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WBA - Q1 2017 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 1Q17 sales of $28.5b, GAAP net earnings attributable to WBA of $1.1b and GAAP diluted EPS of $0.97. Expects FY17 adjusted diluted EPS to be $4.90-5.20.

CORPORATE PARTICIPANTS

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George Fairweather *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

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Alex Gourlay *Walgreens Boots Alliance, Inc. - Co-COO*

CONFERENCE CALL PARTICIPANTS

Ross Muken *Evercore ISI - Analyst*

Alvin Concepcion *Citigroup - Analyst*

George Hill *Deutsche Bank - Analyst*

Ricky Goldwasser *Morgan Stanley - Analyst*

Lisa Gill *JPMorgan - Analyst*

Robert Willoughby *Credit Suisse - Analyst*

David Larsen *Leerink Partners - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Walgreens Boots Alliance first-quarter 2017 earnings conference call.

(Operator Instructions)

I would now like to turn the conference over to Gerald Gradwell, Senior Vice President, Investor Relations and Special Projects. Sir, you may begin.

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

Thank you. And can I first say that in keeping with our corporate stance on cold and flu, a number of us have gone out and caught colds and flus so please bear with us if we sound slightly bummed up this morning.

Welcome to our first-quarter earnings call. Stefano Pessina, our Executive Vice Chairman and Chief Executive Officer, and George Fairweather, Executive Vice President and Global Chief Financial Officer, will take you through our results as usual. Alex Gourlay, Co-Chief Operating Officer of Walgreens Boots Alliance, is also here and will join us for questions.

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.

Certain statements and projections of future results made in this presentation constitute forward-looking statements, but are based on our current market competitive and regulatory expectations, and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by the law, we undertake no obligation to update publicly any forward-looking 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 for a discussion of risk factors as they relate to forward-looking statements.

As a reminder, today's presentation includes certain non-GAAP financial measures, and 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. I will now hand it over to George to take you through the numbers.

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

Thank you, Gerald. Overall, we are pleased with the progress this quarter, with results in line with our expectations. We continue to make good progress towards completing our Rite Aid transaction, and today we have raised the lower end of our adjusted earnings per share guidance for FY17.

So turning now to the financial highlights for the quarter. As we expected, currency had a negative impact on the year-over-year financial performance, the US dollar being around 18% higher versus sterling. Sales for the quarter totaled $28.5 billion, down 1.8% versus the comparable quarter last year. On a constant currency basis, however, sales were up 1.1%.

GAAP operating income was $1.4 billion, a decrease of 1.4%. GAAP net earnings attributable to Walgreens Boots Alliance were $1.1 billion, and diluted EPS was $0.97. Adjusted operating income was $1.7 billion, up 0.4%, and in constant currency, was up 2.8%.

Adjusted net earnings attributable to Walgreens Boots Alliance were $1.2 billion, up 6.1%, and in constant currency, up 8.2%. Adjusted diluted net earnings per share was $1.10, up 6.8%, and in constant currency, up 9.7%. The adjusted effective tax rate, which we calculate excluding the equity income from AmerisourceBergen, this was 25.5%. This was lower than the same quarter last year, primarily due to changes in our forecast geographic mix of pretax earnings, and the US taxation of our non-US entities.

So now, let me turn to the performance of our divisions in the quarter, beginning with retail pharmacy USA. Retail pharmacy USA sales were $20.7 billion, up 1.4% over the year-ago quarter with comparable store sales increasing by 1.1%. Adjusted gross profit was $5.5 billion, up 0.1% over the year-ago quarter, reflecting an increase in retail, which is partially offset by a decline in pharmacy.

Adjusted SG&A was 20.4% of sales, an improvement of 0.5 percentage points compared to the year-ago quarter. This reflects benefits from our cost transformation program. Adjusted operating margin was 6.2%, up 0.1 percentage points, resulting in adjusted operating income of $1.3 billion, up 3.7%.

So next, let's look in more detail at pharmacy. US pharmacy total sales were up 2.5%, driven by increased script volumes and higher specialty sales. We filled 237.6 million prescriptions on a 30-day adjusted basis including immunizations, an increase of 3.0%.

On a comparable basis for stores, which excludes central specialty, our pharmacy sales increased by 2.0%, with scripts filled up 3.4%, primarily due to growth in Medicare Part D volumes. Within sales, volume growth and brand inflation was partly offset by reimbursement pressure, which was in line with what we anticipated, and by the impact of generics. While branded drug price inflation continued, it was at a more moderate level than in prior quarters. Keep in mind that these factors impacted sales and gross profit.

Our reported market share of retail prescriptions in the quarter on the usual 30-day adjusted basis was 19.5%, up approximately 40 basis points over the year-ago quarter. Total retail sales were down 0.9% on the same quarter last year. This includes the impact of the previously announced closure in September of certain e-commerce operations.

Comparable retail sales were down 0.5% in the quarter, due to declines in the consumables and general merchandise category and in the personal care category, partially offset by increases in the health and wellness category, and beauty category. Gross margin was higher than the same quarter last year, primarily driven by owned brand performance, and procurement benefits. Since the quarter end, while our December comparable sales were still negative, we saw stronger performances in our key health and wellness and beauty categories.

We have now completed the first phase of the rollout of our new differentiated beauty offering, which is available in more than 1,800 stores. In addition, in October, we launched Beauty Enthusiast, a new loyalty offering, which engages our most valuable beauty and personal care customers. Since the launch, both sign-ups and incremental spend among beauty enthusiasts has been above plan.

As we anticipated, we have increased beauty sales in these remodeled stores, particularly No7 and Soap & Glory. During 2017, within these stores, we plan to introduce further new product lines, as well as expand the number of stores with beauty offerings. A significant element of the rollout is the recruitment and training of beauty consultants. In order to maintain high standards, we are doing this in a methodical manner, which is taking slightly longer than expected.

So now, let's look at the results of the retail pharmacy international division. Sales for the division were $3.0 billion, up 0.5% in constant currency. On the same basis, comparable store sales decreased 0.1%. Comparable pharmacy sales were down 0.5% on a constant currency basis, due to a decline in the UK, which was partially offset by growth in other international markets. Boots UK comparable pharmacy sales were down 0.8%, due to the expected reduction in pharmacy funding, partially offset by a strong performance in pharmacy services.

Comparable retail sales for the division increased 0.2%, due to growth in all countries, other than Chile and Mexico. Within the UK, Boots performance was flat versus the year-ago quarter, and we saw growth in our opticians business. Adjusted gross profit for the division was down 2.7% in constant currency to $1.2 billion, mainly due to lower margins in the UK, in what is really a new environment for retailers.

Adjusted SG&A as a percentage of sales on a constant currency basis increased by 0.7 percentage points to 32.5%, mainly reflecting higher depreciation costs than the year-ago quarter. As you may recall, in January last year, I explained that FY16 first quarter results benefited from purchase price accounting refinements. In addition, the higher depreciation this quarter reflected our ongoing IT and store investment program.

Adjusted operating margin was 7.2%, down 2.0 percentage points in constant currency. This resulted in adjusted operating income of $213 million, a decrease of 21.6%, again in constant currency. Since the quarter end, I'm pleased to report that the December retail sales growth was notably stronger than in the first quarter.

Boots December retail performance was solid, reflecting actions taken in the Fall to counter what are challenging market conditions. However, from December 1, as expected, Boots was impacted by the government action to lower pharmacy practice payments.

So now, let's look at our pharmaceutical wholesale division. Sales for the division were $5.4 billion, up 0.6% versus the same quarter last year on a constant currency basis. Comparable sales on a constant currency basis increased by 4.7%.

This was slightly ahead of our estimated market growth, weighted on the basis of our country wholesale sales, with growth in the UK and emerging markets offsetting competitive market conditions in Continental Europe. Adjusted operating margin, which excludes ABC, was 3.1%, up 0.3 percentage points on a constant currency basis.

Adjusted operating income was $224 million, up 45.2% in constant currency. While the increase was mainly due to equity earnings from ABC, excluding this, adjusted operating income grew by 10.2% in constant currency, cost benefits out weighing margin pressures. Operating cash flow in the quarter was $525 million.

During the quarter our working capital outflow was $1.2 billion. This reflected our typical seasonal build in inventories, and inventory builds for certain new initiatives, partially offset by improved payables days. Cash capital expenditures for the quarter was $378 million. We continued to invest in our core customer proposition, including our stores and US beauty program, as well as the upgrades to our IT systems, which we have previously talked about. Overall, this resulted in free cash flow for the quarter of $147 million.

So turning now to our pending acquisition of Rite Aid. As you'll see from today's earnings press release, we are actively engaged in discussions with the FTC, and are still working towards a close of the acquisition in the early part of this calendar year, having announced the Fred's agreement on December 20, 2016.

So turning now to guidance for FY17. We have raised the lower end of guidance by $0.05, and now expect adjusted diluted net earnings per share to be in the range of $4.90 to $5.20. This assumes, as before, Rite Aid accretion of $0.05 to $0.12 and current exchange rates remaining constant for the rest of the fiscal year.

Now keep in mind, we still expect second-half year growth to be stronger than in the first, as we begin to benefit from the strategic partnerships announced last year. During the quarter, we purchased 5.6 million shares, at a cost of $457 million. This substantially completes our anti-dilutive share buyback program for FY17. At the quarter end, this resulted in just over 1.079 billion common shares outstanding.

So I will now hand it over to Stefano, for his concluding comments.

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

Thank you, George. As you have heard, the events for the quarter are good, and very much in line with our expectation. As usual, they tell the story of a dynamic business with many moving parts, and we are aware of the complications this sometimes creates for people looking from outside the Company, when they try to measure our progress, especially on a quarter-by-quarter basis, when we are pursuing strategies that are aimed at delivering value over the long term.

Last quarter, we told you that we expect that our results for FY17 would be weighted towards the second half of the year, as our new agreement with key strategic partners begin to deliver volume increases to offset the commercial pricing that we have given. As this implies, we will continue to see this impact in the second quarter of the year, which is as we expected and previously signaled.

We continue to deliver major progress with cost reduction and sourcing, both areas in which we have a lot more progress to make, which is allowing us to deliver these good financial results, while we implement initiatives to drive growth in our stores, further differentiate our retail offering, and promote our owned and exclusive brands across our businesses. We are still at an early stage of the deployment of new initiatives in Walgreens, and are refreshing the offerings and the processes to enhance the customer experience.

It is important to recognize the nature what we are doing in the US. We are trying to bring a new way of thinking to our Company, which if we are successful, will hopefully influence the sector as a whole. We are focused on working in partnership to provide a better, more efficient and more effective approach within the US healthcare system, to make better use of the infrastructure in place at the moment, and re-think how we do a number of the things that we do today.

There is no doubt that the healthcare system needs to change, by improving the provision of healthcare, while at the same time acting to control the rapid growth in costs. We are working to play our part in the changes that need to happen to achieve this, and as we deliver value in the system, we create, and capture an element of that value within our own business.

Of course, we are a single part of the system, so can only do so much on our own, which is why we are so committed to partnership, and talk about it so much. Working together with others to rethink the interactions and interfaces within the overall system, allows us more impact within the system, and more leverage over time, and more ways and opportunities to create value, both in our business and in the system as a whole.

Of course, the US is only a part of our business, albeit a very significant part of it. All across our Company, our businesses change and constantly reinvents themselves to remain relevant in their ever changing markets. So we continue to work and grow and develop the Company as a whole. During the quarter, I have visited many of our operations outside the US, and remain convinced that there are opportunities for us internationally.

I said in the past that Asia and Latin America are areas of particular interest for us outside the US, and the more I see of these markets the more convinced I am of this. In terms of corporate development, you have seen the progress we have announced at the end of December, regarding the proposed transaction with Rite Aid, in having reached a conditional agreement with Fred's.

We still have to complete our work with the FTC, and as we have seen, these things can take some time, as the FTC are scrupulous in ensuring that they consider everything properly and fully. That said, I remain as convinced as ever of the strategic benefits of the proposed Rite Aid transaction, and look forward to being able to provide you with another update as soon as we can. We are clearly making progress, and while I would always like to move faster and do more, we must be measured and ensure we work at a pace with which we are confident we can deliver for our customers and our shareholders, on all the plans and strategies we have discussed with you.

Our confidence is only strengthened by our recent performance. Holiday shopping started later than usual, with the bulk of the sales occurring in the last days before Christmas. That said, we have once again seen what appears to be a solid holiday trading period in our main retail markets.

As George has told you, we are raising the lower end of our adjusted earnings per share guidance for the year, as we see the business performing in line with our expectations. We continue to have many different ways to deliver the value and growth we see possible in the businesses, and as ever, we will vary which of these we prioritize, depending on the market and the competitive changes that we see. But overall, these continue to give us the tools we need to maintain the financial performance that we have committed to for the Company as a whole.

Overall we remain confident in the outlook for the Company, optimistic that the strategies we are pursuing will deliver future growth, and convinced of the long term opportunities to create genuine value for this business for many years to come. Thank you. Now I will hand you back to Gerald.

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

Thank you, Stefano. We're now ready to take your questions, Operator can you open the lines?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Ross Muken with Evercore ISI.

Ross Muken - *Evercore ISI - Analyst*

So Stefano, you talked about the changing healthcare landscape, you're obviously doing a lot of things to revolutionize in some ways how the supply chain functions. As you think about the competitive responses, as you think about the partnerships that have happened, where do you feel like you've made the most progress, and where do you see the next leg of big opportunity? And obviously it depends somewhat on the Rite Aid transaction, in terms of what you do next. But just on the core business, where do you feel like you've done the most, and where do you feel like in the US business, you have probably the most to do?

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

Well apart the Rite Aid transaction as you said, I believe that the big achievement of last year has been for us to be able to create really a bridge with the main PBM, and other big players in this industry, and now we have a certain joint venture, so we have, certain, let's say contracts, that maybe new patients as a consequence of what we have done. But we have something, which is much more important.

We have established the trust between us and certain number of companies. Not all of them, not everybody has been able to create this elements of trust, but for certain companies, the trust is there, and on the trust and we can build a lot of additional opportunities in future. So our relationship with Prime, our relationship with Express Scripts, our relationship even with Optum, even though there have been many discussions about Optum are creating a new base of discussion, a new basis of collaboration which of course can go beyond a simple contract and can probably at the end also take in consideration a wider finale.

Ross Muken - *Evercore ISI - Analyst*

No that's helpful, and maybe just quickly, on the international business, you highlighted obviously key emerging markets as a place for expansion. You've entered number of different countries with different models, acquisition, joint venture, et cetera, over time. Is this the kind of environment currently that is favorable toward accomplishing maybe more of those goals, and in terms of expanding your geographic reach?

And then, two, help us understand what are the key challenges? Obviously we've seen folks enter Brazil and at times that's been tough, or Russia, et cetera. What makes for a good emerging market in your view in terms of the ability to make money there, and what not?

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

It's always tricky also because things change so rapidly. For sure, I wouldn't be particularly excited to invest in Brazil, unless we could find a very, very favorable situation. But it's still a big country, sooner or later it will be interesting again.

But you'll see countries like China, for instance, are still enormously interested, and remember that in China, we have a good presence in sales, but not in retail. But this is due to a historical reason that until three years to go, they were allowing people just 30 pharmacies. So we had 30 pharmacies, that were 29 in Beijing so we were prevented to buy other pharmacies, so the only way to do so was to team up with State owned Company.

So we are -- now this restriction has been in reality I would say even withdrawn, there are still certain things, but substantially withdrawn. And from the last two years, we have been very, very active in finding the right partner for us, we're a big pharmacy chain. Sooner or later, we will be able to do it.

The problem is that you have to dedicate a lot of time to get a deal in China, and it's true that we have a team in China, a permanent team in China of Chinese people. But it's also true that to do a big deal in China, you must have the agreement of the Chairman of the relevant Company, and the Chairman generally just wants to talk to the Chairman, you know China is really it's a very hierarchical society.

And so it's also true that in the last two years I have not gone to China as frequently as I used to go, and so I was not able to keep the relationship as I should have done. But now I have gone to China and spent some time in China in the last month, and now we are back and I believe, I strongly believe that sooner or later we will be able to do something. When, I don't know, but it's possible.

Ross Muken - *Evercore ISI - Analyst*

Great, thank you so much.

Operator

Thank you. Our next question comes from Alvin Concepcion with Citi.

Alvin Concepcion - *Citigroup - Analyst*

How would you characterize the competitive promotional environment in the US? There's been some concerns at least in partnerships and your wins could result in things like a price war, so I'm just curious your take on it.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It's Alex here. Yes, we are, I think I said quite a few times in the last 12 months our partnership strategy is to really get deeply inside conversations with partners to understand what they want from us, and it's not about price, only price. It's also about price and service on how we work together to really help them get their goals of creating better health outcomes, so we feel good about where we are now, we are in the very early stages of delivering these services through our pharmacies to TRICARE, and the first [time] month has gone well.

And of course, (inaudible) is a very important one for the extension of Med D and our new Prime networks, which again kick in January 1, so it's not about price from our point of view. We've got a very clear government structure, we make sure that we stick to the pricing structure, and where the market is at not below the market, and that's very important to us, and we're working very hard to deliver excellent customer care through our pharmacies to make sure we take care of the patients our payers have given us to take care of.

Alvin Concepcion - *Citigroup - Analyst*

Thank you and I know this is a tough question, but in light of the new political climate, in the US, what changes to the operating environment things like the potential repeal of the Affordable Care Act, what are you planning for in your outlook, is there anything proposed out there that would change your way of thinking about the business?

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

We really believe that we could start to work on hypothesis with the information that we have. We have a lot of affirmation they will repeal Obamacare, but after they say yes, but maybe we have to give something similar, we have to create a transition. It's difficult to understand what practically the new administration will decide to do, because for sure they would try to do something sensible and rational, and they will start with something which will not be to the detriment of the citizens.

So it will take some time to start and probably the outcome will be quite rational, and other times we will be able to organize ourselves and prepare our business to respond to the new environment. We don't have to be taken by panic, just because many rules change. We have to wait for the changes, and after, rationally, we will decide how to react, without panicking.

Alvin Concepcion - *Citigroup - Analyst*

Thank you very much.

Operator

Thank you. Our next question is from George Hill with Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Alex, I wanted to talk a little bit about the US business, and the price versus volume trends you're seeing there a little bit. Where you are continuing to see volume up pretty comfortably on the script side, with dollar sales coming in below that. However, from a lot of the data that we look at, it looks like net price mix is still trending positively. So I guess can you talk about what are the factors that are driving the discrepancy where dollar sales are coming in below script volume growth?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Sure, George. I think that in particular from a quarter-to-quarter differential for us, it's under 3%, as you rightly point out and we see really a couple of main factors, as George mentioned on the script. The first one is less inflation in branded drugs, that's pretty clear and a major chunk of it.

The second one is volume. Volume in the market is down, so as you see we are doing pretty well in the market, 40 basis points up in market share from what we measure. But overall the volume in the market is down in this quarter relative to the last quarter, and I think that's a chunk of it.

And then as you said, we have been pricing more competitively in some of our networks in preparation to drive volume, as Stefano and George both said in the second half of this year. And again, that's the third element for us. So that really is the three elements we see, reimbursement pressure continuing, branded inflation deaccelerating, and a bit of volume decline in the market during this period.

George Hill - *Deutsche Bank - Analyst*

Okay that's helpful and maybe a quick follow up. There's a little bit of chatter in the market recently about the launch of some of the biosimilars, particularly on the pharmacy-benefit side, with wholesalers trying to take different tacks around whether or not they will supply or carry these drugs. How are you thinking about primary and secondary wholesaler relationships in general, and secondary source contracts, if your primary vendor doesn't want to carry certain products? Or if wholesalers all of a sudden want to be more selective about products they want to carry, depending upon the economics they can generate from manufacturers?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

To be honest, we have a great relationship with AmerisourceBergen, and as you know, we are very strong partners now, particularly having bought the second warrants. So from our point of view we have direct conversations about how do we continue to make the supply chain more efficient. That is a small part of the conversation, there is many more opportunities that we are speaking about today for tomorrow. So to be honest it's really not an issue we see as a big opportunity or threat at this point.

George Hill - *Deutsche Bank - Analyst*

Okay, I appreciate the color. Thank you.

Operator

Thank you. Our next question is from Ricky Goldwasser from Morgan Stanley.

Ricky Goldwasser - *Morgan Stanley - Analyst*

So a couple of questions. So first of all, obviously retail and pharmacy comps soft across the industry, yet you did raise the bottom end of the guidance. So what has changed since you guided, that gives you more confidence in the outlook for the remainder of the year?

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

We're obviously very pleased to be able to raise the lower end of guidance by $0.05. This really reflects that we are now four months into the year, that gives us a clearer view of our performance. You've seen that we've obviously delivered to expectations in the first quarter, and we remain confident very much about our ability to deliver the numbers going forward.

But I think when you actually look at the shape of the results, you can see, obviously Alex has talked about the market, the volume issues and there has been questions about margin, but we delivered very strong cost controls, which is very much a key focus of us across all of our divisions. And again, you referred to the mix of the profits and the taxes has again helped us a little bit on the comparables.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Ricky, it's Alex here. There's really two things. First one, I have spoken about already. We have seen the first month of TRICARE and it's on plan, and that gives us confidence for the rest of the year, and we'll see the first month of Prime already this month.

Secondly, and I think equally important strategically, we have seen ongoing solid trends through our investments, particularly in beauty, wellness and health, capturing these on the front end, and we saw retail pharmacy operating margin, as you know, step up as a result of our investments and our focus on environment, service on differentiated products, and view differentiation is the key example there.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay, and then when we talked in the past, you talked about the vision of Walgreens as being the new retailer with a lot of different wrap-around services that will attract patients and consumers into the stores. I think you recently opened or are piloting a vision offering in one of your flagship stores. Can you talk a little bit about what type of assets you're looking to add to your current offering, and how it fits in with the recent partnerships that you've signed in 2016?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Sure, I think we have got solid businesses in Europe, particularly in all the UK, in both optical and hearing care. So we have great partnerships in these businesses, and we have partnerships with manufacturers that help us. We have tackled, as you said, a pilot really in a flagship store in Chicago, and that really is to understand the market, and how customers react to it and we'll take decisions based on how that comes through, going forward, so these are two vision and hearing care which clearly we could transport from our experience in Europe.

I think also, we've been very successful in the last 12 months, been able to outsource our retail clinics, and again, that's a partnership model that we speak about a lot. And we have continued to sign deals and add sources successfully with many partners across America, and again, that's another way that we bring wrap-around services and more patients into Walgreens, is by working closely with local service providers providing the services that they want inside of our pharmacies across USA as another example of how we're thinking how we're working.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay, thank you.

Operator

Thank you. Our next question is from Lisa Gill with JPMorgan.

Lisa Gill - *JPMorgan - Analyst*

George, I just want to start with a question for you. You talk about being back-half driven and I think we heard you say that when you gave the initial guidance, but I'm just curious as to how to think about the cadence, and how do we think about going from Q1 to Q2? Should it be a little more back-half weighted than what you're currently seeing in the street? Is that the message that we should be taking today?

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

I think the message today is no different than the message that we were certainly trying to give in the full quarter, in the full-year results, in that the partnerships that we have been talking about, it will, it takes time for us to build the volume. And so, when you're actually looking at relative numbers, our expectation is, it's always been that the earlier part of the year relatively would be the tougher part, and it will take time for us to build the volume to see the gross profit therefore in dollars come through the new partnerships that we're all so excited about. So you should think of that in shape, and really be thinking about that as that of being a build across the four quarters and take the first-quarter results as an indication of that, and then think in terms of building.

Lisa Gill - *JPMorgan - Analyst*

And then my second question and maybe I've misunderstood this, but I never thought of drug price inflation as being very important to the drug retail model. Am I misunderstanding that? Is there more than just that interim opportunity of capturing some level of spread as the price went up before the reimbursement changed, or are there other inventory opportunities coming up? Because I did hear you call out today less or moderating drug price inflation as being a little bit of a headwind.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

This is Alex. No it's a headwind to sales via the volume differential, if you'd like. But in terms of, it's a slight headwind to the retail business, obviously it's a support to the wholesale business, so in the mix it really isn't a big difference. But it does make a difference in sales, which is the question I was answering, I think, from Alvin earlier on.

Lisa Gill - *JPMorgan - Analyst*

Okay, and I guess if I could just slip in one last one, and that's just around utilization. You talked about increasing your level of market share, but yet you're seeing less utilization. Do you have any thoughts around why that is, and normally this is a quarter end in November, but we start to see it pick up as people move towards the end of their deductible. Are you seeing anything, or have you seen anything in the December quarter that shifted from what you've seen historically?

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

No the December quarter, it's one month so far, so this season is a season for obviously for cough, cold and flu and illness, and as Gerald said, it's (inaudible) the table here this morning as well, so I think we're seeing a more normal flu trend, which kicks in a bit later in the season than we had expected, but that's the only thing really that changed in December, which is going to be obviously a slight headwind, sorry slight tailwind for us in the second quarter, but that's still early on and we'll see what happens with the rest of the season.

Lisa Gill - *JPMorgan - Analyst*

Okay, great. Thank you.

Operator

Thank you. Our next question comes from Robert Willoughby with Credit Suisse.

Robert Willoughby - *Credit Suisse - Analyst*

What's a good assumption for what sale leasebacks can contribute in cash over the remainder of the year? The first quarter was a bit higher than where we thought. And secondarily any metrics on what the new store format is contributing for you?

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

Okay, I'll take the sale and leasebacks one. We're continuing to look at sale and leaseback opportunities on a go-forward basis. The timing of those is a little tricky to actually predict, because we're very disciplined on the returns that we're looking for on the various transactions. But you should take it that it's something that we will continue to do going forward. But as I said, those tend to be the individual transactions. It's hard to predict quarter by quarter exactly when they are going to occur.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

I'll take the second one, Robert. With regard to new-store formats the investment at the moment is to upgrade into the whole estate so we have been upgrading the whole estate with a particular focus on beauty in our top volume stores, top 1,800 so far, with more to come next year, as George has said.

We have got some pilots and tests both in urban and what we are calling the lower volume stores. We call these opportunity stores and in the very early stages of their testing and trialing these out. And again, we'll update you when we get farther down the line, but the investment is to upgrade the whole estate, to make sure that we give a more consistent Walgreens brand and offer across our 8,000-plus drug stores in the USA.

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

But I would like to assure you that the cash flow this year will be -- operating cash flow, will be very good. We expect a very good operating cash flow. And of course we have had the first quarter with relatively low operating cash flow, but this happens every quarter, because of course we buy more stock for Christmas, because we pay bond fees, because we pay the dividends that are mainly cash (inaudible)n this period.

And so in all of our stores, the first quarter has been relatively modest in cash flow and free cash flow, but after it goes up during the year, and we don't see any reason why this year should be so dramatically different from the previous year. But of course it depends on how we manage our investment, how we manage our lead, but substantially we don't have structural differences, so it's very difficult to analyze things quarter by quarter, and to draw a conclusion adjusted from the last number.

Robert Willoughby - *Credit Suisse - Analyst*

That's great, thank you.

Operator

Thank you. Our next question comes from David Larsen with Leerink.

David Larsen - *Leerink Partners - Analyst*

Can you please talk a bit about the $1 billion in synergies that you expect to capture from the Rite Aid transaction by year three or four? I'm assuming that's $1 billion a year, and then what makes up those synergies? And then how do you think about RAD earnings themselves versus cost synergies? Is that $1 billion inclusive of both?

And then how do I tie this $1 billion back to $0.05 to $0.12 accretion in year one. The $0.05 to $0.12 sounds very modest to me, so that's a lot. Thanks very much, appreciate it.

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

Okay, so it's quite a few questions in there so hope I don't miss any. To start by saying that the first thing is that, in terms of the accretion for this year, I think that it's important to remember where we are, we are already four months into the year, and when we complete transactions, the first priority is always very much about focusing on the customers, getting the key elements of everyone working together.

And in terms of delivering synergies, our approach to synergies, as you saw in the Walgreens Alliance Boots transaction, is to have a very clear plan going in, and then build the synergies up over or ramp up over a period of time so that we do things in a disciplined way, that we can secure the synergies year after year. So we don't just go for quick wins and pay the price later, and we've got a good track record of doing that.

Clearly there are certain synergies that take time to access, so on procurement synergies for example, it takes time to put in place new arrangements, we've got stock sitting on the balance sheet that needs to be sold through. So that is really reflective of the guidance that we've given for the balance of this year.

In terms of the synergies themselves, the key areas that the $1 billion will come from starting with areas like procurement, where we've got our sourcing operation, on generics that sources products later today both for ourselves and for AmerisourceBergen. There is going to be that certain overhead cost savings that we will be able to deliver over time. But what the billion doesn't include, which is important to understand, is it doesn't include the opportunity that we would have to actually rationalize the portfolio, where there's overlaps in existing large markets and that's something that we would do separately, and it's equivalent to [file vise], and that is outside the synergy numbers.

What's also important in the number of the $1 billion is that we are very disciplined in the way we measure and track synergies, and the $1 billion is the synergies that we are confident that we can -- are very clearly identifiable and quantifiable synergies, that we can measure and track and report on, because that delivery is very important. What one always gets in transactions over above that is a lot of the less tangible measurable synergies, but these are the ones that over time really all help to deliver real long term sustained shareholder value.

The $1 billion I say, is a run rate, just to be absolutely clear. It's what we expect to deliver per item.

David Larsen - *Leerink Partners - Analyst*

Okay, that's very helpful, thank you. And then how is -- when we think about like Prime and TRICARE and Express Scripts, for this most recent quarter, were the new prices and also co-pay and deductible plan designs in place at the start of the quarter?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It's Alex here, no remember, the first one (inaudible) was DoD and TRICARE, which started on December 1 and Prime starts January 1, 2017, started January 1, 2017.

David Larsen - *Leerink Partners - Analyst*

Okay that's great, so then all of the new prices and the co-pay and plan design start on those dates, right?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Yes.

David Larsen - *Leerink Partners - Analyst*

Okay, thanks very much.

Operator

Thank you. Our next question comes from Eric Percher with Barclays.

Eric Percher - *Barclays Capital - Analyst*

To start, Alex, did you just mention rationalization of the Rite Aid base post acquisition, and is that a important part of the opportunity strategically following completion and approval of the transaction?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Yes, (inaudible) I did mention it, but George answered the question and I think we covered it. No decision is made on this at all. Let's be straight about this, and it's not including the $1 billion synergies that we've announced, is what George said.

Eric Percher - *Barclays Capital - Analyst*

So we looked at as a strategic effort?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It's a possibility for sure, of course it is, but it's not in the $1 billion synergies and it's not currently in the plan.

Eric Percher - *Barclays Capital - Analyst*

Okay, so with --

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

More generally when we talk of synergies, we talk of mergers. We try to figure out which is the level, the potential level of synergies, and with the elements that we have, comparing that they are stores in this case to us in thinking that at the end we will be able to unify the terms with the supply, imagining that we can reduce a certain function, a certain duplication, and so reduce certain costs.

So we put in place all of the area we know where we can reduce costs, but it's an exercise which cannot be precise, because we don't know exactly the situation or the other company. We don't know exactly how these companies buy today. We don't know exactly which kind of contact they have with the PBM. When we will be in charge of the company, we will analyze all these documents, and of course we will be able to assess a level of synergies, which is much more precise.

What does it mean? This means that the level of synergies that we are, have calculated in a relatively prudent way, a rationally prudent way, because of course we cannot run the risk not to meet our target internally. So we take some contingencies, and are not really not all of them are really dependent on the number of stores. I mean 500 stores more, 500 stores less, 10% more, 10% less, are in reality in the -- in the rounding, on which we have to calculate the synergies, because we don't have a very clear understanding of what our counterparty is, simply because we cannot.

The law doesn't allow us to share all these secrets so our due diligence is by necessarily a superficial, relatively superficial due diligence. So in reality we will -- one thing I can tell you that when we do whatever acquisition, whatever merger, we find that the final synergies are wider and substantially wider and substantially larger than the synergies that we have announced. And so today, we shouldn't talk too much about the synergies, and we would be able to review a precise target and timing that we have acknowledged what there is really in the company. But as we have calculated these synergies in a rational way, we believe the number probably will be higher, and not lower.

Eric Percher - *Barclays Capital - Analyst*

So I'll come back to the rationalization at a point where we can all talk about it, but maybe my original question was actually going to be volume. We've talked a lot about this year's volume. As we consider commercial versus Part D where a lot of the growth has been, do we expect that commercial may actually be a greater contributor to growth in the second half? And does that then extend over the next year or two, where commercial pricing could be stable, and give you a bit of an offset to the reimbursement pressure we see annually in Part D?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

It's Alex here. So the truth of it is that the reimbursement pressure is consistent on, while Med D for sure is an annual contract that you'll see more regularly coming through, the pressure in the commercial book of business is also strong, and one does to some extent follow the other.

So the market is the market. We are very clear on how we govern within the business, and how we structure our pricing within the business. We do that both at the Walgreens level through myself and Alan Nielsen, our FD, and also the group level through Stefano and George, but the reimbursement pressure is real and we manage within the market.

So I don't think you'll see the upside to be really straight with you. In the future, I think you'll see continued reimbursement pressure and we are managing it through a combination of three things. Through more volume, through better partnerships which we are very happy with at the moment and are going well. Secondly, through increasing our retail gross margin and retail operating margin, where we are seeing good green shoots, and have seen good growth in the last three years, and that continues. And good cost control.

Eric Percher - *Barclays Capital - Analyst*

That's a straight answer, thank you.

Operator

Thank you. Our next question is from Steven Valiquette with Bank of America Merrill Lynch.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

So it's interesting now with some hindsight that Walgreens never ended up pulling the trigger on the international tax inversion phenomenon from a couple of years ago, even now you may be in a position to benefit from US corporate tax reform. It's really just a couple questions on taxes.

I guess first, over these past couple of quarters, you seem to have been able to get your tax rate down to levels that people were only dreaming about with this inversion craze a few years ago, so kudos on that. But how should we think about your tax rate for the rest of FY17? And then second, do you have any preliminary comments on the pros and cons of this potential US corporate tax reform, and what it might mean for Walgreens? Thanks.

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

I can answer on the second part of the question, whether we have some ideas on the coming tax reform. I can repeat the same thing I said before. Now there is not the project of tax reform.

There are certain principles, where people are discussing about certain principles. Not everybody in the administration agrees on the same principle, and even if they agree on the same principle they don't agree on the level of the quantity of the principles. So it's a waste of time today to start to create this scenario which very lightly will be in reality different, substantially different. So let's see when we will have the frame of the tax, and after we will start immediately to think how we can live with this new environment.

In any case, we will not have a new tax system tomorrow morning, it will take months, and we will have time to see how this will shape over time, and when we believe that we are close to that shape, we will start to see how we can work. But even though, having looked at the tax at a different principle that now have been debated, yes, there are certain principles that could damage us, but there are principles who could benefit us.

And it's clear that the principle who could damage us will damage all our peers, and so the market will find another equilibrium and other assets. So at the end of the day, the conclusion is that for the time being, we have to continue to work with the rules that are in place today, and probably one year or two years or three years we will have to change something, but now it's too early to distract our people to do things which probably would never happen, and at the end, the mix will be completely different.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

Okay.

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

The second part of your question?

George Fairweather - *Walgreens Boots Alliance, Inc. - EVP and Global CFO*

It's George. Just commenting on the rate itself, at the year end, we indicated our effective tax rate last year was I think around 26.3%, excluding the discrete tax items, and we look at the calc excluding ABC equity income on an adjusted basis, because it's the only easy way to do the math. This quarter we've come in around the 25.5%, so a little bit better.

It's a function really of two things, the geographic mix which of course varies quarter by quarter, and then the certain discrete items in an individual quarter, if it resolves historic tax issues or other discrete items that can have a little impact on the quarters-by-quarters results. That mix really reflects the composition of profits across Walgreens Boots Alliance, recognizing we obviously got profits from our international operations, and we try and obviously organize our inter-group funding structure in an efficient way from a taxation perspective.

And we obviously have sources of profit outside the US that benefit our rate, but beyond that really, not a lot to comment on. And Stefano has already commented on the view of what may or may not happen in the future, but we seek, we are very focused on EPS, and whether it's tax or whether it's our funding costs, they got a lot of focus in our organization, as well as adjusted operating income. And along with cash flow which Stefano also talked about, to drive shareholder value.

Steven Valiquette - *BofA Merrill Lynch - Analyst*

Okay that's helpful, thanks.

Operator

Thank you. Our last question is from Scott Mushkin with Wolfe Research.

Scott Mushkin - *Wolfe Research - Analyst*

So just wanted to talk about strategy, and I know Stefano, you talked about acquisitions overseas. When we think about Rite Aid, what's the Plan B if it doesn't get approved, as we get down to the end here in the US business, and then does that speed up some of your thoughts overseas?

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

We are working hard to have this deal approved, and for the time being, we don't want even to think of the fact that this could not be approved after so many months, when we have given a lot of information, and we have had a very good relationship with the people of the FTC. And they have continued to ask information, and we have continued to give information. And in reality, we believe that we have spend so much time asking and analyzing so many documents, is because they want to understand the substance of this transaction, which is fine.

So we are not thinking of a Plan B today. We don't have to distract people today. I can assure you that let's say, we had a big surprise, that this wouldn't happen after we would have to sit down and decide what to do, because there are many, many possible reactions to this, as you can imagine. We would have to see what our counterparty, Rite Aid wants to do, and see whether there are solutions or not, what are the other alternatives.

And in reality we would have money and we would use the money in the best interest of our shareholders. We will continue to act rationally and we will not spend the money in an irrational way, just for the matter of principle. We will analyze all of the opportunities very quickly, because I and the multiple people here are thinking the ways of difference and are analyzing many other things.

And I think we will decide what to do and we will communicate to the shareholders what we want to do. But I can assure you that we will not have, how could I say, a hysterical reaction, and we will not be forced do something at any cost, just to be sure we are doing something. We will take stock of the money that we have, and we will analyze very carefully and very rationally to achieve the best use of this money at the time for our shareholders.

Scott Mushkin - *Wolfe Research - Analyst*

It does seem like you potentially could litigate depending on what happens, is that correct interpretation of what you said?

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

Potentially sorry?

Scott Mushkin - *Wolfe Research - Analyst*

Potentially litigate.

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

Listen, how can I give you an answer like that? For the time being, everything looks fine, so we don't go so far.

Scott Mushkin - *Wolfe Research - Analyst*

Perfect, and I wanted to move on to one last question, and appreciate the time. So Boots in the UK, the retail side of the business, it sounds like it was slightly positive, but I think there were comments that maybe December got a little bit better.

We were over in the UK, it seemed like the discounting was pretty significant in the front end of the Boots operation, so I was wondering if we could get a little bit more color on the retail side of Boots, and what's going on there? And then I'll yield, thank you.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - Co-COO*

Hi, Scott it's Alex here. Yes, I think that as George said really clearly in the script, two things. First of all, the environment in the UK changed and it's a big change to the retail environment in particular, which we are working with. So we repositioned our business, and focused on rebasing our costs again, and also focused on customer care.

So the good news is these plans are working, and as George said, we've had a notable improvement in sales performance in through December, as we said in the script. And again, we're very much focusing back on that core business in a very clear way. The real challenges going forward, as I say for other retailers, which we are taking care of we have a very effective online omnichannel model which is working well, which we obviously have to operate our costs lower, because that does affect the margin slightly.

And of course, as George said in the script, from December 1, the government is taking additional action new action effectively on practice payments, which really means more callback in terms of pharmacy, which we are aware of and we've planned for and actually planned against, so we are feeling we are in a good position with a very strong business in a difficult environment, and we're pleased with the progress.

Scott Mushkin - *Wolfe Research - Analyst*

Thanks. Appreciate it. Good luck.

Operator

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

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

Thank you very much indeed, everyone. That concludes our call today. Obviously as ever, if you have further questions, please feel free to reach out to any member of the IR Team, myself, Ashish, Deborah, Jonathan or Patrick. And we will all look forward to seeing some of you during the quarter, and if not, talking to you all in the next quarter. Thank you very much, indeed.

Operator

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