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INDUSTRY EFFECTS AND STRATEGIC CONVERGENCE: A STUDY OF THE STRATEGIES OF INDEPENDENT PHARMACISTS

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ABSTRACT

The pharmacy industry is experiencing significant change. With the increasing presence of regional discounters, the appearance of mail service and internet pharmacies, the continuing ascendancy of managed care (including HMOs and PPOs), third party reimbursement plans, and pharmacy benefit managers (PBMs), the strategic options for independent pharmacies are dwindling. This exploratory study examines the relationships among generic business level strategies of independent pharmacies, industry effects -- in terms of consequences of third party reimbursement plans -- and performance outcomes. It seems that the impact of managed care reimbursements more than offsets the various strategic efforts by pharmacies. The evidence indicates that different generic strategy approaches are not producing significant differences in performance. The findings suggest that industry effects may be creating a situation of strategic convergence. The practical implications for the independent pharmacists and future research are addressed.

INTRODUCTION

THE CHANGING FACE OF THE PHARMACY INDUSTRY

Independent pharmacies, like many other businesses, are faced with a rapidly changing competitive environment, which could be classified as very turbulent (Harrison & Ortmeier, 1997). The increasing presence of regional discounters, the availability of mail service and internet pharmacies, the continued ascendancy of managed care (including HMOs and PPOs),

third party reimbursement plans, and pharmacy benefit managers (PBMs) are reshaping the pharmacy industry. These environmental changes are placing intense demands on independent pharmacies, those privately held, usually owner-operated, pharmacies that are not affiliated with any chain (Beliveau & Bernstein, 1997).

Industry context continues to be a major determinant of a firm's success and survival (Sandberg & Hofer, 1987). Using a deterministic perspective, a pharmacy's strategy and performance may be primarily determined by industry effects, those attributes common to an industry (Stratton & Martens, 1994). In particular, third party reimbursement plans are an element which has had long-term detrimental effects on pharmacy profits (Frederick, 2001b; Carroll, 1991). While independent pharmacists have seen increases in gross sales revenues and in the numbers of prescriptions filled (West, 2001), third party plans are depressing the profitability of independent pharmacies.

This study examines the relationships of the generic business strategies of independent pharmacies, industry effects, in terms of consequences of third party reimbursement plans, and performance outcomes. Performance is measured in terms of self-reported financial returns and a composite measure of overall success. The evidence suggests that different generic strategies are not producing significant differences in perceived performance. Not surprising is the finding that third party reimbursement plans significantly and negatively affect independent pharmacies' perceived performances. The research supports the argument that industry effects may be creating a situation of strategic convergence where pharmacies are copying the strategies of their competitors in order to succeed. The implications for both practitioners and future research are discussed.

STRATEGIC OPTIONS

Under upper-echelons theory, managers matter a great deal, depending upon how much discretion or latitude of action they possess (Cannella, 2001; Finkelstein & Hambrick, 1996: Hambrick & Mason, 1984). Independent pharmacists who are usually owner/operators should possess considerable discretion in setting the strategy and course for their firms. However, discretion exists only in the absence of constraint; it emanates from the business's environment, the organization itself, and from the executives. For an independent pharmacy, the industry environment is a likely constraint upon the choices available to the owner/operator in crafting strategies. Where managers are constrained and their choices restricted, the economic differences among them may not be so great (Cannella).

Generic Strategic Options

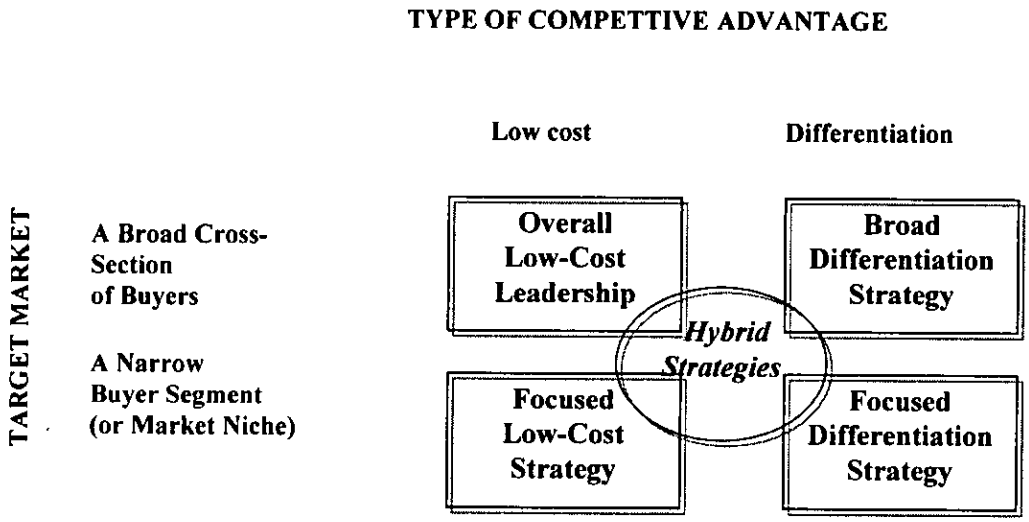
While recent research, particularly the resource based view, has concentrated on firm-level attributes, generic business strategies remain useful in characterizing strategic positions of firms at the simplest and broadest level (Porter, 1996). The generic strategies framework continues to highlight the inherent contradictions of different strategies and the tradeoffs which must be made by managers in implementing their strategic choices (Hodgetts, 1999; Porter).

The generic business strategies, as identified by Porter (1980), include overall low cost leadership and differentiation (see Figure 1). A low cost leadership strategy comprises an internal orientation on product efficiencies and cost control. Cost savings can be achieved by minimizing expenditures on innovation and advertising and offering no-frills rather than concentrating on image and brand name products. Differentiation strategies endeavor to offer customers unique products or services. Miller (1988) identified two distinct types of

differentiation: marketing and innovation. Extensive advertising and image management and intensive marketing, such as offering attractive features, convenience, and service guarantees characterize marketing differentiation. Innovative differentiators are characterized by creativity in product offerings, application of new technologies or products, and current innovations (Dess, Lumpkin & Covin, 1997). In the past, smaller firms, with limited resources, skills, and capabilities, were advised to adopt narrower differentiation strategies, or niche strategies, which focus on specialized products or services for targeted markets (Broom & Longnecker, 1979).

Figure 1

Generic Competitive Strategies



Historically, independent pharmacists have adopted differentiation strategies to gain competitive advantage. Pharmaceutical care generally incorporates three components of cognitive services: dispensing services, dispensing-related services, and non-dispensing value-added services (Christensen, Fassett & Andrews, 1993). Differentiation was previously gained by offering non-dispensing value-added services (Bouldin, Bentley, Huffman & Garner, 1996). Most pharmacists now offer a wide variety of non-dispensing value-added services, which have blurred the distinctiveness and uniqueness amongst pharmacies (Frederick, 2001a, 2001b). The wide ranges of services which pharmacists can provide are changing their roles and providing opportunities for competitive advantage and commensurate improved performance. Pressure is placed upon pharmacists to involve consumers in their pharmaceutical care (Holdford & Watrous, 1997). Pressure to inform consumers of price and cost differences among products originated in part as a result of third party reimbursement plans' attempts to control rising costs (Szeinbach, Barnes, Summers & Banahan, 1995). Further, for the individual consumer, co-payment policies of third party plans have removed price as a competitive weapon. As the expansion of third party reimbursements creates greater competition in the pharmacy industry (Genuardi, Stiller, & Trapnell, 1996), pharmacists in order to be successful in this new environment must position their businesses to meet or satisfy most or all of the needs of their customers.

Industry Constraints

Industrial organization economics (I/O economics) posits that strategy and performance are determined primarily by membership in an industry. Industry effects pertain to the attributes customary to an industry. The dominance of industry effects within an industry demonstrates the similarities by which companies in that industry respond to industry conditions and their imitation of successful strategies (Mauri & Michaels, 1998). Regardless of the school of I/O economics (Bain/Mason, Schumpeterian, or Chicago), the I/O economics literature generally assumes that firms within an industry will be homogeneous in terms of their patterns of competitive behavior (Mauri & Michaels).

The rapid growth of third party prescription reimbursement plans is changing the dynamics of the pharmacy industry. Third party reimbursement programs play an increasing role in the prescription drug market, now accounting for over 80% of the prescriptions dispensed in the entire retail setting (Frederick, 2001b). As a result of cost containment efforts and the preeminence of third party plans, independent pharmacies have experienced decreases in dispensing fees and corresponding decreases in gross profit margins. Third parties (managed care groups and PBMs) are offering pharmacies contracts with smaller dispensing fees, and some have even closed their networks, effectively excluding some pharmacies. Consequently, independent pharmacies can either accept decreasing levels of reimbursement for services or be excluded from some plans. Although third party reimbursement programs appear to have a detrimental effect on profit margins, retail pharmacists continue to provide these prescription services for fear of losing business to competitors (Szeinbach et al. 1990). A previous study by Carroll (1991) predicted that third party reimbursement programs would have a detrimental effect on the profits of independent pharmacies. Anecdotal evidence from discussions with independent pharmacists indicates that performance is negatively affected by third party reimbursements.

Third party reimbursement plans have effectively eliminated price as a competitive weapon. The consumer has become price indifferent because the out of pocket cost of a prescription is often the same regardless of the pharmacy. For example, under a typical employer drug plan, the consumer pays $30.00 for a name-brand prescription, $20 for a generic. Regardless of which pharmacy she chooses, she will be responsible for only the co-payment. What the pharmacist receives is determined by the contract between the pharmacist and the third party payor. This arrangement removes price as a strategic option, leaving only differentiation of services to the pharmacist's discretion.

Where managers are constrained and their choices restricted, the economic differences among them may not be so great (Cannella, 2001). We hypothesize that faced with an external environment which restricts pharmacists' opportunities by limiting their strategic choices (Szeinbach, et al., 1995), and with the limitations imposed by their size, the performances among independent pharmacies will not be appreciably different.

METHODOLOGY

Survey Procedures

The data concerning the operations of the independent pharmacies was collected by a questionnaire. The questionnaire was adapted from earlier works on the strategies, marketing decisions, and competitive methods of small independent retailers (McGee & Peterson, 2000; Conant, Smart, & Solano-Mendez, 1993). The questionnaire was pre-tested by three independent pharmacists (not included in the final sample) to determine if there were

problems interpreting any of the questions. No problems were detected by the pre-test participants who had no difficulty answering the questions or rating the performance of their pharmacies. The comments of the pre-test participants were incorporated into the questionnaire.

The sample of independent pharmacies was compiled from a list of all licensed pharmacies supplied by a southwestern state's pharmacy board. An independent pharmacy is defined as privately held, usually owner-operated, and not affiliated with any chain (Beliveau & Bernstein, 1997). Pharmacies identified with national or regional chains (108) were deleted, and the survey instrument was mailed to a final sample of 528 pharmacies. The questionnaire, along with a stamped return envelope, was addressed to the licensed pharmacist at each location. Reminder postcards were sent approximately three weeks later. A total of 88 responses were returned, for a response rate of 16.67%.[1] The responses indicated that qualified informants answered 97.4% of the survey instruments: 81.7% were answered by the owners of the establishments, and 15.7% by the pharmacist in charge of the pharmacy. The respondents, the owners or pharmacists in charge, should be aware of the operations and performances of the pharmacies. The responses of 13 pharmacies provided incomplete performance information and were deleted from the final analysis.

Non-response bias occurs when the opinions and perceptions of the survey respondents do not accurately represent the overall sample to which the survey was sent. One test for non-response bias is to compare the answers of early versus late respondents to the survey. The idea is that late respondents are more likely to answer the questionnaire like non-respondents than are early respondents (Armstrong & Overton, 1977). A multivariate t test was computed using the key study variables in order to examine whether significant differences existed between early and late respondents. The results indicated that early respondents do not display statistically significant differences from late respondents ($p < .05$)(Miles & Arnold, 1991).

Definition of Variables

One section of the questionnaire asked what generic business strategies the pharmacies emphasized. Previous research (Dess, et al., 1997; Miller, 1988) has identified three distinct generic business strategies (cost leadership, innovative differentiation and marketing differentiation). The measure of the generic business strategies was conducted using a scale similar to the scale developed by Miller (1988) in studies of manufacturing firms. The scale was developed from questions regarding the importance of specific business strategic tactics and included two cost leadership items, two innovative differentiation items and three marketing differentiation items. Respondents were asked to indicate the degree to which they emphasized certain strategic tactics on a Likert-type scale from 1 = "very unimportant" to 7 = "very important." Factor analysis was used to identify the particular strategies of the pharmacists. The seven strategy items were factor analyzed using a principal components analysis with varimax rotation. All factor loadings were greater than .50 which indicates that they are very significant (Hair, Anderson, & Tatham, 1987).

The performance of the independent pharmacies is operationalized using subjective self-report measures. Pharmacists were asked to compare their pharmacies' performances against their competitors along four dimensions: gross profit [Gross Profit], net income after taxes [Net Income], total sales growth over the past 3 years [Sales Growth], and overall pharmacy performance/success [Overall Success]. Previous research has shown that subjective measures of performance are consistent with objective measures, thus enhancing the reliability and validity of these measures (Dess, et al., 1997; Venkatraman & Ramanujam, 1987; Dess & Robinson, 1984). The questionnaire sought objective measures of performance,

but fewer than half of the respondents provided any of the requested information. Financial measures of performance may be inappropriate for small businesses and family-owned businesses, because the roles and objectives of small business owners make the attribution of success for small businesses complex, dynamic, and problematic (Jennings & Beaver, 1997). Small business success may, indeed, be the sustained satisfaction of the principal stakeholders' aspirations (Jennings & Beaver). Therefore, success in the perception of the owner/operator is an appropriate measure, as well as the use of a composite score. Previous research has suggested that traditional measures of performance may not be appropriate for pharmacies, and that a "benchmarking" performance measure should be used as another nonfinancial performance measure (Stratton & Martens, 1994). Comparing a business' performance against the performances of its competitors is the basis for an additional measure. A comparative measure was adduced by adding together the responses of the four dimensions described previously. A scale which sums the four performance perceptions supplied an appropriate benchmark measure [Sustainability], Cronbach's alpha = .8225, which is an acceptable measure of internal consistency.

The industry context is dominated by third party reimbursement plans and this was used as a proxy for the industry effects in the regression equations. Third party reimbursements are the percentage of prescriptions paid for by third party managed care payors [Third party %]. Size has also been identified as a factor in pharmacy operations and performance (Beliveau & Bernstein, 1997), and was controlled for in this study. Size was operationalized by using the weekly average number of prescriptions filled [Size]. A description of the variables and their sources are set forth in Table 1.

Table 1 – Variables

Name	Source
Independent Variables	
Marketing Differentiation	Factor Analysis
Innovation Differentiation	Factor Analysis
Low Cost Leadership	Factor Analysis
Control Variables	
Third Party Reimbursements	Questionnaire Answer: Percentage of prescriptions paid by third-parties
Size	Questionnaire Answer: Number of prescriptions filled weekly
Dependent Variables	
Gross Profit	Self-report measure - Likert-type answer
Net Income After Taxes	Self-report measure - Likert-type answer
Total Sales Growth after 3 years	Self-report measure - Likert-type answer
Overall Pharmacy Performance/Success	Self-report measure - Likert-type answer
Sustainability	Scale measure created by combining responses to 4 prior performance measures

Methods of Analysis

The research consisted of two phases. First, the responses concerning generic business strategies were factor analyzed. In the next phase, regression analyses were used to test the hypotheses concerning the performance implications of the business strategies and the industry effects. The basic form of the regression equation model is:

$$Y = a + bX + c\,Z_1 + d\,Z_2$$

where

Y = the performance variable [Gross Profits, Net Income, Sales Growth, Overall Success, and Sustainability]

+a = intercept

+ X = business strategy

+ Z_1 = third party reimbursement [Third party %]

+ Z_2 = size [Size]

RESULTS

Table 2 sets forth the descriptive statistics and the correlation matrix for the pharmacies that responded to the questionnaire. Included in the correlation matrix are the factor scores generated by SPSS for the three generic business strategies. The average pharmacy in the study has: 1.77 pharmacists; 1.50 technicians; 5.83 employees; is 16.61 years old; and has a total square footage of 2316 of which 648 square feet (39%) is devoted to the prescription department. The average pharmacy fills 698 prescriptions weekly. Third party plans constitute a large percentage of business done by independent pharmacies (57.10%), a finding which corresponds to national trends at the time of the survey (Fleming, 1998). Average annual sales are $1.145 million.

Table 2 – Descriptive Statistics and Correlations

	Mean	*S.D.*	*Gross Profit*	*Net Income*	*Sales Growth*	*Overall Success/ Performance*	*Sustain-ability*
Gross Profit	4.26	1.39	1.000				
Net Income (AT)	4.00	1.42	.794***	1.000			
Total Sales Growth Over Past 3 Years	5.00	1.42	.357***	.439***	1.000		
Overall Perf. /Success	5.03	1.40	.462***	.523***	.745***	1.000	
Survivability	18.25	4.63	.789***	.847***	.769***	.826***	1.000
Innovative Strategy [1]			-.061	.137	.005	.014	.028
Low Cost Strategy [1]			-.075	.072	-.052	.044	.000
Differentiation Strategy[1]			.001	-.111	.222	.043	.064
Pharmacy Size (Avg. # prescriptions filled/week)	690.3	448.6	.041	.162	.107	.123	.133
Third Party Reimbursements (%)	.56	.14	-.346***	-.369***	-.200*	-.181	-.319***

[1]Scores generated from factor analysis

*** – Significant @ .01 ** – Significant @ .05 * – Significant @ .10

Business Strategy Results

As expected, the factor analysis yielded three patterns of strategic behavior: marketing differentiation, innovative differentiation and cost leadership, each with eigenvalues greater than one (see Table 3). Factor one most closely aligns with a marketing differentiation strategy. Historically, independent pharmacists have attempted to create a competitive advantage through the services they offer. Factor one identifies pharmacies which attempt to best their competitors by extensive use of advertising and lowering their prices. The second factor closely aligns with an innovation differentiation strategy, where the pharmacists' strategy is to offer innovative products and services. Factor three encompasses strategies for cutting costs, coexisting with competitors, and not spending excessively to differentiate their businesses. This strategy does not stress innovation or trying to compete with methods identified with factors one and two. All of the seven items loaded (factor loadings > .50).

Table 3 - Factor Analysis of Business Strategies of Independent Pharmacists (n=85)

BUSINESS STRATEGIES	Factor Loadings		
	Factor 1	Factor 2	Factor 3
Marketing Differentiation			
Try to Beat Competitors	.737		
Cut Prices to Remain Competitive	.743		
Extensively use advertising	.708		
Innovation Differentiation			
Favor growth and innovation		.860	
Use Service Innovations		.839	
Low Cost Leadership			
Coexist with Competitors			.862
Cut Costs			.757
EIGENVALUES	1.664	1.492	1.474
Cumulative percent of variance explained	23.769	45.089	66.145
Cronbach's Alpha [2]	59.44	65.33	57.71

Kaiser-Mayer-Olkin measure of Sampling Adequacy = .636

The regression analysis revealed that three of the models were significant: Gross Profit, Net Income, and Sustainability. However, none of the strategies were found to contribute to the explanation of pharmacy performance. Interactions between the identified generic business strategies and third party reimbursements (generic strategy X third party %) were also tested, and none of the interactions were significant predictors in any of the five regression models.[3] In addition, the strategies did not significantly correlate with any of the performance

measures. These findings support the study's hypothesis that performance differences among independent pharmacies are not significantly different.

As expected, in explaining pharmacy performance, third party reimbursement programs were the only significant predictor. The percentage of third party reimbursements is negatively associated with Gross Profits, Net Income, and Sustainability, the benchmark performance measure ($p <= .01$). Further, the third party reimbursement coefficient was statistically significant ($p <= .05$) and negative in all five regression equations. These findings are consistent with the prediction of prior research (Carroll, 1991). These results also support the anecdotal claims of the pharmacists in the pre-test who bemoaned the negative influence of third party arrangements on their operations, strategies, and profitability. The regression results were similar to the output for the correlation analysis; that the only significant relationships were between third party reimbursements and the dependent measures of performance.

DISCUSSION AND IMPLICATIONS

In exploring the performance of independent pharmacies, this research finds that despite differences in the generic business strategies which were followed, the differences in their performances were not statistically significant. In the past, pharmacies relied upon differentiation strategies to gain competitive advantage (Bouldin, et al., 1996). However, none of the differentiation strategies used by the responding pharmacies was effective in creating competitive advantage, i.e., superiority in performance outcomes. The challenge for the independent pharmacist in a dynamic and turbulent environment is to operate more efficiently, while offering differentiated or unique services in order to compete against the powerful chains and drug discounters. Prior research has shown that combination or hybrid strategies of low cost and differentiation may be successful for retailers (Rubach & McGee, 2002). The factor analysis suggests that pharmacies may be pursuing combination strategies.

The findings also suggest a convergence or homogeneity of strategic behaviors: regardless of the strategy, there are no significant differences in performance outcomes. Industry effects, not firm-level strategies, determine a pharmacy's performance. Industrial organizational economics and the resource-based view of the firm are complementary, not contradictory, theories (Mauri & Michaels, 1998). While other theories, such as the resource-based view of the firm, may offer explanations for the performance differences among pharmacies, the examination of industry effects is still relevant. Industry effects are a complement to other theories and aid in explaining why some firms succeed and others fail. The models of competitive advantage that measure particular resources, capabilities, routines, and processes may impact the explanation of the differences in pharmacy performance. However, industry effects cannot be ignored. It is clear that independent pharmacies are adversely affected by third party reimbursements. In order to prosper, independent pharmacists will have to change their operations and strategies, increase their skills and knowledge, and better serve their customers. Given the changing face of the pharmacy industry, the operations of independent pharmacies will likely be quite different in the near term.

The pharmacy business is a needs-based industry, similar to needs-based industries such as hardware stores and automobile parts stores. All of these industries are facing pressures from their changing industry environments. In response to these changes, we do not wish to suggest that the owner/operator is without strategic recourse. The challenge faced, however, is to operate more efficiently, while offering differentiated or unique services in order to compete against the powerful chains and category discounters Service will continue to be the keystone which can make pharmacies unique. Offering personalized services can differentiate

the independent pharmacist from the chain store. Benchmarking services and performance not only against other pharmacists, but also against other needs-based industries may be a necessity. There are alternatives for pharmacists: creating strategic alliances with other independents to gain buyer power (e.g., buying cooperatives), and with care providers (e.g., nursing homes); reducing staffing costs by utilizing pharmacy technicians, and providing, and charging for, drug therapy and counseling services, especially disease management services (Frederick, 2001a, 2001b).

This study is not without limitations. The method used to measure performance was financial in its scope. Perhaps survival by an independent pharmacy is a better measure. An average of 1,884 independent pharmacies closed yearly during the period of 1990 to 1993 (Frederick, 2001a), but it appears the precipitous decline in independent pharmacies nationwide had finally subsided by the close of the millennium. There were increases in the number of independent pharmacies during the year 2000 (Frederick, 2000). Future research should examine this change and its causes.

The low response rate and consequent small sample could conceivably limit the interpretability of findings because of the increased probability of not detecting a relationship between variables where one actually exists. Although we provided evidence that non-response bias was not a major problem in the study, we cannot be assured that the non-respondents did not differ in important ways from the respondents. Although it is unlikely that sample selection bias drove these results, they should be replicated for more confident generalization. Further, the study is limited in its scope and analyses. It studies only one industry, and industry dynamics that may be peculiar to only the health care industry. The methodology used financial measures. There are disadvantages in using self-report subjective measures, which have been addressed elsewhere in the literature. The study also is cross-sectional, as opposed to a longitudinal study, which may be better suited to studying the effects of the issue of pharmacy performance, especially if survivability is an appropriate measure. Lastly, this study is exploratory in nature. There are additional issues that may affect pharmacy performance, including the study and analysis of more finely grained constructs such as marketing strategies, competitive methods, distinctive competencies, and the perceptions of customers of these services.

CONCLUSION

As the health care industry becomes more bureaucratized through managed care, third party insurance contracts, and pharmacy benefit managers, the demands on pharmacists will increase. There is growing pressure on pharmacists to be customer-focused and to keep better-educated consumers informed of all alternatives. Third party reimbursement plans, in turn, are foreclosing price as a strategic alternative. It is unlikely that the industry will back away from cost-containment, and in fact, independent pharmacists expect new measures to further contain costs (Fleming, 1998). Within this mature industry, pharmacists are pressured to provide unique customer-focused services (Beliveau, Bernstein, & O'Neill, 1994). This will likely entail a reevaluation and modification of the roles of pharmacists toward more involvement in patient care, education, and counseling (Reda, 1997). With the changing roles will come changes in operations and strategies.

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ENDNOTES

[1] While the response rate is not optimal, it does represent 16.67% of the total population of independent pharmacies located in one state. The questionnaire sought responses from the owner/operators of the pharmacies. This research is similar to other research concerning top managers and company executives where response rates are notoriously low. Responses rates of less than 20% are acceptable in this type of research: a 18% response rate (Milliken, Martins, & Morgan, 1998), a 13.6 % response rate (Agle, Mitchell, & Sonnenfeld, 1999); and even a 6% response rate (Simons, Pelled, & Smith, 1999) were acceptable.

Further, where lengthy questionnaires are used, such as in this study, response rates can be typically quite low. Studies with response rates of 22% (Mirani & Lederer, 1998), 11.2% (Carter, 2000), and 17 % (Martin, Beaumont & Staines, 1998) have been acceptable under these circumstances.

[2] To test the reliability of the strategy constructs, coefficient alphas were calculated for the items loading on each factor. They were as follows: innovative differentiation strategy (.6533); marketing differentiation strategy (.5944); and low cost leadership strategy (.5771). These reliability measures are marginally below desired levels (Nunnally 1978). The coexistent environmental pressures to lower costs and be more efficient, and simultaneously be unique may be the cause of these less than optimal reliabilities. Local merchants often find it difficult to articulate their strategies and in dynamic environments they have been found to adopt hybrid or combination strategies (Rubach & McGee, 2002). While the reliabilities are less than optimal, they are useful in measuring a pharmacist's generic business strategy in exploratory research of this nature.

[3] In order to save space and because the findings are insignificant, they are not reported. The results of this analysis are available upon request of the lead author.

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