

CVS in 2015

From Neighborhood Pharmacy Provider to Health Care Company

"It's my job as the CEO to ensure that we're positioning the company for not just short term success, but long term success . . . We're evolving into more of a health care company and we're doing many things. We have 26,000 pharmacists and nurse practitioners, who are helping millions of patients across the country every day, manage conditions like high blood pressure, high cholesterol, [and] diabetes."

Larry J. Merlo, CEO of CVS Health in 2014¹

As Larry J. Merlo, CEO of CVS Health, looked up from the morning news reports, his eye drifted to a picture of his dynamic predecessor, Stanley Goldstein. Goldstein, his brother Sidney, and Ralph Hoagland, a Proctor and Gamble salesman, had founded Consumer Value Stores with a single health and beauty products store in 1963. From that single store in Lowell, MA, CVS had grown into a dominant player in the pharmacy and pharmacy services business, filling more than one in five prescriptions for Americans.² With the just-announced acquisitions of Omnicare and Target's in-store pharmacies, Merlo saw CVS as a dynamic and innovative player migrating from a pharmacy chain to a diversified health care provider. As he glanced back at the announcement, he wondered which assets he still needed in order to accomplish that vision.³

The Pharmacy Industry

The pharmacy industry consists of firms engaged in the distribution of prescription and non-prescription drugs to consumers, divided into four major segments. *Institutional* pharmacies dispense drugs for inpatient use in health care facilities such as hospitals or long-term care facilities. *Retail* pharmacies fill prescriptions for individual customers in physical stores. *Mail Order and Specialty* pharmacies allow patients to access larger doses (90-day supplies) of regularly used prescriptions or provide drugs and related services for specialized medication regimes, such as infusion therapies, that can be used outside of hospitals. Finally, the *Pharmacy Services* segment provides prescription drug benefit management programs for various government entities (the federal Medicare program and state-run Medicaid programs), health insurers, and large employers who self-insure their employees.

Industry Drivers

The industry originated at the turn of the twentieth century as the medical profession saw benefits to separating the prescribing of medications from the sale and dispensing of those drugs; the split avoided conflicts of interest in which physicians would prescribe medications

financially best for them at the expense of patient health.⁴ From the end of World War II through about 1990, the number of retail pharmacies in the United States remained constant at about 55,000 (See **Exhibit 1**).⁵ In 1950, more than 90% of all prescriptions were filled by neighborhood pharmacists, small stores with no more than a few geographically-limited operations. By 1990 that number would decline to 64%. By 2007, concentration in the industry had completely reversed, with 64% of revenue owned by the top four firms, and 68% garnered by the top 20 firms. The largest players by sales in 2014 were CVS (24%), Walgreens (16%), Express Scripts (12%), Walmart (6%), and Rite Aid (6%).⁶

Three interrelated factors drove this radical change in the industry. First, health care in the United States increasingly relied on pharmacology (drugs) as the solution to health problems. Much of this reliance came from innovation within the pharmaceutical industry, the major supplier to the pharmacy industry. Major pharmaceutical companies continued to bring new drugs to market, drugs often aimed at very specialized diseases. It now cost almost \$2.6 billion to bring a new drug to market, more than double the cost a decade earlier.⁷ Many of these drugs targeted special maladies with small markets and long treatment regimens. For example, in 2013 Gilead Sciences gained FDA approval for Solvadi, designed to combat Hepatitis C, at a cost of \$84,000 for a 12-week treatment.⁸ Medicare expenses for the treatment of Hepatitis C increased 15-fold, to \$4.5 billion, in 2014. In spite of these specialty drugs, the increasing cost of inpatient treatment or professional services also drove the use of medication as a lower cost alternative.

Second, and related to the first, the increasing sophistication of drugs, coupled with increased demand, resulted in ever-increasing drug prices. **Exhibit 2** details average drug price increases in the United States during the last 45 years.

EXHIBIT 1 Growth in Retail Pharmacies, 1950–2105

Year	Number	CVS	CVS
		Stores	Share
1950	55000		N/A
1970	55000	100	0.18%
1990	55000	1250	2.27%
1997	43000	3900	9.07%
2002	40234	4122	10.25%
2007	42045	6301	14.99%
2012	43338	7508	17.32%
2015 (est)	44638	9466	21.21%

Data sources: Schondelmeyer and Thomas (see note 5), Hoovers online CVS, Forbes (http://www.forbes.com/2003/09/29/cx_lw_0929mondaymatch.html), Statista (<http://www.statista.com/statistics/241544/cvs-caremark-number-of-stores-since-2005/>) 2015 estimate contains 1,600 Target pharmacies.

EXHIBIT 2 Changes in Prescription Drug Prices, 1970–2013

	Average Annual Increase	Average Annual Inflation
1970–1979	3.60%	8.70%
1980–1989	9.60%	5.00%
1990–1999	10–15%	2.75%
2000–2004	5–6%	2.43%
2006–2013	9.20%	1.95%

Data sources: 1970–1990, Schondelmeyer and Thomas (see note 5), 1990–1999, <http://content.healthaffairs.org/content/20/5/43.full>, 2000–2004: <http://www.gao.gov/new.items/d05779.pdf>, 2006–2013: <http://www.aarp.org/content/dam/aarp/ppi/2014-11/rx-price-watch-report-AARP-ppi-health.pdf> U.S. Average annual inflation: <http://www.usinflationcalculator.com/>