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# EDITED TRANSCRIPT

WBA - Q2 2019 Walgreens Boots Alliance Inc Earnings Call

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## OVERVIEW:

Co. reported 2Q19 GAAP EPS of \$1.24.



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## PRESENTATION

### Operator

Good morning. My name is Krista, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Walgreens Boots Alliance, Inc. Second Quarter 2019 Earnings Conference Call. (Operator Instructions) Thank you.

I will now turn the call over to your host, Gerald Gradwell, Senior Vice President of Investor Relations. Please go ahead.

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

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

Our prepared comments are a little longer than usual today. So you should be aware that to provide the customary time for your questions, our call is likely to run at least 15 minutes past our normal 1 hour. Before I hand you over to Stefano to make some opening comments, I will, as usual, 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 for a discussion of risk factors as they relate to forward-looking statements.



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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 will find a link to the webcast on our Investor Relations website at [investor.walgreensbootsalliance.com](http://investor.walgreensbootsalliance.com). After the call, the presentation and webcast will be archived on the website for 12 months.

I will now hand you over to Stefano.

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

Thank you, Gerald, and hello, everyone. I want to acknowledge upfront that this had been a very disappointing quarter for us. There is nothing entirely new in what we have seen impact our business during the quarter. That said, a number of the trends that we had been expecting and preparing for impacted us significantly more quickly than we had anticipated.

We found ourselves facing a combination of increased reimbursement pressure in the quarter, lower generic deflation, lower brand inflation and lower-than-anticipated benefits from our work to refresh and renew our retail offerings, primarily in the U.S. Of course, the pharmacy trends are not only impacting our business. They are impacting the overall market and will likely continue to do so over the coming months.

Let me be clear, however. I am convinced that our existing strategic priorities are the right ones and will help us to deliver sustainable growth into the future. Let me remind you of our 4 priorities: accelerating the digitalization of our company; transforming and restructuring our retail offering; creating neighborhood health destination around a more modern pharmacy; and rolling out our Transformational Cost Management Program.

We are making strong progress against these transformation priorities across multiple fronts. However, we now need to respond appropriately to the tougher environment that we find ourselves in. We will build off of our existing transformation priorities and we will reinforce and accelerate our actions. We are acting quickly to address select areas of operational weakness with a number of senior appointments, choosing new talent with new ideas and new approaches to drive more rapid change in a number of areas of our business.

We are also strengthening and refocusing our operational management to ensure increased focus on driving operational excellence. In recent months, we have brought in a new Chief Digital Officer, a new Global Chief Marketing Officer, a new Global Chief Supply Chain Officer. We have restructured entirely the organization of our brands business. And since the quarter end, we have brought in a new Global Controller and Chief Accounting Officer. We have reviewed our priorities and business initiatives underway and have reworked our management plans in light of the more adverse environment.

First and foremost, we are acknowledging the short-term headwinds that we are facing and the limited time we have available to compensate for the impacts in the remainder of the year. As a result, we are reducing our guidance for fiscal 2019. James will talk to you about that in a moment. We believe the actions that we are taking will result in improved performance in 2020. Looking beyond that, we are convinced that our business model can deliver sustainable adjusted earnings per share growth of mid- to high single digits.

I will now ask James to take you through the results and our updated guidance for the year. James?

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### **James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Thank you, Stefano, and good morning, everyone. On a constant currency basis, adjusted earnings per share declined 4.3% in the quarter, bringing our first half EPS growth to 3.6%. The results were much weaker than we had expected due to 3 key factors.

As with our competitors, we are seeing continued reimbursement pressure. And the opportunities to mitigate have reduced due to lower levels of generic deflation and lower brand inflation. The second key factor is volume. Our same-store growth in the U.S. is trending below plan in both pharmacy and front of store. And lastly, consumer conditions in the U.K. remain challenging.



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We are also lapping a particularly strong second quarter last year, when constant currency adjusted EPS increased 25.7%. We are clearly not pleased with this quarter's performance, and we are taking immediate actions to improve operational performance and to reinforce and accelerate our existing transformation plans.

Let's now look in more detail at the numbers. In the second quarter, sales increased 4.6%, including a currency headwind of 2.1%. On a constant currency basis, sales were up 6.7%, reflecting the acquisition of the Rite Aid stores. Organic sales growth was 2.5%. Adjusted operating income declined 10.4% or 9.3% on a constant currency basis. The decline was mainly due to our weak quarter in Retail Pharmacy USA, which declined 11.9% year-on-year due to lower pharmacy margins and a decline in front-end comparable sales.

Adjusted diluted earnings per share declined 5.4% to \$1.64, a decrease of 4.3% on a constant currency basis. This includes a 4.5 percentage point contribution from our share repurchase program. GAAP operating income declined 23% in the quarter, including restructuring charges of \$150 million as we ramp up the Transformational Cost Management Program and the prior year adjustment of \$113 million relating to AmerisourceBergen tax law changes. GAAP EPS declined 8.3% to \$1.24 per share.

Before I move on to our divisional performance, let me briefly cover first our financial highlights. Sales increased 7.2%, including a currency headwind of 1.8%. On a constant currency basis, sales were up 9%, reflecting the acquisition of the Rite Aid stores. Organic sales growth was 3.3%.

Adjusted operating income declined 7.5% or 6.6% on a constant currency basis, reflecting the negative impact of reimbursement pressure on U.S. pharmacy gross margins, comp sales declines in U.S. retail and weak market conditions in the U.K. Adjusted EPS increased 3.6% on a constant currency basis. GAAP earnings per share were up 12% as the absence of prior year items related to U.S. tax law changes and impairment were partly offset by \$179 million of pretax restructuring costs related to the Transformational Cost Management Program.

Now let's look at the performance of our divisions, starting with Retail Pharmacy USA. Sales advanced 7.3% in the quarter, reflecting the acquired Rite Aid stores and organic sales growth of 1.6%. Adjusted gross profit declined 3.5% in the quarter, reflecting declines in both pharmacy and retail. Gross margin declined 260 basis points, mostly due to pharmacy.

Adjusted SG&A spend declined 0.6% versus prior year. And excluding Rite Aid, adjusted SG&A spend was 6.8% lower than the prior period. Continued cost-saving initiatives and the impact of a lower bonus accrual more than offset inflation and store labor investments. Adjusted SG&A was 17.7% of sales, an improvement of 140 basis points compared to the year-ago quarter.

Adjusted operating income declined 11.9% in the quarter. Continued SG&A savings, procurement savings and pharmacy volume growth were not sufficient to offset the unusually high year-on-year impact from reimbursement and underperformance in the front of store. This result included store and labor investments of \$40 million in the quarter, equivalent to approximately 240 basis points of adjusted operating income.

Now let's look in more detail at pharmacy. Total pharmacy sales increased 9.8%, reflecting the acquisition of the Rite Aid stores and organic growth of 4%. Second quarter market share was 22.3%, up approximately 90 basis points compared to last year, reflecting the acquired Rite Aid stores. Comp pharmacy sales increased 1.9% and our central specialty business grew 28.7% year-on-year. The number of retail prescriptions filled on a 30-day adjusted basis, including immunizations, increased 6.4%. Comp prescriptions grew 1.8%, slightly behind the first quarter growth of 2%. Pharmacy gross profit declined versus prior year as volume growth was more than offset by lower gross margin.

The pharmacy market is very challenging right now, and we are seeing similar trends to our competitors. Reimbursement pressure has continued and opportunities for mitigation are lower than we expected. The combination of this reimbursement pressure, lower levels of generic deflation and lower brand inflation resulted in pharmacy margins that were worse than planned and 280 basis points below the same period last year. Also included here is a 110 basis point impact due to the faster growth of the lower-margin specialty business. And as we looked at the quarter, the year-on-year reimbursement impact was exceptionally high. And we estimate an adverse timing impact of approximately 60 basis points.

Turning next to our retail business. Retail sales increased 1.3%, reflecting the sales contribution from the acquired Rite Aid stores. Comp retail sales declined 3.8% as we faced some headwinds during the quarter. We are lapping an exceptionally strong prior year cough, cold, flu season. And this accounted for 150 basis points of the year-on-year sales decline. Secondly, we continued to de-emphasize tobacco with an impact of around 125



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basis points. And finally, we had a weak quarter in seasonal and gifting with a 70 basis points impact. And here, we clearly need to improve our range and execution.

Retail gross profit declined in the quarter with retail gross margin 90 basis points lower than prior year, predominantly due to short-term changes in promotional activity. But let me remind you that excluding Rite Aid, our retail gross margin has improved by approximately 290 basis points since 2015. That being said, while we are pleased with our long-term margin performance, we are clearly not satisfied with our recent front-of-store sales performance.

Now let me pass it to Alex, who will update you on our transformation priorities and explain the actions we are taking to address our current business challenges.

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

Thank you, James. While external factors, including reimbursement pressure and a weaker cough, cold and flu season impacted us in the quarter, we clearly need to improve our execution and speed of delivery. We have not moved quickly enough to address the changes in the market and as a result, did not deliver the growth required to help mitigate the continued reimbursement pressure.

With that context, let me share some of the actions we are focused on. Our overall transformation priorities are unchanged, but we're seeking to reinforce and accelerate our actions. As Stefano mentioned, we are accelerating the digitalization of our company; transforming and restructuring our retail offering; creating neighborhood health destinations based on a more modern pharmacy; and rolling out our Transformational Cost Management Program.

On cost management, we are continuing to make major strides and see more opportunities, which James will cover in more detail later. Overall, we recognize the importance of accelerating the transformation of our business more significantly to the customer. So let's look for a moment at some of the specific actions we are taking.

Firstly, it's crystal clear that it all works only if we have the right talent, capabilities and operational focus. To that end, we have recently executed a comprehensive reorganization of my senior leadership team. We have announced a new leadership structure, which clearly delineates between development and delivery. This is allowing my senior executives to focus on driving operational excellence and delivering results in their specific area.

We have also made changes to how we manage our strategic partnerships, increasing the focus on accountability for developing our health care and retail services, ensuring financial discipline, pace, accountability and maximization of new profit streams. As Stefano mentioned, we have brought in a number of new senior executives to Walgreens Boots Alliance with specific skills and expertise. And they will work closely with my team to drive performance improvements.

We are on track on digitalization. The Microsoft teams are onboarded. They are physically present in our offices and we have moved quickly to consolidate our internal digital teams to create a single team under an experienced Chief Digital Officer.

We have put in place new action plans for both pharmacy and retail. In pharmacy, we have created a dedicated, accountable team to drive volume through our partnerships with payers in the marketplace. This will allow the rest of the team to focus on operational effectiveness in our core pharmacy business, delivering our vision of a modern pharmacy, driving efficiency and maximizing opportunities through outcomes-based reimbursement. These new approaches will help us counteract reimbursement pressure.

In retail, we recognized the need to concentrate our efforts where we know we can win. Right now, our execution is lagging where it needs to be. We will continue to accept revenue declines in low-margin categories, where we do not see a winning future path. We've invested some margin this quarter in categories we know drive footfall. And we're already starting to see the benefit of this investment in improved revenue and gross profit.



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We will concentrate our efforts, shifting resources, people and dollars to our flagship brands, including Walgreens health care brands and No7 and our priority categories. A great example is health and wellness. It's a significant cash stream with very attractive margins. We will step up the level of innovation and marketing support. We continue to be pleased with the progress we're making on our partnerships. In particular, we're working closely with the Kroger executive team to determine how best to unlock future growth and synergies.

And the work we are doing on digitalization of our business will deliver an enhanced customer experience and the tools and analytics to drive customer loyalty. This builds on our existing highly successful customer-facing platforms, including our 5-star-rated 55 million downloaded app and our 85 million active Balance Rewards members.

We previously highlighted the very high customer retention rates we have delivered on the Rite Aid store optimization. These very favorable retention rates, which allow us to focus volume locally on fewer stores without reducing our geographic coverage, delivered greatly improved returns and have led to a decision to boost our store optimization program from 600 stores to approximately 750 stores.

Parallel to this, we're undertaking a comprehensive review of Walgreens store networks to address specific underperforming stores. And as you know, we are testing a small store format. And pending positive results, we anticipate building out this format over the coming years. More information will follow in the coming months.

I'll hand you back to James now to update you on Retail Pharmacy International.

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### **James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Thank you, Alex. As usual, I'll report on the division's results in constant currency. Sales declined 1.2%, mainly due to a 1.3% decline in Boots UK in a challenging market. Adjusted operating income was down 2.1%, reflecting a 3.1% decline in Boots UK.

While the quarter was helped by the positive impact of phasing in the U.K., the trend has improved versus the first quarter and the U.K. team are taking actions to further improve performance. U.K. comp pharmacy sales declined 1.5%, mainly due to lower hospital revenues and revenue per item. Boots UK comp retail sales declined 2.3%. The U.K. retail market remains challenging. But encouragingly, we held market share in the quarter.

Alex will now talk you through our Boots UK action plans.

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

Thank you, James. We're taking a balanced approach with our actions focused on both boosting revenue growth and creating a lean operating model. Firstly, we have taken decisive action to reduce our U.K. cost base. In February, we announced our intention to reduce our Nottingham head office personnel costs by around 20% to create a smaller and more agile support team. Our smart spending/smart organization is advancing well. And a store portfolio review is underway, focusing on low-performing stores and opportunities for consolidation.

In addition, we are looking closely at our pharmacy business to further improve efficiency and effectiveness. We continue also to strengthen the Boots leadership team with the appointment of a new Chief Operating Officer. And as mentioned on last quarter's earnings call, we have multiple initiatives underway to improve our revenue performance.

We are refitting 24 beauty halls across the U.K. between now and the end of May, introducing Boots beauty specialists with an in-depth knowledge spanning all categories and brands. And we're significantly expanding our beauty offering by introducing more than 20 new on-trend brands nationwide over the next 6 months.

Finally, a brief update on our international investments in China. Since the quarter end, in collaboration with our partner, GuoDa, we opened our first pilot pharmacy in Shanghai, combining traditional Chinese medicine and skin care with well-known international brands.



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Back to James.

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Turning now to the Pharmaceutical Wholesale division, which we'll also discuss in constant currency. The division delivered another solid quarter with sales up 9.1%, mainly due to growth in emerging markets but also aided by a customer contract change in the U.K., which contributed 2.1% of revenue growth. Adjusted operating income increased 3% with sales growth and an improvement in SG&A as a percentage of sales more than offsetting gross margin pressure.

Turning next to cash flow. Operating cash flow was \$1.2 billion in the first half. Free cash flow was \$401 million. This was impacted by headwinds of \$1 billion, including increased cash tax payments of \$465 million, mainly as a result of U.S. tax reform; legal settlements of \$276 million; and a once-off working capital benefit of \$233 million in the prior year.

Working capital days improved year-on-year. But the first half free cash flow reflects approximately \$750 million of working capital increases, primarily due to higher sales and the timing of receipts. Cash capital investment was \$793 million in the first half, \$128 million higher than prior year due to the impact of Rite Aid store conversions.

Turning now to our guidance for the year. In light of the first half performance and our expectations for a challenging second half, we are revising our full year guidance for fiscal year 2019. We now expect adjusted EPS to be roughly flat on a constant currency basis. However, given the normal level of volatility in a business of this size, realistically, you should expect a range of plus or minus 2%.

The downward revision considers the following key changes. We anticipate gross margins to remain under pressure in the U.S. in the second half. Reimbursement pressure is unlikely to improve in the short term. And it will take time for our complete mitigation plans to kick in. In terms of volume, our U.S. pharmacy and U.S. retail performance has been below plan in the first half of the year. And while we are taking decisive actions in the U.K., market conditions remain weak. And we have reflected this in our revised guidance.

Given the revised full year EPS outlook, the estimated bonus payout for the year has been substantially reduced. And while our Transformational Cost Management Program is very much on track, the contribution to fiscal year '19 results was assumed when we provided guidance in December of 2018.

Finally, let me provide you with some supporting guidance assumptions. As you look forward for the second half, please remember that we have now lapped Rite Aid. And we will continue to see adverse reimbursement pressure impacting the revenue line. Currencies have an adverse EPS impact of approximately \$0.04 versus prior year, unchanged versus our guidance at the beginning of the year.

We now project a full year tax rate of 16% to 17%. The more favorable outlook reflects nonrecurring discrete benefits and changes in our geographical mix of earnings. And we project full year share repurchases of \$3.8 billion compared to \$3 billion guidance at the beginning of the year. This contributes 4.5% to EPS growth.

Turning to our long-term business model. Firstly, we believe the business model is well positioned to deliver sustainable constant currency adjusted EPS growth well into the future. We have good line of sight to levers to counteract reimbursement pressure. Predictable volume growth and excellence in cost management will be key. And this requires us to execute strongly against our existing transformation priorities.

Volume growth will be underpinned by delivering improved value for both payers and consumers. We absolutely must drive a renewed focus on operational excellence, whether it be adherence, patient satisfaction or a management of our offering in the front of store. And we will see the benefits of our digitalization program with more frequent enhancements to our customer offer over the course of the coming months and years.

Finally, in the U.K., we expect our store and brand investments to begin to bear fruit as we exit 2019. Importantly, by 2022, we anticipate annual savings in excess of \$1.5 billion from our Transformational Cost Management Program. And while a program of this magnitude is never easy, we do have good visibility on what needs to be done and strong commitment from the leadership team to get it done.

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Beyond 2022, we expect a rising contribution from partnerships. However, until then, our EPS growth model is not dependent on a material ramp-up of any of the existing partnerships. In fact, we are making significant investments in the short and medium term to drive long-term earnings upside. And long term, we do believe that health care and retail services will provide us with attractive returns and substantial new sources of income.

Let me focus now on the Transformational Cost Management Program. Last quarter, we launched a program targeting annual savings in excess of \$1 billion. We also told you that we needed to complete a 16-week assessment phase. We are now 3 months in. And while we are not fully complete, we do have a much deeper understanding of the areas of potential savings.

Given what we have seen to date, we are increasing our annual cost-saving target to at least \$1.5 billion. Smart spending is progressing well. We have completed our benchmarking for select spend categories. For example, our benchmarks indicate that our consultant and supply costs are second quartile while our contractor, events, technology and travel spend are all above the median of the peer set. This shows the granularity we're operating at and the potential we see to reduce costs.

Moving on to smart organization. As a reminder, in the first quarter, we announced and implemented reorganizations and store closure initiatives to rightsize operations in Chile and Mexico. And we launched an optimization initiative in our Pharmaceutical Wholesale division. We continued to move quickly and we took further decisive steps in the second quarter.

As mentioned earlier, we announced a 20% reduction of the Boots UK central workforce. And the reduction should be largely complete by the end of the fiscal year. On the 21st of March, we announced a new field management structure in the U.S. The new organization combines the previously separate Walgreens and Rite Aid store management teams. And we expect the implementation to be completed by the beginning of June.

The final bucket is digitalization. We just completed a detailed review of our global IT spend, and we are very encouraged by the findings. We see opportunities to reduce our annual IT cash spend by \$500 million to \$600 million, almost equally split between OpEx and CapEx. This represents a reduction of approximately 25% to 30% versus the baseline cost. So it is a significant opportunity. In the short term, we plan to selectively invest part of the savings to build out new customer digital propositions. However, we will expect each project to drive incremental value and benefits, thus creating a virtuous cycle.

As we look forward to 2020 and beyond, we see improved operational EPS performance. Over the long term, we are comfortable that our growth model can deliver mid- to high single-digit adjusted EPS growth in constant currencies. One call-out on fiscal 2020, we do anticipate growth from operations. However, adjusted EPS in constant currency is expected to be broadly flat due to the reduction in bonus payments in 2019.

As we built out our long-term business model, we made the following assumptions, which you may find helpful. We assume share repurchases of \$1.7 billion per year, contributing approximately 2.5% to EPS growth. However, this is partly offset by tax rate, which is expected to increase from 16% to 17% in 2019 to over 18% by 2022 and creating a headwind of 50 to 100 basis points, depending on the year.

In summary, we have reworked our business plans to accelerate and boost our existing transformation priorities. And while there may be quarterly fluctuations along the way, these plans should allow us to return to long-term adjusted EPS growth.

I will now hand you back to Stefano.

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

Thank you, James. As I said at the start, this has been a disappointing quarter. And I am equally disappointed that we had to reduce our full year guidance. However, we need to acknowledge the short-term headwinds that we are facing. And while we are not the only company that has been impacted by the marked change in the environment, that's not an excuse.

What is important now is that we respond quickly to ensure we return to growth as soon as possible. This quarter has focused the minds of the entire team on the need to allocate resources to where they will have the greatest impact, both today and in the future. Importantly, I am convinced





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that our existing strategic priorities are the right ones. And our multiyear transformation program will allow us to deliver sustainable, profitable growth.

However, we have and will continue to reinforce and accelerate our actions to respond appropriately to the tougher environment we find ourselves in. Of course, in addition, from time to time, we have the opportunity for specific initiatives to rebase our cost, often prompted by new technologies, practices or structure. You have heard many examples from Alex and James. And we have significantly increased the goal for our Transformational Cost Management Program.

We remain a global business, delivering billions of dollars in earnings and billions of dollars in cash flow and generating real value for our shareholders while being a huge force of good in the communities we serve and society as a whole. Day in and day out, we continue, directly or indirectly, to be a core and vital part of the lives of a significant percentage of the world's population through a presence and reach into the very heart of communities across the world.

We are not complacent. We must continue to evolve and innovate to drive. And as a management team, we are more focused than ever on delivering operational and financial growth and value for our owners. I can assure you there is innovation throughout our business internally and outward-facing, within our own teams and in a wide range of partnerships. There are innovations in how we work, in our products and services, in how we interact with and serve our customers, both retail and commercial.

So despite the disappointment of the quarter under review and the impact that it will have on the year as a whole, I remain confident that in future, we can return to reliable, mid- to high single-digit earnings per share growth from our businesses. And I remain committed to and confident of delivering real value for our customers, the communities we serve, my colleagues and most importantly, my fellow shareholders looking forward.

Thank you. Now we will take your questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question comes from the line of John Heinbockel from Guggenheim Securities.

### John Edward Heinbockel - Guggenheim Securities, LLC, Research Division - Analyst

Alex, wanted to ask the reorganization in the U.S., right, that you guys just announced, magnitude of savings. And then how do you guard against, right, you talked about operational excellence, sort of guarding against doing that reorg in the current environment without disrupting the business further?

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

It's Alex here. Yes, we've really reorganized the top organization to separate development and deliver. And in the deliver stage, we've got really 3 key roles now. One is driving the very important core business of pharmacy and front-end sales. There's no changes there, apart from driving that more directly. And secondly, to look at future profit streams in areas like health care services, the health care hub project and also the front end in terms of really finding new models to drive the front end of partnerships with Kroger, Birchbox and Sprint. These are really focus areas.

In terms of protecting the customer, we continue to move our money and our focus from the old model to the new model. That's been the trend for the last 3, 4, 5 years. And that's what we continue to do. So along with the savings, there will be reinvestment into these new areas of growth. And then James will cover the reinvestment in a second just. to finish up the question. So we are very, very focused on the customer. We're very



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focused on end-to-end improvement of our operational execution. And that's why we reorganized, along with the opening of opportunity to invest more in the future models. But in terms of investment, James, maybe you can pick up the cost of investment point?

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. So as you look forward, and we're quite clear on where we're targeting in excess of \$1.5 billion of savings, bear in mind, you have inflation that offset some of that. But the key one here is are we investing for the future? And the way we've defined in the program in general is we want to save to invest to grow. And the way we measure success in the program is we want to take the cost down and be the leanest operator in the industry. That's number one. But secondly is, as we exit and execute against the program, we want to see top line benefits coming from this. So there's one number I'm going to give you, and I think it will concentrate your attention on the -- both the achievability of the targets and our determination to drive a successful business longer term. We will invest approximately \$1 billion over the next 3 years in a combination of operating expense and capital. Approximately 80% is operating expense.

So think about it for a minute. In 1 year, we'll be putting in \$300 million to boost the partnerships and to boost our capabilities and digitalization of the company. So we're not going to starve the business for the sake of hitting a cost goal. That's point number one. Point number two is more important is each digital investment and each partnership has to stand on its own merits. We expect an attractive return and we expect long-term significant pools of income. And if you like, the plan is on one side, conservative because we've put in the money to drive the partnerships and digitalization and we haven't fully built in benefits of the partnerships flowing through. So if you like, the plan represents an option on the partnerships.

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

And Stefano here. Maybe you remember that I have always said that we have different ways of savings. And of course, these ways had to be enabled by what we were doing in the company. So it's not a surprise that now we can announce a big program of savings and maybe a little bigger than we were thinking initially. But still even initially, we're thinking of something substantial. And this is possible because we have saved but also invested in the past. And the reason why you don't see really the contribution of all the joint ventures that we have done is that -- is because from one side, we have some benefits. On the other side, we continue to invest in these joint ventures and so you don't see the benefit for the time being. But these investments will mature. And we will have, at a certain time, a substantial contribution from these partnerships. But rest assured that we continue to invest and we will not starve the business.

### Operator

Your next question comes from the line of Ricky Goldwasser from Morgan Stanley.

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

Yes. So a question focused on the reimbursement rate cuts that you highlighted. Can you give us some sense of whether the rate cuts are coming from specific payers or PBMs? Or are you seeing them across the board? And really kind of like the questioning that should we expect an acceleration in pressure for the remaining of fiscal year '19? Or is the run rate that we're seeing for the quarter what we should model for the rest of the year? And then the follow-up question to that is when we think about all the changes that are coming up in U.S. health care, the proposed rebate rule on Part D is a pretty significant one. So how did you factor that one in when you think about 2020 and your comments around operating income growth in 2020?

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

Ricky, it's Alex here. I think there's 2 separate things you've asked. So I'll give you where we're as we look forward with reimbursement pressure. I think as James said in his prepared remarks, this is a very heavy quarter for reimbursement pressure. And we expect that to be not the normal going



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forward. And I think he also said that the FEP, for example, in specialty, which is 110 basis points of the reduction. Clearly, that's an (inaudible) out as well. So there's timing and then there's FEP and there's underlying reimbursement pressure. So I think that the third number is the one that is the real underlying trend going forward. Again, there's always contracts that start and end on Jan 1, particularly Med D. And again, we didn't see really much difference to the trends we spoke about before on Med D. They are really as we saw before.

Going to the second question on the safe harbor and the changes in the government, it's really early. We truly believe in transparency. And we really believe in reducing out-of-pocket costs for drugs for patients across the Medicare. We support that really from day 1. And therefore, we are working hard with other partners in the marketplace to understand how we can bring that forward with the government. And clearly, we don't know yet what that really means for any players in the marketplace. But we are working hard to innovate and to work with other partners. And we'll give you an update as soon as we understand better the rules as they emerge from the government.

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### **James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. And maybe, Ricky, if I could add a couple of just facts for that. So what Alex says is correct. If you like, if you're thinking about your modeling, Q3 had approximately 37% of the entire year's reimbursement impact -- Q2, sorry, have the entire 37% versus the 25% expected run rate. So it was exceptionally high. So I think as you look forward to the second half, the reimbursement pressure will subside because there's a skew to the first half. The impact of the FEP contract is material as well. Because year-to-date, it's around 140, 150 basis points. The specialty business will still grow very quickly. But the negative impact will tail off down to 30 basis points. So there will be quite a material change in the trajectory of the gross margin change year-on-year. And then secondly, as you look into next year, we believe we've planned our reimbursement levels roughly similar to what we've seen over the past couple of years.

And I think individual quarters will always be extremely volatile and rocky. But over a longer term, while reimbursement is a bit over the trend rate this year, we have planned similar levels going forward. But as I said, we won't have this FEP contract next year. And one big thing that did hit us this year and is still hitting us, and it's one of the reasons for the guidance, is we do have a lower level of generic utilization than we projected at the start of the year. And that can have quite a material impact on both the revenue and on the cost line. So it does -- if your generic utilization goes down, it does negatively impact your profitability. That will be one potential tailwind that we will have, I would say, 6 months from now to 12 months from now. Because of contract changes in Med D, we would expect our generic utilization rates to increase, thus giving us some comfort on -- around the gross margin outlook. I hope that's given you enough perspective.

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

As a CEO, we have always known and said openly that we expect growing pressure on margin from -- and from our contracts with our customers. It's up to us to find ways to compensate for this pressure. And until now, we have been able to do it. This quarter, yes, the pressure maybe is a little higher. But the problem is that we have been surprised by the pace of the 3 events that have contributed to the bad results for the quarter and for the year. And we knew that in any case, the trend was in that direction. And we were preparing. If we can react so quickly now is because we were thinking of all the remedies and all the counteractions even before. We have not been probably quick enough in putting those counteractions in place. And now we find ourselves a little behind the pressure that we see in the market. But we are confident that as we have evaluated the work for months, we evaluated all these elements, it's -- we are confident that in the future, we will be able to find the right remedies.

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### **Operator**

Your next question comes from the line of Robert Jones from Goldman Sachs.

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

Great. I guess just to go back to the issue around reimbursement rate pressure, outside of things like FEP being clearly a specific headwind to the year, I was always under the impression that the reimbursement rates coming into the year were something you guys were generally aware of.



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And so could you maybe just explain the dynamic there that has the rates coming in so much worse than what you anticipated? And then I guess, the follow-up question to that would be are we at a point with the PBMs where you need to take a tougher stance? I mean, obviously, there's precedent for playing a little harder when it comes to declining reimbursement rates and just not offering the Walgreens network in certain PBM offerings. Is that on the table? Is that kind of where the industry is at, given this persistent reimbursement rate pressure?

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

Bob, it's Alex here. I think it was a combination of headwinds that hit us in Q3 and it hit us -- sorry, Q2, apologies, through the quarter. And I think James covered them off in -- and they were as such. It was definitely generic deflation was reducing. That has had an impact, and that happened through the quarter. Branded inflation was reducing that happened during the quarter. And of course, the volume, to be honest with it as well, was less than we had expected. Particularly, we had a pretty big, a very big flu and cough and cold season last year and it was early. And this year, it's been more normal and a little bit later. So these are all factors that hit us coming into that period. And I think also at the end of the year, we true-up with our PBM partners the contracts for the year. And we don't really see the effect of that true-up really until middle of February. And that was another factor that happened as well. So it was a combination of headwinds that gave us this unusually high, the highest quarter (inaudible) this fiscal year that created this reimbursement pressure.

I think in terms of our attitude towards our partners in the supply chain, including the PBMs, we have a partnership approach. We are working with our partners to deliver better service, better products, including, for example, improving the ability for us to reduce costs elsewhere in the health care system. I'll give you one example of that. There's more money than ever before coming on the table for our service-based payments, particularly in the Medicare D area. And we again are working with partners towards the government to create a more common framework of KPIs that pharmacists could aim for in terms of getting repayments, for example, in Med D and DIRs. I mean it worked out very well, in my view, with Optum and UnitedHealth in a very successful Medicare Advantage book of business, where again we got more payments than ever for performance-based pharmacy. So I think there's a recognition by our partners that pharmacy is under pressure. I think there's a recognition by our partners who want better joined-up care within the health care system. And they're encouraging us through our learning incentives to invest more, as James has said, in these models. And that's what we intend to do.

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

I guess just the quick follow-up, we hadn't spent a lot of time on specialty, and I know that's part of the U.S. retail business model. Anything worth calling out there? Are you seeing similar headwinds or issues that you've called out kind of on the core Retail Pharmacy business on the specialty side as well?

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

It's Alex again. Yes, I mean, our AllianceRx partnership has been a good one. You've seen the volume we've created and additional sales we've created. And we are happy with the operational standards and the customer standards. But again, the margin is under pressure. There's no doubt that the economics of the specialty business is under pressure as the government is asking questions about how do we get these very important drugs to patients and consumers at lower cost. And we continue to work again with our partners, particularly Prime in this case and the Blues who own Prime, to really improve that model both for the owners of Prime and ourselves but also really important to more quickly provide more local service for specialty. In particular, we're working up more local community specialty pharmacies. We believe more and more that the mixed model of central fill and community pharmacy based where the local specialty doctors are is the right winning model than just a pure central fill model. And we're encouraged by the success of these community pharmacies and by the adoption, particularly by our partners at Prime.

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**Operator**

Our next question comes from the line of Kevin Caliendo with UBS.



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**Kevin Caliendo** - UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution

I'd like to talk to you a little bit about the partnerships. You said you're going to have significant increased investments in these partnerships. Can you talk about which ones? I mean, you've highlighted 7 or 8 different type of partnerships or pilot programs in the last year. So can you talk about which ones might be accelerated or which ones might become more of a focus? And can you talk to why that is the case?

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

Yes, Alex here. I mean I think the one that we should speak to the most this morning is definitely Microsoft and the digitalization of our company. That's a really a significant contract from our point of view but also from Microsoft's point of view. And it's also one that lasts over a number of years as we not just digitalize Walgreens, but we digitalize our partnership infrastructure both in the retail product side and also importantly create new opportunity of partnerships in health care. So that, by some way, is the most important piece of work we're doing. It's where we're investing the most of our money going forward to really create better tools for engagement for customers across both front end and pharmacy and better ways for our business partners to engage with our health care platform. We're also very pleased with our partnership with Verily. We're really working pretty hard to bring real innovation quickly to the marketplace. They've developed a number of market-ready tools, for example, on their Onduo diabetes platform, which we have already active in our own population of health care beneficiaries here in Walgreens in the U.S.A. And the adoption rate of that tool is very satisfactory so far. And we believe that's another example of bringing new tools to market very quickly with new partnerships.

On the retail side, I think we mentioned in our prepared remarks that we're very pleased with the rapid progress from a customer point of view and engagement in the Kroger trials in Northern Kentucky and Cincinnati. We're really very pleased with that. And we expect to be able to move that test and trial further forward going forward. And of course, that is more focused on creating 2 things: first of all, convenience in retail between fantastic grocer and food brand in Kroger and obviously our pharmacy and health care and beauty brands here in Walgreens; and secondly, working to share data appropriately, so we can personalize the offer for many Americans who rely on these categories every single week and every single day. They're the most sticky categories because they're the ones that are most frequently used. Beyond that, Birchbox is in early stages but going well. And Sprint again we announced in the expansion to 80 stores of Sprint. And last but not least, on the health care side, as I said, LabCorp, where we continue to advance our LabCorp partnership with the ambition -- or the intention, should I say, to drive to 600 locations within the next 3.5 years.

**Kevin Caliendo** - UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution

Can I do a quick follow-up? I'm just thinking about this. And your pricing pressures are coming on a lot from partners that you have. You have partnerships basically with all the PBMs in one form or another. Is there any place that you can take pricing or you have pricing power with some of your partners? I'm not sure if it's the PBMs side necessarily. But can you push down on the consumer in any way, shape or form? Can you push down on your wholesaling relationships with manufacturers? Can you talk a little bit about where you might have some increase or some pricing power going forward?

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

It's Alex here. Again, I don't see it as pricing power. As we join up with partnerships, we want to drive efficiency across the whole supply chain. So working with partners like AmerisourceBergen, working with partners like UnitedHealth, we're joining up processes, whether it be marketing processes or whether it be supply chain processes, to drive out cost between us, therefore driving better economics for the marketplace and, of course, better economics for our partners as well. So that's how we see it. We take -- we think our -- one of our most compelling strategies is partnership, the philosophy of creating value with each other over the long term in ways that really brings efficiency and better quality of care to the marketplace. And we believe in this phase of change in the American health care system, for us, we think that's a very compelling part of our strategy.



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**Operator**

Your next question comes from the line of Charles Rhyee from Cowen.

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**Charles Rhyee** - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Yes. And maybe just a follow-up on the partnership question and particularly as it relates to, Alex, your comment about the 600 LabCorp. I mean, is that decision -- at some point, was that an acceleration of your strategy? Or has it always been sort of at plan? And I guess the question really is at what point, when you look at one of these partnerships, they are looking like they're working or they will lead to success? Are we accelerating any of these more so than others currently? And when we think about that \$300 million investment in the partnerships, is this a larger number than maybe you had initially budgeted for? Or has this had been always the number? I'm just trying to get a sense on sort of internally, if you're seeing greater success than you might have expected. Or is this just sort of as in line?

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

I mean it is definitely greater, particularly relative to the rest of our cost base. So we have absolutely protected and driven more of our dollars into accelerating these partnerships. LabCorp is a good example. We started that off really in the Gainesville area as part of our Gainesville trial. And rapidly, we agreed to extend to 600 stores nationwide within 4 years. And we're having great conversations with the LabCorp team about what more we can do. Secondly, I would say that the partnership with Microsoft, as I mentioned already, is a clear acceleration of the digitalization of our company, along with recruiting internally a lot of -- particularly our Chief Digital Officer.

And there's more people coming in to really drive the modernization of our platform and processes to become a new retail and health care company. That's a very important acceleration and investment. And thirdly, I would say that we're encouraged by Kroger. Again, I go back to the importance of food, the importance of footfall in our stores. And we recognize that we have a very low market share in food. And we recognize that Kroger is a food expert and a national food expert here in the U.S. And we are encouraged with the money we spent in the early testing trials. And we believe there's more to test in trial for sure before we can be certain of this. But we see a reason to move forward faster with Kroger.

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**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. And just to clarify, of the \$300 million, approximately 60% is on partnerships. The other 40% is on digital initiatives and the digitalization of the company. So think about 40% will actually improve execution in pharmacy, in retail, back office, everywhere which has the digital investment. And the 60% is specifically on the partnerships. And I think what distinguishes this versus the plans we would have put together 12 months ago would be that the plans are fully funded. So we've actually -- we're funding ahead of the revenue in the plan because the targets we give, we want to be absolutely sure that we can deliver upon the long-term growth model. And we won't do that if we underfund the future drivers of the business. So it is quite different than the plan we would have done a year ago. It's just much more -- I don't want to use the word generous, but it's well-funded in terms of what we need to get done.

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**Charles Rhyee** - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

One partnership you haven't talked about or you haven't really had is Humana. Just curious how that one is going. I know that Humana themselves spoke pretty positively about the trends they're seeing. And I guess, actually when you look at the partnerships and you mentioned footfall, Alex, are you able to calculate the uptick in foot traffic that the partnerships bring to you for each of the different partners?

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

I mean, yes, absolutely. I mean, clearly driving more patients and customers into our corner stores is really important to us. And we can absolutely measure that as part of the business case, as James mentioned. And that's why I mentioned primarily Kroger. For sure, Humana is a good partnership. We're in 2 partners in primary care. It's a senior model that's been well put together to create a complete offer for the senior, including the pharmacist has been part of the morning huddle, for example, with the primary care doctors and the nurse practitioners. And the signs are encouraging. The signs are encouraging, as the Humana team said. And we're still in the very early stages, (inaudible) of this trial. But Humana is a very important testing trial for us as we focus more on the senior and more on primary care.

**Charles Rhyee** - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Would you say that, that's replacing sort of more of your retail clinics, that maybe several years ago you had kind of embarked on more of a retail clinic model? Do you see that this could be more of the go-to model for delivering more of this kind of care in a store format?

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

Yes, it's really early days to be honest. And of course, we need to see the return on that money clearly. But for sure, we know the model and the clinics for us did not give us the returns that we expected. And we've been working to improve the profitability, and to be honest, the customer and patient care in these clinics by working closely with health care systems across the U.S.A. So we've already altered that model quite a long way. And we're very happy with that model. So we think that the full line primary care, particularly focused on seniors, is a really interesting model. We see that more of our future than the episodic clinics, the retail clinics that we had before.

**Operator**

Your next question comes from the line of Michael Cherny from Bank of America Merrill Lynch.

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

There was a comment made about generic utilization being lighter than expected. As we think about all of the moving pieces in terms of script growth versus the reimbursement pressures, any sense as to why that was the case? And what does it portend in terms of your expectations for script growth going forward, particularly since you do have a look at how some of the preferred networks and Part D networks have performed so far year-to-date?

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

So yes. So I think, Mike, it was simply the fact that we lost a major book of business. The book of business went from preferred to nonpreferred 12 months ago. So on 1/1/19, we anniversary-ed that loss of book of business. And we've been satisfied with the growth of our Med D business from that date. So we anniversary-ed that out. And we're, I'd say, growing very nicely with United. We became preferred with Cigna. And therefore, we are happy that we're now back to good, solid market-based market growth with Med D and seniors. Because seniors are usually on more medication and usually more generic medication, we've seen generic utilization start to rise. And that's what we've planned going forward, as James said in his answer to another question. So I think that's the reason for it. And again, I think we're satisfied we're now back to our normal growth, market growth in Med D.





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

And then just one other quick question. You talked about \$700 million or so, give or take, on buybacks for the rest of the year after doing \$3.1 billion in the first half of the year. Any thought process behind some of the rationale for that change? And when are you able to start to buy back shares again?

**James Kehoe** - Walgreens Boots Alliance, Inc. - Executive VP & Global CFO

Well, we can start buying back shares in the next couple of days. And we as we said, we currently project to repurchase \$3.8 billion this year. And just as a planning expense for the next 3 years, we didn't want our guidance to be overreliant on share repurchases. So we've built in \$1.7 billion each year. So as you look to the next 3 years, around 2.5 percentage points of growth comes from buybacks with some offset coming from a tax rate that's turning negative. So as we look to mid-single-digit, if you call that kind of like a 6% to 8%, we see the core business growing at 3.5% to 5.5%, excluding the use of cash for capital allocation. So the remainder of this year is just to get back, be in the market on a particularly constant basis. I hope that covers your question.

**Operator**

Your next question comes from the line of Ann Hynes from Mizuho Securities.

**Ann Kathleen Hynes** - Mizuho Securities USA LLC, Research Division - MD of Americas Research

I know you addressed cash flow on the call, but it did seem very weak even if you x some of the Rite Aid benefits last year. Can you give any type of cash flow guidance for fiscal '19? And then secondly, I'm not sure if recent results changed your view on M&A going forward. I know you've been focused more on these strategies. But does this change your view on capital deployment going forward?

**James Kehoe** - Walgreens Boots Alliance, Inc. - Executive VP & Global CFO

Yes. On cash flow, yes, we had a pretty rocky quarter. And we've got, not surprises, but we have a couple of headwinds that we will face this year. So if you step back from this and look back over the last couple of years, this is a business that can deliver pretty comfortably somewhere in the region of \$5 billion, \$5.5 billion to \$6 billion of cash flow, depending on the year. Now as you compare 1 year to another, you always have -- you're always lapping something of some sorts. This year, we have about \$2.3 billion of headwinds. So I think as you think through a normal level of cash flow, which is somewhere north of \$5 billion, we have to manage through cash taxes this year, which are \$900 million higher than in the previous year. We're cycling through legal payouts of \$300 million. And then we have large movements as a result of Rite Aid, almost \$1 billion. So the cash flow this year will be well below the trend rate. But we have developed a 3-year plan and some support of our guidance. And we're quite comfortable on the long-term cash flow generating part of the company.

And actually, quite -- I would even go so far as saying that I think when you look at some of our payment terms with suppliers and some of the way we manage inventory, we probably have large doses of opportunity. And then the final comment on cash flow, as you look at this year, our cash capital expenditures are exceptionally high. They're about \$300 million or \$400 million higher than the run rate. And that's essentially the conversion of the Rite Aid stores. So it's quite a huge exercise because we took on 1,900 stores. As you saw from Alex, we are raising the store closures to 750. But that still leaves the conversion of 1,200 stores. And by the way, the Rite Aid acquisition has gone extremely well. The return on investment is exactly where we wanted it to be. We're getting there in a different way. And actually, we're very encouraged by the retention we're getting as we optimize the stores. So cash flow this year will be somewhat problematic. But we're quite confident on the future outlook.

**Ann Kathleen Hynes** - Mizuho Securities USA LLC, Research Division - MD of Americas Research

Could you see a normalized level at fiscal 2020?

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**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Sorry?

**Ann Kathleen Hynes** - *Mizuho Securities USA LLC, Research Division - MD of Americas Research*

Could you see that normalized level in 2020?

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes, I think we will definitely plan to be at a normalized level in 2020. We have enough initiatives lined up against the cash flow targets. We have strong capital efficiency programs ongoing. So we're quite comfortable on that kind of -- getting back to that level quite quickly.

**Ann Kathleen Hynes** - *Mizuho Securities USA LLC, Research Division - MD of Americas Research*

Okay. And just on my M&A question?

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

What, M&A?

**Ann Kathleen Hynes** - *Mizuho Securities USA LLC, Research Division - MD of Americas Research*

Yes, I wasn't not sure if the recent results and the deteriorating backdrop of the retail pharmacy industry would change your views on M&A going forward.

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

No, our view is still the same. We are not closed to any deal, provided the price is right. We don't see any reason that we use our cash overpaying for something just because we said deterioration of the market. If anything, we have to be more careful when we buy something. Because if we don't believe that the market will turn around, we have to action more carefully. Honestly, we still believe in this market. We still believe that this market is a market for the future, a big market with continuous growth. But to buy something, we must be sure that the money that we employ will come back sooner or later.

**Operator**

Your next question comes from the line of Erin Wright from Credit Suisse.

**Erin Elizabeth Wilson Wright** - *Crédit Suisse AG, Research Division - Director & Senior Equity Research Analyst*

Great. Can you remind us of your strategy in Specialty Pharmacy? Is this an area where you could build up further in terms of your capabilities there? As well as I think you updated us on the Prime and Express relationships. But also do you think you're competitively positioned in specialty?



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

Yes. And it's Alex here. And I think I said before, we're investing in community pharmacies in particular. These are ones which are very close to the specialist doctors and often also very close to hospitals, where specialist doctors operate. And that's going really well for us. And we're also investing in relationships with AllianceRx. And of course, we've set up a buying group effectively with Express Scripts. So we're very active in the space. We know it's 50% of the market going forward.

We know this is where the innovation is coming from our pharmaceutical partners. And we continue to work with them on potential new models of how you can actually take the drugs more precisely and more directly to these patients who require these narrower, very, very important drugs and more personalized drugs. So we are working on all fronts. It's a really important thing for us. And we're investing what we think in the future of this model. And I go back to again we think the central fill here is important. But it's not the only way that you can bring these products and these very important drugs to the marketplace.

**Erin Elizabeth Wilson Wright** - *Crédit Suisse AG, Research Division - Director & Senior Equity Research Analyst*

Okay. And leveraging your LabCorp relationship, what more could you potentially do there potentially under contract for research side with clinical trials? And what sort of extensions do you contemplate with that LabCorp relationship?

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

Obviously, our relationship with LabCorp is really strong. And also we've built in Walgreens Boots Alliance in our development function what we call Find Care, which really is a platform for being able to attract, engage customers in their own health care, both episodic and long-term chronic conditions and have launched a number of different solutions there. So we think that the platform of the pharmacies with LabCorp, along with the digital platforms are building, will give manufacturers a lot of new opportunity to engage with us in different ways.

And one of the ways they engage with us is speeding up their really important innovations to the marketplace. The wholesale business, under Ornella's leadership, has fantastic relationships globally with the biggest manufacturers across the world. And you can be sure that we are in conversations to try and join up, how do we bring the right patients at every stage of the development of these drugs to our partners in the marketplace, so we can speed up delivery of new innovations and reduce costs in health care.

**Operator**

Your next question comes from the line of Lisa Gill from JPMorgan.

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

I had a couple of follow-up questions. First would be around on the technology side. So James, you talked about being able to cut some technology costs. But as we think about the potential changes with this rebate rule, it potentially could put it in the hands of the retailers to now have to do point-of-sale and then figure out a charge-back, et cetera. Do you feel like you have the systems you need today? Or would there be incremental investments that you would have to make if we actually see what is proposed come about?

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

I'll take a shot and maybe pass it over to Alex. We think, yes, we need incremental investments. That's why we mentioned this \$300 million a year, 40% would go on digital. We have 2 large programs going on in the U.S. right now. One is retail finance transformation, which effectively is the front of store plus all the back office. And the program is going well and would be complete in end of 2020. And then what we call Rx renewal, which is a renewal of all of the pharmacy systems. And that's a longer program. That's much more integrated with the digital journey we're on.



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And that will take a number of years. These are fully funded in any guidance we're giving. And they are quite transformational in terms of the way the company will operate. And we will obviously leverage them to reduce cost to fill across the company, back office, but equally so to engage more deeply with the consumer on the front of store and with patients as they come in through the pharmacy. So it's like a win-win across the entire company.

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

And Lisa, it's Alex here, yes. I'm specifically looking at how do we get a transparency at the point of care, both at the doctors' office and also the pharmacy and to have that as a more open network. And our work -- as you remember early on, we did some work with what's formerly called Valeant, now with Bausch, on creating a new model, a direct-to-pharmacy model for cash payment. So again, we've been working at this opportunity for 3 years now, I think it is. And we remain convinced that these models will be very important for the future as more demands are placed on price visibility and more patients are paying for more and more out of pocket for their drugs.

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

Okay. And then my second follow-up was just the -- around the comments on the acquisition strategy. Clearly, a lot of questions there around your partnerships and what you have in the marketplace. You haven't made an acquisition in the last few years since Rite Aid. We know that it's a tough reimbursement environment on the retail side. But if you or Stefano can talk about what are the things that you target. And I know, Stefano, you made the comment that you have to pay the right price. But there's been talk historically about would it make sense for you to buy the rest of Amerisource? Are there ways that you want to build the relationship in the health care neighborhood, right? So is it -- what are the kinds of things that you're thinking about what that would accelerate that strategy from an M&A perspective?

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

Well, I have to tell you I can just give the same answer that I have given in the past. We are open to any kind of partnership which makes sense, which is compatible with what we are doing, provided that the price is correct and provided that the organization of the company that we buy or that we merge is compatible with us because the prices are important. But also if you don't have a compatible teams at the end, the merger will not work and you will not be able to deliver synergies. We are constantly reviewing a certain number of companies. Don't ask me the names, I cannot give you the names. But of course, until now, we have not found the right numbers to do a combination with these companies.

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

And is that right number more of an absolute number? Or does it have to do with where your stock is currently trading? Because I think that as we look at this, could you potentially make an acquisition to be able to enhance your offering or to diversify from some of the issues we see in the marketplace today?

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

Yes. But the share -- our share price is relative. It depends on the share price of the target. If we have more or less the same multiple, the share price is not a problem. If we have a very different multiple, the share price can be a problem. But we still have a certain possibility, a certain room for additional debt. So some acquisition could be done, mainly financing them through cash. But I repeat, it's not the absolute value of our shares which counts, it's the relative value.

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**Operator**

Your next question comes from the line of Ross Muken from Evercore ISI.

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**Ross Jordan Muken** - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

So two things. So one, as we think about sort of in the rest of retail, a lot of the sort of fears that existed and what companies ultimately have done, and I'm thinking about Walmart and Home Depot and some of the more traditional guys, they basically pursued: one, a sort of omnichannel approach that I think you guys have talked a lot about technology and investment today; but two, there's just been, in general, a big downsizing of boxes in a lot of different areas and sort of a consolidation of the industry. That's the one thing that's sort of lacking here.

Obviously, you guys are closing more stores than what we saw in the past. But how do you think about sort of the state of pharmacy and the competitive landscape? Because if we think about what's driving possibly some of the reimbursement pressure outside of lower brands, some of it is still the fact that we're overboxed across the U.S. maybe by a substantial amount. And so how do you think about that in the context of kind of what you can control and what you can't control and how you expect some of the smaller peers, I guess, to sort of play out over the next couple of years?

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

Ross, it's Alex here. Yes, we really believe that our strategy is based on our stores. But our stores have had a one-size-fits-all mindset since the Walgreens strategy was created in the U.S. in particular. So we are reformatting and reshaping our stores to -- against the priorities that we spoke about earlier on. And secondly, we have a strategy in retail to become even stronger in pharmacy, to really strengthen our health care products and services and solutions and also continue to drive our beauty differentiation in the marketplace. We're partnering with others to take care of other categories. And lastly but not least, we have 80 million, 85 million loyalty cardholders. And we believe that data analytics are really important in terms of on how you personalize the offer as our pharmacy-led and health and beauty specialists and how you work with others to create real personalization in marketing. So that's our strategy. We think our stores are our strength. We have to reorganize them and reshape them over the next 5 to 10 years. And we're on a journey to do that.

**Ross Jordan Muken** - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

And just maybe just going back to the guidance again, particularly on sort of the multiyear basis, I guess, coming off of obviously what's a very disappointing period, as you tried to sort of ring-fence some of these risks, particularly around reimbursement and just pricing and then incorporated your view on again some of the policy changes, I guess, how did you sort of build confidence that mid- to high singles was sort of the correct range and sort of the correct goal and that with what you can do obviously on the cost side, you'd be able to get there? And thinking about that, particularly in the context of just underlying operating income growth, which obviously this year is pretty challenged and we still got some uncertainty possibly in the back half.

**James Kehoe** - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. So let me cover first the back half and then I'll move on to the 3-year. As you look through the back half, we did say that the peak in the issue on gross margins in pharmacy is in Q2. We do expect some continuation into Q3 and then an improvement in Q4. So as you plot out your quarters, I would assume a fairly even split in the EPS between the 2 quarters, maybe 49-51. So Q3 will be worse and Q4 will be improving. We actually -- we set ourselves a different goal when we pulled together, and it's not really guidance, it's a growth model. And we stepped back and we went through very, very detailed reviews with each of the business leaders. And here is the goal we set ourselves. We wanted to set a realistic goal, mid- to high single-digit. We spent a lot of time on the levers to offset reimbursement, particularly on the assumptions around generic deflation and the ability of our generic purchasing organization to deliver a significant offset. And we're comfortable that the generic team can offset approximately 50% to 60% of the reimbursement impact. Then we went through each single volume assumption, particularly pharmacy but also in the retail business. And I really don't want it to be lost on the audience the changes we're making in retail. And one is this business went from a loss-making business 3 years ago to quite a profitable retail business now. So we are -- from a starting point, it's a position of strength but with a weak top line delivery. And the big change will be we will distort and refocus our resources on health and wellness and beauty. And that's where we can win and we know



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we can win. And they're very attractive businesses. And then we will build partnerships with companies like Kroger to address the other parts of retail. And we're very convinced that we have line of sight to improving top line.

The second part is we said can we -- let's put in what we can control. And you can control your cost journey. And we built in \$1.5 billion. We've put a strong governance around it. And we'll be resolute in delivering. And I emphasize at least \$1.5 billion of cost reduction. So that has a high degree of probability. And then the final thing, which we said at the beginning, was you can't cut yourself to glory. So we've built in the investments required to drive the top line. So we have the right investments, \$300 million a year average. It adds up to \$1 billion of investments behind partnerships and digital. So we're investing to make sure especially that the U.S. business has the ammunition required to create that omni-channel experience in both pharmacy and in retail so that we do get the volume delivery that creates the virtuous cycle. And that's the reason why we are actually quite confident that the growth model for the 3 years is founded in a lot of fact. And actually, it's quite a detailed plan we've developed internally. And the question we got earlier, does it translate to cash? And the answer is yes. We see a line of sight in consistently delivering that \$5 billion type of range that we've done in the past. We see no reason why the business can't do something similar into the future. And I said what Stefano said at the past, we're very disappointed with the quarter and the requirement to take down guidance. And to me, that's resolute that we put in place very tangible plans to make sure we don't have to do that again. And that's the commitment from management team.

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

Thank you. And I'm afraid we are now out of time. It's a good place to end. So we obviously -- I know a lot of you didn't get to ask questions on the call. The IR team are here and available for the rest of the week to answer any questions you may have. And we will look forward to speaking to you again next quarter. Thank you very much indeed. Krista, would you like to close the call?

**Operator**

And this concludes today's conference call. Thank you for your participation, and you may now disconnect. Have a great day.

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