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Q2 FY20 Cardinal Health, Inc. Earnings Conference Call

February 6th, 2019 8:30AM Eastern

Operator: Good day, and welcome to the Cardinal Health, Inc. second quarter fiscal year 2020 earnings call. Today's conference is being recorded. At this time I would like to turn the conference over to Kevin Moran. Please go ahead.

Kevin Moran: Good morning and thank you for joining us as we discuss Cardinal Health second quarter fiscal 2020 results. I'm Kevin Moran, Vice President of Investor Relations. And joining me today are Mike Kaufmann, our Chief Executive Officer, and Dave Evans, our Interim Chief Financial Officer. You can find today's press release and presentation on the IR section of our Web site at ir.cardinalhealth.com.

During the call we will be making forward-looking statements. The matters addressed in the statements are subject to the risks and uncertainties that could cause actual results to differ materially from those projected or implied. Please refer to our SEC filings and the forward-looking statements slide at the beginning of our presentation for a description of these risks and uncertainties.

During the discussion today, our comments, including an update to our FY20 outlook, will be on a non-GAAP basis unless they are specifically called out as GAAP. GAAP-to-non-GAAP reconciliations for all relevant periods can be found in the schedules attached to our press release.

During the Q&A portion of today's call, we kindly ask that you limit yourself to one question with one follow-up so that we can try and get everyone an opportunity to ask a question.

With that I'll now turn the call over to Mike.

Mike Kaufmann: Good morning, and thanks for joining us. Before we discuss our Q2 performance and our outlook for the year, I would like to reiterate a few things we shared last Thursday regarding voluntary recalls for any Level 3 surgical gowns and certain Presource Packs containing those affected gowns. The full press release and additional information regarding this issue can be found on our Web site.

First and foremost we apologize to our customers and their patients. We understand the gravity of this situation and are dedicated to resolving this issue as quickly as possible. Simultaneously we are doing everything we can to prevent this from happening again.

We are engaging third-party experts to conduct a comprehensive review of our quality assurance processes and business practices and we are committed to executing corrective and preventative actions.

As we shared last week related to these recalls we recorded a $96 million charge in our Q2 GAAP results. This charge represents our best estimate of cost for the recalls, including inventory write-offs as well as certain remediation and supply disruption costs such as cost to replace recalled products.

To provide some clarity, $56 million of this is within cost of products sold and $40 million is within SG&A. This charge and any future adjustments made to it will be excluded from our non-GAAP financial results.

On behalf of the entire Cardinal Health leadership team, I would like to thank our employees for their dedication and tireless effort. All of us, myself included, are focused on resolving this issue as quickly as possible for our customers and their patients.

I'll now turn the call over to Dave to walk through our Q2 results and updated fiscal '20 outlook and then I'll share some thoughts on our path forward.

David Evans: Thanks, Mike. I'll start with an overview of our performance for the second fiscal quarter and then provide an update to our fiscal '20 guidance. In Q2, we delivered earnings of $1.52 per share, an increase of 18% from the prior year.

This result exceeded our expectations and was driven by a combination of operating and non-operating activities, which I'll elaborate on the comments to follow. Total company revenue increased 5% versus last year to $39.7 billion and consolidated gross margin increased 2% from last year to $1.8 billion.

SG&A increased 3% to $1.1 billion. This increase was driven by higher cost to support sales growth and by fluctuations in deferred compensation liabilities. These items were partially offset by the benefits of enterprise-wide cost savings measures. The net result for the quarter was consolidated operating earnings of $646 million, a 1% increase from the prior year.

Moving below operating earnings, interest and other income and expense decreased 48% to $51 million. This was primarily driven by the change in value of deferred compensation plan investments and lower interest expense as we continue to execute our deleveraging plans.

Of note in the quarter, we paid down more than $700 million of long-term debt and have now paid down nearly $800 million through the first half.

Our effective tax rate for the quarter was 25%, nearly 4 percentage points lower than the prior year, primarily due to the favorable impact of changes in the jurisdictional mix. Average diluted shares outstanding were 294 million, about 6 million fewer than last year.

During the quarter, we completed the $350 million accelerated share repurchase program initiated in Q1. We repurchased 7.3 million shares over the first two quarters at an average value of $48 per share. We now have $943 million remaining under our board authorized share repurchase program.

Moving on to cash flow. Operating cash flow for the quarter was approximately $700 million. We ended the quarter with a cash balance of $1.7 billion, which included $788 million held outside the U.S. As a reminder, timing, in particular, the day of the week in which the quarter ends, affects point-in-time cash flows.

Moving on to segment results, starting with pharma, we were encouraged to see positive momentum across many areas of the segment. Segment revenue increased 6% to $35.7 billion, driven by growth in our pharmaceutical distribution and specialty solutions divisions.

Segment profit increased 4% to $462 million, with our generics program being the largest driver. As a reminder, what we refer to as our generics program includes sourcing, sell-side pricing, volume and new item launches.

For the first time in several quarters, our generics program reverted from a net earnings headwind to tailwind. At the same time we continue to see strong growth in our specialty solutions business.

Brand sales and mix also positively contribute as we manage changing dynamics to capture the value we create through our supply chain. These tailwinds were partially offset by pharma distribution customer contract renewals.

Transitioning to medical, revenue for the segment was flat to prior year at $4 billion. Growth in Cardinal Health at Home was offset by a decline in products and distribution. As a reminder, products and distribution includes both Cardinal Health brand and national brand products.

Overall Cardinal Health brand volumes have lagged their expectations through the first half. While we recognize we still have progress to make, this validates the importance of our commercial initiatives, which Mike will discuss in his remarks.

Medical segment profit increased 4% to $195 million. This reflects the benefits of ongoing initiatives to improve our cost structure, including work to optimize freight and IT relationships. These benefits were partially offset by a decline in products and distribution. Medical segment profits are now up 13% compared to fiscal '19 on a year-to-date basis.

Moving now to our full-year outlook. With half the year behind us, we are raising our full-year fiscal '20 EPS guidance to the range of $5.20 to $5.40 from the prior range of $4.85 to $5.10. I'll call out a few items contributing to this increase.

First, we now have additional clarity regarding external factors we mentioned last quarter that affect the enterprise, including brand inflation, the medical device tax and tariffs. Also based on the sustained improved trends in our generics program, we now expect the pharma segment to exceed our original expectations for the full year.

A few additional items to note in the pharma segment as we look to the second half of the year. First from a year-over-year comparison perspective, recall that it was in Q4 of last year when we started to see an improvement in the generic market's dynamics. That means we'll be comping more challenging performance in Q4 of this year.

Second, we now expect opioid-related legal costs to be in the range of $100 million to $125 million for the year, with the majority of the year-over-year increase occurring in the back half of the year. As a reminder, these expenses are recorded in our pharma segment.

Third, on brand inflation, while the January price increases from our contingent vendors fell within the range of our expectations, they continue to be a smaller dollar contribution each year.

And in medical, I'll remind you of the charge we took in the fourth quarter of fiscal '19 related to Cordis. This will affect our year-over-year growth rate in the second half for the segment.

Regarding the rest of our corporate assumptions, we now anticipate FY20 interest and other income and expense in the range of $260 million to $280 million. This improvement is largely due to the favorability we've seen thus far with our deferred compensation plan investments and the benefits of debt deleveraging that I mentioned earlier. As a reminder, we plan to reduce outstanding long-term debt by at least $1 billion in fiscal '20.

Finally we expect diluted weighted average shares to be in the range of 293 million to 296 million for the full fiscal year. Given that we are halfway through the year, we've decided to narrow this range.

Regarding our segment assumptions, we are making one update. With the favorability I discussed, we now expect pharmaceutical segment profit to decline low single digits. This is a significant improvement from our original expectation of a low double digit decline.

With that, let me turn it back over to Mike.

Mike Kaufmann: Thanks, Dave. As we look to the remainder of this year and the next few, we will continue to focus on enhancing our established core businesses and on fueling sustained growth in evolving areas, including specialty and at home.

In pharma let me start by saying we continue to be actively involved in ongoing negotiations of the terms for a global settlement and we remain committed to being part of the solution to the opioid epidemic.

Overall, we have increased confidence in our work to drive growth across the pharma segment. Our investments in our generic pricing and analytics capabilities, as well as continued strong performance from Red Oak and improving market dynamics, are enabling our generics program to now be a tailwind for the year rather than a headwind as we previously expected. Also our investments in both our specialty and connected care businesses enable us to capture value in the ever-changing healthcare landscape.

Moving to medical, I mentioned last quarter that we had multiple initiatives in flight to enhance our commercial approach and streamline our supply chain. Our work in these areas continues.

However with the recent recalls, we are currently deploying our medical segment teams to meet the most immediate needs of our customers and their patients. While we recognize this will slow momentum in our

commercial and supply chain initiatives, we remain confident in the underlying strategies of these work streams and we are dedicated to their success. We will provide an update on our next call.

At the enterprise level, we remain committed to a disciplined capital allocation approach that prioritizes reinvesting in the business, maintaining a strong balance sheet and modestly growing our dividend. Opportunistically, we will continue to explore share repurchases and M&A.

Across the company we continue to prudently manage our cost structure. We're doing this through focusing our resources, improving our processes and embracing new technologies that create better visibility and velocity throughout the company.

Our goal is to be easier to do business with. As this new mindset takes root, we will continue to see a sustainable behavioral shift and ongoing value creation for years to come.

With that I'll now pause to open it up for questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing star 1 on your telephone keypad. And we'll take our first question from Glen Santangelo with Guggenheim.

Glen Santangelo: Oh, yes, thanks. Good morning. Just a quick question regarding the guidance in the medical segment. I'm kind of curious does the recall have any implications for the outlook in the second half of the year? Because if you look through the first six months your operating profit is already up double-digits and Dave, as you sort of alluded to, you have that easy comp coming in the fourth quarter from that charge last year.

So by maintaining the guidance there, it kind of implies that, you know, the operating performance would be pretty weak in the second half. And I'm just kind of curious if I'm looking at that correctly or if there is anything else there.

David Evans: Yes, Glen, this is Dave. Good question. So as you can see, we collected the direct costs and included those in our charge of $96 million. What we have uncertainty on and frankly at this very early stage is implications to second half in terms of revenue, margin and any disruptions with our customers.

So I would say that you've read this fairly well and that we've reflected some of that uncertainty in the guidance that we're providing for the second half for med.

Glen Santangelo: Okay. And then maybe if I could just ask a quick follow-up to Mike with respect to opioids. I think you were sort of forecasting about $85 million of expenses and now you've taken your opioid litigation expenses up to $100 million to $125 million.

The framework has been out there for a few months. It kind of sounds like you're confident. Why the increased sort of litigation expense now? Hopefully we're winding this down? Could you maybe give us an update on the timeline of maybe what we should be expecting from here?

Mike Kaufmann: Yes. Thanks for the question. We are still dedicated to the framework and progress does continue. So that's a positive. But as you can imagine, these are incredibly complicated arrangements we have to work through with 50 different states that we're working with.

And so to get this over the goal line, there's a lot of work that's going to be done, you know, over the next several weeks and months to get that done. And even when it's agreed to, it's got to get papered and then we've got to work through implementation of the various components of it.

And so when you begin to look at all of those costs and the way that spend we believe will ramp up, we believe that you're right. The costs are going to go from 85, which was our original, to 100 to 125 with a significant portion ramping up in Q3 and even probably a little more in Q4. Next question, please.

Operator: And we'll go to our next question from Robert Jones with Goldman Sachs.

Robert Jones: Thanks for the question. Yes, I guess just to stick with that topic, Mike, because obviously it's so important to Cardinal and to the group. You know, one of your peers talked about narrowing conversations around a potential opioid settlement.

You know, you obviously sound incrementally, you know, more positive that this is progressing. Could you maybe just give a little bit more on, you know, how many other states, maybe not specifically, but are more states and local governments and municipalities engaging at this point?

I think the original framework that we had all seen obviously highlighted just four state AGs. I'm just curious, specifically are you seeing more people coming to the other side of the table?

Mike Kaufmann: Yes, thanks again for the question on this important topic. As I said, we remain committed to this framework and we're very appreciative of the four AGs that took the initial lead on this.

They have been working with all 50 states. We continue to get the feedback from those states and look to the various components of the details of the agreement. But it wouldn't be appropriate for me right now to try to tell you or handicap how many states are in or out.

But I will tell you that the four AGs that we talked to continue to make progress. And I think we all believe that this is the right thing to do for the companies and for the country to help get some relief to the people that need it with not only the dollars we're talking about, which are important, but equally the other components, which are distributing the free goods and working with them on programs to improve the overall monitoring of the opioids.

Robert Jones: No, no. I appreciate that, Mike. And I guess just to go back to this generic program dynamic, you know, you highlighted this is the first time in several quarters it went from a headwind to a tailwind.

You guys talked specifically about four components that I guess comprise your generic program. Could you maybe just dive a little deeper into what exactly changed, you know, to flip the generics from a headwind to a tailwind in the quarter?

Mike Kaufmann: Yes, I think a couple of things. I think first of all by far this is the item that drove the difference in our expectations for the quarter, as Dave mentioned. Pretty much everything else was right there where we expected it to be, maybe a little bit better. But this was the big driver.

And it's really good performance across all of the components. We're very happy with Red Oak. They continue to perform at a very high level not only in getting after cost for us but also just doing an excellent job on service level.

We really believe we have industry-leading service levels and that really helps lead to maintaining and growing our volumes, which is an important part of it. So while volumes were a little lighter than we had expected originally this year, due to the situation as we mentioned with Fred's that went bankrupt and some other customers that are winding down a few stores, we are still seeing volume growth.

And then the other big factor is going to be just market dynamics. We've seen significant improvement in the overall market dynamics on the pricing side. So when you put all of the components together and we had a strong quarter on launches, it was really strength across all of the components that made the program overperform.

David Evans: Yes. Just, hey, Mike, you hit it on the head there. I think we did have an earlier than expected launch of some new items. That was helpful for the quarter. In addition, we had a fairly favorable mix that helped drive the results we saw in the second quarter.

Kevin Moran: Next question please.

Operator: We'll go next to Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yes, hi. Good morning and congrats on a very good quarter. You know, Mike, going back to your comments on market dynamics and just improved pricing, digging a little bit deeper into that, when we think about pricing, are you seeing improved pricing on the sell side versus the buy side?

And focusing on the buy side, you know, China is an important source of generic API supply. Given what we're seeing there with the coronavirus, how does that impact supply, overall global supply, in the marketplace and

what could be the potential implications on potential return to generic inflation? And is any of that in your second half outlook?

Mike Kaufmann: Yes, I'll start with as far as the second half outlook goes, we basically are just taking the trends that we've seen for the first half of the year around generics. The overall programs in kind of forecasting those out for the rest of the year, we're not projecting necessarily any improvements or inflation or anything like that.

It's just really about being more confident that what we're seeing now that we have roughly eight months of activity versus five last quarter, which it just felt a little too early to call it, we feel like we've had enough activity here that we feel good about increasing our guidance related to that. That is clearly the biggest item.

As far as some color on it, I think the important thing is it's hard to really get focused on just the buy side or just the sell side because they work in tandem. And it's really about driving margin per unit.

And what we're seeing is a much better balance between what's happening on the sell side in terms of the amount of inflation being less than historical but also being able to balance any decreases there with good performance at Red Oak so that we can continue to manage our margin per unit in a way to be able to have the overall program grow.

And as Dave said, the units and the overall launch has helped for that too. And so that's really how we look at it.

As far as the China API, as you can imagine, this is something that we monitor. Red Oak is in charge of that for us and they do a great job of understanding where raw materials are coming from, where they're manufactured. And you're right, there are a decent amount of API manufactured over in China in some of the affected areas.

Where we have, we've worked with manufacturers to try to increase supplies ahead of this. I do think it's something that based on the amount of supply in the supply chain is something the industry should be able to work through. But it's hard to say how long this will last and it's something that we're going to have to keep an eye on and we will.

Kevin Moran: Next question, please.

Operator: We'll go to our next question from Lisa Gill with JPMorgan.

Lisa Gill: Hi. Thanks very much. Good morning. Mike, you called out specialty as being a growth area again in the quarter. Can you just remind us, you know, the size of that business and the capabilities versus some of your peers?

And then as we think about the potential for IPI and potential changes around reimbursement, can you talk about, you know, your thoughts on that and any impact that you could see in your specialty business?

Mike Kaufmann: Yes, thanks for the question. Our specialty business, the last number that we publicly gave for FY19 is that we finished around $19 billion in sales. And so that's where that business is.

We continue to expect that business to have significant growth this year across all of its areas, its sales into the actual downstream providers in the acute space as well as upstream services to manufacturers.

So we are seeing good momentum across all three areas in that business and continue to feel good about not only their quality of service to the customers with some of the investments we're making in the businesses that we'll be able to talk about more here in the future, including a recent investment we've made in Vineti that was announced that we believe will also be an area of helping in the cell and gene area. So we continue to be excited about the specialty area.

As far as it relates to IPI, I would say this. First of all we're in favor of anything that can help reduce the cost of healthcare to the US healthcare system. We know that's important. We hope and look to folks to be able to find ways to reduce costs for folks. So that's important to us.

The second thing I would say is that when you think about IPI or any of these programs that folks are looking at, the impact to us, I think, is generally where it could impact us in the first order is, does it change list prices?

Does it mean that the way that manufacturers establish list prices, do they have to lower them? Do they have to reduce their price increases? Those are the types of first order of kind of magnitude impact to us that we look at.

And as you and the others have heard me say, I think that we as a company and as an industry have really worked well over the years in the fee for service model to first of all make anything that's - the part that's dependent on inflation to be less than 5% of our overall margin rate so that helps protect us from any impact on what folks might do with inflation rates.

And secondly the way we've been able to demonstrate our ability to renegotiate DSAs over time as WAC prices fluctuate, we still feel very confident that any impact to list prices we can manage through very effectively as a company and as an industry.

The piece that's really important to us though is the impact to our customers. We really look at any of this legislation with a true lens to our customers and the impact on them. And we want to make sure, and have commented on past legislation that's been out there, that we have to be really careful that type of legislation doesn't reduce access or reduce the ability of our customers and themselves to be able to work with the actual patients to provide the type of care that we know that they deserve.

Lisa Gill: Thank you.

Mike Kaufmann: Thanks, Lisa.

Operator: And we'll go next to George Hill with Deutsche Bank.

George Hill: Hey, good morning, guys. Thanks for taking the question. I guess, Mike and Dave, I'd ask you guys a little bit more about the generics program contribution in the quarter. And I guess, what I'm looking at is, you guys and your friends in Texas kind of highlighted - you demonstrated big beats in earnings this quarter that were generics related that don't seem repeatable either in the next quarter or in the balance of your fiscal years.

So maybe could you provide a little bit more color on the earlier than expected launch of the new items that was highlighted and maybe the contribution in the quarter and maybe some more commentary around what was delivered in the quarter that might seem more one-time versus what might seem repeatable on a go-forward basis? I know that's a lot. Thanks.

David Evans: Yes, George. Let me answer that. Look, when we talk about the four elements of what we described as the generic dynamic, those are a continuation of trends that we would expect to see in Q3 and in Q4. So we'd

expect to see year-over-year some healthy improvement in Q3. Q4, we don't expect to see the same year-over-year improvement because Q4 of last year, if you go back and look at that, was a quarter - it was the first quarter where we began to see the inflection in this deflationary trend. And so we have a much more challenging comp in Q4.

With respect to the accelerated launch of new items, that's not necessarily a one timer. It's just a pull forward of something that was anticipated later in the year. So I think you can expect, which is why we call our guidance up specific to pharma, we expect to see some positive results in Q3 and then possibly today based on what we see somewhat moderation in the year-over-year comparison in Q4. Does that help answer your question, George?

George Hill: Yes, I think you covered it clearly. Thank you.

Kevin Moran: Next question.

Operator: We'll take our next question from Elizabeth Anderson with Evercore ISI.

Elizabeth Anderson: Hi. Good morning, guys. I was hoping you could talk a little bit more about some of the specialty profit drivers in the quarter and maybe more broadly beyond that. You know, is it sort of an increase in services? Is this just a launch calendar, any additional color you could provide on that would be helpful.

Mike Kaufmann: I think in specialty a lot of this just has to do with the normal growth of specialty. We are continuing to see certain drugs grow in the marketplace because of their success, particularly in the oncology space, getting new indications and just normal growth. That's a really big piece of it.

Part of it is some of the uptake of some of the biosimilars, you know, here and there, some of that. While they don't provide a lot more value than normal branded items and they generally act like that, there are some smaller opportunities on the earnings side to earn slightly better there. That's been a piece of it.

We've seen really nice growth in our services business upstream with wins in our 3PL business in our hub and some of our other businesses have continued to grow. So nothing unique about like large pieces of movement, a business or anything, you know, one timers like that. It's just nice solid growth with volumes across the board.

Elizabeth Anderson: Thank you.

Mike Kaufmann: Next question.

Operator: We'll go next to Stephen Baxter with Wolfe Research.

Stephen Baxter: Hey, thanks for the question. So based on how you sized the relative components of the pharma guidance coming into the year, it seemed like renewals were driving at least half of the high single digit to low double digit profit decline you're assuming.

I assume the renewal impact hasn't changed. So the revised guidance for the low single digit percent decline would seem to indicate a decent amount of underlying growth, excluding the renewals and opioid expenses, which has now moved higher too.

So I was wanted to check and see whether, you know, you agree with that logic or anything has changed about the sizing of the renewals throughout the year and therefore whether we should be expecting, you know, segment profit to return to growth on a reported basis as we move into next year. Thanks.

David Evans: Well, Stephen, this Dave. So I'd say your assumptions are all pretty spot on. I would say though that we're really, you know, per our usual practice, we are not in a position to comment on '21 at this early date. But overall, I think you've got a good handle on it and can understand what we've been articulating.

Kevin Moran: Next question.

Operator: We'll go next to Erin Wright with Credit Suisse.

Erin Wright: Great, thanks. Does your guidance assume any meaningful contribution from biosimilars? Do you continue to view that as sort of an opportunity for you longer term?

Mike Kaufmann: Yes. Our guidance, you know, would assume any of the normal type related stuff. But there is nothing new. No new launches that created the increase related to biosimilars. We continue to think that something that we'll keep an eye on.

I don't believe it will be a big driver for us in the short term because right now, they act more like branded drugs and their overall margin rates are similar. There is a little bit of opportunity to make a little bit more money on some of the biosimilars depending on programs we might be able to put in place with customers.

But I would not call them a large driver of anything over this year or over the short term, but something we'll keep our eye on. It is something to be more of a mid-term or longer-term driver, particularly if they become interchangeable. And then I think, for sure, in my opinion would change on their ability to be a much bigger driver for us.

Erin Wright: Okay, great. And then where are you in terms of the streamlining of your commercial and supply chain initiatives on the medical side of the business? You suggested that maybe you face a little bit of a setback here in terms of the recent recalls, but would you say you're still seeing some progress and focus on that front?

And also if you could break out the recent Cordis trends specifically, that would be helpful. Thanks.

Mike Kaufmann: Yes. On Cordis, I'll just handle that real quick, nothing really to report on Cordis outside of what our expectations are. The business is continuing to grow. We're seeing growth in our profit there.

And we continue to be really happy with what the team is doing there to meet or slightly exceed the expectations that we have for that business this year. We don't see it being a driver outside of what we expected for the year one way or the other.

As far as the initiatives in medical, we remain incredibly committed to both of them. There is nothing about the underlying strategies of our commercial realignment or our supply chain initiatives that at this time, I would say, make me feel any differently than we have been talking about.

But as I noted, particularly well - both of them, but probably a little bit even more in the commercial side, it has been slowed with the gowns recall. We have deployed some of our sales reps as well as other people into the field to be actually located at the hospital locations helping them manage through this challenge that is out there.

And it's really important to us that we take care of our customers and our patients. So because of that, it would slow down where we expect to be.

So we have said and committed that on our supply chain, we would have a plan done by the end of Q2. That plan was done. But as we look at implementation of that plan, we're taking into account this disruption that we're working on and just overall reevaluating and make sure we look at the overall global supply chain to make sure there's no changes we would make based on some of the recent challenges.

And then again on the commercial piece, we're on track to get the jobs hired and all that, but we do have folks deployed to customers.

Kevin Moran: Next question, please.

Operator: We'll go next to Michael Cherny with BofA Securities.

Michael Cherny: Good morning and thanks for all the details so far. So as you think about the opportunities that you have, you've highlighted specialty as a growth opportunity. Obviously you're performing well so far in areas of medical.

How do you think about that against the backdrop of capital deployment? How do you think about areas where you think your customers are asking for you to do more? And versus previous capital deployment and M&A opportunities, are there any other components or pieces of the business that you think makes sense to beef up right now?

Mike Kaufmann: Yes, as I mentioned, we still feel really good about having several areas that we would consider strategic growth areas. I would highlight four of them, specialty being one of them, at home that we've talked about, our connected care services business in pharma and our medical services businesses.

These are all businesses we're seeing significant growth on the top line and on the bottom line. And they are also businesses that are really right on trend. You know, care moving towards the home and the various things that go along with specialty and the service businesses. So these are areas where we are prioritizing our capital expenditures to those areas so we can really focus on organic growth.

And if there are M&A opportunities out there that would make sense, those would be the areas that you would see us focus on. Now that being said, we're going to continue to do all the right things in our core businesses to make sure we maintain and grow those.

But for what I would say extra allocation of capital, those are going to be key areas that we're going to focus our capital expenditures on.

David Evans: Yes, Michael, if I can add. So really, you know, I'd say we're focusing as well on partnerships in a way that is probably more so than we have in the past. And when we do think about our internal capital, we're really thinking about it in four different categories.

We've got our maintenance capital, where clearly you've heard initiatives like our supply chain. We are focusing on deploying capital to cost out projects. We're providing capital in areas where we need capacity for growth. But then we are also deploying some capital to explore new growth areas.

So it's a pretty balanced approach, disciplined approach to getting a return on our CAPEX.

Michael Cherny: Okay, thanks.

Mike Kaufmann: Thanks, Michael. Next question.

Operator: We will go next to Steven Valiquette with Barclays.

Steven Valiquette: Great. Thanks and good morning, everyone. So just to follow-up a little bit on specialty. Two things I wanted to just get done real quick. First, I was a little bit surprised about biosimilars because there actually had been a bunch of biosimilars launched into the channel worth billions of dollars.

But that was not the only driver up front just changes in the price experience with either customers or suppliers and that separating specialty pricing from traditional brand pricing, whether that may have played a role in some of the better pharma distribution segment results. Thanks.

Mike Kaufmann: Thanks. I think I picked them up. It was a little spotty on being able to hear. But I think I got all your pieces. So let me see if I can walk through them all.

From a change in price standpoint, I'll look at it. You know, we've been very disciplined over several years in our pharma distribution business to make sure that we're splitting out our pricing on our specialty so that it is priced differently than normal brand so that we don't - so we can make a fair return on the specialty drugs.

And we continue that discipline with any new business or renewals with either, as I've said before, specific pricing in that area to maintain appropriate profitability or some types of mix type of penalties in agreements to make sure that if their mix goes the wrong way that the overall cost of goods adjust.

So we continue to be very focused on that in the PD area. And also in the overall specialty business, since there is very little generics in that space, that is priced on a more individual drug standpoint.

And, again, we remain very disciplined in that area to be careful. So I wouldn't say that pricing changes is a driver of our growth in specialty. But it's also not something that we're ignoring or I would say is a headwind from that standpoint.

As far as growth in specialty, overall I would say it really comes from market growth. The market itself is growing significantly with new indications, new drug launches.

Your question on biosimilars, the thing about the biosimilars the way to think about it is when the biosimilar launches, you're not necessarily getting new volume to speak up because you're replacing a current branded drug with the biosimilar.

So overall your volume doesn't generally go up because of a biosimilar. It's just an opportunity to potentially be able to have some market movement capabilities to have customers prefer one over the other.

And those are where we can make a little bit of extra dollars when we work with our downstream customers to prefer either the brand or the biosimilar. But from an overall perspective of drivers, at this point in time I would not say that is a significant driver. But I think over time, it will get to be a more and more potential driver for specialty. Next question please.

Operator: We'll go to our next question from Charles Rhyee with Cowen and Company.

James Auh: Hey, it's James Auh for Charles. Can you give us a quick update on the cost savings program? Maybe, you know, how much of the $130M of incremental savings expected this year has been achieved? You know, is it tracking in line with expectations? And perhaps how much of that's been reinvested as opposed to, you know, dropping to the bottom line?

David Evans: Yes, James. Thanks for the question. You know, we're making great progress against that program, and we're still on track to achieve the $500 million target as previously communicated.

And I would also say we're on track to realize the $130 million or more this fiscal year. So we're making good progress. We've got a pipeline. As you can imagine, we're tracking all sorts of opportunities and working through kind of stages and maturation.

And we're seeing with, you know, strong confidence now our ability to obtain the entire $500 million. So we're really continuing to focus more on not just simply cost out, but how do we try to drive improved value, speed throughout the organization, increase our capabilities with the belief that that will continue to drive more savings throughout the future?

With respect to the level of reinvestment, we are continually encouraging our organization to press Mike and I with lots of difficult choices and challenges to reinvest this with high-returning projects.

I can't quantify for you the exact amount of that, but we're encouraged that we are seeing more and more opportunities as we build this culture within the organization of encouraging people to seek out new opportunities for ongoing cost improvements, growth drivers, et cetera, et cetera. So I think the program is one that we should deem as a real success.

James Auh: Okay. And just another technical question. In the share count guidance, does that include any additional share repo beyond the $350 million from the ASR?

David Evans: No, James. That assumes that we completed $350 million and there would be no further purchases for this fiscal year contemplated in that guidance.

James Auh: Okay, great. Thank you.

Mike Kaufmann: Thanks for the question. Next question please.

Operator: Our next question comes from Eric Percher with Nephron Research.

Eric Percher: Thank you. I'd like to return to the medical recall, I recognize, you're still working through the potential impact going forward. But could you provide us some context for how surgical gowns and kits fit into medical

broadly, maybe starting with market share where your customers are turning and impact on other elements of the business?

Mike Kaufmann: Yes, we won't, obviously, be able to give a lot of detail on market share. But I can give you a little color is that there - the reason why this is such a - has a large impact is that a lot of surgeries in the U.S. use kits.

There are several different folks that compete in that space, but we do compete very effectively, we think, with market-leading type of quality and services tied to those kits, the ability to design and price those kits appropriately, et cetera.

So the idea here is that a lot of surgeries in the U.S. do use kits. And because gowns are in almost every kit, even though when you look at this as an overall relatively small percentage of gowns sold across the U.S. because they are in kits, that's why it's having a larger impact than you might expect.

And so, I'll just stop there and see what your follow-up question might be beyond that just to make sure I'm hitting the right things for you.

Eric Percher: So I think concerns from the hospital purchasers around impacts on utilization and impacts on their business, you started with an apology and are taking that head-on. But what is your take on the ability to remedy this and any impact on the business from what this has done to relationships here?

Mike Kaufmann: Yes, I think, you know, anytime you have a challenge in any business, it's often the way you respond that makes a difference. And I couldn't be more impressed with how our medical team from the leader, Steve (Mason), all the way down to people in the distribution centers have responded taken accountability and

ownership for this and said we're going to do everything we can to make the customer's life as good as we can knowing the circumstances.

So we have deployed hundreds of people. We've taken out not only our medical segment, but the pharma team and corporate functions have also volunteered and sent people even to the Vice President level out to the field to pack kits, pull things together for customers at their locations to do the best we can. And so I believe that the way we're responding to this is really, really important.

And I think that our feedback so far from the majority of customers is they understand things like this can happen, but they respect and appreciate the way we're responding. It's hard to say how this ultimately, as Dave said, we don't know how this could affect our business going forward and we're hoping that it doesn't.

But we know that we have created some pain and the most important thing to us is that our customers know that we are focused on them first and foremost so that they can treat the patients that they take care of that.

We're also taking a lot of other specific actions too. It's not only deploying people into the field to make things better, but it is also about increasing production of similar or replacement products. For instance, we're offering our more protective Level 4 gowns to help bridge the supply gap. We've ramped up production, because we do source these gowns in multiple locations. And so, we're ramping up sourcing elsewhere.

We're working with folks that make similar products, both brand and I'd say, private-label products to ramp those up to get them going so we have those that go in through with surgeries. So it's really important that we look at all of these actions to make sure that we're keeping surgeries going and keeping our customers - the pain for our customers as small as possible. Next question, please.

Operator: We'll take our next question from Kevin Caliendo with UBS.

Kevin Caliendo: Hi, thanks for taking my question. I just want to go back to the opioid comment. I think you called out that it could take weeks or months to get this done, and that would run into two pretty high-profile state trials that are scheduled.

This increase in spending does it have anything to do with maybe a longer timeline or how should we think about those two state trials coming up in terms of the context of your expected spend now versus what it was before?

Mike Kaufmann: Yes. Clearly if those trials do happen, our spending goes up, which is why we gave a range. We're not trying to indicate that they will or they won't. We just know they're out there. We intend to vigorously defend ourselves. We feel really good that we are, and will be prepared for those trials that happen.

We're not going to use those trials or have those trials cause us panic and do something that doesn't make sense. And so we're going to continue to work with the four AGs and the rest of the states to get this initial framework done. It's still our goal.

But I wouldn't look at the increased spending around - particularly related to the trials. Again there is a range, but it's more around finishing up the negotiations. And then you have got to go through a documentation process like actually papering it.

And that takes - that will take some significant lawyer time to get things papered and work through all those details. So I think it's more things like those and then an implementation process working through the - how would we distribute the free goods? What changes can we make in the overall monitoring systems?

There's a lot of work to be done that will take legal costs. And so we continue to be focused on - and that's why we put that range out.

Kevin Caliendo: If I can ask one really quick follow-up on the API issue, I think Ricky brought it up earlier. You said that you thought there was enough supply in the chain to manage it. Can you quantify like how much is actually in the supply chain in terms of product? If China were to be a six-week issue or an eight-week issue, would that still be - would you just still feel comfortable with that?

Mike Kaufmann: Yes. It's a great question. You know, I can't really give you that level of detail. I don't really know where our competitors are. I know that this is something that we've looked at specifically product-by-product, looked at products that we think have a more potential risk of supply challenges because of where the raw materials are at and the importance of those products to the health care system.

And we have been working to ramp up supply in a few of those to carry a little bit extra. So for right now from what we see, we are not anticipating any problems. But if the shutdowns in China were to go longer or it spreads and creates other challenges, it's just hard to know at this point in time, but we think we're managing it to the best of our abilities at this point in time.

Kevin Caliendo: That's really helpful. Thanks so much.

Operator: And we'll go to our last -- we will take our last question from Eric Coldwell with Baird.

Eric Coldwell: Hey, thanks. Good morning. So in med-surg distribution, you cited that as both a headwind for revenue and profit. I guess I'm a little bit surprised. We've seen both inpatient and emergency department volumes increasing here for the last, call it, you know, give or take, two, three, four quarters. And it's not only increasing - accelerating the increase at least according to some internal data and external data we have.

We also had an early flu season. So what's going on in med-surg, med-surg distribution in the U.S, and what are the challenges that you're seeing now?

Mike Kaufmann: I think I'll start here. And then if there's anything to add, Dave can do that. I would say this. First of all, we're not seeing necessarily anything that would say that the actual med-surg historical volumes of very low-single-digit type of growth has changed significantly out there.

So it's hard for me to comment on what you're seeing. But we haven't seen anything, I would say, dramatic in that spot. Remember last year, we have a lot of lumpiness in our first couple of quarters related to the TSAs.

And so, some of our compare is, you know, we think caused by the fact that we're comparing to last year as we were going off those TSAs. And so if you look at our first half, we're roughly up 2%, which seems more in line.

And so I think we really need to get another quarter or two behind us to understand overall. And again, with this kit recall and gown recall, there is a few challenges there we're still trying to work through.

But there is nothing, I would say, big going on. And from all the work we've done by talking to our customers and to our reps, we still feel really confident about what we're doing in our commercial restructuring that over the mid

to long term, that's going to be a large value creator for us. But we've got to get through these challenges for that to happen.

Kevin Caliendo: Right. And I just - I know the kit recall really didn't pop up until January. So I was clearly talking more about, you know, the last couple of quarters, it just...

Mike Kaufmann: Right. Absolutely.

Kevin Caliendo: I guess maybe the TSA is an issue, we need to go back and revisit, but we can take this up on offline.

David Evans: Yes, Eric, I would just - I would reiterate a little bit what Mike said, which is I wouldn't read too much into single quarter of Q2 because of all the transition is going on last year. I'm really looking at our first half and saying, how is the first half compared to our expectations? And the first half is really - it's very much in line with our expectations.

Mike Kaufmann: Thanks again for the question. All right so let me close. I'd like to close by saying, we remain focused on our customers and their patients. And we will continue to deliver on our strategic priorities.

Thanks for your questions and your time today. And we look forward to speaking with each of you soon. Take care.

Operator: And this concludes today's call. Thank you for your participation. You may now disconnect.