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WBA.OQ - Q3 2022 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 3Q22 YoverY constant-currency sales decline of 2.8% and GAAP EPS of $0.33.

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PRESENTATION

Operator

Good morning. My name is Chris, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Walgreens Boots Alliance Third Quarter 2022 Earnings Conference Call. (Operator Instructions) Thank you. Tiffany Kanaga, Vice President, Global Investor Relations. You may begin.

Tiffany Ann Kanaga - *Walgreens Boots Alliance, Inc. - VP of Global IR*

Good morning. Thank you for joining us for the Walgreens Boots Alliance Earnings Call for the Third Quarter of Fiscal Year 2022. I'm Tiffany Kanaga, Vice President of Global Investor Relations. Joining me on today's call are Roz Brewer, our Chief Executive Officer; James Kehoe, our Chief Financial Officer; and John Standley, President of Walgreens.

As always, during the conference call, we anticipate making projections and forward-looking statements based on our current expectations. Our actual results could differ materially due to a number of factors, including those listed on Slide 2 and those outlined in our latest forms 10-K and 10-Q filed with the Securities and Exchange Commission. We undertake no obligation to publicly update any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. You can find our press release and the slides referenced on this call in the Investors section of the Walgreens Boots Alliance website.

The slides and the press release also contain further information about non-GAAP financial measures that we will discuss today during this call.

I will now turn the call over to Roz.

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

Thanks, Tiffany, and good morning, everyone. Walgreens Boots Alliance delivered consistent execution in the third quarter against very robust growth last year. Sales increased low single digits on a core basis in constant currency, excluding the negative impact of AllianceRx Walgreens and the 65% pro forma sales growth at Walgreens Health. The International business more than doubled its adjusted operating income with its retail sales recovery, and the U.S. segment achieved solid retail comp growth against challenging multiyear comparisons with positive traffic trends as consumers continue to depend on Walgreens for their essential needs.

Our business model is resilient, and we are now successfully navigating a difficult operating environment that is especially impacting more discretionary retail. We have been agile and proactive in managing inflationary cost pressures and supply chain disruptions while further enhancing our relevance to consumers through our loyalty, omni-channel and owned brand initiatives. Our commitment to serve local communities with convenience and real value is resonating well.

At the same time, we're making important strides in building our next growth engine, Walgreens Health. VillageMD and Shields continue to realize tremendous top line growth, and we've added a third strategic partner for our Walgreens Health organic venture, bringing the number of lives covered above the 2022 year-end target of 2 million. Additionally, we launched our clinical trials business to improve access and diversity.

We are moving quickly to implement our vision of consumer-centric, tech-enabled healthcare solutions that improve outcomes and lower costs for patients, providers and payers.

During the quarter, we also took further action to better align our investment portfolio with our strategic priorities. The partial monetization of AmerisourceBergen shares augments our balance sheet and is consistent with our efforts to generate shareholder value.

We also have now completed a thorough review of the Boots business, with the outcome reflecting rapidly evolving and challenging financial market conditions beyond our control. As recent results show, it is an exciting time for Boots and No7, which are uniquely positioned to continue to capture future opportunities presented by the growing healthcare and beauty markets. The Board and I remain confident that they hold strong fundamental value, and longer term, we will stay open to all opportunities to maximize shareholder value for these businesses and across our company.

Looking ahead, given our sustained execution, we are maintaining our full year adjusted EPS guidance of low single-digit growth, which we raised in January. We are well positioned to drive our next stage of growth and value creation in the years ahead.

In October, we introduced four strategic priorities: first, transform and align the core business; second, build our next growth engine, Walgreens Health; third, focus the portfolio and optimize capital allocation; and fourth, build a high-performance culture and a winning team. We are making good progress against each initiative as we are becoming the leading partner in reimagining local healthcare and well-being for all.

First, we are transforming and aligning the core business and building a pharmacy of the future that will enable and support our healthcare strategy. US and Boots UK retail comp sales both reflected very good execution in the quarter, with several of our initiatives continuing to gain traction. US digital sales grew 25% in the quarter on top of 95% growth a year ago. myWalgreens membership is approaching a big milestone of 100 million customers.

We are focusing labor investments to return about 3,000 stores to normal operating hours, which I expect will accelerate script volume recovery as we head into fiscal 2023. Recently, we opened our fourth automated micro-fulfillment center and are now supporting 1,100 total stores. More store locations will continue to be added as these facilities become fully operational. These micro-fulfillment centers remove routine tasks and excess inventory from the pharmacy, allowing pharmacists more time to focus on patient care and clinical services, expanding on the critical role they already provide in communities. The centers fill about 20% of store scripts today, heading to 40% to 50% over time.

And finally, in the US, we've expanded our partnership with ALTO US, a provider of loss prevention and tech-enabled security services. We're now working together across more than 2,200 stores, which is already having a positive impact on shrink.

At Boots UK, I want to highlight our innovative digital healthcare service, Boots Online Doctor, which has already reached nearly 500,000 customer orders.

On the retail side, we are driving share gains across all major categories.

Now let me take this opportunity to discuss the health of the consumer, given our insights from our store network across the best corners of America and the U.K. as well as what we're all observing through macro uncertainty and record-low consumer sentiment. We see our customers making deliberate choices to prioritize overall value and convenience. There's a shift in calculus due to food and fuel inflation, but health and wellness will always be a priority. Pricing is just the start of our customer set of considerations, where we are collaborating closely with suppliers and maintaining price gaps versus competitors. Walgreens and Boots are trusted brands with strong community ties established over many decades of pharmacy leadership.

Historically, we have seen stable script trends in a downturn, which should be aided today by the ongoing return to normalized healthcare utilization levels. Additionally, we see upside at Walgreens as we address staffing challenges at stores to enable a return to normal operating hours.

Our front-end momentum is bolstered through our owned brand loyalty and omnichannel initiatives. Additionally, in this era of rising gas prices, we have leveraged our hyper-local footprint and highly relevant retail offering to achieve positive comp store transaction growth. We are seeing higher levels of traffic to our stores and our website as consumers are looking to optimize their spending dollars across quality, value and convenience.

We're meeting our customers with robust in-stock levels that are slightly above last year despite ongoing supply chain headwinds. We've also been ahead of the curve in managing through inflation. This is all alongside raising the target for the Transformational Cost Management Program for the 5th time.

Underpinning our efforts is our strengthened retail products and customer leadership team with 3 new executives. Walgreens Chief Marketing Officer, Linh Peters, joined us from Calvin Klein, where she served as their Global Chief Marketing Officer, with experience also at Starbucks, Target and Ulta Beauty. Bala Visalatha is in our newly created role of Chief Product Officer having most recently been Vice President of e-commerce at Walmart U.S. And finally, Luke Rauch is our new Chief Merchant, rejoining the merchandising organization after focusing on strategy as my Chief of Staff. We have the right team in place to support our high-performance culture to guide our resilient core business and to serve our customers through these turbulent times.

Next, I want to take a moment to recap Walgreens' progress in providing local communities with access to COVID-19 resources as we cross over into an endemic scenario.

In the U.S., we administered 4.7 million COVID-19 vaccinations within the quarter and over 67 million in the program to date. As of early April, Walgreens has been offering additional boosters to adults aged 50 and older and certain immunocompromised individuals. I am pleased to add that as of Saturday, Walgreens has begun administering vaccines to children aged 3 years and older at select locations nationwide. This follows our offering of boosters to children aged 5 and up starting in May.

Walgreens pharmacy team members are among the most trusted health resources readily available to administer vaccines and provide education to this newly eligible population and their parents or guardian. Our experience has established Walgreens as the largest pediatric COVID-19 vaccine provider in the pharmacy channel.

On the COVID-19 testing front, we completed 3.9 million in-store tests during the quarter and over 32 million in the program to date. Last month, Walgreens expanded access to offering Pixel by LabCorp, at-home PCR kits at no cost through Curbside and in-store pickup. This initiative is important, particularly for uninsured, socially vulnerable and medically underserved populations who continue to be among those most impacted by COVID-19.

Walgreens Health is reimagining healthcare by making it personal. To achieve this goal, we are creating a network of industry-leading healthcare service providers with the experience and capabilities to help people build relationships with primary care professionals, pharmacists, and in-home care teams in their communities.

Our largest partnership, VillageMD, continues its rollout of co-located clinics with 120 now open, on pace towards 200 by the end of 2022. VillageMD is in 22 markets today with over 1.6 million patients.

Shields continues to rapidly expand its platform, including new deals with 3 significant health systems and the launch of Boston Children's Pharmacy. Together, VillageMD and Shields drove pro forma sales growth of 65% for Walgreens Health in the quarter.

In our organic Walgreens Health business, we are excited to have signed on our third payer partner, Buckeye Health Plan. Importantly, this development brings the lives under coverage to 2.3 million, exceeding our 2022 target. Our collaboration with Buckeye also extends beyond health corners to include asthma and COPD patients as part of a multi-phased approach to support comprehensive expanded clinical services. Through this pilot, Walgreens pharmacists counsel patients on how to use their inhalers, provide proactive outreach to non-adherent patients and use predictive modeling to reach out to people at high risk for becoming nonadherent. Buckeye Health Plan is one of the first payers to reimburse pharmacists for these services in Ohio, made possible through recent state legislative changes.

With 56 Health corners in operation, our health advisers logged over 60,000 consumer conversations in the quarter. It's been very inspiring to hear some specific stories. For example, a customer who came in looking for a blood pressure monitor. Our health adviser had a conversation with him about the causes of high blood pressure and its potential complications. As they were talking, the adviser noticed the customer's face was red and flushed, asked to check his blood pressure and it was very high. The adviser insisted that he go to the emergency room. The following week, he came in to thank the adviser, saying this new service saved my life.

Our consumer-centric model of increased access, engagement and convenience is working. We are tracking well against all of our key milestones for Walgreens Health this year and remain very optimistic about our long-term growth potential.

Finally, as part of our continued work in building healthcare solutions, we recently launched a comprehensive offering of clinical trial services to redefine the end-to-end patient experience and increase access and retention in drug development research. Nearly 80% of trials failed to meet their enrollment goals in their stated time frames, contributing to billions of dollars in delays every year. We believe we can increase participation, especially among diverse populations, and support sponsors in meeting their trial goals by leveraging our well-established presence across the nation and enterprise-wide health capabilities.

The opportunity is clear, and I look forward to sharing more with you ahead. With that, I'll hand it over to James to provide more color on our results and our outlook.

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

Thank you, Roz, and good morning. Adjusted EPS of $0.96 was broadly in line with our expectations. On a constant currency basis, EPS declined 29% versus prior year levels. As mentioned before, we were lapping an especially strong prior year quarter with EPS growth of over 90%. We administered 17 million vaccinations last year compared to 4.7 million in the current quarter, leading to an EPS headwind of around 18 percentage points.

We also continued to invest in our fast-growing Walgreens Health business. Sales for the segment grew 65% on a pro forma basis, and the growth investments led to a negative EPS impact of 6 percentage points.

Our US retail business continues to execute strongly, and our International markets more than doubled segment AOI compared to the prior year quarter. Sales grew ahead of expectations and cash flow was solid, with year-to-date operating cash flow of $3.8 billion and free cash flow of $2.6 billion.

The Transformational Cost Management Program is performing ahead of expectations with an expanding funnel of initiatives, and we are now raising our annual cost savings goal to $3.5 billion by fiscal year 2024.

Finally, with our third quarter performance that was broadly in line with our expectations, we are maintaining our full year outlook of low single-digit growth in adjusted EPS.

Let's now look at the results in more detail. Third quarter sales declined 2.8% on a constant currency basis, strong growth from Walgreens and the International segment. And sales contributions from Walgreens Health were more than offset by a 720 basis point impact from the sales decline at AllianceRx Walgreens. If you exclude the negative impact from AllianceRx and the positive benefit from Walgreens Health M&A, constant currency sales growth was approximately 3%.

Adjusted operating income declined 34% on a constant currency basis, driven by a decline in U.S. pharmacy as it lapped the peak COVID-19 vaccinations in the year-ago quarter and planned growth investments in Walgreens Health. This was partly offset by solid gross profit performance in US retail and continued strength in international sales and profitability.

Adjusted EPS was $0.96 in the quarter, a constant currency decrease of 28.9%, driven mostly by adjusted operating income. GAAP EPS decreased 74% to $0.33, reflecting a $683 million charge for the opioid settlement with the State of Florida and higher onetime charges in the quarter related to the Transformational Cost Management Program.

Now let's move to the year-to-date highlights. Year-to-date sales advanced 2.7% on a constant currency basis, including a 500 basis point negative impact from AllianceRx. Without this negative impact and excluding the Walgreens Health M&A activity, core sales growth was around 8%.

Adjusted operating income increased 13.7% on a constant currency basis, reflecting adjusted gross profit growth across both pharmacy and retail in the U.S. and a continued rebound in International sales and profitability. Adjusted EPS advanced 13.9%. GAAP EPS increased by $3.60 to $5.49, reflecting a $2.5 billion after-tax gain in the first quarter related to the valuation of our prior investments in VillageMD and Shields as well as lapping a $1.2 billion charge net of tax from the company's equity earnings in AmerisourceBergen in the year-ago period. This was partly offset by the Florida opioid legal settlement in the current quarter.

Now let's move to the U.S. segment. Sales decreased 7% in the quarter, a solid performance from Walgreens, up 1.7% despite lapping peak COVID-19 vaccinations, was more than offset by an 850 basis point headwind from AllianceRx. Adjusted gross profit decreased 9.6%, with high single-digit growth at retail, more than offset by a decline in pharmacy. Procurement savings and the strong retail performance were more than offset by fewer COVID-19 vaccinations and lower reimbursement rates.

Adjusted SG&A spend decreased 0.9%. Lower COVID-19 vaccinations and continued cost discipline were only partly offset by higher labor costs and the timing of marketing spend. SG&A as a percentage of sales increased 110 basis points to 17.9% of sales, and this was almost entirely due to an adverse mix impact as a result of the AllianceRx sales decline.

Adjusted operating income decreased 34%, mainly reflecting lower pharmacy performance, including a challenging comparison against peak COVID-19 vaccinations in the year-ago quarter.

Now let's look in more detail at U.S. pharmacy. Pharmacy sales declined 9.7%, negatively impacted by an 11.2 percentage point impact from AllianceRx Walgreens. Comparable pharmacy sales were up 2%. Comp scripts decreased 1.8%, but excluding vaccinations, comp scripts increased 2.1%.

We completed 4.7 million COVID-19 vaccinations in the quarter compared to 17 million vaccinations in the prior year quarter, and we administered 3.9 million COVID-19 tests in the quarter compared with 3.4 million tests in the prior year quarter. Pharmacy benefited in the quarter from better trends in seasonal scripts. However, while we did see some improvement in the quarter, scripts continued to be challenged by temporary operating hour reductions due to labor shortages. We estimate an impact of around 190 basis points on comp scripts in the quarter.

Pharmacy adjusted gross profit declined as procurement savings and volume growth were more than offset by reimbursement pressure, and we lapped peak COVID-19 vaccinations in the prior year. Comp retail sales increased 1.4%, and excluding tobacco, comps were up 2.4%. We saw strong growth across health and wellness, driven by at-home COVID-19 tests and cough/cold flu.

Personal Care was up 2.6%, but the consumables and general merchandise categories were impacted by strong sales of COVID-19-related items last year and the planned decline in tobacco.

Gross margin increased strongly year-on-year due to effective margin management and stabilizing shrink levels, partly offset by supply chain pressures.

Turning next to the International segment. And as always, I'll talk to constant currency numbers. International had a strong quarter. Sales increased 9.3%, reflecting growth across all international markets, with Boots UK advancing 13.5% and Germany wholesale growing 6.8%. Adjusted operating income was $174 million in the quarter, more than doubling versus prior year, led by sales growth and tight cost control. The integration of our Germany wholesale business is very much on track with operational synergy benefits running ahead of schedule.

Let's now look in more detail at Boots UK. Boots UK sales grew 13.5% in the quarter, led by strong retail performance. Comparable pharmacy sales decreased slightly as we lapped favorable NHS reimbursement timing in the year-ago quarter. Comparable NHS volumes showed modest growth, while pharmacy services advanced 22% in the quarter, with stronger demand for new online healthcare services. Comp retail sales advanced 24%, reflecting a recovery in footfall and strong commercial execution.

Market share increased across all categories with beauty performing particularly well. Despite the strong performance, store footfall in the quarter remains around 20% below pre-COVID levels. Travel locations are now improving, but remain quite subdued. We saw continued strength in basket size, which is up around 14% in the third quarter compared to pre-COVID levels.

Boots.com sales more than doubled compared to pre-COVID levels. More than 13% of total U.K. retail sales came from our digital channels in the quarter, up from around 6% pre-COVID.

Turning next to Walgreens Health. Segment sales were almost $600 million in the quarter, with VillageMD contributing $511 million and Shields Health contributing $85 million. Walgreens Health AOI was a loss of $129 million in the quarter. Organic investments accounted for $31 million. Investments at VillageMD more than offset the profit contribution from Shields Health, and led to a $97 million AOI loss across our majority investments.

VillageMD sales advanced 69% on a pro forma basis, reflecting existing clinic growth and footprint expansion. At the end of the third quarter, VillageMD had 315 clinics, an increase of 97 clinics year-over-year.

Shields delivered a strong quarter. Pro forma sales growth was 47% with improved operating margins, driven by growth from recently signed contract wins and by expanding their value-add proposition with existing health system partners.

Let's now look at some of the key metrics for Walgreens Health. As Roz mentioned, we have already exceeded our December '22 goal of 2 million covered lives, and we recently announced the strategic partnership with Buckeye Health Plan. The rollout of VillageMD continues, with 120 co-located clinics open at the end of the third quarter, up from 94 at the end of the second quarter. We are progressing towards our goal of 200 by the end of this calendar year.

Our fiscal '22 sales goal is now at $2 billion, reflecting a delay in the closing of the CareCentrix investment. Apart from that, there are no changes to our underlying sales assumptions. And as you can see, VillageMD and Shields are delivering impressive growth with pro forma combined sales growth of 65% in the quarter.

Turning next to cash flow. Year-to-date free cash flow was $2.6 billion, $737 million below the prior year, as we cycled through some exceptional headwinds. Free cash flow was adversely impacted by the working capital impact of a decline in the AllianceRx Walgreens business and the year-over-year impact of COVID-19-related government support. Free cash flow also included a $240 million increase in capital expenditures behind our growth initiatives, including the VillageMD footprint expansion, rollout of the new automated micro-fulfillment centers and continued omnichannel and digital investments.

Turning now to full year guidance. We are maintaining our full year guidance of low single-digit growth in adjusted EPS. We have raised our estimate for the base business slightly, from 6% to 8% growth, to 7% to 9% growth to reflect strong U.S. front-of-store performance and increased testing and vaccinations. We are now expecting 35 million vaccinations this year compared to 31 million previously. Investments in our healthcare business negatively impact EPS growth by around 6 percentage points compared to 5 points previously.

In summary, we are executing well, performing in line with our expectations and reconfirming our full year EPS guidance of low single-digit growth in constant currency. I would remind you that this is better than the original guidance we provided at the start of the year of flat EPS growth year-over-year.

Next, I will offer some additional color on our fourth quarter outlook. First, let me remind you that we are lapping a strong year-ago quarter with EPS growth of 28%. The prior year growth was driven by strength in COVID-19 vaccinations with 13.5 million administered last year versus an estimated 2.9 million this year. Additionally, last year, we saw a strong front-end results aided by at-home COVID-19 tests.

Consistent with what we said previously, we anticipate some headwinds in the fourth quarter, and this chart highlights the most important ones. Vaccinations are an expected headwind of 15 to 17 percentage points. Investments to build out our Walgreens Health segment could result in 10% to 12% impact on fourth quarter EPS. Other headwinds include labor investments of around 5 percentage points and lapping prior year one-time gains of approximately 4 percentage points of EPS growth. Combined, these headwinds amount to an expected 34% to 38% year-on-year headwind and leads to full year EPS growth of low single digits.

I would caution against any extrapolation of these EPS impacts. For example labor costs include temporary premiums to address short-term

[Additionally, Walgreens Health will scale quickly next year, and become a much lower year-on-year headwind. Turning next to fiscal 23.

Our long-term algorithm is unchanged, building toward sustainable low-teens EPS growth. We are not updating our fiscal 2023 outlook today. As usual we will provide guidance with our fourth quarter results in October. However, it is fair to say, that there are a lot of moving pieces as we look forward into fiscal 2023.

You are well aware of most of the challenges we are facing - ongoing reimbursement pressure, rising inflation and wages, consumer sentiment, and manufacturer restrictions on the 340B program. These are all headwinds that we are facing today, and we have created mitigation plans to address them.

Additionally, we have planned for continued healthcare investments to build out our next growth engine, Walgreens Health.

COVID-19 is the single biggest unknown,and] (added by company after the call) it is difficult to predict today how new variants, booster adoption, reimbursement dynamics and underlying health policies will impact consumer behavior. Against this backdrop, we have a strong array of strategic growth initiatives that will drive our long-term growth algorithm.

First, we expect script volume to recover as we get back to normal operating hours and launch targeted patient retention programs. Second, our U.S. retail business is demonstrating good momentum through digital and omnichannel growth from myWalgreens loyalty program, owned brand innovation and alternative profit streams. Fiscal 2022 was a strong year, and we have extensive plans and initiatives to drive continued success. Third, fiscal year 2022 has been affected by elevated retail shrink, running at above 3% of sales year-to-date. Trends in the most recent months are more promising as we roll out actions to counteract the rising shrink levels, and we expect shrink to trend downwards in 2023. Fourth, the International segment is achieving very strong results, and it is clear that next year should see continued sales and profit growth. Fifth, the Walgreens Health segment is scaling up and margins will build over time. Additionally, we are aggressively working to capture synergies across our various healthcare investments. Overall, we expect the Walgreens Health EPS headwind in 2023 to be much lower than this year.

Lastly, we continue to expand our save to invest-to-grow program and have raised the overall target savings for the Transformational Cost Management Program from $3.3 billion to $3.5 billion by fiscal 2024. The majority of the increase will benefit fiscal '23.

In summary, we are aggressively driving growth initiatives, and we remain fully committed to achieving sustainable low teens EPS growth over the long term.

With that, let me now pass it back to Roz for her closing remarks.

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

Thank you, James. As you have just heard, we are executing very well across our business despite several challenges and making major progress on the goals we laid out in October. Our transformation is very much on track, and I remain excited about the future. As we move forward, we will continue to be laser-focused on: one, making further improvements in our core business; two, evolving our portfolio to ensure we are dedicated to the areas which provide the best returns; three, building out our Walgreens Health business, which is expected to be a significant percentage of our earnings growth over the long term; four, managing and preserving our capital across our many assets; and five, recruiting and retaining a world-class team of top talent.

I am optimistic about the opportunities ahead and our ability to deliver strong results on each of our key strategic priorities. We remain strongly committed to driving our long-term earnings growth algorithm and look forward to keeping you updated as we achieve our vision to be the leading partner in reimagining local healthcare and well-being for all.

Now I would like to open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Lisa Gill with JPMorgan.

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

My first question would just really be around keeping the Boots business for now and the announcement that you had made earlier this week around that. Roz, as I think about the investments that you want to make around your healthcare initiatives, does this change the time line at all? I didn't hear you talk about that today. It would be my first question.

And then secondly, as we think about really reallocating some of the investments that you made, does this at all change the timeline of the sale of ABC? I'm just curious as to how we should think about how those things play into the longer-term opportunities around Walgreens Health?

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

Lisa, thank you for that question. So let me give you just a few highlights in terms of how we came to this decision to retain Boots. So first of all, as you can imagine, we ran a highly confidential process. We gained early high interest at the very beginning of these discussions back in January. We started off with roughly about 8 to 10 interested parties in the Boots business. And we had very productive discussions, got into a detailed due diligence just as the market began to turn on us, and such an unexpected and dramatic change. So as a result, we made this decision to slow this opportunity down. But at the same time, the Boots and No7 business continue to do well. And our thinking is in any of these situations, the business should be good enough for us to retain as well as to look at strategic opportunities for it. So the business is healthy, and we'll continue to ensure that it remains healthy.

As you look at the time line going forward, you need to think about our fuller portfolio. When we talked about doing a strategic review of our businesses, we started off with Boots, but we have other opportunities that we can look at in here. So in terms of the time line, it's important to state that we are going to stay bullish about moving forward on Walgreens Health and making sure that our investments are prioritized in that direction. We've seen good success in terms of the initial investments that we've made there. So we feel like we're on a good trajectory.

So in terms of the time line, we still will continue to make the investments there and move forward. We're committed to building those things. And the most important parts of that business is to make sure that we get our commercial assets up and running. And so that's the work that we're focused on.

I will also tell you that in terms of our commitment to looking at the balance of our portfolio businesses, we will continue to do that as well.

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

And then just a point of clarification, James, I appreciate all the comments that you made about 2023 and getting back to that double-digit growth. Is your comment that you anticipate getting to double-digit growth after '22 for '23? Or were you just making a comment that you believe longer term that, that's still on the horizon for Walgreens?

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

So Lisa -- go ahead, James, and take us through '23.

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

Lisa, if you go back to the October Investor Day deck, I think what we said was the next 3 years, the compound annual growth rate would average 4%. And then FY '25 and beyond, it would rise to 11% to 13%. So there was a measure of deceleration of the EPS growth over a number of years. And then when we gave guidance at the beginning of this year, we said 0%, and we would have acceleration into mid-single-digit EPS growth beyond '22 year. And you could actually argue that we're ahead of where we said we would be because we're at low single digit versus 0. So we won't be getting to low teens next year because we never said we would go to low teens next year. We said mid-single digit.

And I think as we look forward, there's a lot of concerns out in the market. Some participants have been taken -- they'll take the Q4 and multiply by 4, which is just a wrong calculation. And Q4 is about 16% of our total full year income. So I think you have to actually do the right proportions. And we then decided to lay out these tailwinds that we have. And I'm sure you'll agree, they're substantial and I do want to hit those. We do expect a fairly strong rebound in Rx scripts next year because we had some operational issues in the stores.

The front-of-store strength, I don't think it should be lost on anybody just how well we're doing versus the overall peer set in front of store. Our margins are up substantially year-on-year, and we're still doing nice same-store sales growth. And then you add on to -- we see International going from strength to strength, plus -- and I do want to point this out. People are looking at the heavy investments in Walgreens Health. We're spending potentially more in the second half because of timing. But the headwind on Walgreens Health will go from 6% this year, down to very low single digits next year. So we have a lot of elements to get to an attractive growth rate that is broadly in line with the 4% 3 year compound growth rate that we laid out as we did October -- the Investor Day. So what we're doing with this is to express our confidence in the long-term targets. Sorry, what...

Operator

The next question is from George Hill with Deutsche Bank.

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

And I appreciate as well you guys giving all the color. I guess, Roz and James, I'd kind of like to hit on two topics. Number one is, James, I know I'm inquiring minds want to know you brought up 340B as a headwind. I was wondering if you'd be willing to frame any numbers around that as to how we should think about what the earnings risk looks like or the earnings exposure to the 340B program. And then part B would be, I guess, you kind of called out COVID as the biggest headwind as you think about fiscal '23. I guess do you have any kind of embedded assumptions thus far as to what you guys expect from the contribution of COVID as we think about kind of the jumping-off point from fiscal '22 to fiscal '23.

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

I think, George, I'm not sure we want to give out specific guidance because we have to go through a process with our Board on this. But we will expect lower levels of activity on COVID vaccinations next year. And I think you can form your own assumptions on that. So it does generate a sizable headwind next year. But that's why we laid out the growth initiatives, which are equally sizable tailwinds. And we're going to be working through this over the next few months. We'll come out with the guidance when we issue earnings. But overall, we see as many opportunities as we have risks right now. And maybe I'll pass it to John on 340B, which is embedded in our current year guidance, and we've absorbed a fairly sizable negative. John?

John T. Standley - *Walgreens Boots Alliance, Inc. - Executive VP & President of Walgreens*

Sure. George, this is John. And so as James said, we've seen some continued manufacturer restrictions in the 340B space, and that's reflected in our current run rate. We've got, I think, a couple of things going for us. One is Shields, which is a really amazing business that we've got a majority investment, and it's just done really well. But in their model, the hospital is actually -- the covered entity and operates the specialty pharmacy. So I think that's in a very good position. We have the opportunity to be the designated pharmacy in many instances for our 340B clients. And then ultimately, we believe 340B is an appropriate program that really gets money back into community healthcare where it's really needed. So we strongly support it. And we're working from a legislative and a legal perspective to try and protect that program.

Operator

Our next question is from Michael Cherny with Bank of America.

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

So maybe, James, I know we're not talking specifically about fiscal '23. But as you think about that Slide 24 that you gave us relative to the growth initiatives, where do you see the variability in particularly on the growth initiatives and the comfort level you have in tying back to those numbers, whether it's script volume, whether it's some of the international recovery, that Walgreens Health component? How do you think about the puts and takes on those items given the broader macro dynamics that could sway them one way or the other?

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

Yes. I would say the only item we see is truly variable. Where we have lesser line of sight is on the vaccinations and testing volume. And we want to see how the next couple of months pan out.

I'd even say that even on the challenges, we have a fairly good line of sight. Reimbursement pressure, we're not assuming as we're thinking through this any major change versus the current year. And we're quite happy with the current year. We had a forecast coming into the year, and we're pretty much honest. So we expect -- well, we don't expect anything to get any better in reimbursement.

Rising inflation on wages, we have a fairly good level of confidence here, and I'll tell you why. We've had now had 2 quarters where many other players in the market have called down margins. We have had 2 quarters where our margins are actually up on the retail business. We have a combination of mix. And that's one of the growth initiatives on the right-hand side. We've got all of our omnichannel investments coming through, owned brand inflation. myWalgreens has hit almost -- I think that we've actually passed 100 million myWalgreens members, which is tremendous. I think it's one of the biggest membership programs in the U.S. And then alternative profit streams. And we have great line of sight to all of those. So we have -- and our ability to offset inflation on wages has been very strong in the quarter.

And you'll bear this in mind, International freight is up 200%. And our pricing actions overall as a business, I think we've got 0 impact on a full year basis. All the cost increases, shipping increases, goods not for resale, all of that, effectively, we've priced away through very effective margin management.

And 340B, John already mentioned. And Walgreens Health, we've got good visibility. We are investing a little bit more as we're exiting the year. And remember what we told you in the Investor Day, we said there would be a spending level this year and one next year. So we will actually probably spend more money, slightly more money on Walgreens Health next year. But the headwind is significantly lower, and we have good visibility to this. So instead of a 6%, as I said, it will go down to 1%, 2% at most.

So the change in this is quite visible to us. I'm trying to cover all of these. International recovery, we have good visibility to this. You saw the double-digit income in the quarter. It won't be at that rate next year, but there's consistent growth across all markets. And we had every single international market grew revenue in the current quarter. So good visibility there as well.

Transformational Cost Management, we've called up $200 million. All of that is next year. And I'll give you a good example of it. The U.S. business has just formed a new entity called Walgreens Business Services. And we have signed a partnership with TCS to ramp up, build our own shared service center in India. And it will take on -- we've already done finance. We've done HR, all the traditional back office. We'll be moving marketing, merchandising, store ops, back office to a more cost-effective offshore service. But we will own and operate the service assisted by ECS, and that will deliver tremendous savings for the business. It's a really big deal.

And over time, we will leverage it as a growth engine to continue to drive costs out of the business.

The only one that we have less visibility on, and that's because the actions are happening currently, that's on the script volume. So we've had a couple of quarters where we've been maybe 200 to 300 basis points below where we would have liked to have been. And we called out, specifically in Q3, 190 basis points from the store operating hours. We're putting investments back in the market or in the market now. We haven't -- we've seen that the churn has slowed down of turnover, but we still haven't flipped the switch on more aggressive hiring in the market. So, we have a couple of months of experience that we need to get behind us before where we have very good line of sight. So I think it's a good question. We have good line of sight to all of the items here. And the only exception is we've 3 months probably ahead of us on the store operations and getting the scripts back. I hope that's useful as you think through this.

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

No, I appreciate that. And if I can ask one more, maybe a quicker one. You've talked in the past about the potential for inorganic investments for Walgreens Health. Obviously, there's no proceeds coming in after the Boots review. How do you think about that potential for further inorganic investment, given also a rising rate environment and the need to fund one way or the other if you are going to go and acquire something to build out the Walgreens Health capabilities?

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

Yes. So I'll take that question. So we remain committed to looking at further opportunities on the acquisition side for Walgreens Health. And I will tell you that we're constantly looking through the marketplace, particularly in tech enablement. And so as we mentioned back, early in the year that we would have one additional significant advancement in Walgreens Health on the acquisition side, we still remain committed to that in order to really bring, come full circle in that space. So we should look forward to that and also, too, in terms of how will we prioritize that.

I just want to remind everyone that we have a portfolio that we can look at and still look at how we could fund something like this. So we're still in the marketplace, and we remain committed to investments in Walgreens Health.

Operator

Our next question is from Elizabeth Anderson with Evercore.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - MD & Fundamental Research Analyst*

I guess maybe on Walgreens Health, I appreciate what you're saying about the sort of pacing of investments and things next year. Can you just help us sort of tie together the performance in the quarter, particularly maybe on the gross margin line and then how we should sort of think about that shifting in sort of the fourth quarter and as we move forward into next year.

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

Thanks, Elizabeth. I'll have James answer that gross margin question on Walgreens Health.

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

Yes, this is -- it's basically an investment and timing issue. You got -- I think, we're $21 million negative on gross margin with Shields very strong, and the investments are all in Village. And the best way to look at that is to look at the number of stores, the total number of clinics, 315 versus prior year, it's almost up 100 more clinics. And we gave some indications back in January on the profitability of a clinic.

And when you get to full run rate, which is year 7, I think it's like $14 million of revenue and a $2 million clinic contribution. But year 1 is the revenue is $1 million, and you're losing $600,000. Year 2, I believe, is probably $200,000 to $300,000 loss. So you've got 2 years of losses, right? And you're only turning profitable at the beginning of the third year. So you've got 90 -- 100-plus clinics that are unprofitable to the tune of around $600,000. You got the ones in the previous year that are unprofitable to the tune of $200,000 or $300,000. So what this is, it's the -- and bear in mind, Elizabeth, when you look at a gross margin in Walgreens Health, it includes the entire cost of the clinic. So it's got the rent. It's got the doctors. It's got the depreciation and amortization. So it's fully loaded. So moving forward, as more and more clinics achieve profitability, the first 100 will turn profitable next year, right? So you've got more profitable ones coming on. And then I think that basically covers it. So it's a temporary thing, and it will turn profitable next year that's the way to think about it.

Elizabeth Hammell Anderson - *Evercore ISI Institutional Equities, Research Division - MD & Fundamental Research Analyst*

Got it. Okay. And then I know, obviously, you said that CareCentrix, you are expecting to close, if you get approvals by the end of the fiscal year. So then that would obviously impact the estimated annual run rate for the end of this year. But as we think about the jumping-off point for just sort of '23 and beyond to get to that $9 billion to $10 billion in FY '25, you wouldn't expect to change to that broader trajectory. Obviously, there's a short-term timing issue with the CareCentrix deal, right?

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

Right. You're right about that, Elizabeth, the way you're thinking about it. And we're looking forward to the closure of that deal. We're still in process with that, but you're thinking about this in the right way.

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

We've really, really -- once CareCentrix closes, we have a strong line of sight to the $9 billion to $10 billion, very strong.

Operator

The next question is from Steven Valiquette with Barclays.

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

So two interrelated questions here. I think first for the U.S. retail front-end business and pricing strategy, Roz, you mentioned that Walgreens is working closely with suppliers and maintaining price gaps versus competitors. So I was just curious to hear a little more detail either on the mechanics or just examples of what you're referring to with that comment. And then just to check the box on a related question, just for your overall set of SKUs in the retail front end, do you have any approximate percent of SKUs where you may be witnessing supply shortages. It could be a very small percent, potentially even less than 1%. But just wondering if it makes sense to frame it this way.

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

Sure. Thanks, Steve. And I'm going to start off with that, and then I'm going to ask John Standley to fill in on some of the details there. So you mentioned about the front end of the store and what are we seeing in terms of our exposure there. So first of all, I want to make one clarifying point.

When you compare us to maybe some of the other retailers in terms of our in-stock position and also to with what we're seeing from a supply chain standpoint, we have some categories in our stores that are dramatically different. There are other retailers that are facing long lead items like apparel, kitchen furniture, televisions, large items in that respect. We are working very quickly, strongly against moving towards our private-label business and trying to get to roughly a percentage of about 22% of our private-label opportunities in our store. We run roughly about 16% to 18% right now in private label. So moving to 22% gives you an idea of some of the cost benefits that we could share later on.

Also, along with that comes some innovation in bringing in new categories. So when I think about front of store and what we're facing in terms of being a little bit more recession-proof and also to looking at supply chain issues that impact our business and those kinds of things. But I'll let John go into some detail in terms of what he's seeing in front of store.

John T. Standley - *Walgreens Boots Alliance, Inc. - Executive VP & President of Walgreens*

Sure. I guess I'll just pick up right there. As Roz said, we are working closely with all of our major supplier partners to address issues as they arise. And it kind of -- it moves around a little bit in the business from time to time, depending on the category. Obviously, we're working through things like baby (inaudible) and things like that. But generally, I think we've done a good job of staying close to our partners and getting products the best that we can. I think the over-the-counter test kits is a great example.

The demand on this and the supply on this have kind of bounced around pretty dramatically over the last several months, and our team has just done a fantastic job of really aligning between supply chain and merchandising and operations to really be there for our patients and customers is just kind of one example.

Talking about pricing and pricing mechanics. Obviously, a lot of inflation in the marketplace. We work, again, really closely with our supplier partners. And the first thing we try and do is just mitigate that cost increase really through the relationship the best that we can. And we've had some success at that. But we have seen cost increases come through like all retailers have. And I think we've worked hard to manage that into the marketplace the best way we can. And as Roz said, we've really done that successfully while managing our relative price position to the market. So again, I think our team has done a great job executing against those pressures as they have it risen.

Operator

That will conclude our question-and-answer session for today. I'll now turn it over to Roz Brewer for any closing remarks.

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

Thank you for joining us today. I just want to summarize what we discussed here today and how we are looking at our business. We've delivered really strong execution across our operating segments and against a very robust growth this year. Third quarter results were broadly in line with our expectations, and I want to remind everyone of that. And we've been executing well on the strategic priorities we shared last October. We will continue to make some improvements in our core business. We'll evolve our portfolio. We remain committed to our Walgreens Health business. We also will manage and preserve our capital and really continue to work on this world-class team. I'm really proud of what this team has been able to do under some tough market conditions. They continue to outperform my personal expectations. So I remain optimistic about the opportunities ahead.

We're strongly committed to driving our long-term earnings growth algorithm. And we look forward to keeping you updated as we make further progress. So thank you for joining us.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.