Q1 FY16 Cardinal Health, Inc. Earnings Conference Call

November 2, 2015 8:30AM Eastern

Operator: Please standby. We are about to begin. Good day and welcome to the Cardinal Health First Quarter Fiscal Year 2016 Earnings conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Sally Curley, Senior Vice President, Investor Relations. Please go ahead, ma'am.

Sally Curley: Thank you, Erik. And welcome to today's quarterly conference call. We will be making forward-looking statements on the call today. 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 the SEC filings and the forward-looking statements slide at the beginning of the presentation found on the Investor page of our website for a description of risks and uncertainties. In addition, we will reference non-GAAP financial measures. Information about these measures and reconciliations to GAAP are included at the end of the slides.

I'd also like to remind you of a few upcoming investment conferences and events. First, we will be webcasting our Annual Shareholder Meeting beginning at 8:30 am Eastern, this Wednesday, November 4. And secondly, we will be webcasting our invitation only Investor and Analyst Event on November 19.

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 the site often for updated information. 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: Thank you, Sally, and thanks to all of you for joining us this morning. We're off to a very strong start to our fiscal 2016. Our first quarter revenues increased 17% to $28 billion. Non-GAAP operating earnings increased 30% to $737 million. And we reported non-GAAP earnings per share of $1.38, an increase of 38% over the prior year. These are strong numbers representing meaningful and measurable results in a very positive start to the fiscal year.

Our operating performance is a powerful indicator that our organization is creating value for our customers. With an emphasis on disciplined execution, we have competitively positioned for sustained growth for both the near and long term future.

With a strong quarter behind us and some better visibility to the balance of the year, we are raising our full year non-GAAP earnings per share guidance to $5.15 to $5.35, which represents an 18% to 22% growth rate over our fiscal 2015.

At Cardinal Health, each of our lines of business contributes to making the company as a whole better, stronger and more accountable to our customers and our shareholders. With that, as a reminder, I'll take just a few minutes to comment on our segments and the overall healthcare environment. And then, I'll turn the call over to Mike, who'll provide greater detail on the quarter.

Our pharmaceutical segment had an outstanding first quarter. Revenue increased 19% to $25.1 billion. Segment profit was up 46% to $657 million. Our pharmaceutical distribution business continues to demonstrate the highest levels of operational excellence, thoughtful product and customer positioning, and unyielding attentiveness to the needs of our customers.

Most of our growth this quarter was driven by organic activities. Our world class generic program continues to be a source of real and measurable value for us, our manufacturer partners and, most importantly, for our customers. In July, we completed the acquisition of the Harvard Group, enhancing our generics business and our ability to support both retail and institutional customers.

The integration of that business is going well and we feel very optimistic about achieving our financial targets. At the same time, our branded biopharma partners see us as an efficient, effective, and committed partner in getting products to market. Make no mistake, this is an extraordinary time in the pharmaceutical industry.

As I said before, we are at an inflection point. We are witnessing a new wave of pharmaceutical innovation. This requires a strong position in specialty pharmaceuticals. Our specialty solutions business continues its record of robust growth, and this quarter delivered the highest rate of growth we've seen in recent years.

The acquisition of Metro Medical is expanding and strengthening our position in some important therapeutic areas including Rheumatology, Nephrology, and Oncology. These added capabilities make us an important partner as pharmaceutical companies try to deepen their connections to patients with distinct needs.

Turning to our medical segment, revenues were up 2% to $2.9 billion. As we noted in our fourth quarter call, we expected our medical segment profit to decline in Q1 versus the prior year at a number we estimated to be in the high teens.

Our fundamentals were stronger than expected, and in actuality, medical segment profit declined 11% versus the prior year. We saw increased penetration in our Cardinal Health brand products, Cardinal Health at Home and in our service offerings. And we continue to see higher than market growth in our strategic accounts.

We've made meaningful changes in our medical segment that allow us to create more value in more ways. Our intention here is to better serve customers, who've considerably more complex needs and more highly distributed system.

As we recently announced, subsequent to the end of the quarter, we closed our Cordis acquisition, which strengthens our ability to provide innovative, efficient and effective cardiovascular solutions for aging populations across the world. This is a key element in our physician preference item strategy. Our team did an outstanding job managing the many working parts across this global business to close the transaction “dead-on” our timeline.

Our integration teams have been working very effectively and this enabled us to serve patients, around the world, on day one. Many thanks to that team and our colleagues at J&J for their partnership. We welcome the global Cordis employees and their terrific leadership team, so many of whom have joined Cardinal Health.

The modernization of our portfolio is particularly relevant as we see a system in which payment models continue to evolve. Now more than ever, it's critical that we have the ability to get patients the right care, at the right time, and in the right setting.

That's why in August we took a majority stake in naviHealth, a Nashville based, market leader in post-acute management for payors, health systems and providers. Through its predictive analytics and evidence based care protocols, naviHealth helps determine the appropriate care plans for patients post-discharge.

This kind of predictive population management is a critical capability for Cardinal Health. NaviHealth will report through our Medical segment specifically as an expansion of our post-acute offerings. However, the capabilities represent broad-based technologies and skill sets, which will serve Cardinal Health across our entire enterprise and many of our partners across multiple channels.

The recently announced proposed rule on mandatory post-acute bundling for hips and knees, CCJR and CMS's announcement last week requiring changes to the discharge process, are two recent examples further evidencing the shift to value within our health care system.

Combining Cardinal Health at Home's patient reach, our broad pharmacy capabilities, and naviHealth's predictive analytics at discharge positions us well to advance our value proposition of right care, right time, right setting and makes us the partner of choice for hospitals and health systems in the emerging value based payment models.

Finally, I'll make a few comments about the continuously evolving healthcare environment, focusing on the U.S. where the activity has been to say the least, very dynamic. A few things remain clear - demand for healthcare will only increase with our aging population and continued challenges in public health. There is no place in the world where more innovative and high quality care can be delivered than right here in the U.S.

Having said this, the system needs, and will continue to experience changes to make it more accessible, better coordinated, of consistently high quality and more cost-effective. As I mentioned earlier, it is also clear that we will see the emergence of some new payments models.

This is one of the reasons that we're so excited about Cordis, as it further enables us to deliver both products and services, which help in the overall efficacy and efficiency of an interventional cardiovascular procedure. All this catalyzes the industry as it adapts to these changes.

And we're seeing moves across the industry, among many players as they try to address one or more of these forces. Our Cardinal Health moves, both organic and inorganic, have been geared toward ensuring that we are uniquely positioned to compete not only in today's environment, but in tomorrows.

In closing, I'm pleased to report an excellent start to our fiscal 2016. We feel confident that we are positioned for sustained growth well into the future. Our Cardinal Health people remain committed to creating meaningful and measurable value for our customers, our partners, patients, our communities and our shareholders. We look forward to seeing many of you later this month at our Investor Day in New York. And with that, I'll turn the call over to Mike.

Mike Kaufmann: Thanks, George, and thanks to everyone joining us on the call today. I'm pleased to be reporting an outstanding start to our fiscal year. During our fourth quarter call, I shared that I was confident, we had set the table well for this fiscal year, and this first quarter provides some validation.

In my remarks, I'll review our first quarter financial performance as well as updated expectations for our 2016 fiscal year. You can refer to the slide presentation posted on our website as a guide to this discussion.

First quarter non-GAAP earnings per share grew 38% to $1.38. This was led by the strong performance of our pharmaceutical segment and aided by better than expected performance from our medical segment, both of which I'll discuss in detail later.

Starting with consolidated company results, revenues were $28 billion, a year-over-year increase of 17% and total company gross margin dollars were up 18%. Consolidated SG&A increased 9% versus the prior year, primarily driven by acquisitions. Resulting non-GAAP operating earnings in the quarter were $737 million, an increase of 30% versus the prior year.

Moving below the operating line, net interest and other expense came in at $52 million in the quarter. This increase versus the prior year is primarily due to the increase in long-term debt to fund the acquisitions of Cordis and the Harvard Drug Group.

Our non-GAAP effective tax rate in the first quarter was 32.9%, which is 3.6 percentage points favorable to the prior year rate. This was due to a few net favorable discrete items that totaled approximately 8 cents. We still expect our full year non-GAAP effective tax rate to be between 35.5% and 37%.

Our first quarter diluted average shares outstanding were 331 million, about 9 million shares less than the same period last year. We did no share repurchases during the quarter, and at the end of the quarter, our remaining board-authorized share repurchase program was about $700 million.

Also during the quarter, we had net operating cash outflows of $52 million, our annual expectations for operating cash flow remain unchanged, as it is natural to see fluctuations and some shift between quarters. We ended September 30 with a strong balance sheet, including a cash balance of $3 billion, of which $480 million were held internationally. As a reminder, on October 2, we used nearly $1.9 billion to fund the acquisition of Cordis.

Now let's move to segment performance, starting with pharma. Our pharmaceutical segment performed exceptionally well this quarter. Segment revenue increased 19% to $25.1 billion driven primarily by growth in existing and new customers and, to a lesser extent, the acquisitions of Harvard Drug and Metro Medical.

Because of this strong Q1 growth and the performance of our acquisitions, we now expect full year pharmaceutical segment revenue growth in the mid to high teens versus the prior year. Pharma segment profit increased 46% to $657 million, due to strong performance under our generics program, which includes the net benefit of Red Oak Sourcing.

As you may recall, the first quarter of last year was the startup quarter for Red Oak Sourcing, and so there was minimal benefit in that quarter. As we lap the initial quarter, we continue to be excited about the performance of Red Oak and the strength and positioning of our overall generics program.

Segment profit margin rate increased 49 basis points in the quarter to 2.6%, driven by performance of our generics program and the acquisition of Harvard Drug. We're very pleased with this margin expansion. I do want

to note that the impact of the launch and growth of certain brand products, like Hepatitis C products, and the addition of certain customers will have a dilutive impact on margin rates going forward, but are beneficial to the bottom line growth of our company.

As you think about the rest of the year, let me provide color on a few unique items that were favorable to our assumptions for our pharma segment in the quarter. These items together were worth about 11 cents. First, we had 8 cents of favorability largely from benefits related to different competitive dynamics than we anticipated for a few key generic items. The dynamics have since adjusted to expected levels.

Additionally, through great execution, we were able to accelerate about 3 cents related to the integration of acquisitions ahead of schedule. Net-net, our underlying growth was really strong. As far as it relates to generic and brand manufacturer price inflation, neither were significantly different than we modeled. On our fourth quarter call, we told you that we believed the generic inflation rate would moderate versus the prior year, and this was true for the first quarter.

And while the branded inflation rate was slightly higher than the prior year, it was generally consistent with the low double digit range we anticipated. During the first quarter, our pharma segment and the team continued to execute at a high level, all this resulting in an exceptional quarter.

Let's now go to the medical segment performance. As I mentioned earlier, performance of the medical segment was better than we anticipated. Revenues for the first quarter grew 2% to $2.9 billion, driven by growth in Cardinal Health brand products and our At Home business. Of particular note within our Strategic Accounts, growth of Cardinal Health brand products increased in the low double digits.

Also during the quarter, we had incremental revenue from a number of smaller acquisitions. However, the incremental revenue was essentially offset by the divestiture of our office-based physician business to Henry Schein. Medical segment profit decreased 11% to $101 million during the quarter, versus the high-teens guidance we had previously communicated.

The primary driver versus the prior year was the decline in our Canada business, which included some unfavorable foreign currency impact. Remember that the prior year quarter included the one-time benefit of the winding down of the Canadian CareFusion business.

For some additional color, if you normalize for the winding down of the CareFusion contract and the unfavorable impact of foreign exchange, the underlying segment grew. As George mentioned, we're very pleased to have closed Cordis on October 2 in line with our original expectations.

We will continue to update you on the Cordis inventory fair value step-up. And, while we don't yet have complete visibility, we feel very comfortable that this step-up will not exceed our original assumptions. Turning to slide number 6, you will see our consolidated GAAP results for the quarter. The 23 cent variance to non-GAAP results was primarily driven by amortization and other acquisition related costs.

I'd like to take a moment to describe a minor technical change to the presentation of our financial statements, due to the recent acquisition of a 71% interest in naviHealth. You'll note that in accordance with GAAP, we added lines called “non-controlling interest” to our applicable financial statements and schedules.

This reflects the 29% minority interest in naviHealth and a few other immaterial minority interest. Historically, we haven't presented these separately. This reporting differentiates our earnings from those associated with the non-controlling minority interests. As a result, references to non-GAAP EPS will refer to “Non-GAAP earnings per share attributable to Cardinal Health.”

Looking to the rest of the fiscal year, based on our strong first quarter performance, we've increased our initial non-GAAP earnings per share guidance range which was $4.85 to $5.05 to a new range, which is $5.15 to $5.35. Our new range implies growth of 18% to 22% over the prior year.

While the first quarter has had a bit of a rebalancing effect on the full year financial performance, we are still expecting a cadence that slightly tips the scales to the back end of the year. There are a few other updates to our fiscal 2016 assumptions that I want to highlight. These changes are denoted on slides 8 and 9.

First, we now expect total company revenue growth to be in the mid-teens versus the prior year. Next, we've updated our weighted average shares outstanding assumption to 332 million to 334 million shares, which is lower than the initial range provided of 334 million to 336 million shares.

And finally, our assumption for acquisition related intangible amortization increased to approximately $277 million or about 52 cents per share. This change is due to acquisitions that closed during the quarter and doesn't reflect the impact of Cordis, and doesn't affect our non-GAAP earnings. All other FY16 assumptions provided during our Q4 earnings call remain unchanged.

In closing, we're excited about our performance in Q1, and what we see for the rest of our year. Operator, let's begin our Q&A.

Operator: Thank you. If you'd like to ask a question please signal by pressing star 1 on your telephone keypad. If you're using a speakerphone please make you're your mute function is turned off to allow your signal to reach our equipment. We ask that you limit to 1 question and 1 follow-up question. Again, press star 1 to ask a question.

And we'll take the first question from Bob Jones with Goldman Sachs.

Bob Jones: Great. Thanks for the questions. You guys gave a lot of detail. Just trying to get a better sense of how you're thinking about the balance of the year on the core business. It looks like you're raising the full year by about 19, X the 11 cents that Mike referenced as more being on -time. You beat the street pretty handily this quarter, even ex-tax. So, you know, is there any other moving pieces or any updates you can give us just as far as better underlying assumptions as you think about the next 3 quarters relative to your previous assumptions?

George Barrett: Bob, good morning. It's George. I'll start and I'll just turn it to Mike. Well, I think we're coming out of Q1 with some momentum. You know, as Mike mentioned, sort of the underlying performance characteristics for us have been feeling pretty strong over these last months. And so it really runs across our lines of business.

You know, again, we mentioned our expectations for med, we outperformed those. We're starting to see some momentum there. Our pharmaceutical distribution business is on a good pathway with strong momentum, and we feel like we anticipated some of the market shifts reasonably well.

And I think as Mike mentioned, we modeled into our numbers some moderating in some of the pricing dynamics around generics, which I think is - we sort of got roughly right. So, Mike, I don't - what you want to add to that.

Mike Kaufmann: No. I could just summarize, Bob, to maybe hopefully be hopeful. Yes, so the 11 cents of favorability was really related to the pharma segment. And then, from a corporate perspective, we had the 8 cents of the discrete items on the tax side.

But while those are, you know, more defined as somewhat one timers or thoughts that way, I would tell you that the underlying performance net-net of all the business is really strong and we're seeing really strong performance across all the businesses.

Bob Jones: No, that's helpful. I guess just one more as we think about the balance of the year, you know, I think, it's well established; you guys had won a large managed care contract in the quarter. But just curious, it looks like you're raising revenue for the year, can you maybe just walk through if there were any changes around contract movement relative to your previous outlook?

Mike Kaufmann: I wouldn't say there were any real changes related to it. I think you're right that is a strong revenue top line business for us, but as we said before, we only expected it to be slightly accretive this year, when you consider all the start-up costs and everything that go along with a new large contract like that.

Sally Curley: Operator, next question.

Operator: And we'll go next to Ross Muken with Evercore ISI.

Ross Muken: Good morning. Sorry to stick on the point. I'm just trying to understand, in terms of the favorability, the way you described in terms of changes in the competitive environment, is this specifically pricing or is this some other element in maybe one of the other parts because we didn't hear this from the other players? I'm just getting a ton of questions to get a little bit more clarity on maybe not exactly what it was, but more a little bit of context.

George Barrett: Ross, this is George, I'll start and again Mike can clarify or correct me, if necessary. So, I think what happens is, this has to do with everybody's own internal modeling. So, the way we modeled certain products, we expect X product to have X competition at various stages.

And so, that's just a nature of the way we model them. So, we may have modeled for example on a given product that there are going to be a certain number of competitors. If there is one or two or more or less, then that can change. And so, when we're talking about the competitive dynamics, it's usually the number and composition of those players.

Ross Muken: Got it. And then...

Mike Kaufmann: The one thing I would add Ross to maybe be helpful is remember our mixes can be different than our competitors' mix too. And this really just had to do with the way we modeled a few key generic items and what our overall margin rates would be on those items.

And over the first quarter, those margin rates were just stronger than we expected, but they've more normalized as we expected towards the end of the quarter and that's why we don't see those being quite the same levers going forward.

Ross Muken: Thanks. I just want to make sure folks were clear. And then you've obviously closed on Cordis, can you talk just a little bit about sort of how the organization is responding to you bringing them in house? I'm assuming there's probably some good enthusiasm as you obviously, you know, will take a little bit of a different bend on that business.

And maybe talk a little bit about geographically some of the markets where you feel like you can help inflect maybe ex the U.S., any more than maybe you originally thought, because I think the original assumption was a lot of impact on the U.S. and then the sort of ex-U.S. is a little bit more left to itself. Any updated thoughts on the ex-U.S. business?

George Barrett: Sure. Let me get started again with the caveat, this is very, very new. We literally just closed this business a few weeks ago. But, I would say the enthusiasm level is extremely high. Again, recognize that we are making this a high priority as part of our physician preference item strategy and we've had all the key leadership around the world join us. We've had meetings all over the world.

The reception from the Cordis people to Cardinal has been fantastic, and really gratifying. So, I think from that standpoint, the energy level, the enthusiasm and I think the alignment with the strategy is really great. And part of that has to do with the service component of what we bring.

And the ability, for example, to bring other tools that go along with the product into new markets has been really exciting. And so if you had to say to the second part of your question, where have we been, maybe a little surprised is the enthusiasm for some of the service components ex-U.S. And I'll highlight China and EMEA where some of the markets see these opportunities to help manage inventory, for example as real value drivers for their customer base.

So, you know, we're - it's very, very early, but I would say the level of excitement here and among those Cordis people who have recently joined us is pretty high.

Mike Kaufmann: Yes. The only thing I would add is that, besides the - I completely agree with George, the excitement is really, really high. But just a couple of quick reminders. First of all, it did close on our target date. So, we had expected early October to be our target date from the beginning. So, we were dead on that target date.

And as I mentioned in my opening remarks, while we don't have perfect visibility to every component right now of the inventory, we do have enough visibility to tell you that the impact of the inventory step-up that we had originally said would be 13 to 15 cents, we still expect that to be the number and we do not expect any variance to the upside or it to be more expensive than 13 to 15 than we did before.

Sally Curley: Operator, next question.

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

Ricky Goldwasser: Yes. Hi. Good morning and congrats on a great quarter. So, two questions here. First of all, and obviously, there has been a lot of - we're hearing a lot about just inflation in general. You talked about your expectations for generic inflation.

But, can you share with us your thoughts about how you see brand pricing inflation being impacted by all the political noise that we're hearing and also what's Cardinal's exposure to it? We've heard some different data points from your two peers last week.

George Barrett: So, why don't I give you some quick thoughts, Ricky. First of all, good morning. Some quick thoughts on the environment and then maybe I'll let Mike just talk about our - what you call our exposure to pricing dynamics. I'd start by the way, saying, this has been – we have a very robust and balanced portfolio and I think that always is helpful.

So, let me just start, clearly, pricing in pharmaceuticals has become a hot topic, particularly as we go full swing into the election cycle. And again, let me caveat it the acknowledgement that a price of any drug could create a difficulty or a hardship for any given patient, I think it's important to remind ourselves that from a system standpoint, pharmaceutical care is still the most cost effective in the system.

And it's actually roughly around 10% of our national spend on healthcare, so it gets a lot of attention. But I want to try to put in context, the thing that we have to put in context is that with about 85% of prescriptions filled in the U.S. being generic and mostly at lower price points than brand, that's a powerful tool for keeping system cost down. And so it sort of allows the head space to fund innovation in the system.

So again, having said this, this is a highly political issue; it's a highly personal issue. No doubt companies are looking at the environment very carefully, watching the public discourse and public debate on this and I'll just assume that that's going to influence, you know, the way they think about the environment.

But it's really hard to predict exactly how any company is going to respond to that. But certainly it’s very much in the news. Mike, I don't know if you want to add in terms of...

Mike Kaufmann: Yes, the only thing I would add is, remember that over 80% of the fees that we get on branded manufacturers are on a fee for service model, so, inflation actually doesn't matter on over 80% of the fees. So, on the portion where it does matter, we always have the option to work with those manufacturers to adjust those agreements.

So if, you know, we're expecting a certain inflation rate with those suppliers and that inflation rate starts to drop, we will go back and work with those manufacturers to adjust those agreements to be able to make sure that we're earning the fees that we deserve with the services that we provide. Because we still see what we do is incredibly valuable, they still see it as incredibly valuable.

So there is definitely ways for us to continue to manage in an environment even if inflation rates were to moderate on branded products.

Ricky Goldwasser: Okay. And then my follow-up relates to the EBIT margin for drug distribution. So, Mike, even when that generic benefit that you highlighted is the one-time, we've seen some pretty meaningful expansion both year-over-year. I think we calculate about 33 basis points year-over-year if you exclude that generic benefit, and also a benefit quarter to quarter I think.

So, can you help us maybe sort through it, I mean how did Harvard Drug maybe perform and how did they contribute on a sequential basis because what I'm thinking what was three months in this quarter versus last quarter? So if you can just help us understand that and the moving parts that helped drive that margin expansion?

Mike Kaufmann: Yes, it's going to be hard for me to get into a lot of details there, Ricky. It's really what I was saying; it's really strong performance on our overall generics program. Obviously, Red Oak is an important piece of that, but also our customer mix, our ability to execute on launches, pricing, all the other components that make up our generic program.

I will tell you that it wasn't generic inflation that was a driver in the quarter. That moderated as we said that, it would moderate. And so, generic inflation was not really a driver. Clearly, Harvard was also a component of our margin improvement, so generally again those are the two biggest as I've said before, but we have a lot of other things going on.

We're highly efficient. We continue to drive efficiencies in our business, which is something that we will always do. We're a distribution company. So, we're never going to lose sight of that in our pharma side in many components of our business. So, we'll always focus on efficiencies too.

Operator: The next question is from Charles Rhyee with Cowen & Co.

Charles Rhyee: Yes. Thanks. Sorry I missed the first couple of minutes here. But when you guys talked about the guidance here, can you talk about what your assumptions are for in terms of timing for acquisitions by CVS such as like Target and Omnicare?

Mike Kaufmann: Yes, we really can't comment specifically on any of the acquisitions. The only thing I can say is what we've said before is that that's a decision CVS is going to have to make on where the branded distribution will go. But remember, all of the generics on those businesses as CVS are going to go through Red Oak and so, really that's the only piece to keep in mind.

George Barrett: And Charles, we didn't build anything in. We don't have complete line of sight on transition timing. So that's really with CVS Health right now. So, we did not build anything in as it relates to additional value from the generic component, Red Oak component on those deals.

Charles Rhyee: So the Red Oak component is in there in the guidance, but the branded size for Target, that is not in the guidance just to be clear, right?

Mike Kaufmann: Yes. Just to be clear none of the branded volume is in our guidance or projections of revenue growth going forward.

Charles Rhyee: Okay. Great. Thank you.

Sally Curley: Operator, next question.

Operator: We'll go next to Garen Sarafian with Citigroup.

Garen Sarafian: Good morning, guys. Maybe on the medical side of your business, your guidance previously assumed a ramp in the medical partly from the launch of new and also the expansion of various product lines midway through your fiscal year.

So was there anything that went ahead of schedule this quarter? And if it didn't, can you just update us as where you are regarding the timing?

Mike Kaufmann: I wouldn't say anything really was ahead of schedule. It was just a little bit better performance in several different areas across Medical. So our Cardinal Health branded products did a little better than we expected. They did some great work focusing on efficiencies and SG&A and the kind of dilutive impact that we've been talked about on the national brand products wasn't as great as we expected it to be in the quarter.

So all those areas, good management over those three areas were really the key drivers.

Garen Sarafian: Got it. And then maybe switching over to capital deployment and share buybacks. I thought last quarter you mentioned how you pulled in; I think it was $300 or $400 million to buy back shares when it was around $88 a share. And you sounded pretty opportunistic in terms of buying back more.

So today's $2 million lower share count sort of what you were thinking of or is there still more of an appetite to do opportunistic buybacks of shares that are around the same price range or if they reached certain thresholds? Thanks.

Mike Kaufmann: Yes. You're right. We did accelerate our share repurchases from this year into Q4 of last year. It was about $350 million of share repurchases that we did in the fourth quarter that we typically might have done this year. At this point in time, clearly, share repurchases are something that we will consider.

Number one for us is going to be to continue to invest back in the business and we've said we would spend about 510 to 540 this year in capital expenditures, and we're still looking at that. We will also continue to have our differentiated dividend, and then as always we're going to look at M&A and stock repurchases as opportunities.

And so, there is - that's clearly on the table and something that we'll continue to look at for the rest of the year.

Operator: Next will be Lisa Gill with JPMorgan.

Lisa Gill: Thanks very much, and good morning. George, I just want to go back to your comments when you talked about the shift to value based care. And obviously looking at the legislation or what CMS is doing, they're talking about hips and knees and you're talking more about cardiovascular. So I guess my question is really two parts.

One, do you expect that we're going to see cardiovascular shifting in the same kind of payment methodology in the near-term? And then secondly, has Cardinal thought about your hip and knee programs and things that you could do to have more of a private label in some of those products?

George Barrett: Good morning, Lisa. So let me do first generally the prospective on the bundled payment program. I think it is reasonable to assume that, again with the caveat that this is early stage, that this directionally is an area that's on CMS' mind. And so, it wouldn't be right for me to predict which therapeutic areas or which procedures are necessarily going to come under bundled program.

But I think it's fairly easy to imagine that the discussions in CMS are looking at a number of areas. So, we feel like the tools that we've begun to build here are valuable and will have sort of transferrable value. As it relates to the

specific product lines and the specific big joints in hips and knees, obviously as orthopedics is an area we've begun to move on, has interesting characteristics, we are beginning to expand our program there.

I don't really at this stage want to go into specific details about which product lines, but we do believe, as we have felt it in cardiovascular, there are opportunities to bring both the product and the service components to the market and for providers who may be living under a different payment model.

Those value drivers that we create are actually even more important, that ability to help them manage that patient, the cost of the procedure. The controls in the OR or in the surgical suite, the management of the inventory and even watching for that patient post-acute, those are things that I think are going to matter and we're devoting energy to those things.

Lisa Gill: And so, George, when you think about - you are just putting all those tools in place to help the hospital manage that process as we move to fee for value versus taking on and maybe I'm wrong here, but you know, thinking about Cardinal taking on some level of risk around that patient in the future, is that correct?

George Barrett: Yes. I don't think Lisa I'd get into the question of exactly what model will be used as this unfolds. I think there is a lot of discussion around this system, around risk models and who bears the risk, and I think that it's very early in that process.

We are developing tools that allow us to compete in any environment, whether the environment looks a little bit more traditional or starts to evolve to some kind of shared risk model. So I think we're open minded, but building capabilities that I think are very important going forward.

Operator: We'll go next to John Kreger with William Blair.

John Kreger: Hi. Thanks very much. Mike, you had mentioned in your comments that the margin in the Pharma segment would see some pressure. Can you just quantify that a little bit? It was very strong in the quarter. Can we assume that the margin percent will be up year-over-year or perhaps not?

Mike Kaufmann: It's hard to say for the whole year. I'm not going to give specific guidance for the year. But I would tell you that we felt obviously great about the first quarter. But I just wanted to make sure that I give you guys a little color around just to remind you of the stuff that we have been talking about and you guys have asked questions about in the past around the hep C drugs.

Those will continue as they grow. They are much lower margin rates, so they are dilutive to our overall margin rates. But again, they are the right type of things to do. We still make money on them. They're just at lower margin rates and they're very capital efficient. Same way with some of our customer mix.

We have some wins that we've had that will be lower margin rates than some of our other ones. But the capital efficiency on those is outstanding as well as our SG&A leverage on those. And so, over time I just want to remind it's a balance. We think there are things going in the positive for us on our margin rates, and there are some things on the other side. Just wanted to try to give you a balanced view.

George Barrett: Yes. John, this is really - again, this is George. This is the mix phenomenon basically. So, the fact is that the products and the customers that have been building into the portfolio, this is all good news. But the mechanics as you look at the margin rates will have this dilutive impact, but to the corporation, to the benefit, to our shareholders of creating these opportunities create a greater setting for us.

John Kreger: Great. Thanks. And then a quick follow-up. The very strong top line growth in the pharma segment, could you give us any more specifics around what you view as the key drivers there? How much of that came from

acquired businesses? Perhaps what sort of underlying unit growth you're seeing versus inflation? That'd be great. Thank you.

Mike Kaufmann: Yes. Couple of different things. I would say obviously brand inflation is a key driver of the overall top line growth. Second of all would be our wins in our new customer business. We also feel like we're aligned with some outstanding customers that are existing customers and that their growth is very strong in the marketplace and so that's important to us.

And then probably the fourth benefit is some of the launches of the new drugs like the hep C drugs are a new category of expensive drugs. And so that's going to be another component. So, that's probably roughly four things and then I would also add acquisitions will have a component of our top line growth with both Harvard and Metro Medical relatively new this year to our overall revenue stream.

Operator: Next will be Eric Percher with Barclays.

Eric Percher: Thank you. So I think I'll extend on that last question, and this is for both George and Mike. As you think about - we've now gone through several generic waves, we have the generic inflation benefit. Has your business model become much more tied to revenue growth and absolute gross profit will be the focus and we should have less concern relative to gross margin and maybe more concern on op margin? Do you think there has been a shift in the business at this point?

George Barrett: Let me start generally and then Mike, you can be more specific on this. So I think that there is a dynamic that relates to revenues that as Mike said has to do with who you serve. So part of it is we feel very good about our customer mix. There is also again a dynamic that we know relates to the pickup of some new business. So these are all sort of year-over-year contributors.

As it relates to the top line being a better, which is I think what you're asking, is it a better measure than it once was given some of the dynamics. I think it's always a little bit tricky given that just the very nature of having generics in the marketplace.

So at any given moment a product that goes from brand to generic is going to change the revenue line and so I guess we always give the caution that in pharmaceuticals, the revenue line is influenced by the shift from brand to generic.

Yes, it's true there were probably fewer launches than they were in 2008, but it's still a phenomenon that affects that number. We really are focused internally on every internal measure that we can have that indicates improvement of efficiency and productivity and customer positioning.

So ultimately the way that flows for you frankly is the margin of the corporation growing. And the margin rate will be affected by some of these mix issues we talked about. But really internally, we're always looking at the individual components that drive margin and that are indicators of productivity.

Mike Kaufmann: Yes. I would just - I totally agree with George. I think revenue is a little tricky to say is a key driver. It's always going to be something we look at. Clearly, it's been important to us. The only thing I would probably add is that when you have a large revenue base like we do and we have some of these acquisitions that we have that are at much higher margin rates whether it be in P or M, you cannot see significant revenue growth, but we're able to add gross margin dollars in operating income to the bottom line.

So, again, revenue is just a tricky indicator, something to consider, but there's so many other components between efficiency, growing margin rates, mix, generics, sourcing, etc that are drivers that you got to look at a large group of things.

Eric Percher: And maybe the follow-up on that more specific to this quarter. You mentioned Red Oak and the contribution now versus a year ago. Should we think of Red Oak as currently up and running? We know you've made the additional milestone. And when we look back to last year, is a relatively low contribution.

How should we think about how that ramped up over the following three quarters, and what that does to your comparison moving off from here?

Mike Kaufmann: Yes. You're right. So the first quarter of last year, there was very little Red Oak benefit because that was our start-up quarter. And then Red Oak really ramped faster than we expected. The team just did an excellent job in our - which would have been our quarter two of really getting after all of the synergies and working with the manufacturers to sync up all of our purchasing agreements.

And so, Red Oak has ramped up nicely in the back part of last year. As we've said in the past, we continue to believe that Red Oak will be a tailwind for us, and that it will continue to have upside. But clearly, this is probably going to be the quarter, where we're going to have the biggest year-over-year benefit just because it was, you know, essentially a start-up quarter last year.

Sally Curley: Operator?

Operator: The next question is from David Larsen with Leerink Partners.

David Larsen: Hey. Congratulations on a very good quarter. Can you talk a little bit more about naviHealth? And what sort of incremental in-sell opportunity is there into your hospital base and what value could this bring to your existing hospital customers? And how will you tie this into your overall sort of analytics platform that you provide to your IDN clients? Thanks.

George Barrett: Yes. Good morning, David. Yes, we're excited about this new business. We think that again if you follow what's happening both in the public and the private sector as it relates to the attention devoted to particularly post-acute and how we mange patients in a post-acute setting, naviHealth provides us just great analytical tools, know-how and actually field-based people that are helpful in managing the discharge and the patient follow-up.

So I think if you are sitting in the seat of an IDN or health system now and there is increasing attention on how you will manage those patients and how you will be responsible for those patients post-acute, I think that our value proposition with naviHealth and with the other tools that we have at Home, our pharmacy, medication therapy management, those really are an interesting combination of things. Hospitals are extremely interested right now in what we have and in what naviHealth brings. And I think it's changing some of our conversations in a very positive way.

Just as a reminder, there are two components to this business, one that is sort of serving the payer side as well as the provider side. So I just want to make sure I highlight that. But I would say that it is changing the discussion with many of our customers who recognize this as an emerging area of attention and one where we can provide some value.

David Larsen: Okay. Great. And then Mike, did I hear you correctly that excluding CareFusion and currency, the operating income in medical would have increased year-over-year this quarter? And can we assume that to be true for next quarter as well excluding the inventory step-up charge?

Mike Kaufmann: So, Yes. Segment profit for the medical segment would have been up year-over-year if you'd excluded the prior year CareFusion one-time payment as well as foreign currency unfavorability that we experienced in the quarter. So the medical segment would have been up.

As far as go forward quarters, I can't speak specifically by quarter on how Medical is going to do, but I will tell you that the Cordis step up, we do expect to impact Q2 and Q3 for the medical segment. And, you know, we've

mentioned that before that we thought it would take roughly two quarters that that 13 to 15 cents would be essentially amortized over.

And then by our fourth quarter, you would see that essentially go away, and you'd see strong performance from Cordis in the fourth quarter.

Operator: Next will be Steven Valiquette with UBS.

Steven Valiquette: Thanks. Good morning, George, and Mike.

George Barrett: Good morning.

Steven Valiquette: So I guess for me just a couple of additional questions on the brand inflation. And maybe first, just to try to better frame this, given that your antenna along with everybody's is obviously up now and just the potential for brand inflation to decelerate by let's say several percentage points in calendar '16 versus the trend we're seeing in calendar '15. Should we just assume this is something that would be more than absorbable within your 20 cent guidance range for fiscal 2016?

And also Mike, when you said that you can go back to brand manufacturers and adjust the terms of fee-for-service contracts, are you talking let's say essentially in real time in a given quarter or is this more something that would have to be done at the end of the duration of an existing fee-for-service contract with the manufacturer? Thanks.

Mike Kaufmann: Yes. So first of all, any deceleration that we might be assuming in our - for branded inflation rates in our Q2 through Q4 has been included in our current guidance range that we gave you. So we do expect - we still expect brand inflation to still be about what we saw last year. So, we're not necessarily assuming branded inflation will decelerate.

As far as generic side, we still continue to believe that it will moderate versus the prior year. But on branded, we're still expecting it to be very similar to the prior year. On the DSAs, you're right, we would have to wait till contract ends typically with the manufacturers to adjust those rates. But remember we look at each manufacturer differently.

So when you think about branded inflation, on many of the vendors, the branded inflation doesn't matter, because they're 100% fee-for-service. And so the inflation rates are the really most important to us are the inflation rates on the suppliers that are the ones where we have contingent margin on those.

And so as you can imagine, we talk to those suppliers quite often. We try to understand their point of view on inflation and we try to be proactive at managing those agreements if we think that we're hearing things that are going to change. So, to your point, it would be hard to change immediately, but we'd have to wait till the end of the contract.

But over any long period of time, decelerating inflation in branded is not something that I wake up and worry about every day.

Steven Valiquette: Okay. That's perfect. Okay, right. Thanks.

George Barrett: Thanks.

Sally Curley: Next question?

Operator: We'll go next to John Ransom with Raymond James.

John Ransom: Hi. Good morning. I just want to get into the weeds just briefly on naviHealth. Is there a template for post-acute bundling that you are implicitly putting your models on or is it - how would you - how does this business model work under the various types of aggregator models?

George Barrett: Yes. Good morning, John. It's George. I probably won't get into excruciating detail here or the weeds as you'd like. So again we have two essentially customers in the naviHealth business. One is the providers, and one is the payers, and each of those contracts is different.

But essentially what we are doing, the value proposition is to help them manage the optimal sight of care for patients post discharge. Today, again we are - this is very, very new, so again, we're not broadening that line in other ways. We're basically using the model as naviHealth exists.

What we are doing is sort of combining this with other tools that we bring in post-discharge management through Cardinal Health at Home and through our medication therapy management. But it really has two components to it, and one as a provider to - or a support system to provider and one to the payer.

John Ransom: Okay. Thanks.

Operator: We'll go next to Dave Francis with RBC Capital Markets.

Dave Francis: Hi. Good morning. I'll add my congratulations as well. George, kind of a bigger picture question, as you look at some of the consolidation throughout different points of the supply chain right now, can you talk about your

view of all that activity and characterize where you see Cardinal Health sitting today and any kind of other strategic moves that you guys might need to make to jive with the different movements in the market? Thanks.

George Barrett: Yes. Good morning, thanks. Yes, and look as I said in my prepared remarks, it's been a pretty dynamic environment and we feel really well positioned. We have scale, we've got reach, and we've got tools that I think are valuable today, but their value in some of these emerging - with these emerging trends and forces.

We've seen consolidation in virtually every part of healthcare. And as I said earlier, I think it's a response to some fairly powerful forces. We could debate the logic of any individual move that a company does, but it's clearly a chessboard that's been moving. We feel very well positioned to compete given some of the changes in the system.

And we've been fortunate in that some of them that have been beneficial to us and some are neutral. But by and large, I think that we've been preparing ourselves over these last seven years for some of these forces, and it's certainly not hard to anticipate that we'd see continued consolidation. And we've seen it really along every subset of the healthcare continuum.

Sally Curley: Operator, next question?

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

George Hill: Hey. Good morning, guys. Thanks for taking the questions. I guess Mike, just kind of a technical question to start. With the fee-for-service arrangements on the branded side, are most of Cardinal's fee-for-service agreements hard dollar or are they WAC based? And I ask that because then are they - basically are they kind of inflation insensitive is the way I'm thinking about it?

Mike Kaufmann: Well, they're percentage fee-based type agreements. They're typically not fixed dollar agreements. They vary by manufacturer, but so they can be different. Some have score-carding components to it where you earn more if you perform at certain levels, some are more flat. They're all across the board, but generally their base is a percentage of the cost of the products and that's how they work.

George Hill: Okay. That's very helpful. And then I guess either from Mike or George, I guess can you talk about how the rolling of the Omnicare business and the Target business into Red Oak impacts your economics? And maybe if you can, I understand there is a much history to look at, but I guess can you talk about how you're thinking about that and how as Red Oak grows if there is anything you can give us around kind of sense of severity around how much better Cardinal's purchasing economics get? Thank you.

George Barrett: Yes. Good morning. This is really one that's hard to answer. Here's what I would say, we know that in generics, scale matters, global knowledge matters and know-how. And so to the extent that our business grows from the growth of Cardinal Health and from the growth of CVS Health in bringing more generic products to Red Oak, I think that's only a good thing for us.

I think it allow us to do great work for manufacturers in moving their markets. It allows us to provide great value to customers. But quantifying that or giving you an exact picture of how those specific deals impact us would be difficult to do.

Operator: Our next question is from Eric Coldwell with Baird.

Eric Coldwell: Hey. Thanks very much. First off, just a housekeeping item, if I missed it, I apologize. Could you possibly give us the organic and actual growth for both the China operation as well as Specialty?

Mike Kaufmann: Well, from a Specialty standpoint, we told you that we did a little bit of over $5 billion for FY ‘15 and that we expect it to be over $8 billion in FY ‘16 in terms of revenue, so strong growth in Specialty. And then in China, we do continue to expect that business to continue to grow in double digits.

Eric Coldwell: Grow double digits. And then my follow-up, then just shifting gears quickly. Medical, I didn't catch you mentioning anything about manufacturer price increases or any special situations in the quarter. Your largest U.S. competitor in acute care did mention and has actually mentioned for three of the last five quarters, some unexpected benefits from manufacturer price increases.

I'm curious if you could give us your views on that and if you also had any similar benefits. Thanks.

Mike Kaufmann: Yes. I think a part of that could be a mix between their business and our business. It was not a driver for us in the quarter at all, and so again, this doesn't mean it couldn't be for them. It may just be the timing it may be mix, but for us, inflation on medical surgical products was not a driver for our quarter.

Operator: And we'll take our final question from Bob Willoughby with Bank of America.

Bob Willoughby: Yes. I actually jumped on late, but also to Eric's question on China, any potential for the one child rule being abandoned there? I guess it's 2 million more births a year. Do you see yourself as positioned for any step-up in healthcare consumption there?

George Barrett: Not tomorrow.

Bob Willoughby: Nine months?

George Barrett: There's a gestation period. Look, I think just broadly on China, because we didn't get a chance to talk about it much today. We still feel very excited about being positioned there. Obviously, China is going through some unique dynamics, certainly affecting the industrial sectors a bit more than the service and healthcare sectors.

But I think in general, we talk about lifestyle changes, we'd now talk about an increased population about them. And I think continue over time, it's hard to imagine that we're not going to see this as a growth environment. We should probably acknowledge there was a little bit of FX issue in China naturally, but again to the overall picture of it, not a material impact.

So, we like the positioning there and we think long-term, we'll see a growing middle class, they're going to come through this difficult stage. We'll see a larger population and we're happy to be positioned there.

Bob Willoughby: And are you involved heavily in diagnostics there at this point, George?

George Barrett: Not particularly. Not particularly, no. We do a little bit of lab supplies, but I would say it's a very small component for us.

Operator: This concludes today's question and answer session. Mr. Barrett, at this time I would like to turn the conference back to you for any additional or closing remarks.

George Barrett: Sure. Thank you, Erik. And thanks to all of you for joining us this morning. We're off to a good start to the year. We look forward to speaking with many of you in the coming weeks and hope to see lots of you at our Investor Day in New York. So, with that, we'll conclude. Thanks everyone.

Operator: This concludes today's call. Thank you for your participation.