THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

WBA - Q4 2018 Walgreens Boots Alliance Inc Earnings Call

EVENT DATE/TIME: OCTOBER 11, 2018 / 12:30PM GMT

OVERVIEW:

Co. reported FY18 GAAP EPS of $5.05 and 4Q18 GAAP EPS of $1.55. Expects FY19 adjusted EPS to be $6.40-6.70.

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

George Robert Hill *RBC Capital Markets, LLC, Research Division - Analyst*

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

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

Ross Jordan Muken *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Walgreens Boots Alliance, Inc. Fourth Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Mr. Gerald Gradwell, Senior Vice President of Investor Relations and Special Projects. Please go ahead.

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

Good morning, ladies and gentlemen, and welcome to our earnings call. I'm here today with Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer of Walgreens Boots Alliance; James Kehoe, our Global Chief Financial Officer; and Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance and President of Walgreens.

Before I hand you over to Stefano to make some opening comments, I will, as usual, take you through the legal safe harbor and cautionary declarations.

Certain statements and projections of future results made in this presentation constitute forward-looking statements that are based on our current market, competitive and regulatory expectations and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by the law, we undertake no obligation to update publicly any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. Please see our latest Form 10-K and 10-Q for a discussion of risk factors as they relate to forward-looking statements.

In today's presentation, we will be using certain non-GAAP financial measures. We refer you to the appendix in the presentation materials available on our Investor Relations website for reconciliations to the most directly comparable GAAP financial measures and related information.

You will find a link to the webcast on our Investor Relations website at investor.walgreensbootsalliance.com. After this call, this presentation and webcast will be archived on the website for 12 months.

I'll now hand you over to Stefano.

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

Thank you, Gerald. Hello, everybody. Today, we are announcing another solid financial performance, both in the fourth quarter and for the full year as a whole.

I am particularly pleased with the strong full year adjusted earnings per share growth, up 18%, meaning that we have delivered mid-teens compound annual growth since WBA's inception. A significant feature of our growth has been our strong cash generation, which continued to develop well this year. These strong and resilient cash flows stem from the important role that our pharmacy businesses play in national health care systems and in the daily lives of our customers.

I believe true customer focus will be key to our future. Focusing on our customers and their needs will drive growth. And with that in mind, it is very encouraging to see the continued market share gain here in the U.S.A. as we continue to deploy the benefits of scale in part to offset the inevitable pressures that occur as demand for health care continues to grow.

The team in the U.S. has continued to make good progress on a number of initiatives, notably with the work to integrate the stores that we acquired from Rite Aid, which the team are delivering on schedule and on budget. James will update you on that in a moment. Of course, we have also made a significant progress in the formation and development of partnerships and alliances, as you have seen from our announcements in the past weeks, including the announcement of our expanded partnership with LabCorp. This is all part of our strategic initiative to transform our offering, organization and infrastructure to be fit for the future.

We believe in true partnerships that share resources, skills and expertise and either accelerate our own work or bring us capabilities that we could not easily or economically develop ourselves. You will hear about these partnerships once James has taken us through the numbers.

So with that, I will hand over to James.

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

Thank you, Stefano, and good morning, everyone. Overall, we delivered a solid set of results in the fourth quarter and the full year.

GAAP EPS more than doubled in the quarter, with the full year up 33.6%. Adjusted EPS increased 13% in the fourth quarter, both on a reported and constant-currency basis, and for the year, adjusted EPS grew 18%, with 17.1% growth in constant currency. We delivered full year sales growth of 11.3%. On a constant-currency basis, and excluding the impact of acquisitions and divestitures, our organic sales growth was 3.2%.

Encouragingly, our U.S. comp sales improved sequentially versus the third quarter, both in pharmacy and retail. Reimbursement pressure continued, and we partially offset the impacts through good cost management and procurement savings.

Cash generation was strong, with free cash flow up 16.9% to $6.9 billion. And as we've said many times, if we don't make any significant investments in the year, we will return excess cash to our shareholders and maintain an efficient balance sheet. In total, our strong cash generation allowed us to return $6.8 billion to shareholders this year, $5.2 billion in share repurchases and $1.6 billion in dividends.

Turning now to our full year results on Slide 5. Full year sales increased 11.3%, and GAAP EPS was up 33.6% to $5.05. This performance reflects high single-digit growth in adjusted net earnings, the absence of the prior year cost transformation program and a lower share count.

On an adjusted constant-currency basis, our key metrics increased versus prior year. Sales advanced 10%, including the impact of the acquired Rite Aid stores and organic growth of 3.2%. Adjusted operating income was up 2.9%, reflecting the solid performance in Retail Pharmacy USA.

Adjusted net earnings were up 8%, and adjusted EPS increased by 17.1% to $6.02 per share. Our ongoing share repurchase program contributed approximately 5.5 percentage points of EPS growth. The full year adjusted effective tax rate was 18.8%, 4.4 percentage points lower than prior year primarily due to U.S. tax reform.

Turning now to our fourth quarter highlights. Sales increased 10.9%, and GAAP EPS more than doubled to $1.55, reflecting a lower effective tax rate and the gain on the sale of our interest in Premise Health in July of this year.

On an adjusted constant-currency basis, our key metrics increased versus prior year. Sales advanced 11.3%, reflecting the acquisition of the Rite Aid stores and organic growth of 4%. Adjusted operating income was up 0.3%, and adjusted EPS increased 13% to $1.48 per share, primarily reflecting a lower tax rate and the benefit from share repurchases.

Now let's look at the performance of our divisions, starting with Retail Pharmacy USA. Sales were up 14.4% in the fourth quarter. Full year sales advanced 12.7%, reflecting the acquired Rite Aid stores and organic sales growth of 3.4%. Adjusted gross profit was up 2.8% in the quarter and 5.2% for the year. The favorable impact of higher sales more than offset a lower gross margin.

SG&A spend increased 3.7% in the quarter, entirely due to the acquired Rite Aid stores. Excluding Rite Aid, SG&A spend declined 7.6% primarily due to an amendment to certain employee postretirement benefits and continued cost reductions. Excluding Rite Aid, full year SG&A declined 1.5% versus prior year, mainly driven by strong cost discipline. The amendment to certain employee postretirement benefits had no impact on the full year comparisons as there was a similar amount in the third quarter of 2017.

Adjusted SG&A was 17.1% of sales in the quarter, an improvement of 1.8 percentage points compared to the year-ago quarter. On the same basis, adjusted SG&A as a percentage of sales has now improved for 21 consecutive quarters.

Adjusted operating income increased 0.1% in the fourth quarter and 3.8% in the year. You will recall that we were lapping a very strong fourth quarter last year with double-digit growth in adjusted operating income. Our full year adjusted operating margin was 6%, 0.5 percentage points lower than prior year, almost entirely due to the dilutive impact of the acquired Rite Aid stores and the Prime strategic partnership. On an organic basis, lower pharmacy gross margins were offset by strong control of SG&A and higher retail margins.

Now let's move to pharmacy. Total pharmacy sales advanced 16.7% in the fourth quarter and 17.2% for the year, mainly reflecting Rite Aid and organic growth of 6.5%. Our central specialty business led the way and delivered full year growth of 80%. Fourth quarter market share was 22.3%, up 180 basis points compared to last year.

The number of retail prescriptions filled on a 30-day adjusted basis, including immunizations, increased by 11.8% in the quarter and 10.6% in the year. Comps were up 1.3% in the quarter and 3.5% in the year, with the second half growth rate impacted by the Medicare Part D network changes. Comparable pharmacy sales and prescriptions improved sequentially compared to the third quarter and included a benefit from the transfer of prescriptions from our Rite Aid stores.

Pharmacy gross profit was slightly lower in the fourth quarter, entirely due to timing. And full year gross profit increased mid-single digits versus prior year. The fourth quarter gross margin reflected the continued shift to specialty, which accounted for around 190 basis points; and reimbursement pressure, which was due in part in favorable timing. These factors were partially offset by procurement savings.

Turning next to retail. Retail sales increased 8.3% in the quarter and 2.4% in the year, with the fourth quarter reflecting an increased sales contribution from the acquired Rite Aid stores. Comp retail sales declined 1.9% in the quarter and 2.4% in the year. The fourth quarter comp improved sequentially compared to the third quarter decline of 3.8%.

Full year retail sales were held back by 2 factors. Firstly, promotional optimization had a negative impact of approximately 90 basis points. Secondly, we deemphasized cigarettes and seasonal products within our overall offering, and this led to a negative revenue impact of around 110 basis points. So in total, these 2 programs explain around 200 basis points of the full year sales decline, and both of these have enabled improved retail margins.

We grew comp sales in both the health and wellness and beauty categories in the fourth quarter and for the year, benefiting from investments in our top stores. In fact, total retail sales in the beauty differentiation stores continue to outperform and resulted in an improved margin in these stores. Retail gross profit was higher in both the quarter and the year. Excluding Rite Aid, retail gross margin expanded 30 basis points in the quarter and an impressive 170 basis points in the fiscal year.

Next, let's look at Retail Pharmacy International, which, as usual, is in constant currency. Sales decreased 2.7% in the quarter and 2.1% in the year. On an organic basis, sales decreased 1.5% in the quarter and 1.2% in the year. Comp pharmacy sales declined 3.4% in the quarter and 1.2% in the year, mainly due to lower U.K. prescription volume and continuing U.K. government reimbursement pressure.

Comparable retail sales were down 0.9% in the quarter and 1.5% in the full year as we saw improvement towards the end of the year. Excluding the U.K., comp retail sales were up 0.9% in the year and 1.1% in the quarter, with good growth in the Republic of Ireland and Thailand.

Boots UK comp retail sales were down 1.4% in the quarter in a difficult retail market. While our beauty business declined in a changing category, we drove continued growth in our health and wellness and personal care businesses. We are taking actions to address our U.K. retail performance, and we'll be investing in new store and digital content. More to follow on this in future quarters.

Adjusted operating income declined 2.3% in the quarter. This was entirely due to lower revenue. Good cost management allowed us to hold our fourth quarter and full year margins at the same level as last year.

Turning now to the Pharmaceutical Wholesale division, which we'll also discuss in constant currency. Fourth quarter sales increased 4.7%, with continued strong growth in emerging markets. Adjusted operating income increased 2.7% in the quarter, reflecting relatively lower generic procurement pressure and a higher contribution from AmerisourceBergen.

Before I move to cash flow, let me give you a quick update on Rite Aid. The integration of the Rite Aid stores is progressing well, and strong execution is leading to favorable results on prescription volume retention. The store optimization program is on track. And as of year-end, we had closed 458 stores, in line with our plan. We aim to complete the store optimization program by the end of fiscal year 2019.

Integration and rebranding are also progressing, with pilots underway. We are now anticipating a total benefit from store optimization and synergies of more than $650 million per annum, ahead of the $600 million we had originally forecast. And we expect our overall integration and store optimization costs to be in line with our original estimate of approximately $1.2 billion.

Turning now to cash flow. Our cash generation was strong. Free cash flow for the year was up 16.9% to $6.9 billion, the highest level in the company's history, reflecting higher operating income and cash tax benefits. Cash taxes were lower in fiscal 2018, partly due to nonrecurring benefits of approximately $450 million.

We reduced working capital by $1.5 billion for the second year running. Around 25% of the reduction was as a result of the acquisition of the Rite Aid stores, and good management of both receivables and inventory led to a reduction of our cash conversion cycle days.

Let's turn now to our guidance for next year. We are projecting constant-currency adjusted EPS growth of 7% to 12% in fiscal 2019. Our currency assumptions result in an adverse EPS impact of approximately $0.04. This leads to an adjusted EPS range of $6.40 to $6.70 in reported dollars, and we will tighten the range during the course of the year.

Now let me share some of the assumptions embedded in our guidance. We estimate that next year's adjusted effective tax rate will be broadly in line with 2018. We project a tax rate of between 18% to 19% depending on the level of discrete items in the year. We will be making select incremental investments of around $150 million in fiscal '19, mainly in store wages but also to fuel our new community health care initiatives. And you can view these in light of the favorable tax reforms in the U.S. In total, these investments represent a headwind of approximately $0.12 in the coming year or 2 percentage points of EPS growth.

THOMSON REUTERS

In 2018, we returned $6.8 billion to shareholders, of which $5.2 billion was share repurchases. In 2019 and absent major M&A, we are planning share repurchases of around $3 billion under our current program.

In addition, since WBA's inception, we have had a rigorous and continuous focus on cost reduction. Our guidance assumes significant strategic cost management programs, and we will provide further updates over the coming quarters. In summary, we are projecting adjusted constant-currency EPS growth of 7% to 12%, and this guidance includes incremental investments of $0.12 or 2 percentage points of growth.

Thank you. And I'll now hand you over to Alex.

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

Thank you, James, and hello, everyone. As you have heard from both Stefano and James, it's been a busy year.

Before I come to some of the things we have just announced since the end of financial year, let me first give you a quick update on some of the initiatives within the U.S. business. You've heard that the growth in the U.S. pharmacy sales has been robust. And given the pricing pressures in the market, it'll come as no surprise to you that this growth has been fueled mainly through the healthy growth in prescription numbers.

In the last year, we filled the highest number of prescriptions in Walgreens' history. The shift in contract volumes do create an element of volatility from time to time, but the underlying trend in terms of our prescription volumes and market share in the U.S. has been positive for a number of years now ... and in the fourth quarter reached 22.3% of the U.S. retail prescription market.

We also announced the acquisition of scripts from DaVita Rx and since the year-end, the pending acquisition of the prescription files from Fred's, and both are expected to contribute positively to next year's script numbers.

James mentioned the higher-than-forecast retention rate we've been achieving on Rite Aid script transfers, which gives us a high degree of confidence in these acquisitions. We are very aware that these good retention rates are being achieved through the high service levels and customer-centric approach that our teams are demonstrating when bringing these new patients into our system.

Turning to specialty. We opened a further 12 community-based specialty pharmacies in the quarter and a total of 31 in the year, taking our total to 306 at the year-end, up over 10% on last year. We also announced the implementation of a new cloud-based pharmacy platform, the Inovalon ONE platform, for AllianceRx that will improve the efficiency of the business and allow the team greatly enhanced oversight and management of the work they do.

We have continued to work on developing our online offering at Walgreens and driving the use of our app for patients who value online convenience as part of their daily health care regime. Our apps have now been downloaded around 53 million times. And around 22.5% of Walgreens retail refill scripts were initiated through digital channels in the quarter, up 2.4 percentage points on the same quarter last year.

As you know, we've been using our stores in Gainesville, Florida to trial a number of different ideas. And we're continuing to cycle programs through these stores to assess customer reaction to the offerings and to validate their commercial viability. We've always been clear that it will take time for these initiatives underway in Gainesville and elsewhere to be validated and potentially developed across our estate. However, we are beginning to look at implementing the concepts in our wider network.

In recent months, we've expanded trials of express pickup points for pharmacy in store, and we'll soon be expanding mobile self-checkout beyond its current trial in Gainesville, allowing customers to scan merchandise and pay using an app in the store.

In the quarter, we also saw the first store outside of Gainesville refitted with our new health offering, inspired by some of our concept work. This store is close to our head office in Deerfield, Illinois, and we've characterized it as a neighborhood health destination store. Although we're still developing this concept, I am really excited to see an enhanced health care offering beginning to be deployed in our U.S. stores.

Also across the network, we're working to complete the rollout of the FedEx offering, which is now in around 7,700 stores. And we have expanded the trial with Sprint to additional 80 locations planned to be opened by the end of this year in Illinois and Texas. There's now a real energy and drive in the business to make a step change in enhancing the customer experience, starting in our leading stores but over time, flowing down to every store in the network.

More recently, you've seen us announce an exciting new collaboration with Kroger to test a concept that brings together our pharmacy, health, beauty and personal care expertise with their extensive skills and resources in general retail and merchandising. Kroger's scale and expertise, combined with our own, can potentially create a truly unique concept in the marketplace. Clearly, this is a very early-stage trial, but this is the type of initiative that could drive a step change in the transformation of our customer offer and our stores overall. I am very excited by both the concept and the flexible approach and fresh thinking this initiative demonstrates in the Walgreens team.

The success of such initiatives does, however, also rely on Walgreens continuing to develop its own expertise and resources in its areas of specific expertise. The announcement of our collaboration with Birchbox to develop a store-in-store offering and provide integrated access to Birchbox online via walgreens.com and the Walgreens app clearly shows a drive to develop our beauty offering in the U.S. and internationally alongside our pharmacy, health care and personal care offer.

Finally in the U.S., to complement the work we are doing to improve the pharmacy experience for our patients and enhance the health care offering in our stores, we're expanding our partnership with LabCorp. We are planning to open at least 600 LabCorp patient service centers at Walgreens stores over the next 4 years, building on the 17 locations that opened since June 2017. So far, we have been delighted with the customer response to this partnership.

Outside the U.S., Boots in the U.K. has faced a challenging year. Sebastian James, a seasoned specialist retailer, has joined us to head up Boots from 1st September and is already working with his team to take actions to address the opportunities of the U.K. business given the challenging market.

I should also highlight our agreement with Alibaba to bring our beauty brands to Chinese consumers through a flagship store on the Alibaba Tmall Global platform. We have had a long-standing presence in China, and this is an exciting new step in building on that. It demonstrates that the growing digital environment, which is often characterized as a threat to traditional retail, we see as a great opportunity to work with forward-looking market leaders such as Alibaba. In summary, we're extremely excited by the opportunities created by the partnerships we've announced recently, LabCorp, Birchbox, Kroger and Alibaba, which are all great examples of our partnership strategy.

I'm going to hand you back to Stefano for some closing comments.

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

Thank you. As you can see from our results, our businesses have mostly done a good job of growing or at least holding their own in a tough year in many of our markets. As a company, we have improved year-on-year on our headline financial measures.

We have, as usual, built on the respectable operating performance with further scale and financial efficiencies to maximize returns for our shareholders while investing, as appropriate, for future growth. We have continued to improve the operational performance of our core businesses. And at the same time, we have done a great deal to advance the overall transformation of our company.

You have heard that we are expanding our initiatives and partnerships, and there are a lot more to come. This work supports our focus on driving our business forward in 3 key areas.

First, we are developing our omnichannel capabilities across pharmacy and retail to revolutionize the customer experience. We'll be introducing leading-edge thinking and infrastructure as we move much of our business into the digital space. This will bring us closer to our customers in their daily lives beyond the physical presence of our stores. It will allow us to focus on our customers more closely and more individually than we have ever done before. As we look forward, I believe this is easily one of the biggest transformations our business has ever seen. How we do this and the partners we choose to work with will have a major influence on the future shape of our company. It is of such importance that I am leading this personally.

Second, it's essential that we transform our retail business to create a modern retail offering that builds on our convenient locations and differentiates our stores in a crowded market. Most importantly, we must do this at a value proposition that is attractive to our customers and competitive against other comparable retailers.

Third, we intend to transform our pharmacies worldwide, expanding from our pure pharmacy focus to create health care destinations. Building on the current trusted role of the pharmacist, we will offer a wide range of health and well-being services supported with a strong and, in many cases, unique, health, beauty and personal care retail offering.

We are actively working to make our company the first choice in this sector for customers and partners alike. These partnerships bring us additional scale, knowledge, experience and resources beyond anything we could build by ourselves in areas that are very important for our future. And they do so quickly. Partnerships also create an agile, open and collaborative mindset that is vital for our growth as we look to the future. They enable us to quickly align our products, services and people to the needs of a rapidly changing and integrated omnichannel marketplace to meet the demands of a more dynamic and demanding customer base.

Of course, while we undergo the transformation, we must also continue to deliver good financial performance from our existing businesses, protect the strong market position we have today and meet the needs and expectations of our stakeholders. Our commitment is clear. We will return capital to our shareholders when we do not have the opportunity to deploy it in the near term for accretive value creation.

Our guidance for fiscal 2019 shows that we expect further robust growth in the year ahead, and we will continue to deploy our strong cash flow for the benefit of the business and our shareholders. I am confident in our company. I am excited by the work we are doing to transform our businesses. And I am looking forward with enthusiasm to the year ahead.

Thank you. Now we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Brian Tanquilut from Jefferies.

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

Just the first question on the guidance. So as we think about -- obviously, the EPS growth is being driven largely by the buybacks, but how are you thinking about EBIT growth on an organic basis if we consider Fred's and Rite Aid as acquisitions? Or I guess, how are you thinking about top line growth as well in terms of your ability to grow same-store and the front end of the store in the pharmacy in the U.S.?

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

Yes. James here, Brian. I think as you dissect the guidance, I'm inclined to take it from an EPS basis. That's the only forward guidance we're giving. So 7% is -- approximately 5.5% is coming from share repurchases. So I think even at the low end of the guidance, we're looking for core business growth of 1.5%. And we did call out quite significant investments in our stores, $150 million. That's about 2 points of growth. So we're saying the low end is 3.5 percentage points ex buybacks and the high end is 8.5%., and we think that's a strong statement of confidence in the future. I think as you look forward to next year, I think Q1 will probably have similar trends to Q4, actually the average of this year. And then as we go further into the year, we're going to see a distinct improvement in the gross margin trends as we move into the second half. So we have actually pretty good visibility on gross margin. We have a strong pipeline -- we have investments, but we have a strong pipeline of costs as well. And maybe I'll ask Alex to give you some perspective on the visibility on file buys and Rite Aid. The one thing I would say about Rite Aid is there are synergies next year, but we are actually also incurring a significant increase in interest costs. So factor that into your model. So the contribution year-on-year is relatively marginal from Rite Aid. So maybe I'll ask Alex to give you some perspective on how we think about the revenue line.

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

Thanks, James. Brian, yes, I think, on the revenue line, we've seen, first of all, a slight improvement in both underlying items growth and retail sales in the quarter, and we expect that improvement to continue into next year. As James pointed out in his prepared remarks, for example, around about 90 basis points of the sales impact this year was promotional programs, which have now cycled out of the year, as one example of the ongoing improvement. And we're encouraged by our investments in the larger, more -- larger stores and also by -- in health and beauty as we continue to see a good return on sales and margin from these investments. On the pharmacy side, we'll cycle through the Med D networks on January 1. We expect to grow at the market next year. We know these contracts pretty well. And therefore, that is the fastest growing area of pharmacy underlying in the business. Maybe the Rite Aid, we are encouraged by the retention, as we said in the prepared remarks, of the scripts we're now transferring from Rite Aid to Walgreens stores. They are higher than we've seen historically, and the team have done a really good job to drive that up. And we expect that to be sustained. And the file buys are important. It's important we continue to add customers into our stores from other pharmacies who are willing to sell their contracts at reasonable price. So all of these factors lead us to believe the underlying growth will be solid and we'll continue to see progress through the year.

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

Just a quick follow-up for me. Alex, as I think about the $15 Amazon minimum wage increase, how are you thinking about that in terms of how it impacts your ability to hire and retain employees?

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

Well, we've announced already the investment of $150 million in James' prepared remarks, which is primarily going into store labor. And we remain confident, with the offer we have at local level and the way that we treat our people in stores, look after them in different ways, that we will remain a very, very competitive employer. And don't -- also remember the fact that Amazon today primarily recruits people who walk in warehouses, and therefore, that is quite different in terms of market rates to those who primarily walk in retail shops.

Operator

Our next question comes from Robert Jones from Goldman Sachs.

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

Great, yes. I guess just taking your comments, James, on the 3.5% to 8.5% EPS growth excluding the buyback, it seems like interest expense and tax kind of offset each other for next year. So I guess -- I was hoping maybe you could just give a little bit more context around the contribution you're expecting relative to guidance from continued impressive SG&A control versus kind of core gross profit growth.

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

Yes. I think the -- I think it's an ongoing challenge, the gross margin we have. It's an industry with reimbursement pressure. And we have 3 valves for that, for offsetting the pressure, and that has been quite successful over the last 3 years since the company was formed. I'd point that the average EPS growth was 16% over the last 3 years. Last year was 17% constant currency, 18% reported. So the model is there. And some quarters will be messy, and other quarters will be much better. So the way we look forward is we have, first of all, volume. It's a scale business. So the more prescriptions we put into our stores, the more we can offset any kind of reimbursement pressure and, honestly, the better a partner we are for all of the payers, which makes us just a more valuable commodity and less pressured. The second one is how we purchase generics and the significant benefits we've gotten over multiple years. These are tailing off a little bit. But to compensate that, we will be significantly scaling up the SG&A efforts. And even on SG&A, there's a track record, 21 consecutive quarters of percentage reduction in SG&A. I actually think we can do better than that. I think we can start making better inroads on an absolute basis as well. So we actually look forward quite encouraged that -- whereas procurement goes down, we see the lever on back-office optimization in general. I come from consumer goods, which is very ZBB oriented. So we will become a very lean and cost-efficient company, and that's what's required when you've got reimbursement pressure. So we're extremely cognizant, and I'm very focused on the overhead side, as Alex has been in the past. And I don't know, Alex, do you want to add anything to that?

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

Yes. I mean, I think James said it really well. And I think the one thing I'd just remind you of is we are also investing in technology. So we are re-platforming both our retail supply chain as well as our pharmacy supply chain, and we expect that investment will again give us opportunities for really simplifying the business in the future and give us data points and processes we've never had in the past before. So we remain focused and confident that we can continue to take SG&A cost out of the business and importantly, improve the customer experience in our pharmacies and online.

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

Yes. Just maybe to add one thing. I mentioned in the guidance section Q1 margins and gross margin will be probably similar to the trend in the latter part of 2018. Well, actually, we do see a significant improvement in the last 3 quarters and an improving trend mainly because of the items we said, the procurement valve, the scripts in the store. And where we've -- our numbers have been very, very messy this year because we've had this FEP contract in the specialties. So our business is growing 80% in the full year. And just the mix, because it's lower margin, is driving 170 basis points of gross margin slippage. But actually, if you peel back, take out the FEP and take out some timing differences on reimbursement in the quarter, actually, there wasn't that much change in the gross margin. So it's a headline problem, and it's an explanation problem. But the -- once we lap FEP in Q2 of next year, the gross margins start looking more -- they could -- more flatter in terms of trend. And still, we're going to start pushing the SG&A engine much, much harder. So I just wanted to recognize that.

Operator

And our next question comes from Lisa Gill from JPMorgan.

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

First, let me start with the gag order that's being lifted on the pharmacists speaking to the individuals. Can you talk about the impact that, that will have on your pharmacy? Is that a positive for Walgreens? Or is that a potential headwind?

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

Lisa, overall, it will have no impact. Our pharmacists have always been allowed, encouraged to talk, to be honest, to make it -- the cost as low as possible for the patients in every occasion. So this will have no impact. And obviously, we welcome that, of course. It's a big step forward.

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

Okay, great. And then second, when we think about the LabCorp partnership, Alex, is there any metrics you can give us around what you've seen thus far? I know it's only 17 stores. But as we think about that future relationship, whether it's incremental buying when people come in, perhaps a correlation between giving a lab requisite and picking up a prescription, is there any data points that we can think about as we think about that relationship over the next several years?

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

Lisa, again, obviously, this year, I can't. But I can give you the big one this morning, which is you can imagine the team in LabCorp would not have agreed to expand by 600 stores now with Walgreens Boots Alliance had we not seen results that we're very pleased with. And this is a platform -- think of this as a platform for the industry and a platform for patients in terms of convenience. So whether we can expand on helping customers take better care of their own health by getting information quicker in a convenient form from their pharmacy and LabCorp or whether it's about advancing medicine through the work that they do with the manufacturers and clinical trials, et cetera, or whether it's about getting better health outcomes because of the convenience and the data, but just these are all things that we are looking to do with our partners in the future. And that's why we also had a memorandum of understanding in place as well to develop the business further. So we're really excited by this partnership. We think it's great for the industry. We think it's great for patients. And the economics are good enough. So that's where we are with that one.

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

Okay, great. And just lastly, James, the conversation keeps coming back to the underlying organic growth, and I appreciate all of your previous comments to this. But as we think about the core business of Walgreens in the U.S., how do you think about that core underlying growth? So strip away Fred's, strip away all the things that are kind of onetime, what are your thoughts around how you see that business growing just in the face of reimbursement and other issues? Just really want to understand what the baseline is that you think about this over the next several years.

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

Yes. I'll just give you my thoughts, and then I'll ask Alex to maybe add on to this. I think if you look at the full year, our adjusted operating income growth on the corporation was 2.9%; and the U.S. business, over 3%. And for a business that size in a complicated industry with a lot of pressure on reimbursement, that's pretty solid results. So -- and the starting base is pretty, pretty strong here. So I think as you look forward, we've got Rite Aid for an additional couple of periods next year. We got some new file buys coming in. We got a lot of operational excellence. And I don't want to discount all of these partnerships and the benefit they're going to bring generally in terms of a halo on our importance in general in the industry. So that's where we play up. It's more a 3-year horizon. And then, in the short term, you've got reimbursement pressure, and I don't want to start guiding to the pressures. But effectively, last year, we offset about 70% of the pressure through, generally, procurement and other such procurement activities. So what's left to offset is about 30% through overhead management. And I think you've seen enough data points -- and I'm repeating a little bit what I said at the start. I think you've seen enough data points to show that neither of these tools is new to the company. I just see -- coming in with a fresh set of eyes, I look at things a little bit differently, and I've toured many countries. I actually see that we could be a little bit more aggressive on the SG&A and procurement in general. I think we've got good skill sets, but I think they're -- are they at world-class levels? No, they're not. So I think the job that management has to do is make all of these world-class quickly. And that's why I'm actually feeling quite good about the main business. It's not an easy business, don't get me wrong, because of the reimbursement, but I think the toolbox we have is quite well developed and we can scale it up even more. I don't know, Alex?

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

Yes, Lisa. I think the core driver for the underlying base business is prescriptions, as you know. And even this year, where we've had -- going from preferred to non-preferred for the Aetna book of business in one single year, we've been able to grow overall 3.5% (inaudible) all year, and you've seen a sequential improvement of 1.3% in this quarter. So even in what was a more difficult year for the underlying business, we've been able to grow at or beyond the market underlying. And on top of that, there's a lot of that dislocation in the market. There's a lot of businesses who are looking to move away from pharmacy, and we're able to pick up the file transfers, as you've seen, from different companies. So we think that the core business is strong in a way that James has described. The volume is strong. We think we've done a good job on the front end in terms of shifting the emphasis to become more of a health, beauty, wellness expert. And there's a lot more to go. And it may be taking us longer than we had first anticipated, but the signs are very clear where we're heading to and the transition is well underway. And in the U.S., that's the core of the business, along with SG&A. That is the core of the business. So I think we believe the core is strong, the market is challenging, but we're very well equipped to deal with it.

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

Yes. And Alex mentioned it a little bit earlier. Don't underestimate the positive impact on operational excellence from new systems investments, and we're spending significant amounts of money in the U.S. business, both on financial systems, store systems, stock availability. It's just an enormous amount of positive momentum that will be brought online in the next couple of years, and this will all produce effectiveness in store and actually in the back office as well. So it's a multiyear cycle, unfortunately, and we have to go through it, but 2 years from now, it will be a very different animal in terms of the ability to execute.

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

Lisa, Stefano. Stefano, Lisa. For years, we have been told, "Is your model sustainable? Will you be able to reduce costs forever? Will you be able to buy better forever?" And you see year-after-year, we are delivering. Look at what we have done since the first days that we are here. We have always given guidance. You can judge by yourselves whether our guidance were correct or not and where we ended up. At the end, we see our guidance. So I'd say that we continue to deliver what we promise. And if we tell you that we believe that there is still a long way to go in our -- for our costs, for our buying power, well, at the end, we have demonstrated that when we promise something, we do it. So...

Operator

Our next question comes from Eric Percher from Nephron Research.

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

To start big picture, this quarter, we saw the introduction of an authorized generics strategy at Gilead. And be interested to hear your thoughts on how expansion of such a strategy might impact pharmacy and the opportunity with generic and, of course, a little more limited with an authorized generic. How do you think about that?

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

Eric, it's Alex here. Yes, I think, again, we are very open to anything that reduces the cost for the customer and provides access to care and very important molecules. Because we are absolutely focused on the customer and what the customer wants, so we think, overall, this is a good move for the industry. Economically, it's a small impact on us and one that we can absolutely manage going forward. And I think that it'll be interesting to see what happens with other molecules of similar types. This is -- the move to these generics has been happening in the U.S., as you know, for years and years and years. The penetration of generics overall is about 90% now, I think, overall, and it's just a further example of our trend. So it's good news for the customer. I believe it's good news for Walgreens pharmacy overall. And we will remain very competitive as it shifts in the marketplace.

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

Okay. And then for James, appreciate the commentary so far. Your comment on the first quarter was helpful. And maybe what I would ask is, with respect to gross margin, as you look at the headwinds you felt over the course of the year, and gross margin this quarter was lower than we expected, what's your take on how those have built? And I know that FEP played a large role, and therefore, where that sets up in terms of the quarterly progression for next year.

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

Yes. The only one I would -- the most significant one is about 170 basis points as a result of specialty, and it was somewhat higher in Q4. In the earlier part of the year, it was around 150 basis points, so not a big deal. So talking about 170. It will repeat in Q1, and then it will tail off in the rest of the year. So if you build out your projections, the business will continue to grow really quickly, but the actual margin impact in Q2, Q3, Q4 just tails off because we're lapping the big FEP contract. So that's the primary one in gross margin, and I think you won't go wrong if you just adjust for that one. If you look at -- I mentioned before in the comments, if you look at -- you plot reimbursement at whatever your estimate is and you assume the majority of it is offset either through procurement of generics or on the SG&A side. So that's kind of like the model as you might want to work through the quarters. Just in general, our business is not that seasonal. So we have -- we estimate we'll have something -- like between 49% and 50% of the year is in the first half, and then somewhere around 21%, 22% is in Q1. And it's always kind of like that. If you go back over 3 years, it's relatively predictable. So you won't go too far wrong -- if you look back on 2018 or '17 and plot it out, you'll get a good indication for the phasing. Now individual quarters will be lumpy. And Q3 was -- Q4 was a lumpy quarter. We had phasing impacts on reimbursement contracts, which are enormously difficult to predict, and that gives you a 30 basis point impact in the quarter. It won't repeat. So I think we've given enough insights, probably a lot more than in the past, in terms of how to think about next year. So I really don't want to go any further than that. Yes, there's only one comment we've lost a little bit, is the 13% in Q4, you should look at it and the AOI growth, which was a little on the weaker side, lower than the full year trend. Q4 of prior year, we grew adjusted operating income by 22%, so we're lapping a really tough quarter. And as you think about what was the quality of the quarter, bear in mind -- you do a 2-year stack on this, and then you might come to a different impression on the quarter, which we think was stronger than maybe the headline would suggest.

Operator

And our next question comes from George Hill from RBC.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

We definitely appreciate all the color. I guess thinking about the quarter and the go-forward guide, both in talking about the U.S. business at the AGP line and at, I guess, we're calling it, the AOI line now. I guess, how do we think about the dollar growth and the margin impact? Because it seems like we saw, at the gross -- adjusted gross profit line, like a big step down either in the contribution from Rite Aid or erosion in the core. And I guess what I'm trying to figure out is how much of the negative impact would we think of as onetime versus how much is mix because you talked about the change to the reimbursement contracts? And then maybe, to the degree to which you can comment, on the visibility as we go through the back 3 quarters of next year, it sounds like we're calling for -- we're not calling for gross margin expansion but just a much slower rate of erosion. Is that -- am I -- I want to make sure I'm hearing things correctly.

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

Yes. It's Alex here. Yes, I think James explained it really well. So just to repeat very briefly what James has said. The FEP contract was 190 basis points, more or less, of the impact, and that will be gone by January 1, which is halfway through our second quarter. We've also mentioned that we have some timing issues in the quarter. This quarter had -- was lumpy in their own way because some of the contracts paid us differently to what they did the previous year. I think, James, you mentioned that was about 30 basis points. And then I always say that reimbursement pressure going forward is about normal. I don't think you'll see they are worse or better than what we've been seeing on our visual over the last 3 or 4 years. And remember we have got good visibility into Med D at this time of the year, which is the annual contracts. And of course, the commercial contracts

THOMSON REUTERS

are longer by nature. And I think also -- I mean as already -- so I think that last year, we -- in terms of front end, as James has said, we saw 190 basis points improvement in the front end margin in the full year this year. We continue to invest in that strategy. So some of that was the 90 basis points of, I'll say, a one-off effect of stabilizing our promotional programs. We were overinvesting, we believe, in using new tools and techniques to make sure that we got adequate return. But the rest of that is really a shift in mix and focus in the business. So we expect to see ongoing improvement in the front end margin. So I don't know if that helps in any way, shape or form, but that's just some additional color to what James has said already.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

No, it does help square it all. And then, James, I guess, a real quick follow-up is the guidance for 18% to 19% tax rate would actually imply that tax is a headwind for fiscal '19 as opposed a tailwind.

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

No, we actually -- if I was to guide that, I think I would say flat. And this is kind of interesting, that the tax rate reform benefit of 2.5 -- of roughly 2.5 percentage points is offset by the other elements of tax reform that people don't talk about, which is the GILTI tax, and there's a repeal of Section 199 relief. And that 2.5 is offset by 1.6 points of the negative impacts of tax reform. So tax reform is probably a net 1 percentage point. And then we have discrete items in the base year. That's favorable tax judgments that are stuffed in '18 that, right now, we project won't repeat next year. And that's why we made the comment that's a range of 18% to 19%. In reality, it's flat because discretes and the not-talked-about parts of tax reform will offset the rate improvement because, bear in mind, we still have 1 favorable quarter left of favorable rates, and that's roughly 2.5 points. And as I said, I'll repeat, 1.6 points are GILTI tax and Section 199 relief. So we're kind of thinking of it as basically flat right now.

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

But you see -- you have to remember that the tax reform has been mildly favorable for us because we were very tax efficient. And as many international global companies, of course, we had a mixed rate -- or tax rate. And of course, when the reform came in, there were positive effects in the U.S. and negative effect on everything that was outside the U.S. So of course, overall, it had been positive but not as much as we could hope and not as much as other companies mainly based in the U.S. have enjoyed.

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

And bear in mind the tax is based on current guidance -- sorry, current regulations and our interpretation of them. The treasury department hasn't finalized all of the regulations yet. So in Q1, when it gets clearer, we'll give a further update on where we see tax evolving to.

Operator

And our final question will come from Ross Muken from Evercore.

Ross Jordan Muken - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

So maybe just on sort of the PBM/reimbursement front. Obviously, a number of mergers closing in the upcoming weeks. I guess, how are you thinking about sort of your positioning with the very players given what those entities will look like and sort of how maybe others may come to you given some of the natural conflicts in those businesses and just ultimately, how to think through whether that is a net positive or negative relative to either rate pressure or incremental kind of channel opportunity?

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

Let's say that time will tell whether it will be a net positive or a net negative. We are quite positive on that. We believe that our position should improve. We believe that the network of partnerships that we are creating, and we have just announced some of them, will help us to improve overall our position and to improve our profit. But the market is, let's say, quite open and quite excited now. And as you know, we have never excluded any M&A activity. We have just said that we are open to any kind of M&A provided, provided that it is really value creating for our shareholders. So we will see how the market evolves. For the time being, you have to see that what we can perceive today, it's more favorable than negative. But we are, let's say, very, very aware of this, let's say, volatility of these effervescence of the market, and we are very willing to take advantage of any opportunities that we could have.

Ross Jordan Muken - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

And maybe just on the SG&A side. I mean, obviously, it was a really strong performance in the quarter, but it felt like -- I think you called out there was sort of a pension benefit, give or take, and then it looked like there were some legal reversals or accrual reversals. I guess, just help us think about sort of the sequential cadence there because I want to make sure, at least in terms of the Q1 numbers, folks kind of have the right base. I guess, how should we think of kind of the underlying, I'm thinking more of the North American business SG&A base relative to the fourth quarter, compared to those call-outs? And then how do we think about the phasing in of that sort of $150 million of incremental investment?

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

Okay, I'll take a shot, and Alex can help me out later. So I would say that you're right. I think the biggest item I would be concerned about or adjust in your model is the 110 in the quarter. So that was this curtailment benefit. I do want to point out on that, we had a similar one last year in the third quarter. So on a full year basis, it doesn't really change the achievements, right? So that's really important. So it has -- it does impact the run rate. So we were at a 17.1% SG&A number in Q4. I would not plot that one forward because it's a little lower due to the 110 pickup in the quarter. So -- but I don't want to start giving guidance on SG&A. So I would add back something and maybe project out, but we will have cost reductions. But I would describe the 17.1% as unusually low, and it wouldn't be correct to project that forward. It would be somewhat higher.

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

But again, you don't have to look at the business or judge the business on a single quarter. A quarter, by definition, are volatile. So in reality, we should judge a business and look at the business at least on a yearly basis and try to understand what is the trend year-over-year. And in this case, you have heard that, on yearly basis, part of these elements -- one-off elements are practically new to all of them.

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

And also, as an operator, I can tell you that having a good starting position in Q1 from a cost profile is a good place to start from, and that's what we have. So as we manage the business, the team here led by Richard Ashworth and the operational team have done a great job to get to this position. So as we look forward, our starting position on SG&A is a good position to start from, from 2019 from a trend point of view.

Operator

And that does conclude our question-and-answer session for today's conference. I would now like to turn the conference back over to Gerald Gradwell for any closing remarks.

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

Thank you, Crystal, and thank you, everybody, for participating in our call. I know there are a number of you that had questions that we didn't get to, but we do have to break the call up now. So the IR team are here on our usual numbers and contacts for any further questions that you have later on during the day.

Thank you very much, indeed, and we'll speak to you again in a quarter.