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WBA - Q3 2020 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 3Q20 YoverY sales growth of 0.1% and EPS loss of $1.95.

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PRESENTATION

Operator

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

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

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

Good morning, ladies and gentlemen, and welcome to our Third Quarter 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 forms 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. This quarter, once again, a main theme for our call has to be the global COVID pandemic and how it has impacted our business. So I want to start once again by thanking our people for their outstanding effort and dedication in the service of their local communities despite facing challenging situations. Our teams have continued to work tirelessly, demonstrating exemplary dedication and commitment to help ensure continued availability of medicine and advice to our patients and to maintain as efficient a supply chain as possible to our own pharmacies and our wholesale customers. Our priority is to protect the health and well-being of our customers and our people as we work to serve our communities, playing an essential role in the health care systems in many countries around the world.

We made clear on our last earnings call that we had only begun to see the impact of the COVID virus. In this quarter, the full extent of that impact is all too apparent. COVID has impacted all of our markets, but for us, the impact has been more significant in the U.S. and especially in the U.K. markets. The immediate measures to address the spread of the virus have fundamentally changed the way our customers have had to approach managing their health and their daily shopping needs.

As lockdowns and restrictions were introduced, we saw significant declines in footfall in our stores, at times reducing to a fraction of the pre-COVID levels. At the same time, we needed to keep the majority of our locations open to help ensure the timely supply of medications and to continue the vital support we offer people in our local communities. We have leveraged all the resources available to us in order to maintain our services while ensuring adequate safeguards are in place to protect our teams and customers.

As you would expect, we have seen unprecedented demand for home delivery and for online services. The development of these services is a core strategy for us, and during the crisis, we have significantly increased our capacity to serve this demand.

We believe that as the situation resolves, the process of lifting restrictions will be progressive, and we expect the return to a normalized state will take some time. Furthermore, we also believe that it is highly likely that certain aspects of customer behavior may change permanently. Obviously, we have taken a hard look to our key strategic priorities and validated that they are still very relevant.

As you know, our digitalization program was 1 of our 4 key strategic priorities, and you will see an acceleration of this over the coming months, together with the major expansion of our mass personalization and customer engagement platforms that our recently announced agreement with Adobe and Microsoft will deliver.

We are also accelerating our Transformational Cost Management Program. A strong focus on controlling and reducing costs, is even more important now. Investing the savings to drive future growth is one of our top priorities.

Of course, we remain absolutely committed to developing our health care offering across our network and making our stores neighborhood health destinations. We have taken a key strategic step forward here by expanding our partnership with VillageMD. This brings physicians and pharmacies together, both in physical locations and through a virtual platform. It will also allow both companies to accelerate our virtual health care solutions and fits well with our own digital strategy. We believe the capability to access physicians alongside pharmacists in a closer and more coordinated manner is the future of community health care.

I have already taken the first steps to ensure that as a management team, we accelerate our strategy with appropriate focus and clarity. I have asked Alex and Ornella, our Co-Chief Operating Officers, to become more geographically focused rather than dividing their responsibilities by operational discipline. Recognizing the significance of Walgreens as our largest single business, Alex will now focus entirely on our U.S. operations. Boots will now report in to Ornella, along with the rest of our international operation.

The business was broadly on track prior to the COVID crisis.

Both Alex and Ornella are very clear on the need for us to move quickly to ensure we emerge from the current situation in a position of strength, and prepare to return to sustainable long-term growth.

I will now ask James and Alex to take you through our earnings presentation. James?

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

Thank you, Stefano, and good morning. As you have seen from our earnings release, our third quarter results were significantly impacted by COVID. Firstly, the Boots impairment charge led to a third quarter EPS loss of $1.95, and constant currency adjusted EPS was 43.4% lower than prior year. This decline was mostly due to an estimated negative COVID impact of $0.61 to $0.65.

Retail Pharmacy USA delivered sequential improvement in total comp sales with continued improvement in retail performance offsetting a slowdown in scripts.

We were faced with significant footfall declines across most of our markets in Retail Pharmacy International and especially in the U.K. This was only partly compensated by much-faster growth from our online businesses. And finally, Pharmaceutical Wholesale delivered yet another strong performance.

The other 2 bright spots in the quarter were cost management and cash flow.

A little later, I'll talk you through the great progress we are making on our Transformational Cost Management Program. In summary, we are increasing our annual cost savings target to in excess of $2 billion by 2022.

I do want to highlight that we remain in a solid financial position. Year-to-date free cash flow was $2.4 billion, up 24% versus prior year. During the quarter, we moved quickly to increase our financial flexibility by over $5 billion. And today, we announced a 2.2% increase in our dividend.

First, let's look at the estimated impact of COVID on the third quarter results.

Overall, we estimate a negative adjusted operating income impact of $700 million to $750 million. However, COVID impacted each of our divisions very differently. In Walgreens, solid comp retail sales performance partly offset lower gross margins and a fall-off in scripts versus pre-COVID levels.

Comp script growth decelerated due to a drop in doctors' visits and hospital admissions. Comp scripts slowed from 4.9% in the pre-COVID second quarter to 0.4% in the current quarter, consistent with the market as a whole.

By contrast, U.S. retail grew faster in the third quarter with comp store sales up 1.9% compared to 0.6% in the second quarter. Although foot traffic was down around 20%, this was more than offset by a bigger basket.

While retail comp sales improved, gross margin was under pressure as consumer spending shifted from higher-margin discretionary categories to lower-margin essential categories and more customers shopped online.

Adjusted retail gross margin declined by 85 basis points versus prior year, whereas in the second quarter, gross margin was 65 basis points higher than the prior year period.

We managed SG&A quite well. COVID-related operational costs were a little over $100 million in the quarter, including onetime bonus payments for certain employees and higher cleaning and safety costs.

Our U.K. retail businesses were sharply impacted and accounted for around 46% of the overall impact on adjusted operating income. And ultimately, our review led to $2 billion of impairment charges in the quarter. Strict lockdown conditions led to a sharp reduction in high street footfall, and Boots U.K. retail comps declined 48% in the quarter.

We did much better with our online business. Boots.com delivered very strong growth, with sales up 78% in the quarter. Orders exploded, and we quickly added new capacity to meet demand. And boots.com exited the quarter in much stronger shape.

However, this came at a cost. Retail gross margin declined 440 basis points in the quarter as a result of higher fulfillment costs, reflecting increased online orders, and a significant shift from in-store pickup to home delivery. Boots U.K. was also hit by higher operational costs, but these were largely offset by U.K. government programs, including temporary abatement of property taxes.

Let's now look in more detail at the results. Third quarter sales were up 0.1% and up 1.2% on a constant currency basis, with the performance held back by an estimated COVID impact of around 2%. Adjusted operating income declined 46.4% on a constant currency basis, almost entirely due to COVID, which accounted for over 40 percentage points of the year-on-year decline.

Let's turn now to the financial performance for the first 9 months of the year. Constant currency sales increased 2.5%. On a constant currency basis, adjusted EPS declined 18.3% with around 13 to 14 percentage points of the decline coming from the COVID impacts we encountered in the third quarter.

Let's now look at the performance of our divisions, starting with Retail Pharmacy USA. Sales increased 3.2% in the quarter. Total comp sales increased 3%, slightly faster than the second quarter growth rate. Adjusted gross profit was down 8.7% with declines in both pharmacy and retail. Retail gross margin declined versus pre-COVID levels due to higher fulfillment costs and adverse product mix. Adjusted SG&A spend decreased 0.4% versus prior year, despite over $100 million of COVID-related cost in the third quarter. Adjusted operating income declined 38.4%, of which we estimate the COVID impact accounted for around 26 percentage points of the year-on-year decline.

Now let's look in more detail at our pharmacy business, which encountered a slowdown in comp script growth compared to the previous quarter. Total pharmacy sales increased 4.6% versus prior year due to higher brand inflation and specialty sales. Central specialty sales continued to grow nicely, up 15.9% versus prior year. Comp pharmacy sales were up 3.5%, and this was pretty much in line with the second quarter but with a different composition. As mentioned earlier, comp script growth slowed to 0.4% growth in the quarter, and this was quite a bit lower than the pre-COVID second quarter growth of 4.9%. This was partly offset by higher brand inflation.

While comp scripts declined 5% in both April and May, we are encouraged to see improved script growth in June of around 8%. Note that this includes some benefit from phasing and the dayfall-adjusted figure is closer to 3%.

Turning next to our U.S. retail business, which delivered improved revenue growth, although with a lower gross margin. Retail sales declined 0.7% in the quarter, including the impact of store closures. Comp sales increased 1.9%, a sequential improvement from the second quarter. Excluding tobacco and e-cigarettes, comps were up 3.5%. Although consumers were shopping less frequently, they were buying more per visit.

Our flagship health and wellness category performed particularly well, up around 9%, led by demand for vitamins and new PPE products. Personal care grew 5% and grocery was up 8% despite a weaker Easter. Discretionary categories remained under pressure with beauty down 9% and photo down 34%.

Geographically, we are seeing buoyant sales in rural areas with the overall result held back by sizable declines in urban locations.

Turning now to store gross margin. And I should point out that it is a slightly different definition than the adjusted gross margin numbers used on Slide #5. Store gross margin represents scanned gross margin, and it is a good measure of core margin movements as it is less impacted by timing or phasing.

In the third quarter, store gross margin declined 80 basis points versus prior year, and this compares unfavorably to the 95 basis point increase we delivered in the second quarter. This negative impact was due to a shift in consumer spend from higher-margin discretionary categories, such as photo and beauty, to lower-margin everyday essentials. A good example here is the 34% decline in photo sales, which led to a 90 basis points negative impact on gross margin. While store gross margin improved somewhat in June, we are still tracking around 50 basis points below prior year levels. In May and June, we saw improved retail sales trends as stay-at-home orders were relaxed, but footfall remains very weak, and it was only partly compensated by strong dotcom sales.

Turning next to the Retail Pharmacy International division, which was most heavily impacted by COVID. As usual, I'll talk to constant currency numbers.

Sales declined 26.2% as the global COVID pandemic caused severe disruption across all of our international markets. The U.K. had a more stringent lockdown than the U.S. with stay-at-home orders imposed nationwide on the 23rd of March. As an essential retailer, most Boots U.K. stores were required to remain open. However, high street footfall ground to a halt and fell by as much as 85% at its peak. Additionally, our premium beauty and fragrance counters were closed for almost 10 weeks, and given Boots' position as a leading beauty retailer, this had a significant impact on comp sales.

Additionally, on official advice, most of our 600 Optician stores were closed. The impact was sizable as this business had annual sales of almost $500 million and comp sales declined by over 70% in the quarter.

The combination of high fixed cost stores and sharp sales declines led to an adjusted operating loss of $143 million in the third quarter compared to adjusted operating income of $165 million in the third quarter of last year. Overall, the estimated COVID impact on adjusted operating income was $365 million to $390 million.

On a brighter note, our retail JV in China is performing very strongly with third quarter percentage sales growth in the mid-30s. As of the end of May, the JV had more than 5,700 stores.

Let's take a look now at some of the U.K. trends. Boots U.K. pharmacy comp sales declined 1%. We saw a pull-forward of demand ahead of the lockdown but a decline in April and May, as you would expect, as the pull-forward corrected and we saw fewer new prescriptions.

Retail comp sales declined 48% in the quarter. Note that retail comps do not include boots.com direct-to-home sales.

Again, we saw some increased demand prior to the lockdown but a very significant reduction after the stay-at-home orders were imposed.

As I've said, although the majority of our stores remained open, footfall virtually ground to a halt, and Boots was not a destination for consumers making a single-weekly grocery shopping trip.

By contrast, we saw very strong growth in our online business, and we moved quickly to increase capacity. Towards the end of the quarter, volumes reached Black Friday levels on a daily basis, and May sales increased almost 120%, with June sales growth even higher.

The success of our online business has been encouraging, but it did have an adverse impact on retail gross margin, which fell 440 basis points year-on-year, mostly due to higher fulfillment costs.

Since quarter end, comp retail sales have shown a gradual improvement. Almost all of our Boots U.K. stores and the majority of Opticians are now open. But while we have seen a slow return of consumers for the high street, footfall remains significantly down on last year, and we estimate comp retail sales decline by around 40% in June.

Turning now to the Pharmaceutical Wholesale division, which I'll also discuss in constant currency. Pharmaceutical Wholesale delivered another strong performance, with sales up 5.3% versus prior year, led by the U.K. and Germany. Adjusted operating income increased 5.1%, reflecting sales growth and a higher contribution from AmerisourceBergen. partially offset by lower gross margin.

Turning next to free cash flow, which, on a year-to-date basis, increased 24% versus prior year. Free cash flow was strong in the year-to-date period, with $2.4 billion delivered in the first 9 months of the year, up $467 million on the same period last year.

We estimate a COVID-related inventory build of around $500 million at quarter end, and this was mostly offset by reductions in capital expenditures and cash inflows from government support initiatives.

We took proactive action in the quarter to increase short-term financial flexibility by $5.1 billion, including a $1.5 billion bond offering and $3.6 billion of credit capacity.

We are increasing our dividend for the 45th consecutive year, and we have decided to suspend activity under our share repurchase program for the time being. Year-to-date, we repurchased $1.3 billion of shares, whereas we previously targeted $1.75 billion for fiscal year 2020. Please note that our anti-dilutive program is unaffected by this decision, and we will continue with our anti-dilutive share repurchases.

Next, let's go to the Transformational Cost Management Program, where we continue to over deliver. We are increasing our savings target to in excess of $2 billion in annual cost savings by fiscal 2022, reflecting continued momentum and better line of sight to savings. Our store closure program is broadly on track, and we're actually slightly ahead of target on the transition of our IT-Run and Operational Services to TCS, by the end of the calendar year.

Last week, we selected Genpact as our long-term partner for our Finance for the Future program. This multiyear program will lead to improved cost, capability and controls and help drive improved business outcomes.

Given the severity of the COVID impact in the U.K. and the uncertain outlook, we are accelerating the transformation of our Boots U.K. and Opticians businesses. This reorganization will impact more than 4,000 positions or around 7% of the workforce.

Now I'll give you some more detail on guidance. Last quarter, given the many variables surrounding COVID, we decided to temporarily suspend guidance. Although there are still many uncertainties, we now have a clearer understanding of the full year impact on our business.

We are now introducing guidance for fiscal year 2020 and expect adjusted EPS in a range of $4.65 to $4.75. Furthermore, we estimate the full year impact of COVID to be in the region of $1.03 to $1.14, with the most significant impacts in the U.K.

While we do expect to see some improvement in sales trends, U.K. comp sales are expected to remain very weak. Gross margins will remain under pressure in the short term, mainly due to adverse category mix and higher fulfillment costs.

In the fourth quarter, we expect U.S. script growth of around 3% to 3.5%, and this remains below the 4.9% pre-COVID run rate. In U.S. retail, sales are off to a strong start in June and suggest a fourth quarter comp sales growth of around 2% to 3%.

However, the U.S. retail result will be held back by continued adverse category mix. June margin is around 50 basis points below prior year and it's likely to be in that kind of range for the rest of the quarter.

In the U.K., we expect Boots U.K. retail comps to decline by around 40% with retail gross margins down around 400 to 500 basis points. As I said earlier, the U.K. margin declines are mostly due to increased fulfillment costs, reflecting a significant increase in online sales and home delivery.

These assumptions lead to an adverse COVID operating income impact of around $500 million to $575 million for the fourth quarter, with around 60% from international.

A word of caution here. This guidance is based on the trends we are seeing in the month of June, and does not factor in a potential reversal of these trends.

In summary, COVID had a significant impact on our third quarter results with an estimated $0.61 to $0.65 hit to adjusted EPS. We are seeing some improvement in sales and gross margin trends, but the nature and duration of the recovery is uncertain. However, we are introducing full year adjusted EPS guidance in a range of $4.65 to $4.75 as our best estimate of the likely full year outcome. This assumes COVID-related adverse impacts of $1.03 to $1.14 per share.

While COVID has presented a huge challenge, we remain in a good financial position led by excellent free cash flow delivery. We've increased our financial flexibility, we've suspended our share repurchase program for the time being, and we're raising our dividend for the 45th consecutive year.

What's important now is that we're taking swift action both operationally and financially. We've raised our savings target for the Transformational Cost Management Program, and we're quickly scaling up our omnichannel and health care investments to spur future growth.

I'll now hand over to Alex, who will bring you through our plans for investing in future growth.

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

Thank you, James. As you've heard, the COVID pandemic has impacted all areas of our business. First and foremost, I would like to send my sincere thanks to the incredible teams we have working in our stores and behind the scenes. Our teams have faced many challenges to help ensure communities continue to receive medications and services. Throughout this, their dedication on a daily basis to serving our patients and our customers has been outstanding, in what has been a very difficult time for many, both at work and at home.

Now I'll update you on the significant progress we have made against our key strategic priorities, starting with health care.

As you know, creating neighborhood destinations across the country is one of our core objectives. So I'm delighted that we've agreed a significant expansion of our partnership with VillageMD, a major step forward for both of us. Our goal is to provide an integrated primary care and pharmacy model that will drive better health outcomes, reduce costs and provide a differentiated patient experience to the communities we serve.

We'll be opening between 500 and 700 co-located full service Village Medicals in more than 30 U.S. markets within the next 5 years. These doctor-led clinics, located at Walgreens pharmacies, will provide comprehensive primary care services and will focus on developing relationships with patients to manage their long-term conditions. Once we've completed this initial rollout, we intend to build several hundred more clinics in at least 20 additional U.S. markets.

Very importantly, beyond the physical locations, we will be developing home-based monitoring and telemedicine services leveraging VillageMD's integrated data and technology and our own Find Care platform. We're investing $1 billion of debt and equity in the partnership over the next 3 years, including a $250 million equity investment announced yesterday. On completion of this investment, we expect to have ownership interest of approximately 30% in VillageMD.

Another core strategic priority is the digitalization of our business, where we've taken significant steps in the quarter. We're now accelerating our plans, and we'll be further increasing our investment in digital initiatives in the coming months.

The pandemic has, of course, significantly increased demand for omnichannel products and more convenient services. We've extended our reach to customers in-store and online, acting swiftly to provide new products and significantly expand fulfillment services, for example, extending our drive-thru service to include retail products, such as health and wellness and household essentials. Customers can now order online in advance and have products ready to collect at around 7,300 drive-thru windows without leaving the safety of their car. We're also rolling out curbside collection for online orders and other delivery alternatives.

Omnichannel performance in the quarter was very strong, as you'd expect, driven in part by changing customer behavior during the pandemic. And we've increased capacity in our online operations threefold to improve service to our customers.

Sales on walgreens.com were up 23% versus prior year. Total digitally initiated sales were also up around 23%, and mobile app traffic was up over 200%.

Finding alternative ways to receive care while staying safe has become paramount, with many turning to telehealth offerings. Our Find Care platform traffic was up 48% versus the second quarter to over 3 million visits and up 14-fold versus last year.

Demand for our 1-2 day Walgreens Express Pharmacy Delivery Service with FedEx increased significantly, with the volume of prescriptions delivered up 78-fold since the last quarter.

A program to roll out mass personalization, facilitated by new technologies, is already well advanced. For the second straight quarter, this boosted retail performance, increasing sales in the third quarter by 95 basis points.

Last week, we announced a strategic partnership with Microsoft and Adobe to launch a world-class marketing technology and customer data resource, which will form the basis of a new customer engagement platform. This will further transform our already successful retail mass personalization activities, allowing us to create a personal experience for each individual customer in pharmacy, health care, wellness and beauty.

Turning next to our third strategic priority: To transform and restructure our retail offering. We have expanded our role in the community during the pandemic to offer vital health care services. We are working to establish a comprehensive testing solution across our U.S. store network to provide self testing, in-store testing and a lab-based testing solution that will provide every patient with virology and serology tests as appropriate, in a way that best suits their needs.

To do this, we are working with a number of partners, including expanding our partnership with LabCorp, alongside other solutions to provide the range and capacity of testing we need.

Looking forward, we are of course all hoping for a vaccine to be developed soon. Once this happens, we believe we will have a key role to play in protecting patients by administering the vaccine quickly, to those who need it, among the 8 million customers we interact with daily.

Also in retail, we've upgraded our electronic accessory offering to focus on the high-quality brands that customers are seeking, including an agreement with Apple to sell their branded accessories.

And finally, the benefits from the Kroger partnership have been even greater during the COVID pandemic, and we're continuing to explore how we might be able to expand this partnership.

Next, Boots U.K. This of course has been a very difficult quarter. And as you've heard, the COVID pandemic had a far greater impact on our U.K. operations than it's had in the U.S. Today, we announced a program to restructure Boots, accelerated to adapt to the changing operating environment and reduce fixed costs in the wake of COVID. This has been a very tough decision, but we are taking this action to ensure a sustainable future at a time of economic uncertainty and a shift in customer behavior towards online and digital channels.

We are proposing a reduction of over 4,000 roles in total across Boots U.K. and Boots Opticians, representing around 7% of the current workforce. This includes a proposed reduction of approximately 20% of our employees in our head office, around 7% of our store colleagues and the closure of 48 Boots Opticians.

As you heard, COVID has caused a dramatic and radical shift in our business, but our teams have responded rapidly to the challenges.

In pharmacy, we are playing a key role in supporting NHS. We quickly developed and implemented drive-thru testing, and in the quarter undertook more than 330,000 COVID tests. We trained our Boots pharmacist team to support the NHS medical help line. We have increased the capacity of our online pharmacy to meet demand for home delivery. And, again working with NHS, we have stepped up deliveries for vulnerable patients.

Turning to our retail operations. As James mentioned, Boots' online business has grown significantly since the start of the pandemic, increasing 120% in the month of May. To meet this increased demand, and make it as easy as possible for our customers to get the products they need, we have moved swiftly to reconfigure our online operations and significantly increase capacity.

In beauty, we built online advice and tutorials which have gathered momentum in recent weeks. And, building on our online presence, we recently undertook our first global digital skincare product launch, No7 Advanced Retinol. The product had over 100,000 customers on the waiting list ahead of launch and has been well received. That said, the most popular categories online continue to reflect the core offering that Boots is so well known for: Health and wellness, beauty and personal care.

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. In the company, we are facing some significant challenges and are moving fast to overcome them. Many of our businesses have been operating very successfully for many years, and have faced extraordinary challenges and disruptions in various markets in that time. We have always been able to survive, adapt and thrive. And I am convinced that we will come out of this crisis in a strong position, with a clear path to sustainable long-term growth.

I'm encouraged by the tangible progress we have made in the quarter in developing our strategic priorities.

Our agreement with Microsoft and Adobe is hugely significant, and will deliver a significant step forward in our ability to offer a personalized service to our customers.

The increased saving goals for our Transformational Cost Management Program gives us even more capacity to react quickly to the new market environment, as we implement our mantra of Save to Invest to Grow. And most importantly, I am very excited about the huge step forward we have taken in our healthcare strategy through our extended partnership with VillageMD, which will transform our community healthcare offering.

Despite the challenges of COVID, we continue to be a well-positioned company, with robust and defendable cash flow and a solid balance sheet.

This will allow us to invest with confidence in our business at a time when many other companies do not have the same capability.

As you have heard, 2021 will be a year of increased investments to pave the way for a return to sustainable, predictable growth. The strength of our company, the dedication of our people and the response of our customers, as they recognize our commitment to serving them and supporting their communities, gives me great confidence in the future of our business and, if anything, further strengthens my own resolve to deliver the changes we need to drive sustainable growth.

Thank you. Now we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question today comes from the line of Eric Percher from Nephron Research.

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

Thank you for your efforts on behalf of consumers and patients during this time. Given the strong U.S. comp, I think the impact on gross margin is quite striking. I understand the front-end shift which you outlined. But to what extent is there pressure on the pharmacy? And beyond reimbursement pressure, you would expect, are there pressures from movement from 30 to 90 or from commercial to cash and Medicaid? Could you help us on that front?

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

Eric, it's Alex here. The pharmacy trend in margin was really as we had expected. So we saw some decline, and you see the IQVIA data as the pandemic come through on commercial. So that's recovered as people have come back into employment to some extent. But really, it was as expected. There was really no other change. And as we've come through now to June, again, we're watching this, as you can imagine, very carefully. And there's nothing within that trend that went beyond what we had expected to see.

What is very different is new to therapy, which I think James has covered in his comments, where, again, we're seeing a reduction of just -- of I think of 20% according to IQVIA data in new to therapy. So the volume through this quarter was substantially less than we had expected.

Having said that, we were quite worried, as I think we -- as we saw the mail order number shift, particularly in the early weeks of the pandemic. But again, we're more relaxed now to see that the mail order and the retail business has stabilized, particularly in the last 6 weeks. So that really has been the story of the pharmacy margin. It's more of a volume story than it is of any shift in the margin from our perspective.

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

Yes. And I'd confirm exactly what Alex said. If you look at the U.S. business, with an impact of around $300 million to $315 million, 2/3 of the impact was due to gross profit and 1/3 was due to higher SG&A as a result of bonuses for select employees plus cleaning and sanitary expenses. When you go back to the gross profit, which is around $225 million, $250 million, all of it is due to rate and it's all in the retail business. So essentially, we didn't have a volume impact because the negative trend that we saw on pharmacy scripts, and that was entirely due to medical visits and the impact on new prescriptions, was entirely offset by continued buoyancy on our retail business.

So it was actually, just to answer you, to summarize, everything on the gross profit was rate. And the best example is the one I gave in the script, is we have a fairly large photo business with quite attractive margins, and the decline in that business in the quarter essentially cost us 90 basis points of margin just due to how profitable it is compared to the average of the business. I hope that's helpful.

Operator

And our next question comes from the line of Charles Rhyee from Cowen.

Charles Rhyee - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Yes. Sorry, I think I was on mute. Maybe just to follow up quickly on Eric's question, which is on -- when we look at the June trends at 3%, have we started to see within that new scripts accelerating as people kind of come back to the physicians?

And then secondly, the VillageMD partnership sounds great, Alex. What does that say to the other pilots you had been doing with Partners in Primary Care, with Humana, MedExpress, with United and even with LabCorp? How do those kind of fit in with the new strategy, it looks like, you're embarking on?

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

Charles. Yes, we are seeing a recovery in new to therapy, but it is still, I would say, unpredictable for all the obvious reasons as we're seeing a further spread of the virus in many states across U.S.A. So we are seeing a return, and James has given you the number we saw in June for scripts. So encouraging, but still not completely predictable and certainly not back to the number it was before the pandemic.

In terms of second question, we just had a really successful trial in Houston with VillageMD, which we have accelerated with a very good management team. They are agnostic to payers. They work within every payer in the marketplace in every health care system. They do both fixed; they do fee-for-service; they do, of course, taking risk. And most importantly of all from our point of view, they take care of people with long-term conditions.

We know the $4 trillion of spend in the U.S.A., 85% of that is long-term conditions. So they come to us with a full file from doctors. They move that file through their very strong technology, to move from fee from service on to taking risk. And the model just works really well for us and really very quickly, and therefore, we're very keen to accelerate it.

We still have very good relationships with UnitedHealth. And we're working with them, as you know, in the Las Vegas area, both on centers for enrollment, but also importantly, centers for primary care. And of course, we continue to expand our Partners in Primary Care model, we've opened 3 more of them as well. So we continue to believe strongly in the neighborhood destination concept. We believe we'll have to have more partners than just one. But at the moment, the partner who really has performed the best for us has been VillageMD, and we're very committed to accelerating in the way we described.

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

Stefano here. You remember probably that we have tried many different formats of clinics. And as always, we try, we are patient, and we want to see where we have the return. And with VillageMD, we found the model where we could see a real return in a relatively short term or medium term, and we see really a complement with our pharmacies, with what we normally do in a pharmacy. After many trials, we have found that this model is probably the one which fit best with our pharmacies. And when we have seen this, we didn't hesitate to invest heavily in this model.

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

And just finally. Sorry, Charles, I missed LabCorp. LabCorp are really important partners to us. We have about 110, 112, I think it is exactly. So that rollout continues. And we're developing, of course, new models with them for testing. And obviously, we're continuing to work very closely with that team. So again, we feel very good about our partnership with LabCorp.

Operator

And our next question comes from the line of Kevin Caliendo from UBS.

Kevin Caliendo - *UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution*

I just wanted to get a little bit more detail on the impact, the delta between your online sales and your inside-store sales. Sort of what they were, what's the difference in gross margin on that? And sort of what are your expectations going forward? Is this the new normal, or do you expect foot traffic to increase and online sales to sort of stay where they are? I'd love to sort of get a take on the impact now and sort of what you expect the mix to be going forward.

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

Yes. I'll take a bit of a shot at that. Our biggest online business is actually in the U.K. It's a $500 million-plus business and has a very strong position in beauty. And what we're looking at right now, and I said in the prepared remarks, foot traffic in our stores was down 85%, we saw was a tremendous impact in the U.K. So effectively, it was at a standstill. And at the beginning of the crisis, we didn't have enough capacity in our online business, and we've exited the quarter with sufficient capacity for the future.

So what are we seeing right now? We are seeing in the U.K. that there is a slow recovery on the high street, but transactions are still down 46%. Again, it's a huge number. But our online business over the last weeks and months is running in excess of 120% growth, and we would expect that to continue at least for the next quarter.

And I think what the job we have now is how do we move this business from being a $0.5 billion business to a $1 billion business? So we're setting different goals, and we actually don't want the market to define what we want to do. We want to define a much stronger e-commerce business in the U.K. where we actually have a very strong set of assets. We have a very powerful loyalty program with, I think it's 17 million, 18 million members. The second thing is strong starting position. And we clearly want to stake out our #1 position in -- as a beauty retailer online.

Regarding the permanency. I think as you build models into next year, I think you have to assume we will have transaction declines for the first half of next year. And I think you will see that as well in the U.S., but it's less exaggerated in the U.S. But you will also see a very strong online business.

And to get back to your margin question, this is quite unusual. So in the quarter, we had a 78% increase in online sales, and that's a weak start for the quarter and running at 120% in May. The biggest issue on margin, though, is not necessarily the absolute increase in the online margins because we actually have had a very attractive margin profile in the U.K. on our e-commerce business. The issue is prior to the COVID pandemic, 70% of the orders were picked up in store, and right now, it's less than 20%. And the biggest incremental cost we have is the fact that it has a 0 cost if somebody is picking it up in store, and it's probably costing you $3 to $4 more to actually ship it to somebody's house.

So we believe that will reverse, but it's probably 6 months away. So as consumers get much more comfortable coming back to the high street, they will also become much more comfortable at pickup in store, which will reduce the headwind on margin as we move forward. But this will be a month-by-month kind of thing, where we're actively managing the situation. And secondly, we did put in place some short-term distribution gap fillers that obviously have a higher cost right now. And as we put in place more permanent omnichannel delivery methods, the cost will come down.

The U.S. market is a little different. The margins are not attractive in the U.S. market. It's a $300 million to $400 million business, so we're quite behind the competition. And maybe I'll pass it over to Alex because we have a very aggressive strategy in mind to really build a strong omnichannel presence in the U.S. We do recognize we're behind the market and we're scaling up the investment as we speak. So maybe I'll pass it to Alex, and he can bring you through some of the vision for the next 6 to 18 months.

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

Thanks, James. Yes. Hi, Kevin. Yes, I think that the way we see it, and one of the key numbers reported was a 200% increase in our mobile app usage, which is very encouraging. And therefore, as we see all decline in physical stores and as customers adopt new omnichannel methodologies from how to do the shopping, we are very committed to accelerating the use of the app and the conversion of the app into sales, both retail and health care sales, particularly in Walgreens.

You saw an announcement a few days ago about the Adobe-Microsoft partnership. That's really about a new approach to marketing which we've tested for about 12 months. And we're really excited by the performance, seeing significant increases in sales in that performance. So as we go forward, we believe that our ability to personalize our marketing, turn the dollars we spend today into different types of dollars that personalize marketing for customers, we believe that we'll be able to convert more people in mobile app, drive, as James has said, in the U.K., which has been very successful for us, buy online, pick up in store, also drive-thru windows and convert more and more people into this idea of omnichannel and ultimately a platform strategy. As I mentioned, I think, in prepared comments, this idea of a customer engagement platform is one we're investing in very heavily, focused on our pharmacy, focused on health care, focused on all the partnerships we've created, including the VillageMD partnership, as Stefano referred to a few minutes ago.

So we remain convinced that our stores are beautifully placed as forward distribution hubs in the communities, and we're now investing to make sure as people more and more move to omnichannel ways of getting their goods and services, including health care, we are absolutely convinced our investment strategy will come through strongly in the years ahead.

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

Yes. And maybe the part we didn't cover was what's happening in the U.S. front of store. Right now, the transactions are down somewhere between 10% and 12%, but the basket size is up considerably. So we're doing a lot of work on retention of [customer]. But we expect -- we've seen a dramatic improvement over the last weeks as the lockdowns relaxed.

So currently, these transactions are 11%. The drug channel is a channel that was losing transactions over a multiyear period, call it 3% to 4%. But the gap is starting to close on transactions, but we're quite surprised, pleasantly surprised, by our ability to retain basket size. And this -- there is a shift happening in the market where convenient locations have an advantage here, that we're becoming a destination. It's less frequent right now, but the destination when they come to it, are picking up a higher selection products.

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

And just one other number that's important to understand is that we do have a lot more urban stores than some of the direct competition, which I think is an advantage in the long term. But at the moment, the urban areas are most affected by the risk and the fear of the pandemic. So for example, in New York City and Manhattan, we have almost 100 stores in Manhattan alone. And you can imagine the footfall and the sales and the transactions are heavily down in these markets.

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

Yes. It's quite interesting because it's -- as Alex said, it's very geographically dispersed. So we have a large proportion of our stores are rural, and they're up about 8% in the quarter. And you've got a small number of urban stores, maybe 300 to 400 urban stores, and they're down 18%. So as you move out of the big cities, which have been disproportionately impacted, our performance is much, much better.

Operator

Our next question comes from the line of Steven Valiquette from Barclays.

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

So my question actually kind of picks up right where you left off, some of the geographic discussion in the U.S. I'm not sure if you're able to comment on this or not, but some investors are wondering whether you're seeing any dichotomy in the most recent trends in Sun Belt states, like Florida and Texas, versus trends in the Upper Midwest and Northeast, where things are more stable now. So separate from that rural versus urban, I think just people are focused on the Sun Belt. Just any comments you can make geographically given some of the investor concerns around rising COVID cases in some key states, it might also be helpful.

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

Thanks, Steve. It's Alex here. The reality of it is there are hot spots where we're seeing some pantry-loading and then some quieting down. But really broadly, it's pretty consistent apart from the urban areas via the suburban areas, which James has mentioned.

So again, it's -- the patterns are there when you look -- when you click down a level or 2. So for example, if we take Houston as maybe an example of it, we did see evidence of some pantry-loading a couple of weeks ago. But they are in very specific areas, and the trend is not really that clear from the numbers that we are seeing. The really clear trend that go back to what James quoted before is a very clear trend. And we're watching this every single day.

And of course, we're continuing to take all the actions we have to take to keep our stores, our pharmacies clean and applying all the rules, which are so important and of course, making sure the #1 priority is keeping our people safe and secure and our customers safe and secure in our premises. So there's no real trend beyond the one that James has said, that we've really picked up.

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

Yes. We did see slight outperformance in May in Texas and the Southwest on a transaction basis because they relaxed sooner. But these things are moving around. It's not 15 points of growth, it's more like 2 to 3 as a difference. It's really metropolitan compared to rural and suburban, that's where you see the biggest shift.

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

I mean, one thing I would say, and again, it's been well commented on, is that the local, smaller stores are doing reasonably well. Again -- so again, we feel confident about the position of our pharmacies and the size of our pharmacy in their boxes. Again, that's another comment I think that's coming through in a lot of market research that I've seen, for sure.

Operator

Our next question comes from the line of Lisa Gill from JPMorgan.

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

Alex, I just want to go back to the comment that you made around VillageMD and how well the pilot had gone in Houston, and that's the reason that you've chosen them as your big partnership going forward. What did you measure that on? What -- did you see a lift in pharmacy comps? Like what's going to be the best metric for us to look at when we think about the success of the partnership? Again, is it the pharmacy comp? And can you share with us potentially the lift that you saw?

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

Yes. So absolutely, pharmacy comp is a big one for all the obvious reasons. And I think as we said already, Lisa, they bring in a full file of patients with them. So these doctors come in with a full file. So from day 1, they are writing prescriptions for all the patients who fall then into the surgery.

We love this idea of the family doctors. Really clear from market research that the family doctor, the PCP, is the person that people really trust. They are the quarterback of the health care system. And when you put them in partnership in physical stores and in digital assets with their pharmacists and their nurses, then you get quality care in a way that really reduces costs, improves care and particularly helps people to manage long-term conditions in the way we described. So that is definitely one driver, along with other health care products which are associated with that doctor's practice and what the doctors recommend and what, of course, people pick up inside of the pharmacy as OTC.

The other thing that's important to understand in the short term has been the NPS score. And the NPS scores are over 90%. And so this is a really fantastic feedback. And the way that these particular VillageMDs are designed is really strong from the point of view of your local surgery, quite different. And I hope you've seen the picture to what many local surgeries look like today.

And last but not least, of course, they are very good as a practice and as a company with the software they have. They are able to really use that software to help doctors to spot gaps in care and make the best next step. So closing, improving Star ratings and all the things that really drive the more risk-based models, which is very strong in their software. And again, we expect, as we go forward, this will become more and more of an integrated care model and there will be more opportunities for ourselves and other partners to provide the solutions that long-term patients with chronic conditions needs going forward.

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

And I understand all that. Is there a number that you can quantify? Like -- so if you think about that specific market. And again, we're not looking to extrapolate it across that 500 to 700, but just any kind of qualitative number you could give us?

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

Well, what I can describe is that Walgreens, I guess, has a 20% of an average market share. You can expect us to be well above 50% when these -- of market share when these settle down.

Operator

And our final question today will come from the line of Elizabeth Anderson from Evercore ISI.

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

Just to piggyback on some of the other questions that were asked on the cost side. Can you talk in a little bit more detail about where the incremental transformation costs are coming from? And then specifically, could you comment on how you sort of view CapEx for rest of this year and how you sort of balance that need for CapEx spend versus the -- some of the transformational costs?

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

Yes. Sure. As we look at why did we raise the guidance on the Transformational Cost Management Program is it's the savings we're seeing year-to-date. And then two is, we just have greater visibility to the future programs and the degree of certainty has gone up dramatically. And I think we alluded to that on the prior call. So it's not a specific program, it's a combination of programs over a multiyear period.

We did see some delays as a result of COVID. We had to move quite a lot of supply chain and operations people away from transformational cost management programs. And we estimate that probably cost the program, in the year, about $45 million. But we were easily able to absorb that with other actions to contain costs.

So we think if you look against the peer set out there and the amount of incremental overhead some of them have incurred, we believe that our $100 million in the quarter is quite a low number compared to the peer set. And we tried to manage that as closely as we could. So we think we've done quite well on that.

Your cash flow question is a good one. This is kind of interesting because there is a lot of moving pieces here. One is we do estimate that at the end of the quarter, we had approximately $0.5 billion of higher inventory to fulfill the actual volatility in demand. And whether that's across pharmacy or across retail, we took a conscious decision that we were privileging, having availability in store. And we exited the quarter with very, very strong availability.

So that $500 million will work itself -- some of it, out of the cash flow by the end of the year. But we actually believe that with a risk of a potential second wave, we will probably retain somewhere between $200 million and $300 million of excess inventory at the end of the year. And when I say excess, that's to cover volatility that's increased significantly.

Some of that is offset by a good [question] on capital programs. And a really good example here is we had to halt for a period of time our SAP rollout in the U.S., which is a huge program, because we couldn't go into a store when they were struggling to fulfill demand and in a very complex environment. So we will have a deferral of capital expenditures of probably $150 million to $250 million. And I give a deliberately round range because I'm not sure how much of that will impact next year. So there will be -- the inventory will probably go down next year compared to this year, but capital expenditure will go up because of deferrals this year.

And then the last part is there have been some assistance from the U.S. government in terms of the deferral of cash contributions on payroll taxes and other items, and there's been some in the U.K. as well. That probably benefited our cash flow to the tune of $300 million. And as you look forward, that will work itself out of the system going forward.

So it's -- in summary, we added a lot of inventory, $0.5 billion, and that was offset by government contributions and the -- government contributions and the capital expenditure phasing. So we effectively exited the quarter with a 0 impact on cash flow as a result of COVID. We do think it's probably a good idea that we keep excess inventory as we exit the year, and that will have some impact on the profile next year. I hope that's helpful as you're thinking through the impacts.

Operator

I would now like to turn the call back to Gerald Gradwell for closing remarks.

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

Thank you, Lisa. And just to say, I know that there were a number of you that didn't get to ask questions today. As ever, we ran out of time, but the IR team are here and available to take your questions over the coming days and weeks. So please feel free to reach out to us.

Thank you very much, indeed. And we look forward to speaking to you on the next quarter.

Operator

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