Q2 FY16 Cardinal Health, Inc. Earnings Conference Call

February 1, 2016 8:30AM Eastern

Operator: Please standby. We're about to begin. Good day and welcome to the Cardinal Health Second 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. Please go ahead.

Sally Curley: Thank you, Bethany, and welcome to the Cardinal Health Second Quarter Fiscal 2016 Earnings call. Today, we will be making forward looking statements.

The matters addressed in the statements are subject 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 those risks and uncertainties. In addition, we'll reference non-GAAP financial measures.

Information about these measures and reconciliations to GAAP are included at the end of the slide. In terms of upcoming events, we will be webcasting our presentation at the Leerink 5th Annual Global Healthcare Conference on February 10th in New York.

Today's press release and details for any webcasted events are or will be posted on the IR section of our website at www.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: Thanks, Sally. Good morning, and thanks to all of you for joining us. We reported a strong quarter this morning, wrapping up an excellent first half to our fiscal 2016. Our second quarter revenues increased 23% to $31.4 billion.

Non-GAAP operating earnings increased 14% to $726 million and we reported non-GAAP diluted earnings per share of $1.30, an increase of 8% over the prior year.

Our organization continues to demonstrate the discipline necessary to compete in a very dynamic environment and the capacity and readiness to take the actions to position us to sustain growth over the long term.

We are confident about our position and our ability to create value for health systems experiencing change, and we are reaffirming our full year non-GAAP diluted earnings per share guidance of $5.15 to $5.35. This range represents an 18% to 22% growth rate over our fiscal 2015.

Both of our reporting segments demonstrated strong operating performance in the second quarter.

Specifically, the pharmaceutical segment reported significant profit growth and the medical segment showed strong underlying performance, largely masked by the Cordis related inventory fair value step up.

Adjusting for this, both segments reported robust revenues and double digit growth in segment profit.

Turning to our segments - our pharmaceutical segment continued its momentum with a very strong second quarter. Revenue for the pharma segment increased 25% to $28.3 billion and segment profit increased 16% to $627 million.

Over the past few years, we've referred a number of times to the importance of having deep expertise in two specific areas in our pharmaceutical business. Generic drugs, which represent the vast majority of prescriptions

filled in the U.S.; and specialty pharmaceuticals, which account for many new launches and a significant number of development projects in the pipeline of the pharmaceutical industry.

As you know, these products tend to require very distinct capabilities. We continue to show excellent progress in both of these areas. As it relates to generics, we continued to grow our base of customers spanning independent pharmacies, chain, mail order, institutional and hospital pharmacies.

Our generics program is designed to meet the needs of our pharmacy customers who recognize that generic drugs are extremely important to support their patients. And our program is strengthened through the purchasing capacity of Red Oak Sourcing, our joint venture with CVS Health.

While our generics program is an important offering for all of our customers and for us, it is also the broad and deep range of services that we provide to these customers, which enable pharmacists to provide clinical support both to their patients and to the physicians with whom these pharmacists will increasingly be coordinating.

As more precision medicine emerges from the pipelines of the pharmaceutical industry, our specialty solutions group builds the linkages between biopharmaceutical manufacturers and physicians to help manage the complexity in delivering this important care to patients.

Our specialty solutions business continues its steep growth trajectory, growing both in our base of provider customers we serve and in the tools that make us an outstanding partner to biopharmaceutical companies. We're confident that our specialty solutions sales will exceed $8 billion for our fiscal 2016.

Our medical segment continues its repositioning and is adding value through reinvigorated distribution businesses, new product lines and services as well as new channels inside and outside of the U.S. Revenue for the medical segment was up 9% to $3.2 billion.

Segment profit declined 8% versus the prior year to $106 million. And remember, that this is the first quarter that includes the impact from the Cordis related inventory step up. Excluding that impact, medical segment profit growth was 10% versus the prior year.

Mike will provide more color in his commentary. The work that we're doing in consumables, physician preference items, medical supplies to the home, our service offerings and discharge management all align with the trend towards value based payment models.

Related to this, it's our ability to bring to our increasingly complex customers the full Cardinal Health portfolio across both our medical and pharmaceutical segments that will help as new payment and delivery models begin to emerge.

Our business in China continues to grow at double digit rates. Of course, China has been a subject of considerable economic news over these past months. And while the economic slowdown has significant impact for many industrials, the impact on the services sector has been more muted. Healthcare specifically, continues to be a national priority.

China's policy reforms, aging population, public health issues and expanding middle class have created increased opportunities for scaled healthcare solutions, and we expect the healthcare market in China to continue to grow.

Finally, a few words on Cordis - as you know, we closed the acquisition of Cordis on October 2, 2015. This is not a simple integration process and our teams are doing an outstanding job managing all of the many moving parts across multiple markets.

The integration of Cordis has gone well and is on target. Of greatest significance, on day one, we were ready to serve customers and their patients seamlessly in markets across the globe.

Our new Cordis leadership team is off to a strong start and this reinforces our optimism that Cordis will serve as a platform for growth. As the healthcare market introduces fee for value models, our physician preference item strategy is designed to help our customers meet this challenge.

Our offering of products combined with business model innovation that includes services and analytics creates real value for our customers. Cost effective, meaningful and measurable solutions. This is at the heart of our value proposition.

We close out the first half of fiscal 2016 with strong results and well positioned for long term growth. Ours is an organization that internalizes its mission.

And seeing our people work to serve our customers through the extreme weather of the last few weeks is a reminder of their deep commitment, not only to our customers but also to their patients. And I want to take this opportunity to thank them for their work.

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. As George mentioned, we had a strong quarter and halfway through our fiscal 2016, we're off to a good start. We feel comfortable reaffirming our non-GAAP EPS guidance range.

In my remarks, I first want to review our second quarter financial performance in more detail, and then I'll end with some additional color on our expectations for the full year. You can refer to the slide presentation posted on our website as a guide to this discussion.

Second quarter non-GAAP diluted earnings per share were $1.30, growth of 8% versus the prior year. Starting with consolidated company results, revenues were $31.4 billion, growth of 23%.

Based on what we've seen through the first half of the year, we are updating our full year revenue assumption from mid-teens to mid- to high-teens percentage growth versus the prior year. Total company non-GAAP gross margin dollars were up 13%.

Consolidated company SG&A increased by 13% versus the prior year, with the vast majority due to acquisitions. We remain focused on disciplined management of our core SG&A to ensure that we maintain a lean, efficient organization.

Resulting non-GAAP operating earnings in the quarter were $726 million dollars, an increase of 14% versus the prior year. Below the operating line, net interest and other expense was $43 million for the quarter.

This is an increase versus the prior year, primarily due to the interest expense related to long term debt issued in June of 2015 to fund the acquisitions of Cordis and The Harvard Drug Group. Our non-GAAP effective tax rate in the quarter was 37%.

While this is three percentage points higher than the prior year, it is common for the rate to fluctuate from quarter to quarter. For the full fiscal year, we still expect our non-GAAP effective tax rate to be between 35.5% and 37%.

Diluted weighted average shares outstanding were nearly 332 million shares, slightly fewer shares versus the second quarter last year. We did not re-purchase shares in the quarter and had about $700 million remaining on our board-authorized share re-purchase program.

As I've said in the past, we will continue to evaluate share re-purchases opportunistically in the context of our overall capital deployment strategy. In the quarter, operations generated cash flow of nearly $1.5 billion. As a reminder, quarterly operating cash flows can be effected by timing.

It's more representative to look at operating cash flow over a longer period, such as the first half of our fiscal year. Operating cash flow for the six-month period was $1.4 billion. At the end of the second quarter, we had a cash balance of $2.3 billion with $394 million held internationally.
Overall, we have a strong and flexible balance sheet.

I'll now review segment performance starting with the pharmaceutical segment. In the second quarter, the pharma segment increased revenues by 25% to $28.3 billion.

This was a result of continued growth in our existing and new customer relationships, and to a lesser degree, the recent acquisitions of Harvard Drug and Metro Medical.

Segment profit increased 16% to $627 million, driven by growth from existing and new customer relationships, which includes strong performance from our generics program. The acquisitions of Harvard Drug and Metro Medical also contributed to segment profit growth in the quarter.

Segment profit margin rate for the quarter was down 17 basis points versus the prior year. As we previously mentioned, our new relationship with a large mail order customer, while positive from an earnings and capital standpoint, was dilutive to margin rates.

Our integration of Harvard Drug continues to go well. And while still early, we are on track to achieve our accretion targets of greater than 15 cents in this fiscal year and greater than 20 cents for fiscal 2017.

Our specialty business had strong double digit growth which includes the contribution from the acquisition of Metro Medical, which is also going well. Of late, many of you have been asking us about branded and generic manufacturer pricing.

I'll share our current view, which is consistent with what we recently communicated at a mid-January webcasted event. We continue to model that branded manufacturer price increases will generally be similar to historical levels. This would be in line with our FY16 assumptions.

As it relates to generic pricing, over the last 18 months, our commentary and assumptions have been that generic inflation would moderate. In our fiscal 2015, that moderation was about as we expected.

When we provided assumptions for our fiscal 2016, we communicated that we expected further moderation. In fact, we are seeing moderation in generic pricing. Although as we recently shared, it is somewhat steeper than we had originally modeled.

That being said, generic manufacturer pricing is only one piece of our overall generics program, which in total, we still see as meeting our expectations.

Our solid work in sourcing, attracting new customers, penetrating existing customers, utilizing data and analytics, as well as executing on new item launches has been key in our overall success.

I continue to be excited about our overall generics program and the different components we have created to ensure long term sustainability. Overall, this was another solid quarter for the Pharmaceutical segment, and while there always puts and takes, the quarter was largely in line with our assumptions.

Now, let's go to the Medical segment performance. Second quarter revenues grew 9% to $3.2 billion driven by the net impact of acquisitions and divestitures. Our at-Home business, which grew double digits, also contributed to topline growth for the segment.

Segment profit decreased 8% versus the prior year to $106 million. As a reminder, this was the first quarter that included the acquisition of Cordis and the related impact of the inventory fair value step up. Excluding the step up of $21 million, the Medical segment profit grew 10%.

The total step up came in at about 8 cents, which is lower than the 13 to 15 cents of EPS impact we had anticipated. We expensed 4 cents in Q2 and we will do the same in Q3. There will be no inventory fair value step up to recognize in Q4.

In this quarter, the favorability of the step up as compared to our original guidance was offset by some one-time items resulting from the execution of the transaction as well as FX. Looking to Q3, we expect the step up favorability and FX to be a wash.

Setting those non-operating pieces aside, as George mentioned, Cordis is off to a good start with all key personnel in place and day to day operations up and running. As we integrate the Cordis business through the remainder of our fiscal year, we continue to be excited and will work to drive efficiencies.

As we've previously shared, in FY17 we still expect the transaction to be greater than 20 cents accretive and increasingly accretive thereafter. We are also working towards achieving the $100 million of annual synergies as we exit our fiscal 2018.

Switching to other pieces of our Medical business. As expected, from an operational standpoint, our Canadian business has stabilized, though foreign currency created a bit of a headwind. The team there continues to work diligently to ensure we position our business for the future.

Our Cardinal Health brand products continue to grow over and above the incremental increase from Cordis. Notably, we saw this growth in our Strategic Accounts, which are those customers that we have identified as key partners in the continually evolving health care landscape.

Turning to slide number 6, you will see our consolidated GAAP results for the quarter. The 32 cents variance to non-GAAP results was primarily driven by amortization and other acquisition related costs, as well as a $39 million LIFO related charge.

With the first half behind us, there are two variables I'd note that probably have the most impact on us achieving the very high end of our guidance range for the full year.

The first is generic manufacturer pricing levels, and the second is the net impact of foreign currency exchange rates related to our specific businesses.

These items moving in our favor would push us toward achievement of the very top end of our non-GAAP EPS guidance range of $5.15 to $5.35 that we re-affirmed this morning. As a reminder, this is a growth of 18% to 22% to the prior year.

While there are a few moving parts, our overall breadth and presence across the continuum of care provides us with the confidence to deliver on our commitments. I believe we have positioned ourselves well in the first half.

We continue to be focused on our customers and have the talent to drive results and execute against our strategic priorities. Operator, let's now go to the questions.

Operator: Okay. Thank you. If you would like to ask a question, please signal by pressing star 1 on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment.

As a courtesy, please allow yourself one question and one follow up question. Again, press star 1 to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions. And we'll take our first question from Eric Percher from Barclays. Please go ahead.

Eric Percher: Thank you. With FX called out as one of the key elements to hitting the higher end of guidance, could you speak a bit to the exposure in FX now with Cordis under your control, and some of the elements of scale or

maybe impact at the top end - top line as well as offsets at the profit line and maybe also touch on Canadian exposure?

George Barrett: Yeah. Mike, why don't you - good morning, Eric. Mike, want to grab that?

Mike Kaufmann: Hey, Eric. As you could imagine with the company - with our breadth, not only in our commercial operations overseas, we also have manufacturing operations overseas.

So we are seeing FX be both positive and negative depending on which country we're talking about and whether or not we're talking about on the manufacturing side, or on the commercial operations.

And so, clearly with Cordis, we are getting some additional exposure with FX, with 70% of that business being overseas. But to be able to actually get into any detail about how that FX will be impacting our business exactly, it's really difficult to do that.

And not something at this time that I'd be comfortable with talking about. But it's something that we'll take a look at as we go forward and decide how much more color we can provide.

Eric Percher: And is there - so as you're considering that color I mean at this point, is there a general rule of thumb that you've thought about, maybe even pre-Cordis in terms of when you see the exchange rate moving, how much is naturally offset because of their location of operations?

Mike Kaufmann: No. I wouldn't say there's a general rule of thumb because it's - as one moves in one direction, often other ones could be moving in other directions - so it's very difficult.

Also as you could imagine with us just starting up with Cordis, we're just beginning to ramp up our hedging strategies and taking a look at all the things we can do in terms of hedging to be able to make sure that we have more consistent earnings.

So it's just so early with the changes in the mix of our business, it's hard for me to be able to provide you a lot more detail than what I said, which is that, you know, right now we see FX as a little bit of a headwind in the second half of the year. But it - other than that, it's - I really can't give you more details.

Sally Curley: Operator, next question.

Operator: Okay. We'll take our next question from Ricky Goldwasser from Morgan Stanley.

Ricky Goldwasser: Yeah, hi. Good morning. Mike, I think you mentioned that to arrive at the high end of your guidance, generic manufacturing needs to be at a certain level. So can you just give us more color on your assumption at kind of like the high end of the - of guidance range around generic pricing?

Do you assume that it's going to accelerate from current levels; stay the same? And also, at the low end of the guidance range, what are you assuming for generic...

Mike Kaufmann: Yeah.

Ricky Goldwasser: ...inflation?

Mike Kaufmann: Thanks, Ricky. I would tell you this - I think what we are trying to communicate there was that right now we're assuming that the moderation of generic pricing is steeper than we originally modeled at the beginning of the year.

So generic pricing we expect to be a little bit more of a headwind in the second half than we had originally anticipated. Now as I've mentioned, there's other things going in the direction which is why we re-affirmed our overall guidance.

But the two things that we think that would need to go back to more similar to the first half would be FX and generic pricing.

If they were to return to more similar levels as where they were in the first part of the - this fiscal year, then that would enable us to get to the very high end of our non-GAAP EPS guidance.

George Barrett: And Ricky, just - it's George. As a reminder, and I know I do this probably every call, but it's really important.

This is a huge number of products in this line, so it doesn't take - that's one of the challenges always in modeling is it doesn't take that many products moving to alter the overall equation. But in the big sense, it's - it tends to be driven by a small percentage of the overall total products.

Ricky Goldwasser: Okay. And just one follow up, just because there are a number of moving parts in the quarter.

So can you quantify for us what same store kind of like top line growth for distribution segment after you normalize for Metro and for Harvard and for kind of like the new Optum business and also kind of like on the EBIT line, just kind of like what we think about with kind of like normalized growth in - for the distribution segment?

George Barrett: Go ahead, Mike.

Mike Kaufmann: You know, that would be hard to do, Ricky. You know, clearly, Harvard, Cordis, Metro Medical, are all providing, you know, revenue uplift for us.

But other than the fact that we said they are one of the components of our revenue and earnings growth, we still are just having really robust, you know, activities and growth with our existing and new customers.

And to split that apart would be difficult and - and not something I think would be right for us to do right now.

George Barrett: Yeah. I mean I would probably add, if you look at the revenue line, the contribution is not overwhelmingly coming from the forces. It's really our core business and our customers and new customers.

Sally Curley: Operator, next question.

Operator: Okay. We will take our next question from Ross Muken from Evercore ISI.

Ross Muken: Hi. Good morning, guys. So, it - it feels on the medical side like we're trending kind of in a much better direction. And if you think about on sort of the basis - so let's put Cordis aside for a minute. It seems like the home piece is doing well.

What on the traditional base business, if you look at maybe ex what happened in Canada, where do you see the sort of key trends that are kind of moving in the right direction?

And where do you feel like you've sort of, you know, met plan versus are there any areas in that piece where you actually feel like you sort of exceeded plan?

George Barrett: Yeah. Good morning, Ross. This is George. I'll take that. And Mike, jump in.

Mike Kaufmann: Sure.

George Barrett: I think the underlying characteristics actually feel as good as they have in some time. I think partly the value proposition across our lines of business, Ross, helps us to sell the individual lines of business.

Because I think what we're going to our customers who basically have very new kinds of strategic and financial needs with a line of products and services that I think touch those hot buttons.

And I think increasingly, that just allows us to strengthen the position of each of the lines. So our underlying business, you know, feels like it's going pretty well. Of course, it's always competitive out there. But I think we - we've done a good job of articulating that value proposition.

We've also done a good job, I think Ross, in some of our legacy lines of improving efficiency and reducing costs where necessary. And I think that was also an important thing for us to do over this last year.

So I think in general, we feel good progress along many of the lines in the medical segment.

Ross Muken: Okay, that's helpful, George. And again, just sort of sticking on Ricky's theme, because I think, you know, the heart of what everyone's trying to figure out is, amongst the three players, each of you obviously have slightly different generic businesses and transact slightly differently.

And so can you help us understand - it seems like Cardinal has sort of weathered the storm, at least relative to one of your peers better in terms of a change in the market. And you've had a more balanced portfolio in generics.

Can you just help us philosophically understand maybe some of the differences at least as you see it for Cardinal, relative to the peers?

George Barrett: Yeah. I'll try to speak to Cardinal. It's really it's tricky for me to try to speak for Peer Group and I shouldn't and probably won't.

I think what I would say is that as you guys look at peer groups - again, we have many different competitors in different lines of business, and I always have to remind you of that. But I think every business is different. Everybody's product line is different. Their product mixes are different.

And their customer mixes are different. So from our standpoint, we've devoted a lot of energy over these last seven years to positioning ourselves both in terms of product line and in terms of customer mix, to be on what we think are the right side of trends.

And so again, this is not a comment on anybody else, but on our business. I think our teams have done a good job of segmenting our markets; understanding what their needs are and how we can attach value from our work to theirs.

It's been a long process, but I think we're generally doing that fairly effectively. So it's a hard question to answer as a comparative answer. But I think I can describe our organization, which is very much focused on certain key trends, and we have been for quite some time.

And then really disciplined execution around priorities that tie to those.

Mike Kaufmann: Yeah. I would just add that I think that, you know, we've been really focused on the day to day blocking and tackling as well as the strategic, you know, priorities that we're on.

So when it comes to things like focus on our SG&A to really making sure that we're investing in the right places and controlling that. Staying, you know, insanely focused on the customer to deliver value to them and listening to what they need.

I really like what both the M and the P teams are doing there. And then you take a look at the acquisition on - the acquisitions and how we're performing on those has been excellent. And then overall, just execution against our strategic priorities.

So all those things also I think are helping contribute to our success.

Sally Curley: Operator, next question?

Operator: And as a reminder, please allow yourself one question and one follow up question. And we will now take our next question from Charles Rhyee from Cowen & Company.

Charles Rhyee: Yeah. Thanks for taking the questions here. George, you know, you mentioned earlier about your physician preference item strategy here and, you know, the shift to value based care. Can you talk about though, where your customers are at in this progress?

I mean, you know, if you look at sort of targets from CMS and etc., it looks like, you know, there are aggressive targets out there. But, you know, hospitals might be moving at a little bit of a slower pace here.

Can you talk about how they are viewing it and, you know, how that fits into your strategy and when we can maybe see - maybe acceleration and driving into your numbers? Thanks.

George Barrett: Sure, I'll try. Good morning, Charles. You know, this is a process. Obviously we have an enormous healthcare system that's been operating with a certain financing model for many, many years. And so, you know, change doesn't happen overnight and we don't expect it to.

So I think what's going to happen is we're - it's a process. We'll be living in a world in which both the fee for service model exists and alternate models are emerging. And I think again, you can look around the country at different health systems and they're all responding differently.

There are of course pressures from, as you said, the public and the private sector, to move to some new financing models. And - which focused more on outcomes than activity. And I think everybody's in a different stage of adapting to that.

What we've tried to do is make sure we're in a position to compete in either model. In a fee for service model we know how to do that and I think we're very, as Mike said, disciplined about that.

But we've started to build some tools that allow us to be a valued partner in models that are emerging. So I think as you're describing, it's a mixed bag around the system. But the pressure is to move towards some kind of value based model exist.

And that's probably true here. It's probably true elsewhere in the world as well.

Charles Rhyee: Great. And just a follow up can you talk about M&A opportunities then as you keep trying to build out your capabilities here? You know, how do you see the landscape, you know, and stating your capabilities to attack on it? Thanks.

George Barrett: Yeah. Yeah, well look, you know, for us this is very hard to comment on. I would say this, as Mike highlighted in his commentary, we've got great financial flexibility. But for us it's always a question of strategic positioning.

Whether or not we are - see opportunities to enhance the capabilities, the scale, the efficiency of some operation we do or some market that ties into some value that's really connected to a customer need, we'll continue to be open minded about that, as we have been.

I don't think our view has changed as it relates to the overall balance of our capital deployment. We will look at that as one of our - one of the tools. And we'll continue to look if the opportunities are right. But we have a financial flexibility to do that and I think organizational capacity.

Mike Kaufmann: Great. Yeah, I agree with - our capital deployment policy, you know, hasn't changed. We still believe that CAPEX is, you know, obviously number one on our list. And then continuing with our differentiated dividend.

And then we're going to look opportunistically at both M&A and share repurchases. And as George said, we're going to stay balanced and disciplined on that.

Sally Curley: Operator, next question.

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

Lisa Gill: Hi. Thanks very much. Good morning. George, just really want to follow up, or Mike, want to follow up on thoughts around the medical segment. Mike, I think you made a comment that Cardinal Health products grew again this quarter.

Can you give us an idea of what you've seen from a growth rate perspective? And then secondly, I think you have this role out in the marketplace, around where you can get the margin on the medical segment over time.

You know, if I back out the onetime item around inventory, step up in the quarter, it looks like the margins are trending just above 4%. So can you talk to us about, you know, how do you reach that goal of above 5% over the next couple of years? Is that the private label product?

You know, what are the things that we need to see in that segment? And do you feel like you're on target for reaching that goal?

Mike Kaufmann: Yeah. Let me start with first a couple of things. I think first of all, our Cardinal Health brand products, even if you pulled out Cordis, still we're able to grow. And so we were excited about the execution of the team being able to sell those products.

So important to note even without Cordis, the Cardinal Health brand products did grow. As you know, there's many margin initiatives in medical that we can get to go after getting to our aspiration of 5.75%.

And as you know that by definition, an aspiration means it's something you can think you can achieve, but it's hard to reach and it's something that you've got to get out and execute and get a lot of things done to do. And we're not backing away from that aspiration.

But it's not only growing the Cordis products. It's the other Cardinal Health brand. It's growing the at-Home business, which also had a nice revenue growth this quarter. It's also our services business, which tend to be higher margin rates.

And we've always said all along that to get to that rate there would probably be additional M&A to get there. And so we're going to continue to evaluate, in a very disciplined way, other M&A opportunities to reach that goal.

Lisa Gill: If we think about the comments that you made, additional M&A around fit to reach that goal. But do you feel like operationally you're where you wanted to be as - as we think about that - the margin today?

Or do you see more enhancements that you need to do in your core business outside of acquisitions?

Mike Kaufmann: I don't think, you know, whether it's Don or Jon or George or I or any of us are ever operationally where we want to be. We're always striving to get better. I mean that's what I think makes us as successful as we have been lately is that we're always focused on getting better.

But I do like where we're at on the medical side as far as how they're executing on all those things I mentioned earlier, like services; like the current products businesses; launching new products ourselves in our more commodity like lines as well as driving our higher physician preference items.

So I don't know, George, do you have anything else?

George Barrett: No. I think that's right. Lisa, we're going to be - I think one of the things that you hopefully will see for us as we have tried to adapt quickly where we need to. So for example, we talked about the legacy business on the med surge side.

We had to make some moves I think, really to tighten the reins there in certain parts of it. Manage the expenses differently but also manage the mix differently. And I think it's - a lot of this is about that kind of discipline to manage both of the expense side. But certainly of the mix of products.

And so I think that's an effective and important tool. And we can still get better.

Operator: We will take our next question from George Hill from Deutsche Bank.

George Hill: Yeah. Good - good morning, guys and thanks for taking the question. And Mike, I wanted to follow up on Ross's question a little bit. And when we think about generic inflation, I guess, can you qualitatively talk about the buckets?

Will you guys monetize either the inflation or the deflation, kind of the buy side margin and sell side margin and carry margin? And how should we think about the importance of each of the buckets or the sizes of each of the buckets?

Mike Kaufmann: Yeah. Obviously George, I won't be able to get into lots of detail but I'll give you a little bit of information to see if I can be helpful. First of all, you know, we can make money in both an inflationary environment on generics or a deflationary environment.

History - historically, generics has been a deflationary environment. And we've been able to make money in that. And so I look at it as two ways. Think about it this way.

When generics are going up in price, you do make some inventory revaluation income or, you know, some people call that buy side margins. And so in a deflating market you don't make the upside on the inventory inflation. But you're protected from any inventory exposure.

You get floor stock adjusted. So you basically, in an inflating environment, you know, make the money on the extra bucket of money on the inventory inflation.

But in both environments you're able to reprice to the customer and be able to adjust your pricing, in order to work on your margins.

But I think one of the keys you have to remember, whether you're in an inflationary or a deflationary environment every single day, our goal is to keep our customers competitive.

And our pricing is not often - is based on what we need to do to be able to sell the products and keep our customers competitive as they look at things like reimbursement that impact them every single day. And so that's really important to us.

And, you know, there's a lot more levers than just generic pricing. As I mentioned before, our ability to launch drugs effectively, penetrate current customers and existing customers, Red Oak has clearly been a driver of our ability there.

There's just a lot of pieces that go together. And it's hard to disconnect any one of those and try to quantify those when it's all blended together.

George Hill: Yeah. That's helpful. And then maybe a quick follow up on one of the other levers is you hear a lot of also small and midsized brand side - brand drug manufacturers, complaining about the fees that they pay to the wholesalers to access the channel.

I know that brand drugs is a portion of the margin - is a portion of the total segment margin or a smaller piece.

But how should we think about how important those fees from the smaller and midsized branded guys are, and kind of what's the risk to that segment of the business if they're consolidated away? And I'll hop off. Thanks.

Mike Kaufmann: Yeah. I think all of our manufacturer partners are important to us. We, you know, we work really, really hard to make sure no matter what size you are, whether you're in medical or in pharma, that you're seen as important.

I think that's one of the things that Red Oak has done a good job of is also is working hard to treat every manufacturer like an equal partner. But as you think about the pricing, sure, I think most suppliers were always going to say that their fees are too high.

But we're very, very disciplined about how we charge our fees. And we look at things like line extensions, whether they're controlled drugs; whether they're refrigerated drugs.

All those different costs that we incur that they would have to incur that if they were to go direct, we look at those to understand what we should charge as a fee.

And so we work incredibly hard to make sure that we don't charge fees to manufacturers that would be more expensive than them going around us. And so I feel really confident with our model and our pricing that we're the most efficient way of getting products through the supply channel.

I don't see any country that's more efficient or any supply chain that's more efficient than the United States. And I think the other piece is I can't even remember the last time there's been any, you know, significant supply chain integrity issue in the U.S., and so that's - that to me is incredibly important.

George Barrett: It's George, I'd like to follow up again, just having had some experience outside the U.S. The supply chain for pharmaceuticals in the U.S. is the most efficient - has the highest line item flow rates; is the safest and is the most secure in the world.

So I think that this is something that is important to our partners. We actually generally hear very positive things from them about that work. And that's important in terms of our value proposition.

Sally Curley: Operator, next question?

Operator: We will take our next question from Dave Francis from RBC Capital Markets.

Dave Francis: Hey. Good morning, guys. And sorry to keep going back to the pricing well. But given the focus everybody's had on it of late, I had a couple more questions.

First, how - from your seat George and Mike, kind of how are you seeing your end customers in the marketplace, whether it be health systems or PBMs or retailers?

How are they reacting either strategically or operationally, to the changing price dynamic in both the brand and generic baskets? And how is that affecting your business particularly?

George Barrett: Good morning, Dave. Yeah. It's a hard question to answer, because it really depends what seat you're in. I do think that as Mike described, all of our customers are influenced by the reimbursement dynamics - how they're compensated.

And that can come either from the private sector or the public sector. I think what can be worrisome to them is when there are lags between how they get compensated in reimbursement or how they're not just time lags but lags in general between what their costs look like and what their reimbursement looks like.

So we just try to stay very close to it. It can vary by product and it can vary by different classes of drugs. But I do think it's an environment in which there's - as you guys have all said, a lot of attention on this. We try to stay very close to it.

I think we pride ourselves on having a certain intimacy with our customers and understanding where they are. So they try to make sure that we do everything that we can, to put them in a position to be successful in serving their patients.

But yeah, but certainly a lot of it has to do with reimbursement dynamics and what's happening around financing models in the system.

Dave Francis: Okay.

Mike Kaufmann: I think also Dave, just so you know, I think while cost and reimbursement are obviously incredibly critical to our customers, there's a lot of other services that we provide that are helpful to them. Helping them take capital out by helping them manage their inventory, helping - giving them a broader array of private label products or physician preference products.

Or helping them with various types of programs to run their business are also critical. And so we try hard to find more than - while we focus incredibly hard every day on having the best cost, to provide great pricing, there's a lot of other pieces that are critical.

George Barrett: Just to add one piece to that - one of the things that we find is that the absence of standardization around healthcare is often a source of inefficiency. And so one of the things that we've been able to help many of our customers do is standardize, for example, around consumable products.

So when they do that, that tends to be much more cost effective. And so that's one of the tools that we use.

Dave Francis: And as a quick follow up, just to put a fine point on it, understanding there are a lot moving pieces in it. But would you characterize the overall generic basket today as still being moderately inflationary? Or have you seen it gone deflationary?

Mike Kaufmann: Gosh, that's - it's clearly moderated significantly. So I would say it's, you know, very close to right - almost a wash in between right now what we're seeing right now.

So it's hard to say whether it's slightly inflationary or slightly deflationary, depending on the day of the week and, you know, where you are. But it is clearly moderated steeper than we had said.

But again, while it's moderated more than we expected it to, we're doing really well overall in our overall generics program. And like the other, you know, other components that are delivering valuable.

George Barrett: Dave as a reminder, because you describe the overall basket. Again, just as a reminder, the overwhelming majority of products are moving the way they typically move.

And then what tends to swing that total or the net total - the net aggregate, is just a relatively small basket of products. And so I think that's probably worth noting all the time that you have thousands of products that are moving fairly typically.

Sally Curley: Next question, operator?

Operator: Okay. We will now take our next question from David Larsen from Leerink.

David Larsen: Hi. Can you talk a little bit more about the pharma operating margin itself? I mean it looks like revenue was good in the quarter. But according to our model, it looks like an 18 basis point contraction year over year and a slight, you know, decline in operating profit itself, on a sequential basis.

Just I mean anymore color around that? I mean is that new customer starts? Or is it all generic inflation or, you know, have you changed the way that you're pricing new business sort of, you know, what Dave Francis was asking about? Thanks.

Mike Kaufmann: Yeah, no real fundamental changes to the way we're pricing or the competitive environment or anything like that. This is merely - the 18 basis point is - really the majority of it is the addition of a new customer that was added in the quarter that was at lower margin rates.

And remember, we talked about this and this is a situation while the margin rates are lower, the amount of capital that we deploy is incredibly efficient. And so we're willing to take lower margin rates when we have the, you know, the ability to manage our capital effectively.

As far as the sequential drop, remember last quarter, we did mention that there was about an 11 cents in that quarter that we said were kind of like one timers. Part of it being those generic items that were operating a little bit differently than they - we anticipated.

And then also, we had the acceleration of some of the benefits of our M&A in the quarter that was a little bit better than we thought. So if you think about 11 cents of kind of extra in last quarter.

The reason we talked about that then it was to give you some insight that was kind of a way to think about how this quarter would be. So this was very much in line with what we expected for this quarter.

David Larsen: Okay. That's very helpful. Thanks a lot. And then you made some comments I think on the Cardinal Home Health business, growing I think double digits year over year. Is that the top line organic growth rate - the home health business is growing over 10% per year on a top line? Is that correct?

Mike Kaufmann: Yes. That's top line.

Sally Curley: Operator, next question?

Operator: Okay. We will now take our next question from Garen Sarafian from Citi Research.

Garen Sarafian: Good morning, everyone. On branded pharma contracts and inflation, Mike you had mentioned last quarter that you tried to proactively manage those agreements. And I'm assuming you had at least some contracts that were up for renewal at calendar year end.

So could you elaborate a bit on how those conversations have changed in any way, even if I think you mentioned that they were broadly in line in the prepared remarks?

Mike Kaufmann: Yeah. Thanks for the question, Garen. I wouldn't say anything's, you know, different. I'm not getting a different sense from the manufacturers. There's always a good negotiation every time one of these happens. Everybody wants to pay lower. We want to, you know, get paid more.

We spend a lot of time talking about the various dynamics of the manufacturers' mix and whether their line extension has gone up or down, whether or not they've changed their mix as far as control drugs or, you know, refrigerated items.

And so we work through all those. We have incredibly productive relationships with our manufactures. And so I would tell you that the way these are going, still training the way they have historically and they're still about 80% or so of the margins are coming from a non-contingent standpoint.

And roughly 20% or so are coming from what we call a contingent basis, which means that inflation can drive the actual value of the dollars, when we talk about contingent versus non-contingent.

Garen Sarafian: Got it. Great. And then - and apologies if I missed this in your prepared remarks. But on you having raised the high end of sales guidance, did you mention which segments or in specific businesses you're seeing evolve more favorably? Thanks a lot.

Mike Kaufmann: No. Our revenue overall, was an overall revenue guidance increase. But as you can see, obviously, the pharma segment has performed well. But with the addition of Cordis and some other good activities; medical also had a good top line growth. So, but it - that was an overall to go from mid-teens to mid to high teens.

Operator: Great. We will now take our next question from John Kreger from William Blair.

Roby Fatta: Hi. Good morning guys. This is Roby Fatta filling in for John today.

George Barrett: Good morning.

Roby Fatta: Thanks for taking the question. You mentioned earlier in the call that there were a few things on the generic side that are offsetting the inflation rate moderation. Can you flesh that out a little bit?

Perhaps, give us a sense of what percent of customers are currently still buying direct versus how many have shifted to buying through the channel.

Mike Kaufmann: Yeah. I won't be able to do that. I know that's a question but go ahead George, do you want to comment? Or...

George Barrett: Why don't you take the first part...

Mike Kaufmann: Okay.

George Barrett: ...which is the moving - moving parts?

Mike Kaufmann: Yeah. From a moving part standpoint, I would tell you that the two things that we said would moderate the shares as we talked about a couple of times, was generic inflation. And as I've mentioned, it's moderated a little bit more than we had modeled.

We expect generic launches for this year, to be slightly less than this past year. But in terms of overall, our ability to source products, is doing better. Our ability to penetrate existing and new customers is going very well.

Our use of data and analytics and how we price our products, is going really well. So when you wrap it all together I still feel like our overall generics program, is performing about as we expected. But there - it's just coming in a little bit differently.

Other than that, I really can't split it down more. It's - actually, even if I wanted to, it's incredibly difficult because they're all so interrelated on how we work with customers. It's very difficult to split it apart.

George Barrett: And Roby, I'll try to touch base - I'll try to touch on one part of your question, which was those customers that source generics from us. I think if you look at our numbers, it's pretty clear that that has increased for us.

I do think the market recognizes that, particularly given the strength of our capacity in working through Red Oak, that we're a very attractive partner.

And so I think there are many customers in the system that actually have done for years, a blend of buying generics, some directly, some through distribution partners. And so even small swings in those percentages can be beneficial to us.

We think our value proposition is very strong, as Mike said, and getting increasingly strong. So we're hoping that we can continue to attract those customers.

Roby Fatta: Great. Thanks very much. And one quick one on medical if I could. Is there any update on what kind of commodity related tailwind you might see in the coming quarters if oil remains low?

Mike Kaufmann: Yeah. Remember too, the oil price that you see every day is more of a spot market versus the - more of the forward curves. But at the beginning of the year we had mentioned that we thought commodities would be a $10 million to $20 million, you know, good guide for us this year.

And that's still tracking essentially, as we said, it would at the beginning of the year. And then the other thing to remember is that we've employed a lot of - a host of hedging strategies.

We've renegotiated our contracts over the last several years, with manufacturers, as well as if you look at the overall supply line and our commitment to inventory, it takes about six months before any type of changes in commodities will have an impact on us.

And then the last bucket is, is that, you know, we have a lot of different commodities and not all move with oil.

And so where probably five to ten years ago, oil was a much better proxy for how our commodities would go, it's very different today, when you look at our mix of commodities that we buy. Many of them do not move in correlation with oil at all.

Sally Curley: Operator, next question?

Operator: We will take our next question from Steven Valiquette from UBS.

Steven Valiquette: Thanks. Good morning, George and Mike. I guess just for me, one question that we keep getting from investors - this kind of relates to Red Oak a little bit. But without going into specific details, investors keep wondering, is there anything maybe mechanical about Red Oak that perhaps smooths out your generic profit?

Where, you know, perhaps Cardinal made a little bit less profit during the big, generic hyperinflation quarter so maybe it shields you a little bit on the way down, on generic pricing?

Or, you know, if there is a better, you know, smoothing of generics profits for Cardinal versus Peers, as some investors perceive, does it maybe have nothing to do with Red Oak in your view? I'm just curious if you want to offer any additional color on that. Thanks.

Mike Kaufmann: Yeah, I think it's a little bit Red Oak. But really I - this was really pre-Red Oak was that probably about four years or so ago, when we were reevaluating our overall way we buy generics, we made a very conscious decision that we would cut back on our spec buying and the way we managed inventory with generics.

And we really want to focus on how can we be the best possible partner for our generic partners? And trying to manage inventory more from a supply standpoint versus, you know, a pricing standpoint was a way that we felt that it would go.

It was better for the manufacturers and we thought, over the long run, it would improve our relationships. And hopefully, make them stick here as well as lead to a better everyday low price for us. And so we did that. And that philosophy was also shared by CVS, when we formed Red Oak.

Is that our focus is - at Red Oak, is how can we be the absolute best partner to our manufacturers? Obviously we want to get a great price. But we want to be transparent. We want to be easy to do business with. We want them to want to come do business with us.

And one of that way is helping smooth out fluctuations in the supply chain, which is something that we've done for a while, that I think maybe has made us a little different from an exposure standpoint to declines in pricing.

Steven Valiquette: Okay. So maybe it's just a little bit less forward buying versus your peers that again, didn't necessarily have to do with the Red Oak but...

Mike Kaufmann: It's hard - it's hard for me to say what my peers were doing.

George Barrett: Yes.

Mike Kaufmann: I won't comment on what they were doing. But I can just tell you that for us, managing inventory more around being a great partner and making it efficient in the supply chain, was the focus for us versus other types of activities. Thanks Steve.

Sally Curley: Operator?

Operator: Okay. We will take our final question from Eric Coldwell from Robert W. Baird.

Eric Coldwell: Thanks very much. Good morning. Question - first question's around pharma. Very strong growth in the quarter. A couple of billion of upside versus street. It seems like that was probably your net wins driven.

But can you give us a sense on the M&A impact in pharma in terms of percentage points of growth? And also maybe your best estimate of what your same store trend might be, excluding net wins and losses?

Mike Kaufmann: Yeah. I would tell you that majority of our growth was growth from our relationships with new and existing customers. Acquisitions were a, you know, a smaller contributor of our overall growth. But that's the best I can give you in terms of trying to size the two.

George Barrett: Eric, just a reminder. We have tens of thousands of customers. And so again, the small movements in those customers can be meaningful. And of course, as you know, in the branded side over the last year has seen a lot being driven by some of the important new products in the system.

And so we shouldn't - we shouldn't ignore that as well.

Eric Coldwell: Yeah, that's fair. Just a quick follow up on - we didn't hear much about the Henry Schein relationship. And I'm just curious if you can give us a sense if that was a driver of your Cardinal brand growth in the quarter and how that's tracking to date?

George Barrett: Yeah. So again, plays with the relationship. I wouldn't say economically yet a big driver. But definitely positive to be able to sell many of our Cardinal brand products through these additional channels. So we really look forward to greater growth there.

And it's again, it's early but it's off to a pretty good start.

Sally Curley: Operator, is there anybody else in queue?

Operator: No, there is not. And I will turn the call over to George Barrett for closing.

George Barrett: Sure, thank you Bethany. Again, just closing summary - I think we're off to a really good start to the first half of our fiscal 16.

We thank all of you for joining us this morning and for your questions. And we look forward to seeing many of you in the coming weeks. And with that, we'll close the call. Thank you.

Operator: And at this time, this does conclude today's conference. Thank you for your participation. You may now disconnect.