

Walgreen Co. (WAG)

Rating	NEUTRAL*
Price (22 Dec 14, US\$)	74.27
Target price (US\$)	(from 68.00) 73.00 ¹
52-week price range	76.08 - 55.57
Market cap. (US\$ m)	70,878.17
Enterprise value (US\$ m)	81,551.00

*Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.

¹Target price is for 12 months.

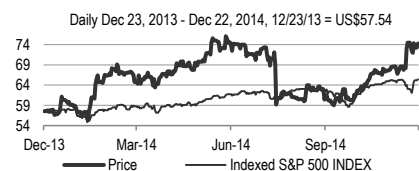
INCREASE TARGET PRICE

Q1 Highlights Fundamental Challenges, but Market Remains Focused on L/T Opportunity

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- CS View:** Walgreens' Q1 beat expectations, but the company's tepid underlying growth and cautious tone on the remainder of the year highlight its issues and the need for a more aggressive strategy long-term. Q1 EPS of \$0.81 exceeded consensus of \$0.75 and our estimate of \$0.71, although non-operating items like the tax rate seem to account for most of the upside. Core WAG U.S. EBITDA growth of 4% was actually somewhat lower than expected. Gross profit growth of 2.7% was disappointing and well below sales growth of 6.7%, but strong cost control (SG&A increased only 1.7%) allowed for better earnings growth. AB accretion of \$0.11 also modestly exceeded our estimate. On the call, management indicated that trends should deteriorate over the next few quarters as reimbursement rate pressures step up on January 1, but the company remains optimistic on its longer-term earnings power from front-end merchandising initiatives and additional cost containment efforts. The new CFO also endorsed the company's 2016 earnings goals. We continue to rate WAG NEUTRAL, as we do not view the risk/reward favorably given the recent operational challenges, structural issues with the stand-alone drugstore model, questions around the upside associated with its longer-term strategy, and valuation. We raise our estimates and our TP (to \$73) to reflect the Q1 beat and accelerated closing of the AB deal.
- Our estimates:** We raise our FY15E Adj. EPS to \$3.65 from \$3.40 and maintain our FY16 estimate at \$4.45.

Share price performance



On 12/22/14 the S&P 500 INDEX closed at 2078.54

Quarterly EPS	Q1	Q2	Q3	Q4
2014A	0.72	0.91	0.91	0.74
2015E	0.81	0.92	1.06	0.85
2016E	1.04	1.17	1.23	1.02

Financial and valuation metrics

Year	08/14A	08/15E	08/16E	08/17E
EPS (CS adj.) (US\$)	3.28	3.65	4.45	5.15
Prev. EPS (US\$)	—	3.40	—	—
P/E (x)	22.6	20.3	16.7	14.4
P/E rel. (%)	121.8	117.1	103.7	100.8
Revenue (US\$ m)	76,392.0	108,043.9	125,967.1	131,084.7
EBITDA (US\$ m)	5,841.0	8,212.9	8,594.6	9,552.5
OCFPS (US\$)	4.03	8.77	6.10	6.90
P/OCF (x)	15.0	8.5	12.2	10.8
EV/EBITDA (current)	12.4	8.8	8.4	7.6
Net debt (US\$ m)	1,864	10,673	10,159	9,467
ROIC (%)	14.66	12.29	15.54	17.56
Number of shares (m)	954.33	IC (current, US\$ m)	22,425.00	
BV/share (Next Qtr., US\$)	20.4	EV/IC (x)	3.5	
Net debt (Next Qtr., US\$ m)	-1,708.4	Dividend (current, US\$)	—	
Net debt/tot cap (Next Qtr., %)	-8.0	Dividend yield (%)	0.45	

Source: Company data, Credit Suisse estimates.

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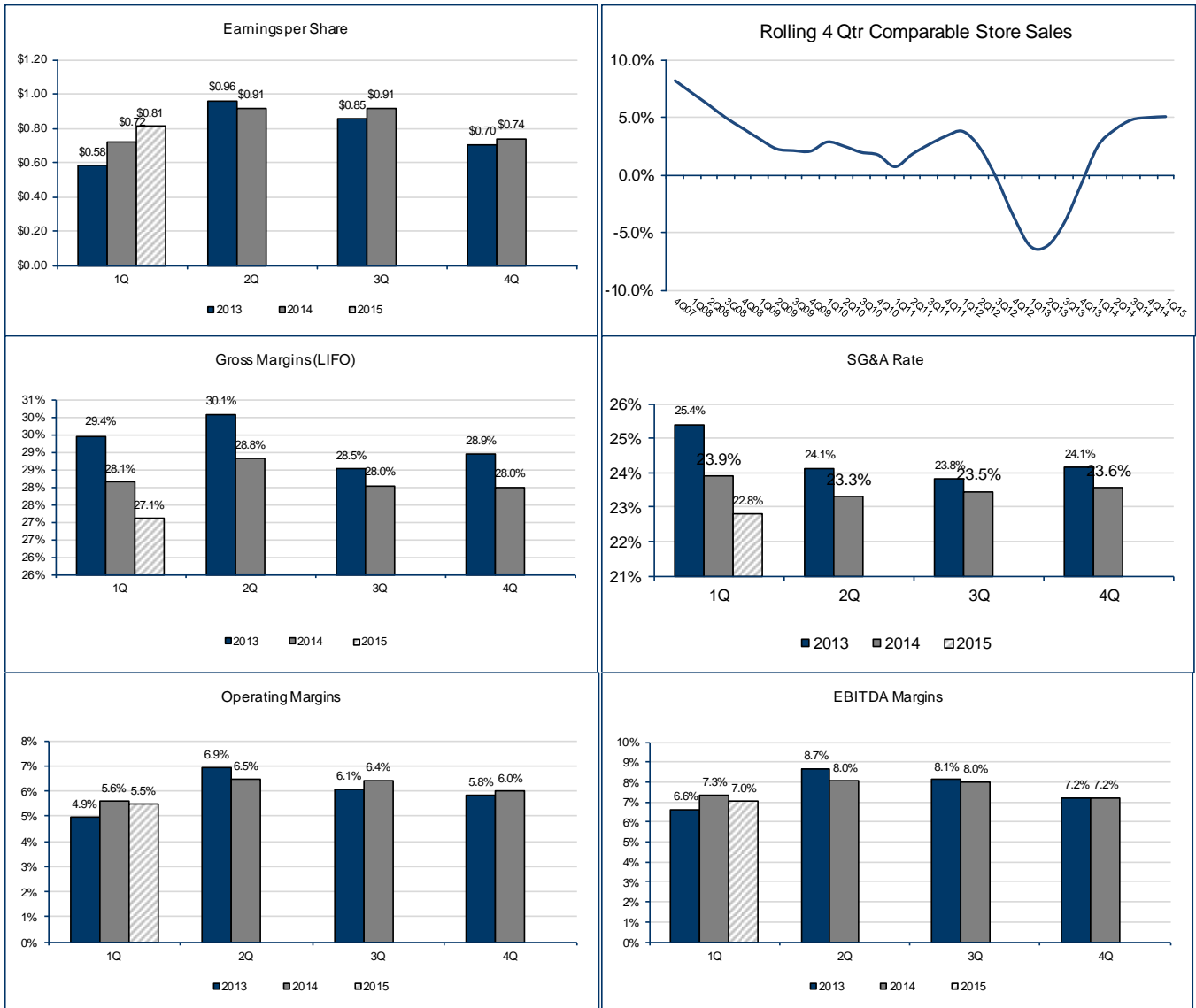
- Key takeaways:** (+) Adj. EPS of \$0.81 was ahead of consensus of \$0.75 and our estimate of \$0.71. (+) Cost control was solid as Adj. SG&A dollar growth of 1.7% y/y came in below our 3.0% estimate. (+) Front-end gross margin improved y/y for a third sequential quarter. (+) Q1 synergies of \$140m were roughly in line with our expectation and the company remains on track to reach at least \$650m by year end. Management also reaffirmed prior FY16 EPS guidance of \$4.25-4.60. (-) Consolidated FIFO gross margin of 27.1% was a touch below our 27.4% estimate as reimbursement rate pressure in the pharmacy was not fully offset by an increase in new generics, purchasing synergies, and improved front-end gross margin. (-) The company foresees ongoing pharmacy margin pressure from generic drug inflation, third-party reimbursement rates, and a step-down in Medicare Part D reimbursement rates beginning in 2015.
- Derivative implications:** WAG's gross margin pressure in pharmacy represents a negative read through for other drug stores.

Exhibit 1: WAG Year-Over-Year Comparison

	2014A	2015E	Y/y		2014A	2015E	bps
	Q1A	Q1A	Growth		Q1A	Q1A	Change
Total Sales	\$18,329	\$19,554	7%	<u>Margin Analysis</u>			
Gross Profit	5,157	5,296	3%	LIFO Gross Margin	28.1%	27.1%	(105)
SG&A Expense	4,379	4,456	2%	SG&A Ratio	23.9%	22.8%	(110)
Operating Income	1,024	1,068	4%	Operating Margin	5.6%	5.5%	(12)
Interest Expense	41	55	34%	EBITDA Margin	7.3%	7.0%	(32)
Net Income	651	739	14%	<u>Balance Sheet</u>			
EBITDA	1344	1372	2%	Net Debt	\$4,103	\$1,669	
Adj. Earnings Per Share	\$0.72	\$0.81	13%	Inventory Turns	6.7x	8.0x	
Average Shares	962	956	-1%	Free Cash Flow	-\$231	\$696	
Book Value Per Share	\$20.86	\$21.72	4%	Net Debt/Total Cap	17%	7%	
Dividends Per Share	\$0.315	\$0.338	7%				

Source: Company data, Credit Suisse estimates

Exhibit 2: WAG Sales and Margin Trends



Source: Company data, Credit Suisse estimates

Exhibit 3: WAG Operating Results Summary and Financial Analysis

Income Statement	Quarterly Results and Estimates								Annual Results and Estimates			
	2014A				2015E				2013A	2014A	2015E	2016E
	Q1A	Q2A	Q3A	Q4A	Q1A	Q2E	Q3E	Q4E	Aug	Aug	Aug	Aug
Total Sales	18,329	19,605	19,401	19,057	19,554	20,611	20,472	20,023	72,217	76,392	101,412	125,967
Gross Profit	5,157	5,650	5,440	5,334	5,296	7,116	8,272	7,127	21,119	21,581	27,812	32,235
SG&A Expense	4,379	4,569	4,551	4,493	4,456	4,659	4,691	4,617	17,589	17,992	21,918	26,013
Operating Income	1,024	1,268	1,243	1,140	1,068	1,462	1,718	1,389	4,305	4,675	5,638	7,150
Interest Expense (Income)	41	37	35	43	55	145	148	148	165	156	495	582
Other Expense (Income)	0	0	0	0	0	0	0	0	0	0	0	0
Pretax Income	983	1,231	1,208	1,097	1,013	1,317	1,571	1,242	4,140	4,519	5,142	6,568
Adj Net Inc. (ex-LIFO)	651	847	855	726	739	925	1,128	893	2,808	3,079	3,685	4,716
GAAP EPS	\$0.68	\$0.88	\$0.88	\$0.75	\$0.77	\$0.88	\$1.03	\$0.81	\$2.94	\$3.19	\$3.50	\$4.30
Adjusted "cash" EPS	\$0.72	\$0.91	\$0.91	\$0.74	\$0.81	\$0.92	\$1.06	\$0.85	\$3.10	\$3.28	\$3.65	\$4.45
Average Shares	962	964	968	968	956	1,051	1,100	1,100	955	965	1,052	1,097
EBITDA	\$1,344	\$1,577	\$1,551	\$1,369	\$1,372	\$1,783	\$2,118	\$1,685	\$5,827	\$6,123	\$7,570	\$9,523
Margin Analysis												
Gross Margin	28.1%	28.8%	28.0%	28.0%	27.1%	34.5%	40.4%	35.6%	29.2%	28.3%	27.4%	25.6%
SG&A Ratio	23.9%	23.3%	23.5%	23.6%	22.8%	22.6%	22.9%	23.1%	24.4%	23.6%	21.6%	20.7%
Operating Margin	5.6%	6.5%	6.4%	6.0%	5.5%	7.1%	8.4%	6.9%	6.0%	6.1%	5.6%	5.7%
Net Margin	3.6%	4.3%	4.4%	3.8%	3.8%	4.5%	5.5%	4.5%	3.9%	4.0%	3.6%	3.7%
EBITDA Margin	7.3%	8.0%	8.0%	7.2%	7.0%	8.7%	10.3%	8.4%	8.1%	8.0%	7.5%	7.6%
Year-Over-Year Growth												
Pharmacy Same Store Sales	7.2%	6.1%	6.3%	7.8%	8.1%	6.8%	6.9%	6.0%	-0.9%	6.9%	6.9%	4.5%
Front-End Same Store Sales	2.4%	2.0%	2.2%	1.3%	1.5%	1.5%	1.5%	1.5%	-0.4%	2.0%	1.5%	2.0%
Overall Same Store Sales	5.4%	4.3%	4.8%	5.4%	5.7%	4.8%	5.0%	4.5%	-0.7%	5.0%	5.0%	3.6%
Square Footage Growth	1.8%	1.8%	1.4%	1.0%	0.4%	0.6%	1.0%	1.1%	2.0%	1.0%	1.1%	1.1%
Total Sales	5.9%	5.1%	5.9%	6.2%	6.7%	5.1%	5.5%	5.1%	0.8%	5.8%	5.6%	4.3%
Operating Income	19.8%	-1.8%	11.7%	8.9%	4.3%	15.3%	38.2%	21.9%	13.7%	8.6%	20.6%	26.8%
Earnings Per Share	23.1%	-5.0%	7.1%	4.9%	13.0%	0.5%	16.7%	15.3%	6.9%	5.9%	11.5%	21.9%
EBITDA	17.0%	-2.4%	4.5%	6.1%	2.1%	13.1%	36.5%	23.1%	10.6%	5.5%	19.1%	23.5%
Key Operating Statistics												
Store Count	8,681	8,681	8,683	8,309	8,332	8,357	8,382	8,407	8,585	8,309	8,407	8,507
Selling Sq. Ft (millions)	89.6	89.7	89.6	89.7	89.9	90.2	90.5	90.7	88.8	89.7	90.7	91.7
LTM Sales/Avg. Selling Sq. Ft	\$825	\$835	\$846	\$856	\$865	\$874	\$885	\$894	\$821	\$856	\$1,124	\$1,381
LTM Op. Expenses/Avg. Selling Sq. Ft	\$774	\$785	\$795	\$803	\$812	\$820	\$825	\$832	\$772	\$803	\$1,062	\$1,303
LTM EBITDA/Avg. Selling Sq. Ft	\$65	\$64	\$65	\$65	\$65	\$68	\$74	\$77	\$66	\$69	\$84	\$104
Balance Sheet												
Net Working Capital	2,503	2,337	2,173	1,475	1,316	(1,573)	(2,018)	(2,632)	1,455	1,475	(2,632)	(2,633)
Net Debt	4,103	3,289	2,401	1,864	1,669	-1,708	11,831	10,673	2,941	1,864	10,673	10,159
Common Equity	20,056	20,833	21,485	20,561	20,767	21,450	22,019	22,452	19,454	20,561	22,452	22,737
Total Capital	24,159	24,122	23,886	22,425	22,436	19,741	33,850	33,125	22,395	22,425	33,125	32,896
Selected Measures												
Net Debt / Total Capital	17%	14%	10%	8%	7%	-9%	35%	32%	13%	8%	32%	31%
Common Equity / Total Capital	83%	86%	90%	92%	93%	109%	65%	68%	87%	92%	68%	69%
Leverage Ratio (Net Debt/Equity)	20%	16%	11%	9%	8%	-8%	54%	48%	15%	9%	48%	45%
Net Debt / LTM EBITDA	0.5x	0.4x	0.5x	0.3x	0.2x	-0.2x	2.2x	1.5x	0.5x	0.3x	1.4x	1.1x
Current Ratio	1.3	1.4	1.4	1.4	2.4	2.1	1.4	1.4	1.3	1.4	1.4	1.4
Payables / Inventory	62%	62%	66%	71%	80%	62%	66%	71%	68%	71%	71%	71%
Inventory Turns	6.7x	7.7x	8.4x	8.5x	8.0x	8.2x	9.2x	9.5x	7.3x	8.5x	12.2x	15.1x
Book Value Per Share	\$20.86	\$21.62	\$22.20	\$21.24	\$21.72	\$20.42	\$20.02	\$20.40	\$20.37	\$21.30	\$21.35	\$20.72
Statement of Cash Flow												
Net Income	704	768	764	(205)	836	925	1,128	893	2,450	2,031	3,782	4,716
+ Depreciation & Amortization	332	331	338	315	319	348	571	467	1,283	1,316	1,705	2,132
-- Changes in Working Capital	771	(250)	(133)	(598)	(189)	(2,889)	(446)	(613)	(667)	(210)	(4,137)	(1)
-- Changes in Other Assets & Liabilities	132	245	(37)	(676)	313	191	(25)	(81)	99	(336)	398	155
+ Capital Expenditures	364	227	230	285	335	350	438	438	1,212	1,106	1,560	1,750
Free Cash Flow	(231)	877	1,042	1,099	696	3,620	1,733	1,618	3,089	2,787	7,666	4,945
Per Share	-\$0.24	\$0.91	\$1.08	\$1.14	\$0.73	\$3.45	\$1.58	\$1.47	\$3.23	\$2.89	\$7.29	\$4.51
NOPAT (\$)									3,985	4,378	5,386	6,502
IC (\$ Average Invested Capital)									41,430	43,729	53,594	62,346
NOPAT Margin (NOPAT / Sales)									5.5%	5.7%	5.3%	5.2%
IC Turns (Sales / IC)									1.7	1.7	1.9	2.0
Return on Invested Capital									9.6%	10.0%	10.0%	10.4%

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 22-Dec-2014)

Walgreen Co. (WAG.N, \$74.27, NEUTRAL, TP \$73.0)

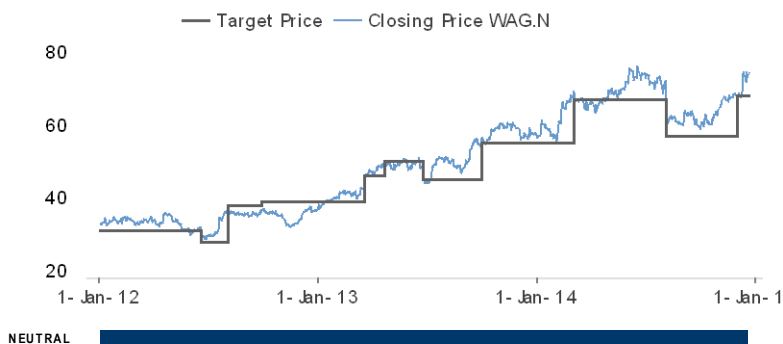
Disclosure Appendix

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3-Year Price and Rating History for Walgreen Co. (WAG.N)

WAG.N	Closing Price	Target Price	
Date	(US\$)	(US\$)	Rating
03-Jan-12	33.06	31.00	N
19-Jun-12	30.09	28.00	
03-Aug-12	35.80	38.00	
28-Sep-12	36.44	39.00	
19-Mar-13	44.74	46.00	
22-Apr-13	49.72	50.00	
25-Jun-13	45.22	45.00	
01-Oct-13	56.24	55.00	
05-Mar-14	68.48	67.00	
06-Aug-14	59.21	57.00	
03-Dec-14	67.38	68.00	



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Restricted	2%	

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Price Target: (12 months) for Walgreen Co. (WAG.N)

Method: Our \$73 target price for Walgreen Co. embeds a 16-17x P/E (price-to-earnings) multiple on FY16E EPS (earnings per share).

Risk: Risks to our \$73 target price for WAG include better than expected synergies from the Alliance Boots acquisition. Further downside risk comes from structural problems due to their acquisition of Alliance Boots, ongoing pharmacy reimbursement pressure, and questionable capital allocation. Sales could also struggle with current industry issues such as share losses to discount formats such as dollar stores, Wal-Mart, Target, and weak industry script growth.

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