Recommendation: BUY **Target Price until (08/2015): $76**

1. Reasons for the Recommendation

Walgreens Company has entered into strategic partnerships with two large pharmaceutical companies that are currently top competitors in the pharmaceutical industry. The company, Alliance Boots, is the largest pharmacy-led health and beauty retailer and pharmaceutical wholesaler in the Euro Zone. AmerisourceBergen is the largest pharmaceutical sourcing and distribution services company in the U.S. The potential of these three companies and their superior business model and first mover advantage in establishing a global platform is tremendous. The value of this partnership is bringing together iconic brands with vast and expanding geological footprints; achieving significant operating synergies to fulfill a shared vision of providing quality care and services to customers worldwide. Although my target price does not reflect an immense return a year from now, I believe the optimal value of Walgreens will be realized in three to five years in from now.

In 2012, Walgreens acquired 45% of Alliance Boots; the acquisition of the remaining 55% of company extends over a six month time period starting on February 2, 2015. This acquisition opens the doors for Walgreens to expand its business into international markets, extend its products and services to new populations and merge its successful business strategy into an established international pharmaceutical company. This partnership is considered the first global pharmacy-led health and wellbeing enterprise. Alliance Boots has a strong presence in the UK, Norway, Ireland, and Thailand. Their reach extends throughout twenty-five counties in Europe and Asia. They plan to utilize this strategic partnership to grow core businesses in existing markets through quality products, customer care and innovation. By improving productivity and cost savings through efficient business strategies, they will seek opportunities to launch new and attractive products to new markets. The goal for operating synergies between Walgreens Company and Alliance Boots for 2016 is $1 billion.[1] A joint venture development company, Walgreens Boots Alliance Development GmbH, has been established in Switzerland to facilitate the delivery of synergies.

These two reputable companies plan to work in unison to expand and establish a dominant position in the European, Asian and African markets. However, as in any large acquisition there will be a transition period. Once the acquisition is complete it is expected that Walgreens stock price will drop for a period of time depending on the performance of both companies and how long the transitional period lasts. It is crucial for the future analyst to reevaluate the company and analyze their progress during this time. The potential of this strategic partnership is expected to create substantial value for Walgreens Company and Alliance Boots but nothing is guaranteed.

In March 2013, Walgreens Company, Alliance Boots and AmerisourceBergen entered into a long term partnership. The partnership includes a collaborative effort to improve service levels and efficiencies, while cutting costs and extending customer access to pharmaceutical products. This year begins a ten year distribution contract with AmerisourceBergen and Walgreens. This agreement offers a solution of operational efficiency and cost effective product distribution. By utilizing

[1] "Alliance Boots 2012/13 Annual Report MicroSite." *Allianceboots.com*. N.p., n.d. Web. 29 Apr. 2014. <http://annualreport2012-13.allianceboots.com/>.

AmerisourceBergen's optimum distribution channels Walgreens plans to achieve economies of scale. In their second quarter report, AmerisourceBergen unveiled agreements to acquire a minority stake in a Brazilian pharmaceutical company, Proforma Distributora de Produtos Farmaceuticos S.A. Through these large corporate collaborations and existing business operations in the U.S., Canada and parts of South America, AmerisourceBergen is evolving into a top global pharmaceutical company with expertise in supply chain management. This partnership also includes an agreement that gives Walgreens and Alliance Boots the right to acquire 23% equity minority position in AmerisourceBergen in 2016 and 2017; Walgreens currently owns 4.5% equity holdings.

The downside to Walgreens strategic partnerships are the risks it will be exposed to. However, every firm that decides to conduct international business must deal with the risk of uncertainty of foreign markets and differing foreign laws and regulations. Walgreens Company has established a strategic business plan to utilize all potential resources to prepare for the transition. They have deployed three key drivers for future development of the organization. The drivers are: Creating a Well Experience, Advancing Community Pharmacy and Establishing an Efficient Global Platform. The three drivers anchor the company to their core competencies, create a vision for the future growth.

2. Company Analysis

Walgreens Company is the largest drugstore chain in the U.S. The Company operates 8,681 locations in the United States, Guam, Puerto Rico and the U.S. Virgin Islands. An additional 408 Healthcare clinics are operated within existing Walgreens and other partly owned entities. Prescription drugs account for the majority of the Company's sales at 63% in fiscal 2013. General merchandise made up for 27% of total sales, followed by non-prescription drugs at 10% of total sales for fiscal 2013.[2] Pharmacists also provide valuable personalized services to customers. They perform drug consultations and recommendations for those that need advice on how to treat their symptoms. Vaccines and other immunizations are administered by the professionally trained and licensed pharmacists. Friendly and helpful staff is on-hand to provide the ultimate customer experience through personalized customer care.

Walgreens Company has notable strengths including an efficient network. Walgreens' integrated network of pharmacies, mail delivery service, mobile phone application and any of the following ecommerce websites: Walgreens.com, drugstore.com, beauty.com, and visiondirect.com; allow for convenient prescription ordering and product purchases through one easy to use, state-of-the-art information system.

Walgreens top management and Board are highly valuable personnel and add to the strength of the company. Gregory Wasson is the President and CEO of the company and sits on the Board with 12 other individuals. The 13 directors bring an immense amount of diversified experience and expertise to the Board. Most of the directors have extensive backgrounds in senior management and leadership. There is plenty of expertise in the healthcare and retail industries. Expert knowledge on marketing, product development, operations management, and business strategy and business growth is abundant. They have brought directors with expertise in the Alliance Boots Company, international business and acquisitions and mergers to address the global platform initiative. There is also plenty of experience in the financial services industry (investing), auditing and accounting. The Board of Directors is well rounded and is capable in governing the company while stimulating growth and profitability.

Walgreens Company's weaknesses are evident when you expose their dependence on pharmacy benefit management companies. In 2012, Walgreens was not a pharmacy provider for Express Scripts, the largest US pharmacy benefit manager (PBM) organization. That year total net revenues dropped a negative .76% without the Express Scripts partnership. These third-party entities are also forcing the reduction of prescription drug prices and pharmacy reimbursement rates. Walgreens Company was at one time vertically integrated with their own PBM segment but they sold off the segment in 2011 and now lack that resource to be self-sufficient in the industry. Their close competitor CVS Caremark Co. has the upper hand considering that their PBM segment brought in 53.7% of the company's $126.7 billion revenue in 2013.

[2] "Walgreens Company 10-K." *SEC.gov*. N.p., 21 Oct. 2013. Web. 28 Jan. 2014. http://www.sec.gov/Archives/edgar/data/104207/000010420713000104/10-k.htm

Although healthcare reform causes uncertainty for the industry as a whole, Walgreens has taken the changing industry trend and is capitalizing on the opportunity to expand business. Walgreens Company has taken the initiative to establish themselves as a preferred provider. They work with hundreds of Medicare prescription drug plan networks throughout the U.S. and accept most Medicare Part D Plans. Walgreens primarily works with the top Medicare Part D plans including: AARP MedicareRx, First Health Part D and Humana. In the most recent quarter report, Walgreens' market share of Medicare Part D grew 80 basis points from the same quarter in 2013, resulting in their Medicare Part D clientele growing 16%.

Both federal and state government regulation and increased stringency on health care laws is a threat to the entire healthcare industry. Walgreens Company does not have the ability to predict what federal and/or state legislation or regulatory restrictions that will be implemented in the future on the healthcare industry. Failure to conform to these laws and guidelines will have an adverse effect on business operations and financial results. For example, the Affordable Health Care Act (ACA), although its primary goal is to require the entire US population to own health care, it also seeks to reduce spending on healthcare in the long term; which adversely impacts pharmaceutical drugs reimbursement rates. This lowers profit margins and disrupts profitability.

Another threat to the Walgreens Company is the pressure from top competitors. Rite Aid Co. has 10.4% of market share, CVS Caremark Co. holds 25.4% and Walgreens Co. is the industry leader with control of 28.4% the market.[3] Competition from large superstores and wholesalers such as, Walmart and Costco is becoming more significant. These companies are able to sell both prescription drugs and over the counter drugs at extremely low prices; conventional pharmacies and drugstores cannot be price competitive and must rely on higher profit margin, band name pharmaceutical sales, front end sales and customer loyalty to boost net revenues.

[3] IBISWorld Industry Report 44611, Pharmacies and Drugstores in the US, January 2014, Sarah Turk
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3. Industry Analysis

Pharmacies and Drug Stores (NAICS: 446110) and Drug Stores and Proprietary Stores (SIC: 5912) industries consist of "Establishments engaged in the retail sale of prescription drugs, proprietary drugs, and nonprescription medicines, and which may also carry a number of related lines, such as cosmetics, toiletries, tobacco, and novelty merchandise."[4]

Competition in the industry is relatively high and expected to increase as the industry has seen healthy growth in the past five years and projected to continue at an annual rate of 2.6% till 2019.[5] Events including, healthcare reform, the Patient Protection and Affordable Healthcare Act (ACA), the rise in population of adults over 65 and overall increases in per capita annual income, are driving growth in the industry. Recent healthcare reform has increased Medicare and Medicaid funding, making it more affordable for the elderly and low income households to purchase medication. The ACA has been amended and is now covering more cost for prescription drugs for people in the coverage gap, allowing them to purchase brand name medications that tend to be high cost. The population of individuals over the age of 65 is growing due to advances in modern medicine prolonging life expectancy. Elderly have a higher risk of diseases and demand more pharmaceutical products. The upturn of the economy in recent years has increased the average per capita annual income; allowing Individuals and families who earn adequate incomes to make both nondiscretionary and discretionary purchases. As more consumers obtain the resources that allow them to purchase proper pharmaceutical products at an affordable price, the amount of prescriptions filled is expected to grow. Consumers can afford to purchase their doctor recommended prescriptions and follow the recommended dosages.

The three top competitors that exist in the industry make up for 64.2% of the industry. As consolidation and expansion becomes more present in the industry, the major companies continue to increase their control of the market share. However, regardless of market share, profit margins are historically low. The industry leaders rely heavily on sales from front-end products with high profit margins. Expirations of patents on brand name drugs are creating price wars on generic prescriptions. Pharmacy benefit management (PBM) companies are third-party administrators of prescription drug programs that process and pay for drug claims. Large PBM companies are using their size and power as leverage to force pharmacies and drugstores to accept lower than market reimbursement rates. The external factors of competition are felt industry wide and are subject to change over time. Development of new and attractive business strategies is the only way to gain a competitive advantage in the industry.

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[4] Integra Industry Reports, 5/20/11
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[5] IBISWorld Industry Report 44611, Pharmacies and Drugstores in the US, January 2014, Sarah Turk
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Appendix: Inputs into valuation using multiples

	2007A	2008A	2009A	2010A	2011A	2012A	2013A	2014F	2015F	2016F
Stock Price	$41.13	$29.51	$33.89	$33.76	$36.05	$36.69	$53.85	$68.90	$75.69	$115.72
Diluted EPS	$2.03	$2.17	$2.02	$2.12	$2.94	$2.42	$2.56	$3.00	$3.15	$4.82
Sales	$53,762.00	$59,034.00	$63,335.00	$67,420.00	$72,184.00	$71,633.00	$72,217.00	$75,670.42	$79,288.98	$122,349.59
Net Income	$2,041.00	$2,157.00	$2,006.00	$2,091.00	$2,714.00	$2,127.00	$2,353.00	$2,861.49	$3,438.22	$5,280.83
Shares Outstanding (Diluted)	1,006.30	995.50	991.30	987.90	924.50	880.10	955.20	955.20	1,090.20	1,095.20
Sales per Share	$53.43	$59.30	$63.89	$68.25	$78.08	$81.39	$75.60	$79.22	$72.73	$111.71

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*