Q2 FY15 Cardinal Health, Inc. Earnings Conference Call

January 29, 2015 8:30AM Eastern

Operator: Please stand by. Good day, and welcome to the Cardinal Health Second Quarter Fiscal Year 2015 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the call over to Sally Curley. Please go ahead.

Sally Curley: Thank you, Lisa, and welcome to today's second quarter fiscal 2015 earnings call. Today, we'll be making forward-looking statements. The matters addressed in these 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 the presentation, found on the Investor page of our website for a description of those risks and uncertainties. In addition, we'll reference non-GAAP financial measures. Information about the measures is included at the end of the slides.

I'd also like to remind you of a few upcoming investment conferences and events. We'll be webcasting our presentation at the Leerink Partners Global Healthcare Conference on February 12 at 8:30 am local time in New York; the RBC Capital Markets' 2015 Global Healthcare Conference on February 24 at 8:00 am local time in New York; the Cowen and Company's 35th Annual Healthcare Conference on March 3, 8:00 am local time in Boston, and the Barclays Global Healthcare Conference on March 10 at 8:30 am local time in Miami.

Today's press release and details for any webcasted events are or will be posted on the IR section of our website at cardinalhealth.com. So please make sure to visit this site often for any updated information, and we hope to see many of you at an upcoming event.

Now I'd like to turn the call over to our Chairman and CEO, George Barrett. George?

George Barrett: Thanks Sally. Good morning everyone and thanks to all of you for joining us on our second quarter call. I'm pleased to report a very strong second quarter, bringing to completion an excellent first half of fiscal 2015.

I'd like to take a moment to welcome Mike Kaufmann to his first quarterly earnings call as the CFO of Cardinal Health. Mike and Jeff have worked closely during the transition and I appreciate their collaboration. Mike brings tremendous operating experience to our financial team and has adjusted quickly to his new role.

Total revenues for the second quarter were $25.5 billion, an increase of 15% versus last year's second quarter. We were pleased to see sales growth from both existing and new customers. Our second quarter non-GAAP diluted EPS was $1.20, up 33% from last year's 90 cents. Remember that our same quarter last year included a 16 cent expense related to a tax item. When we adjust for this tax item, our second quarter FY15 non-GAAP diluted EPS increased by a robust 13%.

At the same time we returned $438 million to our shareholders through a combination of stock repurchases and dividends during the second quarter, bringing the total amount returned to our shareholders for the first half of the fiscal year to over $900 million. Based on our results through the first half of our fiscal 2015 and our perspective on the back half of the year, we are now raising our guidance to a full-year EPS range of $4.28 to $4.38.

As I typically do, I will provide some color on the segments, but before I do that, I would like to offer a slightly different perspective on viewing Cardinal Health. Our health system is going through significant changes, not the least of which is the continued blurring of the lines between healthcare players and channels. Our approach to addressing the market has been aligned to this trend, bringing the full range of Cardinal Health capabilities in a holistic framework to address the needs of these increasingly integrated customers.

With this as backdrop, I'll speak about the segments, but please recognize that in many instances we are going to the market not as a Pharmaceutical segment, not as a Medical segment, but as Cardinal Health, an integrated

source of strategic solutions and the creation of our strategic account teams will only expand this enterprise wide effort.

Now to the segments. First, our Pharmaceutical segment. Second quarter Pharmaceutical segment revenue was very strong. Sales for the quarter were $22.6 billion, an increase of 16% over the prior year, showing positive signs in nearly all of our business lines and in all classes of trade.

Our organization has been unwavering in its commitment to ensure that our customers see us not only as extraordinarily reliable, but also able to help them adapt to the changes in the system.

A couple of notes here on revenues. On a year-over-year basis, we were pleased to pick up some new business crossing all classes of trade, but including one larger mail order customer, which as you know historically contributes lower margin rates.

And as many of you know, the treatment of hepatitis C has evolved into a major therapeutic class, and one which has changed dramatically over this past year. The distribution of these products contributed meaningfully to our revenue growth, but have a dilutive effect on our margin rates.

The overall performance of our generic programs remains very strong and Red Oak sourcing, our venture with CVS Health, is clearly an important strategic initiative for us. We are increasingly excited about this partnership, and are very pleased about the way our collective talent has fully integrated as one team.

They have been working hard to make sure that our supplier partners feel that they're part of something that creates value for all stakeholders. We feel confident that the Red Oak model was designed thoughtfully and built to prioritize execution and simplicity. I can report that at this stage, we are tracking somewhat ahead of our plan to transition manufacturers to the Red Oak program.

Of course, sourcing products is only one half of the story. We have seen continued growth in our base of customers, an increasing number of whom source generics from us, and our range of products and services continues to attract pharmacy customers. Our specialty solutions organization continues its track record of excellent revenue growth.

You will remember from our last earnings call that we expect sales for this unit to track at $5 billion for the year, and we are increasingly confident that we will exceed that number for our fiscal year. We continue to look for opportunities to expand our reach to a broader range of therapeutic areas.

We have positioned our specialty business at the nexus of biopharma, payor, provider and patient. We are committed to keeping the patient at the center of our strategy and our enhanced patient access and support HUB reinforces that focus. Upstream, we continue to look for opportunities to broaden our Pharmaceutical and biotech relationships and to expand the tools we offer these partners who serve unique patient populations.

So next on our Medical segment. We reported revenues for the quarter of $2.9 billion, an increase of 4% versus prior year. Our Medical segment's top-line growth was driven by recent acquisitions and growth in existing customers. Our profits were affected by continued challenges in Canada and the year-over-year customer loss in surgical kitting referred to in prior calls.

One important financial note, our Medical segment profits were significantly impacted this quarter by increased incentive compensation, a by-product of raising our enterprise-wide forecast and the accompanying expense to the segment. Having said this, our strategic initiatives in the Medical segment continue to send positive signals, each of which is critical to our overall positioning.

We've spoken consistently about the movement of care migrating into more ambulatory settings. Our collaboration with Henry Schein addresses an important link in the chain as we help serve highly integrated health systems, whose networks now include many smaller physician practices, as well as independent practices.

Combining Henry Schein's logistic and service capabilities with Cardinal Health's strength in other channels will enable us to serve these customers more efficiently while increasing the flow of Cardinal Health products into these new channels. The partnership is off to a good start. Meetings with our two sales organizations have gone extremely well and they are working hard on the implementation of the integrated selling effort.

We've made our first customer presentations as a combined selling organization, and here at Cardinal Health, we've seen our first orders for products destined for these new channels. Consistent with our perspective that care will increasingly be delivered in different settings, we continue to be really excited about our work in the home. Cardinal Health at Home continues to deliver good growth.

Our direct-to-patient business, EdgePark, continues to grow at double-digit rates. We have been introducing Cardinal Health branded products into this channel - specifically we would expect that by the end of fiscal 2015 to have launched over 100 new products through this platform, primarily in the areas of wound care and incontinence.

Our strategy around private label consumables and physician preference items is aligned to address an important need in the system, tackling the inefficiency associated with the proliferation of products and the need for standardization. Building scale, reducing variability, improving outcomes while reducing costs - this is at the heart of our strategy.

Specifically in the trauma area, we've made tremendous progress in building out our product-line, helped by the acquisition of Emerge Medical. We expect to be able to offer a reasonably full line of trauma products by early next fiscal year. At the same time, we have trained over 200 residents on orthopedic trauma using the Cardinal Health trauma products.

In wound management, we've made a strong commitment to negative pressure wound therapy, and we're in the process of launching 25 skus in this area. As is true with all of our products, the introduction of a wound care

portfolio leverages our channel reach to create an integrated wound care solution that stretches across the continuum of care.

Finally on interventional cardiology, our Access Closure acquisition is going extremely well. Some recent new sales of closure devices in our strategic accounts is an encouraging sign as it relates to the power of combining Access Closure's product line and the breadth of our customer relationships. Further on the technical side, our Mynx Grip is now the only closure device in the U.S. indicated for venous closure.

Finally, China continues to execute well against our plan with very robust double-digit sales growth. As you know, our development in China has been thoughtful and purposeful - built on a foundation of service, integrity and compliance as our key differentiator.

Our balance sheet remains strong and we will not be shy about deploying capital to achieve best, sustainable, competitive positions in strategically important areas. Having said this, we will continue to be both creative and disciplined in our deployment of capital using partnerships to strengthen our position where that's more efficient - Red Oak and Henry Schein being two recent examples.

Let me conclude my comments by offering this perspective. This remains an exciting time to be in health care and our organization is aligned with the important trends which are shaping our new landscape.

But we're also an organization committed to disciplined execution in a business that demands great attention to detail. Over the past 18 months, our Pharmaceutical segment has come through a critical transition - repositioning its customer base and dramatically improving its tools - and has emerged stronger than ever.

Our Medical segment is going through its own transition - moving from an organization focused on med-surge distribution to an organization which creates value in new ways for customers with new needs. It is also a segment which contains many important mid and long term drivers of growth.

It seems clear that growth will be driven by demographics; by more Americans having health coverage in some form; that care will continue to be delivered in new settings and at times by different caregivers; consumers will be more actively involved in their own care; Pharmaceutical innovation will continue to create treatments and in some cases, cures for life's most threatening diseases.

Those who bring tools to help manage the quality and cost of care will be winners, and the efficiency created by scale will be valuable. We bring these things, and we are increasingly aware that we have a unique position in the marketplace.

It's difficult to find another company with this kind of reach across the system and we are committed to bringing an increasingly integrating marketplace solutions that cross traditional lines. This is central to our competitive advantage.

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

Mike Kaufmann: Thanks George and good morning everyone. Before we get into the earnings discussion, I just wanted to say that it has been an exciting few months for me since becoming CFO. I've enjoyed not only leading the Cardinal Health Finance team but also meeting with many of you - our investors and analysts. For those of you I have not met, I look forward to speaking with you soon.

Now on to the quarter. As George mentioned, we are happy to report strong financial performance this quarter, and to be raising our non-GAAP EPS guidance.

I will first walk through the drivers for the quarter's financial performance and then provide some insight into our expectations for the remainder of this fiscal year. You can refer to the slide presentation posted on our website as a guide to this discussion. I will start by talking about consolidated results then go into more detail in my segment discussions.

Non-GAAP EPS for the quarter was $1.20, an increase of 33% versus the prior year. As a reminder, the prior year quarter includes a 16 cent charge related to a tax item. Eliminating this item, Non-GAAP EPS grew 13% year-over-year. Again this quarter, revenues exceeded our expectations up 15% to $25.5 billion.

Total company gross margin dollars were up 8% for the quarter but the rate was compressed a bit largely because of Hepatitis C therapies launched within the last year and some shift in margin rates related to the recent expansion of our customer base.

Total SG&A increased 6% versus the prior year, primarily driven by the impact of acquisitions. Consolidated non-GAAP Operating Earnings were up over 10% to $639 million or a non-GAAP operating margin rate of 2.5%. In the quarter, Net interest and Other expense was $7 million higher, due in large part to the timing of various components of the long-term debt refinancing we completed during the quarter.

On Tax, as we have said in the past, our non-GAAP effective tax rate can fluctuate quarterly due to changes in international and U.S. state effective tax rates resulting from our business mix and discrete items. This is why we only provide annual tax rate guidance. You'll notice that for the first half of this fiscal year, our non-GAAP tax rate was 35%.

We still expect our full year tax rate to be 36-37%, which implies a higher rate in the second half of this fiscal year. Our second-quarter diluted weighted-average shares outstanding were 334 million, 12 million shares favorable to the prior year's quarter. During Q2, we repurchased $324 million worth of shares leaving about $1 billion of share purchase authorization remaining under our Board approval.

To complete my review of the consolidated numbers, let's move to consolidated cash flows and the balance sheet. We generated a robust $953 million in operating cash flow in the quarter. As a reminder, operating cash flow in Q1 was light, which was largely just a function of timing and we expected some shift between quarters.

At the end of the second quarter, we had cash on our balance sheet of $2.9 billion, which includes $448 million held internationally. Our balance sheet allows us the flexibility to deploy capital in the most efficient way to return value to shareholders and to drive sustainable growth.

Speaking of capital deployment, as Pharmaceutical segment CEO, I was part of our capital committee and actively involved in all major deployment decisions. You should expect that our strategies around capital deployment will remain intact.

Let me take a moment to reiterate our priorities. First, we are committed to investing in activities that reinforce the sustained strength of our core businesses. Next, we remain committed to our differentiated dividend that we expect to grow at least in line with our long-term non-GAAP earnings growth rate. Third, we will not be hesitant to deploy capital for acquisitions which further strengthen our businesses and best position us for leadership in this evolving environment. We've talked pretty consistently about our strategic priorities and these will of course be the areas where we will devote the most attention as we consider inorganic moves. And as we've done in the past, we will continue to consider share repurchases. This fiscal year, we've repurchased $684 million worth of shares.

Now let's move to segment performance, starting with pharma. Pharmaceutical segment revenue increased 16% to $22.6 billion, driven by growth in our base of existing customers, as well as the impact of new customers. Pharma segment profit increased 12% to $542 million, due to strong performance under generic programs, which includes the net benefit of Red Oak sourcing.

Also, our profit was positively impacted by continued growth from existing customers, as well as growth from new customers. The Pharmaceutical segment profit margin rate decreased 9 basis points, impacted by customer pricing changes, newly launched hepatitis C Pharmaceutical products and the impact of new customers. These were partially offset by strong performance from generic programs, which again include the net benefit of Red Oak sourcing.

The branded hepatitis C therapies launched within the last year have been a topic of great interest in health care. Just to be clear, for Cardinal Health, these sales contribute to top-line growth, but the overall impact is dilutive to margin rates. Additionally as a reminder, these products are recorded within Pharmaceutical distribution results, not our Specialty sales.

With respect to our generic programs, we saw strong unit growth this quarter. Also, as projected Red Oak sourcing was accretive in the quarter, Net of the $25.6 million payment we made to CVS Health. As a board member of Red Oak, I continue to be impressed with the efficiency and speed at which the Red Oak team has executed.

They have now transitioned suppliers representing greater than 95% of the total generic spend. For the quarter, as it relates to the impact of generic manufacturer price increases, we did see a slight year-over-year decrease in contribution.

Now let's go to the Medical segment performance. Revenue for the Medical segment increased 4% to $2.9 billion, driven by acquisitions and growth from existing customers.

Medical segment profit decreased 12% to $115 million, with the largest negative driver being a year-over-year increase in enterprise-wide incentive compensation, as well as the continued impact of market pressures in Canada and the related repositioning of that business. These factors also drove the Medical segment profit margin rate this quarter, which decreased by 73 basis points.

Since the performance of our Canadian unit has been a challenge over the last 9 months, let me take a moment to discuss it. I recently met with the Canadian team and left impressed with the new team members, the optimism of the entire team, their pipeline and their strategic plan - which includes accelerated movement of Cardinal Health brand products.

We should see some recovery in that business starting later this calendar year. While there have been some challenges in certain discrete areas, the Medical segment continues to execute against its strategic priorities. For example, within our Strategic Hospital Accounts, we continued to achieve organic growth of more than 5% versus the prior year quarter. This remains a key area of focus, as we demonstrate to the large integrated health systems that we create enterprise solutions to address the challenges they face.

Now, I'd like to give you my observations on our Medical segment, not only from my new CFO seat, but also from my experience as CEO of the Pharmaceutical segment and President of the Medical business some seven years ago. As George mentioned, Medical has been going through a critical transition. I'm particularly aware of this as I compare our profit drivers today to what they were seven years ago.

Over this time, the profit pools have shifted, and under Don's leadership the team has adapted and made tough decisions to invest in certain key priorities while reducing emphasis and investment in others. Our Medical team has built new capabilities and made the moves necessary to reposition the segment to create more value for customers and partners and to participate in new profit pools going forward.

Before we move on, I'd like to briefly touch on what we are seeing around commodities as this has been top of mind for many of you. For FY15, as we've previously said due to the time lag within our supply chain, we only expect to see very slight benefit and that is included in our updated guidance range.

Now while it is very early, I want to give you my preliminary observations regarding FY16. We are continually updating our commodities forecasts including analyzing them based on forward curves. Our most recent analysis indicates that there will be a modest benefit of $10 million to $20 million in fiscal '16. For those of you who remember commodities being a large headwind some years ago, this may seem low.

While there are several factors causing this, let me touch on two of them. First, over the past few years the prices of inputs to our Cardinal Health brand products no longer move in tandem with crude oil prices. Second, since we experienced significant commodity exposures in the past, we have worked to temper these through strategic and

operational measures we have taken with our suppliers. Any updated estimates would be included in the FY16 guidance that we typically provide on our Q4 call.

Now turning to slide number 6, you will see our reconciliation of consolidated GAAP results to non-GAAP for the quarter. The 34 cent variance to non-GAAP results was primarily driven by litigation expenses, amortization and other acquisition related costs and loss on extinguishment of debt. You will see on this schedule that the net of tax impact of the debt redemption resulted in a $37 million GAAP expense.

Let me begin to wrap up with a brief discussion on the remainder of FY15. Based on our strong first half performance, and helped a bit by the lower tax rate in Q2, we are increasing and tightening our overall FY15 non-GAAP EPS guidance range to $4.28 to $4.38 from the prior range of $4.10 to $4.30.

A few comments about the new guidance range, what we've realized to date and what we are assuming. Based on overall revenue growth fiscal year-to-date, we are updating our total company revenue guidance from “up modestly” compared to FY14, to now expecting the full year revenue growth to be in the high single digits.

As for each segment, we continue to expect our Medical segment revenue growth to be as originally provided - low to mid-single digit growth versus FY14. And following two quarters of strong growth, we now expect that full year pharma segment revenue growth will be in the high single to low double-digit range, compared to the prior year.

With respect to Red Oak, as George mentioned, the transition of manufacturers to the Red Oak program has been a little faster than our previously discussed expectations. It is too early to comment on the timing, sequencing or impact around a possible Nexium launch, and so we have not included this in our updated guidance.

There are multiple variables that are still up in the air including legal maneuvers, the timing of launches, capacity and the number of other companies who could potentially launch. When the facts become clearer, we will evaluate its impact on our new guidance.

Also, it is worth mentioning that our assumptions around branded and generic inflation have not changed. We still expect branded inflation to be about the same as fiscal ’14 - in the low double-digits and across our generic portfolio, while we still expect slight inflation, we have modeled the overall benefits to moderate in our second half versus what we experienced in the first-half. Our guidance range also assumes that our head wind we’ve experienced in Canada year-to-date will carry through the remainder of the fiscal year.

Looking at our corporate assumptions, our full year non-GAAP tax rate guidance range of 36-37% remains unchanged, which as I mentioned previously, implies a higher tax rate during the second half of this fiscal year. We are slightly reducing our Interest and Other range to $135 million to $145 million.

We are also lowering our diluted weighted-average share outstanding range to 336 to 337 million shares. We are modifying our capital expenditure guidance to $340 million to $350 million, and finally, our amortization slightly increased, based on the few previously mentioned small acquisitions we’ve completed in the first half of this fiscal year.

In summary, we are really pleased with the progress we have made in the first half of fiscal ’15 and expect similar execution in the back half of the year. So with one quarter under my belt as the new CFO, I look forward to sharing our progress with you in the coming weeks and months.

Operator, let's begin our Q&A.

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Operator: Thank you, sir. If you would like to ask a question please signal by pressing *1 on your telephone keypad. If you are using a speakerphone please make sure your mute option is turned off to allow your signal to reach our equipment. Once again, everyone, that is *1 to ask a question. Also please limit yourself to one question and one follow up question. And we'll pause for a moment. Our first question comes from Bob Jones with Goldman Sachs.

Bob Jones: Thanks for the question. I actually just had couple of on Medical, trying to calibrate things here. I know you guys had mentioned incentive comp as a headwind in the quarter. Could you maybe just give us a sense of what the margin in Medical would have been of you adjust for incentive comp year-over-year?

Mike Kaufmann: This is Mike and thanks for the question. Really can't go into details of what it would be adjusted, but I will give you a little color in that the majority of the comp that you saw pushed out into the Medical segment was in the area of 401k and that's because that's based on employees and as you know, a significant portion of our employees are in the Medical segment.

Bob Jones: That's helpful. I guess just one big question around that then is as we think about where we are today in Medical on the margins, you know, and moving towards at some point that long-term goal of, you know, 5.75%, just wondering if you can maybe help us think about the path to get there?

And then if I could just sneak in one specific one, Mike, on the commodities. I believe you said it was a tailwind of $10 million to $20 million for next year. If I go back and look at your 10-K filing, it looks like the impact from a 10% move and the example you gave in your filings would have resulted in about a $30 million impact. I'm wondering if there was some changing in hedging between June and today.

Mike Kaufmann: Yes, thanks for those questions. So I'll talk about the commodities first and then I can go back to giving you a little bit more color on Medical margins or George can do that.

And as far as the commodities go, remember a couple of different things. First of all, as I said, which is really most important, what we've seen over the last couple of years is all of the components of our -- of the items that make

up commodities for us, they do not really track in tandem with crude oil prices anymore. While historically, several years ago, you would see that for the most part, you don't see that any more. So that's a really big driver for us as we track both current and future rates on commodities.

Also, you also know that when we did have those significant issues in the past, as you could imagine we took a look at our contracts with our manufacturers and really focused on trying to rework those contracts and relationships with the manufacturers, so that we would not see these types of ups or downs going forward in the future. And so that's really what's probably tempering your estimates of the numbers.

George Barrett: And Bob if I can -- its George -- maybe just touch base a little bit on the drivers as it relates to the goal of expanding margins in Medical. Let me just carve them out. Key growth areas would be the services around our distribution platform. So the traditional supply chain activities are now a much broader range of services that we're beginning to offer. Those typically carry higher margins.

Growth in our consumables, particularly our private label consumables, our physician preference items, I talked about wound management, I talk about interventional cardiology, I talked about trauma. Growth in these are higher margins. Growth in the Home is important to us. Again this is an area where we've seen excellent growth and expansion of margins. So the overall positioning of these activities really drives mix.

Again I think remember, for example private label products now being driven in through our home strategy. So these are all expansive to margins. And then finally positioning with the key accounts in the system. So it's really -- a large component of that it's both mix of product line and in some degree mix of customers.

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

Charles Rhyee: Yeah, thanks for taking the question. You know, maybe if I can follow up on Bob's question, and maybe ask in a little different way. If we were to exclude the Canadian business out of the Medical segment, can you kind

of give us sense on how that is performing over the last couple of quarters? In terms of margin improvement and, you know, as you have been pushing out preferred products and the physician preference items?

Mike Kaufmann: Yes, I can appreciate the question but I really don't want to go into that level of detail on it. Again there are a couple of discrete items that we mentioned. It's really the Canadian business that is a big factor and a pushdown of compensation that are really driving the Medical segment year-over-year negative performance.

Charles Rhyee: Then maybe on the Canadian side, you talked about meeting with the team and you said you like the strategy they're kind of laying out to you. Can you maybe give us a little bit more details on how you guys are planning to tackle some of the issues here? I know you talked about more Cardinal branded products. But, you know, what is specifically there that we can, you know, hope to kind of get around some of the issues?

Mike Kaufmann: Yes. Thanks for that question. I did get a chance to actually go up there and spend some time with the team and I've had some involvement over the years with them. I think a couple of things on their mind. First of all as I mentioned, focusing on shifting where possible our Cardinal brand products, that's a big important piece.

One other thing to remember is we are really the only distributor up there in the Med/Surg area that has reach of the entire -- all of Canada. And so I think the team has done some really good things around leveraging our supply chain to be able to work with manufacturers to drive more opportunities up there.

They're also as you can imagine looking aggressively at their cost structure and they're doing things with their management team and I've really like where they have been able to bring some new blood in too, some really talented folks that are looking at the business differently. In fact, I know our new CFO up there came from one of our customers up there and really understands the business and is going to bring some, you know, new ideas to the table.

George Barrett: This is George. I might just want to add something to sort of back to where you started. We're not going to start to break out and pull out the pieces of the business on Medical, but I would probably offer this. When we

look at our all of our strategic priorities, and we're doing pretty consistent metrics around our Medical business, we actually see some very good signs, and it's actually been an operating according to our internal forecast.

So our growth in Strategic Accounts is good, consumables growth is good. The physician preference item strategy as we've told you is sort of a more mid-term driver of the business, but we actually like some of the underlying characteristics that we've seen.

We have seen over the years that traditional Med/Surg distribution has seen some pricing pressure over the years. But that's something that we anticipate and expect and we like the growth that we're seeing in the home. So, when we look at the components that are making up this segment, we really like the way the pieces are going. Again we're going to have to absorb the changes that we saw in this Canadian market and I think we'll also lap those -- part of it was just the market change that we had to deal with.

Operator: And we'll take our next question from Glen Santangelo with Credit Suisse.

Glen Santangelo: Yeah, thanks. George, I just want to follow up on some of the commentary around generic price inflation. I think you seemed to suggest that maybe you saw slightly better inflation on generics sort of year-over-year. But I think you're moderating your assumptions in the second half of the fiscal year versus the first half. Are you kind of implying that maybe some of that was pulled forward? Could you maybe just flesh out a little bit more what you're seeing in the marketplace and how we should think about the trends?

George Barrett: Glenn, let me start and then I'll be happy to have Mike chime in and he's obviously been very close to it from his prior role. You know, when we talk about moderating for the back half of the year, it's largely just a model at this point. We don't have perfect transparency on pricing. We have historical models. We do the best we can to use those to guide us going forward.

We have the interactions with the suppliers. But, there is not something absolutely discrete, a perfect trend line that tells us what to do. We just thought the numbers in the first half were reasonably strong. And so what we did

was we just moderated that somewhat in the second half, and that's the way we approached it. But it's difficult to come to us a perfect number on this.

Mike Kaufmann: Yes. I can just add a little bit of color. So as I did mention, for the quarter as it relates to generic inflation, this quarter was slightly less than last year's quarter, as there was a year-over-year decrease in the contribution. As far as Q1 versus Q2, Q1 was a little stronger than Q2 in terms of rate.

And you were right, you did hear me right. We do expect the second half of the year total generic inflation contribution to our bottom line will be moderated compared to the first half of the fiscal year.

Glen Santangelo: Okay thanks. Maybe if I could just follow up on capital deployment. George, you said all along that your preference is clearly to do strategic M&A versus share repurchase, but here we are halfway through the fiscal year and you've kind of already blown through your share repurchase target.

Should we sort of read into that, that maybe you don't see anything on the strategic M&A front that interests you, you know, or maybe if you can just give us an update there on how we should think about, you know, capital deployment through the balance of the fiscal year, given where the leverage sits on the balance sheet?

George Barrett: Yeah, thanks, Glen. No, I don't think you should read and anything into it actually. We are always looking at the most efficient way to create a great positioning for strategic growth. And there are moments where those opportunities are right in front of you and there are moments where they are not, but I don't think I would read into it.

We've done a small -- a couple of small moves in the physician preference item area over the last year -- last few months. And we're always actively looking. It's just a matter of finding that opportunity you think drives the value you want and you have to have someone on the other side ready to do it -- at that moment. But I don't think I would read anything into it.

Mike Kaufmann: We'll continue to opportunistic where it makes sense on the share repo, but I guess -- maybe the only other thing you could read into is that we're being disciplined and we're going to make sure we pick the things that match to our strategic priorities and are at the right price.

Operator: Our next question comes from George Hill with Deutsche Bank.

George Hill: Good morning, guys. And thanks for taking the questions.

George Barrett: Morning.

George Hill: Maybe, Mike, quickly on generic inflation, when you talk about the decreasing impact year-over-year, should we think about the decreasing impact as lower sell side margin contribution on higher generic drug prices or should we think about kind of lower carry on inventory that inflates? What's the right way to think about the contribution there?

Mike Kaufmann: I really don't think I can go into a lot of detail on that. Let's see if I can help a little bit. As you know there are different ways you can make money on generics. There is obviously the difference between what you sell it at and what you buy at. So we're always focused on that. And then obviously there is the appreciation on inventory when you have -- do have price increases.

So there are a lot of different components including how you price, penetrating current customers, etcetera that improve our programs and drive margin. So to be specific how any one single margin bucket works would be difficult. And obviously our manufacturer contracts and discussions are incredibly confidential and competitive.

George Barrett: I guess some -- I want to make sure I understood the question George. I don't think there is anything mechanical that we're highlighting here. It's just the overall pricing environment. So I don't think that we can -- if that's the question it's a not a unique mechanical dynamic. I think Mike's just describing the overall pricing trend.

George Hill: Okay, that's helpful. And then maybe just kind of a quick follow-up on the Medical segment again. Just -- I don't know -- I'm wondering is there any more color you can give us on kind of what would drive the rapid increase in the 401k contributions in that segment of the business compared to other segments?

Mike Kaufmann: So the best way to think about it is, is the way we look at compensation, we look at it is all of Cardinal. And so when there is overall performance from the business, then one of the biggest pieces that get funded first is our 401k program. And we don't distinguish between our employees on whether they're in the M or the P segment when overall Cardinal Health is performing.

And so since we had a strong first half, it caused us per our internal guidelines to increase our accruals on our 401k. And knowing that a significant portion of our employees are in the Medical segment, then those costs just get allocated to the Medical segment for the employees and their 401k contribution.

Operator: Our next question comes from David Larsen with Leerink.

David Larsen: Hey, can you guys talk a little bit more about the operating margin in the Pharma division. So I think you called out a couple of things; pricing, new customers, and Hep C. So, margin I think decline by about 8 basis points year-over-year. Can you just give any more color on sort of what the -- like the size -- the buckets for each of those items that you called out and which ones have greatest impact? Thanks.

Mike Kaufmann: Yeah, I can get into a kind of detail, but clearly those were the two largest - so it was 9 basis points of decline in margin rate and the two biggest drivers were just some new customers that we mentioned. As George mentioned we had one large mail order customer that tends to come in at lower margin rates.

And then as I think you've seen from a lot of folks in the industry, the hepatitis C drugs have been doing very well. This is really important drug class and we too have seen significant sales of those drugs in our business. And because they come in at much lower margin rates than typical our average, they are lowering our overall margin rate.

David Larsen: So you obviously saw a good growth year-over-year in terms of dollars, I think up 12% year-over-year. So the mail order customer, that's a new customer that came in at lower margins as a percentage of revenue? Is that correct? It wasn't a shift just to mail? And then obviously the Hep C is new revenue at a lower margin rate, right? Is that correct?

Mike Kaufmann: That's right. It's a new customer, that again being mail-order is mostly brand business and so it comes in at lower margin rates.

David Larsen: Okay, thanks a lot. Congrats on a good quarter.

Mike Kaufmann: Thank you.

Operator: Our next question comes from Ross Muken with Evercore ISI.

Elizabeth Anderson: Hi. This is Elizabeth Anderson in for Ross. I had a question about the Hep C -- the Hep C product as a percentage of your total sales. Could you provide a little bit more color on that?

Mike Kaufmann: Sure, our Hep C drugs as a percentage of our total Pharma segment revenues is less than 25%.

Elizabeth Anderson: Okay. And in addition, I was just wondering if you could give some additional color on the early wins and challenges from Red Oak? I know you said that you have sort of 95% of the contracts. But I was just wondering if there are any more specifics you could give us on that?

Mike Kaufmann: Sure, let me just make sure on that, first one. Just to make sure I got it right. It's less than 25% of our growth, not less than 25% of our volume of drug spend. So just to be clear, the Hep C drugs were less than 25% of our overall growth for the quarter. And then as far as Red Oak goes, I guess all I can add to it is, I just continue to be impressed with the team.

The leaders there - the executive team has done an excellent job of really blending together the employee bases. You could go there and - I think George has mentioned this the past, as have I in some situations - you really can't tell who was a CVS or a Cardinal employee, or who came from the outside.

And when I was at our Board meeting just recently, a lot of the executive management said the same thing, that they're having to remind themselves some of new people who came from where. So I think from a culture standpoint that's really important.

And then also -- that's been really exciting is we were able to get all the people we wanted to transfer to go there. So all the key folks from CVS moved over there, as well as the key folks from Cardinal and that really helped us get a really quick start, because we weren't training anybody.

We had literally experts who have had decades and decades of experience in the generic business move straight over to Red Oak. So that's been positive. So again culture is going well, discussions with the manufacturers have gone well, and as I said we're at above 95% of the manufacturers moved over. So let me ask George to add couple comments.

George Barrett: Just one additional thing, because you asked about challenges. We were very focused on simplicity, and speed and clarity for the manufacturers. So one of the biggest challenges, it's an incredibly complicated system, but if you look at all of generics and trying to do all the trade terms and conditions with every manufacturer.

So as Mike said getting through this many, given the complexity and then trying to come out with a program, that was really straight forward and simple, was a great challenge and I think the team did an amazing job of doing that.

Operator: Our next question comes from Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yeah, hi. Good morning. A couple of follow up questions here. First of all, on the top line growth, Mike, I think you mentioned that Hep C was less than a quarter of growth, that's about 3% contributions. So when we parse out the new customer is in the Hep C, what percent of growth do you think is Cardinal specific versus just overall market growth?

Mike Kaufmann: I can't get into real specifics, but I would tell you that we all I think have seen if -- we've all looked at IMS data. We've seen some really strong comparatively to the past numbers from IMS, in around that 1% to 4% range. Specifically over the last several months we've seen strong growth there. So that's obviously a contributor to our top line growth.

But breaking it down between what's industry growth, how much is new customers, how much is existing, how much you know because you have brands moving to generics et cetera, it would be really tough to parse all of that out. And then there is also lot of other things going on in the environment.

George Barrett: Ricky I want to make sure I understand your question, but again in general terms, our prescription growth was very good. As Mike said our unit growth in generics was very good, our positioning in the market looks very good. And again the IMS data, last time it was 3 point something. So there is clearly some demand growth which is good in the system. Our position in the market is good and so that is a good combination.

So I'm not sure if you're asking about Hep C and whether we're disproportionately, and I was trying to make sure I understood that question. But I say again, for us think about it just, we've got a base of customers. Those Hep C products flow through different channels and we're present in all those channels.

Ricky Goldwasser: I'm actually trying to understand what growth is, when you normalize for Hep C, right, assuming that over time will actually settle down?

George Barrett: I don't think we'd probably take any piece of business out of our business and say that's normal. I think this is now part of the base of the business.

Ricky Goldwasser: Okay. And then on Red Oak, you said that 90% - 95% manufacturers moved over. So when we think about kind of the contribution that flows through your P&L, how far are you in the ramp in the generic stage? Is what we've seen this quarter and we take that and annualize it for the reminder of the year or should we see sequential improvement over the next four quarters?

George Barrett: Ricky we're having a little bit of difficulty hearing you.

Mike Kaufmann: If I got it right, as George mentioned, I think I emphasized as we did see a ramp faster in this quarter than we had originally expected. So I guess I would tell you that.

Now to try to describe with Q3 and Q4, we obviously still expect some ramp in the second half of the year compared to the first half of the year because every day we're signing up new vendors and transitioning suppliers, but obviously with 95% of them already moved over to the new contracting, you're getting close to where you could take Q2 and you're going to see it again ramp up over the next couple of quarters.

George Barrett: Again this is all built into the guidance.

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

Lisa Gill: Thank you. Good morning. George, you know, just following up on thinking about Red Oak and your opportunities with share existing customers, can you maybe talk about the greenfield opportunity for customers that source generic products from Cardinal?

George Barrett: Yes, good morning Lisa. Yes, look we believe that we've got a unique model here and a terrific partner we're really excited with flowing, and I think as we look at the overall market of those who buy generics, we have started to see a little bit of change as companies start to consider the most effective way for them to source their products.

Some companies who historically have sourced those products directly are reevaluating whether that's the most effective tool for them and I think in some cases we've been able to demonstrate to those customers that we're a very attractive alternative as Cardinal Health.

So it's hard to size that opportunity for you, but I would say it's pretty clear that there are existing players out there who today are still trying to -- I am sure evaluate the most effective way for them to source products. We think we're very attractive supplier to those and we have picked up some business in this area, and I think those are encouraging signs.

Lisa Gill: Is there -- asking it the other way, is there a number that you can give us as far as your existing customers that source and buy generics through you today? Is it greater than 50%, is it 90%? Just trying to get some idea of just even in your existing customer base, what the greenfield opportunity is?

Mike Kaufmann: Yes, we wouldn't be able to give you that exact percentage. I would tell you that, you know, every customer buys at least some generics from us. It's just whether -- what percentage of their generic spend they buy from us. You know, sometimes it's in a backup position or in other times they'll buy a 100% from us.

So, I would tell you that we still have opportunity to be able to do that -- to grow that going forward and -- but we've done a great job historically in penetrating a lot of the chains, independents and even our hospital class of trade on their solid orals.

Operator: We'll take our next question from Eric Percher with Barclays.

Eric Percher: Thank you. Maybe I'll start by following up. You just mentioned you've been able to penetrate even independents and hospitals. I'm curious, you've brought on a mail customer recently that you spoke of, that is probably quite a bit smaller than your sourcing program when it comes to purchasing. So is there a value proposition even where you wouldn't be taking over the fulfillment of the products?

Mike Kaufmann: Yes, absolutely. We think we offer really great solutions in generics, not only in terms of the potential to save money in terms of cost, but also in the terms of our quality of the products, the supply, the way we work with the customer. And so, we've a lot of components of our program that we're going to work with each customer.

Now that being said, I can't speak for any one individual customer and they may have various reasons why they may choose or not choose sourcing from us, but we think we have as competitive or more competitive a program than anybody else out there and then we do see opportunities going forward or working with our various customers who are not buying a 100% of the generics from us.

Eric Percher: And then my follow-up would be on Canada, and you may have covered this when we first started talking about the issue, can you just remind me in simple terms what the issue has been? Is it competition, volume, pricing related? What is that work there?

Mike Kaufmann: Yes, it's been a couple of things. Generally overall I would just say it's really market pressures, and those market pressures, a lot related to reimbursement in the environment, have driven a lot of behaviors as you could imagine. Less purchases of capital equipment, utilization, all those types of things, pricing pressure is on them. So it's really reimbursement pressures in the market have put a lot of pressure on that business and it has forced them to relook at their model and work with their customers in different ways.

Operator: Our next question comes from John Kreger with William Blair.

John Kreger: George could you give us an update on how the China business is doing and what aspects of that business are gaining the most traction?

George Barrett: Yes, good morning John. It's going well. We mentioned that we had significant double-digit growth again in China. All the components of business are growing. Our distribution platform continues to expand. We have continue to provide some wrap around services with those customers, building out those capabilities, more marketing presence, which has I think been an exciting potential.

Our geographic reach continues to expand and we continue to expand the number of the direct-to-patient pharmacies, probably in and around 30 at this point. So -- and the product lines that we're carrying is now bigger on those pharmacies. So it's not unusual for us to carry double-digit number of products in those pharmacies. All good news because it expands our touch points to the patient, reinforces our relationships with our biopharmaceutical partners. So we're encouraged by the continued growth in China and we see it as a really exciting market.

John Kreger: Great, thank you.

George Barrett: You're welcome.

John Kreger: And then maybe a quick follow up. Can you remind us how the Henry Schein alliance will flow through the P&L? Did that have an impact on the quarter just reported or will it mostly be in the March quarter?

George Barrett: Yeah, no, so essentially what's going to happen is the sales that used to be reported through a part of our Medical business which was in ambulatory, those sales will shift to Schein. We will see our value coming through the gross margin line as our products flow through their channel. So that's the basic mechanics. And you would not have seen any value in the quarter completed.

George Barrett: And obviously our sales reps obviously moved over to Henry Schein. So revenue and expenses moved over to Henry Schein and obviously the margin they'd generate. But that's going to be more than offset, as we said this will be accretive to us by the margin that we will make on our sale of products to Henry Schein.

John Kreger: Great, thank you.

George Barrett: Thanks, John.

Operator: We'll take our next question from Dave Francis with RBC Capital Markets.

Dave Francis: I'll drill down on a couple of questions asked earlier. George and Mike, can you talk a little bit more about the drivers that you're seeing from your chair on what's creating the current pricing activity on the generic front? Is it push back from insurers or the retail folks in the chain or other folks in the supply chain that are kind of equalizing the supply/demand dynamic, or is there something -- other factor at play that's causing a moderation in pricing on the generic front.

George Barrett: Yes, I'm not sure that it's a single factor, and again Dave, it's hard to say, to describe a trend. I think we've talked at times about the conditions that we saw that probably led to some of the increased prices. I would say systemically we're not seeing a big change in that. So it's really individual behaviors. These are all individual products. You have to remember that when we talk about the pricing movement, the biggest swings that have occurred over the last couple of years are on hundreds, not thousands of products.

And so it's really discrete to the individual supplier and their product line, and so I wouldn't say the overall conditions of the market have necessarily changed. We're just -- based on just some data we have and we saw in the first half, we just decided that in our model we would moderate that second half. But as I said before, it is extremely difficult to project this, because it really is individual companies with individual product lines.

Dave Francis: As a follow up, going to the capital deployment side of things, you guys have quite a few different strategic development efforts going on across both product lines and geographies. Is it possible to try and tease out from you a little bit more about where you see more specifically in the different areas that you're looking at better options than others relative to putting capital to work on the acquisition front.

George Barrett: It's a good question. I wish I could answer it fully for you, which of course I can't, in terms of what we look at. But let me just highlight the priority areas. Certainly where we can build scale in our Pharmaceutical business and particularly around generics, it's always attractive.

Those opportunities don't come up every day. But those are high priority. Specialty continues to be an area of high emphasis. We believe that you'll continue to see the growth of specialty biopharmaceuticals and products that address unique patient populations. And so we continue to look in that area.

Everything around the IDN hospital services for us is important. Many hospitals are beginning to look, particularly given some of the changes in reimbursement and even some of the news coming out of HHS this week, looking at bundled payment models.

Some of the area that used to be revenue drivers in a different model could become cost centers, and so the opportunity to provide those services might be areas we look. Consumables -- the ability to grow our consumable and our physician preference items, clear priorities for us. The home -- activities around the home and China those are all areas that we've talked about as high priority.

You guys know the system there. Some of those areas that have many, many more activities and more players and there are others that have fewer, maybe more highly consolidated, etcetera. So those are sort of priority areas. We're looking at all of them, pretty much all of the time and the opportunities will come when they come.

Operator: Our next question comes from Steven Valiquette with UBS.

Steven Valiquette: So for the Medical segment, I guess as we move further into calendar '15. Are there any signs at all or any buzz still within the industry about accelerated patient volume growth for your hospital customer base related specifically to health reforms. There still seems to be some mixed views on this within the investment community for the hospital sector in particular.

George Barrett: I think mixed use is probably right. There are some clear signs, and CMS at this point I think is saying enrollment is close to 10 million at this point coming through the ACA. It's very difficult to tease out exactly what the contribution is in a hospital setting.

I think we certainly -- as we look at our Pharmaceutical business and we look at prescription centers, there's certainly some indication and it's more intuitive than anything else that there are more patients in the system. And I think it's reasonable to assume that more patients covered have some impact on the hospital side. But it's much harder to tease out, partly because we're seeing some shift in channel behavior.

So it's not like you have one system. When you have moving for example from an acute care setting to an ambulatory setting, you can see a shift in volume. So it's much more difficult to tease out the exact total volume impact of the Affordable Care Act and how that flows through the acute care centers, because we're seeing sort of a natural shift in delivery of care where it's being delivered.

We're also seeing a little bit of shift of market-share among players, given some of the network design issues in the system. So it's a little bit difficult to tease that for you.

Steven Valiquette: And you actually hear your customers talking about there or is it just sort of a quiet on that front right now?

George Barrett: No, you actually hear views from different customers. So there are some that are clearly telling us that they're seeing increases and some that are not experiencing quite as much. So as you describe mix signals, it's probably a little bit of an accurate description.

Steven Valiquette: Okay got it. Okay, thanks.

Operator: Our next question comes from Garen Sarafian with Citigroup.

Garen Sarafian: Hi guys. Thanks for taking the questions. So I'm trying to get a better idea of how conservative your guidance is putting Nexium aside. So as I think about it, Pharma sales were very strong -- maybe incrementally lower margin from Hep C. The Red Oak contribution is ahead of schedule.

There is now slight commodity tailwind. But guidance seems to be raised roughly by the amount of the beat from litigation. So is the offset from Canada and incentive comp that might not have been fully baked in before? Is that the right way to think about it or is there anything else to consider?

Mike Kaufmann: Well, one thing that I consider remember is the tax rate is an important driver. I'm not sure how the litigation piece would effect -- that was in GAAP, not in our non-GAAP numbers. And so I'm not sure how that would effect. But tax rate is one thing to consider.

Remember last year we also had a minority investment income in Q3 that we had talked about. That's not expected to repeat in the second half which was a large number. We did expect the Canadian pressures to continue to happen throughout the rest of the half, and while we've said Red Oak started a little sooner, that doesn't mean necessarily that it's going to get a lot bigger into Q3 and Q4. It just came a little bit sooner.

George Barrett: Again, I'm going to just jump in here for second. Again I wouldn't comment on how conservative or not conservative our guidance is. I'd say this, we're performing very well right now in general, and so we feel very good about the first-half and actually pretty excited about the second half of the year. So our guidance was increased. We feel good about that and again, we'll leave it to others to judge whether or not it was conservative or aggressive. But, you know, we like our positioning and we're pushing ahead.

Garen Sarafian: Okay, thank you very much.

Operator: And we'll take our final question from Eric Coldwell with Robert W. Baird.

Eric Coldwell: Can you hear me?

George Barrett: We do. Hi, Eric.

Eric Coldwell: Okay, good morning. Just a quick one here off topic related to foreign currency. I didn't hear a lot about that today. I'm curious about the impact overall of course specifically in Canada, with the Canadian dollar we gained about 17% in the last six months. Curious is on the impact to the Medical surgical segment and if you can talk through some of the dynamics on revenue and profit dollars related to that? Thanks.

Mike Kaufmann: Yes so I'll give you a little bit of information here. First of all, we did realize a smaller benefit from FX in Q2 than we did in Q1, but again it was minor. Our assumption for the remainder of the fiscal year is really some modest upside to -- with FX and that's already built into our guidance.

The thing you have to remember on FX that makes it unique is because we operate in some countries but we buy in others, you have the impact that one could be a positive, the other one could be a negative. And so the net, if you really want size, it's very small at this point in time.

Sally Curley: Eric or the operator, do you have a follow-up?

Eric Coldwell: No, I'm good. Thanks very much. We can catch up later.

Mike Kaufmann: All right, thank you.

Operator: And that does conclude the question-and-answer session. I'd like to turn the conference back over to Mr. Barrett for any additional or closing remarks.

George Barrett: With that, thank you all for you questions and I very much appreciate all of you joining us on today's call. We look forward to speaking with all of you later. Thanks.

Operator: And again that does conclude today's presentation. Thank you for your participation.