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WBA - Q3 2016 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 3Q16 net sales of $29.5b, GAAP net earnings attributable to Co. of $1.1b and diluted EPS of $1.01. Expects FY16 adjusted EPS to be $4.45-4.55.

CORPORATE PARTICIPANTS

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

Alex Gourlay *Walgreens Boots Alliance, Inc. - Co-COO*

CONFERENCE CALL PARTICIPANTS

Steven Valiquette *UBS - Analyst*

Lisa Gill *JPMorgan - Analyst*

Robert Jones *Goldman Sachs - Analyst*

George Hill *Deutsche Bank - Analyst*

Mark Rosenblum *Morgan Stanley - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for standing by. Welcome to the Walgreens Boot Alliance Inc. third-quarter 2016 earning conference call.

(Operator Instructions)

As a reminder, this conference is being recorded. Now I will hand the conference over to Gerald Gradwell, Senior Vice President of Investor Relations and Special Projects. Sir, you have the floor.

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

Thank you. Hello, everyone, and thank you for joining us today. Welcome to our FY16 third-quarter earnings call. Stefano Pessina, our Executive Vice President and Chief Executive Officer; and George Fairweather, Executive Vice President and Global Chief Financial Officer, will take you through our results today. Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance, is also joining us on the call and will be available for questions.

You can find a link on our to our webcast on our investor relations website at investor.WalgreensBootsAlliance.com. After the call this presentation and webcast will be archived on our website for 12 months.

Certain statements and projections of future results made in this presentation constitute forward-looking statements and are based on our current market competitive and regulatory expectations and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by the law, we undertake no obligation to update publicly any forward-looking statements after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. Please see our latest form 10-K and subsequent filings 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 of the presentation material available on our investor relations website for reconciliations to the most directly comparable GAAP financial measures and related information.

With that, I will turn the call over to Stefano.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

Thank you, Gerald. As you can see from our results, I am pleased to announce that we have delivered another solid performance, with adjusted earnings per share of $1.18, better than the original expectations. We have also made further progress in positioning our Company for the future. We are continuing to build strong business partnerships across our markets.

In the US, we have made particularly good progress in developing a closer relationship with payers and PBMs. In March we exercised our first tranche of warrants in AmerisourceBergen, purchasing common stock. We subsequently extended the pharma sales distribution and sourcing arrangements by [Tria]. ABC has agreed to make certain working capital investments in the relationship and we proceed with additional capital investments in its distribution network.

Our proposed acquisition of Rite-Aid is progressing as planned. As you know, we are in the process of seeking a regulatory approval. In part, our integration team is continuing its work on preliminary planning.

In June, we completed a $6 billion public bond offering to support the funding of the acquisition. Also in June I am pleased to report that we achieved our $1 billion synergy goal for FY16 from the organizer and Alliance Boots merger.

June was quite a busy month for us. We have also changed our senior management responsibility to structure the Company in such a way that is more efficient following the successful integration of the Walgreens Boots Alliance as we move to operating a unified Company. To support me in my role, we have created Co-Chief Operating Officer Alex Gourlay and Ornella Barra, who will oversee the day-to-day activities of the Company with the support of George Fairweather as Global Chief Financial Officer and Marco Pagni as Global Chief Administrative Officer and General Counsel. And of course with the continued support of our other senior leaders.

Over the past 10 years Alex and Ornella have established an extremely effective working partnership and that created significant value for our Company today. They will be instrumental in driving the operations of our Company in the next phase of its evolution. This will allow me to focus even more on driving the growth strategy and developing our Company. You can be assured, however, that this change will not in any way reduce my scrutiny and expectations of our businesses and the team.

Since the quarter end, as you have seen, the UK has surrendered from Europe has created some uncertainty and volatility in our market. Our businesses and management teams have operated through many business cycles in many markets. Perhaps changes normal and a sign of life. We work with and manage it every day.

Yes, volatility and uncertainty create issues to be overcome, but they also provide opportunity for our Company. It is our job to ensure that we meet these opportunities positively and position and structure our Company to its best advantage. As events unfold and the uncertainty in the wider markets leave us all, I am confident that we will emerge well-positioned as we enter more optimistic times.

The progress that we have made to date gives us a stronger platform from which to drive further efficiencies, meet the challenges of current volatility mainly of our market and the potential wider economic impact it may have in many of the regions we work in. And puts us in an even better position for the Company to deliver long-term success.

Now, let me hand over to George.

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

Thank you, Stefano. I'd like to start by pointing out that for the first time since the acquisition of Alliance Boots, we have fully comparable quarterly results. Net sales for the quarter totaled $29.5 billion, up 2.4% versus the same quarter last year. These were impacted by currency translation, net sales on a constant currency basis being up 3.3%.

GAAP operating income was $1.5 billion, up 9.4%. GAAP net earnings attributable to Walgreens Boots Alliance were $1.1 billion and diluted EPS was $1.01. The decrease in both GAAP net earnings and net earnings per share was due to fluctuations in the fair value of our ABC warrants.

Adjusted operating income was $1.8 billion, up 3.7%. On a constant currency basis, this represents an increase of 4.7%. Adjusted net earnings attributable to Walgreens Boots Alliance were $1.3 billion, up 14.7% and adjusted diluted earnings per share was $1.18, up 15.7%.

The adjusted effective tax rate, which we calculate excluding the equity income from ABC, was 24.4%, the rate benefiting from revisions to the full-year tax rate forecast, including certain discrete items. We now expect the full-year adjusted effective tax rate to be broadly in line with the year-to-date rate of 27.2%.

For completeness, here are the numbers for the first nine months of FY2016. These results are of course not directly comparable with the first nine months of the previous year.

I will not go through them in detail, but you will see that GAAP diluted earnings per share was $2.88, down 28.7%. This reflects a number of accounting factors, including the fluctuations in the warrants and last year's non-cash gain relating to Alliance Boots. On an adjusted basis, diluted earnings per share increased by 17.3% to $3.52.

Turning now to our segmental performance, starting as usual with the retail pharmacy USA. Total sales for the quarter in retail pharmacy USA were $21.2 billion, an increase of 3.7% over the same quarter last year. Sales growth was driven by an increase in pharmacy, partially offset by the sale of a controlling interest in our infusion business back in April 2015.

Comparable store sales increased by 3.9%. As we expected, adjusted gross margin declined by 0.5 percentage points to 26.9% for a pharmacy margin being partially offset by retail products.

Adjusted gross profit was up 1.8% to $5.7 billion and adjusted SG&A was $4.3 billion, an increase of 1.1%. As you may recall, in the same quarter last year SG&A was lower than normal. This was because we had a temporary pause in certain investments while we evaluated the returns being generated.

We are pleased with our performance, and we are well on track towards achieving our overall target savings from our costs transformation program. This program, the vast majority of which is in the US, will deliver $1.5 billion by the end of FY17. Adjusted operating margin for the quarter was 6.5%, resulting in adjusted operating income of $1.4 billion, up 4.1%.

Turning now to look in more detail at pharmacy. Total US pharmacy sales in the quarter were up 5.8%. We filled 235 million prescriptions on a 30-day basis, including immunizations, an increase of 3.9%. This reflects our strategy of increasing script volume in our stores.

On a comparable basis, pharmacy sales increased by 6%, scripts filled being up by 4.5%, primarily due to continued growth in Medicare Part D volume. Our reported market share of retail prescriptions on the usual 30-day adjusted basis was 19.6%. Over the year-ago quarter, this was up approximately 30 basis points. As we expected, gross margins were lower, mainly due to reimbursement rates and changes in mix, partially offset by procurement efficiencies.

Retail product sales on a comparable basis increased by 0.1%. This was primarily due to higher sales in the health and wellness and photo categories, partially offset by declines in certain convenience categories. As we've said previously, we are focused on expanding front-of-store gross margins and are pleased with the progress we've made this quarter. To further drive performance, we are starting to expand our differentiated beauty offering across over 1,800 stores and expect to complete this phase by the end of calendar 2016.

Turning next to our retail pharmacy international division. Total sales in the quarter for the retail pharmacy international division was $3.2 billion, an increase of 3.4% on a constant currency basis. Comparable store sales increased by 0.2%. Clearly comparable figures are in constant currency.

Adjusted operating margin was 8.1%, up 0.4 percentage points in constant currency. This resulted in adjusted operating income of $258 million, an increase of 8% in constant currency.

Comparable pharmacy sales decreased by 0.7% due to Boots in the UK and the loss of certain institutional sales contracts in Chile. In Boots UK comparable pharmacy sales were down 1% due to the negative impact of a reduction in government pharmacy funding that was expected.

As you may know, the UK government has been consulting with the industry on pharmacy funding. The consultation period closed at the end of May and we are waiting to hear their conclusions.

Comparable retail sales for the division increased 0.7% with strong performances in the Republic of Ireland and Thailand. Boots UK's comparable retail sales increased by 0.6%. We were particularly pleased with the performance of our Sleek cosmetics brand acquired in November last year and No7 where in April we successfully launched our new Lift & Luminate triple action serum.

Turning now to our pharmaceutical wholesale division. Total sales in the pharmaceutical wholesale division were $5.7 billion. In April we sold Alliance Healthcare Russia to 36.6 in return for a 15% stake in the combined group. Comparable sales on a constant currency basis, excluding acquisitions and dispositions, increased by 6.3%. This was ahead of our estimate of market growth weighted on the basis of our country wholesale sales.

In a number of our emerging markets, sales growth was particularly strong. Adjusted operating margin was 3%, level with the same quarter last year.

Within the pharmaceutical wholesale division, we report a 16% share of ABC's net earnings. This is reported on a two-month lag. The quarter included only two weeks of equity method income.

Overall, the division's adjusted operating income increased 4.7% to $179 million. On a constant currency basis, the increase was 7.6% of which 4.7% was for ABC. Next quarter we will recognize a full three months share of ABC's net earnings based on their quarter to the end of June.

Combined net synergies in the quarter from the strategic combination with Alliance Boots were $330 million. This takes a cumulative total up to the quarter end to $947 million. As Stefano said, since the quarter end we have achieved our goal of reaching at least $1 billion of combined net synergies. Going forward, we will therefore not be breaking them out separately as we have said before.

In the quarter operating cash flow was $2.1 billion. This was due to our solid profit performance and favorable working capital cash flows. Cash capital expenditure was $247 million. This resulted in free cash flow of $1.9 billion.

Looking to the full fiscal year results, we have raised the lower end of our guidance by $0.10. Guidance is therefore $4.45 to $4.55. This assumes no impact from the proposed acquisition of Rite Aid and related financing, and already assumes current exchange rates for the rest of the fiscal year. Looking forward to FY17, our current plan is to issue guidance in October when we announce our full-year results.

I will now hand back to Gerald. Thank you.

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

Thank you. Operator, could we now throw the call open for Q&A?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Steven Valiquette, Bank of America.

Steven Valiquette - *UBS - Analyst*

Thanks. Good morning, everyone; congrats on these results.

A couple things I wanted to touch on was -- first, on the renegotiation of the distribution agreement with AmerisourceBergen that was announced a few months ago. Seeing that was driven by some shifting of cash flow, but curious if you have any additional color on that, and also what drove the timing of that renegotiation? Thanks.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

You can understand -- Stefano here -- that we cannot comment on a contract. We have been quite clear that there has been some agreement on extending our payment terms, and also an agreement on the size of their investments to follow us in our future expansion. So, we cannot go further. But, of course, if we have extended our agreement by three years and we have committed to take them as our main source for the future, we have done this because we had the right reasons for doing it.

Steven Valiquette - *UBS - Analyst*

Okay, got you. One other quick one -- the legacy Walgreens management used to talk about driving gross profit growth at maybe 100 basis points or maybe 1 percentage point higher than SG&A cost growth. It seemed you achieved that this quarter in Retail Pharmacy USA because you had 2% gross profit growth, 1% growth in SG&A dollars. Just curious, should we still think about that relationship in terms of managing the US operations? Or have the targets changed a little bit with obviously some of the management changes as well? Thanks.

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

We haven't, since the formation of Walgreens Boots Alliance, published any targets relating to this. Our focus is obviously on growing our overall profits. We're focused on improving our retail gross margin, which I talked about in my presentation.

And then on the pharma side, we've talked about very clearly that our focus is on growing our profitability on pharmacy, in a way linked to building our volume. We're clearly pleased with the share gains that we've announced today, which is really continuing the trend we've seen for some time.

Steven Valiquette - *UBS - Analyst*

Okay, got it. Thanks.

Operator

Lisa Gill, JPMorgan.

Lisa Gill - *JPMorgan - Analyst*

Great, thank you very much, and good morning. I was wondering if you could give us a little more color around your new relationship with Optum? It appears that they've been winning some nice pieces of the business in the marketplace. Do each of those new pieces of business -- are they tied to the new relationships that you have -- any incremental color you can give us around expectations of the types of volumes you could see with the new Optum relationship.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Lisa; it's Alex here. We have had a great relationship with Optum on with cash before that for many years. So, our relationship is very strong historically and has improved in the last period, as you have seen.

They are doing a nice job, I think, in the market with their offer. We are helping, particularly with [the slight] 90 program, which gives the customer the choice to go to mail order or have 90-day at retail. We believe, from the evidence we've seen before, that 90-day retails are a very good option for customers, and so does Optum.

So, with that relationship and with the contract we have in place to support it, we are working with them on a commercial basis. And they are doing a nice job in winning contracts, which obviously we're very pleased about.

Going forward, we hope to see them continue to be successful, and we hope to be their partner commercially for the medium to long term, as we have been in the past. So, when they win, I believe that we win. As we have done in the past, we will do in the future.

Lisa Gill - *JPMorgan - Analyst*

Alex, is there any way to put any numbers or expectations around that, as we think about pieces of business that we have known publicly that they have won? Any thoughts at this point or do you think it's too early?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It is really too early. Most of these contracts, as you know -- well, all these contracts start in the first of January.

The focus that we have -- our part of the deal is to make sure we give a great customer experience. So, they are health plan members as they come into Walgreens, so that we can actually make sure that we pull through the customers and they stick with us. That's the bit that Richard and the team have done a great job on in the last period, as you've seen by our volume increase and by our gradual increase in market share.

So, we're confident that when they win contracts, we can win more than our fair share. But our job is to make sure we do that by providing great service and care at the pharmacy.

Lisa Gill - *JPMorgan - Analyst*

Great. And then a follow-up -- George, I know you said that included in the guidance is the expectation around currency. But can you remind us what the EPS sensitivity is to FX? I know you've talked about this in the past, but I want to make sure we have this correctly.

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

George, before you answer that, Stefano, I think --

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

I was saying -- it's irrelevant -- I was saying that, of course, when we do the conference we will generate more (technical difficulty). We analyzed and we made our calculation of the life of the contract.

When you see a new contract, you don't have to expect to see the benefits immediately. The benefit will come, and it will be, of course, bigger if we perform well. And you will see a growth during the entire life of the contract.

So, the benefit of all the contracts that we will do will be -- we grow over the next years. Sorry about that.

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

I think, as we've said before, in terms of currency translation, a 1% movement in the value of the pound versus the US dollar is approximately $0.01 impact on adjusted EPS.

Lisa Gill - *JPMorgan - Analyst*

Okay, great, thank you.

Operator

Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Great, thanks for the questions -- trying to get a better gauge of the fundamental performance of the retail USA business. You guys have given us details on synergies every quarter. Could you give us a sense of how you're tracking on the SG&A savings relative to the $1.5 billion target by the end of FY17? And how we should think about how that's contributing to the EBIT growth in the quarter would be really helpful.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Robert; it's Alex here. I think as George said in the script, we are on plan. The majority of the $1.5 billion, as George said, comes from the USA pharmacy business. We have a comprehensive program, and our program is on track and it's delivering to plan.

We see more opportunities going forward, and the team here in the USA and also across the rest of the group will continue to drive the most efficient business we can and build more cost plans. We'll give an update at the end of the year in terms of how that plan is going. It's a major part of our strategy to use our scale, use our efficiency both in the US and globally, to make sure that we are the most cost-effective pharmacy retailer, particularly here in the USA.

Robert Jones - *Goldman Sachs - Analyst*

Okay, got it.

Then one question on Part D -- you mentioned prescriptions on a same-store basis seeing strength from Part D in particular. I know getting bigger in Part D has been a specific goal of the Company. Can you share a little bit more of how you have progressed in winning Part D, and where you think you are today from a market share perspective as it relates to Part D lives?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It's Alex again. I think it's about partnership philosophy. We worked really well across all of these plans.

We've always had a strong relationship with United, and that continues. As we've continued to offer our strong 8,200-store network, the right value, the 90-day retail option in terms of Part D, we've been able to win more contracts, and we've been able to get into some of the more narrow networks which are forming naturally in the marketplace. So, I would put down to partnership and delivering really well in stores.

It's a very important segment for us. The market is growing faster than the rest of the market. It will continue to grow that way because of the aging population. And 90-day retail is really, really popular with that population.

So, partnership and focus is the reasons why we are winning. And we will continue to do both as best we can.

Robert Jones - *Goldman Sachs - Analyst*

Great, thank you.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Good morning, guys, and thanks for taking the questions. George, two parts -- number one, is there any way that you could quantify for us the impact of the med-D -- the increasing med-D mix on US drug margins in Q4?

And correlated to that question is -- we thought that we would've seen more modest gross margin deterioration, given the deterioration in generic drug pricing against the MAC part of the book. Any quantitative or qualitative color you can put around the gross margin deterioration in the quarter would be helpful with the big moving pieces. Thanks.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, it's Alex here. We see this on plan. There's been constant reimbursement pressure in the market. We've spoken about this constantly. And we see that pressure going forward. We've been very open about this, as the market consolidates and the mix moves.

Remember: We focus on operating margin, and that really is the number we pay attention to here. So, using our very large fixed assets, going to more 90-day, where we're dispensing once rather than three times, is a very important part of that. And also the growth of specialty, which is lower margin in terms of percent but higher dollars, is another feature of the marketplace.

So, overall, we are comfortable with where we are. And we're comfortable with the strategy we're driving to focus on operating profit rather than just gross margin.

George Hill - *Deutsche Bank - Analyst*

Okay, then a quick follow up, Alex, if you just want to rank them. In separating pressure and mix, is the change in mix leading to more down-draft, followed by pressure, followed by 90, followed by specialty? Is that the right way to think about the order of the moving pieces as it relates to the margin profile?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

No, I just think that the market is growing through the aging population. So, that's why med-D is the fastest growing channel, as is all of that. People are putting together more competitive offers, both in terms of price, but also in terms of care and performance. And that comes as well.

So, I think that's what's driving it -- is really the market's being driven, as always, by the customer. And it's a growth market, so, therefore, if you're able to provide the right value through a good cost structure, which I think we have through the scale we have here in the USA, and the buying power we have globally, and then you're able to have the right relationships and partnerships, you can take advantage of the fastest-growing channel, which is med-D, in that profitable way. And that is what we're doing.

So, I don't think one outdoes the other, to be honest, George. I think it's about a market change. And we are just positioning ourselves in what's a very important market segment for our model, and one we are very well positioned to continue to win.

George Hill - *Deutsche Bank - Analyst*

Okay, I appreciate the color. Thank you.

Operator

Ricky Goldwasser, Morgan Stanley.

Mark Rosenblum - *Morgan Stanley - Analyst*

Hi, this is Mark Rosenblum on for Ricky.

Can you talk about the partnership with Valeant now that you guys are about six months in -- take-aways and lessons you've learned, and commentary on how you think the relationship is going to date?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, it is Alex again here. We are satisfied and pleased with performance in the dermatology business; the volume is as we expected. And remember: We're paid for the service we provide. We're not paid on the margin mix here at all.

So, we're satisfied. The relationship is good. We know Joe well from the past from Perrigo, where the group had a very good relationship with Joe and Perrigo. And we are in constant dialogue with Joe and the management team. We can see their situation, and we are very willing to help them in a positive way.

So, it's early days of a 20-year contract, and from our point of view, we are pleased. We want to help our partner to be more successful in the market.

Mark Rosenblum - *Morgan Stanley - Analyst*

Got you. And then, following up on the RAD acquisition, I know you guys are still expecting a second-half close. But if the deal were not to get done, how would you rank your capital deployment priorities, now that you have the additional cash on the balance sheet?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

We would have a lot of ideas, but I can assure you that we are -- for the time being, we are not taking it into consideration because we are very confident that, at the end, this deal will go through. It takes some time, but we knew it. It is normal for these kind of deals, which is a complex deal at the end of the day -- is normal for this kind of deal to take months and months.

So I would say that we are on track. Our lawyers are telling us that we don't have any negative signals, so we are operating on the hypothesis that we will do the deal. You'll see that we have raised the capital. You'll see that we have a big team in place starting the integration; and they are working hard to prepare the integration.

We are trying to find the right buyers for the pharmacy sector. For sure, we will have to [divest] and that is it.

Mark Rosenblum - *Morgan Stanley - Analyst*

Okay, thank you, that's very helpful.

Operator

Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

Thank you. Focusing on international, going back to your comment about discussions with the UK authority, is there a focus on recent cost reduction, on any changes that might reduce that? Is it more of a service focus? Could you detail that?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Eric; it's Alex here. Obviously, from the past, I know the UK pretty well, and I've caught up with the team in the last period. This is a deeper conversation about what they call a global sum in the UK, which is the amount of money they pay our pharmacy -- a combination of drop costs and services.

The government are keen to get more value from pharmacy, and that's the negotiation that's currently being carried out. It's not just for Boots, but it's for the whole market. Boots has around about 1/5 of the market in the UK in pharmacy.

It is not untypical. We have lived with this sort of pressure and these requests for very many, many years, both in the UK and Europe, and we're used to dealing with it. But there's a particular phase we're going through where that request is slightly deeper than the norm. Obviously, the industry is working together to try and give the government the best answer we can.

Eric Percher - *Barclays Capital - Analyst*

Thanks for that detail.

And then also on international, the piece in Russia, was that previously consolidated and now has been moved to discontinued? Would we see that in the year-ago result?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

Correct. It was consolidated, and now it's not consolidated anymore because we have 15% of the new company. To be honest, Russia was quite a volatile account, where the results were depending very much on the weather. Also, over time, they were selling business which was really the best part of the supply chain of the chain in Russia earning-wise is deteriorated because the pharmacies have become more important.

In part, the pharmacies were not particularly profitable because the cost of the rents was really very, very high. Now the situation is normalized. You can have a long-term or medium-term rents with a way of extending the rents. And so, the pharmacies are becoming the most important and the most profitable part of the chain.

And so, we had the opportunity to contribute [I'll say] to the largest pharmacy chain because we have 1,000 pharmacies in 36.6, but a 1,000 pharmacies also in another chain, A5, and the two chains have merged. And so, we have had 15% in a company where we had in reality 2,000 pharmacies. And the opportunity to buy out the company [in five years].

So we will see what happens in five years and we will take the decision. It is a big opportunity for us because this is the best segment of the distribution in Russia today.

Eric Percher - *Barclays Capital - Analyst*

Thank you for that. And the financial impact from that, George -- that sounds a little larger than I was thinking, but is there much of a profit impact from that, given your ownership stake?

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

The financial impact, looking at income is -- it's very, very small in relation to the size of WBA. Where we will see an impact is obviously in the sales, being a low-margin wholesale business. The sales were just under $700 million historically, just to give you a size.

But that's why we are showing comparable sales on a constant-currency basis, excluding M&A, so that you can really understand the clear performance of wholesale. But really in actual profit contribution terms, this is pretty immaterial.

Eric Percher - *Barclays Capital - Analyst*

Thank you.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

[Especially] after the devaluation of the ruble. You will remember that the ruble lost quite a lot versus the dollar. And so, the impact has been really low.

Eric Percher - *Barclays Capital - Analyst*

Thank you.

Operator

John Heinbockel, Guggenheim.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

Two things for Alex -- let me start with store-level labor -- if you can touch on cross currents, impact of minimum wage going up, and then change in overtime rules?

And then the flip side offsetting that, where do you think there's still opportunity to trim labor hours or get more efficient? Is it a backroom issue, how you use the pharmacy tax? Thoughts on those would be helpful.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

John, I think there's always more opportunity. As you remember, we're investing quite a lot in our core IT systems right now, both in retail -- and our [SAP] program is about six months in -- and also in pharmacy where we are redoing our pharmacy system over the next five years.

These two, although not part from working capital benefits, will clearly make the whole supply chain more efficient and allow us to remove a lot of non-customer-facing activity out of the drugstores and save money. And also put more hours into customer care, which is part of our strategy to become more differentiated in health, wellness, and beauty care and pharmacy.

So I think there is a significant investment going in. The Board signed this off only a couple of months ago really. And we are very confident the programs are well set up.

We've got the global expertise, both here in America and Europe, applied to these two very important programs here in the US. We will update you on what that means in the future as it becomes clearer about the benefits that we see coming through.

We have already -- going back to the first question, starting with minimum wage -- we've already, in the backroom we have already, for most lower-paid people in stores, improved the base salary. We've done that already; that's already in the costs you see. And we will continue to improve minimum wage against the market, paying very close attention to the market.

Second to that, we are also upscaling our people. For example, we'll [throw out a few] differentiation. We're putting in place a number of beauty consultants in our top 2,000 stores who have got deeper expertise and more knowledge, and more ability to take care and drive up sales appropriately with customers. That's another investment we're making in labor costs in our stores, but with a very clear return on our investment. So, we're feeling good about where we are on these two investments.

With the overtime, we studied this very carefully. We have a solution very clearly mapped out, and we'll announce that solution at the appropriate time. It's one that will be both fair to people and cost effective to shareholders.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

And then secondly, you talked about, within the guise of the front end, the convenience categories. Talk a little bit how you are rethinking that whole part of the Business.

And when you broaden it out to consumables, can that business effectively drive traffic? You think about -- I'm not sure how productive some of those soft drink promotions were -- but can that drive traffic? Or do you want to go back and drive traffic on beauty, the experience, and really not use consumables to do that?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Consumables is really important to driving traffic. Particularly, the fill-in shop effectively, which is becoming really important to customers across America. And we believe that Walgreens in particular can play a much broader role in that walk.

We've only really had the data with the cards, reward card, for just about three years. We're now seeing very clearly the opportunities for the fill-in mission.

We're now constructing our offer across convenience cash [using technologies] that we believe will offer the right brands at the right price. Not the lowest price, but the right price. And we're on with that walk.

It will be different by types of stores, for sure, and therefore, it's quite a complicated piece to get done. But we are well on the journey and you will see that coming through in the months and years ahead. It's very important to our plan.

Obviously we're trying to create more destination beauty. That plan has already been executed in 1,000 of the under stores as we speak. And there will be more to come once we get these stores complete.

And healthcare has always been a very important category to us, and we continue to drive that category pretty well. So, that's how we see driving footfall back into drugstores.

The final thing I'll say about footfall is (inaudible) it was really important to see that in the UK. The UK team has done a really nice job in the UK market here to join up the supply chain and to make our effective customers. Clearly we can share and borrow some of that best practice from Europe, and we intend to do that.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

Thank you.

Operator

Scott Mushkin, Wolfe Research.

Mike Otway - *Wolfe Research - Analyst*

Good morning, everyone; this is Mike Otway in for Scott. Thanks for taking the questions.

First question -- the $0.10 raise in the low end of the guidance -- could you parse that out into tax rate versus stronger profitability? How much is due to both?

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

There is a bunch of factors coming into this. Obviously, the tax rate has come in a little bit lower, as I talked about in my presentation.

I think the most important point I would make is obviously we are continuing as we -- if you look at the guidance we set out at the beginning of the year, our ability to continue to raise the lower end are really at a time when we've been able to cope with currency moving in the wrong direction for us in translation, really, I think, illustrates the overall strength of the Business. Really not a huge amount more I can add to that at this stage.

Mike Otway - *Wolfe Research - Analyst*

Okay, thanks, George.

And then following on John's question earlier, given the focus is on expanding gross margin in the US, how should we think about the front-end comp trajectory over the next couple quarters? Should we expect more of the same until -- is there an expectation that the beauty rollout is going to change the trajectory of comps -- any thoughts there.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

I think obviously we're in this transition period, for sure, as we've spoken about before. We were seeing nice improvements in the operating margin, and in the gross margin within that. And the expense of some sales loss in some convenience categories and some seasonal categories where we actually fundamentally over-bought.

The next phase is to really start to drive sales, particularly in beauty. That will be progressive over a period of time -- actually this summer into the autumn. So, you should start to see the comps gradually improve quarter by quarter.

But the key thing, really, that we keep on repeating is the comps are important, but always going to be relatively low in reality in a mature market where we were really shifting the mix. The important thing is the operating margin, and that's the thing that we've been consistently focused on now for the past couple of years. And we are pleased with the progress we're making there, and we see more progress in the future.

Mike Otway - *Wolfe Research - Analyst*

Great, appreciate the color, thank you.

Operator

Alvin Concepcion, Citi.

Alvin Concepcion - *Citigroup - Analyst*

Great, thank you. I wanted to follow up on Rite Aid -- sounds like it's still on track. Wondering when you expect to hear more color from the SEC? If you could give us any more color on your discussions related to other changes in the number of store divestitures you expect?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

We still believe that our initial estimate is correct. We still believe that, at the end, we will stay in the range of the stores that we initially indicated, around 500. And time-wise, we still believe that we will be able to really do the deal, finish the deal, by the end of this calendar year, as we said. So, by December, we believe that everything will be done.

But of course, it doesn't depend on us. The FTC will let us know when they are ready.

Alvin Concepcion - *Citigroup - Analyst*

Got it, thank you. And a tough question -- I realize it's very early, but as it relates to Brexit, have you seen or would you expect to see an impact in underlying demand or margins in the UK business since the announcement, excluding currency impacts, of course?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

Very, very difficult to say. The situation -- it's very volatile at this time. For sure, the period of uncertainty will be quite long, whatever happens, because even if the UK will leave the Europe, it cannot happen overnight. It will take at least two years. And the consequence of it will be much longer than two years.

So, I believe that once the emotional impact is gone, things will settle down and we will have an idea of what is happening. But for now really it's really too soon; we have seen in the stores days very good, days very bad. So, in a few months probably, we will be able to say something.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Alvin; it's Alex here. Again, just a couple of things tied up with what Stefano said. I think that historically Boots has been very solid through difficult times. But it tends to overperform the market during recessions or slowdowns because it's got a very strong beauty business, and people still buy into beauty even in tough times. And that's been historically the case. So, we feel that's important.

Boots is still broadly positioned both in beauty and in healthcare in the UK. The team have done a nice job there to keep it strong, and the model's still very strong. So, I think if any retail business is positioned to do okay during these uncertain times, as Stefano has talked about, I think it is the Boots brand in the UK.

Alvin Concepcion - *Citigroup - Analyst*

Got it, thank you for that color, appreciate it.

Operator

David Larsen, Leerink.

David Larsen - *Leerink Partners - Analyst*

Hi, congratulations on a good quarter. Can you talk about, at a high level, who buyers of these RAD stores could potentially be, especially for stores that are in rural markets? Thanks.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

We cannot give indication on that.

David Larsen - *Leerink Partners - Analyst*

Okay.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

We cannot go -- even because, at the end of the day, we don't know exactly how many stores and where. We have an idea, but we don't know exactly. So, for the time being, it's really too early.

David Larsen - *Leerink Partners - Analyst*

Okay. And then, let's say the FTC wanted to continue to review the transaction until, say, March of 2017. Are you willing to allow the process to continue into 2017?

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

For the time being, we don't have this feeling; our lawyers don't have this feeling. If this will happen, we will see, and we will try to understand why the process becomes so long.

Because if there are just technical reasons, of course, we will wait. If it is a symptom of something which is going not in the right decision, we will take a decision at that time. But I repeat, for the time being, our lawyers are very quite optimistic -- I would say optimistic.

David Larsen - *Leerink Partners - Analyst*

Okay. And then my last question is -- do you have any thoughts on -- would you keep the volumes with McKesson or switch them over to AmerisourceBergen? Any high-level thoughts on that? Thanks.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

When we will conclude the deal with Rite Aid, we will see what to do. Of course, we have to take into consideration that we have a good contact and a fantastic relationship with Rite Aid. So, we will analyze what to do at the right time.

David Larsen - *Leerink Partners - Analyst*

Okay, thanks very much.

Operator

Eric Coldwell, Robert W. Baird.

Eric Coldwell - *Robert W. Baird & Company - Analyst*

Thanks very much. First, I have a, hopefully, an objective and friendly comment here to help. Walgreens, both prior to and after this current team's leadership, has only beaten revenue three times in the last five years, even with the Street lowering forward targets after each quarter. I guess what I am saying is I just really think you need to maybe circle the wagons and provide better insight into things such as pricing, generic launches, conversion rates, mix. Anything that could help folks get to a better method on the top line, I think, would be a huge help. So, that's my comment; I'd love you to take it under consideration.

THOMSON REUTERS

The question is around tax items. I'm curious, I did not see this -- what were the discrete items in the quarter? How much did they impact the third quarter? And did any of the lower expected tax rate for the year -- did any of that come from items that might be deemed as more sustainable, as opposed to discrete? Thanks very much.

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

Fundamentally, there was a small amount of discrete items. Typically, obviously, one is prudent in doing provisioning; and then when one is able to agree numbers with the various tax authorities, then one has the discrete items.

But fundamentally, we've been doing a lot of work looking at our underlying tax rate, and exactly with the quite complex structure that we've got in place, what is the real underlying rate? We've been quite conservative in the first part of the year on this while we are doing this work. And really, the numbers that you've seen in the quarter, if you look at the year to date, as we said in my presentation, that really gives us a true reflection of what the rate would be with this mix of profits at the currency rates that we've seen in this year to date.

I think you should really look at it as the clear rate. Clearly, if we then -- going forward, the mix changes. And clearly it will change with Rite Aid coming in, being US-based. And the US being obviously one of the highest tax countries in the mix of where we trade, then you will see the tax rate going up, reflecting mix, but only mix.

Stefano Pessina - *Walgreens Boots Alliance, Inc. - EVP & CEO*

Substantially, this quarter we have taken back some provisions that we had made before in the previous quarter for the bulk of it, being prudent. And now we have released it, and that's it. So, overall for the year, this is the real -- substantially the real tax rate, and the real dollars that we have paid in tax -- we will pay in tax.

Eric Coldwell - *Robert W. Baird & Company - Analyst*

Okay, thanks very much for the comments.

Operator

Charles Rhyee, Cowen and Company.

Charles Rhyee - *Cowen and Company - Analyst*

Thanks. Going back to the rollout of the Boots products in the US, I know you're expanding it now to more stores. Can you talk about what the uptake has been in the existing stores as a percent of the front-end sales? I know you're calling your target a 5% mix shift over time, but just curious where we are at this point?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Charles; Alex here. We've had these products in different tests and trials in New York, and more importantly in Phoenix, which is a more normal market for us in terms of our stores, really for 18 months. And we're really seeing two effects.

We're seeing bigger baskets across the beauty spend from customers. And we're seeing more repeat customers coming back with particularly No. 7 skincare in their basket. And these numbers we extrapolated with costs.

We also looked at different models of investment from a people point of view and investment in fixturing. We created what we thought was the most customer-effective and importantly the best model for return to our shareholders. And that's what we're implementing right now this summer in around about 1,600 more stores. And we are very confident because we have seen these customer behaviors of more in the basket and coming back more often, specifically for No. 7 skincare, consistently for the 18 months.

So, that's what we've seen and that's how we've measured it. And clearly, we have long-term goals to shift the mix to more owned brands and own brands in the US business. And this is the start of our journey, particularly in the important beauty categories.

Charles Rhyee - *Cowen and Company - Analyst*

Can you talk about -- if I recall correctly -- No. 7 and some of the other Boots products are sold in other chains today. Can you talk about what that mix looks like in those shores in those other chains, and how relevant they are to what you expect for Walgreens over time? Are there ways to also leverage that brand recognition that you already have and maybe shift those buyers back to the Walgreens stores? Thanks.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

The intention is to grow the brand, so we have good distribution and target, and have had for many years, and a good relationship. And we have distribution growing in Ulta, who are doing a nice job with their brands and many other people's brands. To be fair to them, they're doing a good job.

So, from our point of view, they are different channels to Walgreens. Walgreens is a drugstore channel, and the customers, some customers, do swap across both -- of course they do.

But we have so much opportunity with Walgreens, with 6 million customers. About 20% of them are what we call look good/feel good customers who are prepared to buy more beauty products from Walgreens. And that's what we're focused on in the Walgreens channel.

The rest of the team, led by Ken, who heads up our brands division for WBA, are focused on building the brands across America and building good relationships with the partners outside of Walgreens. It's a very clear strategy and one where we want to be successful in both. And that's what we intend to do.

Charles Rhyee - *Cowen and Company - Analyst*

Great, thank you.

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

Thank you; that was the last question we had time for. Thank you to everyone for participating in the call. If folk do have other questions, we did try and slightly restructure the presentation and call today to allow more time for questions than we normally would have done. If there are other people who do have questions or queries, please feel free to contact anyone at the IR team here -- myself, Ashish Kohli, Deborah Walter, Jonathan Spitzer or our new member, Patrick Bartoski. And thank you very much indeed.

Operator

Ladies and gentlemen, this does conclude today's program and you may all disconnect. Everybody have a wonderful day.
