Getting generic: **Brand-name patent expiration and wholesale bypass will stunt growth**

**IBISWorld Industry Report 42421**  
**Drug, Cosmetic & Toiletry Wholesaling in the US**  
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Andy Brennan
About this Industry

Industry Definition
Drug, cosmetic and toiletry wholesalers primarily distribute pharmaceutical products intended for internal and external consumption, such as tablets, capsules, vials, ointments and powders. The industry includes a range of biological and medical products and botanical drugs and herbs. The industry does not include businesses that primarily distribute surgical, dental, and hospital equipment.

Main Activities
The primary activities of this industry are

- Antibiotics wholesaling
- Antiseptics wholesaling
- Beauty supplies wholesaling
- Cosmetics wholesaling
- Nonprescription drugs wholesaling
- Pharmaceuticals wholesaling
- Prescription drugs wholesaling
- Toiletries wholesaling
- Vaccine wholesaling
- Vitamins wholesaling

The major products and services in this industry are

- Auxiliary services
- Brand-name prescription drugs
- Cosmetics and toiletries
- Generic prescription drugs
- Non-prescription pharmaceuticals
- Specialty medications
- Vitamins and nutritional supplements

Similar Industries

32541a Brand Name Pharmaceutical Manufacturing in the US
Pharmaceutical manufacturers develop and manufacture prescription and over-the-counter drugs that are then distributed by wholesalers.

32541b Generic Pharmaceutical Manufacturing in the US
Generic pharmaceutical manufacturers develop and manufacture prescription and over-the-counter drugs that are then distributed by wholesalers.

42345 Medical Supplies Wholesaling in the US
Medical supplies wholesalers distribute medical and surgical equipment directly to healthcare providers.

42346 Glasses & Contacts Wholesaling in the US
Glasses and contacts wholesalers distribute professional equipment, instruments, and goods sold, prescribed or used by ophthalmologists, optometrists and opticians.
About this Industry

Additional Resources

For additional information on this industry

www.cms.hhs.gov
Centers for Medicare and Medicaid Services

www.ifpw.com
International Federation of Pharmaceutical Wholesalers

www.nacds.org
National Association of Chain Drug Stores

IBISWorld writes over 700 US industry reports, which are updated up to four times a year. To see all reports, go to www.ibisworld.com
Industry at a Glance
Drug, Cosmetic & Toiletry Wholesaling in 2013

Key Statistics
Snapshot

Revenue
$625.7bn
Annual Growth 08-13
-0.3%

Profit
$26.9bn
Annual Growth 13-18
-1.3%

Wages
$26.1bn

Businesses
8,753

Market Share
McKesson Corporation 16.9%
Cardinal Health Inc. 14.5%
AmerisourceBergen Corporation 12.9%

Key External Drivers
Per capita disposable income
Median age of population
Number of people with private health insurance
Research and development expenditure
World price of crude oil
Government consumption and investment

Products and services segmentation (2013)

Industry Structure
Life Cycle Stage
Decline
Revenue Volatility
Low
Capital Intensity
Medium
Industry Assistance
Low
Concentration Level
Medium
Regulation Level
Heavy
Technology Change
Medium
Barriers to Entry
High
Industry Globalization
Medium
Competition Level
High

FOR ADDITIONAL STATISTICS AND TIME SERIES SEE THE APPENDIX ON PAGE 39
The success of the Drug, Cosmetic and Toiletry Wholesaling industry is driven by the essential nature of its main product: pharmaceuticals. Demand for many of the industry's products is largely unaffected by swings in the larger economy, as healthcare spending is a necessity. The aging population has also strengthened demand for drugs over the past decade; older individuals typically spend more on healthcare because they are more likely to be affected by medical ailments. Consequently, the industry suffered only slightly during the recession. However, the industry has been shaken up by the “patent cliff”; because several brand-name pharmaceuticals have lost patent exclusivity, generic drug use has increased. Generic drugs are much cheaper than their branded equivalents and increased generic drug use has led to price deflation, hurting the industry’s revenue. On the plus side, the expanding use of generic drugs has helped wholesalers maintain healthy profit margins. Generic drugs carry higher margins for wholesalers because manufacturers cannot charge a brand premium. Revenue is expected to decline at an annualized rate of 0.3% to $625.7 billion in the five years to 2013, including a decline of 1.9% in 2013 alone.

Consolidation has increased within the industry over the past five years as the already-powerful major wholesalers have expanded their market share. In 2013, the top pharmaceutical wholesalers – McKesson Corporation, Cardinal Health and AmerisourceBergen – are expected to earn 44.3% of industry revenue. Because the industry has become more competitive over the past five years and pricing pressure has increased, a number of smaller wholesalers have exited the industry after merging or being acquired by another wholesaler. Consequently, the number of industry players is expected to fall at an average annual rate of 0.5% over the period.

The Patient Protection and Affordable Care Act of 2010 is expected to benefit the industry over the next five years due to increased access to insurance coverage for many Americans. However, the industry’s decline is expected to continue for at least the next two years as the patents of a number of widely-used pharmaceuticals expire. Furthermore, large retailers will continue dealing directly with manufacturers of generics, omitting the need for traditional wholesalers. Over the five years to 2018, industry revenue is forecast to fall an annualized 1.2% to $587.7 billion.

Key External Drivers

**Per capita disposable income**

Higher levels of disposable income result in a greater capacity to pay both for essential goods like medicine and non-essential items like fragrances and cosmetics. As disposable income increases, industry revenue is expected to rise. Per capita disposable income is expected to increase slowly during 2013, indicating a potential opportunity for the industry.

**Median age of population**

Americans are living longer on average than at any point in history due to improved medical treatments. Older age groups suffer more from chronic illnesses and disabilities than the rest of the population and account for a larger share of total healthcare expenditure in the United States than younger age groups. An aging population increases demand
Industry Performance

Key External Drivers continued

Number of people with private health insurance
Private health insurance coverage increases access to medical care, thereby boosting the number of doctor visits and prescriptions filled. As more Americans go to the doctor and increase their healthcare spending in general, the number of prescriptions increases, driving demand for industry goods and services. As a result, demand for drugs tends to increase when private health insurance membership rises. The number of people with private health insurance is expected to increase slowly during 2013.

Research and development expenditure
Traditional research and development (R&D) and the advent of new research, production and delivery methods, such as biotechnology and gene therapy, continue to generate more effective pharmaceuticals and delivery methods. Pharmaceutical manufacturers’ R&D expenditure contributes to growth in the industry through the development of new drugs; however, wholesalers tend to generate higher profit margins on generic drugs. Consequently, the benefit from higher R&D can change from year to year. Expenditure on research and development is expected to increase slowly during 2013.

World price of crude oil
The price of commodities, including oil, affects the industry’s costs. As fuel prices increase, wholesalers’ profit declines as transportation costs rise. Other commodity prices that affect industry profit margins include oil-based resins and latex used as raw materials in products that the industry distributes. The world price of crude oil is expected to increase slowly during 2013, which is a potential threat to the industry.

Government consumption and investment
In response to rising government debt and the role of healthcare costs in government spending, governmental and private payers may adopt cost-containment measures that pressure pricing on products that the industry distributes, which could reduce industry profitability. Government consumption and investment is expected to decrease slowly during 2013.

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![Chart of Per capita disposable income and Median age of population](source: www.ibisworld.com)
Industry Performance

Current Performance

Operators in the Drug, Cosmetic and Toiletry Wholesaling industry act as intermediaries between the manufacturers and retailers of an assortment of industry products, from specialty medications to tooth brushes. The industry earns the majority of its revenue through the sale of both prescription and over-the-counter (OTC) pharmaceutical products. Over the past five years, trends in the pharmaceutical product mix have affected the industry’s performance. The primary driver of industry revenue and profit has been the increased use of generic pharmaceuticals in the United States due to the expiration of the patents on a large number of widely used brand-name medications. Generics are typically much less expensive than their branded equivalents and an increase in their use causes average selling prices to decline within the industry. In 2012 alone, there were more than 30 brand-name to generic conversions. For this reason, the Drug, Cosmetic and Toiletry Wholesaling industry’s revenue is expected to decline at an annualized rate of 0.3% to $625.7 billion over the five years to 2013, including growth of 1.9% in 2013 alone.

External influences on growth

Although drug, cosmetic and toiletry wholesalers benefit from the essential nature of pharmaceuticals, some external factors have constrained revenue and profit over the past five years, including volatile commodity prices, decreased discretionary spending on cosmetics and high-end toiletries during the recession and increased costs due to rising regulation.

Historically, the most significant factor affecting the industry has been the volume and price of drugs purchased in the United States. Distributors benefit directly from the American public’s rising pharmaceutical consumption. While total pharmaceutical market sales have increased in recent years, the sales growth rate has slowed. Since 2008, healthcare-related industries have generated minimal increases in sales, particularly due to slower growth rates in physician and hospital visits. The weak US economy contributed to sustained high unemployment, low private health insurance coverage and falling disposable income. These trends have slowed consumer spending on doctor visits, prescriptions and discretionary products that industry wholesalers distribute.

On the other hand, the rapidly aging US population has significantly helped maintain industry revenue in recent years. Driven by a declining birthrate and longer life spans, the median age has risen consistently for several decades, including an average annual increase of 0.3% over the five years to 2013. Advances in medical technology, greater health consciousness and improved knowledge of nutrition have all helped Americans live longer on average. As such, a larger group...
Industry Performance

External influences on growth continued
of Americans qualify for coverage under Medicare (a federal program that pays for certain healthcare expenses for people age 65 and older) and, thus, more consumers require prescriptions and other wholesaler-provided products.

Generics spur profit growth

The slowing growth in drug spending can also be attributed to the shrinking number of “blockbuster drugs,” which are pharmaceuticals that generate more than $1.0 billion in revenue. Several recent patent expirations, such as Pfizer’s Lipitor in November 2011, have opened the market to cheaper generic versions.

While the growth of generic drugs has led to price deflation and, therefore, a decline in industry revenue, generics growth has been a boon for the industry’s profitability. Profit margins for generics are generally higher than branded pharmaceuticals and are typically highest during the six-month exclusivity period granted to the first generic to hit the market. During this initial period, manufacturer prices fall due to the branded drug’s competition with the generics, but do not completely collapse, yielding high margins for wholesalers. Relatively high competition among generic manufacturers also allows wholesalers to extract better terms from the manufacturers. Additionally, generic distribution involves lower inventory and general operating costs for wholesalers. The patent expiration of many brand-name drugs over the past two years helped push profit up from 4.2% of revenue in 2008 to 4.3% in 2013.

The rise of generic drugs has improved profit margins but pressured revenue growth

The escalating presence of many industry operators in higher-margin specialty and biopharmaceutical distribution has also helped operators maintain healthy profit margins. Injectable, infused, oral or inhaled specialty drugs are high-cost drugs that generally require special storage or handling and close administration. As such, they command higher profit margins. As the population ages, more operators are focusing on this product category because specialty drugs for cholesterol and arthritis (diseases particularly associated with aging) significantly drive growth. This product segment represents a substantial growth opportunity for wholesalers as more specialty pharmaceuticals are available to treat chronic conditions. Additionally, specialty biologics are less prone to generic competition, keeping prices and industry revenue high.

Consolidation trends

Industry consolidation has occurred mainly as a result of the increasing pressure on operators to lower costs. The top three wholesalers – McKesson, Cardinal Health and AmerisourceBergen – now account for an estimated 44.3% of total industry revenue in 2013, meaning that their combined market share has grown almost 5.0% since 2008. Over the five years to 2013, the number of enterprises operating in the industry is expected to fall an annualized 0.5% to 8,753. The consolidation has contributed to a change in the industry’s revenue model, evolving the core distribution business into a low-margin model that...
Industry Performance

Consolidation trends continued

A number of trends bode well for the Drug, Cosmetic and Toiletry Wholesaling industry over the five years to 2018. The industry will benefit from an improving economic environment and a rise in the number of people with access to healthcare. Rising per capita disposable income is also expected to boost industry sales, as consumers become better able to afford healthcare products and discretionary cosmetics and toiletries. Furthermore, as the median age of the population rises, an increasing number of people will require healthcare, including prescription and over-the-counter drugs. However, industry revenue will be hampered by the continued growth of generic pharmaceuticals (which means lower prices for a growing number of products the industry sells), as well as rising wholesale bypass as manufacturers and retailers increasingly deal directly. For these reasons, over the five years to 2018, revenue is forecast to decline 1.2% per year on average to $587.7 billion. In 2014, a year in which generic competition is expected to be particularly strong, revenue is forecast to decline 4.2%.

Healthcare reform

Greater access to health insurance will boost demand for drugs and other industry products

The Patient Protection and Affordable Care Act and the Healthcare and Education Reconciliation Act (collectively the Healthcare Reform Acts) seek to expand health insurance coverage to about 32 million currently uninsured Americans by 2019. Many of the significant changes specified, including a requirement that most Americans carry health insurance, do not take effect until 2014. Nevertheless, the eventual expansion of access to health insurance will increase demand for industry products and services. The number of physician visits – forecast to increase an average of 1.9% annually over the period due to the greater number of insured consumers – will boost drug sales, benefiting drug distributors, including industry firms.
Industry Performance

Healthcare reform continued

While expanded insurance coverage will bolster revenue, other provisions of the Healthcare Reform Acts are expected to hurt the industry. Provisions designed to generate revenue to fund coverage expansions and reduce the costs of Medicare and Medicaid could result in moderate profit margin compression. Government and plan providers will negotiate lower reimbursement rates with wholesalers’ customers (mainly pharmacies and drug manufacturers) and those lower rates will then be passed down to industry wholesalers, squeezing industry margins. Likewise, the gradual filling of the Medicare Part D coverage gap (the gap in coverage between $900 and $4,400 in drug costs that patients must pay themselves) by 2020 will cost drug manufacturers more than $80.0 billion, in turn, encouraging them to pressure prices at the wholesale level.

The implementation of healthcare reform is mired in political uncertainty; however, the future has become somewhat clearer with the June 2012 Supreme Court ruling that upheld the constitutionality of the individual mandate. Nonetheless, companies and states remain unsure about how to implement some provisions within reform and how these will affect operations. This insecurity is expected to subside through the next five years as the political environment becomes more settled.

Opposing trends in profitability

In terms of profitability, pharmaceutical distribution companies are set to benefit as demand for generic drugs rises and as branded drugs lose patent exclusivity over the next five years. Prominent drugs set to lose patent exclusivity include Nexium, a drug manufactured by AstraZeneca that treats gastroesophageal reflux disease, Eli Lilly’s antidepressive Cymbalta, as well as Crestor, a cholesterol-lowering drug from AstraZeneca. Generic drugs generally bring distributors higher margins than brand-name drugs because generic manufacturers face high competition and compete on price. Consequently, manufacturers depend on wholesalers to get their products to retailers. During the five years to 2018, the industry’s average profit margin is forecast to remain relatively stable, increasing marginally from 4.3% of revenue in 2013 to 4.8% in 2018. The boost in profit from generics will likely be offset to some degree by rising operating costs and regulation.

As branded drugs lose patent exclusivity, demand for generics will rise, aiding profit

In response to the growth of customers who need regional or nationwide service and because of the greater purchasing power that having large operations can provide, the industry’s level of market concentration is expected to increase. As distributors consolidate, the number of companies is forecast to decrease 0.4% per year on average to 8,596. Due to the increased automation and supply chain efficiency, employment is forecast to decrease at an average annual rate of 0.7% over the period to 252,482. Despite the fall in employment, the average wage is expected to remain high as employees become increasingly responsible for managing highly technical systems.
Industry Performance

Wholesale bypass poses a threat

Over the next five years, wholesalers will increasingly be bypassed by retailers and manufacturers, albeit at a slow pace, as third-party logistics providers begin to accommodate pharmaceutical regulations. In addition, the increasing efficiency of logistics systems allows manufacturers to sell more goods directly to end users through e-marketplaces such as the Worldwide Retail Exchange and Global Healthcare Exchange. Continued wholesaler bypass will foster further consolidation among wholesalers as they attempt to maintain bargaining power.

Consolidation and growth in the size of retailers is also threatening the industry. Walmart buys most of its generic drugs directly from manufacturers, leaving out distributors. Moreover, Walmart’s actions have spurred its competitors to purchase a broader portfolio of generics directly from manufacturers to maintain competitive pricing. This trend, along with more mail-order penetration, will likely damage demand for the industry. However, a boom in biotechnology products has occurred, which will benefit distributors because these products are more difficult to distribute (i.e. they have a shorter shelf life and often require refrigeration).

The potential for drug manufacturers and retailers to completely bypass wholesalers will likely be limited by the strict regulations surrounding pharmaceutical distribution. Additionally, the potential influx of about 32 million newly insured consumers into the market as a result of the Healthcare Reform Acts will necessitate the logistical capabilities that wholesalers provide.
Industry Performance

Industry value added is growing roughly in line with the economy

The industry is consolidating

The industry is benefiting from an aging population and the introduction of higher-priced innovative pharmaceuticals

Life Cycle Stage

Maturity
- Company consolidation; level of economic importance stable

Quality Growth
- High growth in economic importance; weaker companies close down; developed technology and markets

Quantity Growth
- Many new companies; minor growth in economic importance; substantial technology change

Decline
- Shrinking economic importance

Key Features of a Decline Industry
- Revenue grows slower than economy
- Falling company numbers; large firms dominate
- Little technology & process change
- Declining per capita consumption of good
- Stable & clearly segmented products & brands
Industry Performance

Industry Life Cycle

The Drug, Cosmetic and Toiletry Wholesaling industry is in the decline stage of its life cycle, with industry value added (IVA), which measures an industry’s contribution to GDP, forecast to increase at a slower rate than US GDP during the 10 years to 2018. IVA is expected to increase at an average annual rate of 0.2%, compared with US GDP growth of 2.1% per year on average during the same period. Disintermediation (i.e. the removal of intermediaries, such as a distributor, wholesaler, broker, or agent, in the supply chain) is fostering industry consolidation and slowing the industry’s growth rate. Wholesalers are becoming less necessary in the healthcare supply chain as manufacturers progressively sell directly to retailers and healthcare providers. In addition, the greater role of generic pharmaceuticals has given wholesalers less bargaining power and has led to lower prices for industry pharmaceutical products.

In response to pricing pressures from manufacturers and retailers, industry operators have consolidated during the five years to 2013, and this trend is forecast to continue through 2018. The top three companies will account for an increasing share of total revenue as they acquire smaller operators. Consolidation is necessary in order to maintain profitability by spreading fixed costs over a larger sales base and by increasing their negotiating power with both retailers and manufacturers.

Some of the industry’s product segments have already reached maturity, such as cosmetics and toiletries. These markets are nearing saturation, despite efforts by manufacturers to introduce new or revised products. This trend is also restraining industry revenue growth; however, it is partly offset by the rapid introduction of new medicines in the pharmaceutical product segment, including higher-priced biologic pharmaceuticals. An aging population has also encouraged industry revenue growth in recent years, and it will continue to do so in the next five-year period.
## KEY BUYING INDUSTRIES

**44512**  
**Convenience Stores in the US**  
Supermarkets and convenience stores demand OTC drugs and other products supplied by drug, cosmetic and toiletry wholesalers.

**44611**  
**Pharmacies & Drug Stores in the US**  
Pharmacies and drug stores purchase a wide range of medications, medicinal supplies, cosmetics and toiletry products from wholesalers.

**44612**  
**Beauty, Cosmetics & Fragrance Stores in the US**  
These retailers sell a wide range of cosmetics, hair preparations and toiletry products that are supplied by wholesalers.

**44619**  
**Health Stores in the US**  
Health stores sell a wide range of vitamin supplements and natural cosmetic and toiletry products.

**45211**  
**Department Stores in the US**  
Wholesalers supply a variety of products to department stores, including cosmetics, perfumes, soaps and toiletries.

**45291**  
**Warehouse Clubs & Supercenters in the US**  
Warehouse clubs and supercenters, such as Walmart and Target, retail a variety of products, including prescription and non-prescription drugs.

**62111a**  
**Primary Care Doctors in the US**  
Primary care doctors demand medical-related products from wholesalers in the industry.

**62111b**  
**Specialist Doctors in the US**  
Wholesalers in the industry supply specialist doctors with a range of medical-related products.

**62211**  
**Hospitals in the US**  
Hospitals demand medical supplies, endocrine substances and blood plasma from wholesalers in the industry.

## KEY SELLING INDUSTRIES

**32541a**  
**Brand Name Pharmaceutical Manufacturing in the US**  
Brand name pharmaceutical manufacturers supply pharmaceutical products to wholesalers.

**32541b**  
**Generic Pharmaceutical Manufacturing in the US**  
Generic pharmaceutical manufacturers supply pharmaceutical products to wholesalers.

**32561**  
**Soap & Cleaning Compound Manufacturing in the US**  
Soap and cleaning compound manufacturers supply soaps and toothpastes to wholesalers.

**32562**  
**Cosmetic & Beauty Products Manufacturing in the US**  
Cosmetic and beauty products manufacturers supply products such as perfumes, cosmetics, hair preparations, face and body creams and shaving preparations to wholesalers.

**33911a**  
**Medical Instrument & Supply Manufacturing in the US**  
Medical instrument and supply manufacturers supply first aid and other medical products to wholesalers.
Products & Markets

Products & Services

The Drug, Cosmetic and Toiletry Wholesaling industry distributes a range of products and services, with prescription and over-the-counter (OTC) medications making up a majority of revenue. Indeed, these two product groups total about 77.0% and 2.3% of industry sales, respectively.

**Brand-name and generic drugs**

A prescription drug is a licensed medicine that requires written instructions from a physician or other medical practitioner to a pharmacist before a consumer can purchase it. In contrast, over the counter (OTC) drugs can be obtained without a prescription. In the United States, the Federal Food, Drug and Cosmetic Act defines what drugs require a prescription. As a general rule, OTC drugs treat conditions that do not necessarily require care from healthcare professionals and have been proven to meet higher safety standards for self-medication by patients. Often, a lower strength of a prescription drug will be approved for OTC use. For example, ibuprofen has been widely available as an OTC painkiller since the mid-1980s, but it is still available by prescription in doses that are up to four times the OTC dose for use in cases of severe pain.

Sales of prescription drugs account for an estimated 67.0% of industry revenue and, as a percentage of total industry sales, have increased in the five years to 2013. Growth in this product segment is attributable to the implementation of Medicare Part D (which adds prescription drugs to Medicare coverage), strong growth in several therapeutic classes and increased use of specialty drugs. While brand-name drugs account for an estimated 49.0% of industry revenue, generic drugs have increased their share within the prescription drugs product segment at the expense of branded drugs. IBISWorld estimates that generic drug sales will account for just over one third of total wholesale prescription drug sales by dollar value in 2013. Generics are estimated to account for 80.0% of prescriptions filled across all retail channels in 2013, up dramatically from 30.0% in 1990, according to mail-order pharmacy Prescription Solutions. This number is estimated to increase over the next five years as a large number of patents for widely used brand name drugs are set to expire, leading to competition from suppliers of generic drugs. Generic drugs are typically 30.0% to 80.0% less expensive than their branded equivalents, driving volume
growth against branded drugs. Since generic drugs have a lower price point, increasing use of them pressures revenue downward.

Specialty drugs
Specialty medications are high-cost and more complex prescription drug therapies (e.g. self-injectable drugs and biologics). Specialty drug spending is increasing significantly faster than traditional drug spending and has become the primary driver for increased growth, even though specialty drugs still represent less than 20.0% of overall prescriptions. A higher percentage of consumers aged 64 years and older are specialty drug users, with a higher average cost per prescription. Since the US population is aging, pharmaceutical wholesalers are progressively focusing on specialty drug distribution. Specialty drugs within the multiple sclerosis, anticoagulant (e.g. Lovenox) and rheumatoid arthritis categories primarily drive specialty drug use and costs for the older age group. Specialty drugs account for about 10.0% of industry revenue in 2013.

Non-prescription (OTC) medications
Sales of OTC medications, specifically cough and flu medicines, posted respectable gains for wholesalers from 2008 through 2013. Although OTC medications still represent an ancillary product-line for wholesalers, the recession led to increased demand for OTC as it became more common for employees to go to work while suffering from upper respiratory illnesses. According to 2009 survey by market researcher BIGresearch, employed Americans more frequently buy cough-cold and flu medication. Similarly, the recession has caused many consumers to lose their prescription drug coverage as the unemployment rate increased. In 2013, OTC medications are expected to account for about 2.3% of industry revenue.

Cosmetics and toiletries
In response to lowering profit margins on prescription drugs, pharmacies and drugstores have increasingly offered more high-margin products, including cosmetics and toiletries, which now account for an estimated 12.0% of revenue. Cosmetics are substances used to enhance the appearance or odor of the human body. This product category includes items such as skin care creams, lotions, powders, perfumes, lipsticks, nail polish, eye and facial makeup, hair colors and hair sprays and gels. Toiletries include items used for personal hygiene or grooming, such as toothpaste, shampoo and body soap. Cosmetics and toiletries are more sensitive to fluctuations in economic conditions, so their relative portions of industry revenue change in line with discretionary consumer spending patterns. The strong demand is due to the rise in ethical purchasing and the “mainstreaming” of natural products and products labeled “organic.”

Vitamins and nutritional supplements
Vitamins and nutritional supplements are estimated to account for a modest 2.3% of industry revenue. However, as demand in the natural and organic market increases, so too will the demand for health supplements and vitamins, many of which are marketed to consumers as organic products. This trend, coupled with increasingly health conscious consumers, is expected drive sales in this segment going forward.

Auxiliary services
Wholesale distributors provide a growing number of specialized services to increase their value to both manufacturers and retailers; these services are expected to account for about 6.4% of revenue in 2013. Services include specialty drug distribution, drug repackaging, electronic order services, and reimbursement.
Products & Markets

**Products & Services continued**

Support and drug buy-back programs. Drug buy-back programs are offered by manufacturers and are facilitated by wholesale distributors. Buy-back programs aim to minimize the financial risk that pharmacies must assume in stocking products by allowing them to sell unused products or products with near-term expiration dates back to the manufacturer.

**Demand Determinants**

Demand is directly related to expenditure patterns in the healthcare and social assistance sector. The sector includes physicians, dentists, optometrists, mental health and substance abuse centers, medical and diagnostic laboratories, ambulance services, general and surgical hospitals, and nursing and residential care facilities. For example, doctors and specialists operating in these industries prescribe drugs and diagnostic tests and surgeons and other specialists select procedures, prostheses and devices.

Factors that affect demand for the healthcare industries include government health programs and related expenditure. In recent years, programs such as Medicare and Medicaid, along with private healthcare insurance and managed care plans, have attempted to control costs by limiting the reimbursement paid for a particular drug, procedure or treatment. This factor has increased price sensitivity among customers for products distributed by wholesalers. Similarly, changes in domestic and international regulations, including more vigorous compliance and enforcement activities by government agencies, may delay or prevent the approval of certain products, influencing sales at the wholesale level. On the other hand, government healthcare reform via the Patient Protection and Affordable Care Act, if implemented, is expected to increase demand by opening the market to more than 30 million previously uninsured consumers.

At the same time, a number of other variables have influenced the product portfolios of drug wholesalers. For example, the aging American population and the trend toward more consumer-oriented healthcare products and devices is increasing demand for the pharmaceutical and medical equipment and supply industries. As a result, these industries are developing technologies and products that enable patients to take a more active role in their own healthcare.

As conditions such as heart disease, cancer, AIDS and hepatitis increase, the demand for specialized drugs, instrumentation and consumables also increases. This demand is derived from the health of the population and the methods employed by medical professionals to treat disease, illness and injury. Product development by manufacturers and their marketing practices may also influence demand. Manufacturers are spending more on developing and marketing new products in an attempt to boost demand and product scope in an otherwise mature and saturated marketplace.

**Major Markets**

About 85% of prescription medicines sold in the United States are stored, managed and delivered by drug wholesalers on the way from manufacturers to healthcare settings. Wholesalers then distribute relevant products to various downstream healthcare providers, including hospitals, clinics, retail pharmacies and mail-order companies. In some instances, manufacturers bypass wholesalers and...
deal directly with downstream end users like pharmacies, chain stores and mail-order companies. Supermarkets and supercenters represent the bulk of the demand for cosmetics and toiletries from industry wholesalers.

**Warehouse clubs and supercenters**
Warehouse stores, such as Walmart, Target and Costco, are the largest markets for the goods that industry wholesalers provide. Walmart has significantly changed the retail landscape for pharmaceuticals with its $4 generic prescription drug program. Walmart has also altered the environment for cosmetics and toiletries by offering a wide selection of products at notably low prices. The growth of warehouse stores threatens sales in the wholesale industry, because large retailers often have the resources to negotiate, purchase and manage sales directly with manufacturers. Warehouse clubs and super centers are estimated to account for 25.0% of industry revenue in 2013, a slight increase compared to 2008.

**Retail pharmacies**
Retail pharmacies buy medicines from drug wholesalers and sell them directly to customers. As larger chains continue to rapidly expand their retail pharmacies, product demand in this sector is expected to increase. Chain drug stores, such as Walgreens and CVS, are pushing back against Walmart’s growing dominance in drugs, cosmetics and toiletries. During the five years to 2013, pharmacies and drug stores increased their range of discretionary products. These companies have also increased their range of healthcare services (e.g. in-store clinics) in an attempt to gain market share. Retail pharmacies account for an estimated 17.5% of industry revenue.

**Hospitals**
Hospitals process the majority of all prescriptions and offer patient care services, such as the administration of vaccines. Demand from hospitals remains relatively steady due to the essential nature of the services they provide. It is more cost effective for hospitals to source a majority of goods needed from a single wholesaler, rather than negotiating prices and deliveries with multiple providers. Hospitals account for an estimated 17.0% of all industry revenue.

**Clinics**
Clinics are healthcare facilities primarily devoted to the care of outpatients and
Major Markets continued

typically cater to the healthcare needs of local residents in a community. Throughout the economic downturn, local clinics have been struggling to meet rising demand. As discretionary income decreased, consumers turned to local clinics, many of which offer services for free, for their healthcare needs. Demand is forecast to increase further as the Patient Protection and Affordable Care Act expands insurance coverage to over 30 million Americans. Clinics’ share of industry demand has remained little changed since 2008 and accounts for an estimated 11.5% of industry revenue in 2013.

Mail-order retailers
Mail-order companies, particularly pharmacies, are the fastest-growing provider of prescriptions to the US insured population. Demand is expected to increase in mail-order pharmacies, which boast higher efficiency than pharmacies in other practice settings due to the use of highly automated equipment to process and prepare prescriptions and large discounts attained when buying in bulk. Mail-order retailers are increasingly negotiating directly with manufacturers which reduces industry revenue.

Food stores and supermarkets
Food stores and supermarkets provide consumers with toiletries, cosmetics, and OTC medicines. Smaller stores have very little bargaining power and represent a steady demand for industry wholesalers. Bigger chain supermarkets, however, increasingly feature in-house retail pharmacies, and are able to pressure prices at the wholesale level as they increase in size and scope. These stores are similar to warehouse and supercenters in their ability to negotiate prices since they purchase in bulk; however, they tailor services to consumers’ individual purchasing needs instead of their bulk needs. This segment accounts for an estimated 4.5% of industry revenue in 2013, a figure that has remained relatively constant over the past five years.

International Trade
Many of the products distributed by this industry are sourced from foreign suppliers. International trade of drugs, cosmetics and toiletries is accounted for under the relevant upstream manufacturing industries: Pharmaceutical and Medicine Manufacturing (32541); Medical Equipment and Supply Manufacturing (33911); Soap and Cleaning Compound Manufacturing (32561); and Cosmetic and Beauty Products Manufacturing (32562).
Products & Markets

Business Locations 2013

Additional States (as marked on map)

Revenue (%)

- Less than 3%
- 3% to less than 10%
- 10% to less than 20%
- 20% or more

SOURCE: WWW.IBISWORLD.COM
The location of drug, cosmetic and toiletry wholesalers largely reflects the nation’s population distribution. Business activity is concentrated in the West (which accounts for 22.7% of establishments and 13.8% of revenue), the Southeast (21.6% of establishments and 21.2% revenue) and the Mid-Atlantic (22.4% of establishments and 28.4% of revenue). By state, California, New York, Texas, New Jersey and Florida account for a relatively large number of establishments, employment and sales receipts in the industry.

California is the most populous state, followed by Texas and New York. The population of those aged 65 years and older also makes up at least 10.0% of these states’ populations. Other key states with a high proportion of seniors include Florida, West Virginia and Pennsylvania. Wholesalers remain close to these markets, since older populations are major markets for goods sold at pharmacies and drugstores.

Industry operators also locate in areas that are well supported by infrastructure and close to downstream markets for convenience. Other factors that affect location include proximity to medical supply and pharmaceutical manufacturers, which are also concentrated in the West, Mid-Atlantic and Southeast regions.
The Drug, Cosmetic and Toiletry Wholesaling industry has a medium level of concentration. This concentration has increased significantly over the past decade following a wave of consolidation. Cardinal Health Inc., McKesson Corporation and AmerisourceBergen Corporation, which have benefited from this trend, are driving further changes in the market. Popularly known as the “Big Three,” these companies account for an estimated 44.3% of industry revenue in 2013. The top four companies account for an estimated 44.9% of total revenue in 2013 (up from 40.3% in 2008), which illustrates the major drop off in market share between the third and fourth largest players. In addition to being the major customers for manufacturers, the Big Three are in a powerful position to control delivery to pharmacies and other outlets. This dominance has come to the attention of regulators, especially because pharmaceutical pricing is a politically sensitive topic.

Despite their dominance, the Big Three continue to look for further acquisitions, and market conditions favor a trend toward greater consolidation.

During the five years to 2013, the number of industry operators is expected to decrease 0.5% per year on average to 8,753. New regulations have restricted the activities of smaller distributors and may make them easier targets for the Big Three in the years ahead. Specifically, the pedigree requirement of the Prescription Drug Marketing Act (PDMA) has been detrimental to smaller distributors. The PDMA necessitates that all prescription pharmaceutical transactions be accompanied by the appropriate paperwork, going to the authorized distributor or to the manufacturer. According to PDMA’s provisions, manufacturers and authorized distributors do not need a pedigree. To qualify as an authorized distributor, a distributor must have an ongoing relationship with a manufacturer based on regulation from the US Food and Drug Administration (FDA). Because of their business volume, this requirement is more attainable for the Big Three than for smaller competitors.

For more information on Medicare and Medicaid reforms and regulations, see the Regulation and Policy section.
Competitive Landscape

Key Success Factors continued

Ability to control stock on hand
Computerized stock controls allow for up-to-date monitoring and inventory analysis. These systems are used to service clients by advising them about stock levels and expected delivery schedules.

Cost Structure

Profit
The Drug, Cosmetic and Toiletry Wholesaling industry is characterized by thin profit margins (currently at 4.2% of revenue). Product margins on brand-name pharmaceuticals are razor-thin for wholesalers, usually below 2.0% of revenue. Wholesalers enjoy higher margins for generic and specialty drugs, meaning the industry’s enterprises have benefited from patent expiration of brand name drugs over the past five years. Cardinal Health, in particular, has seen its operating margin grow as its generics distribution business has expanded over the past five years. As the patents of major drugs continue to expire over the five years to 2018, new generics will flood the market and are expected to help boost profit margins of wholesalers in the industry.

In contrast, reduced reimbursement levels have negatively affected profitability during the five years to 2013. Increasing healthcare costs have triggered various legal and regulatory measures to contain them. Reduced reimbursement has affected healthcare providers’ purchasing patterns, which has negatively influenced the industry’s profit margin. Operators are consolidating in order to maintain profitability. Firms can incur lower costs through scale, which spreads fixed costs

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Sector vs. Industry Costs

Average Costs of all Industries in sector (2013) vs. Industry Costs (2013)

<table>
<thead>
<tr>
<th>Percentage of revenue</th>
<th>Profit</th>
<th>Wages</th>
<th>Purchases</th>
<th>Depreciation</th>
<th>Marketing</th>
<th>Rent &amp; Utilities</th>
<th>Other</th>
</tr>
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<tbody>
<tr>
<td>100</td>
<td>3.9</td>
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<td>1.4</td>
<td>3.1</td>
<td>1.5</td>
<td></td>
</tr>
</tbody>
</table>

SOURCE: WWW.IBISWORLD.COM
The Drug, Cosmetic and Toiletry Wholesaling industry is highly competitive, and intensity has increased in recent years. Three major national wholesale distributors operate in the industry (Cardinal Health, McKesson and AmerisourceBergen) along with a number of smaller regional wholesale distributors, direct-selling manufacturers, specialty distributors and third-party logistics companies and self-warehousing chains. Industry wholesalers tend to have narrow profit margins, so success depends on a company’s ability to distribute a large volume and variety of products efficiently and to provide quality support services to external customers.

Key competitive advantages include the ability to compete effectively on price; distributing a large volume and variety of products; providing quality support services; maintaining low-cost sourcing arrangements with pharmaceutical manufacturers; and effectively managing inventory and other working capital items.

Purchases
Purchases make up the largest cost segment for the industry, which is typical of most wholesalers. IBISWorld estimates that purchases account for about 83.5% of industry revenue. The cost of products has increased during the five years to 2013 because of the accelerating pace of new product introductions. However, this trend has been partly offset by increased demand for generic products, which are relatively cheap compared with their brand-name counterparts. Larger businesses have lower purchasing costs and are better able to move their stock of inventory from areas of weak market and product demand to areas with higher demand. Over the five years to 2013, the cost of goods sold is expected to decrease as many drugs come off of patent and wholesalers consolidate, leading to stronger negotiating power.

Wages
Wage and salary costs fluctuate with revenue and employment. Most wage and salary costs are incurred in the areas of sales and sales support; over half of the industry’s employees are engaged in sales support. In comparison, roughly 30.0% of employees are salespeople. Overall, wages in 2013 are estimated to represent 4.2% of revenue. The cost of labor for logistics and storage is expected to continue to decrease over the next five years due to increasing use of technology for similar functions.

Other costs
Other costs include general office expenses, advertising and promotional costs, and shipping and handling costs. Advertising expense amounts to 1.5% of net sales revenue. Most participants incur minimal marketing expenses and devote more resources to developing existing arrangements with suppliers and customers to sell and distribute products. Given the small degree of capital expenditure in the industry, depreciation accounts for a small proportion of revenue.

Cost Structure

Basis of Competition

Competitive Landscape
Competitive Landscape

Basis of Competition continued

Auxiliary services
Wholesalers are increasingly expected to provide supplementary services to retailers. This trend is escalating in importance as pharmacies and drugstores grow in size and become better able to purchase from and negotiate directly with manufacturers. The range of value-added services includes marketing, management, training and merchandising. In recent years, these services have extended to include manufacturing, packaging, contract sales and drug testing.

Diversified product mix
Wholesalers offer a variety of products, including prescription medicines, over-the-counter drugs, cosmetics and toiletries. Within the product category of prescription drugs, competition is mounting in the generic and specialty drug space. Generics offer consumers more affordable options versus the brand-name counterpart; consequently, more wholesalers are entering the market. Specialty drugs are made up of complex molecules and include bioengineered proteins and blood derivatives. They target and treat specific complex conditions or illnesses such as cancer, rheumatoid arthritis, multiple sclerosis, hepatitis C and HIV/AIDS. Since specialty drugs often target illnesses associated with age and given the aging US population, more operators are competing in the specialty drug space.

Operators with a wider variety of products in various categories are more competitive. Many prescription drugs have low margins, so companies that also supply cosmetics and toiletries can augment sales and profit. Diversified product portfolios also reduce a company’s exposure to fluctuations in demand for any product and increase the wholesaler’s value to the retailer.

The price is right
Price competition is increasing due to the entry of large retailers such as Walmart into domains that were traditionally dominated by wholesalers. Also, commoditization, or the move toward lack of differentiation of generic drugs, is causing price competition to rise.

Wholesalers face different markets for branded and generic drugs. They can only purchase branded drugs from a single manufacturer, while they can purchase most generic drugs from many manufacturers. As a result, they create price competition among various generic manufacturers of a particular drug. Large retail chains also buy directly from generic manufacturers, pitting one generic manufacturer against others to obtain the lowest price. As a result, gross profit margins for wholesalers and large retail chains are larger for generic than branded drugs.

It’s who you know
Relationships with drug stores and other downstream retail outlets are also a key source of competitive advantage. Given the industry’s increasingly competitive nature at the distribution and retail levels, relationships have grown in importance in recent years.

Similarly, relationships with upstream manufacturers have also become more significant. Collaborative relationships are increasing as wholesalers seek to take on a greater role within the pharmaceutical supply chain. This factor has led to the adoption of new business models such as fee-for-service arrangements.

External competition
While wholesalers are partnering with manufacturers, the industry also competes with manufacturers that are adopting new direct-to-pharmacy models to gain greater control over the supply
Competitive Landscape

Barriers to Entry

Barriers to entry in the industry are high. Profit margins are meager, and extensive distribution networks and customer relationships are required. Potential new companies must invest in buildings and other structures and information technology (IT) systems to establish warehouse and distribution systems to compete against large existing players.

Established, vertically integrated operators that also operate at the manufacturing or retail level of the supply chain also impose a significant entry barrier. For example, Cardinal Health, one of the largest industry companies, also operates the Medicine Shoppe International retail pharmacy franchise and manufactures medical and surgical products. Incumbent firms are also in a better position to escalate advertising expenditure when new companies enter the industry.

In most segments, customers are much more aware of the brand name of key components. To a certain extent, this factor gives manufacturers greater bargaining power in selling to firms that target more experienced buyers. In most cases, wholesale operators are required to obtain licenses and accreditation from state and federal agencies. For example, wholesalers in California must have a license to operate.

Basis of Competition continued

chain. Manufacturers manage the actual distribution of drugs from manufacturing facilities to drug wholesalers and, in some cases, directly to retail pharmacy chains, mail-order and specialty pharmacies, hospital chains and some health plans. Manufacturers may also distribute products directly to government purchasers, such as the Veterans Administration, AIDS Drug Assistance Programs and Vaccines for Children, which typically receive the largest price discounts. In rare cases, a manufacturer may distribute drugs directly to a self-insured employer with an on-site pharmacy, but the typical employer-sponsored plan does not follow this path. Very few drugs are distributed directly to consumers. In contrast to the United Kingdom, a direct-to-pharmacy model is not growing in the United States. Pharmaceutical manufacturers are finding the investment too costly. However, manufacturers and retailers are acquiring wholesalers.

Barriers to Entry checklist

<table>
<thead>
<tr>
<th>Barriers to Entry</th>
<th>Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competition</td>
<td>High</td>
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<tr>
<td>Concentration</td>
<td>Medium</td>
</tr>
<tr>
<td>Life Cycle Stage</td>
<td>Decline</td>
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<tr>
<td>Capital Intensity</td>
<td>Medium</td>
</tr>
<tr>
<td>Technology Change</td>
<td>Medium</td>
</tr>
<tr>
<td>Regulation &amp; Policy</td>
<td>Heavy</td>
</tr>
<tr>
<td>Industry Assistance</td>
<td>Low</td>
</tr>
</tbody>
</table>

SOURCE: WWW.IBISWORLD.COM
The Drug, Cosmetic and Toiletry Wholesaling industry has a medium level of globalization, in line with the pharmaceutical manufacturing industry. In recent years, the trend toward globalization has become more pronounced throughout the entire pharmaceutical supply chain, including the distribution level.

At the manufacturing level, the pharmaceutical product manufacturing industry is one of the world’s largest manufacturing industries. It is characterized by a broad geographical distribution of final production and marketing operations, high foreign penetration in national markets and extensive intra-firm trade. A number of factors contribute to the industry’s highly globalized nature, including minimal technical barriers in final drug formulation, the need to meet variations in the evaluation process and government regulations for admission of drugs onto the local market, and the highly segmented nature of individual markets as a result of national health and price regulations.

A number of wholesalers (including Cardinal Health and McKesson) have operations overseas, and industry participants will likely continue to expand their global operations in the future. In 2010, Cardinal Health completed the acquisition of Yong Yu, a leading healthcare distributor in China. The acquisition points to the increasing confidence that major players have in the industry’s global growth opportunities. The move by upstream manufacturers to outsource their manufacturing operations to contract manufacturing organizations (CMOs) located in lower-cost Asian countries (including India and China) will also further industry globalization.
McKesson Corporation is a San Francisco-based wholesaler of pharmaceuticals, beauty products, healthcare products and medical supplies to retail and institutional pharmacies and alternate healthcare sites across the United States and Canada. McKesson has over 40,000 employees and is the biggest wholesaler of its kind in the United States, earning $122.5 billion globally in the year ended March 31, 2013.

Following a recent restructuring, the company now operates in two segments. Relevant to the Drug, Cosmetic and Toiletry Wholesaling industry, the McKesson distribution solutions segment distributes prescription and proprietary drugs, medical-surgical supplies and equipment, and health and beauty care products. The company derived 97.0% of its annual revenue from this segment in fiscal 2013. McKesson’s other main business segment, technology solutions, provides enterprise-wide services such as clinical, financial and managed care to healthcare organizations in North America, Israel, the United Kingdom, Ireland and other European countries.

According to McKesson, the company distributes one-third of the medicines used in North America, supplying more than 40,000 US healthcare locations from Walmart to community pharmacies. The company serves all 50 states and Puerto Rico through a network of 28 distribution centers. McKesson has partnerships with companies such as Community Health Systems, Aetna, Blue Cross and Blue Shield of Massachusetts, Proventys, the Clorox Company and ProMedica Health Systems.

Over the past five years, McKesson entered into the biologics distribution market, which provided it with diversification in its core pharmaceutical product distribution business. The company established the McKesson Plasma and Biologics unit in April 2009 to distribute plasma and biologics products directly from manufacturers to customers. Plasma and recombinant derivatives (products manufactured from human plasma), coagulation (clotting) biotherapies and biologics are costlier than other pharmaceutical products and can pose challenges to customers. Therefore, the biologic distribution has been a value-added service through which the company can charge premium rates. This factor has provided McKesson with a higher overall profit margin. Moreover, with most of the blockbuster drugs facing generic competition, biologics that are less susceptible to generic conversion are expected to bring in more profit.

**Financial performance**

Over the five years to fiscal 2013, McKesson’s US distribution segment revenue grew at an average annual 3.7% to $105.5 billion. Strong growth in 2012 was primarily due to growing drug use and price increases. Nonetheless, overall growth was constrained by lower average selling prices associated with providers and patients shifting from brand name to generic drugs. Over the past five years, a large portion of McKesson’s revenue...
growth has been dedicated to a small number of large customers. According to the company, McKesson’s ten largest customers accounted for over 50.0% of its revenue (CVS Caremark Corporation being the largest, with about 17.0% of total consolidated revenue). McKesson’s operating margin improved slightly over the five year period due to an increase in sales of higher-margin generic drugs and the December 2010 purchase of US Oncology Holdings, Inc.

### McKesson Corporation (US distribution segment) – financial performance

<table>
<thead>
<tr>
<th>Year*</th>
<th>Revenue ($ million)</th>
<th>(% change)</th>
<th>Operating Income ($ million)</th>
<th>(% change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>88,104.0</td>
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<td>2008-09</td>
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<td>2009-10</td>
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<td>2011-12</td>
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<td>2012-13</td>
<td>105,462.0</td>
<td>-0.5</td>
<td>1,946.2</td>
<td>-1.2</td>
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</tbody>
</table>

*Year-end March  

**SOURCE:** ANNUAL REPORT

Cardinal Health is a global healthcare services company that provides products and services to hospitals, physician offices and pharmacies. Founded in 1971 and headquartered in Dublin, Ohio, the company has over 30,000 employees, of which roughly one third are based outside of the United States. In fiscal 2012, Cardinal Health earned $107.6 billion in revenue, making it one of the largest distributors of pharmaceuticals and medical supplies in the country. The company currently distributes about one-third of all pharmaceuticals prescribed in the United States.

Cardinal has two segments: pharmaceutical, which accounts for more than 90.0% of revenue and covers the company’s pharmaceutical wholesaling activities; and medical, under which the company distributes medical products to pharmacies, hospitals and doctors. The pharmaceutical distribution segment is a full-service wholesale distributor to retail customers (including chain and independent drugstores and the pharmacy departments of supermarkets and mass merchandisers), hospitals and alternate care providers (including mail-order pharmacies) located throughout the United States and Puerto Rico. The segment also helps pharmaceutical manufacturers with services like distribution, inventory management, data reporting, new product launch support and contract administration.

Despite its size, Cardinal has considerable customer concentration with CVS Caremark and Walgreens, which represented 22.0% and 21.0%, respectively, of Cardinal’s distribution business in 2012. In a major setback for the company, Walgreens announced in early 2013 that it would not renew its $22.0 billion-a-year contract with Cardinal to supply more than 8,000 pharmacies across the United States. Instead, Walgreens awarded a 10-year supply contract to Cardinal’s competitor...
AmerisourceBerkern. While the loss of this contract will not affect Cardinal’s revenue in fiscal 2013, the company’s revenue is expected to fall heavily from 2014 onward. This follows the loss of the $9.0 billion annual contract to supply Express Script in 2012. The loss of these contracts is expected to further hasten Cardinal’s drive toward diversification as it targets smaller, independent pharmacies and seeks to build the medical segment of its business. Fortunately for the company, its lucrative $23.0 billion contract with CVS Caremark had been extended through mid-2016.

**Financial performance**

Over the five years to fiscal 2013, revenue for Cardinal’s US distribution segment is expected to grow at an average annual rate of 2.7% to $90.9 billion. While Cardinal’s revenue grew in every year from 2008 to 2012, its revenue in fiscal 2013 is expected to drop significantly due to the loss of the Express Script contract. Despite underperforming its competitors in terms of revenue growth over the past five years, Cardinal’s profit margin is expected to climb considerably over the period, due mainly to greater sales of generic drugs. Most branded drugs (including some branded generics) generate considerably lower gross margins for wholesalers because they are forced to purchase the product from one manufacturer, leaving little bargaining opportunity.

### Cardinal Health Inc. (US distribution segment) – financial performance

<table>
<thead>
<tr>
<th>Year*</th>
<th>Revenue ($ million)</th>
<th>(% change)</th>
<th>Operating Income ($ million)</th>
<th>(% change)</th>
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<td>90,903.1</td>
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*Year-end June ** Estimate

**Source:** Annual Report and IBISWorld
Major Companies

Player Performance
continued

includes the operations of AmerisourceBergen Drug Corporation (ABDC), AmerisourceBergen Specialty Group (ABSG), Bellco Health and AmerisourceBergen Packaging Group (ABPG). ABDC includes the company’s full-service wholesale pharmaceutical distribution facilities and other healthcare-related businesses. ABDC also provides pharmacy management, consulting services and scalable automated pharmacy dispensing equipment, medication and supply dispensing cabinets and supply management software to a variety of retail and institutional healthcare providers. ABSG distributes specialty pharmaceutical products (e.g. vaccines, other injectables, plasma and other blood products) and provides supplementary services. Specialty drugs account for about one-fifth of the company’s total revenue. The segment’s customers include physicians, clinics, patients and other providers in the oncology, nephrology, plasma and vaccine sectors. This business also provides commercialization services, third-party logistics, reimbursement consulting services, physician education consulting and other services to biotech and other pharmaceutical manufacturers.

ABC has recently won two significant contracts which are expected to result in substantial revenue gains over the coming years. Due to the 2012 merger of ABC’s largest customer, Medco Health Solutions Inc., with Express Scripts, ABC won a new $18.5 billion three-year contract to supply Express Scripts from October 2012. The company also announced a deal with Walgreens in early 2013 to supply the retailer with over $20.0 billion in generic pharmaceuticals from September 2013. This long-term contract gives Walgreens the right to purchase equity in ABC, increasing the mutual benefits of both companies.

Financial performance

AmerisourceBergen’s industry-related revenue grew at an average annual rate of 3.2% over the five years to fiscal 2013 to reach $80.8 billion. ABC’s significant presence in the biologics and specialty pharmaceutical distribution market has been a key sales driver over the past five years. ABC’s generics business continues to perform well, with the company benefiting from the rapid growth in this market.

AmerisourceBergen Corporation (US distribution segment) – financial performance**

<table>
<thead>
<tr>
<th>Year*</th>
<th>Revenue ($ million)</th>
<th>(% change)</th>
<th>Operating Income ($ million)</th>
<th>(% change)</th>
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<td>2010-11</td>
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<td>80,810.2</td>
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<td>1,178.2</td>
<td>-2.5</td>
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*Year-end September; **Estimate

SOURCE: ANNUAL REPORT
Major Companies

Player Performance continued

growth of generic pharmaceuticals in the US market. For the same reasons, ABC’s operating margin grew slightly over the five year period. With several branded products scheduled to lose exclusivity over the next five years, ABC’s generics business is expected to continue to grow.

Other Companies

Morris and Dickson Co.
Estimated market share: Less than 1.0%
Morris and Dickson Co. is a family-run pharmaceuticals wholesaler headquartered in Shreveport Louisiana. The company was founded in 1841 and is one of the largest privately-owned pharmaceuticals wholesalers in the United States. Morris and Dickson distributes primarily to independent hospitals and pharmacies and provides customers with an IT platform that allows them to make and track orders electronically. The company is expected to earn revenue of $3.7 billion in 2013.

Quality King Distributors Inc.
Estimated market share: Less than 1.0%
Quality King Distributors Inc. is a privately held wholesaler of pharmaceuticals and health and beauty care products to pharmacy and grocery chains throughout the United States. Quality King was formed in 1961 and is based in Ronkonkoma, New York. The company’s QK Healthcare subsidiary is involved in pharmaceutical distribution. Quality King Distributors’ business practice is to buy US brand-name products that have been exported to overseas markets and then reimport them to the US market at below-market prices. Company revenue in 2013 is expected to hit $3.0 billion.

The Harvard Drug Group LLC
Estimated market share: Less than 1.0%
The Harvard Drug Group distributes generic-focused pharmaceuticals, over-the-counter drugs, vitamins, supplements, medical supplies and compounding chemicals to 42,000 independent pharmacies, retail pharmacy chains, and buying groups. The company employs more than 100 sales representatives and is in partnership with about 35 different vendors. The firm also offers manufacturing services through its partnership with Canadian pharmaceutical manufacturer Apotex. Founded as Great Lakes Wholesale Drug in 1967, a steady regimen of acquisitions helped it transform into the Harvard Drug Group in 1997. Investment firm Court Square Capital Partners controls the company which is now based in Livonia, Michigan. The company’s 2013 revenue is expected to reach $360.0 million.
Operating Conditions

Capital Intensity | Technology & Systems | Revenue Volatility
Regulation & Policy | Industry Assistance

**Capital Intensity**

The Drug, Cosmetic and Toiletry Wholesaling industry has a moderate level of capital intensity. For every dollar spent on labor in the industry, an estimated $0.33 is spent on capital. Wages and associated labor expenses account for an estimated 4.2% of industry revenue while capital expenditures comprise 1.4%.

Capital expenditures include warehousing and logistics and computerized inventory systems. Wholesalers are increasingly adopting technology for applications in distribution and storage. Fully automated warehouse systems now encompass inventory control, the forward replenishment of products and automatic packing and shipping, allowing wholesalers to improve productivity and efficiency. Most advanced wholesalers also now allow customers to make and track orders.

**Tools of the Trade: Growth Strategies for Success**

- **New Age Economy**
  - Recreation, Personal Services, Health and Education. Firms benefit from personal wealth so stable macroeconomic conditions are imperative. Brand awareness and niche labor skills are key to product differentiation.

- **Investment Economy**
  - Information, Communications, Mining, Finance and Real Estate. To increase revenue firms need superior debt management, a stable macroeconomic environment and a sound investment plan.

- **Old Economy**
  - Agriculture and Manufacturing. Traded goods can be produced using cheap labor abroad. To expand firms must merge or acquire others to exploit economies of scale, or specialize in niche, high-value products.

- **Traditional Service Economy**
  - Wholesale and Retail. Reliant on labor rather than capital to sell goods. Functions cannot be outsourced therefore firms must use new technology or improve staff training to increase revenue growth.

- **Capital Intensive**
  - Drug, Cosmetic & Toiletry Wholesaling

- **Labor Intensive**
  - Convenience Stores, Pharmacies & Drug Stores

Change in Share of the Economy

Dotted line shows a high level of capital intensity

SOURCE: WWW.IBISWORLD.COM
Operating Conditions

Technology & Systems

Technology has grown in importance within the industry during the five years to 2013. Healthcare distributors are at the forefront of efforts to revolutionize the way pharmaceutical products are tracked through the distribution system, from the manufacturing plant to the provider. Companies need systems that address pricing, inventory, packaging and regulation. Pricing in the drug, cosmetic and toiletry distribution value chain is notably complex, particularly in the pharmaceutical product segment. There are often requirements for multiple price lists and contract pricing with a wide variety of discounting models including support for rebates, promotional discounts and bonuses.

Depending on the nature of the drugs being distributed, there may be very stringent conditions associated with the inventory storage and handling. Technological applications assist wholesalers in this function. For example, handling some biopharmaceuticals involves strict monitoring and reporting of chill chain parameters. Also, some products may be hazardous in nature or may require secure storage. In most cases, a combination of consignment stock and distributor-owned stock will be in each warehouse.

Technology also aids in packaging and shipping. The volume packaging at peak times can be extremely high. Most warehouses have automated packing systems for high-volume items, which are integrated with enterprise resource planning systems.

Regulatory compliance
The Food and Drug Administration (FDA) implemented the “pedigree provisions” of the Prescription Drugs Marketing Act (PDMA) in December 2006. The provisions require that firms implement radio frequency identification (RFID) technology, which uses radio-frequency electromagnetic fields to transfer data from a tag attached to an object. Among the technologies studied by the FDA, including bar coding, RFID seemed to be the most promising. Therefore, the committee felt that the pedigree requirement could be met by easily leveraging something that is readily available.

In addition to combating pharmaceutical counterfeiting and diversion, pharmaceutical wholesalers have benefited from the ability to examine their businesses and track the movement of prescription drugs with full transparency through the use of RFID. This trend has yielded added benefits of inventory optimization, demand forecasting and improved knowledge of what products are selling.

Technology trends
The main technological developments include electronic ordering systems such
Operating Conditions

Technology & Systems continued

as Supply Management On-Line, which allows industry products to be ordered over the internet. Programs such as Optipak allow customers to customize their supply orders. The internet has had a major influence on the cost efficiency of the wholesale distribution process, by providing an alternative method for wholesalers to provide services to customers. However, manufacturers can also use this technology to bypass the wholesale function.

The growing acceptance and use of the internet and other electronic commerce systems over the past decade continues to have far-reaching implications for the Drug, Cosmetic and Toiletry Wholesaling industry. In fact, information technology will likely continue to redefine the relationship between distributors, retailers and customers in the immediate future. Many of the industry’s major players have employed electronic ordering systems for internet use. Internet orders can be stored automatically in the company computer system, reducing manual entering errors, speeding the ordering process and providing a more efficient system. The internet also facilitates the sale of pharmacy items such as over-the-counter drugs and prescription medications. This phenomenon is already widespread in the United States and is expected to continue over the coming years.

Recent technological developments also includes the use of an electronic product code (EPC), which identifies individual items by serial number. That number is read and transmitted using RFID technology via a miniscule chip placed on individual product packaging. Chips can also be placed on pallets and cases for transportation and warehouse purposes. A combined EPC-RFID system efficiently tracks each product unit as it moves through the supply chain. Unlike the bar code, which requires line-of-sight for laser scanning, the EPC-RFID tag and reader combination is “activated” by a reader that broadcasts radio waves and receives the transmitted EPC number from the tag. The reader then provides the code to connected computer systems, similar to what barcode readers have done for 30 years. Now in its early stages, the new system is expected to be an important method to make the pharmaceutical supply chain more cost-effective and efficient and prevent product tampering and counterfeiting. While still relatively rare, incidents of tampering and product diversion are rising, and the counterfeiting of pharmaceutical products has become a growing problem.
Operating Conditions

Revenue Volatility

Given the essential nature of many pharmaceutical and medicine products supplied by this industry, year-to-year volatility tends to be low. In the five years to 2013, industry revenue volatility has averaged 2.2%. Over the period, revenue increased by as much as 2.1% in 2008 and is expected to decline 1.9% in 2013 (the heaviest fall over the past five years). An individual’s health concerns are not highly sensitive to short-term changes in the economic environment. However, some products that the industry distributes are more discretionary in nature, such as fragrances and cosmetics. The sale of these goods is affected by changes in disposable income and consumer sentiment.

The industry’s performance may also be affected by changing drug utilization and mix patterns, government healthcare policies and pricing pressures. For instance, the industry is currently adapting to the “patent cliff”, a situation where several brand-name pharmaceuticals have lost patent exclusivity and generic drug use has increased. Those companies with a higher concentration in generic medicines are experiencing an increase in demand; however, total revenue is not increasing due to the lower price of generics. Sales from generic pharmaceuticals are highest during the period immediately after the initial launch of a generic product because generic pharmaceutical selling prices often decline over time, particularly after the sixth month exclusivity period – granted solely to one generic – has expired.

Additionally, a portion of a company’s sales is often made to major pharmaceutical distributors and retail chains. Consequently, sales may be affected by fluctuations in buying patterns that result from seasonality, pricing, retail buying decisions and changes in overall demand. Due to the poor economic environment over the past five years, pharmacy chains are more tightly managing their inventory based on expectations of patient demand, which has led to greater purchasing volatility than in previous years.

A higher level of revenue volatility implies greater industry risk. Volatility can negatively affect long-term strategic decisions, such as the time frame for capital investment. When a firm makes poor investment decisions it may face underutilized capacity if demand suddenly falls, or capacity constraints if it rises quickly.

Volatility vs Growth

* Axis is in logarithmic scale

SOURCE: WWW.IBISWORLD.COM
The Drug, Cosmetic and Toiletry Wholesaling industry is highly regulated at both the federal and state level. Regulation covers the supply chain that wholesalers are involved in, as well as areas (such as healthcare policy) that influences the industry’s downstream demand.

**DEA and FDA**
The US Drug Enforcement Administration (DEA), the US Food and Drug Administration (FDA) and various state regulatory authorities regulate the purchase, storage and distribution of pharmaceutical products, including controlled substances. Relevant statutes include the Prescription Drug Marketing Act of 1987 and the Federal Controlled Substances Act. Wholesale distributors of controlled substances must hold valid DEA licenses, meet various security and operating standards and comply with regulations governing their sale, marketing, packaging, holding and distribution. The DEA, FDA and state regulatory authorities have broad enforcement powers, including the ability to suspend distribution centers from distributing controlled substances, seize or recall products and impose criminal, civil and administrative sanctions for violations of applicable laws and regulations.

**Fraud and abuse laws**
Industry operators are subject to fraud and abuse laws, including the federal anti-kickback statute and the Stark law. The anti-kickback statute and related regulations prohibit people from soliciting, offering, receiving or paying any remuneration for the sale of items or services that are in any way paid for by Medicare, Medicaid or other federal healthcare programs. The Stark law prohibits physicians from making referrals for designated health services reimbursable under Medicare or Medicaid to certain entities with which they have a financial relationship. Fraud and abuse laws and regulations are broad in scope and are subject to frequent modification and varied interpretation.

In recent years, some states have passed or proposed laws and regulations that aim to protect the safety of the pharmaceutical supply channel. These laws and regulations are designed to prevent the introduction of counterfeit, diverted, adulterated or mislabeled pharmaceuticals into the distribution system. For example, Florida has implemented pedigree requirements that require drugs to be accompanied by information that tracks the drugs back to the manufacturers; other states are in the process of implementing similar requirements. California has enacted a law requiring chain of custody technology using electronic pedigrees, though the effective date has been postponed until July 1, 2016 for pharmaceutical wholesalers and repackagers. These requirements and others are expected to increase the industry’s operation costs.

**Medicare and Medicaid**
The Medicare Prescription Drug Improvement and Modernization Act of 2003 (MMA) significantly expanded Medicare coverage for outpatient prescription drugs through the new Medicare Part D program. Beginning in 2006, Medicare beneficiaries became eligible to enroll in prescription drug plans that private entities offer and varying levels of coverage for prescription drugs. Beneficiaries who participate select from a range of stand-alone prescription drug plans or Medicare Advantage managed care plans that include prescription drug coverage along with other Medicare services (Part D Plans). The Part D Plans are required to make certain drugs available. Each Part D Plan negotiates reimbursement for Part D drugs with pharmaceutical
Operating Conditions

Regulation & Policy

The Part D Plan program has increased the use of pharmaceuticals in the supply channel, positively affecting industry revenue and profitability.

The Medicare Improvements for Patients and Providers Act of 2008 (MIPPA) established timeframes for Part D Plan payments to pharmacies and long-term care pharmacy submission of claims. It also required more frequent updating by Part D Plan sponsors of the drug pricing data they use to pay pharmacies. Additionally, it modified statutory provisions regarding coverage of certain “protected classes” of drugs, limited certain Part D sales and marketing activities, and made other Part D reforms.

Healthcare reform

The US healthcare environment is changing in many ways, particularly because of recent federal healthcare legislation. In March 2010, the Patient Protection and Affordable Care Act (PPACA) and the Healthcare and Education Reconciliation Act (collectively the “Healthcare Reform Acts”) were signed into law. Among other things, the Healthcare Reform Acts seek to expand health insurance coverage to about 32 million uninsured Americans by 2019. This provision will increase demand for pharmaceuticals as they become more affordable to more individuals. Many of the significant changes in the Healthcare Reform Acts do not take effect until 2014, including a requirement that most Americans carry health insurance. Other provisions of the Healthcare Reform Acts could adversely affect wholesalers. The industry will be indirectly affected by provisions that will affect pharmacies, especially for generic drugs. Pharmacies earn higher profit margin from uninsured and underinsured individuals, who do not have the negotiating power of large insurance companies. After the reform is fully implemented, consumers’ share of drug spending will drop, due to the subsidized exchange coverage and expanded Medicaid coverage. Additionally, pharmacies have been dealing with lower reimbursement limits on generic drugs. A considerable amount of wholesaler profit comes from generic drugs. Drug wholesalers may face margin pressure on generic drug sales, because pharmacies will be more price sensitive and require bigger discounts to remain competitive.

Industry Assistance

The Drug, Cosmetic and Toiletry Wholesaling industry receives a low level of industry assistance. Industry assistance by tariffs does not apply at the wholesaling level; rather, tariffs are accounted for at the manufacturing level. Participants do receive some assistance via industry associations. For instance, the Healthcare Distribution Management Association (HDMA) is a national association that represents healthcare distributors. HDMA facilitates an exchange of industry knowledge and best practices to enhance the value of the healthcare supply chain. The association also advocates for standards, public policies and business processes that produce safe, innovative and cost-effective healthcare solutions.

Level & Trend

The level of Industry Assistance is Low and the trend is Steady.
## Key Statistics

### Industry Data

<table>
<thead>
<tr>
<th>Revenue ($m)</th>
<th>Industry Value Added ($m)</th>
<th>Establishments</th>
<th>Enterprises</th>
<th>Employment</th>
<th>Exports</th>
<th>Imports</th>
<th>Wages ($m)</th>
<th>Domestic Demand</th>
<th>Number of Physicians (Million)</th>
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### Annual Change

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<th>Industry Value Added (% change)</th>
<th>Establishments (% change)</th>
<th>Enterprises (% change)</th>
<th>Employment (% change)</th>
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### Key Ratios

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<th>IVA/Revenue (%)</th>
<th>Imports/Demand (%)</th>
<th>Exports/Revenue (%)</th>
<th>Revenue per Employee ($'000)</th>
<th>Wages/Revenue (%)</th>
<th>Employees per Est.</th>
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### Figures are inflation-adjusted 2013 dollars. Rank refers to 2013 data.

SOURCE: WWW.IBISWORLD.COM
**Jargon & Glossary**

**Industry Jargon**

**BIOLOGICS** Type of specialty drug made from living organisms.

**DISINTERMEDIATION** The removal of intermediaries in a supply chain: “cutting out the middleman.”

**FEE-FOR-SERVICE (FFS)** A standard business model where services are unbundled and paid for separately.

**GENERIC DRUG** Drug that is not protected by any patents, but can act as a substitute for the original brand-name product.

**IMPORTS** Total value of industry goods and services brought in from foreign countries to be sold in the United States.

**EXPORTS** Total value of industry goods and services sold to customers abroad.

**ENTERPRISE** A division that is separately managed and keeps management accounts. Each enterprise consists of one or more establishments that are under common ownership or control.

**ESTABLISHMENT** The smallest type of accounting unit within an enterprise, an establishment is a single physical location where business is conducted or where services or industrial operations are performed. Multiple establishments under common control make up an enterprise.

**PROFIT** IBISWorld uses earnings before interest and tax (EBIT) as an indicator of a company’s profitability. It is calculated as revenue minus expenses, excluding interest and tax.

**INVESTMENT BUYING (IB)** A standard business model where large quantities of a commodity are purchased under the assumption that its price will increase.

**MANAGED CARE** A type of health insurance plan that controls costs by providing a network of pre-approved doctors and hospitals.

**OVER-THE-COUNTER (OTC) MEDICATION** Medicines that can be sold without a prescription.

**SPECIALTY DRUG** Complex drug therapies, including injectables and biologics.

**INTERNATIONAL TRADE** The level of international trade is determined by ratios of exports to revenue and imports to domestic demand. For exports/revenue: low is less than 5%, medium is 5% to 20%, and high is more than 20%. Imports/domestic demand: low is less than 5%, medium is 5% to 35%, and high is more than 35%.

**INDUSTRY REVENUE** The total sales of industry goods and services produced by the industry minus the cost of goods and services used in production. IVA is also described as the industry’s contribution to GDP, or profit plus wages and depreciation.

**INDUSTRY VALUE ADDED (IVA)** The market value of goods and services produced by the industry minus the cost of goods and services used in production. IVA is also described as the industry’s contribution to GDP, or profit plus wages and depreciation.

**INDUSTRY CONCENTRATION** An indicator of the dominance of the top four players in an industry. Concentration is considered high if the top players account for more than 70% of industry revenue. Medium is 40% to 70% of industry revenue. Low is less than 40%.

**CAPITAL INTENSITY** Compares the amount of money spent on capital (plant, machinery and equipment) with that spent on labor. IBISWorld uses the ratio of depreciation to wages as a proxy for capital intensity. High capital intensity is more than $0.333 of capital to $1 of labor; medium is $0.125 to $0.333 of capital to $1 of labor; low is less than $0.125 of capital for every $1 of labor.

**CONSTANT PRICES** The dollar figures in the Key Statistics table, including forecasts, are adjusted for inflation using the current year (i.e. year published) as the base year. This removes the impact of changes in the purchasing power of the dollar, leaving only the “real” growth or decline in industry metrics. The inflation adjustments in IBISWorld’s reports are made using the US Bureau of Economic Analysis’ implicit GDP price deflator.

**DOMESTIC DEMAND** Spending on industry goods and services within the United States, regardless of their country of origin. It is derived by adding imports to industry revenue, and then subtracting exports.

**EMPLOYMENT** The number of permanent, part-time, temporary and seasonal employees, working proprietors, partners, managers and executives within the industry.

**ENTERPRISE** A division that is separately managed and keeps management accounts. Each enterprise consists of one or more establishments that are under common ownership or control.

**ESTABLISHMENT** The smallest type of accounting unit within an enterprise, an establishment is a single physical location where business is conducted or where services or industrial operations are performed. Multiple establishments under common control make up an enterprise.

**EXPORTS** Total value of industry goods and services sold by US companies to customers abroad.

**IMPORTS** Total value of industry goods and services brought in from foreign countries to be sold in the United States.

**LIFE CYCLE** All industries go through periods of growth, maturity and decline. IBISWorld determines an industry’s life cycle by considering its growth rate (measured by IVA) compared with GDP; the growth rate of the number of establishments; the amount of change in the industry’s products are undergoing; the rate of technological change; and the level of customer acceptance of industry products and services.

**NONEMPLOYING ESTABLISHMENT** Businesses with no paid employment or payroll, also known as nonemployers. These are mostly set up by self-employed individuals.

**BARRIERS TO ENTRY** High barriers to entry mean that new companies struggle to enter an industry, while low barriers mean it is easy for new companies to enter an industry.

**INVESTMENT BUYING (IB)** A standard business model where large quantities of a commodity are purchased under the assumption that its price will increase.

**MANAGED CARE** A type of health insurance plan that controls costs by providing a network of pre-approved doctors and hospitals.

**OVER-THE-COUNTER (OTC) MEDICATION** Medicines that can be sold without a prescription.

**SPECIALTY DRUG** Complex drug therapies, including injectables and biologics.
Jargon & Glossary

VOLATILITY The level of volatility is determined by averaging the absolute change in revenue in each of the past five years. Volatility levels: very high is more than ±20%; high volatility is ±10% to ±20%; moderate volatility is ±3% to ±10%; and low volatility is less than ±3%.

WAGES The gross total wages and salaries of all employees in the industry. The cost of benefits is also included in this figure.
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It is combining data with analysis to answer the questions that successful businesses ask

Identify high growth, emerging & shrinking markets
Arm yourself with the latest industry intelligence
Assess competitive threats from existing & new entrants
Benchmark your performance against the competition
Make speedy market-ready, profit-maximizing decisions

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