INSOLVENCY INSIGHTS

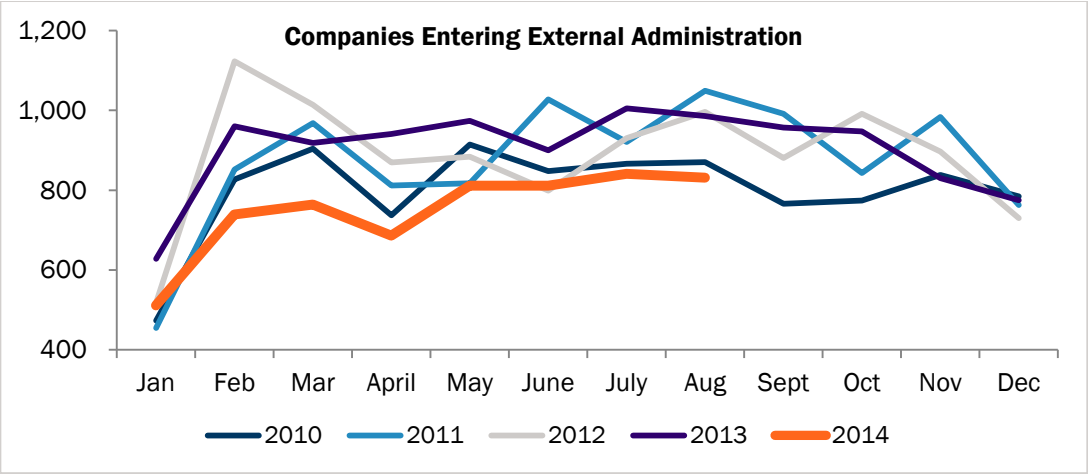
Analysis of ASIC's latest external administration appointments statistics from August 2014

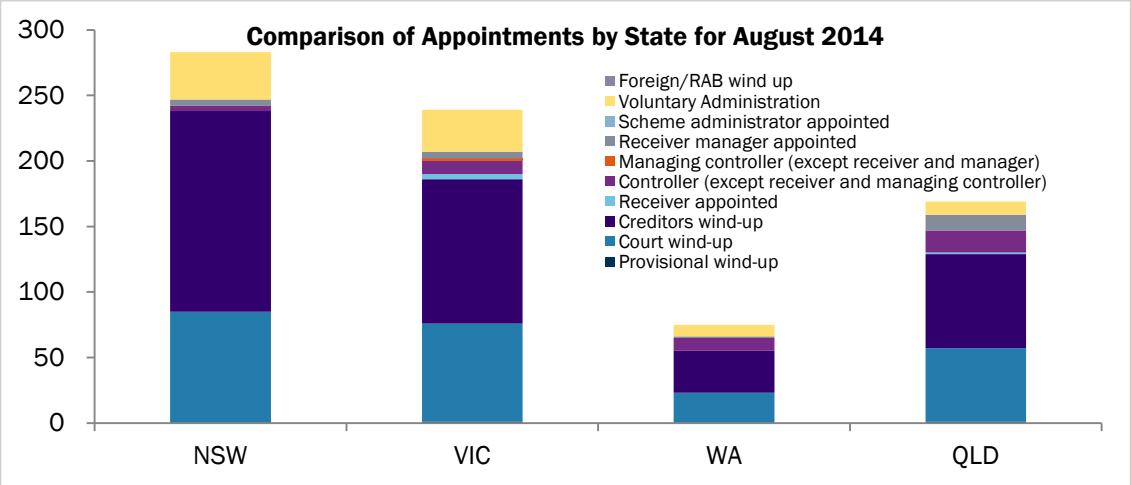
3 NOVEMBER 2014

The Figures

What the latest figures show

- ASIC figures show 831 companies entered external administration in Australia during August, representing a slight dip from July's 841 companies, which was the highest monthly level in 2014.
- A total of 5,994 companies have entered external administration in the first eight months of 2014, down 18% on 2013, and the lowest level for that period since 2008.
- External administration appointments fell slightly month-on-month in all states, except for South Australia and Tasmania. In Tasmania, insolvencies almost quadrupled to 11 from 3 in July. New South Wales had 283 companies entering external administration; the highest number nationally in August, followed by Victoria (239).
- There was a sharp drop in receiver appointments in August to 29, from 57 in the previous month, which is the lowest level since January this year. Companies entering voluntary administration fell 27% to 99 in August. In Western Australia, voluntary administrations fell from 24 in July to 9 in August.





About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring. More information can be found at www.fticonsulting.com.

Economic Influences

The broader market and its potential impacts on insolvency levels

- Reserve Bank of Australia ("RBA") Governor Glenn Stevens said global economic growth was continuing at a moderate pace, taking the lead from steadier conditions in developed countries. The RBA left rates on hold at 2.5% in August, saying financial conditions overall, "remain very accommodative, with long-term interest rates and risk spreads remaining very low."
- Consumer sentiment rose in August to reach levels not seen since before the May Federal Budget. Data from the Westpac Melbourne Institute showed the Index of Consumer Sentiment increased by 3.8% in August to 98.5. Westpac's Chief Economist Bill Evans attributed the boost to the scrapping of the carbon tax and the potential for a restructure of the budget led by resistance in the Senate.
- Labour market conditions seem to be improving, with unemployment in August falling to a revised 6%, seasonally adjusted. ANZ job advertisements rose 1.5% month-on-month in August, up 8% in the year to date.
- The Australian Performance of Manufacturing Index ("PMI") slipped 3.4 points in August from July to 47.3 points, according to Australian Industry Group ("AIG") data. July had seen the seen first growth in the index in eight months. Concern over the impacts of the strong Australian dollar on the manufacturing sector and trading conditions continue to weigh. The Performance of Services Index ("PSI") remained stable from July (49.3) to August (49.4). The Performance of Construction Index ("PCI") expanded at a faster rate than July, increasing by 2.4 points to 55.0 points in August, boosted by strengthened activity and new orders.
- New home construction approvals rose 3% in August month-on-month (seasonally adjusted), again beating expectations, following a spike in July as well, according to ABS figures.
- Business conditions in August came back from July's four year high, but remain resilient, NAB's monthly business survey showed. A steep fall in profits and sales was behind the fall in the business conditions index in August to +4, with manufacturing, construction and retail experiencing the biggest declines. Business confidence eased as well, dropping 2 points in the month to +8.
- New car sales fell a seasonally adjusted 1.8% in August from July to 91,391, ABS data showed. Year-on-year, total sales of new motor vehicles were 3.5% lower.

Special Focus

Testing times for pharmacies

- The last two years have seen relatively strong trading conditions and sale values for community pharmacies. However, some recent developments have the potential to negatively impact this performance. The industry is in a "watch this space" position as the full impact of these developments becomes clear over the next 12-24 months.
- There are two principal developments that will impact the industry going forward:
  - The effect of accelerated price disclosure on a pharmacy's gross margin; and
  - The relaxing of ownership and location laws and continued growth of large discount pharmacy chains leading to an increase in competition.
- Of the two developments, FTI Consulting believes accelerated price disclosure will have a larger and more immediate impact on the community pharmacy industry.

Accelerated Price Disclosure

- Certain changes to the Pharmaceutical Benefits Scheme ("PBS") along with the timing effect of several drugs coming off-patent has resulted in significant falls in pharmacies' gross margins in respect to their dispensary sales. This reduction is having a dollar-for-dollar impact on a pharmacy's bottom line. A brief explanation of this issue is as follows.
- The PBS subsidises pharmaceutical costs for over 750 widely used drugs to pharmacy customers, at a cost of over AU$9 billion a year to the Federal Government.
- The Federal Government pays pharmacists:
  i. Their net cost of the drug, being the pharmacists' purchase price from a wholesaler less the on-sale price to the consumer (known as the co-payment — currently capped at AU$36.90);
  ii. A dispensing fee; and
  iii. A profit margin (i.e. a mark-up).
- However, the calculation of the purchase price is not the actual cost (which varies from pharmacy to pharmacy), rather it is based on industry data periodically sourced by the Government from wholesalers (i.e. theoretically the average cost price of a drug over the relevant period).
- If actual market prices for a drug have fallen since the last data collection, windfall profits accrue to pharmacists as part of (i) above, in addition to their mark-up (iii).
- This has been the case for the past two years where several of the world's most widely used drugs have come off-patent. The rush of generic suppliers entering the market has caused a drastic fall in market prices for these particular drugs. Until data collection pricing caught up, pharmacies temporarily benefitted, with windfall gains meaning that pharmacy profits were higher than would otherwise be the case. In response, the Government introduced accelerated price disclosure measures, which has shortened the data collection periods and has captured falls in market prices sooner than otherwise would be the case.
- Pharmacists' ability to obtain these price gains has therefore fallen in recent months with gross margins returning to more historic levels.
- Consequently, FTI Consulting expects FY2015 results in the pharmacy sector will show falls in gross margin of between 3-5%.

Change in ownership and location laws

- As with any retail based offering, any change in ownership and location laws can lead to an increase in competition which has the potential to negatively impact pharmacy performance. Traditional community pharmacies are facing increasing competition from:
  - Supermarkets and department stores selling 'front of shop' health, cosmetics and toiletries products;
  - Discount chains such as *Chemist Warehouse*, competing on both dispensary and 'front of shop' sales at lower margins; and
  - Potential relaxation of location and ownership rules, which will pave the way for supermarkets to compete with pharmacies with respect to dispensary sales.

Conclusion

- Pharmacists will increasingly have to adapt their business models away from a traditional 'something for everyone' approach to either:
  - A 'stack it high' discount model; or
  - A highly personalised, targeted offering which builds and maintains a loyal customer base — with location (near hospitals, GP surgeries, in older-demographic suburbs, etc.) being a key factor.

Insights Q&A

What implications are there regarding the value of pharmacies in the current market?

Sale multiples for pharmacies are not yet suffering any material falls despite an expected decline in profits and risk of structural change. This may change in the medium term. Further, any reduction in net profit will also have an adverse impact on value.

How will the outcomes of the 6th Community Pharmacy Agreement, currently being negotiated, affect the future of the pharmacy industry as a whole?

With respect to the threat of supermarkets entering the dispensary sales area, the Government and The Pharmacy Guild (the pharmacy industry body) are currently negotiating the 6th Community Pharmacy Agreement, which aims to agree service provision, including subsidy levels and competition issues. The current agreement (5th Agreement) expires in June 2015.

Against this backdrop, the Competition Review Panel, discount chain *Chemist Warehouse,* the supermarket sector, the pharmacists union (Professional Pharmacists Australia) and others are pushing the Government to open up competition, especially around the ownership and location rules applicable to pharmacies — factors which currently restrict the discount chains and supermarkets from fully competing with traditional pharmacies. Commentators expect the 6th Agreement will materially maintain the status quo, but acknowledge that the time for change is coming soon given the argument that increased competition will reduce the cost of the PBS.

What implications/opportunities exist for investors in the pharmacy industry in the current market?

The risk of intense competition in the medium term and an increasing wariness by financiers means that the industry is a risky proposition, unless industry participants are willing and able to adapt their business model, to reconsider their staffing and floor-plan sizes, and meet competition head-on without the benefit of an overused subsidy cushion.

Recent Industry Case Study

Situation

- The secured creditor of a 10-site pharmacy group with multiple owners became concerned with its exposure and engaged FTI Consulting to undertake an investigating accountants report.
- Operating a discount pharmacy model, the Group was on COD terms with its major supplier, had significant rental arrears and its pharmacies were endemically understocked.
- In addition, several of the pharmacies were operating without a Medicare approval number (i.e. script shuffling was occurring within the group).

FTI Consulting's Role

- Our team engaged a pharmacy management company to conduct a review of each pharmacy to ensure compliance with the various legislative obligations.
- We completed a financial and operational review of each pharmacy in the Group.
- Senior Managing Directors of FTI Consulting were subsequently appointed as receivers and managers of several pharmacies in the Group.
- On appointment as receivers and managers, our team took immediate steps to bring the pharmacies into compliance, and increased the stock levels in all pharmacies which in turn stimulated sales. We also implemented several other initiatives aimed at further improving sales.

Outcome

- Once the pharmacies were stabilised, we conducted a sale programme that resulted in all the pharmacies being sold at or above valuation.

Outlook

The broader market and its potential impacts on insolvency levels

- After a 5.9% post-budget claw back between June and August, the Westpac Melbourne Institute Consumer Sentiment Index plunged 4.6% in September to 94.0, eroding nearly all of the previous gains. Westpac economists attribute the significant fall to concerns over the budget, taxation and general deterioration of economic conditions.
- The RBA says it sees continued interest rate stability as it again left rates on hold in September. Additionally. the RBA says the most recent survey data shows improved business conditions and household sentiment, but cautions that weak resource sector investment, and only moderate growth in other sector spending, is expected to see growth "a little below trend" in the year ahead.
- The national construction industry continues its growth momentum, hitting a nine-year high in September. AIG data showed the PCI increased by 4.1 points to 59.1 points in September. It's the fourth consecutive month that the index has been above the 50.0 point level, which indicates expansion. Meanwhile, the Australian manufacturing and services indexes continued to contract in September. The PSI contracted in September for the seventh consecutive month.
- The seasonally adjusted unemployment rate edged slightly higher in September to 6.1% from an adjusted 6%, in August.

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