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EDITED TRANSCRIPT

WBA.OQ - Q1 2023 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

WBA reported 1Q23 sales of $33b, GAAP net loss of $3.7b and adjusted EPS of $1.16. Co. maintains FY23 adjusted EPS guidance of $4.45-4.65.

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PRESENTATION

Operator

Good morning. My name is Rob, and I will be your conference operator today. At this time, I would like to welcome everyone to the Walgreens Boots Alliance First Quarter 2023 Earnings Conference Call. (Operator Instructions) Tiffany Kanaga, Vice President of Global Investor Relations. 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 2023. I'm Tiffany Kanaga, Vice President of Global Investor Relations. Joining me on today's call are Roz Brewer, our Chief Executive Officer; and James Kehoe, our Chief Financial Officer; Rick Gates, Senior Vice President of Pharmacy and Healthcare at Walgreens will participate in Q&A. Today's call will be approximately 1 hour in length, including Q&A.

Let me note that all references to the COVID-19 headwind include U.S. vaccines, drive-through tests and OTC tests. 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 forms, 10-K and 10-Q, 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. The slides in the press release also contain further information about non-GAAP financial measures that we will discuss today during this call. I will now turn the call over to Roz.

Rosalind Gates Brewer - *Walgreens Boots Alliance, Inc. - CEO & Director*

Thanks, Tiffany. And good morning, everyone. WBA entered fiscal 2023 with good momentum, and we delivered a solid start to the year. Sales grew 1% in constant currency or over 3%, excluding the headwind from AllianceRx Walgreens and tailwinds from our new healthcare assets. The decline in adjusted EPS comes against very strong growth of 53% last year and reflects the anticipated headwinds from lapping COVID execution and our investments in the U.S. Healthcare segment and labor.

Our core business remains resilient despite historic macro challenges. We are driving healthy retail comp growth on top of record prior year performances. Our script volume growth is on track with plans as our restaffing and marketing initiatives are gaining traction. We made an important announcement on our opioid legal matters in November. Reaching an agreement in principle to pay approximately $5.7 billion over 15 years to resolve a substantial majority of our opioid-related litigation brought by states, political subdivisions and tribes.

This allows us to move forward and focus on our purpose, helping consumers lead more joyful lives through better health. We are making great progress to accelerate our transformation to healthcare, most notably in the quarter with the VillageMD acquisition of Summit Health. At the same time, we're unlocking value and strengthening the company by simplifying the portfolio. Our execution to date reinforces our confidence in achieving our full year guidance for adjusted EPS of $4.45 to $4.65. We are raising our sales guidance, and we have greater visibility toward the strong 8% to 10% core growth that underpins our results, offsetting the COVID headwind of 16% to 18%.

We are quickly scaling U.S. healthcare with a defined path to achieve profitability exiting this fiscal year. Our strategic actions are working to create sustainable shareholder value as we reimagine local healthcare and wellness for all. We are making progress against each of our 4 strategic priorities. U.S. and Boots U.K. retail comp sales were both strong, with the U.S., excluding tobacco, up over 2% on top of almost 12% last year and Boots up 9% on top of 16% last year.

I am especially pleased with this good performance against a tougher consumer backdrop. The convenience and value that we offer are resonating well, and our initiatives to align the core are driving traffic and margin expansion. Walgreens launched 24 hours same-day delivery, offering the widest range of retail items for around-the-clock delivery across the country. This adds to our broad range of channel access, including 1-hour delivery and 30-minute pickup.

The Boots consumer responded very favorably to holiday campaigns and promotions delivering record Black Friday online sales. Boots.com was one of the U.K.'s top 10 most visited retail websites on that day. And we're maintaining price positioning versus competitors and benefiting from inventory availability through our proactive buying ahead of this year's cold, cough and flu season.

In the pharmacy, our team members administered over 8 million COVID-19 vaccinations in the quarter against our goal of 16 million for the full year. Walgreens has been a leading contributor to the national pandemic response with the study from the Commonwealth Fund showing that total industry efforts have prevented 18.5 million hospitalizations, saved 3.2 million patient lives, and prevented 120 million COVID infections. This adds up to an estimated over $1 trillion in medical cost savings through the U.S. vaccination program.

I could not be prouder of our pharmacy team's tireless execution being among the most trusted health resources available. We continue to care for our local communities and countless ways and we are focusing investments to return stores to normal pharmacy operating hours. Pharmacy staffing has been positive nearly every week since mid-July, and we are leveraging our digital platform to reconnect on a personal level with customers.

Our efforts are on pace, resulting in over 2% comp script growth excluding immunizations in the quarter, up 220 basis points sequentially. Importantly, we are seeing mid-single-digit growth in stores with normal hours. We have also opened our ninth automated micro fulfillment center, now supporting about 3,000 total stores. These facilities remove routine tasks and excess inventory from the pharmacy supporting our team and the path to script recovery.

They give pharmacists more time for services and outreach that drive adherence and improve patient health. Turning to our second strategic priority. This was a landmark quarter for accelerating the build-out of our next growth engine, the U.S. Healthcare segment. We invested $3.5 billion to support VillageMD's acquisition of Summit Health creating one of the leading independent provider groups in the country. We recognize the critical importance of scale in value-based care delivery and density in attractive markets. This highly strategic transaction expands VillageMD's addressable market with primary care, multi-specialty and urgent care and reinforces our approach across the care continuum.

We see meaningful synergy potential over time. The deal is also immediately EPS accretive and accelerates profitability for U.S. healthcare. We expect to exit fiscal '23 with positive adjusted EBITDA. Shields Health Solutions and CareCentrix continue to perform well, which led to the accelerated acquisition of both entities. Shields closed on December 28, and CareCentrix is scheduled to close in the third quarter of fiscal '23.

VillageMD is leading the way in value-based care for the country, with 393 clinics as of year-end, including 200 co-located with Walgreens, achieving the calendar 2022 target. Following the close of the Summit transaction earlier this week, VillageMD now operates over 680 locations across 26 markets. We also exceeded our goal for health corners with 112 now versus the 100 we had expected by the end of December. Our healthcare strategy is coming to life through all of our best-in-class assets, which drove a combined 38% pro forma sales growth in the quarter.

This growth is funded through actions we continue to take to better align our investment portfolio and simplify the business. In November and December, we unlocked $3 billion in after-tax cash proceeds from the sale of 19 million AmerisourceBergen shares executing with tight discounts and near 52-week highs. We also realized approximately $150 million in proceeds from the sale of our stake in GPC. Lastly, we have a strong team that is fully aligned with our strategy including a new structure for U.S. retail pharmacy and John Driscoll, leading U.S. healthcare.

Perhaps most crucially, we are continuing to invest in our people to recruit and retain the very best talent, which is key to providing a superior customer experience. Fiscal '23 includes further investments in our pharmacy team and minimum wage, as previously stated. We're also reinventing the role of the pharmacists through micro fulfillment centers and eliminating task-based metrics, further enabling them to practice at the top of their license, while creating a differentiated work environment.

Our retail pharmacy business provides the foundation for our leading healthcare assets to deliver value across the full care continuum. We are able to unite digital and physical models to guide consumers through the complex healthcare landscape. We are building the scale and resources to help health plans and patients improve outcomes and lower costs as only Walgreens can do. There are significant opportunities for synergies, allowing us to pursue value-based care and risk arrangements, which will demonstrate the value of an integrated approach.

We are focused on expanding our risk business supporting integrated care models, expanding our pharmacy value proposition and driving operational efficiencies. I'm looking forward to sharing more with you ahead. With that, I'll hand it over to James to provide more color on our results and our outlook.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Thank you, Roz. And good morning. In summary, we had a solid start to the fiscal year. Despite the expected headwinds, the first quarter results were broadly in line with our expectations, and we are maintaining our full year EPS outlook. Adjusted EPS of $1.16 declined by 29.9% on a constant currency basis as we were lapping a very strong prior year quarter when we delivered EPS growth of over 53%.

The year-over-year decline was mainly due to a 19% headwind from COVID-19, U.S. healthcare growth investments of 5% and labor investments of 5%. These were partly offset by good retail performance in both the U.S. and International segments and a favorable tax rate. Excluding AllianceRx and U.S. healthcare M&A, sales grew 3.2% on a constant currency basis. The core business remained resilient in a challenging operating environment.

Comparable sales were up 3.8% in the U.S., despite lapping a very strong prior year comp of 7.9%. International sales grew 4.6%, led by the U.K. and Germany. And our U.S. healthcare business continues to rapidly scale with almost $1 billion of sales in the quarter and growing 38% on a pro forma basis. With the first quarter broadly in line, we are maintaining our full year adjusted EPS guidance of $4.45 to $4.65 with 8% to 10% constant currency core growth offset by a COVID-19 headwind of around 17 percentage points.

Our guidance now includes the EPS accretion from Summit Health and dilution from our reduced ownership stake in AmerisourceBergen. We have raised our full year sales guidance by over $3 billion to reflect the closing of the Summit Health transaction, refreshed currency rates and a good start to the year.

Let's now look at the results in more detail. Sales of $33 billion, rose 1.1% on a constant currency basis despite an adverse impact of 485 basis points from the anticipated decline at AllianceRx. This headwind will stop after December. Adjusted operating income declined 42% on a constant currency basis due to 3 factors. Firstly, a much lower contribution from COVID-19 vaccinations and testing led to a negative impact of approximately 20%. Secondly, the U.S. Healthcare adjusted operating loss was $139 million higher in the quarter, with an impact of 8 percentage points.

The current quarter includes higher Walgreens Health organic investments and a full quarter of results for VillageMD compared to only 6 days of losses in the prior year quarter. Thirdly, our previously disclosed labor investments in pharmacy staffing and minimum wage are a $100 million headwind, equivalent to 6 percentage points of AOI growth. Adjusted EPS was $1.16, a constant currency decline of 29.9%, due entirely to operating income. This was despite a favorable tax rate which benefited from the release of valuation allowances related to capital losses.

GAAP earnings were a loss of $3.7 billion compared to net earnings of $3.6 billion in the year-ago quarter. The current quarter included a $5.2 billion after-tax charge for opioid-related losses, partly offset by a $900 million after-tax gain on the sale of Amerisourcebergen shares.

Additionally, we are comparing to a prior year quarter that included a $2.5 billion after-tax gain on the company's investments in VillageMD and Shields. Now let's move to the U.S. Retail Pharmacy segment. While the U.S. performance was impacted by the anticipated COVID-19 headwinds, we do expect year-on-year performance to improve in the second half as the COVID headwind lessens and initiatives to drive script volume gain traction.

Sales decreased 3% in the quarter, but if you exclude the negative impact of AllianceRx, sales increased by 3%. Comp sales increased 3.8% despite lapping a very strong prior year comp of 7.9%. Adjusted operating income of $1.1 billion, declined 35%, broadly in line with our expectations. Headwinds from fewer COVID-19 vaccinations and PCR tests and increased labor investments were partly offset by retail sales growth and gross margin expansion and savings from the transformational cost management program.

Let me now turn to U.S. Pharmacy. Pharmacy sales declined 4%, held back by a 7.8 percentage point headwind from AllianceRx and by significantly lower contributions from COVID-19 vaccinations and testing. Comparable pharmacy sales were up 4.8% despite lapping a solid 6.8% comp last year. The sales growth was favorably impacted by branded drug inflation. Comp scripts were flat and excluding immunizations, comp scripts were up 2.1%, a sequential improvement of over 200 basis points.

We administered 8.4 million COVID-19 vaccinations in the first quarter, down 46% versus the prior year quarter. Flu vaccinations were up versus prior year due to higher flu incidences. Season to date, we have administered over 9 million flu shots. As expected, pharmacy adjusted gross profit and gross margin declined in the quarter due to fewer COVID-19 vaccinations, a mix shift to lower margin at home COVID-19 tests, and ongoing reimbursement pressure net of procurement savings. Reimbursement was broadly in line with our expectations and represented a lower level of pressure compared to the prior year. Turning next to our U.S. retail business. We saw good retail performance in the quarter with continued growth in both sales and margin.

Retail comp sales increased 1.4% despite lapping a very strong 10.6% comp in the prior year quarter. Excluding tobacco, comps were up 2.1%. And on a 2-year stack basis, comp sales growth was 13.8%. We benefited from a 220 basis point tailwind from cough, cold flu. However, this was largely offset by a 170 basis point headwind from lower sales of at-home COVID-19 tests. Comp sales were led by 4.9% growth in Beauty and a 2.9% increase in consumables and general merchandise.

Both categories benefited from own brand offerings and decisions to invest early in inventory availability. We delivered another quarter of strong retail gross margin performance, reflecting effective margin management, including strategic pricing and promotional optimization and favorable shrink trends. Turning next to the International segment, and I'll talk to constant currency numbers. Sales increased 4.6%, with growth across all international markets. Boots U.K. was up 4.3% and Germany wholesale grew 4.2%. Adjusted operating income was $116 million, down 20% versus prior year. Strong U.K. retail sales and good operational execution in the Germany wholesale business were offset by lower demand for COVID-19 pharmacy services in the U.K., the adverse gross margin impact of NHS pharmacy funding, and the expiration of temporary rental reductions received in the prior year.

On a combined basis, these 3 items had an impact of around 27 percentage points. Looking forward, we do expect the International segment to return to strong profit growth in the second quarter. Early indications show that Boots had a strong Christmas season with comp sales growth of around 15%. Key categories, including gifting, beauty and fragrance performed extremely well along with an uptick in OTC cold and immunity categories.

Let's now look in more detail at Boots U.K. Boots U.K. sales growth of 4% was led by continued strong retail performance. Comparable retail sales advanced 8.7% and this is coming on top of a 16% comp growth in the year ago quarter. Footfall grew 8% with flagship and travel locations, again showing robust improvement. Boots continued to gain market share with personal care and health and wellness performing particularly well. Comparable pharmacy sales declined 0.9% reflecting lower demand for COVID-19 services. Boots.com continues its strong performance with sales more than doubling versus the pre-COVID period. Approximately 18% of our U.K. retail sales came from Boots.com in the quarter, which compares to roughly 9% in the equivalent pre-COVID quarter. November was a very strong month with Black Friday being our biggest ever online event.

Turning next to U.S. healthcare. We are very excited about developments in our U.S. healthcare segment as the business continues to rapidly scale. Sales were almost $1 billion in the quarter compared to only $50 million in the year ago quarter. Pro forma combined sales growth of 38% compared to 34% in the fourth quarter of fiscal '22. VillageMD had sales of $550 million advancing 49% on a pro forma basis, with growth driven by existing clinic growth and expansion of the clinic footprint.

Shields again showed very strong growth with sales of over $100 million and pro forma growth of 44%, driven by recent contract wins, further expansion of existing partnerships, and strong executional focus. In its first full quarter, CareCentrix delivered sales of over $330 million. Pro forma sales growth was 22%. Segment adjusted operating income was a loss of $152 million. This was flat sequentially and compares to a loss of only $13 million in the year ago quarter.

Adjusted EBITDA was a loss of $124 million in the quarter compared to a loss of $11 million in the prior year. The year-over-year increase in losses largely reflects a full quarter of VillageMD in the current year versus 6 days in the prior year quarter and higher Walgreens Health organic investments. These headwinds more than offset positive profit contributions from Shields and CareCentrix. Let's now look at some of the key metrics for U.S. Healthcare.

As Roz mentioned earlier, VillageMD ended the calendar year with 393 clinics, including 200 clinics co-located with Walgreens. This was in line with our target. VillageMD had 440,000 value-based patients at quarter end, up 46% from 300,000 at the end of the prior year quarter. At quarter end, the Walgreens Health organic business had 2.9 million contracted lives, up from 2.3 million at the end of the fourth quarter as existing payers added new lines of business. We exceeded our original goal of 2 million lives.

As we scale our access to lives and add new partners, we will continue to build out our Walgreens health corners. We ended the quarter with 112 Health corners, ahead of our goal of 100. Health corners play an important role in engaging patients, addressing care gaps and improving health outcomes. Since the program was launched, Walgreens Health corners have facilitated more than 300,000 patient interactions. In summary, we performed strongly against our key objectives and we are well positioned for future success in the coming year.

The addition of Summit Health will further enhance our portfolio of leading assets across the care continuum, drive meaningful synergy opportunities and accelerate the path to profitability. Turning next to cash flow. We generated almost $0.5 billion of operating cash flow in the first quarter while free cash flow was negative $117 million. Operating cash flow was negatively impacted by increased inventories, including successful advanced buys to secure product availability in the U.S. and U.K. holiday seasons.

The year-over-year decline in free cash flow was due to lower earnings, some phasing of working capital and increased capital expenditures related to growth initiatives, including the VillageMD footprint expansion, the rollout of micro fulfillment centers, and digital and omnichannel investments. Turning now to guidance. Overall, we are confirming our full year EPS guidance. The guidance now incorporates EPS accretion from the recently closed Summit Health transaction and this offsets the dilution from our reduced ownership stake in AmerisourceBergen.

Our projection for the total number of COVID-19 vaccinations is unchanged. But we do now expect a slightly greater headwind from COVID-19 testing due to a demand shift from drive-through testing to lower margin at home tests. This has had a negative impact of roughly 1 percentage point of EPS. Currency rates are somewhat favorable, and this has reduced the year-on-year currency headwind from 2% to 1%. Excluding these items, we continue to project core business growth of 8% to 10%.

In terms of phasing, at the midpoint of our guidance, we see a balanced 50-50 cadence between the first half and second half versus our original expectations. This assumes a shift of COVID-19 vaccinations from the second quarter into the third quarter with an impact of approximately $0.09. Second quarter earnings growth will continue to be adversely impacted by the ongoing headwind from COVID-19, continued investments in U.S. Healthcare and labor and the higher tax rate.

In the second half of the year, EPS will grow around 30% with good visibility into the key drivers. Firstly, we expect significant second half momentum in U.S. retail pharmacy, including ongoing script recovery as we normalize store operations and implement marketing win-back initiatives; favorable trends in reimbursement net of procurement, lower levels of shrink and continued strong retail performance.

Additionally, while COVID-19 will remain a headwind in the second half of the year, it will be a lot lower. And we expect an impact that is less than 50% of what we saw in the first half of the year. Secondly, International has delivered a strong Christmas trading period, and we expect to see strong ongoing performance through the balance of the year. Our international business, particularly in the U.K., has emerged in a competitively strengthened position and is well positioned for growth.

Finally, the first half of the year is the peak investment period for U.S. Healthcare. And consistent with prior guidance, we expect the segment to achieve positive adjusted EBITDA exiting the year. The overall segment will flip from being a headwind in the first half to a significant mid-teens EPS tailwind. Let me now provide some additional detail around our segment sales and profit assumptions. We are raising our WBA sales guidance by $3 billion to $3.5 billion. The increase is driven by VillageMD's acquisition of Summit Health, refreshed currencies and better-than-expected sales in the first quarter. Adjusted operating income is unchanged at $4.7 billion to $4.9 billion.

The acquisition of Summit is offset by a lower contribution from AmerisourceBergen as we reduced our ownership stake. For U.S. retail pharmacy, we have raised our sales guidance by $500 million due to a better-than-expected first quarter, which benefited from brand inflation and broad-based retail strength. The AOI range is lowered by $150 million to reflect the sale of the AmerisourceBergen shares in November and December. These actions have reduced our stake from around 26% to 17%.

We have raised our guidance for the International segment to reflect a lower headwind from currencies. We now expect sales of $21.2 million to $21.7 billion, up $800 million versus the prior range. We are also raising our AOI forecast to $870 million to $900 million. For the U.S. Healthcare segment, we expect sales of $6.5 billion to $7.3 billion and an adjusted EBITDA range from a loss of $50 million to positive $25 million. Both of these are consistent with the goals we provided when the Summit Health transaction was announced in November. We continue to expect to exit fiscal '23 with positive adjusted EBITDA for the U.S. Healthcare segment.

Moving on to our corporate assumptions. The full year tax rate is unchanged at around 16%. Interest expense is expected to be $560 million to $580 million, an increase of $70 million to $80 million compared to prior guidance, and this is mostly due to the Summit transaction. We are raising our forecast for equity method investments and noncontrolling interest with the combined range increasing by nearly $100 million versus our prior guidance.

This reflects the Summit Health transaction and the acceleration of the full acquisitions of Shields and CareCentrix. In summary, we are raising our fiscal year '23 sales guidance for WBA and we are confirming our full year EPS guidance. With that, let me now pass it back to Roz for her closing remarks.

Rosalind Gates Brewer - *Walgreens Boots Alliance, Inc. - CEO & Director*

Thank you, James. Before we kick off Q&A, let me sum up what you've heard. We are executing against our fiscal 2023 plans with solid first quarter results reported today, broadly in line with our expectations. We performed well against our record levels of growth in the first quarter last year. Our core business is resilient, and we are accelerating our healthcare transformation with a well-defined path to profitability exiting this year.

Given our first quarter execution and the Summit Health acquisition, we are raising full year sales guidance, and I'm comfortable reconfirming our adjusted EPS guidance. Our strategy is working. And we will be relentless in driving continued progress ahead. I remain confident in our future growth potential, enabled through our bold investments today and the long-term sustainable value that WBA can create for our customers, our partners, our people and our shareholders. Now I'd like to open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Charles Rhyee from Cowen.

Unidentified Analyst

This is Lucas on for Charles. I wanted to talk about script recovery and the investments to return stores to normal hours. I wanted to ask and see how script recovery has gone for the locations that you've returned to normal hours. And how those have trended versus your expectations going into it?

And then on the $100 million in investments in Q1, that's close to 40% of the $265 million that you guys guided for fiscal '23, I want to understand if we should expect the rest of that investment to come -- be front-loaded in the first half? And then how the timing of that investment will impact script recovery as we move throughout the year?

Rosalind Gates Brewer - *Walgreens Boots Alliance, Inc. - CEO & Director*

Okay. Thanks for that question. I'll start that off and then joining us today is Rick Gates from our pharmacy operations. He will assist in the questions. So we'll add James in there if we need to. So first of all, on our script recovery, it starts with the investment that we've had in our labor position. And let me start by saying that we announced last quarter that we were working to really improve our positions with our pharmacy.

So with these investments, our applications are up about 23%, and we've got accepted offers approaching about 40%. So in our minds, the brand remains strong and the intentionality to regain pharmacists in our stores, it's working. Second, I will tell you that stores that are operating without reduced hours had Q1 Rx comp trends including -- excluding immunization in the mid-single digits. And we're seeing about 9 percentage points better growth versus the impacted stores on limited hours. So we feel good about the direction we're moving forward. We continue to make progress on the recruiting.

We've got new incentive policies, and we're leveraging the micro fulfillment capacity that we have. And as we improve the store operations for the pharmacists, we're getting better engagement. So we're moving strongly in that direction. We're continuing to see -- net gains of about 600 incremental pharmacists have joined Walgreens and to the extent that the new pharmacists are being hired, we're seeing these really in some of our more challenged markets.

And so as you can imagine, we are focusing on those challenged markets first to regain pharmacy and now we're applying the marketing incentives. And those incentives have been on a one-to-one basis to reengage the consumer back to the store. So we're feeling confident that we're moving in the right direction. So these labor investments have been necessary to move us forward. We like the direction that we see this happening. I will say another thing that's happening in terms of the performance in our stores is also when we look at the balance of the maintenance scripts versus the ongoing scripts.

And I will tell you that we are seeing some favorability there. So we feel strongly that this is not a long-term issue for us, but we are regaining the pharmacists back in the stores and reopening the stores accordingly.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes, just to clarify your question on the timing of the spending of the payroll investment. The $100 million we quoted includes both minimum wage and the pharmacist investment. So it only represents $100 million, is about 19% of the -- 20% of the total for the year. And I'll just remind you, the pharmacy investment full year -- year-on-year was $265 million but there was also a minimum wage investment previously communicated of $260 million. Is that okay?

Operator

And your next question comes from the line of A.J. Rice from Credit Suisse.

Albert J. William Rice - *Crédit Suisse AG, Research Division - Research Analyst*

Maybe just to talk a little bit about capital priorities. And if there's any updated thoughts, obviously, with VillageMD closing Summit, there's discussion about synergies, and you talked a little bit about updated growth objectives there. Can you just comment on how you sort of see the cash flow needs laying out, if there's any updated thinking in priorities?

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. Just I think from the point of view of funding, we've basically announced anything we intend to do in the short term. So we disposed of ABC -- our partial stake in ABC and we raised debt to fund the $3.5 billion transaction. We raised about $1 billion. And this puts us in a fairly comfortable place with the rating agencies.

Looking at Summit, it's too early to say because, frankly, you can't get involved until the deal closes. So Village and Summit will be moving very, very quickly on the integration and synergies. As Roz pointed out in her material, we have pretty good line of sight to about $150 million of synergies -- cost synergies. We would go after very rapidly. That's about 40% and 60%, which is coming from the migrations. The risk will be over a longer period of time. There were some items not captured in there.

For example, we haven't made any assumptions on synergy between Walgreens stores and Summit locations. So there's probably a fair amount of upside to the $150.

I don't know, A.J., does that answer your question?

We're not considering any M&A type activity in the short term. We're taking a pause. We need to focus on integration activities.

Albert J. William Rice - *Crédit Suisse AG, Research Division - Research Analyst*

So that was the one other thing as you had talked previously about maybe another leg to the Walgreens Health story over time. So that's not a short-term priority. That's a longer-term thing once we get clarity on how all the integration is going with VillageMD and Summit.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

I think it still is a priority in the short and medium term, but I think the scale of the acquisition won't even trigger on your radar. So we're more likely to buy smaller companies with specific, call it, capabilities that we need to advance our organic business. So we're not going to go out and do a $2 billion or $3 billion acquisition on a health tech company. We're likely to be very targeted, and it will be in the hundreds of millions, not in the billions.

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*

Also, James, I know that you guys don't provide quarterly guidance, but could you maybe talk a little bit about expectations for cadence. This quarter had a good portion of COVID and COVID pull forward into it. Fiscal Q2 seems like it's going to be a little bit below the Street. And maybe the question to focus on here is kind of what inflects the most as you think about the back half of the year? And if we think about earnings risk, like maybe talk about the biggest points of inflection, which we would see as the biggest points of risk.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. That's an expected question. I would like to give a little bit of context first on the first quarter because there's a perception out there that it was overly dependent on tax rate. And I do want to give you our position. As we look against our budget internally, we actually came in $0.01 better and only $0.03 was from tax.

So the tax upside we predicted on the full year, the 16%, is still intact, and we had already planned for this type of tax rate in the quarter, as I said, $0.03 better. We have -- we're about $0.04 weaker on the operating business, and it was all in international. To be honest, it's a bit of a planning blow. They didn't predict carefully enough what the reimbursement timing was going to be like from the NHS.

So it became a short-term margin issue. And I do want to reassure the listeners, we see a return to very strong profit growth in the International segment in the second quarter. So compared to market expectation -- to our expectations, we came in relying $0.03 on tax. So the beat of $0.04 was, you can say, all due to tax, right? But the core business was on track. And the only thing that surprised us was international and it was more of bad planning than it was execution. And I do want to emphasize, we won Thanksgiving, sorry, Black Thursday type events in the U.K. And then we did put it in the prepared comments.

We make 40% of the profit in the U.K. in December. The growth in December was 15% on the front of store, which is 70%. So now I'll go to your real question, which is the cadence between the first and second half. We looked into the second quarter and -- versus the consensus that was out in the market. The consensus felt a little heavy only for one reason. There is a shift going on right now. Vaccinations have slowed down. The boosters have slowed down a bit. So there's a slight shift into the Q3 from Q2, and that costs us about $0.09.

That's the only change we're making to our thinking, first half versus the budget we had before. There are no other changes. And I just want to be very clear on that. When you look at performance versus consensus models, and we do look at this, and I'll just be very transparent. We collect like, I don't know, 20, 17 models and we compare whether it's gross profit or SG&A and all the rest. Our actual absolute gross profit in the quarter was better than consensus by $60 million and it was better than FactSet by $94 million.

So where we're getting the disconnect is on the SG&A. And my hypothesis there is there are some impacts from currency. There are some impacts from the way you've built in some of the investments in labor. And we have to dig into it that we haven't communicated succinctly enough what the SG&A outlooks are on a quarterly basis.

But we're looking at here -- we're exiting the quarter feeling like operationally, most of the businesses were on track. In fact, the U.S. business came in stronger than the budget. So let's look at first half, second half. We basically said now it's a 50-50 split. And that implies that the first half will be down EPS roughly 28% to 30%, just round numbers. And it's driven by COVID, the labor investments and the healthcare investments. It's -- the story doesn't change in the second quarter, and it's consistent with original guidance. And you've asked for -- and this is a bit of a long-winded response.

You've asked for, what are the key drivers, first half versus second half? The first one is vaccinations and testing is a headwind in the first half of 20 to 21 percentage points. So if you take the first half of the year, we will be pulled down to the tune of 21%. If you take the second half, that goes below 10%. So the change of the headwind, it gives you an improved profile of about 11 to 12 percentage points. The biggest driver, however, is healthcare. In the first half of the year, that's a negative drag on income in the low single digit.

And we said in the prepared comments that the healthcare business will drive EPS around mid-teens, so call it 15%. So the change between the first half and the second half, you got 11 to 12 points coming from COVID and you've got, call it, 15 to 18 points coming from healthcare. The other big numbers are reimbursement, and we haven't provided much guidance on this in the past.

We expect, and we have a very good line of sight because I would call it, 95% of all contracts are closed. Reimbursement in the second half of the year compared to the first half will be less than 50%. So this gives us a tailwind of approximately $350 million in the second half of the year. So if you take second half versus first half, just due to the timing of reimbursement, I'm probably going to get 14 percentage points of growth, and I have extremely high line of sight to that number.

The second one is volume. Volume in the second half will probably be -- the volume contribution in pharmacy will be about 3x what it was in the first half because as we said, the marketing programs will kick in later in the year. That's worth probably another $200 million, so call it 8 points of growth. So we're going to see a big change in the trajectory of the pharmacy business in the first half versus the second half. And the final one I'll leave you with is, we did -- while we hit the absolute gross profit in the quarter, pharmacy margins were lower than we anticipated because we had some timing items on cost of goods sold. They're going to wash out in the remainder of the year.

And that's probably another $200 million to $300 million. So what we're really looking at is quarter 1 being a fairly difficult quarter in terms of -- the majority of the costs are concentrated in the first half of the year and are coming out in the second half. Reimbursement, as I said, $350 million. Good line of sight -- volumes on pharmacy, good line of sight but the programs are there. There's always some risk to it. And the cost of goods sold items another $300 million. These are very large numbers.

So you're talking about pretty explosive growth in the U.S. business in the second half. And I do want to reiterate, we're going to see the same from the international business. So I don't know if that's enough insight. I've gone on for too long, it's probably too much, but...

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*

Maybe to piggyback just off of that last question, thanks for all the details there. Could you specifically comment on some of the other things you called out in terms of shrink, the strong retail performance. And then also what your expectations are for cold, cough and flu given some of the product shortages we've been hearing about?

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. I think the shrink is built in the forecast. We're probably -- maybe we cried too much last year when we were hitting numbers that were 3.5% of sales. We're down in the lower 2s, call it, the mid 2.5%, 2.6% kind of range now. And we're stabilized. So -- but we've spent a fair amount, and that could be 1 of the disconnects in SG&A.

We've put in incremental security in the stores in the first quarter. Actually, probably we put in too much and we might step back a little bit from that. But what we're seeing is we're putting in more law enforcement as opposed to security companies. The security companies are proven to be largely ineffective. So we're investing more SG&A to drive the lower shrink. And it's -- actually, we're quite happy with where we are. It's around 2.5% to 2.6%.

So that's well below the prior year levels. And we have a fairly good line of sight to new programs going in. The second part of the question, cough, cold, flu?

Yes, we did get a bounce from cough, cold, flu in the quarter. But as you look at our retail business in the first quarter, where the comps came in at 2%, cough, cold, flu boosted the result for the tune of, I think, it was 220 basis points. But on the flip side is the COVID OTC tests were a headwind of 170.

So actually, the way I'd encourage you to think about the first quarter is, if you take out the noise of the 2 of these, roughly the business is doing a 2% comp. And if you go back to the guidance we gave 3 months ago, we actually said we expect the retail business to do a 2% to 3% ex-COVID. We did see a little bit of weakness in some of the -- some other categories. But I think where we won in the first quarter was we built fairly aggressive inventory levels, and we were extremely well positioned on cough, cold, flu and we've actually gained share in the category.

We will get some opportunity on the full year from cough, cold, flu. It's too early to say what's going to happen in the second quarter. Honestly, we've seen a little bit of a slowdown in the last few weeks. Flu vaccinations are still up, I think, 9% or 10% versus prior year. So there's no issue in cough, cold, flu. It has given us a bit of a boost. But as I said, if you think about cough, cold, flu in the first quarter, it was offset by these cost items in pharmacy that I talked about, and they'll roll out of the system in the second half.

Operator

And your next question comes from the line of Lisa Gill from JPMorgan.

Lisa Christine Gill - *JPMorgan Chase & Co, Research Division - MD, Head of U.S. Healthcare Technology & Distribution Equity Research and Senior Research Analyst*

I'm going to take it more from a strategic standpoint. So when I think about your U.S. Healthcare business and Summit, CityMD as well as VillageMD. Can you maybe just spend a minute and talk about how you think about them, integrating and fitting together. As I understand it, both Summit and CityMD today are primarily fee-for-service.

I think the reason that VillageMD was at a loss is that they have at-risk lives. So as you think about this over the next few years, is the goal to move more people onto the platform from an at risk perspective? Where do you see those opportunities? Summit is in a single market? Do you think you can replicate some of that multi-specialty in other markets since I know you gave some numbers around some of the synergies. But just more conceptually, I want to try to understand how you're viewing this going forward?

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. And I think we -- I did allude to it. And I think there's 2 pieces you should think about. One of them is easier and one of them is tougher. The easier one is the capabilities that VillageMD have in value-based care. So right now, they have roughly 440,000 patients. I'll call it on a value-based arrangement out of roughly 1.6 million total patients.

So they're in their own evolution. And of that 440,000, 125,000 are fully at risk. So that is delegated -- full delegated risk from the insurance company. So Village's stand-alone is, they want to grow the 125 and they want to grow the 440 as a percentage of the total 1.6 but bear in mind here, it's really, really, really, really important to have commercial patients. They pay the bills, right? And they allow a very effective procurement and negotiation model in the local markets.

Strategically, I think, Lisa, the one difference versus a year ago is there's a decision by Village to get bigger in fewer markets. And what I mean by that is scale locally is critically important. And that's why Summit and CityMD was a very attractive acquisition. The game that they have to play in Village is they'll probably run the businesses somewhat independently for a period of time and transfer value-based care management into City -- sorry, into Summit Health and Summit Health will grow its patient population that is at risk. So that's the opportunity. That's the $19 million.

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The other one is a little bit more complex, which is -- the beauty of the Summit model is they have a multi-specialty business and they have a primary care physician business. They are feeding, if you like, patients between each other and cross referring between the two. So when and if they take on risk, they will manage a much greater proportion of the total cost of care because you know how much specialty or multi-specialty care would cost.

So instead of Village, which farms out its business to local providers, Summit will be able to use its own providers to directly manage the cost of care. And I would argue, have a much higher return on the risk-based patients. The question is how do you push the multi-specialty into the Village practices? And I know the Village team are looking at bigger primary care physician practices that incorporate more multi-specialty type activities and testing. So -- but I would take the second -- the first one, the move to value-based care will happen in the first contract year.

So I would call it in the current contract year. In the case of the multi-specialty, I think that's a 5-year journey, and that does require investment because you'll have to change the structure of your local practices. But I think it's quite exciting because none of the multi-specialty opportunity and none of the synergy between Walgreens and Summit is built in the projections that we provided to the Street back in November. So we see a fair amount of opportunity.

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*

I know you know there's a lot of debate on the Street on the company's ability to gain back that $30 million market -- $30 million of scripts that is embedded in guidance. And I know some of that $30 million scripts is just regained in market share of stores closed hiring pharmacists. But I know some of it also is just regaining like people that haven't left Walgreens, that maybe have been compliant to therapy and pharmacists during COVID that did the basic blocking and tackling. And to me, that feels like an easier guess than bringing someone back to Walgreens. So could you let us know how much of that $30 million, maybe break it down, what is actually having people come back to a Walgreens versus what is -- versus people being more compliant with therapy?

And secondly, your free cash flow was negative. Can you give us any type of free cash flow guidance for the year, that would be great.

Rosalind Gates Brewer - *Walgreens Boots Alliance, Inc. - CEO & Director*

James, why don't we start with the free cash flow? And then, Rick, just go into the detail around the script performance on the core script business.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes, we're not going to give guidance on the full year. Honestly, we're still working through some of the implications of the Summit acquisition. But I think you'll see some progress year-on-year on an absolute basis. The first quarter is traditionally quite weak as a start in the company. So I wouldn't get very concerned by it. We are looking carefully at the investments in the rest of the business and to optimize cash flow for the rest of the year. But we're not going to start giving guidance on that.

Rick Gates - *Walgreens Boots Alliance, Inc. - Senior VP of Pharmacy and Healthcare*

And just to -- this is Rick. Just to walk into the 5% script growth. There's actually building blocks that are part of that. And I think you are correct. Part of it is just market growth that we have that is the first part of the building block, then it goes into the adherence and services, which are a key part of all the programs we've invested in.

So that is a huge part of how we're going to continue to grow scripts. The marketing win-back plans based off of staffing is the third one, then obviously, core staffing and reopening of store hours is the fourth building block. And I would say that as you look at the cadence of scripts and how it's going to grow into the second half of the year, Roz has talked a lot about the hiring pieces, but it actually goes into -- there's kind of a time line to get there, right?

You have to hire. We have to train appropriately, get our pharmacists ready, then we will reopen our stores to full store hours that we have before and then obviously, the win-back program. So there is a timing element to the scripts and how the growth will really start to ramp up in the second half of the year.

Operator

And our final question comes from the line of Michael Cherny from Bank of America.

Michael Aaron Cherny - *BofA Securities, Research Division - Director*

I guess one just quick cleanup question and one broader one. First, on the cleanup side, is it possible if you could give us the after-tax proceeds from sale-leaseback transactions for the quarter, that would be great. And then maybe on the international side, I understand the success that you've had on the various different holiday items for the U.K. But can you give us a sense whether it's FX oriented beyond that, how to think about the confidence level you have in raising the adjusted OI for segment for the year and all the moving pieces beyond simply the contribution that you got from the Black Friday, Black Thursday, I apologize if I missed a couple of the holidays there, James.

James Kehoe - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Yes. So the -- I'm just looking for the sale and leaseback. I think it was around $170 million pretax. I don't have an after-tax number. But we don't -- on a cash tax basis, we don't pay very much tax on this because we have capital allowances -- capital losses against it. In the U.K., what we did was a technical update basically to reflect only currencies.

So if currencies change in the future, we would adjust that. We have -- I would describe it as a large degree of confidence in the base forecast in the international business. I would suggest that given how December came in, which was better than we expected, that 15% growth. And as I said, 40% of the profit is in December. So this takes -- massively derisks the international forecast. So I don't -- you never want to say anything is in the bag, but I think international is probably the very safe number.

And just to cycle back a little bit on everybody, I think, has been very, very focused on the 5% script growth rate. 2.5 percentage points comes from the marketing programs on the store reopening and 2.5 comes from market growth plus adherence programs plus all the rest. So there is the possibility that we over-perform on some of the other programs that will compensate for some of the risks that you perceive and then 2 is just to dimensionalize this and -- sorry, the labor on, but the change in the direction of procurement is $350 million and the change second half versus first half and the volume change is $200 million.

So if you were looking in terms of what's going to have the biggest impact, second half versus first half, it's reimbursement, cost of goods sold changes versus first quarter and then it's volume on the pharmacy business. And I'm not saying it's not important, but we have a very, very good line of sight to the reimbursement and we have decent line of sight to the cost of goods sold, and we have programs in place for the script volumes. So I just wanted to kind of close on that, kind of stealing your last question.

Operator

And this ends our Q&A session. I will now turn the call back over to Ms. Roz Brewer for some final closing remarks.

Rosalind Gates Brewer - *Walgreens Boots Alliance, Inc. - CEO & Director*

First of all, thank you, everyone, for joining us this quarter. We'll conclude our Q&A, but I want to end briefly by just recapping the main points that you heard from us today and then touch again on some of your questions.

First of all, we have had a solid start to the year. Our results are broadly in line with expectations and our underlying sales growth is over 3% despite the tough environment we've all been in.

Secondly, our core business is resilient. The convenience and value that we're offering customers continue to resonate as we cycle from the COVID surge. And it reminds us every day that our brand remains strong and our customers are very loyal to us.

Thirdly, our healthcare growth engine is showing great progress. We've closed and accelerated major acquisitions, and this segment is expected to exit fiscal '23 with positive adjusted EBITDA so we're investing to grow in a very difficult time frame, but we remain committed to our strategy.

Fourthly, we're optimizing our portfolio. So our shares in AmerisourceBergen were sold with tight discounts and near 52-week highs, and we continue to have significant access to capital. And lastly, we're maintaining guidance for the fiscal year, while controlling cost, and investing to grow to deliver our long-term sustainable value for all of you on this call. So thanks again for your support, and we wish you all a very happy new year. Thank you.

Operator

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