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WBA - Q2 2016 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported that 2Q16 net sales were $30.2b and GAAP net earnings attributable to Co. were $930m or $0.85 per diluted share. Expects FY16 adjusted EPS to be $4.35-4.55.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Walgreens Boots Alliance second-quarter 2016 earnings conference call.

(Operator instructions)

As a reminder, today's call is being recorded. I would now like to turn the conference over to Gerald Gradwell, Senior Vice President, Investor Relations and Special Projects of Walgreens Boots Alliance. Sir, you may begin.

Gerald Gradwell - *Walgreens Boots Alliance Inc - SVP of IR & Special Projects*

Thank you, and good morning, everyone. Welcome to our FY16 second-quarter earnings call. Today, Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer, and George Fairweather, Executive Vice President and Global Chief Financial Officer, will take you through our results in greater detail. Also joining us on the call and available for questions is Alex Gourlay, Executive Vice President of Walgreens Boots Alliance and President of Walgreens.

You can find a link to our webcast on our Investor Relations website at investor.walgreensbootsalliance.com. After the call, this presentation and a webcast will be archived on our website for 12 months. 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 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 other filings for a discussion of risk factors as they relate to forward-looking statements.

As a reminder, today's presentation includes certain non-GAAP financial measures. We refer you to the appendix of the presentation materials available on our Investor Relations website for reconciliations to the most directly comparable GAAP financial measures and related information. With that, I will turn the call over to Stefano for some opening comments.

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

Thank you, Gerald. Good morning, everyone and welcome to our second-quarter 2016 earning call. It is a pleasure to be talking to you all today, although I must say that these quarterly earning calls always present me with a [mighty] challenge. The work that we are doing within our businesses around the Company is far-reaching and over time will have a transformative impact, but quarter-to-quarter, it is not always easy to find new things to say or to demonstrate the changes in our Company, other than by the meticulous tracking of the daily numbers, and that is, naturally, what George is here to do.

My role on these calls is to put the results in the context of a bigger picture, but that bigger picture, though it will look very different over the years to come, does not show great shifts and [lurches] over time, and frankly, we should all be glad about that, as stability is generally a good thing. The changes we're making must be managed carefully and progressively if they are to have a long-term and sustainable impact on the Company.

This quarter we have continued to make good progress in driving costs down, establishing even more efficient working practice, and restructuring the Company appropriately for the future. We can see the impact of these in the Company's results announced today, with adjusted net earnings attributable to Walgreens Boots Alliance per diluted share, up 11%, compared to the same quarter last year to $1.31.

All three divisions have, we believe, delivered a very credible financial performance, but there is plenty more to do and we are still at a relatively early stage in this process. Since last quarter's results, we have made good progress in developing the Company with a more focused mindset and strategic direction, and I will talk about this later in our presentation. But for now, I will hand over to George to talk us through the financial performance.

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

Thank you, Stefano. Good morning, everyone, and good afternoon to those listening in Europe. Overall, we view our second-quarter performance as quite good, particularly given the number of headwinds, including the weak cough-cold-flu season and currency translation. Beginning as usual with the key financial highlights for the quarter, net sales were $30.2 billion, up 13.6% versus the same quarter a year ago.

This increase was largely due to the consolidation of Alliance Boots for the entire second quarter this year, and to sales growth in our Retail Pharmacy USA division. Foreign currency translation adversely affected sales by approximately $750 million or 2.4%. This was due to the strengthening of the US dollar. On an adjusted basis, operating income was $2.1 billion, up 15.2%.

Our net earnings attributable to Walgreens Boots Alliance were $1.4 billion, up 14.4%, and diluted earnings per share were $1.31, up 11%. These results are, of course, not directly comparable with the second quarter of FY15 due to the Alliance Boots transaction in December 2014 and the resulting changes in our consolidated group and segmental reporting. We've now lapped the closing of that transaction and will have fully comparable quarterly results beginning in the third quarter.

On a GAAP basis, operating income was $1.9 billion, up 35.1%. At the GAAP net earnings level, our performance versus last year was impacted by a number of accounting factors, the most significant being last year's non-cash gain on the remeasurement fair value of our previously held equity investment in Alliance Boots, and the change in fair value adjustments on our AmerisourceBergen warrants. As a result, GAAP net earnings attributable to Walgreens Boots Alliance were $930 million and diluted EPS were $0.85.

As this is a leap year, our second-quarter results have benefited from one extra day versus last year. We have therefore prepared all comparable sales and prescription figures to include only the first 28 days of February. For completeness, here are the numbers for the first half of FY16. I will not go through those in great detail, but you will note that adjusted diluted earnings per share of $2.34 is up 18.2% versus the same period a year ago. Turning now to our segmental performance.

Total Retail Pharmacy USA sales for the quarter were $21.5 billion, an increase of 2.1% over the same quarter a year ago. Sales on a comparable-store basis increased by 2.2%. The sales growth was driven by increased market share, partially offset by the sale of a controlling interest in our infusion business last April, and a weak cough-cold-flu season, which was particularly strong in the comparable period last year. Adjusted gross margin increased 10 basis points to 27.7%, primarily due to procurement efficiencies.

This resulted in $6 billion of adjusted gross profit, up 2.8%. Adjusted SG&A was $4.3 billion, an increase of 30 basis points as we continued to focus on store efficiencies and controlled corporate costs. Adjusted operating income was $1.6 billion, up 2.1%, giving an adjusted operating margin of 7.6%. Excluding Walgreens' share of equity earnings in Alliance Boots in the year-ago quarter, adjusted operating income for the division grew by 10%, and adjusted operating margin by 60 basis points.

Turning now to look in more detail at pharmacy. Pharmacy sales were up 3.2% for the quarter. 233 million prescriptions were filled on a 30-day basis, including immunizations. That was an increase of 3.9%. On a comparable store basis, pharmacy sales increased by 3.7%, with comparable scripts filled up 2.8%. We view this as a good performance, particularly given the weak cough-cold-flu season this year, which we estimate had a 30-basis points negative impact on comparable scripts.

The reported incidence of flu across the USA declined by 16% compared with the year-ago quarter according to IMS Health. Overall, our retail prescription market share on a 30-day adjusted basis increased by 19.5%, up approximately 20 basis points over the year-ago quarter, again, as reported by IMS Health. Our increase in comparable store scripts was driven by our Medicare Part D growth strategy, where we grew market share.

Consistent with our expectations, we experienced a decline in pharmacy gross margins, which were impacted by ongoing reimbursement pressure and changes in mix, including an increased contribution from Medicare Part D. As you know, the new Medicare Part D rates came into effect on the 1st of January this year. Our second-quarter results therefore included two months of the new rates, but looking ahead, our third and fourth quarters will reflect their full impact.

As we've said before, we continue to anticipate gross margin pressure in pharmacy, but remain confident in our ability to grow the business over time. Retail product sales were up 30 basis points compared with the second quarter of 2015, with sales on a comparable basis down 30 basis points. Gross margin increased compared with the year-ago quarter.

Again, we are pleased with these results, given the week cough-cold-flu season. We estimate this headwind had an impact of approximately 100 basis points on comparable sales this quarter. We saw good performances over Christmas and New Year, with strong sales in giftables and candy. Wellness, another area of focus, also performed well, driven by sales of vitamins and first aid products.

We also made good progress in driving sales of No7 during the quarter. As I've mentioned before, we are on track to roll out our differentiated beauty offering to an additional 1,600 stores beginning this summer. This will increase the total number of stores with this beauty offering to approximately 2,000 by the end of calendar 2016.

Let me now provide more detail on our Retail Pharmacy International division. Total Retail Pharmacy International sales for the quarter were $3.7 billion, with pro forma constant currency comparable store sales up 2.3%. Adjusted gross profit was up $1.5 billion, with an adjusted gross profit margin of 41.1%. As you're aware, this quarter is not directly comparable with the same quarter last year, which did not include December 2014.

December is a very significant sales month, but typically has a slightly lower gross margin, reflecting a higher proportion of gifting items. Adjusted SG&A was $1.2 billion and adjusted operating income was $335 million. The adjusted operating margin of 9.1% was higher than the year-ago period, due to the seasonally strongest month of December being part of our second-quarter this year.

Looking more closely at this segment, comparable pharmacy sales on a pro forma constant currency basis were up 2.6%, and comparable retail sales were up 2.1%. Comparable pharmacy sales in Boots UK increased by 3% as a result of an increase in average item value and additional high-value drugs dispensed in hospital pharmacies. Comparable retail sales at Boots UK were up 1.8%, driven by good performance over the holiday period.

Growth in our boots.com Order & Collect service was strong, with seasonal categories and our beauty product brands, such as No7 and Soap & Glory, being key drivers. Liz Earle also performed very well in the quarter, both in store and online. We are continuing UK rollout of Liz Earle and Sleek, which we acquired in November. Outside the UK, sales growth continued to be particularly strong in the Republic of Ireland.

Turning now to our Pharmaceutical Wholesale division. Total sales for Pharmaceutical Wholesale were $5.6 billion. On a pro forma constant currency basis, excluding acquisitions and disposals, comparable sales increased by 1.6% over the same quarter in 2015. This was in line with our estimate of market growth, weighted on the basis of our country wholesale sales.

Turkey, the UK and Norway performed well, while the French and Russian markets remained challenging. Adjusted operating income for the division was $155 million in the quarter, and adjusted operating income margin was 2.8%. Going forward, the Pharmaceutical Wholesale division will include our share of net earnings attributable to our equity method investment in AmerisourceBergen.

I'll now take a few moments to explain how we will account for this. As you know, following the exercise of our first tranche of warrants on the 18th of March, we owned 34.2 million shares, or approximately 15%, of the outstanding shares of AmerisourceBergen. We will account for this investment using equity method accounting, subject to a two-month reporting lag.

The lag synchronizes our reporting with the end of their quarterly fiscal periods. Due to the lag, in our third quarter, we will only recognized our share of equity income for a couple of weeks, but of course, we will recognize a full quarter of equity income in our fourth fiscal quarter, based on AmerisourceBergen's quarter ending the 30th of June. From a funding perspective, we used approximately $1.2 billion from existing cash on hand to exercise the warrants.

Combined net synergies in the quarter from the Alliance Boots program were $329 million, taking the cumulative total for this fiscal year to $617 million. We are well on track to deliver our goal of reaching at least $1 billion of combined net synergies in FY16. We're also continued to make good progress in delivering our $1.5 billion cost saving program by the end of FY17 and are well on track to achieve this.

Operating cash flow in the quarter was $2.4 billion, driven by a combination of operational performance and cash conversion from the sale of seasonal inventory. Cash capital expenditure in the quarter was $317 million. As I have said on previous calls, we continue to invest in key areas that develop our customer proposition, including IT. This resulted in free cash flow for the quarter of $2 billion.

As we have stated previously, we are very focused on cash flow, and are very disciplined in making capital allocation decisions, and we remain committed to a solid investment-grade rating. As you have seen from our press release, we have narrowed our FY16 guidance range to between $4.35 and $4.55 by raising the bottom end of the range by a further $0.05.

This assumes AmerisourceBergen equity income on a two-month lag, no material accretion from the agreement to acquire Rite Aid, the previously announced suspension of the balance of our $3 billion share buyback program, the continuation of our normal anti-dilutive buyback program relating to equity incentives, and no significant changes in current currency exchange rates.

Please remember that we have currency translational exposure. Not only does this impact our adjusted operating income and EPS, but it can also cause quarterly volatility in the sales, gross margin, and SG&A line items. We estimate that a 1% move in pound sterling and the euro versus the dollar impacts full-year sales by approximately $150 million and $125 million, respectively.

On an adjusted earnings level, a 1% move in pound sterling impacts full-year adjusted EPS by approximately $0.01 per share; off the impact of the euro is somewhat less significant. Note that other currencies can also impact reported result, particularly on the sales line, as they did this quarter.

Our guidance reflects current currency rates, and so factors in a headwind of $0.06 since we provided our initial FY16 guidance back in October 2015.

Since Walgreens provided its FY16 adjusted earnings per share goal way back in August 2014 -- that was a $4.25 to $4.60 -- we have encountered a currency headwind of around.$0.19 per share. And lastly, when considering the outlook for the balance of this fiscal year, please keep in mind that during the third quarter of our last fiscal year, that we had a temporary pause in certain investments within our US business, as we evaluated the returns being generated on certain projects.

By the time we entered the fourth quarter of last fiscal year, we had finished this exercise and resumed our more normalized SG&A spend. This led to SG&A last year being a little lower in Q3 and a little higher in Q4 than you would expect on a more normalized basis. With that, I will hand you back to Stefano.

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

Thank you, George. As you have heard, overall, our Company is performing pretty much in line with our expectation. In many respects, we are now past many of the exceptional items that have impacted us during the last few quarters, as we began the work of bringing our [management] information system together. Although this work, as with most of our projects, is now complete after such a short time as a unified Company, we are making good progress.

As our business begins to normalize and embrace a new approach to reporting and control, both at the [business] and operational level, we are beginning to see far more clearly the impacts and implications of the levers we have to influence our operations, and the areas where we have the greatest opportunity, and the areas where we have the most work to do. I have to [say] that this is very much what we expected.

It is an important and necessary exercise to help ensure our priorities are correct and our assumptions are [not float]. I believe that one of our greatest strengths as a Management team is that, where we can, we base our decision on provable facts, and where we can't, we always, and I mean always, question our own assumptions. Then we go back and check whether we were right or not so that we can learn and do better next time.

In our US division, you can see some examples of how a slightly new focus on the way we work is impacting the Company already in a very real way, beyond the impact that our cost saving and synergy programs are bringing. In [the more narrative] approaches we are taking in terms of partnership and strategic relationship, such as that we have entered into Valeant Pharmaceuticals.

While Valeant is, as a company, is clearly still working its way through some challenges, the collaboration we have with them, though still in its early stages, is showing some very promising results in terms of improved access and affordability of their products. Since the close of the quarter, we have announced a partnership with OptumRx to create a new 90-day at retail pharmacy collaboration, giving eligible OptumRx members choice of how to receive their medication and providing them with 24/7 pharmacist availability.

Although I cannot disclose the terms of this contract, it is fair to say that it has been structured so that there is a shared and mutual benefit to us working together to increase the optimization and volumes in a more collaborative manner that I understand to have been the case in the past. Of course, our agreement to acquire Rite Aid is continuing as we expect, with the regulatory approval process progressing in line with the timetable we had expected.

All these actions not only contribute to the development of the Company, but also provide us with opportunities and the flexibility to continue to the process of reviewing and rejuvenating our increasing operation, both in retail and pharmacy, further differentiating us in the marketplace.

These actions also validate that, in seeking to lead improved efficiency in the healthcare value chain, we not only target highly selected M&A activities, but also new partnership and relationship, driven on equity alignment, like AmerisourceBergen; in [normative] commercial relationship, such as the Valeant supply contract; as well as improvement in long-standing arrangements with our critical business partners.

As we have always said, this is much longer term, but it's essential to the sustainable future of our Company. We have to find new [in normative] and value offering to continue to bring people to our store. In pharmacy, the contracts can help us to do this to an extent, but we need to announce our patient offering and ensure we maximize the value of that interaction, both to the patients and to ourselves as a Company, to announce services and the richer relationship between the patient, the pharmacist team, and our Company overall.

In the front of our stores, we need to focus our offering, be clear what we stand for, and define our two areas of expertise and differentiation. We need to offer these through whatever medium or interface the customer wants. We've done well in controlling costs and improving efficiency, but we understand that these have a limited lifespan if the [flowing] of the sales cannot be altered. Alex and his team know this, and are very focused on their strategies to address the recent trend.

If this all sounds very US-focused, it is perhaps not surprising, as today, the US is the market where we have the most immediate opportunities. This does not mean we are neglecting our other markets. Far from it. In the UK, the team is working hard on strategies to keep Boots stores and our [Wentworth] portfolio not just ahead of the market, but the most relevant to its customers, while working on plan to manage and mitigate the next round of what is ever-present government pressure on pharmacy pricing.

And across our businesses owned and in partnership through our equity investment, with the work continues, constantly, daily, to renew and restructure them to be the best they can be and to always be ready to address the challenges, but more importantly to face the opportunities where we see them. As ever, we must do this with extreme vigilance and vigor, so that we achieve it without distracting the extraordinary level of sales with our customers that have come to and have a right to expect from us, and without failing to deliver for you, as the owners of our Company. Now, let's open up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator instructions)

Alvin Concepcion, Citi.

Alvin Concepcion - *Citigroup - Analyst*

Good morning. Thanks for taking my question and great performance in the quarter. I just had a question on the US Retail Pharmacy operating margin. On an adjusted basis, it looks to be flat relative to last year, so I'm wondering, to what extent did the soft flu season hurt your margin this quarter? And as a follow up to that, based on what you're seeing out there, what is your level of confidence that the operating margin in the US Retail business will continue to improve both this year and longer term?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Morning, Alvin. It's Alex, here. Yes, the cough cold season, the mix, particularly, in the front-of-store, does have an impact. You probably noticed that we actually managed to increase the margin in front-of-store despite that impact. On the other side, which is still the bigger impact on the operating margin in the US, is pharmacy reimbursement, and we continue to see the pressures we've spoken about in the past and today.

Also, going forward, as George mentioned on the call, the Med [DCs] has been good from a volume point-of-view on plan, had the expected impact on margin and reimbursement pressure as a result. So I would say that there's really no change over all in the margin. We continue to work hard to improve the front-of-store margin with some successes. We continue to see constant reimbursement pressure, which were dealing with as we are planning to do going forward.

Alvin Concepcion - *Citigroup - Analyst*

Thank you. And on the guidance, it does appear to include the ABC equity income now. I'm just curious what you're building in for the EPS contribution from that?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

Yes, it does include ABC. We've obviously -- this is no change to where we've always, internally, looked at this is, because obviously the economics of the warrants were such that it was the right thing to do to exercise the warrants, the first set of warrants, at the earliest opportunity, which is what we've done.

Alvin Concepcion - *Citigroup - Analyst*

Got it. Last one for me, I'm just curious about the beauty rollout. I know New York and Phoenix are some of the most mature markets. I'm curious if you could give us a little bit more color on what you've seen there. Have you seen an uplift -- I'm sure to the beauty section -- but I'm curious if you've seen one to the overall front end?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Hi, Alvin. Alex, again. Yes, we're really pleased with the performance, both --particularly in Phoenix, which is more normal for the Walgreens estates. We're taking the best model we saw in Phoenix, and we're now rolling that out, as George said, to 1,600 more stores this autumn, and we're very confident about the return we'll get from that. It's certainly impacting the beauty basket in a positive way.

In particular, No7 continues to be the brand, and skin, in particular, which is driving more frequency and driving a bigger basket. So we're feeling good about this. The execution plan is on track and the team are really excited about this. And a further thing I want to say, it's not just about the products; it's also important about the customer care model and a slight and an important enhancement to the overall look and feel in our standard drugstores.

So it's not just about the products; it's about the overall experience the customer will start to get in beauty. It leaves a really good foundation for the future where we have potentially more opportunity with more brands and more opportunity over time to satisfy more customers in the front end and beauty.

Alvin Concepcion - *Citigroup - Analyst*

Got it. Thank you very much.

Operator

Robert Willoughby, Credit Suisse.

Robert Willoughby - *Credit Suisse - Analyst*

Just a quick one. Do you have any opportunities to expand the generic purchasing power of your Consortium? What we're asking is, do you have a role, any role whatsoever in the Amerisource discussions with Express Scripts about renewing their distribution agreement this year?

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

No. We, of course, Amerisource, it's a separate company and they have to manage their contract independently on us. For the generics, the situation it's quite complex because it's not obvious that if you buy more, you buy better. It depends on what you buy and where you buy. It's an analysis which has to be done very carefully, and we have also to think that if you want to really be a preferred customers, we have also to abide by certain rules, one of those rules being the fact that you must have the right quantity of products.

Because if you need more product than a manufacturer can manufacture, you have to go and have many manufacturers at a certain time. At that point, your bargaining power, of course, is less because instead of them needing us, we need them. So the situation is complicated. Of course, we analyze any opportunity on the market. We are open to discuss everything which can improve our efficiency, but we don't have to believe that every contract of every [addition], at the end, is really profitable.

Robert Willoughby - *Credit Suisse - Analyst*

Thank you.

Operator

Eric Percher, Barclays.

Eric Percher - *Barclays Capital - Analyst*

Alex, you mentioned that, in Part D, you're seeing the type of volumes you expected, but obviously rate pressure. Could you speak to your overall strategy on rate versus volume and what you've seen in commercial plans. I know there's some major contract renewals this year. What you've seen in January and February, in terms of volume delivered, and how this fits in with the broader Optum strategy?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Thanks, Eric. Starting at the top, we've been pretty clear that we want to drive more volume into our pharmacies, and we've been encouraged by what we've seen in Med D. Again, this season has gone well, and therefore you should expect us to continue to drive that strategy.

Optimum select 90 is an example of that, where we have an opportunity to work with the team Optum and to really take care of customers 24/7 and provide more services, whether they want to get it on mail order or whether they want to pick up in their local pharmacy. We're pleased with that partnership, and of course, that starts in January 2017.

In terms of our overall strategy, to drive more volume into our pharmacies, we know that we have to continue to build good relationships and strong relationships with every single peer, including PBMs and health systems and insurance companies. That's what we intend to do. That's been a real focus of Brad and Richard and their teams and we're happy with the progress we're making.

The last thing I would say is that, as we always say, we said this from the start, is that we know that reimbursement pressure will continue; so therefore, we think this is going to be an effective strategy, and we believe this will be true tomorrow as it has been for us in the last 12 months.

Of course, finally, we don't make any comment about the major contracts. As you know, that's not something we talk about in the open until we have completed them.

Eric Percher - *Barclays Capital - Analyst*

Fair enough. Maybe the follow-up is, have you seen uptake as a result of programs, clinical programs you're putting into place? Have you seen any willingness to adopt narrow networks and a more aggressive stance? I'm thinking back to the caterpillar-type strategy that we saw several years ago?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Yes. We are seeing a narrowing of networks. That's been a feature of the market, certainly for the last couple of years. But more importantly, we're seeing people pushing forward more of a health outcomes, particularly in the Med D space, where there's payment available now for delivering against [the stars] on generic utilization. These are features the markets are continuing and we continue to recognize them and do what we can to make sure that we are part of these networks and delivering good care and good quality to our customers.

Eric Percher - *Barclays Capital - Analyst*

Thank you.

Operator

Ricky Goldwasser, Morgan Stanley.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Good morning and congrats on a very good quarter. Stefano, in your preferred comments, you talked about really how you are challenging the norm in looking for new ways to partner with the different players on the continuum. So when we think about the Optum relationship, can you maybe share with us any thoughts about your opportunity to expand that beyond Optum and also to include the United population? Are you having these conversations or is this something that would depend on the success of the relationship with Optum?

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

This is a first step, of course, and as you have said, we are very keen to create new partnerships and to have good relationship with as many companies, as many people as possible. I don't exclude that we could do similar things with other partners. Whether this is the first step for further integration, it seems to me that we go too far if we say this.

It's obvious that any kind of additional relationship, any collaborations, it's helping to understand better each other and to find other ways to collaborate. But this agreement is what it is; it's a commercial agreement, which makes a lot of sense, which can create value for both parties. It could be followed by another agreement, of course. We are open, but we could also have similar or different agreements with other partners.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay.

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Ricky, it's Alex here. I just had one thing. Our biggest Med D partnership remains with United. They're very important player in our space and we've been with them for some time in Walgreens and continue to work closely with them.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. The question was right -- because there's opportunities once you tie in the health plan data to take a more holistic view of the patient and really empower the pharmacist, which are things that you've been talking about in the past. So for us, when we step back and we think about the longer term, this is part of the bigger vision for an Optum United tie?

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

I wouldn't give too much weight to this agreement, but I can also say that this agreement, for sure, is not an impediment for the relationship in future.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. And then I know that, obviously, you can't say a lot about Rite Aid, but obviously the divestitures are top of mind for investors. We get a lot of questions about it. Has anything changed in the competitive landscape since you announced the deal that could impact the potential divestitures?

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

No. Nothing has changed, except the fact we are collaborating, and as the time is passing, probably the solution will be closer, because at the end of the day, we knew from the very beginning that this would have been a very long process, that would have been asked for many, many documents and information. We are going through the process.

The process is developing and an absolute normal way and so we hope that, sooner or later, we will have an indication on where we are, but of course, we cannot put a day or even a month for this indication because it depends very much on how deeply the FTC wants to analyze all of the documents that we have given. But it's nothing atypical, exactly online with what we were expecting.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. Great. Last question for George. I know you said no comment on Express, but just in terms of maybe timing clarification given your fiscal year, should we think about an Express contract, is it relevant to FY16 or is it more FY17 type of an impact?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

We obviously don't comment on individual terms of contracts with any of our peers, as just Alex had said earlier. So really, I'm afraid I can't really answer that question.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. Thank you very much.

Operator

Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Great, thanks for the question. Sorry if I missed this, but could you share what the generic headwind and price inflation impact were on the US Pharmacy same-store sales? It seems to us like price inflation meaningfully decelerated, so first, is that correct? And then if that is correct, did the weakness come more from the branded or the generic side?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Hi, Robert, it's Alex here. Yes, there was a shift towards more of an deflationary impact, particularly in generics, which is the -- obviously bulk of our volume, not our values. Again, that is true, but again, obviously it's a trend that's been happening that we were more or less flat the last quarter and this quarter we're going straightly deflationary. The other thing that's worth remembering really in terms of sales is the importance of the specialty business within that as well.

Again, we are driving that pretty well overall, but again, that was an impact in terms of sales year-on-year, again in terms of some less inflation in specialty, which is quite a big value number overall. That was the two key things. We're pretty pleased with volume. The volume was, as George said, was up 3.9%.

We gained some market share according to IMS, and that's pretty much on the trend we've going out for some time now. We continue to drive that quite hard. So that's where we are, so yes, a slight deflation in genetics, a slight slowdown in specialty, and pleased with volume.

Robert Jones - *Goldman Sachs - Analyst*

Got it. And then, George, just want to ask a question on the proposed treasury rules from last night. I know it just came out, but is there anything specific around the proposal, specifically around inter-company lending that would affect your tax strategy? Just curious if that or either of the proposals, as you see them, at first glance, would limit your ability to generate a more efficient tax rate?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

We continued to obviously closely watch all those developments. At this stage, it's too early to comment. We continue to look to ways to optimize our arrangements in terms of funding, but at this point, really, I'm not envisaging any change from what you're seeing in our account numbers, but we will keep you posted.

Robert Jones - *Goldman Sachs - Analyst*

Fair enough. Thanks so much.

Operator

Lisa Gill, JPMorgan.

Lisa Gill - *JPMorgan - Analyst*

Thanks very much. I just wanted to go back to a couple of comments. First, Stefano, you talked about pace in offerings and announcing services related to your pharmacists. Can you give us any indication as to some the things you're thinking about there and does that tie into specialty?

We're starting to hear more in the market that we're seeing more and more specialty drugs actually come through the retail pharmacy. Is that a trend you're seeing, and is it more that you'll have pharmacists helping to manage some of those trends? If you give us an indication as to what your thoughts are there?

And then as it relates to Optum, I know you don't want to give specifics, but is there any way that you can maybe give us parameters, you or George, around how to think about how many incremental prescriptions we could see come with this relationship based on other narrow network type relationships that you've had with United?

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

I don't believe that we can give numbers. We cannot give indication about the contract. And about the specialty, what do you want to know exactly?

Lisa Gill - *JPMorgan - Analyst*

Are you seeing more specialty drugs coming through your retail pharmacy than in the past, where perhaps in the past, it's gone through a specialty pharmacy rather than coming through the retail network? Are you starting to see programs, for example, where your pharmacist is interacting on behalf and doing more services around specialty? Just any thoughts that you have around specialty contracting and the impact to your business right now?

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

I believe that this should be an important development in our Company in the future. We have started, we are focusing our attention on specialties. Specialties are important and will continue to be important even through the margin will probably shrink, and so they will be important because they will be a big part of the market, but they will not be probably future so profitable as they are today.

All the same, of course, we have to play our part, and so we are focused on that. But it's true that we could offer further specialty service to the customers as pharmacists, that not many other people could offer. Maybe, Alex--?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Lisa, it's Alex here. Again, it's a really insightful question. For sure, there's more interest from manufacturers in a mixed model of central specialty on distribution through retail pharmacy. That's because the patients and the customers do like having care closer to where they live when they are certain medications, or their carers do, as well. We've seen that trend, I would say, growing for a while, but there has been more interest, more contacts with us, particularly since we started to speak about a new model and the relationship with Valeant.

But at this stage, we are really working that through, in terms of what does that mean for what we do today. You know we have got some great assets in communities, beyond the almost 1,000 centers of excellence we have within our normal drugstores, we have community pharmacies, well over 100 now, close to where some of these specialist doctors look after patients.

And we have, again, plans for well over a couple of hundred in hospital pharmacies, as well, again, dealing with outpatient specialty. So we think we've got a fantastic network, to be honest, to deal with this trend as it comes through, but we're still working it out. The interest is high. We're building out our assets and we're working out what other partnerships we need with both manufacturers and others to try to take advantage of this trend.

Lisa Gill - *JPMorgan - Analyst*

Then my last question would be, your comment, Stefano, around the relationship with Optum and the fact that it doesn't preclude you from with working from others. You could see some closer relationships in the marketplace. Back to that, the comments around the Express Scripts contract being up. I know, a few years ago, there was a Smart90 contract that was signed.

I'm just curious, do you see incremental opportunities to work with Express specifically? Are there ways to enhance what you've learned from that Smart90 relationship, and perhaps to increase the offering, and have a tighter relationship between Walgreens and Express Scripts?

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

We have been very clear that we consider partnerships as one of our -- the most important value that we have, and we want to put this in practice. So we will try to create a partnership with as many players as possible, and of course, I see the opportunity to have a great relationship with Express Scripts. I don't see any impediment. After, you have to do what is possible.

If there are certain relationships which could be good on the paper but difficult to achieve because after you have to interact with other players, the manufacturers, the insurance company, maybe certain partnerships cannot be practically achieved. But everything that can be achieved and everything that can be in the interest of the two parties, has to be explored, and if possible, has to be done. So for sure, I see the possibility of having a very, very, very good relationship with Express Scripts.

Lisa Gill - *JPMorgan - Analyst*

Okay. Great. Thank you.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Good morning, guys, and thanks for taking the question. This one is either for George or maybe Alex. As we think about the moving pieces that drove the improvement in retail pharmacy gross margins in the quarter, I'm trying to get a sense for understanding the severity between the generic drug price deflation and the changes in reimbursement rates that impacted at the start of the year.

Was it a big positive from the changes in drug pricing and a big negative from reimbursement or should we think of a small positive from the changes in drug pricing and a small negative from reimbursement changes? I just want to understand the severity of the mix?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Yes, and again, the first thing I would say is -- it's Alex here, the Scottish accent -- it's Alex here. The impacts happen definitely in each quarter, to be honest, so I wouldn't look at any quarter in isolation. As George has said, we've only had two of the three months this quarter, actually had the Med D impact. So it's difficult to look at one quarter in isolation.

What I also say is that we are constantly working hard at procurement, not just because deflation, as Stefano said, because of the good capability we have had in Europe. And therefore we're working hard to deliver more synergies, the cost base also that was working, we're just balancing that out. But all of that is balanced out by the ongoing reimbursement pressure beyond simply the Med D contracts.

There are commercial reimbursement pressures. When the impact is, we will let you know, but they are definitely there. And also, we are working them hard as well. So I would say on balance, the operating margin in this quarter was slightly more positive because of the impacts of when certain things hit. The overall trend is really the same trend that we've seen and we've been seeing for some time, and we're just managing that trend.

George Hill - *Deutsche Bank - Analyst*

Okay. All right. Thank you.

Operator

Eric Coldwell, Robert W. Baird.

Eric Coldwell - *Robert W. Baird & Company - Analyst*

Thanks. I have a couple here. First, going back to Optum quickly, without going into contract specific details, could you explain in more detail how the economics of a deal like this might work in terms of revenue and profit to Walgreens? Will you be booking full script revenue on the 90-day fills, just a service fee, some combination of both? And realizing this won't be overly meaningful to revenue for some time, would a deal like this generally be seen as a margin accretive or margin dilutive to the Retail Pharmacy segment?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Hi, a lot of detailed questions there, Eric. I'm sorry I can't answer them, as part of the contract. What I can say is that our objective is to get more prescriptions into our pharmacies. That lowers our overall operating margin by making better use of our fixed assets. That's a really important component in this particular program.

It also allows us to take better care of our Optum members within the pharmacy, particularly making sure they are taking their medication properly and making sure that, as they are in chronic conditions, that they get directed back into the right part of the health system a bit more fast, as well, saving costs elsewhere.

That's the real aim of this program. We're comfortable with the deal that we have struck. It's a fair deal both ways. We had a great conversation on the way through with the team from Optum and we are in good shape. Obviously, there are certain assumptions that's gone in from both sides and we will wait and see what happens over the length of the contract. Remember this doesn't really start until January 2017, so it will be some time before any impact of this new contract is seen in our P&L.

Eric Coldwell - *Robert W. Baird & Company - Analyst*

Okay. That's fair. If I could just do a quick follow-up on Bob Jones's question. I'm not sure if I caught it, but did you specifically quantify the year-over-year revenue impact from generic shifting from inflationary to deflationary?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

No. We didn't and we can't.

Eric Coldwell - *Robert W. Baird & Company - Analyst*

Okay. Thank you very much.

Operator

David Larsen, Leerink Partners.

David Larsen - *Leerink Partners - Analyst*

Hi, congratulations on a good quarter. I just want to talk a little bit more about the USA Retail gross margin. It looks like the first year-over-year expansion in a couple of quarters, so congrats there. With your Part D rates and those Part D contracts, do they all now have price protection built into them, so if generic inflation comes back, you have protection on the reimbursement side?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

Again, Dave, I can't be specific, but we can say is we've been working hard to put that in, so the majority do have some price protection, yes.

David Larsen - *Leerink Partners - Analyst*

Okay. And then in terms of the gross margin expansion that we did see, was it due to generic deflation like George was asking earlier for the most part?

George Fairweather - *Walgreens Boots Alliance Inc - EVP & Global CFO*

It was a combination. That was part of it. Also, as we said before, we've still got another month of the real impact of Med D to come. We're not fully protected on deflation. We are mainly protected, not fully protected. And finally, we are making good progress on the front end. You saw the front-end margin improved in the quarter, as well, despite a slight change in mix.

David Larsen - *Leerink Partners - Analyst*

Okay. And then one last one. It looks like, for the wholesale piece of the business, there was a sequential decline in operating income, and revenue was slightly below our model. What drove that and can you remind me what impact FX had on the quarter? Thanks.

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

(Inaudible) to take into account the fact that almost all of it is in UK, Europe, and other countries, whether the currencies have played a big role and the mix of the different currencies. So it's a difficult really to judge what is happening. And after, you have also to appreciate that in the last year, we have divested some more businesses, which are irrelevant of course, but of course, represented some [face] because we have tried to streamline and we are still trying to streamline our business more generally, not just our selling business.

Eliminating all those businesses which are not profitable or which are requiring a big attention, a big absorption of energies. Now, we have a big program. We have big opportunities to create value, and it's time to -- and we started this last year -- to, let's say, close, extract, sell all those small businesses which are not adding much, but can reduce the overall efficiency of the Company, of the Group.

I could say that independently on the number -- if you look at, as we do, of course, at the countries, specifically, overall, most of the countries are doing quite well, even well, surprisingly, countries like Turkey and Egypt are doing very well, Romania. And other countries are suffering, particularly France, I would say, and particularly Russia, and also Germany is not particularly brilliant. So it's a mix.

And the combination of this portfolio with the combination of the different currencies, because we don't have just the pound sterling and the euro, but we have the Turkish lira, we have the ruble, we have many other currencies. The combination of these two things can give strange effects, but overall, you see that the results are not that bad. The margin is still there, which is important of course in a selling business.

David Larsen - *Leerink Partners - Analyst*

Thanks very much.

Operator

John Heinbockel, Guggenheim Securities.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

I have a strategic question, then one that's more tactical. When you look at the partnership with Optum and maybe other PBM partnerships, how does that -- how do you think that fits in with your potential ownership of Envision? Is Envision too small to matter or do you think -- are you committed, assuming Rite Aid goes through, committed to owning Envision or maybe divest that? How would that work with the partnerships?

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

First of all, we will decide to do with Envision once we will have completed the deal with Rite Aid. We cannot anticipate what we will do on something that is not here today. Secondly, even if we decide to develop it, I don't see any difficulty because of course we would not be a major competitor on the market and so we could find a niche where we could collaborate.

And we could have a big collaboration as a pharmacy chain and maybe some niche or more limited collaboration on the PBM business. We cannot be considered a true competitor, a competitor at the point that we could not collaborate in the most important element of the business, which is to [help] the PBM to give through us a very good service to the customers.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

And then more tactically, a lot of the improvement in gross this quarter in the US looked to be front-end. Maybe for Alex, if you think about, and I know you're probably more focused on driving top line than margin per se, but if you think about where the Walgreens front end of margin is today, maybe benchmarking that against Boots or others, do you think there's a significant amount of front-end of margin opportunity left from mix and maybe promotional cadence or not so much from where we are right now?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

Hi. Yes, I still think there's a lot to go. It will just take a number of years to get there, so the focus has been operating margins. We're really focused in on removing unprofitable activity, unprofitable items, and try to simplify the offer and focusing on the key destination categories for us, which really is primarily health, beauty, and convenience, and we feel good about where we are, but there's a long opportunity ahead of us.

That opportunity is to get customers to reevaluate the offer inside of Walgreens and to see it as more unique and more differentiated. We starting that journey really with beauty, with a few differentiation project we spoke about earlier in the call, earlier on this summer and autumn. So I think the opportunity is still a lot to come, particularly on the expansion of differentiation and higher-margin products. It will just take us longer to get that done as customers, one by one, reevaluate what they are seeing inside of Walgreens.

Finally, I would say is that we've had a one-size-fits-all approach to the Walgreens front end for quite some time. As we evolve our thinking on omnichannel and formats, again, we believe there will be more opportunity there in the outer years. But the first thing is to get people to reevaluate their current at Walgreens, which we're on with right now and then we'll figure out how do we use the space differently in over the medium to long term.

John Heinbockel - *Guggenheim Securities LLC - Analyst*

Okay. Thank you.

Operator

Eric Bosshard, Cleveland Research.

Eric Bosshard - *Cleveland Research Company - Analyst*

Good morning. From a pharmacy margin environment, you talked a couple quarters ago about some of the challenges and ongoing challenges. I'm just curious, as you reposition the Company to some degree with some of these relationships, if you feel on more stable footing about the future of pharmacy margins in the US or if you have a different view of how that is going to play out?

Alex Gourlay - *Walgreens Boots Alliance Inc - EVP & President of Walgreens*

No. Again it's Alex here. We said this already, but it's an important point. We see the volume to value mix very important for both our partners, our payers, customers, and also for ourselves. So we will work within the market, which means that we believe there will be ongoing reimbursement pressure, and then we'll work hard within that to drive our volume through offering better value and better care to customers. That's really the strategy.

I'm not saying it's very simplistic, but that's what we're trying to do. If we do these things, we think we can stabilize the operating margin over time and we can grow the business. That's what we're doing right now and we believe that's the future going forward. That's how we see it, but we accept, and Stefano said this, and [I've is pleased] in Europe, reimbursement pressure is a constant factor, and we believe it will be a constant factor here in America going forward and our strategy is as I described it.

Eric Bosshard - *Cleveland Research Company - Analyst*

Within that, it sounds like the strategy is, therefore, more volume in order to leverage the expenses and net out to a stabler beneficial operating margin. Rite Aid is a piece of that. Optum is a piece of that. Am I correct in the perception is that is the strategy is more volume, and therefore, are there more alliances that you will evaluate or pursue to drive more volume through the business?

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

It's part of the strategy. You see, when you have to accept that the margin or the gross margin, [inelactably] decline, will decline over time, you have to find ways to compensate for it. So additional services like Valeant can help, a better organization of the work, not just synergies, but a different structure of the work. A rethinking of the organization, of the flow of the medicine, of the flow of the work, the use of the pharmacies can help.

Other -- an increase, better relationship with your suppliers can help of course because it contributes to the margin. A better relationship with the clients, with the PBM, with all the people who are, at the end of the day, the source for the scripts. And a clever way of collaborating with them can help because it can increase the number of scripts, and of course, the volume is very, very important because if you can compensate at least partially the volume -- by the volume, the reduction in margins, of course, this can help substantially.

So there are many, many different actions that you can take and we are taking. And these actions can stabilize the results, the final result, as Alex was saying, for years and years to come. And in 10 years time, or whatever, we will have probably have another organization of the business and we will see what will happen at that time.

But for the next years, we see enough ways to compensate the margin reduction. We accept that the margin reduction will be there and we are trying to find, and we are finding, different ways to compensate for it.

Eric Bosshard - *Cleveland Research Company - Analyst*

Great. Thank you.

Operator

Charles Rhyee, Cowen and Company.

Charles Rhyee - *Cowen and Company - Analyst*

Thanks for squeezing me in here. Actually, just one other random question. There's a vote coming up in the UK regarding the European Union, they refer to it as the Brexit. If that referendum were to actually happen, how would that affect the Boots business here, and Walgreens, in general?

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

To be honest, I don't believe that it will be impacted directly, because at the end, the retail business is -- let's say, a local business. The brand business, even now, we don't manufacture just in UK, so at the end, we will find a way to continue to manufacture at the lowest possible cost. So the brand will not be impacted. The retail business is local, so it will not be impacted.

It could be impacted by a change of a whole economy. If we had a recession or if we had difficult consequences from the Brexit, this could impact more generally our business, as all the other businesses. The same is true for Europe because our businesses in Europe, again, are local businesses. Our retail and wholesaling businesses, are local business, depend more on the consumption of the medicines, of the products, than on the political and economical situation. So they could be impacted by a general trend, but not specifically.

Charles Rhyee - *Cowen and Company - Analyst*

Okay.

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

We don't take -- we have thought of it and we had decided that we don't need an emergency plan for it. While, when there are big changes, we try to think at least potentially of an emergency plan, but in this case, we don't see the need for it.

Charles Rhyee - *Cowen and Company - Analyst*

Great. Thank you.

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

You're welcome.

Operator

Thank you. I'd now like to turn the call back over to Gerald Gradwell for closing remarks.

Gerald Gradwell - *Walgreens Boots Alliance Inc - SVP of IR & Special Projects*

Thank you. Thank you everyone for joining us on the call today. We look forward to speaking to you again on our next earnings call at the beginning of July. In the meantime, I'll try and find something to keep Stefano slightly more entertained with his comments.

Till then, if you have any the queries or need to speak with us, the IR team here, myself, Ashish, Deborah, and Jay, are around and available to answer your calls. With that, we will draw the call to a close. Thank you very much indeed for joining us today.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. Thanks for your participation. Have a wonderful day.