September 11, 2014

Janice M. Babiak
Chairman of the Audit Committee
Walgreen Co.
108 Wilmot Road
Deerfield, IL 60015

Dear Ms. Babiak:

We are deeply concerned that Walgreen's recent $2 billion reduction in expected operating earnings for FY2016 reflects a lack of adequate oversight by the Audit Committee. In particular, we do not understand how the Audit Committee could have allowed Walgreen's executives to persistently cite the $9-$9.5 billion figure for 2016 operating earnings for at least six months after it became clear that the company's actual performance was not sufficient to meet that goal. Not only is the Audit Committee required to discuss earnings releases and guidance, but leading audit firms argue that audit committees should take care that guidance provided to analysts, ratings agencies, and shareholders accurately reflects management and the board's best understanding of available information. Therefore, we urge the committee to disclose in conjunction with its upcoming earnings call:

- A clear description of the Committee's role in overseeing management's development of estimates relevant to the guidance provided to shareholders.
- The timeline according to which the Committee became aware that Walgreen and Alliance Boots's financial performance were not consistent with the projections first issued in June 2012.
- A description of any steps the Committee took prior to the August disclosure and the termination of key executives to ensure that forward-looking statements were not misleading with respect to the continued applicability of the guidance issued beginning in June 2012.
- Any steps already taken or planned to address the apparent breakdown in communication and internal controls which allegedly resulted in the CFO's office being unaware that both generic drug price increases and 2015 Medicare D reimbursement rates were so far out of line with expectations that a 22% reduction in expected FY2016 operating earnings would be required.
- Additionally, we urge the board to promptly implement our proxy access proposal, which received support from 49.8% of non-insider shareholders at this year's annual meeting.

As we have noted in previous communications with Walgreen directors, we find it frustrating that the board persistently denies long-term shareholders an effective voice, even as management has made a number of major strategic missteps. In the past few years, Walgreen shareholders have endured a prolonged and unconstructive conflict with Express Scripts, an extended public debate over tax inversions that threatened the company's reputation with key health insurance payors, and now a critical mistake in guidance directly relevant to current management's central strategic commitment – the Alliance Boots merger. All the while, the board has refused to adopt our proposal for proxy access for long-term shareholders, even as it grants direct board representation to entities with potentially very different interests, such as Stefano Pessina and now JANA Partners. We are particularly concerned that the decision to grant JANA Partners seats on the board will further dilute the voice of long-term shareholders at a moment critical to the company's future. Absent a clear commitment from the board to ensuring that long-term shareholders will be appropriately represented in the board's deliberations going forward, we will treat future proposals from the company with considerable skepticism.

The CtW Investment Group works with union-sponsored pension funds to enhance long-term shareholder value through active ownership. These funds invest over $250 billion in the global capital markets and are substantial investors in Walgreen.

The Audit Committee's Role in Overseeing the Issuance of Guidance

Both regulation and best-practice establish that audit committees should play an important role in overseeing all aspects of public company financial reporting, including the issuance, updating, and revision of earnings releases and forward guidance. The New York Stock Exchange listing standards require the audit committee to discuss forward looking guidance, as well as earnings press releases. Furthermore, leading audit firms such as PWC and Deloitte stress the importance of audit committee oversight of management's decision to issue guidance and the quality and reliability of earnings projections. Deloitte urges audit committee members to review with management the specific metrics subject to guidance, whether the disclosure of assumptions and trends is adequate, and whether continuing to issue guidance is consistent with the company's strategic goals. PWC draws particular attention to the issue of earnings "surprises," management's discussion of such surprises with the audit committee, and the general recognition by the courts of a duty to update forward-looking statements that may be "live" in the minds of reasonable shareholders, when the underlying circumstances have materially changed.

The Walgreen Audit Committee's charter only spells out its duty to discuss forward guidance and earnings releases. The Charter does not make clear whether those discussions typically take place prior to the issuance of those releases, or what protocols exist to alert the Audit Committee to changes in the material conditions underlying forward guidance issued in the past. Given the continuing ambiguity around the timing and sources of the changes in conditions that led to the negative revision of Walgreen/Alliance Boots FY2016 operating income, which we discuss below, we believe that it is incumbent upon the Audit Committee to provide a clear description of the processes through which it discusses forward guidance with management, and to institute regular consideration of the appropriateness of existing guidance given changes in the company's circumstances.

Ambiguities in Walgreen's August 6th call

Unfortunately, neither the August 6th earnings press release, the discussion provided by management on the conference call with analysts, nor any subsequent statements or reporting adequately describe either the sources of the earnings revision or the reasons for its timing (coinciding with the board's discussion of a corporate inversion). For instance, management has stated that the negative revision was primarily a result of rising generic drug prices, as against the expectation of falling prices for generics, but also cited unfavorable rates on its Medicare Part D business, and pressures on Alliance Boots' pharmacy margins. Analysts covering Walgreens have attempted to parse management's comments in order to break out the relative importance of each of these components, but given the ambiguity in management's statements these estimates vary considerably. Cowen analyst Charles Rhyee stated that "we believe management should have been correcting questioners and been clearer [in describing] what was assumed in the [revised] FY16 target."

Moreover, analysts have expressed being puzzled or confused by the specific sources of the negative revisions to 2016 guidance, in so far as the company described what these analysts viewed as ongoing trends rather than sudden and surprising developments. For instance, commenting on Walgreen's claim that generic price inflation played a key role in the reduced earnings projection for 2016, Morgan Stanley analysts noted that CVS "seems to have mitigated the impact of inflation and expects trends to reverse over time." Charles Rhyee of Cowen asserted that "Management's focus on …generic inflation is a bit confusing to us, given that this is not a new issue and shouldn't come as a surprise." Similarly, with respect to reimbursement rates in Medicare Part D contracts, analysts at William Blair & Co. write that "this is not a new issue" and that "Walgreens has apparently taken a lower-conflict approach to reimbursement negotiations with third parties, although the downside is that pricing terms have been less favorable." Finally, analysts noted that additional headwinds to the 2016 revised operating earnings guidance were generated by increased reimbursement pressure on Alliance Boots in Europe, which analysts at Deutsche Bank note "has faced myriad challenges, from regulator restrictions on profit in the wholesaling business to challenges to pharmacy margins to continued weakness in the front end due to a weak consumer environment." We note that none of these challenges represent new developments since the announcement of the Alliance Boots merger proposal in June 2012, let alone Walgreen's earlier earnings releases and conference calls this year.

Our review of Walgreen's forward looking statements and earnings guidance with respect to combined company operating profits for FY2016 similarly suggests that the original projection of $9-$9.5 billion ($8.5-$9B in GAAP terms) could have been downwardly revised considerably sooner than this past August. We note that Walgreen began guiding investors toward an EBIT goal of $8.5 - $9 billion in its announcement of the Alliance Boots transaction on June 24, 2012. On its September 2012 earnings call, the company reiterated the $8.5-$9 billion goal for FY2016, and added an adjusted operating income goal of $9- $9.5 billion. On each of its next four earnings calls the company confirmed this projection in nearly identical language. However, in December 2013, Walgreen's management began to "recognize risks" to this goal, primarily because the combined companies' compound annual growth rate was not adequate to meet this target. Nevertheless, both on this call and on the March 2014 earnings call, management continued to issue the $9-$9.5 billion guidance and pointed to several additional sources of earnings – including the AmerisourceBergen relationship, further synergies, and cost savings initiatives. On its June 24, 2014 conference call, Walgreen withdrew its guidance for FY2016, and announced that new goals and metrics for FY2016 would be announced on a conference call in late July or early August.

Thus, even looking only at Walgreen's own statements concerning its guidance for FY2016, its seems that as early as December 2013 it should have been clear to the Audit Committee that material trends were underway which could put the achievement of management's goal at risk. Both the reports by Deloitte and PWC concerning audit committee responsibilities seem to us to strongly recommend that in a circumstance like this, an audit committee should be constructively engaging management to determine if the previously announced guidance might now be misleading to investors, given these changes in circumstances and trends. But it is not clear to us if the Audit Committee took action at this time or at any time up to and including the June 2014 conference call: reporting in the *Wall Street Journa*l instead suggests that the Audit Committee did not realize that the likely change in projected 2016 earnings would be in the billions of dollars until early July.

Long-Term Walgreen Shareholders Need Proxy Access
Compounding our concerns over the effectiveness of the oversight provided by the Audit Committee, the board has again chosen to dilute the voice of long-term shareholders by appointing individuals with potentially very different interests and orientations to seats on the board. As we have previously

communicated to you and your fellow directors, we have been frustrated by the company's decision to structure the Alliance Boots transaction in manner that delays the vote for Walgreen shareholders to the point that the merger is likely to be viewed as a *fait accompli*. The fact that the performance of the two companies has been so far below the expectations management generated in June 2012 only reinforces our frustration. Now, the company has appointed a new director – Barry Rosenstein of JANA Partners, and has agreed to appoint an additional director recommended by JANA. Furthermore, Walgreen has committed to giving Mr. Rosenstein a say in the first new appointment to fill any vacated board seat up to the company's 2016 annual meeting. Given that JANA holds about 1.3% of Walgreen shares, and will enjoy Walgreen's support as a director through January 2016 so long as JANA's position does not fall below approximately 0.65% of shares outstanding, two boards seats and a key role in the choice of a third director seem to grant Jana and Mr. Rosenstein influence and authority out of proportion to JANA's commitment and exposure.

Moreover, the substantial reduction in projected FY2016 operating earnings strongly suggests that Walgreen faces long-term challenges in its core pharmacy business, but Mr. Rosenstein's public comments on Walgreen focus on short term fixes, such as cost-cutting and share repurchases. It is far from clear to us that Mr. Rosenstein brings expertise either in health care or retail operations, the areas that we believe are and should be of greatest concern to Walgreen shareholders in the long run. As you know, the CtW Investment group urged Walgreen to adopt a proxy access mechanism for electing directors, in order to empower long-term shareholders to put forward board candidates who would take such a long-term focus. However, the board rejected that option; had the board agreed to implement our proposal to grant proxy access, long-term shareholders would now have an effective counterweight. to short-termism, which appears poised to gain a disproportionate voice on the Walgreen board.

Conclusion

The large negative revision to the projected operating earnings of a combined Walgreen/Alliance Boots for FY2016 has understandably generated a noteworthy drop in the share price and has presumably made investors more skeptical of the company's future prospects. While executive departures occurred in conjunction with this disclosure, we believe that shareholders would benefit from a much more thorough description of the Audit Committee's role overseeing the generation and issuance of forward looking statements, as well as a description of steps the Committee intends to take to address the internal communications failures which appear to have played a role in producing a larger than anticipated revision. Moreover, we again urge the board to adopt our proposal for proxy access, which provides a much more reliable mechanism to ensure the representation of long-term shareholders than the ad hoc appointment of Mr. Rosenstein.

Sincerely,

Dieter Waizenegger
Executive Director