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WBA - Q2 2015 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

WBA reported 2Q15 net sales of $26.6b and adjusted net earnings attributable to Co. of $1.2b or $1.18 per diluted share. Expects FY15 adjusted EPS to be $3.45-3.65.

CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Robert Jones *Goldman Sachs - Analyst*

Ricky Goldwasser *Morgan Stanley - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Walgreens Boots Alliance second-quarter 2015 earnings conference call. (Operator Instructions) As a reminder, this conference call is being recorded.

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

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

Thank you, Nicole, and good morning, everyone. Welcome to our fiscal 2015 second-quarter earnings conference call.

Today Stefano Pessina, our Executive Vice Chairman and acting Chief Executive Officer, and George Fairweather, Executive Vice President and Global Chief Financial Officer, will take you through our second-quarter results. Also joining us on the call and available for questions are Alex Gourlay, Executive Vice President and President of Walgreens, and Jeff Berkowitz, Executive Vice President and President of Pharma and Global Market Access.

As a reminder, today's presentation includes certain non-GAAP financial measures, and I direct you to our website at investor.walgreensbootsalliance.com for reconciliations of the most directly comparable GAAP measures and related information. You can find a link to our webcast on our investor relations website. After the call, this presentation and the webcast will be archived on our website for 12 months.

I'd now like to read out the Safe Harbor statement. Certain statements and projections of future results made in this presentation constitute forward-looking statements that are based on our current market, competitive, and regulatory expectations and are subject to risks and uncertainties that could cause actual results to vary materially. Except to the extent required by law, we undertake no obligation to update publicly any forward-looking statements after this presentation, whether as a result of new information, future events, changes in assumptions, or otherwise. Please see our latest Form 10-K and subsequent filings for a discussion of the risk factors as they relate to forward-looking statements.

Today's presentation includes certain non-GAAP financial measures, and we refer you to the appendix to the presentation materials available on our investor relations website for reconciliations to the most directly comparable GAAP financial measures and related information.

With that, I will hand you over to Stefano for his opening comments.

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

Thank you, Gerald. Good morning, everyone, and welcome to the first-ever earnings conference call for Walgreens Boots Alliance.

Let me begin by underscoring how pleased we were to finally bring the two Companies together on December 31, 2014. This was an historic and pivotal milestone for two iconic companies, Walgreens and Alliance Boots, as we completed our merger to establish Walgreens Boots Alliance, forging a new Company: the world's first global pharmacy-led health and well-being enterprise.

We established a senior management team to bring together our businesses and lead them forward to the next phase of their evolution, while making steady progress with the integration and the establishment of a single, unified corporate identity and culture. Our team worked very hard to accelerate closing the deal.

Two months [highlight] of the beginning of the completion window. We raised the funds to complete the transaction and refinanced essentially all the AB debt in an efficient manner, while going through a complicated process of preparing our first full consolidated earnings under US GAAP, including eliminating the three-month reporting lag. The complexity and effort these tasks have taken cannot be underestimated.

I would ask you to remember that, until completion, our businesses had to operate at arm's length as separate entities. We are today only 14 weeks -- in fact, 99 days -- into the creation of this new global entity. It is still very early, but we have moved mountains in what we have done and are still in the first steps of our journey.

We have achieved much in a short time and are moving quickly. We have expanded our restructuring program to create a more competitive cost structure; begun to access synergies created through the combination; and sharpened our focus on our strategic priorities, including the sales of a majority interest of our infusion business subsequent to the quarter close.

Today, I am pleased to announce a strong quarter, achieved along with all the other tasks that we have undertaken. We are looking forward to the future with enthusiasm.

Our transaction has created a group which I believe has enormous potential to grow in ways that give us a great excitement and optimism for the future. Let's start by looking at our business as we stand today.

Based on an in-depth review of our Retail Pharmacy USA segment, I can say that Walgreens is on a sound structural footing. As you might expect, some parts are better than expected, while others offer room for improvement.

Our first priority is to understand the business fully, its interdependency, and its differentiation also. This exercise is underway and will ensure we stay focused on what is truly important: delivering against of the needs of our customers in a dependable yet innovative manner that provides us with sustainable and growing income across all parts of our business.

This will be achieved through a combination of efficient practice, research, and insight, investment in our co-business, and innovation in our business model. From what we have seen already, we believe there to be significant scope to enhance the performance of our pharmacies through refreshing and differentiating our store, improving customer experience, delivering proven services to customers and patients, and introducing new offerings through innovative partnerships.

We believe that through good business practice and application of these and other initiatives, we can over time expand or retain margin, grow market share, and prepare ourselves to better address the competitive and market-driven headwinds we face in certain areas of our business. Let me be perfectly clear: our aim is to help Walgreens further develop strategies that will continue to deliver growth for many years to come.

It is vital that we make best use of the assets we have, core to which is our unrivaled portfolio of location across the US. We must work tirelessly to drive the best possible return from these assets; and to that end we have today announced an enlarged but necessary restructuring program to focus the Walgreens business back on its core assets. We believe we will come out of this stronger and better positioned to deliver enhanced performance that our premium location should command.

In Retail Pharmacy International, in Boots, we are working hard to refine the new cycle of our business that will deliver growth in the coming year. We are continuing to develop our online offering and building on recent success. We are working to further integrate this with our physical stores and logistical network to enhance the customer's choice while making better use of our resources.

The constant work to keep our offering fresh through innovation, within store and within our own brand and exclusive product portfolio, is continuing to differentiate us in the extremely competitive UK retail market. I am confident to that the work which Simon and his team are doing will set us on a path for further growth in the years ahead.

As well, our Retail business is also continuing to perform well. It has been a particular pleasure to welcome our new colleagues in Mexico and Chile to our Company, making the expansion of our International Retail presence in Latin America through the addition of two outstanding businesses with excellent prospects for growth.

Our Pharmaceutical Wholesale division is continuing to develop the integrated business model that we introduced many years ago, operating an ever-growing suite of services to the manufacturers that tie us more close than ever to them as partner. On the other side of the supply chain, we are expanding our offer into our pharmacist customers to both align them more closely with us, the wholesalers, and let them improve the quality and economics of their own businesses.

While such initiatives enhance the vertical integration of our Wholesale businesses and creates strength and value, the ever-changing market that we are operate in and they continuous economic pressure that healthcare systems are under present us with regular opportunities to expand our network. These present themselves in many ways: in one extreme, through consolidation within market; and at the other extreme, through innovative partnership and alliances, as you have seen us to do with AmerisourceBergen.

As Wholesale is a business that is enhanced by volume and market presence, we will continue to explore opportunities to expand our network as they arise.

Underpinning all of this, Walgreens Boots Alliance has embarked on the beginning of a new year, a new year that will bring a new attitude, a new culture, aligned toward driving [performance], serving our customers, and creating long-term, sustainable shareholder value.

Now I will ask George to take us through the quarterly results. George?

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

Thank you, Stefano. Good morning, everyone, and good afternoon to those listening in Europe.

Today I would like to cover the following three topics: first, to provide detail on our fiscal 2015 second-quarter performance; second, to provide you with an overview of our restructuring program; and finally, to articulate our views on FY15 and FY16 results.

To summarize, the second quarter was a solid start for our new Company. Key highlights include net sales of $26.6 billion; GAAP earnings per share of $1.93, while adjusted EPS was $1.18; cash flow from operations of $1.3 billion; and free cash flow of $1 billion.

The quarter's financial results are complicated, as we began reporting as a consolidated entity part-way through the quarter, and the comparability to last year is a challenge and of limited use. Before we get into the details of our second-quarter financial performance, I'd like to explain certain elements of our new reporting structure.

Historically, Walgreens has reported as one segment, which consisted of the results of Walgreens in the USA, its corporate costs, synergies from the Walgreens Boots Alliance Development joint venture, also known as WBAD, and equity earnings from Alliance Boots on a three-month lag. Our focus was to merge the businesses as soon as possible and eliminated the three-month reporting lag. This aligns the reported results of the global enterprise and will make our performance easier to understand going forward.

As Walgreens Boots Alliance, we now report results in three segments: Retail Pharmacy USA, Retail Pharmacy International, and Pharmaceutical Wholesale. Segmental reporting includes the allocation of synergy benefits, including WBAD and combined corporate costs.

Within our Retail Pharmacy USA segment, since the deal closed on December 31 we have reported one month of Alliance Boots equity income this quarter versus three months in the comparable quarter a year ago, recognizing the 45% stake that Walgreens had in Alliance Boots until end December. The months of January and February are fully consolidated.

Year-over-year comparisons of results require consideration of the foregoing factors and are not directly comparable. So now let me take you through our financials in greater detail, beginning with the consolidated results.

For the quarter, GAAP net earnings attributable to Walgreens Boots Alliance were just over $2 billion or $1.93 per diluted share, while adjusted net earnings were $1.2 billion or $1.18 per diluted share. This compares to $0.74 of GAAP net earnings per share and $0.97 of adjusted earnings per share in the prior-year quarter.

Net sales in the second quarter were $26.6 billion, an increase of 35.5% versus the prior year. Operating income on a GAAP basis was $1.4 billion and on an adjusted basis was $1.8 billion. The increase in adjusted operating income was driven by growth in our Retail Pharmacy USA segment, as well as the consolidation of Alliance Boots results for January and February.

We reported $144 million of net interest expense this quarter, which included interest expense associated with the pre-funding of the transaction for the month of December. Consistent with last quarter, our adjusted EPS excludes this interest expense, which we will not need to do going forward.

The adjusted tax rate for this quarter was 27.7%. Now, this has been impacted by a number of factors including a change in the geographic mix of forecast profits now that Alliance Boots has been fully consolidated. It includes net discrete tax benefits specific to the quarter and the presentation of Alliance Boots taxes in the income statement.

Prior to the full merger, Walgreens' 45% of Alliance Boots adjusted results, net of Alliance Boots' tax, were presented in a single line within operating income. Now, following the transaction, Alliance Boots tax is reported within the income tax provision line in our income statement, impacting the calculation of the adjusted tax rate.

Diluted shares outstanding at the end of the quarter were 1.1 billion, and average diluted shares outstanding for the quarter were 1.05 billion, resulting from the issuance of 144 million shares on December 31 as part of the consideration for Alliance Boots.

Now let me walk you through the component pieces to explain the change from GAAP to adjusted EPS. The GAAP earnings per share for the quarter of $1.93 reconciles to an adjusted earnings per share of $1.18. The net adjustment of $0.75 per share, this reflects the removal of net gains on transaction-related item of $0.67 and gains on the warrants we hold of our AmerisourceBergen shares of $0.35, which was partially offset by LIFO provision costs of $0.04, acquisition-related amortization expenses of $0.15, which includes $0.08 relating to the inventory step-up which will not reoccur in future quarters, and special items of $0.08 related to optimization costs and asset impairments.

The components of the net gain on transaction-related items were a gain on Walgreens' previously held equity interest in Alliance Boots of $0.77, a foreign currency hedge loss of $0.07 related to the delivery of the British pound element of the Step 2 consideration, and a net $0.03 cost of transaction fees, tax adjustments, and interest costs from pre-funding the cash consideration.

Next I'd like to provide insights into financial results at the segmental level, starting with Retail Pharmacy USA. Reported net sales were $21 billion, up 6.9% on a comparable-store basis. In the pharmacy, comparable-store scripts, which includes immunizations, these increased 5% on a 30-day adjusted basis. The increase was driven by the positive impact of a strong cough, cold, and flu season; by continued growth in Medicare Part D scripts; and positive underlying share trends.

For the quarter ending February 28, the division's 30-day adjusted retail prescription market share in the US reached 19.3% as reported by IMS Health. This represents an increase of 20 basis points versus the same time last year. In retail products, comparable-store sales increased by 2.5%. This was partially driven by strong December holiday sales, including seasonal sales of cough, cold, and flu products.

GAAP operating income for the quarter was $1.3 billion, while adjusted operating income was $1.6 billion, up 13.4% over the year-ago quarter. Strong expense control and efficiencies offset the expected pharmacy gross margin pressure from declines in reimbursement, generic drug inflation, as well as the Med Part D rate step-down that began on January 1 this year. Retail product margins increased this quarter, helped by seasonal and cough, cold, flu mix as well as our focus on reducing less profitable promotions.

We remain very pleased with the progress on controlling and reducing SG&A expenses this quarter. Our GAAP SG&A expense declined 0.3% compared to the prior-year quarter.

Next let's review the Retail Pharmacy International division, which is pharmacy-led health and beauty retail businesses in eight countries. The biggest contributor is Boots in the UK.

Total sales for the two months ended February were just over $2 billion. As the businesses included in our Retail Pharmacy International division were acquired as part of the merger with Alliance Boots, no comparable information is included in the WBA consolidated results.

On a pro forma constant-currency basis, comparable sales for January and February grew by 2.9%. Comparable sales at Boots UK were up 2.3%, while sales in our businesses in Chile and Mexico, which were acquired by Alliance Boots back in August 2014, these were up 2.9%.

The acquisition brings us over 1,000 stores in Mexico and over 400 in Chile and provides strong growth opportunities in the Latin American markets. Inclusion of these businesses in the division, combined with contract manufacturing, are reflected in the margins.

Now turning to Pharmaceutical Wholesale, which mainly operates under the Alliance Healthcare brand in 12 countries. Results in any given quarter are influenced by performance in larger geographies including the UK, Germany, France, and Turkey, and the division's contribution from WBAD. Total sales for the two months ending February were $3.9 billion.

Similar to Retail Pharmacy International, our Pharmaceutical Wholesale division was acquired through the merger with Alliance Boots, and so no amounts are reported in the comparable period. However, on a pro forma constant-currency basis, sales were relatively flat compared with the same period the prior year.

Now let me spend a minute on our expectations for synergies and how they will be reported going forward. Prior to the merger, the majority of our synergies were flowing through WBAD, the former joint venture between Walgreens and Alliance Boots, which Walgreens fully consolidated and then removed the Alliance Boots portion via the noncontrolling interest line item. Following the combination, we are allocating all synergies, including those generated by WBAD, to the segments; and we are doing this according to the relative proportion of purchases driving the synergy benefits.

With regard to performance in the quarter, combined net synergies were $170 million, bringing the fiscal year-to-date total to $310 million, driven primarily by our drug procurement efforts. We remain comfortable with our ability to achieve at least $650 million in combined synergies this fiscal year.

For FY16, we continue to expect at least $1 billion in combined, quantifiable net synergies. Consistent with prior reporting, these synergies do not include any benefit from our AmerisourceBergen relationship.

Now that we're a combined Company, as expected, we are focusing on driving incremental synergies from sharing of best practices and working more closely together. However, not all of these can be easily quantified, as some of them tend to blend into our normal business.

So, moving on to the cash flows, we generated approximately $1.3 billion in cash from operations during the quarter, and our free cash flow was $1.0 billion. We're pleased with the cash generation during the second quarter, due in part to an improvement in our primary working capital within our Retail Pharmacy USA division driven by reduction in inventory levels. We will continue to focus on working capital and remain confident in future opportunities to increase efficiencies.

Net debt as of the quarter end was $14.1 billion.

With regard to uses of free cash flow beyond reinvestment back into the Company, we completed $94 million of share repurchases in the quarter against our $3 billion authorization. We've purchased additional shares post the end of the quarter under preestablished trading plans, bringing the total purchases to $330 million.

I would now like to make a few comments on our capital allocation policy. As we've consistently communicated, we remain committed to a solid investment-grade rating while looking for ways to enhance our cash generation. This includes driving working capital efficiencies, tightening capital expenditures, controlling costs, and of course improving operations.

Beyond maintaining a long-term 30% to 35% dividend payout target, our top priorities for free cash include M&A consistent with our strategy and share buybacks. All of these are with a view to optimizing long-term shareholder value. Following on this theme, and as Stefano mentioned, we are focused on becoming a more agile and more productive Company.

As you know, in August 2014 we announced a three-year $1 billion cost-reduction initiative. After a rigorous analysis we've identified additional opportunities for cost savings, primarily in our Retail Pharmacy USA division. These additional cost opportunities will increase the total expected cost-savings program by $500 million to a projected $1.5 billion by the end of fiscal 2017.

So [moving nearer] is the focus include plans to close approximately 200 stores across the USA; to reorganize corporate and field operations, drive operating efficiencies, and streamline information technology and other functions. These actions are designed to restructure and invest in our Company's future in a way that is better for customers and simpler for our employees, resulting in a faster and more agile organization.

We estimate that total pretax charges associated with this program to our GAAP financial results will be in the range of $1.6 billion to $1.8 billion, of which the cash component is expected to be approximately 60%. The restructuring charges will be recognized over time as the program is implemented, in accordance with GAAP. Looking ahead, we will continue to focus on other areas of cost reduction.

So now let's talk about the rest of fiscal 2015. We understand and appreciate that there are a lot of factors that impact our results; so in order to help you, we are providing an adjusted EPS guidance range of $3.45 to $3.65 for fiscal-year 2015.

Now, this range assumes quarterly interest expense of $140 million to $150 million. It assumes a full-year adjusted tax rate of approximately 29% and a fiscal-year diluted share count generally consistent with the current quarter.

It assumes management's estimates for foreign exchange rates that reflect current market rates over the balance of the fiscal year. Now, this guidance also includes recast fiscal Q1 results due to the elimination of the three-month lag.

Finally, you will see an increase in the share count in Q3 and Q4 due to the full inclusion of the 144 million shares issued with Step 2 of the AB transaction. This will result in approximately 1.1 billion diluted shares per quarter. Any additional share repurchases will impact, of course, the fiscal-year diluted share count.

Moving on to FY16, our previously published goals were based on a variety of assumptions to arrive at estimate ranges for both sales and adjusted EPS. These included operating assumptions for our businesses and certain below-the-line items including interest, tax, and share count.

When we set the goals in August, we made foreign currency assumptions based on exchange rates that were close to market rates at that time. Since then we've seen significant global currency movements, especially the strengthening of the US dollar.

Because we report in US dollars, we do have currency translational exposures, primarily based on movements in the pound sterling versus the dollar. Simply put, a stronger dollar hurts our sales and earnings in dollars, while a weaker dollar helps them.

We estimate that a 1% move in the pound sterling versus the dollar from current levels would impact our adjusted EPS by approximately $0.01 per share. Despite the FX headwind, I am confident that we have initiatives and resources in place to address the controllable elements that drive our adjusted EPS goal for FY16.

Our revenues have greater potential variability due to the varied mix of businesses, particularly in our Wholesale division, which accounts for a significant proportion of our overall revenue. In addition, the geographical spread of the Wholesale business increases its exposure to currency variations.

This being the case, we view overall revenue as a less relevant measure of our business. So taking these two factors into account, we decided to no longer provide our published revenue goal. Please note that our forward-looking statements assume no significant changes to the current exchange rates.

I'd like to wrap up today by saying that our reporting structure has changed and comparability is limited, which I know makes it really difficult for you. Therefore, in an effort to be as informative as possible, we've provided adjusted EPS guidance for fiscal-year 2015; and next week we will have a financial session to provide further insights.

In addition, we plan to provide operational insights in each of our three segments, as well as views on our key financial drivers and future strategy. We really look forward to seeing you then.

With that I'll turn the call back to Stefano.

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

Thank you, George. Let me finish today by reminding you of our key priorities as we look forward.

We are working to deliver the benefits of our transaction within our core businesses. This will involve executing our synergies and efficiency programs across the Group, including the progressive development of our procurement initiatives.

We must also properly manage the assets of the business to ensure we are suitably structured and prepared to address the pressures we face as the pharmacy market evolves. These pressures may variously be from reimbursement cuts, competitive action, or simply changes in consumer behavior. Whatever form they take, if we are properly structured and prepared, operating an efficient, high-quality, patient-oriented pharmacy service, we will earn the right not just to participate but to be [enactive] of the changes in our market.

We are already seeing the benefits that can be achieved in Retail with the initiatives underway at Walgreens and ongoing at Boots. We must ensure that we get the best return for our investment and create the best environment for our employees and customers alike. This will require us to operate enhanced systems and control so that we can monitor and manage our business [operations].

Now, many of you have asked where we are on the CEO search. As you know, we formed a search committee of the Board and they have been working with one of the top executive recruiting firms to help us find a new CEO.

Currently, we are in the process of reviewing the candidates they have proposed. Finding candidates with the combination of attributes that we deem important for the role is naturally challenging, as we expected it to be; but we remain confident that in due course we will find the right person for the job.

Lastly, as the new culture takes hold and finds roots in a Company, you can see echoes of it in all parts of the business. I hope that in one particular area you are seeing the new culture emerge very clearly, and that is in our approach to our owners and the financial community in general.

I have always viewed investors as my business partner, as I hope that they will view me in the same way. As an organization, we strongly believe it is our duty to care for our shareholders and ensure that we are as accessible, responsive, and transparent as we can be.

We also believe in being proactive in reaching out to our investors to properly understand their requirements and ensure that in our investor relations efforts we are as mindful of our shareholders as we are of the patients in our pharmacies or our customers in Wholesale. I think that Gerald and his team have done well to demonstrate these new [hakers], and it is a great pleasure to see, although there is still more to do.

We are on the first step of a long and exciting path, and I look forward to traveling it with you as fellow owners and partners. As I said earlier, I am optimistic about the long-term future of our Company and have made a significant personal commitment to our future, not only as Executive Vice Chairman and Acting CEO, but also as a significant shareholder.

I am convinced that the formation of Walgreens Boots Alliance is a unique first which will almost inevitably lead to many other new firsts in our industry. It may not yet be clear which steps these will be, but we are determined to continue to show the way and be at the forefront of innovating healthcare.

Our ambition is to build a [genuine] global Company and a universal healthcare champion. We look forward to providing a more comprehensive outlook on our future strategy and value creation next week at our first Analyst Day.

With that, we are now ready to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Robert Jones, Goldman Sachs.

Robert Jones - *Goldman Sachs - Analyst*

Good morning and thanks for the questions. I know we will get a lot more detail next week at the Analyst Day, but I thought maybe I would start on the incremental cost cutting you introduced today.

I believe the previous expectation was for the bulk of the cost cutting to come in fiscal 2016. Just curious if you can give an update on how we should think about the cost cutting over the next three years.

And then related to that, given that there is an additional $500 million in cost cutting, obviously reiterating the fiscal 2016 guidance, wondering if there was any negative offsets that you've realized since giving that 2016 guidance. Thanks.

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

George, and after Alex can give you, I believe, a satisfactory answer.

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

On our first priority, I think -- now remember, we're merged as a relatively short time; a key priority is to see what additional savings were achievable.

The second, the increase of $0.5 billion will take time to come through. So quite a lot of this will be into the year -- into 2017. So it's really over the next two and a bit years is how I would look at that in terms of driving performance.

I think what's -- when we're -- the piece I would really reiterate on the guidance that we have given is: please do remember the change in currency. And remember, sterling is about $1.48 today and it was about $1.68 back in August, just as a reminder. So in setting the guidance and reaffirming the guidance, you've got to take into account that we've had an unfavorable wind on the currency versus some of what we're doing in other areas.

Robert Jones - *Goldman Sachs - Analyst*

That's fair. Then I guess just maybe more near term, looking at the US SG&A: quite a bit lower than what we were looking for and obviously quite a bit lower than it was a year ago this time. I am just wondering if you could give a little bit more clarity on what went on within the US SG&A line.

Is that reduction that we saw there in any part a result of these cost initiatives? Or is there other things at play within the US cost structure?

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

Alex?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Hi, Bob, it's Alex here. Yes, it's a combination of both. First of all, the additional $500 million is going to be -- almost all be in 2017; so this is a result of what we've been doing over really the last nine months, as we've really deeply understood the current operating model and really tried to lay out the ground for the new operating model that we are going put through the business.

We've been really successful. The team have done a great job in Walgreens, in terms of being able to find cost savings that do not affect the customer. The most pleasing thing about this, beyond this cost savings, is the fact that we are still growing volume ahead of the market both in pharmacy and in retail products; and also we are seeing internally our measure in customer delay improving.

So the whole idea of better for customers, simpler for our teams, and more faster, agile organization is what's driving all of this; and we will keep on going. We will keep on working the old model and creating the processes, the IT structures for the new model.

So yes, we are delighted with the SG&A savings in this quarter, and they are materially better than the same period last year. And as part of the restructuring we started already is in there, but a lot of this also is just good ongoing cost control and cost management.

Robert Jones - *Goldman Sachs - Analyst*

Great. Thanks for the comments. I look forward to seeing you guys next week.

Operator

Ricky Goldwasser, Morgan Stanley.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Yes, hi. Good morning and congratulations on closing the transaction and a good quarter. When we think about this space, the consolidation obviously continues. We just heard the news last week on, like, how United is thinking about the supply chain and the payer world.

Do you think that you now have all the relevant pieces that you need in the US market? Or are there still areas that you think that you might be missing or below scale at?

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

Well, what we think is not really important. The reality is that, as I have said many times -- and I have realized immediately after being for two weeks in the job -- is that this market, the American market, is ready for another round of consolidation. Because the margins are squeezed everywhere; the government is more and more in charge for the costs of the healthcare business and so for sure they will exercise their power to squeeze the cost as much as possible, as we have seen in Europe for decades.

So the complex structure of delivering the medicines to the patients will have to be rationalized. And as a consequence, it's easy to believe that we will have additional synergies coming from M&A activities.

These could be, of course, at a level of horizontal consolidation. But in many layers of the chain, the consolidation is still up and is still quite advanced.

So it's very likely that we will see also vertical consolidation, and the opportunities are there for everybody, and we will see what happens. But as I have said before, we want to be, as we have been in the past, at the forefront of changes. So if this need for consolidation will be confirmed, we will try to be part of it.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Okay. Then just as we think about the trends on the front end, can you talk a little bit about promotional activities in the quarter and just how you think about promotional activities for the rest of the year, and also about private-label penetration?

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

Alex?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Hi, Ricky; it's Alex here. Yes, the team have built a new tool in and there's some good data. So this has been driven really from the implementation of Balance Rewards, the insights we are getting; and they're driving that through better tools for merchants.

So the merchant team has done a really great job in terms of understanding more precisely where customers truly value promotions and where actually they don't. And you can see the growth in the front-end margin; you can obviously see the growth in product sales at the same time. So we have really been able to pull these two things off together.

We feel confident with the new tools we've got and the [capable] to developing will continue forward. Also a great hire. Linda Filler has come into us, and again, Linda we believe will accelerate that journey given her tremendous experience in Walmart and Sam's Club in particular. So that feels pretty good.

In terms of own brand penetration, we've created a new division within the organization within Walgreens Boots Alliance led by Ken Murphy. And again we are able to think about how do we understand, look close, [say] it's America and also global insights; and Ken will speak more about this next week. And how therefore do we get the right products and the right brands into the American consumers' hands in the drugstore channel.

Having said that, we've done a couple of things recently. We have introduced two new mass-dis cosmetic brands, CIRCA and Colour Prevails. That has happened in the last two or three weeks.

So we are not waiting for that to happen. We continue to work on a base of growing own brand penetration.

So I think in both fronts we made good, solid progress, and there is more to come.

Ricky Goldwasser - *Morgan Stanley - Analyst*

Great. Thank you very much and see you next week.

Operator

Lisa Gill, JPMorgan.

Lisa Gill - *JPMorgan - Analyst*

Great; thanks very much. George, as I look at the first half versus the second half, it looks like there is a deceleration in earnings. Can you talk about what the primary contributors are there?

I am just curious if the Medicare Part D -- while you talked about the trends being positive from a script perspective, we know that there has been pressure there on the reimbursement front.

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

George?

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

Yes, there is a number of factors. And I know it makes it really, really complicated looking half year and half year, because of course it includes the deal and remove from three-month lag, etc.

In terms of Med D, the step-down, obviously firstly we've got two months' results in Q2 given this kicks in at the beginning of the year, but will impact us for the full quarters in each of Q3 and Q4. Second half of the fiscal year is seasonally weaker than our first half normally.

And of course I know we haven't got all the comparables to give you the overall seasonality, which makes it tough to model. And then of course we've got the exchange rate issue as well coming in because of what's -- where the exchange rate has moved over the last number of -- the last six months; and of course we were all still bringing in the 45% of AB at that point in time.

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

Alex, maybe you can add something.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Yes, absolutely. We have also got some cost-savings timing. For example, we've got much closer to the plan of how we are going to actually drive out the cost savings, and therefore we've been able to take a few more of the cost savings in the first half relative to the first half of last year.

Then the remainder of the year we have still cost savings coming through, but we actually had quite a lot of costs ratings in Q4 of last year to go against.

Lisa Gill - *JPMorgan - Analyst*

Then my second question would just be around generics. If we think back to last summer, a lot of talk about drug price inflation on generics being a headwind. As I think about the generic pipeline for the back half of your year, it looks to be improving.

Can you maybe talk about what you are seeing, one, on drug price inflation and the impact that is having? Are you able to offset that with your procurement entity?

And then secondly your outlook for incremental generics that are going to come as we go through the next couple of quarters. Thanks.

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

Jeff, can you answer this question?

Jeff Berkowitz - *Walgreens Boots Alliance, Inc. - EVP, President of Pharma & Global Market Access*

Sure. Thanks, Lisa. The generic manufacturers are continuing to react to the supply issues and approval delays in ways that we've come to expect, which is what has been driving the inflationary environment. But we do continue to see a similar range of inflation as we seen in the past 12 months or so.

The teams of WBAD, Walgreens, ABC, and Alliance Healthcare are all continuing to work extremely effectively together to assure -- that is the biggest buyer of generics in the world -- that we are appropriately managing the industry dynamic. The teams in particular have gotten very sharp and have a number of effective mechanisms in place and are working very collaboratively with the generic drug manufacturers to really manage through this dynamic. They have gotten very flexible and nimble in understanding the marketplace, where there might be issues, and really managing them proactively.

In terms of the generic pipeline, we've recently seen in February the entry of Nexium; but we haven't seen it go multisource, and we are looking forward to that. We are seeing the list of generics that are coming out. We are looking forward to maximizing those opportunities as they come.

Lisa Gill - *JPMorgan - Analyst*

Great. I look forward to seeing you next week.

Operator

George Hill, Deutsche Bank.

George Hill - *Deutsche Bank - Analyst*

Good morning, guys, and I'll echo the congratulations on getting the transaction closed. You highlighted in the press release a target of closing about 200 stores. I guess the first thing I am wondering is, is that a complete evaluation, and could there be upside to this figure?

And how should we think about the earnings profile of these stores? We would assume that they are less profitable than the composite of the business. But is there any chance that they are losing money and there is going to be a positive margin lift from this?

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

Alex?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Hi, George; it's Alex here. Yes, we have done a thorough review; and again, we have been doing this for a while. We have also reviewed the performance of the closure of the stores we made in the last year as well.

The good news there was that we saw more retention of customers and we saw the ability also to retain a lot of our people as well, which is really important to us as a team and as a business. So we feel confident about the number we've given out, approximately 200.

Of course we will tell our people first where we are going to go and actually making these closures. Another key point is that we will be opening up about 200 stores in the same period. So this really is just getting the right stores in the right place.

I also think it's about the right cash and the right returns per store basis. This is a very individual store-based decision; and of course in the stores which are potentially going to be closed we have looked carefully at the markets today and the number of customers in them and how they are shopping that market, and also how the population has flowed over the course of these stores being open. We've seen stores which really -- the population is moving away from and there is less future opportunity than today.

George Hill - *Deutsche Bank - Analyst*

Okay. That's helpful. Maybe if I can go with a quick follow-up, you guys also highlighted that your synergy targets explicitly exclude the ABC relationship. I guess, where should we think about where we are in the lifecycle of that relationship?

I guess, how much cost can continue to be taken out? And maybe from an inventory perspective, what can still be taken out?

I guess, like, is there a lot of store inventory left that can be taken out and better served through the DSD delivery of ABC? Thanks.

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

Alex?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Hi, yes, it's Al again. Yes, we have made really good progress in terms of inventory reduction. Myself and Jeff are working really close in this together.

It's really end-to-end view from the pharma manufacturers all the way through ABC into the work which Ashworth is doing in stores. We are also seeing, importantly, our service levels improve as well.

So again we've seeing this nice thing. When you get less [bulk] at the system, you improve costs and you improve working capital; and importantly you improve service levels. So again we will continue to work at this.

There are more opportunities. And we will do it in a really balanced way to make sure that we care for our customers first, get our items going forward, and the Tier 1 capital out. And we're confident that the working relationship with ABC will continue to improve.

And of course working in Europe as I did before with Ornella and the team at Alliance Healthcare, we really worked this well for a number of years and saw more and more opportunities, which comes through very clearly in the UK business performance for both the Wholesale and Boots division.

George Hill - *Deutsche Bank - Analyst*

Okay. That's helpful. Thank you.

Operator

Steven Valiquette, UBS.

Steven Valiquette - *UBS - Analyst*

Morning, everybody. Congrats on the results. I guess for me, just a clarification question on the gross margin for the quarter. I think the LIFO adjustment is pretty straightforward; but I think I heard you mention there may have been an inventory step-up charge as well.

So I apologize if I missed this, but I guess, did you provide the fully adjusted gross margin for the quarter, just to make it a little bit easier for us?

And also part two within that, just curious: all the talk about the US Medicare Part D rate reductions that went into effect on 1/1/15, is there any way just to get a rough sense for how much that impacted the gross margin in the quarter? Was it perhaps 100 basis points year-over-year or maybe something greater than that? Just trying to get a sense for that. Thanks.

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

So, George, you can answer to the first answer.

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

I'll try not to (multiple speakers) the inventory step-up one. It was $0.08 because under -- that is in the legacy AB businesses; so it's in the Retail Pharmacy International and Pharmaceutical Wholesale.

And that we've -- it's one of the key differences between adjusted and the US GAAP results. And that's simply because under -- when you are doing the purchase accounting -- and we have done the provisional purchase accounting allocation where we got a year to finalize that -- what you have to do is revalue the inventory at selling price less a small margin.

So we are not valuing the inventory at cost. So that it gets -- what it does is it essentially artificially takes down the US GAAP profit in those two divisions as a result. So that's why we've stripped it out, to show the operating results with that out.

It has no impact at all on the comparables, because it doesn't impact the Retail Pharmacy USA segment. I'm sorry there's so many of these adjustments.

We will try -- next week I will try and take you perhaps through them in a little more detail. It really does make it very difficult to articulate the story as clearly as I am sure you would like and we would like.

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

Jeff, can you answer to the second question?

Steven Valiquette - *UBS - Analyst*

Yes, that was just the impact on the Medicare Part D, within the quarter, just roughly how much that might have impacted the overall gross margin. That was the second question. Thanks.

Jeff Berkowitz - *Walgreens Boots Alliance, Inc. - EVP, President of Pharma & Global Market Access*

Yes. Medicare Part D, it's an important component of the business. We are not commenting specifically on the gross margin impact.

You know that we've said it's about a third of our business moving forward. Right now we're in the midst of negotiations for the 2016 year. They are very productive right now; but we are very -- it's very early days in terms of the impact moving forward.

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Yes, from a volume point of view, we are pleased with volume; and really the margin has come through as we expected. So again, this is really a -- it really has been a solid selling season, and we feel good about the pullthrough.

Steven Valiquette - *UBS - Analyst*

Okay, all right. Great. Thanks.

Operator

Mark Miller, William Blair.

Mark Miller - *William Blair & Company - Analyst*

Hi, good morning, everyone. Thinking about the opportunities with both horizontal and vertical consolidation, that obviously goes in many different dimensions. But when you think about the opportunities, is it more about getting leverage with suppliers, or more about getting leverage with payers in pharmacy?

And then I guess sub-point to that is getting more scale within the retail operations. Or is it more about strategic moves that allow you to drive more share across your own network? I am specifically thinking about better managing the payer relationships and potentially having some type of a pharmacy benefit management relationship.

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

Well, it's Stefano. In -- of course, we are looking at the market. I have -- I believe that we are starting to understand quite well the market, and there are many opportunities.

When we talk about opportunities, of course we don't exclude atypical M&A opportunity. But there are many, many opportunities which are not related to an acquisition or to a merger, related to a potential joint venture, commercial joint venture, as we did initially with WBAD when we approached Walgreens.

When we started our discussion, the first thing we decided was to create this joint venture to buy together. This joint venture would have been there even without the merger.

So there are many ways to deliver synergies, and of course we are open to any kind of organization which can improve the value of our Company. We are analyzing many, many different alternatives. And, of course, it depends also on the maturity of the potential partners, on the willingness that they have to do something with us.

What I was saying is that the market goes clearly in one direction, and sooner or later these kind of things will happen.

Mark Miller - *William Blair & Company - Analyst*

I assume if we are speaking about this real-time that you believe the organization is ready to move when the opportunities develop, I mean, given everything that's going on with the consolidation of Walgreens and Alliance Boots?

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

We have always been able to face the opportunities because -- of course, it will take time to create the platform here in Walgreens Boots Alliance, a solid platform, because of course we have to integrate the two companies. The integration is doing very well, I have to say -- higher than my expectation.

But still there is a lot to do.

But the fact that we have not yet finished this job doesn't mean that we cannot do something else in the meantime. Of course if we had an opportunity, we will take this opportunity. And you know, any big, important opportunity -- be it an M&A activity, be it a joint venture, a commercial joint venture -- takes months to be perfectionated, to come to life. So we will have time to continue our integration while discussing with other possibilities.

Of course, if we will see opportunities, we will be ready.

Mark Miller - *William Blair & Company - Analyst*

That's helpful. Thanks. Then just quickly, George, does the EPS guidance -- can you clarify whether that includes additional share repurchase?

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

We've obviously got our $3 billion program authorized. So I think that should give you an indication of our thinking in that respect.

We've obviously not been specific on this, but we wouldn't have put a program in place if we hadn't felt that we had the ability to generate the necessary cash to complete that program whilst maintaining solid investment grade.

Mark Miller - *William Blair & Company - Analyst*

Thank you.

Operator

Edward Kelly, Credit Suisse.

Edward Kelly - *Credit Suisse - Analyst*

Yes, hi. Good morning, guys. I have a question on your guidance, particularly as it relates to getting to 2016. Could you just give us a little bit of color on what your expectations are for the underlying growth of the business? Maybe profit dollar growth by division that you've contemplated here.

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

In terms of the overall guidance, we're really today just reaffirming the guidance that was put out in the summer last year, recognizing that currency has gone against us. We have not been through, obviously, our intensive, detailed budgeting exercises as a combined Group, and we are getting everything on a comparable basis under US GAAP. So we are going through quite a bit of change to try and then be -- to go through this process.

What we will try and do next week when we meet is try and give you a little bit more insight into the drivers as we go through each division's section. And then we've got the half-day on the financial modeling on the Thursday; so hopefully we'll be able to give you a little bit more insight in that.

It is quite complicated because of the lack of comparability. Because we have obviously put the segments in place that particularly reflect in terms of where the synergies are. We are putting the synergies in where the real economic activity is happening.

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

So, you don't have to be too impatient. At the end of the day you have to leave us with something to tell you next week.

Edward Kelly - *Credit Suisse - Analyst*

All right; that makes sense. Then just one quick follow-up for you on real estate. Obviously getting smaller is not necessarily something that you want to do in US pharmacy. But do you still have other stores that you would consider underperforming or lower-margin stores?

I guess the question would be, what's the real answer to improving those stores if it's not necessarily closing them?

Alex Gourlay - *Walgreens Boots Alliance, Inc. - EVP, President of Walgreens*

Yes. I mean obviously we have a range of stores. I said before as I really get a look at this and this is about 2% of our estate we've talked about this morning, so therefore 98% of the estate is in either good or satisfactory order.

I think also we've done a lot of work on the front end. We are becoming more confident about our ability to not just improve the front end through margin expansion, but to develop potentially new formats, integrate [particular] assets to become all new channels.

Some of the work really that Simon and the team have done in Boots has been great in that respect in the last couple of years. So there will be different strategies that we will apply over the months and years ahead to make the very most of what is a great set of assets.

Stefano said this in the introduction. We have got the best corners in America, and we've looked at them, and we still think they are really important assets to the future of the Walgreens Company.

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

But also -- Stefano here -- also we are talking of a few hundred stores, with the stores that we have already closed. A few hundred stores. It means a few percent, a few unit percent of the number of stores that we have.

In reality all the retailers should, let's say, have a program on maintenance for their stores. And when you have such a vast territory, such a high number of stores, ineluctably you will have some stores which have been maybe profitable in the past and are not particularly exciting today; and you will need to open stores in areas which didn't even exist in the past.

So the reality, you see a certain concentration -- which is still small, because a few hundred out of 8,300 stores is not a big number -- but you see it, a certain concentration, because this program has not been done in the past in an orderly fashion. In the future, once we have, let's say, re-created these new [bays], I believe we should every year look after -- review all the stores; and if we have every year -- if we have to close 10 stores, or five stores, or 15 stores we will have to do it, in order not to have this concentration of stores just in one year.

Because it is better to do this gently over time. Tactically this will be business as usual, and nobody will see the reality (multiple speakers) inside the Company.

Edward Kelly - *Credit Suisse - Analyst*

Excellent. Thank you.

Operator

Thank you. That is all the time we have for questions today. I would like to hand the call back over to Gerald Gradwell for any closing comments.

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

Thank you, ladies and gentlemen. I know there have been plenty of other questions we haven't had time for today.

We are looking forward to seeing as many of you as possible next week at our analyst event on the 15th and 16th in New York. That will also be webcast live and will be archived on our investor relations site; so I hope as many of you as possible can participate in that.

We will address as many of your additional questions as we can then. And thank you very much indeed everyone for participating today.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Have a great day, everyone.

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