Q3 FY17 Cardinal Health, Inc. Earnings Conference Call

May 1, 2017 8:30AM Eastern

Operator: Good day and welcome to the Cardinal Health Third 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: Thank you, Kyle, and welcome to this morning's call to discuss our third quarter fiscal 2017 earnings. With me today are Chairman and CEO, George Barrett, and CFO, Mike Kaufmann. George and Mike will have some prepared comments, and then we'll move into Q&A.

Before I turn the call over to George, since we will be making forward-looking statements, we need to remind you that 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 statements slide provided at the beginning of the presentation found on the investor page of our website for a description of risks and uncertainties.

We will be ending today's conference call promptly at 9:45 AM. To more efficiently get through our question-and-answer queue, we are limiting each individual to one question with one follow-up. As always, the Investor Relations team will be available if you have additional questions.

Thank you and I'd now like to turn the call over to Cardinal Health Chairman and CEO, George Barrett. George?

George Barrett: Thanks, Sally, and good morning to everyone joining us on today's call. We had a fairly full conversation with you just two weeks ago, so my commentary this morning will be relatively brief, and I'll let Mike walk you through the numbers.

The quarter came in largely as we expected. Our value proposition is resonating with our customers and our business partners, customer retention is high, and unit growth is solid. As I mentioned on our recent call, the performance in most of our lines of business is strong, and I'd like to highlight a few. Our specialty solutions group continues to grow at a good clip, well into the double digits. Or medical-surgical business has been performing very well, with help coming from new customers, the strength of our consumables portfolio, and the value of our supply chain services.

In addition, our naviHealth and post-acute activities are extremely attractive to a market going through significant changes, and are also growing at a pace faster than we had originally modeled. Most important, we are seeing that the value of our portfolio is fueling a more broad-based interest in Cardinal Health. With a provider system increasing in complexity, reconfiguring itself, and wrestling with new payment models, we feel confident that we can bring added efficiency, quality, and safety to virtually any system. And the value that we create in serving these providers increases our critical role in helping pharmaceutical, biotech, medical, and lab manufacturers bring their products to the patients they ultimately serve.

Having said this, we have highlighted these past months, and reinforced two weeks ago, the dynamics we've been experiencing around pharmaceutical pricing, particularly in generics, and the impact it has had on our pharmaceutical segment. There is little for me to add to my commentary from our call on April 18. In summary, we are experiencing pricing deflation in generics, some heightened reimbursement pressures, which affect our customers, and a scarcity of new generic launches in the near term. It's these factors, plus some company specific discrete items, which largely informed the fiscal 2017 and early 2018 outlook we provided.

One quick note about our Cordis business. We've said before that we expected our transition activities to cause some lumpiness in our Cordis numbers, which Mike will address. But overall, we were encouraged by our commercial momentum on a global basis. We've recently added some products to our bag, which will offer our customers even greater value. We are building a platform off of which we can offer additional products and services globally once we fully integrate the Patient Recovery business we plan to acquire from Medtronic.

I'd like to provide an additional comment specific to our recent conference call. We faced an interesting dilemma two weeks ago. We were extremely pleased to be able to bring our negotiations with Medtronic to the finish line. This is a business that has been on our radar for many years. At the same time, we began to see our early numbers for fiscal 18 roll-up. And while we always challenge ourselves to improve our numbers as we go through our planning process, we did not want to give you the good news about the acquisition without sharing the important facts that we were seeing in the current market. This has always been our approach with you. We are an organization that will take the necessary actions to improve and adapt to set ourselves up for the long-term.

Our people are competitive, focused, and committed to serving our customers and their patients. And a near-term disturbance in market conditions will not deter us from our obligation to be accountable for performance and our commitment to our customers. We will continue to invest in and drive those activities, which differentiate us in the marketplace as a creator of sustainable value.

It is with this in mind that I am even more excited about the acquisition of Medtronic's Patient Recovery business. As we said two weeks ago, these product lines are natural extensions to the work that we're doing across the continuum of care, from acute care, to surgery centers, to long-term care, into the retail setting, and even to the consumer. These are product areas and channels with which we have enormous experience.

I won't repeat all of the many reasons why we are thrilled about this transaction, but let me summarize by saying that the addition of these businesses increases our scale, our balance, and our relevance to all of our customers. These are products used every day in our global healthcare systems, and this acquisition will leverage all of the tools that we've built over the years to be the daily touchpoint to the providers of care and their patients.

I'd like to make one more observation about this acquisition. Some of you have asked whether this transaction represents a departure from our pharmaceutical distribution business, and the answer is no. As I mentioned earlier, we've had our eye on this business for a long time, and we believe that adding these product lines to our existing portfolio will provide additional value to our customers, and to you, our shareholders.

Let me be clear on this: Our pharmaceutical distribution business is an important and valuable part of an integrated portfolio. While market conditions can, from time to time, affect any business, we are confident in the value that our best-in-class distribution business provides today and into the future.

I'll finish by reiterating that our portfolio of product and service offerings is strong, valuable to our customers, and increasingly well balanced. And we are extremely positive about the opportunities in front of us.

And with that, I'll turn the call over to Mike, who'll walk you through the financials.

Michael Kaufmann: Thanks, George, and thanks to everyone joining us on the call today. In my comments this morning, I'll first provide some context around our third quarter performance. Then, I'll review the expectations we detailed a couple of weeks ago for our full fiscal year. At this time, we don't have any updates to our FY18 or FY19 early thoughts we provided on April 18, so I won't say anything more, other than our leadership team has a strong sense of optimism and accountability. We are managing the company with discipline and for the long-term.

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 with our consolidated company results, our third-quarter GAAP diluted EPS was $1.20 and non-GAAP diluted EPS was $1.53, an increase of 3% and 7%, respectively. Note that both the GAAP and non-GAAP diluted EPS for the quarter benefited from a lower effective tax rate and fewer outstanding shares as compared to the prior year. Total company revenues grew 4% versus the prior year to $31.8 billion.

Consolidated GAAP and non-GAAP gross margin dollars increased by 2% and 1%, respectively. GAAP gross margin rates were down 8 basis points for the quarter, while non-GAAP gross margin rates were down 15 basis points, primarily due to generic pharmaceutical pricing.

Consolidated company SG&A increased 5% from the prior year. Since we have lapped our significant acquisitions, the growth is mainly driven by the costs associated with our pharma IT system refresh, new medical segment business wins, and Cordis infrastructure expense, partially offset by assumptions around incentive compensation. As you would expect, we continue to be disciplined in our expense management. Both GAAP and non-GAAP operating earnings declined in the quarter versus the prior year by 8% and 4%, respectively.

Moving below the operating line, net interest and other expense was $41 million, a 7% decrease over the prior year. This decrease was driven by deferred compensation income, which has an equal offset in SG&A expense, so there is no net impact to EPS from this favorable variance. For the third quarter, the GAAP and non-GAAP effective tax rate was 32.3%, down 4.6 and 4.3 percentage points, respectively, versus the prior year. This improvement was due to a few favorable discrete items in the quarter.

Diluted weighted average shares outstanding were 318 million, 13 million fewer shares than the third quarter in the prior year. During the quarter, we did not repurchase any shares and, as of the end of the quarter, had $443 million remaining on our Board-authorized share repurchase program.

During the quarter, we had net operating cash outflows of $198 million. We ended the quarter with a cash balance, including short-term investments, of $1.6 billion, with $514 million held outside the United States. While we don't typically provide cash flow forecasts or guidance, we do expect to generate significant cash in the fourth quarter. Consequently, as we shared with you on April 18, about $1.6 billion of cash on hand will be used during the first quarter of FY18, when we expect to close the purchase of the Patient Recovery Business from Medtronic.

Next, I will cover segment performance, beginning with the pharmaceutical segment. Revenues grew 3% to $28.4 billion due to performance from the Specialty Solutions business and growth from Pharmaceutical Distribution customers. Segment profit for the quarter decreased 7% to $611 million. This decrease was driven by generic pharmaceutical pricing, the final quarterly impact of the loss of Safeway, and the investment in our pharmaceutical IT platform. This was partially offset by solid performance from Red Oak Sourcing.

During the third quarter, we began to see planned incremental expenses associated with the first few phases of our pharma IT refresh project. This multi-year project is on time and on budget. It will enable us to maintain the excellent service our customers have come to expect from Cardinal Health, provide us with the ability to expand in a cost-efficient manner, and better facilitate our ability to go-to-market as an integrated enterprise.

Finally, our pharma segment profit margin rate of 2.15% for the quarter was down 25 basis points versus the prior year, largely due to generic pharmaceutical pricing. A couple of other points to note on the quarter, our Specialty Solutions and China businesses saw double-digit bottom-line growth.

Now, I'll move to our medical segment results. Revenues for the quarter grew a robust 9% to $3.4 billion, driven by contributions from new and existing customers. Medical segment profit increased 16% to $148 million, reflecting solid performance from naviHealth, supply chain services, and Cardinal Health consumable products.

The quarter was unusual, in that we saw a decline in Cordis profit. This decline was mostly related to increased SG&A expenses to support our investment in an international infrastructure. This investment will benefit us as we integrate the Patient Recovery Business. The increased SG&A expense was partially offset by the net impact of the Cordis inventory adjustments.

Let me explain the third quarter inventory adjustments in more detail. First, this year benefitted from the absence of the inventory step-up, which we recorded in the prior year. This benefit was largely offset by an increase to an inventory reserve in the quarter --in the current year. This reserve is an estimate based on information often provided by third parties, including under-the-transition service agreements and from various service providers. During the period, we received more detailed information for this reserve and have adjusted it accordingly.

As both George and I have mentioned in the past, the exit from the transition service and manufacturing agreements could result in some lumpiness to the Cordis earnings, but we fully expect this to diminish as we move forward. We expect Cordis to return to growth in the fourth quarter and are working hard to ensure we have the right infrastructure for the long-term to support our customers and their patients. Segment profit margin rate increased 26 basis points to 4.34% due to the same factors I just mentioned on the segment profit dollars.

Turning to slide number 7, you will see our consolidated GAAP and non-GAAP reconciliation for the quarter. The $0.33 variance to non-GAAP diluted EPS results was primarily driven by amortization and other acquisition-related costs.

I'll now update you on our assumptions for the fiscal year. We expect full year 2017 revenue growth to be in the mid-to-high single-digit percentages, which is a change from our previous outlook of high single-digit growth. One item of note, the actual closing date for the Medtronic transaction we announced on April 18 involves multiple parties, including regulators. Because of this and other factors, we need to quickly be ready to execute the best possible financing to secure attractive terms associated with the acquisition. This means that we could issue debt in the fourth quarter and, if we do, we would see up to $0.05 of financing costs, which is not included in our current fiscal 2017 EPS guidance. We will let you know when we access the debt markets and be transparent on the incremental costs.

To reiterate, as we shared with you on April 18, we expect our full year non-GAAP EPS to be at the bottom of our $5.35 to $5.50 range, and this served as the base for our fiscal 2018 early outlook.

Moving on to slide 10 of the presentation, the corporate assumptions around tax rate, shares, and capex will be at the low-end of the range, and acquisition-related intangible amortization will now be about $389 million, or $0.81 per share, which does not affect our non-GAAP earnings.

You can turn to slide 11 to see our pharma segment assumptions for the full fiscal year. We now expect mid-to-high single-digit percentage revenue growth for 2017, a change from our previous outlook of high single-digit growth. This is largely related to the loss of brand sales associated with the retail network changes at CVS Pharmacy, which they disclosed in late 2016. Additionally, we now expect full year pharma segment profit to decline low double digits versus the prior year.

Note, this tightening of the range is primarily due to the previously mentioned generic market pricing, which, while less deflationary than what we saw earlier this year, is still lower than we modeled for the second half of the year. All other pharma segment assumptions remain unchanged.

On slide 12, you can see there is only one change to our medical segment assumptions, which is we now expect a high single-digit percentage increase in revenue versus the prior year, up from our previous assumption of mid-to-high single-digit growth.

Let me close with this. I am confident we are well positioned and are working on the right things at the right pace for both the near term and long term. Thanks. And with that, operator, let's go to the questions.

Operator: Thank you. We'll take our first question with Robert Jones from Goldman Sachs.

Robert Jones: Great. Thanks for the questions. You guys guided generic deflation down low double digits for the year. I'm curious if maybe you could just talk a little bit about what you saw in the quarter relative to deflation, and then maybe how that plays into what you're expecting to see in the fourth quarter.

Michael Kaufmann: Thanks for the question. As far as the deflation goes in the quarter, we're not going to specifically comment on quarter-by-quarter deflation rates, other than, as you know, we did update to be -- that deflation for the entire year we now expect to be in the low double digits. So, again, as I emphasized before, it's definitely lower than we had modeled in the second half, but it's improving.

Robert Jones: Okay. Got it. And then, I guess, if we think about the moving pieces that drive the deflation metric, as you guys have it, next year thinking about it getting back into the mid-single digits, could you just talk about what factors will play into that improvement off of what you're expecting this year? Is it really just a comp issue, or do you have visibility into how that metric will actually improve in fiscal 2018?

Michael Kaufmann: Yes, thanks. A couple things. First of all, I think one of the biggest things to think about how it will improve next year is that you actually have to break down the individual items and take a look at where the various items are going. And as you do that, what we see in that is there's a very small subset of items that have deflated significantly this year, items you probably might be aware of over the last couple of years that launched that had limited competition, either because they were hard to make or there was raw material issues or those types of things, that were relatively high priced towards the beginning of the year, or higher priced in terms of generics go, and then they deflated significantly during the year.

And what we believe is that subset, that small subset of items which are very material, have really reached probably near the bottom of where they'll be. And so the impact of those items we don't see reoccurring next year, and that has a significant impact on the overall deflation rate for next year. And then when you combine that with all of the other efforts that we have in terms of pricing, sourcing, working with our customers on penetration and things like that, that's why we feel confident about where the overall deflation rate's headed.

Robert Jones: Great. Appreciate the comments.

Operator: We'll take our next question from Ross Muken with Evercore ISI.

Ross Muken: Good morning, guys. So on the Medical business, can you just expand a bit on sort of your experience so far in Cordis and how that's gone versus plan? And then, how the new Medtronic business, as that comes in, will both enhance your ex-U.S. strategy as well as your bundle in the U.S., and how you think maybe that could also further synergize your Cordis presence?

George Barrett: Ross, good morning. It's George. Thanks for the question. I'll start, and then Don Casey, our Medical segment CEO, is here with us, so I'll let Don weigh in a little bit. But, by and large, the thing that Mike just

described on Cordis has been the hardest part, which is basically ramping up the international infrastructure. Commercially, we're actually feeling very good about the way we're positioning, we're seeing some really interesting growth, particularly outside the U.S., and we're also seeing what we always like to see, which is some demand from our global operations for other services that Cardinal has to offer. And that's always been part of our thesis.

On the commercial side, some things that we see that are very optimistic. I think building up that infrastructure has been one that has taken a little more time than we expected, but we want to get it right. And, as we said, we're building a platform now, and maybe Don could talk a little bit about that.

Don Casey: Yes, and two questions. The first is, how has Cordis impacted our bundle in the U.S., and it's been very positive. I mean, we get a tremendous amount of interest from people that are very familiar with what we would consider kind of our base Cardinal Health businesses, our base brands, which tend to be a little bit more commodity-oriented now that we're moving into something like Cordis, where we can deliver value. It, one, enhances our 360 Program, which we think is important, and that's had particular resonance among our strategic accounts.

Ex-U.S., we're very excited. Look, we built a platform, and George said it very well: it's taken us a little longer, and we've been very careful to create something that we could build a significant foundation on. It's taken us, A, a little bit more time, and a little bit more money. But as we looked at the Patient Recovery business that we're getting from Medtronic, we think we're going to be able to slide that right on top of the foundation we've built. And that scale is going to be important in a couple ways.

First, it gives us a lot more critical mass, particularly in Asia and EMEA. We believe that critical mass will allow us to have a comprehensive bundle that will be very relevant to a lot of the acute care customers there. So, we're very optimistic that the foundation we built for Cordis is going to pay dividends as we bring the Patient Recovery business on top of that, when we're able to close the business, hopefully sometime in the first quarter.

Ross Muken: And can you just quickly update us on where you are with Kaiser, and how maybe your enhanced relationship there has helped you think through --obviously, they're a pretty dynamic organization --helped you think through what you could bring, from a distribution bundle perspective, to other potential key large IDNs in the U.S.?

George Barrett: Yes, Ross, let me start, and then maybe Don will jump in. I want to be careful here, because I never want to speak for a customer. What I can say is, they are, as you mentioned, an incredibly interesting organization. We've built a business model that's really around creating value through efficiency and safety, the ability to standardize, the ability to drive cost, and the ability to actually support that through some of our clinical activities, particularly in post-acute.

And I think that overall portfolio is beginning to resonate with a lot of customers. And I think a very -- instead of speaking for Kaiser, use them as an example of a highly complex integrated system, I think we're able to create real alignment with their strategies of, how do they make sure that they're treating patients in the right way, in the right setting, at the right cost. And I think that's part of the alignment strategy for us. I don't know if you want to add to that, Don.

Don Casey: Just briefly, George. It's been very interesting. The conversations were --that we were six months ago, we -- let's make sure that we're able to get this business up and running. It's, again, as George said, a highly complex organization that represented a significant challenge for us. We've met that challenge. We're actually delivering better customer service than they've ever experienced, and now they've begun to sit there and say, these trucks are moving into our facilities, what else can you put into them? And it's really changed the complexion of the conversation to how is this a basic distribution agreement, to how does this become a strategic asset that we can look to become much more efficient as they look to expand their own operating horizons.

Ross Muken: Great. Thanks, guys.

Sally Curley: Thanks, Ross. Operator, next question?

Operator: We'll take our next question from Charles Rhyee with Cowen & Company.

Charles Rhyee: Yes, thanks for taking the question. George, I wanted to go back on the generic pricing, and I think last quarter you talked about the sell-side margin for --sorry, the last call you talked about the sell-side margin pressure. And just wanted to get a sense on what you're seeing currently and whether what --the actions that you took in terms of revising the guidance down just a short while ago was really sort of maybe a trailing impact of now we've settled out or can you talk about the forward environment, how it looks to you? Thanks.

George Barrett: Right. Thanks, Charles. As you know, this is a hard one to answer. As Mike said, there are things in our control and things that are not. We're doing the things in our control, as Mike said, around sourcing and pricing strategies, et cetera. How the market behaves is more out of our control. Here's what we've done as we modeled this. We try to take sort of exit rates, and we use those based on the real data and the best information we can get from sort of market conditions and the feel of what we're seeing in the market and that's basically how we model.

We talked, I think late in the year or early in the calendar year, about some shifting away from the very steep rates that we saw early in the fall. That did look a little better. As Mike said, it has been a bit better than it was last fall, but not I would say a full recovery, sort of the way I would say it. So we've tried to take that data we're seeing, use it real-time, use the experience that our teams have, and then just try to do some basic forward modeling. But always a little hard -- lot of moving parts here and it's always a little hard to get it perfect.

Charles Rhyee: Then -- just a follow up then. Apart from what -- the things that are in your control, if you think about the competitive market for customers, can you talk about how that pricing -- is it fair to say that all your clients are

now -- been level-set to the sort of the new prevailing rates, including clients that may not have been up for renewal in the near term?

George Barrett: Right. So let me start with the basics. Again, we've said this before. As you know, this is always a competitive market. I do think that from time-to-time, you see activities that seem a little bit more aggressive, and then those tend to stabilize. So, I can't speak for other companies. Everybody has their own renewal cycle. I would say we have limited exposure to major renewals. And most of what happens in the market moves across the system fairly quickly, so that's probably the best way to characterize it.

Charles Rhyee: Okay. Thank you.

George Barrett: Thanks, Charles.

Operator: We'll take our next question from Michael Cherny with UBS.

Allen Lutz: This is Allen in for Mike. Thanks for the question. On generic deflation, in some of the drug classes that have matured recently or undergone significant pricing pressure, are you guys seeing manufacturers rationalize production or exit markets entirely? And then, can you talk about how this compares to the past five years or so?

George Barrett: Yes, so let me start. Again, trying to describe the manufacturers when there are this many is, as you can imagine, difficult. It's really each company has its own product line and its own strategy. I think we would expect on some kinds of products, where you wind up with many, many, many competitors, it's not unusual that

companies will drop out. So if you wind up as a 12th launch --with a 12th launch in a product, it's not unusual that one or two players may say, look, we'd rather use our capacity directed in other areas.

So I don't know that I could characterize that we've seen a ton of this, but I do think as we think about the nature of the industry, we'll see that from time to time. And we fully expect on given products where there's very mature products with lots of competition that you might see companies come in and out of those markets.

Allen Lutz: Got it. Thank you.

George Barrett: Thanks.

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

Ricky Goldwasser: Yes, hi. Good morning. So, the first question is about the discrete items. George, in your prepared remarks I think you talked about company specific discrete items, which largely impacted fiscal 2017 and headwinds in fiscal year 2018. So, can you just help us and give us more detail on what were these items in 2017? And were they included in guidance before or were they incorporated into kind of like the updated outlook that you provided us last week?

George Barrett: Yes, Ricky, good morning. Let me turn it over to Mike actually, and this is really primarily references that we made a few weeks ago on 2018. But, Mike, if you want to...

Michael Kaufmann: Yes, thanks for the question, Ricky. As you can imagine, back on April 18, while we weren't completely closed with the quarter, we had very good line of sight into what the quarter was going to look like. So when I talked about those discrete items, I was taking into account what we expected to see for really the entire full year. So those were given with the knowledge of what was going in the third quarter, so there would be no update -- I'll go through the details, but there would be no update to those four discrete items just because of the actual results in the Q3 are what we see happening in Q4.

Those four items were, first and foremost, the largest was tax and reserve adjustments. And, as you can see, in this quarter this year we mentioned as one of the drivers for the quarter that tax was a positive for us versus the prior year. And we knew that when we gave you some insight a few weeks ago that that would be the largest. So of the greater than $0.50 of discrete items we expect to incur this year that we'll not incur next year, tax and some reserve adjustments that I've talked about was the biggest one.

The second bucket -- and the next three are all similar in size -- would be compensation. You heard me mention that today. So that will be an adjustment year-over-year. Investments in the business where we were very disciplined this year, particularly early on in the year as we knew how things were shaping up to be, very careful in that area and to manage our SG&A expense. And then in P-Mod, which is our Pharma Distribution IT refresh project, we know and have known that as we roll this out, that we're going to be incurring some incremental expenses over the next couple of years, particularly next year is a larger year for us in P-Mod expenses. And so those are the four that add up to the greater than $0.50, with the tax and reserve adjustments being the largest.

Ricky Goldwasser: Thank you. And then my follow-up is one on brand, one on generic. Mike, I think you talked about the impact to the revenue line from loss of brand sales associated with CVS. So just trying to understand if there is any pull-through also to the profit line. And then on the generic deflation level, your gross profit in the quarter still grew year-over-year. So at what level of generic deflation year-over-year gross profit starts to decline?

Michael Kaufmann: Yes, as far as the brand one related to the CVS piece, again, this was all contemplated in the guidance that we had. We had some insight into that, and is low-margin brand sales. And it doesn't really have any pull-through impact to us on generics as far as it goes to CVS. So we feel very comfortable that all of that sales decline is already modeled into our outlook for 2017, as well as our early thoughts on 2018.

As far as generic deflation goes, I'm not sure what more I can talk about on that other than, again, we see it getting better. We feel like we're positioned incredibly well with Red Oak Sourcing and our pricing teams, and it's definitely getting better. Not quite as good as we modeled, but definitely getting better.

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

Lisa Gill: Thanks very much. Good morning. George, when we spoke back two weeks ago, one of the things I think you highlighted on the drug distribution side was this idea of renegotiating some contracts specifically around penetration on the generic side. Is that something that's ongoing? You just made comments that you don't have any large renewals this year, but is that something that happens on an ongoing basis? And how should we think about how that will impact the business and the margins going forward?

George Barrett: Lisa, let me let Mike jump in on this one.

Michael Kaufmann: Yes, thanks, Lisa. A couple things on that. I think, we always have a portion of our contracts that are renewing every single year. And when we talk about renewals, we're really talking about those large renewals that are out there and to your point. So there's always independents that are renewing and other acute hospitals and stuff. And so we're constantly looking at our contracts and trying to make sure that they're fair to both the customer and to us.

And so where customers are looking for improved branded pricing or improved generic pricing, we're, of course, going to look at things like, okay, then you need to commit to higher percentage of your generics from us. You're going to need to buy more OTC, HBA products from us. You may need to accelerate your terms and pay faster. And so we constantly look, as we model, to make sure we're doing all the right things to pull the levers to be fair to both the customers to meet their needs in the marketplace as well as making sure that we protect our profitability.

George Barrett: Yes, Lisa, I'd just add. We have a pretty comprehensive approach to thinking about the mix and the portfolio, and they are very tailored to the customer. And so I think our team does a pretty good job of really understanding the customer needs here.

Lisa Gill: Is there a way to think about where penetration is today on generic purchasing and where it potentially could go? When we think about stabilization, my expectation would be, in that independent market, that there's less stabilization if you have, obviously, more places that you can buy product. So the more you can lock your customer in on the penetration side, the more stable it will become. So how do we think about where it is today and where it potentially could go as you think about all the other elements that Mike talked about in those conversations?

George Barrett: Lisa, why don't I start just very broadly, generic penetration rate actually varies a fair amount across classes. We think classes tend to be pretty steady. So there are areas -- so, for example, a chain drug tends to be very high. Independent pharmacies have been growing significantly in recent years in their penetration rate. I would say the institutional area is still little bit lower in overall generic penetration rate. And so we're thinking about each of these areas and where there's opportunities.

The other thing that we've talked about in the past is that we still have in the system some purchasers of generic drugs that do a hybrid of buying directly and through a channel partner, and we see those as opportunities. We think we're an extremely efficient sourcer of products and our value proposition downstream is very broad and comprehensive. And so, for us, that's another lever that we think about all the time, which is how do we basically create the incentive and encourage all those players to source their generics through us.

Lisa Gill: Okay. Great. Thank you.

Operator: We'll take our next question from David Larsen with Leerink.

David Larsen: Hi. Mike, what did you see for brand inflation this past quarter, and what are your expectations for brand inflation for fiscal 2018, please?

Michael Kaufmann: Yes, so brand inflation, just a couple comments. As I mentioned earlier, I did say it was just a little bit less than where we expected it to be within the range of the 7% to 9% that we gave in the last quarter. And so it's still tracking within that range, but again, a little lower than we had originally modeled for the quarter in the second half. And that being said, it's a small driver for the second half of the year. And quite honestly, we have been at -- over 85% of our branded agreements are now non-contingent to inflation. I would expect that, if not by the end of FY18, definitely during the year, or by the end, we will be at closer to 90%, if not even slightly over 90% by the end of the year.

So I think what we're -- we're seeing a couple things. One, we're making ourselves less and less dependent upon it. And because it's already gone down from low double digits to more high single, I think the risk of it going significantly lower in the future, I think, is lower also. And so I don't see that as a big driver, one-way or the other,

for 2018 and, honestly, even probably 2019 and those years going forward, unless there's dramatic changes in the environment.

David Larsen: Okay. And then you said that generic deflation has improved. Can you give any more color around that, like when exactly did you sort of start seeing this improvement? Was it like in the March of 2017 timeframe? And then, we say things have improved, but we're now expecting sort of double-digit deflation for the full year. Can you put any numbers around – did it go from 11% to say 9% in March? Any more color would be really helpful. Thanks.

Michael Kaufmann: Yes, a couple things. Remember, when we're talking about an entire year rate of low double digits, and it was significantly lower in the first half of the year, so, as you could imagine, what we'd expected it to improve a little bit more, to average out to low double digits for the year. And so, again, it is improving, and the low double digits is an average for the entire year. And you do remember, probably back on one of the other quarter calls, we said we started seeing it get better in the December quarter. There was a lot of noise in there for launches. And, as I said, we see it getting better in the second half, just not as good as we had modeled.

Operator: We'll take our next question from Garen Sarafian with Citi Research.

Garen Sarafian: Good morning, George and Mike. Just related to a prior question, so on branded manufacturer contracting, when trends had begun to moderate a few quarters back, there was the possibility to go back to have a candid two-way dialogue to make the contracts more of a win-win. So have you gone back to successfully update some of those contracts to reflect current trends with any sizable drug partners since then? If there's any sort of a metric you can provide as to what percent has been completed or not.

George Barrett: Hi, Garen. It's George. I'll start, and then let Mike jump in. I think we're going to be careful about describing, in too much detail, any of our proprietary conversations with our manufacturer partners. But you should assume that we are pretty regularly in dialogue with all of our manufacturer partners, and we've worked closely together for years and when there's some shifting around, I think we work hard to make sure that we're getting compensated for the work that we do. And I think those conversations are productive. I don't know if you want to...

Michael Kaufmann: The only thing I would add is, my whole comment around going from 85% to at least 90% is all around the success of those agreements, and we're already seeing that rate increase. So you can assume that we've been able to work through some of the conversations with some of the manufacturers, and are continuing to have very productive dialogue with other manufacturers, and that's what's leading to us being able to increase from over 85% to 90% timeframe.

Garen Sarafian: No, that was useful. And then as a quick follow-up. Related to marketplace M&A, asking in sort of new generic terms, when one of your larger pharmacy clients that purchases both generics and brands from you acquires a substantial asset, set of stores, whatever you want to call it, how do those contracts evolve? Do they simply flow through the current contract typically, or are contracts typically set up where there's a mechanism that initiates a new contract conversation? Anything you could elaborate on there, in generic terms?

George Barrett: Yes, Garen, and it's probably going to be disappointing, because it's hard for us to give specifics about these relationships, but it varies all across the board. There are sometimes where the -- built into the agreement is just an extension of what we're doing. Sometimes there's some discussion that has to take place, given a new portfolio and a new mix. So, each story is its own story, I would say. And again, for us to try to characterize this generally would be a mistake.

Operator: And we'll take our next question from Robert Willoughby with Credit Suisse.

Robert Willoughby: Hey, George. On the naviHealth upside, what drove that, and how do you get paid for that? Why isn't it a bit more predictable? And then a quick one for Mike. Just, you mentioned a better fourth quarter cash flow experience. But why didn't the working capital accounts, inventories, receivables, payables trend as well as we'd hoped for in the third quarter? What was the setback there?

George Barrett: Bob, I'll take the first part of it, and turn it over to Mike. I think the naviHealth value proposition is so clearly aligned with what's happening in care. We have an aging population, so the post-acute area is a particular hot button. We know that there's a huge percentage of Medicare spend that occurs in the post-acute setting. So our ability to reduce costs, reduce readmission, reduce time of stay, those are powerful drivers, I think. And almost independent of any short-term policy issues, we know that that's valuable. And I think that's part of what's been steering the attention to naviHealth.

Part of the business model is very steady and predictable on a per-patient per-month basis. Some of it has to do with, what I'll say, gain sharing or savings programs. And so there's going to be some natural -- again, when you use the word lumpiness, it's of course a technical term of art here. But there is some natural bumpiness to this, because you have to -- basically you reconcile after a period of time on the share and on the savings that you've created. So some part of that model has that dynamic, but it is a really exciting part of our portfolio and we're thrilled to have it.

Michael Kaufmann: And as far as working capital goes, Bob, there's nothing fundamental that's changed in the net working capital. In other words, no big vendor term changes or customer mix changes or anything. It's more just the timing around some inventory builds related to some of the IT changes that we're doing and a few other projects that we have going on that we think we'll work through here in the fourth quarter and see significant cash flow in the fourth quarter. But no fundamental changes going on in the net working capital.

Robert Willoughby: George, is there a new business number or a backlog number, anything like that, for naviHealth we can point to?

George Barrett: Bob, that's a great question. We've never provided that. It just hasn't been part of our public disclosures. All I can say is broadly, the demand for our work in naviHealth is substantial, and at times, I wish we could keep up with it. So we're working really hard to build out the capabilities to make sure that we can support the interest in that kind of, I'm going to say, predictive analytics to help drive patients to the right side of care and to manage them effectively.

Michael Kaufmann: And again, even if there was, just because the agreements take time for the results to pop out, we might indicate what's in the pipeline, but it would still be hard to predict what the savings are until you actually work through the process with the customer.

Sally Curley: Thanks, Bob. Kyle, next question?

Operator: We'll take our next question from Eric Percher with Barclays.

Eric Percher: Thank you. A question on the Patient Recovery business. Looking at the Medical business ((inaudible)) and they're running high-teens margins and what Medtronic has said about the impact ((inaudible)) those margins even expanded. When I back out, the inventory cost and look at the ((inaudible)) contribution. And so I know that acquisition cost...

Sally Curley: Actually, Eric, I'm sorry to interrupt to. You're breaking up a bit. If you're on a cell phone, we're getting kind of every other word.

Eric Percher: Guys, well, let me put it simply. The Medical Patient Recovery businesses, is there an expectation for cost and transition services that's going to weigh on the margin relative to what we saw at Covidien?

George Barrett: Thank you. Eric, good morning. Sorry, we just couldn't hear the first time around. Now we got you. So I think one of the things that has been a great learning on the Cordis thing is, particularly in the international operations, the work that we need to do to ensure that there's no disruption to the patients. So I think we've done that work, and as we did the business planning and the modeling for this acquisition, we took all the learnings from that international work that we did with Cordis, and it was applied into our model. So we feel very good about that.

The second thing I would just add is that on the international side, we are building out those capabilities to support Cordis. And so, as Don said, I think we'll start to see a framework that we can roll business onto internationally. I guess, the third point would be, proportionally, more of the Patient Recovery business is actually in the U.S., and that's riding on a system that we know and use every day with our consumables business. We will have some transition agreements on the Patient Recovery business, but I think we've modeled those very carefully. Mike, you want to add something to this?

Michael Kaufmann: Yes, just a couple things. Related to the transition service agreements, transition manufacturing agreements, we actually have them going both ways. And so both companies are highly invested in each other's success here. So I think that will be an important thing as we work through those, and I think that's important. A couple other learnings is, on the Cordis piece, the U.S. piece has gone really well, in terms of infrastructure, has gone right according to plan. And remember that this Patient Recovery business is largely U.S., and so we feel really good about our back office capabilities in the U.S.

And as George mentioned, ex-U.S., we are definitely going to be able to leverage what we're doing with Cordis on the Patient Recovery business. And then just two other quick things is, I think we've done a very nice job in managing the R&D mix in terms of expenses and managing that. Don and team have been able to manage that well, really held onto sales momentum and actually created some. And just to wrap it up, from my point is that we did mention too, that the Cordis business would return to growth in Q4.

George Barrett: One thing I might want to add, just to make sure we're totally clear on this. So there are costs associated with the transition agreements, but I think what we're saying is we've built those in. So I don't want to suggest there's no cost. Transition agreements temporarily create some costs, but I think we've modeled those very effectively and we've taken all the learning from Cordis to make sure we're doing that very well outside the U.S.

Eric Percher: Thank you.

George Barrett: Thanks.

Operator: We'll take our next question from John Kreger with William Blair.

John Kreger: Hi. Thanks very much. George or Mike, the sell-side pricing pressure that you guys have talked about the last couple of quarters for generics, have you seen any of that bleed into either traditional brand or specialty?

Michael Kaufmann: No, I wouldn't think so. I would say that the repricing has been normal in the brand and specialty. It's hard. The only reason you heard a little bit of a hesitation is they're all kind of bid as one basket, right? And so if

you just look at a customer who was buying brand from us in one year to the next, I wouldn't say there's been anything unusual at all from any erosion on that. That tends to be -- it flows right off of the WAC manufacturer price, whereas the generics is more of a market price that adjusts up and down on a daily basis. So they're very different markets, but no, nothing of concern in the brand or specialty market that I would call out.

John Kreger: Great. That's helpful. And then a question for Don was in Medical. Once you complete the Medtronic asset purchase, does that sort of complete your sort of shopping list to build out a Cardinal brand, or are there other categories where you have a high level of interest in adding?

George Barrett: Don, give a go and I'll jump in.

Don Casey: Look, once we complete this, it's going to take us a little while to digest this business and really make sure we're optimizing this and Cordis, and that's going to take us a fair amount of time, talent, and treasure to get that done. Once we are finished that, we'll put our head up and see where we want to go. But right now, we feel very good about the fact that we've built a really strong group of products, of services, that are really putting together a pretty compelling offer that's winning in the marketplace. So we're going to focus on making sure we do a great job on integrating the Patient Recovery business, and then we'll go from there.

George Barrett: Thanks, John.

John Kreger: All right. Thank you.

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

Steven Valiquette: Thanks. Good morning, George and Mike. So I do hate to beat the generic questions to death, but just a high-level question on the sequential flow of generic drug profits from the March quarter to the June quarter. Your phrase that generic pricing is worse than expected, but getting better is still, I think, throwing some of us off a little bit. I guess the question is, if we were to isolate just your generic drug profits for the upcoming June quarter versus the March quarter just reported, in your budgeting do you expect directionally that those generic profits would be down sequentially? Could they still be flattish sequentially, or could they even be up? Because you keep talking about the "generic pricing getting better." So maybe the sequential conversation might help us out a little bit. Thanks.

Michael Kaufmann: That's hard to do. Let me see if I can help a little bit. Again, the low double digits is an annual rate, and so if you start with a higher double digits number in the first half of the year, you have to see second half has to be better, and again, we are seeing it better than the first half, but not quite as good as what we had expected. Again, if you just take a look at the curve is --what we're saying is better means it's less steep on the curve, and so the declines are less in the second half.

Now, we've always, historically, typically get deflation and we've just seen over the last few years some unique sets of items seeing significant inflation that have offset that. So I think it's hard to just look at the deflation as one single component. To me, the key is that curve being less steep, but at the same time, using Red Oak and our customer mix and our other initiatives to continue to drive down costing even more so that we can begin to either maintain or grow our margins. That to me is one of the keys that we're clearly working on.

Steven Valiquette: Okay, and one quick follow-up. I think I heard a comment from you guys about the CVS revenues being a little bit softer and that prompted a little bit lower revenue outlook for the Pharma segment. But did that get worse as the March quarter progressed, the CVS revenues and prompted you to lower the revenue guidance

now from them or are you just sort of playing catch-up on some trends that have been in place since January? Thanks.

Michael Kaufmann: Yes, that's really the news that CVS had given at late in calendar 2016 around some of the contract changes that they had. And so we saw that hit us early right in the quarter, and so we saw the impact in the March quarter, we projected it into our Q4 and through next year. So this all is contemplated in everything that we've given you in terms of brand sales and our impact on the revenue line and the bottom line, and so it is low-margin brand sales and so we don't see it having a significant impact to us. But again, everything that it does have and any impact is already contemplated in all of the 2017 and 2018 guidance that we've given to you guys.

Sally Curley: Thanks, Steve. Kyle, is there anybody else?

Operator: We have no further questions in queue. I would now like to turn the conference back over to George Barrett for any additional or closing remarks.

George Barrett: Thanks, Kyle. Thanks all of you for joining us this morning. We look forward to speaking to all of you in the coming days and weeks. And with that, have a good day. We'll talk soon.

Operator: This does conclude today's conference call. Thank you all for your participation and you may now disconnect.