Q4 FY19 Cardinal Health, Inc. Earnings Conference Call

August 8, 2019 8:30AM Eastern

Operator
Good day, and welcome to the Cardinal Health Inc. Fourth Quarter Fiscal Year 2019 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 ***Cardinal Health, Inc. - VP of IR***
Thank you, John. Good morning, and welcome to Cardinal Health's Fourth Quarter Fiscal 2019 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 also provide guidance for fiscal year '20. You can find today's press release and presentation 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 all relevant periods can be found in the schedules attached to our press release.

In addition, during the call, we will provide forward-looking guidance for fiscal '20 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 and non-GAAP effective tax rate.

As always, the IR team will be available after this call so feel free to reach out to us with any questions.

I will now turn the call over to Mike.

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Thanks, Lisa. Good morning, everyone, and thanks for joining us. Let me begin by providing a few thoughts on fiscal '19 before turning it over to Jorge to discuss the financial results for Q4 and for the year. Then I'll share some perspective on our fiscal '20 outlook and our commitment to future growth.

In the last 18 months, we addressed various business challenges and put near and long-term plans in place to grow in the future. Importantly, in fiscal '19, we delivered on the overall commitments that we made at the beginning of the year. Some of our highlights from fiscal '19, including progress against the 6 strategic priorities we outlined a year ago, are as follows: notably, we exceeded our initial EPS guidance, delivering $5.28 per share; we continued to see double-digit revenue and profit growth in Specialty, Cardinal Health at Home and Medical Services as we advance these strategic growth areas. With the recent renewals of CVS Health and Kroger, we now have contracts with our 3 largest customers for at least the next 4 years.

Regarding our cost structure, we have been engaged in a cost optimization program and the initial work has exceeded our savings targets. We delivered $133 million this year, positioning us to make strategic reinvestments and generate significant future savings.

For capital deployment, our focus on strong cash flow generation resulted in operating cash flow of $2.7 billion for the year. We delivered value to our shareholders in the form of dividends and share buybacks and we improved our financial flexibility while continuing to reinvest in the business.

In the portfolio and partnerships area, we took steps as part of our ongoing portfolio management strategy. During the year, we rationalized and exited underperforming geographies and finalized the partnership to accelerate the growth of the naviHealth business. With respect to Pharma, we are pleased that our Pharma Distribution business met plan for the year. However, meeting the plan is not enough. We are focused on returning to sustainable profitable growth. To achieve this, we have work underway across a few key areas that I'll discuss when I cover our future outlook.

Turning to Medical. While we improved execution across the segment during the year, we did not meet our expectations. Challenges from Cardinal Health brand products, including cost associated with supply chain infrastructure and commodities, prevented this ongoing work from translating to the bottom line this year. I'll discuss this in more detail when I talk about fiscal '20.

A quick update on Cordis. This business is on a path to profitability with sustained top line growth in many geographies and improving trends for fill rates and back orders. Additionally, we improved fill rates in our medical solutions business, which includes patient recovery. Overall, we made positive strides in fiscal '19 and we have confidence in our strategic direction and our ability to translate this work into results in the future.

To provide some additional color on Q4 in fiscal '19, I'll turn it over to Jorge.

Jorge Gomez *Cardinal Health, Inc. - CFO*
Thanks, Mike, and good morning. I'll provide a high-level overview of the quarter and a review of the year. As always, our results for both can be found in our press release.

For Q4 results, Pharma segment profit performed roughly as expected while Medical met our forecast for the quarter, primarily due to a large charge, which I will explain in segment results. Our ETR was once again lower than expected in the quarter due to multiple items that were more favorable than we anticipated. As a result, we delivered a better-than-expected Q4 EPS of $1.11.

Turning briefly to the segments. Pharma delivered a strong Q4 with segment profit increasing 7% to $447 million, reflecting the positive impact from Specialty Solutions, a higher contribution from brand sales and mix and the benefits from our cost-savings initiatives. These were partially offset by generics program performance and customer contract renewals.

Medical segment profit decreased 15% to $97 million, driven primarily by Cardinal Health brand products. Much of this reflect a charge related to an exclusive distribution agreement with the Cordis supplier. This decline was partially offset by the benefits of our cost-savings initiatives.

Our at-home, national brand and services business performed in line with our expectations. We continued a strong cash generation in the quarter, finishing the year with $2.7 billion in operating cash flow. Additionally, we repaid $1.1 billion of long-term debt, reflecting our commitment to a strong balance sheet.

Transitioning now to the full year, I'll provide an overview of the results and a perspective on the commitments we established at the onset of the year. Total company revenue for the year was up 6% to $145.5 billion. Total company gross margin decreased 5% to $6.8 billion, and operating earnings were down 9% to $2.4 billion. Fiscal '19 EPS came in at $5.28, a 6% increase versus last year. The full year ETR came in around 22%. This lower-than-expected rate was driven primarily by the legal entity reorganization work related to Cordis, which we completed in Q1 of fiscal '19 and we discussed on prior calls.

For the Pharma segment, as Mike mentioned, we met our expectations for the year. Revenue increased 7% to $129.9 billion due to sales growth from Pharma Distribution and Specialty Solutions customers, partially offset by the divestiture of the China distribution business.

Segment profit decreased 8% to $1.8 billion, reflecting the negative impact from generics program performance, customer contract renewals and opioid-related expenses. It was partially offset by Specialty Solutions performance, a higher contribution from brand sales and mix and the benefits from our cost-savings initiatives.

Despite several bright spots in businesses such as at-Home and services, which both delivered another year of strong results, Medical segment performance for the year was below plan.

Revenue was flat at $15.6 billion, with growth from existing customers offset by the net impact of acquisitions and divestitures. Segment profit decreased 13% to $576 million, driven by the performance of Cardinal Health brand products. This was partially offset by the benefits from cost-savings initiatives and the net impact of acquisitions and divestitures.

Of note, total company SG&A improved 3% versus last year due to dispositions and our cost optimization work. We also improved interest and order expenses 12% versus last year, primarily as a result of the lower debt balance and higher cash balances.

Importantly, we demonstrated a strong financial discipline throughout the year from a capital allocation perspective. We increased hurdle rates for capital deployment initiatives and ensured capital was allocated strategically and effectively. This allowed us to return $1.2 billion to shareholders and to strengthen the balance sheet of the company by paying down $1.1 billion of long-term debt.

Before I turn it back over to Mike, I'd like to share a few remarks. I am very grateful for the nearly 14 years that I have spent at Cardinal Health and I would like to express my gratitude to the investment community as well as to Mike, the whole management team, our Board and the rest of my Cardinal Health family, especially the finance team. This is a fantastic company with incredible people and an incredible mission, has been a privilege to work in service of that mission.

With that, I'll turn it back over to you, Mike.

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Thanks. I'd like to take a moment to thank Jorge for his partnership in his numerous roles over the last 14 years. As our

CFO, he has been a true thought leader and has set the pace for change. We look forward to continuing the many initiatives that he began.

I also want to thank Jon Giacomin, who has contributed in countless ways over the last 17 years. His passion for the business, the details and the people propelled him as a leader in Pharma. And over the last 18 months, he has laid the groundwork that positions Med for future success. Both Jorge and Jon led strong teams that will continue to build on their positive momentum going forward. On behalf of the Board and the management team, we wish them both all the best in their new roles.

Now let me share some perspectives on our path forward. As you know, we operate in a dynamic industry with significant consolidation, increasing demand, a shifting generics landscape, growth in specialty and the delivery of care moving toward the home. We have and will continue to shape our portfolio, strategies and priorities with these trends in mind.

In Pharma, we are focused on fueling continued growth in key areas while also making progress regarding our Pharma distribution model. Accelerating our growth platforms like specialty and our services businesses are a priority.

For instance, we have made targeted investments to develop and grow our medication therapy management, telepharmacy and health messaging services businesses. We like what each of these can do on its own. But working together, they can increase connectivity among manufacturers, payers, pharmacies and patients.

Regarding Pharma Distribution, we are testing new downstream models and evaluating upstream strategies. Also, while we expect the rate of brand inflation in fiscal '20 to be similar to fiscal '19, we will continue to transition even more of our buy side margin to noncontingent contracts. Overall, we remain confident in the long-term future of the pharmaceutical industry, our role in the supply chain and the strength of our assets and capabilities.

Before I leave the Pharma segment, I'd like to spend a few minutes here on the opioid epidemic, a significant issue that we care deeply about and one where we do significant work, both in our company and in our communities.

We have an important but limited role in the pharmaceutical supply chain, have sophisticated anti-diversion systems and do and have always done, extensive reporting to federal, state and local regulators. Even though wholesale distributors do not drive demand for prescription opioids, we have been targeted in lawsuits, many with novel and unprecedented legal claims that go well beyond the balance of credibility. We are vigorously defending ourselves against these suits, while at the same time continuing to explore resolution opportunities that makes sense for our shareholders.

And as always, we will continue our long-standing commitment to making a meaningful difference in communities. In fact, this year marks the 10th anniversary of Generation Rx program, which, with more than 100 pharmacy school chapters, has reached 1.7 million people around the country with educational and training materials to prevent prescription drug misuse.

For over a decade, the Cardinal Health Foundation has supported fighting prescription drug misuse and the opioid epidemic in other critical ways as well. We look forward to continuing these efforts as we work alongside others in the industry, government and health care to find solutions.

Now turning to the Medical segment. We believe in this business and its role in helping our customers deliver efficient and high-quality care. Our recent history has included some execution challenges in this otherwise attractive market.

Meds will be a growth engine for us as we successfully execute our initiatives to drive top line growth and improve our cost position. To that end, we are concurrently engaged in the following: first, we will continue to invest in our growth platforms, both at-home and medical services will continue to deliver strong results.

Second, we are enhancing our commercial capabilities to improve our offerings and mix. We recently introduced the new sales structure that will enable us to better focus on our customers and make our team more effective.

Third, we are making progress on optimizing our infrastructure and our portfolio. Both of these areas are complicated and take time but we are committed to improving and transforming our manufacturing, supply chain and data capabilities. Overall, the Medical team is focused on executing plans that we are confident will drive sustained future growth.

As we move forward with multiple initiatives across the company, we remain committed to disciplined capital deployment and continuous cost management. This will enable us to reinvest in key opportunities and in strategic areas close to our core businesses in a way that leverages our operating capabilities. For example, we are empowering leaders to leverage automation, analytics and additional technologies to drive cost savings and aligning internal accountability to ensure we deliver results.

We are confident that we will generate more than $500 million in savings relative to our fiscal '18 baseline in 5 years or less. We will continue these initiatives through and beyond fiscal '20 with a balance of urgency and discipline to create value for our shareholders, customers and employees.

We also remain committed to returning cash to shareholders and to improving our balance sheet. At this time, we expect modest increases to our dividend until we return to the lower end of our target payout ratio of 30% to 35%. Additionally, we intend to further strengthen our balance sheet by paying down at least $1 billion of long-term debt in fiscal '20.

With this in mind, let me turn to our fiscal '20 outlook on Slide 13. First, we anticipate an EPS range of $4.85 to $5.10. Interest and other expenses should be in the range of $295 million to $315 million. While we may see some fluctuations across quarters due to discrete items, we expect a full year ETR in the range of 24% to 26%. Also we expect our diluted weighted average shares outstanding for the year will be 292 million to 297 million shares. As we continue to thoughtfully manage our cost structure and deploy capital, we expect to deliver incremental savings of more than $130 million on top of the $133 million we achieved in fiscal year '19.

In connection with these cost-savings initiatives, we expect to record restructuring charges in the range of $120 million to $145 million. And we may incur additional charges as we pursue our long-term savings goal. We expect capital expenditures to be in the range of $320 million to $360 million.

As it relates to our fiscal '20 segment outlooks, while we expect mid-single-digit revenue growth for the Pharma segment, we anticipate high single to low double-digit profit decline due to customer contract renewals, primarily those we previously announced and the continued headwind of our generics program. Essentially, the full effect of our recent renewals with CVS Health and Kroger will appear in fiscal '20.

Additionally, we expect opioid-related litigation expenses to be about $85 million, an increase of about $20 million for the year. As a reminder, we record these expenses in our Pharma segment. Partially offsetting these headwinds, we expect Specialty to continue its trajectory of strong growth.

In Medical, we believe our ongoing work to transform key areas of the business will begin to translate into results. We expect low single-digit revenue growth and low double-digit profit growth, reflecting a positive contribution from Cardinal brand products. Keep in mind that our fiscal '20 guidance does not include potential uncertainties of changes around the regulatory environment, opioid-related taxes, commodities, tariffs and medical device taxes.

Looking forward, we know our success depends on our people. We are committed to attracting and developing world-class talent at all levels. And as I wrap up my remarks, I'd like to share some updates in this area.

As you likely saw in our press release yesterday, our Board of Directors approved 2 new members. I'm delighted to welcome Dean Scarborough, a former Chairman and CEO of Avery Dennison and John Weiland, former Vice Chairman, President and COO of C.R. Bard. Both bring global management backgrounds and industry-leading expertise to further strengthen our Board with a broad array of skills, experience and viewpoints. We look forward to benefiting from their perspectives.

Regarding our senior management team, we are actively engaged in an external search for our next CFO. In the meantime, we have brought on Dave Evans, who will serve as interim CFO, as you may have seen in our filing this morning. I've known Dave for more than 30 years and he has extensive experience leading finance organizations and large companies, including the Scotts Miracle-Gro and Battelle. He has been working with Jorge to get up to speed and I appreciate his partnership as we conduct our search.

Also on the topic of senior management, I'm excited to have Steve Mason in his new role as CEO of the Medical segment. With his leadership, we look forward to building on the steady progress underway in this business. Steve has a track record of positive results in every business he's led throughout the company, and he will empower the team to drive performance and generate long-term growth.

To wrap up, we believe in our team and we are confident that our strategic plans and our near to midterm objectives will enable a future of growth for Cardinal Health.

With that, let's now open it up for questions.

Operator
We will now go on to our first question from Charles Rhyee of Cowen.

Charles Rhyee *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*
I want to talk about the Medical business here a little bit. I mean, Mike, you expressed confidence in this business and you feel like it's going to deliver value for shareholders. Obviously, there's been a struggle over the last few years here. And over the last couple of years, right, some of the issues have kind of shifted to different spots here and there. Can you talk about sort of where you think you are in that process in kind of rightsizing this business here or really kind of identifying the issues? And what kind of gives you sort of confidence here as you move to the next fiscal year? We think we have -- we've identified all the issues now and we are kind of poised back for growth.

And then I guess, secondly, sort of can you kind of remind us, specify how much of the charge was for Medical and assuming all the restructuring charges assumed in the guidance is for Medical as well?

Michael C. Kaufmann *Cardinal Health, Inc. - CEO & Director*

Well, I'll address the restructuring charges real quick. The restructuring charges in the guidance are for the entire company. So that would be any and all of the expected restructurings across Pharma, Med, and our functions would be covered by those initial restructuring charges. And as I also said, we may have additional ones as we continue to get after the $500 million number that I said that we would hit.

So just -- so that's that piece. As far as my confidence in Med, I think a couple of things. Some of them were complicated things like working through old agreements, getting through the TSAs, a lot of those things that created a lot of the noise in the Medical segment, we're through those. We also -- as you know, we don't plan to do any product acquisitions in the near future in that space or M&A around products in that space so that we can focus on execution. Also, I have a ton of confidence in Steve. He's been a great operator in all of the businesses that he's run and he's surrounded by a really good team that Jon Giacomin put in place.

And it's kind of to your point. A lot of the challenges that we have in Medical have been a little bit self-inflicted and I feel that where -- with the people that we've added, the fact that we're through a lot in the complicated transitions and we're focused on execution, that's why we feel confident. We have seen good underlying demand in the business and I think that's kind of the key areas at this point in time.

Charles Rhyee ***Cowen and Company, LLC, Research Division - MD and Senior Research Analyst***
And if I just follow up from a modeling standpoint. When we think about the guidance in Medical, should we sort of think about that ramping up through the year? Or is that something we could see maybe earlier in the year? Maybe from a cadence perspective you can give us a little bit of thoughts around that.

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. Good question. This year, we really expect the Medical guidance to kind of be -- for the segment to not be as back-end loaded as it has been in the past. We really think we have a more normalized, I would guess, cadence for our quarters for Medical this coming year. And you're right. You also mentioned earlier I didn't get to is the charge that Jorge talked about that affected our Cardinal brands, products because it was in the quarter's related charge, and obviously, we don't expect that to recur at this point in time.

Operator
We will now move on to our next question from Ricky Goldwasser of Morgan Stanley.

Rivka Regina Goldwasser ***Morgan Stanley, Research Division - MD***
So my first question is on specialty. It seems to be an important contributor in the quarter. So can you just share with us what's driving the outsized growth? Is it specific products or customers? And how sustainable is it? And also if we think about just the margin in the quarter, if you exclude specialty contribution, would distribution segment margin, operating margin be up year-over-year?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. I'll give you a couple of comments on that. I'm not going to able to split out the margin component but we're really proud of the performance of our specialty business. Victor and Joe DePinto and the whole team have done a very nice job there and we do expect that business to continue on a trajectory of strong growth. The growth is a lot coming from just our customers growing and new items in the market, growth of the items already in the market. So a lot of it is just positive growth in Specialty overall.

I wouldn't say that it's massive changes in the share of those type of things. It's really just the segment is growing well and we believe that, that will continue to happen, particularly as it relates to our more downstream customers. And then as -- when I look at our upstream services to Pharma, we continue to see very good progress in growth in those businesses, too, for us this past year and we'll continue to look forward to seeing those grow going forward.

Rivka Regina Goldwasser ***Morgan Stanley, Research Division - MD***
Okay. And then one follow-up, Mike, on your opioid comments. I mean obviously, we've seen some press in the last couple of days around potential settlements. So thinking about that and in line with earlier comments about paying down debt, from your standpoint, is it feasible to resolve all the existing and potential litigation in the manner that's financially manageable for the company?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Well, there's a lot to take into consideration there but at this time, it's so early and we've got to, as I commented on opioids where we stand, we feel good about the work that we've done historically. We believe that we operate in an outstanding system to manage this. We have always and will continue to report all those things that we do, we feel strongly about. But specifically commenting on any litigation and settlement, I don't think would be appropriate at this time.

Operator
We will now move on to our next question from Michael Cherny of Bank of America Merrill Lynch.

Michael Aaron Cherny ***BofA Merrill Lynch, Research Division - Director***
Just to go back quickly to the comment you made, Mike, about the charge. Is there any way to just give a size there or magnitude relative to the impact we had in the quarter?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. That charge itself basically was the difference between our Medical segment hitting our expectations for the quarter and missing expectations. So that is the primarily contributor of not delivering on that. And just to give you a little more color, it was a charge related to an exclusive distribution agreement with a Cordis supplier. It was entered into -- over 2 years ago, and other than that, it really wouldn't be appropriate to comment further on the specific supplier, but we still feel incredibly good about the progress we're making with Cordis.

Michael Aaron Cherny ***BofA Merrill Lynch, Research Division - Director***
No, that color is very helpful. And then just one quick question on the Pharma outlook. When you talked about the challenges you're seeing, continuation of the generics program, can you maybe parse that out a little bit more? There's varying data points around the dynamics of the buy side, sell side spread. And so as you think about your book of business and [way] you're going to, either whether trying to offset those headwinds or what you're seeing that you have to wait through, especially with your new contracting, maybe just dive in a little bit more into the color around how that's impacting the Pharma outlook for '20?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Sure. Thanks for the question, Michael. A couple of things. First of all, the largest year-over-year driver for Pharma being down is going to be our customer contract renewals with customers that we've already announced that I mentioned, CVS Health, Kroger. So that is our biggest headwind year-over-year for Pharma.

Our second headwind is our generics program. It's a smaller headwind in FY '20 than it was in FY '19. So we like the progress that we're making. Specifically, to give you a little bit of color, I hate to give a lot of details. We like to talk about it as one overall program, but I will give you a little color that we are seeing the generic deflation component itself beginning to improve. And -- but when you take a look at the generic launches, the ability for Red Oak to continue to drive cost savings, some of those tailwinds are a little smaller and -- but we are seeing some market dynamics that would tell us that things are beginning to improve. But overall, our generics program continues to be a net headwind for us next year.

Operator
We will now move on to our next question from Lisa Gill of JPMorgan.

Lisa Christine Gill ***JP Morgan Chase & Co, Research Division - Senior Publishing Analyst***
Mike, just starting with the $130 million of cost savings. Will that primarily be on the Medical side or between the Pharma and Medical side? How do I think about that?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. We -- it's really spread across both segments. I'm not sure if it's proportionally higher, it's not -- I wouldn't say a lot different on either side. But our functions, obviously, all are working on things to be more efficient. That will then get pushed into the segments and each one of the segments are working on their components. And I feel good that every single department, whether a business unit or function is committed to hitting our target of $130 million of incremental savings this coming year.

Lisa Christine Gill ***JP Morgan Chase & Co, Research Division - Senior Publishing Analyst***
And then this is a follow-up. When you talked about the renewals being the biggest headwind, as we think about those contracts over the 4-year period of time, do the economics improve over that 4-year period of time?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Well, a couple of comments. First of all, there isn't any like step-downs in pricing over the next 4 years related to those unless there would be some change in the number of stores or some large change or something like that from the customers that wouldn't be typical. So typically, those contracts have a fixed program over the lives of them. So that's one thing to keep in mind.

Other than that, they often can improve slightly just because volumes can go up over time. But typically, the rates don't change much. You may get a few more dollars to your bottom line based on increased volumes and we're excited to be aligned with really excellent customers such as CVS and Kroger, who have been historically growing and have really good business models that we're excited to be partnering with them.

Operator
We will now take our next question from Robert Jones of Goldman Sachs.

Robert Patrick Jones ***Goldman Sachs Group Inc., Research Division - VP***
I guess, Mike, just to go back to the Pharma guidance. Obviously, because it does seem like a pretty big reversal from what you guys saw this quarter. Even if I exclude the additional opioid litigation charges that you shared, it still looks like you're calling for high single-digit declines in profit year-over-year. And if I remember correctly, the comments I thought on the CVS renewal previously were kind of that it was typical structure and nothing really different than what you'd seen in the past. But today, obviously, that, plus Kroger, seems like it's driving, if I'm hearing you correctly, it sounds like it's driving most of this anticipated decline year-over-year.

Could you maybe just share a little bit more around what you're seeing in those contract structures and pricing, even relative to maybe what you've seen in the past as far as those renewals have gone?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. A couple of things. I would say that, first of all, I still feel very confident that we got very, fair and appropriate contract renewals with both of those accounts.

Remember that they are contracts that are 4 years or longer. So they are little bit longer than typically the contracts have been. Remember that it also is a full year impact. Essentially, we have a full year-over-year impact because as I mentioned specifically to CVS, it was a July 1 start date. So that's a very important component of thinking about the year-over-year impact. So hopefully, that's helpful.

Robert Patrick Jones ***Goldman Sachs Group Inc., Research Division - VP***
Okay. Great. Yes. And I guess just one other thing you had mentioned, I believe you said, was not in guidance was any kind of tariff exposure. Is there anything you could share as far as just how we should think about the potential impact? How much of the portfolio is exposed to potential changes or issues of tariffs?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Sure. As you can imagine, it's really hard to predict this. But I'll give you a little color in the sense that, first of all, we do have -- currently, in our numbers, we do have forecasted some small headwind related to tariffs that are already in place. And so we have already had the opportunity to deal with tariffs this past year. We have done a good job in managing the impact so far and it was a small headwind for us in FY '19. So we built that continued assumption in.

What we didn't build in was what new tariffs may be because it's just so hard to predict. And even when you get numbers such as a certain percentage at a certain dollar amount, oftentimes after you get through all the wrangling, the medical products have had a chance to be carved out because of some of the concerns and issues they could create on increased pricing to consumers in the United States. And so we constantly work with our industry to make sure we educate folks on the importance of those products and the cost that it can have on the health care system or shortages and other issues.

So it's so hard to predict what that could be. That's why we don't have anything built in at this time. But each time something comes up, we will make sure that we try to help give you some color on that and let you know what's going on those when they happen going forward. Next question?

Operator
We will now move to our next question from Kevin Caliendo of UBS.

Kevin Caliendo ***UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution***
Couple of questions, you mentioned quickly that generic deflation was improving. Is that on the sell side or on the buy side? Can you talk a little bit about the dynamics there?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. When we're talking about generic deflation, for us, we're always talking about the sell side because really the buy side is how Red Oak is doing. We continue to be very confident in the team and the capabilities of Red Oak Sourcing. The partnership there with CVS Health continues to operate very well. But when I talk about that, what I'm saying is that we're seeing it improve from a sell side deflation standpoint.

But remember, it's just one component of our overall generics program and I get hesitant to just focus in on that because you still have to look at what the launches are going to deliver this year, what penetration is going to deliver this year and what you're going to be able to do from a year-over-year cost savings standpoint. So all in, our generics program is still looking to be a net headwind for the year.

Kevin Caliendo ***UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution***
Just a quick follow-up, thinking about that $130 million. Are you expecting that all to sort of drop to the EBIT line and should we -- I'm looking at cadence for the year, Medical is so lumpy in fiscal '19. Is there any reason to think cadence for earnings over fiscal '20 should be different than what we saw in fiscal '19?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Well, I think there was, to your point, some lumpiness in Medical that we don't expect this next year. We had some bumps, remember? We talked about it in our Q3 around transitioning up TSAs. This Q4 we had a large charge related into branded -- our Cardinal branded products. And so with those alone or 2 pretty lumpy items that occurred during the year. You can also have flu type of things that comes earlier or late can affect both businesses. So those things -- set aside flu. The other 2 things, we don't expect to happen this coming year so we would expect Medical to have a more normal cadence.

As far as the $130 million that -- we will look at that all year long. That is -- if we're tracking ahead in other areas, we see some appropriate investments we want to make in the business for longer-term growth, we may make decisions there. And so that's something that we will evaluate quarter-to-quarter as we move along, obviously, with the goal of always delivering on our commitments. But we're excited to get after the $130 million in our $500 million overall target over the next 5 years.

Operator
We'll take our next question from Eric Percher of Nephron Research.

Eric R. Percher ***Nephron Research LLC - Research Analyst***
I'll stick with Medical. Mike, when you looked out a year ago, you would've expected that the TSAs could have been bumpy, I don't know that you would necessarily expected the charge, and then obviously, there were service levels and cost reductions. When we look out over the next year and what needs to be accomplished, are there other elements that could be bumpy that you're looking at? And what in your mind are the 2 or 3 items that has to occur in order to meet the expectations you're laying out here?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. Great question. I don't know that I see anything out there that, at this point in time, I would say gives me concern about bumpiness like the TSAs. And again, I think we've done a good work working through a lot of these challenges over the last year.

I would say to your second part of the question around what are the things that we have to do well, I would say the first thing that jumps out to me is we've just recently restructured our commercial organization and we're really excited about the increased focused that we're going to have on our customers and the way that it should free up the time of our sales reps to actually spend time selling. So that's going to be an important driver.

Somewhat for FY '20 but more importantly to really get the momentum going for beyond FY '20 so we can become the sales engine on Cardinal Health products and service and quality with our customers overall. So that would be one of the top ones for me.

I think second of all, the team on the operations side of Medical has got a lot of projects that they have on their list that they have laid out around both our manufacturing and our distribution supply chain network, that are going to be important also for the mid and longer term.

We're going to be making some investments this year to get after our manufacturing efficiency. And that, again, we think are going to pay big benefits for us going forward. So making sure that we execute on the things that help both our manufacturing footprint and our distribution footprint are going to be important components.

Eric R. Percher ***Nephron Research LLC - Research Analyst***
Are there any major changes to the supply chain network that has to occur?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Well, some of those things that we're working on, on our manufacturing and distribution network are going to be things like possibly where we manufacture, what type of automation we have in the plants. We're looking at our footprint in distribution and potentially relocating and changing some of our footprint to be more efficient in distribution. So yes. There are things like that, that need to be done and will be done and we need to make sure that we stay on top of and execute flawlessly.

Operator
We will now take our next question from Ross Muken of Evercore.

Ross Jordan Muken ***Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Healthcare Services & Technology and Fundamental Research Analyst***
I guess just getting back to the Pharma business. It's hard to sort of compare apples-to-apples across the 3 major distributors, but the other folks obviously had sort of highlighted more growth in the business.

I guess it's not comparable, you guys have some of the opioid charges related in there. But I guess if you think about what happened on the customer side with CVS and Kroger and kind of adjusting for that, I guess, do you feel like performance is more like-for-like versus the peers? And I guess as we get through kind of this period, and I know we're only in '20, but I guess after 4 years or so kind of declines in that business, do you think we'll get back to the growth after you get through these renewals? Or is it too early to call that?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. I want to be careful not to comment on '21 and -- other than we are absolutely, absolutely committed to growing in the future. It's something we're talking about and focused on every single day. So we have a lot of things going on that excite us to be able to grow in the future.

It is hard for me to comment on other folks but let me put it this way. I believe that we are executing very well across our Pharma Distribution business. And depending on how you want to adjust things or not adjust things, I feel very confident that we are performing very well compared to our competitors on that standpoint.

Keep in mind that we have very different mixes than our competitors. For example, in specialty, we're really excited about the growth and execution in our specialty business but the tailwind that we get from specialty is smaller just given the size of our respective businesses. And -- but other than that and the timing of our renewals, I feel very good about where we are and how we would compare with anybody.

Ross Jordan Muken ***Evercore ISI Institutional Equities, Research Division - Senior MD, Head of Healthcare Services & Technology and Fundamental Research Analyst***
And maybe just on the capital allocation side, maybe just a thought given where the stock is, you're focusing more on

the debt pay-downs front versus buying back more stock. I guess what's the thought process of why you're more biased to sort of shoring up the balance sheet?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Really, it goes back to our commitment that we've made that related to our leverage ratio is we've made commitments that we're going to get those to certain levels over the time frame. And so from our standpoint, we feel that it's very important to focus on debt pay-down in order to live up to the commitments that we've made.

We also committed to our dividend, although we plan to continue with very modest increases in our dividend until we get down closer to the 30% to 35% payout ratios. And as always, we will continue to evaluate share repurchases. It's just that we made commitments around our leverage ratio and we want to live up to those commitments.

Operator
We'll take our next question from Steven Valiquette of Barclays.

Steven James Valiquette ***Barclays Bank PLC, Research Division - Research Analyst***
So just to summarize the overall cost-savings initiatives, if you go back a year ago, you mentioned you expected cost structure savings in excess of $100 million in fiscal '19. You have to talk about that zero-based budgeting journey to deliver greater than $200 million in savings by fiscal '20.

So I guess with the $133 million that you got in fiscal '19, $130 million more expected for fiscal '20, is this all tracking in line with what you visualized a year ago? Or how would you characterize it just versus what you saw a year ago?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. I think it's actually tracking ahead and so we thought we would do $100 million this past year in fiscal '19 and be on a run rate of $200 million. We actually, as we said, delivered $133 million in '19. We expect to do at least $130 million. So just those 2 alone would be $263 million.

So we're ahead of where we expect it to be, which is why I put out the comment that based on this work and based on the change in the way I think our entire team is thinking and looking at expenses and understanding prioritization, which is why we put out the target of $500 million over the next 5 years compared to our fiscal year '18 run rate.

Steven James Valiquette ***Barclays Bank PLC, Research Division - Research Analyst***
Okay. And just a quick one-liner question. In the Pharma segment, do you think operating profit would grow in fiscal '20 if you, in isolation, just excluded the pricing reset on the customer contract renewals?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. I don't want to get into that level of detail at this point in time. Just to reiterate that the customer contract renewals were the largest year-over-year headwind for us and we're excited to be locked up for at least 4 years with our top 3 customers.

Operator
We'll now take our next question from Erin Wright of Crédit Suisse.

Katie Anne Tryhane ***Crédit Suisse AG, Research Division - Research Analyst***
This is Katie on for Erin. Can you -- so you're forecasting, I guess, low single-digit top line growth for the Medical segment. Is this how we should be thinking about that segment longer term? And can you speak to the lay-in synergy

opportunities associated with the recent Medical acquisition?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
As far as the top line number, that's kind of been historically what that industry has grown in. It has been a flattish to low single-digit growth industry.

As we become and have improved our execution, we would expect to continue to see our top line growth be at least at what the industry growth rates are, and then further acceleration to our bottom line as we continue to improve mix and get after our costs. I'm not sure I -- what was your other question exactly, Katie?

Katie Anne Tryhane ***Crédit Suisse AG, Research Division - Research Analyst***
Yes. Are there any other, I guess, lay-in synergy opportunities associated with recent Medical acquisitions that you may see going forward?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Okay. Got it. Yes, we still believe that our Patient Recovery business is still on track to get its $150 million of synergies exiting FY '20. And so that has the combination of working with our distribution network and our manufacturing teams, et cetera, sales teams working together we have -- continue to have and that has been reflected in all of our thoughts so far.

Operator
We'll take our next question from Stephen Baxter of Wolfe Research.

Stephen C. Baxter ***Wolfe Research, LLC - Senior Analyst***
I wanted to follow up on some of the moving pieces on the Medical side of things. So it seems like you're guiding medical EBIT up approximately $70 million. It sounds like this onetime item was somewhere between 50 and 70 bps on a variation versus the prior guidance.

And I think you were talking about the Patient Recovery synergy still continuing to ramp throughout the year. So trying to understand ex these moving pieces, it seems like Medical EBIT will be flat to maybe down. I'm hoping to understand the moving pieces better, do I have that right? And if so, when do you think the core can get back to growth?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. So I can't comment specifically on the size of those pieces. But I will tell you that, again, that, that charge for that exclusive distribution agreement was the largest difference between making our plan or not in Q4. We do expect to see growth across all the various components of Medical next year.

And you remember I had mentioned earlier, we also are making some investments in Medical this year. From an expense standpoint, in order to set us up for the future as we redo our distribution network and our manufacturing footprint, there are going to be some expenses that we'll be incurring or investments that we'll be making that will be some headwind. So you have to net all that together to get to where we are and we feel good about Medical at this point and confident we can deliver on this.

Stephen C. Baxter ***Wolfe Research, LLC - Senior Analyst***
Good. And then just on the Pharma growth in the quarter, 7%, obviously, a big swing from where things have been recently. Just for our modeling purposes, would you be able to give any insight into what the gross profit in the Pharma

segment in the quarter in terms of growth?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Again, Pharma had a good quarter, lived up to the expectations that we had for them, too, for the year. As far as specifics, I would say the drivers have just been similar to what they have been. The large renewals, as I said, don't essentially start until July. So we didn't see any of that large customer contract renewal until July 1. We did have a little bit year-over-year from last year.

But I wouldn't say that the drivers were a lot different Specialty was the biggest positive driver, brand mix and increased sales was -- been this kind of a second driver and then the negative impact of our generics program and contract renewals that, as most of them already had been announced, would be the negative drivers.

Operator
We will now take our final question from John Ransom of Raymond James.

John Wilson Ransom ***Raymond James & Associates, Inc., Research Division - MD of Equity Research & Director of Healthcare Research***
Mike, just to kind of pull back from the quarter a little bit. Yes, as we think about where you sit in the pharma chain, I mean it's -- if you look at the stock price of Teva and Mylan, it would imply nuclear winter, and then you look at the margins of the retailers and they go down every year. Just look at some of the trading actions, some of the public chains.

Just how do you think about your position when kind of both your upstream and downstream customers are just experiencing what the financial markets would expect to see as just record distress? It just seems like hard for a middlemen, if you will, to stay prosperous when both partners, upstream and downstream, are struggling so.

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Yes. Thanks for the question. Thanks for ending with such an easy one. So it's -- first of all, I'd say we're way more than a middleman. I would start with that. Sure, that may be the traditional piece of what we do and I'm actually glad you said it because I think it's important for us to talk about that. As you know, we have a lot of areas that are more than just middleman.

When I take a look at the -- our medical services businesses, what we're doing in at-Home, yes, we're providing supplies but it's really our unique relationships with insurers and with providers and how we connect them with the patients and there's so much more there with other technical businesses. We continue to see good headwinds or good tailwinds in Specialty. We feel good about our nuclear business going forward. So there's a lot of other things.

But from -- when it comes to the Pharma Distribution business itself, it's definitely an ecosystem that is in a state of flux. I think all of our customers continue -- luckily, we're aligned, I think, with very, very good customers in the sense of CVS, Kroger, Optum, we're aligned with the strong players who have, I think, excellent game plans for continuing to grow in the future. That's helpful for us. As we look at the way our retail independents have been resilient and are acting like scrappy entrepreneurs to figure out how to reduce their expenses but at the same time get into other niches, I like the way they're responding to all of this. And I think our position in having a broad portfolio with medical and Pharma positions us well with the medical or with the downstream providers in the hospital marketplace.

So there are a lot of challenges for sure but I really believe in our position and our capabilities to be able to manage through this. And health care is going to continue to grow and stay an important piece. I think it's why many of us, if not all of us, stay at companies like Cardinal Health because we know how important it is, what we do every day.

John Wilson Ransom ***Raymond James & Associates, Inc., Research Division - MD of Equity Research & Director of Healthcare Research***
So on that point, I'm glad you mentioned independents. At a very high level, I mean you always have market share ebbs and flows, but is your independent customer based just in terms of pharmacies you're servicing? Is it the same higher or lower than it was, say, 5 years ago?

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
Compared to 5 years ago, it would -- we would definitely have more customers and have seen some growth in that business. It's a group of customers, as I said, that we just had our retail businesses conference a couple of weeks ago and I had a chance to be down there and spend time and it was a record conference for us.

We had a couple of thousand stores represented and the buzz amongst the group and the understanding that they need to do things differently and focus on various niches, the front end of their store, how to drive cost out, they are really looking to us as someone to help them run their business, manage their inventory, help them with things like medication therapy management, mobile technology, those types of things. So we continue to see this business as going to -- continue to be an important customer base for us going forward. So that's the last question?

Lisa Capodici ***Cardinal Health, Inc. - VP of IR***
Yes.

Operator
At this time, it appears there are no further questions. I'd like to turn the conference back to Mr. Mike Kaufmann.

Michael C. Kaufmann ***Cardinal Health, Inc. - CEO & Director***
I want to just thank everyone for joining us this morning. We're really pleased that we delivered in fiscal '19, and we look forward to discussing our '20 progress with you very soon. Take care, everybody.

Operator
Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.