

OUTPERFORM

Walgreen (WAG)

Susan S. Karr (New York) – February 28, 2000

Price	52-Wk Rng	Div	Yld	Shs Out (MM)	EPS 97A	EPS 98E	P/E	EPS 99E	P/E	5-Yr Est growth	
\$35	\$36–20	0.25	0.7%	500.9	\$0.88	\$1.02*	34.5	\$1.15	30.4	14%	
Target Price: \$41				Market Cap: \$18.2B				EV/EBITDA xxE: xx.xx			

Fiscal year ends in August. *Operating earnings

Company Description

Walgreen is the largest U.S. drug chain in terms of sales and operates 2,390 stores in 31 states and Puerto Rico. About one-third of the store base features a drive-thru pharmacy, which helps build pharmacy traffic. WAG has strong market shares, excellent merchandising, and superb systems, including the most efficient distribution system of any drug chain.

Valuation

We rate WAG with a target price of \$41, which is \$3.00 higher than our target price of \$38 just one month ago (February 1998). This new price target is based on the assumption that shares will trade at a multiple of roughly 33 based on our calendar 1999 EPS estimate of \$1.24 and reflects a 13% increase from current levels.

Key Investment Positives

- **Aggressive Expansion Program.** Walgreen anticipates having 3,000 units by 2000 and has set a new long-term goal of reaching 6,000 units by 2010. In addition to building 280 units by the end of the 1998 fiscal year, WAG expects to add 350 units in FQ1999. The company is expanding into new markets (Illinois and Pennsylvania, for example) while aggressively expanding its current markets, particularly in high-traffic areas.
- **Positive Impact of Intercom Plus Pharmacy System.** With the rollout of this highly automated system, WAG should benefit from contained costs and an increased long-term growth rate to 18–19%. Once the system has been up for one year, WAG

expects 50% of pharmacy refills to be ordered through integrated voice response (IVR), thereby freeing up pharmacist time.

- **Strong Sales Trends.** With 50% of revenues coming from its pharmacy business, WAG plans to continue to build this business. In particular, Walgreen will focus on sales of both pharmacy and convenience items to an aging baby-boom generation. To increase customer awareness, WAG has begun advertising nationally on cable-television stations.

- **Negligible Debt.** We believe Walgreen is one of the soundest companies on a financial basis in the food and drug retail industry.

Key Investment Risks

- **Margin Pressure.** As third-party prescriptions (now roughly 78% of pharmacy sales) constitute more of the mix, we believe margin pressure will continue. However, management has stated that it has obtained rate increases in the majority of its recent negotiations with third-party vendors, a factor that should help improve profitability or at least limit the drop in reimbursement rates.
- **Choice of Location for Units.** Walgreen anticipates a challenge in choosing the locations for the final 4,000 units to be built by 2010. However, management is aware of the importance of selectivity. It is our view that WAG does an excellent job choosing locations.

**Walgreen
Stock Price History**

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