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WBA - Q2 2018 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

WBA reported YoverY reported sales growth of 12.1%. Expects FY18 adjusted diluted net EPS to be $5.85-6.05.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Walgreens Boots Alliance Second Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Mr. Gerald Gradwell, Senior Vice President, Investor Relations and Special Projects. Please go ahead.

Gerald Gradwell - *Walgreens Boots Alliance, Inc. - SVP of IR*

Good morning, ladies and gentlemen, and welcome to our 2018 second quarter earnings call. As usual, I'm here today with Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer of Walgreens Boots Alliance; Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance and President of Walgreens; and George Fairweather, our Global Chief Financial Officer.

We are presenting in a slightly different format today to try and give you a better overall picture of our thinking, where we are with the business and where we want to be. We would welcome any feedback you may have on the updated format to ensure we're addressing your needs.

I will shortly hand you over to Stefano to make some opening comments and host the call. Before I do so, however, there are some things that never change. So I'd ask your indulgence and attention, please, while I take you through the legal safe harbor and cautionary declarations.

Certain statements and projections of future results made in this presentation constitute forward-looking statements that are based on our current market, competitive and regulatory expectations and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by the law, we undertake no obligation to update publicly any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. Please see our latest Form 10-K and 10-Q for a discussion of risk factors as they relate to forward-looking statements.

In today's presentation, we will use certain non-GAAP financial measures. We refer you to the appendix in the presentation materials available on our Investor Relations website for reconciliations to the most directly comparable GAAP financial measures and related information. You'll find a link to the webcast on our Investor Relations website at investor.walgreensbootsalliance.com.

After the call, this presentation and webcast will be archived on the website for 12 months.

I'll now hand you over to Stefano who I should say is slightly under the weather today with a bad cold. So if he sounds a little croaky, that's why. Stefano.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Thank you, Gerald. As you will have seen from this morning's announcement, it has been a rather good financial quarter for the company with reasonable progress in our key numbers. This is despite what has widely been seen in the retail markets as a rather mixed start to the year. George will run you through the numbers. But before then, I would like to say a few words about our markets and strategy and ask Alex to give you some insights about how we are interpreting and implementing that strategy in our daily operations.

So I would like to start by reminding you why we believe that we are at the heart of an extraordinarily dynamic sector despite it apparently being a little out of favor at the moment and why we have such conviction about our future.

Fundamentally, we see ourselves as being in very attractive markets. The pressure on pharmacy are just elements of the overall pressure in the healthcare system. In the U.S., this is mainly reimbursement pressure from the payers, the PBMs and the health plans. Although, as I have always predicted, these are now pretty much one and the same and the sign of the pressure the payers are under from their customers. It is a sign that everyone recognizes the need to control the inevitable growth in demand.

Populations continue to age. With increased life expectancy comes increased expectation for quality of life and increased demand for healthcare. In the U.S. alone, over half of all prescription drugs are taken by the over 65s and this percentage is even higher in many of the entirely state-funded healthcare systems in other countries. The cost of care continues to rise. The relative attractiveness of medication-based treatments to keep people leading productive lives in the community continues to increase as the cost of medication remains materially lower than the total cost of healthcare.

The innovation in healthcare means demand is infinite and most markets manage cost by managing supply. Against this backdrop, we see different approaches to managing healthcare spend. In most countries around the world, this has been achieved through government intervention either to limit reimbursement, limit availability of treatment or more usually, some combination of the 2. The most sophisticated system combine this with some element of free market economics. The United States is one of the markets with the greatest element of such free market economics built into the system.

But with some 18% of U.S. GDP already spent on healthcare, significantly more than any other country in the world, everyone recognizes that the U.S. system can be more efficient. The greater the element of free market economics in the healthcare system, the greater the scope for us and the greater the number of ways in which we can add value through reducing overall cost of care and working with others to evolve the way in which healthcare is both delivered and funded.

We have outstanding experience and a strong track record of success in managing our business to play an active role in the management of our area of healthcare costs. We have shown that we can thrive commercially while doing so, sharing the benefits and at times the growing pains of the market with our partners in the relevant healthcare system.

This has made us a trusted partner for patients, payers, governments and providers, most notably the drug companies and, of course, has been the foundation on which our team has delivered many, many years of excellent financial performance.

In this market, we are applying the same strategies that have systematically delivered us a combination of cost control and commercial growth in other market.

I can summarize our approach really quite simply. The main points of our strategy are to: Drive growth and consolidate volume through organic growth, partnership or acquisition and use these volumes to buy best-in-class and most importantly, significantly better than our competitors; control cost, optimizing financial efficiency and leveraging our financial strength. We rigorously apply financial discipline in everything we do from day-to-day operation to business development; differentiate ourselves where we can through value, quality of service, exclusivity or innovation and our owned brands form a strong point of differentiation; build a portfolio of complementary businesses across a broad geography to provide protection from the unique cycles in any one area; reinvest for both organic and external growth and foster a portfolio of opportunity to give us multiple levers for growth.

Naturally, we must adopt this approach specifically to the condition in each of our markets and the U.S. is no different. In fact, if anything, these approaches are more relevant to the U.S. than to many other markets. I can honestly say that there is nothing that we have done in the U.S., indeed anywhere across the company, that cannot be traced directly back to one or more of these themes. And of course, underlying these are 2 basic principles;

the need for dynamism, ensuring that we move with, indeed, lead the market; and a strength of leadership and management, ensuring we have the right team with the right skills and experience.

Our announcement of James Kehoe's appointment to join us as Chief Financial Officer from 1st of June, freeing George to help me with business development after a carefully managed transition, demonstrate our ability to attract exceptional skills and experience. It also demonstrates the commitment of our current team to remain engaged in our future and to evolve the team as much as the company to keep it relevant and strong.

Don't take this as any indication that I am going anywhere. There is still a lot for me to do, but it is an indication that we are committed as a team at every level in our organization.

George has done outstanding work as CFO over many years, which we all thank him for and that he has a lot more to contribute to the company.

Thinking of other members of the team who have done great work but still have a lot more to do, this is probably an appropriate time for me to hand you over to Alex, who will tell you about how we are implementing our strategic approach in the U.S.

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Thank you, Stefano. I'm going to focus today on the U.S. as this represents so much of our activity. Stefano has defined our strategy succinctly and the evidence of this strategy in action is clear from our recent earnings performance and in our stores, although, of course, a lot more goes on behind the scenes. That said, everything we do eventually comes back to the service we give to the patients and customers and how we deliver for our partners.

Before I talk about the future, let me just review how we've applied our strategy in the U.S. market today. To start with, we've had to do a lot of work to collect the data we needed and apply it in the way we needed. As you know, we are investing considerably in our systems and are spending a lot of time getting them pointed in the right direction and working even better. Overall, we spent over $500 million to date on building, testing and implementing new systems. We are on track and in addition, in the next 3 years, we anticipate investing more than $500 million on this area of transformation of our business, which will in turn allow us further cost savings and efficiencies. We are starting to get good data from our stores and we're making progress towards what we need.

We are now running the Balance Rewards program as a data and customer insight tool as much as a marketing program as it was originally designed. And we now have 88.6 million active users. We are still working to simplify the program, but we now have available to us nearly 3 years of excellent customer data. We are partway through updating other core retail systems, which will give us a full suite of data, enabling us to better manage the business and provide a platform for future growth. We are also working on a number of other key systems. We've been very open about the fact that our pharmacy management system, although state-of-the-art when it was implemented some 25 years ago and still performing very well given its age, has some constraints in its abilities to handle the future needs of the business and our markets. This is a big priority for us. The work is progressing on track and we've been significantly helped in this by our recent experience of developing such systems elsewhere in the company.

In addition, some of the work George and his team are doing within Walgreens to update the financial systems and related processes is already giving us additional visibility on our financial performance on a much more timely basis, which is helping us track and respond to changes much more quickly. As ever, there's more to do but the combination of management data and customer insight has really begun to kick in and inform a great deal of change in our business.

Turning now to pharmacy. As you know, one of our top priorities has been to grow volume in keeping with Stefano's first strategic aim. It was pretty clear to us 3 years ago that our cost base was designed for a volume of prescriptions that had been lost but not fully replaced. We did some work to validate the information we had on the market and compared that with our own internal information. It was clear we were outdated in our thinking and approach. The implication was a pretty big shift in our approach, which we had to work hard to manage, significantly cutting our prices to bring us back into line with the market while also focusing on improving our service standards, particularly availability of prescriptions and speed of service.

In this, we had to make the judgment call that our network, our position in the communities we serve and our service levels would make us attractive at market prices. We made this judgment based on extensive consultation at every level with payers and both the legwork and the consultation paid off.

Once again this quarter, you have seen prescription volumes grow and our market share increase to the highest level we've ever reported at 21.4%. Over the past 3 years, we have grown our market share by over 200 basis points. While volumes and market share come and go as contracts shift, I am confident that we are now back to a position where we are competing strongly.

Despite any short-term shifts in the market, we are well positioned to see volume and market share growth over time. This gives us a strong basis on which to review our pharmacy operations, improve them in areas where we can generate more value for both ourselves and our partners and look at ways to improve costs and efficiency over time to augment the growth we will see in volumes.

Of course, as you know, this team in Switzerland are using these volumes alongside those of our procurement partners to do a truly fantastic job in terms of getting us great buying terms, but we do not and cannot rely solely on buying. The procurement work is there to support the pharmacies and volume counts in procurement.

Specialty growth can also be seen clearly in this quarter's performance as we continue to develop our AllianceRx partnership with Prime Therapeutics and extend the number of successful community specialty pharmacies.

I'm proud to say that we have recently earned URAC accreditation in Specialty Pharmacy at 23 Walgreens community-based specialty pharmacy sites. Overall, I believe we are well positioned to grow Specialty market share in the future.

In the retail side of the business, despite it having been an area of much discussion, we are at an earlier stage. Over the last 3 years, we have been focused on driving profitable growth.

Looking at the comparative quarter 3 years ago, on a usual adjusted basis, we have delivered higher retail gross profit through improving gross margin by over 300 basis points. This progress has been made through a combination of good solid retail management and focusing promotions and applying the rigorous financial discipline which Stefano has already mentioned.

Through changes in merchandising and product mix, we have furthered our strategy of differentiation and increased penetration of owned brands while significantly improving margins. This has been achieved in comparative markets by driving improvements in our health and beauty offerings. We've made good progress, but not perhaps as quickly as I would've hoped. But the new store formats we're working on will provide a platform for us to accelerate this growth. Of course, there have been many areas we've been able to make good progress within the current store formats such as optimization of ranges and promotional activity, all of which have delivered improvements in performance. This can be clearly seen in our Beauty differentiation rollout, where in partnership with our suppliers, we have extended the rollout to around 2,900 stores, adding more brands including our own brands. And it's not just about improving the look and feel, but making sure we have the skills and training in our own team to support this work. Since we completed the rollout, Beauty sales in Beauty differentiation stores have outperformed the non-Beauty differentiation stores in the quarter. This accounted for a retail margin differential of around 2 percentage points. We intend to continue this initiative to add more stores and more categories in Beauty.

In the new store format, we'll bring together such areas as optical, hearing care and lab along with further testing of value, loyalty and supply chain initiatives. We plan to bring together all of this learning in the pilot stores, which we will begin launching in the coming months as we mentioned in our first quarter update.

I would stress that the new formats are as much about bringing Walgreens up-to-date as in themselves delivering the future, though they will provide a platform from which we can deliver future services, retail offerings and accessible healthcare. The pilot stores will also provide a platform for the existing initiatives we have already introduced such as our strategic partnership with FedEx already available in almost all of our Walgreens and Duane Reade stores, all performing very well.

Equally, there are areas unique to us that we don't have the scale or expertise to optimize in our group. We have gone for some quick wins, but are now in a position for more fundamental change.

The development of the new store formats and iterative evolution as we learn more from their performance in the market also provides us with the opportunity to develop a wide range of services and a different value proposition.

The acquisition of the Rite Aid stores, which has now been completed, is allowing us to accelerate the development of our network during this transitional phase, accepting as we have said that there will be no material accretion from Rite Aid this fiscal year.

Another key initiative is developing a digital presence, which is not just a buzzword but increasingly of true relevance in the healthcare arena as well as, obviously, in retail. And again, while it's early days, we have not been sitting still in this area. Our app has been downloaded 50.6 million times and has a 5-star customer rating on the U.S. Apple App Store.

During the second quarter, around 21% of Walgreens' retail refill scripts were initiated through digital channels, up almost 3 percentage points versus the comparable quarter last year. So with all these initiatives, while there's a long way to go, we must not lose sight of the shifts in the market while we are transforming the business.

We have many great opportunities to take and many paths that we can choose to follow as we drive our business forward to create a more differentiated customer proposition in the U.S.A.

My job is to make sure that we have the right team, with the right tools and the right focus to make sure we have the dynamism that Stefano talked about, reaching all parts of our operations. That's why in the U.S., we are preparing to invest around $100 million per annum in increased wages beginning later this calendar year. Putting the systems in place, as I said in my opening comments, is an example of providing the right tools. And the forthcoming appointment of Sebastian James to head up Boots is a good example of how we can broaden and renew the skill base of our team while we execute a planned succession within our operations. I'm delighted that in doing this, we have also been able to keep the experience of Elizabeth Fagan within the business.

Now over to George.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Thank you, Alex. We are pleased with our overall progress both in the quarter and through the first half of the fiscal year, and we continue to expect to have a solid year. And today, we have raised our guidance for fiscal 2018.

In the quarter, our key profit metrics were all up on the comparable quarter last year, both on a reported and constant currency basis.

As we announced this morning, on a reported basis, sales were up 12.1%, adjusted operating income was up 7.3% and adjusted diluted net earnings were up 16.6%. Most importantly, adjusted diluted net earnings per share increased by 27.2%.

This very strong growth was in part due to the U.S. tax law changes, our share buyback program and, of course, good growth in adjusted operating income.

On a GAAP basis, diluted net earnings per share increased by 38.8%, the key difference between GAAP and adjusted growth being the cost transformation program in the same quarter last year, partially offset by the provisional net discrete tax expense.

For completeness, here are the first half financial highlights, showing adjusted diluted net earnings per share growth of 22.4%.

So turning now to the performance of our divisions in the quarter. Starting with Retail Pharmacy USA. Retail Pharmacy USA total sales, comparable store sales and adjusted gross profit all increased versus the comparable quarter last year with adjusted gross profit being higher in both Pharmacy and Retail. At the same time, adjusted SG&A as a percentage of sales has improved versus comparable quarters for 19 consecutive quarters. These together resulted in adjusted operating income increasing by 6.3%.

So let's look in more detail at Pharmacy, where we have continued to make good progress. U.S. pharmacy sales were up significantly, increasing by 18.7%. This was primarily due to higher prescription volume including central specialty and mail following the formation of AllianceRx Walgreens Prime and from the acquired Rite Aid stores. On a comparable basis, pharmacy sales increased by 5.1%, partially due to higher volume.

Reimbursement pressure and generics had a negative impact, partially offset by brand inflation. The number of retail prescriptions filled on a 30-day adjusted basis including immunizations increased by 9.1%, leading to an increase in reported market share in the quarter to 21.4%, up 100 basis points. On a comparable basis, prescriptions filled increased 4%. This was primarily due to the positive impact of our strategic pharmacy partnerships and to Medicare Part D.

As in the first quarter, we delivered higher pharmacy gross profit despite ongoing reimbursement pressure and a higher proportion of specialty, which adversely impacted gross margin by around 190 basis points.

So turning next to retail. Total retail sales were 0.7% lower. Comparable retail sales were down 2.7% as we continued to focus on delivering improved margins. This action resulted in higher retail gross profit than in the comparable quarter last year. As Alex has said, looking at the comparable quarter 3 years ago, we have improved adjusted retail gross margin by over 300 basis points.

Next, let's look at Retail Pharmacy International. Retail Pharmacy International total and comparable store sales on a constant currency basis were lower this quarter. Market conditions continuing to be tough, particularly in retail. Comparable pharmacy sales increased by 0.6%, Boots UK being up 1%, mainly due to mix. Comparable retail sales decreased 2.8%, Boots UK being 3.3% lower.

As I indicated on our January earnings call, while trading has been challenging, we are managing our business as well to address this. In particular, we are managing our cost base very tightly. As a result, we have been able to increase adjusted operating income on a constant currency basis by 6.6%.

So now let's look at our Pharmaceutical Wholesale division. Sales increased by 3.4% on a constant currency basis. This was behind our estimated market growth weighted on the basis of our country wholesale sales due to challenging market conditions in certain continental European countries, partially offset by strong performance in emerging markets. Adjusted operating income was down 1.3% on a constant currency basis, generic procurement margin pressures being largely offset by higher adjusted earnings from AmerisourceBergen, primarily due to the U.S. tax law changes.

So turning next to cash flow. We continued to deliver strong cash generation. Operating cash flow in the quarter was $2.2 billion. During the quarter, our working capital inflow was $502 million, reflecting our seasonal reduction in inventories. Cash capital expenditure was $288 million. We continued to invest in key areas to develop and differentiate our core customer proposition as well as the upgrades to our IT systems which Alex had referred to. Overall, this resulted in free cash flow of $1.9 billion. This brings our free cash flow for the first half to $2.5 billion, which is another strong performance.

So turning next to tax. Now that we have better clarity on the tax benefit for this year and beyond, I thought it would be useful to explain the impact. The adjusted effective tax rate for the quarter, which we calculate excluding ABC, was 16.5%. This was lower than in the same quarter last year, primarily due to the recent U.S. tax law changes. For the first half, the tax rate on the same basis was 20.3%. The core tax rate in our half year income statement is a blended rate. As we have an August fiscal year-end, this reflects 4/12 of the old U.S. tax rate and 8/12 of the new rate.

Our GAAP effective tax rate in the second quarter was 27.4% compared with 19% for the comparable period last year. This was significantly impacted by a provisional net discrete tax expense of $184 million associated with the new U.S. tax law. This net figure consists of current estimates of $794 million of transition taxes payable over the next 8 years, partially offset by a $610 million reduction in deferred tax.

In terms of the fiscal year 2018 cash tax benefit, we now expect this to be more than $350 million. This compares with our previously announced estimate of over $200 million. All these figures are current estimates, which we will continue to refine.

Finally, turning to guidance for the full financial year. We now expect adjusted diluted net earnings per share to be in the range of $5.85 to $6.05. Our guidance now incorporates the U.S. tax law changes. The expected benefits are now marginally higher than the $0.35 per share upper end of our previously indicated range. As we've said before, we do not expect Rite Aid to significantly impact this year's adjusted diluted net earnings per share. And as usual, this guidance is based on current exchange rates remaining constant for the rest of the fiscal year.

I'll now hand you back to Stefano.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Thank you, George. So from what you have heard, I hope that you can see we remain very confident of the robustness of our business and our ability to drive growth in it. The results that we have delivered today demonstrate the real value we are creating as we continue the transformation of our business and our updated guidance reflects the confidence we have in our ability to continue to deliver solid financial return.

The strength of a company like Walgreens Boots Alliance does not lie entirely with the momentary place any single business in the company is in its specific business cycle. It lies in our ability to bring multiple businesses and multiple opportunities to bear to manage our portfolio of businesses, our brands, our market position and our partnerships to create opportunities, to deliver consistent performance as a company overall.

We have a great deal of experience of doing this. And despite ever-changing markets, we see much to give us confidence that we can continue to do that going forward.

So to conclude, as we look ahead, we are as optimistic as we have always been.

Thank you. We will now take any question that you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Ross Muken from Evercore.

Elizabeth Hammell Anderson - *Evercore ISI, Research Division - Associate*

This is Elizabeth Anderson in for Ross. Given the recent speed in industry consolidation, how has that changed your view, if at all, on any of your capital allocation priorities?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Stefano here. Well, it doesn't change it at all. We have our strategy and we follow our strategy trying to be consistent in what we believe. I have just announced which are our principle. And of course, we are always willing to do a deal if the deal is consistent with work that we expect from a deal, if we have the right return, if we can see a way to have back [the case] that we use for the deal. So we are always open to the deal. We are open to joint venture, to collaborate with other partners in order to extract synergies, to extract benefit that we can share, possibly investing capital but not enormous amount of capital. But if all these would not be possible in spite of our cost and attention to the market, we will return somehow the money to the shareholders. We are a good cash generative company. Of course, we have to use the money that we create. We will try to do reasonable M&A, if possible. Otherwise, we will give back the money to the shareholders.

Elizabeth Hammell Anderson - *Evercore ISI, Research Division - Associate*

That's really helpful and in addition, your AllianceRx partnership seems to be going off great. What do you think is about your offering that's really resonating with clients?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Elizabeth, Alex here. I mean, it's really early stages, so we're pleased with where we are. I think there's a couple of things. I think that we are able to really work in a different way in terms of the visibility of the partnership and what the payers are seeing within our partnership. Clearly, there's more to do here, but that's one part of it. Second part of it is that we're able to connect some of the customers to our local specialty pharmacies who are also handling the additional LDD drugs that we've been able to acquire as a result of both partnership with AllianceRx and the expansion of our local community pharmacies within the Walgreens network. So we feel good about where we are and we think we have a more local model that's more relevant along with a great partnership essentially with Prime Therapeutics.

Operator

And our next question comes from Robert Jones from Goldman Sachs.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

I guess just looking at scripts growth, up 4% on a same-store basis was maybe a little lighter than what we were expecting given the residual benefit we thought you'd still have from the Prime arrangement and obviously, a very strong flu season. Could you maybe just comment on what you saw as far as volumes on scripts in the quarter? And then I know earlier this year, you had talked about the back half seeing script growth in the 2% to 3% range. Wanted to see if that was still a valid target?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Thanks, Bob. But yes, I think that -- remember we haven't invest -- the Q2 -- in Q2 they met the wins of last year and that happened obviously January 1, so Q2 does contain an element of that. Secondly, the flu season was unusual in a sense. It was very strong in December and January, but relatively weak in February. And overall, it was a pretty -- from our point of view, a pretty normal flu season. And remember, Q2 for us is these 3 months. So we saw the flu season pretty much level off to normal. So I wouldn't say there was much impact in our volumes there. Going forward, as we said before, we still expect to grow in the back half of the year. And also, we expect to grow going forward. We have seen some additional marketing activities from some of our competition which, again, is impacting some of the volume, but it's pretty much as we said and we're very comfortable and in a really strong competitive position not just for this year but the future as well. And of course, last but not least, very importantly, this move -- transfer of the Rite Aid businesses that we have purchased to ourselves, of course, again is growing our volumes in the second part of this fiscal and calendar year.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

Great. Now that all makes sense. I guess, just 1 quick follow-up or clarification on the plan to increase wages, I think you mentioned by $100 million. That won't affect this fiscal year. Is that correct? I think you said it would start in fiscal '19. And then I guess, more importantly, any sense you can give us on where you think this puts you relative to others in the market where you're competing for hourly wage earners?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Yes. We haven't given a date yet, but we did say it will be really strong this calendar year. So you can assume that it will have little or no effect on this calendar -- this fiscal year. In terms of the marketplace, we review this all the time. There's quite a lot of announcements we've made from people in the marketplace and we're confident that what we're doing later on this year will keep us in a very competitive situation and we continue to invest in our people over the long term. And while -- this really has nothing to do with the tax benefits that George outlined in his prepared remarks, this was already something that we planned to do, but obviously, was helped by the fact that we had some relief there as well.

Operator

And our next question comes from George Hill from RBC.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

I guess, first I start with George. If I look at the guidance change kind of where you guys came into the quarter versus the updated guidance, it looks like most of the benefit is coming from the tax change. I guess, I would just ask, are there any changes to any of your internal operating assumptions as it relates to the guidance? Or should we just think of most of the changes to happen? And then I have a quick follow-up for Alex.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

I mean, yes. You've summarized it pretty well. Our updated guidance really reflects no change to our core growth assumptions, which you can -- if you do the math from the midpoint to midpoint, you'll see that it's really primarily from the expected tax reform benefit. So really no change. Just -- to add to that, I think as we said in the last 2 earnings call, we said that we expected fiscal '18 to be more balanced between the 2 halves than was the case in fiscal '17, so...

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

That's helpful. And then, I guess, Alex, as we think about the payer environment, we've seen the Cigna-Express deal and the CVS-Aetna deal. I guess, are you seeing anything from your end that makes you concerned about future reimbursement pressure on the commercial side of the book from payer consolidation? Or does this -- do the alignment of these payer organizations not seem like they're going to impact future reimbursement?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

No. Too early in any case to see it. But remember, that for sure, there will be some negative effect in the consolidation, but there will be mainly positive effect because we are in a free market. And so the people who are not taking part to the consolidation will more -- will be more willing to work the people who are independent on the market. It's too early to see the effect, but overall we would expect it's likely positive effect for us.

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

George, I have nothing to add to Stefano's remarks. I was -- I see the same way, yes.

Operator

And our next question comes from Ricky Goldwasser from Morgan Stanley.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

My first question is on the new store format. Just -- if you can kind of like help us quantify what type of capital investment do you envision is required per store and how should we think about the cadence of the rollout?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Ricky, it's Alex here. Yes. These really are tests. They're tests based on a lot of stuff we've learned in the last 3 years both on front-end product mix and also importantly some tests that we've got in the market separately with health care services along, of course, with our new platform with FedEx and a digital platform that we already have in place. So we'll be putting all of that together to understand this test. So we really haven't got any more information on rollout. In terms of affordability, I think we've been very clear that we are fiscally very disciplined and we will work this within the normal rules that we have in the business about the returns that we would expect to get from any initiative including one rolling out a format. And our experience in the past has been that you can achieve with a reasonable spending capital in a small box like Walgreens a good return as you start to shift the mix and introduce more services and also improve the value proposition overall. And that's exactly what we intend to do in these formats to prove that case and then when we're ready, we'll come back and let you know how that looks in terms of the plan.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

If I can say something, Stefano here. This is what we are typically doing. We make trial, spending a limited amount of money, and after we refine the trial because -- before rolling it over, we work on the trial. And if -- we know that this takes a little more time at the end of the day, but we believe that it is worthwhile to spend some time and to be sure of what we want to do in order that when we roll over the trials to many stores, we have a model which is not perfect but is quite robust. And of course, these take time, but at the end, we save a lot of money because we don't handle risk to roll over a trial, a format or any activity that after we have to adjust or probably to substitute. So we try not to waste money.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Okay. And then my follow-up, one is on -- United and Aetna are moving to point-of-service rebates for their fully insured members. Does this have any impact on the pharmacy economics as it relates to the co-pay? That's one. And second of all, when we look at your front-end comps, obviously, they're down 0.27 in the quarter, but how should we think about the impact from your decision to rationalize SKUs? So how should we think about comps on the same SKU basis?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Thanks, Ricky. So the first question -- I mean, we actually believe that point-of-sale rebate is a good thing for the customer, so we actually think it's a good move forward. It creates more visibility and we don't expect that to be any more than a normal reimbursement pressure that we've seen consistently over the years as a result of this, but we expect that pharmacy experience to get better, which should help us from an efficiency point of view and a customer care point of view. But clearly, you will see what happens when our colleagues in the industry roll out these initiatives. On the front-end comps, we have been consistently saying and I think the number we gave today, about 300 basis points, is but one important data point that we are driving for profitable growth. Part of that was a significant SKU reduction in the bottom quartile of our stores last year. And I don't have any specific data to give you today, but we are pleased with the performance of these stores and are moving that thinking on as an important part of simplifying our offer both for our people who service the customers, but also importantly for customers who want to actually have a really good experience in Walgreens as well. So one of the things we have seen is good improvements in [MPS] as a result of our work. So there's more management to do, more work to do, but we remain confident in this approach. That's why we're accelerating it.

Operator

And our next question comes from Lisa Gill from JPMorgan.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

George, I understand your comments around guidance and primarily being tax. But what did the quarter look like versus your internal expectations? It beat nicely, I think, versus straight expectations? So I'm just trying to understand the way that we had it modeled versus your internal expectation.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

I mean, overall, the year-to-date is very much turning out as we had anticipated, hence, really what we said today about the guidance for the full year.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

Okay. Great. And then just secondly, Stefano, I know you consistently get this question. The first question today was about capital allocation. But if I go back to our discussion in January where we talked about vertical integration and you anticipated there would be even more post the CVS-Aetna deal, I want to better understand -- and I understand what you're talking about, whether you're talking about a deal that's consistent with return, when you think about being financially, but is there something that you believe you need to do strategically from where you sit today? Or is it just more of if something comes along that fits our financial criteria, that's the direction we're looking at? I just want to better understand how you're thinking about it from a strategic standpoint.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Well, from a strategic standpoint, I really believe that our market, our pharmacies, our stores, tomorrow will have to be very, very different. And so for sure, from a strategic standpoint, we have to change a lot. But I don't believe that the change is only possible if you merge with a health plan. This is one way to rationalize the market. Of course, if you can extract the value from it -- if the value that you can extract from it is justified by -- justifies the price that you pay, but this is one model. But there are many other models because we will have to change the stores quite substantially in future and the way we will serve the consumers in a very radical way. So there is much to do with or without a merger with a health plan, with or without a merger with other players in this market. And I see that the main transformation in future will be -- will not be just a merger with someone. The main transformation will be to adapt the stores to what the future customer will require. And if you go to Asia and you see what is happening there, if you look at what the people like Tencent, Alibaba and other are doing or are talking of doing, you'll see that at the end even we have to think in a different direction for the future. And this is something that, of course, is ineluctable, while a merger with an insurance company or with PBM or with a wholesaler is not ineluctable. The fight in future will not be on this basis.

Operator

And our next question comes from Steven Valiquette from Barclays.

Steven J. James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

So just curious here now that you completed the purchase of the 1,900-plus Rite Aid stores, just curious if there's anything that has surprised you on the upside or downside now that you have all these assets under your ownership?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Steve, no. We're really pleased to have got to this point, as you can imagine. And the process has been good. Nothing surprises on the upside or downside and we remain confident that we will be able to execute what is still quite a big plan. I mean, adopting over 1,900 stores into your network is not straightforward. So we still have a lot to do, but we remain confident that it's on plan and will give us the returns that we had expected.

Steven J. James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And then just quickly, just to throw it out there, since nobody else brought it up yet. Are you able to comment at all on these broad news articles a month or 2 ago suggesting there were talks going on between ABC and Walgreens on the potential buyout of the rest of ABC that you don't currently own? Just curious -- again, just to throw it out there.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Quite obviously, we don't comment on any market speculation.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Many people are curious about that.

Steven J. James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

Yes. Now you're right about that.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

People are so curious that we, too -- we have become curious reading in the press.

Operator

And our next question comes from Michael Cherny from Bank of America.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

So I want to go back to Lisa's question a little bit regarding the store of the future. I think, Stefano, you talked about some of the changes you're seeing globally. As you think about the positioning of where the stores are right now, along some of the partnerships you're doing, whether it's with LabCorp, with United's MedExpress business, how do you think about the transition of that moving target in terms of staying ahead of whatever you think the consumer might demand in the future versus the investments that you're making now to make sure that you can react to those demands?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

Whatever additional service you can offer, apart that this additional service represent an additional source of revenue and profit, which of course is not irrelevant. But apart from that, it's clear that the more services you will be able to offer, the easier will be to catch the customer and to keep the customer with you. Just probably in future, you will have to offer your services in a much more sophisticated way. And knowing more about your service or your customers, being able to anticipate what the customers will need, all things that everybody says today. But of course, it's necessary to prepare the company for it and the preparation of it's quite a complicated one. This doesn't mean that we don't have to expand and to live in the world of today and we have to do whatever we can to improve the efficiency and to improve the profitability of our companies, the 2 things are not excluding. I was asking -- what I was asked before how I would see the pharmacy in 5, 10 years in the future? And I see it -- the pharmacy and the stores quite different from now. But of course, if now we could do a good deal with someone at reasonable terms, where we could see a substantial return not just in earning per share but also in IRR, also in [EDA], cash return, we will be delighted to do it.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

And then George, one just quick clarification question on the tax savings. I'm not a CPA, so I won't admit that I'm an expert here. But if you think about the difference between the original $200 million cash tax benefit, which led to about $0.30, $0.35 based on your previous guidance, the guidance at the midpoint in terms of the official change was $0.37. You increased that tax benefit by $150 million. How do we think about the bridge in terms of those 2 numbers?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

They're essentially 2 quite different numbers because of the way the tax law is structured. The way I would try and think about it -- if you think about the rate, then -- and what the rate is, I think the best way of looking at it is at the half year adjusted effective tax rate and that came in at 20.3%. And within that, we had a discrete charge of about 0.5%. So that in effect says that for this year, we anticipate it as -- because the half year is based on a forecast for full year, you should be thinking around the 20% mark plus or minus for whatever discretes end up being. In terms of the cash tax this year, when we first did the estimates, it was very quick after the law was enacted. And some of the details on timing and other things have really only come out since that time and we certainly were always very careful before we publish numbers that we're absolutely sure that we're clear that the numbers are really good estimates that we always feel comfortable out before publishing. And so that's really what's driven the increase. And then I also talked a little bit about the deferred tax and repatriation tax. And again, that's just taken us a little bit of time to work through to publish the estimates that we've put in our numbers today. I'm afraid it's really quite complex. And of course, as I said in the prepared remarks, because of our fiscal year starting 4 months before the tax reform came into place, then when you're thinking about next year, you have to remember that we'll obviously have the full year of the numbers that year. But everything -- all the numbers I stressed are provisional under the accounting. We have 12 months to finalize this. And of course, we're over time increasingly seeing more clarification from the authorities on exactly how to interpret the various changes that have come in a very, very short period of time.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

So the 20% just, I apologize for this, should be a good tax rate for the second half of the year or the annualized full rate? I just want to make sure we get this clear.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

The -- as a proxy, the way the accounting works, for the first half year, you have to -- businesses have to forecast your full year rate before discretes and that based on your forecast and that is what you use for the half year. So the half year rate is a good indication but it can vary, obviously, depending on the mix in the second half if that is different versus what we forecast it internally at this time and it can also change depending on the discretes which, of course, vary quarter-by-quarter. Some quarters it could be positive, some quarters it could be a charge.

Operator

And our final question comes from Eric Percher from Nephron Research.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

So as the discussion on consolidation brought to bear, it sounds like you would expect that there will be some pressure over time on volume and reimbursement that that's a reasonable expectation you would do the same. I wanted to get your thoughts on relative to the commentary on the past 3 years what you've seen in share gain and reimbursement. How do you view the steady state of growth? What do you think the opportunities are for growth over the next 3? Do they look similar given those headwinds on consolidation? And then on reimbursement pressure, are we at a point where your relationships have evolved to a place where there may not be as much pressure as we've seen in the last couple of years?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

This is Alex here. Yes, I think it's always hard to have a crystal ball over 3 years. But yes, we're assuming that we have the same opportunity to grow as we have in the last 3 years. So I think in terms of volume, that would be a reasonable assumption to take. In terms of margin pressure, it's harder to anticipate at the moment, but we see the same trends right now. So as we build and think forward and think about how we are preparing the business for the future that Stefano mentioned earlier. Within the pharmacy, we're looking for similar reimbursement pressures in the past, ebb and flow a bit year to year, but there's no indication it's going to be any materially different. What is going to be different we think is the ability to take care of customers better and link them better to total offer going forward. We mentioned quite a lot about our investment in data and technology and we're doing that for a reason, which is to try and create a more joined up experience for our customers and we see pharmacy as the area where we have got in the next few years probably more opportunity going forward. So I would be happy to see the future in pharmacy in the next few years.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

And on that investment, I heard you speak to data and efficiency. I would think that your peers are also going to look at clinical capabilities to make these transactions impact cost. What is your view on investment today and the ability to impact the pharmacists and enable them as part of a care team?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Yes, and we see the same way. Go back to what Stefano said many times, and I agree with this, which is you don't have to be vertically integrated to be able to provide the same services to the payers as well as to the patients. So you can assume that the investments we are making that we are going down the same route. And of course, we're getting there, as I said already in the prepared remarks, in a pretty decent shape at the moment.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

And I just wanted to squeeze in, the $90 million legal benefit this quarter, could you just define that for us?

Alexander W. Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

We really have nothing else to add to that, Eric. I mean, obviously, we can't speak about it. It is what it is, so we have nothing else to hide.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

I mean, it's a place -- as you can see, it's just -- it's an accrual related to ongoing U.S. regulatory matters.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - Executive Vice Chairman & CEO*

We have our ways to review carefully the potential risks that we have and we account for it consistently what we see.

Gerald Gradwell - *Walgreens Boots Alliance, Inc. - SVP of IR*

We'll close now.

Operator

Thank you. And I would now like to turn the conference back over to Mr. Gradwell for any closing remarks.

Gerald Gradwell - *Walgreens Boots Alliance, Inc. - SVP of IR*

Thank you. Thank you all for your questions. As I mentioned at the beginning, this was a new format in the presentation for us. So while we are talking to -- anyone who wishes to talk to us afterwards, the IR team are all here, Ashish, Deborah, Jay, Patrick and myself, to take questions over the next few days. And any feedback you have on the presentation format will be much appreciated as well. Thank you very much, indeed.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone have a wonderful day.
