OFF BALANCE

Out-of-Stock and Mislabeled Sale Items at Walgreens

INTRODUCTION

For decades Walgreen Co. has been synonymous with exceptional operational execution. Immortalized in the book *Good to Great*, the company prided itself on its focus and organic growth.[1] Over the last two years, though, Walgreen has faltered, engaging in a costly contract dispute with pharmacy benefit manager Express Scripts, and more recently embarking on an international acquisition strategy that exposes the company to risk abroad with little indication that the deal will strengthen its core business.

Meanwhile, Walgreen has suffered declines in same store front-end sales while its competitors' sales are growing. The company hopes to combat this trend with its first ever loyalty program, Balance Rewards, launched in September 2012. Although Walgreen's program comes years after its major competitors introduced their own loyalty programs, CEO Greg Wasson has trumpeted Balance Rewards as "a new kind of currency in place that will drive our front-end business."[2] However, more than six months after rolling out the program, management has not disclosed detailed, substantive metrics to show whether there has been any impact on customer shopping habits.

Out-of-stock items at Walgreens stores in New York City and St. Louis, MO.

Of particular concern is the company's management of weekly sales. Access to discounted prices and promoted specials now require membership in Balance Rewards, and these sales are an important driver of participation in the loyalty program. To understand how well the company is implementing in-store promotions, Change to Win (CtW) researchers made 600 visits to Walgreens locations in four of the company's largest markets to survey key indicators of operational performance. Researchers checked for in-stock levels of a basket of selected Walgreen's promotions and for whether these sale items were clearly labeled in stores.

The results show problems surprising at a company long seen as a strong operator. Across all markets, 76 percent of stores were out of stock of at least one surveyed sale item during every visit. More than one in five stores were out of stock of three or more surveyed sale items during every visit. At 94 percent of stores, at least one surveyed sale item was not labeled as on sale during every visit, and at half of stores CtW found three or more surveyed sale items not labeled as on sale during every visit.

These operational issues could be the result of problems rationalizing inventory or cuts in the labor force. We believe that these issues also call into question whether the company is focusing sufficiently on its domestic operations.

As Walgreen seeks to grow and remain competitive, store-level execution is vital. Industry research has found that product availability is fundamental to building trust with customers and that in-store advertisements are an important factor in increasing sales. We believe that Walgreen's failure to execute the most basic of retail tasks—keeping its shelves fully stocked and correctly labeled—may undercut its efforts to improve customer experience and build loyalty.

HIGH HOPES FOR BALANCE REWARDS

In September 2012, Walgreen rolled out Balance Rewards to drive its front-end recovery and build long-term customer loyalty. Enrolled customers accrue points for certain purchases that can be redeemed for credit on subsequent shopping trips. The company has been pleased with customer enrollment, reporting that it has more than 68 million members as of April 2013.[3]

Management has suggested that Balance Rewards will increase traffic, move customers to a bigger basket size and help the company better target its marketing spend. In addition to helping bring back Express Scripts customers, the program is also designed to connect with the company's "Well" brand and its increasing focus on health services by being "more explicitly anchored to health and wellness" than other loyalty programs.

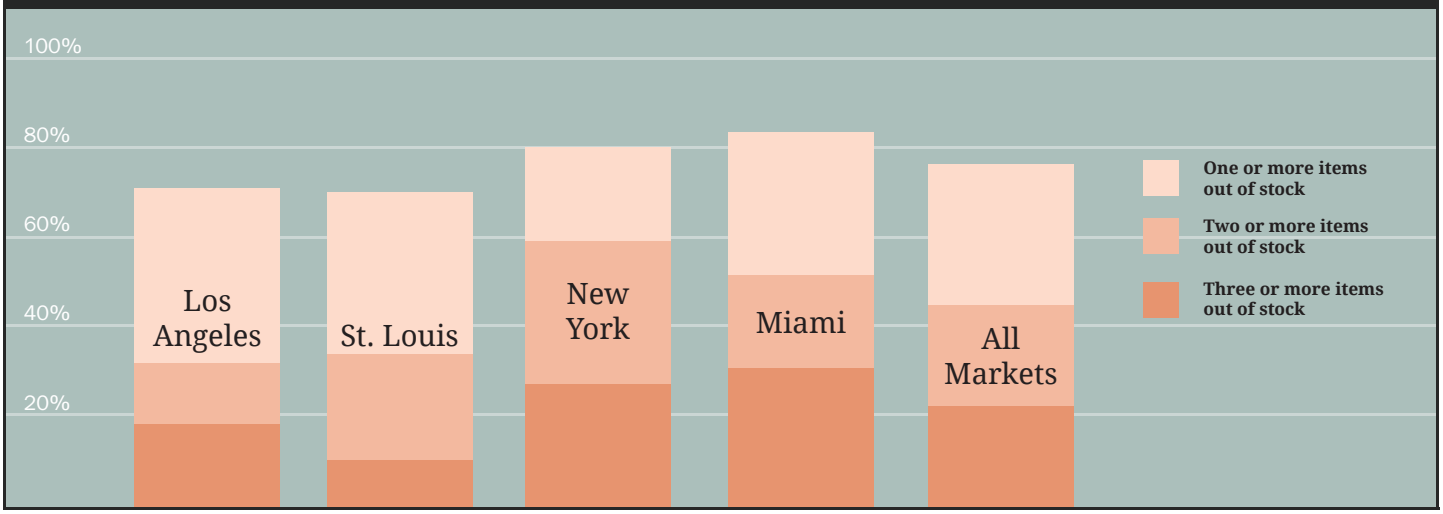
Since customers must be enrolled in Balance Rewards to get access to sale prices, what used to be normal sales promotions are now an exclusive privilege of members and a central part the new program. CtW's survey of Walgreens stores focused on the company's execution of these sales.

CtW FINDINGS

CtW researchers made 600 visits to Walgreens stores in four markets: New York City, Los Angeles, Miami and St. Louis. In each market, a set of 50 stores was surveyed three times during three different weeks in March and April 2013, to determine whether a basket of selected sale items in the weekly circular were in stock and labeled as on sale on Walgreen's shelves, two important retail metrics.

Each survey's basket of items included a mix of food, household products, over-the-counter medication, personal care items and baby-related products. The survey included both name brand items and products marketed under Walgreen's private label brands.

Proportion of Walgreens stores with out-of-stock sale items during every visit, by market.



WIDESPREAD OUT OF STOCK ITEMS

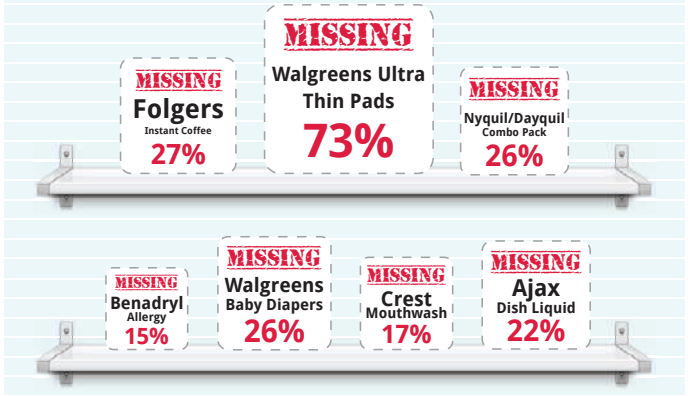
Across all markets, 76 percent of stores were out of stock of at least one surveyed sale item during every visit. More than one in five stores were out of stock of three or more surveyed sale items during every visit, out of a basket of 23 to 24 items. Across all visits, an average of 12 percent of surveyed items were out of stock.

The problem was most severe in two of Walgreen's three largest markets, New York and Miami. In the course of 150 store visits in New York, an average of 15 percent of surveyed sale items were out of stock. At the store level, the out-of-stock rate reached as high as 30 percent. Every store surveyed was missing three or more surveyed sale items during at least one visit. In 80 percent of stores, at least one sale item was out of stock during every survey visit. No stores surveyed had every item in stock during all three survey visits.

The Miami market saw out-of-stock rates of 13 percent. CtW researchers found 30 percent of stores were out of stock of three or more surveyed sale items during each week of the survey. As in New York, none of the stores surveyed had every item in stock for all three survey visits.

The items surveyed were typical products consumers purchase in drug stores for their household and health needs. For example, a 27-count pack of Walgreen brand diapers was out of stock in 26 percent of stores surveyed. An 8-ounce container of Folgers Instant coffee was out of stock in 27 percent of stores surveyed. Over-the-counter medications were also found to be out of stock. In 26 percent of store visits, a 24-ounce Nyquil and Dayquil combo pack was out of stock while a 24-count pack of Benadryl Allergy was out of stock in 15 percent of visits during spring allergy season.

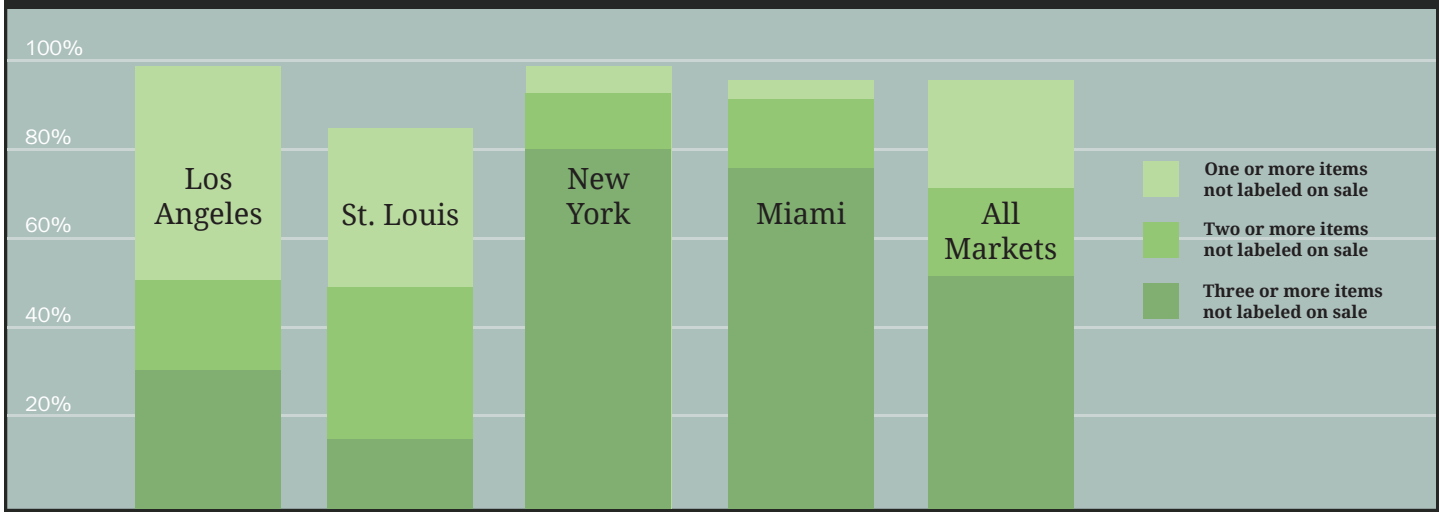
Out-of-stock rate for selected sale items at Walgreens stores.



MISSING SALE SIGNS COMMONPLACE

In addition to finding many advertised sale items out of stock, CtW researchers found that at 94 percent of stores, at least one surveyed sale item was not labeled as on sale during each visit, and at half of stores three or more surveyed sale items were not labeled as on sale during each visit. Twenty-five percent of surveyed items were not labeled as on sale across all store visits

Percentage of Walgreens stores that had sale items not labeled as on sale during all visits, by market.



to Walgreens stores. No store visited had every surveyed sale item marked as on sale during every visit.

In New York, several stores had more than 70 percent of sale items inaccurately marked. Miami performed poorly as well, with two stores missing sale price signs and labels for more than 90 percent of items researchers checked.

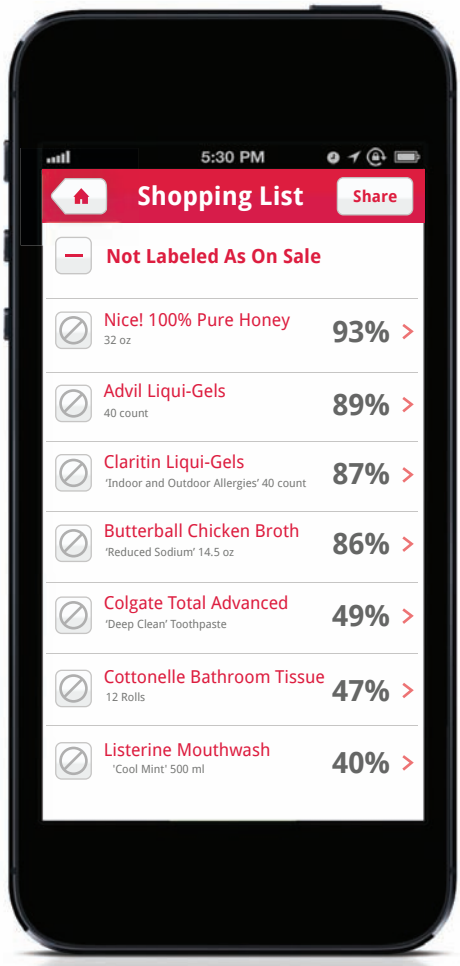
LOST SALES AND LOST TRUST

Out-of-stock or mislabeled sale items can cost Walgreen immediate sales and hurt its efforts to build long-term loyalty.

Research shows that when customers cannot find items they are looking for, the retailer loses the sale 40 percent of the time, with the customer making the purchase at another store (31 percent) or not purchasing the item at all (nine percent).[4] The impact of these lost sales is significant: a study published with the support of the grocery and retail drug store industries found that the out-of-stocks cost retailers four percent of sales on average.[5]

Out-of-stock products represent a significant threat to Walgreen's efforts to build customer loyalty. A 2009 IBM Global Business Services report based on a survey of 30,000 U.S. consumers identified product availability as an important factor in establishing trust, warning that shoppers "can become frustrated and lose trust when a product is not available," especially when it comes to special promotions.[6]

When a sale item is in stock, it is important that it be promoted on the shelf. Walgreen management has pointed to customers' tendency to make purchase decisions once they are in the store—observing that "the average Walgreens shopper comes in our store to buy 1.5 items and leaves with three items."[7] Consumer research bears this out, showing that customers make upward of 70 percent of purchase decisions in the store and sale signs are an important influence on in-store



Percentage of Walgreens stores where selected sale items were not labeled as on sale.

purchasing decisions.[8] A 2012 study found that in-aisle advertising of sales is a top reason why shoppers purchase items they did not plan on purchasing.[9]

Over time, inaccurate shelf tags also hurt customer loyalty. In a 2007 survey of 5,000 consumers, 62 percent of shoppers said that inaccurate pricing at the shelf would affect their willingness to shop in a retail store.[10]

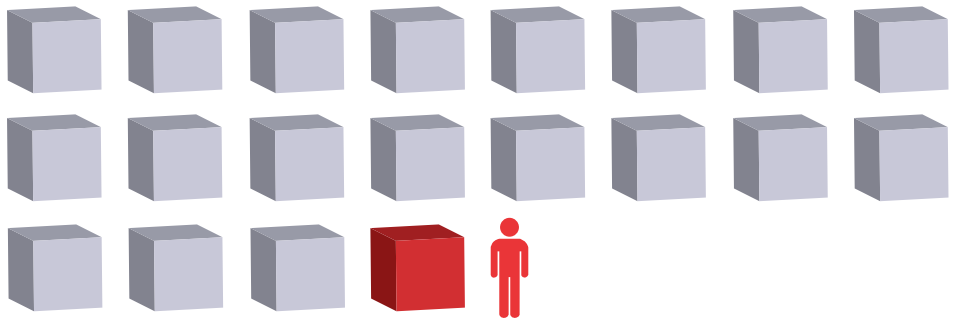
INVENTORY AND STAFF CUT TOO FAR?

Walgreen has been making adjustments for several years to improve its inventory control. In 2009, the company undertook a substantial SKU rationalization program to eliminate 3,500 SKUs, or unique products, from its stores and reduce inventory by $500 million chain-wide.

After several years of inventory fluctuations, Walgreen reduced its inventory again over the course of fiscal year 2012. CFO Wade Miquelon commented in June 2012 that the company was "very focused" on supply chain initiatives and was making sure "as we reduce inventory that our out of stocks don't go up and that our customer satisfaction goes up."[11]

We believe lower overall staffing levels may be a contributing factor to Walgreen's operational problems. The company's staffing has not kept pace with its store growth, even as it has slowed store openings. Since 2008, Walgreen's selling square feet have increased by 19 percent, while its staff has increased by just one percent.[15] In the last two years Walgreen's staff actually decreased by two percent even as selling square feet increased four percent. Some employees and former employees have commented online that stores are short-staffed. One former employee, writing on job review site Glassdoor in January 2013, observed: "they cut essential staff hours making the work and customer service experience sub-par."[16]

Total selling square feet growth and labor growth at Walgreen, 2008-2012.



19%
Increase in selling square feet between 2008 and 2012

1%
Increase in total employees between 2008 and 2012

However, inventory reductions may have been too aggressive based an analysis using first in first out (FIFO) measures, the best reflection of current inventory. While both total sales and FIFO cost of sales went down about three percent per store for fiscal year 2012, FIFO inventory per store was down 9.4 percent over the year.[12] In light of these figures and CtW's survey findings, we are concerned that management's inventory reductions may have hurt the company's ability to keep its shelves well-stocked.

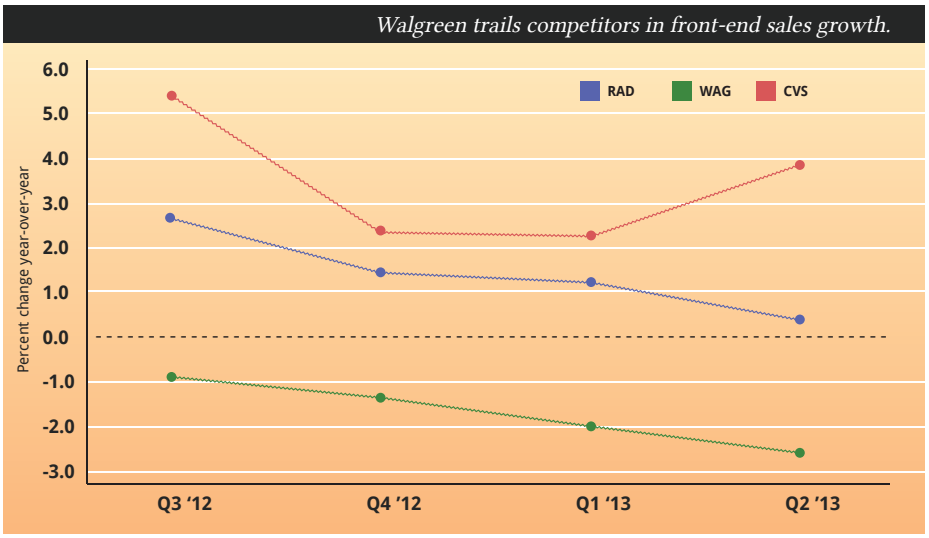
Inadequate labor supply can also contribute to out-of-stock problems. A Proctor & Gamble funded study shows that an estimated 25 percent of out-of-stock items are actually in the store but not on the shelf when a customer wants to buy them.[13] Recent coverage of Wal-Mart's struggle with out-of-stock merchandise and slowed sales suggested that the company "doesn't have enough associates on hand to get stuff from back-of-the-store staging areas to the shelves."[14]

Missing sale products at a Walgreens store in Miami, FL.

CONCLUSION

Since Balance Rewards was launched, there have been indications that customer response has been lukewarm. Speaking to analysts in April 2013, CFO Wade Miquelon acknowledged that some customers do not like that they have to be a member in order to get sale prices. Based on online commentary, it appears that at least some Walgreens shoppers have found the program's rules confusing.[17] One customer wrote that "the Balance Rewards are designed to make you think like you're getting something that you aren't."[18] As of December 2012, three months after the program was launched, about five percent of enrolled customers had actually redeemed any points. This is the only redemption metric released by Walgreen thus far.

Perhaps most tellingly, Walgreen has not seen improved front-end sales since introducing Balance Rewards. In the seven months since the program's launch, front-end sales for comparable stores have been negative, with a drop of two percent in the first quarter of fiscal 2013 and 2.6 percent in the second quarter. Meanwhile, management has not disclosed any detailed breakdown of the program's costs.



Leading drug stores' front-end comparable store sales growth for most recently reported quarters.[19]

We believe that Walgreen's operational problems and flagging sales may arise from the company devoting much of its management's time and resources to its recent entry onto the global stage. In June 2012, the company acquired an initial 45 percent ownership stake in European pharmacy wholesaler and retailer Alliance Boots, with an option to buy the rest of the company in 2015. The deal has been met with skepticism because it exposes Walgreen to the turbulent European market and does not address problems in the core business. One analyst noted the transaction "could prove to be a distraction to management as the company works to improve its U.S. business."[20]

To make its promotional strategy successful and regain competitive advantage, we believe Walgreen management must focus on the operations of its core business, and should share its plans with investors. Specifically, management should disclose more information about the performance of its loyalty program and in-store promotions. Improving performance in these areas is Walgreen's best chance to increase sales, enhance investor confidence, and build long-term relationships with customers.

NOTES

1. Collins, Jim. *Good to Great: Why Some Companies Make the Leap…and Others Don't.* (Harper Business, 2001.)

2. "Returning ESI patients, strong start to loyalty program has WAG executives bullish," *Drug Store News*, December 21, 2012.

3. Walgreen Co. Q4 2012 earnings calls transcript, September 28, 2012.

4. Thomas W. Gruen, Ph.D. and Dr. Daniel Corsten, "A Comprehensive Guide to Retail Out-of-Stock Reduction In the Fast-Moving Consumer Good Industry," Grocery Manufacturers Association (GMA), Food Marketing Institute (FMI), National Association of Chain Drug Stores (NACDS), The Proctor & Gamble Company (P&G) and The University of Colorado at Colorado Springs, 2007, at 10.

5. Ibid at 7-8.

6. IBM Institute for Business Value, "Shopper advocacy: Building consumer trust in the new economy," 2009, at 11. Available at: http://ibm.co/7e8INY.

7. "Walgreens selects Arc Worldwide as promotional marketing agency," *Drug Store News*, January 11, 2009.

8. Point of Purchase Advertising International, "2012 Shopper Engagement Study," 2012, at 4. OlgivyAction "Shopper Behavior Instore," 2008, at 2.

9. Point of Purchase Advertising International, supra n8, at 4.

10. Sterling Commerce, "What consumers want in their shopping experience," 2007, at 12.

11. Walgreen Co. Q3 2012 earnings call transcript, June 19, 2012.

12. CtW analysis of company figures. Walgreen Co. 2012 Annual Report. Gruen and Corsten, at 9.

13. Gruen and Corsten, supra n1, at 9.

14. "The Trouble Lurking on Walmart's Empty Shelves," *Time Magazine*, April 9, 2013.

15. CtW analysis of company figures. Walgreen Co. Annual Reports, 2008-2012.

16. Glassdoor.com review by former employee in Chicago, Illinois, submitted January 24, 2013. Available at: http://bit.ly/10vhQaK.

17. "Walgreens' New Reward Program: Balance Rewards (pre-Enroll for a Chance to Win 1 Million Points," *PocketYourDollars.com*, September 12, 2012. Available at: http://bit.ly/10vj0CX.

18. "The Inside Scoop on Walgreens New Balance Rewards Program," *The Krazy Coupon Lady*, October 9, 2012. Available at: http://bit.ly/SO3X9R.

19. Figures from quarterly earnings reports from each company, released between March 2012 and March 2013. The most recent quarters by company fiscal year are: Walgreen Co., Q3 FY2012-Q2 FY2013; CVS/Caremark, Q1 FY2012-Q4 FY2012; Rite Aid Corporation, Q1 FY2013-Q4 FY2013.

20. Weinswig, Deborah. "New Boots Won't Fix the Feet," *Citi*, June 20, 2012, at 7.

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