

WALGREEN CO.



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EXECUTIVE SUMMARY

Walgreen Co. (“Walgreens”) is the largest retail drugstore chain in the United States, offering consumers a variety of basic consumer goods including household products, convenience foods, personal care, beauty care, photofinishing, and seasonal items, as well as over-the-counter and prescription medication. In addition to its well-known retail pharmacies, Walgreens also operates its Health Services division, which offers medical and prescription drug plans, and its Health and Wellness division, which operates in-store clinics. This report will focus on retail drugstores, mail-order services, and Take Care clinics, which Griffin believes are the most promising sources of future growth. As of January 31, 2012, Walgreens has 247,000 employees and 8,270 locations in all fifty states, Washington D.C., and Puerto Rico.

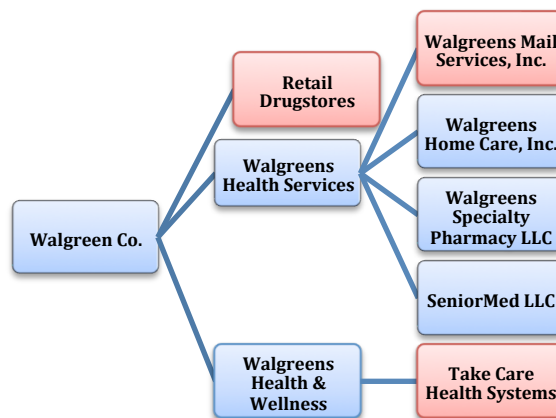


Figure 1.1: *Walgreens breakdown. Take Care facilities are located within existing Walgreens pharmacy locations and on work sites, SeniorMed LLC operates as a pharmacy provider for long-term care facilities, Specialty Pharmacy helps customers manage complex health conditions, Home Care assists with home care needs such as delivery and setup of medical equipment and supplies, and Mail Services refills prescriptions conveniently by mail.*

Currently, Walgreens faces two major competitive challenges and two significant industry adjustments. The first challenge arises from the loss of contract with pharmacy benefit manager (PBM) Express Scripts effective January 1, 2012, which negatively impacts Walgreens’ prescription drugs sales, its main source of revenue. The second challenge also involves Express Scripts. In April 2012, the Federal Trade Commission (FTC) approved the \$29.1 billion Express



Scripts-Medco merger, which unites the two largest PBM companies. This could both increase bargaining power about pricing against Walgreens, and draw away prescription market share with their sizable mail order services.

In addition to the changing pharmacy benefit manager landscape, the Patient Protection and Affordable Care Act (PPACA) will change the retail pharmacy industry by bringing currently uninsured Americans into the health care market. While the impact on pharmacies of government pressure to lower prices is unclear and likely to be shared with insurance companies and PBMs, the increase in health care demand in the United States in 2014 when the Act comes fully into effect will undoubtedly benefit Walgreens if it can position itself to capture more of this demand than its competitors. The second major industry adjustment, the rise of mail-order pharmacy, is challenging traditional brick-and-mortar pharmacies, like Walgreens, to modify their business models to utilize technology effectively and compete based on factors other than convenience.

Griffin Consulting Group looks forward to collaborating with Walgreens to develop effective consumer and growth strategies for both the near and the intermediate/long term. In summary, Walgreens should focus on customer experience, competing on personalized service rather than convenience alone, as mail-order pharmacy and pharmacy units within big box stores have the obvious advantage in that area. In terms of growth, Walgreens should stop brick-and-mortar expansion and prepare for a significant reduction in prescription sales from the loss of contract with Express Scripts. Instead, Walgreens should turn to its online business, aggressively marketing newly acquired drugstore.com and taking advantage of its strong balance sheet and low interest rates to update its existing locations to better reflect the new service-based role of brick-and-mortar pharmacy.



PART 1: INTRODUCTION

COMPANY HISTORY

Charles R. Walgreen founded Walgreens in Chicago in 1901, and by 1926 the company had expanded to one hundred stores throughout Wisconsin, Missouri, and Minnesota. Originally, Walgreens pharmacies were connected to local grocery stores, modeled after the format used by its largest competitors at the time. This business model relied on the concept of walkthrough customers, or customers who would visit both the grocery store and the pharmacy. However, the modern business model has evolved to operating independent and often freestanding locations at the corners of intersecting streets, in the style of the traditional “corner drugstore”.

Walgreens has always been on the cutting edge in terms of design and technology initiatives. In the 1920s, it opened stores on the Chicago World Fair grounds, which showcased design features, such as advanced fixtures, new lighting techniques, and unique color schemes. It was the first drugstore chain to use radio advertising in the late 1920s. It revolutionized the drugstore industry with the opening of its first self-service drugstore in 1952, and its drive-through locations in 1992, of which there are now more than 700. It also pioneered next-day (which eventually became one-hour) photofinishing services in all of its stores starting in 1982. Further, its pharmacy system, Intercom Plus, was implemented in 1997 and is the best pharmacy system in the industry, providing superior patient counseling and prescription fill times. To recognize and accommodate changing demographics, Walgreens became the first drugstore chain to offer prescription labels in multiple languages in 2002.

Walgreens has continued to expand substantially over the past decade. In 2006, Walgreens acquired the Happy Harry’s chain, located throughout Delaware, Pennsylvania, Maryland, and New Jersey. In 2007, Walgreens acquired Option Care, a chain of more than 100 pharmacies throughout 34 states. Also in 2007, the Company bought Take Care Health Systems (“Take Care”), a leading operator of convenient care clinics, one year after CVS acquired the largest in-store clinic operator, MinuteClinic. The following year, it purchased twenty additional locations in Puerto Rico from Farmacias El Amal. Its largest acquisition has been that of New York City-based chain Duane Reade’s 258 locations in early 2010 for \$1.075 billion. While it closed Duane Reade locations



that competed directly with existing Walgreens locations, it continues to operate many Duane Reade locations under their original name.

The acquisition of Take Care signaled Walgreens' move to expand the role of traditional pharmacy. At the time, Take Care operated 51 clinics in Chicago, Kansas City, Milwaukee, St. Louis and Pittsburgh, and was largely owned by Beecken Petty O'Keefe & Co., a private equity firm that had helped fund the roll out of clinics. At the time of the acquisition, Walgreens already had 59 "Health Corner Clinics" in its stores. While Take Care already operated most of those clinics, RediClinic also operated within Walgreens in Atlanta and EasyCare in Las Vegas. Walgreens transitioned non-Take Care operated clinics to Take Care management, hoping to operate 400 Take Care clinics by the end of 2008. However, this goal was not reached, as the company faced challenges operating the clinics profitability. Walgreens currently has 355 pharmacy locations with Take Care clinics.

Take Care, founded in 2004, was established with the hope of making health care more affordable and accessible, and differentiated itself through patient-focused care and hiring the best people. Take Care recognized the value of nurse practitioners, built the company around their input, and consequently attracted some of the best in the field. Additionally, it utilized electronic medical record keeping, allowing patients the flexibility of visiting their clinics for minor maladies while effortlessly keeping their primary care physician's records up to date. All of these factors plus their existing clinic relationship made Take Care an attractive acquisition target for Walgreens, and the move into the clinic space marked Walgreens' first step toward changing its pharmacies to a more service-based model.

In addition to its brick and mortar expansion, Walgreens has expanded into the online space over the past two decades. It launched Walgreens.com, a comprehensive online pharmacy, in 1999. Additionally, in March 2011, it acquired drugstore.com for \$409 million. Today, much of its clinic scheduling, prescription orders and refills, as well as retail purchases are made through virtual storefronts. This has become critical to the business, particularly since the recession prompted a company-wide initiative to reduce annual costs by approximately \$1 billion by 2011 through more efficient processes, strategic sourcing, and reductions in corporate overhead.



Table 1.1 breaks down the number of locations Walgreens currently operates, and the company segment in which each location serves. These numbers do not include Walgreens' Take Care Clinics, a wholly owned subsidiary, which operate within other Walgreens locations. While the total number of locations has consistently increased, non-drugstore locations have consistently decreased. Clearly, drugstores represent the vast majority of Walgreens operations and will play an even larger role moving forward, and will therefore be the primary focus of this report, with occasional asides to other areas of importance.

Table 1.1: Number of Locations

Location Type	2011	2010	2009
Drugstores	7,761	7,562	6,997
Worksite Health and Wellness Centers	355	367	377
Infusion and Respiratory Services Facilities	83	101	105
Specialty Pharmacies	9	14	15
Mail Service Facilities	2	2	2
Total	8,210	8,046	7,496

Source: 2011 Walgreens Annual Report



PART II: ANALYSIS

FINANCIAL ANALYSIS

Overview

Walgreens, the nation's largest drugstore chain with 7,700 locations, is a leader in the field with a strong history of expansion and profitability. Despite the challenging economy, the Company experienced its 37th consecutive year of record sales and raised its quarterly dividend for the 36th consecutive year in 2011. New records set in fiscal 2011 include \$72.2 billion in sales, gross profit of \$20.5 billion, and earnings per diluted share of \$2.94. This includes the largest increase in net income in 10 years and the largest earnings per share growth in 15 years. This EPS growth includes a \$0.30 per diluted share after-tax gain from purchasing drugstore.com and selling of the Company's PBM business (\$525 million before tax, \$273 after).

In order to stay ahead of the curve in the intensely competitive environment that characterizes the retail pharmacy industry and ensure continued success in a weaker economic environment, Walgreens has recently enacted several programs to reduce costs and improve operational efficiency. Three years ago, Walgreens launched its "Plan to Win", aiming to improve customer service, reduce costs, and increase productivity. To satisfy the goal of improving customer experience, Walgreens initiated "Customer Centric Retailing" in 2009, and has enjoyed increased customer satisfaction and sales in 5,500 locations thanks to improvements in shelf height, product placement, and category layouts. Additionally, the new pilot store design that brings pharmacists out into the front of the store has shown promising results. To increase productivity, Walgreens launched "Rewiring for Growth", which achieved its three-year goal of \$1 billion in annual pre-tax savings through actions including reducing corporate overhead and rationalization of inventory categories, and the Company continues to look for cost-saving opportunities in the future.

Looking forward, industry analysts expect pharmacies to experience an increase in sales volume as well as an increase in foot traffic in their in-store clinics from the PPACA, which is expected to bring 32 million currently uninsured Americans into the health care market. However, despite the increase in sales, profits are expected to come under pressure as the government attempts to reduce costs. This pressure will continue to increase industry rivalry, which



could potentially push out smaller companies that cannot compete with the operational efficiency of larger operations like Walgreens and the nation's second largest pharmacy chain, CVS. Depending on how Walgreens adjusts to the lower margins/higher volume trade-off, the PPACA could help, hurt, or not affect its bottom line. Weakening or strengthening of the economy is unlikely to have a significant impact on Walgreens, as the demand for healthcare is characteristically inelastic.

Walgreens is in a strong financial position, as its ability to consistently increase revenue and control costs have left it with a solid balance sheet. In the past five years, the Company opened net 2,749 locations, although openings slowed significantly in 2011 (164 versus 550 in 2010 and 562 in 2009). Management has shifted focus from rapid expansion to cost cutting, store renovation, and service expansion, most likely in preparation for the loss of Express Scripts business and increased competition from mail order and big-box retailer pharmacies. Walgreen's slowing store growth should result in higher margins, as new stores often post losses in their first years, and operating margins increase considerably as these stores age. In the short term, Walgreens will see reduced sales as it no longer fills 88 million prescriptions a year for Express Scripts. Although the Company is already taking promising strategic action to position itself competitively in the changing retail pharmacy market by remodeling its stores and buying online giant drugstore.com, pharmacy is a relatively high fixed cost business. Loss of business is likely to deteriorate margins and further cost cutting could reflect negatively on customer experience, making Walgreens operationally vulnerable in the case of additional customer loss.

Profitability and Growth

Walgreens' productivity and cost-saving initiatives launched in the later part of the previous decade are visibly paying off. In 2011, Walgreens' net earnings increased by 29.8 percent. This increase was largely attributable to three key factors: higher gross margins, the gain on the sale of its PBM business (\$273 million after tax), and a lower effective tax rate (see Appendix I for historic tax rates and additional data on profitability and growth). Total front-end (non-prescription drug) sales growth increased by 8.5 percent in 2011 versus 6.8 percent in 2010, and Duane Reade taken independently increased front-end sales by 2.8 percent versus 1.9 percent last year. This growth can be attributed to both increases in existing stores as well as acquisitions and openings of new stores. Increased corporate costs and Duane Reade operational expenses were offset by lower costs and savings from the "Rewiring for Growth" initiative, which successfully reduced expenses and store payroll as a percentage of sales.



Prescription sales growth stagnated in 2011, which is reason for concern as prescription drugs make up 65 percent of Walgreens' sales. This trend is likely to continue as the lost business from Express Scripts takes its toll, which is further discussed in the "SWOT Analysis" section of this report.

Table 2.1: Operating Statistics

Fiscal Year	Percentage Increases / (Decreases)		
	2011	2010	2009
Net Sales	7.1	6.4	7.3
Net Earnings	29.8	4.2	(7.0)
Prescription Sales	6.3	6.3	7.8
Front-End Sales	8.5	6.8	6.3
Gross Profit	8.0	7.7	5.8
Selling, General, & Admin Expenses	6.7	8.0	8.8

Source: 2011 Walgreens Annual Report

Over the past 5 years, Walgreens has enjoyed consistent top-line revenue growth, as the firm continues to expand and increase sales both through openings and acquisitions. Comparing Walgreens to its competitors, it has proven its ability to increase revenue and manage costs in the challenging retail pharmacy market, as shown by Figure 2.1. In general, the retail pharmacy market emerged unscathed from the recent economic slowdown. While Walgreens and the nation's second largest pharmacy chain, CVS, have competed intensely in recent years, the third largest, Rite Aid, has fallen behind in its ability to manage costs since the 2007 Eckerd acquisition, as shown by its consistently negative net income since 2007.

Table 2.2 further demonstrates the profitability of Walgreens compared to its competitors. Walgreens has the highest gross profit margin and net profit margin of the largest retail pharmacy chains. Additionally, Walgreens enjoys the highest return on equity and return on assets, which means the firm is effective at converting investments into net income. Although Walgreens has more pharmacy locations, CVS enjoys higher revenues thanks to its PBM arm, Caremark, which it acquired in 2006. Despite their differences in scale (Walgreens has 7,700 locations, CVS has 7,000, and Rite Aid has 4,700), they share similar product breakdowns (see Figure 2.2). Across the board, prescription drugs take the largest share followed by general merchandise and over the counter drugs. Large retail pharmacies appear to have converged to a similar product class breakdown, which could indicate both that this is the optimal breakdown and/or that similar customers shop in these types of stores, and are looking to buy similar types of items regardless of which location they select.

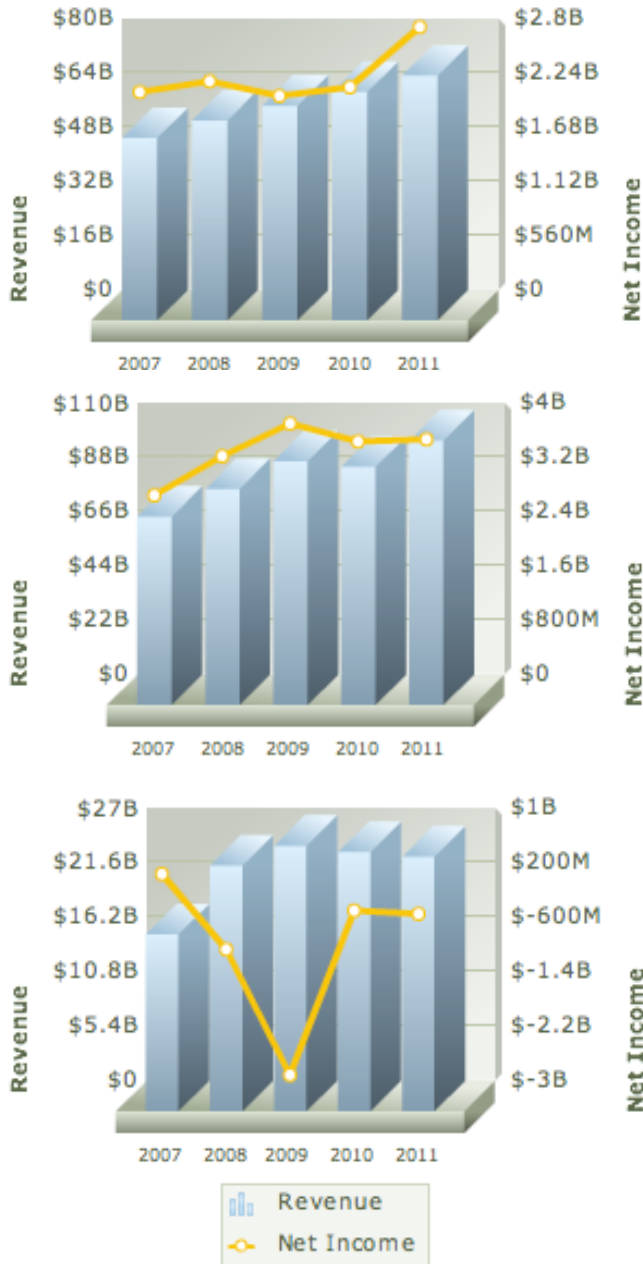


Figure 2.1: Revenue versus net income for the three largest pharmacy chains.
Source: Hoovers



Table 2.2: 2011 Consolidated Income Comparison

	Walgreens	CVS	Rite Aid
Revenue	72.18B	107.10B	25.21B
Gross Profit	20.49B	20.56B	6.69B
Operating Income	4.37B	6.33B	23.78M
Net Income	2.71B	3.46B	(555.42M)
Diluted EPS	2.94	2.57	(0.64)
Gross Profit Margin	28.29%	19.20%	26.54%
Net Profit Margin	3.76%	3.26%	(2.20%)
Return on Equity	18.51	9.24	--
Return on Assets	9.87	5.39	(5.50)

Source: Hoovers

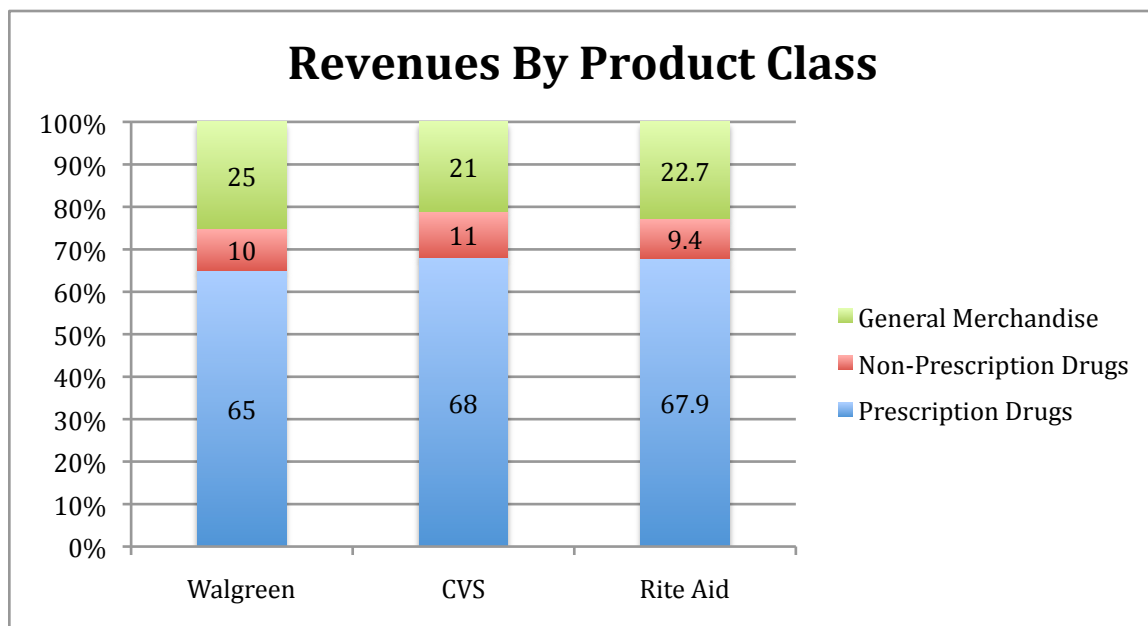


Figure 2.2: Revenue Breakdown for Walgreens, CVS, and Rite Aid.

Source: Wikinvest



Solvency and Liquidity

As shown by Table 2.3, Walgreens’ current ratio is below industry median but above 1, which indicates it is capable of paying back its short-term liabilities if they immediately came due, but comparatively less capable than its competitors. The quick ratio, which is more conservative than the current ratio because it excludes inventory from assets, is also below the industry median and that of its closest competitor, which also indicates a comparatively weaker ability to meet its short-term obligations with its most liquid assets. However, Walgreens’ debt to equity ratio is notably lower than the industry median, indicating that the Company has not been aggressive in using debt to fuel growth. While this could generate savings in interest expense, the Company should take the shareholders’ required rate of return into account in its borrowing strategy and potentially increase earnings, especially given the low interest rates from recent expansionary monetary policy. Additionally, the Company’s interest coverage ratio indicates that it is more than capable of meeting its debt expenses – any ratio above 1.5 indicates reasonable confidence in ability to pay interest. Conversely, Rite Aid’s interest coverage ratio below 1.0 indicates that it is not currently generating enough revenue to meet its interest expense, and is facing significant financial difficulty.

Table 2.3: Industry Financials 2011

	Walgreen	CVS Caremark	Rite Aid	Industry Median	Market Median
Current Ratio	1.52	1.60	1.82	1.64	1.46
Quick Ratio	0.50	0.57	0.44	0.58	1.30
Leverage Ratio	1.85	1.65	--	1.97	5.80
Total D/E Ratio	0.16	0.27	--	0.39	1.08
Interest Coverage	63.59	10.68	0.22	14.27	7.61

Source: Hoovers

Looking at Walgreens historically, Table 2.4 illustrates the Company’s increase in external financing to fund its “Customer Centric Retailing” initiative, which costs approximately \$45 thousand per store and was put into action in 2009. Despite a consistent slight increase in the leverage ratio over the past five years, Walgreens remains below the industry median and, as indicated by the analysis of Table 2.3, is in good financial health and more than capable of meeting its financial obligations.



Table 2.4: Walgreens Co. Historical Financial

	2011	2010	2009	2008	2007
Current Ratio	1.52	1.60	1.78	1.57	1.41
Quick Ratio	0.50	0.58	0.75	0.45	0.37
Leverage Ratio	1.85	1.82	1.75	1.74	1.74
Total D/E Ratio	0.16	0.17	0.16	0.10	--

Source: Morningstar

Operational Efficiency

As shown by Table 2.5, Walgreens has significantly lower days of sales outstanding than its competitors, which indicates that the Company takes fewer days to collect money from its customers. Walgreens has an inventory turnover ratio very close to the industry median, which means that the Company is doing well with managing inventory while still keeping enough on hand so as to not jeopardize potential sales. The high asset turnover ratio means that Walgreens is efficient at using its assets to generate sales, but could also be an indicator of pricing strategy as companies with lower profit margins generally have higher asset turnover. However, as shown by Table 2.2, CVS operates at lower margins than Walgreens, which means Walgreens is highly skilled at generating sales since it operates at higher margin and has higher asset turnover. Net receivables turnover measures effectiveness in extending credit and collecting debts – the Company’s comparatively high ratio implies that it operates on a cash basis or that it is efficient in the aforementioned areas.

Table 2.5: Industry Operations Statistics

	Walgreen	CVS Caremark	Rite Aid	Industry Median	Market Median
Days of Sales Outstanding	12.65	19.32	13.96	17.22	43.20
Inventory Turnover	6.49	7.97	5.57	6.70	7.63
Days Cost of Goods Sold in Inventory	56.27	45.81	65.52	54.47	47.87
Asset Turnover	2.68	1.64	3.31	1.96	0.27
Net Receivables Turnover	28.86	18.89	26.15	21.20	8.45

Source: Hoovers

Again, turning to historical numbers, Table 2.6 shows continuous strengthening of operations statistics over the most recent five years. Asset turnover had a minor dip corresponding with “Plan to Win” initiatives in 2009, but recovered significantly in 2011.



Table 2.6: Walgreens Co. Historical Operations Statistics

	2011	2010	2009	2008	2007
Days of Sales Outstanding	12.51	13.39	14.47	14.73	14.59
Inventory Turnover	6.70	6.84	6.51	6.04	6.00
Days Cost of Goods Sold in Inventory	54.45	53.37	56.03	60.44	60.84
Asset Turnover	2.69	2.62	2.66	2.83	2.95
Net Receivables Turnover	29.18	27.26	25.22	24.79	25.01

Source: Morningstar

Market Valuation

Table 2.7 highlights some key financial statistics for Walgreens, CVS, and Rite Aid. As previously discussed, Walgreens has very little debt, which explains why its market value is comparatively much closer to its enterprise value than is the case for CVS. However, one area of concern is the comparative trailing and forward price-to-earnings ratios. Forward P/E ratios will be lower than the current P/E ratio if earnings are expected to grow in the future, which in this instance favors CVS strongly. This is partially due to the decrease in earnings expected from the loss of contract with the Express Scripts effective January 1, 2012. In fiscal year 2011, Express Scripts processed 88 million prescriptions filled by Walgreens, which represents about \$5.3 billion in sales. The consequences of the loss of contract with Express Scripts are further discussed in the “SWOT Analysis” section of this report.

Table 2.7: Financial Highlights

	Walgreen	CVS Caremark	Rite Aid
Market Cap	29.26B	58.61B	1.77B
Enterprise Value	30.46B	67.53B	8.40B
Cash (mrq)	1.09B	1.42B	148.47M
Debt (mrq)	2.40B	10.01B	6.31B
Revenue (ttm)	73.00B	107.10B	25.43B
EBITDA (ttm)	5.09B	7.90B	769.04M
Trailing P/E (ttm, intraday)	11.36	17.53	N/A
Forward P/E (fye)	11.34	12.19	N/A

Source: Yahoo! Finance, March 15, 2012

Abbreviation Guide:

mrq: most recent quarter

ttm: trailing 12 months

fye: fiscal year ending



Figure 2.3 shows Walgreens' historical stock price information compared to CVS, Rite Aid, and the S&P 500. Share prices fell dramatically in July 2011 after the announcement that Walgreens would not be renewing its contract with Express Scripts, and have yet to recover from this news as investors wait to see how Walgreens handles the expected decrease in prescription sales volume. The Company initiated a share buyback program in 2008, and since then has reduced shares outstanding from approximately 1 billion to 885 million. Additionally, Walgreens has consistently paid a quarterly dividend, with a current dividend yield of 2.70 percent. Current analyst consensus lists Walgreens as neutral/hold, with analyst revenue estimates projecting a 0.52 percent contraction in 2012 and an average growth rate of 3 percent over the next five years, compared to 8.8 percent over the previous five years.

Figure 2.3: Stock Performance



Historical stock price information over the past 5 years compared to CVS, Rite Aid, and the S&P 500.



COMPETITIVE ANALYSIS

Defining the Industry

Walgreens operates across many industries, with its retail pharmacy, Walgreens Health Services, and Walgreens Health & Wellness divisions. Just within its retail pharmacy, it is a brick-and-mortar pharmacy, a convenience store, an over-the-counter drug store, and now a healthcare provider. However, since approximately 95 percent of Walgreens locations are drugstores and 65 percent of sales come from prescription drugs, this analysis will focus on the pharmacy business, including Take Care clinics.

Table 2.8: Porter's Five Forces Analysis

Factor	Importance
Internal Rivalry	High
Entry/Exit Costs	Moderate
Substitutes	High
Supplier Power	Low
Buyer Power	Moderate

Internal Rivalry

Walgreens operates within the retail pharmacy industry, which characteristically depends heavily on prescription drug sales for continued revenue but also offers customers basic consumer goods and over the counter drugs. The retail pharmacy industry has two 800-pound gorillas: Walgreens and CVS. Both companies have over 7,000 pharmacy stores (Walgreen has slightly more with approximately 7,700), and both count on prescription drugs for about 65 percent of their revenue. Competition between Walgreens and CVS pharmacies is aggressive and direct. For example, CVS recently ran an advertisement in millions of circulars instructing Walgreens customers how to transition their accounts to CVS, and this behavior has continued as Express Scripts customers can no longer use Walgreens as their prescription drug provider and CVS works to acquire this market share.

Both Walgreens and CVS have several advantages compared to the other. Walgreens enjoys a better credit rating (A vs BBB+), which makes property owners comparatively more willing to give leases to Walgreens than CVS, and



also cuts down on Walgreens' borrowing costs. Walgreens has also traditionally operated in better locations with superior store management, resulting in historically higher profits-per-square foot. CVS has two main advantages: first, CVS has a robust PBM arm, giving it some protection from consolidation in the market, which is further discussed in the "Buyer Power" section of this report. Second, CVS moved more quickly into the in-store clinic space, giving it a first-mover advantage in a promising sub-industry.

While Walgreens and CVS are comparable retail pharmacies, in recent years they appear to have moved in slightly different strategic directions. While Walgreens continues to focus primarily on retail pharmacy sales, CVS is making moves into pharmacy benefits management. Specifically, in March 2011, Walgreens sold its PBM division for \$525M, and promptly bought drugstore.com for \$409M, solidifying its position as the nation's largest retail pharmacy. CVS, on the other hand, remains the nation's largest pharmacy services provider after the \$26.9 billion purchase of Caremark Rx in 2007.

Entry & Exit

Although Walgreens and CVS are the giants in the retail pharmacy industry, there is still plenty of room for smaller competitors. Entry into the brick-and-mortar prescription drug business is feasible even on a small scale: in total, small independent pharmacies still comprise approximately 15 percent of the market. The National Community Pharmacists Association (NCPA), which represents over 23,000 independent pharmacies across the United States, reports that local pharmacies can be operated very profitably. The key differentiator between retail pharmacy chains like Walgreens, CVS, and Rite Aid and independent pharmacies is product breakdown. While prescription sales make up about 65 percent of revenues for three largest retail chains, but the NCPA reports that prescriptions, which have higher profit margins than over the counter drugs and general merchandise, make up 90 percent of revenues in its member pharmacies. Consequently, in 2009 (latest available data), independent pharmacies enjoyed a profit margin of about 23.8 percent in 2009, up slightly from 2008 and competitive with large chains (see Figure 2.4).

Logistically, creating an independent pharmacy is relatively simple: requirements include only a small storefront, a pharmacist, and a license. Given the scale of Walgreens and that many consumers choose their pharmacy based on locational convenience, however, the existence of these smaller local pharmacies is unlikely to become a competitive threat.

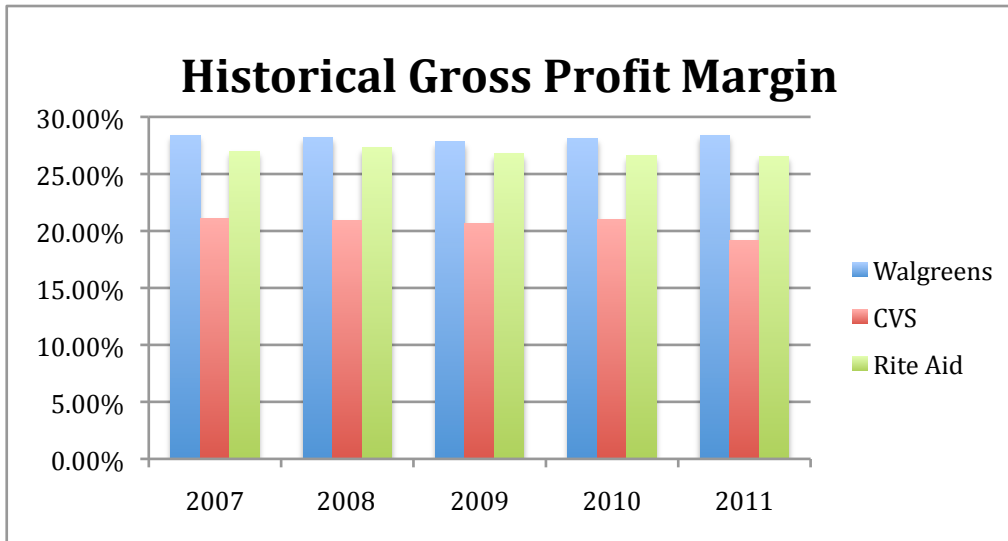


Figure 2.4: *Historical gross profit margins for the three largest retail pharmacy chains in the United States.*

Source: Hoovers

On the other end of the spectrum, big-box stores like Wal-Mart can open a pharmacy section in their existing locations with relatively little overhead. Additionally, since pharmacy is only a small part of their business, big-box stores might be willing to earn negative margins in their pharmacy division to increase traffic in other parts of their stores. This is an ongoing issue, as the once-small grocery stores have expanded to fill massive spaces and become one-stop shops, now commonly including small banks and pharmacies. The threat of these non-pharmacy-exclusive competitors taking market share is notable, and each new entry intensifies industry competition.

However, in the retail pharmacy specific space, an entrant seeking to mimic the Walgreens/ CVS type large chain faces a monumental task, from establishing new branding to renting and operating huge spaces. In light of the rise of mail-order pharmacy, it is possible that Walgreens and CVS have saturated the market for retail pharmacy specific locations, as evidenced by the struggling of Rite Aid. In this case, the threat of a new robust pharmacy specific competitor is minimal.

Walgreens also competes with convenience stores and supermarkets that sell non-drug goods. In this case, entry costs are generally low: from a new corner store to a new chain of stores, there is generally little overhead, minimal staffing



needs, and no regulation. Walgreens stands little chance of transforming this sector of its business to sustained above-market profitability, since new entrants could quickly and easily drive margins down.

Substitutes

The most pressing - and perhaps most dangerous - substitute to Walgreens' business model is the mail-order pharmacy. Walgreens faces more competitive and reimbursement pressure than it has in the past, as PBMs are using their bargaining power to push down prices for pharmacies and encouraging their customers to switch to their own mail-order pharmacies. Modern consumers continue to favor the convenience and often the cost advantages of shopping online for non-pharmacy goods including books, clothing, and electronics. Given this consumer mind set, the extra travel and time required to pick up a prescription at a brick-and-mortar pharmacy makes online and mail order an attractive alternative to those who take prescriptions consistently, and is a serious threat to Walgreens' current business model. This threat is exacerbated by the recently FTC approved Express Scripts-Medco merger, which unites two large mail-order pharmacies under one roof (this merger is discussed further in the "SWOT Analysis" section of this report).

Supplier Power

Clearly, many prescription pharmaceutical drugs are available only from one company: the pharmaceutical giant that holds the patent. This is, by definition, a monopoly, and therefore subject to enormous supplier power. On the other hand, this has been the status quo in pharmaceuticals for quite some time, and pharmaceutical companies would have some trouble using their negotiating power against Walgreens specifically, because public pressure against perceived differentials in access or differential pricing would be significant. Finally, pharmaceutical companies need to earn back high fixed costs of R&D by selling drugs in the United States. Since Walgreens is a major source of prescription drugs, Walgreens has some bargaining power against its suppliers.

Additionally, long-run reduced pharmaceutical innovation will decrease the proportion of new, patented drugs on the market and existing generics will probably assume a more dominant role. Since generic drug typically could have many producers, this will reduce the power of suppliers, to the advantage of Walgreens.



Buyer Power

While individual consumers have very little buyer power, both private and public insurance plans as well as PBMs have very significant buyer power, which is likely to become more of a challenge as the government puts cost-cutting pressure on the health care industry.

Prescription Benefits Managers can also run private insurance plans and are heavily involved in drug administration. Historically, the PBM landscape was quite fragmented and was not a major threat to pharmacies. However, as the recent Express Scripts-Medco merger and the breakdown of Walgreens' agreement with Express Scripts indicate, this is no longer the case. A highly consolidated PBM sector could have significant bargaining power over Walgreens and other pharmacies, since losing a contract with a large PBM means significant lost revenues (as we have already seen in the case of Walgreens). How much bargaining power is yet to be seen, and depends largely on the degree to which existing Medco contracts are honored (further discussed in the SWOT Analysis section of this report). Accordingly, the Company should prepare for contract revisions with other PBMs, as additional loss of contract could be devastating for its future sales (see Appendix II for more information about the extensive role of PBMs in the health care market).

While the PBM landscape is changing and relatively uncertain, public insurance plans are obviously very centralized. Medicare and Medicaid are a large proportion of insurance buys, and pricing power is in the hands of the government. For instance, Medi-Cal, California's insurance program, recently attempted a 10 percent cut to reimbursement rates. While this action was blocked by a judge concerned with the implications to access to medical care, the threat stands: as America's healthcare costs continue to spiral out of control, the government will have to make cutbacks, and these cutbacks will likely take some toll on Walgreens and other pharmacies.



SWOT ANALYSIS

Strengths <ul style="list-style-type: none">• Industry Demand• Size, Ubiquity, Brand Recognition• Balance Sheet	Opportunities <ul style="list-style-type: none">• PPACA & The Aging Population• Take Care Clinics• Drugstore.com
Weaknesses <ul style="list-style-type: none">• Dependency on Generic Conversion• Competitiveness with Big Box Stores	Threats <ul style="list-style-type: none">• Loss of Express Scripts Contract• Express Scripts-Medco Merger• Mail Order Pharmacies

Strengths

Industry Demand

Walgreens reported a 6.3 percent increase in prescription sales for 2011, and despite short term setbacks from the loss of contract with Express Scripts, can reasonably expect long-term growth in this segment for three reasons. First, the population of the United States is aging. According to The Administration on Aging, individuals 65 years and older represented 12.4 percent of the population in 2000, and this number is expected to increase to 19 percent by 2030 and 25.5 percent by 2050 (see Figure 2.5). Walgreens can expect to benefit from the aging population, as older citizens typically require more medication and prescription drugs sales make up so much of Walgreens' core business. Second, medications are being more effectively utilized to both extend and improve quality of life. Comprehensive electronic records are allowing doctors to more effectively diagnose and treat their patients in a timely manner, and more diagnoses means more business for Walgreens. Third, the PPACA will increase the insurance coverage and corresponding drug utilization of 32 million individuals, which will also most likely increase customer volume for Walgreens.

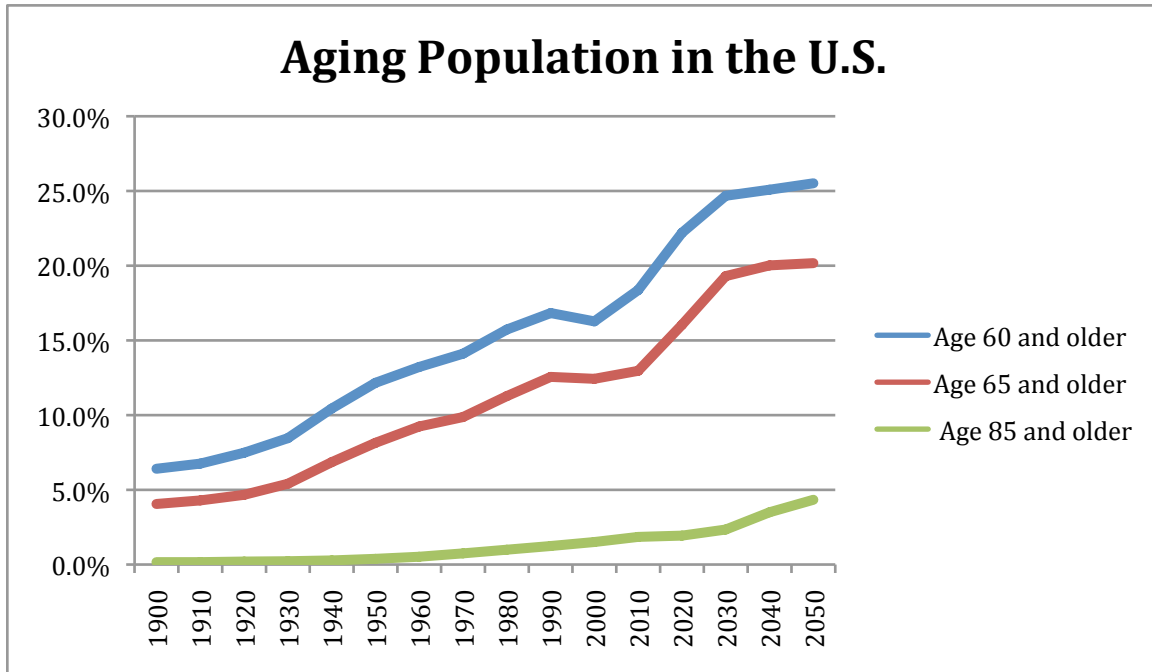


Figure 2.5: *The aging population in the United States from 1900 projected until 2050. Source: The Department on Health and Human Services Administration on Aging*

Size and Ubiquity

Walgreens currently operates 7,700 pharmacies in deliberately chosen prominent and prime locations, often on busy intersections. Consequently, approximately 75 percent of United States consumers live within five miles of a Walgreens brick-and-mortar pharmacy location. This convenience is critical to keeping the business of modern shoppers who are likely to shop based on proximity: the NPD Group used shopper data to estimate that 67 percent of consumers choose to visit stores like pharmacies and retail outlets based on their convenient location. In addition to its physical locations, Walgreens is accessible to its customers 24-7 via Walgreens.com as well as through its mobile application. This multi-channel availability is particularly valuable to Walgreens, as the company estimates multi-channel shoppers are three times more valuable than single-channel shoppers.

Balance Sheet

As discussed in the Financials section of this report, Walgreens enjoys a very strong balance sheet. Its “Rewiring for Growth” initiative in 2008 was hugely successful, delivering more than \$1 billion in annual pre-tax savings. Thanks to



these strong financials, Walgreens enjoys an A credit rating from Standard & Poor's and an A2 from Moody's. This allows the Company to borrow relatively cheaply, setting it up well for future growth, which is especially valuable given the change in the retail pharmacy landscape that appears to be occurring.

Weaknesses

Dependency on Generic Conversion

Walgreens pharmacies face significant and consistent risk from the variability of "generic conversion", or when a generic version of a drug is allowed to compete with the original branded version. The Pharmaceutical Research and Manufacturers of America reports spending on R&D spending has been growing at an average compounded rate of 12.3% since 1970. During this time, however, the number of new drugs introduced to the market has remained relatively constant, except for one spike in 1996, which can be attributed to the passing of a backlog of applications following the Prescription Drug User Fee Act in 1992 (see Figure 2.6). According to the FTC's analysis of 95 drugs, the retail price paid to a pharmacy for a generic in a market with only one generic is 14 percent less than the brand-name price. This discount is approximately 18 percent if there is more than one generic. Correspondingly, the price the pharmacy pays to acquire the drug in a single-generic market is 20 percent below the brand-name price, and 27 percent less with multiple generics.

Accordingly, as costs for pharmaceutical companies keep rising, Walgreens could see a decline in profits unless innovators find a way to restructure to reduce costs and ensure the continued introduction of new brand-name drugs so that the more profitable generics may follow. This weakness and its potential impact on sales, gross profit margins and gross profit dollars, however, is well acknowledged by the Company. Generic conversion matters to Walgreens because generic drugs have higher gross profit margins and gross profit dollars when compared to brand name drugs. This effect is most significant in the first few months after the generic has been introduced into the market, so a consistent flow of profits from new generics would be most beneficial to the Company. This generic conversion risk is particularly concerning because the factors are completely outside of the Company's control.

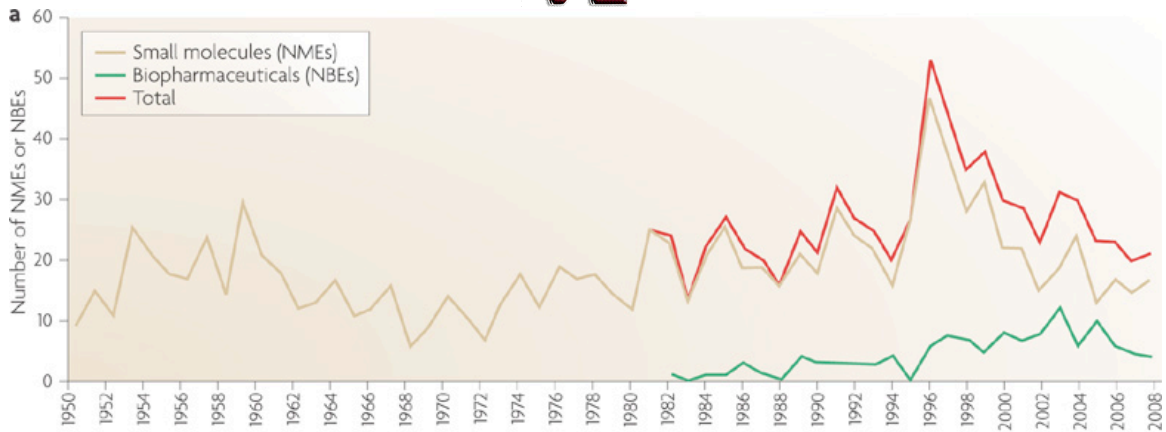


Figure 2.6: Timeline of approvals of new molecular entities (NMEs) and new biological entities (NBEs) by the US Food and Drug Administration (FDA) between 1950 and 2008.

Source: Bernard Munos. "Lessons from 60 years of pharmaceutical innovation". *Nature Reviews Drug Discovery*. Dec 2009.

Competitiveness with Big Box Stores

As previously mentioned, convenience is a major factor in retail outlet selection for consumers. Qualitatively, the one-stop shopping experience that big box stores like Wal-Mart offer puts retail pharmacy focused chains like Walgreens at a disadvantage. Wal-Mart is already the third largest pharmacy in the United States, which indicates that consumers are willing to make pharmacy part of their supermarket shopping routine. This means that Walgreens and other retail pharmacy chains need to find a way to compete with the convenience of big box stores through customer service, as product offerings no longer serve as a differentiating factor.

Opportunities

PPACA & The Aging Population

As mentioned previously, the PPACA aims to insure 32 million currently uninsured Americans by 2014, materially increasing the pool of individuals seeking regular health care. In addition to an increase in volume of sales from PPACA beneficiaries, the aging population of the United States promises to increase the fraction of the population seeking care for chronic conditions. These two population groups provide Walgreens with an opportunity to step in and take market share if the Company can find a way to effectively cater to their needs better than its competitors.



Take Care Clinics

The American Association of Medical Colleges estimates that the coming years will bring a shortage of physicians across all specialties (see Figure 2.7). The combination of the increased number of individuals in the health care system combined with the shortage of doctors will pose a serious challenge to the current health care system, leaving another opportunity for Walgreens. Walgreens currently operates 355 in-store Take Care health clinics in the United States, which primarily employ physicians assistants and nurses rather than doctors because of their costs savings and relatively equal ability to diagnose simple ailments. Expanding the scope of these clinics in response to the increased number of patients expected as a result of the PPACA could provide a source of future growth, as these clinics can easily serve individuals experiencing routine illness.

The convenience of these clinics is likely to appeal to consumers. Single-site diagnosis, medication prescribing, and medications pick-up reduces travel time and the hassle of making stops at multiple stores. As the number of individuals seeking health care increases, Take Care clinics have the potential to ensure the continued success and growth of Walgreens pharmacies in the face of increased competition from online mail-order pharmacies, if the Company can find a way to operate them profitably.

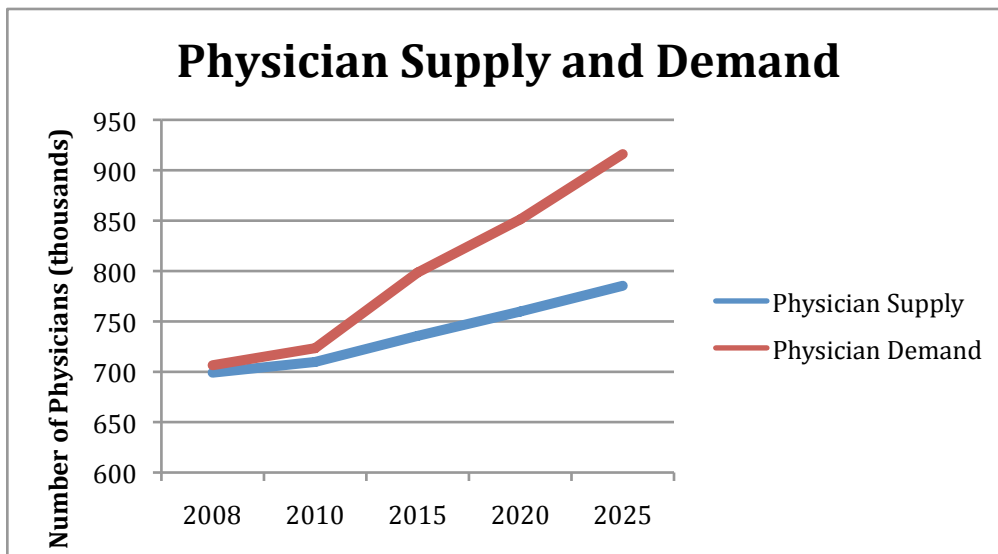


Figure 2.7: Projected Supply and Demand for Physicians in the United States. The physician shortage is expected to increase from 13,700 physicians in 2010 to 130,600 in 2025 across all specialties.

Source: AAMC Center for Workforce Studies, June 2010 Analysis



Drugstore.com

The acquisition of drugstore.com shows Walgreens' ability and willingness to actively adjust to and accommodate the changing industry landscape. Walgreens completed the acquisition of drugstore.com in June 2011, including all websites owned and operated by drugstore.com: drugstore.com, Beauty.com, SkinStore.com, and VisionDirect.com, as well as its corporate office, its customer service operation, and its distribution center operation. drugstore.com has a strong online presence in health, personal care, beauty, and vision, and Walgreens can now take advantage of its 3 million loyal customers as well as introducing existing brick-and-mortar customers and new customers to the online space. While Walgreens remains a brick-and-mortar powerhouse, moving into the online space with the already well-known and operationally experienced drugstore.com gave it exposure to the industry without having to create it internally from its own small mail-order service. Marketing and utilizing the resources from drugstore.com could help Walgreens increase volume and lower costs if operated effectively.

Threats

Loss of Express Scripts Contract

Walgreens' failure to renew its contract with Express Scripts caused its 7,700 pharmacy locations to be removed from Express Scripts' pharmacy provider network as of January 1, 2012. In fiscal year 2011, Express Scripts processed 88 million prescriptions filled by Walgreens, which represents about \$5.3 billion in sales. While the Company has plans to offset up to 50 percent of gross profit reduction through cutting costs of goods sold and general and administrative expenses, it is uncertain whether this offsetting can be achieved if 75 percent or more of Express Scripts business is lost. Because of this, it is critical that Walgreens do everything it can to retain the business of Express Scripts customers, and be prepared to adjust its business to accommodate a lower sales number if this goal is not met. Currently, Walgreens claims to have retained 15 percent of Express Scripts sales through efforts like promoting its prescription savings card. However, Express Scripts reports that 95 percent of its prescription volume is moving forward without Walgreens, which suggests the Company might be exaggerating retention rates. It is unlikely that Walgreens can further offset lost revenue through expense reductions, since so many cost cutting moves have already taken place.



The Express Scripts-Medco Merger

Beyond failure to renew its contract, Walgreens faces another threat from Express Scripts. In April 2012, the FTC approved its merger with another large PBM, Medco Health Solutions, Inc, to form “Express Scripts Holding Co.”. Walgreens filled approximately 125 million Medco prescriptions in 2011 representing approximately \$7.1 billion of net sales. Fortunately for Walgreens, Express Script’s Chief Medial Officer, Steve Miller, plans to honor the current terms of Walgreens’ contract with Medco, although this contract could be terminated with short notice. Walgreens should prepare for and expect further aggressive bargaining: as cost cutting becomes less of an option, a loss of contract with Medco could be devastating to sales.

As shown by Figure 2.8, combining the 9.5 percent market share of Medco with the 5.1 percent market share of Express Scripts would give their combined mail-order businesses a market share of 14.6 percent, much closer to the 16.5 percent market share that Walgreens enjoys. Additionally, considering PBMs independently, the combination of Medco (9.7 percent) and Express Scripts (13.5 percent) would have an approximate 23.2 percent market share, with CVS/Caremark as their closest competitor at approximately 12.7 percent, as shown by Figure 2.9. Additional market power in the PBM space means more bargaining power against Walgreens as it negotiates for favorable pricing terms.

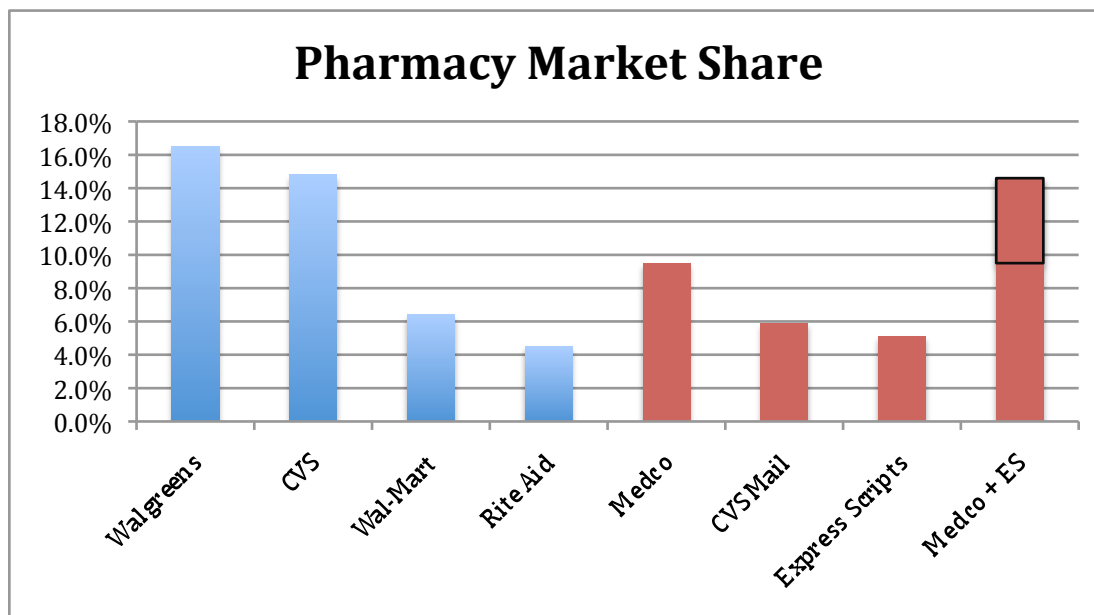


Figure 2.8: Pharmacy Market Share. Traditional brick and mortar retail pharmacies are featured in blue, and PBM mail order pharmacies in red.

Source: 2011-12 Economic Report on Retail and Specialty Pharmacies, drugchannels.com

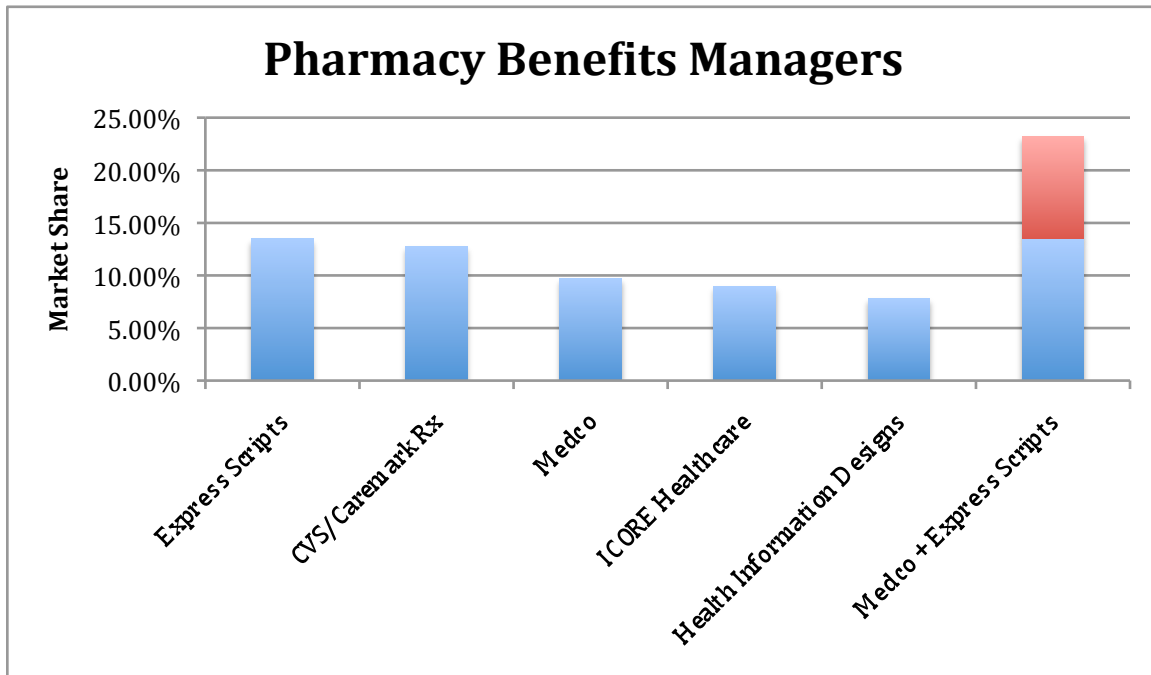


Figure 2.9: The current break down of market share in the PBM industry. An Express Scripts-Medco merger would create a powerhouse in this space and potentially cause more customer challenges for Walgreens.
Source: Pharmacy Benefit Manager Institute, LP

Mail-Order Pharmacies

One of the largest threats that Walgreens faces going forward is the gradual consumer shift to mail order pharmacy as their primary pharmacy provider. As previously mentioned, Walgreens operates 7,700 retail pharmacies in the United States and Puerto Rico, and has invested a great amount of time, effort, and funding into securing prime locations for these pharmacies. Based on exposure to technology and online shopping, each aging generation can reasonably be expected to be more technologically savvy and confident in online/mail order pharmacy. Even if Walgreens expands to include a large mail order business, as it has started to with drugstore.com, this could still pose a threat as operating costs for its retail locations continue at the same level and brick-and-mortar sales drop. In short, mail order Walgreens could cannibalize the brick-and-mortar Walgreens that made the Company a powerhouse. However, transferring business within the Company is preferable to losing business to competitors. Additionally, Walgreens can counter this challenge by re-structuring its brick-and-mortar locations, which is further discussed in the “Growth Strategies” section of this report.



PART III: RECOMMENDATIONS

STRATEGIC RECOMMENDATIONS

Customer Strategies

Walgreens has traditionally been a brick-and-mortar powerhouse, with thousands of locations on prime street corners across the country. However, the face of modern retail pharmacy is changing. Machines can count pills, patients can request refills online, and pharmacies and pharmacy benefits managers can mail 90-day supplies of prescriptions right to the customer's doorstep. As the retail pharmacy industry adapts to take advantage of technological advancements and potential cost savings, Walgreens must take the opportunity to adjust its business model to enable future success.

As brick-and-mortar pharmacy becomes more about service than convenience (mail-order and big box stores obviously have the leg-up in that category), converting the store experience is essential. With machines taking over rudimentary tasks, pharmacists should now play a larger role as health consultants, helping the in-store customers understand their medications, side effects, and possible drug interactions. This personal contact could establish valuable company loyalty, and draw in new customers by offering outstanding in-person service. The prioritization of service will help Walgreens compete with big box stores, and the Company should ensure its marketing portrays a quick, easy, and pleasant shopping experience, with shorter lines, closer parking, and more intimate service. Additionally, by operating both a mail-order pharmacy and outstanding physical locations, Walgreens could gain the business of customers who do not wish to sacrifice the option of in person service in exchange for just convenience.

Walgreens has already taken some initial steps to ensure this industry transition will not leave the Company behind. As shown in Figure 3.1, pilot stores with completely reorganized floor plans have been introduced in Illinois near its corporate headquarters. In this new model, a health guide greets and directs visitors at the front and center of the store, and the pharmacists are brought out into the front of the store so that they may play a larger role in the customer experience. Certain locations also include a Take Care Clinic, which would also contribute to the newly emphasized Walgreens service element. Walgreens should aggressively expand this new business model, as it contains a



visible and memorable customer service element that differentiates it from big box locations and could result in a significant first-mover advantage.



Figure 3.1: *The new store experience being piloted by the Company.*
Source: 2011 Walgreens Annual Report

In addition to changing the design of its current retail locations, Walgreens should aggressively market its recent acquisition of drugstore.com. After the June 2011 acquisition, drugstore.com maintained separate branding of its website, which shows no indication of affiliation with Walgreens. Mail-order pharmacy is on the rise but still new to the industry, and customer association with a well-known and trusted brand could serve as a valuable jumpstart to bring in additional customers. Besides marketing externally, Walgreens should also market the mail-order option to customers who pick up their prescriptions in-store. By training its pharmacists to pitch mail-order to customers and help them sign up for this option easily in-store, Walgreens could reduce routine in-store traffic, which would reduce staffing needs, freeing up resources to create an even better in-store experience for service-seeking customers.



Growth Strategies

Short Term

In the short term, Walgreens' key focus should be to adjust to the customer loss from the loss of contract with Express Scripts. Walgreens has already worked to offset up to a 50 percent loss of Express Scripts business, primarily through reductions in selling, general and administrative expenses and cost of goods sold. However, as of the end of the first quarter of 2012, the Company reported only 15 percent of Express Scripts prescriptions were retained. Walgreens must take some defensive operational action until the total effect of the loss of the 88 million prescriptions is known. Griffin has identified two steps that can be feasibly implemented in the near term:

- 1) Stop internal brick-and-mortar expansion. Although the Company expects and has prepared for loss of volume, the exact amount remains uncertain and the wise course of action is the conservative one. Even independent of the Express Scripts situation, the rise of mail-order pharmacy is enough reason on its own to scale back brick-and-mortar growth. Walgreens already has a large number of pharmacies in a variety of locations, and could benefit from reducing fixed costs of operation like rent and wages.
- 2) Actively encourage health plan sponsors, such as employers, to offer their beneficiaries pharmacy networks that include Walgreens. Walgreens has two huge advantages: 1) it has thousands of branches across the nation, and 2) it has a steady relationship with OptumRx (United Healthcare), the now second-largest PBM in the nation. The first incentivizes health plan sponsors to make the switch, and the second makes the switch easy.

Walgreens could additionally benefit from increasing sales enough to regain bargaining power with other PBMs. Walgreens has a recent track record of acquiring business from Rite Aid: in 2008 Walgreens bought Rite Aid patient prescription files after the closing of its 27 Las Vegas metro area locations, and in 2009 Walgreens bought its 12 stores in San Francisco and Eastern Idaho. In March 2012, Rite Aid shares rose 25 percent after a Credit Suisse analyst stated that a Walgreens acquisition of Rite Aid would make sense strategically given the dispute with Express Scripts, and that it would result in significant synergies. This merger would more than offset the loss of Express Scripts business. The legality and practicality of this union is discussed in Case Study 1.



Case Study 1: A Walgreens/Rite Aid Merger

The acquisition of Rite Aid, the third largest pharmacy chain in the United States, would solve Walgreens' customer-loss problem and create a pharmacy company large enough to push back against increasingly strong PBMs that are driving down reimbursements for prescription drugs. Specifically, in 2011, Rite Aid filled approximately 290 million prescriptions, which would add significantly to the 819 million filled in 2011 by Walgreens and more than offset the 88 million lost from Express Scripts. Credit Suisse analyst Edward Kelly estimates that the combination of both consolidating locations and increasing purchasing power could generate between \$400 and \$650 million in cost savings. However, this merger has several challenges, both regulatory and financial.

The combination of two of the three largest pharmacy retail chains, which would unite 12,500 U.S. locations (almost 80 percent more than CVS), could face regulatory scrutiny. Combined, Walgreens and Rite Aid would fill about 30 percent of the country's prescriptions and operate 21 percent of its pharmacy counters. As evidenced by the recent rejection of the proposed \$39 billion takeover of T-Mobile by AT&T, the justice department looks down on creating market duopolies, which it states could increase prices and decrease innovation. However, Walgreens could present the argument that more bargaining power with PBMs would result in lower consumer prices, especially given the recent FTC approval of the \$29.1 billion Express Scripts-Medco merger. This is still an uncertain move, but Mr. Kelly estimates that Walgreens will only need to divest in 3 percent of combined locations (about 400 stores) to avoid regulatory issues.

However, there are several cons to this acquisition:

- ◆ Considering the strategy of stopping brick-and-mortar expansion, adding 4,700 locations (a 60 percent increase) poses a challenge, regardless of how many customers Walgreens would gain. Additionally, Rite Aid stores are generally not up to par with Walgreens stores in appearance, design, and location, and downsizing locations comes with significant cost and effort.
- ◆ After the acquisition, downsizing locations and personnel would be particularly challenging, as 30 percent of Rite Aid's 71,000 workers are unionized.
- ◆ Rite aid has a weak balance sheet with over \$6 billion in debt (compared to \$2.4 billion for Walgreens), and the acquisition could do serious damage to Walgreens' strong credit rating.

In conclusion, acquiring Rite Aid as a solution to the loss of business from Express Scripts has a significant opportunity cost, as resources would be drawn away from Walgreens' goals surrounding customer service and online expansion. While Rite Aid is slowly improving its operations (which have been helped by the transfer of some Express Scripts business from Walgreens), it is still struggling and does not have the luxury of cheap financing for market adaptation projects. Therefore, rather than acquiring Rite Aid, Walgreens should work to reduce the stickiness of pharmacy customers, aggressively marketing its service and superior locations, and providing simple instructions on how to transfer prescriptions to Walgreens online, to be picked up in store or delivered to their front step. Additionally, Walgreens should look to continue to take over business of closing Rite Aid locations.

Sources: Rite Aid 2011 Annual Report, "Banking on a Rite-Aid/Walgreens Merger"



Intermediate/Long Term

As additional brick-and-mortar acquisitions look increasingly less palatable, Walgreens should take advantage of other opportunities to remain competitive in the brick-and-mortar space and gain ground in the online mail order space. In order to ensure that Walgreens remains competitive with mail order pharmacies and pharmacies in big box stores, the company has three significant options. To some extent, it has pursued all three:

- 1) Walgreens could make mail order pharmacy part of its core business. With its large network of physical locations, immense economies of scale, and strong brand name, it would be a formidable competitor. Risks include taking revenue from its core business, diluting the Walgreens brand, and technological implementation difficulties. However, Walgreens bypassed this last problem by purchasing drugstore.com, an existing large Internet pharmacy, signaling willingness and ability to move in this direction.
- 2) Walgreens could directly challenge the mail order pharmacies. By offering good service and maintaining a strong brand name, the Company could reinforce the Walgreens message. However, taking on this low-cost and forward-looking business model head on is risky. As online security improves and consumers become more accustomed to making online purchases and enjoying the convenience of front door delivery, Walgreens would more than likely lose significant market share if it pursues this option alone.
- 3) Instead of facing the mail order pharmacy head-on, Walgreens could expand into other related business segments. This is the evident strategy behind including clinics in stores: clinics cannot be outsourced virtually, and having a clinic within a pharmacy could potentially allow Walgreens to take market share from existing walk-in clinics like First Med on the basis of convenience. However, Walgreens is not the only industry competitor to attempt this strategy, and its feasibility is still unproven, whereas mail order companies are claiming market share now.

This third strategy is both the least-tested and the most promising in the long term. Walgreens currently operates more than 350 Take Care clinics nationwide, although this represents only about 5 percent of total stores. Since healthcare costs are expanding quickly and a primary physician shortage has been increasing in recent years, many market commentators have noted that that retail



clinics could take on an expanding role. Additionally, in the case of Walgreens, this approach offers significant same-store synergies: a patient could be diagnosed and prescribed medication at a Walgreens clinic, and then pick up the prescription from the Walgreens pharmacy.

The long-term viability and popularity of these quick-clinic options is still uncertain. However, there are some early strong signs. A 2008 Deloitte report on retail clinics suggested that only 10 percent of clinic visits necessitated a referral to a doctor. A Physicians Assistant (PA) usually staffs clinics, and some research has shown that PAs have similar performance metrics as MDs in early screening visits. In other words, clinics may represent an opportunity to shift healthcare's cost structure downward while increasing accessibility and without compromising care—an approach that will be endorsed by health insurers and companies looking to trim ever-increasing legal costs. As competition in this sub-industry intensifies, the first to discover how to operate in-store clinics with consistent profitability will likely enjoy a lasting source of additional revenue and an additional source of new customers, especially given the convenience-based experience modern shoppers value.

However, Walgreens is not the only company to attempt this strategy. As previously mentioned, competition in the retail pharmacy industry is intense, and each company must continuously seek opportunities to gain a competitive advantage. The combination of the shortage in primary care physicians and the influx of care-seekers from the PPACA has opened up an opportunity in the form of in-store clinics to all industry players. As of November 2011, Wal-Mart operated 140 clinics and CVS Caremark operated nearly 550 Minute Clinics, compared to Walgreens' 355 Take Care clinics. Additionally, running these operations is not cheap or straightforward. According to an executive vice president of CVS, which has operated Minute Clinics since 2006, it expects to break even for the first time in 2012. While CVS expects to open approximately 10 stores a month, Wal-Mart opened 3 but closed 10 in October 2011, which demonstrates the continued difficulty of operating a clinic profitably.

Walgreens, with its current connections to some of the largest health insurers such as UnitedHealth and Aetna, stands well positioned to take advantage of this trend. Walgreens can maximize its chances by being more selective and strategic with the hours of operation and location selection for Take Care Clinics. Griffin has identified two actions that would help start Walgreens down the road to operating in-store clinics with consistent profitability:



- 1) Walgreens should save on expensive nurse and physicians assistant wages by operating the Clinics with more selective hours, focusing on lunch breaks and after school hours when most individuals are likely to arrive.
- 2) Walgreens should expand Take Care Clinics into New York and California, states with areas of very high populations. Within those states, locations near concentrated workplaces and schools should take priority, as working individuals and individuals with school-aged children have the most exposure to contagious disease and the most limited schedules.

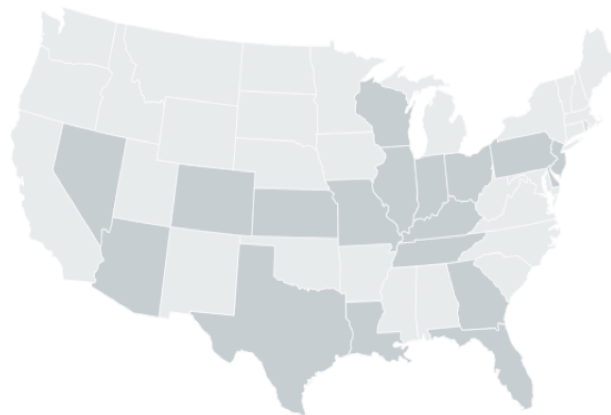


Figure 3.2: *Current states where Walgreens operates its 355 Take Care Clinics. Strategically expanding into high population states like New York and California could make these Clinics more valuable to the Company.*

Source: takecarehealth.com

Thanks to recent cost-cutting efforts, Walgreens has a very strong balance sheet and can afford to take on the calculated risk of experimenting with pharmacy remodeling to reflect the new purpose that physical locations will soon serve: consultation, outstanding service, and in some cases walk-in care. The Company can take advantage of its clean balance sheet to revitalize its image, focusing on mail order pharmacy, Take Care Clinics, and in-store convenience and outstanding service. How people get their medicine is changing, and Walgreens can take advantage of its historically strong positioning, trusted branding, solid balance sheet, and record low interest rates to use this as a period of transition.



APPENDIX I

Additional Financial Tables

Table A1: Profitability

	2011	2010	2009	2008	2007
Tax Rate (percent)	36.80	38.01	36.60	37.12	35.99
Net Margin (percent)	3.76	3.10	3.17	3.65	3.80
Asset Turnover (Average)	2.69	2.62	2.66	2.83	2.95
Return on Assets (percent)	10.10	8.13	8.44	10.34	11.20
Financial Leverage (Average)	1.85	1.82	1.75	1.74	1.74
Return on Equity (percent)	18.56	14.53	14.73	17.99	19.24
Return on Invested Cap (percent)	15.94	12.47	12.94	15.62	17.77

Source: Morningstar

Table A2: Selected Consolidated Financial Data (in millions)

Fiscal Year	2011	2010	2009	2008	2007
Net Sales	\$72,184	\$67,420	\$63,335	\$59,034	\$53,762
Cost of Sales	51,692	48,444	45,722	42,391	38,518
Gross Profit	20,492	18,976	17,613	16,643	15,244
Selling, General, & Admin	16,561	15,518	14,366	13,202	12,093
Gain on Sale of Business*	434	--	--	--	--
Operating Income	4,365	3,458	3,247	3,441	3,151
Other (Expense) Income	(71)	(85)	(83)	(11)	38
Earnings Before Income Tax Provision	4,294	3,373	3,164	3,430	3,189
Income Tax Provision	1,580	1,282	1,158	1,273	1,148
Net Earnings	2,714	2,091	2,006	2,157	2,041

Source: 2011 Walgreens Annual Report

*In fiscal year 2011, the Company sold its PBM business, Walgreens Health Initiatives, Inc., to Catalyst Health Solutions, Inc. and recorded a pre-tax gain of \$434 million, \$273 million after tax, or \$0.30 per diluted share

Table A3: Industry Profitability

	Walgreens	CVS	Rite Aid	Industry Median	Market Median
Effective Tax Rate	36.84	38.69	--	--	--
Gross Profit Margin	28.28	19.71	26.39	24.27	30.57
Pre-Tax Profit Margin	5.83	5.37	(1.62)	4.48	10.96
Net Profit Margin	3.68	3.29	(1.66)	2.63	3.29
Return on Equity	18.51	9.24	--	10.17	5.28
Return on Assets	9.87	5.39	(5.50)	5.14	0.88
Return on Invested Cap	15.89	7.13	--	7.25	2.43

Source: Hoovers



APPENDIX II

Understanding the Role of Prescription Benefits Managers

Table A4: Leading Prescription Benefits Managers

Company	Sales	Employees
Medco	70,063.30M	23,200
Express Scripts, Inc.	46,128.30M	13,120
OptumRx	14,452.00M	5,000
Catalyst Health Solutions, Inc.	5,329.59M	1,036
MedImpact Healthcare Systems, Inc	44.60M	650

Prescription Benefits Managers (PBMs), also known as Pharmacy Benefits Managers, serve as intermediaries between payers (employers and other health plan sponsors) and suppliers (brand-name and generic drugmakers, drug wholesalers, and retail pharmacies). They distribute prescription medications and other health products on behalf of managed care plans, corporations, government agencies, and insurance companies. PBMs aggregate the purchases of millions of enrollees through their client health plans, enabling plan sponsors and individuals to obtain lower prices for their prescription drugs through price discounts from retail pharmacies, rebates from pharmaceutical manufacturers, and the use of mail order pharmacies. They and also provide services such as claims management and specialty pharmacy distribution.

PBMs also advise in designing drug benefit plans, setting up formularies with different patient copayments for generics, preferred or less-expensive brand-name drugs, and non-preferred or more expensive brand-name drugs. The main function of formularies today is to specify which medicines have approval to be prescribed under a particular contract. The development of formularies is based on evaluations of efficacy, safety, and cost-effectiveness of drugs. The increased sales potential from being on a formulary can incentivize pharmaceutical manufacturers to negotiate favorable contracts with the PBMs.

PBMs have two key functions. The first is to make sure that members received their prescriptions. This is usually done for ongoing prescriptions for chronic conditions filled at retail pharmacies and mail order pharmacies. Their most important function is to reduce costs for both the purchasers and the enrollees. They accomplish these goals in using the following six methods:



- **Negotiating Manufacturer Discounts**
 - PBMs pool purchasing power to negotiate discounts and rebates from pharmaceutical manufacturers in order to lower benefit costs for clients and consumers

- **Building Pharmacy networks**
 - PBMs build networks of retail pharmacies to provide consumers access to prescriptions at discounted rates.
 - PBMs may develop and distribute prescription discount cards, which provide uninsured or underinsured consumers with access to discounted rates on their prescriptions across a pharmacy network

- **Utilizing Prescription Monitoring & E-prescribing**
 - PBMs monitor prescription safety across all of the network pharmacies, alerting pharmacists to potential drug interactions even if a consumer uses multiple pharmacies
 - PBMs ensure patients take their medicines as prescribed by tracking when prescriptions are renewed, and sending patients reminders when they haven't filled prescriptions on time

- **Encouraging Clinical Management**
 - PBMs use e-prescribing technology to provide physicians with clinical and cost information on prescriptions to help them counsel consumers on which medications will be the safest and most affordable choices
 - PBMs use a variety of tools such as drug utilization review and disease management to encourage the best clinical outcomes for patients.

- **Assisting with Plan Design**
 - PBMs advise their clients on establishing tiered copayments and other programs that encourage use of cheaper generic drugs
 - PBMs use panels of independent physicians, pharmacists, and other clinical experts to develop formularies in order to encourage clinically appropriate and cost-effective prescribing

- **Offering Mail Service Pharmacy Services**
 - PBMs provide mail-service pharmacies that supply home-delivered prescriptions at lower prices



Understanding how PBMs make money is a complicated and difficult task. As Samuel Nussbaum, MD, chief medical officer for WellPoint stated, "Exactly how PBMs make money is something of a mystery to many of us". Plan sponsors pay PBMs for administering the plans, and they keep a percentage of the money saved. PBM's charge their clients a discounted price over the retail price of a prescription, pay the pharmacies a lower price, and keep the spread. PBM's also receive rebates from manufacturers in exchange for the inclusion of their drugs into the PBM's formulary.



APPENDIX III

A brief outline of the Patient Protection and Affordable Care Act (PPACA)

*Items marked with asterisk come into effect in 2014; all others in 2010

- Insurance Market Changes
 - Insurance companies barred from denying coverage to children because of pre-existing conditions
 - Insurance companies prevented from placing lifetime caps on policies, or from dropping coverage if the patient gets sick
 - Establishment of “high risk pools” for those who have pre-existing conditions (safeguard until all provisions enacted) with standard (non-high risk) premiums
 - Limits out of pocket spending, no age requirement
 - Insurance companies must cover preventative services (like vaccines) recommended by the Centers for Disease Control and Prevention
 - Insurers are prohibited from imposing lifetime dollar limits on essential benefits, like hospital stays
 - Insurers' abilities to enforce annual spending caps will be restricted, and *completely prohibited by 2014
 - Insurers are required to spend 85% of large-group and 80% of small-group and individual plan premiums (with certain adjustments) on healthcare or to improve healthcare quality, or return the difference to the customer as a rebate
 - Parents allowed to keep their children on their insurance plan until age 26
 - *Insurance companies prohibited from denying coverage or charging more from pre-existing conditions
 - *Impose a \$2,000 per employee tax penalty on employers with more than 50 employees who do not offer health insurance to their full-time workers
 - 60% of Americans currently get their health insurance through their employers
 - *Most Americans required to have health insurance or pay a fine (except for low-income)
 - Small businesses, high-risk patients, and the uninsured can shop on health insurance exchanges

Health Insurance Exchanges

A health insurance exchange is a set of state-regulated and standardized health care plans in the United States, from which individuals may purchase health insurance eligible for federal subsidies. All exchanges must be fully certified and operational by January 1, 2014 under federal law



Obama stated that it should be "...a market where Americans can one-stop shop for a health care plan, compare benefits and prices, and choose the plan that's best for them, in the same way that Members of Congress and their families can. None of these plans should deny coverage on the basis of a preexisting condition, and all of these plans should include an affordable basic benefit package that includes prevention, and protection against catastrophic costs. I strongly believe that Americans should have the choice of a public health insurance option operating alongside private plans. This will give them a better range of choices, make the health care market more competitive, and keep insurance companies honest."

However, the public health insurance option was ultimately dropped from the reform legislation; the insurance sold on the health insurance exchange in the United States will, therefore, now be exclusively from the private insurers.

The PPACA sets up insurance exchanges in each state known as American Health Benefits (AHB) Exchanges. Implementation of the individual exchanges changes the practice of insuring individuals.

The PPACA requires health plans offered in the individual and small group markets, both inside and outside of the exchanges to offer a comprehensive package of items and services.

The four largest for-profit insurance companies refused insurance to 651,000 people for previous medical conditions, number that has increased significantly each year (49% increase in that time period). **These 651,000 and others who might not have received insurance under previous industry practices are guaranteed insurance coverage under the PPACA. Hence, the insurance exchanges will cause a greater amount of financial risk to be placed upon the insurers, and will help to share the cost of that risk among a larger pool of insured.**

Thus, the individual insurance exchange's guaranteed issue requirement lays a far greater amount of financial risk on insurers than they had previously born.

This condition of the Health Benefits Exchanges will begin in 2014. Until that time, the PPACA provides funds for state-run high-risk pools (*mentioned previously in the outline*) for those with previously existing conditions.



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