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WBA - Q2 2017 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 sales of $29.4b, GAAP net earnings attributable to WBA of $1.1b and GAAP diluted EPS of $0.98. Expects FY17 adjusted diluted net EPS to be $4.90-5.08.

CORPORATE PARTICIPANTS

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

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

Gerald Gradwell

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

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Walgreens Boots Alliance Fiscal Second Quarter 2017 Earnings Conference Call. (Operator Instructions). As a reminder, this conference is being recorded.

I'd like to introduce your host for today's conference, Mr. Gerald Gradwell. Sir, please begin.

Gerald Gradwell

Hi there, and welcome to our second 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 our results as usual. Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance, is 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 on this presentation constitute forward-looking statements that are based on our current market, competitive and regulatory expectations, and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by the law, we undertake no obligation to update publicly any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. Please see our latest Form 10-K for a discussion of risk factors as they relate to forward-looking statements.

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

I will now hand over to George to take you through the numbers.

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

Thank you, Gerald. Our performance this quarter was in line with our expectations, despite challenging conditions in a number of our markets. We were particularly pleased with growth in U.S. pharmacy volume and market share, with the early benefit of our new pharmacy contract starting to come through. We continue to work hard to secure regulatory clearance for the Rite Aid transaction, and we are reiterating our guidance for fiscal 2017.

With that, let's look at the financial highlights for the quarter. As we expected, currency again had a negative impact, the U.S. dollar being around 16% higher versus sterling than in the comparable quarter last year. Sales for the quarter were $29.4 billion, down 2.4% versus the comparable quarter. On a constant currency basis, sales were up 0.9%. Without the extra day in February last year, this would have been up 2.2%.

GAAP operating income was $1.5 billion, a decrease of 20.5%. GAAP net earnings attributable to Walgreens Boots Alliance were $1.1 billion, up 14%, and diluted EPS was $0.98, up 15.3%.

Adjusted operating income was $2 billion, down 4.9%, and in constant currency, it was down 2.7%. We estimate this would have been broadly flat, taking into account the leap year impact. Adjusted net earnings attributable to Walgreens Boots Alliance were $1.5 billion, up 2.7%, and in constant currency, up 6.2%. Adjusted diluted net earnings per share was $1.36, up 3.8%, and in constant currency, up 6.1%. The adjusted effective tax rate, which we calculate excluding the equity income from AmerisourceBergen, was 23.7%. This was lower than in the same quarter last year, primarily due to a reduced estimated annual tax rate associated with our current year pretax earnings and incremental discrete tax benefits. But year-to-date, the tax rate on the same basis was 24.5%. For completeness, here are the numbers for the first...

(technical Difficulties]

Gerald Gradwell

Sorry, ladies and gentlemen. I just thought (inaudible) it does appear that we've got some technical difficulties with our mics here. Please bear with us. We're going to restart again in just a second when we have the chance to reset everything. Please bear with us. Sorry about that, ladies and gentlemen. We're going to start again as we have technical difficulties and a number of people couldn't hear us talking.

So hello, and welcome to our second quarter earnings call. I'm Gerald Gradwell. I'm here with Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer; and George Fairweather, Executive Vice President and Global Chief Financial Officer. He will take you through our results as usual in a moment. We're also joined by Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance, who'll be joining us for questions.

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For completeness, here are the numbers for the first half of fiscal 2017. I will not go through those in some great detail, but you will note that GAAP diluted net earnings per share was $1.94, up 3.7% versus the same period a year ago. Adjusted diluted net earnings per share was $2.46, up 5.1%, and up 7.7% 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 $21.8 billion, up 1.5% over the year-ago quarter, comparable store sales increasing by 2.4%. As 2016 was a leap year, when we calculate comparable sales and prescription figures, we exclude the 29th of February 2016.

Adjusted gross profit was $5.9 billion, down 0.6% over the year-ago quarter, with the impact of the extra day in 2016 holding back growth in adjusted gross profit by over 1%. Lower retail gross profit was partially offset by an increase in pharmacy.

Adjusted SG&A was 20% of sales, an improvement of 0.1 percentage points compared to the year-ago quarter. Adjusted SG&A as a percentage of sales has improved versus comparable quarters for 15 consecutive quarters. As a result of the lower adjusted gross margin, adjusted operating margin was down 0.5 percentage points at 7.1%, resulting in adjusted operating income of $1.6 billion, down 4.9%.

So now let's look in more detail at pharmacy. U.S. pharmacy total sales were up 3.7%, mainly driven by increased retail script volume. We filled 246.7 million prescriptions on a 30-day adjusted basis, including immunizations, an increase of 5.9%. On a comparable basis for stores, which excludes central specialty, pharmacy sales increased by 4.2%, with scripts filled up 7.9%. This was the highest quarterly growth rate in more than 7 years and was primarily due to strong volume growth from Medicare Part D and strategic pharmacy partnerships, which we announced last year. We are pleased both with the progress of Medicare Part D and early indications of the benefits derived from our new pharmacy contracts.

Within sales, volume growth and brand inflation was partially offset by reimbursement pressure, which was in line with what we had anticipated, and by the impact of generics.

Our reported market share of retail prescriptions in the quarter on the usual 30-day adjusted basis was 20.4%, up approximately 100 basis points over the year-ago quarter.

Total retail sales were down 2.7% on the same quarter last year. This includes the impact of the previously announced closure of certain e-commerce operations and the impact of the leap day in the prior year. Comparable retail sales were down 0.8% in the quarter in what was a challenging environment, with declines in the consumables and general merchandise and personal care categories partially offset by solid growth in the health and wellness and beauty categories.

Adjusted gross profit was lower than in the same quarter last year, primarily due to the decline in sales. Despite the difficult market conditions, we were pleased with growth in our key categories. This was reflected by our absolute performance as well as recent market share gains. Based on the latest Nielsen data for the 13 weeks ended the 25th of February, we gained share in the health and wellness, beauty and personal care categories. However, we know there is more to do and are therefore taking further actions to help drive future performance. This includes simplifying our product offering, further emphasis on our omni-channel capabilities and expansion of our beauty differentiation program. While still early in the journey, our own brands are performing well and currently represent over 15% of beauty sales in our beauty differentiation stores. We have now recruited beauty advisers across more than 1,800 stores, which is helping to drive No7 sales and gross profit. Repurchase levels of No7 products have been very encouraging, and Soap & Glory has also got off to a good start. Following the successful introduction of No7 and Soap & Glory, we're planning to introduce another of our own brands, Botanics, into our existing beauty differentiation stores in the next 6 months. Looking ahead, we are now developing plans to introduce our enhanced beauty offering to over 1,000 additional stores by the end of the calendar year.

So next, let's look at the progress of our cost transformation program. In our previously announced cost transformation program, we set ourselves an ambitious target of delivering $1.5 billion in savings by the end of fiscal 2017. I'm delighted to announce that we achieved this target ahead of plan. We now expect that accumulated pretax charges associated with this program will be approximately $1.8 billion. This is in line with our expectations when the expanded program was announced in April 2015. These costs are higher than we anticipated in October, primarily as we now expect to close around 60 more stores. The program will be completed as expected by the end of fiscal 2017, and the full benefits will be realized in future periods. We continue to expect that approximately 60% of the program costs will be in cash over time, the principal items being future lease obligations.

So now let's look at the results of the Retail Pharmacy International division. Sales for the division were $3.1 billion, down 1.9% in constant currency, again impacted by the leap year. Comparable store sales decreased 0.9% in constant currency. Comparable pharmacy sales were down 3.7% on a constant currency basis due to decline in the U.K., which is partially offset by growth in other markets.

In Boots UK, comparable pharmacy sales were down 5.2% mainly due to the reduction in government pharmacy funding. Comparable retail sales for the division increased 0.6%, reflecting Boots growth in the U.K., the Republic of Ireland and Thailand. Within the U.K., Boots comparable retail sales increased 0.7% versus the year-ago quarter, supported by solid December trading.

Adjusted gross profit for the division was down 4% in constant currency to $1.2 billion, mainly due to lower pharmacy margins in the U.K., reflecting the reduction in funding and the impact of the leap year -- leap day in the prior year.

Adjusted SG&A in constant currency dollars was flat versus the year-ago quarter. However, adjusted SG&A as a percentage of sales on a constant currency basis was 0.6 percentage points higher at 31% as a result of the largely fixed cost elements of the cost base.

Adjusted operating margin was 7.8%, down 1.4 percentage points in constant currency. This resulted in adjusted operating income of $242 million, a decrease of 16.7%, again in constant currency.

So now let's look at our Pharmaceutical Wholesale division. Sales for the division were $5 billion, up 0.6% versus the same quarter last year on a constant currency basis. Growth was held back by the sale of Alliance Healthcare Russia in March last year and also by the leap year. Comparable sales on a constant currency basis were up 5.2%. This was behind the company's estimate of market growth weighted on the basis of country wholesale sales, with challenging market conditions in Continental Europe partially offset by growth in emerging markets and the U.K. Market growth was particularly strong in certain emerging markets due to the timing of price increases.

Adjusted operating margin, which excludes ABC, was 2.9%, up 0.2 percentage points on a constant currency basis. Adjusted operating income was $226 million, up 59.4% in constant currency. Excluding the $79 million in adjusted earnings from ABC, adjusted operating income was up 8.4% in constant currency, reflecting procurement and cost benefits.

Operating cash flow in the quarter was $2.9 billion. During the quarter, our working capital inflow was $1.4 billion. This reflected our seasonal reduction in inventories as well as an improved receivables position. Cash capital expenditure in the quarter was $261 million. This was lower than in the first quarter, mainly due to phasing. As I said last year -- last quarter, 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. This resulted in free cash flow for the quarter of $2.6 billion.

Today, we announced a new share repurchase program of up to $1 billion in this calendar year. We have the flexibility to do this due to the changes to the pending Rite Aid transaction announced in January.

So turning next to our guidance for fiscal 2017. We have maintained guidance and continue to expect adjusted diluted net earnings per share to be in the range of $4.90 to $5.08. Remember, our guidance assumes current exchange rates remaining constant for the rest of the fiscal year and no material accretion from Rite Aid or from the new strategic alliance with Prime announced on Monday.

So I'll now hand over to Stefano for his concluding comments.

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

Thank you, George. So as you have seen, we have once again come to you with quarterly results pretty much in line with our expectations. However, the guidance behind the results vary, depending on where we are with the development and continual transformation of our businesses. But we have mainly different levers to pull to fine-tune the company, and that gives us some confidence in our ability to deliver solid financial performance.

This quarter, much of the most visible work we are reporting have been driving efficiency within the company, further improving the cash flow from the businesses and the cost structure. We are doing this while we continue to operate a slightly inefficient balance sheet as we work to complete our proposed acquisition of Rite Aid. Even in the balance sheet, however, you can see the signs of our drive for constant improvement. We are returning an element of value to the shareholders through our new share buyback program without undermining our intention to [profitably] deleverage the company following the closing of the proposed Rite Aid acquisition.

The U.S. pharmacy market is performing very much as we believed it would. Pricing pressures are increasing to address the steady and unrelenting volume growth in the use of medication. To meet these challenges, we believe that collaboration and cooperation is vital. It is vital, of course, to the health care system as a whole and between all the components of it, from the regulators to the individual pharmacists who serve their communities every day. We have proved time and time again that by shaping our business to anticipate and address what is a clearly identifiable trend, we can operate growing and thriving businesses in this environment. As we grow and develop our company, we seek to ensure that the structure and nature of our business is properly aligned with the needs of the market. In this, we will never do anything that we are not convinced is in the long-term interest of our shareholders. If we do not believe this to be the case, we will not do it.

A very good example of our commitment to working in partnership is our strategic alliance with Prime. This puts in place a new pharmacy contract between our 2 companies and brings together our central specialties and mail order businesses into a structure in which we have just over 50%. It is designed to improve our scale and competitive position, to [announce] service, competitive pricing and improve market access. Relationships like these are about more than just improving the work we have today. They can create an entirely new set of opportunities for us to approach the market, achieving more together, [greater] than either of us could do alone and in a structure that helps ensure we both benefit fairly as a result. While this will not have a significant impact on our adjusted earnings per share this fiscal year, it is benefiting our volume and sales. And as we integrate this business over time, we believe it will benefit our adjusted operating income. Equally important, it establishes a strategically beneficial alliance that will deliver future growth by better addressing the needs of a changing market. Since the announcement, our strategic alliance has already contributed to Prime winning 2 significant contracts, which demonstrate how well it is being received by the market. And we are addressing some of the legacy business issue in Walgreens and are seeing script volumes return. We are in a much better position to begin to address the operational challenges which market demands will continue to place upon us.

The retail market in the U.S. has its own economic and competitive pressure. There is no doubt that it is a harsh and unforgiving economic climate in which to be reviewing and updating the retail offering, but we are making progress. You have heard George talk about the early indication of success in our strategy for beauty of using our expertise and brands to differentiate our offering. The growth we have seen in the health and wellness and beauty category sales and underlying margin in our stores is encouraging. Our decision to expand the beauty differentiation strategy reflects the positive response we have had from our customers. With the evolution of our Walgreens beauty offering, we expect to see leading third-party beauty brands [forming] part of the growing range in our stores. Of course, our work in beauty is only part of the changes we intend to make to change and [announce] the retail mix and offering across our stores.

This work is made simple, not quick. And as we do it, we must constantly monitor each individual change, carefully balancing the space allocation [which is part of the mix] and the overall customer experience. There are, however, plenty of examples of how successful this can be if you get it right.

Turning to Rite Aid. I am still optimistic that we will bring this deal to a successful conclusion. But there is no doubt that the process of getting clearance for the transaction is taking longer than we expected. We are constantly and currently collaborating with FTC, Rite Aid and Fred's to get the necessary approvals and close the transaction. At the same time, we are working to be in a position to certify compliance. We believe that we can achieve this in the coming weeks and are still working toward our revised time table to obtain a clearance by the end of July. The changes to the deal that we agreed in January demonstrate our absolute commitment to ensure all transactions meet our demanding financial and strategic requirements while allowing us the ability to address any reasonable demand that may be made of us in obtaining regulatory approval.

In terms of guidance, as George said, we are reiterating our estimated range for the full fiscal year. Looking to the second half and beyond, there are some big challenges ahead and a lot of hard work, but a huge amount of opportunity. Overall, therefore, we have confidence in our ability to continue to generate and capture true value for our shareholders for this year and beyond.

Thank you. Now I will hand you back to Gerald.

Gerald Gradwell

Thank you, Stefano. We'll now open the lines for questions. Vince?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Robert Jones of Goldman Sachs.

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

Given the really strong same-store script comp this quarter, that 7.9% you guys highlighted, can you share any thoughts on maybe why you didn't see a stronger corresponding increase in the front end? Seems to be a little bit of a disconnect between the strength in the script count and then the performance on the front-end comp.

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

Bob, Alex here. Yes, as I think was said in the prepared remarks, George and Stefano said it was a tough market, first of all. So we saw good growth in a tough market, particularly in health care, which you expect to see the link to the pharmacy business. And also through investment in beauty care, we saw again some solid growth. Where we didn't see growth in the front end was really in the seasonal businesses. It was a tough Valentine's Day for the whole market, and also in food where there's clearly a lot of deflation driven by competition and some commodity pricing that sort of affected us last summer and still running. We do track as best we can linked sales, and we are confident that we're seeing the link we expected, and also very confident as the market moves on, this new volume and the new footfall will improve the front-end performance against the strategy that we've clearly laid out.

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

Okay. Great. And then I guess just going back to the Rite Aid deal and the timing. Stefano, you talked about this obviously dragging on longer than you anticipated. I guess, where exactly aren't you and the FTC seeing eye to eye? And then I'm curious, do you think the deal can get approved given the current configuration of the FTC? Or does there need to be more commissioners added in order to gain approval?

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

Well, as I said, I am still positive on this deal. I believe that we have a strong argument for -- to defend this deal. I cannot comment on the organization of the FTC. It will be up to them to decide whether they have enough people or not to judge on the quality of this deal. We are doing what we can with -- together with Rite Aid and Fred's. We are collaborating very well with the FTC. And as I said, we are preparing our facts to be ready to certify compliance, if we will decide to do so.

Operator

Our next question is from Eric Percher of Barclays.

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

Stefano, I'd like to come back to your comment around Prime. The FEP win was notable and not something we expected to see on their own, so it seems like early success. As you talk about the opportunities, midterm and long term, do you see a role as enabling fulfillment in dispensing? Or do you see Walgreens of having a role in enabling pharmacy benefit management as well?

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

Well, we believe that we are in the market, that we have to follow the needs of the market and to be as useful as possible.

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

And so are there elements of Walgreens negotiation with manufacturers or purchasing that you think are of value in the pharmacy benefit space? Can you add on to what Prime has already created there?

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

To be honest, I believe that the market is evolving. It's changing. And for sure, we will have a role to play in this market. And we will try to, let's say, seize all the opportunities that we will have in this market.

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

Okay. Fair. George, quickly, is the buyback at all impacting fiscal year '17 guidance?

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

No. It's -- I mean, given the timing that we've just earlier this week announced, there would be the buyback of up to $1 billion. It won't have any material impact in this year's earnings where we -- to stop buying back shares.

Operator

Our next question is from Lisa Gill of JPMorgan.

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

Just given your comments around the challenging front end environment and the comments of not seeing as much pull-through on certain -- whether you talked about seasonal or more commodity or food, how do you think about the layout of your store going forward? Alex, I think I heard you say that you did see pull-through on a little bit of beauty as well as health care. Do you think about your strategy around retail clinic and maybe perhaps growing that more? How do you think about the strategy around labs? Not talking about like a Theranos, but more of blood drawn, more services in that aspect as we think about health care and to Stefano's comments around the changing and evolving landscape as we think about health care needs.

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

Lisa, it's Alex here. I think you're absolutely right. We've clearly got great corners. The other platform we've got is a great digital platform, so we have definitely got a -- the right presence in the market. We don't have the right products in this space that we have physically in our stores. And we are doing something about that. I mean, as George said in his prepared remarks, we're now going to accelerate the reduction of our unnecessary SKUs. We've already been working hard, and it is like seasonal before this and we're going to go further, particularly as we look at our lower-volume stores going forward. We're very committed to finding the right products and the right health care solutions for the space that we free up. And we've got good experience in Europe, for example, with our opticians business and with the hearing care business. And of course, we've got good experience in America with clinics. So you're absolutely right. We are really thinking very hard and testing and trialing different ways by which we can offer customers more, particularly as we move to more of a health, wellness and beauty convenience model, and it's very much part of the thinking. But it will take some time, I think, as we said before, to get the right customer experience, the right partnerships in particular, and the right economics, but we're very confident we'll find that model in this marketplace.

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

And just one follow-up for George. If I look at the comps, we're basically up 8% on the pharmacy side, but sales were up about 4%. How do I think about that? I mean, clearly, I'm sure generics was part of that, but is there something else? is that the reimbursement component of it that's a drag?

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

It's the -- I mean, as ever, it's the combination, if you look at the relativity of generic deflation relative what's happening on the branded. Mix is always the other factor and to a much lesser extent, the reimbursement element. It's a combination, yes.

Operator

Our next question is from John Heinbockel of Guggenheim Securities.

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

So the question, how do you guys think about the evolution of limited networks going forward, right? The composition of those, in a lot of cases, is the economics more likely to be around Walgreen versus a CVS in some of those networks, or can it be kind of more the 2 of you and other retailers not participating? How do you think that evolves?

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

George, it's Alex here. Yes, I think we play in the marketplace, and the marketplace is definitely evolving towards narrower networks. We really work hard to figure out what the payer or the marketplace wants, whether that be the commercial marketplace or Med D, and often -- and obviously, Medicaid as well. And we work out an economic model to see what the volume and the value looks like. So we don't try and drive the marketplace in that direction. We believe strongly in partnerships. We have no vested interest apart from looking out for our customers and giving good value, a combination of price and service. But there's no doubt that the marketplace is evolving towards narrower networks, and we have to operate and participate in that marketplace.

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

Okay. And then completely different. Given your -- right, your expertise in beauty, is there an opportunity for stand-alone beauty stores? And I say that from the perspective of getting access to brands that you might not be able to inside a Walgreens box. Is that an opportunity? Or you simply have too much to do inside a drugstore to think about that?

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

Yes. We think the opportunity is very much inside of our drugstores and move towards more of a health and beauty convenience specialist. That's where we're seeing the investment and the growth right now. The future of the business will be focused on many ideas, but at the moment we're absolutely focused on making the very most of the 8 million customers who use Walgreens today, both online and in the pharmacies, and also developing a more appropriate beauty offer. And we're seeing some really good things happening in the early stage of this promotion of the strategy, and we're going to continue to drive it. And as George has said already in his prepared remarks, we are moving to another 1,000 stores with our beauty differentiation project, so that shows you the confidence we have in the strategy.

Operator

Our next question is from Steven Valiquette of Bank of America Merrill Lynch.

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

Just on the Prime Therapeutics and narrow network deal that started back on January 1. Just curious if there's any more color on whether the amount of additional Rx volume was in line with your expectations or perhaps slightly better. And also are you able to comment on how many of the 14 Blues plans have signed up for the Walgreens narrow network deal so far?

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

Steve, I can't obviously make any comments on the second one, but we can tell you that it's absolutely in line with expectations. And I can also tell you that we are pleased and also Prime is pleased -- the owners of Prime are also pleased, the Blues plans who own Prime. So we're satisfied with the progress we've made. The next phase for us is to give the members of the Blues a better value and obviously have a look at ways we can do that as the market evolves.

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

Okay. And then just quickly on Rite Aid. Not sure if you can comment on this or not, but just if for some reason the FTC were to decide that Fred's cannot be the buyer of the Rite Aid store divestitures, should we assume that one option would be that Walgreens could then still go back to the drawing board with other potential buyers of those divested stores? Or if Fred's is not the buyer, does that essentially kind of bring an end to the potential Walgreens-Rite Aid merger? Just curious if you would be able to comment on that. Or is it too early to think about that next scenario?

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

For the time being -- Stefano here. For the time being, we believe that Fred's is the right buyer. We believe that they have -- particularly in the configuration we are proposing now, they are absolutely a legitimate player in this industry. If for some reason this will not be the case, we will review our options, of course, and we will take a decision.

Operator

Our next question is from Brian Tanquilut of Jefferies.

Brian Gil Tanquilut - *Jefferies LLC, Research Division - Equity Analyst*

George, it looks like you're continuing to make good progress in leveraging G&A. Obviously, you're tracking ahead of schedule, that $1.5 billion target. So how should we think about the opportunity going forward and the flow through for the rest of the year of the other -- of the efforts that you've put in, in the past on -- in terms of driving more G&A dollars down?

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

Well, this -- I mean, on the particular program that we talked about today, we're obviously very pleased to achieve our target. The program will conclude, as we've previously announced, at the end -- around the end of this fiscal year. Some of the benefits of that we'll obviously continue to see and see more of in the coming years. Given that, nevertheless, looking for opportunities to drive efficiency in our sort of business is just a way of life, so we will absolutely continue to look for opportunities year after year. They will come in different places. There may be in different geographies, but there are always opportunities to drive efficiency. And so it's just never ending. We will continue -- this program will finish, but we'll continue to look for more opportunities.

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

Just a minute, sorry. People say while cutting cost is something that has an end, you cannot really rely on it forever. But it's not just a matter of cutting cost. Synergies and savings are not just coming from reducing costs. Very often, it depends -- they can depend on a different organization. And so if you have, let's say, an approach to the business which is completely open minded, you can continue to drive efficiency and reduce cost, just a change in the organization. And this is really work we have done for many, many years and work, I believe, we are relatively good at doing. And so we continue to believe that we will be able to drive efficiency for many years, independently on the obvious cost cutting that everybody can see.

Brian Gil Tanquilut - *Jefferies LLC, Research Division - Equity Analyst*

To follow up on Eric's question earlier on FEP and specialty, I was just wondering how would you describe your -- the pipeline that you have right now in terms of that partnership with Prime on the specialty side in terms of pipeline for new contracts. Or should we think of this as a kind of like a one-off win where it's kind of choppy? And also what is the pitch that you guys make to potential clients? And what differentiates the Walgreens and Prime specialty offering?

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

It's Alex here. I think the -- it's pretty clear that what we've done here has gotten the attention, particularly of the Blues plans, which we're very pleased about. And really, the pitch is really quite a simple one. Prime Therapeutics really works out to make sure that the value it creates is passed through to the Blues members in different ways. And what we do is really as a back-shop operator, particularly of mail order and also specialty, still is to make sure that we're really, really efficient and give great service directly in the dispensing process. So this was a win for Prime Therapeutics, FEP. And obviously, we believe with our greater scale and our expertise in dispensing prescriptions in specialty and central fill, that, that gives extra capability to Prime and that appears to be being seen in the marketplace as well.

Operator

Our next question is from Ross Muken of Evercore ISI.

Ross Jordan Muken - *Evercore ISI, Research Division - Senior MD, Head of Healthcare Services and Technology and Fundamental Research Analyst*

Just following up on the specialty question. So how is your sort of view of that market and the right competitive landscape and the right level of profits sort of evolved as you've thought about the launch of Alliance Rx? Because it's obviously been an area, there's a lot of scrutiny, there's a lot of questions on what the right dollar level per script or what services should be required or should not be required. How do you feel like you bring a bit of a different viewpoint to maybe a market that had been somewhat stagnant the last couple of years in terms of its evolution?

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

It's Alex again. I think that we bring, as I said before, that efficiency to the marketplace, but that -- we're not the only one doing that, for sure. There's others who are larger who bring that efficiency as well. Then secondly, we bring the opportunity of the network pharmacies. As we said before, we don't just do central fill. We actually own, independent of Alliance Rx, the specialty network of about 1,000 centers of excellence, primarily based around HIV. And also we have now a couple of hundred specialty pharmacies, which are across the hospitals, across the specialist doctors. So again, we offer different routes to market, and we offer a different approach. And we also believe strongly in this area that we should be paid for the service and the care we provide. These are expensive complicated medications. We have pharmacists who're playing to the top of their certificates when they're taking care of patients who are on these medications. And we want to make sure that we are adequately remunerated for that part of the process. And other remunerations belong to other bits in the system, for example, the PBM, for example, the insurance company. We want to be well rewarded for giving the care that our pharmacy gives in that way.

Ross Jordan Muken - *Evercore ISI, Research Division - Senior MD, Head of Healthcare Services and Technology and Fundamental Research Analyst*

And maybe on the big-picture side, a lot of the managed care organizations have talked about sort of a more integrated model or have talked about wanting a presence closer to the individual. Obviously, you have some of the best real estate. And you've also been quite great at lowering costs and prices for individuals and bearing that high level of service. How have your conversations with managed care around sort of what else you can provide to them, or how your sort of dispensing organization, other services fits in with their goals? How has that conversation evolved over time? And what should we be focused on in terms of sort of future opportunities, high level or big picture, that could go on in those relationships?

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

Yes, again, it's Alex again. So again, we have, as you've seen, outsourced effectively a couple of hundred of our clinics in different ways. And in these conversations, we focus on really our strategic ability to become a very efficient and available (inaudible) dispensing service for them. And that really resonates with them. And secondly, we have, as you said, the real estate, where they can actually come in and have the lower-cost ways of delivering services in the community, outside of their more expensive systems. So these really are the 2 areas that we talk about a lot. We have a lot of different ways of doing that, a lot of ways of working, whether it be with Advocate here in Chicago. So again, it's an area where, for sure, the conversations are good. And we're learning together. And again, it goes back to partnership. We know what we're good at and we know the areas where we want support. And for sure, the clinic strategy, I think, is a great example of that.

Operator

Our next question is from Ricky Goldwasser of Morgan Stanley.

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

A couple of follow-up questions here. First of all, when we think about the script comps up 90 basis points quarter-to-quarter, should we think about these comps continuing to accelerate through the back half of the year when you think about the opportunity to capture membership and volume from these partners? Do you think that it was all captured in this first quarter, or we'll see an uptick later in the year? And same questions about kind of like the cadence of margins. Should we expect to start seeing margins that are associated with these scripts improving in the back half of the year?

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

It's Alex again. Yes, I think that we did have a helpful uptick in seasonal illness, flu effectively, for a few weeks, which spiked some of the numbers for us certainly in Q2. So the way I think about it is that these are driven by 2 factors, the small uptick in flu we saw, and also all of these contracts. (inaudible) started 1/1, so 2 months, and then with DOD started, as you know, at 1/12. And remember Med D was again -- we've had a good season in Med D again, started 1/1. So we are confident that the rate we have at the moment is what we expected and the strong volume will therefore continue. In terms of margin, I would think, again, go back to operating margin for us. It really is a bit leveraging our fixed assets as we continue to offer market competitive prices, not below market, but market competitive prices and drive volume through our fixed assets. And we expect to leverage that more, as we've always said, in the second half of the year compared to the first half of the year. And it's important to look at the annual results. As George has reiterated again, we are keeping our guidance for the full year between -- you can work that out, between 7% and 11% EBIT growth, yes.

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

But remember -- Stefano here. But remember that our goal has always been to keep the overall operating margin as flat as possible. And the dynamic in this market and many other market is that you have to give more to your customers, you can get a little more from your suppliers, and you can become more efficient. And so at the end, combining these 3 elements, you have to manage to have the margin overall, year-on-year, more or less flattish, if possible.

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

Okay. And following up on that, when we think about getting more from the suppliers and getting more efficiencies on the back end, do you still see opportunities to improve kind of like purchasing efficiencies or grow scale for WBAD? One contract that's kind of like up in the market that comes to mind is the Express Scripts, AmerisourceBergen contract. Do you see an opportunity there?

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

There are always opportunities on the market. And we are looking at the market very carefully. And we will try to seize all the opportunities that we will see in the market.

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

But is this something that's kind of like already included in guidance? Or is that -- could be potential upside?

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

When we give our guidance, we try to put in the guidance all the elements that we believe are certain or very likely. I cannot give you more details, as you can easily understand.

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

And then lastly on the tax rate, tax rate came in lower than we anticipated. How should we think about the tax rate, George, for the remainder of the year?

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

I think, really, always look at the year-to-date effective tax rate. And if you look at that from an adjusted basis, as I said, that was around 24.5%. So I think tax, obviously, mix can change quarter-by-quarter, but looking at year-to-date, I think, is perhaps the best way of thinking about this. Discrete items, of course, the timing of those are always a little bit uncertain. They can all go up or down, but think of the year-to-date.

Operator

Our next question is from Michael Cherny of UBS.

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

Maybe to ask Ricky's WBAD question a little bit of a different way. As you think about the generic deflation you're seeing across the market, how do you think about the trade-off in terms of what you're seeing across the market, what you can -- what you can't control versus what you're doing with regards to sourcing? And on a go-forward basis, depending on how -- planning for what's an uncertain generic deflationary environment, how does that position you in terms of being able to drive either incremental sourcing or essentially eating some of the potential challenges you have on the pricing side?

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

We make certain assumptions. And on the basis of these assumptions, we have our internal targets. And I repeat, the assumptions are taking really into account all the different pieces of information that we have on the market.

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

Yes. So, it's Alex here. And I think we're in the market, so we see how the market is changing with -- in terms of price pressure, and we accept that. And we're always working on the 2 areas: One is how do we actually buy better and how do we continue to not just save money, as Stefano said, but to really recreate the organization and move money around to invest in areas where we can grow and grow volume. So I think we've never denied the fact that the pricing pressure is there, but never -- we've always been aware of it and always try and anticipate that in our guidance. So the market is the market, and we've got to operate within it. And for sure, we believe we have a strong strategy for the market here in the U.S.

Operator

Our next question is from Alvin Concepcion of Citi.

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

Just wanted to follow up on the question about operating margin in the back half of the year. How should we think about it by segment, international, retail operating margins in the back half? Should that continue to be challenged at a similar level as you saw in the quarter? Or are there opportunities there? And also the U.S., is that something that you would expect to flatten out in the back half?

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

Obviously, we haven't given specific guidance by segment, so first try by -- start by reiterating our overall guidance figures. I mean, in terms of thinking about sort of the modeling, there's going to be a number of factors that you've got to think about. And firstly, we will -- we are consolidating the new Prime deal from Monday when we complete it. And you need to think about that in factoring the U.S. model, recognizing obviously that, that is a specialty and mail business with different dynamics. In terms of the international businesses, I think as we've said in the prepared remarks, the -- there is still the challenge in the U.K. with the NHS having cut the reimbursement. That will continue, but Boots has performed robustly, as we've said, over the key Christmas period. But retailing is still itself quite challenging, particularly in the U.K., which is our largest market. And then on wholesale, wholesale is always a business or a division that operates in a number of markets. You can always get a certain mix effect quarter-by-quarter, so it's tough to model, I know, quarter-by-quarter. But I did point out in the prepared remarks that in certain of the emerging markets, we had some growth really in the period when you get price changes in the market where people tend to buy-in ahead -- customers buy-in ahead of the price change. And that was the notable impact in the second quarter.

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

And it's Alex here, again. Just really quickly on the U.K., as George has said, the reimbursement pressure was the main reason for the decline. Really, there was 2 things we've got. One we normally do, which is the buying margin, which is normal in the U.K. contract. Then secondly, this year, on December, they actually removed some of the service payments, practice payments. And again, if you look on news reels, you'll see that's a big issue in the U.K. So that really is the reason why we've had that decrease in operating profit. The retail business had a good December. And we're focusing on controlling our costs, really driving, as we always do, new innovative products, particularly in beauty into the marketplace, and developing new pharmacy services. So we are -- we're looking to stabilize that business. But the impact of the government action has been pretty strong this year for our main U.K. business.

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

Great. And just a quick follow-up on the beauty initiatives, the remodels. Just wanted to get an update on what you've seen from those, if you've seen an uplift in comps, not only in the beauty section, but also the overall store in some these newer markets. And if so, could you quantify that at all?

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

It's Alex again. I mean, really, it's so early on. The 2,000 stores, if you recall, we had about -- a marketplace in Phoenix, which we tested in trials. And we took the best model and implemented that really last year into the first 2,000 stores. So far, so good. We're seeing that the beauty brand is growing, which we expect it to. And over time, we'll develop the offer and the marketing around that new beauty offering. But it's too early to tell the effects it's going to have on the rest of the business. But we remain confident it will have a positive impact.

Operator

Our next question is from David Larsen of Leerink.

David M. Larsen - *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Can you talk a bit about how you're going to roll up the Prime partnership into your P&L? So like for example, obviously, with this $2.9 billion contract of Prime just wanting specialty, like, how much of that is going to flow through to your P&L? When we think about central fill for specialty, I guess, what portion of specialty would that be? Any color there will be great.

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

Just on the accounting side, I mean, we will account for it on a fully consolidated basis. So when you're looking at our sales, our adjusted operating income, then you will obviously see 100% of the entities' results coming through. But then when you're actually looking at earnings attributable to our shareholders, to the WBA shareholders, we strip out and align the proportion that is attributable to Prime itself. And those, I think, we've said we own just over 50% of the business. So when you're thinking of EPS, then it will be our share. If you're thinking of operating, it's 100%. That's the way the accounting works.

David M. Larsen - *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

That's great. So for the FEP win, that $2.9 billion in revenue, all of that is going to flow through on to your P&L. And then if they win, say, mail in a year or so, that would also all flow through into your P&L, that full $2 billion or $3 billion for mail and $2 billion or $3 billion for specialty for revenue?

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

Anything that goes through the venture, the new combined venture, as I said, we show 100% in revenue, 100% in adjusted operating income. But when -- but then we strip out, as I say, the lower end of the P&L, the Prime share. So when we're looking at adjusted earnings attributable to Walgreens Boots Alliance, that's got their share netted out.

David M. Larsen - *Leerink Partners LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. Great. And then I think Prime uses WBAD as well, right, through ABC. So the value-add or pitch to managed care clients is both -- I mean, there's a significant COGS benefit there, I would imagine, right, for the managed care?

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

We cannot comment on that. We cannot comment on the contract that Prime have or will have.

Operator

Our next question is from Scott Mushkin of Wolfe Research.

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

Most of my questions have been answered, but I just had one regarding the U.S. profitability and the pharmacy as we look out. If the Rite Aid deal does not get approved, how should we frame this as we move out over the next year or 2 or 3 with all of these contracts that have been signed the -- specifically, the profitability of the pharmacy?

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

Scott, it's Alex here. Again, as we've been really clear, we are independently working hard on our pharmacy strategy, independent of Rite Aid. And we feel very confident that the network we have already is strong enough to be very competitive in the marketplace. Anything that we achieve when the FTC give a decision to approve Rite Aid will be incremental, as George has indicated, in the EPS numbers and also in terms of the synergies we announced as part of the deal.

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

And also you will appreciate that we will not be able to integrate all the stores of Rite Aid overnight. So there will be a period clearly of certain number of years where we will have to rely mainly on our stores. And in the meantime, we will integrate all the stores of Rite Aid. So you cannot see the effect immediately.

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

Right. And then looking at the front end, just the -- obviously, the beauty part of it seems to be working out well. And I just want to clarify, you say another 100 stores are going to get the enhanced beauty between now and at the end of the year. I just want to make sure I had that number correct.

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

It's 1,000, Scott. So we've got roughly just under 2,000 just now. And this moves up to roughly a few thousand over an estate of just under -- we have an estate of just approaching 8,300. So 3,000 will have this by the end of this -- really the end of the summer, effectively.

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

Okay. And then any thoughts on what those stores do in comparison to the rest? I know -- I think you're at negative 0.8 comp on the chain, but those stores perform 100, 200 basis points better? Any parameters you have on that?

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

Again, it's really early on. And the way we measure this really is about the underlying retail margin, the operating margin in particular. And the more we see increases relatively speaking in beauty care and health care, but in the beauty care, then the more we see the retail underlying margin improving over time in a sustainable way. We're working around, I'd say, the rest of the model. As Stefano said in his opening remarks, we're changing this model in quite a torrid time in the U.S. for market changes. So we're very pleased with the progress we're making, but that's how we measure it.

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

Okay. so then my final one is -- pretty good quarter considering all the headwinds that the business faced. As we look out over the next 6 to 12 months, I mean, there -- do you see any change in the headwinds that the business face? Do you think it's abating? Is there any light at the end of the tunnel? Or is it going to continue to be this difficult as you move through the next 6 to 12 months? And that's it for me.

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

Well, there are headwinds, but we hope that we will be able to have also some tailwinds. And so we hope that at the end, that we will be able to deliver what we have promised.

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

I would just reiterate, or if you just think of the guidance that we've given, we've maintained our guidance today. If you do the math, then that implies a 7% to 11% year-over-year growth. And that includes approximately a $0.12 headwind for currency. So if you exclude the headwind, then -- obviously, currency can go one way or the other. But if you exclude the headwind, then the guidance implies 9% to 13% year-over-year growth in underlying adjusted EPS. So I think that really, I think, gives a strong indication of what our thinking is and what we see, how the business is performing overall. And as we said at the start of the year, this would be a more second half-weighted. And the year, the first quarter, second quarter has come out very much in line with our expectation. So that's really how we are thinking about the -- about how the business is performing at the moment.

Operator

Our next question is from Ajay Jain of Pivotal Research Group.

Ajay Jain - *Pivotal Research Group LLC - Co-Head of Consumer Sector Research and Senior Analyst of Supermarkets, Drug Stores, Food Distribution*

Most of my questions have been answered already, but I just wanted to clarify why you feel like you have more flexibility now. I think, in your prepared remarks, you tied together the new buyback program with the latest Rite Aid developments. So maybe I'm reading too much into it, but did the earlier comments just reflect any -- did they reflect any greater or less confidence in the merger going through? Or is the flexibility just a function of the lower offering price for Rite Aid?

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

The flexibility is simply obviously the lower price and the timing. I mean, we've been very clear that -- in terms of our policy is solid investment grade. We work very closely with the credit agencies, as you would expect, which is important for our debt investors. And with the timing of the transaction, with the revised consideration and with what continues to be a very strong cash flow, as I think you've seen again from this quarter's results, that simply is why we've decided to announce what is a relatively modest buyback program. It's fine-tuning is how I would describe it.

Operator

At this time, I show no further questions. I'd like to turn the call back over to Mr. Gradwell for any closing remarks.

Gerald Gradwell

Thank you very much, indeed, ladies and gentlemen. Thank you for our call. Sorry for the technical problems we had at the beginning, but I believe you could all hear after we restarted. So thank you very much, indeed. And we -- the IR team, are available to take calls and answer any questions you may have in the coming days, weeks, months, whatever. And we will look forward to talking to you again next quarter. Thank you very much, indeed.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone, have a great day.