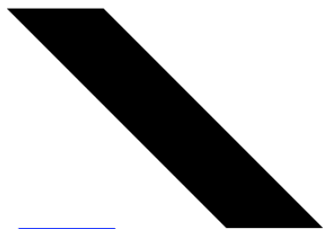


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Q3 2024 WALGREENS BOOTS ALLIANCE INC EARNINGS CALL

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- **Operator**
- **Lisa Gill** *JPMorgan - Analyst*
- **Charles Rhyee** *TD Cowen - Analyst*
- **Eric Percher** *Nephron Research - Analyst*
- **Ann Hynes** *Mizuho Securities USA - Analyst*
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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Walgreens Boots Alliance third-quarter 2024 results conference call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference call over to your speaker today, Tiffany Kanaga, Vice President of Investor Relations. Please go ahead.

Tiffany Kanaga *Walgreens Boots Alliance Inc - Vice President, Investor Relations*

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

Joining me on today's call are Tim Wentworth, our Chief Executive Officer; and Manmohan Mahajan, Global Chief Financial Officer. In addition, Mary Langowski, President of US Healthcare; Rick Gates, Senior Vice President and Walgreens' Chief Pharmacy Officer; 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. We encourage you to review the comparable GAAP measures and reconciliation to non-GAAP values in the other earnings materials we provided. I will now turn the call over to Tim.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Thanks, Tiffany, and good morning, everyone. While this quarter's results were not in line with our expectations, I want to start today by sharing some reflections on what I've observed since joining WBA. I'm at Walgreens today because I believe in the future of retail pharmacy and particularly in our future. We are motivated by the trust Americans place every day in their Walgreens pharmacy. And the experience we provide them in our stores and with our digital offerings is important in their lives.

Over our 125-year heritage, we have earned the right to engage with patients and customers in a way that few others can rival. I believe that this human-to-human interaction is an imperative in healthcare, and the core foundation of our business is the relationship we have with our customers. Through our nationwide footprint, we touch nearly 9 million lives a day as the leading independent integrated retail pharmacy and healthcare provider. This dynamic is why PBMs, payers, providers, and pharma choose to work with Walgreens.

Looking back over the last several quarters, we've built a world-class leadership team, including five new members. We now have the right people in place who are already executing with a sense of urgency on a turnaround for our business. All of this is underscored by our 330,000 passionate and dedicated team members who differentiate us and deliver exceptional customer and patient experiences every day.

The bottom line is that I'm confident WBA will be a leader in the future of healthcare with pharmacy and retail at its center. And the long-term potential of the company will be shaped by offerings built around the relationship that we've nurtured with our customers over time.

But we also acknowledge where we are today and what we need to do to realize our longer-term ambitions. The severity and duration of the challenges in the operating environment have only added urgency to our strategic and operational review, and we are addressing them directly. Our review has been a significant driver of action as we assess both our existing retail pharmacy business and our collection of strategic assets. I will unpack the series of conclusions we have reached in greater detail after Manmohan, and I review the quarterly results.

For the third quarter, we delivered adjusted earnings per share of \$0.63, reflecting significant challenges in the US retail pharmacy business stemming from a worse-than-expected consumer environment and challenging pharmacy industry trends, partially offset by strength in US healthcare and international. In light of these factors, we are reducing our full year outlook, which Manmohan will take you through in more detail.

In US retail pharmacy, we witnessed continued pressure on the US consumer. Our customers have become increasingly selective and price-sensitive in their purchases. In response, we invested in targeted promotion and price decisions which have driven traffic and will generate improved customer loyalty, but they weigh on near-term profitability as we refine our approach. We remain relentlessly focused on enhancing the front of store and creating the right omnichannel experience for our customers while driving in-store efficiencies.

We also continue to face an incrementally challenging pharmacy industry. Recent trends such as branded mix impacts and increased regulatory and reimbursement pressures, including fluctuations in NADAC pricing, have negatively impacted pricing dynamics.

Additionally, the script market is growing but continues to trail below pre-pandemic growth levels. These headwinds have affected our performance and are materially weighing on our ability to serve patients profitably.

We are at a point where the current pharmacy model is not sustainable and the challenges in our operating environment require, we approach the market differently. For example, we are in active discussions with our PBM and payer partners to align incentives and ensure we are paid fairly.

We are also working with our suppliers and partnering directly with pharma companies to build out specialty pharmacy, clinical trials, and other services, which Walgreens is uniquely positioned to facilitate, given our physical footprint and the trust we've already established with patients.

In US healthcare, we had another quarter of positive adjusted EBITDA and year-on-year growth driven by continued growth and disciplined cost management at VillageMD along with strength at Shields. Following last quarter's actions to rightsize VillageMD's footprint, the business is now on a clearer path to profitability as it continues to add lives and optimize its cost structure.

In international, the business continues to perform strongly and in line with expectations. Boots UK delivered meaningful retail comp growth and achieved another sequential quarter of market share gains from strength in both physical and digital channels. We continued to execute with discipline across the organization to drive further cost out and prioritize free cash flow. We remain on track to deliver \$1 billion in cost savings this year.

As we look ahead to the remainder of the year, we are operating under the following assumptions. We expect the operating environment to remain challenging. We do not expect an improvement in the US retail environment. And finally, we expect script volume growth to remain muted and anticipate continued pressures on pharmacy margins.

In light of these factors, we are reducing our outlook. We now expect to deliver adjusted earnings per share of \$2.80 to \$2.95 for the fiscal year 2024. While we acknowledge that this range is wider than normal, we believe it is prudent, given fluctuations in recent pharmacy industry trends. Consistent with our historic approach, we will provide our outlook for fiscal 2025 on our fiscal year-end call in October, but we expect the current trends I've outlined to persist into next year. Before going into details of our strategic review, I'll now turn it over to Manmohan to review our financial results.

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Thank you, Tim, and good morning, everyone. Third quarter sales grew 2.5% on a constant currency basis. US retail pharmacy increased 2.3%. International was up 1.6%, and US healthcare delivered sales growth of 7.6%.

As Tim mentioned, overall results were below our expectations. Adjusted EPS of \$0.63 decreased 37% year-over-year on a constant currency basis. This was driven by a \$0.24 impact from lower sale-leaseback gains, a challenging US retail environment and recent pharmacy trends.

Our US healthcare and international segments continued to perform in line with our expectations. And we continue to deliver on our goals related to cost and CapEx reduction and working capital initiatives. As a reminder, last year's GAAP results included after-tax impairment charges of \$323 million related to pharmacy license and tangible assets in Boots UK.

Let's move on to the year-to-date highlights. Sales increased 5.6% on a constant currency basis. Adjusted EPS declined 25% on a constant currency basis due to the softer US retail pharmacy performance and significantly lower sale-leaseback gains. This was partly offset by cost-saving initiatives, improved profitability in US healthcare and a lower adjusted effective tax rate.

GAAP net loss was \$5.6 billion compared to a loss of \$2.9 billion in the first nine months of fiscal '23. The first nine months of fiscal '24 included certain non-cash impairment charges related to VillageMD goodwill as detailed last quarter. The prior year period included a \$5.5 billion after-tax charge for opioid-related claims and lawsuits, partly offset by a \$1.5 billion after-tax gain on the sale of Cencora and Option Care Health shares.

Now let me cover US retail pharmacy segment. Comparable sales grew 3.5% year-on-year driven by brand inflation and pharmacy and prescription volume, partly offset by a decline in retail sales.

AOI decreased 48% versus the prior year quarter. Approximately 70% of this decline relates to lower sale-leaseback gains lapping reduced incentive accruals in the prior year and lower Cencora equity income. Challenging retail and pharmacy industry trends also negatively impacted AOI in the current period.

Sale-leaseback gains, net of incremental rent expense, resulted in a \$277 million headwind to AOI in the quarter. As discussed, three months ago, we do not anticipate any material benefits from sale-leaseback gains going forward. Headwinds in the retail and pharmacy businesses were partly offset by cost savings initiatives.

Let me now turn to US pharmacy. Pharmacy comp sales increased 5.7% driven by brand inflation and volume growth. Comp scripts, excluding immunization, grew 1.7% in the quarter. We are tracking in line with the overall prescription market year to date. However, overall prescription market growth remains below expectations primarily due to Medicaid redeterminations.

Pharmacy adjusted gross margin declined versus the prior year quarter driven by brand mix impacts, reimbursement pressure reflecting last year's negotiations, lower COVID testing demand, and incremental pressure from certain generic launches with procurement dynamics similar to brands. Recent fluctuations in NADAC drove an incremental \$20 million of the partial quarter impact.

Turning next to our US retail business. Comparable retail sales declined 2.3% in the quarter. As Tim mentioned, the consumer backdrop remains a challenge. With this continued channel shift and a sustained pullback in discretionary spending, we have responded by lowering prices across health and wellness, personal care, and seasonal categories.

Where we invested in price and promotions, we saw returns in sales and unit lift. At the same time, value-seeking behavior and new product launches year-to-date helped to drive our own brand penetration up 65 basis points in the quarter.

While we're seeing early signs of customers responding to our actions, retail gross margin declined more than previously anticipated due to our price and promo investments this year lapping last year's margin recovery actions as well as higher levels of shrink. This was partly offset by positive impact on gross margin from our category performance improvement initiatives, which are tracking in line with our expectations as we deepen relationship with select suppliers.

Turning next to international segment. And as always, I will talk in constant currency numbers. Total sales grew 1.6% with Boots UK increasing 1.6% and Germany wholesale up 4.9%. Segment adjusted gross profit increased 2% with growth across all businesses. Adjusted operating income was down 17% due to lapping real estate gains in the prior year period.

Let's now cover Boots UK in detail. Boots UK continues to perform well. Comp pharmacy sales were up 5.8%. Comp retail sales increased 6% with all categories showing growth. Across formats, destination health and beauty, flagship and travel locations performed particularly well. Boots.com sales increased 13.8% year-on-year and represented nearly 16% of our UK retail sales.

Turning next to US healthcare. The US healthcare segment delivered its second consecutive quarter of positive adjusted EBITDA. Third quarter sales of \$2.1 billion increased 8% compared to prior year quarter.

VillageMD sales, up \$1.6 billion grew 7% year on year. The increase was driven by growth in full risk and fee-for-service lives, partly offset by the impact of clinic closures. Shields sales were up 24% driven by growth within existing partnerships. Adjusted EBITDA was \$23 million, an improvement of \$136 million compared to last year driven by rightsizing costs, improved productivity at VillageMD, and continued robust growth at Shields.

Turning next to cash flow. Operating cash flow in the first nine months of fiscal '24 was negatively impacted by \$785 million in payments related to legal matters, \$386 million in entity premium, contributions related to Boots pension plan, and underlying seasonality.

Capital expenditures declined by \$497 million versus the first nine months of fiscal '23. As a result, free cash flow was down by approximately \$1.1 billion versus the prior year. We continue on pace to achieve a year-over-year reduction of \$600 million in capital expenditures and \$500 million in working capital initiatives in fiscal '24.

I will now turn to guidance. We are lowering our fiscal '24 adjusted EPS guidance to \$2.80 to \$2.95. The updated range versus our expectations three months ago incorporates two key items.

First, the US consumer environment has not improved and is driving higher promotional activity, negatively impacting retail margin. We continue to expect fiscal '24 retail comp sales to be down approximately 3%. Second is the continuation of worse-than-expected pharmacy margin headwinds. Pharmacy margins in the second half include impact from certain generic launches with procurement dynamics similar to brands, fluctuations in NADAC, inflation and mix within branded drugs, and lower overall market growth.

We are maintaining full year expectations for US healthcare segment adjusted EBITDA to be breakeven at the midpoint of the guidance range. We continue to expect our adjusted effective tax rate to be under 5%. Our revised full year guidance range implies fourth quarter adjusted EPS of approximately \$0.39 at the midpoint. While we're not providing fiscal '25 guidance today, let me offer key considerations to bridge from fourth quarter to next year.

Seasonality impacts all of our businesses, and the fourth quarter is typically the lowest quarter of the year. Additionally, we expect profitability growth in US healthcare and international segments. However, as Tim mentioned, there are other factors discussed on today's call that we assume will impact fiscal '25. Our decision to wind down the sale-leaseback program, sell Cencora shares, and a more normalized adjusted effective tax rate are expected to have an approximately \$0.75 impact in fiscal '25.

In retail, despite easing comparisons, we do not anticipate significant improvement in the US consumer spending backdrop. We are especially seeing signs of strength on the lower-income consumer driven by accumulated inflation and depleted savings. While we're adopting our model, these changes will take time.

We expect to see some pharmacy headwinds continue in fiscal '25. However, we are focused on stabilizing pharmacy margins as we continue to have active discussions with our PBM, payer, and supplier partners. We have more hard work ahead of us, and we are focused on building a solid foundation for the future, driving the stabilization of our business and returning to longer-term enterprise growth. With that, let me pass it back to Tim.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Thanks, Manmohan. Let me now turn to our strategic review. Since launching our strategic and operational review at the beginning of the calendar year, we have been clear-eyed on what we're trying to achieve, and everything has been on the table.

We have a deep understanding of the opportunities and complexities, and we have come to a number of important conclusions. Some will take more time to execute as we maximize optionality, but all of them are aligned around three principles to drive long-term shareholder value. First, to simplify and focus our business. Second, to use our core foundation, our relationship with our customers, to grow and expand in capital-efficient ways into adjacent areas. And third, to continue to identify opportunities to deliver profitable growth, generate meaningful cash flow, and strengthen our strategically relevant businesses today and long term.

Before unpacking the details, I want to reinforce the most important conclusion from our review. The retail pharmacy experience will be more important to the healthcare industry in the years ahead, but it will evolve. With widespread demand for convenient healthcare solutions, including chronic diseases, and nationwide labor shortages, the pharmacy and pharmacists have never been more important. Our retail pharmacy business is uniquely positioned to expand the role we play in the lives of our patients who have come to expect and need retail pharmacy at the center of their care.

So let me begin this discussion around our strategic decisions with our core business, US retail pharmacy. The success of the business hinges on an efficient, highly relevant customer experience, and we've launched a multifaceted action plan for improvement.

As the convenient destination for millions of customers and driving \$27 billion of retail sales, the store and its digital channels are central to our strategy and consumer experience. But the customer has evolved. Demographics and preferences have shifted, and we need to reposition and operate our stores accordingly. Currently, 75% of our US stores contribute roughly 100% of segment AOI. For the remaining 25% of the stores in our network which are not currently contributing to our long-term strategy, changes are imminent.

To start, we are finalizing a multifactor store footprint optimization program, which we expect will include the closure of a significant portion of these underperforming stores over the next three years. Plans to finalize this number are in motion, and we will update you in due course.

For the remaining portion of this cohort, we are taking action to return them to profitability and deliver an improved customer experience. We will contemplate additional closures if performance does not improve, which includes external factors such as reimbursement rates.

While it is not an easy decision to close a store, we will work to minimize customer disruptions. And importantly, as we have done in the past, we intend to redeploy the vast majority of the workforce in those stores that we close.

In addition to these closures, we are taking a series of actions and making investments to enhance the customer and patient experience across several key areas. First, we are reevaluating our assortment to ensure its relevancy, leveraging select partners

and our own brands. This means we will work with fewer partners who are helping us win.

For example, in the last quarter alone, we've removed eight national brands and redeployed those SKUs towards own brands and preferred partners within health and wellness categories. We are sharpening our focus as a definition for areas we are uniquely positioned to lead such as health and beauty and women's health.

We are accelerating our digital and omnichannel offerings to meet our customers when, where, and how they want to engage. We continue to deliver approximately 80% of same-day delivery orders within one hour, and we see upside for improvement. As the ultra-convenient option for our over 120 million myWalgreens loyalty members, we have plans to meaningfully build our loyalty program. We are doubling down on our efforts to define the future of pharmacy in this country.

As I mentioned earlier, this starts with changing the dialogue with payers and PBMs to ensure we are paid fairly for the value we provide. We're also investing in the industry's best talent. For example, as we focus on leading in the development and elevation of the pharmacy industry profession, we're partnering with critical stakeholders such as our Deans Advisory Council to help advance our work environment and make WBA the practice setting destination of choice for pharmacy talent.

Just two weeks ago, we spent two full days with 14 deans of pharmacy across our country engaging in productive discussions to reinvigorate the community pharmacy labor supply chain. And we're enhancing our pharmacy services like immunizations to attract more patients to an improved experience and enhanced digital solutions. We've significantly decreased the average wait time per customer in the highest volume stores. And this is a result of several initiatives underway to improve the patient experience and increase retention.

Finally, with a mindset for driving continuous improvement throughout the organization, we are committed to operating with excellence and identifying further efficiencies in both our headquarters and our retail operations. We are restructuring our organization around these conclusions to streamline and ensure efficient development and deployment of services, to go to market as one Walgreens with more impact for our industry partners and to help close critical gaps in delivery of healthcare.

In that regard, Mary Langowski, our President of US healthcare, will assume responsibility for operations of specialty pharmacy, pharma and manufacturer relations and contracting, supply chain, and all services development and deployment. With these operations now under one team, we will be better aligned to go where the market is moving, sharpen our contracting, operate more efficiently, and achieve better economic outcomes. And Rick Gates, our Chief Pharmacy Officer, will take on an even greater role in defining the future of pharmacy from a strategic, operational, and labor force perspective.

Turning to our broader portfolio. We have evaluated every non-retail pharmacy asset prioritizing strategic fit, profit growth potential, and cash flow generation. With that in mind, we have already stopped or will stop initiatives that distract from our focus and will grow in areas that create longer-term shareholder value.

Let me touch on several of our larger assets. Our review of Boots UK showed that we have attractive options to unlock value in this business. While we believe there is significant interest in Boots at the right time, its growth, strategic strength, and cash flow remain key contributors to the company. We are committed to continuing to invest in Boots UK and find innovative ways for this business to fulfill its potential.

Moving next to VillageMD, which currently includes three distinct assets in VillageMD, Summit Health, and CityMD, we believe in the future of these businesses and intend to remain an investor and partner. But as part of our persistent focus on value creation for WBA, we are collaborating with leadership toward an endpoint to rapidly unlock liquidity, enhance optionality, and position them for additional growth.

As it relates to Shields, its performance, growth, and leadership team remain best-in-class and serve as a complement to our core specialty business in the market. We are not taking action at this time. We are committed to executing on all of these decisions in a timely manner that maximizes shareholder value while creating optionality, and I look forward to providing more details as we progress.

Before opening the call up for Q&A, let me leave you with four thoughts. First, our core retail pharmacy business is relevant but will be different. Second, we have the right team and the right strategy to enhance our focus, strengthen our own execution, and ultimately turn around the business performance.

Third, there is a clear market need for our services, but our economics are not currently structured in a way that is sensible for our shareholders. We have a firm grasp of the issues and are working to address these challenges in our business model. Fourth, while it may take time, and there's a great deal of work underway, I am confident we are executing on the conclusions from our strategic review thoughtfully and urgently to deliver the Walgreens that our country needs. With that, let's begin Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Lisa Gill, JPMorgan.

Lisa Gill JPMorgan - Analyst

Thanks very much. And Tim, thanks for all the comments and the color. I really just want to understand just a couple of things a little bit better. One, you started with your four thoughts and that the core will be different than what we can say. So one, what do you view is the future of pharmacy? And within that, can you talk about the conversations that you're having with payers and PBMs around what the new reimbursement model would look like?

And then just my second question would be, just when we think about the financial side, you called out NADAC pricing on Medicaid. And I think Manmohan said that it was \$20 million in this quarter. Is that a material number when we think about going forward? If you can put any numbers around that would be great. Thanks.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Thanks, Lisa. So big question, future pharmacy, I'll take quickly. And then I'll let Mary Langowski talk a little bit more detail about our payer conversations. Obviously, we won't get specific. But needless to say, they have, I think, changed both in tenor and content and are constructive. And then I'll let Manmohan talk about NADAC.

As far as the future of pharmacy, retail pharmacy in particular, which we talk about the store as part of an overall experience, we are working to essentially meet the consumer where they are today and where they need us to be. And there are a number of elements to that, both in the back of the store and in the front of the store.

And so -- and I don't want to take as much time to take you in detail through all of those pieces. But at the front of the store, you saw us talk about footprint which leaves us a more rational investment horizon in terms of them bringing up to the standard that our customers would expect the store experience as well as the assortment that we would have for them, reducing our -- using almost a PBM-like approach to formulary to how we work with national brands, being deeper with fewer in order to both drive better economics and better outcomes for them as well as I saw yesterday a really exciting presentation on where we're taking our loyalty program.

And so again, how we engage with our most valuable consumers as well as everything from home delivery, omnichannel and freeing up our store managers to really have flexibility in their framework, changing their compensation program dramatically in order to incent outcomes in their individual stores and have them act as owners. That's the front of the store.

The back of the store, we know, and Rick and the team have done a tremendous amount of work around automating the workload at the back of the store. As you know, we had paused our investment in backend automation, but we have pushed forward. We are continuing to drive and ultimately are highly committed to having that be a key part of how we both free up labor to do higher order things as well as be more efficient.

Also at the back of the store, the Deans Council, we spent two detailed days working with the deans of 15 pharmacy schools as well as the trade association -- or association of deans rather, looking deeply at community pharmacy is a preference, what we can do to be a leader in that space, design of -- we're talking about design of curricula, so these pharmacists come out of the school excited.

And importantly, starting even as far back as middle school, to animate and excite sort of potential future pharmacists to the idea of community pharmacy where unlike hospital pharmacy, you have the opportunity to build long-term relationships with your patients. So the supply chain of labor, we're taking super seriously, both in terms of the effectiveness of it but also the size and the sort of skill set.

Our contracting strategy is a key part of what we do in the back of the store, expansion of pharma services. I got an e-mail yesterday from the CEO of a major vaccine manufacturer, who again, wanted to make sure that we were on the edge of our seat getting

excited about what their innovation was going to bring and how we were going to play a role in that.

So a lot there between the front and the back, but you don't need the number of stores we have today. We have a very clear picture of what we need to do there. We will have more details to follow. With that, I'll turn it over briefly to Mary to just go a little bit more color for you with the payer conversations that we've had, which I believe are highly constructive and then Manmohan.

Mary Langowski Walgreens Boots Alliance Inc - President, U.S. Healthcare

Yeah. Thank you, Tim, and thank you, Lisa. Quite frankly, we are laser-focused on being paid fairly for the value we provide. And put simply, the playbook is a bit dated and does not account for nor does it adequately or fairly pay for the role and value that we think the pharmacist is bringing and delivering services.

We also don't think it accounts adequately for the complexity that we now face in the system. And it certainly doesn't facilitate putting pharmacotherapy and behavioral interventions at the center of chronic disease management in this country. We think that has to change. And so we're collaborating with our PBM partners across the industry to make those changes.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

And Manmohan?

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Yeah. Hi, Lisa. This -- so on NADAC, maybe a couple of thoughts. First, we've seen significant fluctuations in the last several months on the index itself. We had \$20 million of impact in the quarter, but you got to think about that was a partial quarter impact. We have seen some improvement as the index, again, was updated in June. However, we are taking a very prudent approach as it relates to Q4 and the guidance for the year. And I'd say this is one of the reasons the fluctuations we've seen on NADAC is one of the reasons why we have the broader range as we put out the fiscal year guidance at this point.

Lisa Gill JPMorgan - Analyst

Okay. Thank you.

Operator

Charles Rhyee, TD Cowen.

Charles Rhyee TD Cowen - Analyst

Yeah, thanks for taking the questions. Tim, I wanted to touch a little bit more on the strategy to looking at this 25% of stores that are underperforming. And a lot of these are under probably long-term leases. And I'm just wondering sort of what your cash flow position is to be able to affect getting out of these leases perhaps earlier than intended.

And maybe also when you look at these stores, how much of the underperformance is just purely a broad retail issue, just a weak consumer versus maybe stores that are facing higher levels of shrink? And thus, when you close those stores, does that solve a lot more of your margin problem all at once?

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Thanks, Charles. So I'll take the first part. As far as leases, one of the good news stories here is we actually opened stores over a long period of time that I think was widely acknowledged to be on the best corners in America. And so in many cases, as we close stores, we believe there is the opportunity to not simply carry the lease as a dark store over a period of time.

And we are actually part of -- something I haven't talked about, but an underpinning of our strategic review is actually engaging in a different way as it relates to how we handle exits of stores and leases so that we actually have a much less probabilistic overhang as we look at those things. So we think actually -- you certainly do have some carry on the balance sheet for those leases over time. We think they can be minimized.

We're actually going back and looking at leases that we had already sort of just taken as dark because we think there's gold in them. They're hills, as they say. So from that standpoint, we're going to be highly disciplined on the leases, and that's part of our underlying economic analysis of what stores to close as well.

So it needs to be clear that, that is a multifactor analysis, super detailed and that is one of the elements of it. As far as what sort of the profitability impact is and the underlying dynamics that might cause a store to -- or the underlying benefit of closing a store, I'll let Tracey Brown, who obviously is president of our stores, talk a bit more about that because it is -- that's also not as simple as just high shrink stores, for example. Tracey?

Tracey Brown Walgreens Boots Alliance Inc - President, Walgreens Retail and Chief Customer Officer, Walgreen Co.

Yeah. Thank you, Tim, and thank you, Charles. So as Tim has mentioned, this is a multi-factored disciplined way of looking at where to close. Yes, shrink is an issue in some stores, but we have our eyes on our high shrink stores all the time.

The second thing is consumer behavior, consumer trends and where you look at the markets and where our stores are located in terms of the markets that are growing versus the markets that are declining. Third, you actually have to look at like the competitive landscape in each of these markets. And then the fourth thing that I would say is we are actually looking at how we are actually leveraging our assortment in these markets.

So there are multiple levers that we look at that go into the model that drive underperformance. The other thing that I will say is there are stores that would be on this bubble. We're also taking a focused approach on those stores to get them in the right context.

And I guess the last thing that I would say, Charles, as you know this is a multi-level set of factors that come into play between ourselves, between local state officials, between law enforcement. There are a lot of players in these markets that need to partner with us in order to make sure that we are growing those that need to grow. And those that are not, we're taking the appropriate action.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Yeah. Let me just add to that, because that is such an important point from a policy in our country standpoint. The fact of the matter is, we know that we are the last company standing in a lot of places. We are the only thing standing between those places and being pharmacy deserts.

And our goal is not simply to be the last one to leave. Our goal is to actually find new ways to work together, whether it's with state Medicaid programs, whether it's a local law enforcement, and so forth for them to do their jobs so that we can do our jobs and continue to provide care in those communities.

Charles Rhyee TD Cowen - Analyst

Okay, thank you.

Operator

Eric Percher, Nephron Research.

Eric Percher Nephron Research - Analyst

Thank you. Two related questions relative to the gross margin in the pharmacy. And I think, first, if we look at the retail gross margin, it appears to be at a low point relative to the last 10 years. Can you give us a bit more on the discounting that you engaged in and your expectation for that through the fourth quarter and how you expect it to taper?

And then the second part is looking at NADAC, if it was \$20 million over a month and change and you're saying conservative over the second or this full quarter, are you assuming that there's still more expansion as it flows from Medicaid to commercial? Or do you think we can -- we've kind of seen the peak in this one or month and change?

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Sure. I'm going to pass it to Manmohan in just a second. What I'd say is, first of all, as it relates to commercial and NADAC, I believe what Rick would say if I passed it over to him, would be that while we do have some commercial contracts that use NADAC, those conversations we're having around sort of neutrality in terms of outcomes, that's actually the easier part of NADAC, quite frankly.

As it relates to the gross margin in pharmacy, I will pass it to Manmohan. And as I quickly would point out, gross margin is not only discounting. It is also mix and so forth. And so Manmohan, if you want to talk more about that?

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Yeah, sure. So as you think about the gross margin on the retail pharmacy side, maybe a couple of things there. Let me start on the retail side. And what we've experienced in the third quarter, and we think the trend is going to continue in Q4 is the environment didn't improve as we anticipated. And as a result, we focused on investing in price and promotion.

Now we've seen the unit and sales uplift as a result thereof, but at the same time, there was impact on gross margin in the short term. And so that is coming through, and we expect that's going to continue along the same lines in Q4.

The second piece that does impact our gross margin year-over-year is the level of shrink. And I think we talked about shrink in last couple of calls as well. We have seen it on an increasing trends, and there are a number of actions that Tracey and the team are taking to bring it back to historical normals.

On the pharmacy side then on the margin, a couple of themes playing out. NADAC is one of them, significant fluctuation as I said earlier in the call. We have seen some level of improvement as the index itself changed in June. But as I said, we're -- at this point, the level of fluctuations we have seen month-over-month, we're just being prudent in terms of what can play out here in Q4.

Outside of that, there last to -- last point I'd say there are some market dynamics that we experienced in Q3 as well and some will play in Q4. And maybe a couple of those to point out is there are certain generic launches where the procurement dynamics continues to be just like branded. And so that is impacting our gross margin on the pharmacy side. And then lastly, I'd say the mix that's coming in on the branded side is also having a negative impact on the margin. So that's maybe overall profile of what's driving our margin in the quarter.

Operator

Ann Hynes, Mizuho Securities.

Ann Hynes Mizuho Securities USA - Analyst

Hi, good morning. Thank you. I have two questions. One is just about your commentary around prescriptions and not back to pre-pandemic level. I guess I find that a little surprising just because overall healthcare utilization is so strong. So do you think it's a market share issue? Is it a pharmacist issue?

I know you lost some pharmacies during the pandemic. Maybe if you can provide some updates on that. I know you mentioned Medicaid, but it was my understanding Medicaid's pretty small as a percentage of total revenue. So any other detail would be great.

And then my second question is just, I guess, bigger picture. I know you're not giving all the details on the strategic review, but your stocks down a lot premarket. Like do you have a sense for maybe some of your longer-term investors when you think you could stabilize operating profit in the retail segment and free cash flow, is it like a 2026 timeframe? Like any update on the timeframe when you think you can recover this business would be great. Thanks.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Sure. And by the way, we share the same goal that your second question implicitly implies, which is to be very clear, as you've heard us say or let me make sure you hear us say, we actually have a really strong level of conviction around the core business that we are remodeling here. It will be very different Walgreens in a lot of ways, different experience.

But by the same token, we see a clear stabilization and actual growth path for that business. It is going to take time. We're not going to give you a guidance but it's quarters, not months. It's not necessarily multiple years, but it is probably a period of time that we will have to demonstrate to you and frankly, to our consumer that we are going to deserve their preference.

As it relates to the share dynamics and sort of why share is growing more slowly. And you're right, it's not just Medicaid, although that does impact things, the Medicaid re-enrollment challenges. By the way, which many of our urban stores could have played a role in if we were to have a closer relationship with Medicaid, and we are having some of those discussions do -- is one factor. But Rick, do you want to talk more broadly?

Rick Gates Walgreens Boots Alliance Inc - Senior VP and Chief Pharmacy Officer

Yeah, Ann. And I think as you look at volume, I think we stated that we are growing with market right now. So it's not just a Walgreens thing. It is a market dynamic. And so when you look at Medicaid redetermination as an example, Medicaid enrollment really ballooned during the pandemic as obviously they were not moving people outside of the Medicaid coverage.

And so what we've seen is that states has continued to move patients out. We're seeing upwards of closer to 18 million to 20 million individuals who have moved out of Medicaid coverage and either have to go out and find coverage like either discount cards, individual plans, or get into commercial plans. And so we've seen a dynamic where they actually have not picked up coverage as quickly, and utilization has dropped.

And so what I think we're seeing is that pandemic, we were running closer to 4%, 4.5% towards the end of it from a market growth perspective. Pre-pandemic, it was closer to 2.5%. And I think what we're seeing right now is we're actually running below the 2.5% from a market perspective. And obviously, we're trying to track with that.

Operator

Kevin Caliendo, UBS.

Kevin Caliendo UBS Equities - Analyst

Thanks for taking my question. I guess I wanted to expand on Charles' question a little bit. If we were to just do simple math of the stores that you've identified, the 25% stores, and let's just say those stores were gone as of today, what would be the financial impact on the company right now? Like what would be the change in terms of your gross profit or your EBIT, however, you want to define it?

And then the follow-up to that is, of those 25% stores, I appreciate you calling out that you expect to retain most of the workforce, what is the expectation on the retention of Rx, of the scripts in those stores, meaning usually when you close a store or relocate a store, you oftentimes are able to keep a vast majority of those scripts. Has there been an analysis of that done yet? Thank you.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Thanks for the question. I'll take the second half, which is absolutely, that's a key part of the analysis and underlying assumptions that we have experience with. Obviously, as you may know, we've been closing multiple hundreds of stores over the last several years.

And we've gotten very good at being able to not only move those scripts and those patients more importantly, but also to predict sort of what the drop-off would be based on certain circumstances. So it is a key part of the analysis. The short answer is we retain nearly all of them, not all of them necessarily, but nearly all of them and certainly in a way that makes the underlying overall economics of closing the store makes sense.

As it relates to essentially a pro forma of what the business looks like with all of that gone, which would be fairly complex because of a number of factors that you have to assume and that we have assumed but we wouldn't want to necessarily put out there as guidance right now, I'll let Manmohan talk a bit more though about those dynamics.

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Yeah, sure. So look, I think from an analytics perspective, as we think through the closure, maybe two points there. 25% is the overall footprint that we're evaluating. And as Tim mentioned, it's not that all of them are for closure.

So we're going through the detailed analysis store by store, where we can improve the performance and bring them back into the portfolio and what's the remaining part where we need to take the action. Now Tracey mentioned a number of -- several factors that go into our determination of where we need to take the action.

I'd say maybe I focus on the financial side. It's really driven -- it comes down to the cash flow analysis, it's cash flow positive to keep it open or cash flow positive to close. And the decision to close typically would result in accretion, both on the cash as well as on the adjusted EPS side.

And then so far as retention is concerned, yeah, I think Tim covered that as well. We've closed 2,000 locations over the last 10 years. So at this point, I think we have a pretty good view of -- depending upon the location of the stores, what would be the retention on the script side.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Yeah. And let me be clear about one additional thing. We are extremely focused on the fact that closing those stores means we have to reduce our fixed costs that support those stores as well. So if you're trying to model it, what you would need to do is assume some percentage of stores and then back out the fixed cost because we will be highly disciplined at ensuring that any fixed costs that are being carried by those stores are also removed, which is what makes closing the stores in part very attractive.

Operator

Michael Cherny, Leerink Partners.

Michael Cherny Leerink Partners - Analyst

Good morning and thanks for taking the question. So I don't want to get too far ahead of this reboot plan, but Tim, you talked about 25% of the stores in the strategic review that you've outlined. How do you feel comfortable that, that's the right number of stores to be evaluated?

And in the event that we play this forward in -- let's say, you close 25% of the stores, how will you be judging about whether or not that's the appropriate footprints to give the right coverage for payers, to give the right localized coverage to your point to retain the scripts that you like? I'm just trying to get a sense of a little more detail on how you landed most of that number and why we should sit here today thinking that is the right number.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Sure. I would tell you that we have not only ourselves using our models, but used a very aggressive outside firm that brings incredibly thoughtful models to the table and have done this in other scenarios to challenge our thinking.

And so listen, there's no one exact right number. Let's be clear. There are group of stores that are clear. There are a group of stores that we will be working to see whether or not they make sense. And one of the factors that we actually factor in is our payer mix.

But I also want to be clear, this industry has been reducing its capacity over the last several years, and that is not a bad thing. I think most of us knew when I was in the PBM business, I knew that retail pharmacy was largely overbuilt for where the future was going to be, particularly given the possibility of technology, home delivery and so forth.

And so for us, that's another factor as well as the number of stores we may need to serve a particular payer today may be very different than what it would have been 10 years ago. I mean, if you look at the Department of Defense as a contracting entity, they have minimum standards. And they're very tough, and they don't require 70,000 pharmacies, let's be clear, in their network.

So we think that reducing capacity in the industry is not a bad thing. We think it's good for the labor so that we're not actually overusing pharmacists in stores that we don't need. But we also think that from a payer standpoint, we are going to be positioned to serve payers very effectively with the footprint that remains.

Operator

Elizabeth Anderson, Evercore ISI.

Elizabeth Anderson Evercore ISI - Analyst

Hi, guys. Thanks so much for the question. I have maybe a short-term one and then maybe sort of a longer-term one. On this year, obviously, you had a nice quarter-over-quarter improvement in free cash flow. Can you help us think about sort of the free cash flow expectations for the fourth quarter? And then sort of maybe anything you can say directionally on 2025?

And then as we think about some of these payer conversations that you've been having, I mean, have any of the payers sort of agreed to terms that kind of help stabilize things for, I don't know, starting 1/1/25? Is this like more of a longer-term kind of conversation? Any other color you could provide on that side would be very helpful. Thank you.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Sure. So I'll turn it over to Manmohan for the free cash flow conversation, and then Mary to give you any color on payer conversations. What I would remind you of is that we're fairly -- we're right in the middle of those conversations now. It wouldn't be appropriate to necessarily characterize any one of them, but they're super encouraging. And I think Mary can talk a little bit more about that at this juncture. But Manmohan, do you want to talk about the cash flow?

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Sure. So from a third quarter perspective, we did have positive free cash flows in the quarter, and that was aided in part by the working capital improvements in the quarter as well as decreased capital expenditures. As you think about the first nine months of the year, though, the cash flows are impacted by lower earnings and then \$785 million of payments related to legal matters as well as the phasing on the working capital.

As we think through Q4, we expect Q4 free cash flows to be positive, similar to third quarter. And that is including a roughly around \$150 million payment related to opioid in the quarter. And then maybe finally, I'd say, look, this is a top priority for us in the company. And all the actions we've outlined and -- we'll continue to boost the cash flow position here.

Operator

Thank you.

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

And then Mary? Sorry, I'll let Mary take the piece around (multiple speakers) characterizing our conversations.

Mary Langowski Walgreens Boots Alliance Inc - President, U.S. Healthcare

Right, I won't speak to specific payer conversations. But I will say that there is an understanding and a collaboration going on that some of these models need to change, and we're reshaping our current negotiations on brand versus generic reimbursement and obviously, in discussions on some of these new models, new payment models that are out there. We, I think, are seeing an understanding that we need to align incentives better. And just as I said before that the old playbook is old, and it's not currently serving the system.

Elizabeth Anderson Evercore ISI - Analyst

Thank you.

Operator

George Hill, Deutsche Bank.

George Hill Deutsche Bank - Analyst

Good morning, guys, and thanks for taking the questions. I just kind of have a quick one for Manmohan. You talked about the \$0.75 of earnings contribution in fiscal '24 that wasn't expected to continue. And you guys have talked about the challenges in fiscal '24 in retail pharmacy kind of expected to persist in fiscal '25.

I know you guys aren't ready to give full year 2025 guidance yet, but I just want to make sure, are we kind of talking about an earnings number in the low \$2 range, given where the current fiscal '24 guidance is? And I guess, I mean how would be, is there -- are there any other like moving pieces as it relates to cash flow for fiscal '25 that you guys would call out now? Thank you.

Manmohan Mahajan Walgreens Boots Alliance Inc - Global Chief Financial Officer, Executive Vice President

Yeah, sure, George. So on the earnings for fiscal '25, you're right, we're not providing guidance. But we will come back and provide detailed information and guidance in October.

But what we offered in the prepared remarks is a couple of things to consider as you bridge to '25. First is Q4 seasonality impacts all of our businesses, and you think about vaccinations, you think about cough-cold season, you think about the season -- the holiday season impacting the retail sales. So seasonality drives Q4 to be our -- typically our lowest quarter, and so you got to consider that.

And second is, we do expect profitability growth, both in our US healthcare segment as well as in our international segment as we move into fiscal '25. However, said that, there are a few headwinds. And the biggest one here is as we think about our decision to wind down the sale-leaseback program, sale of Cencora shares, and then you consider a more normalized tax rate into fiscal '25 that we believe will result in approximately \$0.75 headwind.

And then on the retail side, you have to consider -- we do believe the environment will continue to be challenging here in '25 from a consumer perspective, but there is a little bit of easing comparisons as you think about '24 versus '25. And on the pharmacy side, some of these headwinds will continue as you think through this. So this is -- these are all kind of the building blocks as you work through modeling '25.

George Hill Deutsche Bank - Analyst

Thank you.

Operator

Stephanie Davis, Barclays.

Stephanie Davis Barclays Bank PLC - Analyst

Hey, guys, thanks for taking my question. I have a question, this might be best for Mary, but maybe, Tim, I'd love for you to weigh in on the future of the US healthcare strategy. Just given the plan to exit VillageMD and the idea that value-based strategies often take a few years in order to get profitable versus some of your near-term profitability goals, what's the forward take on the need to be in the value-based strategy for the best of US healthcare? And could we see this become more of a fee-for-service asset going forward?

Timothy Wentworth Walgreens Boots Alliance Inc - Chief Executive Officer, Director

Yeah. I will let Mary -- I would remind all the listeners, Mary joined about three months ago and brings tremendous experience and relationships in this space, understands it well. And I want to be clear, we are big believers in value-based healthcare.

Actually, pharmacy is the value-based healthcare provider in the ecosystem, quite frankly, if you really look at cost for outcomes and the work that we can do to impact those outcomes. So we love the fact that we actually own what will be seen over the next 20 years and needed as the most valuable part of the healthcare ecosystem and frankly, the most accessible. That's number one.

Number two, as it relates to VillageMD in that model, we like that model. That's why we've said we would continue to have some investment and participate in their growth. It will take time. And as I said, we are looking for a different horizon for what we're going to be investing in strategically under our own leadership. But Mary, do you want to talk more generally about sort of that question as it relates to US healthcare strategy and Village -- fee-for-service versus value?

Mary Langowski Walgreens Boots Alliance Inc - President, U.S. Healthcare

Yeah, absolutely. Thanks, Stephanie. In the US healthcare business, we are laser-focused on being extremely disciplined around where we will focus, what we will do, and importantly, what we'll stop doing. So there are areas where we'll grow and double down. And those areas fit the lens Tim articulated earlier.

Those things have high-growth potential. They build on our core business. We're streamlining how we operate as we discussed around going to market with higher impact, how we develop services, and how we partner across the industry with payers, health systems, at-risk providers as well as pharma manufacturers.

And then third, we'll stop things. And frankly, we already have stopped certain things that don't fit this lens or create near-term value. In some cases, we'll exit or restructure those things. So it's important that we stay really laser-focused on that.

With respect to value-based care, we have already articulated that we don't have plans to continue to invest in brick-and-mortar owned primary care practices. Now having said that, we believe strongly, as Tim said, in value-based care as well as in VillageMD. And we believe in these businesses and payers believe in these businesses, and consumers, frankly, love getting their care in these types of businesses.

But what we've stated, and I'll state again is we'll be a partner of VillageMD in an ongoing way. We'll continue to be an investor. But what we're really looking to do is invest in capital-light services to be a broader partner across the industry with a range of providers and with a range of payers as well as a range of pharmaceutical manufacturers.

And we think we're really well positioned to do that, particularly based on the conversations we've already been having over the last three months. We are very complementary to a lot of players in the system. And they, frankly, want what we have that they don't have, which is reach -- our ability to reach people, our ability to engage them, and our ability to create interventions in really critical moments. So that's what we're planning to do.

Operator

Thank you. I would now like to turn the call back over to Tim Wentworth for closing remarks.

Timothy Wentworth *Walgreens Boots Alliance Inc - Chief Executive Officer, Director*

Great. Thanks, everyone, for the questions and for dialing in. Just to leave you with a couple of thoughts. First of all, our team is very clear that we are in a turnaround. We have a clear-eyed view of the things we need to do. We have gone very deep in understanding every part of this business and being realistic about the baseline we're resetting for growth.

Second, we have a team that is literally, I believe, one of the best teams any company could ever have. I am extremely blessed to work with a group of folks who not only work effectively together but are relentlessly focused on the challenge and most importantly, highly committed and believe in the future of our business, the retail pharmacy experience that patients and payers and pharma companies need us to be.

Retail pharmacy is central to the future of the experience that we're going to create and the growth that we will have. It is necessary, but it will be different. And over the coming quarters, we look forward to showing you as well as telling you how it will be different and the kind of results that it will achieve in a more capital-friendly way.

And finally, we are very clear about our role as stewards of capital and making investments that make sense. We have some great assets that are part of our company today. We're going to be thoughtful about how we continue to improve the value of those assets or do other things that make sense based on our longer-term strategy. So thanks again. We look forward to sharing more in the coming quarters.

Operator

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

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