Q4 FY18 Cardinal Health, Inc. Earnings Conference Call

August 6, 2018 8:30AM Eastern

Operator: Good day, and welcome to the Cardinal Health Inc. Fourth Quarter Fiscal Year 2018 Earnings conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Lisa Capodici. Please go ahead.

Lisa Capodici: Thank you, Sylvia. Good morning and welcome to Cardinal Health's Fourth Quarter Fiscal 2018 earnings call. I am joined today by our CEO Mike Kaufmann and Chief Financial Officer Jorge Gomez. During the call, we will provide details on our fourth quarter and full year results and update on our strategic initiatives and FY19 guidance.

Today's press release and presentation are posted on the IR section of our website at ir.cardinalhealth.com. During the call, we will be making forward-looking statements. The matters addressed in the statements are subject to 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 will be on a non-GAAP basis unless they are specifically called out as GAAP. Our GAAP to non-GAAP reconciliations for the fourth quarter and full year can be found in the schedules attached to our press release.

In addition, during the call, we will provide forward-looking guidance for FY19 on a non-GAAP basis. We do not provide guidance on a GAAP basis due to the difficulty in predicting items that we exclude from our non-GAAP earnings per share.

During the Q&A portion of our call, we ask that you limit your questions to one with a brief follow-up so that we may give everyone in the queue a chance to ask a question. As always, the IR team will be available after this call, so feel free to reach out to us with any additional questions. And with that, I will turn the call over to Mike Kaufmann.

Mike Kaufmann: Thanks, Lisa, and good morning, everyone. I'm glad you could join us. As Lisa mentioned, I'll start with some comments on our fourth quarter and full year 2018 and then spend a few minutes on the strategic initiatives we have under way to best position Cardinal Health for the future.

We have many opportunities ahead to build on Cardinal Health's strengths as a critical contributor to the healthcare industry. I feel good about the progress we are making. We encountered a couple of unexpected challenges in fiscal '18, and we are addressing those issues. We are on track and well positioned to deliver long-term growth and enhance value for all of our stakeholders.

Overall, for the quarter, our non-GAAP EPS of $1.01 came in higher than expected due to a lower tax rate. Revenue for the quarter reached $35 billion, up 7%. Non-GAAP operating earnings were $465 million. For the year, non-GAAP EPS was $5 on revenue of $137 billion, up more than 5%. Non-GAAP operating earnings were $2.6 billion and operating cash flow was $2.8 billion.

Turning to the pharma segment, I'll make a few comments. For the quarter, we saw revenue growth from both existing and new customers. In PD, while Red Oak continued to have a positive impact, our generic program remained a headwind overall. As it relates to brand drugs, the contribution was better than expected this quarter, but we know this is an evolving marketplace.

We provide significant value to our manufacturing partners and we will continue to work closely with them during this evolution. Both the specialty and nuclear businesses had a strong finish to the year. Specialty continues to be a standout, once again delivering robust double-digit revenue and profit growth, while nuclear also performed well, generating top-line growth and an even stronger performance on the bottom line.

As we enter fiscal '19, our focus is on taking the necessary steps to address the changing industry dynamics to position the pharma distribution business for long-term growth. You can see from our guidance and comments that we do not expect PD to grow operating earnings in fiscal '19. Customer contract renewals, some of which occurred in FY18, and generic deflation are expected to be the largest headwinds.

Our team is actively working on several initiatives to return this business to our more typical upward trajectory. We recognize that industry pricing dynamics, both upstream and downstream, are likely to change, and they should, and we are extremely skillful at adapting to these types of changes, as we have done it before.

Turning to the medical segment, while Jorge will discuss the specific items that affected the segment's earnings, let me share a few highlights. We continue to be pleased with the performance of the Patient Recovery business. Our integration of this business is currently on track.

We exited our TSAs with Medtronic for North America, Latin America, and the global supply chain in late July, and the team is continuing to move forward on exiting from the TSAs in other global regions in late calendar 2018 and early 2019.

At Cordis, we continued to see topline growth. We're making progress in executing on our plan to resolve the inventory and cost challenges we've previously discussed, and the team is moving with a great sense of urgency to implement our turnaround plan. I am pleased to report that service levels are significantly improved, and we have the enhanced inventory visibility we need to run this business more effectively.

As we said in May, it is going to take some time for us to see the benefits of these actions on the bottom line. However, we remain confident that Cordis is on a path to profitable growth by the end of fiscal year '19. At naviHealth, we have now completed the sale of a 55% interest in this business to Clayton Dubilier & Rice.

As you know, naviHealth has been a strong performer. We believe that this new structure will provide naviHealth with the resources needed to better support and accelerate its growth trajectory, while at the same time allowing us to focus on our larger businesses and strategies. We are excited to have CD&R as a partner in positioning this business for future growth and success.

Finally, both our Distribution Services and Cardinal Health at Home businesses performed well. Both grew earnings double digits during the quarter, driven by strong demand for their services. So, in summary, I remain confident in the prospects of our Medical segment, which has expanded our reach across the continuum of care and provided us with new avenues to enhance our value to customers and patients.

I am also very pleased with the progress Jon Giacomin has made in strengthening his management team, focusing on execution, and changing our go-to-market strategies and culture to drive product growth. While this will take some time, he has the right team in place, and they are working hard to achieve their goals.

Now, let me switch gears a little. As I look back over the past five years, we made great progress on three critical strategic priorities. First, recognizing that the overwhelming percentage of prescriptions were filled with generic pharmaceuticals, we knew that we needed a best-in-class, large-scale generics program.

Secondly, as specialty pharmaceuticals were becoming the focus for innovation and patient breakthroughs, we knew it was important for us to be a larger, more relevant player in this space with deep clinical experience and insights. Thirdly, with customers looking for cost efficiencies, we saw the opportunity to expand our medical products portfolio to leverage and complement our excellent medical distribution capabilities.

So, today, we have a generics business that is now a leader, with our 50/50 JV with CVS. We have both significant volume and a highly experienced team with industry-leading strategy and analytics skills. We have a specialty business that has grown from a $1 billion, mostly blood products business to a diversified specialty business with greater than $15 billion in revenue that competes successfully for many types of services with both manufacturers and providers.

And, finally, we have a wide breadth of Cardinal Health products through the expansion of our historical line and the additions of Cordis and Patient Recovery. We have a high-quality, significant, and cost-effective portfolio we can offer to our customers. We are now both a strong distribution and medical products company.

Today, we are squarely focused on driving the greatest value from this attractive portfolio of assets. At the same time, as you recall from the third quarter discussion, I indicated that we were undertaking a comprehensive, top-down, bottom-up review of our business, focusing on three key elements. One, our business mix and balance across the portfolio, two, our cost structure, and three, our capital deployment strategy.

Of course, in addition to these three areas, execution remains a top priority across the board. Let me take a minute to address each of these. In terms of the portfolio, as you know, we divested our China distribution business on February 1, having concluded that we would need to make substantial expenditures to drive future growth and allowing us to monetize our investment and focus our resources.

Then, in June, we announced the naviHealth transaction, creating a valuable partnership designed to accelerate growth. These are just two examples of how we are always looking at our overall portfolio and assessing where and when to take additional action that will optimize our performance and deliver the greatest value.

As it relates to our cost structure, here, too, we have made considerable progress. We are executing on near-term initiatives that will deliver at least $100 million of annualized cost savings and working on others that will deliver significantly more. The largest piece of the near-term savings involves a significant reduction in our workforce, which is mostly complete.

This reduction will have the benefit of simplifying our reporting structure while more closely aligning us with current industry dynamics. We are also working on a more detailed plan to optimize our go-to-market strategies and other elements of our cost structure to deliver additional savings.

Driving organic growth is a top priority for us, so you can expect that we'll be investing some of these savings back into the business. Finally, regarding our capital deployment approach, we are being very disciplined. This approach emphasizes reinvestment in the business for future growth as well as returning cash to shareholders through dividends and share repurchases.

Any M&A in the near term will be limited and focused. We believe that this approach, along with continued emphasis on financial flexibility, will deliver growth and long-term value. As I hope you can see, work is well under way in each of our priority areas. Let me be perfectly clear about the road ahead. I am not wed to the past.

Everything is on the table when it comes to driving long-term growth, delivering shareholder returns, and serving our customers. We have a great team, the right plans in place to move forward, and we are executing. All of us are committed to being disciplined with a laser focus on achieving results in the months and years ahead.

*Looking now to fiscal year '19, based on the factors we've communicated, we expect consolidated company revenue growth in the low-single digits and non-GAAP EPS in the range of $4.90 to $5.15.** This is consistent with what we said in May, adjusting for the impact of the lower tax rate this quarter. Jorge will give you more details in his remarks.

In closing, I want to thank each of our employees for their hard work in fiscal 2018 and their continued commitment to Cardinal Health. We are fortunate to have such a talented and dedicated team. We have work to do, but we are well-positioned for the road ahead. Together, we look forward to continuing to evolve and grow our business and to further enhancing our value as a vital part of the healthcare system.

With that, let me turn it over to Jorge to discuss our financials and outlook for fiscal year '19.

Jorge Gomez: Thank you, Mike, and good morning. Today, I will cover three topics. First, I will review some key elements of our fourth quarter results. Second, I will share additional information on our operational and strategic initiatives. Third, I will discuss our outlook for fiscal '19. To allow ample time for Q&A, my comments on these results will be focused primarily on the fourth quarter. Our full year results can be found in our press release.

On slide 4, Mike already covered revenue and EPS, so I will give you additional commentary on other financial items. Gross margin grew 7% in the quarter, driven by Patient Recovery. We show increased SG&A this quarter, primarily due to acquisitions and incremental 401k plan contribution.

This SG&A increase is not one we anticipate will continue, as we are laser-focused on managing our expenses in a very disciplined way. I will cover specific initiatives later in my presentation. Net interest and our expense was about $107 million in the quarter. The increase versus the prior year was primarily driven by the interest on the debt issued to finance the Patient Recovery acquisition.

Our Q4 effective tax rate was 12%, which was substantially lower than what we had modeled for the quarter. Let me take a moment to further explain. The Q4 tax rate was driven by a one-time tax benefit derived from the restructuring of international legal entities for Cordis. We took decisive action over the last three months to address the tax rate pressure we mentioned in Q3 that was related to Cordis financial performance in certain jurisdictions.

This one-time tax item was a result of the faster-than-anticipated progress we made in Q4. We are continuing to work on this front and expect to complete most of the steps of this plan in Q1 fiscal '19. This ongoing work on Cordis-related legal entity restructuring puts us in a likely position to benefit in fiscal '19 from U.S. tax reform to the extent we originally estimated.

Fourth quarter diluted average shares outstanding were approximately 312 million, about 7 million fewer shares than in the fourth quarter of fiscal '17. During Q4, we completed $100 million of share repurchases, bringing our full year repurchases to $550 million. We have about $900 million remaining under our board-approved share repurchase program.

In Q4, we also recognized a $1.4 billion non-cash goodwill impairment charge, which is excluded from our non-GAAP results. This accounting charge resulted from our standard annual impairment testing process and is primarily related to the quarter's business, including its operational challenges we discussed previously.

Our continued focus on cash flow generation and working capital management resulted in fiscal '18 operating cash flow of approximately $2.8 billion. This cash flow performance also reflects a timing of vendor payments of roughly $400 million that were accelerated in fiscal '17 and subsequently normalized in fiscal '18. Our cash balance was $1.8 billion at the end of June, with about $560 million held outside the U.S.

Now, I will add some detail for segment performance, found on slide 5. Pharmaceutical segment profit for Q4 was $416 million versus $505 million in the prior year. The decrease was in line with our expectations for the quarter in light of the generic program performance we mentioned in May.

To be clear, during the quarter, we saw a continuation of stable generic market dynamics. I'd like to highlight that the trends in our specialty business are strong. We continue to execute well operationally and commercially with strong top and bottom line growth. Industry dynamics are positive as well.

Continuing with the Medical segment on slide 6, segment revenue grew over 14%. This increase was driven primarily by contributions from Patient Recovery. The fundamentals of this business are solid. Segment profits decreased 17% or $24 million to $114 million in Q4. This decrease was driven by the performance of Cardinal Health-branded products, primarily Cordis, as well as compensation-related items. This was mostly offset by contributions from acquisitions.

Now, I'd like to direct you to slide 12, which connects Mike's commentary around strategy to the economics of the initiative that we're implementing to build a future of growth. In May, we told you that we're beginning an operational review. Here, we list elements of this phased, disciplined action plan to simplify our business, reduce cost, and invest for growth.

I'll walk through some of our current areas of focus and progress we have made. Regarding cost structure, we recently implemented enterprise wide cost reduction measures, which provide annualized savings in excess of

$100 million in fiscal '19. We're also beginning a zero-based budgeting journey, which we expect will deliver more than $200 million in annualized savings by fiscal '20.

This fundamental shift in mindset will allow us to successfully prioritize, invest, and drive earnings growth through cost discipline now and in the future. The Cordis repositioning is progressing well with our new leadership team in place. The team is moving with a sense of urgency to implement initiatives that will enhance the efficiency and profitability of this business.

In Q4, Cordis continued to see top line growth. As we said last quarter, we expect that Cordis will be on a path to profitable growth by the end of fiscal '19. Also, as I mentioned earlier, we are making good progress to resolve the Cordis-related negative tax dynamic we experienced in Q3. Related to Patient Recovery, I'm pleased to report that we achieved our fiscal '18 accretion goal. This business continues to perform in line with our expectations and we expect fiscal '19 EPS accretion for Patient Recovery to be consistent with the goals we outlined previously.

Regarding the pharma model, we are actively evaluating multiple upstream and downstream opportunities. We continue to have discussions with our branded manufacturer partners. We're also evaluating our contracting models in light of some of the shifts in this environment. We're actively managing our portfolio and expanding critical partnerships. This has translated into a few key business decisions.

We divested our China distribution business, established a strategic partnership for naviHealth, and expanded our relationship with Optum. We are diligently assessing additional opportunities. Finally, with respect to capital deployment, our priorities to deliver growth and long-term value are as follows.

First, reinvesting in the business for future growth, second, returning cash to shareholders, and third, focusing on limited and disciplined M&A. As we execute these priorities, we will maintain financial flexibility. With the right change agents in place throughout our global leadership team, we continue to implement these strategies and see the value thread of the enterprise.

Some of these areas have short-term runways to growth while others may take some time, but we wanted to give you some context around these initiatives because we are executing action plans now to address each of them. Next, I'll discuss our guidance for fiscal '19. Our full year enterprise financial expectations can be found on slide

14. For fiscal '19, we anticipate low-single digit percentage growth in our consolidated company revenue. We expect non-GAAP EPS in the range of $4.90 to $5.15. On our Q3 call, we indicated we would see modest EPS growth in fiscal '19 based on the expectation that we would finish fiscal '18 between $4.85 and $4.95.

As we just discussed, in Q4, we saw the impact of a large, one-time discrete tax item. Although this item impacts our year-over-year percentage change, it does not change our view of fiscal '19. While we may see some quarter-to-quarter fluctuations, we expect our non-GAAP effective tax rate to be between 25% and 28% for fiscal '19, which reflects the full year of benefit from U.S. tax reform as well as the resolution of our prior Cordis-related legal entity structure issues, which I mentioned earlier.

Our diluted weighted average shares outstanding are expected to be between 302 million and 307 million shares. Interest and other expense should be between $340 million and $360 million. We expect capital expenditures to be in the range of $360 million to $390 million.

Now, for the segment assumptions on slide 15, for our Pharma segment, we anticipate low-single digit revenue growth. For segment profit, we expect a high-single to low-double digit percentage decline due to headwinds related to customer renewals, generic programs, and the loss of Pharmerica. However, our specialty business is expected to deliver another year of strong growth.

We expect tempered brand inflation, which we are modeling to be in the mid-single digits. We expect generic deflation on the sell side to follow the pattern it did in fiscal '18, where the environment was competitive but stable. We anticipate Red Oak will continue to provide a year-over-year benefit, but less than in fiscal '18.

Due to the uncertainty around the New York State opioid assessment, we have not included any impact from this item in our fiscal '19 assumptions. For the medical segment, we expect low-single digit percentage revenue growth in line with market growth. We also anticipate mid-to-high single digit segment profit growth for the year, driven by projected contributions from Patient Recovery.

In closing, we have made significant progress in identifying a path to our growth in fiscal '19. We are also diligently implementing initiatives that will position Cardinal Health for a future of long-term success. We will continue to share more about this in the coming months. With that, I'd like to open the line and invite your questions.

Operator: Thank you, sir. Ladies and gentlemen, if you'd like to ask a question over the telephone at this time, please press star 1 on your telephone. Please ensure that the mute function on your telephone is switched off to allow your signal to reach our equipment. We kindly ask you to limit yourself to one question and one brief follow-up question.

If you find that your question has already been answered, you may remove yourself from the queue by pressing star 2. Again, it's star 1 to ask a question over the telephone. We will pause just for a moment to allow everyone the opportunity to signal. And, the first question comes from Michael Cherny from Bank of America. Please go ahead. Your line is now open.

Michael Cherny: Good morning and thanks for taking the question. So, I want to unpack some of the generic commentary you've made over the course of the call. You talked about stabilizing performance in the business, you talked about Red Oak being less of a contributor going forward.

As you think about the moving pieces and the competitive dynamic, where are the areas where you're gaining upside opportunities on generics, and what are the – is it competitive dynamics, sourcing, or what are the biggest areas that are creating those incremental headwinds on a year-over-year basis as you think about how generics play forward in the market against the commentary of that "competitive but stable"?

Mike Kaufmann: Thanks for the question, Michael. I would say, as you know, there's several components that we've talked about in the past to our generics program. The one that we continue to feel very good about is Red Oak. We continue to expect that to be a positive for us, just less of a positive than we saw this prior year.

We continue to see generic launches as a positive, although we see them as a pretty small set of launches this year. We continue to see overall generic volumes to be growing for us as we've been able to work with some customers to buy more generics from us and some recent wins.

Then, the biggest offset being the generic deflation, which we continue to see the market being stable compared to where it was this prior year. But based on all the other facts, the net of all that for our generics program we would still expect to be a headwind.

Michael Cherny: Thank you.

Mike Kaufmann: Next question.

Operator: Thank you. Next question comes from Ricky Goldwasser from Morgan Stanley. Please go ahead. Your line is now open.

Ricky Goldwasser: Yes. Hi. Good morning and thank you for all the comments. So, Mike and Jorge, I just wanted to focus a little bit on the branded inflation assumptions. You talk about mid-single digit assumptions factored into the guide. Can you clarify what the cadences are? What are you assuming for branded inflation between now and December?

And then, for the second half of the year, with the comments we've heard for manufacturers, it seems that we're unlikely to see much in terms of inflation between now and year-end. So, I just want to better understand whether you're assuming mid-to-high single digits in the second half of your fiscal year versus assumptions for the first half of the year.

So, that's the first part of the question. And then, the second part of it, obviously, you're just guiding for fiscal year '19, but when we think about the business and we think of everything you're doing, do you think that fiscal year '20 and beyond, you can return to growth in the distribution segment?

Mike Kaufmann: Thanks for the questions, Ricky. On branded inflation, I'll start there, a couple different things. I'll step back first and just say that we really believe that what we do for manufacturers and what's often forgotten with customers is incredibly valuable. We are a very important part, as you know, of a very secure and transparent supply chain where industry service levels have really been near 100%.

So I think both customers and manufacturers find what we do to be incredibly valuable, and I would expect that going forward. But, as I think about branded inflation, let me give you just a few comments. First of all, remember that less than 10% of our branded DSA margins are contingent to inflation, and we are continuing to have active conversations with those manufacturers that still have a contingent portion.

And so, we will continue to look at that and specifically look at reducing risk where possible on that. That being said, July is typically our second most important month when it comes to branded inflation. Now, that being said, it is a far distant second to January and our Q3. So while it's the second largest month, it's significantly less than January. And so, it was a little light.

What we saw in July was light, and again, we heard what you heard, which is branded manufacturers potentially waiting until end of calendar year. So, at this point in time, we still expect our Q3 to be our strongest quarter because that's when our contingent manufacturers tend to take their price increases.

We continue to have discussions with them, and while we are forecasting the overall branded inflation to be slightly less than what we incurred as an actual this year, a significant and vast majority we expect to happen in our Q3. So, it's going to be probably honestly hard for us to update whether it's going to be neutral, tailwind, or headwind until we really see what happens in the first part of January.

As far as giving you a little bit of size to that, I would try to be at least helpful here in the sense that if branded inflation versus our current assumption, which I said is a little bit lower than what we did last year -- than the actual incurred last year, if it's just a few percentage points off, we would expect to be able to absorb that within our current guidance range.

Now, if it continues to be zero or very low single digits for the whole year, then that might create some type of a headwind, but we think that we have enough room in our current guidance range if it's just off by a few percentage points.

Moving to your question on FY20, at this point in time, we just gave FY19. We really have a lot of strategic initiatives under way that are early in the process, and there's just a lot of variables that continue to evolve, one of them being what we just talked about, brand inflation. So, at this point, I'm not going to make any comments on '20, other than we're focused on positioning Cardinal right for the future.

Ricky Goldwasser: Thank you.

Mike Kaufmann: Next question, please.

Operator: Thank you. Next question comes from Charles Rhyee from Cowen and Company. Please go ahead. Your line is now open.

James Auh: Hi, it's James on for Charles. Could you maybe provide us with greater visibility regarding the impact of inventory to Cordis? Maybe help us quantify what the write down was this quarter, last quarter, and perhaps, how much is assumed in fiscal '19.

Jorge Gomez: I'll take that question. We have not provided specific numbers around inventory write-offs, but what I could tell you is that the team has made tremendous progress in fiscal '18 in terms of improving our demand planning system, improving our global supply chain platform. And as we go into fiscal '19, we believe we are in a much better position to manage our inventory levels across our global supply chain.

So, I'd say we're making good progress, the trends are moving in the right direction, and it's one of the key elements of our turnaround plan for Cordis.

James Auh: Okay. And, one of your peers recently noted that they renewed a notable customer contract but didn't expect that to be a margin headwind. In contrast, the repricing of Optum is a headwind for Cardinal.

Can you maybe provide us with some color on some of the components of a customer contract that could account for this disparity, and are there any notable customer pricings assumed in fiscal '19?

Mike Kaufmann: Thanks for the question. A couple things to keep in mind, each customer is very unique unto itself. There have been multiple times over the years where we've renewed customers with very minimal year-over-year margin impact because we've either been able -- because they've either been low-priced in market already at the time of the renewal, or that we've been able to find ways to grow other parts of their mix to offset some of those.

So, I think that it's hard to compare individual contracts. Each contract often is at different times in its lifecycle, different percentages of brand and generics that you have, and other items that can affect the mix. So, for us, when we look at our mix and where we are, the length of term of our contracts, our ability to go after additional mix and that, we do continue for us to see customer contract renewals to be a headwind for FY19.

Just a couple quick points on that: Many of those contract renewals have already occurred at '18, so what you're seeing is the impact. One of the notable ones is Optum, which is a customer that went from a three-year renewal kind of cycle to a longer-term six-year renewal, and we've agreed to work with them in a more strategic way.

And so, we've made some investments working with them as a partner going forward. And, as far as any other detail on customer contract renewals, we don't like to go into any detail on specific accounts at this point in time. Next question.

Operator: Thank you. Next question comes from Ross Muken from Evercore ISI. Please go ahead. Your line is now open.

Ross Muken: Thanks, everybody. So, maybe just trying to understand one thing on the quarter. So, if I look at the segment results for Medical and for Pharma, it kind of implies on the corporate side a larger loss than normal. Is that some of the compensation charges you were talking about? I'm just trying to figure out how to net those out and figure out what the true underlying margins were and how they net to the total for the quarter.

Jorge Gomez: Good morning, Ross. Thanks for the question. When we step back and look at the performance of the segments in Q4, we actually -- operationally, we landed pretty much where we thought we were going to in Q4. You're right, in the corporate segment there's a large expense amount that is related to the 401k contributions I mentioned in my prepared remarks. So that's what reconciles the performance of the segments to the total performance of the company in the quarter.

Ross Muken: Got it. And so, then, if Medical was truly a little bit sub-three for the quarter, how are you thinking about the cadence? Obviously, we're coming up against the inventory charges in the first part of last year, but then, some of the restructuring in Cordis is going to take some time, and then, you stated that Patient Recovery is on plan.

And so, are we expecting a step up over the balance of next year and the normal seasonality? I'm just trying to get that medical cadence a little bit more finely tuned.

Jorge Gomez: Yes, I think medical in Q4, it's hard to look at that and see those numbers as representative of the cadence that we'll see next year. The other element we had in Q4 for medical was the push down, the allocation of enterprise wide compensation entries that happened in the quarter.

So, when you combine that with the amount of inventory write-offs that we had in Q3, Q4, that brings the margins for medical in Q4 below the levels we would expect to see for that business. So, when we think about '19, we should see a lift in those margins given the non-recurring nature of some of those items.

Mike Kaufmann: Thanks. Next question.

Operator: The next question comes from Robert Jones, Goldman Sachs. Please go ahead. Your line is now open.

Robert Jones: Thanks for the questions. Mike, just starting on the EBIT guide for pharma to be down high-single digits to low-double digits, I know you've walked through some of the headwinds, obviously, but I was hoping you could maybe just give a little bit more of a breakdown, maybe rank order of the headwinds that you're expecting or baking into guidance in '19. If you could just talk a little bit about generic deflation versus the lower branded inflation expectations, the contract expiry, and the offset from some of the cost cutting.

Mike Kaufmann: Yes. So, why don't I just do this to be helpful, and you'll be able to figure out which pieces are specifically medical, pharma, or something that might be captured as a top-end. I'll just go through all of the puts and takes in descending order for each because I try to be helpful.

First one on the put side, Patient Recovery year-over-year accretion is going to be number one for us. Number two is going to be growth in our existing businesses, with specialty continuing to be expected at double digit growth. Tax is going to be third for us. We expect the tax rate, as Jorge mentioned, to be in the 25% to 28% range versus roughly the 29%. Shares would be next.

The discretionary 401k contribution, which we don't expect to have next year at this point in time. And then, next would be the net benefit from the cost structure initiatives. Remember that I told you that we expected annualized savings of over $100 million this year, but we are reinvesting a large portion of those back into the business to grow and drive future growth. So, those are kind of the puts.

The takes would be the divestiture of China and naviHealth. The P&L impact of both of those are -- obviously, China is gone and naviHealth is much lower next year. Customer renewals would be the second piece. And again, remember, a lot of those have already been done in '18. And then, generics programs would be next. Pharmerica would be after that, and last would be the tempered brand inflation that Jorge said.

So, specifically for us in Pharma, it's going to be the customer renewals, generics, Pharmerica, and brand.

Robert Jones: I appreciate all that, Mike. On that last point, brand doesn't sound like it's as big a headwind as some of the other issues, but you mentioned talking to some of the branded manufacturers about potentially changing fee structures. Just curious, have those discussions been received and what's their willingness to renegotiate the way that you guys get paid?

Mike Kaufmann: We have been having discussions with manufacturers, and in fact, not only discussions. As I mentioned, some of the ones that were contingent last year have been moved to non-contingent this year, and those have gone well. The reasons for the headwind year-over-year is essentially we're expecting a little bit lower inflation rate.

And as I mentioned, some of those converted, so there's some timing of when you go off of the contingent to non-contingent. So, those are really the things driving the year-over-year headwind for pharma. But, conversations have been going well. I think the -- what I would say about them is that I've not had any manufacturer that does not recognize. That is contingent that's not going to be able to have expected inflation that they don't understand that we're going to need to negotiate for higher rates.

And if some of the other things being talked about in the marketplace such as changes to WAC prices occur, all of the manufacturers understand that there needs to be discussions and that the way we get compensated will need to be changed. They're negotiations, so it's always hard to predict how those will go. But as far as having the right attitude to want to work with us, having the willingness to work with us, understanding that we provide significant value.

And that it's the best way to get to market, I don't think there's any doubt from any of the manufacturers or our self that that's the right thing to do and that we would expect to work through these. Thanks. Next question.

Operator: Next question comes from Erin Wright from Credit Suisse. Please go ahead. Your line is now open.

Erin Wright: Great, thanks. Can you speak to the rationale behind the naviHealth partnership/divestiture, as that business was growing nicely for you, and how does this put into perspective about how you're thinking of other potential divestitures, and are there any other exits you guys contemplated in your guidance at this time?

How do you envision your business mix evolving here? Thanks.

Mike Kaufmann: Yes. Thanks for the question, Erin. A couple things. We really like the naviHealth business, but as we look to a couple things that were important. One is there's a lot of changes in that space, and we knew there was going to be significant investment needed in that space, particularly over the next 12 to 24 months.

And, we knew that all of that investment would be not only an impact on the P&L, but even more importantly, an impact on our ability to focus on the things that will drive even more value in our medical segment.

And so, we began to explore opportunities of potential for us to be able to, if we could in a disciplined way, get back what we had invested in the business, but still retain some type of ownership with a path back as an opportunity to take it back if we wanted to over the midterm, then that might be something worth doing.

And so, we did that. We were able to accomplish, we were able to exit the business and get back more than what we had invested as well as retain 45% ownership and work with a really good partner like CD&R that we think is really well-positioned to invest significantly in the business over the next 12 to 24 months, both in terms of hiring people and talent, and it was a way for us to do this.

So, we really think that this maximizes the growth potential of naviHealth and really allows us to stay focused on the big key drivers for us in medical, which is turning around Cordis and landing the Patient Recovery business and driving the rest of our business. So, that was the overall reason behind that.

As far as other decisions on our portfolio, as you can imagine, we can't talk about those specifically right now. But as I said in my prepared remarks, there's nothing off the table. We continue to look at our portfolio. Each business needs to perform well and we need to feel that we're an advantaged owner, and with those types of lenses, we'll continue to take a look at our portfolio.

Erin Wright: Okay, great. On that note, just on the Patient Recovery accretion goals, can you quickly mention the accomplishments there and where we stand with that process of exiting the TSAs and how we should think about the financial implications of transitioning those off? Thanks.

Jorge Gomez: Thanks, Erin. So, with respect to our accretion goals, as I indicated in my prepared remarks, we delivered what we committed to delivering in fiscal '18, and we are also on track to be in excess of the accretion that we had forecasted for fiscal '19. So, things are going well in that part of the performance of the business.

With respect to TSA exits, we just began in the last couple of weeks the exit out of the TSAs in North America. It is a complicated process that is going well. It will take several weeks to bring everything in line and make sure that all the processes are working as expected, but the early indications are positive.

After we complete the exit from the North American TSA exit, we will move on to OUS TSA exits in the fall. We will begin to exit the arrangements that we have in place for Europe and Asia/Pacific. All the preparation work for those exits is also on track, and we feel good about the ultimate outcome of those transitions.

Mike Kaufmann: Next question, please.

Operator: Next question comes from David Larsen from Leerink. Please go ahead. Your line is now open.

David Larsen: Hi. You had talked about 16 cents of higher costs tied to client investments in the back half of fiscal '18. Are we through those, are those complete, and were those tied mainly to renewals? Thanks. And then, also, the opioid investment, are you through that as well? Thanks.

Jorge Gomez: Dave, thanks for the question. With respect to customer investments, yes, the amounts that we had contemplated to invest in fiscal '18 were completed. And it was a combination of customer renewals and other types of initiatives that we have in place with key customers.

Mike Kaufmann: As far as the opioids go, we continue to be committed to this. This is something really important to us as a company. We think that 10 years ago, we started doing our various programs that we had Generation Rx and have been making investments steadily over the last 10 years into this, both internally and externally. So I don't see that changing. At this point in time, it's hard to predict what the level will be in '19 versus '18, but we will continue to make investments in opioids going forward because it's important to us.

David Larsen: Okay. And then, how many more renewals do you have in fiscal '19? New renewals? Thanks.

Mike Kaufmann: Since we don't go through specific customers, it's difficult for us to really give you any color on that other than of the renewal impact. A portion of it has already occurred in '18. And then the rest are those that we know have come up for -- the contract expires or that we anticipate to renew early.

So it's just us looking at our entire portfolio, as we do every year. But other than that, I can't give any more detail. Next question, please.

Operator: Next question comes from George Hill from RBC Capital Markets. Please go ahead. Your line is now open.

George Hill: Hey, good morning, guys. I appreciate you getting me in. All of my questions have been asked. Jorge, one for you would be can you give us the timing of the net realization of the cost savings programs versus the gross number? It seems like you guys are going to reinvest a lot.

My follow-up is it seems we've stopped talking about the gloves business. Have we fixed the sourcing issues there and is that business back on track?

Jorge Gomez: Thanks, George. With respect to the savings, we have a number of initiatives going on. The most important one for fiscal '19 is in the process of being executed right now, and so, I expect to have the majority of those savings in '19, but not 100%. So, they will annualize as we go into fiscal '20, but the majority of those savings will be captured in '19.

There are elements around labor reductions, elements around changing spending policies, there is indirect procurement initiatives. All of those things are under way. We began to implement all of them, so I expect the majority to be captured in fiscal '19, but there's going to be a piece that is going to annualize in fiscal '20.

With respect to gloves, the situation is not that different from what we have experienced in the last several quarters. So, as we go into '19, I think we will be lapping the effect of the increased cost that we began to see in early fiscal '18. The teams continue to work on multiple fronts to address those cost concerns.

I don't see it as a headwind going into '19 at this point, but we are trying to make sure that we implement initiatives to actually improve and go back to our prior cost position with those products.

George Hill: Okay, great. Maybe just a quick follow-up on gloves. Is there a tariff step on there, or is that just a COGS issue?

Jorge Gomez: It's COGS, for the most part, this year.

George Hill: Thank you.

Mike Kaufmann: Next question, please.

Operator: Next question comes from Eric Percher from Nephron Research. Please go ahead. Your line is now open.

Eric Percher: Thank you. Mike, early on when you were talking about evaluating customer contracts and the way that you contract. And you were also speaking to pricing. You said that things were likely to change and that they should change. Is the “should change” specific to the pricing environment or did you actually mean that to extend to the way that we're contracting today with manufacturers? And do you see risk and opportunity from that?

Mike Kaufmann: I think it's both directions, but probably a little bit of different color. I think upstream with manufacturers, as we continue to see manufacturers make different decisions on the amount of inflation they feel comfortable with, if they're a contingent manufacturer. Then we're going to need to work through those contracts.

If manufacturers also decide to make any decisions around WAC prices and any reductions there, again, in order to make sure we get compensated for the value that we provide, those agreements are also going to have to change. And so, I think from that standpoint, as I mentioned earlier, we feel good about the conversations we're having.

It's a little early to say how they're going to go because manufacturers are still assessing themselves, what they're going to do, if anything in those areas. And so, we'll continue to monitor and continue to have discussions, but if they do change WACs or they do change their inflation assumptions, then the contracts should change, and they will change, but I believe we'll get through those.

As far as downstream, I think it's a little bit differently in the sense that we need to continue to have the type of conversations we've been having with customers to educate them on the changing marketplace and to make sure that we're looking to them to have those types of conversations, look at the mix that we have with the customers.

Because at the end of the day, it all comes down to balancing your pricing with your cost structure. We're obviously a little bit out of balance, which is why we've had declines in our pharma distribution, and we're working both on the cost side and the customer side to get that more in balance.

Eric Percher: And, having been through a transition once before, it feels like the last couple of years of working both upstream and downstream have been heavy lifting. If there was a change and you needed to recontract across because there had been a major shift in WAC, how difficult would that be if we know 1/1/21 or some certain date, you have to make that change?

Mike Kaufmann: It's a good question. I think part of the -- last time, I was the head of procurement when we went through this, so I was in the middle of all of those DSA negotiations. And one of the things that was helpful is that it kind of changed overnight, that it was very clear that it was gone away with the situation in the marketplace.

And so, every pharma manufacturer and all the distributors knew that things had to change because it was very obvious and everybody knew what had happened. In this case, I think there's still a lot of uncertainty, which is why I think you see a lot more conversations, because the fact is what we did 12, 13, 15 years ago has worked incredibly well.

Manufacturers have seen near 100% service levels, customers like it and have moved most of all their purchasing directly into their distributors and love the prime vendor model, the supply chain is very secure. When was the last time you heard anything about a counterfeit hitting the system?

So, I think everybody really likes the current system. It's transparent, it works, so I think one of the reasons why it's a little hard to predict is because we don't know exactly where it's going and it's working really well. That being said, if there is a date certain that something is going to change, that would be nice because then, we'd all know that what we're working to.

And, I think the conversations as such -- like I've said, everybody understands it needs to be changed, and it will. But, if it's overnight where it's more of a surprise, as you can imagine, like it was back then, it's probably going to be rocky for a few quarters as we work through them. So, it's not if we'll work through them.

I'm confident that we will, it might just be the timing could be a little off if it's more of a surprise and less of a date that's out there that we could work towards. Next question, please.

Operator: The next question comes from Steven Valiquette from Barclays. Please go ahead. Your line is now open.

Steven Valiquette: Thanks. Good morning, everybody. So, you guys are pretty good about providing guidance on a quarterly basis if your expected trends are a little bit different than what the street may be modeling, but given that you didn't make any comments about F1Q '19 and street is showing some modest EPS growth year-over-year.

I'm just curious if you're comfortable with the view of EPS growth in F1Q '19 or have you not even focused on the quarterly cadence of your EPS growth yet relative to what the street might be modeling right now?

Jorge Gomez: Steve, good morning. Thanks for the question. Let me start. The first thing I would say is at this point, we don't want to be too granular about the quarterly guidance because as you know, there are elements that create some difficulty in making those estimates.

For example, the ETR, as you've seen, could fluctuate from quarter to quarter, and therefore could move the EPS around a little bit without actually reflecting the underlying performance of the business. So, a few things that you should expect to see in the quarter in fiscal '19. Obviously, Q3 will remain one of the strongest quarters of the year due to the seasonality, particularly on the pharma side.

On the medical side, we should see improvement throughout the year as Jon and the team continue to improve the operations of Cordis, continue to transform the commercial approaches, commercial strategies for the overall medical segment. We should be seeing the benefits of those changes ramping throughout the year. And, that's probably what I could tell you at this point. Is that helpful?

Steven Valiquette: Yes, that's helpful. Thank you.

Operator: Thank you. Next question comes from John Kreger from William Blair. Please go ahead. Your line is open.

John Kreger: Hi, thanks very much. Mike, just to go back to your discussion a minute ago about the changing economics within the pharmaceutical distribution business. From your perspective, do you have a model that you envision that would work in an environment where the gross-to-net spread is getting materially smaller?

Mike Kaufmann: I don't necessarily have a specific model at this point in time. I think the importance is that we were very disciplined 12 or 15 years ago when we went through the model change. We created what we called our next best alternative model, where we really look at each specific manufacturer to the value that we deliver for them.

And as you know, each manufacturer has their own dynamics and mix, and the adjustments they may make and the growth they may have differs. So, we're going to continue to work with each pharma manufacturer to see what is the right type of structure that may work for them and for us. We're going to be really focused on our value prop and to make sure we get paid for what we do.

But I'd say it's still a little too early to know exactly what might be the right model, but we're having multiple discussions, including keeping it similar to what it is but higher rates if the WACs are lower. So, that model could be a very simple change from that standpoint, but we're looking at a continuum of different opportunities.

John Kreger: Great, thanks. And then, a quick follow-up for Jorge. The guidance in fiscal '19 for low-single digit revenue growth within the medical segment -- if you take out the acquisition benefit of Patient Recovery, what would you say the organic growth implied is on the top line?

Jorge Gomez: We haven't broken down the pieces of the revenue growth, but I would tell you that within the Medical segment, there are a number of businesses that are growing organically well. You have At Home, you have Cardinal brands other than Patient Recovery, we have Cordis, which is also ramping up, continues to grow from a top-line perspective. So, I think there are a number of multiple businesses within the medical segment that are organically showing increment from a top-line perspective.

Mike Kaufmann: Next question.

Operator: Thank you. Our last question comes from Eric Coldwell from Baird. Please go ahead. Your line is now open.

Eric Coldwell: Thanks very much and good morning. Jorge, at the end of the call, you made a comment on the New York State opioid assessment. I didn't catch that. I was hoping you could clarify what you were talking about. I do know the judge's decision there was considered a negative precedent. But I'm not sure I'm familiar with this assessment that you're talking to.

Jorge Gomez: Sure. Let me help you a little bit with that. So, in April, the state of New York created an aggregate $100 million annual assessment on all manufacturers and distributors who sell or distribute opioids in New York. Based on that law, the initial payment is due on January 1st of '19 for opioids sold or distributed during calendar year '17. And we haven't factored any impact from this newly passed law into our guidance because there is still a lot of uncertainty around how it would be implemented. Some of the uncertainties that we see with this law include -- there's a significant legal challenge pending against that law. There are a lot of complexities in the way the law was written and we're awaiting some guidance from the state. Frankly, there's a lot of uncertainty in terms of how much each participant in that market will actually pay.

Eric Coldwell: Thanks very much. That's helpful.

Mike Kaufmann: Great. Well, thanks, everyone. Are there any more questions?

Operator: There are no further questions over the telephone at this time, sir.

Mike Kaufmann: Great. Well, I just want to thank everyone for taking the time to join us this morning, and we look forward to seeing many of you at some of the upcoming conferences. Thanks, and have a good day.

Operator: Thank you. Ladies and gentlemen, that will conclude today's conference call. Thank you for your participation. You may now disconnect.

*Corrected for accuracy. The speaker actually said, "*Looking now to fiscal year '19, based on the factors we've communicated, we expect consolidated company revenue growth in the mid-single digits and non-GAAP EPS in the range of $4.90 to $5.15."*