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New York Pharma Forum

The Value of Pharmaceutical Distribution

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Agenda

- Cardinal Health overview
- Distributor value proposition
- Cost effectiveness of prime vendor model
- Market forces driving change
- Next-best alternative study
- Key components of “Fee for Service” model

Core business sectors

Pharmaceutical Distribution and Provider Services

- Pharmaceutical distribution
- Specialty pharmaceutical services
- Pharmacy consulting & services
- Data and clinical services
- Pharmaceutical contracting
- Pharmacy franchising

- Revenue: $54 billion

Medical Products and Services

- Medical/surgical distribution
- Perioperative products
- Custom kit creation
- Medical specialties manufacturing
- Nuclear pharmacy

- Revenue: $7.4 billion

Clinical Technologies and Services

- Pyxis® products, Alaris® products
- Clinical services & consulting
- Controlled pharmaceutical dispensing
- Controlled supply utilization
- Point-of-care technology

- Revenue: $681 million

Pharmaceutical Technologies and Services

- Pharmaceutical development
- Packaging and printing
- Sterile manufacturing
- Healthcare marketing services
- Modified release technologies
- Cell line engineering

- Revenue: $2.8 billion

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Pharma distributors

A critical link

Pharmaceutical distribution

500 < manufacturers

- ***Logistics***
- ***Administration***
- ***Financial***

140,000 providers

Deliver two million pharmaceuticals daily

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Pharma distributors

A critical link

- The ***Prime Vendor Model*** strengthens the “link”
- Providers have designed their business around this model
  - **Space**
  - **Capital**
  - **Customer service**
  - **Administration**
  - **Operations**

This is what the market requires

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Value required by providers

Logistics

- Deliver one consolidated order
- Provide next day deliveries
- Provide emergency deliveries

Administration

- Provide sophisticated ordering technology
- Provide manufacturer product information
- Provide marketing programs

Financial

- Manage customer inventories
- Provide product formularies
- Ensure contract compliance
- Maximize reimbursement

Drive for efficiency with provider customers

Past

Multi-source model

- Multiple wholesalers/direct ordering
  - Multiple orders, shipments, invoices
- 2 day order cycle
- Deliveries 2-3 days/week
- Minimal cost benefit for aggregation
- Limited services

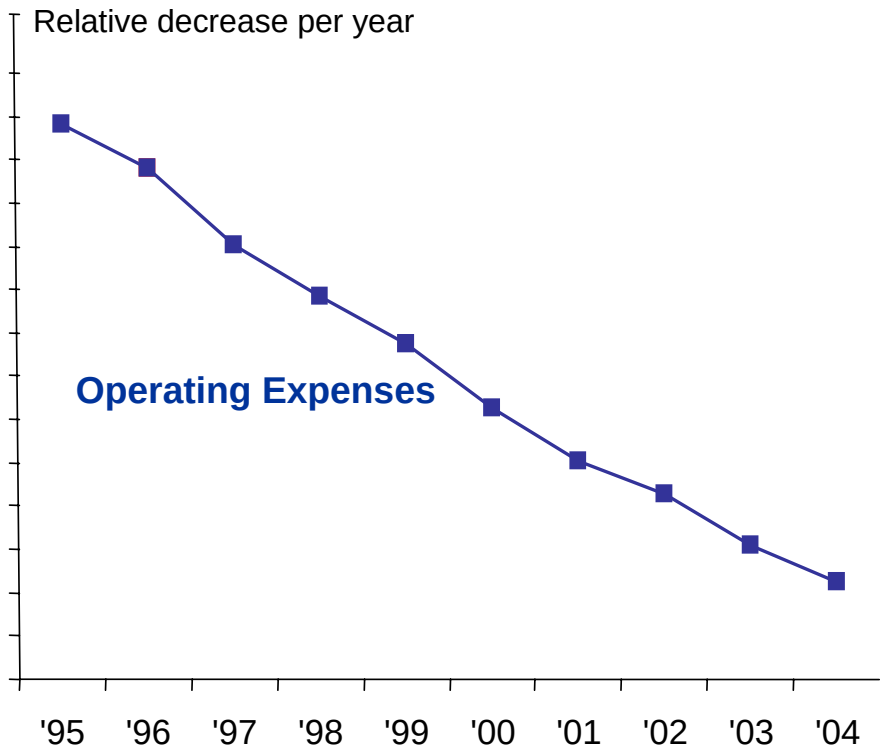
Present

Prime vendor model

- Single source
  - Single point of contact for orders, shipments and invoices
- 12 hour order cycle
- Deliveries 5-6 days/week
- Value derived from aggregation
- Comprehensive business solutions
  - Inventory management tools
  - Contract compliance programs
- Administrative enhancements
  - Contracting services
  - Expanded returns processing
  - Impeccable customer service
  - Special product handling – refrigerated and Schedule II items

Prime vendor model pricing

- Efficiency contributed to operating-expense decline
- Least expensive, most effective distribution system
- Provider benefit



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Drive for efficiency with manufacturers

Past

- Uneven ordering patterns
- Limited information
- Lack of transparency
- Orders by mail
- Hundreds of wholesalers
- Quarterly “deals” common
- Secondary market

Present

- Level buying pattern
- Robust information exchange
- Full inventory transparency
- Electronic transactions
- 3 wholesalers, 90% of volume
- Limited secondary market
- New item launch support
- Logistics innovations

Value delivered to manufacturers

Logistics

- Single daily delivery to providers
- 150 ship-to-points vs. 140,000
- Licensed, environmentally controlled, PDMA compliant facilities
- Reverse distribution
- Restock and resell customer returns ($3 billion +)
- Recall processing
- 12-hour turnaround/99% SL
- Handle C2s, Refrigerated, Hazardous products
- Business continuity

Financial/Administrative

- Maintain $9 billion + in working inventories
- Manage credit risk ($200 million in losses)
- Administer 100K contracts and $20 billion in chargebacks
- Handle customer service (40 million phone calls per year)
- Make sales calls (1.8 million in-pharmacy calls per year)
- Ensure contract compliance
- Promote sales and marketing
- Provide inventory and sales data

What has changed?

- "Buy and Hold" compensation model developed over 30 years
- U.S. health care system created most efficient drug supply chain in the world (Prime Vendor Model)
- Manufacturers have changed selling and pricing practices
  - **Benefits of Prime Vendor Model at risk**
- Dismantling Prime Vendor Model would cost at least $10 billion per year.*
- Cardinal Health solution: non-contingent, fee-for-service model, paid by manufacturer

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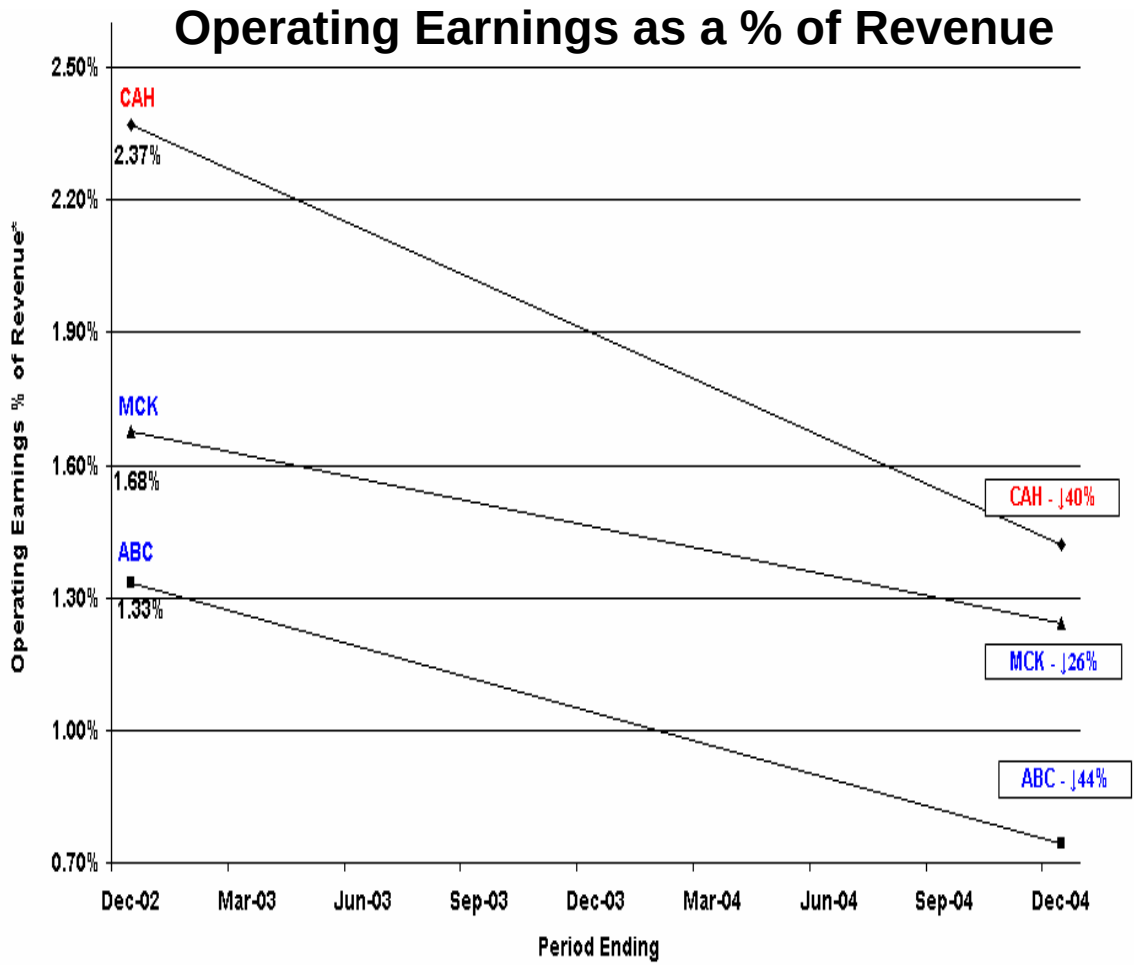
* HDMA Study: *"The Role of Distributors in the US Healthcare Industry"*

What has changed?

- Distributors' earnings reflect changes in manufacturer practices
- Transition to fee-based model necessary to maintain benefits of prime vendor model



Results exclude extraordinary charges

**CAH, ABC & MCK - Revenue includes Bulk Sales*

Source: Company & Merrill Lynch Analyst Reports - January '05

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Cardinal Health's approach

- Customer insight
  - Reviewed services and pricing
  - Studied provider reimbursement – inelastic market
- Tested the efficacy of Manufacturer-Wholesaler-Provider model
- Determined need for fee-based system

The challenge

Manufacturers want to…

- **Have** wholesalers perform critical supply chain services
- **Balance** inventories with prescription demand
- **Eliminate** excess product in pipeline
- **Receive** additional market information
- **Gain** administrative and operational efficiencies
- **Eliminate** regulatory concerns
- **Receive** immediate value of price increase
- **Measure** costs of accomplishing above

Wholesalers want to…

- **Be paid** for their critical role in the supply chain
- **Increase** administrative and warehouse efficiencies
- **Manage** inventories better
- **Make** margins more predictable
- **Maintain** (or improve inadequate) historical vendor margins

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The win-win solution

Cardinal Health and manufacturer enter into a **DSA (Distribution Service Agreement)**

- Cardinal Health agrees to:
  - Continue to provide the basic critical distribution and supply chain services
  - Insure purchases will equal sales out
  - Provide other value-added services
- Manufacturer agrees to:
  - Provide adequate compensation to Cardinal Health that is in a **"Fee for Service"** structure which simply means that it **is not inflation-based**

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Appropriate fee?

- **Select** a number that would replace former margins
- **Aim** for highest number manufacturers will pay, then negotiate
- **Perform** a detailed, study
  - Determine each manufacturer's costs
  - Charge fees at a discount to this cost
  - Continue to provide superior services

NBA

Next Best Alternative

Five key fee drivers

1. **Net U.S. sales**: *High or low*
2. **Product concentration**: *Consolidated or Fragmented ("Large-tail")*
3. **Product handing requirements**: *Significant special or primarily regular handling*
4. **Customers' channel bias**: *Number and nature of ship-to-points (acute or all)*
5. **Line extension**: *High or low*

Costs considered in the NBA model

- Basic operational costs such as picking smaller orders and shipping directly to individual pharmacies
- Other operational costs such as:
  - Special handling costs (C2s, Refrigerated, etc.)
  - Returns processing (including cost of destruction and inventory write-off)
  - Sales and marketing effort to large number of customers (in different classes of trade)
  - Required new capabilities: customer service / order management / billing / CRM

Costs considered in the model

- Bad debt / slow pay
- Opportunity cost for unfilled prescriptions, therapy days lost, and reduced compliance due to stock-outs in the retail channel
- Emergency shipping costs for stock-outs in hospitals and nursing homes
- One-time investments to build capabilities

Types of models created

A. Manufacturer **builds own** capabilities

B. Manufacturer **outsources** to a 3PL

Looked at both five deliveries and one delivery per week in both models

Fee for service examples

- A **flat fee** paid on all purchases
  - *Expressed as % on all purchases or an amount per piece or line*
- A **fixed amount of weeks** less BOH allocation after a price increase with a **guaranteed inflation rate**
- Yearly **dollar payments** for certain services
  - *Example: a $5 million payment for data*
- Any **combination** of the above

Typical DSA services provided/offered

- **Base services**
  Covers the everyday value of the wholesaler to the manufacturer
- **Level buying**
  Purchases equal sales out, so no speculative buying
- **Data**
  Covers basic inventory and sales reports
- **Enhanced reporting**
  Collaboration on forecasting and data interpretation
- **Customer order monitoring**
  Monitoring customer speculative activities

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Typical DSA services provided/offered

- **Product launch and support**
  Build in awareness programs and launch assistance
- **Secondary market limitations**
  Limited or no buying in secondary markets
- **Returned goods limitations**
  Rewards or penalties based on targets
- **Deduction process changes**
  Collaborative handling of deductions

Final points to consider

- **Manufacturers are now also customers**
  - They can and should hold wholesalers to a high standard of service
  - They sell product to wholesalers and **also** buy the services necessary to get them to providers
  - The costs of wholesaler's services will vary by manufacturer based on the product characteristics of each manufacturer

Robinson-Patman Act does not apply to the fees manufacturers pay wholesalers

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Final points to consider

- **Manufacturer's P&Ls are impacted**
  - Benefit of price increases is immediate
  - Production and administrative expenses can be reduced
  - The costs of distribution services are reflected in a measurable line item
  - The wholesaler model, even if at a higher cost than the past, is still significantly cheaper than any next best alternative

Cardinal Health recognizes these changes and wants to ensure as smooth as transition as possible

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Final points to consider

- **Cardinal Health requires a DSA**
  - We must have compensation that is measurable and predictable in order to effectively manage our business
  - We are willing to negotiate structure of the agreement, but not fees

We are confident the end result of these changes is a better, stronger, more dependable supply chain

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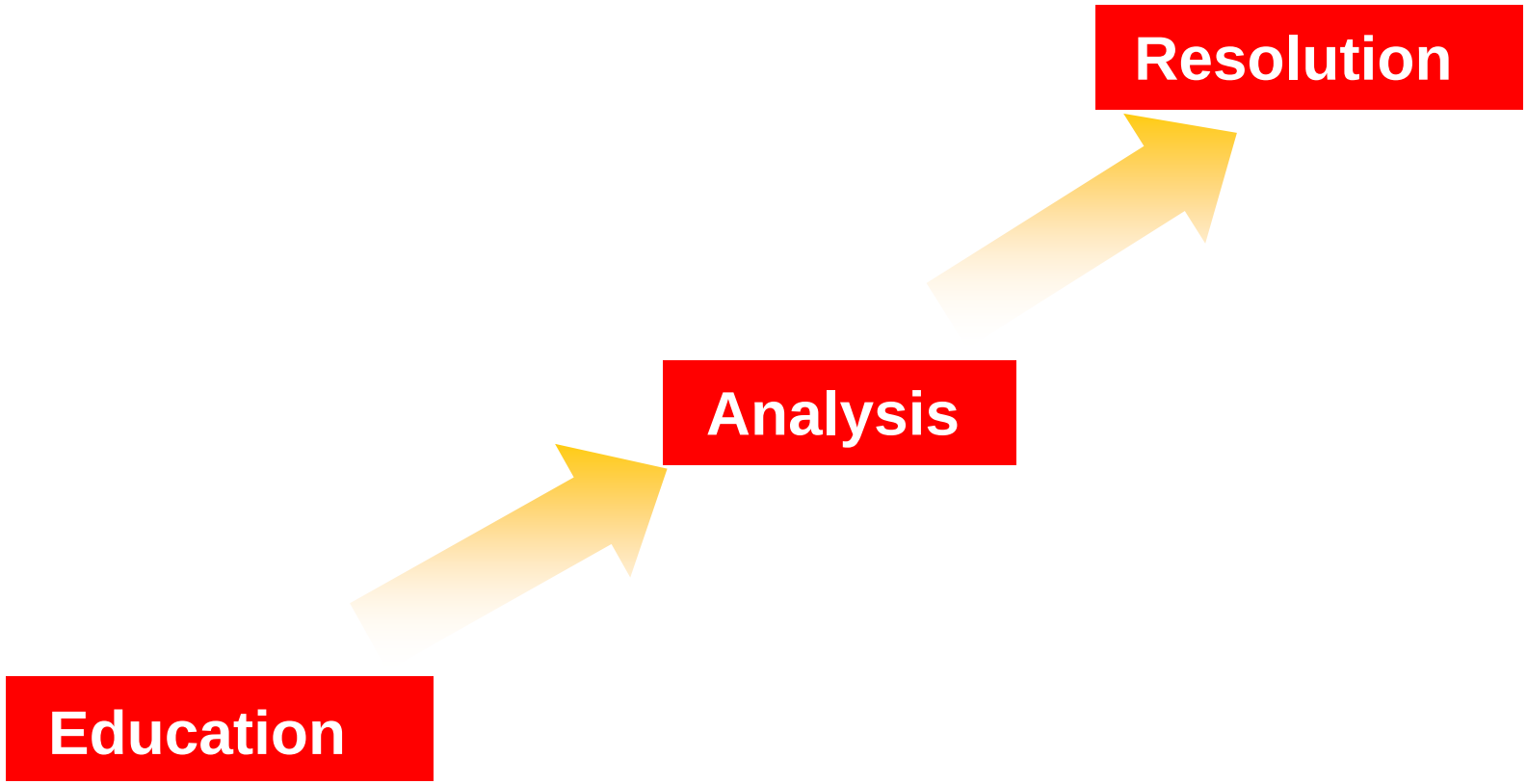
Cardinal Health's disciplined approach



Cardinal Health's beliefs

- **Prime vendor model** drives efficiency for entire channel
- **Provider pricing** is inelastic
- **Next-best alternative** based on fair market value
- Manufacturer community has accepted **fee-for-service**
- **Fee-for-service transition** will be completed by mid year

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