Q2 FY17 Cardinal Health, Inc. Earnings Conference Call

February 7, 2017 8:30AM Eastern

Operator: Good day and welcome to the Cardinal Health second-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 ma'am.

Sally Curley: Hi. Thank you Eric and good morning everyone. Welcome to Cardinal's second-quarter fiscal 2017 Earnings Call. I'm Sally Curley, Senior Vice President of Investor Relations and joining me on the call this morning are Chairman and CEO, George Barrett and CFO, Mike Kaufmann. Today we will be making forward-looking statements. The matters addressed in these statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected or implied.

Please refer to the SEC filings in the forward-looking statements provided 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 end of the slides.

As a reminder, during the Q&A, we ask that you please limit your questions to one, with one follow-up, so that we can address everyone in queue. We'll do our best this morning to get to everyone's questions, but if we don't, please feel free to reach out to IR VP, Lisa Capodici or myself after the call.

In terms of upcoming events, we will be webcasting our presentation at the Barclays Global Healthcare Conference on March 16th at 8:30 a.m. Eastern. Today's press release and details for any webcasted events are or will be posted on the IR Section of the 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. Also, please note that neither this

call nor any other Cardinal Health event can be rebroadcast without the express written permission of Cardinal Health. 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 thank you for joining us this morning. As I typically do, I'll spend a few minutes of my discussion covering, at a high level, our performance for the quarter. However, these are not typical times and on the surface, not a typical year for Cardinal Health.

The impact of this year's generic pricing environment accounts for the primary headwind on our financials. It is masking the fact that we are seeing growth in more key initiatives and priorities than we have seen in quite some time. In that context, I want to make sure that woven throughout my comments we address the following three questions: how are we executing and competing in the market? How would I characterize some of the more recent market dynamics; and how are we positioned for long-term sustainable growth?

Before I get to that, I want to acknowledge that in spite of the extraordinary dynamism in the industry, we at Cardinal Health remain focused on the millions of people that we touch every day. We embrace our vital role at the center of the healthcare continuum, and our responsibility remains unchanged. Our role, providing the highest quality products and services to all of our partners and their patients around the world, lies at the core of who we are and what we do.

Certainly, healthcare discussion in the U.S. has been so prominent; my commentary today will be more focused on the U.S. So how did we do this quarter? To summarize the performance for the Q2, revenue was up 5% vs. the prior year to $33.1 billion. Non-GAAP earnings per share increased 3% to $1.34 vs. the prior year. And non-GAAP operating earnings were down 4% vs. the second quarter of last year to $701 million.

At the segment level, our pharmaceutical segment performed a bit better than we had expected this quarter. Revenue was up 5% vs. the prior year to $29.7 billion, and segment profit declined 14% vs. the prior year to $537 million. This decline was almost entirely the result of generic pharmaceutical pricing, and the loss of Safeway, both of which we covered in our last call.

Our medical segment had another strong quarter continuing its repositioning to better serve the needs of its evolving market. Revenue for the medical segment was up 8% vs. the prior year to $3.4 billion and segment

profit was up 50% versus the prior year. I would note here that about half of this is attributable to the mechanics of last year's inventory step-up. Still, these are really strong numbers.

As you know, our guidance for the year which we provided in early August was based on both our plans for the upcoming year, as well as our assessment of market conditions at the time. By the time we reported our first quarter, we had seen a stepdown in generic pricing, which prompted us to make a small change to our guidance for the year to reflect that dynamic. At that time, Mike also provided you with the key factors which could dictate where we might fall in that range.

With actual data from Q2 and preliminary data from January, we can now forecast that the top end of that range is unlikely. This is more a function of the math rather than any further deterioration of market conditions. With that in mind, and wanting to provide enough of a range to account for the normal variables, we are adjusting our guidance range for FY17 to $5.35 to $5.50 from our prior range of $5.40 to $5.60. Mike will provide some additional color on how the various factors were included in this decision.

Across the board, Cardinal Health is seeing the results of our teams' dedication to addressing the needs of our customers and the people they treat every day. This team's hard work is evident as our lines of business are showing strong fundamentals. Unit sales look strong, our customer service levels have never been higher, and our ability to operate across the continuum of care with a broad range of products and services creates a uniqueness to our model, which is resonating with our customers across the enterprise.

Our rates of customer retention are extraordinarily high, and we are growing with our customers - building on a sustainable value proposition that aligns with long-term trends. We are confident that we can improve efficiency for virtually any part of our customer base and do so with a valuable and integrated portfolio. At a time of rapid change, we know how essential it is to demonstrate customer intimacy in ways that meet their specific needs and enable them to adapt to a shifting landscape.

I've had the chance in recent weeks to meet with many of our customers - both upstream and downstream. And I came away from those conversations with the clear sense that they are eager to work closely with us. Together we are better equipped to address the complexities of the system with Cardinal Health well positioned as a

partner. Reinforced through these conversations, I'd like to focus on five major initiatives which should be familiar to you. They are:

1. Growing our generics program

2. Driving growth in our specialty solutions group

3. Increasing our offerings of valuable products and services to our acute and integrated delivery customers

4. Driving additional penetration of Cardinal Health consumable medical products and physician preference items

5. Establishing a leading position in the post-acute space

Let me walk through these one by one. On generics, as I said, industry pricing dynamics were challenging throughout the first half of our fiscal 17. We are, however, seeing some signs of a return back to more typical patterns. While it may be too early to characterize this as a trend, we see it as encouraging.

Our customer base is solid, and we continue to offer tremendous value for any retail or institutional customer looking to offer an industry-leading generics program. Our team's innovative approach to generics serves our customers well. And our joint venture with CVS Health, Red Oak, continues to be a driver of value, and in our view, a unique source of competitive advantage.

Turning to specialty solutions, our group continues its high rate of growth increasing our reach across key therapeutic areas and strengthening our suite of services that we can offer our pharmaceutical partners who seek to get closer to their patients. We've more than doubled the number of clients in our specialty hub and significantly grown the client base in our 3PL business. We are beginning to see the first wave of biosimilars entering the market. We've built the right therapeutic footprint to effectively serve any part of this system with these products and have a team of experts in place to support this business.

With regards to our acute and integrated delivery customers, these providers of healthcare are experiencing significant changes. Changes in the size and complexity of their systems, the new technologies which they employ, the shifting sites of care, the adoption of more integrated delivery models, which are directed towards more patient-centered value designs, and the accompanying evolution of payment systems which align with that

value-based model. As their partners, we've built a suite of products and services that are designed to address these forces.

Let me give you some examples. We offer critical supply chain and inventory management solutions that allow clinicians to focus on their patients and remove themselves from supply chain activities and administrative documentation. Our solutions provide visibility to real-time analytics enabling customers to make data driven decisions around products supporting patient safety up to the point of care.

This past week, we celebrated the third anniversary of our Academy for Excellence in Healthcare kicking off our eleventh cohort. This program, based on our deep expertise in operational excellence – lean, and six sigma techniques - has been designed to help healthcare organizations identify and solve their greatest operating challenges, ultimately driving results that can significantly reduce costs and improve patient outcomes.

To date, we've worked with 36 hospitals, training and coaching 49 teams comprised of hundreds of medical providers, and the group has published 16 white papers. Through this work, we have helped our partners reduce readmissions, improve the discharge management process, reduce length of stay and surgical wait times and increase patient satisfaction. Our medical surgical distribution business is highly efficient and growing again and we continue to see growth in Cardinal Health brand products, which, as you know, includes Cordis.

We continue to grow the number of products and product categories in our Cardinal Health brand and now offer more than 19,000 skus in 110 product families. Our Cordis acquisition is largely on plan, and I'm proud of the way in which our teams have come together, around the world during this first year. We feel very confident that we can add value to any system in their interventional cardiology activities.

Demographics and delivery system shifts remain key drivers behind our focus on the post-acute world. We believe that patients can be treated more efficiently, more safely and with better outcomes using the right tools. In our Cardinal Health at Home business, we continue to focus on bringing medical products to patients in their homes, and the work we are doing at naviHealth in post-acute care management and care transitions, is industry leading and growing quite dramatically. That business uses the tools and clinical data needed to create the optimal care experience for patients.

In summary, our value proposition is increasingly resonating with our customers and this includes our manufacturer partners, who are also dealing with a dynamic and shifting landscape. We have a unique capacity to navigate through environmental road bumps. Our portfolio is robust, balanced and fully integrated. Our organization has critical scale, but is still nimble enough to deal with short-term disturbances. And our team has proven their mettle - they're mission driven and possess a clear sense of where we are going. Because of this, as an enterprise, we are positioned for sustainable and enduring value creation for our business partners and for you, our shareholders.

Finally, we are an active participant in the unfolding policy discussions around healthcare. We bring to those conversations our key tenets - all people should have access to coverage for healthcare, which most experts agree requires a stable insurance system. We need to support our providers of care, most of whom recognize that healthcare can be centered more around the patient. It can be more clearly coordinated and incentives can be designed to encourage innovation, including ways to drive the best outcomes in the most affordable and accessible way. And we know that the overwhelming power of demographics will continue to fuel demand.

Those are the inescapable realities which guide our course. This commitment to our True North helps us serve our customers and the people that they treat every day. So, with that, I'll turn the call over to Mike and get back to you during the Q&A.

Mike Kaufmann: Thanks George and thanks to everyone joining us on the call today. This morning I'll start with a review of our second-quarter financial performance and then provide some additional color around our expectations for the remainder of the fiscal year. 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.

Starting on slide 4, our second-quarter fiscal results were slightly better than expected with GAAP diluted EPS at $1.02 and non-GAAP diluted EPS at $1.34, a 4% and 3% increase respectively. Note that both the GAAP and non-GAAP diluted EPS for the quarter benefitted from a lower effective tax rate and fewer outstanding shares as

compared to the prior year. I'll review both segments in greater detail later, but let me start with consolidated results.

Revenue increased 5% year over year to $33.1 billion. Consolidated GAAP gross margin dollars were flat, while non-GAAP gross margin dollars were down 2% versus the same quarter in the prior year. GAAP gross margin rates were down 29 basis points for the quarter, while non-GAAP gross margins rates were down 38 basis points. The decline in rates is best described in the explanations of the pharma and medical segment profit rate changes which I will cover in a few minutes. Consolidated SG&A was down by 1%.

As you would expect, we continue to have a disciplined approach to managing costs while still investing in our future. Both consolidated GAAP and non-GAAP operating earnings declined by 4% versus the prior year. Below the operating line, net interest and other expense, was $51 million for the quarter, a moderate increase over the prior year. For the second quarter, the GAAP effective tax rate was 34.0% and the non-GAAP effective tax rate was 34.2%, both somewhat lower than historical norms. Both declined 3 percentage points versus the prior year, and these lower rates were primarily due to a few favorable discrete tax items.

Our second quarter diluted weighted average shares outstanding were 319 million, 13 million shares fewer than the second quarter of fiscal 2016. This is a result of our share repurchases including 350 million dollars worth of shares repurchased during the quarter. We now have 443 million dollars remaining on our board-authorized share re-purchase program.

As I've said in the past, we will continue to evaluate share repurchases opportunistically in the context of our overall capital deployment strategy. We generated $554 million in operating cash flow during the quarter. At the end of the second quarter, our cash balance, including short-term investments, was $2.1 billion, with $552 million held outside the United States.

Now I'll move to the segment reviews. You can follow along on slides 5 and 6. Our pharmaceutical segment revenue increased 5% to $29.7 billion. This increase was a result of growth from existing pharmaceutical distribution customers, as well as strong performance from the Specialty business. Segment profit for the quarter decreased 14% to $537 million. Generic pharmaceutical pricing and, to a lesser extent, the previously announced loss of Safeway, partially offset by solid performance from Red Oak Sourcing, drove this decrease.

Note that while profits tied to branded inflation were a headwind in Q2, this headwind had a smaller impact than the loss of Safeway. Remember that less than 15% of our branded margin is tied to inflation, and we continue to work with our branded partners to ensure that we receive fair value for our services. My expectation is that this contingent component will be less than 10% in the near future. Segment profit margin rate for the quarter was down 41 basis points to 1.81% largely due to generic pharmaceutical pricing.

Last quarter we told you we expected that generic pricing and brand inflation would cause Q2 pharma segment profit to decline a percentage similar to Q1. While these items came in about as expected, our better than anticipated performance in Specialty distribution, as well as SG&A, contributed to the pharma segment's better than expected results. The excellent performance in Specialty was driven by growth in the acute space and Metro Medical on the provider facing side and growth in our 3PL and regulatory science service offerings on the biopharma side.

Now let's go the medical segment which had another strong quarter. Revenue for the quarter grew 8% to $3.4 billion driven by contributions from net, new and existing customers. Segment profit increased 50% to $159 million due to the contribution from Cardinal Health Brand products, which includes Cordis. This increase reflects the $21 million unfavorable impact of the Cordis-related inventory fair value step-up in the second quarter of fiscal year 2016. Excluding this step-up, year-over-year medical segment profit growth was a robust 25%.

Please remember that in the Q3 comparison, we will have the same $21 million inventory step-up from fiscal year 2016. Segment profit margin rate increased 132 basis points to 4.68% due to the Cardinal Health Brand products, which as noted above, includes Cordis. Overall, the medical segment team is working well together to drive results. My comments until now have been largely U.S. focused, so I want to highlight two global items. First, Cordis is performing well, particularly in Europe and Latin America.

And second, the China team continues to execute well, and they're on track to achieve double-digit top and bottom line growth for the full fiscal year. On a related note, during the quarter, we didn't see much of an impact resulting from foreign exchange or commodities. Before I discuss our outlook for the full year, you can turn to slide number 7 to see our consolidated GAAP to non-GAAP results for the quarter. The 32-cent variance to non-GAAP diluted EPS results was primarily driven by amortization and other acquisition-related costs.

Let me move to our fiscal year 2017 non-GAAP earnings guidance range and assumptions on slides 9 through 12. As George mentioned earlier, with six months of data behind us, and a good view into January, we believe achieving the upper half of our $5.40 to $5.60 guidance range will be challenging. So, to adjust for this and provide some room for variability, we are modifying our guidance range to $5.35 to $5.50.

To be specific, the most significant moving parts for the second half are mainly environmental. They are generic market pricing, taxes and brand inflation. So all this translates to a non-GAAP EPS growth rate of between 2% and 5% for the fiscal year, a minor adjustment from our prior guidance. With that context as a backdrop, I'll walk through our updated corporate assumptions on slide 10.

We expect diluted weighted-average shares outstanding to be between 320 and 321 million shares. Additionally, our updated assumption for acquisition-related intangible amortization will be about $384 million or 77 cents per share, which does not affect our non-GAAP earnings. As you can see, all of our other corporate assumptions, remain unchanged.

On slide 11, there are two updates to our full-year pharmaceutical segment assumptions. First, based on our six months of data, plus a good view into January, we are updating our generic drug price assumption from mid-to-high single digit inflation to high-single inflation for the full fiscal year. Second, our Q1 assumptions expected pharma segment profits for FY17 to be down mid-to-high single digits versus the prior year. Based on the factors I discussed earlier, we now expect full year pharma segment profit to be down high-single to low-double digits. All other pharma segment assumptions are unchanged.

Now turning to the medical segment assumptions on slide 12. We are on track to achieve mid-to-high single digit percentage growth in revenue, up from our previous assumption of mid-single digit percentage revenue growth. All of our other medical segment assumptions are unchanged, and we expect to see double-digit profit growth versus the prior year for the segment. One final comment - as you can see, based upon our first half performance and updated total year guidance, we expect our second half to be somewhat better than our first half, with Q3 slightly larger than Q4. Overall, we believe that we are well-positioned to manage the changing healthcare landscape with a clear, well-defined strategy across the enterprise. The vast majority of our businesses and initiatives are going very well, and we know our key priorities and how to get after them. With that, Operator, let's go to the questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing *1 on your telephone keypad. If you're using the speaker phone, please make sure your mute functions turned off to allow your signal to reach our equipment. As a reminder, we ask that you limit yourself to one question and one follow-up question during the question and answer session. Again, press *1 to ask a question. And we'll go first to Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yeah, hi. Good morning and thank you for all the details.

Mike Kaufmann: Good morning.

Ricky Goldwasser: Just to follow up on how we should think about the update to guidance and kind of how we think about the different factors that are getting worse in the second half, are these things that you think are gonna be isolated to one - the third or fourth quarter or should we expect some of these headwinds to persist throughout the year? And basically, what I'm trying to get is will some of these things carry, carry-over or flow through to fiscal year 18? How should we think about that?

George Barrett: Ricky, good morning its George – I'll start and then I'll let Mike pick up. Again, it's important in my commentary I made the observation that actually we're not seeing a further deterioration that, in fact, as we started to come to the very end of our Q2, we started to see more normal patterns on generics. So largely, and I'll let Mike touch on this, the base sort of reset lower but Mike want to add to that?

Mike Kaufmann: Yeah. I would just emphasize, Ricky, as I look across all of our businesses and all of the various factors that contribute to our overall results, I would emphasize that as we been saying for the last couple quarters, it's really this generic pharmaceutical pricing that is the number one factor. And all we're saying here is that it basically ended up finishing a little lower than we expected to.

In the sense that our base is reset a little bit lower than we expected it to, but the actual activity that we saw in December and January looks to be stabilizing in that we just set at a little bit lower base. And so, when we took that lower base and spread it across our second half, that's really essentially what lowered our overall guidance. So as you think about the various components, I mentioned three things, generic pricing being the biggest factor that can have a little bit of variability to it.

But again, as George mentioned and I mentioned, it's looking much better over the last couple of months. Branded inflation - we did see some branded inflation in January, and it seems to be about where we're expecting it to be. But again, depending on what happens over the last five months, we just want to call that out.

And lastly taxes, which I call that as the third factor. It's more about timing within quarters than overall being concerned that we're going to fall outside our 35 to 37% guidance range. It's really that you might see it be a little better in one quarter and a little worse in the other, but overall for the year we expect it to be.

George Barrett: So right, Ricky, my comments were specifically about the generic environmental issues that I thought you were asking about. I think Mike actually had the more broad perspective on this.

Mike Kaufmann: Yeah, and I would emphasize I think, you know, it's really just a slight EPS reduction because of the, again, this variability in the generic market pricing.

Ricky Goldwasser: And just go clarify on - on the generic pricing and deflation, I know last quarter you mentioned that generic deflation is also a mix, right? So it's the sell side versus buy side. So should we read into your comments, that you've seen both the sell side and buy side environment stabilizing? Are they centered?

Mike Kaufmann: Yeah, I would say - I would say that the answer's yes. That'd be, as far as price activity from manufactures to us, that's been tracking all year about as what we expected. It was really the side - the sell side

that started out for the first couple quarters lower than we had originally anticipated, but again, we see it stabilizing now.

George Barrett: Thanks Ricky.

Operator: And we'll go next to Lisa Gill with J.P. Morgan.

Lisa Gill: Hi, thanks very much. Can I just start and just follow up there just so that I understand this, George? When we talk about it stabilizing, but yet we think about the fact that you're lowering the back half of the year, I guess I'm just trying to understand that math - how that works. So if it's stabilized in the most recent quarter, and SG&A and specialty drove a little bit of better upside, was it just that your anticipation was that things were going to get better in your fiscal back half of the year, and now they're somewhat carrying through although they've stabilized?

Mike Kaufmann: Yeah, that's a fair question, Lisa. I would say that's pretty much accurate. I'd say that, you know, where it stabilized at, which is the little bit lower than we had originally anticipated when we projected our second half, and so that even though specialities over performing, and we're seeing some really good controls in SG&A, that when mix the two together, then that net was a little bit potentially lower for us. And then we just wanted to give ourselves a little bit of variability when we first thought about taking off the top half of the range and having just a 10 cents range. That seems a little tight for us only halfway through the year. And so we thought that adding another 5 cents to give us a little bit of room would be the smart thing to do.

Lisa Gill: Okay, and then, Mike, you also made a comment about Q3 being better than Q4. Can you just talk about is there something specific that you're anticipating on either side of your business in Q3 or was that comment specific to drug distributions?

Mike Kaufmann: No, that was just specific overall just to try to be helpful. Obviously, you'll be able to estimate we think the second half will be. And then I just wanted to give you a little thought that Q3 would be bigger than Q4, mainly because that's the quarter where you see the majority of the branded inflation anyways. As you know, that's typically the quarter where you see it, and so I thought you guys were all going to be thinking Q3 is bigger than Q4 generally because it historically always is. But I just wanted to give you a little thought around that it should about, you know, slightly bigger than Q4 to give you a little a little help.

George Barrett: Thanks Lisa.

Operator: The next question is from Ross Muken with Evercore.

Ross Muken: Ah, good morning guys, George, appreciate the commentary I've listened to - it's a tough environment for all us to kind of navigate, and amongst your peers you have the commentary regarding the outlook. It's been slightly different in terms of various drivers. I guess from your standpoint, what do you think are the one or two things we need to be spending the most time thinking about as we analyze and grade how this business is doing, given all these macro factors.

And, obviously you've felt, as if underlying, you know, was better than sort of what the guidance or the quarter showed. And so help us think through what sort of KPI's you're looking at or - or how your thinking about the evolution relative to kind of how the last 12 months played out because it's obviously been a pretty volatile environment relative to what this business has been used to.

George Barrett: Sure, thank Ross. Yeah, let me try to do this. And I'll comment a little bit on the unique dynamic of having some of our peer's report was actually different year-ends, and Mike will touch on it, cause I actually think it's an interesting dynamic at work. For us the drivers - we do know that economically, as we've said, that the

generic pharmaceutical pricing environment is a big factor. We'll watch to see for us that those rates look more normalized.

We started to see that towards the end of the quarter at the beginning of January. Obviously, as I've said, a little early to declare trends, but I thought that was an encouraging sign of something. I - I said to you guys I thought it would start to happen. The other thing is all of our priorities have to be going in the right direction. Specialty - our specialty businesses is in really good position right now. We're seeing really good signs of growth broadly, both downstream and upstream.

Across our medical segment, we're seeing really encouraging signs. Even in what I think of as our legacy medical surgical business, it's really beginning to get a little of wind in their sails. So watching for all the components. Our service lines in medical, our Cardinal Health Branded products, our work in naviHealth, our activity with our med-surg products, these are all for us, key indicators of our long-term positioning playing out the way we want.

And actually, the general growth and customer base. We - we want customers to see us as that go-to company at a time of complexity. So we're beginning to see that, and so, actually we're feeling quite optimistic about where we are. We're having to navigate and have had to navigate through a little bit of tough environment in generics, but as we've said to you, that happens from time to time, and we're keeping disciplined about how it is to the future of the business. Anything to add to that, Mike?

Mike Kaufmann: I think the only thing I would add is that, as you mentioned, generic pharmaceutical pricing is a key driver, and I think the timing of the three distributors' year-end is an important factor to consider when you think that where we really saw the impact of that was really in our Q1. And if our - I'll just put it simply - if our year-end had been three months later, we'd probably wouldn't be revising guidance because we'd of had some insight and built that into the year.

If our year-end had been three months earlier, we probably would have had a bigger mess because we would have had even less insight into it. So it's difficult to compare when you have three different year-ends.

Ross Muken: Thanks, and obviously, George, you talked about just in terms of key priorities. On the medical business, the growth there has been obviously quite good - you gained some share, you've executed on the deals. The balance sheet still has - had some capability, and then in terms of any incremental adds to the mix, and continuing to evolve that strategy, where are you in terms of appetite for having digested Cortis contemplating whether or not it makes sense to add more into the bag there in medical?

George Barrett: Yeah - thanks Ross. I'll just do this very generally and probably consistent with comments we've made in the past. We continue to look for opportunities to grow our business organically and certainly through the strength of our balance sheet. So to the extent that we see opportunities to grow capabilities that we think have sustainable, competitive advantage positioning us for this continuing evolving market, we will not be shy to look at those opportunities.

But again, hopefully you'll expect from us discipline in doing that. But certainly, part of the equation for us is how we use our balance sheet, and that may be true through our activities that are available external to us and the other ways that we deploy capital.

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

Eric Percher: Thank you. I think I'd like to maybe split hairs a little bit on the direct pricing conversation. So I heard you loud and clear on the impact of this quarter from generic drug pricing assumptions moving to high-single digit deflation. Can you just - I want to make sure I understand perfectly that commentary relative to competition in the marketplace and your view. Did that competition element impact the change in guidance or are we really focused on the element and the assumption that you focused on?

Mike Kaufmann: Well, I think one feeds the other. The competitiveness in the generic market is what drove the revision to the generics being down net on single digit deflation for the year because it's made up of two key components,

pricing from the manufacturers which we said we haven't seen really much variability from what we expected from the year. And then, our pricing downstream to the customers. The combination of those two drive that factor. And so since we've seen, like we said, more aggressive pricing in the market early on in the year, although we didn't - we've seen some positive signs lately, that is what drove that number to be down high single digits.

Eric Percher: Okay, now I get it relative to the math expectations, but that's helpful. And then, your comment on Q3 versus Q4, Mike, we've been trying to understand the ramp through the year. Should I expect that we're still down high-single digits in Q3? Then potentially up as get to Q4 and you lap some of the headwinds?

Mike Kaufmann: As far as actually given growth percentages, I don't want to necessarily step right into that, but I do think that, again, just trying to be helpful, if you take what you obviously think the guidance for the year is and take a look at the second half, we just want to give you a little bit of color that Q3 would be slightly larger than Q4.

Operator: The next question is from Robert Jones with Goldman Sachs.

Robert Jones: Great. Thanks for the questions. Just following up, Mike, on the back half commentary, you know, seeing some of the key metrics stabilizing as you move into the back half? You know, other than maybe some residual impact from something like Safeway, do you feel that the back half, as you look at it today, is more representative of, you know, the New World Order? Is this how we should think about how the business can perform in this environment as you think about, obviously a little about a difference between 3Q and 4Q? But taken together, is that how you envision the business performing going forward?

Mike Kaufmann: Generally, probably overall that's not a bad assumption. Again I'd have to think through all the pieces and how it relates over a full year because you've got, you know, comps and stuff for the prior year. But if you think about certain things like, if the generic market has stabilized, which again we say early results we've seen

will lap Safeway in the fourth quarter, then you have the 21 million dollar step-up in Q3 that completely goes away.

You do have some large moving parts that kind of settle out during the year. But you're going to continue to have positives like Red Oak and some of the other initiatives that were driving, that continue to be tailwinds for us. But a lot of those things that have created some noise in the P&L should either be stabilizing or we should be lapping.

Robert Jones: Okay, got it. And I know we've spent a lot of time on the generic pricing side, but just - can you remind us on the branded side, what's factored in for the year? I guess specifically, is there another assumption in your - in your fiscal 4Q that you would see another round of, you know, more significant branded price increases?

Mike Kaufmann: Yean, a great question. It's hard to know whether or not we'll another set of increases or what they'll be for rest of the year, but we still believe that our estimate of 7 to 9% for the full fiscal year is approximately the right number to be at. Again, that's, you know, a range that obviously there's some variability into that, so we're trying to take into account all of those factors as to whether or not there should be. I would also mention that, again, most of the price increases in the second half do happen in January. So we have seen a lot of it. So the amount of it in the second half that's left to go is not necessarily huge.

George Barrett: Yeah, and I think the other thing again just as a moving part - movement here is not as relevant as - economically - as what we were describing in generic.

Operator: And we'll take a question from George Hill with Deutsche Bank.

George Hill: Yes, good morning guys and thanks for taking my question. I guess, Mike and George, I ask what type of insights is Red Oaks giving you in the ability to kind of forecast generic drug pricing, and does Red Oak provide you any protection from downward price activity that might differentiate you from your peers?

George Barrett: It's George. Okay, I'll start with that and then Mike. So on the buying side - remember there are two components to this. There is the buy and the sell. Red Oak - I think we've got really sophisticated analytics and capabilities and just great dialogue with our manufacturer partners. So, as much as you can obviously, these are products that as you know change frequently in the generic world. But I would say we've got pretty good line of sight and really good analytics and great teams. This sell side is a different story and to Mike - thoughts on that?

Mike Kaufmann: I'd say I guess the first comment again kind of emphasizes what George said on Red Oak, right? The ultimate, lack of what's a better word, game in generics is while you can have a deflating sell price, but if your managing your costs better, you can always be expanding your margins. So if you're asking me do I think we're in a great position with Red Oak - absolutely, based on what George said. I have a ton of faith in the team, the analytics, the fact that we're, you know, the largest in that standpoint.

I feel really good about that. As far as Red Oak working together with the sell-side, there's actually no cut over. Red Oak doesn't do anything or have anything to do with what our sell price should be. Their goal is to ultimately go out and get us the best absolute cost, and then we actually have a firewall between the two because I think it's incredibly important that our selling side folks aren't actually seeing the cost of our generics, because I don't want that to influence how they decide to price.

We want to price to market, and we want to make sure we're overall evaluating our overall selling proposition. So we actually have a very strong firewall between our sell-side decisions and our costing decisions with Red Oak.

George Barrett: What I would add to this, George, is I do think our telemarketing operations give us on the sell side probably a very nice line of sight because we're having so much daily dialogue with the pharmacy world. So I think, I think we're - as good a line of sight as can, but, as this year it's been little bit more difficult to model than past years. But we're a little bit encouraged by the more recent signs.

George Hill: Okay. And then maybe quick follow-up might just be your largest customer seems poised for some market share launches - losses. I know for you guys that's largely brand business. Is there any impact to kind of market share shifts on retail end factored into the guidance or is it immaterial?

Mike Kaufmann: Yeah, we knew about all of that in the past as we mentioned before. All that was factored in - into our guidance.

Operator: The next question is from Steven Valiquette with Bank of America Merrill Lynch.

Steven Valiquette: Thanks. Good morning George and Mike. Just on the generics and the signs of returning that to more normal, typical pricing patterns, I'm just curious to get more color on what you think are the drivers of the improving generic deflation rate? You don't have to throw things out there. I'm just curious. Are you seeing maybe some pricing increase activity to, you know, offset price erosion on others? Is it just anniversary and other times? I just want to get more color on what you're seeing that's leading to the better trend?

George Barrett: Steve, I'll do the best I can - these are complex markets. I would say in general we saw what we felt to be a pretty unusual flurry of activity in the early part of our fiscal year. And our expectation just based on sort of history was - we see those things from time to time, and they tend to stabilize and become back to more normal patterns when - if you don't see significant movement of share. And I would say that's probably what we saw.

So what happened during a period of time was that the steepness of the curve was sharper. It was a more steep, downward curve. There's always been - there's always erosion on the sell price. That's sort of the normal pattern. But the rate - the steepness of that curve was a little heightened, and our feeling was that what me might see and we expected to see was a bit of a calming down of that at some point. And I think that's largely as best as we can describe that dynamic.

Steven Valiquette: Okay, and then just quickly on the brand side. You mentioned that 15% of the profits may be tied to brand inflation. If for whatever reason it seems like investors have a higher than normal amount of focus on the upcoming mid-year round of brand pricing increases for the industry, in my sense kind of as you touched on a little earlier, it's just not that critical to the overall earnings picture in any year. I'm just wondering is there any breakdown of how much of that 15% of those economics occurs around the January round of brand inflation versus the mid-year round? I'm guessing the overwhelming majority is tied to the January round. Thanks.

Mike Kauffmann: Yeah, absolutely. When you take a look at the historical patterns and even so far what we've seen this year is the branded price increases are heavily more weighted to the January timeframe than any other time. Probably that mid-summer timeframe is the second largest, but it's by far larger in the January timeframe. And again, to emphasize, if I had to talk about the three variables, I would rank them in order of generics by far being the largest, and then the taxes, only because of its variability between quarters, and then brand being the smallest of the three, at least for our mix of products and what we're expecting.

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

Charles Rhyee: Yeah, hey, thank for taking the question. George, if we, and Mike, if we go back to the Dublin Day in December, you have talked about the competitive environment of the sell-side, highlighting your independent book, and, George, if I recall, you made a comment saying that you had factored in sort of the competitive sort of step down of the pricing into your guidance here. So that when I think about your comments today, are you saying that we continue to see more competitive price erosion or was it, you know, your assumptions of what you needed to give in terms of maintaining your book had changed? Thanks.

George Barrett: Yeah - hey Charles, good morning. No, I think largely what we're saying is that as we came to the tail end of Q2, we started to see more typical rates of erosion in comparison to what we had seen in the early fall, which was more sharp. So actually again, we're being a little cautious here because it's - we wish we had more

data to say this a discernible trend. But I'll say it's a good sign that we did see some stabilization to the more normalized rates. Mike, do you want to add to it?

Mike Kaufmann: I just again emphasize that at the time in December, we didn't have quite as much information as we did by the end, and the bottom line is it just settled out a little lower than what we expected it to across all the channels where we saw generics but, the good news is it seemed to have stabilized at that lower level, and we just needed to update where we were for the rest of the year.

Charles Rhyee: Great. And then as a follow-up, you mentioned earlier you expect the component of your fee for service service that's contingent to be less than 10%. I missed what - sort of the timeframe that you expect that to happen. Is that sort of as we get into fiscal '18 or that a contracting cycle within the next few years? Thanks.

Mike Kaufmann: Yeah. I would say that would be more of a next 12 months type of a thing. Right now it's than 15. I would expect it to get to that 10 cent range within the next 12 months.

Operator: The next question is from John Kreger with William Blair.

John Kreger: And good morning. This is Jon Kaufman on for John Kreger. Thanks for taking the question. So you noticed strong growth in your specialty businesses this quarter, so could you touch on how your discussions specialty drug manufacturers are going? And then, how quickly is your specialty distribution business growing compared to the house services piece? And how confident are you that grow in specialty over the long run won't cause some downward pressures on margins?

George Barrett: Yeah, so there were a couple of parts to that question, Jon. I want to make them right. One is, I think you're saying what's driving it? If I got right, again, the most component that's driving it, do we see it as sustainable and the impact to margin rates. So let me start with the basics. I think we're driving it and have been very consistently been driving growth for two - in two primary areas. One is our reach across therapeutic areas has just become dramatically larger over these last three to four years. So we were present in certain areas in institution, and then we started to grow our oncology businesses.

We've expanded into urology and rheumatology. So I would say our overall footprint downstream in therapeutic areas right now is very strong. And that just makes us a stronger partner for anyone. On the upstream, I think we've started to build more tools and capabilities for the manufacturer partners and particularly, I'd like to highlight our patient hub. And this is a time where manufacturers really want to connect with their patients, and I think our hub allows us to do that. So we do see continued progress in our specialty business.

As it relates to margin rates, we don't break out the specific margin rates in specialty versus sort of traditional pharma. Having said that, we don't see the specialties being dilutive to it. And again, Mike, I'll ask you to add anything here.

Mike Kaufmann: Yeah. Just a couple quick comments. I would say if you think about specialty just separated in two different businesses, services upside, the biopharma downstream to the providers, both are growing significantly on the downstream side, although we've lapped the Metro Medical acquisition, it continues to perform very well in some of the areas where we weren't as strong before the acquisition.

For instance, we were strong in oncology. They were very strong and rheumatology and nephrology. And those areas continue to go very well for us, and the team down there executes very well. So we're seeing very strong growth downstream on the provider side. That's going to be our more lower margin typical distribution type of margin business. And then upside on the biopharma side, the strong areas have really been our hub, our 3PL business and our scientific and regulatory businesses are all doing very nicely. And these are gonna be much higher margins services businesses. So when you blend it together, it makes for a nice mix for us.

John Kreger: Okay, great. Thank you.

Operator: Next is David Larsen with Leerink.

David Larsen: Hey, congratulations on a good quarter. Mike, can you talk about the - yeah - very good quarter on both divisions - can you talk about your SG&A costs. I mean those looked like the lowest percentage of revenue that I've seen in four years. Are there any focused efforts going on at Cardinal to maybe reduce costs? Can you talk about that please?

Mike Kaufmann: Sure. As you can imagine anytime when you not performing at the level that you would expect yourself and hold yourself accountable to delivering, you're gonna get after managing your expenses even - maybe even tighter than you normally would. And so I think that both the pharma and the med team, even though the med team's performing very strongly, they're also paying attention to their expenses too because we're all one company - we're all Cardinal.

But the pharma side is just being very thoughtful about where they're making investments, trying to prioritize. And I do want to emphasize, we're still making investments. It's important to know that while we're paying attention to our SG&A, we're also at the same time prioritizing things that are still important to our future and investing in those. So I would say it's really about tight focus, prioritization and just managing through those types of things.

David Larsen: Okay and then on the medical side, if Don is in maybe he can comment on the margins?

Mike Kaufmann: Yeah, I think we're going to continue to see some fluctuation in our margin rates in medical, but I do think that you're now starting to see a margin rate where we would expect it to be as you said. We've never given up on our goal to be 5.75 both through our organic growth and inorganic moves that we'll continue to make. I think

that you're gonna see big wins like Kaiser that we talked about. While that's a distribution customer, it's gonna be margin dilutive because it's more margin - it's more of a distribution business.

And then you're gonna see adding businesses like Cordis, which are gonna be higher margins. Then you're gonna see us convert our customers to more Cardinal Health Brand products, which is gonna increase our margin rates, grow our At-Home business which is growing our market rates as well as naviHealth. So I think we have a lot of moving parts in medical that should continue to help us with the momentum on growing our margin rates on that side of the business.

Operator: The next questions from Michael Cherny with UBS.

Michael Cherny: Ah, good morning guys. Most of my questions have been answered. Just quickly, Mike, one for you. It's a more technical question than anything else. It looks like just from your update share count of assumption that we're pretty much assuming no real incremental buyback based on current levels of the back half of the year. Is that how you guys are thinking about it and will you be opportunistic if you see fit?

Mike Kaufmann: Mike, you said it about perfectly. Yeah, we're not anticipating any more stock repurchases in the second half, however, if is there an opportunity and depending on where our cash sits, we may opportunistically do that. But right now, we're not planning to do that at this point.

Michael Cherny: Got it. Must be the Patriot's blood in me. And then, George, one big picture question for you, particularly as you move into your role as head of healthcare leadership council, as you think about all the moving pieces in D.C., and whether it's the uncertainty around stuff around tax reform, be it corporate tax reform in the U.S., border adjustability.

All of the moving pieces related to the changing landscape to healthcare reform and the will they - won't they on the Obamacare repeal, how do you think about positioning the business and positioning the company so that

you're as nimble as possible as some of these changes come down the landscape. Is there any way you can even essentially pre-prepare the business or for something that's a moving target?

George Barrett: That's a great question, Mike. I appreciate it. So let me do the best that I can. One of the interesting things about our business is that our fundamental strategic direction has been set really for a number of years, and we actually have a strategic planning process that we do with about a hundred or so people in the organization a couple times a year. As it turns out, we had one just a few days after the election. The first thing we did with the group was clip out a chart in front of them that these are our priorities. These are the trends in healthcare.

What changes? And with the exception of the fact that we're going to have to deal with some policy issues along the way, fundamentally the directions are clear. Demographics will not turn backwards. We know it's an inexorable marg. We know that care is gonna move to more ambulatory settings - move to different settings. We know that there's going to be focus on efficiency and coordination of care. That the post-acute world is gonna be important. So we've built our strategy around those things. So it's been really interesting to try to sort of navigate the short-term stuff, but keep our eyes very much on the long term.

Here's what I say just very, very generally about the two things you mentioned - the Affordable Care Act and the tax-related issues. The President and the majority party have made it very clear that their intentions are to repeal the Act through the budget reconciliation process. And through that, as you probably know, they can eliminate components of the law, but they've also reaffirmed their commandment to retain certain aspects of the law, like the pre-existing conditions requirement.

So, again, these are complex moving parts, and so the thing that we're doing is making sure that we're there as an educator, that we're reminding people about whether we're gonna replace or rebuild or repair or whatever the right term is. We want to make sure that there's a stable insurance foundation to support it, and that sort of is a key opening a part to it. And we think that's at this point well understood, and that the timelines are probably going to adjust a little bit as people try to figure out how to navigate that. We'll make sure our voice is heard. On the tax proposals, we generally have been a supporter, as you know of tax reform, but again, we want to make

sure that we are educators and informers on certain dynamics. So for example, we know that many medical products, including some of ours, are made outside of the U.S. in regulated facilities, and so we just want to make sure that information is well understood as policies are starting to come through. So, yeah, so it's interesting times, both as Cardinal Health and certainly in my new role as a Chair of HLC, but I think we're well positioned broadly, and I think we're nimble enough to continue to adapt to short-term dynamics at work.

Operator: The next questions from Eric Coldwell with Baird.

Eric Coldwell: Thanks very much. Medical, obviously I think everyone's feeling a little about it today, that being said you do a very large win with Kaiser. I'm just trying to pull back the layers of the onion a here a little bit. If we could strip out Kaiser, my guess is gross looks like 3 to 4%. What is the growth in acute care stand-alone ex-Kaiser? You've got a lot small businesses that are growing faster doing better. I'm just trying to make sure that the acute care distribution piece stand-alone, ex -market share isn't actually flat to shrinking at this point, or maybe it is?

Mike Kaufmann: Yeah, so. Eric, thanks for the question. I don't want to pull Kaiser out for two reasons. One is I wouldn't want to talk specifically about the size of any one customer, but second of all, it is part of our business. It is the result of all of the work that the team has done to reposition the businesses. It is a business that has lots of other services, a broad product line. And so, to me, it is more of the result of all of the work we've done, so to pull it out doesn't make sense. Now business is still definitely growing without the Kaiser piece in it, but it's hard to break it down. I don't know that that would be appropriate - George?

George Barrett: Yeah, Eric, if it's okay, I'll do this because we don't break down individual pieces, and we certainly don't want to break down individual customers. But, remember I talked to you about, and someone asked earlier about lead indicators. So, they're all looking green. Our pharmaceutical - excuse me, our medical surgical distribution business is probably in the healthiest position we've seen in some quite some time. So we're seeing really a very

good organic activity and growth there, so I think can answer qualitatively without breaking out the individual pieces to it.

Mike Kaufmann: Eric, if you even - if you set aside Kaiser and make it Cordis, the business wouldn't grow without…

Eric Coldwell: I mean, I don't want to take - I don't want to take Kaiser from you. I actually think your're structurally advantaged perhaps versus some in the market. I'm just trying to get a sense of where the market is in distribution.

Mike Kaufmann: I understand. Yeah, absolutely, and I didn't mean it any other way, but I appreciate that.

Eric Coldwell: Okay. Thank you. We can take it offline. Thanks.

Operator: The next question from Garen Sarafian with Citi.

Garen Sarafian: Ah, good morning George and Mike. High level question on procurement and generics. One of your peers is in the market getting updated pricing that includes the volume of a large new retail client. So how has that impacted that market and how long do you think whatever changes are going on take to flow through.

Mike Kaufmann: That's a tough question because I don't really want speak for our competitors, and I'm not sure of the timing of exactly when their launching and all the different pieces of when they go to market. But I will say that, as you can imagine, our Red Oak team is paying attention to that, has great relationships with the manufacturers and will be paying attention to that to make sure that we are costed appropriately for our size and simplicity and transparency of our model. And other than that, it's probably all I can say.

Garen Sarafian: Okay, fair enough. And how long in generic terms when there's a large new client it takes to flow through the system. But the follow-up was actually going to be to pose a product question on the impact of branded price increases and impact to Cardinal. So could you put some sort of, any broad weightings around impact of January price increases versus the mid-year. Is it more two-thirds - one-third, or is more 80-20, or something else that you could share. Thank you.

Mike Kaufmann: Yeah. I probably can't share that level of detail because it's obviously hard to know, and manufacturers move slightly between month to month and quarter to quarter. So, again, I'll just emphasize, January's bigger, the biggest month, but other than that, George?

George Barrett: Yeah, can I just add to this. I mean typically January's bigger like Mike said. The other thing that we need to note is it's been an unusual stretch for some time. And so, again, predicting exact behavior is always a little bit tricky. As you know, years ago it was very, very systematic and today it's a little bit more one-off. But I think, as Mike said, January typically is a bigger month. But I think we have to recognize that that things are a little bit different and maybe not as predictable in terms of exactly when things occurred as they might have been five years ago.

Mike Kaufmann: To answer your other question around generics and being able to execute on it, I think that just depends very differently on how you go to market, the size of that customer, whether it even deserves repricing, and then how you go about that. How your relationships are with the manufacturers, so I think that can vary drastically and dramatically between different players in the marketplace. I know we feel really good about when we combine how quickly we executed, but I'm not sure I can say that anybody else would go faster or slower than us.

Operator: And the final question will come from Greg Bolan with Avondale Partners.

Greg Bolan: Hi. Thanks guys, and I hate to ask this at the very of the call, George, but - and by the way, I very much enjoyed the white paper on DIR's, and that just was issued last month. But from the standpoint of your ability to defend or protect independent pharmacies and obviously maintain, maybe even gain market share in the independent pharmacy space as it relates to DIR's, where do you guys sit in the spectrum - because it does feel like this is obviously - these revelations that we're starting to see on DIR's. I mean, it's a very painful experience for your pharmacy customers and I just wanted to kind of see how you guys could possibly - or how you are potentially defending and protecting them, when they're obviously experiencing these pretty massive detrimental margins - 90 - 120 days after the fact.

George Barrett: Well, so there's two points to this. So let me answer the second part first. I'm not sure there's as company more focused on the community pharmacy and pharmacy industry in general. We believe that they're gonna be a key player as healthcare continues to evolve. We have shortages of primary-care physicians. We think pharmacists will and should play a more active role.

We're doing an incredible amount of work through Jon Giacomin's organization to make sure that we are close to them and providing all the solutions and tools that can help them compete in the market, and actually help them provide cognitive care, which we think is very important. Going back to your first point, I want to make an important note about this because we've gotten a few questions.

We are a player in oncology and as such, we've been a member of Community Oncology Alliance. And as a member of that, we have funded research. But you specifically refer to a particular project. We do not direct the researchers set the subject. So it's just important for me to comment on that. So we've had questions about that paper. We didn't specifically fund a paper on this we are basically part of an alliance, and that group does research.

But the summary of what I'm describing is our work around community pharmacy and on pharmacy in general is very much a part of what we do. Whether it's through generic programs, the ability to help them tie to a hospital system or to a post-acute facility, or to set up a diabetes center, we've done a huge amount of work in providing tools to help community pharmacies compete in what is, for all of us, an interesting and challenging environment.

Operator: And this concludes our question and answer session. Mr. Barrett, I'll turn the call back you for any additional remarks.

George Barrett: Sure. Thank you, Eric, and thanks all of you for your questions today. Our organization, just in summary, remains focused on execution, on driving our strategic priorities, on making sure that we are creating, what I've been saying, is, sustainable value creation for our partners and for patients and for you all and we look forward to seeing you all in the near future and thank for joining us on the call today.