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WBA - Q3 2019 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 3Q19 GAAP EPS of $1.13.

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PRESENTATION

Operator

Good morning. My name is Jessa, and I will be your conference operator today. At this time, I would like to welcome everyone to the Walgreens Boots Alliance, Inc. Third Quarter 2019 Earnings Conference Call. (Operator Instructions)

Mr. Gerald Gradwell, you may begin your conference.

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

Good morning, ladies and gentlemen, and welcome to our third quarter earnings call. I am 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 statements 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 use 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 the call, this presentation and webcast will be archived on the website for 12 months.

I will now hand you over to Stefano.

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

Thank you, Gerald, and hello everyone. After what was a very disappointing second quarter for us, it is pleasing to be able to report that this quarter has been broadly in line with our expectations. That said, the pressures we have seen for some time continue to impact our businesses, and we still have a lot to do to deliver the transformation that will allow us to get ahead of the market trends again and return our company to strong and consistent growth. We were clear that the actions we are undertaking to address the market changes take time, and the impact will therefore not fully be reflected in our financial performance until future financial years. But we have been working hard to accelerate our plans and programs.

I have repeatedly said that we have within our company the skills and the assets we need, to address the challenges we face as our markets evolve and transform. Last quarter, we told you that we would focus on accelerating the work we are doing to transform our company.

We are doing that.

The Transformational Cost Management Program that we began earlier this year is one of the underlying foundations of the changes we need to make. Most importantly, this program will help drive a structural change in the company, making us a more efficient, more agile and more responsive organization. It is expected to provide a significant portion of the funding required for our major technology upgrade and development investments. And of course, an element of it will help to give us a bridge in our financial performance as we restructure our businesses to better meet the needs of an ever more rapidly changing market.

James and Alex will address some of these points as they talk you through the quarter, which I will ask them to do now. James...

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

Thank you, Stefano, and good morning, everyone. Third quarter adjusted EPS was $1.47, a constant currency decline of 2.4% versus prior year. The results were slightly ahead of our expectations and included some timing benefits from the fourth quarter. Overall, we are tracking well against our strategic goals.

We are quite encouraged by U.S. comp sales, which were exactly what we needed to deliver to stay on track to meet our full year expectations. And while it is still early days, our Transformational Cost Management Program is very much on track and accelerating.

Based on our performance in the quarter, we are reaffirming our full year adjusted EPS guidance. We continue to expect the year to be roughly flat on a constant currency basis.

Let's now look in more detail at the numbers.

In the third quarter, sales increased 0.7%.

On a constant currency basis, sales were up 2.9% mainly due to growth in Retail Pharmacy USA and the strong performance from our Pharmaceutical Wholesale division.

Adjusted operating income declined 11.7% or 10.4% on a constant currency basis. This was mainly due to lower pharmacy margins and a decline in front-of-store sales in the U.S. and lower results in Boots UK.

Adjusted EPS declined 4% to $1.47, a decrease of 2.4% on a constant currency basis. This includes a 5.8 percentage point contribution from our share repurchase program.

GAAP operating income declined 24.7%, including $86 million of expenses related to the implementation of our Transformational Cost Management Program and $115 million related to our share of AmerisourceBergen's impairment of PharMEDium. In total, these adjustments account for more than 50% of the year-on-year decline. GAAP EPS declined 16.5% to $1.13 per share.

Year-to-date sales increased 4.9%, including a currency headwind of 1.9%. On a constant currency basis, year-to-date sales were up 6.8%, reflecting 7.7% growth in Retail Pharmacy USA and 8% growth in Pharmaceutical Wholesale.

Adjusted operating income declined 8.9% or 7.8% on a constant currency basis. This was more than offset by a 4.8 percentage point contribution from share repurchases and 3.2% from tax, contributing to an increase in adjusted EPS, which was up 1.6% on a constant currency basis.

Now let's look at the performance of our divisions, starting with Retail Pharmacy USA.

Sales increased 2.3% in the quarter mainly due to pharmacy brand inflation and pharmacy script growth. Organic sales increased 2.9%.

Adjusted gross profit declined 3.9% and gross margin declined 140 basis points, mostly due to pharmacy. Adjusted SG&A spend decreased 0.7% and adjusted SG&A was 17.3% of sales, an improvement of 0.5 percentage points compared to the year ago quarter. Adjusted operating income declined 13.8% in the quarter, procurement savings, pharmacy script growth and continued SG&A savings were not enough to offset reimbursement pressure and the lower front of store sales. These results also included store and labor investments of $40 million in the quarter, equivalent to approximately 270 basis points of adjusted operating income.

Now let's look in more detail at pharmacy.

Total pharmacy sales increased 4.3%, reflecting higher brand inflation, prescription volume growth and a strong growth in central specialty, which grew 8.6% year-on-year.

Comp pharmacy sales increased 6%, and comp prescriptions grew 4.7% in the quarter, a strong improvement on the first half growth of 1.9%. Market share was 21.2% in the quarter, down 50 basis points versus prior year, due entirely to our store optimization program.

Pharmacy gross profit declined versus prior year as script growth was more than offset by lower gross margin.

Gross margin was around 150 basis points lower than last year due to continued reimbursement pressure, adverse mix associated with brand inflation and a 50 basis point impact due to the faster growing specialty business. These impacts were partially offset by procurement savings. The key to offsetting long-term reimbursement pressure is: building scale, driving efficiency and creating a sizable health care services business.

Turning next to our U.S. Retail business.

Total retail sales decreased 2.9% and were negatively impacted by our store optimization program. Comp retail sales declined 1.1%, an improvement on the first half comp decline of 3.5%. Tobacco accounted for 150 basis points of the comp sales decline, but we did benefit from a 65 basis point tailwind as a result of the cough, cold and flu season.

Retail gross profit declined, mostly due to lower sales, which as I mentioned earlier were negatively impacted by our store optimization program.

Gross margin was down slightly, by 20 basis points, an improving trend versus the second quarter as we re-balanced our promotional mix. We expect to see a continued improvement in gross margin trends in the fourth quarter.

Turning next to Retail Pharmacy International. As usual, I'll talk to constant currency numbers.

Total sales declined 1.6% mainly due to a 1% decline in Boots UK in a challenging market. Boots UK comp pharmacy sales increased 0.8%, reflecting prescription growth in the quarter. Whereas comp retail sales declined 2.6% as we continued to gain share in a weak market.

Our beauty reinvention is now in place in 26 stores, and we remain on track to introduce 25 new brands in 2019.

Adjusted operating income was down 10.5% due to weak retail sales and lower pharmacy margins in the U.K. Our U.K. pharmacy business was impacted by temporary industry-wide NHS underfunding and higher generic pricing. These impacts were only partially offset by prescription volume growth. We are taking actions to address our U.K. cost base, and I will cover these a little later.

Turning now to the Pharmaceutical Wholesale division, which I'll also discuss in constant currency.

The division delivered another strong quarter with sales up 8.3%, led by emerging markets. Our U.K. performance was aided in part by a customer contract change mentioned last quarter, which contributed 2.3% to revenue growth. Adjusted operating income increased 9.4%, reflecting strong gains in Turkey and solid results from our European business.

Turning next to cash flow.

Operating cash flow was $3.2 billion for the first 9 months of the year. Free cash flow was $2 billion. Operating cash flow was impacted by headwinds of around $1.4 billion. We are lapping a one-time prior year of working capital benefit of $502 million, cash tax payments are $395 million higher mainly as a result of U.S. tax reform. This year includes legal settlements of $276 million and we have $200 million of cash costs relating to the ongoing Rite Aid store optimization and integration and the transformational cost management program.

Underlying working capital increased approximately $500 million primarily due to higher sales. Cash capital investment was $1.2 billion for the first 9 months, $264 million higher than the prior year. This was due mostly for the impact of the Rite Aid store conversions.

Turning now to our Transformational Cost Management Program.

We remain on target to deliver $1.5 billion in annual cost savings by fiscal 2022.

Our smart spending benchmarking is complete, targets and execution plans are setup, and we're accelerating a wide-ranging program to reduce pharmacy cost to fill. The 20% headcount reduction at our Boots UK headquarters and the reorganization of our U.S. field supervision structure are now complete.

On digitalization, our Microsoft cloud migration is moving at pace. And we have now started working on optimizing our many IT vendors. Work has also began on building out compelling customer value propositions.

Given the difficult market conditions in the U.K., we have completed the review of our store portfolio and have started a store optimization program that will impact around 200 locations over the course of the next 18 months. Many of these 200 stores are loss making, and approximately 2/3 of them are within walking distance of another Boots store. While the stores we plan to close represent around 8% of our store base, we expect the revenue impact will be around 1%. We do not expect a significant impact on colleagues as we plan to redeploy to nearby stores.

We are also reviewing our real estate footprint in the U.S. and accelerating the pace of change, especially in our U.S. supply chain. More to follow in the coming months as we work through these key opportunities.

Turning to guidance.

As I mentioned earlier, the third quarter was slightly ahead of our expectations, aided by some timing benefits. As a result, we are reaffirming our full year guidance, and we expect adjusted EPS to be roughly flat on a constant currency basis.

As a reminder, last quarter we told you to expect a range of plus or minus 2%. Given the normal level of volatility in a business of this size, we feel this range is still appropriate.

Let me just give you a couple of assumptions; as you update your models, you should now be building in $0.06 of negative currency impacts, this is $0.02 worse than our prior guidance.

We continue to project full year share repurchases of $3.8 billion, contributing 4.8 percentage points to adjusted EPS growth.

And we now project a full year adjusted effective tax rate of around 15.5% compared to our earlier guidance of 16% to 17%. The lower rate reflects non-recurring discrete benefits and changes to our geographic mix.

When we provided our original fiscal '19 guidance, we highlighted incremental store and labor investments of around $150 million. As we accelerate the pace of our digital investments, we now expect total incremental spend of approximately $175 million with a significant portion of the additional spend coming in the fourth quarter.

Let me finish by highlighting the change in revenue trends coming from Rite Aid. We saw positive revenue contributions from the Rite Aid acquisition in the first 2 quarters of the year. From this quarter on, Rite Aid is actually a headwind to reported revenue, due to the ongoing store optimization program.

I'll now hand you over to Alex, and he will update you on some of the business initiatives we have underway in the U.S.

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

Thank you, James, and hello everyone. During the quarter, we've continued to make progress in our 4 strategic priorities. Accelerating digitalization, transforming and restructuring our retail offering, creating a neighborhood health destination around a more modern pharmacy and rolling out our Transformational Cost Management program.

We'll also continuing to develop our omnichannel offering.

Our Walgreens app has now been downloaded 57.3 million times, up 10.5% since last year.

Around 26% of Walgreens retail refill scripts were initiated through digital channels in the quarter, up 18.4% since last year and we also increased our active Balance Rewards members to 90.2 million.

In Retail, our leading beauty brand, No7, performed exceptionally well in the quarter. In Walgreens, sales of No7 were up by over 50%, helped by the launch and advertising of the No7 Laboratories Line Correcting Booster Serum, and our other retail partners saw significant growth.

In addition to beauty, we're working on refreshing our own brand portfolio in Walgreens to drive sales and improve the customer value proposition.

During the past 2 years, over 60% of the Walgreens own brand product portfolio has been relaunched or rebranded, enhancing the customer offer through better value and quality to deliver improvements in sales and margin. This work is ongoing.

Rite Aid is very much on track. Against our store optimization program, we have completed 631 of the planned 750 store closures and we continue to see good customer retention.

As for the many Walgreens-owned Rite Aid stores, 394 have been successfully converted to Walgreens. We expect to complete the Rite Aid integration by the end of fiscal year 2020.

We've taken further steps to develop our neighborhood health destinations, working with our partners including LabCorp and Humana, and as we announced during the quarter, VillageMD. With VillageMD, we will be opening 5 state-of-the-art primary care clinics in the Houston area by the end of the year, branded Village Medical at Walgreens.

We also remain on track to open 125 LabCorp outlets Walgreens stores this year. And finally on Kroger, the teams are working well together and so far the initial customer response has been positive.

I'll now hand you back to Stefano.

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

Thank you Alex. So as you have heard, we have broadly delivered what we expected, but we have a lot of work ahead to get the business growing again. We have been working hard to initiate or accelerate the changes we need to keep us in line with, or leading the market.

We are investing heavily in updating our systems and infrastructure, creating efficiencies and capabilities, which will give us scope for development for many years to come. We are developing new ways to engage with our customers, introducing new services and products through new channels.

We are working with partners who bring us skills, resources, scale and expertise that complement our own, to accelerate our development, give us access to new thinking and markets and allow us to create significant new income streams.

At the same time, we are continuing our focus on transforming our traditional areas of business, to address the challenges of our core markets. Economic and reimbursement pressures have long been, and remain a fact of life for us. Over the years, we have developed various different levers to mitigate the impact of this pressure.

In recent years, a major element of this mitigation has been improvement in generic procurement, made possible by changes in the global generics manufacturing sector, ongoing patent expiries and significant development in the actual procurement process, all of which have led to continued improvement in buying terms.

These buying benefits have enabled us to compensate for the significant demand made on us by payers. As we have made clear, the level to which we can mitigate current and future reimbursement pressure through generic procurement has reduced. Although it will continue to be an important lever for many years to come. Recognizing this, we are accelerating other levers to mitigate the pressures. We have more to do through cost saving and efficiency, and we expect consistent savings well into the future. There is no doubt that over time, we also have to build a range of services and service levels that drive benefits for our payer partners.

We believe that the future of pharmacy is aligned to a wider range of healthcare services, provided efficiently and conveniently in a community setting.

This is why we are exploring partnerships with a wide range of innovative experts in various fields, allowing us to offer a better service, more effectively and at a lower cost to ourselves, than we would be able to do if we had set these services up on our own or paid a significant premium for them.

Of course, many of the services are still being tested or are still in development.

Let me clear, however, while a number of the partnerships we are piloting have the potential to have a meaningful impact on our business, no single one of these will define or frame our future. In truth, it will be a combination of products and services working together in the convenience of a community pharmacy that will forward the basis of our future customer proposition.

The mixture of products and services will inevitably bring together a range of complex and differentiated business models. Their economics will be, at least in part, based on changes to individuals' health condition management and overall wellbeing over many years.

The consequence of getting these services right has a huge potential benefit for us, for our partners and for our customers. But if we rush into them without truly understanding the operational or financial models, we run the risk of wasting an extraordinary amount of time, resources and more. We must be sure of what we are doing before we enter into these businesses in scale.

Today, many people looking at our company, indeed at our sector, focus on the immediate risks they perceive us to face. And I understand this, we are far from complacent about the pressures we face. However, we can see the inherent strength of our business.

There is an ever increasing demand for effective, efficient and convenient support for people to manage their health conditions, while living productive and fulfilling lives in their local communities.

The unique positioning of community pharmacy, and our place in the sector, gives us practical and financial scale, reach and strength. It gives us a robust platform on which to evolve and transform our company to meet the ever-changing needs of the markets we serve and it gives us a fantastic foundation from which to deliver innovation, growth and value for our customers and our shareholders for many years to come.

Thank you. Now we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Steven Valiquette from Barclays.

Steven James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

So as the U.S. Retail Pharmacy business remains difficult really for all types of stores and operators across the entire industry, we're getting the sense that there could be an additional opportunity among the larger mass merchandisers in the U.S. for a store-within-a-store deal where a Walgreens or a CDS could take over the pharmacies within a specific large U.S. mass merchandiser. So I'm just curious to hear about your current appetite for an opportunity like this right now in the U.S., given the simultaneous store rationalization program that you're going through right now, and also your other initiatives in the U.S.

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

Steve, it's Alex here. One of our strategies clearly there is to grow volume and to make our business bigger to get scale. So we -- and also partnership is really important to us as we've said many, many times. So with the market changes and these changes are really -- you can see the number of pharmacies in the U.S. is in decline as measured for the first time for a long time. We are obviously open to partnership in this area. We bring scale, we bring expertise, and we're investing as Stefano said in his remarks and Jim said in pharmacy and the pharma supply chain. So we're open. And of course, we will look for every opportunity available, providing a mix that makes sense for us, our partners and increase the quality of our business.

Steven James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. Just one other quick one. As we think about the narrow network opportunities for calendar '20. Just curious if you could see the potential for meaningful market share shifts for 2020 among the large retail pharmacies like yourself given the level of RFP activity? Or do you think it's going to be a quieter year for calendar '20 just in terms of narrow-network opportunities and potential market shifts within the marketplace?

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

Steve, it's Alex again. We think it's probably more normal. Again we've laid out our plans in terms of the heightened growth that we expect. And we think it's a more normal year. Now of course within that there is always opportunities and there is always challenges, but we think it's a probably more normal year than 2020.

Operator

Your next question comes from the line of Robert Jones from Goldman Sachs.

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

James, you mentioned that the results included some timing benefits from the fourth quarter. I was just curious if you could share the source of those benefits and anything on the size of those benefits would be helpful?

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

Okay. Yes. Roughly the -- we had 2 impacts in the quarter. One was timing. And I would say that's around $0.03 or $35 million is our best estimate. And the other one is, whereas we also highlighted in the comments, we're ramping up the amount of spending in store labor and now digital and development expense. So we've increased the spending on the full year by -- from $150 million to $175 million. There is about a $0.01 of that in the fourth quarter. So think about roughly around $50 million. Around $0.04-ish was it. And when you get to the 2 timing items, one was $0.02 of the $0.03, but essentially the timing of payer contracts when you do the compliance and true-up part of you or his outcomes or whether you hit volumes in certain tiers. And that's the normal course of business, but we had expected that in Q4. And then a $0.01 is coming from expense timing. We accelerated some real estate savings from Q4 into Q3. So it was actually one of the quieter quarters in terms of volatility, very few surprises.

What's interesting here -- maybe I'll take the opportunity. As you start looking out into Q4 because this takes some income out of Q4. Our Q4 targets is actually quite -- when you start working through it, you start working out your estimates. Bear in mind, we had 2 large onetime items last year. And on an EPS basis, we're cycling through these. The first one is, you'll recall there was a large true-up, a curtailment benefit relating to retiree medical. That was $110 million. And then in the prior quarter of last year, we made an adjustment for legal cost, which was onetime and that was approximately $60 million. So that's another $0.05. So if you think about it, we have a 10 percentage point headwind on EPS in Q4. So we actually -- if you -- when you dissect Q4, we're looking forward to pretty good improving margin trends on the gross margin. And the headwind is all on the overheads and it's all due to onetime items in the prior year. So I think as you shift through it -- this -- the volatility in Q3 was actually quite low. When you get into Q4, think more that we have 2 large items last year. So actually when you analyze the result, the core performance is actually quite -- it's improving quite a bit. I hope that's helped a little bit.

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

That's very helpful, James. And I guess just one other follow-up. In your prepared remarks, you guys highlighted again that you're reviewing the real estate footprint in the U.S. I'm just wondering if you could elaborate a little bit just your thoughts around how we should be thinking about the store rationalization. Is this going to be a bigger focus? Or is this kind of just ongoing course of business at this point?

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

Bob, it's Alex here. Yes, it's more ongoing course of business. In a way this is regular. We have over 9,000 drug stores in America. Therefore, things change, customers shift, opportunities move. We're also thinking about new formats as we spoke before and answered previous questions. So this is just normal business.

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

And just to add though, the calculations are complex. We have to look at the lease portfolio, it's a store-by-store assessment. And the teams are working true to 9,500 stores, which is quite the heavy workload. We just recently confirmed the 200 stores in the U.K., and moving -- we'll move ahead aggressively on that. And it's quite interesting as you through it, about 60% of the stores in the U.K. that we're closing lose money. Not all of them, but some of the others are very like the Rite Aid optimization. Where there is -- think of it as a fly by. So we closed 2 stores close to each other in the U.K. And sometimes they were a 5-minute walking distance, and they're transferring over to scripts but you're taking out fixed cost structure. So the calculations are quite complex. It's -- you have to assess are you leaving a trading area, which we generally don't like to do. We want to preserve our presence both in the U.K. and in the U.S. And I would highlight that in the U.K., we highlighted in the comments we're reducing the store count by 8%. The impact on revenue is around 1%. So I don't want to call that rounding. But it has no strategic impact on our ability to maintain our strength of our position in the U.K. I would actually argue on the contrary. It makes us even stronger because we're a profitable operator in the U.K. market.

Operator

Your next question comes from the line of Justin Lake from Wolfe Research.

Eugene Kim - *Wolfe Research, LLC - Research Analyst*

This is Eugene dialed in for Justin. Quick question on the U.S. pharmacy gross margin. It decline 150 basis points year-over-year, if we read it correctly. And it seems like Q3 was a clean quarter to compare year-over-year because FEP specialty contract lapped. How do we think about -- how should we think about this going forward? Is this a rate of decline in the near term that we can -- that we should consider?

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

I'll take a shot on that. And I'll ask Alex to weigh in afterwards. I think the -- we cycle through the FEP contracts, the specialty business growing at 8.6%, we would expect that always to grow at faster than the core business. So we'll always be somewhat dilutive to margins. One other thing, there is other dynamics in the quarter. So in the quarter we sold more branded, and the margin on branded is lower than it is on generic and that creates a mix impact as well. And that's as significant as any other impact. And the problem is, we can't project with accuracy, the individual mix in any single quarter. But if you take out a lot of these mix items, the core reimbursement net of procurement and other mitigations was actually a pretty solid quarter. We do expect some improvement in both retail and gross margin -- sorry, retail and pharmacy gross margins in Q4. That's as far as we're willing to go. So this is not something you should take and extrapolate out as 150 basis points on pharmacy. We do expect some improvements in the trend in Q4. But mix and everything else plays into it, it would be a very long discussion. Alex?

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

Yes. I think in terms of how we feel about margin going forward, we've always stated, we recognize reimbursement pressures there and we'll stay there, and that's how we compensate for it. And as James has just said, we are seeing the ability to compensating more in Q4 than Q3 as the trends compare. I think in particular, a couple of areas which are just interesting going forward. First of all, we are getting paid more for, I would say, value-based contracts, particularly in Medicare D. So we're starting to hit some of the performance targets, which is encouraging. And I think also we continue to have the opportunity to work differently in some networks. For example, again, I would point to the prime contract we did some time ago where we have a different approach to marketplace, where we're really much more transparent. And again, that process we believe is -- will become more I say -- I will say available to the market going forward that has been in the past. So it's -- if the reimbursement doesn't go away, the margin is under pressure as we've often said. But we continue to be innovative, we work creatively, and we work hard on new levers as well as the old levers that we've spoken about a lot.

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

Yes. I mean any comments we make on the Q4 margins, these are obviously all factored into our full year guidance. We're just giving you the perspective that we had a tough Q2 on reimbursement, which was one of the highest numbers in history. Q3 was a tough quarter as well. We will -- as we said in the previous call, we will start to see an improving trend in Q4 on the gross margin side, but the caution is to call out those 2 large onetime items that are putting pressure on overheads. And the good news on that is they don't repeat in the future, it's just impacting Q4.

Operator

Your next question comes from the line of Ricky Goldwater from Morgan Stanley.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Last quarter, you directed us to fiscal year 2020 EBIT being moderating up year-over-year and I think flat EPS. Are you still -- with everything you're seeing in the marketplace, are you still expecting this?

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

Ricky, we're going to just comment on current year 2019. We don't want to get into a practice of going back to discussing long-term models or 2020 guidance. What we will be doing is, in the next conference call, we will give comprehensive guidance on all of the assumptions around 2020. So we're not going back to a discussion on the -- we just refer people back to the previous material that we placed out there in Q2.

Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Okay. And then just a follow-up. In the prepared remark, when you talked about the review portfolio, I think you also said that you're kind of like looking at the U.S. supply chain for additional improvements. Can you then give us a little bit more color on what the opportunity is there? And what are you seeing in terms of generic deflation trends as a headwind?

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

Yes. So I'll maybe split the -- I think we answered the portfolio question already, Ricky, so I'll move onto the second question, supply chain. We're -- I would say we're halfway into our replacement of our core supply chain system from retail in the USA, the SAP HANAS/4 (sic) [S/4HANA] software is going into stores and into DCs. So it's very clear that we now have opportunities with new tools capabilities and data, especially speed of the data we didn't have before. So as that goes through, we'll give more updates in terms of what that means in terms of projections. But we're encouraged by the progress there, but we're only halfway through it. I think secondly, we have just hired, as you saw quite recently, a very experienced global supply chain. We don't call them Nielsen. And again, we're working hard with the team to really understand how to be even more focused on the new capabilities we're building in the business going forward. I think in terms of generics, as a Stefano said in his preprepared remarks, we continue to be very, very pleased with the performance of our WBAD office. And again we see the opportunity going forward to continue to drive values through that WBAD office into a global platform but also into America. So I think that's how we see the supply chain piece. And -- what was the third part of the question?

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

The generic deflation.

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

The generic deflation, yes. I mean we don't see any difference to what's been recorded in the marketplace to be honest. We see this, I will say, a low single digit deflation. As they have spoken about, we see generics coming off patents in a way that going to describe the others. And of course, we pay a lot of attention to this because it has a material impact on our ability to reduce our register cost of goods. And we feel comfortable that all that's captured in the guidance that we gave last quarter.

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

Yes. And Ricky, just to add in, the low single digit Alex refers to includes new molecules. If you strip out new molecules, the most recent quarter had -- at least these are our numbers, not market numbers. We had -- we saw deflation of around 9%, right. So it's still up at a healthy clip and that will support continued savings in generic procurement. And this is -- the prior quarter was 9.4%. So it's still up there in a healthy high single digit. Then you were -- the market builds in new molecules. I'm very excited about the supply chain piece here in the U.S. because we now have a team setup looking to shrink, so stock office. Whether that's left in-store or at stock office and warehouses. And we're using teams from Microsoft. So this shows the benefit of the bigger Microsoft agreement. There's data scientists on this who are helping us build data links to understand what is going on and true causes of shrink and how to eliminate it. And these are $100 million, $200 million opportunities. And that's without getting into the working capital side of it. So I don't want that to be lost. Once we have SAP for Hana in place across the 9,500 stores, that stock fill a visibility that we don't have today. Now we expect significant reductions in the level of inventory required to be held at store levels. So -- and this is a lot

(technical difficulty)

will be huge. So you would expect that exiting 2020, we're starting to see material reductions in inventory levels.

Operator

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

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

I'd like to dig in on the international performance. And I understand we've seen some of the generic pricing fluctuations, you also made a comment about weakness or a temporary weakness in underfunding. Could you expand on that? And how incremental is it for the pressures that we've already spoken about the last 12 to 18 months?

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

Eric, it's Alex here. Yes. I mean let me start with the last question first, which is the underfunding point. The U.K. government pay in a certain way, they -- I don't want to go into detail of it, but fundamentally, it's a market payment for all the pharmacies in the U.K. And if you go into what's called the PSNC website, there is more details there about how the -- how that works. So we are pretty convinced there's been underfunding in the last period. Now of course, working within the pharmacy contractors and the PSNC, we're now debating that with the government in a positive way as our new contracts are put in place. So that's what we refer to. And of course, we can't make any further comments until that negotiation is complete. But I think in terms of the overall performance of the business. We are making good progress in terms of reinvigorating the Boots model in the U.K. in very difficult times. I don't have to tell you how difficult the marketplace is there. For example, this morning we opened a fantastic new store, a new concept store in Covent Garden that was (inaudible) around the corner. And this is a health wellness and beauty concept store, which will not only feed the future of Boots, but could also of course give us some great ideas for U.S. market as well. On top of that, we've done a lot of digitalization. We've digitalized the Advantage card, which is still the most popular card in the U.K. by some way in terms of beauty and treat cards and a lot of customers use it. I think it's well under 17 million holders today. We've also created digital pharmacy, we've launched that for the first time in the U.K. in terms of managing prescriptions copies, some of the great ideas that we could pass across the Walgreens as part of the merger. So -- and of course, the cost programs James already referred to in his remarks in terms of moving money from maybe the older model into investing in the future of the Boots business. So that's a story really where we're using the current market situation to make sure that we're investing our future. And we're seeing some interesting lead indicators of performance. And of course, we'll give you more updates as that develops.

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

Is your PSNC comment suggesting that your business is now adjusted for the changes that've made -- been made to date and you hope that those -- there might be some improvement moving forward? But you're basing the business from where we sit today?

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

Yes. Yes, absolutely. I would say that's an accurate reflection of where we are.

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

Yes. That's a fair point. I think would emphasize the word temporary. So we expect an improvement in Q4 and back to normal levels of funding next year.

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

Yes. Yes.

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

That's helpful. And could you just -- on the potential store reduction, you mentioned that employees may move to other stores. Can you help us with the way that you run those stores and maybe employment where you could see, I guess, the revenue impact only 1% but it is 8% of the store base? Will you continue to carry all of the employee cost?

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

Yes. I mean it's really straightforward. These are relatively small pharmacies. James said, 2/3 are within a walking distance of another Boots pharmacy. And the main cost there, to be honest, is the cost of the pharmacist. We have pharmacist turnover like any company would have, and we simply see that as we have been able to manage the cost while retaining quality people that we need to take care of customers and communities. And remember, we learned a very important lesson here in the USA that if you retain similar face of the pharmacist and health care assistants in the local pharmacy then very often the customers will transfer the script to the people who they know and trust. So this is economically important to us as well.

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

And its 8% of the stores, it's 3% I believe of the square footage. So that the employee impact is much lower than the percentage of stores. And then the revenue impact is much lower because there are less efficient stores. So it's actually quite logical. And then there's a fair amount of turnover in general in an employee base of -- we have 56,000 people in the U.K. But there's a fair amount of turnover, and I think we've seen in the past most -- you manage the place, the majority of people.

Operator

You're next question comes from the line of Ross Muken from Evercore.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - Associate*

This is Elizabeth Anderson in for Ross. I was wondering if you could expand on some of the comments Stefano made about generic procurement, in particular, sort of areas of future savings that you see.

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

It's Alex here. Yes. I think I'll say what I said already and Stefano said it very clearly, we still have a very efficient, effective and innovative model out of WBAD, and we continue to work in a dimension, which we think is slightly different. We prefer to have contracts with manufacturers to give them certainty of supply so that we get certainty of supply back in the marketplace. That's really important to the customers and allows us to plan together in a different way and that's how we work. Having said that, we all know that the level of opportunities as Stefano is said is changing going forward. It's not we're not going to make savings, we will make savings, it's just changing. So we have setup some innovative partnerships already, the partnership we setup with Express Scripts, for example, is one where we're combining the volume from a PBM with the volume from the Retail Pharmacy. And we continue to look at other ways of making sure that we've got the right scale and mix of partners going into WBAD going forward. I think secondly, the manufacturers are thinking differently as well. And again, we can't talk on their behalf, but you probably head some of the things they have been saying. And we think that our approach to buying in partnership with them and the way that we organize how we work with them will continue to give us advantage into the future going forward. Of course, in the future other markets may open up. We don't know that in reality, and we're not banking on that particularly and how we see the plan going forward. But clearly, things will change in one direction and could change again. And having a global perspective and global volumes we think will give us global opportunities in the future as well.

Operator

Your next question comes from the line of Glen Santangelo from Guggenheim.

Glen Joseph Santangelo - *Guggenheim Securities, LLC, Research Division - Analyst*

I just had -- wanted to follow up on this reimbursement issue one more time. If I heard you correctly, one of the main keys you keep pointing to is that in order to combat the reimbursement pressure you'll need scale, but yourself and your closest competitor, you guys have more scale than anyone else in the marketplace and you seem to be having issues. And so I was wondering if you could comment more broadly on the 65,000 to 70,000 pharmacy counters out there. I mean they must be obviously feeling more pressure than you. And I was just kind of curious, are you starting to see that total number come down? And I guess my question is can the reimbursement pressure subside until some of the capacity comes out of the market?

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

It's Alex here. Again I think we've said already. The way that we measure the market, internally, we are starting to see some pharmacies close, and I think these numbers are pretty open in the marketplace as well. So that is bound to happen and not reopen. And so I think that is a fact you can check obviously out there. I mean secondly, you only have to look at comments from other competitive marketplaces to see the pressure that we are all feeling in the marketplace. The other side of the coin is that we continue to believe strongly that the community care in the pharmacy, the physical location in the community with the pharmacist available and accessible I know is a really great opportunity for not just pharmacies but for health care all connected through data, all connected with other health care professionals, all connected to bringing forward new solutions going forward. That's why we are so excited about the work we're doing, not just with Microsoft but with as Stefano said, other relevant partners, for example, Verily, we've managed this well and LabCorp. And I can assure the list could go on in terms of the people who are talking to us and we are talking to them. So we are really confident about the future of pharmacy. And we're really confident that the model that we see today will change driven by new technologies and the same need that customers and patients have always had, which they have a conversation with their local pharmacist in their local community.

Glen Joseph Santangelo - *Guggenheim Securities, LLC, Research Division - Analyst*

Alex, maybe if I can just follow up on the one just sort of comment you were talking about with respect to some of the partnerships. I mean over the last 1.5 year, we talked a lot about the JV strategies and trying to crack the code of generating additional foot traffic. And it seems like there has been mix results on that front. I'm maybe wondering if you could just sort of reiterate exactly where the strategy stands today. And maybe what has worked better than what you might have thought? What maybe hasn't worked as well as what you thought? And I'll stop there.

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

Thank you. Thanks, Glen. I'll give an example of where we are very comfortable, which is our FedEx partnership. Again we are seeing the footfall that we expected. We are seeing the halo from that footfall that we expected, i.e. new customers to Walgreens, and we are also seeing the opportunities to work closely with the FedEx team strategically to develop new customer propositions in the corner drugstore. So that'd be one example that we are very comfortable with. And of course, going forward there'll be other partnerships, which are really interesting. We mentioned already, the Kroger partnership is going well and the customer reaction has been positive. So again that's another example where we believe that Kroger are really experts in food, and they can help to really improve our customer proposition and our value over time. But time will tell if we can find the right model that works for both companies and also for customers.

Operator

Your next question comes from the line of Michael Cherny from Bank of America.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

Just thinking about 4Q. I know you had talked about a number of the moving pieces and some of the reimbursement true-ups that you've seen so far year-to-date. With regards to the removal of pressure on Retail Pharmacy gross margins or at least less pressure. I guess what gives you the confidence? And why do you think it should get better? Is there something in mix, is there something in timing? Is it just the annualization or I guess within year annualization of those pressures that you've talked about relative to last quarter and this quarter? I guess I just want to know a little bit about the why relative to the sequential gross margin improvement?

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

Yes. I think it's a little bit of everything you said actually because you have to go back on a journey. Q2 was reimbursement pressure, which we said I think was -- exceeded 30% of the full year reimbursement pressure. So we would've set an unprecedented level. We saw it go back to more a normalized level in Q3. But we saw some slowness on the procurement savings in Q3. And we're going to see those -- both of the variables equalize in Q4. So it gets back to -- you can't really look at it as reimbursement, it's reimbursement net of the mitigation. The biggest 2 are, one is procurement savings, and there's being some tuning between Q3 and Q4 there. When you get to volume, I want to highlight, we had a great quarter in Q3. We set some fairly challenging goals internally. Bear in mind, we had script volume for the first half on a comp basis below 2%. So to come in the high 4s was something, we needed to do it and we need those kind of numbers. That's number one. We're also very pleased with the way retail came in. If you strip it back a little bit, it's down 1.1. We were tracking in the first half of a pretty disappointing 3.5% comp store decline. But the change on change is quite impressive. We won't deliver exactly same numbers, but we will continue to hold onto some of these trend improvements. I think what will happen in Q4 is, you will see a little bit stabilization of the top line outlook together with some improvement in both businesses on the margin side. So it's a confluence of trends. And I'll highlight again then you've got these 2 big onetime items and overheads. So it's too early to call victory in Q4 obviously, but that's where our current expectation is improve gross margins and continued stabilization of scripts and the same-store sales and retail. I hope that helps you as you think through it.

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

I'm afraid but that's probably all we have time for -- I know we haven't got to all your questions, but as ever, the IR team are around to answer them all. And I'm sorry for those of you who didn't get to ask questions today. We'll be back again next quarter. Thank you very much indeed.

Operator

This concludes today's conference call. You may now disconnect.