Q3 FY16 Cardinal Health, Inc. Earnings Conference Call

April 28, 2016 8:30AM Eastern

Operator: Please standby. We're about to begin. Good day and welcome to the Cardinal Health Third Quarter Fiscal Year 2016 Earnings call. Today's call is being recorded. At this time I would like to turn the conference over to Sally Curley. Please go ahead.

Sally Curley: Thank you Alicia and welcome to Cardinal Health's Third Quarter Fiscal 2016 Earnings call today.

Today we will be making forward looking statements. The matters addressed in the statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected or implied.

Please refer to the SEC filings and the forward looking statement slide at the beginning of the presentation found on the Investor Page of our website for a description of 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.

In terms of our upcoming events, we will be webcasting our presentation at the William Blair 36th Annual Growth Stock Conference on June 15th at 8:00 am Central in Chicago.

Today's press release and details for any webcasted events are or will be posted on the IR Section of our website at cadinalhealth.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 everyone and thanks to all of you for joining our third quarter call.

We had a very strong and balanced third quarter. So let me get right to the numbers.

First, revenue for the period was up 21% versus the prior year to $31 billion.

Second, we reported an increase of 20% versus the prior year in non-GAAP operating earnings of $788 million.

And third, we delivered an increase of 20% versus the prior year of non-GAAP diluted earnings per share of $1.43.

And as we move into our fiscal 2016 fourth quarter, we are narrowing our guidance range to $5.17 to $5.27. The midpoint of this range would imply a growth rate of 12% for Q4 and a growth rate of 19% for the full year.

I'll turn the call over to Mike who'll go into the financials in a moment. But let me first provide you with more context on our business lines.

Both our Pharmaceutical and Medical segments had a strong third quarter reporting double digit revenue and profit growth versus the prior year. Starting with the results from our Pharmaceutical segment. First, revenue for the pharmaceutical segment increased 22% to $27.5 billion and segment profit increased 16% to $660 million.

Overall, we saw solid performance across the segment with significant contributions from Pharmaceutical Distribution and Specialty.

Second, our Pharmaceutical Distribution business performed extremely well in the period. We continue to quickly respond to our customers' needs and strengthen our relationships through our value-added service offerings, and as a result have outpaced the market in all classes of trade.

Our team has moved decisively with the integration of Harvard Drug and we are on track to deliver our financial targets for this transaction.

As you know generic pharmaceuticals play an important role in our pharmaceutical offering and will continue to play an important role in the overall healthcare system. I'd like to take a few moments to share my thoughts on the environment around generics in the U.S.

With demographics driving demand and breakthrough science opening the door to new treatments, and in some cases, cures for our most dangerous, costly, and complex diseases generic drugs are a key component to our system's ability to contain costs through competition and provide needed head space to help fund pharmaceutical innovation.

We do see some dynamics in the current generics environment which I would like to highlight and which have some financial implications for the near term.

First, demand is up. We all know the pressure that aging Baby Boomers are putting on the healthcare system. And that pressure will continue to drive volume and growth for years to come.

Second, the cycle of patent expirations is never a straight line. It has peaks and valleys with the launch and lifecycle of in-market brand drugs. Right now, we are in a period of relatively fewer generic launches. This has been true in recent quarters and we would expect this pattern to continue into our FY17 with the value from new launches being down from FY16.

As you know this can change based on patent cases. And we'll provide you with more clarity around our launch expectations for next year when we finish our FY16 and guide for FY17.

Third, the flow of new ANDA approvals coming out of the FDA has significantly increased. The average number of yearly ANDA approvals in the period between 2012 and 2015 was 155 per year. The number of ANDAs approved just in the six-month period between November of 2015 and March of 2016 was 279. The FDA is clearly working through its backlog.

Combining this with the heightened election cycle discourse around the "cost and value" of pharmaceuticals, we might expect that across the portfolio, in the aggregate we would see a relatively flat to slightly down generic manufacturer inflation rate in the near future.

Finally, this has been a year in which strategic moves among numerous players in the retail and non-retail sectors has shifted many long-standing generic affiliations. This has naturally caused some competitive realignment, which we would expect to settle out as the coming months unfold.

Given all of these factors, we anticipate that the contribution from generics would be more muted in the near term. That is a challenge, but we are well positioned, well prepared, and will be working closely with our customers and drawing on the capabilities of our sourcing through Red Oak.

Turning to our Specialty solutions group. We continue our track record of delivering very strong double-digit growth. We serve and support our provider customers across a broad range of therapeutic areas. And we're expanding our services to support biopharmaceutical companies. This positioning is extremely important as the flow of new innovative pharmaceuticals emerges from biopharma pipelines.

Finally on the pharmaceutical segment, we're beginning to see an uptick in product volumes in our Nuclear business. We are delivering and driving efficiencies in the nuclear diagnostic space and at the same time, are looking forward to participating in the manufacture and distribution of new therapeutic radio-bio-pharmaceuticals.

Overall – a very solid quarter for the pharmaceutical segment.

Turning to our Medical segment, our Medical segment put up some strong numbers in the period. We continue to deliver the tools, services, and technologies that thousands of care providers depend on every day.

As a result, third quarter revenue was up 13% versus the prior year to $3.1 billion dollars.

And segment profit increased 26% to $128 million. As a reminder this quarter included the negative impact of the Cordis-related fair value step up, which Mike will cover.

Our year-over-year growth for the quarter was not only a result of strategic acquisitions which did contribute nicely – but also the result of some very positive contributions from existing lines of business which continue to get stronger.

We continue to see growth in the number of accounts we serve and in the range of product lines they purchase from us. In the period, we saw growth in Cardinal Health consumables, services to hospitals and health systems, surgical kits, lab products, and Cardinal Health at Home.

Don and his team are driving strong performance and we're very excited to see this kind of growth and importantly, our strategic positioning in the market has been thoughtfully crafted and is being effectively executed.

For example, we've identified the activities and process of discharge into the post-acute arena as an important area of dysfunction in the overall healthcare system. We've taken some important steps including the acquisitions of naviHealth and Curaspan which strengthen our ability to play an important role in helping our customers navigate this critical stage. These capabilities are particularly relevant as we see the emergence of more value-based payment models.

Finally on medical, the integration of Cordis remains on track. Under the leadership of Cordis President David Wilson, we have trained and merged our Cordis and Access Closure US commercial teams. We have finalized

our worldwide leadership teams, appointing a new President in Japan, and a new operations leader to our Cordis headquarters in Zug, Switzerland. We are bringing the best of Cordis and Cardinal Health together and care providers, patients, and investors will see real benefits.

We do have some important work in front of us though. Of course we want to make sure that what we call the Day 2 Countries are closed and integrated. We've seen some encouraging growth in the EU and would like to see a similar pattern in our Asian markets. And we think there's significant opportunity to expand the Cordis product portfolio.

Let me close with an important point. At a time when powerful forces are reshaping the healthcare landscape Cardinal Health is not just prepared to respond but poised to lead. We've worked hard to create a balanced portfolio of products and services that deliver real solutions that address our customers' most pressing challenges. We deliver value across the lines of traditional customer groupings and markets and from a fully integrated Cardinal Health portfolio.

And with that, I will turn the call over to Mike.

Mike Kaufmann: Thanks George, and thanks to everyone joining us on the call today. In my comments I'll first provide some context around our third quarter performance.

Then I'll give some additional color on our expectations for the remainder of the fiscal year. You can refer to the slide presentation posted on our website as a guide for this discussion.

Starting with consolidated company results, third quarter non-GAAP diluted earnings per share were $1.43 a 20% growth versus the prior year. This was due to solid performance in both the Pharmaceutical and Medical segments, which I'll discuss in detail later.

Total company revenues grew 21% versus the prior year to $30.7 billion. Non-GAAP gross margin dollars grew 17%.

Consolidated company SG&A increased by 14% versus the prior year, almost entirely due to acquisitions. Our core SG&A continues to be an area of focus with a disciplined approach to ensure that we maintain a lean, efficient organization.

Resulting non-GAAP operating earnings in the quarter were $788 million, an increase of 20% versus the prior year.

Moving below the operating line, net interest and other expense was $44 million. Again this quarter, the increase versus the prior year is 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.

The non-GAAP effective tax rate was 36.6%, flat to the rate in the prior year quarter.

Diluted weighted average shares outstanding were 331 million, 3 million shares lower than the third quarter in the prior year. During the quarter, we repurchased $300 million worth of shares. And as of the end of the quarter, had slightly under $400 million remaining on our Board authorized share repurchase program.

Cash flow from operations was nearly $920 million, and at the end of the third quarter we had $2.6 billion of cash on the balance sheet. Our strong cash flow is the result of our robust earnings growth as well as our efficient management of working capital by our teams. As always, we remain committed to a balanced approach to capital deployment.

Moving on to segment performance, let's start with the Pharmaceutical segment. Revenues grew 22% to $27.5 billion due to continued growth from new and existing customers as well as the contributions from the recent acquisitions of Harvard Drug and Metro Medical.

Segment profit was $660 million, an increase of 16% versus the prior year. There were two primary drivers of our profit growth in the quarter. The first is the acquisitions of Harvard Drug and Metro Medical which are integrating well and meeting our financial targets. The second is the continued growth in Pharmaceutical Distribution of new and existing customers which includes our generics program.

Also, while not the primary drivers in the quarter, both specialty and nuclear were contributors with specialty continuing its double-digit growth and is on track to deliver at least $8 billion in revenue for fiscal 2016.

Pharma segment profit margin rate for the quarter was down 11 basis points versus the prior year. This is a mix dynamic due to the new relationship with a large mail order customer which began in our second quarter.

As a reminder, while the new contract has a dilutive effect to margin rates, it is positive from an earnings and capital standpoint.

In our Medical segment, we saw the same sort of uplift across the breadth of our businesses. Revenues grew 13% to $3.1 billion driven by contribution from acquisitions, net of divestitures, as well as growth from all of our existing businesses.

Medical segment profit grew 26% to $128 million. This was driven by the net contributions from acquisitions as well as Cardinal Health brand products. As you may recall, this quarter, like Q2, includes the Cordis inventory fair value step-up, which was $21 million in each quarter.

Let me give you a little more color on Cordis. First, the onboarding of Cordis continues to progress well. We have filled the key roles with excellent talent and are focused on execution. As I mentioned last quarter, the expected favorability of the lower inventory step up was a wash with the foreign exchange impact that was greater than we had originally modeled.

As we work through the transaction there are a few mechanics such as the timing of exiting our transition service agreements with J&J, the closing of Day 2 countries and the ramping up and down of certain expenses that could result in variability between quarters.

As you can imagine, all of these moving parts can lead to Cordis results that may not be linear for a few more quarters. Specifically, some of these caused margin rates to be somewhat elevated in the third quarter versus

how they may look over the next few quarters. If anything significant occurs, we will let you know, but again, overall Cordis is performing well.

Organic growth of our Cardinal Health brand products was the primary driver of a 42 basis points increase in the Q3 Medical segment profit rates to just over 4%. Our Cardinal Health brand product portfolio includes private label consumables and physician preference items.

These lines of business are important value drivers for our customers and are key to margin expansion.

Of particular note, this offering is resonating with our customers. In the quarter, Cardinal Health brand product growth was in the low double-digits within our Strategic Accounts. Additionally, the value of the breadth of our offering is also gaining traction as our Strategic Accounts once again grew well above the market this quarter.

Before I move to our outlook for the rest of the fiscal year, let me touch briefly on China which reports in both segments.

In spite of well documented macroeconomic conditions, our businesses in China continue to perform well with strong double-digit top- and bottom-line growth for the quarter.

Turning to slide number 6, you will see our consolidated GAAP and non-GAAP reconciliation for the quarter. The 26 cent variance to non-GAAP diluted EPS results was primarily driven by amortization and other acquisition related costs.

I'll now update you on our thoughts for the remainder of fiscal 16. Based on our current assumptions, we've tightened our non-GAAP diluted EPS to a range of $5.17 to $5.27, or growth of 18% to 20% versus the prior year. This range implies fourth quarter guidance of $1.07 to $1.17 non-GAAP earnings per share, a 12% growth at the midpoint.

Looking sequentially to Q4, four things essentially explain the variance from Q3. First, we typically see higher brand inflation activity in the third quarter which comes down in the fourth quarter. We expect this fiscal year will be consistent with this historical trend.

Second, as a result of the acquisition of Safeway by Albertsons, we stopped servicing them as of April 1st, which has an impact on our fourth quarter comparison. The final two are a higher tax rate and a handful of smaller corporate items.

For our full fiscal year guidance, recall that in the prior quarter I mentioned that foreign exchange and the generic pricing environment could impact us in reaching the very high-end of our prior range. Neither turned in our favor; foreign exchange hasn't moved much from our prior expectations, and as for generic drug pricing, we expect the environment to be similar to what we experienced towards the end of Q3, which was slightly deflationary.

Moving on to slide 9 of the presentation, I'll walk through the updated corporate assumptions that reflect what we expect as we close out fiscal 2016.

First, we expect our non-GAAP effective tax rate to be in the range of 35.5% to 36.5%.

Next, we expect diluted weighted average shares outstanding to be between 330 and 331 million shares.

In addition, we've lowered our expected range for net interest and other expense to 185 to $200 million. Also, we expect that our full year capex spend will be in the range of 450 to $480 million.

And, finally, our updated assumption on acquisition-related intangible amortization will be about $348 million or 68 cents per share.

Now, I want to take the opportunity to share a few preliminary thoughts on what we believe will be some of the key drivers in FY17. We still have work to do on sizing each of these, so my thoughts will be more qualitative than quantitative.

Starting with the Medical segment, we expect strong growth to be led by our Cardinal Health brand products, which will include Cordis. As a reminder, FY17 will not have the negative impact from the inventory step-up.

Also, we expect growth in our post-acute initiatives, which includes our Cardinal Health at Home business. As in past years, we would still expect repricing on National Brand to be a headwind.

Moving to the Pharma segment, as we mentioned, the Safeway contract has expired and will be a factor until we anniversary it in Q3 of next year.

Under our generics program, we expect continued strong performance from Red Oak. As it relates to new item launches, due to the timing of our fiscal year and the shifting of a few product launches, we expect the contribution in FY17 to be less than FY16. Also, we are currently expecting generic inflation to be less in FY17.

As I mentioned in our Q4FY15 call, we initiated a multi-year program to refresh our information systems in our Pharmaceutical segment. This investment is being made to support our significant customer growth and acquisitions.

Per our plan, FY17 expenses related to this program will be more than what we incur in FY16. We have outstanding talent and metrics in place to ensure success.

Lastly, we expect to continue with our current moment in the Specialty business. As we complete our budgeting process this Summer, we will finalize our FY17 outlook and will provide additional clarity on our Q4FY16 call in August.

Let me close by expressing my appreciation to our people who delivered a record quarter in Q3, who continue to do things necessary to position us on the right side of healthcare trends, and who I know will work tirelessly and with discipline to achieve our goals and of course, serve our customers and their patients.

Operator, let's go to the questions.

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

We'll go first to Robert Jones or Bob Jones from Goldman Sachs.

Robert Jones: Yes, thanks for the questions. You know George and Mike, you know, I appreciate all the details you guys shared around generics and then some of the changes from 3Q to 4Q.

But I guess I'm still trying to parse out, you know, what was incremental relative to what you had line of sight into previously? You know if I just look at the implied 4Q guidance you guys highlighted, you know, having a hard time based off the trends in both segments seeing how growth will slow as much as you're implying.

So I guess really just if you could go back to some of the buckets you highlighted. What kind of moved against you from where you were thinking about the year previously to how you're thinking about the fourth quarter now?

Mike Kaufmann: Yeah thanks for the question, Bob. I appreciate it.

I guess I'll just go back a little bit to emphasize what I talked about and see if that's helpful.

So I'm not sure things changed a lot in the sense if you think about what typically often happens between Q3 and Q4 as it relates to the branded inflation piece. That is what we're seeing sequentially both in pharma and in med. We see a stronger Q3 from price increase activity on branded products.

So we're planning to see that again in our Q4. That's number one.

Second of all the Safeway contract expired and we quit servicing the business on April 1 so we have a full quarter of the impact of Safeway. Those are the two biggest drivers sequentially from Q3 to Q4.

And then we are expecting a higher tax rate in Q4 which will have impact sequentially on it. And then also there's just some corporate items, several smaller corporate items that we expect to happen in our fourth quarter.

And then so that's kind of maybe helps a little bit for a chunk of it. And then the other piece, if you think back to our last quarter, what we were trying to help everybody understand is to get to that top end of our range we really needed to see FX rebound and generic inflation change. And neither one did. We didn't see really much change at all in FX. And so we're not seeing any pickup from that in the fourth quarter.

And then generic inflation in the fourth quarter, we're expecting it to be more like what we saw in the last part of Q3 which as you know as we mentioned before was declining in the back part of Q3.

Robert Jones: Just to be clear then, Mike, the generic pricing didn't change from what you had thought. It just didn't come back in your favor. Is that a fair characterization?

Mike Kaufmann: Yes. I would say it didn't change from the second half of Q3 but what we're expecting is the whole Q4 to be more like the end of Q3.

So yeah, I wouldn't say it really changed from what we were trying to help you to get to that top end of the range, we needed it to, you know, go back the other way.

But it did change from Q2. And then as I said it seemed it - we're expecting it to be more similar to the second half of Q3 than it was for the whole Q3.

Operator: And once again that is...

Sally Curley: Operator.

Operator: ...that is Star 1 to ask a question. And as a reminder we do ask that you limit yourself to one question and one follow-up.

We'll go next to George Hill of Deutsche Bank.

George Hill: Hey good morning Mike and George and thanks for taking the questions.

George Barrett: Morning.

George Hill: I guess George could you provide a little more color on this industry realignment that you mentioned? I don't know if you can get anymore granular on what you're seeing and the impact it's having on the business.

And then I guess as it relates to the changes in generic drug price inflation versus deflation, I guess as we look into 17 is the expectation that inflation will be less than it was in 16 or are we back to a more normalized modestly deflationary environment?

George Barrett: Yeah, George, good morning. Let me start with the second part in a sense because as I described in the call, there really is sort of a number of factors at work here, including the launch cycle, the rate of approvals, which creates more products in the system, reimbursement dynamics, which our customers feel.

So this is all sort of part of the dynamic that affects the overall pricing environment. So that's sort of what I was trying to capture which is that this is really not a single factor, but we're seeing a number of factors that actually come together.

As it relates to the environment I was really referring to some of the big moves that have occurred over the course of the year. You have CVS buying Target and Omnicare. You've got the move with Albertsons and Safeway. You've got Walgreens and Rite Aid.

And so I think those kinds of big moves have a tendency to create a little bit of sort of short term disturbance and then they just sort of settle out.

And I just wanted to highlight that. But, you know, I think what we're describing here is more, again as Mike said it is quite different than it was at the early part of the year of our Fiscal 16. And that's sort of what we're describing.

So we just wanted - what we tried to do with you George is to always be transparent about the environment that we're seeing. And this is sort of as clear as we can be about the way we see the environment today.

Sally Curley: And I think...

George Hill: Okay.

Sally Curley: ...your question George about 17, Mike do you want to...?

Mike Kaufmann: Yes. On 17 George we are expecting generic inflation to be less in 17 versus 16. But again, it's early. And that can change. There's so many factors as you know George, I think, described several of those that can impact it.

But we're kind of looking at it more as what we're seeing in the second part of Q3 and what we're assuming for Q4. If that stays consistent we would expect 17 to have less generic inflation than FY 16.

George Hill: Okay. And then Mike maybe just a real quick follow-up. Can you give us any sense for what OP margins in the core drug business were like in the quarter, kind of ex-Optum ex the acquisitions?

I'm trying to get a sense. Would we have kind of seen the changes in the deflationary environment in the quarter ex the bigger moving pieces?

And I guess kind of the margin deterioration rate that we're seeing in Q4, is that kind of how we should be thinking about the business, you know, in what I'll call the near to medium term?

Mike Kaufmann: Yes. Gosh, a lot of moving parts on that. I can tell you, you know, again the biggest driver is really the mix dynamic with the addition of the large customer. You also have to remember in Q3 it's our biggest branded inflation quarter so that obviously has some impact on the quarter.

And then you have the acquisitions rolling in and synergy. There's just so many moving parts. It would be hard for me to break those apart.

But I think hopefully that's at least enough color to give you a little bit of help.

Operator: We'll go to our next question from Ross Muken of Evercore ISI.

Elizabeth Anderson: Hi. It's Elizabeth Anderson in for Ross this morning.

I have a question. In terms of you obviously had some pretty impressive cash flow generation in the quarter, is there any - have you guys changed any of your thoughts regarding capital allocation and sort of as a follow-up how are you're seeing, you know, valuations in the market generally?

Mike Kaufmann: Yes. I can take it and George can add a little too. You know right now there would be no change in our capital deployment policy. We're still going to be focused on investing in the business first through our capital expenditures and then, you know, we're going to stay focused on our differentiated dividend.

And as we said before we're going to continue to balance between M&A and stock buybacks. You know we did do some stock buyback this quarter, as I mentioned, we did $300 million worth of it in this quarter.

So we do look at that all the time to see what's the right use of our cash and we will continue to do that going forward.

As far as the environment from M&A, I can see if George wants to make a couple comments.

George Barrett: Yes. No. Just generally I think our team did a really good job of managing working capital. And so we're very conscious of - certainly we don't want to just sit still if we're accumulating cash. We will be very, very smart and balanced I think of that, how we deploy that.

As it relates to valuations out there, you know, the primary driver for us as you know when we look at anything related to an acquisition is the strategic fit and how relevant that is to the changes in front of us in healthcare and whether Cardinal can be an advantaged owner of any given asset.

And so we think a lot about those execution things. Obviously valuation when it's coming back to a better place certainly makes those transactions can make them more attractive.

But the driver is always going to be that strategy piece and how we as Cardinal can create value from it.

Elizabeth Anderson: That makes a lot of sense. And then just as a follow-up. I was just wondering in terms of, you mentioned that obviously Red Oak was a contributor in the quarter, have you seen any sort of change in outlook in terms of how it's been helping you guys or any change in sort of the way you're working with that structure?

Mike Kaufmann: No, I was just at the Board Meeting last week, and continue to be incredibly excited about the talent at Red Oak. It's just a fantastic team. Our relationship with CVS continues to be both strategic and positive to work together on opportunities with Red Oak not only today but, you know, going forward.

You know clearly we'll be lapping some of the initial opportunities that we saw in Red Oak. You know when you go from nothing to starting up and executing as quickly as we did we had some larger incremental upticks over the first couple quarters. And that will be coming down a little bit.

But as far as it continuing to be a benefit for us we continue to see Red Oak to be a positive driver for us going forward in the future and we continue to be excited about it.

George Barrett: I just add, you know, we continue to talk to a lot of our manufacture partners. And I think they really appreciate the simplicity of the way that we created that model. And they know what to expect and how to work with us. And so the team there and Mike and the Board at Red Oak have done a great job.

Elizabeth Anderson: Perfect. Thank you so much.

George Barrett: You're welcome.

Sally Curley: Operator.

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

Ricky Goldwasser: Yes, hi, good morning. I have a couple of questions here. The first one George, you know, if we step back, right, and we think about, you know, the generic pipeline, generic inflation environment and the industry dynamics, how should we think about, kind of like, long term growth for the distribution segment on a normalized environment? So beyond fiscal year 17 and the nuance of contract gains and losses, but just when we think about kind of like the core industry drivers?

George Barrett: Yes, so good morning Ricky. At this point obviously we're not going to be guiding long term forecasts for a business unit.

But let me just sort of give some color to the pharmaceutical distribution business. We are incredibly well positioned. I'm not sure that I've ever felt that we're better positioned, certainly during my tenure here, in terms the way that we're creating value for customers. The strength of those relationships, the opportunities in front of us to continue to use the value creation that has occurred through, I think the strength and capability of Red Oak, on generics, demographics are certainly a positive for us.

So I think our long term view is quite positive. We are going to always have these sort of like dips related to activities in the market or pricing dynamics or launches. But fundamentally I think this business is really robust. We're extremely well positioned. And we feel very optimistic over the long term about its growth prospects.

And I think you've seen over these last couple years that our positioning has improved quite substantially.

Ricky Goldwasser: Okay. And then obviously we heard that you, kind of like, won, kind of like, the Kaiser contract on the med device segment, so congrats on that.

Can you maybe share with us, kind of like, what do you think differentiated your offering versus the incumbent? What's included in that contract? Is any of the new businesses that you've acquired are in it?

And also there's still, kind of like, there's still a decision pending on the drug purchasing contract.

How do you think about this opportunity? And are there any read-throughs between the two or are these two completely separate decisions?

George Barrett: Right. Right, thanks for the question. Ricky look, we did confirm that we were awarded the Med-Surg Supply for Kaiser. We do expect that probably to transition over the coming quarters.

I do think it was really about the broad capabilities of Cardinal to create value in a market going through change. I think, again I don't want to speak, It's not fair for me to speak for Kaiser, but I think the general dialogue was really about the future about the evolution of their business how they're going to have to serve a customer base that continues to be treated in different care settings and our ability to take care of that, as well as the services and technologies that we may be able to bring to them that improve efficiencies in their operations.

So I think increasingly that discussion is occurring with our largest customers. They understand that complexity is increasing and that those partners that can help them navigate that are probably more attractive as they go forward.

And I think that was sort of a differentiator for us. Again, being careful of not to speak for them.

There are other lines of business obviously that we serve to the market and Kaiser is looking at those. I could not comment on the status of any of those. It's not appropriate.

I will say that we're well positioned with Kaiser or anyone else on other lines of business. Whether or not that's a surgical kitting or service to the home or pharmaceutical distribution.

So as I said earlier, I think I really like our positioning, but I don't think I can comment specifically on Kaiser and those lines of business and how that's going to unfold.

Operator: We'll go next to Bob Willoughby of Credit Suisse.

Penny Willoughby: Penny Willoughby in for Bob. It doesn't look like Cordis has any impact on your working capital balances. So are we expecting any shifts in future quarters for better or worse?

George Barrett: So I think that is Bob's daughter, Penny. It is bring your child to work day. We have hundreds of kids buzzing around the halls here so good morning.

Mike Kaufmann: Yes.

George Barrett: Mike, you want to take this?

Mike Kaufmann: Yes absolutely. I'm sure that Bob has a smile on his face like we do here when we walk in the morning being able to do that.

You know, Penny, I would say that right now I don't think that the Cordis acquisition will have a huge capital change in either our capital deployment policy or in our cash flows or anything going forward. I still feel really good that with all the other moving pieces we have in our businesses, we're always focused on managing our capital as

tightly as possible, making the right investments at the right time, you know, whether it be with our supplier partners, our customers or in M&A or stock repo.

So I don't think it's going to have any material change going forward.

Penny Willoughby: Thank you.

Sally Curley: Thank you, Penny, for the question.

Mike Kaufmann: Thank you for questions.

Operator: We'll go next to Eric Percher of Barclays.

Eric Percher: Thank you. I'm still trying to wrap my head around sequential trend. And if I understand you right, it sounds like on the pharmaceutical side you're seeing normal seasonality and then Safeway and so it sounds like we could use Q4 as a proxy moving forward.

So I'll ask, you know, that first.

And then the second half would be in medical at the segment level. Obviously a very strong quarter; you won't have the $21 million headwind next quarter. But you mentioned that there's going to be some timing issues over the next couple of quarters.

So I guess first, can I kind of confirm that around the pharma side and then your thoughts on medical?

Mike Kaufmann: Yes. So from pharma, yes, the first two big items I talked about were more majority pharma. But again, part of the branded inflation, when I talked about that, part of that's also in medical. Medical also sees a slightly better Q3 than Q4 from a price increase activity.

But clearly you're absolutely right. The largest piece of that branded inflation component happens in pharma distribution. And sequentially Q4 is always a much smaller quarter than Q3. And then the Safeway piece is the other piece.

So yes, on pharma that would be it. As far as medical goes, yes, that's why I was trying to give you a little color. As we're bringing on Cordis with, you know, again some of the things I mentioned. We've got several different types of Transition Service Agreements that we have in place with J&J, each with different timing of when we roll off of those and how we can work through those.

We have different Day 2 Countries coming in on different timing. And then we have certain expenses where we're ramping up on new headcount and then also getting after the synergies and taking expenses out in other areas so all of those things creates some variability between quarters.

And so again those Cordis results may not quite be as linear as you would expect them to be for a few more quarters until things kind of normalize for us.

Eric Percher: And there - are there dollars flowing out today for the transition services that will dissipate and then at the same time you may have higher upfront costs to standup the same services?

Mike Kaufmann: Yes, I think that's a really good way to look at it, because we're incurring costs to stand those up, then they transition out. And then net-net we expect all of that to be, you know, a positive for us.

As we mentioned in FY 18, as we exit FY 18 we expect to be at $100 million of synergies on Cordis. So we're still expecting that as we exit FY 18.

But there'll be a lot of noise as we're standing up. At the same time we're still long and then we roll off those Transition Service Agreements into what we think are going to be better cost situations for us.

But again I think it's really important to know that the underlying Cordis business is doing really well, does an excellent job of staffing up both from management and the sales teams.

Operator: We'll go next to Lisa Gill of JP Morgan.

Lisa Gill: Thanks very much. So Mike, when you talked about 2017, and I know that at this point it's qualitative, but you are highly medical versus drug, and if you look at the results in this quarter and I know the previous question

asked about kind of next quarter and how do we think about it going forward, but can we talk about some of the underlying drivers and more specifics to this quarter and how to think about them going forward?

And my first question would be around private label. You know the Cardinal products. Can you give us any indication as to what percentage of the sales that was? You know, does your new contract, for example, include private label for companies like Kaiser?

And how do we think about the growth component of that as we start to think about 17 and beyond?

Mike Kaufmann: Yeah, I can't specifically get into what the product mix will be with Kaiser. But as you can imagine with any customer we have, we're constantly looking to be able to shift them to our products both to save them money and improve our margins and work together positively.

So that's the goal with every single customer we have. As far as some of the other private label products and the percentage, I will tell you that it is going up significantly, but we plan to give a more detailed update at our Dublin Day in June when Don's going to spend some time walking through how all of those mechanics are working and how things are going.

But suffice it to say we're seeing some nice improvements both as a percentage of revenue as well as a percentage of margins on our products. So that's a real positive.

George Barrett: Yes, let me add to that Lisa just to give some color. In the last two years we probably added 2,000 SKUs to that line.

So this has been a very focused effort to expand that line, which we think really pays value for our customers and for us.

Lisa Gill: And, you know George, I think historically at your last Analyst Day you talked about a goal of 5.75% as a margin for the medical segment.

Do you feel that you can get there with the assets that you have today and private label or do you think you need to make incremental acquisitions to add to the offering to ultimately get to that goal?

George Barrett: Go ahead, Mike.

Mike Kaufmann: Yeah, I don't think anything's changed from the last meeting. You know that when we talked about this before, again it's an aspiration which means it's something that is not simple, it's not a layup to get to.

But when we really take a look at what we have on tap, both internally with all organic growth with Cordis, with our growth in our distribution services business, with our new post-acute business acquisitions, at home growing faster than we expected, et cetera, we expect to see very good performance against that goal organically.

But we also have said we would expect to get there, we would need to do some more M&A.

Sally Curley: Operator.

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

Dave Francis: Hi. Good morning. Wanted to hit on a couple of different items that you've already covered, but quickly on the generic pricing front, George and Mike, are you guys in a position given your look at the broad portfolio of products to see on the uptick of ANDA approvals at FDA if there is a targeting effort going on by FDA to look at some of the lower competition, higher priced pockets of the market to potentially create additional competition and therefore lower pricing in the market or is this something that you guys just don't have a good window into right now trying to figure out directionally where the market is going?

George Barrett: Yes Dave, that's a great question. I wish I knew the answer to it. I'll give you some historical perspective, but I cannot tell you about the inner workings and how they're seeing this. Historically, the FDA has been very conscious of getting first drug to market and always took priority to make sure that they would - could do that to encourage competition.

Whether or not they're targeting specific drugs is really hard to say. I don't think we would have line of sight on that. You know that they've expressed, you know, publicly and to Congress that they're really working hard to dig out of the backlog.

What's probably worth also noting is there are a lot of - the inflow into them continues to be very high. So the outflow has increased but the incoming number of applications continues to be really robust.

But I don't think we have enough line of sight or insight into their thinking to know that they're targeting particular drugs.

Dave Francis: Okay, that's helpful. A quick follow-up shifting back to the Kaiser win, as you look more broadly at the marketplace you've seen other leading health systems out there kind of identifying the physician preference item issue from a cost perspective.

Where would you say the market is relative to recognizing some of the overall trends that you guys are trying to get after relative to the changing reimbursement environment and how that might play out for you over the intermediate to long term? Thanks.

George Barrett: Well that is the - so essentially part of the work we do in our segmentation, there are certainly systems who are very much on top of some of these trends and pushing very hard to improve efficiency through standardization.

And there are others that are just at a different stage. So it really varies across the country and across the systems.

And I would also say different programs have different sales cycles. So for example on the consumable side you're probably going to have a faster sales cycle than you will for example than on the physician preference item where you want - that requires a little bit more buy-in in the system.

So I think you'd have to look at those a little bit differently from the sort of commodity-type consumables to products that are more used in the traditional physician preference area.

So again it varies a little bit by product type. And it certainly varies a lot by system.

Overall directionally as we've seen more bundled payment models, more payment for performance, shifting financing models, I would say this trend is well understood and most institutions are trying to push in that direction. And it's probably good news for us.

Sally Curley: Operator.

Operator: We'll go next to Garen Sarafian of Citi.

Garen Sarafian: Good morning George and Mike. So I just wanted to go back to your generics commentary. So for a bit of clarification, but more on clarification at this point, you mentioned flat to slightly deflationary environment. But previously you've stated you're protected to the downside.

So did you protect it to the extent it becomes deflationary? Is that the right way to think about it?

And maybe related to the generics again, if there's any way you could help us think through qualitatively the size of the generic contributions stepped down in Fiscal 17 in either moderating inflation or in new introduction? That'd be helpful.

Mike Kaufmann: Yeah, let me take a couple comments and if I miss something please feel free in the follow-up.

But I think first of all yes, when it comes to inventory, we are price protected on inventory. And so I don't have any concerns that as we see, you know, deflation on any generic inventory or any item that we have any generic inventory risk. So let's just take that one off the table first. That one's not a concern.

As far as what we think the rate of deflation will be, obviously that's a tough one. But there is a lot of market commentary out there around it. And from what we're hearing, if you listen to some of the various manufacturers and the discussions, what we're assuming is probably similar to what they're seeing is that we think that our expectations for next year are probably going to be very similar to what those are that you're hearing from the manufacturing partners.

George Barrett: I would just add that again, as Mike said, you're talking a little bit about the purchasing and the inventory.

But there's also the market side, which is reimbursement pressures and we have to live in that environment. And so we're very sensitive to that and that's part of the dynamic as well.

Mike Kaufmann: Yes, and also, when we're in a net deflation environment that doesn't mean there's no inflation. That just means that the net deflating items will be more than the net inflating items. And that's how you get to a net deflationary.

So don't interpret our comments as saying we expect no generic inflation over the next year. I always believe there's going to be some. It's just the net down.

Garen Sarafian: Okay, that's helpful. And then maybe touching on Red Oak, it's clear you've been very pleased with the results of your JV so far, but what's the bar you're trying to set in upcoming quarters and years to the extent you can share?

So maybe taking a step back, now that you've established your joint venture, the successful purchasing entity in the past two years or so. What will Red Oak need to do in two, three years from now in addition to what they're doing now for you to consider them to be a success?

Mike Kaufmann: Well that's a great question. You know I think some of the basic things you would have to do in any business, right? You've got to be able to add and develop talent and make sure that it's sustainable and that's something that I have no concerns that we won't be able to do, but that is something that any business has got to do.

I think you've got to continue to increase your data and analytics capabilities, so you could understand and be more proactive on various opportunities to either lower costs or find new folks in the system that can help you get

after, you know, increasing competition where you may need it on certain items. Understanding what's going on in the API environment and working backwards.

I think, you know, those are always important. Understanding really well what's going on with the various legal cases. All those types of things are really important as you work forward.

And then obviously scale is important too. That and, you know, I believe that's another great piece about Red Oak is when you look at both Cardinal's success recently and over its history as well as CVS's, you know, progress, than you're going to see scale continuing to increase, which I think will always be beneficial to Red Oak.

Operator: We'll go next to Greg Bolan of Avondale Partners.

Greg Bolan: Hey great. Thanks for taking the question. So just from a capital deployment standpoint, I know you guys obviously used $300 of the $700 million this quarter. Just kind of thinking about in a sense kind of going back to Bob's question earlier, moving from 2Q to 3Q obviously a few levers were pulled, buyback being one of them.

Is, I guess as we think about moving into the fourth quarter, is there an opportunity to become more aggressive with the buyback authorization or at this point feel pretty, you know, good with that $400 million and that should last you at least through, you know, at least through the end of this year? And obviously I guess readdress, you know, what's authorized as you think about Fiscal 17.

Mike Kaufmann: Yeah, you know, thanks for the question Greg. You know as you can imagine with a company with our scale and breadth, there's a lot of things going on from an M&A standpoint that we're constantly looking at as well as looking at whether stock repurchases is the right opportunity.

So as far as the numbers go, you're right. We do have just a little less than $400 million left in our stock repurchase program.

So if we do see some opportunity in the fourth quarter, if we do believe that is the right place to put capital, we do have some ability to do that without any further Board authorization.

But to be able to say whether we'll do that or whether we'll do an M&A is just - it's really hard for me to do at this time. And something that I can just tell you, we constantly evaluate where is the best place to deploy our cash.

Greg Bolan: That's great. And then just one quick question going back to an earlier question on medical segment operating profit. I mean organically it absolutely, you can see that the incremental profit margin is accelerating in that business. You know, clearly that seems to be George going back to your comments around the large number of SKUs that have been introduced on the branded side.

I guess if you think about the mix and medical segment revenues and profit, is it safe to say that the operating profit contribution from the branded products is around double that of the contribution to revenues?

George Barrett: So Greg let me try that. I don't think we can break that out for you. I'll probably answer it more generally. And I hope the color will be useful.

You know we always see and I mentioned this in prior calls that on the branded side of Med-Surg distribution, those have over a long period of time sort of been declining.

What has been happening and this is sort of what we've been describing to you guys is that the range of services that we provide that are high value, the number of products that we're providing in our private label, the mix of our business, the work that Don and his team have done is beginning to bear fruit.

And so what we're seeing is what I would describe as organic, well you call organic, it's so hard for me to actually parse that out, but some of our historical lines are doing very well. They're competing well in the market. We're expanding the product and services, and I think that's beginning to bear fruit.

So I can't break out the components for you or predict it. But what I can say is that, directionally, is a very positive thing.

Mike Kaufmann: Yeah, the old numbers just so you remember was that our Cardinal Health preferred products and consumable products in total as a percentage of med segment profit as revenue it would be in the low 20s of med revenues and in the higher 30s for med segment gross margins.

And that is something that we plan to update in our, you know, our June Dublin Day when Don gets into a little more detail about the med segment and as he gets a chance to evaluate what's going on with the Cordis acquisition.

But it's safe to say it will be much higher when you see it.

Operator: We'll go to our next question from David Larsen of Leerink Partners.

David Larsen: Hi. George you mentioned in your prepared comments something about reimbursement rates to your customers.

Can you expand on that a little bit more and maybe touch on, you know, hospitals, docs, retailers and, you know, how you see reimbursement rates trending for that group? And what do you think of this Part B rule that was proposed? What impact does that have on your business? Thanks.

George Barrett: So Dave let me start with - my comments were primarily addressing the retail side, but I'll be happy to weigh-in on the others.

So yes, I think the dynamic, obviously all the payers, whether it's the government or private payers, are working very hard to contain costs. Reimbursement is one of the tools that they have.

And so as they press those customers, we have to be there to support our customers and make sure that they're able to compete and run their business.

So it's just a dynamic in the market that we have to live with. And we're very sensitive to it. I think our customers trust that we understand this dynamic.

As it relates to the Med B proposal, as you know this was - got a lot of attention and got a lot of pushback. Let me start by saying it doesn't really much impact on us very specifically so that's important to note upfront.

You know I think this is, you know, again an attempt - we'll see CMS try to continue to do things to contain costs, to push us towards a more value-based system.

Directionally, we understand that. That's just very, very hard to do and they've got to be careful as they do that not to hurt providers who really are working hard to deliver care every day.

And I think what they've bumped into here was some very strong pushback in the provider world.

So I do think we'll see an active CMS. We expect that. I think they will make proposals regularly. Some of those will come through and stick and I think some with the system will say those are tough for us to adopt and they have adverse consequences. And this is probably one of those ones where the market pushed back, and particularly the physicians, saying this was particularly painful for them. But, you know, this is part of the dynamic that we live with I think today.

David Larsen: Okay. Couldn't the biosimilar component of the Part B rule be a benefit to your model?

George Barrett: It's an interesting question. I'll probably be a little careful in answering because it's so early. I mean the biosimilars, Dave, are still emerging as you know because you don't have this driver of the AB rating. It doesn't get the kind of instant uptick that you see with the launch of a traditional generic drug.

And so I guess we're saying, hypothetically the answer is yes, but we have to just recognize we're in very early days on the biosimilar side and I think a lot to play out still.

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

John Kreger: Hi. Thanks very much. George earlier in the call you talked about a fair amount of customer consolidation within the pharma distribution business.

Can you just remind us how you think that ripples through with pricing trends as some of those relationships come up for renewal for you?

George Barrett: You know we have seen a fair amount of consolidation, certainly among the biggest players, biggest purchasers.

You know I think first of all, that this is still sort of unraveling, not unraveling, probably unwinding. Some of these are still in regulatory approval.

I think in general consolidation is a phenomenon that we've experienced over a lot of years. We're sort of used to it. I think the question that we think about when we look at those consolidated customers is not just are they bigger, but do they have new kinds of need, distinct needs where we have tools that can support them.

So I think the key for us, as we think about these, is not just whether or not we can be efficient in order to be price competitive, but as those combinations occur do we have unique sets of skills that allow us to create value for those merged or different kinds of entities?

I think increasingly we do. So I think it's clear that we have scale and that we can be price competitive. But I think it's also other things that we want to be able to bring to any player whether or not that's on the institutional side in hospital and health systems or whether it's in the retail side.

John Kreger: Great, thanks. And a quick follow-up on the medical side, where are you seeing the best traction with your private label and branded products? If you could characterize that and I'm curious if it's the big IDNs, if it's smaller; are you seeing any patterns emerge as you get more scale in that business?

George Barrett: It's a great question. I wish I could discern. We're very good at analytics. It would be very hard to discern a pattern. We do a lot of work to segment our customers. It really varies. It varies specific to the account, the nature of their buying organizations, how active the CFO and the C-Suite is and the activities deeper in the organization. So it really varies a lot and would be extremely hard to discern a very clear pattern.

John Kreger: Interesting. Okay, thank you.

George Barrett: You're welcome.

Operator: We'll take our last question from Charles Rhyee of Cowen & Company.

Charles Rhyee: Yeah, thanks for squeezing me in here guys. Just a question, you know, George you kind of alluded to beforehand with naviHealth. You know just curious how you are looking at, you know, some of the programs that are going on in that area? So like the bundled payments for care improvement initiative. Also I think more recently the joint replacement one. And can you talk about how naviHealth is helping you position there particularly in BPCI?

My understanding is that program is not really open. I guess it's still sort of pilot. And so where are we in terms of I guess process and when do you think that gets more broadly, you know, opened up for hospitals again?

George Barrett: Right. So let's start with the basic. I think some of these programs we just have to remember are in their early phases.

But there is, Charles, I think no question that there's a push both from the public through Medicare, Medicaid and through private payers, to try to encourage payment models that are not fee-for-service, so that are some kind of value-based program.

The tools that we have in naviHealth are really interesting. And again remember that these have been primarily directed through naviHealth's history at helping hospitals, direct care, post-acute.

But I think that that skillset of being able to look at how to identify different ways of creating payment models, how do you help the hospitals that are going to have to live in that world, how do you help them navigate this.

I think what we have in naviHealth is enormously valuable. And I think it's actually, for a relatively small business, it's generating a lot of discussion between us and our customers.

But again BPCI is early. CMMI looking at that program. Early days in all of these. But the direction I think is unambiguous. I think there's more push to move away, to the extent possible, from the fee-for-service.

And I think the tools of naviHealth and the work that we do in Curaspan which, you know, touches 600 hospitals in their customer base and 8,000 post-acute providers. Those kinds of tools I think are going to be increasingly valuable to us.

Charles Rhyee: And with naviHealth have you seen that already with the hospitals they serve and as you're looking to help direct sort of the appropriate discharge location and that's how you can save money for a system? Is that advantaging sort of on the AssuraMed side, on the home and distribution business yet?

George Barrett: Yeah, I don't want to get ahead of us here. Again remember it's early. But I think it's safe to say that the discussions that we're having with large institutions around naviHealth help us at Cardinal Health position ourselves in the big sense as understanding the challenges and the forces in the market and having sets of solutions and tools that we can bring to bear.

So I think as an asset in the Cardinal Health portfolio it is creating some unique conversations and again I don't want to get ahead of us. It's early. But we're quite encouraged.

Charles Rhyee: Great. Thanks a lot guys.

George Barrett: You're welcome.

Charles Rhyee: Thanks guys.

Operator: At this time I would like to turn the call back over to George Barrett for any additional or closing comments.

George Barrett: Well thank you all for joining us. It's been a long call. I appreciate you taking the time. We look forward to seeing many of you in the coming weeks.

I'll just finish by saying, you know, we're excited about the performance of the quarter. Looking forward to talking with you in June and those of you who will be able to join us for Dublin Day and I hope you have a good day. Thanks all.

Operator: Thank you. And that does conclude our conference for today. We thank you for your participation.