Australian Pharmaceutical Industries Limited
Annual General Meeting
20 January 2009
Address by Stephen Roche, Chief Executive Officer

Good afternoon ladies and gentlemen.

Two years ago we knew that API had excellent underlying assets, and our goal was to optimise our position in the health and beauty market as we restored API. We saw it as an opportunity that was yet to be fully explored and captured in the Australian market.

As you know our first objective was getting the core business back on track. Today we have brought these assets back to a position where they are generating more consistent results, better earnings, profit and cash management.

Secondly, we needed to ensure that not only did the core assets have consistency but they were also aiming for the position of market leadership, improving underlying returns as well as addressing industry issues. I am pleased to report that we have made progress however there is far more we can do to extract efficiencies from the business.

Finally, our agenda had to encompass a clear vision for growth, rather than just improvement. The initiatives we have in place give us great confidence in our execution over the medium term.

Our view to the future was important knowing that the Pharmacy Guild and Federal Government are about to enter negotiations for the next Community Pharmacy Agreement from 2010. These negotiations are integral to the future of pharmacy for the period until 2015 and beyond. Of course API's position will be supporting the independent pharmacy ownership model as it has previously.

Of immediate relevance to the wholesalers will be the renegotiation of the Community Service Obligation payments (known as the CSO) which were part of the last Community Pharmacy Agreement. We will be staying very close to the development of the Agreement because these funds are the current base of the pharmaceutical distribution system. The CSO has worked well during the past few years, ensuring equality in access to medicines for all Australians. While we have confidence in its renewal we must be ready for any outcome.

In addition to these upcoming negotiations, we believe that pricing pressure on generic pharmaceuticals will continue and that the final stage of PBS Reforms that comes into effect in 2011, which adjusts prices based on weighted average discount prices over the preceding 12 months, will mean we distribute higher volumes of products at a lower average price.

All these factors give us confidence that our strategy which focuses on meeting consumer retail demands and reducing our reliance on just pharmaceutical distribution, in conjunction with the development of our own Revitalise supply chain program, will mean we are far better placed.

Looking back on 2008, all the major financial indicators were positive for API when compared to our last 12 month period in 2007. Revenue growth of more than 20%, underlying earnings were up more than 30%, there was a turnaround in profit of more than $26 million. We have previously talked about the importance of cash management and we have been able to finance some growth from better cash management rather than through increasing debt facilities.

Our aim is to continue this steady improvement while developing API for the future. Particularly given the economic environment we've faced this year we know that concentrating on the basic operational facets of the company are critical to that improvement.

There has been considerable discussion in the financial markets about debt structures and funding arrangements. In communications to shareholders in 2008 we clarified the major points which are that we have our debt facilities in place until April 2010 and we believe that the facilities have enough room not only to fund our operations but also to invest in development activities.

While the economic circumstances are far less certain than a year ago, we need to push on with our major development plans because of the industry circumstances and for the superior position we will achieve once completed.

The Chairman has already referenced the need for continued diligence on the matter of working capital. Despite a period of high revenue growth, average debtors days have remained constant and now that we expect the growth to settle we have plans in place to address this in a way that protects the businesses of API and our pharmacy customers. In the other areas of working capital – inventory and creditors – these have been well managed and inventory increases kept lower than growth rates.

During the year we saw sustainable operational improvements and industry events handled very well.

The business maintained a focus on improving results even though there were a number of external issues. We implemented the largest ever pricing change across the PBS during the middle of 2008. This entailed detailed communications with suppliers and pharmacists on approximately 400 separate molecules and through the process API was able to manage inventory and customer pricing to be "first to market".

The volatility in retail spending which we saw through most of 2008 was managed by close monitoring of costs and looking for offsets at every available opportunity. There was a real variance in some of the retail patterns we saw and we were nimble enough to adapt to these changes and still meet our targets.

Throughout this we remained on track in developing Priceline, improving earnings quality and implementing the Revitalise program.

In respect to the divisional performance – firstly the Pharmacy division – revenue growth has been very good, even excluding Alphapharm's contribution we have retained double digit growth.

We really wanted to focus on improving the return from all divisions and we improved the earnings to sales margins throughout 2008 and we expect further improvements in 2009.

Alphapharm has been a real positive – and it appears that way for both companies – the volume of Alphapharm products distributed has steadily increased since June. A position we may have expected with PBS Reforms, nonetheless it is pleasing to see that trend as it vindicated the rationale for such a strategic partnership.

The range of API services, through Soul Pattinson, Pharmacist Advice and the API Members Program has helped to maintain and grow our revenue base. The new Soul Pattinson format – of which there are now 24 – has been very well received.

One concern about PBS Reforms was the impact of ordering trends. There had been destocking by pharmacists in the lead up to the changeover, however it was so smoothly managed that reordering patterns were established almost immediately which placed the division in a good position for the start of our 2009 financial year.

Our Retail division has continued its transition from operating company owned stores to a franchise focussed company. We now have more than 300 stores under the Priceline brand, with the majority now Priceline Pharmacy franchised stores.

The Priceline Pharmacy stores recorded like for like growth of more than 9% during 2008 while across the whole brand we had like for like growth of 5%. By any measure that is a very solid performance.

In 2008 we continued the sale of individual company-owned stores as part of the transition process to franchise stores and we see it continuing for at least another two to three years. As our proceeds from these store sales was less in 2008 than in 2007 we have further evidence of improved underlying operational performance and increase in margins.

We are still seeing demand for joining the brand, and we remain confident of achieving 400 stores in 2010.

In June we implemented the first stage in a new Priceline brand plan. We conducted research with consumers, pharmacists, suppliers and other stakeholders that assessed the position of the Priceline brand and where we needed to go.

The research identified that while we were clearly strong in beauty, the development of our health offer and making it a more prominent part of the brand was the untapped opportunity. Further work was then undertaken to develop a merchandise, marketing, service and training plan to take the brand in that direction.

The new merchandise plans have been trialled, the new visual identity has started its rollout, the training programs are being run to emphasise the importance of service and all these components will be critical in building the brand to the health consumer.

As you can see the new branding is much more prominent in identifying the pharmacy through the use of the green cross and given our Christmas trading results we are pleased with its initial implementation.

Two and a half years ago the Consumer division was barely breaking even after the transition of certain plant and equipment from Australia. We have been able to develop this division in line with our plans – starting to exploit its ability to feed product into the Australian pharmacy channel.

We eliminated marginal sales generated by us as an agent in New Zealand for other companies. This has helped to improve returns and focus on the core part of our operations in manufacturing.

We recently appointed Richard Vincent, the head of our Pharmacy division, to also oversee these operations so that we ensure there is full value being achieved from this division into the Australian pharmacy market. We expect continuing improvement in this division.

I would like to discuss Revitalise in more detail.

Our current supply chain structure sees us operate two distinct supply chains, one for Pharmacy and one for Retail.

Pharmacy supplies pharmaceutical and OTC products to more than 4000 independent pharmacies and the Retail supply chain provides only OTC and front of store products to Priceline branded stores – and it does not supply any pharmaceuticals. The dual structure is a result of the acquisition of Priceline by API.

The current structure means, for example, that all products for Priceline come from one warehouse in Dandenong, Melbourne, often resulting in it being shipped past other API facilities. However a number of these warehouses are not able to cope with the additional capacity they have today, let alone with increasing Priceline volumes.

We evaluated the network and assessed that it would not cope much beyond 2009 and also validated that due to having more than 4000 products in common there were significant efficiency savings.

When we undertook a thorough analysis the Board was presented with a range of options – however they can be distilled into two categories.

The first was to spend less money and only on infrastructure that had to be redeveloped in Melbourne and Brisbane. This involved no integration of supply chains and limited upside in terms of efficiency gains. This is with a backdrop of significant industry change and other developments that meant we had to be more cost competitive in future.

The second option was to re-engineer the supply chain and extract all costs and efficiencies we could that would set up API for the long term. This involved a higher cost, but far greater efficiency gains.

The benefits of Revitalise are straightforward.

Financially it will deliver API savings that equate to more than 30% of our current EBIT.

These savings come from decrease in overall freight and handling requirements – resulting in a lower cost per pick. We will no longer ship product to the same destinations using two separate methods.

Just as importantly it will meet our growth requirements. Even in the current environment we expect volume to grow. The new structure will allow us to get product to retail shelves faster. This means that we can service more stores, keep stock on shelf in store and keep our stock holdings lower because we will have more flexibility. Today we need to maintain higher stock levels because we don't have the systems to optimise that investment. In short it will be more efficient because we will be able to better adapt to requirements.

Finally we will have much more capability to get products into store. We can configure deliveries so that it will make it most effective for stores to get stock onto the shelves, lower out of stocks, and therefore increase sales – as well as enabling us to respond more rapidly to consumer demand.

Our new network will create Super Distribution Centres (DCs) – holding all stock requirements in three major locations and also holding increased stock at other branches.

Due to the unique nature of this industry, having DCs closer to the customer is a compelling feature. A network with less DCs is actually higher cost for us.

As I just mentioned the key savings will come from freight and labour savings due to more efficient and better located distribution facilities that can supply Priceline stores and independent pharmacies.

Revitalise has identified that there are significant potential working capital savings that are not in the planning, transport synergies have already been identified and will be implemented in 2009, while the in-store deliveries could provide significant benefits to on-shelf availability.

The benefits available are so compelling for API that we have made it a priority to execute the plans comprehensively but also to bring forward the timing wherever possible to get the benefits as soon as we can.

We are confident that in FY11 we will generate at least $10 million in savings and that our initial estimate of $18 million annualised savings will be well exceeded.

The program has commenced with the Board approving the Warehouse Management System (WMS) provided by Manhattan and the plan to move our Rowville warehouse into the existing Dandenong facility.

The WMS program is well underway as it is required to be in place for the new warehouse so that orders can be processed for both divisions. Dandenong refitting has commenced this month – as the peak Christmas trading period limited what we could do prior to now – with an expectation of being ready in May for operations. Rowville will then move into Dandenong mid-year.

The Board has approved the plans for the Brisbane DC and now that it has finalised a new site the attention has turned to the finalisation of plans for the Sydney DC.

This is an exciting and pivotally important initiative for API and is our most critical strategic development for 2009.

In summing up 2008, it was the first of three pivotal years that API needed to re-establish itself. We achieved what we set out to do strategically, financially and operationally.

As we all know the economy of 2009 is yet to be determined. We need to maintain strict controls and achieve cost savings where growth is not available.

What we do know is that our strategy is the right one. We need to move reliance away from the PBS towards the consumer, we need to have a more efficient supply chain and we need to continue a sustainable return to shareholders.

We still believe that API is uniquely positioned in the health and beauty industry. In 2009 all our initiatives will consolidate that position and deliver value to API's shareholders.

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