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WBA.OQ - Q1 2024 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good morning. My name is Krista, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Walgreens Boots Alliance, Inc. First Quarter 2024 Earnings Conference Call. (Operator Instructions)

Thank you. I will now turn the conference over to Tiffany Kanaga, Vice President of Global Investor Relations. Tiffany, you may begin your conference.

Tiffany Ann Kanaga - Walgreens Boots Alliance, Inc. - VP of Global IR

Good morning. Thank you for joining us for the Walgreens Boots Alliance earnings call for the first quarter of fiscal year 2024. I'm Tiffany Kanaga, Vice President of Global Investor Relations.

Joining me on today's call are Tim Wentworth, our Chief Executive Officer; and Manmohan Mahajan, our Interim Global Chief Financial Officer. In addition, John Driscoll, President of U.S. Healthcare; Rick Gates, Senior Vice President and Chief Pharmacy Officer at Walgreens; and Tracey Brown, President of Walgreens retail and Chief Customer Officer, will participate in Q&A.

As always, during the conference call, we anticipate making projections and forward-looking statements based on our current expectations. Our actual results could differ materially due to a number of factors, including those listed on Slide 2 and those outlined in our latest Form 10-K filed with the Securities and Exchange Commission. We undertake no obligation to publicly update any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise.

You can find our press release and the slides referenced on this call in the Investors section of the Walgreens Boots Alliance website.

During this call, we will discuss certain non-GAAP financial measures. These measures are reconciled to the most directly comparable GAAP financial measures, and the reconciliations are set forth in the press release. You may also refer to the slides posted to the Investors section of our website for reconciliations of non-GAAP measures to the most comparable GAAP measures discussed during this earnings call.

I will now turn the call over to Tim.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Thanks, Tiffany, and good morning, everyone. When I joined you for the last earnings call in October, I had not yet begun my role as CEO, but I shared how I believe that leading WBA is a once-in-a-lifetime opportunity with a tremendous brand, legacy and neighborhood presence. Today, 10 weeks into my tenure, I am even more certain of my decision.

I am pleased to be here today to share our results, our outlook and my broader convictions around how we can build on our strong pharmacy foundation to partner across healthcare services and drive sustainable value.

As you are by now aware, WBA started fiscal 2024 with on-plan results despite a weak retail environment in the U.S. First quarter adjusted EPS came in at \$0.66, reflecting execution and cost discipline in U.S. Retail Pharmacy, continued strong performance in International and progress with profitability initiatives in U.S. Healthcare. We are maintaining full year adjusted EPS guidance against a challenging backdrop. I must give credit here to the hard work and dedication of our teams. We are navigating the accumulating consumer pressures from inflation and depleted savings and somewhat slower-than-anticipated market trends in pharmacy script volumes, including impacts from a weaker respiratory season and Medicaid redetermination.

Retail customers in the United States are under stress and making deliberate choices to seek value, evidenced in our own brands up 90 basis points in the quarter, while demand for seasonal and discretionary categories remains weak.

At the same time, our teams executed well during the quarter on delivering pharmacy services, including vaccines and maintaining our overall share of script volume in the U.S. International was once again a bright spot in the quarter, building on last year's solid growth. Upside was led by Boots U.K. with further share gains in retail, while both retail and pharmacy delivered gross profit improvement despite inflationary cost pressures. Germany also achieved share gains.

In U.S. Healthcare, we are on track to achieve significant year-on-year profit improvement. VillageMD is rapidly realigning operating costs with sales. The team is executing on several initiatives, from revenue cycle management to procurement with operational actions spanning the organization. As VillageMD focuses on increasing density in their highest opportunity markets, remember the previously announced plans to optimize their footprint and exit approximately 60 clinics in nonstrategic markets. As of today, they are nearly halfway there, having already exited 27.

Additionally, VillageMD is driving patient panel growth and achieved 23% year-over-year growth in full risk lives and 9% growth in fee-for-service volumes. Work is underway to implement targeted marketing efforts, leveraging Walgreens' expertise and patient touch points, and we expect benefits over time as we learn and further develop our provider-based risk strategy.

So macroeconomic conditions are clearly difficult for retailers, and I fully acknowledge the structural headwinds in our core pharmacy business and the growing pains in our Healthcare segment. None of this is a surprise to me. I came to WBA eyes wide open with a clear mandate to act with everything on the table in terms of putting our business on the right track.

In that context, we are taking swift actions to rightsize costs and increase cash flow across the company. We remain on pace toward \$1 billion in cost savings this year. Our U.S. organizational efforts have resulted in a planned headquarter support office workforce reduction of approximately 20%. Over the past 2 months, we have prioritized projects and capital spend to focus on the customer-facing activities that matter most.

First quarter CapEx was over \$100 million lower year-over-year, on track to a \$600 million reduction for the full year. We also remain on schedule to deliver \$500 million in working capital benefits in fiscal 2024.

An additional meaningful and necessary step to strengthen our long-term balance sheet and cash position, today, we are announcing a 48% reduction in our quarterly dividend payment to \$0.25 per share starting in March. This action will free up capital to invest in driving sustainable growth in the pharmacy and healthcare businesses, as well as paying down debt. At the same time, we will continue to deliver a competitive dividend yield as the Board and I continue to view the dividend as a critical component to overall attractiveness of WBA to many of our shareholders.

Our financial flexibility is also supported by other strategic actions, with some already underway and others under consideration. In November, we monetized an additional portion of our Cencora stake with nearly \$700 million of proceeds. We also took advantage of the higher interest rate environment to secure a full buy-in for the Boots pension plan with legal and general to ensure the benefits of all 53,000 members. A buyout scheduled in calendar 2025 will eliminate the company's plan obligations and commitments.

Furthermore, we continue to evaluate our existing portfolio, sharpening our strategic focus on the U.S. Retail Pharmacy and Healthcare with our remaining investments in Cencora, BrightSpring and other minority interests providing financial flexibility.

Let me be clear. We have hard work ahead of us in our journey to simplify and strengthen WBA, but also good momentum with important early actions that we've taken. And there are a number of building blocks already in place for a sharper healthcare strategy, positioning us well for long-term profitable growth.

Walgreens is a dependable, trusted and convenient local healthcare destination for patients, and we have the ability and, frankly, the market mandate to be a valued independent partner of choice in healthcare services. As John Driscoll detailed last quarter, we are leveraging our local presence to engage with patients across our thousands of stores and through our assets across the care continuum on behalf of payors, providers and pharma to help them achieve their objectives at scale. I can tell you from my early days with the team and from meetings with our partners and prospects, there is a lot to be excited about here.

But our competitive advantage is not just our neighborhood footprint and convenience with 10 million customers visiting us at Walgreens in store or online every day. Our stores are access points on the best corners in America. And more specifically, we have over 85,000 people on our teams who directly engage with patients and are trusted providers in their communities. Walgreens has the unique ability through our well-established physical presence and iconic brand for our people to drive trusted, meaningful connections.

We are enabling pharmacists to spend less time on tasks and more time on meaningful interactions and providing essential care, from health screenings to immunizations to diagnostic testing and treatment. Our network of micro fulfillment centers is helping to stabilize staffing and pharmacy hours, reduce workflow pain points and free up capacity to drive the outcomes that matter most to our patients and partners.

You'll remember in October we mentioned a pause in the rollout to optimize productivity. We are happy with our continued progress and the importance of these centers in our overall strategy. We are also piloting virtual pharmacy to redefine connected care, further increase patient access, enhance workplace flexibility, and extend our pharmacist reach.

Finally, we are partnering with academia, and specifically, key schools of pharmacy to explore ways to attract, recruit and create a dynamic workplace for the next generation of pharmacists. Our relationships with pharmacy deans are integral to our strategy and can help us advance the profession, and so we are forming an advisory council to guide us in our transformation. I look forward to personally working with the deans with our first meeting in March to ensure Walgreens is the preferred employer in the pharmacy space. And I want to thank our pharmacy teams for their tireless efforts on the front lines of healthcare delivery in this country.

Let me give you one example of how we can build on our established assets in a capital-efficient way to expand services and support patients and partners: our clinical trials offering. We are partnering with pharma companies and leveraging our community presence and patient engagement to help drive greater patient diversity in clinical research. In a short span, we are already improving participation and equity at double the national average. To date, we have signed over 25 contracts, with a robust pipeline of opportunities ahead.

Shields is another example of our strength serving hospital systems and has consistently delivered strong margin accretive results ahead of plan. Sales were up 27% in the first quarter, driven by meaningful growth at existing customers as well as new partner contract signings. We expect Shields to continue to leverage and benefit from the rapid growth in the broader specialty market and our intense focus on accelerating hospital-owned specialty pharmacy programs.

Our specialty pharmacy assets will be an important focus going forward. And while we have work to do, we are pleased to be executing our next steps with gene and cell therapy. The FDA anticipates approval of more than 20 gene and cell therapies by 2025, and this is an exciting opportunity for patients with rare conditions and for Walgreens specialty pharmacies. In the coming months, you will hear more from us on our initiatives in specialty.

Finally, let me touch on reimbursement models and dynamics. We continue to see the benefits of more comprehensive and responsive discussions with payors as they are realizing the broad set of value drivers that WBA can deliver. We are committed to and entering into pay-for-performance contracts beyond core dispensing as we advance our adherence and outcomes capabilities within our pharmacy platform.

In addition, we welcome and will work with payor and PBM partners on any model that recognizes and reimburses pharmacies for the unmatched value we provide patients, including pharmacy services, as well as those models that can ensure more transparency and predictability in reimbursement.

With that, I'll hand it over to Manmohan to review our financial results and recent execution in further detail.

Manmohan Mahajan - *Walgreens Boots Alliance, Inc. - Senior VP & Interim Global CFO*

Thank you, Tim, and good morning, everyone. Overall, first quarter results were in line with our expectations. Sales increased 8.7% on a constant currency basis. U.S. Retail Pharmacy grew at 6.4%. International delivered 4.4% growth. And U.S. Healthcare pro forma sales increased 12%.

Adjusted EPS of \$0.66 declined 44% on a constant currency basis, mainly driven by lower U.S. retail sales and a 21 percentage point headwind from a higher adjusted effective tax rate. Strong international growth and improved profitability in our U.S. Healthcare segment positively impacted adjusted EPS.

GAAP net loss for the first quarter included \$278 million after-tax charge for fair value adjustments on variable prepaid forward derivatives related to Cencora shares. Remember, in the first quarter of last year, we recognized a \$5.2 billion after-tax charge for opioid-related claims and lawsuits and a \$0.9 billion after-tax gain on sale of Cencora shares.

Now I will cover the U.S. Retail Pharmacy segment. Sales increased 6.4% versus the prior year quarter, driven by brand inflation in pharmacy and higher contributions from pharmacy services. Sales growth was partially offset by a 6.1% decline in the retail business.

AOI declined 37.2% year-on-year, mainly driven by lower retail sales volume and margin, including higher levels of shrink. AOI was positively impacted by execution in our pharmacy services and progress on cost savings initiatives.

Let me now turn to U.S. Pharmacy. Pharmacy comp sales increased 13.1%, mainly driven by brand inflation and higher contribution from pharmacy services. COVID-19 vaccines have now shifted to a commercial model consistent with other vaccinations. Comp scripts grew 1.8%, excluding immunizations, in line with the overall prescription market.

The ongoing impact of Medicaid redeterminations and a weaker flu and respiratory season continued to negatively impact overall market growth. Third-party data showed flu, cold and respiratory activity was down 13.5% compared to the prior year quarter.

Within Pharmacy Services, our vaccines portfolio, which includes flu, COVID, RSV and other routine vaccinations, performed well in the quarter. Pharmacy adjusted gross profit declined slightly in the quarter, with margin negatively impacted by reimbursement pressure, net of procurement savings and brand mix impacts.

Turning next to our U.S. Retail business. Challenging macroeconomic conditions and an anticipated slow start to the cough, cold, flu season contributed to a weaker retail performance year-on-year. Comparable sales declined 5% in the quarter.

There are 3 main drivers. First, a weaker respiratory season had an impact of approximately 160 basis points through the health and wellness category. Cough, cold, flu serves as a primary trip driver. As a result, we also experienced lower attachment sales due to the weaker season, which are incremental to the 160 basis points impact. Second, customers continue to pull back on discretionary spending, and actively seek out promotional opportunities. As a result, we saw an approximately 90 basis points impact from weaker holiday seasonal sales. Lastly, our decision to close most of our stores on Thanksgiving this year to further support our store team members led to a headwind of about 60 basis points.

While these factors resulted in lower sales across all categories, we experienced more pronounced declines in consumables and general merchandise and in health and wellness.

Retail gross margin was negatively impacted by 110 basis points due to higher shrink. Retail shrink continues to be a systemic issue across the retail industry.

Turning next to the International segment. And as always, I will talk in constant currency numbers. The International segment performed better than our expectations in the quarter. Total sales increased 4.4%, with Boots U.K. up 6.2% and Germany wholesale growing 3.7%. Segment adjusted gross profit increased by 7%, outpacing sales growth, with Boots U.K. driving strong retail growth. Adjusted operating income grew 15%, including the impact from inflationary cost pressures.

Let's now cover Boots U.K. in detail. Comp pharmacy sales grew 0.8%. Comp retail sales increased 9.8%, with growth across all categories, led by beauty and health and wellness. We also saw a year-on-year growth across all store formats, with flagship and travel locations performing particularly well. Boots increased retail market share for the 11th consecutive quarter, led by beauty. Boots.com sales increased 17.5% year-on-year and represented 19.2% of our U.K. retail sales.

Turning next to U.S. Healthcare. U.S. Healthcare segment results were in line with our expectations. This is the second consecutive quarter of significant improvement in AOI and adjusted EBITDA compared to prior year.

First quarter sales of \$1.9 billion increased by 95% compared to the prior year, reflecting the acquisition of Summit Health by VillageMD and growth across all businesses. On a pro forma basis, segment sales increased 12%. VillageMD sales of \$1.4 billion were up 14% on a pro forma basis. The year-on-year increase was driven by growth in full risk lives, better same clinic performance, and increased productivity in the Summit Health multi-specialty business.

Shields increased sales by 27% as new health system contracts and expansion of existing partnerships led to a 42% increase in the number of patients on service in the quarter versus the prior year.

Adjusted EBITDA was a loss of \$39 million, reflecting investment in VillageMD, partly offset by profitable growth at Shields and CareCentrix. Adjusted EBITDA increased \$84 million compared to last year, with improvement across all businesses. We are making progress to accelerate profitability at VillageMD, and profit growth from all other businesses contributed positively in the quarter.

Turning next to cash flow. Overall, free cash flows were in line with our expectations. Operating cash flow in the quarter was negatively impacted by anticipated seasonal inventory build and timing of payor reimbursement. Capital expenditures declined by \$104 million versus the first quarter of fiscal '23.

Free cash flow was down \$671 million versus the prior year, driven by the phasing of working capital and lower earnings, partially offset by lower capital expenditures. As Tim mentioned, we are on track to reduce capital expenditures by approximately \$600 million year-over-year and to deliver working capital improvement of \$500 million.

I will now turn to guidance. We are maintaining our fiscal '24 adjusted EPS guidance. We expect certain incremental tailwinds and headwinds in a challenging environment compared to our prior outlook.

On the tailwinds, with strong execution to date, we now expect pharmacy services to deliver ahead of our initial plan. We also anticipate an improvement in our full year adjusted effective tax rate as a result of tax planning initiatives, with a revised range of 15% to 17%, compared to the prior outlook of 19% to 20%.

On the headwinds. First, we expect the pullback in consumer spending and shifting behaviors will continue to impact our retail sales in the U.S. in the short term, while improving in the second half. We now expect retail comp sales for fiscal '24 to decline low single digits compared to the prior outlook of flat. Second, we expect approximately \$125 million in reduced sale and leaseback gains versus our prior outlook. As we explained in October, this is the last year of anticipated sale leaseback transactions. Lastly, we also forecast slightly lower overall market volume growth for prescriptions compared to our previous expectations.

Importantly, as we build on the first quarter progress in U.S. Healthcare, we continue to expect segment adjusted EBITDA to be breakeven at the midpoint of the guidance range. This represents an increase of \$325 million to \$425 million over fiscal '23. The improvement is mainly driven by actions taken to accelerate profitability at VillageMD, robust growth at Shields, and cost discipline.

Next, I will discuss factors impacting the phasing of earnings in the second quarter versus second half of the fiscal year. In the second quarter, we will be lapping adjusted EPS of \$1.16 in the prior year quarter.

Three factors are expected to have an outsized impact on the year-over-year comparison. First, we anticipate lower contributions from sale and leaseback activity. Second, we're incorporating impacts of consumer pressures on spending and sentiment, and higher shrink on our retail business. Lastly, we expect these headwinds to be partly offset by a lower tax rate in the second quarter due to the phasing of tax planning initiatives.

Looking ahead to the second half of fiscal '24, there are 4 key drivers for our improving earnings profile. First, as we have previously discussed, we expect actions to lower our cost base will continue to ramp over the year. Second, we expect U.S. Healthcare segment profitability will scale over the balance of the year, mainly driven by benefits from optimizing the clinic footprint, growing patient panels and realigning cost at VillageMD, and growth across all of the businesses.

Third, we cautiously expect modest level of retail market growth against an easier second half comparison. Finally, our tax rate was elevated in the first quarter. We expect favorability in the remainder of the year.

With that, let me now pass it back to Tim for his closing remarks.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

To summarize what you've heard from us today, we executed on our plans in the first quarter despite the challenging environment, and we also recognize there is still plenty of work to be done. The future of healthcare and of this company both require innovative new thinking. My headline to you is that everything is on the table to deliver greater shareholder value. We have the experience and the license to deeply examine our business and make the changes that position us well going forward.

Having spent time with our team members and our business, I'm encouraged by the significant opportunity to build on our legacy pharmacy strength and our trusted brand, to evolve healthcare and the customer experience. We are not pivoting away from our position as the premier neighborhood retail pharmacy, but we are instead redefining what we can do to help payors, providers and pharma achieve their goals. The reasons I joined WBA weren't just validated in these discussions, they are even more true than I had anticipated.

I have a strong team in place to drive execution who are effectively working together to deliver for all of our stakeholders while I work through several leadership transitions. In the coming weeks and months, we look forward to engaging with you, our customers, our fellow teammates and our shareholders as we are listening, learning and moving quickly to create sustainable value.

Now I would like to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Lisa Gill from JPMorgan.

Lisa Christine Gill - *JPMorgan Chase & Co, Research Division - Analyst*

I want to go back to your comments around the reimbursement model. You talked about pay-for-performance, you talked about the unmatched value transparency, predictability. How much of that do you think can be driven by Walgreens and Walgreens putting a new model in place? And as we think about just what's happened with the margins in drug retail over a number of years, what do you think can be a sustainable margin when we think about the drug retail business?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Lisa, first of all, as it relates to sort of how much can Walgreens drive market shift, I think we certainly, as a major retail player and partner to PBMs and health plans, are in a position to bring value to the table in different ways that they will look at and determine -- help them win in their marketplaces. And so I actually think we can play a fairly significant role in the relationships that we have, the contracts that we write and the risk that we're willing to take in terms of the value we know we will create at the back of the store with the way we can interact with patients on behalf of those payors.

So I don't think, as you know, any change in a reimbursement model is a speedy change. But I think there's very, very strong clear messaging in the marketplace from us and others that would point to the fact that the way that retail pharmacies will create value in the next 10 years isn't going to simply be lowering the cost of -- the unit cost of the drugs that we're purchasing and distributing because, quite frankly, that largely now is not where the real gains can be made for payors and for patients.

And so from our standpoint, we're going to drive hard at it. We can work inside of, and we've proven, we're inside of cost-plus models now, transparent models now. We have a very robust cash program. And we think we're a terrific partner to others that want to win in the marketplace with these more innovative models that they have talked about and that they are pushing into the market. So I feel super good.

Now in terms of -- I'm not going to give you guidance on the, as you would expect, on the margins for drugs, other than to say that most of the -- if you look at the innovation and reimbursement in pharmacy that's likely to evolve, it's likely to evolve in such a way that the margin per drug is going to be largely based on how much service do we provide to patients that's receiving it. And I think we've seen what that looks like in models like specialty. We've also seen, when it disconnects, what it looks like. And those are things that we're working against as well, where we're not compensated for the kind of services we provide.

And we are pretty confident that the value that we can build in what we call our pharmacy services, but also our use of pharmacists to help patients take the drugs and stay on them safely and get the benefits and make sure the payors are getting what they're paying for, we're super well positioned to evolve those models as a leader.

Lisa Christine Gill - *JPMorgan Chase & Co, Research Division - Analyst*

Thank you, and congrats on your first quarter.

Operator

Your next question comes from the line of George Hill from Deutsche Bank.

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

Yes. I'll echo Lisa's sentiment, is welcome aboard, Tim. I guess, Tim, as you look at the business from where you stand right now, you've kind of said that everything is on the table. But I guess, could you spend a little bit talking about what you think is part of the Walgreens core business, the WBA core business, and kind of what might be ancillary? And kind of maybe talk about how you're spending your time and where you think your strategic focus is most important to be spent right now.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Sure. Thanks, George. I appreciate the question. That's a great way to ask what's on the table. And from that standpoint, let me answer your question though. Because we have a terrific group of assets that I think are going to be, on a go-forward basis, critical. But again, let me be clear, I'm 60 days in. We have a lot of work to do. We're working to get our cash flows, our balance sheet, all of our financial models aligned with being able to invest in our company to growth -- to grow.

The first and most easy answer is our stores. And so lest anyone think that where we were headed was a meaningful pivot away from being committed to a community-based engagement model with patients, both with what we do in pharmacy and what we do to create a great experience for them in the front of our store, that is central, a central element to what we will have going forward, and that is not on the table.

Now what is on the table is what's the right footprint in stores. And we've announced already that, for example, this year, we're going to optimize our footprint by roughly 200 stores and we're on track to do that. We will continually look at sort of the model through the lens of where do we need to be and where do we not need to be, and what is creating value and what is destroying value. But there's no question for me that we are going to be a major community-based, neighborhood, point of engagement for patients with human beings touching human beings, which I believe is in the long term how healthcare in this country is going to evolve.

Besides that, though, we very much -- and you've seen -- I get asked, why did you come off the couch that you were sitting on to get back into the CEO chair? It was real simple. Walgreens called me. I had 3 years of experience during the worst pandemic, hopefully, in my life with the pharmacy services part of our business, with the vaccines that my family and I were able to obtain. And so for me, I viewed Walgreens as a fundamental public health utility as much as a business, and something that literally has the potential to be meaningful, not just in a pandemic, but on a go-forward basis. And we have proven that with our pharmacy services businesses.

So we are clearly investing around being able to both free up pharmacists, centralize certain activities and so forth using technology, to then expand the things that we can do in store, be they testing, be they -- including working with LabCorp, but also using our own employees, vaccines and adherence programs and other things that we do to counsel patients.

Besides that, though, we have a really terrific cluster of businesses in CareCentrix and in Shields where we're adding value to payors in areas where they're taking risk and where they're looking for partnership. And those assets are, in my first glance, providing real value to the marketplace and have potential synergy with one another and with our retail pharmacy model.

So again, backing all the way up though, again, there are a number of other things there. The clinical trials business that I mentioned in my prepared remarks, super interesting, leverages some of our assets, capital efficient. And I think that that's the way I'll zoom out here and just leave you with the thought that says, I don't want to detail every asset we have. We've got lots of really good stuff. We also have investments in things like VillageMD that we're actively managing.

But what I would say is this, the lens that we're going to put on these things is, do they create sustained value for payors, patients, health systems, PBMs? And if they do, can we get a fair return for the capital that we're going to invest in them? And if the answer is we can't get a fair return, we're

not a charity, so we won't do it. But I see a lot of opportunities for us to meaningfully create high return on capital investments in the services business.

And that's the -- I think the headline I put out there is that we are going to evolve our services, our strategy, from a healthcare standpoint to a health services strategy, which I think a retail pharmacy basis for that. I thought a PBM basis was terrific to build a health services business. I think a retail pharmacy base is a fabulous base to build a health services business from because of the engagement.

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

Okay. And if I could have a quick follow-up. I guess, do you think of the care delivery business as kind of core to the business in the way you frame the person-to-person aspect?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

When you -- would you define when you say care delivery?

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

The Village and Summit assets?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

So we like that investment. We're working closely with them. And as Manmohan mentioned in his prepared remarks, there's no question that they have put themselves on a good path, both in terms of their costs and their footprint, getting to a place where they're going to be meaningfully growing and profitable. So we like that as an investment.

I think that as a future growth area for us beyond the Village investment, which we're very committed to, I would not expect to see us investing in additional primary care assets in our portfolio of investments.

Operator

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

Charles Rhyee - *TD Cowen, Research Division - MD & Senior Research Analyst*

Yes. And welcome, Tim, back. Tim, I wanted to touch on sort of your comments around specialty. Obviously, given you're in specialty from your prior roles, would love to hear a little bit more about this. You talked a little bit extensively about it and potentially the path for Walgreens to be a significantly bigger player in this segment.

If I'm not mistaken, I think Shields is one of the few specialty pharmacies that has sort of access to almost all the limited distribution specialty drugs in the market. And sort of -- given sort of the shifting channel dynamics in this market over the next few years, particularly with, I would say, some ongoing regulatory scrutiny in this space, what kind of opportunities do you think this could create for Walgreens and Shields in particular?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

I'll start, and then I'll actually let John speak a little bit more, because John has been very close to the Shields business, which has just been a terrific great management team and a great partner to health systems.

First, let me clarify one thing, which is that actually we -- Walgreens specialty have access to the limited distribution drugs and Shields has access to us. And so what Shields is able to do is actually work on behalf of the health systems to build networks and to manage the patients and the pharmacy programs that are really important to these health systems. If you look at their underlying economics, quite often, that can be many times the only place that they're actually earning a profit. And so we become a very, very important partner.

Our Walgreens specialty assets inside that mix, I'll speak to just for a second. We have community, a central fill. We are building a gene and cell therapy, because pharma has essentially indicated strong interest in working with us in that space. And so we think we've got great core assets. I think that one of the things that's been underway, under John and Rick working together, has been really making sure that we've got those assets focused very, very pointedly on the payor market. And since I got here, we've had a number of wins where we were put into the network of large Blue Cross Blue Shield regional plans as a participant.

That's not sufficient from where I'm sitting, though. We've got to be able to win more than our fair share of those patients based on the service that we provide, the cost we can deliver. And we're working through sort of our models to figure out what we need to do to enhance our access to patients.

That being said, though, Shields is a key enabler to a specialty strategy as a potential component for these pharmacies. And John, if you want to just give any additional color there?

John P. Driscoll - *Walgreens Boots Alliance, Inc. - Executive VP & President of U.S. Healthcare*

I think you nailed it, Tim. I think the only thing I'd add is we're not just growing with payors, we're growing beyond Blues plans, with other payors. And it -- and what Shields does an exceptionally good job at in a growing market is leveraging a clinical pharmacy model, which delivers more adherence and better outcomes.

And so it's really a great example, very -- where there's a lot of detail involved of we're being paid for performance, and that's growing in terms of building on Walgreens franchise with large hospital systems and small hospital systems around America. But it's based on execution, which I think there's still a lot of runway both from a payor and from a health system perspective, and obviously, the underlying specialty drug market that is only going to get larger and more complicated, which I think plays to the Shields and the Walgreens strengths.

Charles Rhyee - *TD Cowen, Research Division - MD & Senior Research Analyst*

Great. And if I could just follow up on George's question. Tim, you kind of said that you probably are looking to invest in more care delivery assets, kind of like VillageMD, but could we expect more type of partnerships with entities like Pearl as a way to kind of expand continued access to care?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Yes is the short answer. We recognize that VillageMD represents, and City, represent a fabulous sandbox for us to build services, test them, and by the way, demonstrate that they perform and help them achieve their objectives, while at the same time putting us in a position of growing. And from our perspective, that is a starting point to being a partner of choice for any number of -- as you know, Village has certain geographies they're very deep in, but there are geographies they're not in at all. And there are large provider opportunities for us to partner in similar ways in those marketplaces to grow our business and, importantly, help them grow theirs.

Operator

Your next question comes from the line of Eric Percher from Nephron Research.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

On pharmacy, we've been hearing from Walgreens the pharmacy services are the key to driving better reimbursement for several years. And it looks like we're seeing that in vaccines today, broader reimbursement pressure continues. And you have a peer saying that you've hit a floor on unit cost offsets. Independents are saying the same and it can't go lower. Do you share the view that we've hit a floor that reimbursement pressure has reached a level you can't go past in '24 or '25? And perhaps more important, given your PBM experience, does Walgreens have the leverage needed to drive more fair reimbursement or new models?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

So listen, in my 25 years at PBM, the floor just kept moving lower, not just for retailers, but frankly, for all the players in the system, right, whether that be rebates or acquisition costs, et cetera. And so we don't accept that -- we think that there is very little left, let's put it that way, in the tank.

In terms of if I'm a PBM and I'm trying to deliver value to my marketplace, the levers that I have include retail network design. And what I -- my point would be is squeezing the retailer beyond sort of where it's economically sensible for the retailer, by itself, there isn't much left there. And so to do that doesn't produce enough value for the PBM to go win on that basis. It's way, way more effective to win on creation of more certainty around value beyond unit costs.

So I think we're close -- I'm not going to say we're close to the floor, but we are in this -- and we've had a very successful 2024 negotiations with the various PBMs and are 95% along the way of being done for '24 and have some good indications for '25. And again, we are -- we believe we can help drive a transition in the marketplace over time to a more value-based model, which will frankly show well to -- through to the end users and the patients.

And so from my standpoint, I'll never declare there's a floor. And as I've said to our team, guess what, we still have to compete. We don't get to not compete just because the reimbursement model changes. We will compete, though, on things that we're actually very good at and that we can control. And I think that as I look forward in the next 3 or 4 years, we can play a leadership role in that in a way that helps PBMs win.

Let me be clear. Our job is to help PBMs win. I want more prescriptions coming through our stores, and that does not happen simply by being a great patient experience. It happens by being a great payor partner. And that's the place that we're going to be focused. And we are listening carefully and trying to understand what are the payors trying to do in order to, therefore, configure the places we create value.

And as you've seen, 2 very large PBMs have said at least -- and I think they're responding, it's really interesting to me, to more pull from the marketplace than we may have experienced historically as it relates to either pass-through or transparent models, and therefore, announcing these programs that they're putting out in the marketplace that we can play very, very effectively in. So the fact that there may be more marketplace pull there only presents for me a sense of urgency for our team to do what we've already done and accelerate additional value creation that we can, A, be paid for, and B, that our payers can go out and win with.

Rick, do you want to...

Rick Gates - *Walgreens Boots Alliance, Inc. - Senior VP & Chief Pharmacy Officer of Walgreen Co.*

Yes, Charles, this is Rick.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Rick add some color.

Rick Gates - *Walgreens Boots Alliance, Inc. - Senior VP & Chief Pharmacy Officer of Walgreen Co.*

Yes. Sorry, Eric. The one thing I'll add is that we've been very successful at making sure that we are negotiating straight and core dispensing as one rate and anything else, value add, is a separate rate. So when you think about pay-for-performance contracts or you think about any of our services like vaccinations or test, test and treat, those are completely separate reimbursements that we're getting. So we've been very specific on how we contract so that we can be laser sharp on how we look at the unit economics of our scripts dispensing.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

That's where I was going.

Operator

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

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

Thanks for the question. So just Tim, a follow-up on the reimbursement model because, obviously, it's a big focus for investors. I think you mentioned in Lisa's question that you think it would take some time. Do you have a guesstimate on how long you would take it to implement?

And maybe putting your payor hat on since that was the majority of your career, why do you think payers would be open to such a change? What would be the main drivers for them? And maybe what would be the benefit for them longer term. And what would be the benefit for Walgreen longer term?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

So how long to implement? As you know, PBM and health plan selling cycles are not short. And so what I would expect is to see material potential change within a year or 2. And probably -- but you'd also see for new sales midyear for small groups and stuff that churns more regularly, I think you could see a fairly quick uptake to the extent that the market is looking for this.

And again, I say that cautiously because we've seen before with transparent -- I remember in 2005, I think, as a PBM, I wrote the -- we joined the Towers Watson collaborative and it was -- we were doing traditional deals within 6 months alongside of the transparent because the market actually didn't want the risk shifted to them. They wanted the risk being held by the PBM.

So in this case though, I think that the plan designs that the market have largely evolved to are creating this underlying demand to give patients the pass-through of the cost plus experience so that they don't have an odd surprise when they go to the pharmacy counter of paying more for the drug than actually they would if they were a cash payor.

So I do think that the employers don't like the employees coming into their benefits office asking questions about how good are my benefits, if, in fact -- this is my experience at the pharmacy counter. And that's causing some demand. Again, I'd let the PBM speak for themselves as to why they've launched these programs. But I would suspect that, that's a piece of it. I think as well, the regulatory environment continues to evolve. And I think that it is very appropriately responsive to some of the concerns that exist there.

So I don't think it's going to be -- this is not a 6-month implementation. We are prepared and already have sat down and had conversations to support these models, and we could convert to a cost-plus model overnight. So we are a willing player in terms of what we would need to do to compete and win patients on a cost-plus basis.

Why payers would do it? Again, I think I've just -- I've answered that for you in terms of it comes down to providing a benefit in a labor market that's fairly tough competitive-wise to folks that are valued. And so they want the benefit -- the pharmacy benefits, the most used benefit, they want it to be valued. And they want it to be understood and they don't want it to be confusing. And so I think these models offer a pathway to achieve that.

What's in it for us is being paid fairly for the services we're providing at the back of the store, and not subsidizing in a large-scale way the products that the patients are getting in a way that's not economic for us.

And I think the big change there, if you go back, there was an appropriate amount of incentive being created in the system to dispense generics, for lots of obvious and good reasons. If you go back 25 years ago, the generic wave was -- people didn't believe would happen. We had to do generic sampling in the PBM industry to even convince physicians that they were okay to dispense and easy to dispense.

And so that's different now. You've got 90-plus percent generic dispensing rates in most places. And the need to cross-subsidize and force essentially the profit on to the generic side in exchange for a subsidy on the brand, particularly with the new brands that are coming out, just doesn't work anymore for the pharmacies or, frankly, for the patients in high deductible plans. And so I think those powers will align to force this time a set of changes around reimbursement that may well stick.

Operator

Your next question comes from the line of Kevin Caliendo from UBS.

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

In your prepared remarks around guidance, you mentioned that your expectations were, around market growth in the pharmacy, maybe being a little bit lower now. I would just love any clarity on what that meant and what might be driving that. And then secondly, more a strategic question for Tim. Given your history and everything else as you think about pharmacy services, does it benefit Walgreens to actually own a PBM?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Well, I'll turn the first part of your question over to Manmohan and then be happy to answer the second part.

Manmohan Mahajan - *Walgreens Boots Alliance, Inc. - Senior VP & Interim Global CFO*

Sure. As you think about the prescription market growth, as we shared the outlook in October, our guidance was that we're going to grow in line with market on the prescription side. What we've continued to see in the first quarter is the market is growing at a lower pace. And that's really driven by 2 factors. First is the weaker respiratory season, and the second is the impact or continued impact of Medicaid redetermination. So as we're thinking about the full year now versus October, we expect the overall market growth to slow down roughly around 50 bps versus previous estimates.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

And as it relates to owning a PBM, I don't think that that's the best path for us, quite frankly. We -- I love -- and you've heard me say this in the past lives, I love being independent. I love being someone who can work across the ecosystem in a way that doesn't create anything but trust. And

having a small PBM, the economics of delivering really good service and really good costs favor large PBMs for really obvious reasons. They produce a lot of value by scale. And so buying a second-tier PBM for us does not make sense. I would much rather work with every PBM than own a small one.

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

Understood. Can I ask a quick follow-up, if possible. This morning, Lilly announced a new program called Lilly Direct. I don't even know if you guys were able to see it. But it sounds like something that maybe you could participate in. They're talking about having a third-party online pharmacy fulfillment services, and they're going to use existing pharmacy -- existing pharmacies to help dispense. I don't know if you've had a look at that. But is that something that you're talking about in terms of some of the services you might be able to offer or work with something like this? Or how would this impact Walgreens?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

No, it's a great question, and we did see it this morning. And my preface is, as I've mentioned, we can work inside of almost any reimbursement model and be a service provider to payors as well as patients as well as pharma. With that said, I can toss it over to Rick, who can speak a little bit as it relates to sort of how we think about that program and others like it that may evolve in the market.

Rick Gates - *Walgreens Boots Alliance, Inc. - Senior VP & Chief Pharmacy Officer of Walgreen Co.*

I think, Tim, you hit I think what we can talk about right now. I think what I would say is that, obviously, transparency for consumers and anything that lowers drug cost to consumers, we think is a good thing. And so obviously, we are supportive of those types of programs. We work with all of our partners, be it payor, PBM or pharma partners in order to help deliver against those. So is it an opportunity? Absolutely, and we certainly would support and work with Lilly on that.

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

Thanks so much for all the details on this call. It's been great.

Operator

Your next question comes from the line of Elizabeth Anderson from Evercore ISI.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - MD & Fundamental Research Analyst*

Nice to work with you again, Tim. Just maybe double-clicking on what you've talked about in terms of the pay-for-performance contracts that you've done so far. Can you tell maybe -- and maybe this is a question for Tim and for Rick, like sort of where focus on the contracts that you've signed has really focused on those contracts? And then as we think about the total opportunity, like do you have a sense of like what percent of those contracts have some sort of element of that now and sort of as we think about the broader opportunity for that to improve going forward?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Yes, I will let Rick answer, other than to say I had a conversation last week with the CEO of a very, very large payor who wanted to sit our teams down to actually look at 2025, and how we may work together, particularly on Medicare Advantage, with them. And so there is a lot of -- some of the other dynamics in the marketplace that are macro now are going to then bubble back through our contracting process and the kind of conversations that we can come to the table creatively with.

Rick, in terms of the current state of play, you want to address that?

Rick Gates - *Walgreens Boots Alliance, Inc. - Senior VP & Chief Pharmacy Officer of Walgreen Co.*

Yes. And I would just say that, obviously, most of the pay-for-performance contracts still sit within the Medicare Part D space. So obviously, we not only contract on specific deliverables, but we obviously plan operationally on how we're going to deliver against the ones that make sense so that we can deliver value within the ecosystem.

We are starting to see in the Medicaid space that they are starting to have contracts come through. And obviously, generally then it would move into the commercial space.

I think just reiterate what Tim said, I think we are having conversations and, obviously, our ability to deliver on these pay-for-performance contracts gives us more credibility to actually enter in more going forward.

Operator

Our last question today will be from Brian Tanquilut from Jefferies.

Brian, your line is open.

Your next question comes from the line of Stephanie Davis from Barclays.

Stephanie July Davis - *Barclays Bank PLC, Research Division - MD & Senior Research Analyst*

Tim, I've got one last one on the cost plus model, just given your background in PBM and payor world. I'd be curious about your perspective on market share opportunities in this model. Is it status quo given it's a line of one of your peers? Or is there a way to structure those to increase relative attractiveness or kind of gain some share as well?

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Sure. I appreciate the question. The way that we view every opportunity is how do we gain share with it. What I like is competing on unit price is a fairly straightforward exercise, and we continue to do that. Competing on the underlying cost to deliver the basic service is something again that we understand and live with.

Hard to differentiate on those 2. We will always be the low-cost provider. That's one of the goals that we have and we are driving toward in our pharmacy business. But what I really like is the models that are being discussed and evaluated, and I think being pulled into the market, will allow differentiation on how well you leverage other assets and what assets you have. And in that respect, we've got 123-year head start on some folks as it relates to building out a trusted brand that patients will respond to.

I'm really compelled by the kind of response that we are able to get on behalf of payors, for example, in our Walgreens Health business, when we use our brand and have our pharmacists call a patient and suggest to them, on behalf of one of our plans, that a flu shot would be a good idea for a Medicare Advantage patient, or that perhaps complete -- coming to the store and getting a Cologuard test and actually completing it and showing that we can get 50% plus response rates, even with something as challenging as a Cologuard test. To me that shows the kind of thing that we can do better than anybody that will differentiate us as these contracts with payors broaden out from pure unit cost. And so I feel really, really good about where we sit as an ability to do that to gain access to patients and, therefore, gain share.

Operator

Thank you. I will now turn the call over to Tim Wentworth, Chief Executive Officer, for closing remarks.

Timothy C. Wentworth - *Walgreens Boots Alliance, Inc. - CEO & Director*

Great. Thank you. So in summary, and thanks for dialing in. We are pleased with our first quarter results, but we recognize we have a lot of work to do. It is still early. The market continues to be, particularly for retailers, challenging. I think we're responding really very well. And we have a very supportive Board. You've seen the changes we've already been supported to make, and we have additional things that we are looking to do.

We are on a path, but we are nowhere near the even the halfway point of the kind of things that we believe we can do long term to build a really powerful health services company on the back of and leveraging an excellent community asset that today we call a retail pharmacy.

And so from that standpoint, the exciting thing for me is not only that we are on that path and that the results so far have been what we would have hoped for despite being very challenging and having to make some very, very difficult decisions.

But to me, the thing that I go home and get excited about every day is, after we talk to payors and we talk to the marketplace, we talk to pharma, and we find out the level of need and interest they have in Walgreens being a preferred partner. And I think over the coming quarters, we will be able to give you greater clarity as it relates to what that's going to look like in our future, and we look forward to doing that. Thanks very much.

Operator

This concludes today's conference call. Thank you for your participation, and you may now disconnect.

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