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Strategic Survival and Growth of Small-Scale Franchisers in the Japanese Drug Store Industry: A Case Study of a Japanese Drug Store Franchise

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Abstract

The Japanese drug store franchising industry has experienced significant growth, but faces challenges such as market saturation, a declining population, and intense competition from convenience stores. This paper examines the strategies of mid-sized franchiser Souki Drug Store (SDS), which has successfully navigated these challenges through strategic alliances, a focus on high-margin products, and digital transformation. SDS's approach includes partnerships with local supermarkets and specialty stores, a "scrap and build" M&A strategy to optimize market presence, and a commitment to operational efficiency through advanced logistics systems. Despite challenges such as workforce shortages, particularly in pharmacy staff, SDS plans to extend its store hours and focus on providing value-added services like healthcare and beauty counseling. The paper concludes that to thrive in the evolving market, SDS and similar mid-sized franchisers must embrace digital tools, expand their presence in key urban areas, and adapt to changing consumer needs, especially in aging populations.

Keywords: Drug Store Franchise, Operational Challenges, Japanese Drug Store Industry

1. Introduction

The Japanese drug store franchising industry has expanded significantly, growing by over 200% in the past 20 years. In 2022, the industry reported total sales of $49 billion across 18,429 stores. Japanese consumers are increasingly drawn to drug stores for their convenience, as they offer a wide variety of grocery goods alongside traditional pharmaceutical products (Shigetomi, 2022; note, 2023).

This growth has raised concerns within the Japanese convenience store industry, which has been losing customers to drug stores. However, despite its impressive expansion, the drug store franchising industry anticipates slower growth in the coming decade due to Japan's declining population (Yamazaki, 2022).

To maintain their market dominance, drug store franchisers have turned to aggressive mergers and acquisitions (M&As). Larger franchisers are acquiring smaller ones to consolidate their position in regional markets. Additionally, some major players have begun engaging in mergers of equals to streamline operations and strengthen their competitiveness. These trends have led to the emergence of an oligopoly dominated by a few large franchisers (Komaki, 2012; Smtb, 2019; Shigetomi, 2022; Yamakawa, 2024).

A key challenge remains: how can mid-sized drug store franchisers survive in this increasingly consolidated market? This paper examines this issue through a case study of Souki Drug Store (SDS), a mid-sized franchiser. The study explores potential strategic approaches SDS can adopt to remain competitive within its target market areas.

2. Characteristics of Japanese Drug Store Franchising Operations

Japanese drug store franchisers classify their merchandise into two major categories based on gross profit margins. Category A includes items with very high gross profits, such as prescription medicines, over-the-counter medicines, and cosmetics. Prescription and over-the-counter medicines have a gross profit margin of 40%, while cosmetics generate a gross profit of 35%. Category B consists of merchandise with lower gross profits, such as grocery goods and daily necessities. Grocery goods yield a gross profit of 15 to 20%, while daily necessities have a gross profit of 25 to 30%. The contribution of these items to total sales is distributed as follows: prescription medicines account for 15%, over-the-counter medicines and cosmetics each contribute 12%, grocery goods represent 30%, daily necessities make up 25%, and miscellaneous goods account for 6% (Harada, 2023; Joypalette, 2024; Mynavi, 2024).

Each franchisee operates through designated logistics centers that handle quality control and inspections for all merchandise, removing this responsibility from individual stores. This centralized approach enhances operational efficiency and allows local store employees to focus on customer service, management, and promotional activities. To further optimize operations, all franchisees use point of purchase systems and electronic ordering systems to minimize in-store inventory levels and ensure timely and appropriate merchandise selections (Koizumi & Yamamoto, 2019; Kim, 2023).

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Recently, two of the largest drug store franchisers implemented the Brandwatch AI system, which integrates logistics, marketing, and sales to optimize their entire logistics network strategically. Deliveries to stores are typically conducted once a day, often at night. Merchandise is organized in boxes according to product categories or the designated shelf locations within stores, further streamlining store operations (Prtimes, 2022; Zdnet, 2022; microfocus-enterprise, 2024; Ryutsuu, 2024).

3. General Strategies of Japanese Drug Store Franchisers

The Japanese drug store franchising industry has three unique characteristics. First, Japanese laws and regulations directly impact strategies, operations, and cost structures. Second, store locations and nearby commercial areas strongly influence the merchandise mix and services offered by local franchisees. Third, there is a strong correlation between the number of local franchisees and overall sales. This means that Japanese drug store franchisers must expand the number of franchisees in appropriate market areas (Shigetomi, 2022).

Given these characteristics, Japanese drug store franchisers have adopted a dominant strategy focused on increasing the number of local stores and boosting sales. This strategy can be divided into three types: (1) health and beauty focused, (2) healthcare focused, and (3) convenience focused (Smtb, 2019; Shigetomi, 2022).

Drug stores with a health and beauty focused strategy represent a traditional approach but have struggled to remain effective due to intense competition from convenience stores and supermarkets. Those with a healthcare focused strategy are often located near hospitals and have recently aimed to serve as community healthcare stations for nearby consumers. Finally, drug stores with a convenience focused strategy are common, designed to compete with convenience stores and supermarkets by dominating specific market areas. These stores offer a full merchandise mix, carefully weighted across categories to ensure high profitability (Aichi, 2024; Ono, 2024).

4. Future of Japanese Drug Store Franchising Industry

While minimal growth is expected in the long term, the market for Japanese drug store franchisers is projected to expand steadily over the next decade. The aging population and the increasing financial burden of medical expenses are anticipated to redirect many elderly consumers from hospitals to drug stores for medical consultations, healthcare services, and over-the-counter medicines. This shift will allow Japanese drug store franchisees to compete more effectively with convenience stores and gain new market share. Experts predict that these franchisees will soon play a vital role in community healthcare (Shigetomi, 2022; Kim, 2023; Yamakawa, 2024).

Mergers among dominant drug store franchisers are expected to continue, fostering powerful oligopolies in major urban markets such as Tokyo and Osaka. Similarly, mergers and acquisitions among mid-sized and smaller franchisers are likely to increase, consolidating regional markets into local oligopolies (Kim, 2023; Yamakawa, 2024).

In response to competitive pressures, many franchisees plan to expand their grocery offerings to better compete with convenience stores and supermarkets, attract customers through the use of grocery items as loss leaders, and increase the overall size and appeal of their stores (Kim, 2023, mynavi, 2024).

Large drug store franchisers are also increasingly adopting AI-driven strategies to enhance efficiency and competitiveness. Leading players such as Welcia and Aoki have implemented advanced AI tools to improve operations. For instance, Welcia has introduced the HiTTO AI program for optimizing human resource management, Vertica AI to predict market trends and consumer preferences, and Brandwatch AI to streamline logistics systems. However, these advancements present significant challenges for smaller franchisers, which often lack the financial resources and data necessary to implement such technologies effectively (Welcia, 2023; Eyer, 2024; Takyar, 2024).

Despite these opportunities, the industry faces serious challenges. The dominant strategy of increasing the number of stores in a market area risks creating hyper-competition, potentially undermining profitability. Furthermore, a critical shortage of pharmacists remains a pressing issue. Many franchisees already struggle to recruit and retain pharmacists, and with the declining younger population, this shortage is expected to worsen, posing significant operational difficulties for the industry (note, 2023; aichi, 2024; mynavi, 2024).

5. Future Strategies of Smaller Japanese Drug Store Franchisers

For smaller drug store franchisers, ensuring AI readiness in their operations will be crucial. The first step in this process is data collection or integration. To effectively utilize AI tools, franchisers need to have access to sufficient, clean data. Mergers and acquisitions (M&As) among smaller drug store franchisers could help ensure the acquisition of such data, providing a foundation for the effective use of AI technologies (Koizumi & Yamamoto, 2019; Kim, 2023).

The convenience-focused dominant strategy is expected to become the primary strategy for all drug store franchisers, further accelerating M&As among smaller players. Large franchisers may take over post-M&A, solidifying serious oligopolies in both major and local markets. Additionally, the convenience-focused approach may help alleviate some of the pressure on the ongoing recruitment and retention of pharmacists by increasing profit margins from grocery goods and daily necessities (Koizumi & Yamamoto, 2019; Kim, 2023).

To offset the shortage of pharmacists, many franchisees may shift towards recruiting healthcare and beauty professionals, such as dieticians, estheticians, and individuals with healthcare and beauty certifications. This shift would transform franchisees into regional health and beauty stations, catering to consumers who prioritize self-medication and health-conscious living (Shigetomi, 2022; Kim, 2023).

Becoming a regional health and beauty hub would also provide a one-stop shopping experience for elderly consumers, whose numbers are expected to grow steadily. Older consumers tend to be more loyal than younger ones, so franchisers can anticipate consistent revenue from their purchases. Furthermore, as these consumers age, their spending on medications and healthcare services may increase, as they opt to buy from drug stores rather than visit hospitals for economic reasons (Yamazaki, 2022; Harada, 2023; note, 2023).

6. Managerial Challenges

As drug store franchisers expand their businesses, pursue mergers and acquisitions (M&As), and handle a higher volume of merchandise, logistics operations may become more complex and cost-inefficient. Efficient data collection and utilization for logistics will pose a significant challenge for many franchisers, especially when it comes to sharing this data and collaborating with all logistics stakeholders (Koizumi & Yamamoto, 2019; Kim, 2023).

Smaller drug store franchisers may struggle to improve logistics efficiency on their own. To address this, the Japan Self-medication Data Base Center was developed by the Japanese drug store franchiser association. While the center could provide some support, particularly for smaller franchisers lacking sufficient or clean operational data, it may only offer limited benefits in the context of AI tool integration, which requires high-quality data to be truly effective (Kim, 2023).

Digital transformation in inventory and merchandising management is essential for reducing costs, minimizing product damages, and enabling employees to focus on more value-added tasks. The integration of digital tags, point-of-sale (POS) systems, and electronic order systems (EOS) with AI tools and automation can transform a traditional store into a "smart store." This transformation could also position the store as a smart, local health and beauty hub, enhancing both operational efficiency and customer satisfaction (Koizumi & Yamamoto, 2019; Kim, 2023).

Additionally, the development of customized apps for healthcare, beauty care, medicine, physical therapy, consulting, and promotional communications may increase customer loyalty, particularly among younger consumer segments. As these consumers age, they are likely to become long-term, loyal customers. However, getting them to download such apps could be challenging, as many already have numerous apps on their phones. They will only be inclined to download these new apps if they perceive clear, tangible benefits and recognize that the apps offer services they need or value (Koizumi & Yamamoto, 2019; Kim, 2023; Ono, 2024).

7. Souki Drug Store Franchising (SDS) and Strategies of SDS

We conducted a series of interviews with a key figure from the Strategic Planning Office at Souki Drug Store Franchising (SDS). With 22 years of service at the company, he has gained extensive experience in sales, promotion, store management, strategic planning and implementation, as well as training store managers.

SDS is a mid-sized franchiser operating in Tokyo and surrounding prefectures, with 1,603 employees across 1,177 franchisees. SDS refers to its strategy as the "cellular dominant strategy," using five stores (cells) to cover a market area. In addition, SDS has begun developing flagship stores (flagship cells) to dominate key market areas in Tokyo. The company consistently expands its merchandise mix and store sizes to attract consumers by offering a wide variety of grocery and necessity goods.

As a mid-sized franchiser, SDS has not been a target for mergers and acquisitions (M&As)

and has no interest in pursuing M&As with competitors. This is due not only to its size but also to its relatively limited market coverage. Instead, SDS has focused on building strategic alliances with local supermarkets and specialty stores.

For instance, SDS's alliance with locally dominant supermarkets has allowed it to focus on high-margin products. While the supermarket emphasizes grocery and necessity goods with limited offerings of over-the-counter medicines, SDS specializes in prescriptions, a wide range of over-the-counter medicines, health counseling, cosmetics, and beauty counseling. This customer-sharing strategy has proven successful.

SDS has also formed effective strategic alliances with locally recognized shopping districts and specialty retailers. In these areas, SDS and the specialized retailers can coexist harmoniously by sharing customers. Retailers appreciate the partnership with SDS, as the drug store serves as an anchor, drawing in potential customers. This collaboration eliminates concerns of cannibalization, which is a welcome aspect of the alliance.

8. Potential Strategies of SDS to Survive and Dominate

SDS's strategic planning office has been focused on developing additional strategies to sustain and expand its market dominance, particularly in Tokyo. Dominating Tokyo—and potentially Osaka—has become crucial for any drug store franchiser, given the expected decline in Japan's population. In other words, drug store franchisers that fail to establishdominance in these regions may struggle to survive.

SDS views mergers and acquisitions (M&As) as a key strategy to implement a "scrap and build" approach. This tactic allows SDS to select, reorganize, and strengthen the stores (cells) within specific market areas. Through M&As, SDS aims to retain only those cells that are dominant and profitable enough to secure market leadership. This strategy not only improves the allocative efficiency of corporate resources but also maximizes profitability from each store.

Rather than introducing store-brand merchandise, SDS believes that expanding bargaining power over national brands is a more effective strategy. National brands are favored by consumers, particularly due to the popularity of loss leaders. In contrast, store-brand merchandise can be unpopular and costly, especially if sales are insufficient to cover the costs of research and development (R&D) and original equipment manufacturing (OEM). OEMs also require large upfront purchases with no option for returns if the products do not sell, which poses a significant risk.

Human resources (HR) have been a strategic focus for SDS, particularly given the high costs and turnover rates. For instance, within five years, 8 out of 10 new employees leave the company. Hiring pharmacists has been especially challenging due to a limited supply, high wages, and the high mobility of the workforce. To address these HR issues, SDS has embraced digital transformation to improve operational efficiency. Additionally, SDS has encouraged employees to acquire industry certifications that enable them to offer healthcare services. Employees can earn internal certificates in healthcare and beauty counseling, with part-time employees also encouraged to attend certification programs to support strategic goals. Furthermore, SDS hires part-time pharmacists, including those temporarily retired to focus on family or officially retired professionals.

SDS has worked to establish a strong corporate identity by differentiating itself from competitors. The company aims to be recognized as "the health center" in its market, targeting mothers, caregivers, homemakers, elderly individuals, and health professionals. However, SDS does not cater to those who require shuttle services or intensive support to access stores. All target customers must be able to visit stores independently. SDS strategically locates stores in the center of markets, ideally in large shopping centers, and deliberately avoids locations near hospitals to prevent competition with local pharmacies.

While most Japanese drug stores close by 10 p.m. daily, SDS plans to extend store hours until midnight. The company believes this will capture a non-traditional customer base, such as those who need over-the-counter medicines after regular store hours. This added convenience may help build loyalty among new customers. Additionally, extending store hours allows SDS to improve employee efficiency and productivity during regular hours. With fewer customers in the store during late hours, employees can focus on logistics, inventory management, and restocking, freeing them up to concentrate on promotions, sales, and customer counseling during the day.

SDS has aggressively pursued digital transformation by connecting its point-of-sale (POS) and electronic ordering systems (EOS) to optimize merchandise mix, logistics frequency, and inventory levels. However, the company has not yet introduced AI-supported tools, as it lacks a sufficient and clean data set necessary for effective AI integration.

9. Conclusion

The Japanese drug store franchising industry has experienced substantial growth, but as the market matures and faces challenges such as a declining population and fierce competition from convenience stores, mid-sized franchisers like Souki Drug Store (SDS) must adapt to survive. Through a detailed analysis of SDS's current strategies and the broader industry trends, it is clear that to remain competitive, SDS will need to focus on leveraging strategic alliances, optimizing its merchandise mix, and embracing digital transformation.

SDS's approach to forming partnerships with local supermarkets and specialty stores has enabled it to carve out a niche in the competitive landscape, particularly by focusing on high-margin products such as prescription medicines and cosmetics. However, the company's future success will hinge on its ability to expand its presence in key urban markets like Tokyo, implement a "scrap and build" M&A strategy, and enhance operational efficiency through digital tools. Addressing human resource challenges, particularly the shortage of pharmacists, and embracing AI technologies for logistics and customer service will be crucial in maintaining profitability and ensuring long-term growth.

While the industry faces significant challenges, such as market saturation and workforce shortages, mid-sized franchisers that can differentiate themselves through customer-centric strategies and operational innovations will be best positioned to thrive in the evolving retail landscape. By focusing on providing value-added services and expanding its role as a regional health and beauty hub, SDS can continue to meet the changing needs of consumers and solidify its place in the competitive drug store sector.

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