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WBA - Q1 2018 Walgreens Boots Alliance Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 sales of $30.7b, GAAP net earnings attributable to WBA of $821m, and GAAP diluted net EPS of $0.81. Expects FY18 adjusted diluted net EPS to be $5.45-5.70.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Walgreens Boots Alliance First Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

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

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

Hello, and welcome to our 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 will find a link to our 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 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 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 our 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'll now hand you over to George to take you through the numbers.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Thank you, Gerald. Overall in the quarter, we have delivered strong business performance both in terms of adjusted profit and cash flow, which gives us a good foundation for what we expect to be a solid year. We are particularly pleased with the continued growth in U.S. pharmacy volume and market share. We recognize, of course, that our GAAP numbers have been significantly impacted by some notable special items, which I'll talk about in a moment.

During the quarter, we completed the $5 billion share buyback program announced in June plus the additional $1 billion expansion announced on our last earnings call. Of course, our other development was Rite Aid regulatory clearance in September. In October, we started to acquire our first stores. This has gone well, and by the end of December, we have bought a total of 357 stores.

Since the quarter end, we have announced our agreement to acquire a 40% minority stake in GuoDa, a leading Chinese retail pharmacy chain with over 3,500 pharmacies across 70 cities. While this transaction in the context of the group is relatively small, we believe it has significant potential for the future. We have also announced an agreement to reduce our investment in our wholesale partner, Guangzhou Pharmaceuticals Corporation, giving us a cash-on-cash return of 3.6x. This will leave us with a 20% interest in this successful partnership. Both transactions are, of course, subject to regulatory approval and customary closing conditions.

Moving on to guidance. Today, we have raised the lower end of our adjusted diluted earnings per share guidance for fiscal year 2018 by $0.05.

So now I'll take you through our results for the quarter. Sales for the quarter were $30.7 billion, up 7.9% versus the comparable quarter. On a constant-currency basis, sales were up 7.2%. Currency was moderately favorable, the U.S. dollar being around 5% weaker versus sterling than in the comparable quarter last year.

GAAP operating income was $1.3 billion, down 8.6% versus the comparable quarter. Adjusted operating income was $1.8 billion, up 4.8% and up 4.4% in constant currency. This quarter, GAAP operating income was adversely impacted by our share of AmerisourceBergen's litigation accrual as reported in their last quarter results and by the hurricane-related storm damage and store closures, which I highlighted back in October. We estimate the trading impact of the hurricanes to be around $90 million of sales and a few cents of adjusted EPS.

GAAP net earnings attributable to Walgreens Boots Alliance were $821 million, down 22.1%. This quarter's number was also adversely impacted by an impairment of our equity-method investment in Guangzhou to reflect the fair value of our entire holding. Adjusted net earnings attributable to Walgreens Boots Alliance were $1.3 billion, up 7.8%; and in constant currency, up 7.2%.

Diluted net earnings per share benefited from the lower number of shares in issue. As a result, GAAP diluted net earnings per share were $0.81, down 16.5%. Adjusted diluted net earnings per share was $1.28, up 16.4%; and in constant currency, up 15.5%.

The adjusted effective tax rate, which we calculate excluding the equity income from AmerisourceBergen, was 24.9%. Our core tax rate, which excludes discrete tax impacts, was marginally higher than in the fourth quarter of fiscal 2017.

So turning now to the performance of our segments, starting with Retail Pharmacy USA. Retail Pharmacy USA sales were $22.5 billion, up 8.9% over the year-ago quarter, comparable store sales increasing by 4.7%. Adjusted gross profit was $5.7 billion, up 3.7% over the year-ago quarter, reflecting an increase in both pharmacy and retail.

Adjusted SG&A was 19.2% of sales, an improvement of 1.2 percentage points compared to the year-ago quarter. SG&A expense was higher than in the fourth quarter in part due to the normal seasonal activity. Adjusted SG&A as a percentage of sales has improved versus comparable quarters for 18 consecutive quarters. Adjusted operating margin was 6.1%, down 0.1 percentage points, resulting in adjusted operating income of $1.4 billion, up 6.8%.

So now let's look in more detail at pharmacy. U.S. pharmacy total sales were up 14.1%. We filled 260 million prescriptions on a 30-day adjusted basis, including immunizations, an increase of 9.5%. We have now reached a significant milestone, exceeding 1 billion scripts for the first time on a 30-day adjusted and rolling annual basis. In the quarter, over 20% of Walgreens retail refill scripts were initiated through digital channels, demonstrating the impact of the work that we are doing to improve our digital capabilities. This includes the progressive enhancement of the Walgreens' mobile app, which has been downloaded over 50 million times since its launch and has a 5-star customer rating on the U.S. Apple app store. This growth in script volumes led to our reported market share of retail prescriptions in the quarter on the usual 30-day adjusted basis being 20.6%, up approximately 110 basis points over the year-ago quarter.

So turning back to sales. On a comparable basis for stores, which excludes central specialty and mail, pharmacy sales increased by 7.4%, with scripts filled up 8.9%. This was primarily due to strong volume growth from Medicare Part D and the positive impact of our strategic pharmacy partnerships.

Within sales, volume growth, mix and brand inflation were partially offset by reimbursement pressure and the impact of generics. A higher proportion of specialty adversely impacted pharmacy gross margin by around 140 basis points. These factors combined resulted in higher pharmacy gross profit.

Total retail sales were 2.8% lower than in the same quarter last year. Comparable retail sales were down 0.9% in the quarter partly due to changes to our promotional plans, which I spoke about last quarter, as we continued to focus on delivering improved margins. This was a lower rate of sales decline than we saw in the fourth quarter last year.

Declines in consumables and general merchandise and the personal care categories were partially offset by comp sales growth in the health and wellness and beauty categories. This is the sixth consecutive quarter that we've delivered comparable sales growth in both the health and wellness and beauty categories. Gross margin and gross profit this quarter were positively impacted by the changes to promotions I just mentioned and by improved mix as we increasingly focus on higher-margin categories.

The beauty category today represents around 9% of total retail sales. As discussed in prior quarters, we continue to invest in our beauty differentiation program and are encouraged by the results. As well as developing our offering of own brands, we have now completed the introduction of our enhanced beauty offering to over 1,000 additional stores, bringing the total number of stores with this offering to around 2,900. I'm pleased to report that during the first quarter, the beauty differentiation stores performed stronger than in prior quarters. Beauty category sales in these stores continued to be markedly better than in other stores, resulting in higher retail gross margin and higher comparable retail sales.

As I mentioned on the last earnings call, in the last quarter, we launched our brand-new skin care range, Your Good Skin. This is now being rolled out to all our beauty differentiation stores. Following the success of the program, we have now extended No7 and Soap & Glory to over 4,400 Walgreens stores. Given how well our beauty offering has been received, we are working to widen the range of products offered in our beauty differentiation initiative.

Before turning to Rite Aid, I just wanted to make a comment on December.

Since the quarter end, in pharmacy, we continued to deliver strong growth in prescription volume as we began to annualize pharmacy contracts that contributed to fiscal 2017 volume growth. In retail, while our December comparable sales were lower than in December last year, we delivered a strong performance in our important health and wellness category.

Turning now to Rite Aid. During the latter part of the quarter, we acquired 97 Rite Aid stores and and a further 260 stores in December. As we've said before, we are acquiring stores in phases, with completion anticipated in the spring. This will be followed by the transfer of the 3 distribution centers at a later date. And as we've also said, in terms of our store optimization program, we plan to close approximately 600 stores and related assets over an 18-month period, beginning in spring 2018. Our assumptions on synergies, store optimization, timing, costs and expected savings are as previously announced.

So now let's look at the results of the Retail Pharmacy International division. Sales for the division were $3.1 billion, up 4.1%; and in constant currency, down 0.8%. Comparable store sales decreased 0.7% in constant currency. Comparable pharmacy sales were down 0.1% and comparable retail sales decreased 1%, both on a constant-currency basis.

In Boots U.K., comparable pharmacy sales were up 0.1% mainly due to temporary price rises caused by shortages in certain generic drugs. Boots U.K.'s comparable retail sales were 1.4% lower in a challenging marketplace. Adjusted gross profit for the division was down 0.8% in constant currency to $1.2 billion due to both lower pharmacy and retail gross profit.

Adjusted SG&A as a percentage of sales on a constant-currency basis was 0.3 percentage points higher at 32.9%. On an absolute basis, adjusted SG&A dollars were broadly flat. Adjusted operating margin was 6.8%, down 0.4 percentage points in constant currency. This resulted in adjusted operating income of $210 million, a decrease of 5.6% in constant currency and down 1.4% on a reported basis.

Since the quarter end, as we expected, trading has continued to be challenging. However, we are managing our businesses to address this trading environment both in terms of promotional efficiency and costs. As a result, we remain optimistic about our future prospects.

Now let's look at our Pharmaceutical Wholesale division. Sales for the division were $5.7 billion, up 4.5% versus the same quarter last year on a constant-currency basis. This was behind our estimate of market growth weighted on the basis of our country wholesale sales due to challenging market conditions in certain Continental European countries, partially offset by strong performance in emerging markets.

Adjusted operating margin, which excludes ABC, was 2.6%, down 0.5 percentage points on a constant-currency basis but in line with the fourth quarter of fiscal 2017. This was mainly due to a combination of cost inflationary pressures and lower gross margin, including some generic procurement pressures. Our share of adjusted earnings in ABC was $77 million, up $19 million versus the same quarter last year, mainly due to our increased level of ownership. Adjusted operating income for the division was $224 million, up 0.4% versus the same quarter last year in constant currency.

So turning next to capital allocation. Operating cash flow in the quarter was $961 million. Our working capital outflow was $745 million. This reflected our seasonal build in inventories, which was substantially lower than in the comparable quarter due to actions we have taken to reduce inventory days in the U.S. Cash capital expenditure in the quarter was $378 million. We continue to invest in key areas to develop our core customer proposition, including our stores and U.S. beauty program as well as the upgrades to our IT systems, which we've previously talked about. Overall, this resulted in free cash flow for the quarter of $583 million, an increase of $436 million versus the same quarter last year.

So turning now to guidance for fiscal 2018. We have raised the lower-end level of our guidance and now expect adjusted diluted net earnings per share to be in the range of $5.45 to $5.70. As usual, this guidance is based on current exchange rates remaining constant for the rest of the fiscal year. And as we've said before, we do not expect Rite Aid to significantly impact this year's adjusted diluted net earnings per share.

In addition, our guidance does not take into account the recent changes to U.S. tax law that have just occurred. Once the detailed tax guidance for the new law has been published, companies such as ours will be able to quantify the full impact, and we will, of course, update our guidance accordingly. Based on our initial assessment, we believe that these changes will have a positive effect on cash taxes. As in the past, if changes in tax legislation result in material changes to balance sheet provisions, we will adjust for these. Our tax team are working through all this ahead of 2Q results.

And finally, thinking about the phasing. As I've said on our last earnings call, we expect the year to be more balanced between the 2 halves than in fiscal 2017.

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

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

Thank you, George. As you can see, it has been a strong start to the year. Our strategy of geographic and commercial diversification continues to serve us well, giving us both scale and presence while managing our relationship with the pharmaceutical manufacturers, and diversity to help us manage the downturns of the business cycle in any individual geography or market. That said, we do not just sit passively. We actively seek opportunities that the changes in our markets offer.

Most recently, we have announced our change of emphasis in China. We have been involved in China for some time as a wholesaler with strong local partners, but following regulatory changes, we have taken some time to assess the market and review our position. As a result, as George has said earlier, we are taking a significant stake in GuoDa, a leading Chinese retail pharmacy chain, in a strategic partnership arrangement indirectly with the Chinese state itself. This will help us to participate more actively in the retail pharmacy sector. I am pleased to say that we have been able to do this transaction on terms that recognize the significant benefit that this strategic partnership will bring to GuoDa.

Around the same time, we announced an agreement to reduce our stake in our main wholesale partner in China, providing them with greater freedom to pursue other routes to develop their business. Although, as you have seen, we have taken an impairment charge on this investment, our holding overall has generated a very good return. We remain committed to our wholesale partners in China and maintain a significant interest in them both, but we believe that we are now best served by focusing on the opportunity that the partnership in retail offers.

We are very excited about the potential of the Chinese market. As with every country we operate in, health care and personal care are very culturally-specific sectors, and we are convinced that our strategy of entering markets through strong local partners with excellent local management teams is the best approach. But of course, I know, quite understandably, that your focus is on more Western markets and the U.S.A in particular.

The U.S. continues to be a very dynamic market with a lot going on and many changes underway. We have been contemplating some of these changes for a while. As most of you will know, I have been convinced of the benefits of vertical integration in the U.S. health care system for many years. I do not, however, believe that vertical integration can necessarily best be achieved only through ownership or within a single entity. Much can be achieved through close partnerships and collaboration. Looking at the U.S., it is very important to remember that we are partway through a process of transformation. I believe this will set our business in the U.S. on a path of growth for the future.

I know many of you have heard this before, but it is still relevant, and I think, sometimes, the significance of the work we are doing gets overlooked. As you know, the process of transformation began with a review and enhancing of the Walgreens business. Cost cutting was an important first step. A lot has already been done in this regard, and this work, together with an ongoing strict discipline on costs, has given us the runway to begin the process of reinventing Walgreens while, at the same time, delivering good results.

We are now well underway with our work to upgrade the existing Walgreens business model in pharmacy and in retail. We have been going through a process of fine-tuning throughout the U.S. business. In pharmacy, we have adjusted pricing on our commercial contracts to bring them more in line with the rest of the market and, in doing so, have generated significant net growth in prescription volume to our dispensaries. In retail, we have continued with the detailed and selective refinement of our merchandising, product and service offerings. I believe we are about halfway through this process, and the benefit it is bringing are, again, helping us continue our track record of growth while we develop, trial, assess and then roll out our vision for the future of Walgreens in the U.S. market.

So the third phase in our transformation is to rethink our business model to adapt to changing markets and changing customer behavior and look ahead to the future of the U.S. business. We are already extensively working on this at the same time as continuing to optimize the business that we have today. We have made a lot of progress in defining what our stores should look like in the future. You will hear a lot more about this during 2018.

We are researching and analyzing how customers are shopping our stores to understand the true profitability of each category and area of business and what our patients, payers and customers want from us. We have been working hard to put in place the relationships we need to offer a range of health care services seamlessly across the group alongside a far more focused and differentiated retail offering. There is no doubt that the complete transformation will take time to achieve. But I believe we have the potential to do a great deal more with our core assets, particularly given our physical presence and the strong position this gives us in the community, our scale and the purchasing power this gives us, and our unique global brands.

As you know, over the past few years, we have been conducting pilot studies in certain U.S. stores to test our merchandising, format, supply chains and beauty propositions and a number of new initiatives and partnerships. In 2018, you will see us deploy the first pilot stores incorporating all the work we have done to date in a single store format. We will study the results in depth and fine-tune the format before rolling this new concept out under the ongoing store rejuvenation initiative and within our current capital plan.

However, this is about much more than just our retail offering. It is about rethinking and redefining our presence in and relevance to the communities we serve, and that requires us to rethink our supply chains, the services we offer to our customers and how we deliver those services. This is why strategic partnerships, like the one we have done with FedEx, are so important. It gives us an additional role in the community. It provides flexibility in how we physically move things in and out of our stores, and that creates a completely new way of thinking about how we interact with our patients and our customers.

As I say, you will be hearing more from us over time about all of these areas, but behind all of this is a recognition that our best opportunity to grow our business is also our best defense against new competition or changes in our marketplace. Quite simply, we need to offer the best pharmacy service, be a differentiated retailer and provide services and convenience at a value proposition that keeps us relevant to the communities we serve. In doing this, we must make sure that we provide the goods and services that payers and customers want. We must do this across all channels in an integrated manner and to uniformly high standards.

We must be agnostic about how they wish to interact with us. That is key.

A payer should know that whatever they want or need in terms of services to their patients, we can provide it, provide it well and at a competitive price. A patient or customer should know that however they choose to interact with Walgreens, in person, online or even through a third party, they will get quality products and services at competitive prices, delivered to them directly or by our partners in the way they want, when they want and where they want. To do that, we must actively manage our business, our cost base, our product lines, our services and our partnerships. We must ensure our people and our company as a whole can match or beat our competition in all areas. And we must do this without faltering in our delivery to our owners in this venture.

That is all big picture, very relevant and in truth our future, but in the more immediate term, we have a lot to do in the year ahead.

As ever, we are facing tough market conditions, and as ever, there are many challenges to be addressed in our business and in our markets, but we are more than up to the challenge and I am excited for the year ahead and for the years to come.

With a strong first quarter, which, as George says, gives us a good foundation for a solid performance for the year as a whole, I remain as confident as ever in this business looking forward.

Thank you. I will now hand you back to Gerald for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Lisa Gill with JPMorgan.

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

I was wondering if maybe you could just comment on 2018 around preferred relationships. I know, on the last quarter call, you anticipated that scripts would be up in calendar '18. But now that we know where things have shaken out as far as Part D participants go for 2018 as well as the commercial market, can you just give us updated thoughts around that?

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

Lisa, it's Alex here. Yes. I don't think we have much to add. We still see the same position as we saw in the last update. We are confident we will grow in 2018, and we're also very confident about the customer care we're providing to our partners. That's actually helping to make customers more sticky and grow and stay with us as well. So nothing really more to add to that. The numbers we gave seem consistent with what we've seen since. And of course, we'll give a further update when we have the total market available, probably sometime in April, May or June, as it becomes much clearer.

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

And how do we think about the margin then on that business? I mean, any changes to 1/1/18 around any of your payer or PBM relationships?

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

Again, we don't disclose, as you know, the commercial contracts. We speak all the time about pharmacy reimbursement pressures, so that continues to be a feature of the Med D market. We manage our price to the marketplace, and we do that very carefully. And we're confident that we can sustain the appropriate margin with the volume we've got. Some of the contracts that we became less excited in, of course, we have improved the payment. And of course, some of the contracts stepping down is normal this time of year. So overall, we feel okay about the margin. It's pretty much on trend.

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

Okay, great. And then if I -- I'm sorry, go ahead.

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

You see, when we approve a new contract, of course, we make sure that we can afford the contracts. And so if we give some additional discounts, if we could use our margin from one side, we analyze during the contract where we can recover all or most of the margins that we are giving away. And this is why our results are quite consistent overall, and this is why we are not losing dramatically or at all in our bottom line, in our operating -- overall operating margin, adjusted operating margin, because every contract is studied and approved if we understand or know how to compensate for what we have to give.

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

Okay, great. That's very helpful. And then just lastly, George, you talked about the U.S. tax rate obviously being a positive. Is there any way to think about how to quantify this early on? I mean, by our math, it could be nicely positive for you, somewhere in the range of maybe $0.40 or $0.50. Is that a number that would be close to how you're thinking about it?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Look, where we are, as I said in the prepared comments, is that we're still -- the tax team is still working through this. Obviously, all -- the full details are still in the process of being published, so it would be premature to make any sort of financial comments from our perspective at this point. I mean, for me, the key issue that I'm always focused is -- on is the cash taxes. And as I -- again, as I said in the prepared comments, we'd expect a positive effect on cash taxes. But it's worth remembering, of course, that we are a multinational. It's much simpler for some of the domestic companies to give a fairly quick and dirty estimate. But for us, it takes a little bit of time to work through, and that's what we're doing. But we'll update you in the second quarter, as, again, I said on the prepared comments.

Operator

And our next question comes from the line of George Hill with RBC Capital Markets.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

Alex, I want to drill on this something that you made a comment about. It sounded like you talked about a more challenging procurement environment as it related to generic drugs. I guess, could you throw a little more color on that, tell us what's driving and talk about whether that was specific to the ex-U. S. business? Or is that something that's kind of having a global impact?

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

George, no, I didn't say -- I apologize. Sometimes my accent is a bit hard to pick up. I didn't say that at all. But on the comment on generics, we're really seeing a very similar trend in the marketplace. So we're seeing deflation. Obviously, the market's a bit consolidated, and we feel good about the work of our colleagues in Walgreens Boots Alliance development. And we feel confident. We work with manufacturers in a very consistent way and over time. So no change. I apologize if my remarks were picked up wrongly. We're seeing the same trend, and we feel good about the capability we have to manage this well in this marketplace.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

No. And then -- I apologize for mishearing you. And then maybe, I guess, a follow-up for you and for Stefano would be -- I know that we're not even through the Rite Aid acquisition yet, but you talked about some of the growth initiatives and the new store format. I guess, with 90-ish percent plus beneficiary coverage in the United States, macro script growth is slowing down. Aside from engaging in a battle for market share with your largest pharmacy competitor, what do you guys see as the best opportunities to continue to monetize the box or generate earnings in the box? Or where is the whitespace for growth kind of as we think about the next leg for the company beyond the roll-on of the CVS

stores in first half of '18? And I'm thinking about this more from a top line perspective as opposed to a margin or synergy perspective.

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

Yes. So again, we are working -- as Stefano said in his concluding remarks, we are working really hard to rethink and redesign the box. And we've been doing this really for a number of years with a number of tests and trials. And some of them would be -- just to give you an example, beauty differentiation's the best example, but many others like the mobile app who we have -- again, George in his remarks announced 50 million downloads and a 5-star app. So we're putting all of this together in a single-format trial. Some time later on this year, we'll give more details as we step into it. And we feel very confident that, that box, that single format, we will be able to generate more value from that in the immediate and long term. The data we're seeing, as we develop our ability to use (inaudible) data in a different way, particularly in the front end, we are very confident about as we re-merchandise and simplify and make sure that we have a differentiated offer. We've been doing all of that, of course, not just to Walgreens but into the Rite Aid stores that we have acquired. And last but not least, we feel good about our access strategy. Again, the numbers are very clear, 1 billion prescriptions for the first time ever in Walgreens. And we think we can continue to grow volume by giving good value and great care.

George Robert Hill - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. And maybe just the last tack-on would be, as I think about the new format, it probably includes the clinic model, it includes beauty, it might include the LabCorp demos. Is there any other, what I would call, customer magnet or customer-facing components to the new format we should be thinking about?

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

Listen, we have a clear model, and we are doing certain trials. And we are, let's say, finalizing agreements with certain partners. But you will understand that we cannot present a full model today. As we said, you will hear more from us during this year, during 2018, at the end of the year, but some of the things that we are doing are commercially sensitive, as you can imagine. So you can be assured that, in our box, you will find all the things that we have been talking about until now and, I hope, something more.

Operator

And our next question comes from the line of Glen Santangelo with Deutsche Bank.

Glen Joseph Santangelo - *Deutsche Bank AG, Research Division - MD & Research Analyst*

I just want to follow up on a couple of things. First, on the margin question, when you look at sort of your gross margins in your U.S. retail business, obviously, they continue to come down. And as you anniversary some of those commercial wins here as we look forward to 2018, I understand you don't want to give any sort of specific margin guidance going forward, but just how do you generally think about the reimbursement environment? Do you think we're in an environment where margins will continue to come down, given the competitive nature of the business and the pressure from the PBM and so the goal is ultimately to grow revenues and try to cut SG&A to be able to grow? Or do you think we get to an environment where margins eventually stabilize in this business?

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

Glen, it's Alex here. Again, I think, specifically, in this period, remember the prepared remarks George made about the specialty mix,

which was 140 basis points. And as you also recall, we announced with our partners, Prime, through AllianceRx, the successful FEP contract which kicks off in this quarter we're in -- or in the last quarter. So that mix is quite important as you look at the margin. But more in a long-term trend, we expect to see the long-term trends remain the same, and we said that consistently. That hasn't -- our point of view hasn't changed. We expect to lever the same levers which we've successfully used and will continue to use, costs, cost of goods, developing this front-end margin in a way that we described in the previous question and, importantly, volume. Again, we do believe that we are able to drive volume through our pharmacies in the way we've done in the last 2 years as well. These are all levers we will use to ensure that we drive gross profit dollars and adjusted operating margin -- adjusted operating income, sorry, in the business.

Glen Joseph Santangelo - *Deutsche Bank AG, Research Division - MD & Research Analyst*

And then maybe, if I could just expand that. Any comments on the reimbursement outlook over in Europe? Given some of the challenges we faced this year, as we head into calendar '18, comps should ease. I mean, do you expect that to be meaningful?

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

Again, I can comment specifically on the U.K., which is our main pharmacy business. Of course, in Europe -- we have many other businesses in Europe, but this is the main pharmacy business. The government have taken a large amount of money out. We've been very clear on that and went to the second phase of VAT. And this is something that is a cycle, as mentioned by Stefano before. Almost every decade this happens in the U.K. And we're managing our business appropriately. The pharmacy business is very important to our brand and to our customers in the U.K. and we have the scale and we have the presence to manage this appropriately. So again, it's a tough environment in this period because the government action has been beyond normal. That will come back to normal action in the future years again, and we remain confident we can manage it in that cycle.

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

But you see, in Europe, we are used to it because in all the European countries, I would say, for the last 20 years maybe, we have seen the government pushing down the margins of the pharmacies, the margin of the distribution. So it's a part of the business, and we know how to react and we react. And of course, in Europe there had been a great consolidation, there had been a great improvement of the efficiency of all the operators. Now generally, this is quite -- it goes through, I would say, quite smoothly. We see some shock today -- in this year mainly, I would say, for the Brexit because this has created a lot of instability not just in U.K. but also in the rest of Europe. And also, the strong FX, we were not used to see the pound depreciate 20% in 1 day

or 2 days. We had very big depreciation in the past. We created the euro and the depreciation were much more under control. And to see again this big fluctuation and big depreciation has created an environment which was a little difficult to control. Now these things are coming back slowly into normality, and all the business will come back to normality. But this might be considered quite an exceptional situation overall in Europe. And you see that after all, we and the other operators, in spite of these big changes, have been able to -- in constant currency, have been able to stay more or less where they were before. They are all about there.

Glen Joseph Santangelo - *Deutsche Bank AG, Research Division - MD & Research Analyst*

I appreciate that. Maybe lastly, just on the capital allocation. You decided to pull some of the repo forward here in the current quarter. I understand you still have some authorization outstanding, but do you expect to sort of back that off as we look out to the balance of the fiscal year? Or do you expect to continue to be active in that regard? And then I'll stop.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

We completed the $6 billion program. And so other than sort of our normal anti-dilutive program that, obviously, is something that continues on an ongoing basis, we have no authorizations out at the moment for additional share repurchase programs. Obviously, we continue to review our overall position to have an efficient balance sheet, as you will have seen from our track record.

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

You understand -- Stefano here. You understand that we produce a lot of

cash every year. And you have seen this in the last year, we have increased substantially the cash we're able to create. And of course, we

have to use this cash, either we have to do some external acquisition or we have to buy back shares or we have to increase the dividend. But we have, in any case, to use this cash. We have found ourselves in an awkward situation because we have done -- or we intended to do an acquisition and we have to put the money aside for the acquisition. And after, the acquisition was smaller than anticipated and later, so we had some cash to deploy and we have decided to buy back shares. We hope that we will not find ourselves in a similar situation in future. And we will be able to deploy our cash in a more orderly fashion in future. But for sure, we believe that we don't see any reason why we should not produce the same or more cash in future. Well, of course, this cash has to be

utilized or given back to the shareholders.

Operator

And our next question comes from the line of Alvin Concepcion with Citi.

Alvin C Concepcion - *Citigroup Inc, Research Division - VP and Senior Analyst*

Just wanted to ask about tax reform again. I know you don't want to quantify at this time, but what do you plan to do with the benefit? You just talked about external acquisition. Does this accelerate your time line or plans for an acquisition? Or do you assume most of this just gets

considered away?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

Well, I think, as we all know, the tax reform has got the potential to help companies such as ours invest, whether that's jobs, equipment, facilities, to grow the economy and open up new opportunities really for Americans across the country. And from our perspective, again, as I said in our prepared comments, we're continuing to invest in the U.S., here in our Walgreens business and our core customer proposition. And very importantly, as you also know, we're planning to invest substantially in the Rite Aid assets post acquisition completion and the big conversion program that we've got to convert the stores to Walgreens. So we welcome the tax reform and see this as reinforcing our opportunities to invest here in the United States.

Alvin C Concepcion - *Citigroup Inc, Research Division - VP and Senior Analyst*

And just a question on M&A. I mean, you mentioned vertical integration has many benefits. Does this include managed care as part of your thinking? And what part of the supply chain do you think could benefit the most through integration? And also, what are your priorities, U.S., international? Is it more on the retail side or various parts of the supply chain?

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

We continue to look at M&A opportunities in a very disciplined way. As always, when we are looking at the opportunity for new partnerships, we start with a partnership mentality and look at what the opportunity is and look at the best way to extract value for our shareholders. Sometimes that is just a good commercial arrangement. Sometimes, it's taking an equity-method investment or having a minority partner. And sometimes, it's 100% M&A. But we always start with the mindset of partnership and then, in a sense, what is the logical structure from a shareholder value point of view just really based on the opportunity and how best to deliver it. And we always approach M&A in a very financially disciplined way, and we're very clear on what our returns criteria are. And we continue to look for quantifiable synergies, real hard synergies underlying our key financial models. And then what we always do on top of that is look at the soft synergies, which are the ones one can not quantify but often create a lot of the long-term sustained shareholder value. We'll continue to look at opportunities here in the U.S. and internationally, but -- as you've seen and what we talked about earlier in China, but always in a very financially disciplined way. Clearly, the tax reform and some of the changes in the U.S. make the U.S., in some ways, a more attractive opportunity than it was prior to tax reform.

Operator

And our next question comes from the line of Robert Jones with Goldman Sachs.

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

You noted another strong quarter on the same-store script growth, and I'd imagine that next quarter would be similar. But as you look out to the back half of the fiscal year when you begin to lap some of the market share gains, what kind of script growth or even declines should we be looking for given some of the competitive changes you've seen in the preferred Part D networks?

Operator

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

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(technical difficulty)

Should we be looking for some of the competitive changes you've seen in the preferred Part D --

(technical difficulty)

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

Hi, it's Alex here. As we said in the last quarter, we are very comfortable growth at the market or near the market next year. That's why don't see that as a problem given the changes that we have seen so far. And then on top of that, we do have the additional stores from Rite Aid coming in. It's non-organic, it's non organic growth as well, to help to drive our platform, our buying power and of course, our efficiency. So again, we have different ways of delivering growth. And as you've seen over the last few years, this growth is what we intend to do and I think that's a great example of how, as we move from one phase or maybe into another phase of growth with the same focus and the same intention. The last thing I would say is that we remain extremely committed to partnership in this sector as well. I believe that we provide great value, and I believe that our partners will see consistently us delivering for them what they need from this marketplace as it changes and becomes more competitive. So really, no change. We remain confident, and evident that we are growing in pharmacy this year compared to -- growing above the market this year compared to the previous year.

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

Okay. I appreciate that. And then George, you made some comments on the performance in December, but I was hoping maybe you could just go back and break down what you were seeing relative to the performance in 1Q. I thought you had mentioned, I think it was you that might be -- had mentioned something around generic procurement pressure, but I was just hoping you could elaborate on the December comments that you provided.

George Rollo Fairweather - *Walgreens Boots Alliance, Inc. - Executive VP & Global CFO*

The generic procurement pressure point, if I can just --

(technical difficulty)

Was in relation to the Pharmaceutical Wholesale division, and we emphasize, when we're looking at our generics operation in terms of shareholder value and generic sourcing that we do out of Switzerland, we look at this very much and around as a whole. And whilst we were impacted in this quarter, as we were in the fourth quarter last year in wholesale, we're very pleased with the overperformance of our generic sourcing operation. It's just sometimes where it falls and it can be -- (technical difficulty)

But I say it's the overall that we're really focused on. In terms of the U.S. obviously, we've just finished December, so we're just closing --

(technical difficulty)

But what I was trying to do was give you the, a fairly --

(technical difficulty)

Level overview of the performance. And as I said, in the U.S., in pharmacy, you saw strong growth in prescription volume in Q1. As I said in the prepared remarks, we continue to deliver strong growth in prescription volume in December and it's worth reminding ourselves, that we're beginning to annualize the pharmacy contracts that contributed to the fiscal 2017, what's really building on what Alex has just been saying. And then in retail in Walgreens, again as I said, where our comparable December sales were lower than December last year, and it's worth remembering obviously, what I said in Q1. Again, what's really important for us was we delivered a strong performance in our important health and wellness categories. So that's really the sort of the December story. And then in looking back looking into Europe, the, as again, as what I indicated, it was relatively tough trading in December, particularly Boots in the U.K. And that's no different. I believe we're starting to see in the preliminary figures that are --

(technical difficulty)

From some of the other large High Street-based retailers in the U.K.

Operator

And we have time for one more question. Our last question comes from the line of Brian Tanquilut with Jefferies.

Brian Gil Tanquilut - *Jefferies LLC, Research Division - Equity Analyst*

I just wanted to ask if you could give us some color or comments on any improvement you're seeing in the stores that have rolled out sort of higher-acuity health care services, whether it's MedExpress in your partnership with United, or the clinics that you've sold to some of the health systems such as Vanderbilt here in Nashville. And then how far do you think you can push that MedExpress opportunity in terms of rolling that out?

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

Hi John -- hi Brian, sorry, it's Alex here. I think that -- we're really pleased with the tests we have. It's a strong model, it's a good brand. It's really link, to be honest, to know the success of this. So far, so good, then we'll update you when we have more information and more confidence in the overall model. It would make sense, from a customer point of view, that you can pop into a convenient location, that we have the, a, corners across America, everybody knows that, the best corners in America. So it makes sense from a customer and patient point of view that you can go in and get yourselves sorted, when you have an accident or when you need a medical or something of that type, which is what MedExpress does. So, so far, so good, but very early on and related to give any information that would really make a bit of a narrative, to be honest. I think in terms of the clinics, I mean, we're really pleased with the partnerships we've got there. They are local, which is important to the health systems. We are providing different services depending on what we want to do and what the local needs are, and it fit really well into Walgreens' brand. And of course, as we said, when we did these partnerships, we have the opportunity of providing more pharmacy services to the health care systems alongside that, which is the bit that you don't always see. So again, these are more mature. We are performing exactly as we wanted to. They are different from location to location, bringing added value to customers and driving --

(technical difficulty)

Of a relationship in our pharmacy business with important health care partners.

Brian Gil Tanquilut - *Jefferies LLC, Research Division - Equity Analyst*

Just a quick follow-up to that, as I think about the FedEx rollout. I mean, you already rolled out, across a big base of stores. So how should I think about how you view that as a defensive strategy perhaps, or as a way to drive margin and volume into the stores.

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

This is absolutely not a defensive strategy. We have got a fantastic supply chain. We are situated closer to America's [rooftops] than any other retail brand, and we've got a --

(technical difficulty)

And pharmacists inside that retail brand. So this is about us definitely --

(technical difficulty)

As redefining the promptness of --

(technical difficulty)

Locations across America. This is not a defensive, and FedEx have been fantastic partners, and we're really pleased, the progress we've made, particularly in the holiday season.

Operator

And this concludes today's question-and-answer session. I would now like to turn the call back to Mr. Gerald Gradwell for any closing remarks.

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

Thank you very much, indeed. And thank you, everyone, for participating in the call. We look forward to speaking to you all again on our second quarter results in 3 months' time. And we hope to see you all over the next few weeks and months as we go out and about, and look to speak to our shareholders and the financial community. Thank you again. If you do have any further questions, please feel free to contact any of the IR here. We're around for the next few days. Thank you very much, indeed.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect.
