

Recommendation: HOLD

Target Price until (11/31/2015): 63.07

1. Reasons for the Recommendation

I am recommending a 'HOLD' on our current position in Walgreens with a target price of \$63.07 which corresponds to an approximately 2.1% annual growth in addition to the 2.1% annual dividend for a total annual return of approximately 4.2%. The reason for the 'hold' recommendation despite a lackluster two-year projection is because I am projecting a fair amount of growth in the next six months prior to the completion of the Alliance Boots acquisition at which time I expect the stock price to decline as investor expectations diminish.

I am projecting an increase of 8.3% in the next calendar year, or 10.4% combined with the dividend. The \$63.07 target price is based off of a projected \$2.43 earnings per share, a 26 price-to-earnings (P/E) ratio, and 1,086 million shares outstanding compared to current values of \$2.56, 23.63, and 946 million respectively.

The \$2.43 EPS is based on growth in net sales of 3.33% or approximately \$74 billion in total sales for quarter-ending November 31. The net sales are comprised of prescription drug- and front-end sales- of \$47.3- and \$27.7 billion respectively which results in a more significant contribution from prescription drugs (~64%) then previous months, but still lower than the average (64.6%) going to back to 2005.

Walgreens' prescription sales growth trend using a quarter-on-quarter growth rate, as well as an annual growth rate, indicates a growth to about \$52 billion in FY 2014. However, the model is based on growth with a number of very profitable patented drugs. These drugs which are or will be expiring shortly should suppress the growth in prescriptions and therefore I have projected quarterly growth of 1.8% (7.2% annual).

Front-end projections are quite a bit more difficult because Walgreens does not make it clear how much each of their segments contributes to overall sales in this regard. Walgreens' trend indicates just over 1% quarterly growth rate (4.23% annual), however Walgreens has been pushing to increase the overall contribution to net sales from front-end with a number of pro-active measures. Keeping this into consideration I have instead projected a still modest 1.5% quarterly growth (6.14% annual).

The next measure used in the EPS projections was cost of goods sold (CoGS) which has historically (going to 2007) been around 71.6%. Walgreens has implemented a number of initiatives intended to decrease CoGS, but is also benefitting from an industry trend toward increasing prescription margins which are discussed below. Walgreens' CoGS has been trending down at approximately 0.28% per quarter (1.11% annual), but due to their initiatives and the industry effects I am projecting a quarter decrease of 0.36% (1.45% annual).

On a less positive note are the projections for selling, general, & administrative (SG&A), interest expense, and shares outstanding. Walgreens' SG&A has been trending upward and is projected to be about 25.6% by November 2015 for a quarter-on-quarter growth rate of 0.7%. This trend is taking into consideration the increases attributed to recent acquisitions, a trend which does not appear to be reversing any time soon. Net interest expense in the most recent quarter was \$55million and has been steadily rising since it was at \$0 in November 2007.

Finally, total shares outstanding have trended *downward* on average with the exception being when the company sold new shares to finance recent acquisitions. I am likewise projecting a continued

downward trend, again with a single exception. Beginning February 2014 Walgreens has a six month window in which they may exercise their option to complete their acquisition of Alliance Boots GmbH which will cost Walgreens' approximately 100 million shares.

2. Company Analysis

Walgreens has meteoric rise in their stock price over the last year has been the result of culminating company strengths in combination with favorable environmental opportunities. However, I believe that the weaknesses and threats to Walgreens' success have not yet been revealed fully to the market and these factors, I believe, will ultimately be the reason for their projected stagnant stock growth.

Walgreens' strengths are notable, but possibly the most notable strength is their powerful executive management team which has been carefully crafted to position the company for the future. Thirteen people serve on Walgreens' executive board ten of which are independent. The board is led by an independent chairman – James Skinner former CEO of McDonald's. Janice Babiak who is part of the Audit and Finance committees is a certified public accountant in Great Britain which is particularly useful for their acquisitions of Alliance Boots.

Walgreens also boasts a state-of-the-art information management system integrated with their point-of-sale (POS) system that provides them an incredible amount of inter-business leverage and knowledge. Combined with their recent customer value initiatives they are poised to gain a great deal of purchasing habit information which they hope to leverage into increased basket sizes and improved front-end margins. The success of their initiatives has yet to be determined as it has not yet been anniversaried, but initial indications are that it has had a very positive impact.

Walgreens is positioned to capitalize on a number of opportunities, the foremost being their new-found global presence; of their competitors, Walgreens is the first with a significant global footprint. Also of great significance is the current industry environment – with expiring drug patents providing better margins, the start of the Affordable Care Act increasing availability, and the aging population increasing demand. These factors are a perfect storm to help Walgreens address their mounting debt and leverage it into an even strong strategic position relative to their competitors than they already had.

Other opportunities include their online presence, mail-order drugs, and in-store health clinics. Walgreens, who didn't enter the online scene until 1999 lagged behind their competitors in virtual sophistication. Walgreens management team was aware of the necessity of a strong online presence in today's environment and acquired an online retailer – drugstore.com.

The mail order business presents a particularly good opportunity for pharmacy retailers because regulations on mail-order prescriptions are more lenient compared to over-the-counter (OTC) prescription sales. Mail-order prescriptions sales are not limited quite as stringently as OTC in terms of length of the supply that may be sold in a single transaction. For example OTC may be limited to one month supply while mail order may permit up to three months. To take advantage of this opportunity Walgreens completed the acquisition of BioScrip in 2012.

Among Walgreens' weaknesses is their increasing debt and their currently weak online and mail-order presence. The former has already been mentioned as an opportunity, and though it is currently a weakness my belief is that it presents more of an opportunity and thus will not be discusses in the context

of a weakness, but it would be remiss to not mention that, compared to their competitors, they are substantially weak.

Walgreen's leverage is their greatest weakness, but their timing for incurring the debt was impeccable in this regard as is mentioned below. Walgreens' current debt-to-equity (D/E) ratio, interest coverage ratio, and debt/EV ratio are 0.89, 0.05, and .274 respectively.

The threats to Walgreens are their competitors, regulation, and a slow or shrinking economy. Walgreens' competitors aren't nearly as highly-leveraged and are in a position to make acquisitions in a compressing industry if necessary. CVS has grown rapidly in the number of retail outlets and they are vertically integrated with their own Pharmaceutical Benefits Manager (PBM). Regulation is a concern for Walgreens in two regards: 1) Strict regulation has already resulted in the temporary closing of one of their six distribution centers and they have received numerous fines, and 2) repeal of the affordable care act would result in a less positive future outlook for the industry as a whole. The last threat, the slowing or contracting economy would be particularly bad for Walgreens because they are depending on growth to pay for their debt.

3. Industry Analysis

The Pharmacy retail industry is in the midst of a perfect storm in regard to the core of their business – prescription drugs. The combination of expiring patents on brand-name drugs which opens the window for higher-margin generics, and the ACA coming into play provide a bright future outlook. The front-end portion of the pharmacy retail industry is also expected to grow, but at a rate much more in-line with the retail industry at large,

For prescription drugs specifically the number of prescription drugs sold per citizen is increasing for a number of reasons. An increasing population base itself provides additional potential clients. The increasing average age of Americans results in more prescriptions sold. As reported by the US Census Bureau there is a significant different in the number of prescriptions filled for individuals between the ages of 44 and 64 as there are for those 65 and older. More prescription drugs are being sold as a result of there being more availability to treatments for previously untreatable conditions, and as diagnoses for conditions rise (less-and-less Americans are “normal” apparently). Finally, the ACA makes it possible for more people, who previously were unable, to purchase prescription drugs. According to S&P the prescription drug sector should grow 5.3% annually.

The positive forecasts for the industry would make it an attractive one for potential entrants, but the barriers for entry are high, and the competition is extremely fierce. The industry is condensing as smaller pharmacies are either bought out or close their doors. Together, Walgreens, CVS, and RiteAid comprise more than 60% of the market and they have all made acquisitions to increase their network size or capabilities.

	2008A	2009A	2010A	2011A	2012A	2013A	2014F	2015F
Unit Price	31.49	35.98	31.67	32.32	36.33	60.50	64.21	63.07
Diluted EPS	2.18	2.03	2.13	2.97	2.43	2.59	2.47	2.43
Sales (millions)	59034	63335	67420	72184	71633	72217	74928	73706
Shares Outstanding (million)	990.6	990.0	981.7	915.1	874.7	946.0	944.1	1050.3
P/E	14.46	17.76	14.87	10.90	14.94	22.86	26.00	26.00
Net Income	2157	2006	2091	2714	2127	2450	2325	2640

