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WBA - Q3 2017 Walgreens Boots Alliance Inc Earnings Call

EVENT DATE/TIME: JUNE 29, 2017 / 12:30PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Walgreens Boots Alliance Third Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference call is being recorded.

I would now like to turn the conference over to Gerald Gradwell, Senior Vice President of Investor Relations and Special Projects. You may begin.

Gerald Gradwell

Thank you. Hello, and welcome to our Third Quarter Earnings Call. Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer; and George Fairweather, Executive Vice President and Global Chief Financial Officer, will take you through the results, as usual. Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance, is also here and will join us for questions.

You will find a link to the webcast on our Investor Relations website at investor.walgreensbootsalliance.com. After the call, this presentation and webcast will be archived on the website for 12 months.

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 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.

As a reminder, today's presentation includes certain non-GAAP financial measures, and we refer you to the appendix and the presentation materials available on our Investor Relations website for reconciliations to the most directly comparable GAAP financial measures and related information.

In a second, I'll hand over to George to take us through the third quarter results. Stefano will then cover today's Rite Aid announcement, in addition to his usual quarterly update. After the prepared comments, we will, of course, be happy to answer questions on both the results and our new Rite Aid agreement.

I will now hand you over to George.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

Thank you, Gerald. Overall, we are pleased with our progress this quarter with results in line with our expectations. As in the last quarter, we were particularly pleased with growth in U.S. pharmacy volume and market share. During the quarter, we also completed the $1 billion share buyback program, which we discussed on our last earnings call. I'm also pleased that today, we have raised the lower end of our adjusted earnings per share guidance for fiscal year 2017 by $0.08.

So now let's look at the financial highlights for the quarter. As we expected currency, again, had a negative impact, the U.S. dollar being 12.5% stronger versus sterling than in the comparable quarter last year.

Sales for the quarter were $30.1 billion, up 2.1% versus the comparable quarter. On a constant currency basis, sales were up 5%. GAAP operating income was $1.5 billion, a decrease of 1%. GAAP net earnings attributable to Walgreens Boots Alliance were $1.2 billion, up 5.3% and diluted EPS was $1.07, up 5.9%.

Adjusted operating income was $1.9 billion, up 5.5% and, in constant currency, was up 7.5%. Adjusted net earnings attributable to Walgreens Boots Alliance were $1.4 billion, up 11.9% and, in constant currency, up 13.6%.

This percentage increases were higher than for adjusted operating income. This was due to a lower tax rate, partially offset by losses on certain legacy investments, which adversely impacted both earnings from other equity method investments and other income. Since the quarter-end, we have disposed of the legacy investment, the gain on which will largely offset these losses.

The adjusted effective tax rate, which we calculate, excluding the adjusted equity income from AmerisourceBergen, was 19.1%. This was lower than in the comparable quarter last year, primarily due to relatively high incremental discrete net tax benefits and a lower estimated core annual tax rate of 25.3%. All of this resulted in adjusted diluted net earnings per share of $1.33, up 12.7% and, in constant currency, up 14.4%.

For completeness, here are the numbers for the first 9 months of fiscal 2017. I will not go through those in great detail, but you will note that GAAP diluted net earnings per share was $3.02, up 4.9% versus the same period a year ago. Adjusted diluted net earnings per share was $3.79, up 7.7% and up 9.9% on a constant currency basis.

So let me now turn to the performance of our divisions in the quarter, beginning with Retail Pharmacy USA. Retail Pharmacy USA sales were $22.5 billion, up 6.3% over the year-ago quarter. This included 2 months of results from AllianceRx Walgreens Prime, a recently formed central specialty and mail services business. Comparable store sales for the division increased by 3.7%. Adjusted gross profit was $5.7 billion, down 0.5%, reflecting a decrease in pharmacy, partially offset by an increase in retail. We'll look at this in more detail in a moment. Adjusted SG&A for the division was 18.7% of sales, an improvement of 1.7 percentage points. This improvement was primarily due to sales mix and higher sales as well as an amendment to certain employee postretirement benefits and our cost transformation program. Adjusted operating margin was 6.5%, in line with the comparable quarter last year, resulting in adjusted operating income of $1.5 billion, up 5.9%.

So next let's look in more detail at pharmacy. U.S. pharmacy total sales were up 10.3% versus the year-ago quarter, mainly due to higher prescription volumes, including mail and central specialty. During the quarter, we filled 255.2 million prescriptions on a 30-day adjusted basis, including immunizations, an increase of 8.5%. On a comparable basis for stores, which exclude central specialty and mail, pharmacy sales increased by 5.8% with scripts filled up 8.3%.

In the second quarter, we reported our highest quarterly growth rate in over 7 years. This quarter was even better. Growth was primarily due to strong volume growth for Medicare Part D and the positive impact of our strategic pharmacy partnerships.

Within sales, volume growth and brand inflation were partially offset by reimbursement pressure and the impact of generics. This pressure contributed to lower pharmacy gross profit and gross margin. A higher proportion of specialty adversely impacted pharmacy gross margin by around 100 basis points. However, the higher specialty sales had a positive impact on gross profit.

Our reported retail prescriptions market share on the usual 30-day adjusted basis was 20.5%, up by approximately 110 basis points over the year-ago quarter. This was the highest market share that we have ever reported.

Total retail sales were down 1.8% on the same quarter last year. This included the impact of the previously announced closure of certain e-commerce operations. Comparable retail sales were down 0.4% with declines in the consumables and general merchandise category and in the personal care category, partially offset by solid growth in the health and wellness and beauty categories. Adjusted gross profit was higher, primarily due to mix and underlying margin improvement.

Beauty category performance and beauty differentiation stores continues to be markedly better than in other stores, supported by strong sales growth of No7 and Soap & Glory. We've also continued to introduce new brands into our existing beauty differentiation locations, including Botanics, which I mentioned last quarter. We remain on track to introduce our enhanced beauty offering to over 1,000 additional stores by the end of the calendar year.

This quarter, as part of our strategy and ongoing cost transformation, we've also begun to implement a program in certain stores to simplify our offering and improve our retail operational performance. This is designed to deliver a better experience for our customers, provide ongoing efficiencies and reduce working capital. In the coming months, we expect this program to reach approximately 1,500 stores.

So now let's look at the results of the Retail Pharmacy International division. Sales for the division were $2.8 billion, down 0.2% in constant currency versus the year-ago quarter. Comparable store sales increased 0.2% in constant currency. Comparable pharmacy sales were down 0.1% on a constant currency basis, mainly due to a decline in the U.K. In Boots U.K., comparable pharmacy sales were down 0.4%, mainly due to the reduction in government pharmacy funding. Comparable retail sales for the division increased 0.4%, Boots U.K.'s comparable retail sales increasing 0.1%.

Within this, beauty was Boots U.K.'s strongest category, assisted by the launch of No7 Restore and Renew Face & Neck MULTI ACTION Serum. Adjusted gross profit for the division at $1.1 billion was down 1.2% in constant currency versus the year-ago quarter, mainly due to lower pharmacy gross margin.

Adjusted SG&A as a percentage of sales on a constant currency basis was 0.7 percentage points higher at 34%, mainly due to inflationary pressures and higher variable payroll costs.

Adjusted operating margin was 6.9%, down 1.1 percentage points in constant currency. This resulted in adjusted operating income of $193 million, a decrease of 14%, again, in constant currency.

I'm delighted to report that in April, the first Boots franchise store opened in South Korea. This is in line with our strategy of expanding Boots retail presence in Asia. South Korea is a highly sophisticated beauty market, particularly for cosmetics. And it's strategically important for sourcing innovative beauty products.

So now let's look at our Pharmaceutical Wholesale division. Sales for the division were $5.3 billion, up 2.7% versus the same quarter last year on a constant currency basis. Comparable sales on a constant currency basis were up 3.7%. This was ahead of the company's estimated market growth weighted on the basis of country wholesale sales, with growth in emerging markets and the U.K., partially offset by challenging market conditions in Continental Europe.

Adjusted operating margin, which excludes ABC, was 2.9%, down 0.1 percentage points on a constant currency basis, but in line with the second quarter. Adjusted operating income was $253 million, up 53.1% in constant currency. Excluding adjusted equity earnings from ABC, adjusted operating income was up 0.6% in constant currency.

So turning next to capital allocation. Operating cash flow in the quarter was $1.9 billion. During the quarter, our working capital inflow was $502 million. This primarily reflected improvements in inventories, both in the quarter and year-on-year.

Cash capital expenditure in the quarter was $273 million. We continue to invest in our core customer proposition, including our stores and U.S. beauty program as well as the upgrades to our IT systems, which we have previously talked about. Overall, this resulted in free cash flow in the quarter of $1.6 billion with a total of $4.3 billion in the year-to-date.

Turning next to our guidance for fiscal 2017. We have raised the lower end of our guidance and now anticipate adjusted diluted net earnings per share to be in the range of $4.98 to $5.08. Remember, this guidance assumes current exchange rates remaining constant for the rest of the fiscal year.

I will now hand over to Stefano for his concluding comments.

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

Thank you, George. I will turn first to the new Rite Aid agreement, which we announced this morning. When we first began discussion with Rite Aid, it was with a vision of increasing our network and our population coverage. It quickly became clear that if we could start with the transaction appropriately, potentially greater benefit could begin by bringing the 2 entire companies together through an acquisition. However, given the changes in the market during the longer-than-expected Federal Trade Commission review process and the ongoing uncertainty about the potential outcome, we have decided, after detailed discussion with Rite Aid, not to continue to pursue the acquisition of the old company.

Instead, we have today announced the proposed purchase of 2,186 stores from Rite Aid, together with their warehouses and inventory to support those stores. While we are assuming the real estate obligation, we are not assuming any debt.

In addition, the deal is also expected to give significant cash tax benefit as we tax amortized the intangible assets we acquired. This transaction, though smaller than the original, is due to our original strategic aim and, I believe, simpler to deliver, both operationally and financially.

Overall, I view this deal as being more attractive than the transaction it replaces, recognizing that the adjustment and compromises that we have had to make since the original deal was announced in what continues to be a challenging market for pharmacy. We expect that this new smaller deal will deliver synergies in excess of $410 million per annum within 3 to 4 years of the initial closing and be modestly accretive to adjusted earning per shares in the first full year after the initial closing.

Importantly, the stores we are proposing to purchase are more than enough to create the potential opportunity for optimization of our expanded network and, in doing so, the opportunity to create greater efficiency above and beyond the synergies that the deal is expected to deliver.

In addition, the deal is structured in such a way as to offer opportunities for additional benefits over time.

In constructing this new agreement, we have endeavored to address all the substantive regulatory points raised about the original transaction. We believe that this will enable us to complete the transaction in a timely manner and drive forward with our plans to further grow our company.

I'm pleased to have, once again, being proved right in my firm belief that, as the English say, where there is a will, there is a way, that 2 willing partners can, despite adversity, find a deal that delivers true benefits for both. Given the significantly lower cost of the new transaction, I am pleased that today, we have been able also to keep our commitment to our investors that we will not maintain an inefficient balance sheet longer than is absolutely necessary. This is why we are planning to return the surplus cash that we are carrying on the balance sheet behind the debt that is required for the new proposed transaction to our shareholders through a new $5 billion share repurchase program. This is in addition to the $1 billion program, which we initiated and completed during our third quarter.

On completion of this new program, we will resume our regular reviews of capital deployment, design it to ensure that excess capital, where appropriate, is used as directly as possible to improve shareholder value.

Of course, today, our new proposed transaction with Rite Aid is not our only news. As George said, we have seen progress in many areas of our business in the quarter we are reviewing today. And this has been achieved in an environment when we have seen continued competitive pressures, challenging markets and regulatory uncertainty. Naturally, there is nothing new in these, but it means we must remain focused to ensure our business is meeting the needs of the market and to maintain our strong position.

We are working with our strategic partners to maximize our own role in the health care system, while, at the same time, providing the right services at the right price to support those partners in their task of staying efficient and relevant.

The merger that created Walgreens Boots Alliance and the subsequent restructuring and the realigning of business was an important step in the process. As we are coming to a successful conclusion of that process of transformation, we must look again at the company to understand and identify the next course for us to make sure the business is the right structure, shape and size and with the right skills (inaudible) truly the leader on the opportunities that change offers.

Our proposed transaction with Rite Aid would form a partner of this, but only part. We continue to see many opportunities, both inside the business and potentially outside with other strategic partners and other partnerships. We should be in no doubt that this is where my focus is. Working with my entire team to identify the next step for the business and ensuring whatever we do advances our place in the market is important for our customers and our strategic partner, delivers clear direction for our people and, of course, provides an attractive opportunity to deliver meaningful growth and create true value for our shareholders.

It is obvious to us that the pressures on health care, as a whole, and, by extension, pharmacy will continue. Within the health care market, we face a range of strong competitors. We each have our own business model. At times, that may give them certain advantages over us. But at other times, we believe it gives us meaningful strength and advantages over them.

Managing our company for growth in these markets is a core role of the executive team, and we are never complacent about our position in the market or the competition we face, current and potential.

Remember also that new participants in the market also provide the opportunity for new partnership and collaboration. Change brings opportunity as well as challenges. We continue to forge and strengthen strategic partnership that are delivering real benefits for our businesses today, especially in the U.S., where we are seeing volumes returning to our pharmacies and opportunities arising that enhance both our retail and health care offerings. This will open paths for us to new services with new sources of potential revenue and income over time.

So as you have heard, overall, we believe it has been a recent report where some progress have been made. As a result, we are raising the lower end of our guidance for the year, as a whole. We do, however, continue to experience some very challenging markets. And as I have said, we expect these challenges to continue and these may possibly get more difficult in the months and years to come.

We are completing a phase of our business where we were very much focused on driving the optimum benefit from the merger that created the Walgreens Boots Alliance. In this phase, we have delivered far more, both in terms of efficiencies and cost, than we had originally anticipated.

While we continue to carefully methodically work to drive efficiency and excellence across our business, we are beginning to look at the next phase of the evolution of our company. We believe this next phase will mainly be focused on Walgreens and on the structure and merchandising of our retail operation, which will be intended to deliver further savings and create real value from within the business.

Building on the sound corporate discipline we are exercising, the exceptional presence we have across the world and the ability that gives us to reach people at the time and place convenient to them, we have an excellent opportunity to be a cornerstone in the health care system we work within and a cornerstone of the communities we serve.

As you have heard from George, we have opened our first Boots franchise stores in South Korea, and we continue to look to expand the geographic presence of our business, including increasing our presence in Asia, particularly China, with more of a focus on retail in these markets than we have had up to now.

It is all too easy to allow the reasonable and important focus on quarterly performance as a measure of progress to distract us from our longer-term opportunities. But I am confident in my belief that the challenges we face along the way are more stepping stones than obstacles to the longer-term growth of our company in the months and years ahead.

I will now hand you over to Gerald, so that we can answer any questions you may have. Thank you. Now I will hand you back to Gerald.

Gerald Gradwell

Thank you, Stefano. I'd now like to ask Candace, our operator, to open the lines for questions, please.

QUESTIONS AND ANSWERS

Operator

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

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

This is Elizabeth Anderson in for Ross today. I was wondering -- congratulations on the deal that you announced today. And I was just wondering if you could talk about, one, the -- sort of the profit profile of some of the stores that you are looking to acquire and the attraction of that subcategory of stores. And then, two, more generally speaking, could you talk a little bit more about some of the additional partnerships you guys have been considering and sort of the assets that you guys bring to the table and what sort of things you think might be particularly helpful?

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

Elizabeth, it's Alex here. The profit profile, first of all, of the stores we're acquiring is more or less the average profile of Rite Aid, maybe slightly less, but more or less the same and also the same investment profile. You know that Rite Aid had been investing well in their wellness format. And again, these stores have got the same profile as the stores that we're retaining. So we feel pretty good about that. And they're mainly doing filling in the Northeast, the Mid-Atlantic and the Southern Eastern regions to give us more presence in these regions and to -- and pretty obviously, the service of Walgreens over time can get to customers and patients in these areas. So we feel good about that core of stores we're acquiring. We think they are good value for us and it will really, really improve our network, particularly in the regions that I mentioned. In terms of partnerships, I think we -- you also yesterday saw we announced our partnership with LabCorp, which we're really, really pleased with, 7 store trial called LabCorp at Walgreens. And it adds on to the partnerships that we've announced in the past, particularly with clinics across the many health care systems in the U.S. And how we see this working both from a space usage point of view, a convenience being coursed through our pharmacy and then linking into the various IT systems and technologies that we have, we really see this will drive not just cost reduction for us, but real convenience and access for customers and, ultimately, of course, more volume prescriptions for us over time and more health care and pharmacy services. So this -- we've made good progress in the last couple of years with the strategy. There's more to come. And as long as it fits from a customer point of view next to our pharmacy and as long as it makes sense to reduce the cost in the health care system, we will continue to test and trial and roll out these services.

Gerald Gradwell

We would just ask the questioners, please, to ask their questions loudly and clearly. We're in quite a big room. And so also forgive us if we have to ask you to repeat it if we didn't catch it the first time around.

Operator

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

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

So Stefano, you talked about looking at kind of the next phase of the evolution of the company. And it sounds like partially, it's focused on the retail side and merchandising, but also on the health care side. Can you talk a little bit about or give us more color on how you think of expanding Walgreens' role in the delivery of health care? And are you thinking about it from a partnership model similar to what your saw with LabCorp what you announced with LabCorp yesterday? Or are you also kind of considering opportunities where you can deploy capital, especially when we think about kind of like the whole concept of vertical integration that's discussed in the marketplace?

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

Well, I have spoken of a second phase of development in our company. We see when we merged, of course, our focus was on synergies, our focus was on cutting cost. And as you have seen, we have been consistent with what we were saying. And we have really achieved the level of synergies and the level of cost reductions substantially earlier than promised. And at the end of this year, we will have, for sure, a better numbers than we -- even we, we weren't expecting. So now as I said many times, the integration of the company and the improvement of a new company goes through different phases. Now we have done the first phase. And we have other phases. And in each phase, we will be able to reduce cost and probably to find additional synergies. We have -- for the time being, we have rationalized the company. We have gone through the most evident cost reduction that we could see. We have improved our procurement. And we have tried to buy back or to exploit all the possibilities that we had due to our scale and our geographic expansion. And now we have to go back and refine the work that we have done. And of course, now our focus will be mainly on Walgreens and mainly on the stores. Of course, we have done important things in the stores. We have improved the supply chains. We have changed -- or started to change the mindset of people, focusing more on the customers. We have started to collect information and data on our customers in order to understand better what they wanted and what we could do for them. And now it's time to put all these things together and to reorganize our stores in that direction. We have to understand exactly which kind of categories are really of interest for our customers because it's not particularly useful to us a bit of everything if people are not really appreciating it. And so we said that we are really focusing more on beauty -- on health and beauty, particularly. And so we have started -- as you have seen, we have started to roll out more products. We have started to test many models. But now it's time to really go back and really put in act -- put in the stores, so all the experience that we have done in these 2 years. And this will be the focus of the second phase of the development. Part of this, for sure, is the logic of having other players with us in our stores because we have space. We will get more space with the rationalization of the stores and we have to use this space for -- trying to give a better experience to our customers. And so you know that we are trialing many different partnerships. And most of those trials have been successful and we have to hold them out over time. The combination of these 2 things will give a new look to our stores, which is what we need and what we had really -- what was really in our strategy from the very first moment. But we had to create the platform, the basis in order to build this transformation of the stores. And after we will have another phase, so a third phase, which will be based on technology. We are making big investments, big efforts in updating -- upgrading our technology. We will have a completely new system in a few years, maybe a few years in the next, I would say, many months. And at that point, we would be able to make another jump in the organization of our stores, and this will be the third phase. This is exactly what we told you, I would say, from the very beginning or at least in the last 2 years. And this is the program that we are following. Alex, do you want to add something?

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

No, I think it's really clear, Stefano. Just one add is that's -- I think it was mentioned in the prepared remarks. We're really moving into a phase beyond the beauty differentiation phase of simplifying our offer, the core offer and we're trying to roll out into -- up to 1,000 stores by the end of this year. So it's another important step in the phase 2 Stefano described. So this is very active. It's very real in the business. And we continue to drive that model forward. And the idea of this one really is to simplify these stores and specially extend that customers can find products more easily. And we can edit the products on their behalf using the data that we have been collecting in the last 3 or 4 years. So we're not slowing down here. We're actually speeding up, as the main point I want to add to Stefano's description of the activity.

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

Just one follow-up on the guide, one is for the guide for the rest of the year and the other one within the context of this comment. How should we think about the growth algorithm going forward? So for the guide for the remaining quarter, does the increased guidance include the buyback program? And are you going to see any benefit from taxes next quarter? And then when we think kind of like longer term to '18 and beyond, do you think that given kind of like the competitive environment in the marketplace, but also your efforts to kind of like simplify the offering and sounds like potentially maybe narrowing the SKUs, do you think that you can sustain double-digit EPS growth now that you know what the Rite Aid deal would look like?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

Okay, I'll try and take some of those in the right order. If I start, perhaps, with just the tax, as I said in the prepared comments, the core tax rate was 25.3%. And then this quarter, if you look back historically, we had a relatively high number of discrete positives, clearly, very significantly quarter-by-quarter, as you can see going back historically. And as I say, you can see this was a relatively high number. But I think in terms of the core tax rate and helping with the model, the 25.3% that you see today is clearly under U.S. GAAP, the rate that we would anticipate at this point for the core tax element for the full year. Just in terms of buyback program, clearly, we've announced the program just today. And I think -- and just in thinking about modeling, clearly, we're pretty well the end of June now, so we've really only got a couple of months to go to the year-end. So there's not really long for any impact if where we to choose to commence that program. Any impact will be relatively modest. Obviously, our guidance as ever is all in. But again, as I said in my prepared comments, it is, of course, assuming current exchange rates for the balance of the fiscal year.

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

This is Alex. We are confident from an operational point of view that we can get to that number at the end of the year and continue to drive the strategy that this creates clearly. So the -- you'll see through our numbers the volume in pharmacy continues to be as we expect it, strong as the partnerships. And we've made a slight improvement. But importantly, the underlying sales growth in the front end and the margin in the front end continues to be accretive year-on-year. And cost control is good. So we remain confident that we can get that done.

Gerald Gradwell

If I could just, again, ask people to speak up and speak clearly when they're asking the questions. We can't answer questions we can't hear properly.

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

I would add -- sorry, I would add something. What we are trying to do at the end, we said from the very beginning, our aim is to keep the adjusted operating margin as healthy as possible. And you have seen that in spite of all the difficulties of the market over the last years, we have been successful in doing that. And we hope that we will continue to be able to do this. There are many ways in which you can drive the numbers and the success of the company. And we are really focused on this metric. We know that there are always additional opportunities, to buy back additional opportunities to be more efficient, not just to cut cost for the sake of cutting cost, but to be more efficient. And so we accept that the market is a very challenging market. We have worked in challenging market for decades. So we know that this will be our environment in future. And as we have done for the past, we will really strive to compensate and to be -- and to respond to the challenges of the market through other actions that we can implement, and we have always implemented successfully.

Operator

And our next question comes from Lisa Gill of JPMorgan.

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

Stefano, you talked about challenges and opportunities and talked about different new partnerships that will come about. Obviously, there's been a lot of talk about Amazon and then potentially getting in to the pharmacy market. Do you read that as potential opportunity to Walgreens or a potential challenge as we move forward?

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

Well, let's say that I see everything as an opportunity and not because I am an optimist, but just because we have demonstrated in the past that we can survive in any environment. Having said so, honestly, I don't believe that Amazon will be interested in the near future, in the next few years in this market because they have so many opportunities around the world and in many other categories, which are much, much simpler than health care, which is a very regulated business. And also it's a business, which -- where -- an industry where the consolidation has been really quite significative. So there is not a lot of new things that they could do. Of course, they could, but not so many as they could do in other markets. So as they are a very good team and very rational team, I believe that at the end, this will be -- will not be their priority. Having said so, if we were wrong and our belief was wrong, I believe that at the end of the day, we could find our role in the new environment. We wouldn't exclude to partner with them. We wouldn't exclude to analyze the new situation of the market and to find our place, adopting ourselves. So honestly, I have seen the emotional reaction about the move that Amazon has done with Whole Foods, but I have found this reaction, as I said, emotional. And with all due respect, not rational because if you analyze the things coldly, you will see that this is not the best opportunity for Amazon. And you would see that the market has changed so many times in the past, and the big players in this market have survived. So it's been a lot. We will try to survive in any case.

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

That's great. And then my second follow-up, and I agree with you and I think that a lot of prescriptions filled today are Medicare Part D. and I think that's where my follow-up question is for Alex. As we think about bringing on the new 2,186 stores from Rite Aid, does that help to strengthen any of your Part D preferred networks, number one? And number two, I know it's really early to think about Part D networks, as I'm sure the negotiations are going on right now, but do you anticipate many changes for 2018?

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

Frankly, I'll say yes. And I think, clearly, having more pharmacies in certain markets will drive access for Medicare D for sure, and that's something that we contemplated in terms of the partnerships we have. So it makes us slightly more attractive. I don't think it fundamentally changes the prices paid, to be honest. It just makes us more attractive in certain markets also on health. In terms of market itself, we continue to have strong partnerships, where you see that much of our volume beyond the new partnerships with Prime and Express Scripts have been driven by Med D this year. And we continue to operate well in that market with a target from 3 or 4 years ago. There has been some changes and that will continue to occur and will continue to govern these changes properly to make sure that we are paying within the prices that, we think, is right for the service that we provide. So we remain very confident about our position in the marketplace, very confident about the prices we have and continue to govern what we get paid as best we can under the investment pressure, as Stefano has described.

Operator

And our next question comes from Michael Cherny of UBS.

Michael Aaron Cherny - *UBS Investment Bank, Research Division - Executive Director and Healthcare Technology and Distribution Analyst*

So I want to dive a little bit into further the U.S. Retail Pharmacy gross profit. As you think going forward, you talked about the reimbursement pressures. Can you maybe just qualitatively give some sense of what could be some positive contributors to gross profit dollar growth within U.S. Retail Pharmacy? And then versus the reimbursement change we have now, what could be some additional headwinds that you could expect to see, I guess, over the next 1, 2, 3, maybe 5 years even?

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

I think we -- it's Alex here. So I think as George said in his prepared remarks, we're in the early stages of our new relationship with Rx Alliance Walgreens Prime, and that will be accretive in terms of dollars over time. Although as we all know, specialty is a high-sales and lower-percent-margin business, but that will be accretive. And it's a very important market in the U.S., and we're pleased with the progress made although it's very early days in this partnership. But you would've noted that we were able to do an FEP contract as one example of the attractiveness of this new model in the marketplace. In terms of other gross dollar opportunities going forward, it is more difficult to see in the network side at this stage. To be honest, there's more headwinds, as you can see in the Retail Pharmacy gross profit. As Stefano said quite clearly, we're used to living with these headwinds, and our strategy here has been very clearly to do 3 things: One is to increase our volume to make better use of our network. Secondly is to improve our buying capability, which again, you can see very clearly. And also thirdly is to really make sure that we work with other health care services to improve the overall gross profit dollars we've got. And the major aim of all of these activities is to make sure that we focus on the bottom line. The operating profit at the end of the day is, I think, is the most important to us. So that's how we see it, and I think we see that continued pressure, more headwinds and tailwinds. And we continue to work all these levers to improve our operating profit. You've seen in this quarter, we improved operating profit in the U.S. by [26%] as, I think, is one example of it.

Operator

And our next question comes from Steven Valiquette of Bank of America Merrill Lynch.

Steven J. James Valiquette - *BofA Merrill Lynch, Research Division - MD*

Congrats on the new deal with Rite Aid. So I guess just given the lengthy FTC (inaudible)

Gerald Gradwell

Hello, Steven?

Operator

And our next question...

Steven J. James Valiquette - *BofA Merrill Lynch, Research Division - MD*

Can you hear me?

Gerald Gradwell

Ah, back.

Steven J. James Valiquette - *BofA Merrill Lynch, Research Division - MD*

Sorry. Bit of phone issue there. Sorry. Just congrats on the new deal with Rite Aid. A quick question really, just simply, is just given the lengthy FTC review of the original proposed Rite Aid merger, it's safe to say that you're now obviously pretty familiar with the specific hot-button topics at the FTC. But when you do look at the store maps in the Rite Aid slides, it does look like the stores you're trying to buy do still seem to have a decent amount of overlap with existing Walgreens stores, at least on a state-by-state basis. So I guess I'm just trying to think here. Should we assume that the new plan takes into account feedback from the FTC such that you're highly confident in a shorter FTC review for the new asset purchase? Or could this still be a battle with the FTC even for the new plan?

Gerald Gradwell

We actually have (inaudible) our Counsel, internal General Counsel here, who might answer that. Marco?

Marco Patrick Anthony Pagni - *Walgreens Boots Alliance, Inc. - Global Chief Administrative Officer, EVP and General Counsel*

We should assume that we have taken account of specific feedback from the agency that we've received over the last 22-odd months in formulating the store package that have agreed with Rite Aid. And -- but beyond that, I wouldn't care to express any level of confidence one way or another as to how the transaction will proceed. Obviously, the matter is before the regulator, but I can tell you that we have designed it in a way, which has been very carefully thought through with Rite Aid and with our counsel to take account of all the feedback that we received during the last 22 months in a very detailed, very detailed, review process.

Gerald Gradwell

Alex, do you want to comment on the question of the overlap and -- or whatever else?

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

Yes, as I said before, operationally, we really like the spread of these stores. They really give a -- we get in some new markets locally, we are able to really intensify our presence for patients and customers in these markets. And of course, once we get into the next phase, we'll understand more how we can really operationalize and make the whole areas more efficient. But I think we are pleased operationally with the coverage in these new markets.

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

As we said -- Stefano here. As we said, initially, we were thinking of buying certain stores. And after discussing with -- I did. I am talking of 2 years ago, of course. We decided that the best outcome for both company was to go to a merger. And we were thinking at that time, of course following the advice of the specialists, that the merger could go through without major, major issues. This has not been the case. At that point -- -- at a certain point, we're able to structure the deal in order to address some concerns of the FTC. Also, this new deal has taken, as you have seen, a lot of time. And at a certain point, we have decided, together with Rite Aid, to go back to the old idea and to buy a certain number of stores. Of course, in doing that, we have to take into account the needs of both companies. Because if Rite Aid said -- decide to sell certain stores, they have to do it in a way that the remaining company can be efficient and can overall take into account the money that they will receive. Overall, it can be better than before. And from our side, we have to buy those stores which are filling certain gap that we have in our network and, in other cases, are strengthen our position in other states. So this has been a thoughtful, let's say, deal, as Marco said, taking into account all the objections that we could imagine from the FTC, this is just an asset deal, but also taking into account the -- our needs and the needs of Rite Aid, because they have to come out from this deal as a stronger company. And we have selected a cluster of stores in certain states where we needed them. But we could not really cover all of our gap because these would have left Rite Aid in a situation which, operationally, will not be particularly efficient. So this is really the best possible deal between our 2 companies. And I strongly believe, strongly believe that this is a deal, which is very good for us. Because we get probably 70%, 80% of what we wanted as national coverage and is very good for Rite Aid because they come out from this deal as a stronger company and with a company which can be very efficient operationally.

Operator

And the next question comes from Charles Rhyee of Cowen and Company.

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

Just curious about also, just staying with the FTC issue and in terms of some of the concerns they might have had leading up to today's announcement. I understand what you're saying in terms -- that this is more of a simple asset deal. But if I must -- you've giving them an option to buy generic drugs through WBAD, and it looks like from the Rite Aid slides for a period of 10 years. Can you talk about how the FTC might view that kind of more strategic alliance on the purchasing side? And do you think that perhaps presents a different kind of hindrance?

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

Marco?

Marco Patrick Anthony Pagni - *Walgreens Boots Alliance, Inc. - Global Chief Administrative Officer, EVP and General Counsel*

Yes, Charles, it's Marco Pagni again. We're not able to comment on how the FTC may or may not see any particular facet of this transaction. But I would say is that it's important that the Rite Aid, going forward, be competitive in the market. And clearly, it's option to join our procurement vehicle, WBAD, will help it with its cost of goods going forward, which we believe is important for its competitive position in the market. And I express no view as to how the FTC will see that, but one could imagine that, that might be important through.

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

And in any case, in any case, it's an option. So they can exercise it or not. So it's not a mandatory part of the deal.

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

Great. And if I could just follow up one other question with Alex. You talked in the beginning about stores with the new beauty differentiation having -- doing better. Can you give us a sense in terms of comparison to the stores that have not had the restructuring in that sense, what the differential in performance might be?

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

Alex?

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

Charles, yes. No, I think as we see, they're doing markedly better, particularly, we expect, in beauty. And it's definitely driving the beauty category very well in these stores. So we are pleased with the performance of beauty. It's really coming through quite strongly. You could imagine that beauty is still a relatively, I wouldn't say small, but it's not as big a part of our business, for example, as the consumable side of our business, where we are continuing to refocus on more profitable promotions and refocus on seasonal lines, which end-to-end actually was just money taken out from our ranges. So I think you have to look at the whole mix. So we are very confident. That's why we're rolling it to another 1,000 stores. We're also very confident in our partnerships with other companies. So for example, NYX has been rolled out. It's a L'Oreal brand. It's a very good brand rolling out as well into the beauty differentiated stores. And we continue to see a lot of customers setting up to Beauty Enthusiast cards. So again, it's the whole model that's driving forward, and we continue to see the growth coming in beauty that we had hoped to see. So that's where we are. And I think obviously, we'll have more news as we get deeper into the States and as we get more brands and more beauty customers getting more interested in doing more of their beauty shopping in Walgreens.

Operator

And our next question comes from Eric Percher of Barclays.

Eric R. Percher - *Barclays PLC, Research Division - Senior Analyst*

Stefano, I want to return to your comment on this transaction being more attractive than the original deal. If we look at the cost per store, it's much lower. That would seem to be a clear benefit, the amount of debt you'll issue. I'd be curious to what extent, the fact that you have lower leverage and your ability to execute on the strategies that come next plays a role in that observation that it's more attractive? And then last, as we look at -- I think you said recently 70% to 80% of national coverage, how much of the benefit is achieved via coverage and the ability to offer your partners more coverage versus the density needed to obtain operating efficiencies and synergies from the stores?

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

Well, on the deal, yes, I said that this is a more attractive deal, not because the other deals were bad. The other deal were good. We believed in the other deal. But of course, after we had to make a lot of compromises. And the at the end of the day, the deal were different from the deals that we had in mind. So this deal, it's much simpler. It's an asset deal, so it's less controversial, much less controversial. We don't take practically any liability. You can imagine that as part of the deal we have the stock and we have the tax savings that we will find amortizing the goodwill at least cash-wise. If you think that the amortization of the goodwill is on 2,200 pharmacies practically, and the inventory is on 2,200 pharmacies plus 3 quite big warehouses, you will see that we have a strong cash element in this deal already there. So it's clear that economically and thinking of the IRR, this deal, it's very good. On the other side, this is not a bad deal, I believe, not at all. It's a good deal also for Rite Aid because at the end, we don't have to give any part of the value to third parties. So in reality, the 2 parties are better off. And about our coverage, well, it's very important that we have a complete coverage. We were relatively weak on the East Coast. So this was our main objective, particularly on the Northeast, because it's a very rich region, and it's a region where it's relatively easy to work. So this was our main thoughts. Would we like to have a few hundred stores more on

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the West Coast, on the West? Yes, of course. We would like it even though we are present there. We -- but there are certain spots of southern California and maybe the state of Washington where we would like to have more stores. But at the end of the day, our presence there is already better than the presence that we have in the Northeast. So if we had to choose, by far, we prefer to be stronger now and very present in the Northeast even because, as you know, California is not an easy state for us and for everybody to work in the health care. So I believe that we are very happy with what we have achieved. And it's important that we have this coverage because it's important to be able to offer a wide coverage to our customers. And it's also important for us because we have a better basis to amortize our cost, and we have a better basis to sell our products. Alex?

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

Yes. On this point of coverage, the operating efficiencies, there's both, I mean, but I would say there's probably more on the operating efficiencies side. Again, if you think of all we've achieved with Walgreens and also think of the ambition, as Stefano described very well in an earlier question, to simplify and make the front end more efficient and more differentiated, once we have done that in the first phase of IT simplicity, we'll be able to plug in all these stores into that platform. So I think it all add to go up the operating efficiency probably be more than the coverage site in reality.

Eric R. Percher - *Barclays PLC, Research Division - Senior Analyst*

So that said, George, I'm surprised there's not more than modest accretion. Are you assuming any inventory write-downs or other elements that will weigh on that? And how should we think about the synergy buckets here?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

I think in terms of accretion, what we said is modest accretion in the first full year. And I think that's important to take away. And we're very clear on the synergies that we can deliver, of the $400 million over the 3 to 4 years. We've got a very clear path to delivering it. I think one of our approaches to acquisition integration is one where we have very detailed plans. We take it in a very structured way so that we do things smoothly. We are going to be, obviously, actually acquiring those stores over a period of time, as we've explained in the announcement. And then we will be rebranding those over time to Walgreens, bringing the Walgreens offer. And that is not something that we would ever dream of actually big banging. We need to do it properly so that we have the customer proposition as delivered in a consistent way as we do the rebranding. So we're very confident about the returns. But what's important is to go in a straight line and do it in a way where we keep the focus on the customer as we integrate the business and the service that we provide our patients rather than sometimes, what you see, dare I say, I see other businesses do, where they rush things and they don't execute properly. And I think you'll have seen that consistently, as with the merger of Walgreens and Alliance Boots, I think you'll see we've got a very clear track record of doing that over time.

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

And you'll see the main important thing, looking at the accretion, is that we will ramp up over time the transfer of the stores. And in the first year, we will have -- it will be the, at a certain extent, the most complicated year, because we will have to start to do this transfer. And we have said that the transfer will take a certain -- probably 2, 3 years. It cannot -- if we want to do it in an orderly fashion, if we want to do it without disruption, if we want to keep the value what at the end, we will have both, we have to do -- align that. On the synergies, we have said that we would have at least $400 million of synergies. Of course, as you know, and as we have always done in the past, we -- when we give a number for the synergies, we take into account all the elements we are practically sure or we're very confident. But over time, the experience tells us that we find other synergies. And as you have seen, we have in the past, at least we have exceeded what we were expecting because we cannot see all the potential synergies today until we don't understand exactly the nature of the stores that we will have bought. Remember that for the time being, we don't have the full set of numbers about -- on those stores. And so we cannot see exactly which kind of synergies we can achieve. And we have just taken the basic synergies we are quite confident about.

Operator

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

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

Alex, just wanted to go back to the U.S. business, and I know this is the same case last quarter. But can you just help us understand a little bit better how despite the really strong script growth you've seen in the last 2 quarters, that gross profit dollars were actually down again in the U.S. business? And I guess more importantly, is there a time table that you're thinking about as for as an inflection in gross profit dollar growth in the U.S. business?

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

Robert, it's Alex here. Yes, I think of the drop year-on-year, as George said in his prepared remarks, about 100 basis points, which were in specialty. So for the trend on the 2 quarters, as you pointed out, it's about the same, a little bit of worsening but not significantly worse. And as I said already in an earlier remark, we are really focused on operating margin. So therefore, we drive operating margin by driving volume through the fixed -- the primarily fixed cost base. And again, I want to -- a big call out to our teams who've handled that volume. And the cost base as you see has been almost flat in reality, giving you 6% more growth in the U.S.A. this quarter. So I think that's the model that we spoke about before. That's the model we've been executing, recognizing, as we said consistently, the reimbursement pressure is real. And what's driving really is market conditions, the consolidation really of the PBMs in particular, the downward pressure on pricing. And that's a real effect that we're seeing with less inflation on branded drugs. And that's clearly a feature of the marketplace this year in particular, and we continue to see that going forward. Now we're used to this, as Stefano said. And we're used to managing it in a certain way, and we're pleased with the progress of cost of goods for WBAD. Our organization continues to perform well for us, and we've set a new partnership there with Express announced in May. We continued to work on the cost base and the structure of the company. And as Stefano said already, we're moving into phase 2 there, and we have more opportunity there. And we continue to work in partnership to make sure that we get the volume into that fixed cost base in the future. So that's our focus. It would be wrong of me to tell you that I see a time in the future when I see that reimbursement pressure going away from these current levels in the market -- as the market. And we're operating to -- in an effective way within that marketplace.

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

Okay. That's fair. And then I guess, George, if you look at where the company will be post this transaction, I think it looks like maybe somewhere in the 3.5x leverage range on a rent-adjusted basis is -- factoring the buyback as well. Can you just maybe share what the long-term leverage target is that you're comfortable with post the transaction?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

We've not published our long-term leverage target. We've chosen, as you know, Robert, to talk about our commitment to solid investment grade. And that's very much what our policy is. We've obviously -- because of the time it's taken since the original announcement of the original Rite Aid transaction, we've obviously been building up a lot of cash, which is not something that we like doing. We're very committed to having an efficient balance sheet. We've had to do that. And that's why today, when we've got the -- we've announced the new transaction, we've (inaudible) the $5 billion share buyback program. So we're very committed to being financially disciplined to -- when we're looking at M&A, we're always very focused on the numbers. If the numbers don't add up, don't give out -- don't meet our investment hurdles, then we're very disciplined. We don't do transactions. And so we're very happy to grow organically and invest where -- to do M&A when we get the right returns. But equally, a every clear policy of returning any surplus funds to shareholders within those parameters that I've explained, having an efficient balance sheet very important to us.

Operator

And our next question comes from Brian Tanquilut of Jefferies.

Bryan William Ross - *Jefferies LLC, Research Division - Equity Associate*

This is Bryan Ross on for Brian Tanquilut. Congrats on the record script growth again for the second consecutive quarter. And my question is more, when you're looking at these Retail Pharmacy contracts and networks as they come up, and keeping in mind your goal to continue boosting volume through the stores, do you get the sense that conversation with health plans and players are shifting more to these preferred networks, like Prime and TRICARE? And are you actively pursuing these type of networks moving forward?

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

Bryan, it's Alex. I will say it's mixed. I mean, I think -- so first of all, nothing's fundamentally changed year-on-year in the marketplace from what we're seeing. Some peers prefer preferred networks, and some prefer to have open access across the networks. So I don't think there's anything fundamentally changing. There's certainly a trend towards more preferred networks over time, but that's not accelerated or decelerated. And we are in the marketplace. We look at every partnership to understand what the payer requires of us and what we can bring to them. And then we work out through the government processes, which are very tight in the business, what is it that we expect to be paid in the current marketplace for the services that we provide. So we -- that's how we see it, and it's a very active for us. It's very important part of our business, and we try very deeply to understand what the marketplace and what our peers want from us. And then we're not trying to drive in any direction. We try and drive customer care and access, and that sets really into our strategy.

Operator

And our next question comes from Scott Mushkin of Wolfe Research.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*

I just wanted to poke on a couple of things. Actually, I want a clarification, and then I want to poke on a couple of things. So I think it was referenced that there was a change in a postretirement benefit, the benefited costs. If you guys could tell us how much that was and then whether that's onetime, that would be really helpful.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

I'll try and answer. Yes, the postretirement changes is one of a number of changes that we're doing as we look to make sure that we have a clear remuneration policy that for all our employees. And this was the change that affected a relatively small population of employees. So it's really part of an ongoing program. We're very focused on all aspects of compensation as well as all aspects of our cost base. You'll see when the Q comes out later today that there is a change in the provision of $109 million. So you we'll see that number in the detail of the Q.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*

So $109 million, is that ongoing? Or is that a onetime benefit to the quarter?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Global CFO and EVP*

There's a $109 million change in the provision. But clearly, in terms of the benefit going forward, there will be a benefit going forward in relation to this. But clearly, yes, we've been doing a lot of work on looking at our base remuneration for our employees in our stores. So we're seeing rising costs in those areas for all the right reasons.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*

Okay. Then the second thing I wanted to talk about, obviously, with the deal that's been announced. I was just going through some of the HHI analysis from back when you guys did the original deal, and just kind of curious, I guess. Salisbury, Maryland, the HHI index goes almost close to 4,000. And I assume that's maybe in one of the markets. I mean, there's other markets that jump well into the 3s. I'm just trying to get my arms around why this isn't going to be a problem. It seems to me a lot of these markets, you look at Buffalo, New York, you look at some of these markets, the HHI index has gone really high.

Marco Patrick Anthony Pagni - *Walgreens Boots Alliance, Inc. - Global Chief Administrative Officer, EVP and General Counsel*

Yes. Scott. It's Marco again. I mean HHI Index, Herfindahl indexes are pretty old technology for the FTC. So I'm not sure they're particularly focused on that as a measure at all. As I said before, we spent 22 months with the agency. We've pretty clear idea as to where they're concerned about overlaps and where they're not.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*

So like a (inaudible), where you're going to be 50% share, they're not concerned on that?

Marco Patrick Anthony Pagni - *Walgreens Boots Alliance, Inc. - Global Chief Administrative Officer, EVP and General Counsel*

As I said, Scott, we're pretty sure that we understand where they're concerned and where they're not.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*

Okay. Then my final question just has to do with something that came up earlier in the call, just in transitioning from kind of streamlining the operation to kind of transforming it and then looking at the pressure on gross profit dollars. How should we look at your earnings or your EBIT algorithm in the U.S. as we move out over the next year or 2? I mean, it seems like it's going to struggle to grow. But I wanted to get your take on that, and then I'll yield.

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

Well, as we have said many, many times, we are not living in an environment where we will see a lot of growth, and particularly where we will see margin going -- gross margin going up. We accept this, and we work on other part of the business, on other elements of the profit and loss in order to compensate for it. This is what we are trying to do, what we have done and what we will continue to do. So if you want to say that there are in these market, in these markets, certain headwinds, of course there are. But this is the nature of the business, and we have to cope with it, and we have to work on the elements that are available to us and the levers that are available to us to compensate for it, which we have done until now and I -- we continue to do.

Operator

Your next question comes from Alvin Concepcion of Citi.

Alvin C Concepcion - *Citigroup Inc, Research Division - VP and Senior Analyst*

I know earlier you had talked about the deal closing a lot of gaps in your coverage. But do you have plans to divest or close any of those stores you're planning to acquire to improve the efficiency of stores where there is significant overlap?

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

Listen, when we will see exactly the situation of the -- of each store, we will take the decision what to do. What is important to say is that in our -- in what we have said in the $400 million of synergies that we have given you, we have not taken into account the benefit that we could have from the rationalization of the network. Something will be there, for sure, but we cannot give you an indication because we need to see the details of each single store. Alex?

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

That's right, Stefano. So I think there's nothing in the plan to do rationalization. But obviously, we'll study the situation very carefully when we get to that point in the process, and then we'll update you. That -- it's as simple as that, in the works. We understand that model very well from within Walgreens where we have -- we've been rationalizing some stories in some markets. We have a very clear model we use to assess the opportunity.

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

And in any case, this will be a plus of the deal. For the time being, we are not taking it into our numbers. We will see as soon as we will be able to take a decision, to take a thoughtful decision.

Gerald Gradwell

Thank you. We probably have time for one more question. Thank you.

Operator

And our final question comes from the line of John Heinbockel of Guggenheim Securities.

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

So I guess for Alex, the simplification program, if you can dive into that a little bit more deeply. Is that solely SKU rationalization? Is it also process improvement, labor hours? And then as it relates to SKU rationalization, is the idea that on certain -- take food, for example, that you cut back more deeply in something that's more convenience-driven, right, that you're not necessarily known for? Is that a bigger target than I imagine it would be than OTC, HBA, those core categories?

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

Thanks, John. No, I think -- again, we're very (inaudible) that as we have the data now for 4 to 5 years of what's in customers' baskets. And we're using that data to understand exactly where we should cut the tail. And the stores we're going to, first of all, are our lowest-volume stores that we're looking at from a very local point of view. So that's the first thing I would say. The second thing I would say about this is that really is about taking the workload out of our stores so that our colleagues can spend more time with customers and reduce, of course, store hours as appropriate with the workload (inaudible). We have a very, very complicated operating model, very many -- a lot of -- many promotions, which in these less-intense stores don't sell. They're causing a lot of excess working capital and sometimes loss in the business as well. So the focus really is simply all on making it so easy to shop, make it clear to shop, reducing workloads and making sure there's more hours available within that store for customer care. And we're going to the first 1,500 stores having done some test and trials, because these are the stores where there is least risk to sales. And what's more, we can learn as we accelerate that process going forward.

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

And then just as a follow-up to that, you talked about -- the format is obviously very promotional. So what would you like to do over time? Would you like to dial back the promotions? I don't know if the format will ever work in a quasi [edop] approach, but dial back the promotions. And then if you think about personalizing circulars, what does that do to the ebbs and flows of product demand? Would that help you with respect to taking out or just moving out labor in the stores?

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

Yes, I think, as I've said, I go back to the point that it's very promotional, far too promotional. We don't think it's good for us. It's not good for customers, and we don't think it actually good for suppliers either. So we believe much more in a consumption-driven model, and that's where we're heading to. Also, as customers change, more and more in the future, we'll use personalization and digital marketing more than the circular to understand what Walgreens can do for them. And we've got a mature digital organization for a retailer, as you know. And we're making moves now to really shift the spend over time in marketing towards digital and personalization. So all these things are true, John. And it's an evolution of the model, and we're really accelerating it, but based on fact, based on data, and we're really making strong moves in the next 18 months, as Stefano said, to do that. And then we have the systems coming in, in phase 3 to really sustain that move and accelerate it further. So we've been running for 2 or 3 years. We're very confident that we know (inaudible) what we have to do, and we're now taking the steps to get on with it.

Gerald Gradwell

Thank you. And that's all the time we have for. So thank you very much, indeed, for everyone participating. Obviously, if there are any further questions, I know we didn't have time to address all the questions, the IR team are round and about and available. And please bear with us if it takes a little while to get back to you. We do have quite a lot of questions already queued up to get through. So -- but thank you very much indeed, and we look forward to speaking to you all again with our full year, our fourth quarter. Thank you.

Operator

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