Recommendation: BUY **Estimated Fair Value: $51– $57**

1. Reasons for the Recommendation

Given the estimated fair value and the current market price, which is between $49 and $50 dollars [1], it would appear as if Walgreens is undervalued. The recommendation to buy is not only because the stock is worth more than what the price currently is, but also because the company will continue to grow as they completely acquire Alliance Boots. Also, they will work with Amerisource Bergen to create a significant presence in the global pharmaceutical industry, and will gain most of their customers lost in the Express Scripts dispute. Walgreens will soon become the largest retailer in the pharmaceutical industry with the help of Amerisource and Alliance Boots, who have allowed Walgreens to expand outside of the U.S.[2] Lastly, as the Patient Protection and Affordable Care Act goes into effect in 2014, the company will also continue to grow. The forecasts are that operating margin and revenues will continue to grow within the next five years, mainly due to its expansion to foreign markets and from regaining customers lost to CVS due to the contract dispute with Express Scripts. We have already seen an increase in the number of customers this year, which will continue to grow as they gain most of the customers lost, and as Alliance Boots customers become Walgreens customers.

Positive

Acquiring the remaining 55% stake in Alliance Boots will give Walgreen Co. access to international customers and suppliers. If Walgreens does not expand to other markets, their growth would be restricted only to that of their domestic market; this would mean that they are missing out on opportunities to expand to other places where the industry is growing. Alliance Boots has a presence in over 25 countries, which gives Walgreens the opportunity to gain access to new customers, suppliers and any different technology that Walgreens does not have. Alliance Boots has made many acquisitions and has been able to integrate different ideas from the businesses it has acquired, which have made it the leading pharmaceutical company in Europe; this will benefit Walgreens because it gives it the opportunity to gain important knowledge from a company that has been very successful in a foreign market. Without the current partnership with Alliance Boots, it would have been really difficult and costly to expand to a foreign market because Walgreens would have had to do substantial research on the types of regulations or policies pharmaceutical companies face in Europe. Having international suppliers gives the company the opportunity to lower its production costs. This will be necessary once the pharmaceutical industry begins attracting more entrants after the Patient Protection and Affordable Care Act is enforceable, and the companies in the industry will have to differentiate themselves to remain profitable. In 2015, Walgreens has the option to gain the remaining stake in Alliance Boots, and it would appear as if Walgreens is leaning towards completely acquiring Alliance Boots because it has plans to become the largest retail pharmaceutical company in the world. Being the largest pharmaceutical company will give Walgreens bargaining power, and will put the company in a strong position within the industry; this will be helpful when other big retailers attempt to have a greater stake in the industry, such as Wal-Mart. The

[1] As of 4/25/13

[2] Sec.gov

recent partnership with Amerisource Bergen, a pharmaceutical wholesaler, will also give Walgreens more control over its supply chain, which means it can cut down some of its costs to be able to compete with other businesses in the industry.

Recently, Walgreens and Express Scripts, a third party beneficiary, had a disagreement over reimbursement rates, and their contract was terminated. However, as of September 15th ,2012, Express Scripts customers have been able to get their discounts once again from Walgreens. Walgreens saw a 3.2% increase in sales from the last quarter in fiscal 2012 to the first quarter in fiscal 2013, and it is mainly due to returning customers that were lost during the dispute. The recovery from the loss Walgreens suffered due this dispute will be slow, but it will probably be the case that Walgreens gains most of the customers back.

The Patient Protection and Affordable Care Act will give more bargaining power to third party beneficiaries like Express Scripts, for example. This means that retail pharmaceutical companies like Walgreens will probably have to reduce production costs in order to remain profitable, since a large percentage of their customer base will now be asking for lower prices. Walgreens plans on providing more generic drugs, which means less costs for both Walgreens and customers. Walgreen Co.'s lower prices will allow them to attract customers, and take away sales from other pharmaceutical companies that cannot keep their costs down and produce lower prices to customers. Walgreens has an advantage over small pharmacies because it is such a large company that it can take advantage of economies of scale and produce really low prices to customers. The recent partnership with Amerisource Bergen also helps Walgreens to keep its production costs down. The Affordable Care Act will also require everyone to have health coverage, which means that more people are going to be able to afford the products available at Walgreens. The aging population also gives Walgreens a higher opportunity of making more sales.

Negative

If Walgreens does not gain a higher percentage of market share it can have some difficulty facing the consolidations occurring in the industry. For example, Medco and Express Scripts recently merged, and so did SXC Health Solutions and Catalyst Health Solutions, which means that these third party beneficiaries will now have a great influence on demand [3]; Walgreens needs to be more attractive than its competitors to maintain these customers because third party beneficiaries currently make up about two-thirds of the prescription sales. Walgreen Co.'s competitors, however, only continue to grow. CVS continues to gain market share because they gained the customers that Walgreens lost to the Express Scripts dispute; CVS has been expanding overseas particularly to South America where they recently acquired a Brazilian pharmacy store chain. The acquisitions being made in South America by CVS are particularly important because they have high potential for success since the government is personally growing the industry by proving subsidies, which will create growth for this market. Another reason why Walgreens faces a significant threat is because CVS, who is Walgreen Co.'s biggest competitor, has been known to be able to work better with third party beneficiaries and other businesses in the pharmaceutical supply chain, which makes CVS a more attractive partner from the third party beneficiary stand point.

[3] IBISworld.com

The Patient Protection and Affordable Care Act brings many benefits for Walgreens but it can also bring negative effects because it is one of the main reasons why the pharmaceutical industry is attracting many competitors. Walgreens will have no other choice but to lower its prices in order to remain competitive. If Walgreens is not able to reduce the costs by better managing its supply chain, it will not be profitable.

The loss of a large third party beneficiary would have a very significant effect on the profitability of Walgreens. The dispute with Express Scripts cost Walgreens 85% of sales to Express Scripts' members. If Walgreens is not able to gain back most of the customers back, or if it loses another third party beneficiary customer it will face great difficulty to recover from yet another loss.

Multiples Valuation

The different methods used in the multiples valuation gave me slightly different valuations, which suggest that none of the methods are perfectly accurate. I did not use the multiples valuation when calculating the estimated fair value because some of the competitors used to compare the multiples of each company can be considered outliers and are not easily comparable to Walgreens. Overstock.com and Amazon.com, for example, cannot be considered direct Walgreens competitors. For these reasons, the recommendation is not based on the multiples valuation.

2. Company Analysis

For Walgreens, prescription drugs make up most of the sales with 63%, followed by general merchandise with 25% of sales, and non-prescription drugs with 12% of sales. [4] The pharmaceutical part of the company has customers ranging from everyday customers like me and you, to third party beneficiaries, and even to the government who is a customer through programs like Medicare and Medicaid. The general merchandise part of the business mainly has everyday customers like me and you that shop for food supplies, beauty products, and other convenience items.

- **Prescription and Non-Prescription Drugs Segment**

Being that the drugstore aspect of Walgreens brings in the most sales, it has many benefits, but could also have many risks. The strengths that Walgreens has in this segment of their business include their convenience to the customers. Walgreens makes sure that their building plans for new expansions are made in a saturation manner so that their customers can go to their pharmacy location instead of a competitor's. Another way in which Walgreens is convenient is by the many available ways that customers have to receive their pharmaceutical products. If a customer does not have a Walgreens store close to them, they can order their products online or by phone , and receive them by mail. Walgreens.com makes the drugstore easy to access. Walgreens also makes it easier for their customers to pay for their needs because it maintains relationships with third party beneficiaries, such as health insurances. Walgreens is ahead of its competitors in a product and services availability aspect because other stores that sell prescription and non-prescription drugs are not as easily accessible. Knowing that customers prefer the easiest and fastest way of attaining their products has aided Walgreens in becoming the most profitable drugstore chain in the U.S. These qualities are different from those of its closest

[4] Sec.gov

competitors, namely Rite Aid and CVS, because these companies have not been able to match Walgreens' convenience. Walgreens has over a thousand more store locations than CVS, and many of these locations provide services that neither CVS nor Rite Aid have. For example, Walgreens has worksite health and wellness centers where employees provide medical services to customers who prefer the service in a certain place like the work place, for instance. The infusion and respiratory services facilities are also something that makes Walgreens unique because make it easier for people with serious health issues to get services they need since Walgreens has many of these locations nationwide. [5]

Along with benefits, this segment of the business also has weaknesses. For example, the retail sale of prescription and non-prescription drugs is very seasonal. It has its peaks during flu and allergy season, but can also see lows during the rest of the year. Sales typically are higher during the second fiscal quarter. Taking a portion of their profits from reimbursements that come from third party beneficiaries gives Walgreens benefits, but it can also be a weakness because this form of payment is not as secure as an up-front payment. Another weakness that can be identified in this segment is that it is highly competitive. Walgreens competes with any store that carries the same products as them, such as other chain drugstores or even online pharmacies. The prices, service, and variety need to be considered in order to be set apart from the other businesses that can provide the same products and services that Walgreens can.

- **General Merchandise**

The general merchandise segment of Walgreens has benefits that include their availability to customers as they are purchasing their pharmaceutical products. The fact that Walgreens has these convenience products readily available as soon as you enter the store enforces other sales in addition to the sales from the drugstore. For example, if a customer walks in to buy a pharmaceutical product, they probably will not want to go to another store to get a convenience item they also need, if they can just as easily get both the product from the pharmacy and the product from the general merchandise at Walgreens; this brings in extra sales for Walgreens. Another strength of this segment of the business is that it carries a variety of products, and they are considered to be at a competitive price. A customer can purchase food, beauty products, household products, personal care items, and photo services for what the company considers to be reasonable prices. This gives the customer more to choose from when they shop at Walgreens.

One of the main negative aspects of the general merchandise segment is that it broadens the scope of the companies that Walgreens has to compete against. By having this segment, Walgreens is now not only competing against other drugstores, but also stores that carry the same general merchandise such as grocery stores, gas stations, and many other retail stores.

The threats and opportunities that Walgreens faces will affect both segments in one way or another. As previously mentioned, the Affordable Care Act will create pressure to keep the prices of pharmaceutical products down. [6]This means that the drugstore companies will have to cut costs in the supply chain or any other aspect of the business in order to remain competitive. Another threat that can be identified is that the pharmaceutical industry is highly competitive. Walgreens competes with any store that carries the same products as them, such as other chain drugstores or even online pharmacies.

---

[5] Sec.gov

[6] IBISworld.com

Walgreens and its domestic competitors also need to keep in mind that foreign drugstore companies are growing and expanding to new markets that include the U.S., which will in turn create closer competition for the U.S. based companies. Brazil Pharma and Aisei Pharmacy, for example, are both strong players in their domestic markets, which are Brazil and Japan, respectively. They both have gained opportunities to expand their operations and will soon become competitors for Walgreens and other U.S. drugstore companies.[7] Also, as Walgreens and its domestic competitors expand overseas they will gain other new competitors that are already established in those countries, and who will therefore have a slight advantage over companies like Walgreens who are now the foreign companies going into an established market. For example, as Walgreens completely acquires Alliance Boots, it will have to compete with the other drug store companies in Europe that already have experience in that market.

The opportunity to expand their business outside of the U.S. has recently come about for Walgreens. In 2012, Walgreens made a significant investment in a European company, who is also a health and wellness business. Walgreens acquired a 45% stake in Alliance Boots. Since Alliance Boots does business abroad, this transaction can allow Walgreens to enter into new markets by being exposed to new suppliers and customers. The growing drugstore industry as a whole will also give many opportunities for expansion; more countries are now providing incentives for businesses to join the pharmaceutical industry. In the U.S. the main incentive is the Patient Protection and Affordable Care act, which will bring more customers to the industry. Although the Affordable Care Act will require lowering prices, it will also be the case that more people will be able to afford pharmaceutical products.

3. Industry Analysis

- **Prescription and Non-Prescription Drugs Segment**

The total market capitalization of the pharmacy and drug store industry is $85.6 billion. This industry's P/E ratio is 17.10, return on equity is 10%, and the dividend yield is 1.55%. CVS and Walgreens together make up 98 %, or $83.4 billion of the total market capitalization.

Walgreen Co., Rite Aid, and CVS listed on their 10-k file that they consider the competitiveness of their industry a risk that investors must be aware of. The drugstore industry is so competitive because there are many ways that consumers can attain the products that a drugstore carries. For example, online pharmacies, mail-order pharmacies, and public and private drugstores can all provide consumers with most of the same products. Online services are increasing more; therefore the companies that are able to move along with this trend will remain competitive, whereas the other companies will not. This industry will become more competitive as more companies join in due to the Affordable Care Act, and potential for growth; more than 30 million people are expected to have coverage once the act is implemented, which will help them afford more pharmaceutical products. Seniors will also be large consumers of pharmaceutical companies, especially as more baby boomers are retiring and needing more services.

---

[7] espicom.com. (2012). *Brazil pharmaceutical market*. Retrieved from http://www.espicom.com/brazil-pharmaceutical-market

Baby boomers are expected to create a lot of profit for this industry in the coming years, which is significant since they provide for 30% of the industry's revenue .The medicare Part D coverage gap is expected to continue to shrink, and patients will have to pay less out-of-pocket. The pharmaceutical segment will probably benefit the most from the Affordable Care Act out of all of the segments in the health industry. [8] According to IbisWorld, the pharmacy and drug store industry provides revenue of about $247.7 billion, a profit of $6.9 billion, and an annual growth of 2.8%. This industry includes approximately 22,576 businesses. IbisWorld lists Walgreen Co. as having a 30.9% market share, followed by CVS Caremark with 27.0%, and Rite Aid Corporation with 11.0%. The industry revenue is expected to grow at rate of 2.8% every year for the next five years to $284 billion by 2018. [9]

The drugstore industry is attracting more investments because the new legislation will make the industry a lot more profitable, and easy to enter. The industry is also attracting more entrants from small pharmacies to large retailers, because it is not significantly affected by changes to disposable income; this was proven during the 2008 financial crisis because the demand for pharmaceuticals did not change much. A lot of the products in this industry are necessities, which will not be affected too much by any changes in the state of the economy. The private healthcare allows for cheaper drugstore products, which will increase demand and help the profitability of the industry, provided it has cost deductions in another part of the industry. The number of doctor visits is expected to increase after 2013, which leads to more prescriptions, and hence more sales for drugstores. Funding for Medicare and Medicaid is projected to increase, which will help more consumers reach the drugstore products. [10]

- **General Merchandise Segment**

The general merchandise aspect of Walgreens puts the company in direct competition with many more businesses. Small retail stores, such as dollar stores carry a lot of the same general merchandise that Walgreens carries, but also the very large retail stores, such as Wal-Mart carry the same products. However, Walgreens is able to remain competitive against the large retail pharmacies because it can keep their costs down by having more direct control of supply chain, which transfer into lower costs for the consumer.

This segment has exposure to industries that include grocery, beauty, and household products. These industries saw slight decreases in sales in the past five years due to the state of the economy because consumers were purchasing more discount items. However, the state of the economy will not have a significant impact on these industries because they consist of items that are necessities, and are typically in a low price range. Consumers buy the products in these industries without involving a lot of consideration.

[8] Sec.gov

[9] Sonn, A. (2012, October). *Pharmacies and drugstores*. Retrieved from ibisworld.com

[10] newsystocks.com. (2012). *Drugstore industry and its key drivers*. Retrieved from

http://newsystocks.com/news/4016596

Appendix A: Inputs into the Discounted Cash Flow Valuation

Risk-free rate		1.03%
Default spread		2.50%
	Cost of Debt	3.53%
Bottom-up beta		0.73
Yahoo beta		1.28
Weighted average market risk premium		6.29%
	Cost of equity (bottom-up)	5.65%
	Cost of equity (Yahoo)	9.08%
Weight of debt		14.87%
Weight of equity		85.13%
WACC (bottom-up)		5.15%
WACC (Yahoo)		8.06%
Growth rate		7.26%

**Sources: 10-K, Bloomberg, Yahoo!Finance, Morningstar,IbisWorld*

Glossary:

Bottom-up beta

This is calculated by taking a weighted average of the unlevered betas for each business segment, and then relevering the weighted average unlevered beta using the firm's D/E ratio. Each segment is weighted by revenues from that segment.

Weighted average market risk premium

This is calculated by taking the market risk premium from each country or region of operation and weighted by the revenues from that country or region. The country risk premiums are from http://people.stern.nyu.edu/adamodar/New_Home_Page/data.html.

Appendix B: Inputs into valuation using multiples

Comparable Firms

		P/E Ratio	Risk (Beta)	Growth In EPS (long-term growth)		Enterprise Value/EBITDA	ROC(%)
Walgreen Co.	WAG US Equity	18.80	1.26	13.00%		9.62	10.089
Rite Aid Corporation	RAD US Equity	N/A	1.61	8.00%		9.67	2.81
CVS Caremark Corporation	CVS US Equity	17.14	1.01	12.72%		8.18	9.12
GNC Holdings Inc.	GNC US Equity	18.21	1.193	18.50%		10.70	N/A
Overstock.com Inc	OSTK US Equity	19.90	0.27	3.10%		6.97	N/A
Amazon.com Inc	AMZN US Equity	N/A	0.88	40.25%		45.47	3.90

Average P/E Ratio	18.5125			
Average Risk	1.037166667		Average EV/EBITDA	15.10166667
Median Risk	1.1015		Median EV/EBITDA	9.645
			Median ROC	6.51
Average Growth	15.93%		Average ROC	6.48
Median Growth	12.86%			
Median P/E Ratio	18.21			

**Source: Yahoo! Finance and 10-k*

Historical Multiples

P/E

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	TTM
WAG	31.2	27.5	28.8	25.4	18.5	11.6	17.5	17.4	11.2	16.7	18.9
S&P 500	21.1	19.2	17.2	16.8	16.5	10.9	18.6	15.5	13.7	15	15.6
Ratio to S&P	0.676282051	0.69818182	0.59722222	0.661417323	0.89189189	0.939655172	1.06285714	0.8908046	1.223214286	0.89820359	0.82539683

**Source:* *Morningstar, Inc.*