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WAL-MART, YOUR FRIENDLY DRUGSTORE

The retailing juggernaut is set to move more aggressively into pharmaceuticals and health care, much as it did with groceries 20 years ago

By Pallavi Gogoi, June 8, 2008

Wal-Mart Stores (WMT) wants to be your low-cost destination for not just food, clothing, and housewares, but also drugs and health care. In the past few months, Wal-Mart has announced it is working with several companies to process and pay their prescription claims. The company is aiming to increase electronic prescriptions at its stores by 400%, to 8 million by yearend. It is introducing walk-in clinics at its superstores to treat minor ailments and is expanding its \$4 generic-drugs program. "What our company does best is exactly what the U.S. health-care system needs the most. It needs more affordability. It needs more accessibility. It needs to be more efficient," said H. Lee Scott, chief executive officer of Wal-Mart, in a speech earlier this year.

Sound familiar? It's an echo of Wal-Mart's initial steps into the food business 20 years ago. Today, groceries are Wal-Mart's biggest revenue generator, making up 41% of its annual sales. Along the way, Wal-Mart has dramatically reshaped the grocery store industry. Now it's making a bid to do the same in health care.

The low-cost strategy is paying huge dividends for the world's largest retailer as it heads into its annual shareholders' meeting on June 6. At a time when Americans are being weighed down by record-high prices on everything from gasoline to milk, flour, and eggs, Wal-Mart's new slogan, "Save Money, Live Better," is resonating more strongly than ever for millions of consumers who have consolidated their shopping into one weekly trip to one of the chain's massive stores. On Thursday, the company reported sales at stores open a year or more rose a higher-than-expected 3.9% in April, one of the strongest performances recorded by an American retailer. That's why Wal-Mart shares are trading near a six-year high, at 59. "It's a strategy to get people to come in for different aspects of their life, but all at lower costs," says David Abella, a Wal-Mart shareholder and portfolio manager at New York's Rochdale Investments, which has \$2.3 billion in assets.

Hefty Profit Generator

Already, Wal-Mart's drug and health-care ventures provide big chunks of its sales and profits. The chain says that health and wellness products [including pharmacy sales] made up 9% of its overall \$374.5 billion in revenues in the 12 months ended Jan. 31, 2008. Analysts say the profitability of the health-care lines was better than Wal-Mart's overall 23.5% gross margin last year.

The investment in health care could pay even bigger dividends in coming decades. Health-care costs are expected to continue spiraling upward in the U.S., especially for the estimated 80 million baby boomers, who were born between 1946 and 1964. According to the Census Bureau, 300 people in America turn 60 every hour, and health-care spending averages \$3,262 for those aged 55 to 64. That expense typically climbs 20% per year for those over 65.

"People are worried because health-care costs are growing faster than the average American's income, and it's only going to get more intense as boomers retire at an increasing pace," says Len Nichols, health-care economist at The New America Foundation, a nonprofit public policy institute in Washington. Says Abella: "It is important to cement your health-care credentials as the leader of low-cost drugs at a time when baby boomers are getting older by the millions."

Unbeatable Prices

For two years now, Wal-Mart has been trying to do just that. It has shaken up the industry in the process. After it started offering a group of generic prescription drugs for \$4 in September 2006, Target (TGT) and Costco Wholesale (COST) followed suit. Costco started offering \$4 for a 30-day drug supply and then changed to \$10 for a 100-day supply; now Wal-Mart has a similar offering.

Even at \$4, generic drugs are not a loss leader at Wal-Mart. In its annual report, the company says that its gross margin increased in fiscal 2008 because of higher sales in fresh food and pharmacy. Rochdale's Abella says: "Wal-Mart might not be making the profits on \$4 generics that drugstores were making, but generics have always had higher margins than branded drugs, and Wal-Mart is certainly not giving them away."

On May 5, Wal-Mart expanded its low-cost offering to cover women's medications to treat breast cancer, menopause, and hormone deficiency. For instance, alendronate, a generic version of the osteoporosis drug Fosamax, is being sold for \$9 for a 30-day supply or \$24 for a 90-day supply. That compares with \$54 for a 30-day supply of the generic or \$102 for the branded drug at pharmacy stores. The move should "help gain critical share across its female primary shoppers, and also drive traffic cross-shopping," wrote Adrienne Shapira, a retail analyst at Goldman Sachs (GS) who follows Wal-Mart, in a recent report.

Wal-Mart executives say their strategy is to tap into consumers who don't have health insurance. They say that nearly 30% of the \$4 prescriptions are being filled without insurance, compared with the industry trend of 10%. "[The] \$4 prescriptions now represent approximately 40% of all filled prescriptions at Wal-Mart," says John Agwunobi, Wal-Mart's senior vice-president and president of health and wellness. "People can now take the drugs that were prescribed to them. They no longer need to cut pills in half or not take the drugs at all."

Of course, the irony of Wal-Mart offering low-cost health care to those without insurance is not lost on its critics. Wal-Mart in recent years has come under heavy criticism for providing stingy health benefits for its own workers from various community and political leaders including Democratic Presidential candidate Senator Barack Obama.

Have-Nots on the Payroll

Just over three years ago, a few states singled out Wal-Mart as the employer whose employees were turning up most often on state Medicaid rolls and with children on taxpayer-funded public

health-care plans. For instance, Georgia found that close to 10,000 children of Wal-Mart workers were enrolled in the state PeachCare program, nearly 14 times more than any other employer. In Florida, 12,300 Wal-Mart workers were enrolled in Medicaid.

Wal-Mart has since changed its health benefits plans. Last year, it offered lower deductibles in a range of choices and also reduced the number of years for a part-time worker to qualify for coverage to one year from two. At the start of this year, Wal-Mart said that 50.2% of its employees had signed up for coverage under the company's plan, compared with 48% in 2007 and 44% in 2003. In the latest enrollment period, more than 30,000 of the company's workers signed up for coverage who were uninsured before.

"Being the largest retail company in the world and such a market force, it just didn't look good to have so many employees with no insurance," says Rochdale's Abella. "Besides image, having better benefits makes it a more attractive place to work and reduces employee turnover."

Wal-Mart has proceeded cautiously so far on offering walk-in clinics, where people get treated for minor ailments like a cold or a cough for as little as \$40. Currently, it has 79 clinics in 12 states, compared with 472 clinics in CVS (CVS) drug stores. In most cases, Wal-Mart leases out the space or has co-branded the clinics with companies like RediClinic. However, Wal-Mart has already committed to opening 400 clinics in the next three years, and could have 2,000 by 2015 by contracting with local hospitals.

Clinics Lead to Wider Sales

A report on industrywide walk-in clinics done for the nonprofit group California Healthcare Foundation by Mary Kate Scott, CEO of health-care consultant Scott & Co., found that they generally draw in young families on tight budgets or schedules, and that they lead to more sales elsewhere in the stores. "As many as 70% need a prescription or immunization, and 98% get their prescriptions filled right there," says Scott.

Patricia Edwards, a Wal-Mart shareholder and managing director at Seattle money manager Wentworth Hauser & Violich, says the clinics fall in the sweet spot of Wal-Mart's core low-income customer base. "So many of Wal-Mart's shopping population don't have health-care coverage, and here they can get their kids immunized for a low price. It's a good deal," she says. Indeed, Wal-Mart's own data show that 55% of its customers that go to these clinics are uninsured.

Investors are less enthusiastic, though, about Wal-Mart's moves into claims management. Earlier this year, CEO Scott revealed that Wal-Mart has also started dabbling in managing prescription drug claims for other companies. Scott believes he can leverage Wal-Mart's efficiencies of scale to better process and pay prescription claims from these employers. "Our approach will be based on taking out unnecessary costs while providing high-quality health-care products and services, and we believe we can save employers more than \$100 million this year alone," he says. Wal-Mart spokesman David Tovar wouldn't identify which companies Wal-Mart is working with. Says money manager Edwards: "I hope they are cautious in any further undertaking in health care and don't push this too far."