedgehog Collins discovered for Walgreens is being “the best, most convenient drugstores, with high profit per customer visit” (Collins, 2001 p.92). This strategy of convenience and service delivering sales that are more profitable is as applicable in small markets as large urban ones. The United States has a larger rural population in both absolute and relative terms than Canada does. Given the consistent excellent financial performance of Walgreens, the strategy has been successful. The application of the
strategy may change in rural markets but the strategy itself is still successful and the potential of the rural markets should at least be considered.

5.1 Market Survey

The rural BC market has been defined as communities with populations less than 30,000 people. A survey of the drug store competitors in these communities (Table 4) shows some differences in the store count percentage share compared to the provincial market as a whole.

<table>
<thead>
<tr>
<th>Store</th>
<th>Rural Share</th>
<th>Provincial Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independents</td>
<td>11.6%</td>
<td>11.8%</td>
</tr>
<tr>
<td>Katz Group</td>
<td>12.1%</td>
<td>12.3%</td>
</tr>
<tr>
<td>London Drugs</td>
<td>0.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Medicine Centre</td>
<td>7.7%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Peoples Drug Mart</td>
<td>12.6%</td>
<td>12.8%</td>
</tr>
<tr>
<td>Pharmasave</td>
<td>16.4%</td>
<td>16.7%</td>
</tr>
<tr>
<td>Shoppers Drug Mart</td>
<td>12.1%</td>
<td>11.3%</td>
</tr>
<tr>
<td>Canada Safeway</td>
<td>6.3%</td>
<td>6.4%</td>
</tr>
<tr>
<td>Costco</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Loblaw Companies</td>
<td>8.2%</td>
<td>7.9%</td>
</tr>
<tr>
<td>Save-On Foods &amp; Drugs</td>
<td>5.8%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>4.3%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Zellers/HBC</td>
<td>2.4%</td>
<td>2.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

Source: Compiled from College of Pharmacists of BC Website

Shoppers Drug Mart is the market leader for the province as a whole, but has a smaller 11.3% share of the stores in the rural markets. Pharmasave, Peoples Drug Mart and the Katz group all have stronger representation in these markets than does Shoppers Drug Mart. As would be expected in smaller markets, the grocery and mass merchants
give up some share overall. Within the grocery and mass merchant group, Loblaw Companies assumes the lead position.

A common thread with the companies that have larger shares in these less populated markets is availability of more than one store format. Specifically, the companies have each developed smaller footprint store format with lower operating costs that can compete successfully in the smaller towns. Peoples Drug Mart and the smaller Medicine Centre are the two different banner formats tied to Unipharm® Wholesale. If the store counts for these two banners are combined, this group makes up fully 25% of the market. Pharmasave operates both full format and Pharmasave Health Centre stores in these markets. In the grocery group, Loblaw Companies operates stores in the Real Canadian Superstore, Real Canadian Wholesale Club, and the smaller ExtraFoods formats. These alternate formats were developed and tested in Western Canada, proved successful, and are being rolled out across the country (Lederer, Mavrinac & Smith, 2005).

5.2 Competitive Rural Communities

In rural communities with populations between 30,000 and 10,000, Wal-Mart and other grocery and mass merchants are typically found in market. Many of these communities have more competitors relative to the population that is found in larger centres. When deciding to enter markets of this size, particular attention will be required to the KSFs for the industry. The site selected must be convenient and preferably close to prescribing physicians. If entry is contemplated at a size larger than just a clinic, an
adequate supply of pharmacists must be available to provide coverage for hours of operation that will meet the service and convenience needs in the market. As well, particular attention will need to be made to operating cost containment and distribution efficiencies to ensure that the business is profitable at competitive prices.

Perhaps the easiest entry mode in these markets is the addition of a pharmacy to an existing grocery store or mass merchant. Entry by a small clinic or independent is also relatively easy. For stand-alone drug store entry, there are a couple of options. When real estate is available, and if the market is large enough to support an additional drug store, building a new store is a possible growth or entry strategy for the community. More typically, however, the small market size and the importance of locating the store close to the physicians and convenient to the town centre will require a smaller, lower cost option. Another option would be to acquire an independent or banner competitor to roll into an existing business or to convert and operate in either the exiting location or a new more convenient one.

Entry to these markets will be most attractive to large chains as well as grocery and mass merchants. These companies can take advantage of scale economies and market power to maximize the profit potential in these smaller markets. Based on similarities in the current leaders in this market, the most successful strategy also requires a smaller format with lower operating costs as well.

5.3 Monopolistic Rural Markets

The strategically interesting markets to consider are those with populations less than 10,000 were there are no grocery or mass merchant competitors. Particularly if
these markets are geographically isolated, the drug store in town enjoys almost monopolistic power in the market. While consumers have the option to leave town for their purchases, this market is perhaps the most visible one of people being prepared to pay more for the mix, convenience, and service – the convenience of having goods and service available locally!

The profit margin potential in these markets is significantly higher than anywhere else in the industry. The lower volume resulting from the small population however, will require cost efficiencies in the operation to ensure profitability. To contain cost, operating hours may need to be short to minimize the number of pharmacist required. As well, the footprint may need to be small to keep the rent, staffing, and inventory carrying costs low. Unless a mass merchant enters a rural market, the customer is presented with little choice of retail format. The competitive advantage is being present in the market and the retailer has the opportunity to make significant profit.

5.4 Market Opportunity

The drug store industry continues to experience consolidation through acquisition of independent pharmacies by chains and banners. Expansion into the industry by grocery and mass merchants through the addition of pharmacy departments to their store mix continues to increase competition in the industry. Entry from an alternate format or through capital expansion is a low risk to the ongoing attractiveness of the industry. In the most rivalrous rural markets, stores with high cost structures may not be achieving the growth and profitability experienced by the stores in the larger urban and suburban markets. A focused competitive strategy of acquisition and competition with the small
chain, banner and independent players is possible for a larger chain taking advantage of scale efficiencies.

Significant competitive pressure has been applied to small town independent pharmacy owners by the advent of pharmacies in grocery stores. Not only do these pharmacies increase competition, they also consume pharmacist resources and contribute to the ongoing shortage of pharmacists available for relief and back up. When combined with inferior gross margin performance due to lack of scale purchasing advantages in the independent and banner formats, many of businesses are struggling. This makes them easier targets for acquisition by larger competitors.

A company that has available a store format designed to achieve profitability in small communities can realize good return on acquisitions in these markets. The Katz group has been expanding aggressively in these markets. Expansion contributes to market share and to the strategic power that can be applied against competitors in the larger more profitable markets. Other large chains should carefully consider the opportunity to develop their store network in the small rural markets as well as the potential impact of under representation in these markets.
APPENDIX A

This industry analysis has been adapted from a full strategic analysis prepared for a Canadian firm. The full project was complete and accepted for submission by the senior and second supervisors. To protect the firm's competitive position, only non-confidential aspects of the analysis could be provided in this document.

The original paper included a firm level analysis and a strategy for penetrating rural markets with a format that utilized the scale efficiencies of a large network for purchasing and distribution, the recognition of a well-known brand, combined with a reduced size format to fit the store within the smaller market constraints. Reduced format meant a shallower and narrower product mix with particular attention paid to high volume items in non-pharmaceutical segments. Fewer low volume items and categories of items would make up the product mix. In this way, a firm could profitably serve the rural market by adapting its signature footprint to meet the needs of the smaller market, thus enhancing firm profitability and enhancing consumer welfare as well by bringing superior logistics to the rural areas, resulting in lower prices and/or more convenience compared to the current choices available.
REFERENCES


