



# Cases in Strategic-Systems Auditing



## CVS/Pharmacy

### *Growth Strategies in the Retail Drug Industry*

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## **KPMG/University of Illinois Business Measurement Case Development and Research Program**

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## Introduction

During the 1990s, many factors were exerting downward pressure on retail drug companies' profit margins, including the rise of health maintenance organizations (HMOs)<sup>1</sup> and pharmacy benefit managers (PBMs)<sup>2</sup>, advances in information technology, the emergence of e-commerce, and economic power concentrated in the hands of large pharmaceutical companies. Several retail drug companies concluded that growth was the only viable strategy for responding to these external forces. CVS was no exception and made a series of key acquisitions to become the largest retail drug company in the world based on store count.

*Industry observers now need a scorecard to keep up with who owns what in the rapidly imploding chain drugstore industry.*  
**Wall Street Journal (2/24/97)**

Why is CVS able to succeed where others fail? What is required to be successful in the retail drug industry? How do business risks in the industry impact audit risk, and how should an auditor go about assessing these risks? This case will challenge you to consider these and related issues, while concurrently introducing you to the retail drug industry.

**Case Setting.** The case is set in the late 1997 to early 1998 time period. Markets were volatile during this time period as they are today. Moreover, organizations found themselves increasingly monitoring the environment to ensure the appropriateness of their strategy for positioning within their market. Unless an instructor indicates otherwise, analyses and responses to discussion questions for this case should be based on the facts presented in this document and pertain to the period leading up to, but not beyond, early 1998. The case is designed to give students experience at applying strategic and process analysis frameworks, and drawing implications about the effects of client business risk, and business measurements outside the financial statements, on audit risk. Performing an up-to-the-minute industry analysis is not the purpose of the case.

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<sup>1</sup> An entity that provides, offers, or arranges for coverage of designated health services needed by health-plan members for a fixed, prepaid premium (capitation rate). Health maintenance organizations have three main characteristics: 1) an enrolled population; 2) provision of a comprehensive range of medical services; and 3) prepayment of a fixed fee for the services. *Wisconsin Department of Health and Family Service*, <http://www.dhfs.state.wi.us/medicaid/provider/hmocomp/tgg.htm#top>.

<sup>2</sup> Organizations that function as intermediaries between pharmaceutical manufacturers and large drug purchasers. They sell pharmaceuticals to HMOs, large employers, hospital and nursing home chains, and others at relatively low cost. They also provide a variety of other services for their clients such as claims processing, mail-order distribution, utilization management, and physician monitoring and education. *Standard & Poors*-July 29, 1999 / Healthcare: Pharmaceuticals Industry Survey.

## Company Background

In 1963, Consumer Value Stores (CVS) incorporated in Lowell, Massachusetts. Five years later, the company began to add pharmacies to many of its stores to draw more customers. By 1969, when Melville Corporation (founded in 1892) acquired the company, there were 42 stores. Primarily a shoe retailer, Melville had grown to over 1000 stores by the early 1960s. When Frank Rooney (considered by many to be a retailing genius) took over as CEO in the mid-1960s, he moved Melville out of the cities and into suburban shopping malls. Rooney filled as many slots as possible with new stores—and not just shoe stores but clothing stores, toy stores, discount stores, and drugstores. By the end of 1990, Melville’s sales totaled over \$8 billion. In addition, Melville had 119,000 employees and over 7,000 stores including: 990 Thom McCan shoe stores, 560 Chess King clothing stores, 775 Kay-Bee Toy and Hobby Shops, 350 Marshall discount stores, 500 Wilson’s leather shops, 790 CVS drugstores, and 490 Peoples drugstores. Also, Melville had owned and managed the shoe departments in 2,400 Kmart stores.

Large discounters such as Wal-Mart and Target, however, began to challenge Melville’s success. In 1995, in response to this threat, Melville’s board of directors approved a restructuring plan targeting core competencies. The plan included adopting CVS as the corporate name and disposing of all companies not related to the drugstore business. All the required divestitures were completed by December 1996.

Free to concentrate on the drugstore business, CVS embarked on a growth plan and merged with Revco, Inc. on May 29, 1997. This transaction made CVS the largest drugstore chain in the United States, based on store count, and gave CVS market

**Table 1**  
**Sales per Square Foot**

	Number of Stores	Average Square Feet per Store	Total Square Feet (millions)	Sales (billions)	Sales per Square Foot
<b>1996</b>					
CVS	1,408	9,000	12,672	\$ 5,528	\$ 436.25
Revco	2,184	9,000	19,656	\$ 5,088	\$ 258.84
<b>1997</b>					
CVS (Revco)	3,888	9,000	34,992	\$ 12,738	\$ 364.02

leadership throughout the Northeast, Mid-Atlantic, and Southeast. But the merger created some important challenges for CVS. Revco’s 1996 sales per square foot (SPSF) were \$259 compared to CVS’s at \$436. Not surprisingly, the post-merger SPSF were only \$364. (See Table 1.)

In 1998, CVS continued its acquisition activity by purchasing the 207-unit Michigan-based Arbor Drugs, Inc. With that acquisition, CVS became the largest chain drugstore for dispensed

prescriptions and also enhanced its number one position by store count, growing to 4,100 stores in 25 states east of the Mississippi River.

Also, CVS has a keen interest in expanding its presence in the New York City market, in spite of the high price of real estate. Westward expansion may be more difficult because of entrenched competitors like Walgreens and Rite Aid.

In addition to these major acquisitions, CVS's growth is fueled by internal expansion and purchasing prescription files from independent drugstores (CVS purchases the prescription files of independent drugstores but not the other assets of the store). In 1997, CVS opened 287 new stores—of which 116 were relocations—and purchased prescription files from 190 independent pharmacies. The company's renewed focus on pharmacy operations seems to have been successful. Stores are well positioned and operate in 48 of the top 100 drugstore markets. In approximately 80 percent of these markets, CVS has a first or second place market share. CVS dispenses approximately 12 percent of all U.S. retail prescriptions and employs more than 80,000 people.<sup>3</sup> The company forecasted 1998 revenues to exceed \$15 billion.

CVS drugstores offer a broad selection of over-the-counter (OTC) drugs, health and beauty aids (HBA), greeting cards, photo-processing services, cosmetics, convenience foods, and seasonal items in addition to prescription drugs and services. There are 1,300 products under the CVS private-label brand that, in 1997, accounted for approximately 11 percent of "front-end" sales (referring to non-pharmaceutical merchandise in the front of the store). Total front-end sales, which generally are higher margin than pharmacy sales, represented approximately 46 percent of total sales for 1997.

CVS is integrating its acquisitions and rationalizing its asset base, location mix, and product offerings. However, technological innovations, especially, the Internet and e-commerce, may lead to significant changes in the way drugs are marketed and sold, creating new opportunities and challenges for the company.

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<sup>3</sup> Summarized 1997 financial statements for CVS are presented in Exhibit 1.

## External Forces and Agents

The retail drug industry has changed much over the past decade and it is predicted that the next ten years will bring more, and increasingly rapid, changes. In the early 1980s, the industry was dominated by neighborhood drugstores operated by individual pharmacists who, generally, served a small town or neighborhood. These small retailers had difficulty, however, dealing with the huge and powerful pharmaceutical manufacturing industry, which at that time was dominated by five companies: Merck, Pfizer, Bristol Myers, Glaxo, and American Home Products. These companies not only controlled nearly 80 percent of the U.S. prescription drug market but also held 20-year patents on the newest and most prescribed drugs. While fair pricing laws provided some protection for small drug retailers, prices of, and margins for, prescription drugs generally were dictated by the pharmaceutical industry.

## Health Maintenance Organizations

By the late 1980s, the rise of the HMOs and other managed healthcare companies posed a new and substantial threat to the prosperity/viability of the retail drug industry. To control costs, HMOs or other managed-care providers establish their own price guidelines for various prescriptions. Pharmacists must join these plans or risk losing managed-care customers who pay for prescription drugs through their providers.

Given the economic power of the pharmaceuticals and the managed healthcare industry (by 1996, 85 percent of all prescriptions were sold through managed care), pharmacy margins and market position were squeezed during this period. Most retail drug companies viewed growth as the only viable strategy to offset the increased market power of the drug companies and the HMOs. Thus, large retail drug chains emerged including Walgreens, CVS, Eckerd, and Rite Aid.

## Sales

While other new formats have emerged, drugstores remain the strongest venue for dispensing prescription drugs. *The Chain Drug Review* reports that there were approximately 44,600 drugstores in the United States in 1996. Of these, approximately 20,000 were chain drugstores and 24,600 were independents. That year, the retail drug industry had 179.0 million square feet of selling space and produced \$454 in SPSF. Approximately 441 drugstore chains (consisting of four or more stores) comprised 45 percent of the total units and nearly 67 percent of total drugstore sales which reached \$121.4 billion—a 6.9 percent increase over 1995. In 1996, growth in chain drugstore sales was higher than sales for the overall industry, increasing 8.7 percent to

\$81.3 billion. The average chain drugstore outlet had 8,950 square feet of selling space and \$4.1 million in annual sales. Same-store sales for chains were up 7 percent. Sales of front-end merchandise (i.e. HBA, greeting cards, photo finishing, and OTC drugs) improved as stores learned to manage product lines (categories) better while the average gross margin on prescriptions held steady at about 24 percent.<sup>4</sup>

## Earnings

Over the past several years, price increases have slowed while prescription volume has increased. Prescription drug inflation is expected to remain well below the near double-digit rates of the 1980s. In fact, Standard & Poors (S&P) projected that in 1998 prescription drug price inflation would be only 3 percent to 3.5 percent. Moreover, percentage growth in the drugstore industry's net profits was expected to outpace percentage growth in sales as gross margins improve. On average, the industry's net profit margin is expected to rise as technological advances in inventory management and distribution allow chains to continue to reduce selling, general, and administrative (SG&A) expenses. S&P also projected that earnings will grow about 12 to 15 percent annually over the next few years. In addition, the industry is expected to continue to benefit from higher margins generated by the increasing number of OTC drugs. Demand for OTC drugs is on the rise and a growing number of high profile prescription drugs (e.g., Zantac, Rogaine, and Monistat 7) have switched to OTC status. Over the next five years, more than 50 prescription drugs are expected to get OTC approval.

## Strategies

Drugstore companies have adopted a number of strategies for coping with changes in their competitive environment. Mergers and acquisitions are on the rise, store numbers and size are increasing, and product mixes are changing to reflect customer preferences.

Extensive mergers and acquisitions—one approach to growth—has resulted in significant consolidation in the industry over the past several years. In 1994, Walgreens dominated the market followed by five major regional competitors. In addition, there were many smaller regional and local chains as well as thousands of stand-alone and one-, two-, or three-store operations.

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<sup>4</sup> Same-store sales consist of sales from stores that have been open for more than one year. *CVS 1998 Annual Report*, pg. 15, *Results of Operations*.

As shown in table 2, by 1997 the picture was quite different with three drugstore companies dominating the industry. Although the large retail drug chains have responded to the competitive environment by growing larger, the strategies used to achieve growth have differed. For example, CVS primarily has grown through acquisitions of existing pharmacy chains while Walgreens has focused on internal growth. The trend toward market domination by the large chains continues with the total number of drugstores growing little in recent years.

The growth strategy also is apparent in the increasing number of store locations and

outlet size. The trend has been to locate stores away from shopping centers and strip malls to stand-alone units. The ideal freestanding unit is about 10,000 square feet and is located at a busy intersection. These larger outlets tend to attract consumers wanting the broader array of products provided by larger stores while avoiding the even larger mass merchandise operations such as Wal-Mart and warehouse clubs.

To take advantage of high margin and rapid turnover of front-end operations, retail drug chains have refocused their product mix in favor of HBA. They also have added services such as film developing. While prescription drugs continue to be the large retail chains' most significant revenue item, extensive front-end operations and greater sales of profitable private-label items help to offset the downward pressure on pharmacy margins caused by the economic power of the pharmaceutical and managed healthcare industries.

## Competition

Competition for prescription sales comes not only from independent and chain drugstores but also from supermarkets, discount general merchandisers, HMOs, hospitals, and mail-order organizations (See Table 3). "Combo" stores, which consist of grocery, drugstore, and several other product categories under the same roof, have experienced significant growth recently as consumers become more attracted to one-stop shopping. Retail mass merchandisers with prescription departments, such as Wal-Mart and Kmart, also have grown in popularity.

**Table 2**

**Comparative Total Sales of Chain Store Competitors**

**Sales (billions)**

<b>Chain Store</b>	<b>1994</b>	<b>1997</b>
Walgreens	\$ 9.2	\$ 13.4
CVS	4.3	12.7
Rite Aid	4.1	7.0
Thrifty	3.2	-
Eckerd	-	5.3
Revco	2.5	-
Longs	2.4	2.8

<u>Sales by:</u>	<u>General HBA Sales (in Billions)</u>		<u>Number of Prescriptions (in Billions)</u>	
	<u>1997</u>	<u>1996</u>	<u>1997</u>	<u>1996</u>
Traditional Chain	\$7.90	\$7.60	1,021	963
Independent	\$0.70	\$0.60	718	726
Mass Merchandiser	\$10.30	\$9.40	268	261
Food Store	\$8.00	\$7.30	276	249
Mail Order	<u>N/A</u>	<u>N/A</u>	<u>335</u>	<u>302</u>
Totals (in Billions)	<u>\$26.9</u>	<u>\$24.9</u>	<u>2,618</u>	<u>2,501</u>

As noted in the *Chain Drug Review* (August 25, 1997):

Wal-Mart Stores Inc. and Kmart Corp. are the No. 5 and No. 6 retail pharmacy chains, respectively, with their combined 3,800 pharmacy departments filling some 220 million prescriptions a year. In fact, seven of the 50 leading pharmacy operators are discounters, while 18 are supermarket chains. Safeway Inc., which acquired the Vons supermarket chain earlier this year, moved from 15th place in 1996 to No. 11 in the 1997 rankings, going from 586 pharmacies to 775 such departments. Despite the boost in Safeway's prescription drug business, the company continues to be the second-leading supermarket pharmacy operator behind Kroger Co., which recently opened its 1,000th prescription drug department.

Tables 4 and 5 provide comparative data on characteristics and sales growth for various competitors.

**Table 4**  
**Channel and Store Characteristics – 1997**  
(Dollar Amounts in Thousands)

Store Characteristics	Chain Drugstore	Independent Drugstore	Food Store with Pharmacy	Mass Merchandiser with Pharmacy
Selling Space	8,958	2,326	27,142	68,699
Number of Employees	443,603	162,501	682,418	1,188,048
Number of Employees per Store	23.2	7.8	108.4	241.8
Total Sales	\$72,046,905	\$26,480,095	\$93,952,482	\$161,163,094
Total Pharmacy Sales	\$34,891,667	\$23,898,611	\$9,773,611	\$9,163,889
Average Annual Sales	\$3,768,341	\$1,270,394	\$14,929,681	\$32,796,723
Average Annual Pharmacy Sales	\$1,824,973	\$1,146,546	\$1,553,093	\$1,864,853
Percent Pharmacy Sales	48.43%	90.25%	10.40%	5.69%
Number of Stores	19,119	20,844	6,293	4,914

**Table 5**  
**U.S. Pharmaceutical Sales**

<u>Market Segment</u>	<u>1996 (in Billions)</u>	<u>Percent of Market</u>	<u>Percent Change vs. 1995</u>
Chains	\$ 27.7	28.1	12.3
Independents	16.8	17.2	5.8
Food Stores	11.8	11.0	11.0
Discounters	11.3	11.5	15.3
Mail Order	7.7	7.6	31.5
Hospitals	11.6	11.8	7.2
Clinics	4.6	4.5	23.9
Long-Term Care	2.6	2.6	20.9
HMOs	1.6	1.5	10.9
Home Health	0.7	0.5	10.4
Miscellaneous	2.3	2.4	7.4
Total	\$ 98.7	100.0%	12.1%

Source: *Chain Drug Review* (August 25, 1997)

Technological advances are likely to make business-to-consumer e-commerce more prevalent, giving rise to new competitors in the retail drug industry. These new competitors are likely to have the ability to offer greater convenience, lower prices, and other knowledge-based services. Internet-based sales of pharmaceuticals and other products sold by CVS as of 1997, constitute less than 2 percent of all e-commerce transactions. New companies have begun to offer prescriptions, OTC drugs, vitamins, and HBA through the Internet. Drug chains can develop Internet sites and compete online in the pharmaceutical sales market. But Internet sales could

curtail traffic to chain stores dramatically and reduce impulse buying. For example, online customers shopping specifically for prescription drugs would have little reason to peruse HBA offerings. Therefore, the company could experience a significant loss in overall profitability unless online stores find ways to leverage their customer base. The rich data environment of Internet transactions, for example, suggests the potential for a superior understanding of customer needs, tastes, and preferences that could allow online drug retailers to leverage their customer relationships into other sources of revenue. Consequently, the development of intelligent software agents to focus marketing efforts on individual consumers could counteract the potential loss of revenue and profits resulting from the elimination of walk-in sales of HBA.<sup>5</sup> In essence, a major challenge for all online consumer retailers is to develop ways to create the electronic equivalent of impulse purchases.

For customers with chronic drug needs, the convenience of an Internet transaction could justify switching to that medium. However, many elderly individuals—the demographic within which the aforementioned customer group fits—are uncomfortable using computers. For elderly people who feel inhibited using the Internet, mail-order purchases offer similar convenience and savings. This situation will likely change, however, as the large post-war baby boom segment of the population ages. “Baby boomers” (people born between 1946 and 1964) already are relatively conversant with online shopping.

In addition to competition for prescription sales, there is substantial competition for front-end sales of HBA, OTC, greeting cards, and other products. Many of the same types of businesses previously noted compete in this market. *Chain Drug Review* (June 29, 1998):

Drug chains lost valuable sales ground in both OTC drugs and toiletries last year. Discount retailers emerged as the clear market leader in both categories. And supermarkets, after a dormant period, awakened to pick up market share in both. Critics say that drug chains have become too slow, too picky and too unaggressive in adding new items and promoting old ones. What’s needed, they say, ‘is a new approach to HBA selling, one that capitalizes on chain drug store convenience while offsetting the supermarket advantage of shopping frequency and the discount store advantage of price.’

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<sup>5</sup> Note that all users of potentially confidential patient information must be aware of the privacy issues currently existing in the marketplace.

## Suppliers/Vendors

CVS takes advantage of its size to generate supply chain efficiencies and maximize its negotiating position with vendors. The company contends that the loss of any one supplier or group of suppliers under common control would not have a material effect on its business. CVS purchases much of its merchandise in volume from manufacturers who offer promotional and volume discounts. During 1997, approximately 85 percent of the merchandise purchased by CVS was received at one of the company's distribution centers for redistribution to its stores. The balance of store merchandise was shipped directly to CVS stores by manufacturers and distributors at prices negotiated at the corporate level. The company works closely with vendors to develop proprietary inventory management programs that help control costs. For example, in May 1998, CVS signed a three-year contract with Bindley Western Industries (BWI) to supply individual stores directly, reducing the need for centralized warehousing and distribution. Under the contract, which involves about \$4.5 billion in pharmaceutical products, BWI will partner with CVS to develop and implement a unique bulk inventory acquisition and purchasing management system.

CVS also strives to maximize its receipt of "vendor income." Vendor income — a common merchandising practice — is compensation provided by vendors to retailers who promote their products (by providing desirable shelf space and/or local advertising). The amounts of vendor income often are quite significant, representing millions of dollars per year to the company. However, vendor income arrangements often are sporadic and informal with terms that are vague and unclear making it difficult to determine when revenue is "earned" by the store. Furthermore, these arrangements rarely involve enforceable contracts. Recognition of vendor income in a given period is based on an assessment by management of the extent to which the company has fulfilled explicit or implied contractual conditions. For accounting purposes, vendor income usually is offset against cost of goods sold, sales, and/or advertising expenses.

## Regulation

Pharmacies and pharmacists must be licensed by the appropriate state boards. Pharmacies and distribution centers also are required to register with the Federal Drug Administration (FDA). By virtue of these licensing and registration requirements, CVS faces various statutes, rules, and regulations, the violation of which could result in suspension or revocation of licenses or registrations. Particularly important to CVS (and related stores) is the requirement that licensed pharmacists be present in stores dispensing prescription drugs. Current market conditions have created a significant shortage of licensed pharmacists and excess demand for qualified personnel

is increasing. In addition to the large increases by chain drugstores in the number of outlets requiring onsite pharmacists, retailers like K-Mart, Wal-Mart, and numerous supermarket chains are aggressively recruiting pharmacists. Also, in an attempt to differentiate themselves from competitors, many large chain drugstores have begun the practice of keeping selective stores open 24 hours, thus, requiring multiple shifts of pharmacy personnel.

## Demographic Trends

The “graying” baby boomers are likely to have a significant impact on the retail-drug business. Currently, only about 13 percent of the U.S. population is older than 65. However, this group will grow at more than twice the rate of increase in the general population for years to come. At this rate of growth, the 65 and older group is expected to make up about 16 percent of the population by 2020 and more than 20 percent by 2030. The average 60-year-old purchases 15 prescriptions per year, which is nearly twice as many as the average 30-year-old. Furthermore, *Drug Topics* magazine reports that three out of every four baby boomers try to handle problems themselves before consulting a doctor. This tendency to self-medicate has been buoyed by a resurgence in preventive tactics and remedies, such as diet, exercise, and vitamins. Baby boomers also are sensitive to their appearance and take advantage of breakthroughs in HBA.

The aging of the baby boomers also means a shrinking labor pool that likely will leave drugstore operators scrambling for qualified workers. These workers already are demanding higher wages and better benefits. In addition, training programs must be developed to upgrade the skill level of employees. Many positions may need to be adapted for less-skilled personnel. The costs of finding, hiring, and training employees for all aspects of store operations can put significant downward pressure on margins.

## Managed Care and Pharmacy Benefit Managers

Managed care has been a mixed blessing to the industry. On the positive side, managed-care plans have lowered out-of-pocket drug costs to consumers who have responded by buying more prescription drugs. The plans also tend to favor drug therapies over more expensive forms of treatment, such as surgery. Also, because managed-care patients pay limited co-payments for prescriptions, they are more likely to purchase the more profitable brand name drugs, rather than the less expensive generic counterparts. In fact, S&P reports that about 57 percent of managed-care prescriptions are filled with brand drugs.

On the other hand, managed care has had a negative impact on gross margins. Frequently, drugs sold to wholesale distributors and pharmacy chains for the individual/physician market are priced at the high end of the manufacturer's scale. However, managed-care organizations base their prescription drug reimbursement rates on the average wholesale price, which is a point estimate of what drug retailers actually are paying for a given prescription drug. Therefore, drug retailers are left with thin margins and are pressured to accept even lower reimbursement rates.

The complexity of the pharmaceutical market has led to the creation of organizations specializing in managing the pharmaceutical side of health care. These organizations, called pharmacy benefit managers (PBMs), are hired by HMOs and other managed-care organizations (MCOs) to provide a variety of services, including claims processing, use management, physician monitoring, and education. In conjunction with a MCO, a PBM will establish a "formulary" — a list of drugs covered by the MCO. When a patient-subscriber presents a pharmacist with a prescription, the pharmacist must check to determine whether the prescribed drug is on the formulary. If the prescribed drug is not present on the formulary, the MCO will not cover the cost of the prescription. Between 1991 and 1996, the three independent PBMs that dominated the field were acquired by drug manufacturers: Medco Containment Services was acquired by Merck & Co., Diversified Pharmaceutical Services was bought by SmithKline Beecham plc, and PCS Inc. by Eli Lilly and Co. These captive PBMs can influence whether their parent companies' drugs are listed/preferred on MCO formularies.

By 1996, pharmaceutical company-owned PBMs controlled 57 percent of all managed-care prescriptions and about 22 percent of all prescriptions. In an effort to hold down costs, PBMs often use their tremendous customer base as leverage to dictate the rates at which pharmacies are reimbursed. If drugstores reject the rates, they risk losing access to existing and potential customers. Accepting the rates, however, results in lower margins.

Drug chains could strengthen their position by banding together, through strategic alliances, but this tactic could increase risks (e.g., risk of litigation for violation of fair-trade laws). Rather, they have chosen to attempt to gain economic power by becoming larger. Additionally, drugstores have begun to establish their own PBMs. Walgreens, CVS, Rite-Aid, Eckerd Drugs, and American Stores now operate PBMs.

Without a doubt, the schism between the drug retailers, managed-care organizations, and PBMs is going to widen. For example, in April 1998, CVS announced that it would no longer fill prescriptions for members of Keystone Mercy Health Plan. The prescription benefit for Keystone

Mercy Health Plan is managed by Eagle Managed Care. The contract covers more than 260,000 members in the Philadelphia area. Consumers who wish to continue to fill prescriptions at CVS have the option of switching to other area plans.

## CVS's Strategic Response

CVS's competitive strategy has two major thrusts. First, to achieve a superior position in the retail drug market, CVS is committed to four basic principles:

- convenient and numerous store locations
- superior customer service
- attractive merchandise selection
- excellent price-to-value.

Second, to leverage its growth and offset the external forces buffeting the industry, CVS has adopted an integrated strategy that brings together industry participants such as physicians, pharmaceutical companies, managed-care providers, and pharmacies. These efforts have led CVS to:

- establish and expand PharmaCare, a PBM subsidiary of CVS
- search out strategic alliances with other elements of the industry value chain.

## Retail Strategies

CVS has undertaken an aggressive and rapid program of expansion. CVS has chosen to achieve most of its growth in recent years through a combination of acquiring existing stores and chains and opening new stores. Management believes that achieving a critical mass in terms of store count and locating stores in desirable geographic markets is essential to competing effectively in the context of managed care. Ultimately, the company's goal is to use growth to achieve a return on invested capital that is double the weighted-average cost of capital.<sup>6</sup>

Management believes that store development is an important element of CVS's ability to maintain its leadership position in the chain drugstore industry. The acquisition of Arbor Drugs, the leading drugstore chain in southeastern Michigan in terms of store count and sales volume, allowed CVS to obtain a leadership position in a new geographic region. In July 1998, CVS and Thriftway Pharmacy Associates announced an agreement under which CVS would acquire 16

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<sup>6</sup> Invested capital is the sum of the book value of debt and book value of equity. The weighted average cost of capital (WACC) is calculated by weighting the costs of debt and equity capital according to their respective market values. For a detailed description of the WACC formula and definition of each component see Palepu, Bernard, and Healy, *Business Analysis & Valuation Using Financial Statements* (Cincinnati, Ohio: South-Western Publishing Co, 1996).

Thriftway drugstores in the metropolitan New York market, a prime target location.

CVS also has taken strong steps to improve its competitive position in the area of human resources. The company is hiring and training personnel to provide superior service as part of a human resources program that especially targets recruiting and retaining pharmacists. To help meet this high demand, CVS often hires the pharmacist(s) from the small or independent drugstores from which it purchases prescription files.

CVS also has revamped its product management processes and is using technology to improve its product selection (referred to as category management). These initiatives are described in more detail later in the case.

## PharmaCare and Strategic Healthcare Alliances

To advance its efforts at strategic integration, CVS is focusing on developing Pharmicare (its PBM) and establishing alliances. An important strategic advantage arising from the establishment of captive PBMs is the ability to direct MCO patients to the related pharmacy chain. The fear of being left out has caused pharmacy chains (and pharmaceutical companies) to act, so all large chains now own and operate their own PBMs. Often, contracts between PBMs and MCOs give preference to the related drugstore chains. Furthermore, prescription prices are sometimes set so low that processing fees charged by the PBMs are the only way to earn a profit. Drugstores that are not part of the network will not have the offsetting benefit of processing fees.

Pharmacare offers managed-care providers a full range of PBM services, including plan design and administration, formulary management, claims processing, and generic substitution. In the three and a half years since it was established, PharmaCare has grown considerably. By the end of 1997, it was managing healthcare services for more than 5 million people. In December 1997, PharmaCare merged with Revco's PBM subsidiary, Rx Connections, and also assumed Revco's mail-order pharmacy operations.

PharmaCare's proprietary clinical information management system (CIMS) is unique among PBMs. CIMS enables CVS pharmacists to interface with physicians more efficiently, thereby, improving patient care and reducing costs. Approximately 20,000 physicians currently are using CIMS, which began with only 500 physicians in 1994. In addition, PharmaCare plays an increasing role in healthcare management through integrated partnerships with several large managed-care providers.

CVS also is pursuing strategic alliances with other healthcare partners. For example, CVS Health Connection is a joint venture with Pfizer Health Solutions, Inc., (a subsidiary of Pfizer, Inc.) and Harvard Pilgrim Healthcare, one of the nations largest and most progressive HMOs. Harvard Pilgrim encourages its patients to go to CVS stores for screening services related to cholesterol and blood pressure, health education classes, and for individualized disease management programs in diabetes, asthma, and heart disease. After examination, a drug regime is developed that uses Pfizer drugs at a discounted price. This partnership provides Harvard Pilgrim patients with “one-stop” health shopping. What is unique about this program is that the entire customer-supplier chain is included in the partnership. In many ways, it appears that these companies are trying to use their dominant market position to deal with the two most vexing aspects of healthcare: (1) high cost and (2) lack of easy access. Companies also may be hoping that such partnerships will defuse the concerns of public policy makers about healthcare services that are perceived as too concentrated.

## Information Systems Management

CVS has made significant investments in information systems. The RX2000 computer system enables pharmacists to manage their prescription duties more efficiently. The RX2000 system, which includes one of the largest data warehouses in the country, facilitates the management of third-party healthcare plans and provides a warehouse of pharmacy data that can be analyzed by CVS and its managed-care customers. In 1997, Rapid Refill, an interactive voice-response system, was initiated to enable customers to refill prescriptions orders by telephone 24 hours a day.

In the front-end business, CVS has developed an advanced retail data warehouse that enables analysis of point-of-sale (POS) data on a store-by-store basis for target marketing and merchandising strategies. The company also has implemented a field management system using POS data to identify areas to improve operational execution on a store-by-store basis. In addition, there is a major supply chain initiative to reengineer its warehouse and merchandising network, which is intended to enable more efficient and effective control of merchandise flow to CVS stores.

## Core Business Processes

CVS’s mission is deceptively simple: “offer customers the best shopping experience.” Realizing this goal, however, requires careful management of the numerous processes that impact the extent

to which customers have the desired positive shopping experience, including:

- store locations (including store layout, store hours, and acquisitions)
- core product categories (i.e., inventory management and distribution)
- marketing (i.e., customer acquisition and services).

For each core area, management specifies objectives, identifies critical success factors (CSFs), and collects data to measure progress against the objectives. Also, management identifies risks and establishes controls to mitigate the risks. As management and employees perform activities to meet business objectives, performance is monitored using selected key performance indicators (KPIs).

### **Site Selection, Store Construction, and Store Relocation**

The acquisition staff aggressively seek opportunities and engage potential landlords or operators to initiate contacts. A Web site is used to disseminate information about CVS's real estate needs and to communicate with potential landlords. CVS prefers free-standing or convenience centers although downtown and shopping center locations also are considered. CVS also reviews viable opportunities to buy existing pharmacies.

The ideal location is 10,000 square feet with parking and drive-through facilities. However, less than 30 percent of existing stores meet these criteria. Management feels that preferred locations should have:

- high visibility
- easy access
- heavy traffic, preferably at an intersection of major thoroughfares
- free-standing sites that allow drive-through capability
- adequate space (1 acre minimum) for parking (40 to 60 vehicles)
- opportunity for growth in established population centers.

Population density is an important criterion in site selection. CVS prefers locations providing the opportunity to serve a minimum of 18,000 people but is relatively indifferent to the specific demographics of the trade area. Also, CVS leases most of their locations preferring leases with terms of 10 to 20 years (with options to extend).

**Growth in Existing Stores.** Every year, CVS remodels 20 percent of its existing stores and re-merchandises another 20 percent. In addition, CVS is in the process of relocating many of its

strip center stores to freestanding sites. During 1997, CVS opened 287 new stores, including 116 relocations, and for 1998, it expected to open approximately 300 new stores, including an estimated 150 relocations. Also, during 1997, CVS began converting retained Revco stores into the CVS store format. The conversion process consists of three elements:

- converting the Revco POS and pharmacy computer systems to CVS's systems
- revising the Revco product mix to reflect CVS's mix
- remodeling the Revco stores to the "look and feel" of a CVS store (e.g., wider aisles).

Revco's systems conversion is complete and revising the product mix was expected to be completed during the first half of 1998. Approximately 500 Revco stores had been remodeled as of December 31, 1997, with the remaining stores to be remodeled by the end of 1998.

The establishment of new stores has played, and will continue to play, a major role in CVS's continued growth. New store openings are targeted to ensure that CVS maintains its strong position within identified market areas, creating several important advantages including an ability to save on advertising and distribution costs. It also is an important consideration for managed-care providers who want to provide members with convenient access to pharmacy services.

Management expects that relocating in-line strip center stores to freestanding locations will account for approximately 50 percent of store openings over the next several years. Historically, as a result of their more convenient locations and larger size, relocated stores have realized significant improvements in customer count and revenues driven largely by increased sales of higher-margin front-end merchandise. Management expects this trend to continue, however, there can be no assurance that similar improvements will be achieved in each geographic market in which the company operates, as competition for "ideal" locations becomes more severe. Consequently, site selection will continue to be important to the success of CVS.

### **Customer Acquisition and Services**

CVS's experience in providing solutions to managed-care providers, along with an existing store base that affords easy access and convenience to consumers, are factors that contribute to its continued ability to attract and maintain third-party business. In addition, the RX2000 pharmacy computer system facilitates managing third-party healthcare plans by providing patient use information. With an eye to improving care and managing costs, CVS and its managed-care partners are able to evaluate treatment protocols and outcomes.

***Prescription File Buys.*** During 1997, CVS purchased 190 prescription files from independent pharmacies that contained an average weekly count of nearly 500 prescriptions. The company believes that independent file buys are productive investments. In many cases (mentioned previously), the independent pharmacist is then employed by CVS, thereby providing continuity in the pharmacist-patient relationship.

***Customer Service.*** CVS emphasizes attracting and training friendly and helpful associates to work in its stores and throughout the organization. Twice a year, every CVS store receives a formal customer-service evaluation based on a mystery shopper program, customer letters and calls, and market research. CVS's customer service priority extends into the managed-care portion of its business as well. In every market, a managed-care service team is responsible for ensuring that managed-care partners receive high levels of service. CVS pharmacists consistently rank at the top of the industry on measurements of trust, relationship building, and accessibility.

### **Inventory Management and Distribution**

CVS is committed to continuous improvement in all of its business processes. This commitment has resulted in a move toward implementing electronic communications with its suppliers. Electronic data interchange (EDI) will benefit everyone involved by reducing the high operational costs of paper-driven processes and systems. CVS plans to expand the use of EDI to 100 percent of its suppliers.

The company also is planning to improve the design of its stores so that potential customers perceive CVS as a destination store for front-end merchandise such as greeting cards, photo finishing, HBA, seasonal merchandise, and OTC drugs. CVS's 10,125 square-foot freestanding prototype stores improve store layout, convenience, and selection through the addition of product categories and greater variety within product categories. The selection of merchandise to stock in each store is part of the category management process (see below) and has been greatly improved through the use of proprietary information systems that allow the company to respond to customer needs, manage inventory, and control costs.

***Category Management.*** Having the right product mix is important for attracting walk-in customer traffic and maximizing incremental sales revenue from customers who are purchasing prescriptions. Stocking merchandise that many customers purchase on a regular basis is the essence of CVS's destination store strategy. Additionally, because prescription customers

generally have to walk to the back of the store (except for drive-through pickups), CVS manages its merchandise mix to tempt these customers into impulse purchases.

Category management treats a group of similar products (e.g., breakfast cereal) as a self-contained business unit that is run by a category manager. The key to category management is understanding why consumers buy a particular brand. The category manager studies consumer purchases of individual items to determine what sells the most and/or the fastest. Consumer purchases are compiled from POS data and consumer tastes and preferences are assessed using the compiled data as well as consumer surveys. By honing the store's merchandise assortments to offer products that customers typically buy, valuable shelf space is freed up for quick-selling items. Additionally, the optimum product mix makes the store a more attractive place to shop.

The category manager collaborates with vendors in evaluating the selection, arrangement, promotion, and price of individual items to achieve the optimum product mix. The impact of these decisions can be tracked for each category's sales and profitability. CVS maintains category profit and loss analyses for two years using data obtained from the POS system. This information is used to develop merchandising plans for each category and is tailored to the specific purchasing preferences of customers within each market. Both CVS and its vendors benefit from reduced inventories, increased turnover, and improved profitability.

CVS believes that effective category management has been a primary factor in its front-end comparable sales gains and improved gross margins. In addition, the company believes that its ability to satisfy customers through category management will be enhanced when it implements additional innovations for supply chain management. Supply chain management links CVS stores and distribution centers with suppliers for fast delivery of out-of-stock merchandise. Optimizing this process lowers the required investment in inventory.

## Comparison to Walgreens

Walgreens<sup>7</sup> is America's largest drugstore retailer in sales (\$13.4 billion for fiscal year ended August 31, 1997, see Table 2). The company serves customers in 34 states and Puerto Rico through 2,356 retail drugstores and two mail-order facilities. Walgreens has stores in every region of the country and enjoys nation-wide brand recognition. The company's geographic dispersion offsets the impact of temporary economic and competitive conditions in individual markets. Further, contrary to CVS, which attempts to dominate an area by placing a large number of stores within it, Walgreens locates a single store or a few stores in isolated and less populated rural areas. Faced with similar external forces as CVS, Walgreens also has embarked on an aggressive, albeit different, growth strategy. Specifically, Walgreens has rejected an acquisition strategy in favor of growth by opening (or relocating) new stores. In fact, in a recent public statement the president of Walgreens said, "There's as much chance of Walgreens making a major acquisition as there is of Dennis Rodman joining a monastery." (*Fortune*, 6/18/98, p. 56.)

During the five years ending in September 1998, only 15 stores were acquired by Walgreens. However, the chain opened 995 new drugstores and two new mail-order facilities, remodeled 409 units, added one major distribution center, and closed 389 drugstores and one mail-order facility. In 1997 alone, the company opened 251 new or relocated drugstores, remodeled 46 locations, and closed 86 stores. For that year, the average age of a Walgreens store was 7.5 years but by 2,000 this figure is expected to drop to 5.7 years.

Currently, about 1,400 locations are freestanding stores. Walgreens stores are, on average, larger than CVS stores (10,100 vs. 9,000 square feet, respectively). In the next three years, Walgreens plans to add or relocate 1,000 stores bringing the net total to over 3,000 locations. Walgreens believes that additional expansion across the country still is possible beyond the year 2000.

Even though Walgreens intends to spend \$1.5 billion to accomplish these goals, the company plans to remain debt-free. Projected 1998 sales reflect an increase of 13.6 percent to \$15.1 billion with pharmacy sales at 43.9 percent of total sales excluding mail order and 45.5 percent including mail order. Approximately 80.3 percent of pharmacy sales are third-party or managed-care transactions. Meanwhile, front-end sales are expected to increase by 3.5 percent for the year. In comparison to CVS, Walgreens relies more on front-end sales and offers a broader product line. The gross margin is expected to drop slightly (.26 percent of sales) due primarily to continued

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<sup>7</sup> Summarized 1997 financial statements for Walgreens are presented in Exhibit 2.

growth of third-party pharmacy sales. However, SG&A costs are expected to fall (.41 percent of sales) benefiting from increased efficiencies and reduced advertising expense because of the higher traffic in its freestanding stores. The roll out of Intercom Plus, an advanced pharmacy computer and workflow system, was completed in November 1997.

## Conclusion

The retail drug industry is rapidly changing. What used to be an industry of “mom and pop” local independents is now dominated by large national chains. The forces driving these changes extend beyond the immediate concerns of retail drugstores and are the result of profound changes in the entire healthcare system. Pharmaceutical companies have been large and powerful entities for quite some time due to the nature of their business. Healthcare providers and third-party payers now are growing rapidly as a result of pressures they face. This environment spills over into the retail drug industry and necessitates new strategies to remain viable. Economies of scale, managed care, information technology, the Internet, and changing attitudes of potential customers all promise to make the next 10 years challenging for CVS management.

Exhibit 1

Excerpts From CVS Pharmacies Financial Statements

<b>CVS Pharmacies</b>		
<b>Consolidated Balance Sheets</b>		
(in millions)	12/31/97	12/31/96
<b>Assets</b>		
Cash & Equivalents	169	472
Investments	-	181
A/R (Net of allowance for doubtful accounts)	452	351
Inventory	2,710	2,328
Other Current Assets	355	197
<b>Total current assets</b>	<b>3,685</b>	<b>3,529</b>
PP&E, net	958	966
Goodwill, net	711	722
Deferred Charges & Other Assets	175	283
Reorganization value in excess of amounts allocated to identifiable assets, net	108	195
<b>Total Assets</b>	<b>5,637</b>	<b>5,694</b>
<b>Liabilities</b>		
Accounts Payable	1,182	1,046
Accrued Expenses:	1,166	1,007
Short Term Borrowings	466	-
Other Current Liabilities	41	69
<b>Total Current Liabilities</b>	<b>2,855</b>	<b>2,123</b>
Long-term debt	273	1,184
Other Long-term Liabilities	148	190
<b>Total Liabilities</b>	<b>3,276</b>	<b>3,497</b>
<b>Shareholder's Equity</b>		
Preferred Stock	285	299
Common Stock*	2	2
Treasury Stock, at cost	(263)	(273)
Guaranteed ESOP Obligation, at cost	(292)	(292)
Capital Surplus	1,079	876
Retained Earnings	1,551	1,588
Other	-	(2)
<b>Total Shareholder's Equity</b>	<b>2,361</b>	<b>2,196</b>
<b>Total Liabilities &amp; Shareholder's Equity</b>	<b>5,637</b>	<b>5,694</b>

\* 178 million and 172.2 million shares issued and outstanding as of December 31, 1997 and December 31, 1996, respectively.

**Exhibit 1 (continued)**

<b>CVS Pharmacies</b>		
<b>Consolidated Income Statements</b>		
(in millions)	12/31/97	12/31/96
Net Sales	12,738	10,945
Cost of Goods Sold	9,299	7,893
Gross Margin	3,440	3,052
SG&A	2,575	2,310
Depreciation & Amortization	222	189
Merger, restructuring and other non-recurring charges	443	13
Total Operating Expenses	3,240	2,511
Operating Profit	200	541
Gain on Sale of Securities	-	121
Dividend Income	-	6
Interest Expense, net	(45)	(76)
Other (Expenses) Income, net	(45)	51
Earnings from continuing operations before taxes and extraordinary item	155	592
Income Tax Provision	(118)	(251)
Earnings from continuing operations before extraordinary item	37	341
Discontinued Operations:		
Loss from operations, net	-	(55)
Loss on disposal, net	18	(109)
Earnings (loss) from discontinued operations	18	(164)
Earnings (loss) before extraordinary item	55	177
Extraordinary item, loss related to early retirement of debt, net	(17)	-
Net Earnings (loss)	38	177
Preferred Dividends, net of tax benefit	(14)	(15)
Net Earnings (loss) to common shareholders	24	162

**Exhibit 1 (continued)**

<b>CVS Pharmacies</b>		
<b>Consolidated Statement of Cash Flows</b>	12/31/97	12/31/96
(in millions)		
<b>Cash Flows From Operating Activities:</b>		
Net earnings (loss)	38	177
Adjustments required to reconcile net earnings (loss) to net cash (used in) provided by operating activities:		
Merger, restructuring and other non-recurring charges	487	235
Depreciation and Amortization	226	246
Gain on sale of securities	(30)	(121)
Minority interest in net earnings	0	22
Income (loss) from unconsolidated subsidiary	0	(5)
Deferred income taxes and other non-cash items	(195)	115
Net operating loss carryforwards utilized	69	15
Extraordinary item, loss on early retirement of debt, net	17	0
Change in assets & liabilities, excluding acquisitions and dispositions:		
(Increase) decrease in accounts receivable, net	(81)	5
(Increase) decrease in inventories	(531)	(234)
(Increase) decrease in other current assets, deferred charges, and other assets	(67)	(94)
Increase (decrease) in accounts payable	21	338
Increase (decrease) in accrued expenses	(224)	(220)
Increase (decrease) in federal income taxes & other liabilities	(6)	(17)
<b>Net Cash (Used In) Provided By Operating Activities</b>	<b>(275)</b>	<b>463</b>
<b>Cash Flows From Investing Activities:</b>		
Additions to PP&E	(312)	(298)
Proceeds from sale of businesses and other PP&E	193	240
Proceeds from initial and secondary public offerings of Linens 'n Things	147	189
Proceeds from sale of investments	162	296
Acquisitions, net of cash	0	(374)
<b>Net Cash (Used In) Provided By Investing Activities</b>	<b>190</b>	<b>55</b>
<b>Cash Flows From Financing Activities:</b>		
Dividends paid or payable	(75)	(132)
Additions to (reductions in) short-term borrowings	466	(52)
Increase (decrease) in bank overdrafts	144	(158)
Repurchase of common stock	0	(11)
(Reductions in) additions to long-term debt	(912)	131
Proceeds from exercise of stock options and other issuances of stock	160	46
Other	(2)	(15)
<b>Net Cash (Used In) Provided By Financing Activities</b>	<b>(218)</b>	<b>(191)</b>
Net (decrease) increase in cash & cash equivalents	(303)	327
Cash and cash equivalents at beginning of year	472	145
Cash and cash at end of year	169	472

**Exhibit 2**

**Excerpts From Walgreens Financial Statements**

<b>Walgreens</b>		
<b>Consolidated Income Statements</b>		
(in millions)	8/31/97	8/31/96
Net Sales	13,363	11,778
Cost of Goods Sold	9,682	8,515
Gross Margin	3,681	3,263
SG&A	2,973	2,659
Total Operating Expenses	2,973	2,659
Operating Profit	708	604
Interest Income (Expense), net	4	3
Other (Expenses) Income, net	4	3
Earnings before tax provision	712	607
Income Tax Provision	(276)	(235)
Net Earnings (loss)	436	372

<b>Walgreens</b>		
<b>Consolidated Balance Sheets</b>		
(in millions)	8/31/97	8/31/96
<b>Assets</b>		
Cash & Equivalents	73	9
A/R (Net of allowance for doubtful accounts)	376	289
Inventory	1,733	1,632
Other Current Assets	144	90
Total current assets	2,326	2,020
PP&E, net	1,754	1,448
Deferred Charges & Other Assets	127	166
Total Assets	4,207	3,634
<b>Liabilities</b>		
Accounts Payable	813	693
Accrued Expenses	554	467
Income Taxes	72	23
Total Current Liabilities	1,439	1,183
Deferred Income Taxes	113	145
Other Long-term Liabilities	282	263
Total Liabilities	1,834	1,591
<b>Shareholder's Equity</b>		
Preferred Stock	-	-
Common Stock*	77	77
Capital Surplus	30	-
Retained Earnings	2,266	1,966
Total Shareholder's Equity	2,373	2,043
Total Liabilities & Shareholder's Equity	4,207	3,634

\* 493.8 million and 492.3 million shares outstanding as of August 31, 1997 and 1996, respectively.

**Exhibit 2 (continued)**

<b>Walgreens</b>		
<b>Consolidated Statement of Cash Flows</b>	8/31/97	8/31/96
(in millions)		
<b>Cash Flows From Operating Activities:</b>		
Net earnings (loss)	436	372
Adjustments required to reconcile net earnings (loss) to net cash (used in) provided by operating activities:		
Depreciation and Amortization	164	147
Deferred income taxes	8	3
Other	8	5
Change in assets & liabilities:		
(Increase) decrease in accounts receivable, net	(74)	(60)
(Increase) decrease in inventories	(101)	(178)
Increase (decrease) in accounts payable	121	85
Increase (decrease) in accrued expenses & other liabilities	73	42
Increase (decrease) in federal income taxes	12	(9)
Other	3	4
<b>Net Cash (Used In) Provided By Operating Activities</b>	<b>650</b>	<b>411</b>
<b>Cash Flows From Investing Activities:</b>		
Additions to PP&E	(485)	(364)
Proceeds from sale of PP&E	15	18
Net borrowing from (investment in) corporate-owned life insurance	(16)	47
<b>Net Cash (Used In) Provided By Investing Activities</b>	<b>(486)</b>	<b>(299)</b>
<b>Cash Flows From Financing Activities:</b>		
Dividends paid or payable	(116)	(105)
Proceeds from (purchases for) employee stock plans	17	(20)
Other	(1)	0
<b>Net Cash (Used In) Provided By Financing Activities</b>	<b>(100)</b>	<b>(125)</b>
Net (decrease) increase in cash & cash equivalents	64	(13)
Cash and cash equivalents at beginning of year	9	22
Cash and cash at end of year	73	9