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# Walgreens: Financial Analysis and Recommendations

Madeleine Robinson

*University of Mississippi. Sally McDonnell Barksdale Honors College*

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# Walgreens: Financial Analysis and Recommendations

By  
Madeleine Robinson

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford  
May 2016

Approved by

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Advisor: Professor Victoria Dickinson

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## ABSTRACT

Madeleine Robinson: Walgreens: Financial Analysis and Recommendations  
(Under the direction of Victoria Dickinson)

This thesis is an analysis including recommendations for the publically traded company, Walgreens. By using the most recent 10-K filing, a complete financial analysis was completed. Through the findings it was recommended to Walgreens that they focus more on mobile growth to compete with technology of competitors, as well as bring an in store area to represent their mobile presence.

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## Introduction

This paper was written for the class Accountancy 420. The purpose of this class was to guide students through writing their accounting honors thesis for the University of Mississippi's Sally Barksdale Honors College. This assignment's purpose was to allow us to use skills we learn in class each week, and apply them to a real life company. For my company, Walgreens, I have found some of the main issues highlighting it today Through their purchase of Alliance Boots they have embarked on a mission to go global. This is a very risky time for them, and they must tread carefully going forward in order to successful take their company overseas. They also are a mainly brick and mortar store, and as more and more sales are made online they have to push their online stores to consumers. Finally they are in a very competitive market with very close competition, thus they need to constantly innovate in order to stay successful.

Through this paper I have learned how to deeply analyze financial statement. By working with a 10-K, I was able to become very familiar with financial statement formats and how to understand them. I was also able to learn how to value stock models using two different methods as well as learn how to do advanced ratio analysis. More practical skills such as formulas in Excel were also acquired through this assignment. This familiarity with financial statements, and an exposure to all aspects of Walgreens, and companies in general will greatly help going forward with my career in accounting.

# **Chapter 1: General Company Information**

## **The History of Walgreens**

### **The Beginnings**

Charles R. Walgreen bought the pharmacy he had been working at in 1901, and changed the name to Walgreen's, as it is known today. Eight years later he bought his second store, and by 1915 he was operating five drugstores. His skill as an innovator helped to differentiate Walgreens, and ultimately led to its success.

From the beginning Walgreen's focused on the pharmacy as the heart of his business. He saw the pharmacy as what gave the establishment its credibility, and then built upon that for the rest of the store. He also was the first one to open up the actual pharmacy to the view of the store. Before Walgreen's there was a wall between customers and pharmacists, but Walgreen wanted an open view of the pharmacy. He incorporated soda fountains into his stores with nice wood counters, and created his own line of drugs. By having control over the medicine he was selling, he was able to control their quality and offer the lowest prices he could.

By 1916 Walgreen's owned nine stores, and consolidated them into Walgreens Co in order to create economies of scale. At this point in time Walgreens was making \$270,000 in annual revenue. In the next three years alone Walgreens opened 11 more stores bringing the total to 20. During this time Walgreens opened their first photofinishing studio. In the years that followed Walgreens experienced a boom of



growth. Through continuing innovation Walgreens created a successfully differentiated chain.

In 1922 Walgreen introduced a very popular milkshake to his stores' fountain counters. To meet the high demand and to control quality he opened his own ice cream manufacturing plants. While the milkshakes helped Walgreens grow, so did the American Prohibition. While it was not legal to buy alcohol for recreational use, for a price of about \$40 today one could get a prescription for medicinal liquor that allowed for about a pint a week. The medicinal use helped pharmacies nationwide, but arguably none as much as Walgreens.

Throughout the 20's, Walgreens expanded into neighboring Missouri, Minnesota and Wisconsin. The number of stores skyrocketed from 20 to almost 400 or 500 depending on the historian. In 1927 the store moved to the East Coast, and opened its first store in New York City. This was the same year the company went public. At the end of 1929 Walgreens was in 87 cities with 397 total locations. Sales had soared to \$47 million with net income of \$4 million.

## **The Great Depression and the Recovery**

When the Great Depression hit in 1929 Walgreens experienced little to no effects. due to their rapid growth during the 20's and the help of the Prohibition. In 1930 they even saw an increase in sales to \$52 million. With this increase in sales they were able to open a 224,000 square foot warehouse and lab in Chicago. This lab was built to help expand upon a project that would allow independent pharmacies to sell Walgreen's products. In 1931 they even became the first pharmacy to advertise on the radio in America. However by 1932 they did feel the pinch of hard times. They saw a dip in sales

down to \$47.6 million. To balance the decrease in sales they instituted wage cuts. Even while feeling the effects of the depression they worked to help assist and set up funds for their communities both inside and outside the company.

In 1933 Walgreens was able to pay its first dividend, and Charles Walgreen Jr. became VP. They were also able to offset losses from 1932 by selling concessions at Chicago's Century of Progress exposition. While the repeal of the Prohibition meant no more medicinal alcohol, Walgreen Co was granted liquor licenses and sold wine and whiskey in about 60 percent of its stores. 1934 saw the beginning of the Walgreen Super Store. The concept included nearly doubling the size of a typical store with a larger fountain and a more open layout. The first was in Tampa, FL with stores following in Salt Lake City, Milwaukee, Miami and Rochester, NY. In 1934 Walgreens also began trading on the NYSE.

Walgreens had a fairly easy recovery from the Depression and by 1938 sales totaled \$69 million. The founder, Charles Walgreen Sr. passed away in 1939, and his son, Charles Walgreen Jr., succeeded him as president. He led the company into the 1940's. As one of his first moves as president, Charles Walgreen Jr. opened a superstore in downtown Chicago. It featured the first two-way escalator in any drugstore. Beyond the escalator the store also had a full service restaurant as well as a tearoom.

Walgreens participated in its first merger in 1940 with Dallas based Marvin Drug Co. Marvin Drug Co added 8 stores as well as a warehouse. Walgreens established a pension plan for employees during 1940 as well. The initial contribution of \$500,000 for the fund came from Charles Walgreen Sr.'s own life insurance policy.

## World War II and Effects

As the US entered World War II the company scaled down growth and put expansion on hold. More than 2,500 Walgreens employees served in the war, but the company felt the effects in other ways as well. Certain foods were scarce, as was tobacco and film used in their photofinishing department. While some items became scarce, new items became available. Walgreens became an important marketer of war bonds and stamps. They also opened a not-for-profit pharmacy in the Pentagon in 1943 ("Our Past | Walgreens.com.").

## 1950's – 1990's

The 1950's saw a transition for Walgreens into self-service drug retailing. The first venture into this area was in 1952 on Chicago's South Side with a second following nearby in Chicago's Evergreen Mall. Because the stores were larger with more products they had more employees, but were also able to offer lower prices. Just a year after the first self-service store opened there were 22 countrywide. Conventionally formatted stores were gradually converted into self-service, and underperforming conventional stores were closed. From 1950 to 1960 only 40 new stores opened, but sales grew at a rapid pace from \$163 million to \$312 in just ten years. This massive growth is credited to lower prices, and the wider selection that the self-service stores offered. By the end of 1960 self-service stores outnumbered the original formatted stores, and Walgreens had also opened a store in Puerto Rico.

The 1960's saw big changes for Walgreens. They ventured into their first foray with discount department stores by purchasing United Mercantile Inc. in 1962 for \$3 million. Walgreens gained experience in operating larger stores and expanded on United

Mercantile by opening 10 more stores throughout the Southwest. Under United Mercantile alone Walgreens was making more than \$120 million in sales. This experience enabled Walgreens to open Walgreens Super Centers around the country. The first was opened in 1964 in Chicago, and by 1964 16 more had been opened all over the country.

As they expanded into larger stores, they also began to readjust the format and operation of its restaurants and soda fountains. With a falling return on investment for their food operations, they decided not to include them in their new stores and gradually began to remove them from their existing stores. Instead of completely removing themselves from the food industry, they moved their restaurants outside of their stores. The first restaurant opened in Chicago and was called the Villager Room. Beyond the Villager Room they also started a fast food chain called Corky's as well as a medieval Robin Hood themed restaurants. By 1970 there were 14 Corky's and two Robin Hood restaurants.

1969 saw changes to Walgreen's leadership. When his father became chairman of the board C.R. Walgreen III was named the President of the company making Walgreens one of the few companies headed by both the second and third descendants of the original founder. This followed Walgreen's decision in 1963 to elect outside members to the Board of Directors for the first time.

Continuing their foray into the food business, in the 1970's Walgreens opened Wag Restaurant. Wag was designed to be for the whole family, and many were open for 24 hours a day. They also furthered their hold on the drugstore industry by purchasing the Liggett chain in Florida. This acquisition added 29 new stores. Walgreens grew

corporately by moving into a new headquarters in Deerfield, IL. It also opened a new drug and cosmetics lab in Michigan, expanded distribution centers in Berkeley and Chicago, IL, as well as replacing their plastic container plant and photo processing facility with completely new ones. To accompany this growth they hit the \$1 billion sales mark in 1975.

The end of the 1970's saw further change in the chain of command. Charles R. Walgreen III succeeded his father as chairman of the board, and a Walgreens veteran named Robert L. Schmitt assumed the role as president. As president Schmitt oversaw the liquidation of the United Mercantile Inc chain as its return on investment had fallen, and was incurring losses. He also focused on partnering with the St. Louis grocery chain Schnucks as well as putting optical centers into stores. Unfortunately Schmitt died suddenly, and so in 1978 the relatively young Fred F. Canning replaced him as president. Walgreens closed a very successful decade with 688 total drugstores and sales of \$1.34 billion earning about \$30.2 million in net income.

The 1980's saw Walgreens refocusing on their drugstore business. In 1981 they ended many partnerships including the one with Schnucks. They also removed the optical centers from their stores. They scaled back their restaurant operations, and chose to focus on Wag's. They bought many drugstore chains throughout the 80's including Rennehbohm's and Kroger's SuperX. They remodeled many of their existing stores by adding photofinishing studios and including fresh groceries in many urban area stores. They were also able to increase communication in between stores by establishing an intercom system. This allowed customers to use any Walgreens in the country to fill their prescriptions.

The eighties saw a huge milestone for Walgreens as they opened their 1000<sup>th</sup> store fittingly in Chicago where it all began for them. They continued the pattern of focusing on the drugstore business, and divesting themselves of businesses that were showing a loss. In 1986 they completed their largest acquisition yet by purchasing the 66 stores of the Medi Mart chain. They purchased another 25 stores from the chain Ribordy in Indiana, as well as opening 102 stores on their own. These openings and acquisitions made 1986 Walgreen's single largest year of growth. They also continued to divest themselves of non-drugstore assets by selling the 87 Wag restaurants to Marriot.

## **1990's to the Present**

Walgreens came into the 1990's having seen unprecedented amounts of growth. This trend only continued. At the end of 1989 Walgreens owned 1484 stores and by the end of 1997 they had 2,200. This almost 50 percent increase was accomplished almost completely organically. They did have one acquisition in 1990 of Lee Drug, which only included nine stores. The beginning of the nineties did see a change in management with Fred Canning retiring. L. Daniel Jorndt was promoted from senior VP and treasure to president.

The 1990's saw a lot of change to the pharmacy industry as whole. The amount of people over the age of 50 was growing rapidly which led to more prescriptions being filled. While this made pharmacies evermore important it also led to increased competition between chains. Walgreens saw great competition from Wal-Mart specifically. The amount of healthcare plans also grew leading to a demand for cheaper prescriptions. Walgreens invested more in technology and development in order to take of the new trend of managed healthcare. To respond they formed a subsidiary called

Healthcare Plus as their answer to a mail-order pharmacy. They reached out to care providers through this business. On the technology side of their business they improved on inventory management by implementing point of sale scanning equipment in every store. They then completed an installation of Strategic Inventory Management System, which united every element of the purchasing-distribution-sales cycle. They also updated their already installed intercom system. It allowed customers to simply refill their medicines by a push button. All these additions worked to cut wait time in half.

To support their massive growth they opened two more distribution centers in Pennsylvania and California to cater to both sides of the country. These two centers brought the total to eight. They continued their expansion into new markets such as Detroit, Portland, Kansas City and Las Vegas to name a few. They worked towards opening more freestanding stores rather than locating stores in shopping centers. This freestanding format allowed for the emergence of drive-through pharmacies that furthered enforced to the public the image of Walgreens as the epitome of convenience. In just 10 years they had doubled their sales to \$11.78 billion.

The end of the nineties saw a shift of leadership as Charles R. Walgreen III retired and Jorndt succeeded him as CEO, and a year later also took over as chairman. Throughout the decade Walgreens continued its path of steady growth both physically and in sales. Profits jumped from \$511 million in 1998 to close to \$1.2 billion in 2003. In 2000 they opened their 3000<sup>th</sup> store in Chicago followed by their 4000<sup>th</sup> in 2003 in Van Nuys, California. In 2002 a lifelong Walgreens employee, David Bernauer, succeeded Jorndt as CEO. They also added new distribution center in Florida, Texas, Ohio and California. These new centers helped support their growing online pharmacy business.

While their competitors took a more aggressive stance toward growth through acquisition, Walgreens took a much more organic approach. They carefully selected their locations, which allowed for a quicker transition of the location to a Walgreen's formatted store. It also allowed for more locations to be located on busy corners to allow for more convenience for the customer. They aimed to have mostly freestanding locations with drive through. This format is still present in today's Walgreen's as they have continued on the same path. The pharmacy was at the heart of the business when Charles R. Walgreen began in 1901, and over 100 years later it stays the focus.

## Walgreens's Operations

### Core Business

At the core of Walgreens's business is their pharmacy. They have focused on this aspect of their business since the inception of their company. In past years they have adopted the saying "The Corner of Healthy and Happy". This phrase completely summarizes how and what Walgreens sees as their main business and their goals. They aim to be a leader in health and wellness. They have one reportable segment, and consider themselves a part of the retail drugstore business. They sell prescription drugs, non-prescription drugs and retail merchandise. Prescription is the largest selling with over 699 million prescriptions filled in 2014, followed by general merchandise and then non-prescription drugs. They are a US focused firm with stores in all fifty states plus Guam, Puerto Rico and the US Virgin Islands. All of their revenue in the past three years has been generated within those countries, as they have had no export sales. Beyond their brick and mortar stores they also have a strong online presence through multiple domain names. They served an estimated 59.7 million visits to their websites a month in 2014.

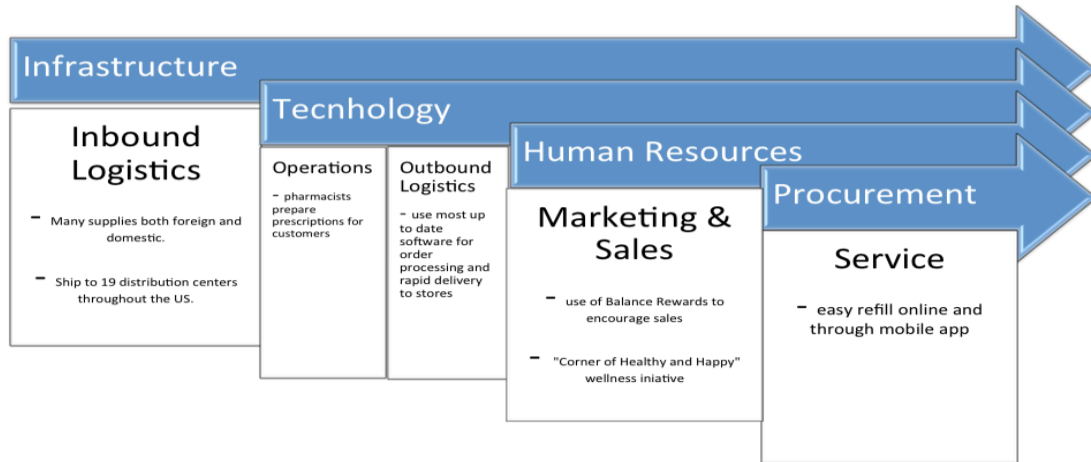


Their online business is supported by their mobile app that makes prescription refilling very easy. They also have a balance reward program that as of 2014 had 82 million users. They recently acquired a controlling interest in the British company Boots opening up the potential for expansion into Europe.

## **Manufacturing Centers and Corporate Headquarters**

To support their US stores Walgreens operates 19 major distribution centers (10K). Thirteen are wholly owned by Walgreens, and the remaining locations are leased. They range in location from California, Arizona, Texas, Illinois, Minnesota, Wisconsin, Ohio, Georgia, South Carolina, Pennsylvania, Florida and Connecticut. All of the distribution centers are outfitted with modern systems for order processing, and allow for the rapid delivery of merchandise to stores. AmerisourceBergen substantially distributes all Walgreens brand and generic prescriptions. Their merchandise is purchased from many suppliers both foreign and domestic. This diversification has taken risk out of losing one or a group of them. Walgreens is headquartered in the Chicago suburb of Deerfield, and operates 34 principal offices. They own thirteen of them, and lease the remaining. They also operate two mail service facilities and own one of them.

# Value Chain



## Board of Directors

### **James A. Skinner**

*Chairman*

Retired Vice Chairman and CEO, McDonald's Corp

### **Janice M. Babiak**

*Chair of the Audit Committee, Member of the Finance Committee*

Retired Managing Partner, Ernst & Young LLP

### **David J. Brailer**

*Chair of the Finance Committee, Member of the Audit Committee*

Chairman, Health Evolution Partners

### **Steven A. Davis**

*Member of the Compensation Committee, and Nominating and Governance Committee*

Chairman and CEO, Bob Evans Farms Inc

### **William C. Foote**

*Chair of the Nominating and Governance Committee, Member of the Compensation Committee, Lead Independent Director*

Retired Chairman of the Board and CEO, USG Corporation

### **Mark P. Firssora**

*Member of the Audit Committee, Nominating and Governance Committee*

Former Chairman and CEO, Hertz Global Holdings Inc and The Hertz Corporation

### **Ginger L. Graham**

*Member of the Compensation Committee, and Nominating and Governance Committee*

President and CEO, Two Trees Consulting

**Alan G. McNally**

*Member of the Finance Committee, and Nominating and Governance Committee*

Retired Chairman and CEO, Harris Financial Corporation

**Dominic Murphy**

*Member of the Finance Committee*

Kohlberg Kravis Roberts & Co. LLP

**Stefano Pessina**

Executive Chairman, Alliance Boots GmbH

**Barry Rosenstein**

*Member of the Compensation Committee, and Nominating and Governance Committee,  
Finance Committee*

Managing Partner, JANA Partners LLC

**Nancy M. Schlichting**

*Chair of the Compensation Committee, Member of the Audit Committee*

CEO, Henry Ford Health System

**Alejandro Silva**

*Member of the Audit Committee, Finance Committee*

Chairman and CEO, Evans Food Group

## Chapter 2: Industry and Strategic Analyses

### Walgreens's Mission and Strategy

*“To be the most trusted, convenient multichannel provider and advisor of innovative pharmacy, health and wellness solutions, and consumer goods and services in communities across America. A destination where health and happiness come together to help people get well, stay well and live well.”*

Walgreen's purpose is to help people get well, stay well and live well. Their vision is to become “America's most loved pharmacy-led health, wellbeing and beauty enterprise” (Walgreens.com). They plan to accomplish this through innovative pharmacy, health and wellness solutions, as well as through offering advice and consumer goods across America. Their website clearly states their four values. The first is honesty. Honesty is paramount for companies in the pharmaceutical industry. They want to have trust and integrity in everything they do, from relationships with shareholders, to suppliers and customers and among their fellow employees. Quality is also very important. They aim to have consistent and reliable service with the utmost quality throughout the country and across every channel of business. They aim to deliver every service they offer with compassion and a desire for healthy outcomes. Finally they aim to

achieve a strong community commitment through the service and expertise of every single Walgreen team member.

Their overarching goal as a whole is to continue their aim to be the first choice in the communities they serve for all health and wellness needs. Their strategies stem from this main goal. They want to extend and transform their traditional drugstore layout into a “retail health and daily living” store (Walgreens.com). Through this format they hope to also create a community centric store with healthcare integration. They also hope to expand their outstanding customer service across new channels and markets through their online and mobile applications.

Beyond their goals centered in the US it is necessary to note that after the 2014 fiscal year Walgreens bought a controlling share in Alliance Boots. Walgreens initially purchased a 45 percent stake in Alliance Boots in 2012 with the option of purchasing a controlling share by the end of 2014. By completing the transaction they established a new company, Walgreens Boots Alliance. Walgreens Boots Alliance is the first ever global pharmacy, health and wellbeing enterprise. Walgreens stated goals of establishing an “efficient global platform” in the 2014 10-K, and became one step closer to this goal through purchasing Boots Alliance. The combined company now operates over 12,800 stores worldwide in over 25 countries. Walgreens came under some speculation before the purchase for suggesting that they may move their headquarters out of the US for tax purposes, but they later announced that they are staying headquartered in Deerfield, IL. While this transaction had a great effect on Walgreens, this paper will focus on Walgreens as one entity from their founding in 1901 to the most recent annual report in 2014.

## Strategic Position in the Market and Competition

Walgreens operates in the highly competitive US pharmacy and retail drug store industry. As a leader in both pharmaceuticals and general merchandise retail Walgreens competes with a variety of companies. By being one of the oldest pharmacies in the United States and the largest, Walgreens is among the leaders in its industry. Their format has been copied throughout history. CVS Caremark is their largest competitor as they also sell both pharmaceuticals and general retail in stores with a similar format. Rite Aid is a similar competitor, however it occupies a smaller market share. Walgreens also competes with in store pharmacies such as those found at Target and Wal-Mart. Mail order pharmacies cause intense competition as well. Independent, smaller chains that may be locally owned also are competitors for Walgreens in individual markets. The “geographic dispersion” of Walgreens helps to offset the impact of any adverse economic conditions caused by the local competition (2014 10-K).

Due to this level of competition, Walgreens differentiates on a basis of “service, convenience, variety and price” (2014 10-K). They have worked to position themselves as the most convenient of drugstores and general merchandisers. Walgreens came under fire in a 2013 CNN Money article that claimed that at some Walgreen’s locations retail may be priced up to 55 percent more than it would be at the local Wal-Mart (Miller). This article operated under the assumption that a company must price every item the same from location to location. In actuality Walgreens is using its pricing strategy to capitalize on the strengths and weaknesses of demand of different markets. Since Walgreens has a product mix of normal necessities as well as inferior goods they can capitalize by offering convenience items such as coffee, gum or cereal at higher prices. Consequently when

someone comes in to pick up a prescription or shampoo they are likely to pick up a convenience item as well and pay the added cost because of the convenience. As long as this strategy is implemented correctly Walgreens, and their stakeholders will benefit. In fact this variable pricing is part of Walgreens's business model. They realize that there are different costs associated with selling at different locations (Miller). Different aspects factor into these costs such as real estate prices, hours of operation and employees. Walgreens does strive to be price competitive, but locally rather than across the board nationally. However, this does mean that they are not the low cost leader in their sector, so they have strived to differentiate themselves on a basis of convenience and service. They have included healthcare clinics in over 400 locations called the Healthcare Clinic. These clinics are managed by the wholly owned subsidiary Take Care Health Systems, and offer service comparable to most nurse practitioners. Walgreens has also differentiated on their health and wellness platform.



"Our Past | Walgreens.com."

As evident in their mission statement they are a company focused on the wellness of their customers in every facet of their lives. This is the main factor that separates similar stores offering similar services from Walgreens. They have branded themselves as the "corner of happy and healthy," focusing on transforming their store from the traditional drugstore into a "retail health and daily living" store through an expanded pharmacy equipped with health and wellness solutions (2014 10-K).

## Porter's Five Forces

Since Walgreens has a product mix ranging from groceries, cosmetics to prescription drugs they deal with a wide range of suppliers. Their inventories are purchased from “numerous domestic and foreign suppliers” (2014 10-K). Due to the number and range of suppliers they do not anticipate that the loss of any one group would have a materially adverse effect on their retail business.

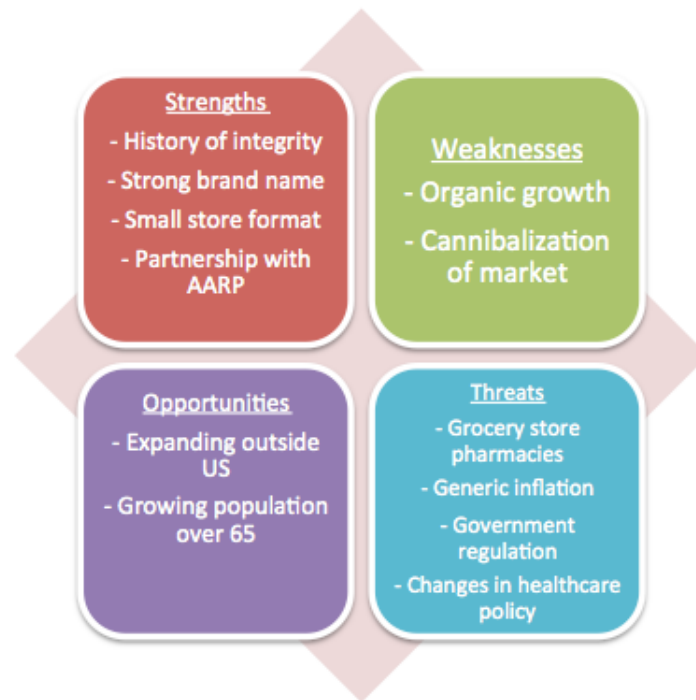
General merchandise however only made up 26 percent of total sales in 2014. Prescription drugs were the largest selling, making up 64 percent of sales in the same year. While many of the prescription drugs fall into the category above, Walgreens sources its own brand name drugs from one source. For branded and generic drugs Walgreens uses one provider. In March of 2013 they entered into a ten-year agreement with AmerisourceBergen. If anything were to happen to this relationship it would adversely affect their ability to provide cheaper drugs to their customers.

Their supply of employees is large. There is a debate currently whether there is a surplus of pharmacists, or if the demand is just leveling off (Covington). Either way the supply is high to meet Walgreens's demand. Cashiers and managers to work in the stores are all abundant, as the jobs need little training and minimal skill.

On the demand side, since they are a retail store, they are mainly selling to customers. Customers' demand will be based on their disposable income as well as competition from similar stores. The growing number of people over the age of 65 will help in the demand for prescription drugs.



## Walgreens's SWOT Analysis



### Strengths

Walgreens has been in operations since 1901. This long-standing history has created a feeling of integrity and trust with its customers. The name Walgreens has become a strong brand name recognizable to nearly everyone. As the market becomes more saturated, this history is very important when a customer is choosing a drugstore. Due to their long history they have time to perfect their operations. Through their smaller store format in contrast to larger stores today, such as Target and Wal-Mart, Walgreens is able to hone in on service. They can offer an array of services at a more personal level. Also through their small format they can focus in on the theme of wellness. They are able to allocate a larger percentage of their store to their brand as the corner of happy and healthy. Walgreens has also taken advantage of the growing number of people over the age of 65 by allowing their Balance Rewards card to be linked with their AARP Card.

## **Weaknesses**

In the recent past, Walgreens has taken an organic method to growth. This means that while they have been open since 1901, much longer than any other drugstore, they are not the largest in the US. They take the time to build their own stores from the ground up rather than buying another chain and building from there. CVS holds a larger market share as they have taken a more aggressive path towards growth. Walgreens is in danger of cannibalizing their own market as they do have so many locations close to each other.

## **Opportunities**

After the 2014 fiscal year Walgreens bought a controlling share in Alliance Boots. For the past three years Walgreens has had no export sales, however this purchase will help change that by opening up a window into the market outside of the US. Walgreens now has an opportunity to make itself a global brand. As mentioned earlier with the population over 65 growing they have the opportunity to market to that generation as well.

## **Threats**

As in any saturated market, Walgreens is constantly dealing with threats from many angles. The emergence of grocery store pharmacies is a major threat. They offer many of the conveniences that Walgreens has branded itself on in the past. They also are faced with the issue of generic inflation. The cost of generic drugs increased throughout 2014 and in some cases significantly. This inflation is expected to continue across the board throughout the fiscal year 2015.

## Chapter 3: Financial Statement Analysis Part 1

### Asset Composition

Walgreen's asset composition is very similar to its competition in the drugstore retail sector. As a retailer, almost half of their current assets are held in inventories. In comparison CVS Caremark holds about 43 percent of current assets as inventory. Accounts receivable follows making up a little over a quarter of total current assets. Cash and cash equivalents makes up 21 percent. Their long-term assets are made up mostly of investments from their purchase and call option of Alliance Boots as well as property plant and equipment. They have invested \$7,248 million in equity in Alliance Boots. They also have \$2,359 million goodwill associated with that purchase. It is necessary to note that the call option they had for Alliance Boots at the year ended in the 2014 10-K was exercised after closing. Also as is typical with retailers, Walgreens owns many of their own stores, and owns pharmaceutical equipment used to perform their services. Their total investment in property, plant and equipment minus depreciation and amortization equals \$12,257 million.

While in the past five years Walgreens has always had more long-term assets than short term, their investment in Alliance Boots has furthered the difference between the two. In just five years, the percent of non-current assets has changed from 55 percent in

2010 to 67 percent in 2014. This investment can be viewed as risky, however it can also be viewed as a good investment. By buying Alliance Boots, Walgreens has the opportunity to expand as a global brand, which will only help its shareholders.

## Walgreens's Financing

### Debt to Equity Ratio

2014	2013	2012	2011	2010
.81	.82	.84	.85	.83

Walgreen's debt-to-equity ratio has held steady the past five years at an average of .83. This ratio is in the healthy range for the drugstore industry. This low ratio shows that Walgreens will be protected against any possible sales decline, thus protecting their shareholders. It also shows that Walgreens could be a little more aggressive in borrowing, and take advantage of the increased profits that could come with increased financing. Their closest competitor, CVS Caremark, has a slightly higher 2014 debt-to-equity ratio of .96. They are taking better advantage of their comfortable position by increasing their financing.

### Cash Flows and Financial Health

In the 2014 financial statements Walgreens showed positive cash inflows from operating activities, and a negative cash outflow from both investing and financing activities. In total the company showed an overall increase in cash flows by \$2,646 million in 2014. These signs indicate that Walgreens is currently in the maturity life cycle. As a company that has been operating for over one hundred years this is to be

expected. They have a flatter line of growth, but steady sales. In this position of maturity they have to continually be competitive, so as to not fall into a state of decline. They have continued to expand their business through the purchase of Alliance Boots. They have also kept competitive through programs such as their Balance Rewards Program, as well as their platform of health and wellness.

## Liquidity and Solvency

### Current Ratio

2014	2013	2012	2011	2010
1.38	1.34	1.23	1.52	1.60

With their 2014 current ratio of 1.38 Walgreens is able to pay off all their current liabilities, and then some with their current assets if need be. They are comfortably liquid, and can meet current obligations. As a retailer inventories make up the largest part of their current assets, and so a change in year-end inventory could be a reason for the differing ratios year to year. Also in 2012 Walgreens made an equity investment in Alliance Boots that could have impacted current assets through cash, and thus a smaller ratio in 2012. AS they have begun to profit from the purchase the ratio has risen. If the ratio follows the trend from 2012 through 2014, it will grow back to what the healthier number it was in 2010.

### Working Capital

2014	2013	2012	2011	2010
3347	2991	2038	4239	4489

Having a positive working capital for the past five years is a great indicator that Walgreens is able to satisfy short-term debt requirements as well as operational expenses that they may incur.

## Times Interest Earned

2014	2013	2012	2011	2010
26.88	23.88	39.36	61.48	40.68

In 2014 Walgreens would have been able to pay their interest expense almost 27 times with their operating income. This is a healthy number, and shows that they are in a position to meet their debt obligations. Creditors will be comfortable lending to them because it shows that they will be able to meet their interest payments in a timely manner. For the past five years Walgreens has shown that they have good credit, and would make a good candidate as a borrower.

## Earnings Per Share

### EPS

2014	2013	2012	2011	2010
2.03	2.59	2.43	2.97	2.13

Earning per share has been steadily within two dollars for the past five years. In 2011 there was a drop in the number of shares outstanding leading to a larger earning per share. In the following two years, the number of shares outstanding steadily grew leading to a lower earning in 2012 and 2013. From 2012 through 2014, there was a steady number of shares outstanding. This means that the drop in EPS in 2014 was due to a drop in net income. Higher expenses related to Alliance Boots could have played a part in the decline.

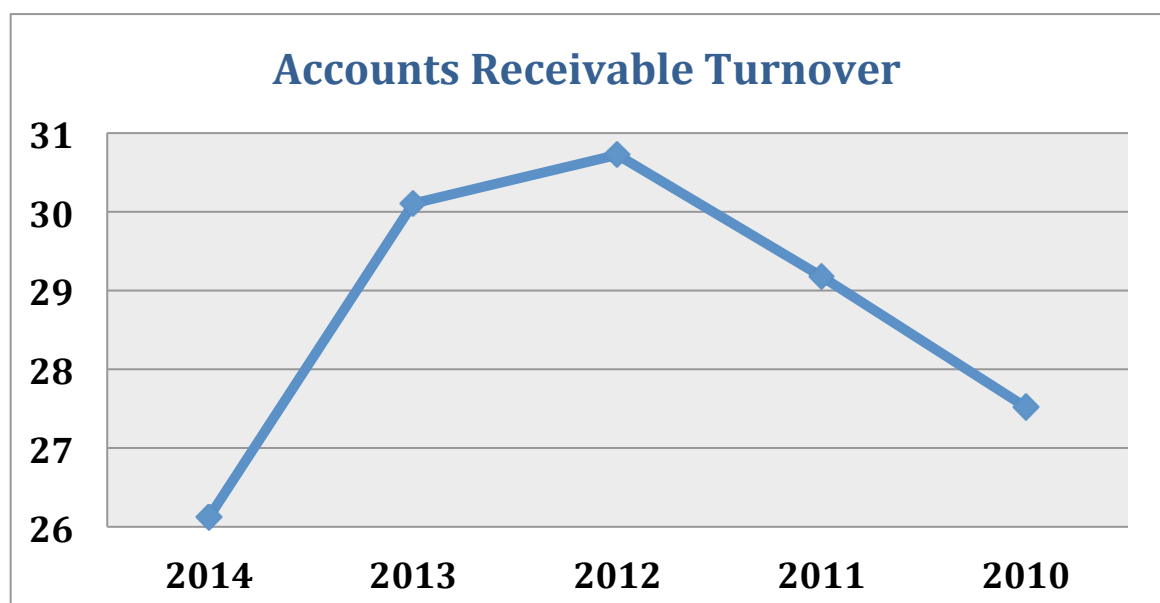
## Chapter 4: Financial Statement Analysis Part 2

### Receivables

Walgreens is a retail merchandise store, so a large portion of receivables come from debit and credit card providers. These receivables are highly liquid and counted as cash. They are generally settled in two business days and are very credit worthy.

Walgreens's accounts receivable account as a whole has been increasing for the past three years. They acquired a controlling interest in Alliance Boots in 2013, which could explain the increase in receivables. With accounts receivables rising 25 percent in the past year and revenue keeping steady this could indicate that the Walgreens needs to find a more efficient method to collect payments.

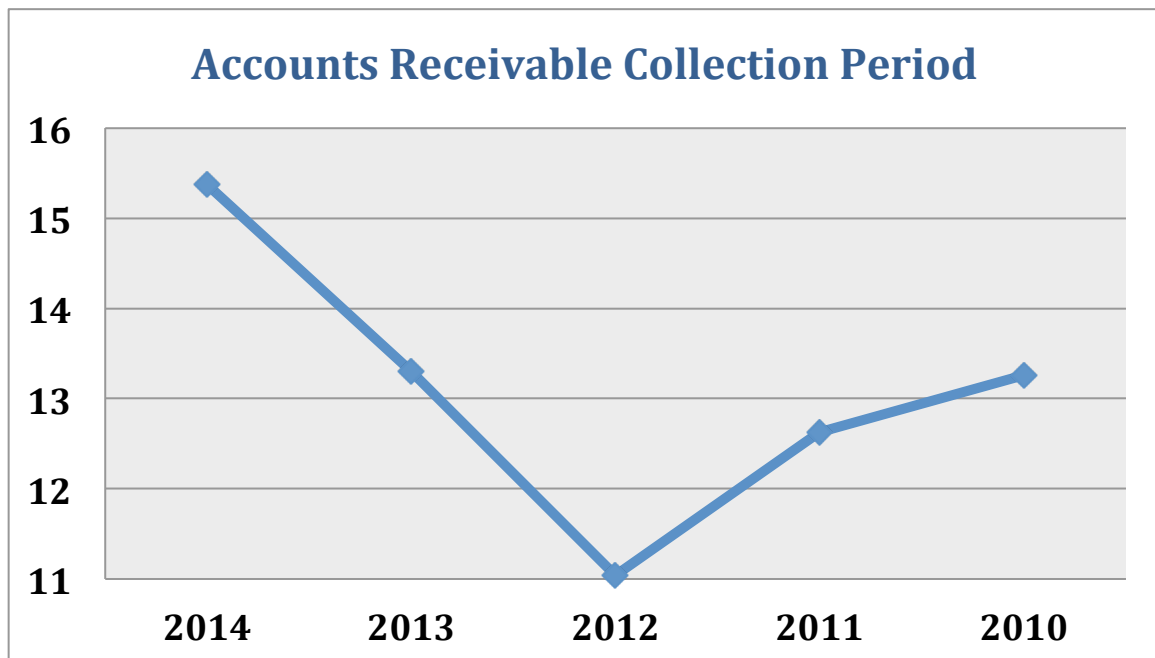
### Accounts Receivable Turnover



2014	2013	2012	2011	2010
26.12	30.1	30.72	29.18	27.52

Walgreens had been collecting their receivables about 30 times a year until 2014 when that number dropped by four days. Walgreens did not provide credit sales, so this calculation was done with net sales. While the number did drop it is still relatively high. From a cash flow standpoint, this is very good as it means that they are able to collect cash quickly from customers. This also means that they will be able to pay back creditors, and bills sooner.

### Accounts Receivable Collection Period

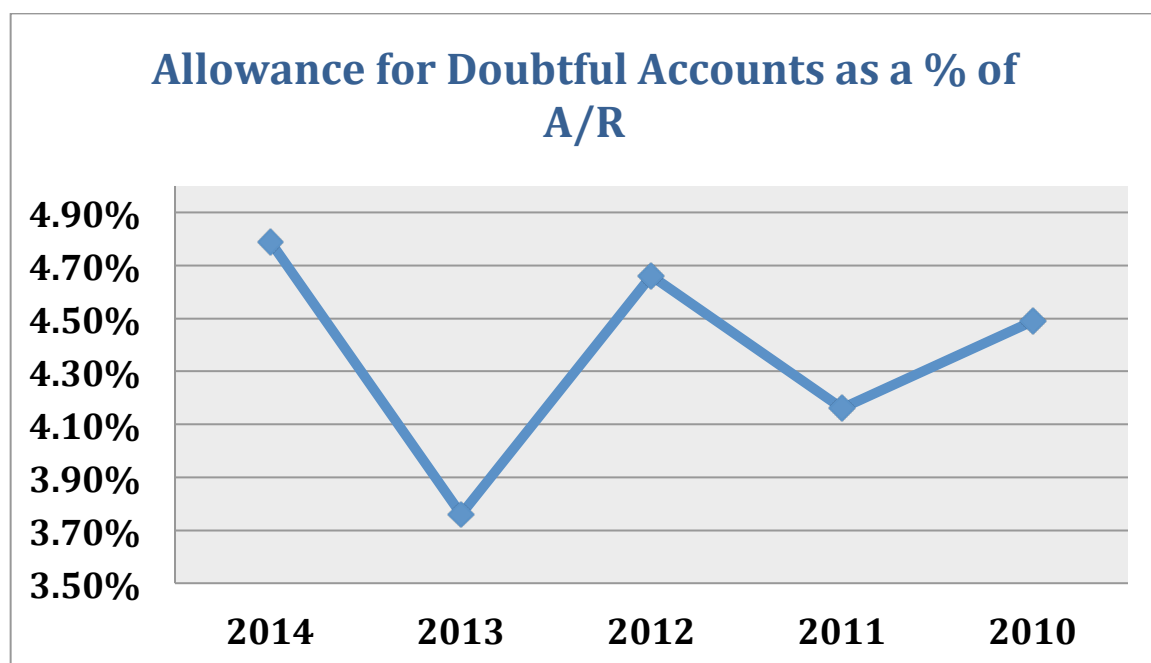


2014	2013	2012	2011	2010
15.37	13.30	11.04	12.63	13.26

This number has been increasing since 2012 when Walgreens bought a controlling interest in Alliance Boots. While this could mean that customer payments are slowing down, it could also be caused by the large acquisition.



## Allowance for Doubtful Accounts as a Percentage of A/R



2014	2013	2012	2011	2010
4.79%	3.76%	4.66%	4.16%	4.49%

While in the past year the percentage has risen, in the past five years it has steadily remained around an average of 4.3 percent. Walgreens uses both historical write-off percentages for bad debt expenses as well as specific identification. They have used this method for the past five years, and expect no change in the future. They also do not believe that there will be a material change in these estimates, as there has not been a change in the past five years.

## Inventories

Walgreens operates as a general retail merchandiser as well as a pharmacy. Their inventories range from general retail to pharmaceuticals. Their inventory also differs quarter-to-quarter as they stock seasonal items. They often buy inventory from Alliance

Boots, who they now own. Walgreens uses the LIFO flow system to account for their inventory.

## Inventory

2014	2013	2012	2011	2010
6076	6852	7036	8044	7378

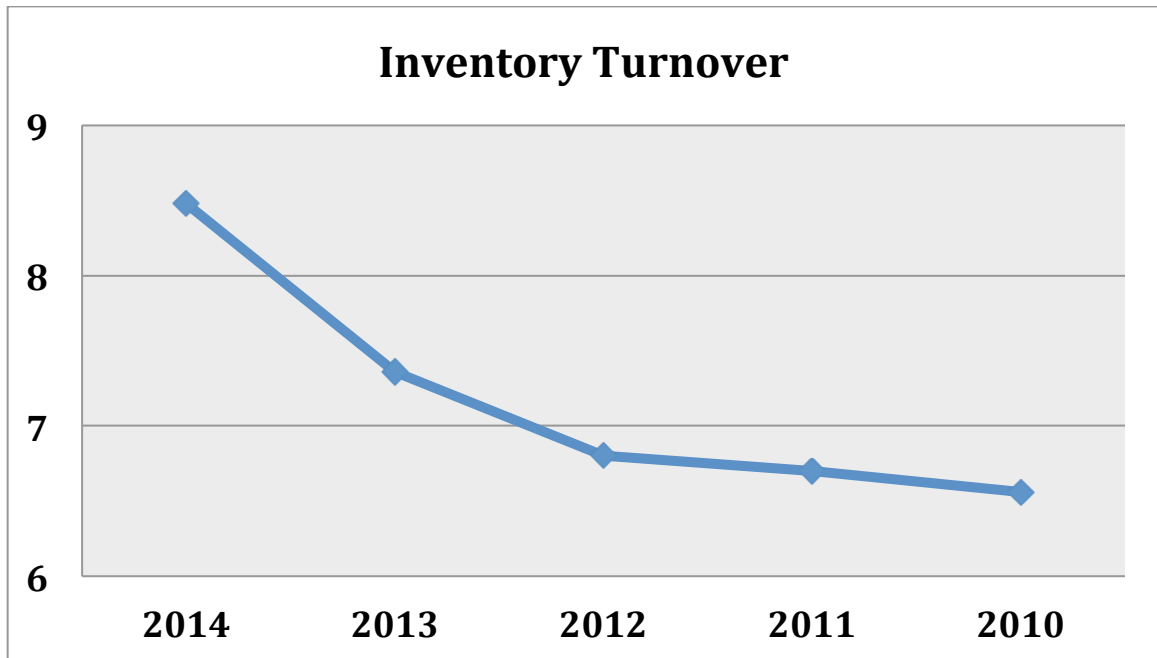
From 2011 to 2014 Walgreens has continuously seen a fall in inventory. This could be alarming as they use LIFO. It could mean that in an attempt to mask inflation they are dipping into older inventory rather than buying new inventory. This causes a temporary increase in earnings that will not last, as eventually they will have to purchase new inventory at the new, higher cost.

## Gross Margin

2014	2013	2012	2011	2010
.282	.292	.284	.284	.282

The gross margin has remained very steady through the past five years. This means that they have had steady, reliable profitability for the past five periods.

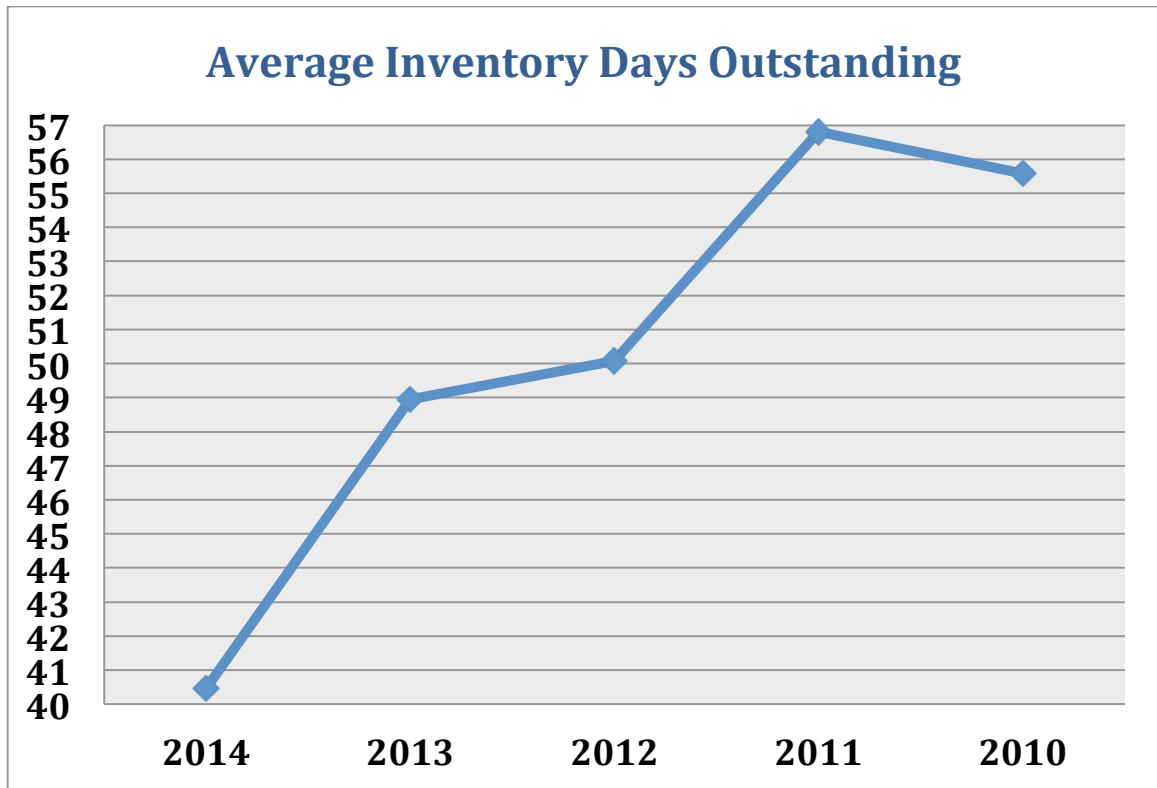
## Inventory Turnover



2014	2013	2012	2011	2010
8.48	7.36	6.80	6.70	6.56

On average in 2014, Walgreens sold its inventory about 8.5 times. The number has risen in the past year, and can be explained by the dip in total inventory. The smaller amount of inventory they have to sell, the more times they will be able to sell it.

## Average Inventory Days Outstanding



2014	2013	2012	2011	2010
40.45	48.94	50.07	56.80	55.59

The average amount of days it would take Walgreens to sell all of their current stock has been steadily falling since 2011. This could also be in relation to the falling inventory. This decrease can be seen as a good thing as it means the inventory is more liquid.

## Property, Plant and Equipment

Walgreens depreciates their property, plant and equipment with the straight-line method over the estimated useful life of the owned asset. Leases are amortized over the length of the agreement or the useful life, whichever one is shorter. These estimated lives

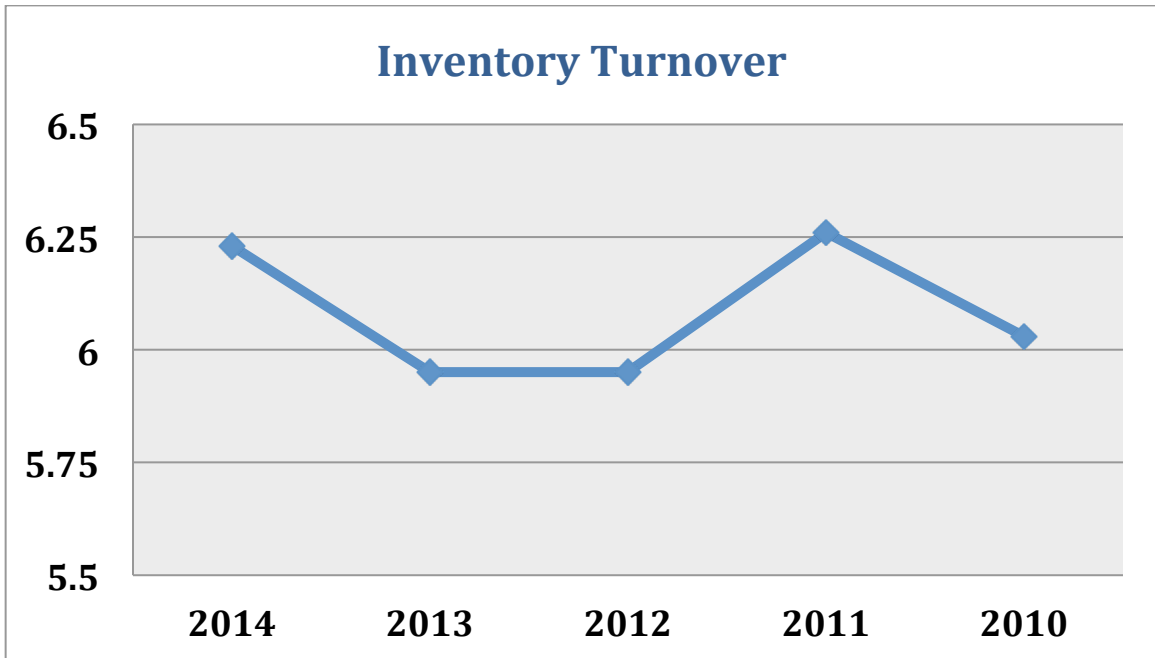
vary from ten years to thirty-nine for building, and land, and building improvements. Equipment tends to have a short life of two to thirteen years. Major repairs that extend the life of assets are capitalized, while routine maintenance is expensed. The composite method of depreciating is used widely across the company for equipment. This means that gains and losses are only shown when an operating location is impaired, remodeled completely or closed. When property and equipment are fully depreciated, they are removed from the cost and from the related accumulated depreciation and amortization accounts.

Walgreens has added some property plant and equipment during the past year. The total has increased by \$119 million to \$12.26 billion total.

They have experienced impairments through the years. They regularly test long-lived assets when circumstances arise that indicate an asset may be impaired. If a store has been open for five or more years they are checked at least once a year for impairments. If impairment is found to have occurred the amount is calculated by comparing the carrying value of the asset to the fair value. The fair value is based on the discounted estimated future cash flows.

In 2014 the company incurred \$167 million in impairment charges that were included in the selling, general and administrative expenses. These mainly resulted from Walgreens's store optimization plan. This is a jump from the past two years. In 2013 and 2014, they experienced only \$30 and \$27 million respectively.

## Fixed Asset Turnover Ratio



2014	2013	2012	2011	2010
6.23	5.95	5.95	6.26	6.03

This number has grown from 2013 to 2014, indicating that the company is better managing and making use of their fixed assets. This means that Walgreens has effectively been using their assets to generate sales.

## Chapter 5: Financial Statement Analysis Part 3

### Walgreens's Recent Investments

#### Alliance Boots Investment

Walgreens has held a 45 percent stake in Alliance Boots since June 18, 2012. This investment is accounted for using the equity method. They purchased this holding for \$4.025 billion dollars along with over 80 billion shares of Walgreens's common stock. Along with this purchase they bought the option, but not obligation to purchase the remaining 55 percent anytime between February and August of 2015. At that time Walgreens will pay an additional 3.133 billion in British pounds as well as another almost 145 million shares of common stock. On August 5, 2014 the agreement was amended to allow the option to be exercisable on that date forward. On that date Walgreens through a wholly owned subsidiary to which the call option rights had been assigned exercised the option.

Immediately before this transaction Walgreens restructured into a holding Delaware corporation named "Walgreens Boots Alliance, Inc.". Walgreens itself will now be a wholly owned subsidiary. All Walgreens common stock will be automatically converted into Walgreens Boors Alliance shares on a one-to-one basis. The closing of the transaction was subject to the shareholder as well as regulatory agreement and approvals, and did not occur until the first quarter of the fiscal year 2015. Due to this, further details

are not available yet.

Alliance Boots is a leading pharmacy as well as a beauty group that operates internationally. They offer a range of products as well as services to their customers. This ranges from pharmacy-led health and beauty retail as well as the distribution of wholesale pharmaceuticals. This investment by Walgreens immediately gives Walgreens access to overseas markets. Together the Walgreens Boots Alliance formed the first, international health and wellness pharmacy enterprise. This is a solid investment because while Walgreens is the largest drugstore in the United States, they have little presence internationally, and have generated no foreign sales in the past five years.

## **Other Substantial Investments**

Prior to the Alliance Boots purchase Walgreens has chosen to pursue a rather organic growth pattern. They have chosen in the past to open their own stores rather than buy existing chains typically. However, they have strayed from this path in the past few years. In the fiscal year 2014, Walgreens acquired 141 drugstore locations through acquisitions while they opened 172 organically. Their largest acquisition of a chain in recent years came through the purchase of the New York City based Duane Reade drugstore. They acquired 258 locations, and dramatically expanded their presence in the New York metropolitan area. This balance of organic growth and acquisitions has helped Walgreens avoid the pitfalls associated with many mergers and acquisitions.

## **Goodwill**

Goodwill has been created for Walgreens due to these acquisitions. Due to the amount of goodwill generated through the Alliance Boots purchase it is very likely in the future that it could become impaired. At the end of its most recent fiscal year Alliance



Boots reported approximately 16.5 billion dollars and other intangibles. This made up about 57 percent of total assets. This number likely increased through subsequent transactions in the first quarter of the fiscal year 2015. Due to the large number, it is very likely they will be impaired and decrease adversely the financial results of the company in the future.

## Restructuring Charges in Past Five Years

<b>(Pre-Tax)</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>Restructuring Charges</b>	106	45	0	0	0
<b>Restructuring-Related charges</b>	252	106	0	0	0

Restructuring charges in 2009, 2010, and 2011 were part of the Rewiring for Growth plan. This initiative enabled eligible employees to retire or resign from the company with severance and pension in an effort to reduce overhead. This way they can reduce the amount of involuntary lay-offs in favor of voluntary resignations. This plan ultimately saved the company 1.1 billion dollars.

While the past two fiscal years showed no restructuring charges, a large amount can be expected in the coming years due to the restructuring associated with acquiring Alliance Boots, and creating the Walgreens Boots Alliance.

## Foreign Currency Changes

As prior to 2014 Walgreens operated solely in the United States foreign currency changes immaterially affected profitability. While they do have international suppliers no

one supplier being adversely affected will affect Walgreens's profit as materially. They also have had zero dollars of export sales in the past five years. Thus sales have solely consisted of American dollars. However, the purchase of Alliance Boots in British pounds could have had a material affect ultimately on profitably, and was lessened by using stock in the transaction.

## Stock Repurchases and Splits by Walgreens

Walgreens has consistently repurchased shares each of the past five fiscal years.

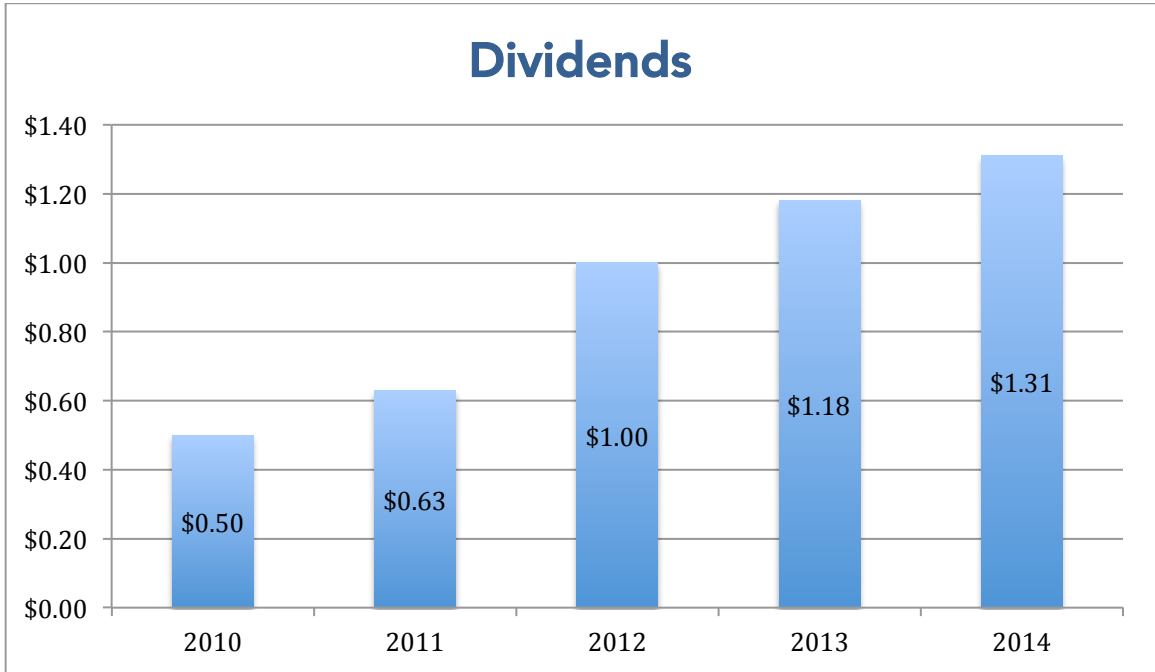
Fiscal Year	Total Number Repurchased	Total Number Part of a Publically Announced Plan
<b>2010</b>	35,003,385	35,003,385
<b>2011</b>	16,809,100	15,809,100
<b>2012</b>	11,063	0
<b>2013</b>	1,200,000	0
<b>2014</b>	8,106,551	0

2010 and 2011 show a large amount of repurchases. This occurred because they were preparing to make their initial investment in Alliance Boots that was part cash, and part common stock. In the following three years, they showed a much smaller number of repurchases, and none were part of a publically announced buyback plan. Walgreens has also not issued any stock splits or dividends in the past five financial years.

## Dividends

Walgreens has however consistently issued cash dividends every year since 1933. They issue dividends quarterly in February, May, August, and November. The chart below shows the cumulative yearly dividend. As the chart shows dividends have grown for the past five years. Beyond what is shown in the chart dividends have also been

growing consistently since 2001. The constant dividends show that Walgreens is a mature company comfortable with declaring dividends rather than reinvesting the money.



### Pension Expense

The principal retirement fund offered to Walgreens’s employees is called the Walgreen Profit-Sharing Trust. Both the employee and the company contribute to the fund with the company’s portion being partially a guaranteed match to a certain amount, and the rest decided by the Board of Directors annually. The company also offers health insurance benefits to retirees that meet certain requirement pertaining to age, years of service, and date of hire. Such costs are accrued throughout the service life of the employee.

It seems as if their plan is underfunded as the plan assets at fair value are worth zero, and the projected benefit obligations (PBO) are \$427 million thus making the funded status a negative \$427 million. Since the plan assets are less than the PBO it can

be inferred that the plan is underfunded. The discount rate decreased from 5.20 percent in 2013 to 4.40 percent in 2014, which means that the company is most likely not using a higher discount rate to decrease the service cost.

## Chapter 6: Financial Statement Analysis Part 4

### Operating Versus Non-Operating Items

#### Balance Sheet

Balance Sheet (In Millions)	Non-operating	
	Operating	
	2014	2013
<b>Assets</b>		
<b>Current Assets</b>		
Cash and Cash Equivalents	2,646	2,106
Accounts Receivable, net	3,218	2,632
Inventories	6,076	6,852
Other Current Assets	302	284
<b>Total Current Assets</b>	<b>12,242</b>	<b>11,874</b>
<b>Non-Current Assets</b>		
Property and equipment, less accumulated depreciation and amortization	12,257	12,138
Equity Investment in Alliance Boots	7,248	6,261
Alliance Boots Call Option	0	839
Goodwill	2,359	2,410
Other Non-Current Assets	3,076	1,959
<b>Total Non-Current Assets</b>	<b>24,940</b>	<b>23,607</b>
<b>Total Assets</b>	<b>37,182</b>	<b>35,481</b>
<b>Liabilities and Stockholders'</b>		
<b>Equity</b>		
<b>Current Liabilities</b>		
Short-term Borrowings	774	570

<b>Trade Accounts Payable</b>	<b>4,315</b>	<b>4,635</b>
<b>Accrued Expenses and Other Liabilities</b>	<b>3,701</b>	<b>3,577</b>
<b>Income Taxes</b>	<b>105</b>	<b>101</b>
<b>Total Current Liabilities</b>	<b>8,895</b>	<b>8,883</b>
<b>Non-Current Liabilities</b>		
<b>Long-term Debt</b>	<b>3,736</b>	<b>4,477</b>
<b>Deferred Income Taxes</b>	<b>1,048</b>	<b>600</b>
<b>Other non-current Liabilities</b>	<b>2,942</b>	<b>2,067</b>
<b>Total Non-Current Liabilities</b>	<b>7,726</b>	<b>7,144</b>
<b>Shareholder's Equity</b>		
<b>Preferred Stock</b>	<b>0</b>	<b>0</b>
<b>Common Stock</b>	<b>80</b>	<b>80</b>
<b>Paid-In Capital</b>	<b>1,172</b>	<b>1,074</b>
<b>Employee Stock Loan Receivable</b>	<b>(5)</b>	<b>(11)</b>
<b>Retained Earnings</b>	<b>22,229</b>	<b>21,523</b>
<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>178</b>	<b>(98)</b>
<b>Treasury Stock</b>	<b>(3,197)</b>	<b>(3,114)</b>
<b>Non-controlling Interests</b>	<b>104</b>	<b>0</b>
<b>Total Shareholders' Equity</b>	<b>20,561</b>	<b>19,454</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>37,182</b>	<b>35,481</b>

## Income Statement

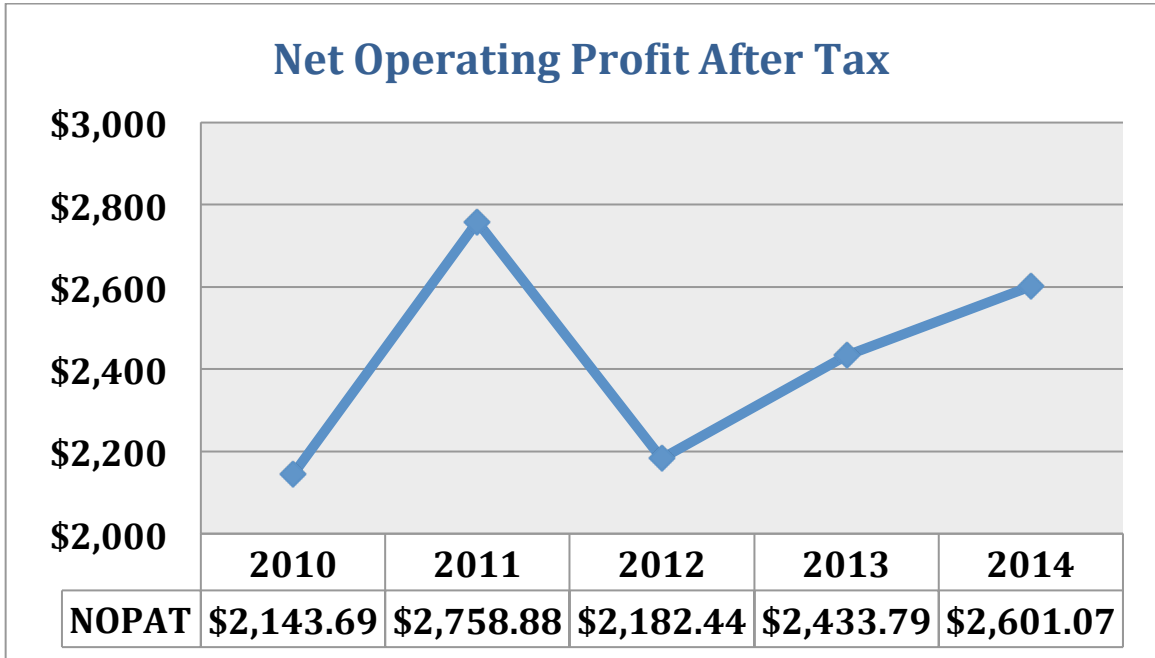
Income Statement (in millions)	2014
Net Sales	76,392
Cost of Sales	54,823
Gross Profit	21,569
Selling, general, and admin expenses	17,992
Equity Earnings in Alliance Boots	617
Operating Income	4,194
Interest Expense, net	(156)
Other (expense)	(481)
Income Earnings Before Income Tax Provision	3,557
Income Tax Provision	1,526
Net Earnings	2,031

## Effective Tax Rate

2010	2011	2012	2013	2014
38.01%	36.89%	37%	37.10%	42.90%

# Financial Analysis

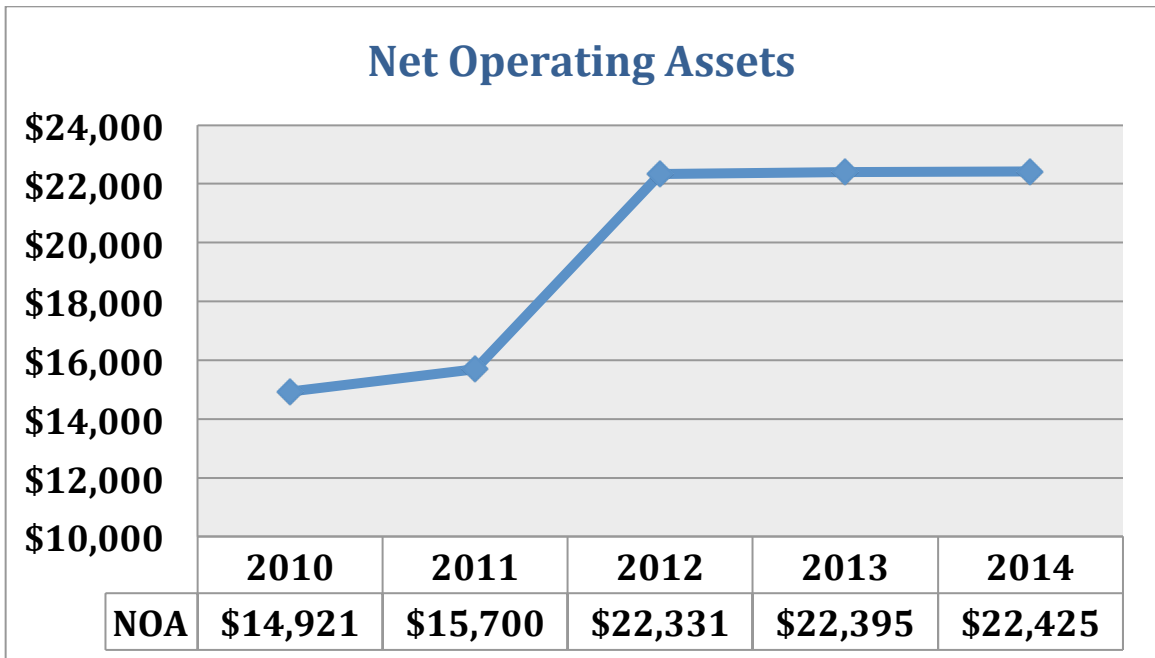
## Net Operating Profit After Tax



Net operating profit after tax or NOPAT is found by subtracting the operating revenue minus the operating expenses. Income attributed to a non-controlling interest normally would not be included in operating revenue. However, since in the fiscal year 2015 they acquired a controlling interest in Alliance Boots the earnings from that investment are still included.

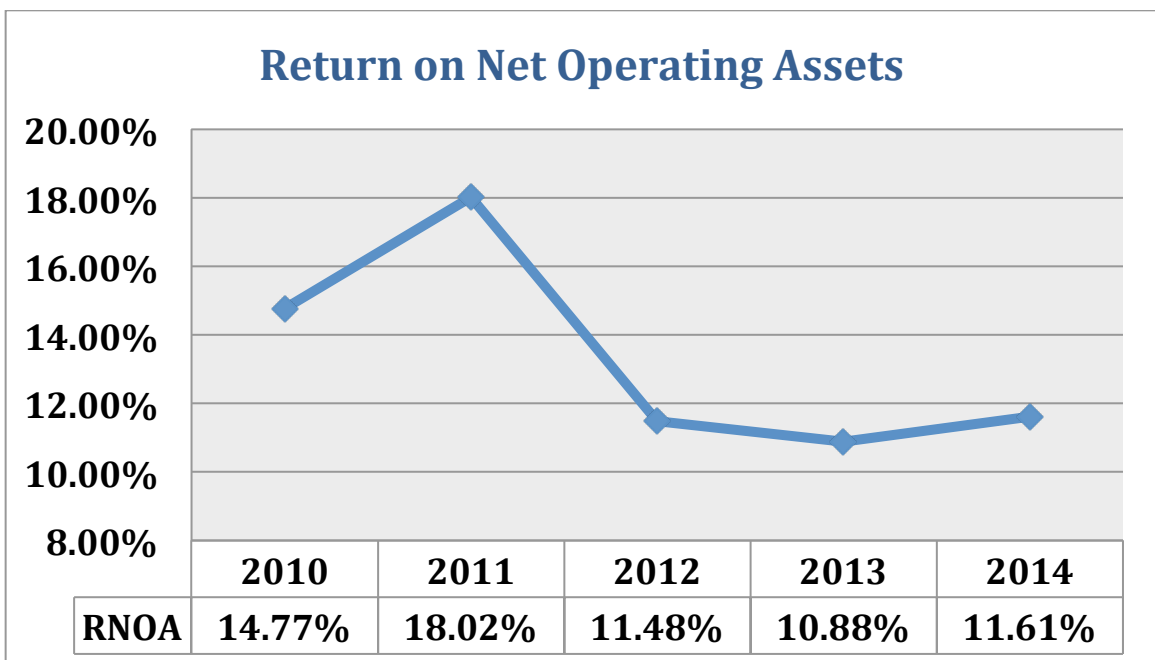


## Net Operating Assets



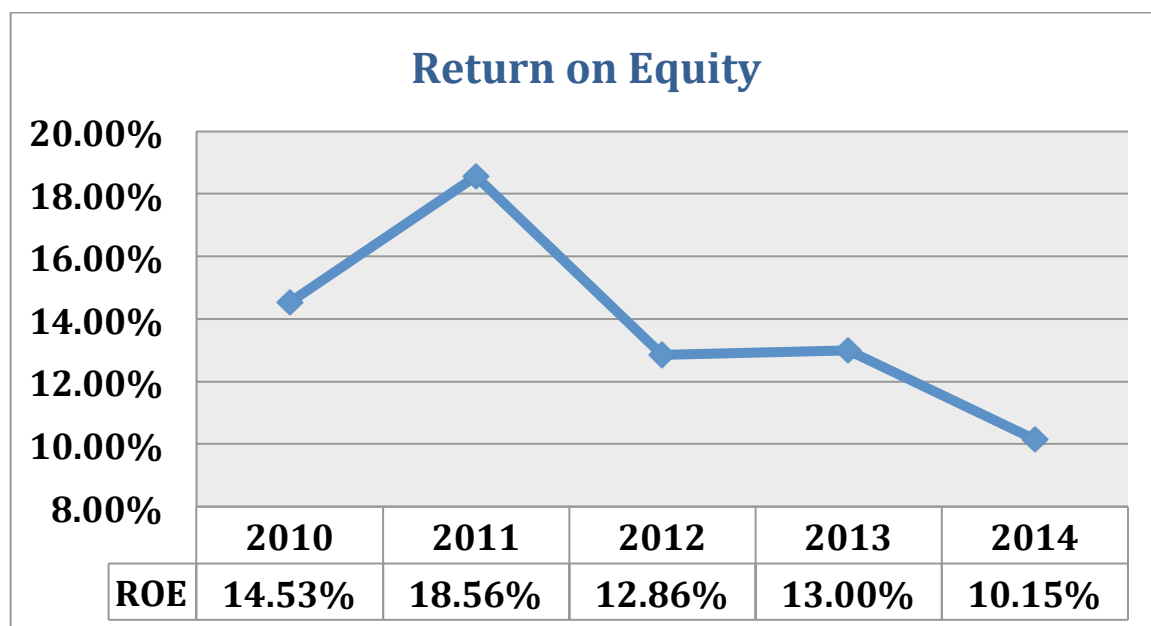
Net operating assets or NOA are calculated by taking the operating assets less operating liabilities.

## Return on Net Operating Assets



Return on net operating assets or RNOA is calculated by dividing NOPAT over average NOA. Walgreens purchased a non-controlling interest of Alliance Boots in 2012, and did not report earnings until the following fiscal year. In the past few years they have also made numerous purchases of smaller drugstores chains. In 2013 they purchased USA Drug that included over one hundred stores, and in the following year they purchased some assets from Kerr Drug that included over seventy retail locations. These purchases were costly not only initially, but also because of the conversion of the standing stores into Walgreens brand locations. Returns on these operating assets are just now being realized.

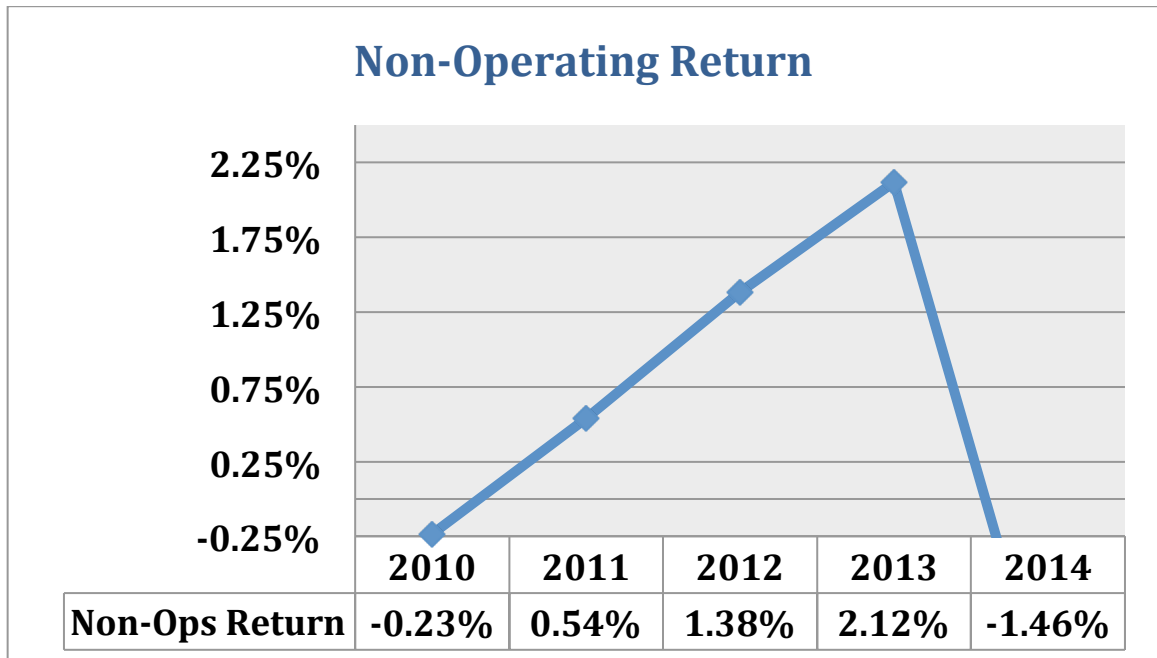
### Return on Equity



Return on equity or ROE is calculated by dividing net income over average stockholder's equity. The majority of Walgreens's ROE is from their operating assets. Their ROE has fallen in recent years. This could mean that they are using more debt,

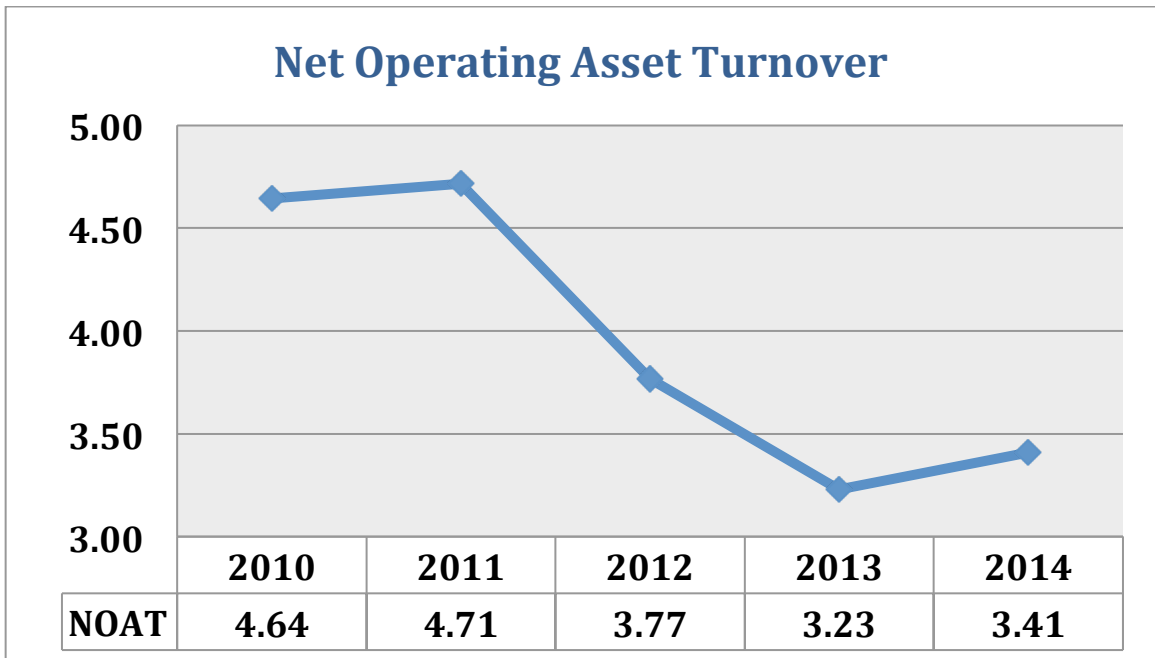
however it is important to note that the return on net operating assets has fallen in a similar manner. This suggest that they are simply earning less on their operating assets.

## Net-Operating Return



The small non-operating return is a good sign for Walgreens. They are taking on less of a risk by not having as high of fixed debt repayments. They are able to finance most of their business through their operations. The small non-operating return also shows that while ROE and RNOA are falling, the return on non-operating assets has not increased enough to show a significant increase in the use of debt financing.

## Net Operating Asset Turnover

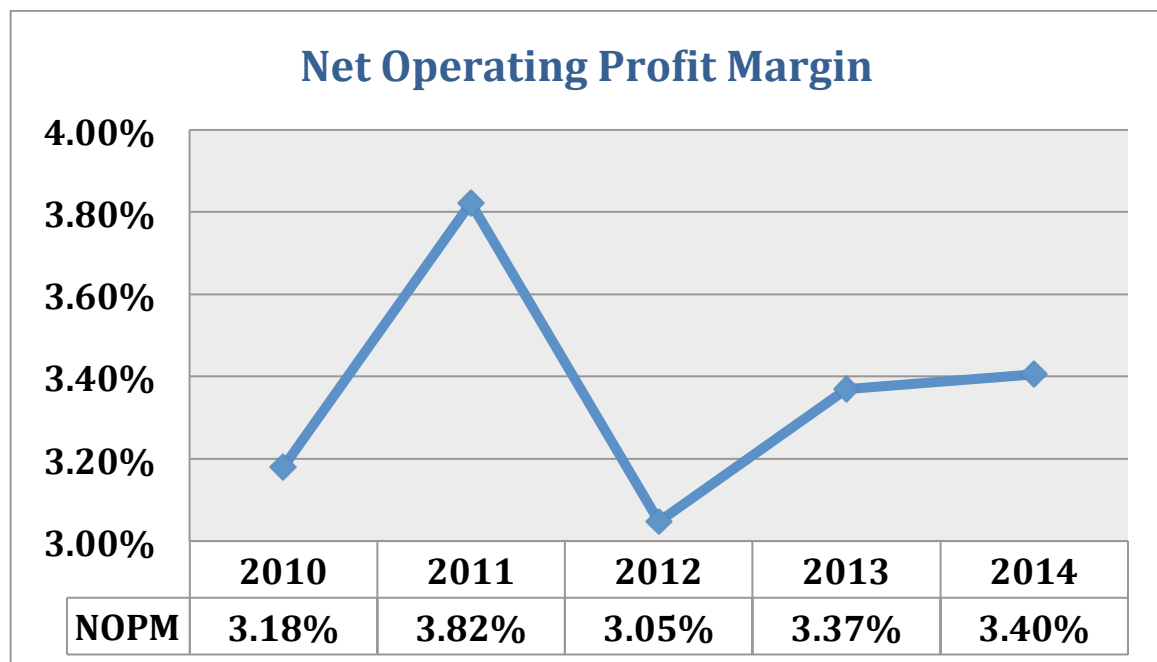


The net operating asset turnover (NOAT) is a measure of the how productive a company's net operating assets are. A higher NOAT is preferred, thus it is a good sign that Walgreens' is beginning to see an increase again after a two-year decrease. In the fiscal year 2014 Walgreens saw \$3.41 in sales for each dollar of net operating assets. Walgreens is just now beginning to realize a profit from their purchase of Alliance Boots. This relationship is evident from the slump in the year of purchase, and the increase now that they have seen earnings.

NOAT breaks down into five components:

	2010	2011	2012	2013	2014
<b>ART</b>	27.26	29.18	30.72	30.10	26.12
<b>INVT</b>	4.50	4.41	4.64	4.93	5.77
<b>LTOAT</b>	4.91	4.90	3.79	3.12	3.16
<b>APT</b>	10.89	11.00	11.16	11.33	12.25
<b>NOWCT</b>	13.80	16.54	22.82	28.72	24.11

### Net Operating Profit Margin



In the fiscal year 2014 Walgreens earned a little over three cents in operating profit for each dollar in sales. While profit margin has been holding steady, the net operating asset turnover had been falling steadily until 2014 when it saw a slight increase. This suggests that they are operating as a product differentiator. In the past fiscal year, however, they both were increasing suggesting that Walgreen's is somewhere in the middle of strategies. This makes sense in that they are in a time of change with the

acquisition of Alliance Boots, but to further investigate it will take a few more years of data to see where their strategy is headed.

NOPM breaks down into two components:

	2010	2011	2012	2013	2014
<b>GPM</b>	28.15%	28.39%	28.40%	29.24%	28.23%
<b>OEM</b>	96.77%	96.74%	96.91%	97.05%	97.32%

### Non-operating Return

2010	2011	2012	2013	2014
-0.23%	.54%	1.38%	2.12%	-1.46%

The non-operating return is composed of FLEV and spread. FLEV stands for financial leverage and is found by dividing the average net non-operating obligations by average equity. The spread is found by subtracting NNEP or the net non-operating expense percent from RNOA.

	2010	2011	2012	2013	2014
<b>FLEV</b>	.018	.05	.15	.19	.12
<b>Spread</b>	-5.46%	11.49%	9.24%	11.34%	-11.62%

Multiplying FLEV by the spread gives the return on non-operating assets. FLEV grew significantly from 2011 to 2012, but has fallen in the fiscal year 2014. This contributed the negative non-operating return in 2014 as well.

## Limitations of Ratios

Measurability is an issue for Walgreens since they are such a well-known, visible company. They hold a significant amount of intangible value. As a trusted pharmacy, and store that has been around for over one hundred years their brand name has immense value. Walgreens also owns a considerable amount of real estate around the country, and any loss or gain on these properties may not have been reported yet.

## **Chapter 7: Accounting Quality**

### **Lagging Economic Indicators**

#### **Changes in GDP**

GDP is one of the strongest economic indicators however it is often measured with error. An increase in total GDP would indicate that the overall economy is strong. A strong economy would indicate an increase in revenues for Walgreens. As a consumer retailer many things they sell require a disposable income. The stronger the economy the higher the consumer's disposable income and a higher disposable income will lead to higher sales for Walgreens.

#### **The Unemployment Rate**

Changes in the unemployment rate can have an effect on revenues and therefore Walgreens' profitability. The higher the unemployment rate the more consumer's total income falls. As a consumer retailer, consumer purchasing power is very important. Many items that Walgreens sells such as beauty products, health and wellness items, and household items may be the first that a consumer cuts out of their budget when they lose their job. Losing a job may also cause a consumer to lose their healthcare plan through their employer, and therefore force them to switch medications to cheaper, generic brands, or even give up their medication all together. As prescription drugs make up a



large percentage of Walgreens' revenue this could cause a serious impact on their profitability as a whole.

## **Consumer Price Index**

As a retailer the consumer price index is very important to Walgreens. A high rate of inflation could diminish consumer-buying power, and therefore lead to a decline in revenues. It could also have the same effect on Walgreens itself when they buy their inventory. However, if inflation is growing along with the consumers' income it could indicate an increase in revenues for Walgreens as it will encourage more consumer spending.

## **Currency Strength**

Because Walgreens has had no export sales over the past five years, currency strength is not the most impactful lagging indicator. However, when buying inventory from overseas having a strong American dollar can be helpful in that they will earn on the exchange rate.

When Walgreens purchased Alliance Boots, they did so partly with British sterling. Due to British currency holding stronger than the USD they potentially opened themselves up to a loss. They were able to protect themselves from further loss by using common stock for part of the purchase.

# Leading Economic Indicators

## Manufacturing Activity

Since Walgreens is a retailer that buys a large amount of manufactured goods an increase or decrease in manufacturing activity will be important to them. When activity is increasing it indicates that consumer buying is up and manufacturing is rising to meet demand. The converse is also true. If manufacturing activity falls, then demand has fallen as well.

## Inventory Levels

While manufacturing activity is important to look at for Walgreens, it must be looked at along with inventory levels. If inventory levels are high, then manufacturing activity is misleading. Retailers are buying more, but consumers are not buying the end product. However, if they are low then it indicates that consumers are indeed buying more.

## Retail Sales

As a retailer, retail sales are a very important indicator for Walgreens. An increase in retail sales across the board means an increase in sales for Walgreens. With more sales Walgreens can open more stores and hire more people. By hiring more people, they are therefore further increasing total consumer's income. This enables even more consumer spending. Therefore, retail sales are a very important factor for Walgreens to consider.

## Effects of New Revenue Recognition Standard

The Financial Accounting Standards Board issued ASU 2014-09, Revenue from Contracts with Customers. The new standard will provide a five-step analysis of sales and transaction in order to determine how much and when revenue is to be recognized. It will go into affect on December 15, 2016.

Due to Walgreens's type of business a majority of their sales come with immediate payment and are without contract. They recognize revenue when the customer takes possession of the merchandise. They expect that the new standard will have no material effect on their revenues due to the type of business they are engaged in.

### Forecast Targets

EPS	2014	2013	2012
<b>Estimated</b>	\$3.29	\$3.12	\$2.58
<b>Actual</b>	\$3.28	\$3.12	\$2.71

Walgreens has been a little sporadic in their actual earnings versus forecasted. They beat earnings in 2012, met earnings in 2013, and missed in 2014.

### Earnings Management

Walgreens's management may want to manage earnings up in order to beat forecasts, and see an increase in stock price. They could accomplish this by buying fewer inventories, and using the cheaper, older inventory to account for cost of sales. This would lead to a higher profit margin, and a higher net income. They could also use optimistic depreciation estimates. Walgreens owns many buildings as well as software for

their stores. With an optimistic depreciation expense, they could decrease overall expenses thus increasing their net income.

On the other hand, there are reasons that they would want to manage their earnings down. They may want to do this in order to smooth out their earnings over future periods. If they see they will significantly estimates they may want to shave off some earnings to smooth out their earnings. In order to do this they could, as mentioned before, manipulate depreciation. This time in order to manage down they can overestimate depreciation. As a large holder of real estate they own many assets that are depreciated. By being overly cautious with depreciation and over estimating the expense it will in turn decrease earnings. They could also expense certain repairs that would normally be classified as major repairs that would be capitalized. This would increase earnings and decrease net income.

## Chapter 8: Equity Valuation

### Capitalizing Leases

#### Capitalization

As a major retail chain Walgreens owns and leases a significant amount of property and real estate. The majority of their leases are classified as operating leases, however they do have some capital leases.

In order to calculate the present value of the operating lease payments the discount factor had to be found. The discount factor was calculated by using the imputed interest from their financial obligations and their capital leases, and subtracting that amount from the sums of their financial obligation payments and their capital lease payments. The IRR was calculated to be seven percent. The IRR was discounted through 5 periods as a present value sum, and then as an annuity for the thereafter. The discount factors were applied to each operating lease payment to calculate the present value.

Year	Operating Lease Payments	Discount Factor	Present Value
1	\$2,569	.937	\$2,407
2	\$2,533	.878	\$2,224
3	\$2,493	.823	\$2,051
4	\$2,407	.771	\$1,855
5	\$2,295	.722	\$1,657
Thereafter	\$2,295	5.014	\$11,508
<b>Present Value of Operating Lease Payments</b>			<b>\$21,704</b>

The total present value of the operating lease payments is \$21.7 billion. This amount would be seen as a non-operating liability while the asset would be operating. It also increases operating expenses as depreciation expense and interest expense would be reported for the leases rather than simply reporting rent expense as with an operating lease. This would change several important indicators and ratios negatively.

### Effects of Capitalization

<b>RNOA pre capitalization</b>	<b>11.61%</b>
<b>RNOA post capitalization</b>	<b>3.35%</b>

Their return on net operating assets fell by a drastic amount. This is due to the fact that a capital lease creates an operating liability while the asset is non-operating.

<b>NOPM pre capitalization</b>	<b>3.40%</b>
<b>NOPM post capitalization</b>	<b>1.94%</b>

Their profit margin fell substantially by capitalizing their operating leases. This is a reason that managers would want to use operating leases rather than capital leases.

<b>NOAT pre capitalization</b>	<b>3.41</b>
<b>NOAT post capitalization</b>	<b>1.73</b>

Net operating assets turnover fell due to the loss of net operating assets.

<b>FLEV pre capitalization</b>	<b>.123</b>
<b>FLEV post capitalization</b>	<b>1.21</b>

Their financial leverage increased through capitalizing leases as the lease liability is now reported on the balance sheet.

## Weighted Average Cost of Capital

Walgreens has a weighted average cost of capital of 4.54 percent for the fiscal year 2014. This was computed through finding the cost of equity and the cost of debt. Cost of equity capital is found using the capital asset pricing model. The risk-free interest rate, and the equity spread were assumed market numbers while the beta was found on Yahoo Finance for Walgreens specifically. Walgreens had a cost of equity of 12.28 percent. The cost of debt was calculated by dividing the interest expense over total debt. This number was then calculated after tax, and found to be 3.70 percent. In order to find the WACC the weights for equity and debt were calculated by finding the percent of

equity to total equity and debt and vice versa. This is the appropriate rate to use for cash flows with similar risk and discounting within the firm.

## Forecast of Growth

A sales growth of 1.5 percent was used in forecasting the next five years. This was estimated by taking an average of the past five years of sales growth. Walgreens has seen random sales growth through the past few years the highest being over seven percent while the lowest was a negative growth. Because of this, and the most recent sales growth percent being under one the future growth was estimated to be 1.5 percent.

Before updating NOAT and NOPM due to the capitalization of leases:

	Reported 2014	2015	2016	2017	2018	Terminal
<b>NOPAT</b>	\$2,601	\$2,636	\$2,676	\$2,716	\$2,757	\$2,784
<b>NOA</b>	\$22,425	\$22,738	\$23,079	\$23,426	\$23,777	\$24,015

After updating NOAT and NOPM to reflect capitalization of leases:

	Reported 2014	2015	2016	2017	2018	Terminal
<b>NOPAT</b>	\$1,479	\$1,501	\$1,524	\$1,547	\$1,570	\$1,585
<b>NOA</b>	\$44,129	\$44,776	\$45,448	\$46,128	\$46,821	\$47,290

## Stock Valuation

### DCF Model

Using the DCF method of stock valuation at the end of the fiscal year 2014, Walgreens had a value of \$52 per share. In the weeks after the fiscal year end of August 30, 2014 Walgreens stock hovered around \$60 per share. In this case an investor would be advised to not buy the share as it was overvalued, and fell under \$60 by the end of September.



	Reported	Forecasted				Terminal
	2014	2015	2016	2017	2018	Period
Sales Growth	0.82%	1.50%	1.50%	1.50%	1.50%	1.00%
Discounted Cash Flow Model:		1	2	3	4	
FCFF	\$2,162.00	\$2,194.43	\$2,227.35	\$2,260.76	\$2,294.67	\$2,317.61
Discount factor		0.95657	0.91503	0.87529	0.83728	
PV of Horizon FCFF		\$2,099.13	\$2,038.09	\$1,978.82	\$1,921.28	
Cum PV of Horizon FCFF	\$8,037					
PV of Terminal FCFF	\$65,469					
Total Firm Value	\$73,507					
Less NNO	\$23,672					
Firm Equity Value	\$49,834					
Shares Outstanding	950					
Stock Value Per Share	\$52					

## ROPI Model

The residual operating income model or ROPI is a different form of stock valuation. It focuses on operating items such as net operating profit after tax and net operating assets. This allows the model to have a more exact, and accurate valuation of the current stock price. In Walgreens's case the ROPI model confirmed the DCF model's undervaluation prediction. The ROPI model predicted the price per share at the end of August 31, 2014 to be \$42.

ROPI	Reported	Forecasted				Terminal
	2014	2015	2016	2017	2018	
Sales Growth	0.82%	1.50%	1.50%	1.50%	1.50%	1.00%
NOPM	3.40%					
NOAT	3					
Sales	76392	77538	78701	79881	81080	81890
NOPAT	2601	2636	2676	2716	2757	2784
NOA	44099	22738	23079	23426	23777	24015
Residual Income Model:		1	2	3	4	
Required Return		2002	1032	1048	1064	1079

<b>ROPI</b>		599	1569	1553	1537	1522
<b>Discount Factor</b>		0.957	0.915	0.875	0.837	
<b>PV of Horizon ROPI</b>		573	1435	1359	1287	
<b>Cum PV of Horizon ROPI</b>	\$4,655.06					
<b>PV of Terminal ROPI</b>	\$42,980.87					
<b>Total Firm Value</b>	\$47,635.93					
<b>Less NNO</b>	\$1,968.00					
<b>Firm Equity Value</b>	\$45,667.93					
<b>Shares Outstanding</b>	950.39					
<b>Stock Value Per Share</b>	\$48.05					

## Possible Explanations

While both models did predict the stock price to fall which it did in later months, it never fell as low as the predictions. A reason for this could be that soon after the fiscal year end Walgreens announced plans to purchase Alliance Boots. The possibility of this purchase could definitely have driven the stock price up, and the value added of this purchase was not accounted for in the DCF and ROPI models.

## Chapter 9: Audit and Tax Recommendations

### Management's Assertions and Effects on Accounts

Major Balance Sheet Account	Existence or Occurrence	Completeness	Rights and Obligations	Valuation and Allocation	Presentation and Disclosure
<b>Cash and Cash Equivalents</b>	The cash account represents the amount of cash and equivalents actually held by the company on the date of the balance sheet.	All cash transactions that were completed during the dates stated on the balance sheet are included in the account total.	The cash balance represents the company's right to the cash, and full ownership.	Cash is clearly valued at what it is worth based on corresponding exchange rates.	The accounting for cash and what makes up cash equivalents is clearly disclosed, and executed properly.
<b>Accounts Receivable</b>	The balance in the accounts receivable account accurately states the existence, and amount of receivables.	The balance of this account is complete; not including any receivables dated before or after the date of the balance sheet.	This balance represents the company's right to future cash from past transactions.	What is reasonably expected to be paid back is the value of the account. Bad debt expense has been correctly written off.	The terms of accounts receivable agreements are disclosed as well as the bad debt expense.

<b>Inventory</b>	The balance in the inventory account correctly represents the amount of inventory owned by the company on the date of the balance sheet.	The balance of the inventory account correctly reflects the entire amount of inventory owned and controlled by the company at the date of the balance sheet.	The company clearly owns its inventory with the right to sell or dispose of it as it seems fit.	Inventory has been correctly recorded using the LIFO method. Any inventory that has lost value has been written down to the correct net realizable value. The computation of the value of inventory is correct.	The method of recording inventory is accurately disclosed, and the account is computed in the stated way. Any changes the method of accounting for inventory are clearly stated.
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<b>Property, Plant and Equipment</b>	The balance in the account represents all the PPE actually owned by the company, and these assets exist.	The amount reflected in the balance sheet is an accurate reflection of the total amount of PPE owned by the company. Leased equipment is not included in PPE.	The amount of PPE reported is the amount that the company has the right to use and hold.	Any impairment to PPE has been correctly recorded as well as depreciation expense.	Any impairment in PPE has been disclosed. Changes in accounting for depreciation as well as the depreciation method are disclosed.
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<b>Equity Investment in Alliance Boots</b>	The amount of investment in Alliance Boots represents a real ownership.	The balance in the investment account is the complete total invested in Alliance Boots.	The company has a clear ownership of its investment in Alliance Boots with the right to purchase the corresponding call option.	The investment in Alliance Boots has been recorded at the correct value in American currency.	The terms of the investment are clearly stated as to what it includes.
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<b>Accounts Payable</b>	The accounts payable balance actually exists at the date of the balance sheet.	The accounts payable is accurately reported at the date of the balance sheet; does not include any payables	The balance represents the company's obligation to pay back what the company owes.	The accounts payable account is valued to what will be paid back.	Important contract obligations are disclosed on the financial statements.
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		before or after the date.			
<b>Long Term Debt</b>	The amount of long-term debt is the amount actually owed by the company at the date of the balance sheet, and exists.	The entire amount of debt that is owed is reported on the date of the balance sheet.	The company is obligated to pay back the full amount of the debt.	The amount of long term debt is valued at the correct amount.	Any debt covenants are disclosed in the financial statements.
<b>Common Stock</b>	The amount of common stock actually exists, and is held by stockholders.	The entire amount of common stock is reported at the date of the balance sheet.	The company has an obligation to the holders of the common stock.	The value of the common stock is correct, and does not include items such as paid-in-capital.	The amount issued, and outstanding or restricted are disclosed on the financial statements.

## Audit Risks and Internal Controls

As such a large-scale operation Walgreens is exposed to many audit risks. They use internally developed software to their connect stores, and communicate across the country. This software stores prescription information as well as reports revenues. It is imperative that these work correctly or revenues could be reported inaccurately. In order to test the system auditors can work backwards and vouch transactions. By working through the system backwards issue will stand out more prominently. Auditors can also trace vouchers through the system. By creating their own voucher they can see exactly what effects it as it moves through the system. By controlling their own transaction they will be able to see exactly the effects the system has on it.

Walgreens management can put internal controls in place to comfort the external auditors. These controls can range from testing their own vouchers weekly or monthly

through the system to checking their software for bugs and errors monthly by an outside consultant.

As a high profile company Walgreens is publically subjected to meeting the forecasters' predictions quarterly and yearly. This leads to the auditing risk of the fraud triangle. Managers are subjected to the pressure of meeting these estimates with bonuses and even their jobs on the line. The high pressure leads to the rationalization of faulty accounting by members of management. When given the opportunity to exploit the balances of accounts to their advantage they may possibly take it. In order to test for possible fraud auditors can check the authorization processes. They can also recalculate account balances to test for error. Inquiring into discrepancies can also help if others were not involved in the fraud.

There are many internal controls that can help prevent this behavior. Companies can implement a clear chain of command and authorization of changes to the books. A segregation of duties will allow for more transparency, and less likelihood of fraudulent accounting. Also regular independent verification of major transactions will give external auditors more confidence when performing their audits.

## Tax Issues

At the time of their most recent financial statements Walgreens had not earned any export revenues in the past five years. Thus the only relevant tax rate will be the American Federal statutory rate of 35 percent.

As a large corporation they have been able to wield their power in their home state of Illinois in exchange for tax credits. The state of Illinois has given Walgreens 46

million dollars in tax credits over the past ten years. In exchange Walgreens has pledged to create over 500 jobs, and upgrade offices (Sorkin). Illinois also offered further incentives by paying Walgreens over half a million dollars in training cost, and almost another million in tax incentives (Sorkin).

Even though Walgreens is strongly supported by their home state, they entertained the idea of domiciling their business in Switzerland when they merged with Alliance Boots. This process called inversion would have legally although controversially lowered their tax bill. The overall effective tax rate in Switzerland is between 11.5 percent and 25 percent. Even at the highest rate in Switzerland their tax rate would have been cut by ten percent while still conducting the majority of their operations, and making the majority of their revenue in the United States.

However due to political pressure, and intense media coverage Walgreens decided to follow through with purchasing Alliance Boots rather than being purchased themselves. A huge reason for this decision by Walgreens was the amount of revenues they make from the United States government alone. Through Medicare and Medicaid alone they earned \$16.3 billion, and earn \$72 billion total from the government. They could have risked losing this revenue by moving their corporation's headquarters. Also it was estimated that a move to Switzerland by Walgreens would cost the United States taxpayers about four billion a year for five years (Sorkin). By buying Alliance Boots Walgreens kept themselves domiciled in the United States, and continued to be subjected to the higher tax rate, but stayed in good favor with the American public.

If they had decided to move to Switzerland, or if they decided to move in the future it could have positive effects on their business besides the tax benefit. If they were

subjected to a lower tax expense they would have a larger range of price flexibility. This would give them a greater gross profit to work with, and enable them to be more price competitive with rivals such as CVS, and Rite Aid. Price competitiveness has been a weakness for Walgreens with gross profits for generic goods falling. Being able to have a larger margin would enable Walgreens to grow more market share.



## Chapter 10: Advisory Recommendations

### Focus on Mobile Growth

Walgreens has consistently seen a drop in foot traffic over the past three years. However, sales and gross profit have grown over the past few years meaning that the drop in foot traffic has not adversely affected the company yet. This indicates a strong shift to online sales as well as mobile. While online sales are important there has been a universal increase in mobile sales as well. It is very important for Walgreens to focus on their omni-channel experience for their customers. Walgreens in its past has been very innovative and a leader in the pharmacy industry. They need to lead the way for convenience on mobile devices. While they have shown impressive numbers for app downloads as well as mobile sales, mobile sales only make up a little over two percent of total sales. This leaves great room open for improvement. They already have an impressively easy to use app that allows for refilling prescriptions, and integrates their Balance Rewards program seamlessly. The issue for Walgreens is encouraging customers to actually use the app. In order to do this, advertising and raising awareness is key. By offering one time promotions for discounts on first time mobile orders Walgreens will encourage users to try the app, and experience the convenience. By offering deals on items in app only will also encourage users to buy from mobile devices. Again once they use it once, they will realize how convenient it is to have their items delivered directly to

their house rather than going to a brick and mortar store. This increased use in technology will put Walgreens on the front of the mobile movement for pharmacies.

## **Corner of Healthy and Happy**

Walgreens has taken on the phrase “the corner of happy and healthy” as their branding outside of their store, but it is not very visible in stores. A designated corner in the store named the Corner For Health would bring the outside image into the stores. A designated area selling organic, healthy food as well as organic beauty items and all natural vitamins would allow for easier, healthier shopping. As public health awareness is at an all time high, this corner would allow Walgreens to cash in. Walgreens prides itself on being leaders in innovation and convenience, and this corner would just be another way they could lead the way. The centralized location would be the epitome of convenience. It would also allow shoppers to use Walgreens to compete with grocery stores such as Whole Foods. This would lead to an increase in foot traffic as well as revenue for Walgreens, and therefore an increase in stock price.

## **Partnership with a PBM**

If Walgreens were to buy, or solidify a partnership with a pharmacy benefit manager, it would enhance their market share. While they have more physical stores than their rival CVS they do not have the greatest market share. In fact according to IBIS World Walgreens has only 31 percent of the market share while CVS holds 54 percent. This is in large part due to CVS owning Caremark a pharmacy benefit manager or PBM. Walgreens, and Express Scripts currently have an alliance making Walgreens a preferred pharmacy in their network. This relationship allows Express Scripts’ beneficiaries to buy

prescriptions at discounted prices from in network pharmacies. While having this relationship is great for Walgreens it is not permanent, and they do not reap the full benefits. By owning a PBM, Walgreens would be able to collect the full revenues from the partnership, and would also be able to control the PBM. Controlling the relationship is crucial because in the past disputes between Walgreens and Express Scripts have lead to a loss of revenue for Walgreens. In 2012 due to a contract disagreement in 2011, Walgreens lost out on billions in sales when Express Scripts took them out of network (Japsen). This kind of loss shows how important it is for Walgreens to have an ongoing, controlling relationship with a prominent PBM. While Walgreens did just make a huge acquisition with Alliance Boots their CEO himself said that they would be open to a closer relationship with a PBM. It would have a positive impact on shareholders by adding a consistent growth in revenue, and being able to cash in on prescriptions made at other pharmacies that they may be in the PBM's preferred network.

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