

# CtW Investment Group

Alan McNally  
Chairman, Walgreen Co.  
200 Wilmot Road  
Deerfield, IL 60015

June 18, 2012

Dear Mr. McNally,

Walgreens shareholders have seen our company lose one third of its market value, more than \$14 billion, since the company announced it would exit the pharmacy network of Express Scripts (ESRX), the largest pharmacy benefit manager in the country, about a year ago. Shareholders bear the costs of this disastrous decision, as the percentage of scripts lost due to the dispute continues to rise, belying management's optimistic statements about recapturing ESRX business. Given ongoing damage to our company we believe the time has come for the Board to establish a special committee comprised of independent directors to review the Express Scripts dispute and set clear benchmarks for performance in the second half of the calendar year.

While Walgreens saw significant achievements in 2011, reaching a twenty percent market share in prescriptions, much of that ground has been lost in the first six months of 2012. Management has repeatedly sought to put a positive spin on bad results even after the Express Scripts-Medco merger raised the specter of additional business losses. Yet there is little evidence that Walgreens can regain the lost business without rejoining the Express Scripts network.

Upon announcing the decision to break with ESRX, management assured investors, "we are optimistic about our ability over time to regain these customers and grow our business."<sup>1</sup> The company touted potential side agreements with WellPoint and Tricare which failed to materialize. Management also put much faith in the company's ability to attract employers who would negotiate directly with Walgreens or switch their PBM to continue to access Walgreens, but these deals, combined with Medicare Part D scripts, resulted in retention of only 15% of the 88 million ESRX scripts filled in 2011, substantially below management's lowest articulated retention scenario of 25% of ESRX scripts.

Discussing this year's PBM selling season, management again spoke optimistically about regaining ESRX client business, boasting, "We've never been this busy this early in a season and every indication is that this will be the most active selling season in recent memory."<sup>2</sup> Walgreens also claims to be competitive on price, describing conversations with payers about direct contracting late last year in positive terms: "the general feeling is a bit of surprise that our rates were much more competitive than they thought."<sup>3</sup> However, only a small number of payers have actually contracted directly with Walgreens. According to Citigroup, 43% of benefits administrators believe Walgreens reimbursement rates are actually higher than their own current rates, versus only 14% who think they are lower.<sup>4</sup> Citigroup concludes that employers will not "agree to allow WAG to directly fulfill scripts for similar or higher rates."

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<sup>1</sup> Walgreen Co., Q3 2011 Earnings Call, June 21, 2011.

<sup>2</sup> Walgreen Co., Q2 2012 Earnings Call, March 27, 2012

<sup>3</sup> Walgreen Co., Q1 2012 Earnings Call, December 21, 2011 (Q&A).

<sup>4</sup> Lisa Gill et al, JP Morgan North American Equity Research, "Walgreens Week Day 3: The Express Scripts Dispute," April 11, 2012, at 1.



While management has repeatedly cited survey findings that health plans want 5-10% savings on drug spend in order to exclude Walgreens from their pharmacy network,<sup>5</sup> it appears that ESRX has made a compelling case in the opposite direction: that keeping Walgreens in the network would increase costs over time.

Pharmacy is the only segment of healthcare in which most patients still have unfettered access to all providers. Now that cost-conscious payers have seen that losing access to Walgreens is generally not a hardship for plan participants, they may be more open to adopting limited networks going forward. In its survey of benefit administrators Citigroup found that 76% of respondents believed their employees could be served by a network of 30,000 or fewer pharmacies – a much smaller number than the 60,000+ pharmacies available in an open network.

To sum up the costs of the Express Scripts gamble, the decision to end our company's relationship with Express Scripts has resulted in a decrease of 10.7% in script count at comparable stores, adding up to a projected \$0.21 reduction in EPS, or a 7.5% decline in estimated EPS for the fiscal year. Competitors have readily taken up the slack and as time passes it will become harder for Walgreens to recapture those lost pharmacy customers.

Walgreens has a track record of aggressive bargaining with PBMs and state governments, which served the company well in the past. But with this latest maneuver, management made a gross miscalculation that has decimated shareholder value and placed the company at loggerheads with industry trends towards limited pharmacy networks.

The CtW Investment Group works with pensions and benefit funds sponsored by unions affiliated with Change to Win a coalition of unions, to enhance long-term shareholder value through active ownership. These funds collectively hold over \$200 billion in assets and are substantial long-term Walgreens shareholders.

The market's faith in Walgreen's management has been seriously shaken and we believe that the time is now for the Board to demonstrate responsible leadership and right the course of the company. If Walgreens insists on maintaining its lone stand against Express Scripts there must be clear measures of performance reported to shareholders that demonstrate whether the company can successfully grow its pharmacy business without the nation's largest PBM. Management should report on the number of recaptured scripts and payers, along with any developments related to its relationship with Medco now that it has merged with Express Scripts.

We hope you will act quickly to increase the level of transparency and initiate an independent board review of Walgreen's current strategy.

Sincerely,



William Patterson  
Executive Director

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<sup>5</sup> Walgreen Co., Q2 2012 Earnings Call, March 27, 2012; Q1 2012 Earnings Call December 21, 2011; Walgreen Co., Transcript of the Annual General Meeting, January 11, 2012.