Q2 FY19 Cardinal Health, Inc. Earnings Conference Call

February 7, 2019 8:30AM Eastern

Operator: Good day and welcome to the Cardinal Health Inc. Second 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: Thank you, Bryce. Good morning and welcome to Cardinal Health's Second 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 second quarter results, full year outlook and an update on our strategic initiatives. 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 statement 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 an update to our fiscal ‘19 outlook 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.

During the Q&A portion of today's call, we ask that you limit your questions to one, with one 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.

Mike Kaufmann: Thanks, Lisa, and good morning, everyone. I'm glad you could join us. Let me begin with some comments on our second quarter of fiscal 2019, and then I'll provide a brief update on the progress we're making on our strategic initiatives to drive future growth.

With the first half under our belt, I'm very pleased that we're on track with executing our plan. Overall, the second quarter came in ahead of our expectations, led by the pharma segment. EPS for the quarter was $1.29 and revenue of $37.7 billion, was up 7%. Operating earnings were $637 million and operating cash flow was $372 million.

Based on the year-to-date performance, we're raising our guidance range for non-GAAP EPS for the full year to $4.97 to $5.17 from our previous range of $4.90 to $5.15. Jorge will walk you through the details and our current assumptions. Our confidence in raising our guidance for fiscal 2019 is based on the tangible results we're beginning to see from the hard work being performed across the enterprise, as we execute on our top priorities.

Turning now to the pharma segment, a few comments. Overall, this business continues to be powered by our partnerships, with strong growing customers and the critical role we play in supporting their missions, day in and day out. Serving more than 26,000 pharmacies on a daily basis and 10,000 specialty physician offices and clinics, we're integral to their businesses and to their success meeting patients' needs.

Further, I'm proud that our team continues to develop innovative new ways to enhance the value we provide to customers. As to performance, revenue for the segment was up 8% to $33.7 billion. As anticipated, our generics program remained the most significant profit headwind, and overall generic market dynamics remain consistent with prior quarters.

On the positive side, we benefited from improvement in brand volume. Within this environment, driving down our cost and increasing efficiency remains critical. And during the quarter, we saw positive impact from the cost reduction initiatives we have underway.

An additional highlight was our specialty business, which continued its strong momentum during the quarter, outperforming our expectations. Specialty once again delivered excellent revenue and profit growth, driven by higher volumes as well as mix.

In the medical segment, revenue for the quarter of $4 billion was about flat with a year ago, reflecting the China and naviHealth divestitures. Importantly, we're making good progress on the major strategic initiatives we have underway to drive better results and longer term growth. Patient Recovery continues to achieve integration milestones, including most recently, exiting our last major TSA in Asia Pacific in late January. Looking ahead, we remain excited about the longer term growth potential of this business.

At Cordis, our stabilization program is also on track, and the steps we've taken are beginning to have impact. Service levels and fill rates are up, while back orders and inventory expenses are moving down. The team continues to optimize the product mix and streamline our geographic footprint. We remain confident that Cordis will be on a path to profitable growth by the end of the fiscal year.

Finally, our services business and Cardinal Health at-Home, were once again standouts this quarter, reflecting ongoing strong demand for both. Services continues to expand its niche, providing value added technology and logistic support to our partners, while the at-Home business is capitalizing on a number of larger healthcare trends.

All in all, the medical segment team is executing and making solid progress. Further, as we look ahead, given our expanded offering of medical products and services, coupled with our strong distribution network, we see opportunities to drive long-term growth, especially in Cardinal Health brand products.

Let me now turn briefly to our strategic priorities beyond my earlier comments on Patient Recovery and Cordis. Overall, we're making good progress and remain laser focused on how we can deliver the greatest value. With respect to our cost structure, as you know, back in August, we announced a significant cost savings program.

And as Jorge will discuss, we're well positioned to exceed both our near term target of $100 million in annualized savings for fiscal year 2019, and our longer term goal of at least $200 million. In addition, the team continues to actively review how we operate and seek further opportunities to reduce cost. We have a significant number of work streams in flight looking at both what we do and how we do it.

As it relates to our pharma model, we continue to actively discuss evolving industry dynamics and evaluate new models with both our upstream manufacturer and downstream provider partners. This includes continuing to push for differentiated pricing models with providers and less contingent margins with manufacturers.

And finally, regarding capital deployment, Jorge will provide a few updates. I would just note that we continue to execute a very disciplined and thoughtful strategy to fund the future growth of the business, return cash to shareholders and maintain our healthy balance sheet. Supporting all of this work of course are our people, and I'm thrilled that we continue to strengthen and enhance our leadership team.

Since our last call, Victor Crawford joined us as CEO of the Pharma segment, and he has brought highly relevant skills and insights as we navigate our evolving industry landscape. In addition, just this week, Brian Rice joined us as our Chief Information Officer to lead our global technology and customer service teams. Brian brings deep experience leading global IT and business services, and we look forward to benefiting from his expertise and perspective.

In summary, while we still have a lot of work to do, there is much to be excited about. As I look back over the past year, we have made significant progress, improving execution, sharpening our portfolio, getting after cost, and strengthening our leadership team. Going forward, our core distribution businesses will continue to be essential to the healthcare system.

We will continue to adjust our pharma distribution business to improve profitability and leverage our medical distribution business, with our significant portfolio of Cardinal Health products. At the same time, we will invest in our current growth platforms such as specialty, at-Home and our services businesses.

Let me wrap up by extending my thanks and appreciation to our entire team for their hard work this past quarter, and for their dedication in continuing to advance our strategic initiatives. We look forward to building on this solid foundation over the balance of the year, with the ultimate objective of delivering the greatest value for our customers, shareholders, employees and the communities we serve.

And with that, let me now turn the call over to Jorge.

Jorge Gomez: Thanks, Mike, and thank you all for joining us this morning. We're pleased with the second quarter performance. We're seeing progress in many areas, as some of our strategic priorities begin to translate into results. Today, I'll focus on three areas, our Q2 results, our full year outlook, and updates on a few of our strategic priorities.

Overall, performance in Q2 was better than anticipated due to a few factors. Several businesses exceeded our expectations. We saw volume favorability in the pharmaceutical segment, better than anticipated expense trends, and a favorable ruling regarding the New York State opioid assessment.

Of note, there was also some positive impact from a timing perspective with corporate expenses and other areas. Total company revenue increased to $37.7 billion, up 7% versus prior year. Total company gross margin was down 7% from last year to about $1.7 billion. Operating earnings were $637 million. Our effective tax rate in Q2 was 28.5%, a 2.3 percentage point increase versus prior year, driven by tax reform and discrete tax items. Our EPS for the quarter was $1.29, a 15% decrease versus last year.

During Q2, we saw a 3% improvement in SG&A due to the divestitures of the China distribution and naviHealth businesses, as well as the early benefit from our ongoing cost optimization efforts, which I'll discuss when I cover our strategic priorities.

Interest and other expense increased 18% versus prior year to about $97 million in Q2. This was driven by the change in the value of our deferred compensation plan. As a reminder, this mark-to-market adjustment has an equal offset in SG&A expenses and the net impact to the bottom line is zero.

Q2 average diluted shares outstanding were approximately 300 million, about 16 million fewer shares than last year, largely due to the approximately $600 million of shares that we have repurchased year-to-date. Our Q2 operating cash flow was $372 million, bringing our year-to-date operating cash flow to $736 million. We ended the quarter with a cash balance of $2.2 billion, with about $695 million held outside the US.

Now I'll turn to segment results. Pharmaceutical segment revenue increased 8% to $33.7 billion, driven by sales growth from pharmaceutical distribution and specialty customers. This increase was partially offset by the divestiture of the China distribution business. Q2 segment profit was $443 million versus $514 million last year.

As anticipated, this decrease was primarily driven by the negative impact from generics program performance and to a lesser extent by customer contract renewals, a China divestiture and opioid litigation expenses. These headwinds were partially offset by the strong performance of specialty, as well as by pharmaceutical distribution brand volume and initial benefits from our cost optimization work.

Now I'll briefly provide an update regarding the New York State Opioid Stewardship Act. As many of you know, in December, a Federal District Court ruled against this law. As a result, during Q2, we reversed $5 million we had originally accrued in Q1. We also reversed the $29 million we accrued for all of calendar '17, and for the first half of calendar 2018, which was excluded from non-GAAP as we said previously. Additionally, we did not need to incur the assessment amount that we originally contemplated for Q2. We continue to monitor this matter and we're following the appeal filed in January by the State of New York.

Continuing to medical. Segment revenue was down slightly to $4 billion, driven by the divestitures of the China distribution and naviHealth businesses, offset by growth from existing customers. We saw strong top and bottom line growth in Cardinal Health at-Home and services.

Segment profits decreased 14% to $188 million. This decline reflects increased costs, as well as the divestitures I just mentioned. The increased costs relate to Cardinal Health brand products and include raw materials prices, SG&A expenses related to TSA exits, and global supply chain improvement initiatives. These costs were partially offset by the non-repeat of the prior year Patient Recovery inventory step-up charge.

Regarding raw materials, we're beginning to see some encouraging data points in the spot markets. However, remember that changes in spot prices take time to flow through our P&L due to the lag in manufacturing and supply chain cost accounting rollouts. As part of the broader work to drive efficiencies across the medical segment, we're streamlining the global supply chain for the full portfolio, including Patient Recovery and Cordis, as Mike mentioned.

Regarding Patient Recovery, we're pleased with the performance of the business and the progress made to-date. Overall, the integration work is progressing as expected. Our team continues to work through some of the typical challenges seen in large integrations, and this work will continue over the balance of the calendar year. We anticipate exiting the remaining minor transition agreement by mid-fall as planned. Finally, we continue to be on track to meet our accretion goal.

A quick update on Cordis. We continue to make progress on our stabilization plan and metrics continue to improve. We have seen an improvement in service levels and nearly 20% reduction in SKUs, and significantly better management of consigned inventory.

Now, I'd like to share few updates regarding our full year assumptions. With half of our fiscal year complete, and based on our expectations for certain industry dynamics and business trends, we decided to raise our non-GAAP EPS guidance to a range of $4.97 to $5.17. This reflects the narrowing of our range from $0.25 to $0.20.

We made the following additional changes to our full year assumptions. First, we expect mid-single-digit revenue growth, primarily driven by pharmaceutical segments. Second, though our tax rate may fluctuate by quarter, as we saw in Q1 and Q2, we expect a tax rate in the range of 25% to 27% for the full year. Third, we revised our diluted weighted average shares outstanding to the range of 300 million to 302 million shares.

For the segment assumptions, with the strong revenue increase we saw in the first half, we expect pharmaceutical segment revenue to grow in the mid-to-high single digits. This is mainly driven by brand sales to large customers. One item of note. In January, brand inflation increases came in within the range we were expecting.

As we have discussed before, brand inflation represents a very small portion of our total brand income, as income from DSA fees accounts for nearly 95% of our total brand compensation. Finally, for the medical segment, we expect revenue to be approximately flat. A key factor impacting this change in our assumption, is foreign exchange.

Let me now provide an update regarding a few of the strategic priorities that we have discussed throughout the year. Regarding our cost optimization work, we now expect to exceed $100 million of annualized savings for fiscal '19. We also expect to exceed the aggregate $200 million in savings by the end of fiscal '20. We continue to empower our employees to reset spending practices across the enterprise, and this work will increase productivity, support our priorities, and fuel growth initiatives.

Moving on to strategic uses of cash, during the quarter, we deployed capital primarily to fund capital expenditure needs of the business and our quarterly dividend. Yesterday, our board approved a regular quarterly dividend which will payable to shareholders on April 15. Most importantly, we continue to increase our level of scrutiny and selectivity regarding capital allocation across all categories.

In closing, we're delivering on our commitments year-to-date, and we're pleased to deliver a Q2 performance that was better than anticipated. As a result, we were able to increase our full year expectations. We're beginning to see our strategic work and our operational performance aligned, and we'll continue to build on this momentum.

With that, I'd like to open the line and invite your questions.

Operator: Thank you. If you'd like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure the mute function is turned off to allow your signal to reach our equipment. Please limit yourself to one question and one follow up question to allow everyone a chance to signal. Again, press star one to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions.

And we'll take our first question from Ross Muken with Evercore. Please go ahead.

Ross Muken: I'd love maybe a little bit of more color on sort of the specialty solution outperformance, maybe just a bit of sort of background on maybe a couple of the pieces that are kind of contributing. And seems like that business has been sort of outperforming now for some time. And maybe just give us a feel for in the context of, you know, I think the space trying to get better economics on those sort of relationships, both on some of the manufacturer service, but on the base distribution, how you've sort of done in terms of essentially getting fair value for the services you're providing in that business.

Mike Kaufmann: Hey, thanks Ross. Appreciate the question. I would say that the performance in specialty is - really cuts across several different areas. First of all, our offering downstream to our physician offices and clinics, we continue to see good traction there. We're continuing to win some volume in that space. And so that's been generating some of the better than expected performance for us.

We've also been able to see benefit from just the pure growth of the specialty business alone. Our manufacture partners continue to launch new items, grow their share, and that's obviously benefiting us. We've also had strong cost control in our specialty unit like the rest of our units. They're getting after their activities and really focusing on what are the value added activities.

And then lastly, our upstream services, we continue to gain traction in our hub, our 3PL business continues to win share. And so really it's across the board. I wouldn't say it's any one thing particularly that stands out. It's just more across the board, saw the performance by the team.

Ross Muken: That's helpful. And maybe just to follow-up. It seems like inflation kind of came in at least on the branded side in line. I mean, in lieu of all of this sort of noise coming out of the government and Azar's sort of latest proposal, I guess how are you thinking about sort of the inflation environment for the rest of the year and what you're going to see maybe for the foreseeable future?

Mike Kaufmann: Yes, it's a great question. You know, at least for this fiscal year, I would tell you that really the - January is really the month that we expected to see all of the inflation. So we have very, very little built in for the rest of the year. So that is not something that we would call out as a risk for the second half of the year.

It was really a big focus on January for us, would have come within that range that we were expecting. It did come in within that range of inflation that we were expecting, and we were able to work with our manufacturing partners there, and really get about what we were expecting. So for the rest of the year, it's really not a factor.

As far as next year, it's just a little too early for us to comment on that. There's so many moving parts related to that. And some of our agreements will be obviously expiring and looking at renegotiating. And so we're going to be looking at trying to move more to non-contingent as we can, since we're well over 90%. In fact, we're nearly 95% at this point in time, that we would look to move more there as we can, but again nothing the rest of this year of any materiality.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Robert Jones with Goldman Sachs. Please go ahead.

Robert Jones: Great. Thanks for the questions. I guess, Mike, maybe just to pick up there, you know. If I look at the implied back half guide, you know, specifically for the pharma segment, you know, the revenue trending above original expectation. So you raised the expectations for the full year there, but, you know, you left the EBIT expectations the same. So obviously implying, you know, slightly worse EBIT in the back half than maybe what you were previously thinking.

Just was curios if there's any, you know, changing dynamics or things in the marketplace that you're seeing today that maybe you weren't seeing when you laid out the original fiscal '19 plan that might help explain, you know, the maybe implied lower EBIT margin expectations in the back half.

Jorge Gomez: Bob, good morning. This is Jorge. Let me try to help you with that. The first thing I would say is, with the first half of the year behind us, we feel good about our guidance. We feel so good that we decided to raise our total guidance for the year. If you look at the over performance in Q2, you probably want to think about it in three buckets.

And certainly from an operational perspective, some of our business has been better. We talk about specialty, strong volume in pharma distribution was good in the quarter, and some of the business units within the medical segments performed well. And so that has given us confidence for - to deliver results in the second half of the year. The trending is good from an operational standpoint.

In Q2, we also had one-timers or non-repeatable items or items that in fact don't have any impact to the bottom line. So for example, the ruling in New York about the opioid assessment, this is something that we had accrued for in Q1. We reversed that amount and then some amount that we had contemplated for Q2, we did not have to accrue.

And then finally, there are some sizable items related to for example deferred compensation. Deferred compensation has a positive impact in SG&A, but a negative impact of the same magnitude in below the line with a net zero impact to the bottom line. So that is something that has no bearing with respect to trajectory going into the second half.

And we had some corporate expenses timing between Q2 and Q3 that again, they have no impact to the overall year. So when we look at the benefit in Q2, all the R's and O's, the trajectory of the business, we decided to raise guidance. And based on all of those factors, this guidance reflects our best estimate for the second half, which by the way as I said before, we feel good about the trajectory of most of our businesses within the context of the guidance we're providing.

Robert Jones: Great. That's helpful, Jorge. And I guess maybe just a follow-up on the pharma segment. You know, not necessarily new news, but you guys highlighted the generic program as remaining a very large headwind. I just wanted to better understand what's at play there. Is this just because you're lapping strong contribution from last year, or is there some changing dynamics in the generic marketplace that, you know, is weighing on the generics business?

Mike Kaufmann: Yes, thanks for the question. I wouldn't say that it's anything new. In fact, what I would say is that our generic program performance remains essentially consistent quarter-to-quarter. Remember, it's made up of several different things. We're seeing sell-side deflation remain consistent quarter-to-quarter. Obviously, we've said in the past, we'd like to see that improved, but it is at least remaining consistent.

We have also our buy side. Red Oak continues to perform as expected. And then we have launches and penetration, all of again which are about as expected. But that sell-side deflation, as we noted at the very beginning of the year, we felt that the pressure from the sell-side would offset the positives we see in launches penetration and costing, and that there would be a net headwind for the year, and that continues to be what we're seeing. So I wouldn't say there's anything new, but when we look at it in total, the program continues to be our largest year-over-year headwind.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Charles Rhyee with Cowen. Please go ahead.

Charles Rhyee: Yes. Hey, thanks for taking questions. You know, I want to go back to sort of the - your early comments around the specialty segment. You know, the performance here that you're talking about and certainly performance in the overall revenue pharma segment, kind of mirrors what we're seeing across the peer group as well. Is there anything sort of characteristic you see that's changing the market overall as well that is kind of - that we're kind of seeing this occur more broadly based?

Mike Kaufmann: You know, nothing that sticks out to me. I mean it continues to be a strong, growing market. So it's one of the fastest growing components obviously of the pharmaceutical segment. So I just think the pure market growth, the manufacturers are doing a good job of driving growth on their drugs, and we're benefiting from that growth from them.

And then as I said, we continue to see improvements on our - both our downstream penetration with accounts, and growth of new accounts. And then upstream, you know, we've had some businesses that we've talked about that we were working on and growing. For instance our hub, which is still relatively a new business, continues to improve its performance.

And our third party logistics business continues to win in the marketplace with the investments we've made in that business. So I wouldn't say anything specific other than it is just overall a strong growing market and we participate in many different areas in it.

Charles Rhyee: Okay. And then maybe a follow-up for Jorge. I think last quarter you said you were expecting the second quarter consolidated operating profit to be more sort of in line with 1Q. I think you've touched on some of the factors that have lifted the outperformance here in the second quarter. Was there anything other - were there any other drivers that you'd point out and maybe you can help size some of these for us? Thanks.

Jorge Gomez: I already kind of listed all of the items that resulted in the over performance. As I said before, good underlying trends in most of our businesses. And then we had some one-timers related to corporate or timing issues related to corporate expenses, deferred compensation. I think I've covered all of the items that really explain what happened in the quarter relative to our expectations. We're really pleased with how the business has performed this quarter.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from David Larsen with Leerink. Please go ahead.

David Larsen: Hi. Can you talk a little bit about Cordis? I think you said that there's more effective management around consigned inventory. Did revenue for quarters grow? And what exactly is leading to that, you know, tighter management of the inventory? Were new technology systems deployed? Were new folks hired? Thanks a lot.

Jorge Gomez: Thanks for the question, Dave. Cordis in the quarter was not a driver for us. We continue to make progress. The plan - the stabilization plan that Jon Giacomin and team are leading, is yielding good results from an operational perspective. Our metrics in that business continue to improve. I think overall, the commercial health of that business has been good for a number of quarters now.

And with respect to specifics around infrastructure and technology, it's what we have discussed before. We have been working pretty intensively in terms of having better data, better demand planning systems, processes around consigned inventory have been put in place, and we're beginning to see the overall results of all of this work. So given all of that, we continue to expect that Cordis will be on a path to profitability - to profitable growth by the end of fiscal '19.

David Larsen: Okay. And then did revenue grow for quarters?

Jorge Gomez: As I said before, the trend in the business has been positive for the last several quarters and the commercial health is good. There is - as I indicated in my prepared remarks, overall in the medical segment, FX was - foreign exchange was a small headwind in the quarter and that impacted kind of all of our businesses across the medical segment.

Lisa Capodici: Operator, next question.

Operator: We'll take our question next from Ricky Goldwasser with Morgan Stanley. Please go ahead.

Ricky Goldwasser: Yes. Hi. Good morning and congrats on a very good quarter. When we think for the second half of the year, if we normalize - you have I think a little bit lower tax rate and lower share count. And when we normalize for that, the second half guide seems to indicate a very wide range down - on EPS down 4% to up 3%.

So when you think about kind of that range, what should we be - what are you watching for? So what are the risks that could lead you to kind of that down 4% that could materialize in the next couple of quarters? Because you know what branded inflation is, so you have a pretty good sight of view to that. So what are the other things that could materialize in the second half for you?

Jorge Gomez: Thanks, Ricky, for the question. Listen as I said before, we have been looking at the entire cadence of the quarters with the first half behind us. We feel much better about the cadence, about the ramp from first half to second half. There are always items that could create some changes.

And starting with probably the easiest one that you have seen a few times the tax rate. We have narrowed the range of the tax rate, but it could be - from quarter-to-quarter, it could fluctuate. We continue to watch other drivers of profitability in each of the segments. In the case of medical, I indicated that for example cost, especially around raw materials is, we're seeing good signs in terms of spot price - spot market prices. But that is something that we continue to watch.

So there's a lot of puts and takes, and when we put all of those together, like we believe that the second half is a reasonable good ramp for us and the range is reasonable. I think the most important point is overall, we're raising the bottom of our range. We're raising the top. We're narrowing the range, and that is a good indication that net-net, all of our risk and opportunities are trending in the right direction, and we feel a lot more comfortable about the rest of the year.

Ricky Goldwasser: Okay, and then one follow-up. When you talk about revenues, you know, you talk about obviously the specialty, the medical, the strong print volume in pharma. Can you just explain to us and what is driving the strength in brand volume? Because we're not necessarily seeing in IMS script. So what's driving that better performance on the branded side?

Mike Kaufmann: I think it's more customer mix than anything. You know, we're partnered with some very strong customers in the marketplace that I think are growing nicely through a combination of mostly organic growth, with probably some small M&A themselves there. And we're just benefiting from being partnered with strong partners, I think is really what it is more than anything else.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Michael Cherny with Bank of America. Please go ahead.

Michael Cherny: Good morning. Thanks so much for the color so far. Jorge, I want to revisit some of the delta, at least in terms of the two quarter performance. You talked about some level of timing related to corporate expenses. That being said, the original commentary, you grew sequentially EBIT by about $96 million. Usually there is a typical sequential step up in this quarter. But if you think about what was different in this quarter, how much of it was timing oriented versus how much of it was structural in terms of some of the restructuring programs and business optimization that you're pursuing?

Jorge Gomez: Yes, Michael, thanks for the question. You know, I won't be able to tell you exactly the relative magnitude of each of the pieces, but I would tell you the items that were timing related or that had no impact to the bottom line, are sizable. So good performance from a lot of our businesses, but those two items, timing of corporate expenses and - is a pretty sizable items. So that is one of the key reasons why we're not letting that flow through in the guidance for the rest of the year.

Michael Cherny: Understood. Thanks. I'll get back in the queue.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Lisa Gill with JP Morgan. Please go ahead.

Lisa Gill: Thanks very much. Good morning. Mike, I just wanted to go back to your comments around Cordis. You talked about refining the geographic footprint. I think when we were together last month, you talked about going from roughly 60 countries to maybe around 45. Can you give us more color on, is that the right number to think about, that you're going to go down to 45 countries for Cordis?

I understood you said profitability by the end of the ’19. But can you also just weave in your thoughts around Cardinal brand products? We saw an increase in cost here in this quarter, but are there opportunities when you think about the countries now that you're overlaying in Cordis, have you made the investments you need to make so that when we think about going towards the back half of this year and that profitability, is that driven by your branded products?

Mike Kaufmann: Yes, thanks for the questions. Let me try to catch on each one of those. First of all, I think, Cordis - there's probably two things we're doing to try to simplify the business. One is, not only reducing the number of countries and your numbers you mentioned are approximately right.

But we're looking to continue to reduce that number, and we're being very specific and detailed as we evaluate each country to make sure that at the end of the day, we're looking at, what is the true growth potential in that country? What are all the other potential hidden costs and risks that might be in that country compared to our current footprint and ability to grow? How might we be in that country in a different way? Do we have to have our own commercialization, or can we just work with distributors? But I would fully expect to see us continue to reduce our footprint a little bit there.

Also the other thing that we've done is, we've taken a really hard look at our SKUs. And so far we've reduced about - our SKUs by about 20% in Cordis, because we had a lot of slow to no moving SKUs, which again drives potential inventory risk, also manufacturing cost. And so we're trying to focus our customers on the SKUs that matter for us and move them from some slow to no moving type of SKUs that were out there, and move them to the right mix of SKUs to help our cost structure.

So those are two big things that we're doing in Cordis. And as Jorge said, the commercial health of the business continues to be strong, and we have seen some FX headwinds, but the overall commercial strength continues to be strong. And we continue to try to be very careful about the way we're going after some of our SG&A right now while we maintain that topline and clean up some of these other things like inventory visibility in there.

As far as our Cardinal Health branded products, I would say that we're really taking a holistic approach on those, to look not only at the breadth of that line, where we manufacture it, how we manufacture it, i.e. our overall global footprint, to also taking a look at those countries where we sell those products, and are we doing it in the right way.

So we want to play in the countries where we believe there's future growth and where we can win, and obviously look at other opportunities, up to and including exiting countries where we don't think it has the right growth trajectories or the opportunities for us to win.

Lisa Gill: Okay, great. And I guess just follow-up would just be, Jorge, I know everyone keeps coming back to try and understand the cadence of earnings. Just so I understand this correctly, when you last told us that things would look sequentially similar between the two quarters, you were not anticipating New York state opioid being reversed.

You were not anticipating that, the expense timing around some things and some of the benefit being pulled forward to December, as well as deferred comp. So those were kind of the three things that when you look at that, that was the big difference between when we spoke last and what you actually reported in the quarter. Is that the right way to think about it?

Jorge Gomez: Correct, Lisa. Exactly right. Those are the unexpected pieces that all came in our way.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Steven Valiquette with Barclays. Please go ahead.

Steven Valiquette: Great. Thanks. Good morning everybody. So another question for me and coming back to the commodity spot pricing and timing, et cetera. I mean it sounds like you're really not raising the guidance today for that metric. You cited the other three buckets of outperformance for fiscal 2Q. But, you know, just coming back to our discussion around this last quarter, you guys mentioned it's hard to calculate the overall inflation, but you do have an example in the 10-K that again, a hypothetical 10% increase in key commodity inputs will be about $0.10 hit to overall EPS.

Now, some of these trends are softening in your favor. You mentioned the data points and everything else. I guess I'm just curios, within the current guidance range, could less commodity inflation risk still be a EPS driver to the magnitude of $0.10 plus within the guidance range? Just curios for the back half of the year, how much commodity inflation could move EPS, was really what the question is.

Jorge Gomez: Steve, good morning. Thanks for the question. So commodities and raw materials cost continues to be a headwind for the rest of the year. What I indicated earlier is, but it's trending in the right direction. However, there is always a long lag between the time we see those positive changes in the spot market and when we see the benefits in the P&L.

So that - I think the most relevant part about that statement is that it's one of the reasons why we are comfortable with raising guidance, because although it continues to be a risk, based on the spot prices we're seeing today, we don't believe at this time that that could get worse for the rest of the year. And so that's how we're thinking about that piece.

Steven Valiquette: So just to be clear then, so the guidance raise today does incorporate a little bit of the better outlook on commodity inflation, or is it?

Jorge Gomez: Yes. All of this…

(Crosstalk)

Steven Valiquette: Or it's now part of the equation?

Jorge Gomez: No, it is - our views on the trending on commodities is one of the factors that is contemplated in guidance.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Eric Percher with Nephron Research. Please go ahead.

Eric Percher: Thank you. Mike, with respect to the HHS proposal last week, and all this starting to think about what a world of discounts might look like, there's a question raised around how the actual flow of funds may occur and maybe if there's a role for distributors to play. I think for your peers, we understand some of their assets and relationships that enable them to play. Could you tell us a little bit about how Cardinal might be able to play a role?

Mike Kaufmann: Yes, absolutely. First of all, this announcement around the Safe Harbor changes was not unexpected. And as you can imagine, we, like many others, support efforts to lower prescription drug costs for patients, and we're truly committed to engaging with the administration and the entire system to figure out how best to do that.

That being said, I would - I guess I would - to your answer, I'd probably put it in two buckets. I agree, there are opportunities for the industry as a whole to help facilitate solutions to get rebates possibly down to the patient. The best way to think about it is, we, just like our competitors, maintain sophisticated charge-back systems already with the manufacturer and with our customer.

So every day, we're managing thousands of transactions between customers and suppliers. And so while this would definitely be at a more detailed level, if we needed to do something down to the patient and the script, it is something that as a company and as an industry, we believe that we could get after. And it's something that I think that the whole industry understands well the importance of the role that we play in healthcare in general, and the important role that we play for manufacturers to be able to do this. So I do think that we are as well positioned as anybody to continue to help in that.

And then, I know some people have some concerns. Would it change the overall list prices and other things like that in the marketplace? And I think, well, if it did, we do feel confident in our value proposition that we've talked about multiple times, that we work with manufacturers. They understand the value of our proposition. We constantly work with them around that and that we'd be able to adjust our overall pricing mechanisms with manufacturers to remain whole on the dollars that we're receiving.

Eric Percher: I appreciate both those comments. So I understand the charge-back piece. Is there any role that Cardinal plays today at the point of sale?

Mike Kaufmann: Yes, in some ways we do. Obviously we work with customers, for instance in the area of medication therapy management, whether you call that point of sale. Are we connected with our customers' pharmacy systems? Yes, through inventory management, through medication therapy management and through other connectivity of communicating with our pharmacy customers on a daily basis.

Yes, we have connection with them specifically related to this particular issue. I think we have enough connectivity that we can work with them through other solutions and through opportunities with the industry to drive benefit.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from Brian Tanquilut with Jefferies. Please go ahead.

Brian Tanquilut: Hey, good morning guys. Jorge, just a question on margins. As I think about the pharma segment, obviously you’ve had some - you're still trying to lap some repricings. But how are you thinking directionally about margin trend past the next quarter in the pharmaceutical segment? Thanks.

Jorge Gomez: Thanks for the question. So clearly as we go into Q3, as all of you know, Q3 is our best quarter in terms of pharmaceutical segment margin profit. And so that's going to be normally higher than Q1, Q2 and even Q4. Other than that, I don't see any significant change with respect to margin trends in the pharma business.

Obviously, a lot of cost initiatives that Mike was referring to, a lot of the pricing initiatives that we have going on, we are always trying to expand margins in that business and across all businesses. So I don't expect to see any - again, other than the seasonality in Q3 related to brand inflation and for this year within the guidance range we've provided, I don't see any major fluctuations in margins for this pharma segment.

Brian Tanquilut: Got it. Thank you.

Lisa Capodici: Operator, next question.

Operator: We'll take our next question from John Ransom with Raymond James. Please go ahead.

John Ransom: Hi. Just following up on that last question. I think we've all - I mean we've been in a three-year journey of margin decline in pharma, high single-digit, low double-digit declines. Are you now saying the current - so let's say that your sustainable revenue growth is in the 7% range. Are you now saying, after lapping this year, you think you can hold margins flat and generate high single-digit revenue growth in that segment? Or are we still looking at margin pressures on an absolute basis because of all the things you talked about?

Mike Kaufmann: Yes. You know, at this point in time, we're not going to get into FY'20 guidance. All I can really say is that we feel good about who we're partnered with, with our customers and continue to feel that we're partnered with the right folks and we'll win as they win in the marketplace. And - but as far as margin rates, the impact of our generics program year-over-year, it's just a little bit too early to say whether that will continue to be a headwind or what size that will be next year as we continue to evaluate all the components I've mentioned.

We're going to have to have obviously our thoughts around what the sell-side deflation rate is going to be, as well as launches penetration in buy side. And so, still a little too early on that. I can tell you that we're going to continue to be focused on being aggressive on cost and being - trying to be focused on the areas that we believe we can grow and stay laser focused on those.

John Ransom: Sure. And just the other thing - I appreciate the comments. Just following up on another thread. Let's just say hypothetically that the manufacturers look at the Safe Harbor changes and decide to move to a low net price model, and we see something like on branded drugs, a 30% compression in gross to net. And the actual dollars - or the actual revenue dollars for Cardinal would be - on the branded side, would be compressed.

Just help us understand the process by which you'd have to go back and re-cut, I'm assuming hundreds of contracts between your manufacturers and your customers. And is there any sort of Safe Harbor provision in your contracts? Or is this just going to be sort of a lengthy protracted re-contracting cycle if we see a big bang change in industry pricing?

Mike Kaufmann: Yes, great question and a couple of things. I think obviously we can't speak for the manufacturers, but there's an - obviously a lot of things they have to look at. There are a lot of implications in reducing WAC prices for them that make it a very complicated and somewhat difficult thing to do for them when it comes to - related to returns and how they would price customers where there are differentiated pricing and all those type of things. It gets very difficult.

But assuming that, you know, just using as a hypothetical, if they did, I think there's two things I would keep in mind. First of all, remember one of the most important things to keep in mind is that our downstream pricing is also attached to WAC or list price. And so not only will our overall dollars that we earn from manufacturers be initially reduced on day one, but the overall dollars that we pass to customers would be reduced on day one too.

So there's a natural hedge against the overall size of that, that reduces some of the impact to distributors. And then also secondly, as you can imagine, with all the talk around this for the last 12 months or so, we have been working with manufacturers to change the way our contracts are structured, if there was a significant change in WACs to be able to renegotiate contracts quickly.

And for the ones that we're still in contracts with, they know our expectations, and more importantly, they know our value. They continue to believe - I believe in the overall wholesaler value proposition. They know through our discussions and through our work on our next best alternative, that there is no better way to get their products to market at a fair price and cost.

And I believe in what this industry does and I believe that the pharma manufacturers do too and they want us to be healthy. And so while it's not something you solve in a week when it changes, it is not something that I would see as a longer term headwind, that our conversations have been very positive on both our value and our ability to change our agreements to reflect the dollars that we currently get.

Lisa Capodici: Operator, next question.

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

Kevin Caliendo: Hi. Thanks for taking my call. Just one quick follow-up to that. You said earlier that you thought in the contract renegotiations that on a dollar to dollar basis, it would be the same. Are you thinking like literally in dollars, or are you thinking about ROIC? Meaning your inventories would be a lot less, your round of capital outlay, such that your returns would look the same, but maybe not the actual dollars. Or are you actually thinking that the dollars themselves in terms of the re-contracting you would think would still remain the same?

Mike Kaufmann: Yes, I still believe that the dollars would be the same. I think that your comment around ROIC, there might be some changes to that as you take a look at overall, the whole model. And those things are always considered when we work with manufacturers. When they ask us to carry more or allow us to carry less inventory, we work with manufacturers.

But generally, we see this as something where we're really truly focused on the dollars that we receive as the value for the services we provide, and we would expect that those dollars would be - match be very similar over the long-term as where they are today.

Kevin Caliendo: Second question. You mentioned earlier, you don't expect any more brand increases - brand price increases for the rest of the year. I'm assuming you were talking about your fiscal year. Generally speaking, what about the calendar year? I'm not asking for 2020 guidance. I'm just talking about, do you expect the typical June or July 1 sort of price increases as well? Do you think there’s going to be anything different with that? Or were you expecting that for the full calendar year, that January was going to be much larger percentage in terms of magnitude and depth or breadth of price increases?

Mike Kaufmann: Yes, it's a fair question. First of all, to be clear, it was our fiscal year I was talking about and that we would expect relatively immaterial increase. Not - it wouldn't be zero, but we don't expect a significant amount of increases between now and June 30. The majority was in January, and it occurred within the range we expected. So that was just more to help you understand. We don't see a lot of risk. If it were, absolutely zero between what we have in and what's left to do.

Regarding the whole year, I don't want to get into a lot of forecasting, but this past year, what I can say is that at the beginning of the year, we did expect more July increases than we actually ended up seeing. So at the beginning of the year, we did expect the old traditional of a little bit in July and then some spread out and more in January. Instead what we saw was less in July and the rest of the year and more pushed to January.

So while the overall dollars were less year-over-year in January or in total for the year, there was a higher percentage in the month of January. And so it's hard to say for right now, but it's probably a reasonable assumption going forward. But again, it's hard for us and we'll continue to listen to the administration and talk to our manufacturer partners to understand their thoughts around timing of price increases.

Lisa Capodici: Operator, we have time for one more question.

Operator: And we'll take our final question from Eric Coldwell with Baird. Please go ahead.

Eric Coldwell: Hey. Thanks. Good morning. So Mike, every distributor has shown really nice revenue upside this quarter. You guys 1.7, ABC 1.6, McKesson over 1.1 billion. That's summing up to about 4.5 billion in the quarter, about 20 billion annualized - 18 billion annualized. So I guess my question is this. Everybody say their growth is because of their big customers doing well. It's sort of unique, but it's really not unique. It's the whole sector of the big three.

Something has to be happening here because we have generic deflation, brand inflation is running at a decade low. I don't think most of us are really seeing it in the volume numbers. So I guess my question is this. There has to be a hook. I'm worried that maybe this is - your big clients are actually starting to decimate the small independence. You might have a different angle on that, but I'll open it up with that.

Mike Kaufmann: No, it's a very fair question. It's hard for me to comment on everybody's customer base. Remember there are few pieces due to some acquisitions by folks acquiring other chains in other businesses in the industry. That's having some impacts on various people's growth. Also, the other thing to keep in mind, and we can't get into detail specific to our customers, but remember, at least in Cardinal's case, which I can comment to is, some of our customers buy certain products direct and they may change some of those products from buying direct to buying through us.

The amount - their timing of their inventory builds could have an impact. You can have extra day of sales or so in a quarter. It's hard for us to know exactly when they've done that and not done that. So there's probably a few things like that moving around the numbers. I wouldn't say that it's - I would say that it's totally at the expense, for instance as your comment around retail independence or anything, that we continue to see that class of trade have similar trends to the past and continue to be healthy. But there's just a lot of potential moving parts which is hard for me to comment on everybody's reasons.

Eric Coldwell: Do you think that some of the changes with price transparency, the California rule, et cetera, is it somehow driving your customers to maybe buy inventory in December that they might have historically bought in January or February? Is there some angle there that we should be investigating?

Mike Kaufmann: You know, it's hard to say how each one of the customers evaluate their balance sheet and what they want to do. It's often hard for customers due to the limited space and stuff they have in their stores, to do a lot of extra buying. But to say that I can tell you that it had zero impact, I can't tell you that. So it might have had a small impact because there is, as you mentioned, a little bit more visibility to some of when price increases are going to occur.

So that could be a potential, which is why I mentioned that you'll see potentially, quarterly fluctuations on sales because of - particularly when you have customers, the warehouse pharmaceuticals like we do, have several of our large customers warehouse them, that depending on the day of the month, their views like you said on price increases, service levels, those types of things, that can cause fluctuation. All right, with that, I want to…

Operator: I'll now turn the conference…

Mike Kaufmann: Okay, go ahead.

Operator: I will now turn the conference back to Mr. Mike Kaufmann for any additional or closing remarks.

Mike Kaufmann: Great. Thank you very much. I want to thank all of you for joining us today. As I think you can see, the team continues to move forward in executing our plan and positioning Cardinal Health for the future growth. I'm proud of the work the team is doing and as we take steps to further enhance Cardinal Health's competitive position in the marketplace, support our customer base and drive shareholder value. And we look forward to reporting on our future progress. Take care and have a great day, everybody.

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