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WBA.OQ - Q4 2020 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported FY20 reported sales growth of 2%, constant-currency sales growth of 2.5% and adjusted EPS of $4.74. 4Q20 reported and constant-currency sales growth was 2.3% and adjusted EPS was $1.02.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Walgreens Boots Alliance, Inc. Fourth Quarter Earnings 2020 Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Gerald Gradwell, Senior Vice President of Special Projects and Investor Relations. Please go ahead, sir.

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

Good morning, ladies and gentlemen, and welcome to our fourth quarter and fiscal year 2020 earnings call. On the call with me today are 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.

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. We undertake no obligation to update publicly any forward-looking statement after this presentation, whether as a result of new information, future events, changes in assumptions or otherwise. Please see our latest Form 10-K and 10-Q for a discussion of risk factors as they relate to forward-looking statements. And note, in particular, that these forward-looking statements may be affected by risks relating to the spread and impact of the coronavirus COVID pandemic.

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'll 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 good morning, everyone. I am pleased to say that the fourth quarter earnings we have announced today are at the upper end of the guidance we provided for the quarter. In common with many other businesses, COVID had a material impact on the year, most notably in the second half. And as a consequence, this pulled down our results for the year as a whole.

This has been a very difficult time but, as you would expect, we are proving to be very resilient. We are financially robust with strong and reliable cash flow, driven in part by our brand and customer loyalty. And this has allowed us to continue to invest in modernizing our company. We are confident we will come out of this in better shape as an organization.

There is nothing that should surprise you in what we have reported today. James and Alex will take you through the quarter in detail in a moment and provide our initial thoughts on what you should expect for the year ahead.

Clearly, there are still many uncertainties around COVID in terms of the development of the pandemic and how governments worldwide will continue to respond. However, in the last quarter, we have seen signs of improvement in customer trends and, as a result, the decline in our business has notably slowed. In addition, there is clear evidence that as and when restrictions are eased, customers do come back to us, both physically in store and through omnichannel. And while some elements of our business may be changed forever, our positioning with the communities we serve remains strong.

As we look at our business going forward, we see opportunities as well as risks, and we are making every effort to ensure we are well placed to maximize the opportunities. It is clear, however, that pharmacy will continue to play an ever-greater role in local community healthcare management through testing and potentially through vaccinations.

For some times, we have talked of our work to accelerate the digitalization of our company. Initially, much of this work was going on behind the scenes: moving it to a more cloud-based data structure and putting in place the systems and structures to use this data more effectively. As you will hear from Alex in a moment, the benefits of this work are now becoming more evident, with notable improvements to our customer experience, at a time when demand for our omnichannel solutions has never been greater.

Throughout this crisis, the vital role that pharmacy plays for the customers we serve has been comprehensively proven. It is a great tribute to our teams that we have continued to service our pharmacy patients without major disruptions to drug availability or to our high standards of care.

Looking forward to 2021 and beyond, we have initiatives underway to further strengthen the bond we have with our customers, whether they choose to interact with us physically or virtually, driving volumes in both pharmacy and retail. There is no doubt that all markets and many businesses will continue to face the negative impacts of COVID in fiscal year '21, and it is expected that the next 2 quarters will see difficult trading conditions. However, we are optimistic that we will see a market recovery as the year progresses.

In our own businesses, we expect to see a significant improvement in our performance in the second half of the year. The work we are doing to address the challenges gives us confidence that we will come out of the year strongly and consistently deliver long-term sustainable growth.

I will hand you over to James now to go through the results we have announced today in detail.

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

Thank you, Stefano, and good morning. Full year adjusted EPS was $4.74, a decrease of 20.6% in constant currency, mostly due to an estimated COVID impact of approximately $1.06. This result was at the upper end of our guidance range we provided at our third quarter earnings call.

Adjusted EPS was $1.02 in the fourth quarter, compared to $1.43 in the prior year, a decline of 27.9% on a constant currency basis. The estimated COVID impact was approximately $0.46.

Our Transformational Cost Management Program remains on track to deliver at least $2 billion of annual cost savings by 2022.

And cash flow generation was strong. Operating cash flow was $5.5 billion, with free cash flow growing 5.6% to $4.1 billion.

Looking ahead, we are introducing guidance for fiscal year '21 of low single-digit growth in adjusted EPS at constant currencies. While we expect the first half to be impacted by continued COVID pressures, we expect strong growth in the second half of the year.

Now let's look in more detail at the full year results. Full year sales increased 2% versus prior year. On a constant currency basis, sales increased 2.5%, with solid growth in Retail Pharmacy USA and Pharmaceutical Wholesale, only partly offset by a decline in sales in Retail Pharmacy International.

Overall, COVID-19 reduced sales growth by approximately 100 basis points, with over 80% of the impact in the Retail Pharmacy International segment.

Adjusted operating income declined 24.8% on a constant currency basis, mainly due to the adverse impact of COVID-19, which accounted for over 70% of the year-on-year decline.

Adjusted EPS was $4.74, down 20.6% on a constant currency basis. Around 18 percentage points of the decline was related to COVID-19 impacts that predominantly impacted the second half of the year. GAAP EPS declined 88%, including the third quarter impairment charge of $2 billion relating to Boots.

Turning next to the fourth quarter performance. Sales were up 2.3% on a reported and constant currency basis, mainly driven by Retail Pharmacy USA and Pharmaceutical Wholesale, and only partly offset by Retail Pharmacy International.

Adjusted operating income declined 27.4% on a constant currency basis, reflecting an estimated $520 million adverse impact due to COVID-19. Over 60% of the impact was in international markets.

Adjusted EPS was $1.02, a constant currency decline of 27.9%. While the COVID impact of $0.46 was significant, it was an improvement compared to the $0.63 impact in the third quarter.

Let's now look at the performance of our divisions, and I will focus primarily on our fourth quarter performance.

Let's start with Retail Pharmacy USA. Sales increased 3.6% in the fourth quarter, including the impact of store closures. Total comp sales grew 3.6%, with pharmacy growing 3.2% and retail 4.7%. Adjusted gross profit declined 4.5%, and adjusted gross margin declined 170 basis points, a sequential improvement of 85 basis points compared to the third quarter.

We estimate that the result includes COVID-19-related margin impacts of approximately 50 basis points, mostly due to continued adverse product mix and higher supply chain costs. The remaining margin variation was due to ongoing pharmacy reimbursement pressure and the impact of specialty mix of around 60 basis points.

Adjusted SG&A spend declined 0.1% in the quarter, and SG&A as a percentage of sales improved 60 basis points year-on-year. Savings from the Transformational Cost Management Program offset inflation and volume impacts, higher investments, year-on-year bonus changes and COVID-related costs of $53 million. Adjusted operating income declined 22.2%, including an estimated adverse COVID impact of approximately $200 million or 17.5%.

Now let's look in more detail at pharmacy. Total pharmacy sales increased 4.2% in the quarter, reflecting script growth, brand inflation, and central specialty growth of 12.5%. Comp pharmacy sales increased 3.2%. Comp prescriptions grew 3.6% in the quarter, slightly better than the growth rate we predicted on the third quarter earnings call. While the comp growth has recovered nicely from the third quarter, it is still below the pre-COVID growth rate of 4.9%. As expected, the prescription market as a whole is down versus pre-COVID levels. However, new-to-therapy scripts improved compared to the third quarter. We have now tested over 1 million people for COVID across 444 sites with an average turnaround time of 24 to 72 hours.

Turning next to our U.S. retail business, which delivered sequential improvement in both sales growth and gross margin. Retail sales increased 1.5% in the quarter, including negative impacts from our store optimization programs. Comp sales increased 4.7%, quite a bit above the 2% to 3% growth expectation we highlighted on the third quarter call, and a sequential improvement of 280 basis points compared to the third quarter. Excluding tobacco, comp sales were up 6.5%.

The performance was boosted by our successful execution across all PPE categories. We estimated that PPE boosted our comps by around 4.6 percentage points, and our mass personalization marketing program drove another 140 basis points of growth.

We saw strong comp growth in health and wellness and personal care, up 15% and 8%, respectively. And this was partly offset by declines in the more discretionary beauty and photo categories, which were down 3% and 4%, respectively.

While foot traffic improved gradually, overall traffic was down a little bit more than 10%, led by sharp declines in larger cities and travel destinations, which were down around 39%. That said, consumers continue to buy more per visit, and basket size increased in the high teens.

Store gross margin declined 10 basis points in the quarter versus prior year, due mostly to adverse sales mix away from higher-margin discretionary categories. However, this was a sequential improvement of 70 basis points compared to the third quarter as we saw improving sales mix as discretionary categories recovered.

Turning next to Retail Pharmacy International, and as usual, I'll talk to constant currency. The COVID pandemic continues to cause notable disruption across many of our international markets and particularly in the U.K. Sales declined 15.4% in the quarter, but this was a big improvement on the third quarter decline of 26%. Overall, the estimated COVID impact on adjusted operating income was around $300 million in the quarter, and this led to an adjusted operating loss of $3 million in the fourth quarter, down $196 million versus prior year.

Now let's look in more detail at Boots UK, which delivered better sales growth than we expected. Footfall remains well below last year, particularly in the major high street and travel locations where Boots has a prominent store presence. Footfall continues to be impacted by government travel restrictions, increased working from home and localized lockdowns.

Comparable pharmacy sales increased 0.4% in the fourth quarter. Lower demand for scripts and services, reflecting reduced footfall especially in city centers, was offset by favorable phasing of NHS funding.

Retail comp sales declined 29.2%, better than our prior expectations, as targeted marketing activities were implemented, and we saw some recovery in footfall to our flagship and destination stores. Overall, the performance was much better than last quarter, when comp retail sales were down 48%.

Boots.com had a great quarter, with sales growth accelerating to 155%, up from 78% growth in the third quarter.

Retail gross margin was lower in the quarter, primarily due to higher fulfillment costs due to the substantial growth of Boots.com, and marketing programs to drive traffic.

Now I'll make a few comments about our international retail business. One of our top priorities is to turnaround Boots UK and return it to profitable growth. The U.K. team is taking swift actions on both sales growth and cost reduction. As mentioned earlier, targeted marketing activity is driving better sales performance than we had anticipated. And Boots.com sales growth was exceptional, and we've further extended our fulfillment capabilities, with in-store picking now operational in over 90% of our stores.

Together with our hybrid stores, this gives us much greater flexibility and capacity as we head into our peak trading season. And online new product launches included popular beauty brands, such as MAC and NARS.

We are investing in our leading No7 beauty brand, with new counters and fixtures in almost 300 stores, with plans to extend to 1/3 of our stores by the end of February. We continue to play a key role in the community, with over 1 million COVID tests completed for the NHS.

And finally, an update on our retail joint venture in China. The store count is now more than 7,500, roughly doubling since our original investment in 2018.

Turning now to our Pharmaceutical Wholesale division, which I'll also discuss in constant currency. Pharmaceutical Wholesale delivered another good performance for the quarter, with sales up 4.3% versus prior year, led by emerging markets, Germany and France. Adjusted operating income increased 8.3%, mainly reflecting sales growth and cost management.

Turning next to cash flow. Full year operating cash flow was $5.5 billion, and free cash flow was $4.1 billion. Strong cash flow generation was mainly driven by working capital initiatives. Included in the results were onetime COVID-related government contributions, but these were fully offset by higher safety stock. Capital expenditures were $328 million lower than prior year, mainly due to project deferrals as a result of the COVID pandemic.

Free cash flow increased $219 million or 5.6% versus prior year despite estimated COVID impacts on adjusted operating income of around $1.2 billion. The growth in free cash flow was driven by a $1.4 billion improvement in working capital, largely due to optimization programs across both inventory and accounts payable.

So overall, it was a very good year for cash flow. And looking forward, we remain highly focused on cash generation and have a strong pipeline of working capital initiatives.

I'll now update you on the Transformational Cost Management Program, which is very much on track. Last quarter, we increased our savings target to in excess of $2 billion in annual cost savings by fiscal '22. In the U.S., our store operating model transformation is well underway, and we continued our store optimization program in the quarter.

In the U.K., we are restructuring the Boots business model. Last quarter, we announced plans to reduce the workforce in Boots U.K. and Boots Opticians by approximately 7%. The program is on track with end-to-end process optimization driving enhanced efficiency and effectiveness.

We have completed the transition of the majority of our IT Run and Operational services to TCS ahead of plan, and we are now starting to unlock the strategic benefits.

And we recently announced a restructuring of our global brands organization to drive efficiency and speed to market.

But let me emphasize one thing. This is more than a cost transformation. At its core is 'save to invest to grow'. We are aggressively tackling our cost structure, and that will free up the funds needed to invest in future growth. At the same time, we are also reinventing how we do business, redesigning end-to-end processes, upgrading operating models and creating new capabilities that will drive long-term growth.

Next, let's turn to guidance. Let me first lay out some of the key assumptions underpinning our fiscal '21 guidance. We expect an adjusted effective tax rate of around 15.5%, and this creates an EPS headwind of approximately 1%. As announced earlier, we have halted our share repurchase program. And with the exception of anti-dilutive share repurchases, we are not planning share repurchases in fiscal '21.

Based on current exchange rates, we expect the impact of currencies to be broadly neutral to operating income.

We are increasing our digital development and omnichannel investments by $400 million to a total of $1 billion in fiscal '21. Of this year-on-year increase, $165 million is higher operating expense, leading to an approximate 3 percentage point impact on adjusted EPS.

And finally, we are confirming our long-term goal of in excess of $2 billion of savings from the Transformational Cost Management Program by 2022.

Turning now to our adjusted EPS guidance. We estimate low-single digit growth in adjusted EPS on a constant currency basis. And we are expecting a very different profile in the first half of the year compared to the second half of the year. While we assume continued gradual improvements quarter-by-quarter, it is realistic to assume continued negative COVID-19 impacts in the first 2 quarters of the year. As such, we are assuming a first half decline in adjusted EPS of 17% to 23%.

Please note that we will be lapping a prior year discrete tax benefit in the first quarter of fiscal '20, and this results in an adjusted EPS headwind of approximately 6 percentage points.

We do expect COVID-19 impacts to subside in the second half of the year as more and more people are vaccinated and foot traffic gradually recovers. As such, we expect a much stronger second half and are assuming adjusted EPS growth of 30% to 40% as growth initiatives take hold, the impact of COVID tails off and we lap a weak prior year.

Obviously, the evolution of the pandemic is uncertain, and COVID-19 could present both incremental risks as well as opportunities. For example, we have not assumed significant new government restrictions or extensive stay-at-home orders, and that could present a risk to our projections. On the other hand, we have not taken into consideration the opportunity from the role we may play in the widespread distribution of vaccines, because those programs and their timing are still being finalized.

In summary, the fourth quarter results were at the high end of our guidance range. We are in a strong financial position and finished the year with free cash flow of $4.1 billion, up 5.6% versus prior year. We are introducing fiscal '21 guidance of low single-digit growth in adjusted EPS at constant currencies. And we expect to exit fiscal '21 strongly, with double-digit growth in adjusted EPS in the second half of the year. At the same time, we are investing to accelerate our enterprise digitalization, with a specific focus on transforming our omnichannel capabilities and developing new healthcare opportunities.

I'll now hand over to Alex.

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

Thank you, James. During these challenging times, we continue to safely deliver essential services while accelerating our digital transformation.

Our healthcare platform is delivering a personalized experience to our millions of customers every day.

At a time when many Americans face unemployment and potential loss of health insurance, we can help patients maintain access to affordable medicines.

As an example, we have relaunched our Prescription Savings Club, offering lower prices on hundreds of medications. Average weekly enrollment in the Savings Club has increased by over 400% since the June relaunch, with members saving over $164 million off the cash retail price on their prescriptions.

Also last week, we launched Find Rx Coverage Advisor, a new resource providing customers with personalized guidance on health and prescription drug coverage options.

Our Find Care platform, which connects patients to telehealth providers, has also grown significantly since the start of the pandemic. In the quarter, traffic to the site increased 36x versus last year, to over 8.5 million visits.

And we continue to make excellent progress planning the rollout of our VillageMD partnership, working closely with our partners on physical locations, digital presence and healthcare services.

Alongside healthcare, we're accelerating our retail offering in-store and through our omnichannel infrastructure.

Our partnership with Kroger continues to progress well, with positive results from Kroger Express and the continued development of a GPO.

Sales on Walgreens.com were up 39% versus prior year, and digitally initiated sales were up 7% in the quarter. Our mass personalization program boosted retail sales by 140 basis points in the quarter, a significant increase from the 95 basis points impact last quarter. And we also saw a significant increase in customers ordering online and collecting at drive-throughs and the curb side, now available nationwide. Versus last quarter, these sales grew by around 2.7x.

We are also accelerating the pace of our technology transformation. with a further 1,145 stores converted to retail SAP in the quarter, taking the total to over 3,500 stores.

The rollout of SAP at a store level provides a wide range of benefits as a management and operational tool, gaining us real-time information on operations, stock levels and movement. It also gives us far better detail and time and visibility on our business. More importantly, however, its implementation joins up our operations with a reliable and proven cloud platform, which will significantly enhance local fulfillment of our omnichannel offering.

In the past few quarters, you've heard us refer to our work to digitalize the company and build a truly omnichannel interface with our customers.

The foundations of this were put in place through our partnership with Microsoft, moving us to a primarily cloud-based data infrastructure, and then working jointly with Microsoft and Adobe to build a mass personalization engine that accesses and enriches our existing data.

The results of our mass personalization work have been driving a new and much more targeted interaction with our customers over recent months. The nature of the personalization engine means that it learns more about our customers' preferences and refines its outputs the more it is used. So with time, we are seeing it get better and more effective quarter by quarter.

We are now beginning to roll out the next elements of this customer-facing initiative, progressively building and enhancing the customer experience through content, engagement and rewards for use and loyalty.

In November, we are relaunching our customer loyalty program as myWalgreens.

This goes well beyond updating the look and feel of our app, to create a seamless retail and pharmacy experience. The new program will greatly simplify how customers accumulate and use their rewards and will create a much more engaging health-orientated relationship. Members will earn 5% Walgreens Cash on all of our owned brand products and 1% on all other qualifying purchases. Walgreens Cash can be applied to future transactions or used to support their chosen causes.

myWalgreens will be heavily focused on health and well-being with content, services and offers specifically curated to each member. All of our 100 million existing loyalty members will have the opportunity to convert their current points balance to Walgreens Cash while seamlessly switching to the new program.

As with our personalization program, myWalgreens will evolve and develop as members use it, and we plan to announce significant developments to the membership in the months ahead.

Supporting this, we have made considerable enhancements to our fulfillment abilities. As you have heard, we have significantly increased our online capacity in response to the heightened demand in recent months.

Starting this Friday, we will be rolling out a significantly improved, convenient customer offering that will allow online or app orders to be ready for collection in as little as 30 minutes, in store, at our drive-through windows or curbside, all available nationwide. This level of responsiveness is unprecedented in our sector, and it redefines customer convenience. A real differentiator for us.

This demonstrates in a very practical way some of the benefits of our work to update our infrastructure and to digitalize our business.

There is a lot more to come from these initiatives as we look ahead over the coming months, and I'm very excited to be able to share some of the first, more customer-focused initiatives of this immense program to modernize our company and rethink so many elements of our business.

Let me now pass it back to Stefano for his closing comments.

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

Thank you, Alex. We have come to unprecedented market conditions, but we are on our way to putting that behind us, and the work we are doing gives us grounds for optimism.

As you have heard, we expect the first half of the year will be challenging, but we are optimistic of a recovery in the second half.

You have heard from Alex about the exciting changes underway in our omnichannel offering. There is much more to come, as the work on each of our key strategic priorities increasingly bears fruit and revitalizes our business. We look forward to being able to share more about these initiatives in the months to come.

While we deliver on our strategic priorities, we are also constantly reviewing the shape and structure of the company to ensure we are best positioned to recover strongly and return to stable and reliable growth.

The changes in management responsibility for Alex and Ornella, our Co-COO, announced last quarter, are allowing us a renewed focus and clarity on our business and are helping deliver these changes. The appointment of John Standley as President of Walgreens will, again, allow Alex to focus most of his attention on the digitalization work and other initiatives.

Now, I know there is much interest in the work we are doing to identify a new CEO as I move to the Executive Chairman role. All I can say is that the work the Board is doing to identify the right person is well underway, and we will update you when we have something to report. That said, as I hope you can see, this is not delaying our progress.

I and the entire team are as committed as ever to driving this company forward. We will continue to strive to deliver high service levels for our customers, innovative and relevant products for the communities we serve and true value for our shareholders.

We are navigating through a global pandemic, but the work that we have done and the trends we are seeing in the market gives us confidence for our future. Thank you. We will now take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Justin Lake from Wolfe Research.

Justin Lake - *Wolfe Research, LLC - MD & Senior Healthcare Services Analyst*

Just wanted to get a couple of numbers questions here. First, I was hoping you could share with us what estimate you've built in for the COVID impact to 2021 earnings guidance versus the dollar plus that you estimated for 2020? And then even though the discussion on 340B recently, I was hoping you could share any thoughts on the contribution to revenue and earnings to the company from this program. And any early impact you're seeing from the pharma manufacturer or provider.

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

Okay. Well, we're not providing specific information on the impact of COVID year-on-year, first of all, because it's just too complex. The further you move on through the crisis, the further -- the more difficult it becomes to dissect market moves versus market share moves versus margin moves. What we would say, as you build out your scenarios, is you have to get comfortable with the quarterly progression.

And if we were to give a ballpark estimate, you could look at -- probably the best analog is in Q3, we had $0.63 impact. In Q4, we had a $0.46 impact. If you were to plot out the first 2 quarters, you're probably looking at something between 35 -- sorry, between $0.25 and $0.30 of COVID in each quarter. That part, we can still follow the logic of the calculation we did in the second half of the year. So we have about 20 percentage points of EPS pressure from COVID in the first half. And then it becomes a much more complicated discussion on what comes back from the prior year impact.

And you'll recall, some of our comments on the last call, we believe the recovery will span a multiyear period and at least 2 years, especially in the U.K. So factors that come into this, for example, is we were very successful in the Q4 in the U.K. in regaining some footfall into the stores. But on the flip side is our shares, with the exception of beauty, remains significantly down because most shopping is occurring in grocery stores. So the key question becomes is, how long does it take to recover the share from the grocers? And that's like you need a crystal ball.

So we've -- as we built together our forecast, we went through it business by business, what's a reasonable set of assumptions for each quarter. And as we went through it, it become more and more difficult to dissect out what's COVID and what isn't COVID.

The other side of it is then we wanted to make a strong statement though on the recovery. So I'm sure you'll appreciate that the 30% to 40% EPS growth in the second half clearly assumes recovery from COVID impacts in the prior period. The question is what happens in the successive years. And as I said, we don't have a crystal ball. So the key message we give is, though we saw definitely green shoots, particularly on the top line in the U.S. and in the U.K. in Q4, we expect continued impacts in Q1. But we expect to exit the year with quite a bit of strength as the EPS guidance would suggest.

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

Justin, and I'll maybe -- I don't have anything add to what James has said on the COVID '21 -- year '20, but what I'll maybe deal with is the 340B piece of the question. We think that -- obviously, we think that it's been overstated. The numbers have been overstated that's been quoted in the marketplace. Clearly, there is a challenge here, but there's also legal challenge coming back in terms of hospital systems. There's significant bipartisan support for the current 340B program, which allows access to required medications in hospitals. And we feel good that we are well positioned whatever happens in the marketplace. We provide an essential service to thousands and millions of customers with these drugs in partnership with our hospital partners. So that's where we are. And of course, we'll wait for the legal case, in particular, to be settled.

Operator

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

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

I want to build on Justin's question a little bit in terms of thinking about the pathway forward and the puts and takes on fiscal '21. Clearly, there's some dynamics in place that were positive COVID beneficiaries, looking at particularly the PPE growth. As you think about some of the puts and takes into the '21 guidance, what else is built in there, how much of that structural cost dynamic still remains in place? And the potential benefit that you have from items that are in increased demand?

And just alongside that, just maybe a little bit a separate follow-up question. Any update on your relationship with Prime Therapeutics? And what's going on there in terms of your overall partnership?

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

Okay. I think if you look at structural costs as a result of COVID, I believe the impact in 2020 was $150 million kind of number, of which there was about $50 million in the fourth quarter. So if you were looking forward, there's -- even if you had the same cost for the entire year, it's $200 million, but we won't have the same cost for the entire year.

You'll continue to have sanitation, and I don't see that going down in the first half. So you could plot out $50 million each quarter for the first half. But thereafter, once vaccinations become more prevalent, we would expect lesser ongoing costs.

You asked for headwinds, pluses and minuses. One is we did call out tax as a headwind. It's not significant. That's one point. We also called out -- we've got significant investments behind the IT and digital agenda, and that's about -- that's a headwind of about 3% on EPS. And I really want that to be clear. We are stepping up our game in terms of what we're going to -- we will surround the consumer with a massive set of choices on how they want to interact, whether it be physical or online or e-commerce, and that will be a totally omnichannel approach for pharmacy and retail. And this will be going on the entire year of 2021 and we will have successive streams of new news over the coming quarters on this. So that is a headwind.

The other one is we obviously won't pay out a full bonus this year. And next year, we'll have a bonus headwind. I can't give you the precise number. So we've incorporated all these headwinds. We also, on the 340B question before, based on our -- the scenario planning, it wouldn't have any material impact on the guidance we just gave.

When you look forward, then on COVID, I've given the numbers, roughly, if you think about next year or the coming year, the first half, it's $250 million to $300 million per quarter for 2 quarters. That's a rough number. So it's a $500 million -- a $600 million negative impact in the first half. And then it's very hard to dissect how much of the prior year impact is coming back in the second half.

We can't give any more than that. We'll update as the quarters -- as we go through the quarters. And as I said, we were pleasantly surprised in Q4. We continue to see decent progress in the month in -- of September. It doesn't indicate opportunity, but neither does it indicate risk. So we're feeling fairly comfortable about the guidance we just gave.

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

Yes. I think just one thing to add to what James has said, which is -- and it was said in the prepared remarks, we've got new technologies in data. We spoke about the SAP system as one example coming forward that's really driving operational efficiency, along, of course, with our ongoing successful cost management program. So these things will intertwine with the cost question as well, Michael.

On Prime, and -- we continue to have a great relationship with Prime. We reset the contract with them, as you're aware, in the network, and we continue to be really pleased with the growth that we are getting with Prime in that contract. We continue to partner JV for specialty, and we continue to work constructively to make that particular offering even more relevant in the marketplace. Of course, the marketplace is changing, as we all know, and especially the big focus for many, many people in the marketplace. But we continue to be very positive with the relationship going forward and the opportunity to grow with Prime Therapeutics.

Operator

Our next question comes from the line of George Hill from Deutsche Bank.

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

There's clearly a lot going on with COVID and the business transformation, but the business going into fiscal '21 clearly has some capital constraints. So I would ask, how are you thinking about the portfolio, I think particularly the big Chinese JV. Clearly, you guys are not getting paid for these, and it's not reflected in your valuation. So I guess how do you think about some of the JV relationships? And can you use these to delever and maybe focus on the core U.S. and EU business? Or is there contribution, either to synergies or to earnings, kind of maybe something that we can't see and you feel like you're getting value for?

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

Yes. I'll just give maybe a perspective on capital, and then I'll pass it over to Stefano for some comments.

If you look back over time, we have spent capital over the last 5 years. It averages about $1.4 billion a year. We did call out that in the course of 2020, we deferred expenditure of about $300 million. And we just actually couldn't execute the programs. A great example is the SAP program. We deferred it for a couple of months at the peak of COVID because it was too complex for the in-store employees to manage COVID and the systems and implementation at the same time.

So we ended out at $1.4 billion. We expected to spend $1.7 billion in 2020. And this money will slide into 2021. So we would expect the capital allocation in 2021 probably to be in the region of somewhere between $1.6 billion and $1.8 billion, depending on various investments we plan on making. And we're quite comfortable with that level, and we have the funding to do that.

So maybe I'll pass over to Stefano for his comments.

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

As James said, we have a very good cash flow. So we are not worried about the future, and we believe that we can fund all the initiatives that we have.

About our joint ventures outside the U.S., really, most of them are very, very promising, and it would be a pity not to exploit the situation and wait for them to mature before thinking of divesting them.

In reality, we are always open, as you -- as we have said many times and as you know, to any kind of this, provides this creates value. And so we are not really very, very focused in keeping all the participations, all the joint ventures that we have. If we were offered good opportunities, so we will take them.

But we are not under pressure. We believe that we can manage our finance very, very well, as James has said. Because remember that this company maybe can suffer from time to time, but is always able to deliver a very strong cash flow. This year, it has been a very difficult year with the COVID and that cash -- the free cash flow this year is better than last year.

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

But George, I will agree with one thing. The China JV is not adequately valued in our portfolio. What's really happened is we've doubled the size, the store portfolio, up to 7,500 stores. We have a significant position now in China, and we have a 40% stake in a very collaborative partnership. We believe the business, we would prefer to let it grow on the current path for 12 to 24 months. But it is significantly undervalued in terms of the future potential. So I'd say, I fully agree with what you just said.

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

And by the way, by the way, we have just made the initial investment, and all the growth up to now has been self-funded in China.

Operator

Our next question comes from the line of Elizabeth Anderson from Evercore.

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

Appreciate the CapEx commentary you just gave. I guess I have a two-part question. One is to the extent that you could comment on your free cash flow expectations for FY '21.

And then also, can you talk about the -- you obviously talked about the favorable NHS funding in international for the quarter. Can you provide any more color there on the size of the benefit? And how sustainable that is in FY '21?

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

Yes, I'll just give you -- we're not going to give free cash flow guidance because it's quite volatile how it comes out. What I'd give you, though, is 2 things: One is we have this slippage between the 2 years of $300 million of CapEx. That's the only material item.

I do want to call out what happened in 2020. We actually -- the biggest single driver has been working capital improvement year-on-year, and it's $1.4 billion. And we've estimated that of that, about $850 million is actually coming from working capital initiatives. And all I would say at this stage is we have a similar, if not, bigger number coming on 2021. So we expect a very big positive coming from working capital in '21, offset to some extent by the slippage of $300 million of CapEx between 2 years.

So we are very, very confident on the long-term ability to drive substantial cash flow in the business. But each -- we don't want to give guidance because it's quite volatile depending on the investment decisions you take in a year.

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

And on upon -- on the NHS funding piece, I mean, we're really aware of the government proposal there. And therefore, you should expect that all to be in our guidance, the ebbs and flows of working capital between the 2 years.

Operator

Our next question comes from the line of Ricky Goldwasser from Morgan Stanley.

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

So one follow-up question on the earnings impact. You talked about -- when you spoke to the EPS, about $0.25 to $0.30 in EPS per quarter in the first half versus the $0.46 in the fourth quarter. But Europe is -- seems to be on start of a second wave, and some new restrictions that were in the media today, talking about potential drastic restrictions in London and also Europe. Is that included in your $500 million to $600 million headwind in the first half? Just kind of like trying to understand whether there is kind like a second wave included in this.

And then secondly, just going back to the CEO search. If you can give us some color on what type of experience are you looking in a new executive? Are you looking for someone who brings healthcare experience versus retail or tech, given kind of like the transformation effort and where the market seems to be heading?

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

Let me just cover the COVID, again. It's 20 -- as I said, $0.25 to $0.30, so call it $250 million to $300 million in each quarter. So a total of $500 million to $600 million in the first half. That would assume -- the best way to think about this is in the U.K., specifically, it would assume maybe a 5 percentage point improvement in comp sales versus the Q4. So it does not substantially improve on the profile versus Q4. As we said on the comments, gradual improvement.

If there was a significant lockdown, it would have a negative impact versus what we just provided as guidance. The question is, we don't believe -- we probably think the U.K. is the one country where there might be lockdowns. It's quite unpredictable. We don't see a major risk of lockdowns in the U.S. There might be the local lockdowns, but not nationwide. So the U.K., you're right to ask the question. So it could present risk for the projections.

What we clearly said in the remarks, though, there's 2 pieces of the remarks. We said is we didn't assume large-scale lockdowns, but we also didn't assume any contributions from vaccinations. Our way of looking at this is the risk of large-scale lockdowns has a lower probability, but it's a larger number. And then the likely upside coming from vaccinations is medium to high probability, but it's a lower number. And we would see both of those factors being somewhat balanced.

But I fully agree with your question is, if there's going to be a tighter lockdown, it's going to be in the U.K. And our issue, if you think about it, isn't across the entire store portfolio. Our issue in the U.S. and our issue in the U.K. is the exact same. It's the big cities, and it's better -- that are dependent on tourism as well, and it's anything we have in tourist destinations, so it's airports, train stations. Our U.K. business has a significant predominant skew to large cities and tourist locations. And then the biggest shortfalls we're seeing in the U.S. are in New York, Chicago, San Francisco, again, large cities with concentrated groups of people and large amounts of tourism.

So we actually gave the point in the script. If you take these large urban destinations, they're down 39% in terms of foot traffic. It's less in terms of revenue. It's about 24%. But if you actually take the flip side of that, our rural stores in the U.S. are up 12%. So there -- it's a tale of 2 cities, if you like. So the lockdown that would concern us most in the U.K. is around the London area and the big cities. A widespread lockdown is a much lesser impact. So I hope that's helpful as you think through your modeling.

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

I'll just add one thing, Ricky, on this point in the U.K. As James said in the prepared comments, the growth online in the U.K. has been great. The capacity has been expanded. So we're in a much better position to manage that risk from where at the start of the pandemic, and the Boots brand continues to be very strong in health and beauty. So again, I think we can manage that. That's my opinion, building on what James said.

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

It's a fair point. That's a good point, yes.

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

For the future and for the search of the CEO. Of course, the Board is going to a total analysis, and they have created a committee, and we cannot give information on what is happening, as you understand. Clearly, if you look at what we have told you in the last quarters, you -- we see that we are doing a big effort in modernizing our company, in digitalizing our companies. Even though it's not evident, we are really changing everything in our company. And so the new chief executive must be someone willing to continue this transformation, for sure, must be someone who understands healthcare for sure. But I cannot give further details now.

Operator

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

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

James and Alex, can you discuss a few of the investments you're expecting to make next year? I was wondering -- and I know, James, you helped size a number of the headwinds and tailwinds. But I was wondering if you could maybe just give us a little bit more detail on how significant you're envisioning those investments to be, and maybe anything around timing would be helpful.

And then just relatedly, thinking about next year, I know last quarter, you called out a fairly significant headwind from reimbursement rate pressure. I was just wondering what you're anticipating on the reimbursement rate front in '21, relative to what we saw this year.

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

Yes. I'll give maybe a general comment on the investment. I'd say you can generally assume equal phasing across the year. This is a combination of about 7 or 8 different large-ish investments across pharmacy and retail. So it's generally -- it's $1 billion, but it's 60% CapEx and 40% expense.

If you then get into reimbursement -- and then I'll hand it over to Alex after this, is if you think, too, as you plot out your income statement for -- by quarter, the first half of the year, we're still working on the older -- the prior year contracts because they run on a calendar year. So we will have reimbursement pressure in the first half. And then COVID will be pressure in the first half on front-of-store margins because the mix isn't very good. And then you plot for the second half of the year, and you will have more favorable reimbursement on a year-on-year basis because you have a new set of contracts coming in.

And then in the second half, as you're recovering from COVID, margins will start coming back on the retail business and, in particular, in the U.K. Because as we lost sales, we lost a lot of discretionary category sales with much higher margins. So as you plot out the year, I would say that the biggest pressure is not on overhead pressure. The biggest pressure is actually, it's the change in the trajectory on gross margin.

I don't know, Alex, do you have a point on this?

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

Yes. I'll maybe speak to the investment point. First of all, in terms of when will customers see the investment, and then for when it will impact our business. So I think what today we've announced, Bob, is really significant. It really is the replatforming of a loyalty card under myWalgreens. You're going to see this happen in November, first of all, digitally then physically. And you'll see us talking directly to 100 million of our loyal customers about the additional benefits they're going to get from their business with Walgreens.

And I think it's going to have elements, for example, of digital wallet, digital receipts. It's going to have a lot of health information coming through as well. And that's the start of the transformation, of this approach and that will become our customer engagement platform. And it's all built on personalization, as I described in the prepared comments, which we're feeling really good about as we've invested already with Microsoft in moving our data to the cloud, have already really invested, understanding different ways to talk to customers in a more personalized way through our mass personalization. You saw the numbers in the prepared remarks.

Secondly, which we think is really differentiating, we've always spoken about the positioning of our last mile with our pharmacies being within 10 minutes of 75% of Americans. So this idea of, in as little as 30 minutes, offering a pickup, we think redefines convenience for us and also for the marketplace. And that starts like tomorrow and will be complete across America by late -- mid-, late November in every single store. So these are real impacts on how customers will experience the Walgreens brand, both in the front end and the pharmacy. And we're going to continue to build on that as well.

So you can tell my excitement. I hope this has been a long time building. It's a big organization to build this out in, and we've got some great support from the talent we've taken to the business and also from our great partners like Microsoft, Adobe and SAP. So we're getting going. And of course, we're going to see the impact on our business, particularly in the second half of '21.

Operator

And we have time for one more question today. Our final question will come from the line of Lisa Gill from JPMorgan.

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

I just want to understand your expectations around economic downturn. We talked a lot about COVID, but we still don't have the stimulus here in the U.S. It's anticipated that maybe it does come after the election. We don't know what that looks like. There's concern about unemployment trends going into 2021. Can you maybe just talk about what your expectations are around an economic downturn?

And then, as we think about this election, if it does go all blue, as some are anticipating, Biden has talked about expansion of the ACA and really expanding it maybe perhaps through Medicaid programs or even the states that didn't have ACA. Can you just remind us of the impact that you had back in 2009, 2010 with the last expansion under ACA, so I can then just understand both of those pieces?

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

Yes. That's a tough question on the economic one because it actually completely merges with your assessment on the impacts of COVID. But I think it's a fair question.

If you go back, a year ago, we would have said that the model of the company was to grow scripts at 4% to 5% range. We've assumed, in general, an economic impact, and that's mixed with COVID of about 1 percentage point in general across both retail and both -- and pharmacy in the U.S.

So we've looked at the economics. We've actually seen it play out in the most recent quarter. So we had quite a strong June, July, and some slowdown was evident in August and a slight slowdown in September as well because there was less stimulus money out there. And you can actually see the impacts. So -- and I think you see it across retail, in general. So a lot does depend -- the forecast do depend on the stimulus that are put in the market by -- particularly in the U.S., which is very sensitive for this.

But as I said, as I think if you were to plot out a pharmacy business, you'd have to assume that there's probably a 1% plus headwind in 2021, essentially coming from the fact that in the earlier part of the year, you have less new scripts, new-to-therapy scripts, and you do have some economic impacts. And then you have economic impact on the front of store of probably the same percentage point.

Bear in mind, as you plot this out, we did a comp in the U.S. business of 1.6 in the full year of 2020. It's unlikely to be in excess of 1.6 in '21 because if you follow what I just said, you've got a negative economic impact, and the front of store did benefit from COVID-related stock building and the PPE category during the course of 2020. So I think the growth rate in retail will moderate year-on-year, and the growth rate in -- the script growth will probably go up slightly because we had a very poor Q3 in 2020.

So it's really hard to dissect out the economics. But as we put our plans together, we had like 1 point to 1.5 points in our head as economic impact. We've built in an assumption of a second stimulus of $600, which didn't happen largely. There's only select states that have put in maybe $300. So -- but there's pluses and minuses in every forecast. And the ACA.

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

Yes, I'll deal with the ACA. So I think our strategy has always been to take care of customers and be very customer-focused, I've explained in the last answer to before. When you think of how this will affect the pharmacy business, for example, which is our core business, we have underrepresentation in the Medicaid space today in Walgreens because the majority of it is managed Medicaid, and we've not been particularly successful at getting in these in our networks because we don't have relationship with a key PBM here that we will want to have, to be honest, and I think that's pretty clear.

However, there's a lot of movement in this space. For example, California and New York are talking about going back to fee-for-service. And in fact, the governors in the states have already authorized that, and it's likely to happen next year.

So as you think of Affordable Care Act, as you think of access, giving more access to more patients, to more healthcare services, including pharmacies, we think our strategy is well positioned. And we continue to work very, very hard to make sure we get our cost right, we get our care right. And we, in particular, focus on our key strength of pharmacy and healthcare services. That's just one example, we think, if things go blue in America, would be Medicaid and how these networks may change in the future.

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

Okay. Thank you very much, indeed. That was the last question we had time for. I know there were plenty of you that wanted to ask other questions. The IR team are available over the next days and weeks, and we look forward to speaking to you while answering your questions.

Thank you. And with that, I'll hand over to Lisa, our operator, to end the call.

Operator

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

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