Q1 FY17 Cardinal Health, Inc. Earnings Conference Call

October 31, 2016 8:30AM Eastern

Operator: Good day and welcome to the Cardinal Health first quarter fiscal year 2017 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 Ashley and welcome to Cardinal Health's first-quarter fiscal year 2017 earnings call. As a reminder, during the Q&A, please limit your questions to one, and one follow-up so that we may get to everyone in queue. We'll do our best this morning to get to everyone, but if we don't, then please feel free as always, to reach out to the IR team after this call with any additional questions.

Also, 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 upcoming events, we will be webcasting our 2016 Annual Meeting of Shareholders on November 3rd at 8:00 a.m. eastern and our presentation at the Credit Suisse 25th Annual Healthcare Conference on November 8th at 8:30 a.m. mountain time.

Today's press release and details for any webcasted events are, or will be posted on the IR section of our website at CardinalHealth.com, so please make sure to visit the site often for updated information. We hope to see many of you at an upcoming event. Now, I'd like to turn the call over to our Chairman and CEO, George Barrett. George?

George Barrett: Thanks Sally. Good morning everyone and thanks to all of you for joining us. Allow me to start by being direct. Our first quarter of fiscal 2017 certainly had its share of challenges, but it came in much as we suggested to you that it would, with healthy and growing revenues up 14% versus the prior year and non-GAAP operating earnings down 9% versus the first quarter of last year.

I'll focus my commentary on the broad outlook for our business and our future and Mike will walk you through our financials for the quarter with more detail and specificity. Let me frame the start to our fiscal year with two lenses - one, the operating performance of our integrated business lines, and the other the environment in which we compete.

Our teams continue to demonstrate their commitment to strong operating performance. Our service levels are extremely high. We are experiencing very high rates of customer retention and our enterprise-wide customer reach is expanding, including the on boarding of some very strategically important customers in the med segment. We also continue to launch new products and service offerings, increasing our value to our customers as they navigate significant change in the industry.

As is imbedded in our DNA, we are taking a disciplined and determined approach to managing our working capital. But make no mistake; this is a very challenging near term environment. This is particularly true for our pharmaceutical distribution business. The public discourse around drug pricing has - at least for the moment - had a significant impact on the way pharmaceutical companies are pricing their products on both the branded and generic side. Combining this with limited generic product launches and significant reimbursement pressure on our customers, the competitive intensity has increased. As a result, price erosion during the period has been more pronounced than it has been in quite some time for our industry.

Our commitment has been and will continue to be to providing world-class service, tools, technology and solutions to help our customers thrive in a challenging environment and better serve their patients. This is central to our value proposition. At the same time that our retail pharmacy customers are experiencing unique dynamics, we are also working closely with our large integrated system customers to help them adapt to a changing environment - one where pressures to be efficient are relentless, where the configuration of their own businesses and portfolios are more complex and where the need to operate across their own internal boundaries is a high priority.

As a result, the historically siloed or departmentally-driven operating model is evolving to one that places a premium on operating coordination across the system and strategic alignment with other healthcare players who can enable their strategies. This is who we are.

Our focus is on finding more efficient and effective ways to create real value for our customers across our lines of business. Today, our customers look to us for our integrated solutions to help them reduce costs, increase efficiency and improve quality. All of this requires deep, multi-disciplinary healthcare expertise and real strategic partnership, which we deliver every day for those we serve.

These are the characteristics of the moment - some very encouraging - others creating short-term headwinds. Of course, I'd like some of that to be different, but this is the environment in which we must compete now. We will play for the long game with a strategic eye on the future, mobilizing the best talent and building the right lines of business to help our customers compete in this changing world.

With this as backdrop and modeling in an adjustment for the current pricing environment, we are slightly lowering our fiscal 2017 non-GAAP EPS guidance to $5.40 - $5.60 from a prior range of $5.48 - $5.73. Let me be clear, we remain committed to navigating today's challenges, embracing tomorrow's opportunities for our customers and shareholders.

Within our pharmaceutical segment, revenue was up 14% versus the prior year to $28.8 billion, and segment profit declined 19% versus the prior year to $534 million. This was primarily driven by generic pharmaceutical pricing, reduced levels of branded inflation, and the loss of Safeway, which we previously discussed.

However, the work that we have done over the past few years has strategically positioned us to more effectively support our customers. The range of our retail service offerings has never been stronger and the Red Oak sourcing venture with CVS Health continues to be an effective, productive and profitable partnership. We see this as a long-term driver of value for us and our customers.

Our specialty solutions group continues to perform well, driven by both our provider facing and biopharma offerings, once again showing strong double-digit growth. We are confident that our growing portfolio of services is well aligned with and valuable to the strategies of our biopharmaceutical partners. I want to thank Jon

Giacomin and his pharma segment teams for their commitment to navigating these challenging dynamics and remaining focused on our customers with a clear eye towards managing efficiency.

Our medical segment had a strong first quarter across multiple dimensions. First, revenues for the medical segment were up 12% versus the prior year to $3.3 billion. Second, segment profit was up 26% versus the prior year to $127 million. And third, our medical segment customer base has been expanding, a testament to the value we've created across our lines of business and the strong partnerships we've developed with our customers. Every day, we see our customers focusing more on the total care of the patient and they recognize the growing shift to value-based reimbursement models.

Discussions with our customers reinforce that they are looking to us as a broad-based, integrated solutions provider and a source of expertise across the continuum of care. Our Cardinal Health branded products continue to be a driver of growth for the segment as we increase our account penetration and growth in our strategic accounts is outpacing the market.

During the quarter, we onboarded a large complex customer in our medical segment. We learned a lot from this rapid deployment and we are very grateful, both to our employees and to our new partner for working together to move us towards the finish line.

October 2nd marked a year since we closed the Cordis acquisition. Don Casey and his team have done a tremendous job leading the integration, thoughtfully phasing in new systems and processes and building out an important platform. The integration of Cordis has proved to be an excellent example of how we can bring together best practices across borders. We have seen over this past year that taking the time to do things right is essential to best serve our customers.

We have also seen growth in some important markets, including Europe, where we believe that taking an integrated cohesive approach to our customers will position us for measurable growth over the long term. Cordis is also providing us with additional partnership opportunities to build out our products, tools and services. As an example, we have signed an exclusive distribution agreement with Biosensors to bring their coronary interventional products to our customers in Europe and Japan as another offering in the bag to deliver even greater value.

While we are operating today in a tough and unique environment, we believe that we are well prepared to lead and quick to adapt. By working with our customers holistically, driving our own efficiencies and delivering integrated effective solutions, we have developed strong partnerships with our customers.

We remain committed to focusing our product lines and capabilities around the patient to position ourselves to capitalize on the changes in our industry. And through the collective drive and dedication of our 37,000 people, we'll continue to deliver meaningful results and measurable growth for our customers, patients and shareholders. With that, I'd like to turn the call over to Mike for a detailed review of the financials. Mike?

Mike Kaufmann: Thanks George and thanks to everyone joining us on the call today to discuss the first quarter. I'd like to begin by reviewing our first quarter financial performance and then walk through our full year, fiscal 2017 expectations. Please note that with all of my comments, I'll begin with GAAP and then provide the comparable non-GAAP figure. The slide presentation on our website should be a helpful guide throughout this discussion as it includes our GAAP to non-GAAP reconciliation tables.

Our first-quarter fiscal 2017 results were about as we expected, with GAAP diluted EPS at $0.96 and non-GAAP EPS at $1.24, a 17% and 10% decrease respectively. In our August call, I mentioned this would be due to some challenging trends and some tough year-over-year comps, particularly on some key generic items in our pharmaceutical segment, as well as discrete tax items, partially offset by strong performance in the medical segment. That's largely what we saw. I'll discuss both segments in greater detail later, but let me start with consolidated company results.

Revenues increased 14% year-over-year, totalling $32 billion. Total company gross margin dollars were up 1% versus the same quarter in the prior year. Consolidated SG&A increased 9% versus the prior year, primarily driven by strategic acquisitions. If you exclude acquisitions, SG&A was favorable for the quarter.

Both consolidated GAAP and Non-GAAP operating earnings declined versus the prior year by 14% and 9% respectively. Moving below the operating line, net interest and other expense was approximately $41 million in the quarter, a decrease versus the prior year. The GAAP effective tax rate for the first quarter was 37.3%. Our non-GAAP effective tax rate this quarter was 36.4%, which is 3.5 percentage points higher on a comparative

basis, primarily due to several favorable discrete items that occurred in last year's first quarter. We continue to expect our full-year non-GAAP effective tax rate to be between 35% and 37%.

Our first-quarter diluted average shares outstanding were 322 million, about 9 million shares fewer than the first quarter of fiscal 2016. This was due to the benefit from our opportunistic share repurchases over the last 12 months, which includes $250 million of share repurchases in the first quarter. We have just under $800 million remaining on our board authorized share repurchase program.

In addition, we generated approximately $104 million in operating cash flow during the quarter. And, due to efficient and effective working capital management by our teams, we ended September 30th, with a strong balance sheet. Our cash balance, including short-term investments was $2.2 billion, of which $622 million were held internationally. Now let's move to segment performance starting with pharma.

Our pharmaceutical segment revenue increased 14% to $28.8 billion. This increase was from growth in net new and existing pharmaceutical distribution customers, driven mainly by the win of a previously announced large mail order customer and the impact of branded inflation. While a smaller driver, the strong performance of our specialty business also drove the revenue increase.

Despite the revenue growth, segment profit for the quarter decreased 19% to $534 million. This decrease was a result of generic pharmaceutical pricing and to a lesser extent, reduced levels of branded inflation, as well as the previously announced loss of a large pharmaceutical distribution customer. This was partially offset by solid performance from Red Oak sourcing.

These same factors as well as changes in our product and customer mix, mainly the onboarding of a previously discussed large mail-order customer, reduced our segment profit rate by 76 basis points, to 1.86%. As a reminder, next quarter, we will fully lap the onboarding of this large mail-order customer.

Getting back to Red Oak, as we've mentioned in the past, if it achieved certain milestones, it would trigger the second of two predetermined payments beginning in FY17. Because of excellent performance, Red Oak met these milestones, so we've made our second and final $10 million increase to the quarterly payment to CVS Health beginning in Q1. As anticipated, our new quarterly payment is $45.6 million for the remaining eight years of the agreement.

Let's now go to the medical segment performance, which had a strong first quarter. Revenues for the quarter grew 12% to $3.3 billion, primarily driven by contributions from our strategic acquisitions and growth from net new and existing customers. Medical segment profit increased 26% to $127 million during the quarter due to contributions from acquisitions and Cardinal Health Brand products.

Segment profit margin rate increased 42 basis points in the quarter to 3.87%, driven by acquisitions and Cardinal Health Brand products, partially offset by the change in customer mix. This change primarily comes from the accelerated onboarding of a new large medical distribution customer.

The recent wins in the medical segment on the distribution side are exciting and very important. They add to our profitability but are dilutive to our medical segment margin rates. Specific to Cordis, it continues to meet our performance expectations and make real and measurable progress.

As we mentioned last quarter, our integration team is on track to have our operations fully stood up and exit the TSA agreements by the end of this fiscal year, while our transition manufacturing agreements will extend for a couple of years. Until we exit these TSAs, they can create some variability in our segment profit rate. Although this quarter, it was about on track. Overall, our team has done an outstanding job driving strong, healthy growth in the medical segment.

Before moving to our fiscal year 17 outlook, you can turn to slide number 7 where you'll see our consolidated GAAP to non-GAAP adjustments for the quarter. The $0.28 variance to non-GAAP diluted EPS results was primarily driven by amortization and other acquisition-related costs.

Next, I'd like to discuss our Fiscal 2017 non-GAAP earnings guidance range and assumptions. But, before doing that, let me comment on Q2. While we don't typically provide quarterly guidance, we want to keep you informed when there are meaningful shifts. So, as it relates to the second quarter, the generic pricing environment, and to a lesser extent the brand inflation rates lead us to now expect the second quarter fiscal 2017 pharma segment profit decline to be relatively in line with the first quarter on a percentage basis.

Now, you can follow along starting on slide 9 of the presentation. As George mentioned earlier, based on Q1 actuals, second quarter expectations and trends we noted, we are slightly lowering our non-GAAP earnings per

share guidance range we provided in August to $5.40 - $5.60, from $5.48 - $5.73. Let me give you some color around this adjustment by walking through our corporate and segment assumptions.

Turning to slide 10, all but two of our fiscal year 2017 corporate assumptions remain unchanged. First, we have updated our weighted average shares outstanding assumption to 320 million to 322 million shares, which is lower than the initial range provided of 324 million to 326 million shares. This new range reflects potential additional repurchases.

Second, our assumption for acquisition-related intangible amortization increased to approximately 385 million, or about $0.79 per share. That does not affect our non-GAAP earnings.

On slide 11, there are three updates to our full year pharmaceutical segment assumptions that I would like to take a minute to highlight. First, we previously expected pharma segment profit for FY17 to be essentially flat. We now expect full-year segment profit to be down mid to high single digits versus the prior year, due to the generic pharmaceutical pricing environment and while much less of an impact, lower than anticipated brand pharmaceutical inflation.

To clarify, when we refer to generic drug pricing, we are referring to a combination of all factors affecting generic selling price such as manufacturer inflation and deflation and customer pricing. We now expect this to be in the mid to high single digit deflation for the full fiscal year.

Lastly, we have adjusted our brand manufacturer inflation assumptions to a range of 7% - 9% from approximately 10%. Overall, we still expect pharma segment profit to be back half-weighted.

Now, turning to the medical segment, all of our fiscal year 2017 medical segment assumptions remain on target and unchanged. We are still on track to achieve mid-single digit percentage growth in revenue and double-digit growth in segment profit.

Now turning back to overall company guidance, since we are slightly lowering our overall fiscal 2017 earnings guidance range to 3% - 7% growth from 5% - 9% growth versus the prior year, we've updated some of our original assumptions to achieve that growth on slide 13. The line titled Business Growth is now assumed to be flat to 3%, and Capital Deployment is now assumed to contribute 3%-4% for the year.

From a corporate standpoint, we are focused on expense management and other actions to achieve these results. Keep in mind that the benefits related to these important items are held at the corporate level and not reflected at the segment level. And while we aren't providing the EPS bridge slide we presented on our August Q4 call, you can infer that based on my comments about the generic pricing environment being more challenging, it would result in a decrease to that line item, while increasing our capital deployment assumptions would result in an increase to that line item.

Net customer activity remains about the same, but our existing or remaining businesses bucket would increase as it includes the corporate actions I just referenced. Additionally, we told you on our fourth quarter call that we were assessing the timing of the adoption of new accounting treatment for the tax effect of share-based compensation.

Our 2017 guidance does not include this, as we believe it is simpler to adopt the new treatment in our first quarter of fiscal 2018, according to the required schedule. So, as you can see, we've now aligned our guidance range given the current pricing environment I just described.

To close, let me highlight a few key points before I turn to your questions. First, while we are experiencing a tough near-term environment, we continue to aspire to the long-term goals we communicated before. In our pharmaceutical segment, we do see generic pharmaceutical pricing and to a lesser extent, branded inflation as challenges. However, we continue to see strong performance from Red Oak sourcing, continued focus on operational excellence and positive feedback from our robust customer base.

In addition, Harvard Drug, Specialty and Nuclear are all delivering value for our customers and our business. On the medical side, we've also won some important new medical distribution customers, which should help us gain scale in sourcing and leverage our cost structure to create greater efficiencies. In addition, we continue to see strong growth in our Cardinal Health Brand products and services, and above-market revenue growth in Cardinal Health at Home.

Finally, Cordis continues to perform well and we are confident in both the fundamentals and growth initiatives in that business.

Overall, it was a challenging quarter, but I want to acknowledge our team for their strong execution and focus in a tough environment. I believe this excellent execution and focus combined with our broad portfolio and balanced capital deployment will allow us to drive long-term sustainable growth. With that, Operator, let's begin our Q&A.

Operator: Thank you. If you would like to ask a question, please signal by pressing *1 on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. We ask that you limit yourself with one question with one follow-up question. Once again, it is *1 to ask a question. We'll take our first question from Bob Jones with Goldman Sachs.

Bob Jones: Great, good morning. Thanks for the questions.

George Barrett: Good morning.

Bob Jones: Yeah, good morning. George, you talked about the moderation in the pricing environment, but I think your comments seemed largely focused on the buy side part of the business. I just obviously wanted to get your views on the sell side of the business given your peer last week talked about more aggressive pricing in the retail independent channels. I just wanted to see what you are seeing there currently.

George Barrett: Hi, Bob. Good morning. Yeah, actually my comments really were about the overall pricing environment, so I was talking about sell side as well. It might - here's my perspective, there are, as I mentioned before, a number of factors coming together to make this a bit of a unique moment. We're not going to overact to that moment.

Our position, our plans for growth really aren't different today than they were six months ago. Our value proposition is very clear. We're an extraordinary attentive partner to our customers. We have a unique ability to follow the patient across the continuum of care - service to offerings are extensive - that's really at the heart of our

positioning so that's, I think, important to state up front. But, I think we're describing some similar characteristics to what you describe.

Bob Jones: Okay, great. Then I guess, Mike, if I could just go over to the guidance. Overall, it looks like the range is coming down by $0.11 at the midpoint. You talked a lot about generic inflation getting a little bit worse than previously thought and then modestly less branded inflation.

But if I look at the guidance for the pharma segment specifically, it seems like that take down in what you're assuming around profit margins there - or overall profits there - mid to high single digits - would actually indicate something more in the $0.25-$0.40 headwind. Just trying to square those two things, relative to the overall amount coming down compared to what you're suggesting is going on with the pharma segment for the rest of the year.

Mike Kaufmann: Thanks, Bob. Let me hit a few different things. I think, first of all, just to be clear, when we talk - when I was talking about generic pharmaceutical pricing, I wasn't really talking about the headwind/tailwind you used to hear over the last couple of years of inflation and deflation on generic products. Because, that's about where we model it to be this year. We're not really seeing that.

We expected it to be a net deflation environment, and that's what we're seeing. So, that's not really the driver. What we're talking about is more the downstream pricing component of our generic pricing. That's where we're seeing an uptick in competitiveness or a little more erosion than we had expected to be. That really was the main driver of us taking down our pharmaceutical distribution numbers. As I mentioned a couple of times, to a lesser extent brand inflation. So we has said about 10% before on brand inflation. We're now modelling in the 7%-9%.

That impact - I guess I would put it this way - if that were the only thing going on this year, then it wouldn't - we probably wouldn't be adjusting guidance. It's more the combination of the generic pricing and then that on top of that. I think that's the first thing I want to say.

The second thing, I can understand why you're maybe having a little trouble with your numbers. I can't quote exactly or comment on exactly what the numbers should be, but remember, I did make a comment in here that we

have some significant initiatives around expenses and other initiatives. That will be captured in our corporate numbers, and so, those aren't going to show up in the segment numbers because we don't push those down at the end of the year.

Probably the piece that you're missing as you try to reconcile having pharma down, capital deployment up, midpoint down, the last bucket that you're missing is that the corporate numbers, we're going to have savings there that'll be in the overall corporate bucket.

Operator: Our next question comes from Charles Rhyee with Cowen and Company.

Sally Curley: Hi, Charles?

George Barrett: Hello.

Sally Curley: You may need to take your phone off mute.

Operator: Hearing no response.

George Barrett: Maybe go back

Sally Curley: Hey operator, yeah let's go back to Cowen if they get back in queue. Let's go to the next.

Operator: Okay. Our next question comes from Garen Sarafian with Citi Group.

Garen Sarafian: Good morning everyone. Thanks for taking the questions. Mike and George, you guys just commented a little bit on the downstream, the sell side dynamics, but on the independent front, you guys aren't as active as some of your peers. Just wondering what specific segments are you seeing that, and if you could just give a little more flavor as to, sort of, the more recent trends into this month, as to the dynamics and how they're trending. That'd be great.

George Barrett: Garen, good morning. Let me start and then Mike jump in. Actually, we have a strong position with independents and have for quite some years. The dynamic Mike described, we are seeing in that segment. I don't know what else to add to that. Mike, anything?

Mike Kaufmann: Yeah, I mean we have a lot of programs, services. We continue to stay very, very focused on that bunch of customers. We continue to have very high retention rates and so we feel really good about where we're positioned in the generic independent space.

Garen Sarafian: I guess, do you, sort of - are you seeing that in other segments other than just the independents, which was, sort of, where I was trying to lead to. Or is this still - is this focused specifically and only that segment?

George Barrett: Let me try. I think it's probably been most intense there. We often have to deal on a - this is sort of a normal thing with repricing of a contract - thankfully as you know, we have not had a lot of big contracts up for renewal. But I think it has been a distinctly noteworthy environment in the independents, would you say Mike?

Mike Kaufmann: Yeah, I would totally agree with that. I think, you have to think about the way contracts are written and just certain customer's contracts are written in ways that the generic pricing or the way it works is - one way in other areas it's much more competitive where they haven't committed to buy all the generics and so they're

constantly shopping them. That's where you're going to see - and that's typically an independence base - and that's where you're going to see some more of these competitive pressures.

Garen Sarafian: Okay, that's useful. Then just as a follow-up on the upstream on the branded inflation side with the branded manufacturers, the moderating inflation has been, sort of, a factor that has been discussed in prior quarters. I thought that at some point, there was an opportunity to go back to the branded manufacturers and re-adjust and realign the contract so it benefits all. I'm wondering, have you done that in between contracts yet, or is this, sort of, still waiting until the contract renews where those conversations come again. I'll stop there. Thank you.

Mike Kaufmann: Yeah, thanks. Good question, and I would say that's really, kind of, across the board. It just depends on the individual manufacturer. As you know, about 15% of our branded margins are based on a contingent basis, which means that generic - or branded inflation is a piece of the driver of the value that we receive. Every one of those where we are not getting the value that we believe we should be compensated for the services that we deliver, we are having discussions with the manufacturers.

Some of those are going to move quicker than others depending on contract dates, and based on prior discussions with those manufacturers on how those deals were arrived. You can imagine with every manufacturer where we believe we're being compensated less than we should have been or should be, we are working with those manufacturers.

Sally Curley: Next question.

Operator: We now have Charles Rhyee with Cowen and Company. Please go ahead.

Charles Rhyee: Yes, sorry about that earlier. Thanks George. You were talking in your - also your comments about - sorry Mike, you were talking about your comments - making the second payment to CVS as related to Red Oak. How much - can you kind of help us understand how much more of a benefit you think you're getting right now this year on your generic procurement and how much of a benefit could we anticipate that we should get the rest of this year?

I guess the point I'm trying to get at is, you talk about your overall estimate on generic deflation. How much is this procurement benefit you think is helping offset? Because I think, George - in relation to your earlier comment to Bob's question - you did, kind of, mention that you are seeing similar characteristics in the market relative to comments from last week? Thanks.

Mike Kaufmann: Yeah, I would say clearly the number one offset to what we're seeing in the competitive pricing on generics has been and should continue to be Red Oak Sourcing. I continue to be impressed with the team there, the depth of talent we have on the team, the way they're looking at things, the creative ways they're working with manufacturing partners, and you know CVS Health couldn't be a better partner working together with us to drive value at Red Oak. So, Red Oak would continue to be a positive driver for us when it comes to offsetting that.

Charles Rhyee: Then is there any other things that we can think about that can be offsets. Or, I guess the other way I'd say this - when you think about the impact that you are seeing potentially in the independence, does your guidance, kind of, extrapolate out potentially what that might look like throughout your entire book of business, or are you only, kind of, anticipating what you're seeing currently? Thanks. I'll stop there.

Mike Kaufmann: Yeah, we said that, we have lots of different things. One of the things that I think is really helpful for Cardinal in general is our broad portfolio. So while we are seeing pressure from generic pricing and, as I said to a lesser extent, branded inflation, when you look across the rest of the 'P' segment, whether it be how we'll perform particularly in specialty, how we're getting and working through with nuclear and some of our other components within that business, we continue to drive value in other areas.

As you could imagine when you're in a challenging environment like that, everyone - whether you're in 'P,' 'M,' or corporate is focused on expense control and making sure we're very diligent on those types of things. We have that benefit. As I mentioned medical is continuing to do very well. We expect them to have a very good year, and they are going, you know, moving along as planned.

I do think our broad portfolio of having medical, being able to drive some initiatives at a corporate level, which are going to show up at the end of the year, as well as some of the other parts of pharma, are what we'll be able to use and, using our balance sheet too, from a capital deployment standpoint through M&A and stock repo is how we're going to continue to manage the rest of the year.

Charles Rhyee: Great, thank you.

Operator: Our next question comes from Eric Percher with Barclays.

Eric Percher: Thank you. I'm going to return to the question of the independence and pricing. It feels like there's a pretty big difference in the magnitude of pressure that we see in your guidance as compared to one of your peers. Mike, I know you've been willing to go into some of the mechanics on items like brand inflation in the past.

If we think about the mechanics of independent contracting, could you tell us a little bit about how much of the book is truly small and mid-size customers versus larger buying groups of independents? Do you see significant differences in those? Maybe the last part of that would be, do you have any major contracts that may be coming up, or how much or how important are those?

Mike Kaufmann: Yeah, let me try a couple of things and feel free to follow-up with another question if I miss it. But a couple different things. First of all, I hate to ever comment on our competitor's numbers. We always want to be careful of those. But remember mix matters. What I mean by mix is how much of their mix may be brand and generic versus our mix.

You look at the other components of our pharmaceutical distribution segment with our growth in specialty, nuclear and other things, and so it's hard to comment on all the various moving parts of any of our competitors on what's in those segments.

Second of all, you hit on something which is customer re-pricings and we didn't have very - we basically had very few major re-pricings this year. Honestly, over the next couple years, we don't have a ton of those. We're in pretty good shape, particularly with some of our larger customers.

I think that may be a different thing as where we're seeing some of our competitors may or may not have more large re-pricings with some of their customers, which can affect each one of us in different timing within the years.

I think it really gets back to a mix of customers, timing of re-pricings and those types of things can drive differences between each one of us, as well as maybe the expectations that we originally set at the beginning of the year and how we looked at things.

Eric Percher: That's helpful. My follow-up would just be - having exposure to telesales and Harvard, has that changed your insight into the market and/or your exposure to the market?

Mike Kaufmann: Yeah, I think in some ways a little bit of both. Because a lot of their sales are into the independent market, you can imagine we're seeing some competitive generic pricing against our telesales business, which obviously is a little bit of a headwind for that group. But on the flip side, because we do have so many contacts into the independent and the regional chain space with our telemarketing business, it gives us a lot of competitive intel on what market price is.

We stay very focused at trying to make sure that we're pricing at that market price and not trying to do anything outside of that, because we believe we have a great service offering that we don't need to price below market in order to win and compete effectively.

Eric Percher: Very helpful. Thank you.

Operator: Our next question is from Ross Muken with Evercore ISI. Please go ahead.

Ross Muken: Good morning guys.

George Barrett: Hey Ross.

Ross Muken: You guys compete on the pharma side, in industry structured primarily as an oligopoly, so for many years, we haven't seen these sort of, spurts of aggressive competitiveness and obviously, it's a tough environment. But, when you look back at prior periods and talk to folks in the organization that have been looking at this longer than probably myself, what are the key tell-tale signs of the end of that?

So looking for, okay, we saw a flare up, something happened and then behavior returned back to more normal. Is it - and then - so one, what should we be looking for to judge whether or not this is, sort of, temporal? Then secondarily, how do you ultimately go back to that customer group and recapture some value? Because inherently, your business model had been delivering a ton of value to the independent base for a very long time. Obviously the margin levels take a hit and then, historically, they've come back. Help us think about the sequence of, sort of, what happens next, I guess.

George Barrett: Ross, why don't I start. First, let me start by saying, we always operate in a competitive environment. That is the nature of our business. Obviously, I've been doing this - as has Mike - for quite some time. We've lived through multiple cycles - for me in multiple parts of the industry.

You see these periods - I mentioned that this is a bit of a unique moment. You've got all of the public discourse around health care costs and pharma costs. It's loud and it's emotional, and at the same time healthcare is going through some changes. I don't think it's shocking that there is some near term disturbance. You know, experience - my experience tells me that over time you see some shifting out and just essentially settling of the

dust. Sometimes when aggressive moves don't result in much change or value creation, things just sort of stabilize. We've lived through different cycles in the past and that's what I would expect here.

For us, again the important thing is for us to be creating new value sources for our customers and our manufacture partners. We work - you've heard the positioning that we've had over these last seven or eight years. It's really been about broad value creation.

We'll continue to focus on that as our priority, and I think, ultimately, the reason that our business has been improving in recent years is essentially the ability to create value. We'll continue to focus on those dynamics. But, we have seen occasionally these kinds of cycles, for me, unfortunately, over many decades and different parts of the industry. That's my general point of view.

Ross Muken: That's helpful. Maybe just quickly, Mike, on the balance sheet. I mean you guys are in a pretty strong position here. You talk about dislocations a bit in some of the pharma service part of the market. I'm assuming to private and other competitors that's also painful. I mean, what about the M&A pipeline at this point, and obviously you're doing a lot on the repurchase and you have a healthy dividend, but there's a lot of balance sheet capacity there. Could we see you guys get more active again?

Mike Kaufmann: Yeah. A couple comments - I think, it's good to hear you mention the dividend because that's something I would like to stress as I think we have a very differentiated dividend and it's something that we continue to be committed to our 30%-35% payout. I think that is a very - very much a differentiator between us and others. I agree with that on one side.

Again, I would tell you that when it comes to deployment of capital, we would like to find great M&A targets - that's probably where we would lean over stock repo, but we're going to stay disciplined. If we can't find the right target at the right price and it has the right culture that fits into our business, then we're not going to move forward.

If that means there's some excess cash on the balance sheet, then we will take a look at deploying that in the stock repo. I think our pipeline is still decent right now. As you can imagine, we look at dozens of items before we ever purchase one, and so it's always hard to tell exactly when something might come out of that. But we're

continuing to be very active in the M&A front, but won't trap cash on the balance sheet either, if we can't find the right opportunities.

Ross Muken: Thanks Mike.

Operator: Next, we have Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yeah, hey, good morning. A couple of questions here. First of all, does your guidance assume any additional stepdown in distribution sell side pricing for your independent book? Did you assume that the stepdown in the pricing that you're seeing in the marketplace to date will spill over to your entire independent book?

Mike Kaufmann: Well, I guess the only way I can respond to that is as I mentioned in my remarks, our guidance includes not only what we saw in Q1, what I've foreshadowed in Q2, but also that it was based on some of the trends we're seeing in Q1 and Q2. So yes, it does include some continued challenges with generic pricing and branded inflation.

George Barrett: Let me just add to this Ricky. I mean, generally, market price is very, it's very effective - very efficient market. So, the market just tends to be the market. It - and so - you can't think of this as necessarily individual customers.

Ricky Goldwasser: So, but George, doesn't that mean that there's a risk that you may have to lower your prices in the future to match a new lower price point –

George Barrett: Ricky, I think –

Ricky Goldwasser: - in the market point. So I guess the question is, is there a new lower price point in the market place?

Mike Kaufmann: We're always lowering our pricing in the generic market. It always has been that way, and so, generally you constantly are competing on generics. All we're saying is that right now, it's just a little bit of an unusual period of time where we're seeing a little more aggressive re-pricing. But there's always some re-pricing built into your go forward. We're always going to price to market. We're not ever trying to leave the market down, but we believe the best competitive position from a cost standpoint that we can always stay competitive.

Operator: Our next question comes from Greg Bolan with Avondale Partners.

Greg Bolan: Oh, great. Thanks guys. If I could just, maybe, qualify what you said here is on the distribution side, your margins on the buy side are about the same, your margins on the sell side downstream have gotten a little bit worse, and so that's A. And then B - my, if we could go back to this time last year, if I remember correctly, you guys were already, kind of, dealing with a little bit of a difficult comp on the distribution margin side. If I remember correctly, you guys got about - I think called out $0.08 of incremental tail wind from generic pricing, this time last year, and I think about $0.03 from synergies from acquisitions. Could you maybe talk a little bit about that and how much of this year-over-year difficult comp has, kind of, played into 1Q? Thanks.

Mike Kaufmann: Yeah, thank you. I did mention that in my remarks. That part of the reason for our Q1 is the comps and that's why we called out Q1 being down and you were right on with that. We did have $0.08 last year that we called out, a favorability largely from benefits related to certain competitive dynamics on a few key generic items that we thought were going to deflate last year that didn't - and they stayed up.

Since then, they have deflated. Then as you mentioned, $0.03 on accelerated integration of some acquisitions. Those were favorable items last year, as well as from an overall basis. Remember, we had a favorable tax component last year, too. Then in last year, we did see in the first quarter, branded inflation was a little higher than we had anticipated. So, that's right. Those were the positive things.

You also summarized accurately the generic piece. When you really break it down into two components - one is the manufacturing actions which is them either raising or lowering price - we're seeing, for instance, less inventory inflation on generics. But it's really no different than we had originally anticipated.

As we mentioned in the past, FY14 was a good year, '15, you know was a solid year and then it started coming down in '16 and we kept calling that, and we said we expected that to be down. That's how we essentially budgeted and looked at it for this year. Again, we're not seeing anything real different when it comes to what the manufacturing actions are related to inflation and deflation. It is the competitive environment downstream and our actual pricing out to the customers.

Greg Bolan: That's great. And then just real quickly, if I, kind of, think back to Kinray six years ago now and what you guys have been able to do there with Kinray and other organic build outs on the community pharmacy side. I think you guys are now, one of the largest if not the largest in the independent pharmacy space in the high 20% market share. As I think about, you know, the competitive dynamics around that market, you guys have, kind of, lived in a world where you've been constantly trying to take share and have been successful at that.

It doesn't sound to me like - it certainly doesn't sound as - what you're saying today is as draconian as maybe what we were, kind of, what I was setup for going into the weekend. If you think about - you keep saying short term - you think it's transient George - I mean, what needs to happen over the next year or so for you guys to, kind of, maybe mitigate this on the downstream margin side and how you're positioned to continue to maintain or even grow market share going forward? Thanks.

George Barrett: Greg let me start - this is really important - our market share independent has grown over years, basically. This is not a sudden phenomenon. Actually right now, it's relatively stable. It's probably been growing

over the seven years of this team's leadership here. Obviously, the Kinray acquisition gave us a very significant boost there. That's not a sudden thing. It's been a thoughtful, purposeful strategy to make sure that we have a good balance to our business. We really feel like we create a huge amount of value for those independents, to the surface offerings and product lines, especially as the world has unfolded as it is so I'll start by that.

I don't think there's a discrete moment of change. We're obviously in the middle of a lot of things. So, the election cycle clearly is creating an enormous amount of discussion and noise, which I do think has an effect on the way people behave. I do think generic cycles come in lumps, and we see that they tend to have some cyclicality. We'll see some growth coming from biosimilars, which will affect the market each - probably each product differently. I think again, most times in competitive moments you have companies just adjusting to what's working and what's not.

That's my experience over a lot of years, and so, I think that the moment right now has a lot of factors coming together to make for a tough environment. But we're going to stick to our value proposition and our long term view as to how we compete in the market and how important product and service offerings are.

Operator: Our next question comes from Lisa Gill with JP Morgan.

Lisa Gill: Thank you and good morning. George, I just want to go back to your comments around the branded side and that primarily everything stays driven more on the generic side and pricing competition. But, you've brought the branded expectation down from roughly 10% down to the expectation of 7% - 9%, can you talk - is that what you're seeing right now? Is that, kind of, your future look?

We've heard from a number of manufacturers that they're lowering their expectation into what their price inflation will be in calendar year '17. I want to understand that, number one. And number two, I just want to understand - because the way that I've historically thought about this is that, that 15% that's on a contingent basis was probably more profitable than a fee for service contract and so, drug price inflation would have a bigger impact on that component of the business. I just want to know if I'm thinking about that correctly?

George Barrett: Mike, you want to start on this one and then I can jump in.

Mike Kaufmann: Yeah, sure. Actually, the 15% piece was margin dollars. It wasn't number of contracts. It was assumed to be of our margin dollars generated. I wouldn't say that that group was a lot more profitable. A lot of the folks that are in there obviously the smaller manufacturers, but - so it's going to have to an overall little higher average rate because it's just by the nature of being smaller manufacturers - but I don't think that's a big component of it.

As far as what we've seen so far, I would tell you that what we've seen so far has been pretty light when it comes to manufacture inflation. But that all being said really, you know, January as you know, our Q3 or the first quarter of a calendar year is always a big quarter for the branded manufacturer price increases. The 7%-9% is really an average for the entire year.

While it's a little lighter than we would have expected now, that's what we're building into why we're lowering, is that we would expect it hopefully, after election and looking at all those other components we'll see a little bit more normalcy - probably not as high, obviously, as what it used to be. But, we think we'll get back in that 7% - 9% range. If that adjusts much differently than that, then we'll have other updates after that. But right now, that's what we're expecting.

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

George Hill: Hey, good morning guys and I appreciate you taking the questions.

George Barrett: Pleasure.

George Hill: I guess, Mike, first off, if we think about the change in the guidance on the generic side, are you able to quantify, I guess, kind of, from down mid-single digits to mid to high single digits, how much of that change is due

to the underlying pricing environment of the drugs themselves - the deflationary environment versus how much of that is the sell side margin pressure?

My second question would be, you started to run down the rabbit hole of purchasing compliance, a little bit. I guess could you talk about what you're seeing in the contracting environment and how that - how pricing is leading into - how pricing is tying into the purchasing compliance discussion?

Mike Kaufmann: Yeah, so as far as the adjustment from mid-single to mid to high single digit net deflation, really that entire adjustment is due to what we're seeing in the generic pricing environment. As I've mentioned, we're not really seeing the inflation/deflation piece to be significantly different than what we modelled. You can assume all of that is essentially related to generic pricing. And, then as far as –

George Hill: The sell side part?

Mike Kaufmann: Yes, the sell side part. That's right, the sell side part. And as far as compliance goes, that's highly contract dependent. When we have customers we're very diligent about the way we write our contracts. If we have a customer contract that says that they've got to buy X% of the generics from us, then we monitor that and we make sure that they do. On the piece that they don't have to directly buy from us in order to make that deal work, they can shop that piece, and we've always known that. So that's the component that we would see obviously so more pricing pressure on.

George Hill: Okay and maybe if I could just steal a real quick follow up for George - when we talk about this increase in the sell side competitive environment - how far off normal are we, if you think about historical spikes and when we've seen heightened competition?

George Barrett: I don't think I'm able to give you a specific number here. What I can say is the kind of erosion that we've seen typically - and it's been relatively predictable - has just been different over these last couple of months. It is different and noteworthy and I think is the largest component as to why we're adjusting our model for the year. The branded part, as Mike said, is much smaller. But, I can't quantify that for you, George, but it is noticeably different.

George Hill: Okay, thank you.

Operator: As a reminder, if you would like to ask a question, it is *1. We'll take our next question from Michael Cherny with UBS.

Michael Cherny: Good morning guys and thanks for all the detail so far.

George Barrett: Morning, Mike.

Michael Cherny: I think the pharma questions been, kind of, beaten to death, so I'll at least ask one on the medical side. You guys talked a little bit about the recent share gains you have - obviously Kaiser is a very notable contract win, can you maybe talk, especially with Cordis anniversary over the last year as you think about now your go to market strategy versus maybe two years ago, what are the biggest differences? Obviously, Cordis is one component, but in terms of being able to gain competitive scale, what's changed the most, or at least most improved your competitive win rate?

George Barrett: Michael, thank you for the question. You're making Don happy - question on medical. Let me just give you a perspective. Our go to market model over recent years has really been focused broadly on a couple of

really important changes. A lot of our customers are getting much more complex. They're bigger systems. So, what historically might have been a single hospital is now an academic medical center, plus some community hospital, plus a few surgery centers and oncology clinics and now some doctor's offices. That requires a different partner.

I think our ability - and we've seen this. We've built our business around that expectation, and I think what's happening is our ability to serve across that continuum of care to create value in different ways for systems that are much more complex than they once were is important. One of the shifts I want to describe is a little bit more of an elevation of those conversations away from the purely departmentally driven ones into a conversation that's more broadly at the system level.

I think that's playing to our strength. Now again, we have to be very strong in each of the departments. We have to be content experts, and we are still that. But I do think that the reason that we've been growing, I think, is largely that we're positioning well to adapt. We anticipated these changes in the way that these big health systems were going to look, and I think that's been beneficial to us.

Mike Kaufmann: Yeah, I think the only thing I would add to that is, I think part of that growth is the really measured and smart approach I think we've taken to expanding our portfolio in the medical segment. Our reps are able to leverage a lot more products in the bag and so when we call on a customer, we have more to sell them. We can leverage our expense structure. We can be more meaningful to them.

I think it would be - I don't think we should also ignore the fact that we've given a lot of energy to the Cordis business. We've put some great people in charge there. It's a business that we're paying a lot of attention to. Don, himself, has a lot of experience in this area, as does David Wilson that is running it. I think there's a lot to be said for when you have people that are excited, know that you're investing in the business, really are committed to that and we've hired some great people. I think that's driving some of the things we're seeing in Cordis, too.

George Barrett: If I could, I just want to add one piece because we're talking primarily in this context about the medical, but it does connect to our pharmaceutical business and our medical business and many of these customers are part of that overall offering so I didn't want to miss the opportunity to show that.

Michael Cherny: Thanks, guys, I'll let you get to the rest of the queue. Thank you.

George Barrett: Thanks, Mike.

Operator: Our next question comes from David Larsen with Leerink

David Larsen: Hi, Mike, can you talk a bit about your efforts to improve your cost structure in the corporate division? What's going to drive that? Any sort of quantification to clear around that would be very helpful, thanks.

Mike Kaufmann: Good question and I mentioned it is a big driver when you think about that EPS bridge, as we mentioned, with the generics slightly going down and net customer activity staying the same. We needed to actually have a real focus on that expense initiative so a lot of the corporate departments across the company are located in corporate.

A lot of the initiatives and things that we fund, we fund out of corporate. So all of those things we're taking a really good hard look at, making sure we're investing in the right things. We're being very targeted on those things and just driving discipline throughout our corporate departments in all lines of our P&L to make sure that we can help contribute to offsetting some of the decline we're seeing on generics pricing.

David Larsen: Ok, great. So can you just remind me again so that the 2Q operating income expectations for the pharma division, pretty significant change there relative to comments last quarter. Can you remind me what's driving that and what's going to cause the re-acceleration in growth in the back half of the year?

Mike Kaufmann: Yes, so Q2 is really being driven by the same trends that we discussed when we take a look at that, the trends that we saw in Q1, related again to generic pricing as well as branded inflation rates being lower than we had anticipated are the two key drivers in Q2 and why we gave you some early information that it would be similar to the percentage decline we saw in Q1.

As far as what's going on back half weighted, some of it has to do with comps and things that are going to happen in the quarter, like branded inflation tends to always be stronger in our Q3 and we have a lot of other initiatives that we're working on that we believe will deliver value in the second half.

Remember we have the step up in Cordis that impacted our Q2 and Q3 last year that doesn't impact our Q2 and Q3 this year. Plus, we'll have a full year of growing and getting up to that business as well as onboarding some other new customers. We think we have enough initiatives in the back half to be able to get us to where we need to for the year.

Operator: Our next question comes from Bob Willoughby with Credit Suisse.

Bob Willoughby: Good morning, George and Mike. While we know absolutely no one speculates on inflation anymore it did appear your competitor bought some inventory in the inflationary market last year, liquidated this year. You bought less year over year, maybe the medical skews that somewhat, but isn't it safe to assume there are some buckets of profit that have fallen out of the model here, year over year?

Mike Kaufmann: I think in the sense if we're relating it specifically to branded manufacturing, when you do have less branded manufacturer inflation, you do, as I've mentioned a couple of times, when that happens quickly you have

those immediate adjustments where that 15% of your portfolio that is dependent upon that inflation sees less inflation. You do have to go through and renegotiate your agreements with manufacturers. That's the first important piece as I've mentioned.

We are doing that with manufacturers. Anytime you see a sudden change you have to go do that. As far as speculating on generics or on brand, no, again, that was something that we quit doing a long time ago, several years ago because of the nature of our relationships with generic manufacturers with Red Oak as well as our agreements on the branded side. Speculation is minimal to almost none of an impact.

Bob Willoughby: Mike, can you re-affirm a cash flow target for the year or is that not the call today?

Mike Kaufmann: Yeah, we don't give cash flow targets for the year, but again, there's nothing I would say that when I look at what's going on in our business that would make me think that we're not going to be able to deliver strong cash flow this year.

Bob Willoughby: Thank you.

George Barrett: Thanks, Bob.

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

John Kreger: Hi, thanks very much. Could you give us an update on what sort of brand inflation you're seeing within the specialty bucket? What sort of assumption you're making in guidance for that category?

Mike Kaufmann: We don't break that out specifically. Generally, inflation on specialty tends to be a little lower because they're higher priced items than in the overall bucket, but our overall 7 to 9 target is across the board for all branded pharmaceuticals including specialty and what's going through our normal pharmaceutical distribution bucket.

John Kreger: Thanks, Mike. One other one on the medical front, can you give us a sense about what your organic revenue growth was in the quarter now with your year lap in Cordis. We were thinking about 6%. Is that about right?

Mike Kaufmann: I can't give you the exact number but I would definitely tell you that we were positive growth in the medical segment without Cordis. We don't still expect Cordis to deliver $0.15 for FY17 and so if you were to back Cordis out you would still see nice growth, healthy growth in the medical segment.

John Kreger: Great, thank you.

George Barrett: Thank you.

Operator: We'll take our final question from Steven Valiquette with Bank of America.

Steven Valiquette: Thanks, just one more here on the sell side customer pricing. I guess I'm just curious, is there any evidence of a change in the actual price methodology in the market being offered by some wholesalers? The reason why I ask is that there was some chatter about maybe a shift to a cost plus pricing model on generics as opposed to just a random spot pricing. Thanks.

Mike Kaufmann: I think all the time people are always trying to be creative on how they price and how to work with customers and different customers have different needs. I don't see a wholesale change in the way people are pricing in the market. The majority of the areas where we're seeing the pricing pressure are just in that normal day-to-day pricing.

Whether or not that's changing on larger deals, it's hard for me to speak to our competitors on how they might be doing that. Deals can often get very complicated on how you compare one to another, but I wouldn't notice any notable change at this point in time.

Steven Valiquette: Ok, great. Ok, thanks.

Mike Kaufmann: Thanks.

Operator: That concludes today's question and answer session. At this time I would like to turn the conference back over to George Barrett for any additional or closing remarks.

George Barrett: Thanks to all of you for your good questions and for joining us today. I know that we'll be seeing many of you in the coming weeks and we look forward to that. With that we'll close the call. Thank you all.

Operator: That concludes today's presentation. We thank you all for your participation and you may now disconnect.