

# Interview with President and CEO Sadatake Kumakura

*As the MEDICEO Group establishes its foundation, President Sadatake Kumakura discusses the progress of the Group's business strategies, the planned launch of the Mediceo Paltac Group in October 2005 through management integration, and the Group's future growth strategies.*



**The MEDICEO Group faced a very challenging business environment in the year ended March 31, 2005. What is your evaluation of the Group's performance for the year?**

The past fiscal year was the first year of the National Health Insurance (NHI) drug price revisions that were implemented in April 2004. Ordinarily, in the first year of drug price revisions, the prices for all products are revised, so until now pharmaceutical wholesalers have used such years to increase their profits. This time, however, price competition was even more severe than anticipated. As a result, first-half sales and earnings dropped rapidly at all wholesale companies, which collectively revised their forecasts downward for the first-half period ended September 30, 2004. Subsequently, prices recovered just as quickly as they had dropped in the first half, and the industry as a whole achieved results that surpassed the revised forecasts. Like the rest of the industry, the MEDICEO Group's revenues were adversely affected by the decline in product prices, and gross profit decreased more than we had projected.

**What caused the decline in product prices?**

This decline did not stem from requests for price reductions from unprofitable customers, as we had seen

previously. Trends such as national bulk purchasing by medical institutions and the development of major dispensing pharmacies into nationwide chains have become pronounced, resulting in broad and rapid communication of pricing information. Consequently, it is no longer possible for the prices quoted for a particular region to be confined to that region alone. In addition, as we wholesalers ourselves have come to operate nationwide, devising marketing strategies for each region has become difficult. We need to reconsider how we conduct price negotiations and secure profits based on an understanding of the trends of this new era. Now more than ever, yardsticks for appropriate pricing, like our standard weighted prices, are essential. Therefore, we will continue to clarify our purchasing prices in order to keep our profits in mind when setting prices.

**A year has passed since the inauguration of the MEDICEO Group. What is your assessment of the Group's progress in establishing the MEDICEO brand, including the merger benefits?**

Our objective in forming the MEDICEO Group was to raise management efficiency not through a merger of operations, but by preserving regional wage differences while still realizing the benefits of a merger by bringing together various systems, distribution, personnel and other structures under a single set of rules, with an operating holding company at the center. This framework aimed at both management efficiency and preservation of wage differences is what we call the MEDICEO brand. All group companies take full advantage of the benefits created by this shared group framework while working to increase market share in their respective regions. I believe the entire Group will be able to grow steadily as a result.

More than a year has passed since the Group was formed. During that time, as I discussed earlier, earnings

declined due to the changes in our business environment. Other than that, our progress is in line with my expectations in areas such as system integration, reduction of costs and expenses through joint purchasing, corporate governance of the Group, conducting operations while preserving each company's independence, and the establishment of cohesive power as a group.

In last year's annual report, I outlined the three main strengths of the MEDICEO Group. First, we already have a strong infrastructure in place, including core systems, a personnel system that incorporates performance-based elements, distribution centers, and a system for implementing joint sales promotion plans. Use of this solid infrastructure enables Group companies to quickly and steadily exploit the benefits of the management integration. Our second strength is economies of scale. The MEDICEO Group has over 5,000 marketing specialists, who are in charge of sales, and we intend to make full use of this sales force, the largest and most powerful in Japan, to achieve the highest levels of sales and income in our industry. Our third strength is region-based sales. The companies in the nationwide MEDICEO Group specialize in sales, and are thus able to tailor their business to their respective regions and achieve high productivity. This also enables us to further enhance customer support and our ability to gather and provide information. I also said last year that our greatest strength will be the understanding of manufacturers and customers of the advantages of doing business with the MEDICEO Group. I believe we are making good progress in deploying these strengths.

## How is the progress of the Group's business strategies in the prescription pharmaceuticals business and other areas?

### Prescription Pharmaceuticals Drug Business

In the prescription pharmaceuticals market, the primary business area of the MEDICEO Group, the hospital and dispensing pharmacy sales channels are changing most rapidly and are capturing a rising proportion of sales. The *Total Solution Model* and *MEDICEO-epi* are positioned as the MEDICEO Group's differentiation strategies in this market.

#### *Total Solution Model*

We designed the *Total Solution Model* to provide comprehensive support to hospitals, and thereby maintain a stable share of sales at each hospital and ensure that MEDICEO is successful not just in price competition but also in added value competition. Drug purchases account for about 20 percent of hospital costs, and until now, pharmaceutical wholesalers had not generally provided support for the other 80 percent. However, we can offer added value to hospitals in various ways.

One area where the MEDICEO Group stands out is support for clinical pathway management. A clinical pathway is a method of standardizing treatments, and is determined by each individual hospital. However, comparison with the national average is a topic of great interest for hospitals, and this is something that only a national wholesaler with information covering the entire country can provide. At present, MEDICEO has an unrivaled lead in this area, and the MEDICEO Group's activities have even been recognized by the Japanese Society for Clinical



### Launch of the Management Innovation Promotion Committee

MEDICEO has consistently led the pharmaceutical wholesale industry in both net sales and gross profit margin. In the past fiscal year, however, we fell to second in gross profit margin and the SG&A expense ratio. We feel that securing industry leadership in quality and quantity will be difficult unless we improve the SG&A expense ratio. This led us to set up the Management Innovation Promotion Committee. The basic objectives of this committee's activities are to (1) generate the economies of scale expected from the size of the MEDICEO Group; (2) target all areas, placing nothing off limits; and (3) aim for an SG&A expense ratio between 6 and 7 percent. We have set the goal of reducing SG&A expenses by ¥10 billion, and the entire MEDICEO Group is pushing vigorously to achieve that goal.

**Genichiro Tanabe**  
Executive Vice President,  
MEDICEO Holdings Co., Ltd.

Pathway. Through clinical pathway management support, we analyze the actual usage of pharmaceuticals and other products, and conduct estimates of cost savings to create a list of standard brands of pharmaceutical products and diagnostic materials. By doing so, we can propose brand switches to conform to the budgets of each hospital, and we believe that this will increase the functions and positioning of the MEDICEO Group.

Following the completion of a one-year pilot project, the past fiscal year was the first year of full-scale implementation and expansion. We set an immediate target of introducing the *Total Solution Model* at 30 of the 500 hospitals that have a high number of acute beds, and succeeded in introducing it at 32 hospitals. Our target for this fiscal year is 70 hospitals.

#### *MEDICEO-epi*

The *MEDICEO-epi* system is a contract model for dispensing pharmacies that combines planned deliveries and usage-based payment. As of the end of March 2005, *MEDICEO-epi* has been introduced at approximately 2,000 locations. We have not yet reached our target of 3,000 locations, but the system is becoming well established, and we feel it is having an effect.

The original purpose of *MEDICEO-epi* was to lower our costs by reducing the frequency of deliveries, but the system is also serving to improve the cash flow and operations of customers who have adopted it. This demonstrates that *MEDICEO-epi* has added value beyond expectation. We intend to expand the use of *MEDICEO-epi* to Group companies in the near future.

#### **Medical Equipment Business**

In the medical equipment business, as in the prescription pharmaceuticals business, our customers are hospitals, clinics and pharmacies, so we have no need to develop new customers. Currently, the medical equipment market is worth ¥2.6 trillion, but as many as 300,000 companies are registered to handle medical equipment.

The MEDICEO Group has a 3.6 percent share of the medical equipment market, but our immediate objective is to increase this share to the same level as our pharmaceutical business, which is 23.6 percent, and grow sales to ¥700 billion. The revision of the Pharmaceutical Affairs Law in April 2005 placed heavy obligations on the medical equipment industry for inventory control and other management procedures. This is expected to lead to a substantial consolidation and shakeout of the 300,000 medical equipment wholesalers. This consolidation and shakeout will allow MEDICEO to develop its medical equipment business through its "main wholesaler" strategy using the distribution and logistics technology and the M&A methods it has applied previously.

We plan to establish a structure capable of total management of the medical equipment business, centered on MEDICEO MEDICAL CO., LTD. (formerly NAKAGAWA SEIKODO CO., LTD.), which became a wholly owned subsidiary in May 2004.

#### **OTC Pharmaceuticals Business**

Deregulation is proceeding in the trillion-yen domestic market for over-the-counter (OTC) pharmaceuticals. The first stage of deregulation in 1999 was focused on the ¥100 billion health tonic market, and allowed these drinks to be sold at convenience stores and supermarkets. Pharmaceutical wholesalers were unable to capture this market, and food wholesalers took charge of distribution.

The second round of deregulation in 2004 was centered mainly on gastrointestinal remedies, which is not such a large market. Daily goods wholesalers entered the market, as once again pharmaceutical wholesalers did not take advantage of the changes.

The third round of deregulation, which is scheduled for 2006, will target a very large market of about ¥300 billion, with products such as vitamins, eye drops, adhesive skin patches and pain relievers slated for deregulation. If this market moves to another sector as a result of the deregulation, pharmaceutical wholesalers could face a serious

situation. Meanwhile, on the buyers' side, convenience stores and supermarkets, which until now have not handled medicines, will need wholesalers that can provide information and knowledge about matters such as merchandise displays, and have nationwide operations.

The MEDICEO Group's strategy for the OTC business is to apply our successful experience cultivated in the prescription pharmaceuticals business to the OTC business, a market that is expected to double in size in the future, to make it a core business area. Partly because of the deregulation situation, however, we decided to implement a management integration with PALTAC CORPORATION, a leading wholesaler of cosmetics and daily necessities, on October 1, 2005.

### What is the purpose of the management integration, and how do you envision the Mediceo Paltac Group?

The purpose of this management integration is not simply to expand the OTC business and broaden our product lineup and sales. Customers are likely to make further requests for reductions in total distribution costs and enhanced service from intermediary distributors in the future. If we can integrate the functions and the know-how of the two companies to respond to these requirements, we will be able to fully meet customers' expectations. By doing so, we intend to make a new start as a next-generation distributor.

Wholesalers in Japan have traditionally been separated by industry, but as I mentioned, convenience stores, supermarkets and drugstores can now handle a variety of items. On the other hand, they won't be able to procure this merchandise from their usual industry-specific wholesalers.

What they will need is a general wholesaler that offers a product lineup that matches their own type of business. Mediceo Paltac will represent the first step toward creating such a general wholesaler. Drugstores, a fast-growing sales channel, will be able to purchase 80 to 90 percent of their merchandise from a single company, Mediceo Paltac. This will have a powerful impact on the industry.

In the first phase after the management integration, we will rationalize the OTC business. Our OTC business has been unprofitable for a long time, but we believe that this management integration will make it a second core profit driver, after the prescription pharmaceuticals business.

In the second phase, we will achieve a high level of functionality and low-cost logistics company-wide. We plan to integrate PALTAC's 14 large distribution centers throughout Japan, as well as its logistics know-how and advanced systems, which have a 99.999 percent delivery accuracy rate, into the MEDICEO Group's ¥1.6 trillion business. This will enable us to implement logistics reform in the Group at unprecedented speed.

The pharmaceutical wholesale industry will converge on the "Big 4" companies, with each wholesale group having a nationwide network and sales of more than ¥1 trillion. Each group is also developing a customer support system with distinctive features, so it will be difficult to differentiate our company on the basis of these qualities alone. On the other hand, if customers see that every wholesaler has the same functions, they will be able to choose one as their main wholesaler. When selecting a main wholesaler, the deciding factor will be logistics, and that is the primary benefit I expect from this management integration.



### Management Integration with PALTAC CORPORATION

The management integration with PALTAC CORPORATION, a company that operates in an entirely different market, will make it a member of the MEDICEO Group. This will enable us to form a corporate group that supports medical care, health and beauty, and aspire to be a next-generation wholesaler that stays a step ahead of changes in the business environment. We intend to fulfill our responsibilities and create the value expected from the MEDICEO Group by blending the Group's technologies and knowledge resources to meet the high expectations of the industry, our customers and communities.

#### Takashi Saito

Executive Vice President, MEDICEO Holdings Co., Ltd.  
President, EVERLTH Co., Ltd.

## Creation of Mediceo Paltac Holdings Co., Ltd.

On October 1, 2005, MEDICEO Holdings Co., Ltd. and PALTAC CORPORATION will integrate their management to form Mediceo Paltac Holdings Co., Ltd. A leading national wholesaler of daily necessities, toiletries and cosmetics with a history spanning more than 100 years, PALTAC has built a solid reputation among retailers and manufacturers for its high-quality services and solutions based on its unique merchandising and logistics systems. The integration will create a next-generation wholesale company with superior ability to support medical care, health and beauty.

### Management Philosophy

Contributing to people's health and the advancement of society through creation of value in distribution

### Management Policy

- (1) Creating a vitalized corporate culture to make the MEDICEO Group trusted by society
- (2) Management that raises shareholder value and thorough legal compliance
- (3) Faithfully create a free and open-minded corporate culture and train creative personnel



The logo design suggests people holding hands and harmony, which symbolize cooperation, coexistence and the strength to live. It also expresses that Mediceo Paltac is a company that grows with customers and business partners, expands broadly and respects people. The futuristic, refined English font also suggests the new direction Mediceo Paltac Holdings will take as a general wholesaler of pharmaceuticals and cosmetics and daily necessities.

## Medium-Term Consolidated Management Plan (Year ending March 31, 2008)

### Basic Policy

Establish a customer-oriented distribution business model

### Focus Points

- (1) Create environment capable of supporting growth
- (2) Evolve logistics that start with the customer
- (3) Create new value that enriches life

### Consolidated Management Targets

Figures in parentheses indicate percentage of net sales

Net Sales	¥2,175 billion	
Gross Profit	¥186.6 billion	(8.6%)
SG&A	¥155.9 billion	(7.2%)
Operating Income	¥30.7 billion	(1.4%)
Ordinary Income	¥41.6 billion	(1.9%)
Net Income	¥24.3 billion	(1.1%)
Return on assets (ROA)*	3.0%	
Return on equity (ROE)**	9.2%	

\* Return on assets = Operating income / Average total assets

\*\* Return on equity = Net income / Average total shareholders' equity

### Mediceo Paltac Holdings Co., Ltd.

(Operating Holding Company)

#### Cosmetics and Daily Necessities Wholesale Company PALTAC CORPORATION

#### Pharmaceutical Wholesale Companies (10 companies)

- SENSU YAKUHIN CO., LTD.
- Chiyaku Co., Ltd.
- YAMAHIRO KURAYA SANSEIDO Inc.
- IZUTSU PHARMACEUTICAL CO., LTD.
- ATOL Co., Ltd.
- USHIODA SANGOKUDO YAKUHIN CO., LTD.
- KURAYA SANSEIDO Inc.
- HEISEI YAKUHIN CO., LTD.
- EVERLTH Co., Ltd.
- MEDICEO MEDICAL CO., LTD.\*

#### Medical-Related Companies (3 companies)

- ORIENTAL PHARMACEUTICAL CO., LTD.
- KURAYA KASEI, INC.
- KURAYA SHOJI, INC.

\* Name changed from NAKAGAWA SEIKODO CO., LTD. on July 1, 2005

The healthcare market in which the MEDICEO Group operates can be broadly divided into 1) patients who require treatment; 2) people in only partially good health and those who are prone to illness, and 3) people who are basically healthy but want to be even healthier. The size of the first market, our main business area, is ¥9 trillion. If we can add to this the ¥4 trillion beauty and home products market in the second and third categories through our management integration with PALTAC, we will become a mega-group that does business in a ¥13 trillion market. The Mediceo Paltac Group will maximize its worth by creating new value as a next-generation distributor that supports medical care, health and beauty.

### What is the Group's policy on corporate social responsibility?

The MEDICEO Group steadily carries out its business activities while ensuring sound, transparent management. By fulfilling the Group's management philosophy, "contributing to people's health and the advancement of society through creation of value in distribution," we earn the trust of all our stakeholders, who comprise shareholders, customers, employees, consumers and society at large. Doing so also allows us to maximize the Group's corporate value.

In fall 2004, we established guidelines for day-to-day decision making and conduct for officers and employees of the Group to ensure their understanding and practice of the management philosophy and corporate social responsibility, with an emphasis on compliance. After lengthy debate, the Group's management formulated the guidelines and created

a manual with detailed explanations, which was distributed to all employees of Group companies. In addition to encouraging employees to keep the manual on hand at all times, we conduct educational activities, including regular divisional meetings to ensure thorough knowledge and practice of each item in the manual.

Our risk management system has been a top priority since the formation of the MEDICEO Group. An example of this is our response to the Chuetsu earthquake in Niigata Prefecture in fall 2004. One hour after the earthquake occurred, we immediately set up an Emergency and Disaster Response Headquarters to establish a unified chain of communication and respond quickly based on assumption of the worst-case scenario. This enabled us to confirm the safety of employees and their families and gain a grasp of the situation. Moreover, our relationships with our various business partners throughout Japan inevitably contributed to the success of our efforts. Even though the quake-hit region was in a state of paralysis, it was able to receive various forms of support from other regions.

We are establishing our foundation as a group that can overcome changes in the business environment and consistently generate profits as an industry leader, which was the original purpose of forming the MEDICEO Group. In the near term, we plan to continue our various investment projects. The returns on these investments will be steady expansion of profits. This in turn will raise our stock price and increase our total market value, which will allow us to meet the expectations and maintain the trust of our shareholders.



### About "Our Stance"

The recently formulated set of decision-making and action guidelines called "Our Stance" are the result of the painstaking efforts of four members of the MEDICEO Group's top management to express in words what they deeply feel are the essential concepts of good management. We will move closer to forming the ideal MEDICEO Group by promoting understanding and diffusion of these guidelines throughout the Group, allowing for differences in the speed and degree of their execution in each area.

**Osamu Watanabe**  
Executive Vice President, MEDICEO Holdings Co., Ltd.  
President, ATOL Co., Ltd.