Q2 FY18 Cardinal Health, Inc. Earnings Conference Call

February 8, 2018 8:30AM Eastern

Operator: Good day, and welcome to the Cardinal Health, Inc. Second Quarter Fiscal Year 2018 Earnings conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Lisa Capodici. Please go ahead.

Lisa Capodici: Thank you, Nicole. Good morning, and welcome to Cardinal Health's second quarter fiscal 2018 earnings call. I am joined today by our CEO, Mike Kaufmann; and Chief Financial Officer, Jorge Gomez.

During the call, 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 our SEC filings and the forward-looking statement slide at the beginning of our presentation for a description of risks and uncertainties.

Today's press release and presentation are posted on the IR section of our website at ir.cardinalhealth.com. During the discussion today, we will reference non-GAAP financial measures. Information about these measures and reconciliations to GAAP are included at the end of the slide presentation and press release.

During the Q&A portion of today's call, please limit your questions to one with one follow-up, so that we may give everyone in the queue chance to ask a question. As always, the IR team will be available after this call, so feel free to reach out to us with any additional questions.

Now, I'd like to turn the call over to our CEO, Mike Kaufmann.

Mike Kaufmann: Thank you, Lisa, and good morning, everyone. We appreciate you joining us today as we report on Cardinal Health's performance for the second quarter. I'll begin with an overview of the results and then touch on

our outlook for the balance of the year. Then, Jorge will provide further details in his remarks. Having worked with Jorge for many years, I couldn't be happier to have him as my partner and our CFO.

Before we turn to the quarter, though, I'd like to take a moment to thank George Barrett. As you know, I took on the CEO role on January 1. We have had an incredibly smooth transition, and we look forward to George's continued guidance and contributions as Executive Chairman. Also, I am excited that Jon Giacomin has assumed leadership of our Medical segment, and we're thrilled to have him in this new role.

Jon is a veteran of Cardinal Health with a proven track record as an operator. His knowledge of our customers, enterprise strategy and focus on execution will be invaluable in his new capacity. I'd also like to thank Don Casey for his contributions to Cardinal Health and we all wish him well in his new endeavor.

Let's now turn to the quarter. Overall, we are very pleased with the results. Performance across the vast majority of the business was at or above plan, and this translated into the numbers, with 6% revenue growth and non-GAAP earnings per share, excluding the benefit of tax reform, of $1.31, ahead of our expectations.

Among the highlights this quarter was the pharmaceutical segment performance, where results were better than expected. And in the medical segment, the Patient Recovery, At Home, and naviHealth businesses all performed well. On the flip side, we have some work to do in a couple of discrete areas, specifically in exam gloves and at Cordis, and we are on it.

Turning first to the pharmaceutical segment, revenue was up 5%, driven by better-than-expected results in pharmaceutical distribution and continued strong performance in the specialty and nuclear businesses. Generic market pricing continues to trend as expected and Red Oak has continued to perform very well, delivering better-than-planned results on the cost side.

I continue to be impressed with the talent, strategies and execution of the Red Oak Sourcing team and appreciate their partnership. On the brand side, I am pleased to report that based on both Q2 results and increases we saw in January, brand inflation remains in-line with our expectations.

And finally in specialty, with another strong quarter, this business remains on track to deliver double-digit top and bottom-line growth for the year. So in sum, I'm very pleased with the results of the pharmaceutical segment.

In the medical segment, we also delivered solid performance across most of the business. Revenue was up 19% for the quarter, driven primarily by the benefits of the patient recovery acquisition. In addition, we saw growth in our new and existing customers reflecting the appeal of our differentiated offer. In fact, we achieved sales growth in all product categories except exam gloves.

This was our first full quarter with the patient recovery business having closed the transaction last Summer. We are thrilled with the job our new associates around the world are doing. The integration is on track and we are excited about the long-term potential of this business.

As I noted, we also saw excellent results from Services, Cardinal Health at Home and naviHealth. In fact, all of these businesses were up double digits for the quarter, driven by growing demand and solid execution.

While most of the medical segment performed well, we did see some challenges in exam gloves where, as we previously discussed, commodity pricing and supply disruptions have created headwinds. We're actively exploring avenues to minimize this impact in the future. Also, at Cordis, the good news is we continue to generate top-line growth.

However, profitability has been softer than we expected, reflecting higher than anticipated cost as Jorge will address. As a result, we now anticipate Cordis results to be lower than previously expected for the balance of the year.

Let me assure you that Jon Giacomin and Pat Holt, the new leader of Cordis, are already on this and working with the team to improve the performance and produce the kind of results we believe Cordis is capable of. As you know, this is a higher-margin business for us, and once we address the current challenges, we expect to see meaningful leverage as we grow sales.

I would also note that we are excited about the recent FDA approval of our partner Medinol's innovative drug-eluting stent for the treatment of patients with narrowing or blockages to their coronary arteries. In January, the first commercial cases using the stent in the United States were implanted successfully.

As Medinol's distribution partner, Cordis can now provide this novel stent and delivery system as part of our interventional vascular portfolio for customers. This is a significant addition to the portfolio and Cordis remains

committed to bringing new technologies like this to the market to provide even more treatment options for clinicians and their patients.

Let's turn now to our outlook. For the full fiscal year, we are raising our non-GAAP EPS outlook by 40 cents to $5.25 to $5.50 to reflect the benefits of U.S. tax reform. While the following items net to zero, this revised outlook includes better-than-expected performance in the pharmaceutical segment, lower expectations for the medical segment due to Cordis and exam gloves and a 5 cent impact from the sale of our China distribution business, which was completed on February 1. Jorge will cover the details of all of this in a few minutes.

Having grown the China business over the past seven years, the timing was right for this transaction. To be a market leader in China and get the type of returns we expected, we recognize that significant scale was required.

Shanghai Pharma brings the strength and scale necessary to position that business to better meet the needs of patients throughout China. We appreciate all of the good work that was done by our talented team in China to build this business, which is now poised for further growth.

As we announced, the gross proceeds from the transaction are $1.2 billion and the net proceeds are approximately $800 million. We will be evaluating the use of the proceeds as well as the benefits from tax reform as part of our overall capital allocation strategy. We remain very committed to the balance capital allocation process that we have followed for many years.

Of course, we'll continue to invest in the business to ensure that we have sustainable growth and we will continue to carefully manage our short and long-term debt obligations. At the same time, we have a differentiated dividend that is very important to us and we always look at strategic M&A opportunities.

In addition, we have a track record of utilizing share repurchases to return cash to shareholders at appropriate times. Toward that end, as you saw in our press release issued this morning, our Board of Directors has approved a new $1 billion share repurchase program.

In summary, it was a strong quarter, and as I look ahead, I am very excited about the outlook for our company. With the breadth and balance of our portfolio, Cardinal Health is well positioned for the future. We have an excellent foundation on which to build. We are a valued partner to our customers across the healthcare

continuum. And as our strategies have taken hold, we are poised to capitalize on the trends taking place in the global healthcare environment from the aging population to the continued shift of care to more efficient settings.

As an organization, we are focused on continuing to innovate to improve the delivery and efficiency of healthcare. As always, our talented team of nearly 50,000 colleagues around the world are the core of our success and what truly differentiates Cardinal Health. It is an honor to represent them as CEO.

I thank them for their hard work this past quarter and their continued commitment to our company. Let me now turn it over to Jorge.

Jorge Gomez: Thanks, Mike. I'm delighted to begin this role and to join my first earnings call as CFO. Now before I share about our performance, I'd like to give just a few thoughts. As I enter my second month in this role, I could not be more excited about the opportunities ahead of us. I look forward to partnering with Mike, our leadership team, our board and our investors to drive sustainable growth for Cardinal Health.

Now, let me review in detail our strong financial performance in the second quarter of fiscal 2018. The financial results that I provide this morning will be on a non-GAAP basis, unless I specifically call them out as GAAP. Slide 7 of the presentation includes our GAAP to non-GAAP adjustments for the second quarter.

As Mike said before, we are pleased with the second quarter results. Based on the performance year-to-date, we feel confident about Cardinal's outlook for the year. Starting with EPS, diluted EPS for Q2 was $1.51, a 13% increase versus the prior year. This includes a reduction of the federal tax rate, resulting from the recent U.S. tax reform. I will discuss this in detail in a few moments.

Revenue increased 6% versus last year, totaling $35.2 billion. Total company gross margin dollars were up 16% to $1.9 billion versus the same quarter in the prior year. Consolidated SG&A increased 24% versus last year in line with our expectations. This increase was driven primarily by our recent acquisitions, most notably the patient recovery business.

Consolidated operating earnings were $730 million, which represent 4% growth versus the prior year. Moving below the operating line, net interest and other expense was about $81 million in the quarter. The increase versus the prior year was driven by the interest on the debt issued to finance the patient recovery acquisition.

Our effective tax rate this quarter was 26.2%, an 8 percentage point improvement versus the prior year, mainly driven by the recent tax reform. Second quarter diluted average shares outstanding were approximately 316 million, about 3.5 million fewer shares than the second quarter of fiscal 2017.

Yesterday, as Mike mentioned, our board approved a new $1 billion share repurchase program, and now we have about $1.3 billion available for share repurchase. Operating cash flow for the quarter came in at about $300 million, in line with our expectations. During the first six months of the fiscal year, we generated approximately $1.5 billion in operating cash flow.

Our cash balance as of December 31 was $1.2 billion with about $500 million held outside the U.S. Now, let's move to segment performance. The pharmaceutical segment delivered revenue growth of 5% in Q2. Revenues were $31.1 billion in the quarter. Sales growth was driven by both pharmaceutical and specialty distribution customers. This segment revenue increase was partially offset by the contract expiration of a large mail order customer, Prime Therapeutics in May of 2017.

While exceeding our expectations, segment profit for the quarter decreased 4% to $514 million. This decrease was driven by costs related to the ongoing investment in our pharmaceutical IT platform as well as the net performance of our generics program. We anticipated these headwinds and they were partially offset by strong performance in the specialty business.

Once again, the specialty team delivered strong top and bottom-line growth in the quarter. The pharma IT project continues to progress well and is on budget. Excluding these costs in the quarter, the pharma segment profit would have been flat.

As Mike said, generic market pricing and brand inflation performed in line with our expectations this quarter. Based on this, and what we saw in January, we continue to be confident in our full-year assumption. As a reminder, our generics program includes the impact from average selling price, volume changes, and the benefits of Red Oak Sourcing.

Now, let's go to the results up in medical segment. Revenue for the quarter grew 19% to just over $4 billion, primarily driven by the patient recovery acquisition and, to a lesser extent, new and existing customers. I'm happy to share that this is the first time this segment revenue exceeded $4 billion in a single quarter.

Medical segment profit increased 38% to $220 million during Q2. This increase was driven by contributions from the patient recovery business, which was partially offset by the performance of Cardinal Health Branded products, including Cordis. Please note segment profit for the quarter includes a $22 million inventory fair value step-up expense related to the patient recovery business.

Excluding this expense, medical segment profit growth versus last year was 52%. I remain close to the integration of patient recovery. I am very happy to report that while still early, this business is performing on plan. Our teams are working very well to ensure a successful on-boarding.

Also, I'd like to call out that Cardinal Health at-Home distribution services and naviHealth all performed very well and were all up double digits in earnings for the quarter. Now, I'd like to mention a few challenges we continue to address. As Mike mentioned, our exam gloves business has continued to see supply disruptions and commodity challenges similar to what we noted on our first quarter call.

Our sourcing and commercial teams are pursuing several projects to minimize the impact from these dynamics. With respect to Cordis, let me provide some additional details around the ongoing performance and overall trajectory of this business. Overall, we are encouraged that in each of the last two quarters, Cordis revenue grew driven by our business outside the U.S. And we are excited to see the acceleration of our product partnership agreements.

As you may recall, these partnerships have grown more slowly than expected. However, we are now seeing improved momentum in both product breadth and financial performance. Notably, as Mike said, we are excited that our partner, Medinol, received FDA approval to launch a new drug-eluting stent in the U.S. market through Cordis distribution.

This is a key addition to our portfolio. While we continue to make progress on the commercial front, the overall earnings performance of Cordis was impacted by inefficiencies in the global supply chain and elevated SG&A outside the U.S. The team is fully focused on these issues and we have implemented robust remediation plans to address both inventory and SG&A challenges. We recognize it will take a little time to work through these items but we are moving expeditiously. The Cordis business remains a top priority for me and for the organization. We

have great leaders in that business who have support from the entire enterprise to put this business on a capital-efficient growth trajectory.

Transitioning back to our Q2 performance, on slide 7, you will see our consolidated GAAP to non-GAAP adjustments for the quarter. A $1.82 variance to non-GAAP diluted EPS was primarily driven by the transitional tax benefit of $2.83 offset by amortization and other acquisition-related costs, impairments, and litigation.

I'd now like to move to the topic of tax reform. I will quickly outline the impact of the U.S. Tax Cuts and Jobs Act on our second quarter and full fiscal year. While we have completed our initial analysis of the tax reform impact, keep in mind that these amounts are provisional and we may require adjustments in future periods.

I think it is helpful to show you the performance for the quarter and the full year with and without the benefit of tax reform. If you look at slide 9, in the first column, we have provided a walk from our second quarter reported non-GAAP EPS of $1.51 to our non-GAAP EPS excluding the impact of tax reform of $1.31.

The 20 cents reflects the benefit of the lower blended federal tax rate applied to our year-to-date U.S. pre-tax income. As a company with a June 30 fiscal year-end, we have a blended U.S. statutory sales tax rate of approximately 28% for fiscal 2018.

Now, let's talk about the total year EPS assumptions in the second column. Our new non-GAAP EPS guidance range is $5.25 to $5.50. The walk to our original full year guidance includes a full-year benefit of 40 cents resulting from tax reform. This reflects the benefit of applying the lower blended sales tax rate of 28% to our full fiscal year forecasted U.S. pre-tax income. Our non-GAAP EPS guidance range excluding the impact of tax reform remains $4.85 to $5.10.

As I noted earlier, there is a benefit of $2.83 resulting from tax reform, which is excluded from our non-GAAP figures. This is the estimated net benefit from both the re-measurement of our deferred tax assets and liabilities, partially offset by the one-time transition tax on accumulated earnings in foreign subsidiaries.

I think it is important to note that there are certain provisions of the new tax law that do not become effective for us until the beginning of our fiscal 2019. Provisions that could be a headwind for us include the elimination or repeal of certain U.S. deductions and the addition of new international provisions. Despite these headwinds, we expect our non-GAAP ETR for fiscal 2019 to be lower than fiscal 2018.

Moving on to slide 10, you can see there are no changes to our fiscal 2018 revenue assumption and we have included the updated non-GAAP EPS guidance range. Now, turning to slide 11, for our full-year corporate assumptions, you will see that we have made three changes. First, given the recent tax reform, we are updating our non-GAAP ETR to a range of 29% to 31%.

This is consistent with what I shared at the J.P. Morgan Healthcare Conference in January. Second, we are revising our full-year share count projection down slightly to a range of 316 million to 317 million shares. And finally, we are updating our acquisition-related intangible amortization to $576 million or $1.16 per share. This is excluded from our non-GAAP EPS.

Our pharma segment assumptions are on the slide 12. We have one change to these assumptions. As you may have seen, we completed the sale of our distribution business in China on February 1 earlier than anticipated. As a result, we estimate a 5 cent per share negative impact to our fiscal 2018 non-GAAP EPS.

As Mike mentioned, we can absorb this in our current guidance. Also as a reminder, the China distribution business reported in both of our segments by contributing more to the pharma segment. Our medical segment assumptions for fiscal 2018 can be found on the slide 13 where we have one update to report. Given the challenges with Cordis and exam gloves that I discussed earlier, we expect the medical segment profit, excluding patient recovery, to be flat to down for this year.

One thing that I'd like to note is that on January 22, the medical device tax was suspended for two years in line with our fiscal 2018 expectations and existing guidance. From a capital allocation perspective, we are continuously looking at the most optimal deployment of capital.

We will review cash benefits from tax reform and the proceeds from the China divestiture through the lens of optimizing sustainable and capital-efficient growth. We are committed to deploying capital in a balanced way through organic growth and differentiated dividend, value-creating M&A and share buybacks.

In closing, we are pleased with our Q2 performance and excited about Cardinal's overall position. We're confident in our ability to execute throughout the remainder of the year. With that, I'd like to open the line and invite your questions.

Operator: Thank you. Ladies and gentlemen if you would like to ask a question today please press star and then 1 on your touch-tone keypad. If you happen to be on a speakerphone, please pick up your handset or do press the mute function so the signal can reach our equipment.

In the interest of time please limit yourself to one question and one follow up question. Again, that is star 1 if you'd like to ask a question. We'll be taking our first question from Eric Percher from Nephron Research.

Clayton Meyers: Hi. Good morning. This is actually Clayton Meyers on for Eric Percher. It's just – a good quarter on the pharmaceutical segment. I just wanted a few questions on that business. Particularly, it sounds to me if I'm reading correctly that you performed better than expected on the buy-side via Red Oak.

And then particularly I'm just wondering as you think about the generic market, if there is a difference in pricing between different generic categories most notably in oral solids and injectables, and maybe that's what we're seeing some noise from the manufacturers over the last couple of months. Thanks.

Mike Kaufmann: Hi, Clayton, thanks a lot for the questions. Yes. Right, I think we had a very good quarter in the pharmaceutical segment, it absolutely exceeded our expectations, and as we mentioned, a lot of it had to do with Red Oak in its performance on the cost side. As I mentioned, the generic deflation is trending basically about where we expected it to be.

As far as your question on solid orals and injectables, yes, the majority of our generics that we sell and when we talk about our higher margin source program are our solid orals. Most of the injectable generics that we sell are through the GPO non-source programs, which are a lower-margin business for us.

So there could be a little bit difference of why you might hear some different messages from pharma manufacturers. But we feel very good about where the pharma segment is, particularly as I mentioned, pharma distribution, but also specialty and nuclear continued to perform well for us.

Clayton Meyers: Great. Thanks. That's very helpful.

Mike Kaufmann: Great. Thanks, Clayton. Next question.

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

Ross Muken: Good morning, guys. So I'm just trying to dig in a bit on the medical side to just sort of understand some of the underlying. The color was helpful. But we've got a euro that's better that should help a number of the businesses and it looked like the inventory step-up was probably a little bit less than what you originally guided, and so those should've been I think a bit of a net benefit.

And so as we're thinking about the headwind, you know, Cordis, you called out but there, you've got a product launch and it seems like that's a pretty good product launch, and that's helpful. So where really is the magnitude, the delta I guess in the traditional business coming from? I'm just trying to tease out some of the parts.

Mike Kaufmann: Yes. Thanks, Ross, for the question. A couple different pieces. The first thing I want to really emphasize, and I'll let Jorge go through some of the details of the moving part, is the overall medical segment is doing very well. That when you take apart the business and take a look at how our post-acute businesses are doing, the at-home and the naviHealth businesses, our services businesses, our product lines, they all are doing really well. So we feel good overall about the segment. But I'll have Jorge talk a little bit about the challenges and see if we can give you maybe just a little bit more color.

Jorge Gomez: Yes. Ross, as we said before, in addition to Cordis, exam gloves is a headwind for us right now. It's been for a quarter or so now and the challenges will continue for a little while. One thing for you to remember also with respect to the core business is that the loss of VA that we had last year. We are still dealing with that headwind.

Beyond that, as Mike said, the other businesses, and I indicated that on my prepared remarks, are doing really well. Your comment about FX, FX is not a headwind for us right now. As you said, it's probably a little bit of a net

benefit. But remember that we have long exposures from a sales perspective but we also buy a lot of products and materials in foreign currency and so that offsets some of the benefit from FX.

Ross Muken: That's helpful. And maybe just a quick clarification on the tax rate. So in the deck, the ETR, you kind of quoted as 29 to 31, and then in the press release we had 28. I'm just trying to understand the difference between the delineation of those two definitions and then really understand kind of what the trajectory is into '19. Because I recall at J.P. you talked about a number of more in the mid-20s.

Jorge Gomez: That's a good question. The 28%, that is the federal corporate tax rate. So that's a clean rate. The 29% to 30% is the effective tax rate, which includes not only the federal corporate tax rate but also all our taxes like state tax and things like that. So there's a little bit more to it on the effective tax rate. So that's the difference between those two.

With respect to the second question about '19, and I indicated that on my prepared remarks as well, we are experiencing a step-down this year is blended given the difference between the first half and the second half of the year. But we also expect a further step-down in '19 as we experienced a whole benefit for the full year of the 28% -- 21% tax rate.

Remember, there's also some provisions that kick in in 2019 that will offset some of the further step-down in 2019. But net-net, you should expect to see our ETR in '19 to be lower than in '18.

Mike Kaufmann: Thanks, Ross.

Operator: We'll take our next question from George Hill with RBC Capital Markets.

Stephen Hagan: Hi. It's Stephen Hagan on for George Hill. So just kind of a housekeeping item on the inventory step-up costs. With the lower impact this quarter, what's the expectation now for the full-year impact?

Jorge Gomez: So Stephen, this quarter, in Q2, was the last time that we had the step-up expense. So going forward, we won't have that effect anymore.

Stephen Hagan: Okay. And then on the pharma segment, what kind of drove the strength this quarter? Was there any pull-forward of future benefit, or was it really mostly the specialty and the other things you pointed out?

Mike Kaufmann: It was really just better than expected results on our generic programs in pharmaceutical distribution and then strength in both our specialty businesses and our nuclear businesses.

Operator: And our next question comes from Lisa Gill with JPMorgan.

Michael Minchak: Thanks and good morning. It's Mike Minchak in for Lisa. I guess first question, in the past, you had talked about 16 cents of investments related to customer initiatives and spending related to opioids. Just wondering if you had any update in terms of that commentary and sort of how much of that ramped in the second quarter and what's the expectation for the full year?

Mike Kaufmann: Yes. Sure. So a couple of pieces. As it relates to the opioids, we started to see some spending in Q2, but it was actually very minor. We took a little bit longer to get that ramped up than we expected. We still expect to spend the full amount that we said we would. So you saw a little bit of a timing benefit in Q2 on not spending it, then you'll see more of a catch-up full spend in Q's 3 and 4. And we actually are starting to see that spend already in January and February. So we feel good now that we're on track to see the spending go the way we

expected it to now for the rest of the year. As far as the customer investments, I still feel like, as you can imagine, we did – they're still included in our outlook for the second half of the year.

So we still are having ongoing conversations with the customers. And as I've mentioned before, I reiterate these are existing customers and these are some strategic initiatives that we're working through with them. And while I was hoping that we might have those finalized by now, I would still – I still feel like we will sometime this quarter.

Michael Minchak: Great. And then as a follow-up, can you talk about utilization and volume trends in the medical segment across both the acute ambulatory and home segments and sort of how we should think about the strong flu season is impacting the results and expectations for the year in both the pharma and medical segments?

Jorge Gomez: Yes. With respect to utilization, that is always a difficult, I guess, metric to track and because it depends on manufacturers. And so for us, the way we think about it is we look at our customer base and how they are doing. And what I can tell you is that our businesses are performing well in terms of sales.

The majority of our customers are growing and they – as you see more consolidation in the medical space, there will always be some winners and some losers. And so utilization for us is a function of that. We see a good growth in our key accounts in the medical front and that's reflected on our revenue growth performance so far.

With respect to the flu season, in December, we saw some activity, and we believe in January, it's picking up a little bit. From a financial standpoint for us, in Q2, flu was not really a driver but we know that over the last few weeks, it's picking up.

Operator: And our next question comes from Ricky Goldwasser with Morgan Stanley.

Liza Garcia: Hi, guys. This is Liza on actually for Ricky. Just a clarification on the tax rate for this quarter. Can you maybe dive into – is this a lower federal tax rate assumed for the December quarter in the 20 cents and also why the 20 cents is outsized relative to the expectations for the next two quarters?

Jorge Gomez: Yes. That's a good question. The way it works is the ETR is a projection for the full year. So the projected ETR is in the 21% to 31% range. So if you pick the midpoint, the first half of the year is adjusted in a way that it's kind of a catch-up entry so that the average for all of the quarters' results in a 30% rate.

The first quarter rate was kind of a typical rate of 36%. And so the entry in Q2 is to average the two quarters such that the average for the entire year is a 30% range that we're talking about. So it's a mathematical adjustment to average the rate for the entire year.

Liza Garcia: Okay. Thank you. I guess I know you've touched on kind of a lower tax rate going into fiscal 2019, but I guess how should we think about that relative to the $5.60 that's been called out?

Mike Kaufmann: Yes. Remember the $5.60 was an early outlook that we gave a while back and we have a lot of moving parts that we're going to be taking a look at. We still feel it's early to really talk about FY19. Clearly, tax rate will be one of the movers that we'll take a look at as we put together our guidance for next year. We're going to continue to take a look at our patient recovery business and how it's doing. So far, it's tracking as we expected it to be, but it's only been a few months, so we're going to want to get a little bit more time under our belt there.

Obviously, the continued impact of the exam gloves, how Cordis is going to ramp up for us next year. And then, we'll take a look at generic programs and the net impact of customer wins and losses. Those are some of the things that we want to still play out for a few more months and another quarter or two.

And then as we have in the past, in August, we'll come out with our guidance for ‘19. Next question.

Operator: Our next question comes from David Larsen with Leerink.

David Larsen: Hi. Can you talk a bit about margin expectations for the medical division? I know that we had talked about with, I think, 5.75% margin long-term at one point. Any thoughts on that? Thanks.

Jorge Gomez: Yes. Thanks, Dave. Yeah. If you look at the margin rate for this quarter, which was about 5.4%, that rate includes actually the inventory step-up expense related to Patient Recovery. So if you adjust for that expense that is not going to happen on the second half of the year. We are very close to the 6% margin rate expectation that we have for the second half of this year.

So we feel good about being on a path to get into those margin rates for medical that we discussed before.

David Larsen: Okay. That's great. And then just any thoughts on commentary from Washington around drug pricing reform, any thoughts on what the administration might do or not and how that could impact the business? Thanks.

Mike Kaufmann: Yes, and thanks a lot for the question, Dave. And just a couple of things about that. When I think about price reform and its impact on us, I'd kind of break it down into generics and branded drugs. And from a generic perspective, I think we can all agree that it tends to be the vast majority of those items are deflating and that they're roughly 90% of prescriptions in the U.S. are generics. And so from a cost effectiveness for the entire healthcare system, generics continue to be very, very cost effective for the system.

So it's hard for me to imagine something in the area of generics that would be materially in the terms of the drug pricing area based on just the overall economics and the trends we're seeing in generics. As far as it goes to the branded side, as we've seen both in our guidance and others is that we're now only expecting to see somewhere in the neighborhood of 7% to 8% inflation from branded drugs.

So the branded manufacturers themselves have cut back significantly on the amount of inflation or price increases that they've had. We continue to see that. And then as you're translate that into how it impacts us, as we mentioned in the past, we expect to be, and from everything we're seeing right now will be more than 90% of our branded margins are going to be non-contingent to inflation.

So if you put that around, less than 10% of our branded margins are contingent to inflation, which again is down to 7% to 8%. So for us, as Cardinal, I think that this is an area that we feel good that we ought to be able to manage through very effectively however it goes in Washington.

Operator: And our next question comes from Charles Rhyee with Cowen.

Charles Rhyee: Yes. Thanks for taking the questions. A lot have been asked but just maybe going back to, on Red Oak. Can you talk about sort of longer-term, when you think about the contribution here, obviously, we're talking about sort of a lower contribution year-over-year expected this year versus last. But as you kind of look at over the next couple of years, we do have some more launches coming.

Can you think about – can you give us a sense on how maybe as we think about 2019, how that contribution could vary as we go forward? Thanks.

Mike Kaufmann: Yes. We're continuing to feel really good about Red Oak. It's not just about the fact that our scale and our ability to source, but that team is just – first of all, it's a great group of folks. They're very strategic. They're constantly thinking about new ways to approach and work with our manufacturing partners, thinking about the pipeline of launches.

So I feel really confident in their ability to continue to give us year-over-year benefit. As I said, it might be a little bit less going forward year-over-year as we continue to work through the items. But anytime we see launches and stuff, I fully expect that Red Oak will put us in the best position possible to compete in the marketplace and have the best cost position.

So continue to feel really good about all the work that they're doing and the benefits that will continue to drive going forward.

Charles Rhyee: Is it fair then as when we just look at the calendar of launches, is that a good proxy then just to think about sort of the incremental change in benefit from Red Oak or do you think we should think about Red Oak continuing to perform maybe better than what the market would look like?

Mike Kaufmann: Yes. It's a great question. There is so many things that go into it. So clearly, the launches are an important piece of it, but each launch is so different. Depending on whether it's a 2-player or a 5-player, whatever number market, the type of drug, how hard it is to make, the timing of the various launches, when other players come out on current drugs that might be 2 or 3-player markets, they get continued competition. So it's hard to really pick any one item and predict it.

And so as we get closer to giving '19 guidance, we'll give you some more color around the benefits that we expect from Red Oak. But whatever the environment is, I expect that we'll be in the best position to compete with just the team we have there. Next question.

Operator: And as a reminder, if you'd like you ask a question please press star 1 at this time. We will move on to Robert Jones from Goldman Sachs.

Robert Jones: Great. Thanks for the questions. Yes, so just I know you've kind of answered this a couple of different ways. I just wanted to go back to make sure I understood the back half of the year. Big beat in the quarter even if I adjust out the benefit for tax from both the quarter and the guidance, and yet it looks like you're really not raising the back half at all.

So I guess the question really is, are you anticipating some areas getting worse? Is there something you have visibility into the back half? I know you mentioned China but that's not all that significant in the grand scheme of what you did in the quarter and then you're not really raising the guidance outside of tax.

Mike Kaufmann: Thanks. I appreciate the question. So let me just give you a few thoughts on that. First, for me right now it just feels a little bit early to be raising guidance. I mentioned there are some small timing type of things that we'll be absorbing like the opioids that I mentioned that had less spend in Q2 and we'll have some more spend in Q3. As Jorge mentioned, we expected Cordis profits to ramp up in our original projections, and those aren't ramping up as quite as well as we would have liked them to. And then also the exam gloves have been somewhat of a challenge and we're still working through our various solutions there. And then as you just

mentioned, we have the 5 cents from China. So you have all those, and then as a positive, as we've said, we feel really good about where the pharma segment's at and that we do continue to expect it to be better than expected.

But at this time, when we take all those puts and takes and put them together, we just feel the right thing to do is just to at this point in time maintain our guidance adjusted for the impact of tax reform.

Robert Jones: Okay. Got it. And I guess just one quick follow-up on medical. And I feel like you do get this question at least the last few quarters, but your largest peer there focused on the acute space continues to struggle quite a bit. And one of the main areas they talk a lot about is a very challenging end-market, yet that doesn't seem to be the case even if we kind of parse out Medtronic and Cordis around what the messages that you're sharing on that core business.

So is there anything, any light you can shed on this for us as far as market share shifts, maybe just a different type of customer mix, because it really has become quite divergent between the message from your core medical business and your largest peer?

Mike Kaufmann: Yes. Thanks for the question on that, too. I appreciate that. I don't want to comment on competitors' actual results. But I will say a few things. First of all, I think there has been some supply disruptions in the market for sure. But those items for us, from a profitability standpoint, have not been that significant of a driver in our Q2.

And while we still see that there'll probably be some supply disruptions in three and four, we also don't expect that to be much of a negative driver for going forward for us. Now, we truly understand how difficult this is on our end-customers, and we know that it is making their lives tough and we are working incredibly hard every day to get after supply and make sure that we are on top of those things.

But as far as the profit driver, it's not big. I think the big difference for us is that we made a decision years ago that we were going to change our value proposition. And that while distribution would always be part of our core and something important for us that we really needed to have a product strategy. And that was going to differentiate us that we could take advantage of those rails going to those customers every single day and that we would be able to then drive our product mix and improve our overall profit.

So I think the real difference here is our value proposition. And we've seen that play out in some of the recent wins over the last year or so. So I think it's really that is the difference on our value prop.

Operator: Our next question comes from Erin Wright with Credit Suisse.

Erin Wright: Hi. Thanks. A quick follow-up on the customer initiatives you mentioned in the previous quarters as well as earlier on the call. I guess given we still don't have so much clarity there, would these expenses get pushed out into fiscal 2019? And can you just give us some greater color on what these initiatives entail? Thanks.

Mike Kaufmann: Thanks. No. We don't expect them to get pushed into '19. The amount that we had set aside and had given some early color on, we still would expect to happen in the second half of our fiscal '18. And as far as more color, I can continue to really only say that it is with existing customers.

It's something that we're working on with them that both sides would really be important long-term valuable opportunities for us. And other than those two things, I really can't speak more about it.

Erin Wright: Okay. Thanks. And on medical, can you speak to some of the broader drivers across international markets? Where did you see sort of pockets of growth on a geographic basis? And I think you briefly mentioned this but what's truly embedded in your guidance as it relates to the foreign exchange impact? Thanks.

Jorge Gomez: Hi Erin, this is Jorge. I'm going to take that question. I would break down the international markets between Cordis and patient recovery. I think for patient recovery, what I would say is right now it's early to tell. We are on track with our deal model with respect to sales expectations in the international markets.

With Cordis, it's a lot easier to see the performance in those markets. And I can tell you that the Cordis business is doing very well in Asia Pacific. We've seen tremendous growth in markets like China. We've seen a good

turnaround of trends in other markets like Japan and we see some growth in places like Korea and Australia-New Zealand. For EMEA, we also see, in certain buckets, a fair amount of growth.

The assumptions that we have with respect to FX in the forecast, we alluded to that before. FX is a little bit of a tailwind for us and that's what we have included in for the balance of the year, but it's not a significant driver.

Operator: And our next question comes from Brian Tanquilut with Jefferies.

Bryan Ross: Hey. This is Bryan Ross on for Brian Tanquilut. Just a quick one on the generic deflation front. I know you've kept the mid-single digit assumption unchanged for the fiscal year. But, I guess, are you seeing anything materially different trend-wise on the buy-side and the sell-side as we've moved into 2018?

And then kind of where do you envision that's going as we get into the back half of the fiscal year in comparison to the first half? Is it still in that mid-single digit range or was the first half slightly more deflationary? And then are there any material contracts, or RFPs, coming up on the sell-side for 2018?

Mike Kaufmann: Yes. Great. Remember, our calculation for generic deflation is a point-to-point calculation. So we basically look at the end of last year and to the end of this year, and we still expect, at that point, to see mid-single digits as our ultimate deflation number. And so we still feel good about that estimate and are trending there as far as we look at our continued trends.

The piece, as I mentioned before, that's doing slightly better which is helping us is on the cost side. So, deflation is tracking about where expect, cost is tracking a little bit better, and that's driving some upside for us in pharmaceutical distribution. And as I mentioned, specialty and nuclear continue to perform better than we expected.

As far as RFPs go, we don't actually really have any large account RFPs that we're renewing in our fiscal ‘18 and those that are out there that are large, actually don't renew until the end of our fiscal ‘19.

Bryan Ross: Got it. Thank you.

Operator: Our next question comes from Eric Coldwell with Baird.

Eric Coldwell: Hey, guys. I tried to back out when all of my topics were covered. So thanks very much. I'm good here.

Mike Kaufmann: All right. Thanks, Eric.

Operator: And we have time for one final question with John Kreger with William Blair.

Courtney Owens: Hi. This is Courtney Owens on for John Kreger. Just a quick question. So can you provide us with just a little bit of an update on naviHealth? I heard you guys say that it performed pretty well during the quarter, but just would like an update kind of on what your expectations for that portion of the business going forward, and kind of what's been like the recent client uptake on that service. Thanks.

Mike Kaufmann: Yes. Thanks for the question. The business – we really are excited about the business itself. It's got a really good team. I think they're on trend. We're continuing to see both providers and payers looking for help in the post-acute space and we think we have a unique model that combines both software and analytics with clinicians to be able to really provide a top-notch service to those customers.

So we continue to feel good about that business. We're making continued investments in that business, because we do see it as a business that we see growing going forward. But other than that I just, again, feel really good about it and feel good about the team.

Courtney Owens: Awesome. Thank you.

Mike Kaufmann: Thank you.

Lisa Capodici: Operator, I think that was the last call?

Operator: Yes, it was. I'd like to turn the conference back over to Mike Kaufmann for any closing remarks.

Mike Kaufmann: Well, again, I want to thank all of you for joining us today. I know you are having a busy day. We really appreciate the questions and we look forward to talking again soon. Have a good morning.

Operator: And once again, ladies and gentlemen, that does conclude today's conference. We appreciate your participation today.