Great by Choice-Walgreens
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Dear Fellow Investors:

In his new book "Great by Choice", Jim Collins talks about the discipline that the companies which performed the best over the last thirty years had exhibited. He used comparisons between companies in various industries. In property casualty insurance, he compared Progressive to Safeco. The watershed moment when the success of the two companies parted was in the late 1980's and early 1990's. Prior to that time both companies ran underwriting profits each year. This meant that they paid out less than 100% of the premiums collected. Unfortunately, for the shareholders of Safeco, the high interest rates of the 1980's and the favorably stock price increases of the 1980's and 1990's lured them into allowing investment returns to override underwriting discipline. When interest rates became historically low and stock market returns gravitated to the mean, Progressive's underwriting profit left Safeco in the dust.

What triggered our thoughts here was a blog I read at Barron's online last week. It said that a Credit Suisse analyst was recommending that investors swap out of Walgreens (WAG) into Rite Aid (RAD). The reason for the negative view of Walgreens on the part of the analyst was his expectation of only a 25% likelihood that Walgreens will settle their dispute over pricing with Express Scripts. Walgreens would have lower revenue and profits in the near future if they lose the Express Scripts revenue. Walgreens has already told analysts that it could cost them as much as $.21 of their 2012 earnings per share (EPS). We at Smead Capital Management believe that the weakness in Walgreens stock created by the uncertainty associated with the Express Scripts negotiation and separation has created a wonderful buying opportunity.

Collins focused on the companies which overcame unforeseen economic and business problems and returned a 10-fold increase in stock price. He calls them 10x companies. His work is done looking backward, while our work is done looking forward. Progressive didn't earn as much in the years when investment markets provided high returns, but they prospered in the 2000's when investment returns were problematic at best. They gave up some income in the short run to be a 10x company in the long run.

Why would Walgreens walk away from billions in revenue from Express Scripts? For the same reason that Progressive did. At the pricing levels dictated by Express Scripts, Walgreens would produce meager margins on that part of its business (3-5 percent of revenue) and drag down return on equity. Their stock has already fallen from the mid 40's to the low 30's. According to our calculations of intrinsic value based on multiple current earnings possibilities, Walgreens trades at a 33-50% discount to its intrinsic value. Walgreens stock has risen from around $4.17 twenty years ago and pays an $.80 dividend to those fortunate enough to have held on. It meets all eight of our proprietary criteria and is a stellar corporate citizen.

Which brings me to the lunacy of recommending a sale of Walgreens in exchange for Rite Aid. Rite Aid is a small-cap company with a deeply checkered past and porous balance sheet. Trading Walgreens at these prices for Rite Aid would be like swapping a new Lexus for an over-sized ten-year old gas guzzler, box seats for the nose bleed section or Kate Middleton for a troubled Hollywood Starlet! Rite Aid has accounting problems and a consistent history of shareholder unfriendliness. It might go up, but it should not be included in the same conversation. We believe that Walgreens is going to be "Great by Choice".

Best Wishes,

William Smead

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