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Q4 2024 WALGREENS BOOTS ALLIANCE INC EARNINGS CALL

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- **Operator**
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- **Ann Hynes** *Mizuho Securities USA Inc. - Analyst*
- **George Hill** *Deutsche Bank AG - Analyst*
- **Charles Rhyee** *TD Cowen - Analyst*
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PRESENTATION

Operator

Good day, ladies and gentlemen. Thank you for standing by. Welcome to Walgreens Boots Alliance fourth quarter 2024 results earnings conference call. (Operator Instructions) Please note that today's conference is being recorded. I will now hand the conference over to your speaker host, Tiffany Kanaga, Vice President, Corporate Investor Relations. Please go ahead.

Tiffany Kanaga *Walgreens Boots Alliance Inc - Vice President, Investor Relations*

Good morning. Thank you for joining us for the Walgreens Boots Alliance earnings call for the fourth quarter of fiscal year 2024. I'm Tiffany Kanaga, Vice President of Global Investor Relations. Joining me on today's call are Tim Wentworth, our Chief Executive Officer; and Manmohan Mahajan, Global Chief Financial Officer.

In addition, Mary Langowski, President, U.S. Healthcare; Rick Gates, Senior vice president and Walgreen's Chief Pharmacy Officer; and Tracey Brown, President of Walgreens Retail and Chief Customer Officer, will participate in Q&A. Also in the room this morning is Eric Wasserstrom, Senior Vice President of Investor Relations.

As always during the conference call, we anticipate making projections and forward-looking statements based on our current expectations. Our actual results could differ materially due to a number of factors including those listed on slide 2 and those outlined in our latest form 10-K filed with the Securities and Exchange commission.

We undertake no obligation to publicly update any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. You can find our press release and the slides referenced on this call in the investors section of the Walgreens Boots Alliance website.

During this call, we will discuss certain non-GAAP financial measures. These measures are reconciled to the most directly comparable GAAP financial measures and the reconciliations are set forth in the press release. You may also refer to the slides posted in the investors section of our website for reconciliations of non-GAAP measures to the most comparable GAAP measures discussed during this earnings call. We encourage you to review the comparable GAAP measures and reconciliation to non-GAAP values in the other earnings materials we provided. I will now turn the call over to Tim.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Thanks, Tiffany, and good morning, everyone. Our fourth quarter and fiscal full year results reflected our focused execution on several critical initiatives against a challenging backdrop for our consumer. When I joined, I had three immediate priorities. First, build a new management team. Second, address items within our control that could improve our financial condition within the year. And third, undertake a strategic review of our collection of valuable assets to lay the groundwork for our longer term turnaround.

With respect to the short term actions, we successfully hit our three declared goals, cutting costs by over $1 billion, reducing CapEx by-over $700 million and realizing over $600 million in benefits from working capital initiatives. These factors contributed to our positive cash flow in the fourth quarter and helped achieve full year cash flow that was also positive.

Building on this momentum is critical as we turn our executional focus to stabilizing our core economics, improving our operating cash flow and strengthening our balance sheet beyond the $1.9 billion net debt reduction achieved in fiscal 2024.

Equally important, we have conducted a thorough strategic review. Coming out of this work, we are an organization focused on two guiding principles with clear operational and financial priorities. The first guiding principle relates to our operating model. WBA is reorienting to its legacy strength as a retail pharmacy led company. This reorientation allows us to leverage our key strategic assets of consumer trust, convenience and relevance.

Our position of trust stems from the millions of face to face interactions our consumers have with our pharmacy personnel every day, and we will continue to take actions now and for the long term to be the first choice for retail pharmacy and health services. Having earned our consumers trust indeed, our reason to exist. We also want to be accessible and convenient but we need to be appropriately sized. Consequently, we are announcing an expanded footprint optimization program.

We have over 8,000 stores of which the majority, approximately 6,000 are profitable. This solid base supports our conviction in a retail pharmacy led model that is relevant to our consumers and we intend to invest in these stores over the next several years.

Part of the funding for this investment will come from accelerating the closure of underperforming stores. We expect to close approximately 1,200 of those over the next three years and reduce the fixed costs associated with them. Executing on this program will realign our footprint to a healthier store base that we believe will enable us to respond more dynamically to shifts in consumer behavior and buying preferences.

Our ability to respond to a changing environment needs to improve and was a critical objective of our strategic review. We intend to close this competitive GAAP with some of our peers who have invested in similar capabilities over the past several years.

While the decision to close the store is never an easy one. We feel confident in our ability to continue to serve our customers and we intend to follow our historic practice to redeploy the majority of the workforce in those stores that we close.

In addition to being trusted and convenient, we must be relevant to today's consumer. To this end. We are reevaluating our merchandizing strategy to offer a refreshed assortment of products including our own brands.

By being more selective with national brands and expanding our own brands, we are sharpening our focus as a destination for categories for which we believe we are uniquely positioned to lead like health and wellness and specifically women's health. We launched over 300 new own brand SKUs this year focused in key categories and we expect to launch another 300 plus in fiscal 2025.

Our second guiding principle is a disciplined financial model which targets strong free cash flow generation and appropriate leverage. Our focus in the near term is on improving our operating cash flows through cost and working capital management, while establishing the baseline for AOI growth. In fiscal 2025, we expect to realize $500 million in working capital initiatives and $150 million in further CapEx reduction.

In addition, we are focused on monetizing non-core assets to generate cash. Chief among these is VillageMD. While our plans for this investment may take several different forms in all scenarios related to VillageMD, we are committed to redeploying any proceeds to reduce our net debt and improve the health of our balance sheet.

Our efforts around VillageMD are just one example of how on a go forward basis, we are maximizing optionality around our portfolio of assets. As we consider if and when to appropriately monetize these assets, we will continue to harvest gains from our portfolio of public equities, Cencora and BrightSpring to generate cash and further enable debt reduction.

As we go forward, we have three priorities. To stabilize pharmacy margin, advance the execution of our retail strategy and improve our net debt position. This emphasis on improving the strength and quality of our balance sheet underscores Manmohan's leadership in establishing our financial priorities to which he will speak in a few moments.

Let me now bring some visibility to the status of our discussions surrounding pharmacy margin and reimbursement rates. We continue to be confident that we are in a multi-year process to reframe our relationship with PBMs on reimbursement. We are changing the dialogue to ensure we both procure drugs at a fair price and that we are paid fairly for the value that we provide.

As part of our efforts, we have worked with some PBMs to bring more stability and predictability to our reimbursement while maintaining broad network access. It continues to be our goal to serve as many patients and communities as possible. However, going forward, Walgreens will make difficult decisions if the PBM will not provide reasonable reimbursement for our services in order to maintain our presence in communities across America.

Today, we have a high level of visibility into reimbursement for approximately 80% of the anticipated script volume in fiscal 2025. We are pleased with the willingness that some of our PBM partners have shown to consider current trends and adjust reimbursement such as rebalancing brands and generics, and we look forward to working with those partners and how we can grow together. Several significant contracts are in the process of being negotiated over the next year and we will pursue rational reimbursement that ensures we are paid fairly.

Turning to NADAC, based on the latest data, we have seen it begin to stabilize. However, it is critical that regulators work alongside us and industry groups to implement a solution that reduces future instability and ensures that NADAC is a predictable product benchmark for pharmacy reimbursement.

Finally, outside of working with PBMs and payers to evolve reimbursement, we continue to progress our efforts to broaden and deepen the services we get paid for. Provider status and other new payment arrangements remain a key opportunity for us to fully deploy our pharmacists capabilities, lighten the burden on the broader healthcare system and further stabilize and improve our overall pharmacy economics.

Many of our actions across this turnaround will take time but I am confident that we have the right team, the right focus and the right strategy. Manmohan will detail our expectations for fiscal 2025 in a moment. Our most recent quarterly results underscore the importance of executing with intent to stabilize the core business irrespective of the macroeconomic backdrop. We have a lot of work to do and 2025 will be an important rebasing year to drive longer term value creation.

And before I conclude, I wanted to say a few things about how we're supporting the communities recently impacted by Hurricanes, Helene and Milton. Of course, our thoughts are with all our patients, customers, team members and everyone else that's been impacted by these terrible natural disasters.

In times of crisis, it is always heartening to see the generosity of America's response. At Walgreens, we've leveraged our public, private partnerships to implement a National Pin Pad program with the American Red Cross to raise over $5 million which has been used to donate water and other urgent supplies for the communities in need.

Walgreens has also made a donation to the American Red Cross Hurricane Helene Fund. In terms of the impact to us, about 1,050 of our stores were brought off line by the storms or in preparation for them, but we have restored all but 16 of them. We're working to make sure we continue to provide essential services to these impacted communities.

I will now turn it over to Manmohan to review our financial results.

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Thank you, Tim, and good morning, everyone. Overall, fourth quarter results were in line with our expectations. Thematically, the quota reflected the same trends that characterized our full year results with pressure on U.S. Retail Pharmacy partly offset by growth in our U.S. Healthcare segment while our international business continues to perform in line with our expectations.

Adjusted eps of $0.39 decreased 41% year-over-year on a constant currency basis. Approximately 70% of this decline relates to lower state leaseback gains, lapping the reversal of incentive accruals in the prior year and lower Cencora equity income. Headwinds in the U.S. Retail Pharmacy businesses were partly offset by cost savings initiatives and growth in U.S. Healthcare business.

GAAP results for the quarter included certain noncash charges. We recognize the $2.3 billion charge for valuation allowance on deferred tax assets. These deferred tax assets were primarily related to opioid liabilities recognized in prior periods and they remain available for the company to offset potential future income including gains from monetizing assets.

We also recognize $696 million in impairment charges for CareCentrix goodwill and our equity investment in Chinese Pharma company, GuoDa. As a reminder, last year's GAAP results included certain charges related to opioid claims and lawsuits.

Let's move on to the full year highlights. Adjusted EPS of $2.88 declined 28% on a constant currency basis due to the softer U.S. Retail Pharmacy performance and significantly lower sale leaseback gains. This was partly offset by cost savings initiatives and improved profitability in U.S. Healthcare.

GAAP net loss was $8.6 billion compared to a loss of $3.1 billion in fiscal '23. GAAP results included certain non-cash impairment charges related to VillageMD goodwill in the second quarter. The prior year period included $5.5 billion after tax charge for opioid related claims and lawsuits partly offset by a $1.7 billion after tax gain on sale of Cencora and option care health shares.

Now let me cover us retail pharmacy segment. Comparable sales grew 8.3% year on year driven by pharmacy and partly offset by decline in retail sales. AOI decreased 60% versus the prior year quarter. Approximately 2/3 of this decline relates to lower sale leaseback gains, lapping the reversal of incentive accruals in the prior year and lower Cencora equity income. Headwinds in the retail and pharmacy businesses were partly offset by cost saving initiatives.

We exceeded our goal of $1 billion in cost savings for the year with most of the benefit recognized in the U.S. Retail Pharmacy segment. Let me now turn to U.S. Pharmacy. Pharmacy comp sales increased 11.7% driven by brand inflation and mix impacts. Comp scripts excluding immunizations grew 2.6% in the quarter. We continue to track in line with the overall prescription market year-to-date.

Pharmacy adjusted gross margin decline versus the prior year quarter. Negatively impacted by net reimbursement pressure, brand inflation and mix impacts. Recent fluctuations in NADAC resulted in $17 million of impact in the quarter versus the prior year.

Turning next to U.S. Retail Business. Comparable retail sales declined 1.7% in the quarter. As Tim mentioned, the consumer backdrop remains a challenge. We see this with our customer as sales pressure in the quarter was almost entirely driven by non-essential categories. We continue to refine our pricing and promotion strategy which helped to improve gross profit margin in the quarter.

At the same time, value seeking behavior and new product launches during the year have driven our own brand penetration of 70 basis points in the quarter, finishing at over 17% of sales to end the year. Retail adjusted growth margin improved year-over-year, positively impacted by category mix towards health and wellness products partly offset by higher shrink levels.

Turning next to the international segment and as always, I will talk in constant currency numbers. Total sales grew 3.7% with Germany wholesale increasing 8.2% and Boots UK up 2.3%. Segment adjusted gross profit increased 2% with growth across all businesses. Adjusted operating income was down 11% primarily due to lapping real estate gains in the year ago period.

Let's now cover Boots UK in detail. Boots UK continues to perform well. Comp retail sales increased 6% with continued market share gains and all categories showing growth. Boots.com sales increased 19% year on year and represented 15% of our UK retail sales.

Turning next to U.S. Healthcare. The U.S. Healthcare segment finished ahead of expectations for the year. Delivering $66 million in adjusted EBITDA. Sales of $2.1 billion increased 7% compared to the prior year quarter.

VillageMD sales of $1.5 billion grew 7% year on year. The increase was driven by growth in full risk lives and fee for service revenue partly offset by the impact of clinic closures. Shields sales were up 28% driven by growth within existing partnerships.

Adjusted EBITDA for the fourth quarter was $65 million an improvement of $94 million compared to last year driven by cost discipline at VillageMD and growth from Shields. Turning next to cash flow. Operating cash flow of $1 billion for fiscal '24 was negatively impacted by $934 million in payments related to legal matters and $386 million in entity premium contributions related to the Boots pension plan.

We exceeded our target of $600 million in capital expenditure reductions in fiscal '24 delivering $736 million in savings versus fiscal '23. Similarly, we also exceeded our target of $500 million of benefits from working capital initiatives in fiscal '24. Free cash flow of $23 million declined by $642 million versus the prior year due to lower earnings, higher payments related to legal matters and phasing of working capital partly offset by lower capital expenditures.

Looking at the fourth quarter, free cash flow of $1.1 billion increased 98% compared to the prior year period. The increase was driven by benefits from working capital initiatives, lower legal payments and lower capital expenditures.

Over the course of fiscal '24, we reduced our net debt by nearly $2 billion and our lease obligations by over $1 billion and our liquidity position is healthy. We ended the year with $3.2 billion in cash and cash equivalents and $5.8 billion of revolver capacity.

Looking ahead, one of our key priorities is to strengthen the balance sheet condition of the company. We are focused on improving our cash flow generation and net debt position through a combination of operational actions and asset monetization activities.

These priorities have significant influence on our expectations for this upcoming fiscal year which I will detail now. As Tim underscored, our priorities for fiscal 2025 is to stabilize our core operations while we make progress on the longer term strategic and operational turnaround. This view is reflected in our adjusted EPS guidance of $1.40 to $1.80.

This guidance is based on three central assumptions. First, in U.S. Pharmacy, we anticipate continued pressure on reimbursement rates. We have negotiated approximately 80% of the contract volume for calendar year 2025.

Due to the multiyear nature of these contracts, there is still more progress to be made but believe we are taking incremental steps towards our goal of reducing the impact of reimbursement pressure on pharmacy margin.

The second major assumption is that our customer is likely to remain under pressure and continue to demonstrate the same price sensitive shopping behavior that we experienced in fiscal '24. In response to this dynamic, we're executing on a number of retail initiatives over multiple periods. In the near term, we're taking cost actions to improve our operating leverage including the accelerated optimization of our fiscal footprint. We expect these closures to be accretive to our cash flows in fiscal 2025. Lastly, we expect growth in our healthcare segment and in the international segment.

Let's cover the footprint optimization program next. We expect to close approximately 1,200 stores over the next three years with about 500 targeted to close in fiscal 2025. Within fiscal '25, we expect this activity to be weighted towards the back half of the year.

We are prioritizing closing locations that are cash flow negative underperforming stores where we own the locations and one where the lease expirations are coming due in the next few years. This focus is expected to partially mitigate the incremental burden of dark rent.

The economic benefits of this approach should begin to be tangible in fiscal '25 by accelerating the scope of our footprint optimization program and focusing on stores with weakest cash generation we expect to reduce our working capital needs and improve our cash flows over the next 12 months.

We expect the in-year benefit from footprint optimization program to be approximately $100 million of AOI with positive cash contributions including the cash benefits from working capital and sales of owned stores net of closure costs.

Over time, these actions should also enable us to fund the investments we plan to make in higher performing stores as we look to improve our customers' in store experience. For this year, we're prioritizing investment in those stores that should be the recipient of the scripts, merchandise and the foot traffic from the stores we're closing.

In our discussions with the investment community last quarter, we highlighted that we were evaluating 2,000 stores as part of our optimization efforts. Net of the 1,200 that we have identified for closure, this indicates that there are another 800 stores for which we're focused on improving their operating performance and cash flows. However, as has always been the case, we will continuously evaluate this group and all our stores to ensure we ultimately operate with the best possible footprint.

Let's now turn to additional guidance line items. We are providing additional guidance on certain enterprise and segment level line items for modeling purposes. At the midpoint of our guidance range for adjusted EPS, about 60% of the year-over-year decline reflects the impact of higher tax rate and lower contributions from sale lease back and Cencora earnings. On a corporate level, we're anticipating higher interest expense due to lapping prior year gains on bonds.

Let me cover segment level details next. For the U.S. Retail Pharmacy segment, at the midpoint of the range, we expect a year-over -year decline in AOI of $1.1 billion. Approximately 40% of this decline is driven by headwinds from sale lease back gains and prior Cencora share sales. We anticipate that fiscal '25 will be the last year of headwinds from sale lease back gains. Excluding these impacts, we expect headwinds from net reimbursement pressure and retail to drive the remaining year-over-year declines partially offset by the impact of footprint optimization program.

Let me share some additional KPI information. We expect the overall market growth for script volume to be between 2.5% to 3% with our total prescription growth impacted by store closures. We expect vaccinations to be slightly lower compared to fiscal year '24. Guidance assumes no significant changes to the recent trends impacting pharmacy margin including brand inflation, mix, authorized generics and continuation of most recent trends in NADAC.

We expect retail comparable sales of negative 2% to negative 3%. And cough, cold and flu season incidences are expected to be slightly down versus last year. We expect international segment profitability to grow in fiscal year '25 led by Boots retail business and Germany. We expect adjusted EBITDA for the U.S. Healthcare segment to improve by $250 million at the midpoint compared to the fiscal year '24 to a range of $280 million to $350 million.

Let's conclude the guidance discussion with cash flow and capital allocation. We expect our efforts to stabilize retail sales and pharmacy margin to take hold over time. In the near term, we will continue to bolster our free cash flows through working capital optimization initiatives as well as right sizing our capital expenditures.

In fiscal '25, we expect working capital initiatives to generate approximately $500 million of free cash flows and capital expenditure reductions of approximately $150 million. We anticipate an AOI had went of approximately $400 million from lower sale lease back gains and Cencora equity earnings. This will not have any impact on free cash flow.

In fiscal 2024, we began to refocus our financial philosophy. This includes decisions to simplify our financial reporting such as wind down of the sale lease back program and Cencora share sales but also in terms of capital allocation priorities.

As we monetize assets in fiscal '24, we reduced our net debt position by $1.9 billion. This is a good start, but there is still much more work to be done to continue to strengthen our balance sheet in the coming years.

Given this imperative, we intend to further monetize non-core assets. Additionally, we expect our lease liabilities to decline further due to the conclusion of our sale lease back program and as we execute against our footprint optimization program. We believe these actions will improve our cash position and financial flexibility as we focus on reducing net debt while supporting the successful execution of our turnaround over the next few years.

With that, let me pass it back to Tim.

Tim Wentworth ***Walgreens Boots Alliance Inc - Chief Executive Officer, Director***

Thanks, Manmohan. Before opening the call up for Q&A, let me leave you with a few closing thoughts. We are confident that we have the right team and the right strategy and we are laser focused on two principles that we are a retail pharmacy led organization and that the economics of this model must be disciplined and sustainable.

To this end, we intend to meaningfully strengthen our balance sheet over the next few years and there is a clear path to doing so. As we work to stabilize our financial performance, monetize non-strategic assets, reduce our lease exposure and address our net debt position.

As part of this approach, we intend to adopt a flexible and pragmatic capital allocation strategy. To be clear, we believe our reorientation to retail pharmacy has a bright future. We're engaging in a multiyear program with a long term goal of appropriately sized and well positioned fleet of stores and an industry- leading customer experience in both retail and pharmacy across consumer channels.

And we continue to believe that the adjacent strategic businesses in which we've invested can incrementally contribute to value creation over the longer term. We are in the early stages of a turnaround that will take time. But the fiscal fourth quarter was an important building block in the foundation of this turnaround and we expect further progress in fiscal 2025.

With that. Let's take questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Lisa Gill, JP Morgan.

Lisa Gill *JPMorgan Chase & Co - Analyst*

Good morning, and thanks for taking my question. Tim, I just want to focus on a couple of things. One would just be some of the comments that were made early on around the restructuring of the reimbursement. When you talk about 80% visibility, you also talked about very difficult decisions around maybe contracting going forward.

So how do I want balance that when I think about improving rates? Do we expect improving rates in 2025? Is this more of like a three year plan? And then secondly, when you think about those difficult decisions, are you thinking about leaving some networks, like, how do I put all those pieces together?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure, thanks, and good morning, Lisa. So first of all, just to answer that directly, as it relates to 2025, we have a lessening of the reimbursement pressure if you looked at a trend line, which by the way, continues a couple of year dynamic, which I've talked about before, where coming in I was fairly confident that we had seen the payers becoming more understanding and realistic about what we could give. And at the end of the day, if all of the retailers are showing up with less being taken out of the market to then share, it begins to support that dynamic. And so in '25 we do see less. Let me start with that.

Number two, there's no question that there is a recognition by all parties, PBMs, payers and our peers that the dynamics have changed and we see that clearly reflected in the conversations, very constructive conversations we have had, both in the 80% where we have actually landed the contracts and we have seen different sorts of mechanisms put in the contracts. There's not a one size fits all. We've seen some cost plus, we've seen carve outs for new brand drugs or existing brands that are at high prices.

We've seen rebalancing of brand and generic and we're showing up open minded to how we reconfigure the risk and also protect our ability to not see unmanageable reimbursement pressures that frankly aren't economic for us and not frankly market required.

All of that said, the 20% that are left, what I would say is those are constructive conversations. I don't want to portray them as something different. But in all of our conversations, not just the 20%, we showed up willing to make a difficult decision if we weren't going to be in a range of being compensated fairly. And it doesn't mean we're raising prices. Let me be clear about that. It means that we are arresting the downward pressure because we are not taking money out of the market, either through purchasing or through the dynamics of generics -- generic inflation, new generics and so forth. To underpin what would otherwise be our ability to increase the reimbursement that we give.

So all of that to say because I know this is a very important topic to our investors and to the market, even the 20% constructive conversations. But let me be clear, we're willing to walk away from a line of business if it doesn't make sense. I've said that there are examples where we would rather have 5% of cash paying cadre than 100% of a reimbursed cadre.

And so from that standpoint, again, we know that I believe the payers are very clear about it and I'm very confident that over a 2 year to 3 year period, we will have reset the framework for reimbursement discussions and frankly be talking more about other value creation that we can do together than simply unit cost reductions.

Lisa Gill *JPMorgan Chase & Co - Analyst*

That's very helpful. And just one follow on, that would be if we think about the cadence of '25. I know Manmohan talked about the store closings impacting more of the back half of the year. Anything else you would call out as I think about how earnings will develop in '25?

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

From a cadence perspective, Lisa, you had to think about maybe the same trend as we have seen in the last couple of years. We do have roughly around 500 closures, which are back half weighted. But then we also had closures in the second half of fiscal '24. So we're going to see the benefit from store closure continue to scale within '25 and then beyond over the next 3 years as well.

Lisa Gill *JPMorgan Chase & Co - Analyst*

Thank you.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Operator, next question.

Operator

Ann Hynes, Mizuho Group.

Ann Hynes *Mizuho Securities USA Inc. - Analyst*

Hi, good morning. Thank you. Thanks on all the details about free cash flow. So just had a question on timing. I know, Tim, in your prepared remarks, you talked about fiscal 2025 as a rebasing year or you want to get AOI to a point where you can grow. Is that -- is it fiscal 2025? Or do we really have to wait until you're able to stabilize these PBM contracts and grow from there? So any timing that you can provide on when you think would be a base to grow from?

And then secondly, I think last conference call, you talked about going to go and negotiate some vendor contracts. Can you provide any update on that progress? That would be great.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Yes, I'm sorry, could you just repeat your second question, which contract?

Ann Hynes *Mizuho Securities USA Inc. - Analyst*

I think some supply -- I'm sorry, some contracts whether it's drug distribution or anything in the front store. I think the company has talked about maybe the potential of being able to renegotiate the contracts. So any progress on that would be great.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure. Thanks. So first, from a timing standpoint, as you can appreciate, we've said all along, this is a multiyear turnaround. This is a rebasing year in '25. I'll let -- we're not giving three year guidance at this point other than to say that we believe this replatforming of the company and the things that we've said we are going to do and are already doing are meaningfully positioning us for growth in the longer term, both in terms of pharmacy services, U.S. Healthcare and the front of the store.

I'll let Manmohan give you any additional color as it relates to the longer-term perspective that we have. Coming back to the second part of your question, and then I'll turn it over to Manmohan. As it relates to Cencora, because I guess that is your question, as you know, we do have a longer-term arrangement with them that goes until '29.

We meet with them regularly to make sure that they understand sort of where we sit and we evaluate together how they can help us, both in terms of our cost of acquisition as well as frankly, operationally because they're a crucial part of our underlying operating model.

And we're not going to give any updates at this time, but there is a meaningful dialogue that we're having. It is very constructive, and we believe that there are ways that we can together, inclusive of inventory, working capital, micro fulfillment-related activities and indeed purchasing acquisition cost, that there are things we can do together to allow for the one thing we both want, which is us to grow because that's good for both us and them.

Now I'll turn it over to Manmohan to just give you any additional color as it relates to the longer-term outlook that your first question asked about.

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Sure. So not providing long-term guidance today. But as Tim mentioned, goal is to grow AOI and free cash flows over the next three years. Maybe a couple of themes for fiscal '25 first. As you -- the guidance we shared today, it reflects roughly around $0.80 to $0.85, roughly around 60% headwinds from higher tax rate, sale of Cencora shares recently as well as lower sale-leaseback contribution. And so '25 is a better base when you think from a quality perspective.

We do have roughly around $250 million of equity earnings expected in fiscal '25 from Cencora. Now those will -- we will lap those in fiscal '26 as our existing variable prepaid forward contracts comes to maturity in late fiscal '25 and early '26.

From a business or underlying business performance perspective, we do expect U.S. Healthcare to continue to grow and we expect International to grow in fiscal '25. As Tim mentioned in his prepared remarks, from a USRP perspective, from a longer-term growth perspective, we're very focused both on pharmacy margin as well as retail sales in the U.S.

Those benefits from those initiatives we expect to scale over the next three years. And so in the meantime, from a fiscal '25 perspective, we're going to be very focused on cost discipline, including the footprint optimization program that we announced today, which we expect to be accretive in the year.

And as I said earlier, the benefit from the optimization program, we expect it to continue to scale as we close locations over the next three years and the benefit in the year is roughly around $100 million, so that I think gives you a shape of '25 and getting out of '25, what are going to be some of the factors we're looking at longer term.

Operator

George Hill, Deutsche Bank.

George Hill *Deutsche Bank AG - Analyst*

Good morning, guys. And Manmohan, maybe I missed this, but are you able to talk about like what is the discrete impact of the store closures in fiscal 2025 and maybe from a run rate basis to the U.S. Pharmacy business?

And then my follow-up question would be is, are you able to provide any color on earnings cadence in the U.S. Pharmacy segment as we think about the progression of fiscal '25 just kind of given the slope of how earnings have progressed recently? I think that would be helpful. Thank you.

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Sure. So far, store closure benefits in the year, we expect roughly around $100 million contribution to AOI in fiscal '25 and that will then continue to scale into '26 and '27 as we close more locations over time. So that's kind of the run rate. From a cash perspective, we expect footprint optimization to be accretive in the year as well.

And I think the way -- simple way to think about this is the benefit from working capital as we close locations as well as there are certain owned locations that we're going to be closing and monetizing in the year that significantly outweighs the closure cost in the year. So that's on the store closure. On the cadence side, look, I think we're going to be pretty much in line with how the cadence has played out over the last couple of years. So don't expect significant changes there, first half versus second half.

George Hill *Deutsche Bank AG - Analyst*

Thank you.

Operator

Charles Rhyee, TD Securities.

Charles Rhyee *TD Cowen - Analyst*

Yeah, thanks for taking my question. Just a follow-up on Lisa's question. Tim, I think you said that with the 80% renegotiated in terms of the contract volume that is lower, but is that stable going forward? So this is sort of -- at least where 80% is setting a new baseline.

And then secondly, I appreciate all the comments around free cash flow, but can you give us a sense for where free cash flow will be for fiscal '25? I mean there's a lot of moving parts here. But if I kind of look at some of these pieces, we're still coming out negative free cash flow for the year. Just maybe give us a sense for what kind of sits when we think about the high end and the low end of the EPS guide? Thanks.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure. And I'll let Manmohan take the second question. As it relates to the contracts, again, what I'd reinforce is it is an ongoing and dynamic process. When I call it a reset, it's more a structural reset than it is we're going to do something that -- than just stand still. And so those contracts typically are multiyear contracts, which is why it's going to take us a few years to actually work through all of the contracts that we have, which, in many cases, have us taking more risk or less reimbursement than we believe is ultimately appropriate and sustainable.

And so it is an ongoing dynamic. And furthermore, in my background, probably this won't surprise you to hear, I don't view them even when they're done that we're done. There are opportunities to sit back down based on dynamics that occur, whether it's the pipeline, new indications, new products, trying to win a new client, and we work with those PBMs and payers to help them with that.

So from that standpoint, the 80% is sort of a -- it's not an abstract number. It's an actual number. It says we had 100% of a group of contracts that would have been renegotiated for the 2025 plan year. We have 80% along in that, which is by itself not shocking because as you can imagine, PBMs actually operate on a January year for plan design.

So we're actually right where I would expect us to be. And I'm not surprised that the remaining contracts are, again, the ones that probably require a bit more work by both parties at the table to reach a better place, and I think we'll get there. And Manmohan, do you want to take the second question?

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Sure. So from a free cash flow perspective, '25, a couple of things for you to consider. First is we expect adjusted operating income to decline in '25. Now roughly around $400 million of that is due to the lower sale leaseback contribution as well as lower earnings from Cencora. Those items do not impact free cash flow. So we just wanted to flag that.

Outside that, the legal payments in the fiscal year '25 expected to slightly increase as well, roughly around $1.050 billion in total. Before we -- and then before they go down in '26, we expect them to decline over '26. And so what we're working through is partly offsetting these headwinds from A, working capital optimization of roughly around $500 million in the year. And then, B, on the CapEx side, we expect our CapEx to be declining roughly around $150 million in the year. So those kind of are the building blocks from a free cash flow perspective.

Lastly, I'd say this, look, we'll continue to have a pragmatic approach to capital allocation going forward. As you've seen in Q4, we were able to monetize our non-core assets. We do have some flexibility in our portfolio. And so we will continue to tap into that as needed.

Operator

Eric Percher, Nephron Research.

Eric Percher *Nephron Research LLC - Analyst*

A question on U.S. Healthcare, given the guiding principles you laid out, Tim. I guess question one is, is there any component here that's key to the strategy of rebasing around the Retail Pharmacy customer? And then Manmohan, maybe I'll ask you on VillageMD. The focus here, you mentioned profitability or profitable growth from the other elements of the business. Is there a reduction in investment or stabilization in the underlying VillageMD operation?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure. Thanks for that, Eric. I'll take the first part and as you directed, the second to Manmohan, I'll let him take it. In terms of what's core, first of all, it starts with, frankly, our clinicians and our team, which is the underlying asset that enables us to look at other services whether it's for payers or for pharma in the back of our stores.

And so our U.S. Retail strategy is a healthcare strategy. I would start with that, and it's crucial. That's why we've recentered on the pharmacy as a core to our strategy. I would then say, inside of that, what's probably not as well appreciated as it will be over time is our specialty pharmacy, which is really when you look at where the growth of patient need is, payer need is, being the largest independent specialty pharmacy and having the assets that we have and the team that we have is a tremendous starting point to envisioning doing more, whether that's for the pharma companies that actually originate the products, the biosimilar companies that make biosimilars or indeed the payers who want to have their patients have access to a highly reliable, clinically focused, trusted company. And so from that standpoint, we see that as a critical asset.

Other things are very complementary to that, such as Shields and CareCentrix to providing a broader set of ecosystem services or services to a unique set of payers in the case of Shields being health systems. And so those are really important assets for us incrementally to the core asset that we have, which is being a Retail Pharmacy. Do you want to take the second question, Manmohan?

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Yes, sure. From a -- so let me start Q4 U.S. Healthcare segment performance. A couple of things there, a common theme throughout the year has been Shields continues to grow, expansion within the existing partnership and then we have seen improvement within VillageMD as well, driven by a significant cost reduction program that they've gone through.

Now in Q4, we also experienced slightly higher contribution from the risk-based book. And so that's driving a little bit of overperformance in the quarter. As you look out to '25, we expect these themes to continue to play. We expect Shields to continue to grow within their existing partnership, just continue to expand.

And then on the Village side, there is benefit of costs in fiscal '25, including the wraparound benefits from clinic closures that they have executed in fiscal '24. Outside of that, we do expect their contribution margin to also improve slightly year-over-year driven by higher fee-for-service volume and a little bit growth on the risk base side.

Operator

Kevin Caliendo, UBS.

Kevin Caliendo *UBS Investment Bank - Analyst*

Thanks. Thanks for taking my question. Turning to store closures, just within the guide, I'm trying to understand, what do you anticipate over time you're going to retain in terms of Rx and foot traffic? Is there sort of a magic number as you go through this analysis? Is it -- it used to be 70%, is it 50%? Like how do you think about that in terms of what you're guiding for or what's implied in the guidance for that?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Yeah. Thanks for the question. That's an important dimension, one of a number of dimensions that as we've evaluated the 2,000 stores we spoke about last quarter and now the 1,200 that we've announced that we'll be actually closing and as we continue to evaluate the 800.

The recapture rate is critical, and it's something that we're very, very precise about as it relates to store level dynamics. And so there is no one number. There is an aggregating number I suppose that if we added up to 1,200 times the store level assumptions that we are able to make based on a number of dynamics related to how many other stores are there nearby that are ours? How many are competitive? What's the profile of the patients that we're caring for today, et cetera. And there's a number of dynamics.

So it's not as simple as a number, but it is very much a piece that we look at and challenge ourselves. We obviously have a lot of experience both buying files and moving patients but also moving patients as we've closed.

This year, we closed a couple of hundred stores. So we know how to do this. We've gotten very good at predicting. We've also gotten obviously very good at engaging our patients. And so we've got a number, and we will -- that is a key assumption.

What I would say, though, is as part of our broader retail reconfiguration and strategy, our loyalty program, digital interfacing with our customers and so forth, we believe will enable additional touch points with these customers to both serve them potentially, whether that's a home delivery and other things if they're not as close to a store or indeed engage them in other ways.

We are not basing any upside assumption in our underlying model for those things, but we believe it will be meaningfully contributory to bringing most of the patients in many of the stores and some of the patients from other stores along with us. And again, we want to serve every patient, and that is the goal, but we're realistic in terms of that number when we look at these closures particularly.

Kevin Caliendo *UBS Investment Bank - Analyst*

Thanks. And if I can ask a quick follow-up. You talked a lot about deleveraging and getting your net debt down and improving free cash flow. I didn't necessarily hear full endorsement of the current dividend. And I'd just love to understand how you think about it. It's obviously at a pretty elevated level here. Is the dividend, as is, like part of the strategy for shareholders going forward as far as you think about it? Or is it something that you're going to keep an eye on for lack of a better way to describe it?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

What you heard Manmohan say is that we have adopted a flexible and pragmatic capital allocation strategy. And we are going to continually evaluate our situation broadly. We are highly committed to being efficient with our capital and to doing the things that you've already heard us talk about. And we will absolutely continue to monitor and make changes to our capital allocation, including better aligning our dividend with our long-term earnings power if we believe that, that's the appropriate thing to do.

And again, that requires meaningful discussion with our Board on both our long-term plan as well as the dividend that we're paying right now. And those conversations, as you saw early in my tenure here -- are continual. And so I don't have any news for you today. We, in fact, believe in the near term, we can continue to monetize these nonstrategic assets that Manmohan spoke about earlier to improve our balance sheet over time. But everything's on the table.

Operator

Elizabeth Anderson, Evercore ISI.

Elizabeth Anderson *Evercore ISI - Analyst*

Hey, guys. Thanks so much for the commentary and additional color. I have a question on the working capital improvement. Can you help me parse out sort of how you are thinking -- I mean, obviously, those come from a variety of different things. You talked about suppliers, store closures. Can you think -- help us think through sort of the bucket of that and how to think about that so we can think about it sort of on a multiyear basis like how much is coming from stores versus supplier agreements and other factors?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure. I'm going to let Manmohan take it other than to just say at the front because I feel I have to. It's the result of a lot of things being very well managed and executed by a team that is extraordinarily focused and aware of the opportunity that we have on working capital. I have never been prouder of a team in terms of the discipline that they brought to bear as you heard, both in terms of CapEx, expenses and working capital. And what you're going to hear is it's not just one thing. It is execution across a number of dimensions of the business. I'll let Manmohan give you a bit more color.

Manmohan Mahajan *Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President*

Yeah, sure. So for us, as we work through working capital, our goal is always to look at all components of cash conversion cycle. And as you think about some of the initiatives that have played out in fiscal '24, let me just talk about on the retail side. We've talked about assortment mix that we have at the stores today. And one of the initiatives we ran is how do we make sure that we take out unproductive inventory out of the stores and monetize that and replace it with more productive inventory.

Now on the Rx side, things like Nucleus, which is our micro fulfillment centers, is also giving us ability to optimize our inventory levels within the company as well. And then there are a number of initiatives on our account receivables and improving the collectability and timing of it as well as rightsizing the timing on our accounts payable as well. So all components of it being looked at.

Yeah, as you think about kind of the incremental opportunities within fiscal '25, store closure is one of them. As we close these locations, it gives us an opportunity to take the remaining inventory and optimize that within the remaining network, and that generates obviously free cash in the year.

Elizabeth Anderson *Evercore ISI - Analyst*

Got it. That's very helpful. And then just as a quick follow-up, maybe on the OpEx and things, how do you feel like -- I mean, you've obviously executed many years of OpEx improvement. How much more opportunity on the sort of core corporate base, particularly in U.S. Retail, do you see available? I know you're sort of talking about like on the store count adjusting that. But does that -- how do we think about that as a driver of AOI going forward?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Sure. Well, what you just said is really important, which is if we close 1,200 stores as we plan over the next two years to three years, then there's no question that there are stranded costs that we will go after. And our goal is to, frankly, be out ahead of those store closures as it relates to managing those costs. So that's important. And it's something that we are very committed to.

Second, it is now the culture of the company, I would say, which is that it will be a way of life forever in this company to look at ways that we can get smarter about every dollar that we spend, particularly as it relates to non-direct store-related pieces. I'm -- we are looking -- I'm looking -- we are looking to be able to invest back into our stores, both in terms of capital and frankly, in terms of our associates in terms of training and so forth.

And so from that standpoint, the things that I think will be different this time as we look at these is we have a management team that's really focused on this topic. We have a level of discipline that I think we've shown already and will continue to show and we execute. And so that will continue.

Is the opportunity as big as it was $4 billion ago? No, it's not. But we continue to see meaningful opportunity across our business to improve what we do and do it in a more efficient way. And so that's just going to continue. And there are assumptions in this plan for our continued optimization in advance of those store closures from -- again, principally a corporate level.

What you would see in our stores, and I have to say this because you can walk in the stores and see it. We don't have a lot of destaffing left in the stores at all. Our stores are tight. And so from that standpoint, that's not where you will see us making a difference. In that point, from our standpoint, we know we can come back to you and talk about our strategic positioning, vis-à-vis, Amazon and so forth, but we think those people in our stores are the crucial touch point. And so there, we're looking to invest even as we rightsize our support system.

Operator

Michael Cherny, Leerink Partners.

Michael Cherny *Leerink Partners LLC - Analyst*

Good morning. Thanks for taking my question. Maybe just diving back in on the U.S. Healthcare side. I appreciate the color you gave on the various different moving pieces, in particular, in VillageMD, but also the dynamics expectations on monetization. Is there anything that's, I guess, holding you back on that front in moving faster?

I know Tim, it's something you've talked about basically since the time you started about recognizing the need to fit the business. And so as you think about the pathway for monetization, given all the dynamics around free cash flow you've discussed, given the questions about flexibility and regarding the dividend, what are some of the thought process we have in terms of understanding the checkpoints you need to see to complete a process for monetization?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Well, the key asset in the U.S. Healthcare business where we are looking to monetize, as you know, is VillageMD. And our goal is to monetize it, but to do it without destroying value unnecessarily. And so from that standpoint, it has been a longer process. I wish I could have wiggled my nose and just made it happen, believe me, because we've declared it's not a crucial part of our future. We also believe it's a great business, and will do well on its own. But the process of getting there has been longer than we would have hoped but we're going to be very methodical and very appropriate in trying to preserve value.

There are physicians that are part of that, that are outstanding and ensuring that we have thought through their situation and that we become even more of an employer of choice, for example, means that we're going to be really thoughtful about how we do it. And the good news is you saw us sell Cencora and pay down $1.9 billion of debt over the course of the year.

We have ways of dealing with the short-term cash situation of, we have a lot of room on the revolver and so rushing that particular decision would have not achieved anything and would have potentially destroyed even more value.

So we'll keep you posted as to what happens there. We're very engaged there. Mary Langowski, and our team working with both the Village team and the other investors have been relentless, but it is very complicated and therefore, we're going to get it right.

Operator

Stephanie Davis, Barclays.

Stephanie Davis *Barclays Bank PLC - Analyst*

Hi, guys. Thank you for taking my question. Just going be into the VillageMD kind of topic again. You have a lot of cost reduction that's been going on. But I was hoping you could walk us through any other margin improvement initiatives beyond just cost takeout location closures?

And looking forward, you did announce a new CCO hire that has value-based experience that's very relevant to this business. How should we think about how Jason fits this puzzle?

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

I'm sorry, the last pretty question, how should we think about?

Stephanie Davis *Barclays Bank PLC - Analyst*

How Jason fits the puzzle, new CCO hire. No one's mentioned him yet.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Yeah. No, he's great. I mean, listen, we -- and Jason just sent Mary and I note after his first week about being more excited even than he planned on being based on his conversations with payers, pharma and his colleagues.

So listen, margin expansion isn't just cost cutting to your point. And we have a number of growth initiatives that Mary's incubating right now and bringing Jason on should be and is, and I appreciate you recognize it, a clear signal that we believe we have services that are highly valuable to others. We haven't talked today, for example, about pharma company and some of their go-direct initiatives. We are a natural partner there and are, in fact, inside of one of those.

And so from that standpoint, I couldn't be more excited to ultimately come and tell you more about some of those growth initiatives. That said, I want to be really clear with you that we're in the early innings of that. And so we have not baked all kinds of upside into our guidance as a result of those, we believe they will take time.

The sales cycles, particularly in a B2B are not short in many cases. But boy, we have built -- Mary has built a tremendous team, and I think has laser focus on a number of areas, specialty, pharma services, data and analytics and a number of other things where we believe we can double down and having a team, including Jason is meaningful.

I'm going to let Mary just -- she can give a little bit more color if she wants because certainly, she has been actually very quietly building a very effective team.

Mary Langowski *Walgreens Boots Alliance Inc - President, U.S Healthcare*

Thank you, Tim. Thanks, Stephanie. We've said it before, the U.S. Healthcare business is really focused on a disciplined growth strategy that's really focused on near-term shareholder value creation and cost discipline. And so as part of that, we spent the last six months exiting nonmaterial programs, programs we didn't think would generate growth over the near term. And now we're focused on 2 primary things: Growth of our current core and adjacent assets. So the things that Tim mentioned, specialty pharmacy, Shields, data analytics, our pharma services.

And then secondly, doing more of what we do best, which is really built on our core infrastructure and reorienting to the pharmacy business. So reaching, engaging and activating patients and providing services to payer and pharma. So Jason's really a part of this and a critical part of this with the CVS and Optum experience. He'll be driving a focused approach to commercialization, B2B partnerships and services development.

Operator

Thank you. And I will now turn the call back over to Mr. Tim Wentworth for any closing remarks.

Tim Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Great. Thank you. And I want to thank everybody for dialing in this morning. I've been reflecting on my first almost year here at Walgreens. And the first thing I would tell you is, if I had it to do over again, I would have only done it more quickly getting here.

It has been quite a year. And we've -- in that year, built a brand-new team here with six new leaders, all based in Chicago sitting around the table every day, thinking about how to serve our patients better and at the same time, grow our business. And then you just heard about Jason, we have hired a whole coterie of leaders at the next level who are going to enable this strategy beyond the senior leaders that sit around my table.

We drove a disciplined approach to capital, and we've achieved aggressive goals for expenses, working capital and CapEx, and we achieved positive cash flow for the year. We reduced our net debt by $1.9 billion, and we simplified our financial reporting, something many of you told us you wanted to see.

We held market share in pharmacy for the first time in a number of years. We conducted a thorough strategic review that is driving the VillageMD process we just spoke about. It's driving a meaningful 6-pillar retail modernization initiative that includes merchandising, own brand, loyalty, digital and the footprint evaluation that we spoke about today. We additionally set a framework for multiyear reconfiguring pharmacy reimbursement.

We are meeting the consumer where they are. This guidance does not assume that the consumer is magically stronger in an amazing way by the end of the year. We believe that the consumer needs to be met where they are. I have a brother in law, Al Miller, who's one of the experts of real estate in this country, consumer real estate, and we were talking this weekend about the fact the consumer, they may get stronger, but boy, you wouldn't count on it right now. And certainly, many industry counterparts to ours are seeing that. So we've been realistic about the consumer.

And as important -- maybe the most important thing we've done is evolve our culture to where over 300,000 team members will be the ultimate differentiator in the lives of our patients and our customers. I look forward to updating you on our progress and updating in upcoming quarters. Thanks very much for dialing in.

Operator

Ladies and gentlemen, that does the conference for today. Thank you for your participation, and you may now disconnect.

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