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WBA - Walgreens Boots Alliance Inc at Leerink Partners Global Healthcare Conference

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PRESENTATION

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

All right. Why don't we go ahead and get started? I'm Dave Larsen, the health care IT and distribution analyst for Leerink Partners. We're delighted to have Walgreens with us. We have James Kehoe, the CFO; Gerald Gradwell, Senior VP of IR. We also have Jay Spitzer, Director of IR. So thanks, guys, very much for joining us. We appreciate it.

QUESTIONS AND ANSWERS

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

So why don't we start off at a high level. You've guided to 7% to 12% EPS growth for the fiscal year in constant currency. Maybe you could talk about some of the tailwinds and some of the headwinds to that number. What could cause you to come in at the high end or perhaps the low end of that range?

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

Yes. So when we give the guidance, 7% to 12%, approximately 5 percentage points was coming from share repurchases, and we have about 2 percentage points of investments in store labor for minimum wage plus some investments in the health care ventures, so that's the backdrop to it. That's obviously predicated upon being able to successfully manage true reimbursement. I would say the bigger headwind this year, as you've seen from our principal competitor, is reimbursement pressure, and we're seeing -- we're not giving you guidance obviously here, but we do see similar pressures. I wouldn't say that reimbursement is higher. What I would say is the ability to mitigate it through winning more contracts, more volume, negotiating better is less than we would've expected during the year. So we see somewhat the same pressures they see. The other pressure that has risen somewhat is deflation of generics. So I think earlier in the year, we were more confident in the ability to negotiate, similar to the past, but obviously, on a declining trend. Teva has divested some businesses. Avenues where we expected more supply to come in, like China, are not coming in on track. The FDA is more controlling of China, and we see it as a -- I think the source will be huge in the next 3 years, but we thought these short-term wins and competitive tension would be higher during the course of the year. The place we picked up pace is on cost reduction. So we have essentially in the company, and we're completing our benchmarking right now. So I think we'll see, as we exit the year, a rise in contribution from overheads, but it's mostly a '20, '21, '22 benefit. So I guess, headwinds, reimbursement and a little bit less deflation in generics. Some tailwind is probably on the cost side, but that's probably likely to power us faster in 2020.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

And is your reimbursement tied to list price on the brand side? So if list price isn't rising as rapidly as it had in the past, is that a form of reimbursement pressure, the ability to discount AWP?

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

Yes, it is. It is. So the slower pace of brand inflation which, this quarter, was around 2%. The same quarter last year was closer to 8%. That's a pretty rapid tail-off. That's just comparing 1 quarter versus prior year versus the other. So we're a little greater than, essentially, a percentage of the AWP, so the slower rate of increases is a form of pressure on the P&L. It's not a huge magnitude though.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. And then when we talk about generic deflation, that should improve your COGS though, right, with like WBAD JV?

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

Yes, but generic is different. The AWP doesn't change. So you don't have any change on the top line, so you're getting the same reimbursement. The problem with the lower level, it's always deflation, but it was deflating at 8% to 9%. Now the deflation is trending down. So we got less of a positive contribution to the income statement versus what we would have in prior years. So WBAD is generating billions of savings every year, but it's at a lower pace, and it's declining like this because you can't keep reducing the same pool of dollars.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. So if you go from like 9% generic deflation to, let's say, 5% generic deflation, that's a bit of a headwind.

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

It's a headwind in that we can -- it get less. It's evidence of less competitive tension in the market, which puts pressure on our cost of sales. Now I think as we look forward, we're going to see a difference to that. Two is the Teva restructuring is more behind them. We would hope to see more Chinese competitors in the market. And then the third one is the projection looking forward for new generic molecules is much higher than it was in the past couple of years. So the more new generic molecules that come in, the more money that Mylan and Teva will make, which makes them less fixated on retaining price on the older molecules. So to some extent, the more innovation they have, the better it is for us.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. So the generic launch count for fiscal '19 to fiscal '20 looks pretty good.

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

Yes, the next 3 years cycle looks very high, but it's always wrong. The projections are always wrong, so you don't know.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

All right. And then there's been a lot of talk about rebates. So if rebates were to evaporate, what impact would that have on your business, if any? And you obviously sold your PBM a while ago. Would that have a material impact or not?

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

I think it's -- I think the other thing I would say is purely speculation. We hypothesized 2 outcomes. One is the manufacturers roll rebates into gross price, and then they pay the PBMs of service. But what the folks -- what the government wants to achieve is something different. They want all rebates roll into price, and I don't think all manufacturers will do that. So the only ones that are in a place to do it are CVS and us because we are the ones who are actually billing the end customer. So actually, you could see a different dynamic in the industry that, should we be fulfilling some of the role of the PBM at the store level? The issue is we don't have a PBM. But we don't want a PBM. We want the technology, which is different. So I think we have to wait to see what plays out in June. And I think there's going to be -- either way, there's going to be a dislocation in the market, and the traditional approach won't be there, and we may actually have an opportunity.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

So the point-of-sale rebate that goes to patient, you can play a part in that.

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

Well, I think we're the only one who can play a part because the wholesaler can't, right? Because they're just buying the product. They don't pass directly to consumer. The only one who is dealing with the consumer directly is the prescription.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

And how would you get reimbursed for that? How would you get paid for that?

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

Let's put them in the model. We'll -- I think it would be a fee-for-service. So these are all hypotheses. It depends on how far this goes, but I think it's only one part of a dislocation that will occur over the next 4 to 5 years. And we believe price transparency is a good thing. And I think there's going to be a dislocation in pharmaceutical companies because the fee-for-service logic is going to penalize somebody with a high-value biologic because they currently pay a rebate of 5%. And it's going to help somebody who's paying a rebate of 70% on a very old drug, that's where you need to. Why? Because there's no way they can do a tiered level of rebates -- sorry, of fee-for-service based on the type of product because that's going to be against the logic of fee-for-service. So I think you need to look at the entire value chain. It's going to be dislocated when this happens, pharma all the way down. And actually, the impact is less on us, and I think the pharma companies haven't quite figure this one out yet, obviously.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. All right, great. So your same-store volumes have actually been pretty good. I think in the U.S.A., retail, up around 2% year-over-year this past quarter. They have been very good last year. Can you talk a little bit about some of the managed care sort of narrow network deals that may be going on in the market now? What is the market's response to CVS-Aetna, Cigna-Express? I mean, I would imagine that Express would be much more willing to work with you and to your volumes, the significance to your volumes to you. is that correct or not?

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

One might imagine that, but I think it's fair to say, if you look back over the last 12 months, we've been quite damaged by the merger of Aetna-CVS. So there was a fairly significant transfer of business from Aetna to the CVS Pharmacy. So we'll start lapping those less favorable months. I think we're cautiously optimistic, but bear in mind, that's not upside. This is -- one of the ways you offset reimbursement is through more volume through your store, right? So 2% is not sufficient on an ongoing basis to drive the right scale and efficiency in store. You got to be beating that 2%. So do you want to talk about the volume?

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

No, I was just going to say, look, that in terms of the actual response to Aetna, I would say it's really too early for us to say that at the moment. We are just going through on a number of contract renewal discussions or starting them. A lot of the big commercial contracts don't renew for a while for another year. So we -- in terms of we are talking to everyone as James says, it's -- logic would dictate that there are opportunities for us. But I think as yet, we're not -- it's not clear to us yet exactly what the shift is going to be in the way the contracts are working.

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

But I think the important point is the 2% is decent, but it's not what we aspire to. And we would expect and we're targeting more contract wins in the next 12 to 18 months than happened in the prior 12 months because we've lost -- we lost 2 points of volume on this MD thing. And we have won some other Med D contracts, so it's -- there have been offsets, but 2% is not what we particularly aspire to.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

That's right. So like 2 years ago, you guys took a lot of volume with the Prime deal, and then CVS responded last year with the more aggressive Med D contracts, so you've been battling for volumes.

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

It's very logical what they did. It was expected that they would transfer the volume to their own network. It wasn't expected at pace, and it wasn't expected, however, we didn't expect that they would transfer before the transaction was complete. So I think from that point of view, we kind of have it behind us now, but it arrived at a pace that we frankly weren't expecting.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. And then can you talk about the retail sales at the front of store sales? It seems like that it's been a bit challenged for a while on a year-over-year basis. Any thoughts on that and how you could turn that around? They've been declining, I think, in like the 2% to 3% range for a while.

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

Yes, there's been -- the last quarter was 3.2%. We're clear that about 180 basis points is coming from deliberate decisions to deemphasize. Tobacco is one of those that cost us over 100 basis points. That's declining at 15%, but it's still in the base, and it's a sizable category. And then we said we had cough, cold, flu. But I think you're right. We had a couple of quarters where it's low single-digit declines. I think some of this is coming from a lack of focus, and I think some is coming from a capability thing. We have extremely attractive margins in health and wellness, and we're very good at health and wellness. So what that means is all the OTC and everything that surrounds the pharmacy, our margins are high. The business grows consistently year-on-year, but our marketeers are not spending enough time on it. Our merchandisers don't spend enough time. What I'm trying to drive right now internally in the company is a shift away from growing our business in Thailand to actually focusing on the Walgreens flagship brand in the U.S., where it can support any kind of investment. The other one is we're not going to be the best retailer in food and general merchandise. Our scale is too small. And we are obviously not going to buy as well, so our price premiums are higher than the competition. We've also seen some pretty competitive discounting by our principal competitor, CVS, and they're getting 0.5% growth but at what cost? Our margins have increased 350 basis points over 3 years, and we now make a nice margin on our total retail business without the scale, heavily influenced by health and wellness. So what I'm trying to do is I actually don't care if we decline in food. I really don't care. Because on a fully absorbed basis, it's not the most attractive category. I want all the marketeers working on health and wellness, beauty. And even in beauty, it's skincare first, beauty second. And seasonal is probably pretty attractive at times, so there's been little attention in the past as to where to direct the right dollars and the right management attention, and we're flipping that quite quickly even as we speak. So -- but our target is not to go unprofitable our low-profitability categories. It's to drive the flagship products.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

I think your U.S.A. gross profit was actually up 6% year-over-year in this past quarter so...

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

That's been aided by Rite Aid. So just to be fully transparent, aided by Rite Aid, the health and wellness category is growing. We're making a lot of investments in beauty. So I think what you'll see is if you subsegment our retail business going forward, there'll be a portion of it that's very profitable growing very quickly. And frankly, I'm not too concerned if we deemphasize some of the categories in there, including tobacco.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Yes, okay. So you've been with Walgreens for less than a year. You've announced a pretty aggressive cost restructuring program. Maybe you can talk a little bit about that and what your objectives are there. I think you want to save $1 billion -- have a $1 billion of savings by year 3.

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

I don't see it as aggressive. That's the first thing I'd say. Some others in the company do. But no, I think it gets back to what the business model is. I think long term, with the pressure on investment, we need higher volumes in store. We need generic savings, and we need consistent cost reduction over a long period of time. That's what I'm bringing. So the $1 billion is actually a stake in the ground, and you can presume it's at least $1 billion, and I would suggest that we should be targeting significantly more. We are essentially looking at just doing the fundamental benchmarking. We're driving smart spending, which is nonpeople cost. Another one which is deeper is smart organization, which is how do you reduce the cost of, for example, finance but improve the capability and the outlook and the decision support. So this is not a cost exercise. It's a capability first, followed by cost. And I'm convinced that you can do both at the same time, and I've seen it -- I've done it in the past. The other one is digitization of the company. That's more complex, which is -- I'd give you -- one example of what we're looking at is how do you use advanced data analytics, predictive technologies, machine learning to manage shrink in the stores. Shrink is a $1 billion to $2 billion, I'm not giving precise numbers, cost item in the store, whether it's theft, stock losses, stock that's out of date. If you can take out -- this could be $50 million, or it could be a $400 million savings, but we're not going to do it with traditional approaches of just setting targets, reduce shrink. That doesn't work. So we have to differentially change using advanced technologies the way we work as a retailer. That's one example. The other one is we surround the consumer with an ability to interface with us digitally, and that will reduce the cost to fill a prescription in store. It will also simplify the back office. And theoretically, what we'd like to get out of all this is higher revenue. That will be the test, and we drive fundamentally different revenue profile. That's why we did a contract with Microsoft. That's why we did one with Verily. We see data driving the future of the company.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Yes. So when you say digital connections to the consumer, is this like your response to Amazon? And can you give like an example or 2? You're talking about like texting a member when a refill is ready. Any other additional examples on how you can drive volumes into the store.

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

Anybody that's on the Walgreens loyalty already can get text as a reminder, so that's -- we see it as the basic. I'd try to describe what we're doing at Microsoft. It is -- we have no target because it's a research project, what we call Horizon 1, 2 and 3. 1 is get all our data in the cloud. So they've got a bunch of computer science experts in there, looking at our 900 systems, probably find more. I actually did. I think it must be a lot more. How many can go in the cloud, and that's more of a cost savings and organizing our data. Horizon 2 is for store of the future. Horizon 3 is health care breakthrough through technology. And what they're committing is -- I can't give the number. We haven't given a lot of scientists, experts to work on this, so we're doing it equally. So what we're committing to is a significant research budget to breakthrough on store of the future. An easy example is frictionless checkout. We have it already, so you don't have to talk to anybody going through the store. Pick up your prescription. You pay by passing your phone. That's the simple stuff. We're trying to get them to bring us through a breakthrough level on store and on health care services. But we don't know what the outcome is because we get the questions, well, you're doing a lot of pilots, what's the size of the prize at the end? We don't know. That's the simple answer. But if you don't do something about it now, you're going to get left behind, and it's not a response to Amazon. I don't know if you saw, there's a -- FedEx have launched a new service yesterday, which is an iBot, which will go around and do individual deliveries. So a good example of a partnership is we signed a contract that you can do FedEx in 7,700 stores. The consequence is, together with Walmart and Target, we're a seed partner in this iBot -- delivery iBot they have come up with. And that's the example of you've got to do multiple initiatives because it is a battle. And it is, in the end, it's Walmart with others, with Target, and people are joined in together. Whether it's data, delivery systems, whether it's FedEx, they're joined in together for playing out a battle against Amazon and others. And there's going to be multiple delivery systems, and we believe that we control a large portion of the last mile and that many mail delivery systems are more expensive than going through the combination of our distribution store and last mile. So it's not a -- we have as many advantages and disadvantages versus the others.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Okay. Can you talk a little bit about the Retail International division? How is that division progressing? There've been some challenges there. What are your thoughts as a CFO in turning that around?

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

Yes. I think speed is the answer I would give. We have a particular problem in the U.K. It's a very large company. We have 62,000 people there, 2,500 stores, #1 in pharmacy, beauty, in every category we operate in. The problem is the market is down 3%. We're holding or gaining share, but our profits are down because the guys didn't get out in front of the cost of general. So a little bit, there's been a rapid shift of younger consumers online, which is not an issue because we're, by far, the biggest online participant in beauty. We are the number -- that's the main business in the U.K. It's a beauty and personal care business, less of a pharmacy. We enlist the trend, which is it's not the fact people are going online. They're going online to buy different brands, edgier brands, startups that disappear in a year's time, and our system and culture wasn't flexible enough. So there was an announcement. This is not insider. Yesterday, we downsized the headquarters, which is 2,500 people, by 500 people. So this is -- we've been prepping it for 3 to 6 months. So the action is -- and don't let it be interpreted as a blunt instrument. The action there is there's too many people in headquarters that are not adding value, and two is the consumer is too slow. So it's actually a consumer change mixed with the cost of general to make sure they get out in front of the next. And so don't let it be. We will respond very quickly to the market. And Brexit is not going. the market is going to suffer for a considerable amount of time.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

That's 20% of the corporate headquarters, FTE is reduced.

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

Yes, 20%. The same happened in Chile, a massive competitive price battle that unfortunately, I think, we started, which was kind of steep. The consequence for Chile is we reduced 16% of the store count and 20% of the overall headcount. And they did it in 1.5 months, and it's still not at breakeven.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

Are there challenges with government reimbursement in the U.K. as well for the stores or not?

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

It's a much lesser problem. And I think what we've seen for the first time ever is actually a dip in volume, in units, which is the first time that's ever happened. They have basically -- right now, we're -- they basically have confirmed flat reimbursement, so what you have is a mix issue.

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

Yes, they just -- they have systematically reduced reimbursement over the last few years, but they've indicated to the market that for the next year, for fiscal '19, they're going to leave the global some -- the NHS piece, they're going to leave unchanged.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

So looking forward, more steady reimbursement rates in the U.K. combined with a significant cost reduction.

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

Well, U.K. is 20%, 30% of the business depends on pharmacy. U.S., it's 70%. So we're less dependent. It's more predictable in the U.K. So I wouldn't worry much about pharmacy in the U.K.

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

Right. But the U.K...

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

It's reigniting the beauty business in the U.K., and we're doing -- right now as we speak, we're investing. As we're reducing headquarter, we're investing significant capital to rejuvenate the top 25. These are megastores. They invoice way more than $50 million a year, and they're in Central London, Manchester, these kind of places. We're pumping money into the beauty area of the store. So actually I'm bringing in more brands. These brands I mentioned that we should have had historically. There are 6 or 7 new brands coming in, plus major capital investments. So I think the way to do it is if you're taking out cost, you got to apply some of that back in the business because you got to get the top line back again.

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

But at the end of the day, I mean, everyone knows the U.K. High Street is still very depressed because of Brexit, and the best of what we are aiming to do is coming out of that strongly.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

We're largely through our allotted time. Just a quick sentence on wholesale international, thoughts there. The results actually seem pretty steady, pretty good to me this past quarter. What do you think?

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

Yes. It's a very consistent business. It's done 4% to 5% every quarter in the recent past. It's a business that continues to be under always margin pressure, but it continually gets some profit growth. Here again, and they volunteer this, so it's a little bit the culture of the company. We're all running cost optimization even in the successful businesses to ensure we get out in front of this. But the business is doing really well, very happy with it. But we wanted to do better.

David M. Larsen - *SVB Leerink LLC, Research Division - MD, Healthcare Information Technology and Distribution*

James, Gerald, Jay, thank you so much. Appreciate it.

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

Thank you.
