Outlook for the Economy and the Pharmacy Industry

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After the strongest performance in 30 years, global growth is slowing

OECD industrial production

% yearly change

Official interest rates

% yearly change

Sources: National agencies, IMF, OECD. Bloomberg and Economics@ANZ.
Higher oil prices have caused a ‘soft spot’, but shouldn’t cause the global economy to collapse

- Strong global demand, geopolitical risk and speculation has pushed oil prices to record highs
- Higher oil prices is hitting household discretionary income and corporate profit margins
- The global and Australian economies are now better placed to cope with oil price ‘shocks’
  - Greater energy-efficiency and increased use of alternative energy sources
  - More efficient product and labour markets reduce inflation risk

3 Sources: Reuters
The US and China will keep global growth above trend again this year

Real fed funds rate

Global growth

Chinese industrial production

Note: GDP based on 50 countries aggregated using ‘purchasing power parity’ weights.
Sources: National agencies, IMF, OECD, US Federal Reserve, and Economics@ANZ.
Australia is enjoying its longest run of uninterrupted economic growth since Federation

Australian real GDP growth, 1901 - 2006

- 25 quarters of negative growth in this period, including 6 episodes of 2 or more consecutive quarters of –ve growth
- 3 qtrs of –ve growth in this period
- 1 qtr of –ve growth in this period

Note: data are for financial years ended 30 June.
Sources: Angus Maddison, Monitoring the World Economy 1820-1992; Reserve Bank; ABS; Economics@ANZ.
The headline data suggests growth slowed sharply in the second half of last year

- The official ABS data suggests that economic growth slowed from...
  - ... 4%yy at the start of 2004 to...
  - ... just a 1.4%yy by end-2004
- This is well below ‘average’ growth of around 3¼-3½%pa

Sources: ABS
But the GDP data doesn’t tell the whole story

**Australian economic growth**

% yearly change

- Domestic demand
- Real gross domestic product

Sources: ABS
Part of the slowdown in GDP growth reflects capacity constraints

Contributions to GDP growth, December quarter 2005

-0.8 -0.6 -0.4 -0.2 0.0 0.2 0.4 0.6 0.8 1.0

HH consumption Business investment Housing Public expenditure Inventories Net exports GDP

Labour shortages

Highest in the 15-year history of this survey

Businesses reporting labour shortages as a constraint on output

Sources: ABS
This has been putting upward pressure on some prices – which is why the RBA raised rates

- Rising domestic material costs and labour shortages (in some industries) has put upward pressure on producer prices
- Labour costs are also showing an upward trend
  - Although wage pressures thus far remain contained to a few ‘pockets’ where demand is strongest eg. mining, engineering, construction
- The RBA were concerned that continued strong domestic demand would further stoke emerging price pressures
- Hence the 25bp rise in interest rates in March

Sources: ABS
What has the Government done to address these problems?

- Strong employment growth and company profits has given Government coffers a significant boost
- However, the Government has given most of this extra revenue back, via tax cuts and increased expenditure
- Overall, the Commonwealth Government is imparting a soft fiscal stimulus to economic growth next year
- But it’s what the Government does with the extra cash that matters most

Commonwealth Government underlying budget balance

% of GDP

-0.5 0.0 0.5 1.0 1.5 2.0 2.5

Surplus without 2005-06 Budget Measures

Sources: Commonwealth Budget Papers
The Budget was a good start, but there is further to go

- **Income tax cuts for all with a big lift in top two tax thresholds**
  - A good start, but we still need more comprehensive reform of the income tax system (lowering rates by broadening the base and eliminating the myriad of concessions, exemptions and deductions)

- **Concerted effort to increase labour force participation by moving people from welfare to work**
  - Reducing the lowest marginal tax rate, changing eligibility for Newstart Allowance amongst single parents and receivers of Disability Support, expanded services for work assistance, including wage subsidies for long-term unemployed

- **Not much for businesses except for a few worthwhile tax cuts**
  - Removal of the 3% concessional tariff on business inputs and ability to deduct ‘blackhole’ expenditures

- **A little bit of extra money for education, but very little to address infrastructure bottlenecks**
  - Disappointing, although this largely falls into the domain of the States

- **An attempt to address longer term fiscal sustainability**
  - Sale of remaining Telstra share in three tranches from late 2006, raising $34bn. Proceeds plus underlying surpluses to be invested in Future Fund as an offset to unfunded superannuation liabilities
Which way for the Australian economy now?
The macroeconomic environment is still extremely favourable

Unemployment rate

Profits

% of total factor income (trend)

Sources: ABS, Economics@ANZ
A slight rise in interest rates won’t cause the economy to collapse

Source: ABS, Datastream
Housing is achieving a soft landing, but will now stay softer for longer

**House prices**

- % yearly change

**Rental vacancy rates**

- 4qtr ma

**Housing finance commitments**

- $ bn per month

**Pipeline**

- $bn per quarter (2002-03 prices)

*Sources: ABS*
Conditions have become a little less supportive for consumer spending...for now(!)

**Household net wealth**

- $bn scale
- 1996 to 2004

**Consumer sentiment**

- $ bn per month
- 2003 to 2005

**Petrol prices**

- A$/litre
- Weighted average of capital cities
- 2003 to 2005

**Retail sales**

- % yearly change
- 2003 to 2005

*Sources: ABS*
Will households save or spend their income tax cuts?

- Income tax cuts will boost household incomes by around $3bn in 2005-06
  - That’s a boost of around 1% to national disposable income
- If households spend all of their income tax cuts, we could see a boost to consumer spending of around ¾ppt
  - Adding around ¼ppt to GDP growth
- More likely however, some of these income tax cuts will be saved

Sources: ABS
Solid global growth and a resources boom should see exports turn the corner

**Trade volumes**

- **Imports**
- **Exports**

**Resource exports**

- **% annual change**
- **Forecasts**

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Sources: ABS, Economics@ANZ
A depreciating A$ should also give exporters a boost

A$/US$ and commodity prices

A$/US$ and commodity price index (RHS)

AUS-US interest rate rate spreads

Spread on AUS-US 90d interest rate (RHS)

Sources: Reuters, RBA, Economics@ANZ
Economic growth should moderately improve and inflation is expected to gradually rise.

Source: ABS, Economics@ANZ
Softer growth should keep the RBA on hold, but a tightening bias will remain

- Signs that the (domestic) economy is cooling has seen the RBA become less concerned about the upside risk to inflation
  - This is because the downturn looks to be cyclical as well as structural
  - The sharp reaction to the March rate rise, as demonstrated by the big fall in consumer sentiment, may have also seen the RBA become a little wary
- Our view is that these factors will likely keep rates on hold for now
- Nevertheless, the RBA sees the outlook as far from soft
  - Income tax cuts, strong terms of trade, low unemployment, rising wages
- So the policy bias remains for higher, not lower, interest rates

Source: RBA, Reuters, Economics@anz
The pharmacy industry
Interstate and overseas migration will have an impact

Population growth in 2004

% change over year to Sep 2004

Source: ABS
Pharmacy turnover has been fairly flat despite the strength of the economy

- Growth in pharmacy turnover has picked up following a poor year in 2003
- According to the Guild, turnover grew by 4.1% in Australia in 2003-04, despite a 9.3% increase in the PBS.
- But IBISWorld estimate that turnover was better than that, with growth of 6.9% over the same period
- Industry revenue was estimated at $9 bn in 2003-04
- And at the same time ABS data suggests pharmaceutical and cosmetic retail sales have been growing more strongly
- Likely to be the result of increased competition from supermarkets and health and beauty chains

Source: ABS
Six of the 20 fastest growing grocery categories fall into the health and beauty or over the counter segments.
Supermarkets winning share in cosmetics and toiletries from supermarkets

Total Cosmetics and Toiletries Sales ($b)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>2002</th>
<th>CAGR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supermarkets</td>
<td>1,343</td>
<td>1,814</td>
<td>5.2</td>
</tr>
<tr>
<td>Pharmacies</td>
<td>395</td>
<td>389</td>
<td>(0.3)</td>
</tr>
<tr>
<td>DDS</td>
<td>565</td>
<td>726</td>
<td>1.1</td>
</tr>
<tr>
<td>Specialty/Direct</td>
<td>274</td>
<td>269</td>
<td>(1.9)</td>
</tr>
<tr>
<td>Other</td>
<td>2,798</td>
<td>3,410</td>
<td>(1.7)</td>
</tr>
</tbody>
</table>

Note: Priceline included in DDS channel
Growth in dispensary at expense of front-of-store is a long term trend

Average Australian Pharmacy Sales
Dispensary Versus Front-Of-Store: 1981-01

<table>
<thead>
<tr>
<th>Year</th>
<th>Prescription Sales</th>
<th>Front-Of-Store Sales</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>38</td>
<td>62</td>
<td>(32)</td>
</tr>
<tr>
<td>1991</td>
<td>50</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>70</td>
<td>30</td>
<td>32</td>
</tr>
</tbody>
</table>

Source: IBIS World reports; BCG analysis
Population growth will slow but the proportion of older people will rise

Source: ABS Population Projections
Australia’s demographic profile will change profoundly over the next forty years.

Age distribution of the Australian population

Sources: ABS unpublished data; Productivity Commission.
Australia’s demographic profile will change profoundly over the next forty years.

Age distribution of the Australian population

Sources: ABS unpublished data; Productivity Commission.
Annual growth in pharmaceutical expenditure and total health expenditure, 1998-2003

Source: OECD Health Data 2005
Pharmaceutical expenditure as a percentage of total health spending

Source: OECD Health Data 2005
Health expenditure as a percentage of GDP

Source: OECD Health Data 2005
Government expenditure on health is increasing

**Annual per person expenditure on pharmaceuticals**

- USA
- Germany
- France
- Canada
- Australia

**Total health expenditure & growth in PBS in Australia**

*Source: Department of Health and Ageing*
Costs of hospital treatment and pharmaceutical benefits will rise rapidly as the population ages.

Health care costs will thus rise substantially as a percentage of GDP

- Hospital expenditure will rise from 2.6% to 4.1% of GDP by 2044-45
- Medicare expenditures will rise rather less steeply, from 1.2% to 1.8% of GDP
- Spending on the pharmaceutical benefits scheme will rise more than threefold, from 0.7% to 2.6% of GDP
  - increases in drug prices ahead of general inflation an important additional factor
- Total health spending by governments will rise from 5.7% to 10.3% of GDP
- Total age-related government spending will increase from 18.7% to 25.2% of GDP

Other things being equal, rising age-related costs will have a major impact on government finances.

Change in net fiscal position of Commonwealth, State and Territory governments due to ageing, 2003-04 to 2043-44

Creating a sustainable health system!

- **Australia faces considerable long-term pressures on health expenditure**
- **With the aim of ensuring the long-term viability of the health system, the Government announced a number of policy decisions in the 2005-06 Federal Budget, including:**
  - The Medicare Safety Net threshold is being raised to $500 for concession card holders and Family Tax Benefit Part A recipients and to $1,000 for all other individuals.
  - This measure builds on the 12.5% cut in the price of generic medicines. Together these measures are expected to save an estimated $1bn over 4 years.
  - However the savings will be reduced by the increase in the income threshold for the maximum rate of Family Tax Benefit, meaning that 40,000 families will qualify for the Health Care card.
  - The Budget also encourages more prescribing of generic medicines as a method of reducing the costs of the PBS. In the Budget, the Government also announced increased spending on cancer screening, and for an expanded smoking cessation program. Funding will also continue for asthma and diabetes management, and additional funding for research into juvenile diabetes.
Sales of generic pharmaceuticals are relatively small in Australia.....

### Sales & Patent expiry dates for selected ‘blockbuster’ drugs

<table>
<thead>
<tr>
<th>Drug</th>
<th>Global sales ($US pa)</th>
<th>Patent Expiry Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zocor</td>
<td>5,280</td>
<td>Jul 05</td>
</tr>
<tr>
<td>Norvasc</td>
<td>3,362</td>
<td>Feb 08</td>
</tr>
<tr>
<td>Zoton</td>
<td>3,100</td>
<td>Sep 09</td>
</tr>
<tr>
<td>Claratyne</td>
<td>3,011</td>
<td>Jun 06</td>
</tr>
<tr>
<td>Zoloft</td>
<td>2,140</td>
<td>Oct 05</td>
</tr>
<tr>
<td>Pravachol</td>
<td>1,817</td>
<td>Jun 06</td>
</tr>
<tr>
<td>Flixotide</td>
<td>1,270</td>
<td>Feb 06</td>
</tr>
<tr>
<td>Zyrtec</td>
<td>1,158</td>
<td>Feb 07</td>
</tr>
<tr>
<td>Accupril</td>
<td>553</td>
<td>Sep 06</td>
</tr>
</tbody>
</table>

*Source: DITR, 2002*

### Generics use around the world

<table>
<thead>
<tr>
<th>Country</th>
<th>% of prescriptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>60</td>
</tr>
<tr>
<td>Canada</td>
<td>40</td>
</tr>
<tr>
<td>UK</td>
<td>47</td>
</tr>
<tr>
<td>Germany</td>
<td>40</td>
</tr>
<tr>
<td>USA</td>
<td>45</td>
</tr>
<tr>
<td>Australia</td>
<td>19</td>
</tr>
</tbody>
</table>

*Source: Australian Pharmaceutical Summit, 2004*

- **Currently only 19% of prescriptions are filled by generic medicines compared to 40-50% in the US and Europe**

- **Patents on over 100 drugs are due to expire in the next 5 years**
But sales are growing and have significant potential for further growth

- Growth outlook is positive for generics due to:
  - patents on over 100 pharmaceuticals are due to expire between June 2005 and 2010
  - demographic trends favour greater consumption of generic pharmaceuticals
  - an increase in life expectancy
  - generics can ease the burden on the PBS

<table>
<thead>
<tr>
<th>Company</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alphapharm</td>
<td>71</td>
</tr>
<tr>
<td>Arrow Pharmaceuticals</td>
<td>12</td>
</tr>
<tr>
<td>Hexal</td>
<td>7</td>
</tr>
<tr>
<td>Douglas Laboratories</td>
<td>6</td>
</tr>
<tr>
<td>Mayne</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: BRW, Sep 1994
The outlook for the pharmacy industry is still bright

- **Solid growth is expected due to:**
  - an ageing population
  - rising incomes
  - increased health consciousness – currently over 50% of the Australian population use some form of complementary medicine
  - new products and technology

- **But deregulation will be a critical factor**
Summary of forecasts

<table>
<thead>
<tr>
<th></th>
<th>2003-04</th>
<th>2004-05</th>
<th>2005-06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global growth</td>
<td>5.1</td>
<td>4.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Australian growth</td>
<td>4.1</td>
<td>2.2</td>
<td>3.4</td>
</tr>
<tr>
<td>Unemployment rate (Jun)</td>
<td>5.8</td>
<td>5.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.4</td>
<td>2.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Cash interest rate (Jun)</td>
<td>5.25</td>
<td>5.50</td>
<td>5.50</td>
</tr>
<tr>
<td>A$/US$ (Jun)</td>
<td>0.70</td>
<td>0.75</td>
<td>0.66</td>
</tr>
<tr>
<td>Victorian growth</td>
<td>3.7</td>
<td>3.3</td>
<td>3.6</td>
</tr>
</tbody>
</table>

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