Q3 FY18 Cardinal Health, Inc. Earnings Conference Call

May 3, 2018 8:30AM Eastern

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

Lisa Capodici: Thank you Irena. Good morning and welcome to Cardinal Health's Third 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 the 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 on our website at ir.cardinalhealth.com. During the discussion today, we will reference non-GAAP financial measures. Information about these measures and reconciliation 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 so that we may give everyone in the queue a 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.

Mike will provide an overview of our third quarter performance and discuss some strategic actions we have underway as we plan for fiscal 2019 and beyond. Then, Jorge will provide some additional financial detail and color. And with that I'd like to turn the call over to Mike.

Mike Kaufmann: Thanks Lisa and good morning everyone. I'm glad you could join us. Let me start by saying we recognize that today's results did not meet your expectations or ours. The biggest variable driving these results was some unanticipated disappointing performance from our Cordis business which masked an otherwise better than expected quarter. The quarter's performance not only reduced our non-GAAP operating earnings but more significantly, it created a higher non-GAAP effective tax rate. But for the Cordis tax issues alone, non-GAAP EPS would have been $1.52.

We will walk you through the details. As you'll see on an operating earnings basis, overall results came in largely as expected. In fact, the majority of the business, with Cordis being the notable exception, performed in-line with or above plan highlighted by better than expected results in the pharma segment. Let me start with some overall results then move to segment details. Then I'll give you a broader perspective on our priorities and our plans to optimize our performance going forward and positively impact the trajectory of our business.

Revenue for the third quarter reached $33.6 billion -- up 6% from last year and non-GAAP operating earnings grew 3%. Non-GAAP EPS decreased by 9% to $1.39 for the quarter versus last years $1.53. While Jorge will go into more details, a higher than expected non-GAAP effective tax rate resulted in a 19 cent negative impact to non-GAAP EPS, 13 cents of this was related to the current and forecasted results of Cordis.

Operating cash flow was strong. It exceeded $750 million for the quarter. In addition, we received approximately $850 million in net proceeds from the February 1 divestiture of our China distribution business. In the pharma segment, revenue for the quarter increased nearly 5% to $29.7 billion driven primarily by growth in business with existing customers offset in part by the previously announced loss of our contract with Prime Therapeutics. Segment profit for the quarter was down but less than anticipated, so we were pleased with this performance. Contributing to the results, we saw strong performance from Red Oak, however, it was not enough to offset generic deflation. A strong flu season contributed some upside and brand inflation has tracked generally in-line with our expectations.

Of note this quarter was the renewal of our contract with Optum. We are very pleased that we extended and expanded this important relationship. And our contract now extends through the end of our fiscal year 2024. Optum has been a customer of ours since August 2015 when we signed our first multiyear agreement. We look forward to deepening our relationship with them and pursuing new ways to partner and collaborate. Beyond

Optum, we are excited to have signed some additional new business and completed key renewals with a number of smaller existing customers.

Before I turn to specialty, I want to mention the efforts by the entire industry to combat the abuse of prescription opioid pain medication. As you know we launched our Opioid Action Program last fall. And this quarter, we began distributing Narcan free of charge to more than 40 organizations who are providing the product of first responders and law enforcement. Just last weekend, more than 150 Cardinal Health employees volunteered with our friends at Kroger to staff 105 takeback events in 26 states. And we are continuing to provide grants and support for education and advocacy to prevent misuse and abuse. All of us at Cardinal Health are committed to being at the table. We are continuing to focus significant time and effort to help alleviate this public health crisis that has touched many of us in our communities. On the specialty side, this business continues to exceed our expectations. It delivered double-digit top and bottom line gains reflecting growth with both new and existing customers. Nuclear while not a large contributor also performed well, so overall pharma performance was better than expected.

Turning now to the medical segment, for the quarter the medical segment posted revenue growth of 15% while segment profit increased 34% versus the prior year. Growth was driven by the Patient Recovery acquisition partially offset by the continued challenges at Cordis. We are very pleased that the Patient Recovery business continues on track and we are making good progress on the integration. We are executing on our plan and hitting important milestones as we prepare to transition this business off of the TSAs. Our team is laser focused. And we understand the importance of getting this right. There is a lot of hard work being put in by our integration team and we appreciate their diligence. At Cordis, while we are making progress there is still much work to be done for this business to meet our expectations. We are pleased that year-to-date performance has shown growth on the top line and we are seeing progress in international markets including China where sales are up double digits.

In addition, our introduction of a drug-eluting stent to the offering is going well and the pipeline looks promising. However, as we've noted in previous quarters operating cost and inventory reserves continue to be challenges - both came in even higher than expected this quarter and continue to weigh on profitability. We are moving aggressively to stabilize this business. Jon Giacomin has taken on this challenge in his new capacity of the Medical Segment CEO and he and Pat Holt, Cordis' new leader, have spent the last few months digging into the

business. Together with the Cordis team they are executing on a series of initiatives to improve performance and drive profitability. However, this will take time.

We must not lose sales momentum and we need several tools in place to enable significant progress. For example, the recent launch of our new global supply chain platform will be critical in providing the team with better inventory visibility. It will also provide better insights into demand so we can more effectively and profitably manage this business. In addition to the launch of our supply chain platform, work is underway to help us do four things.

First, we are implementing new process and technology improvements that will better manage our Cordis-consigned inventory. Next, we will refocus the product portfolio to enhance efficiency and profitability. Additionally, we continue to look at ways to reduce the cost structure. And finally, we will enhance our capabilities around demand planning to better ensure we have the right inventory in the right markets to capitalize on sales opportunities and reduce inventory reserves. We expect that Cordis will be on a path to profitable growth by the end of FY19 and remain confident that the business can be a significant tribute – a significant contributor over the longer term.

On a positive note, while the year over year contributions to segment profit growth was relatively smaller, we continue to see strong demand and execution at our At Home, naviHealth and Medical Services businesses. So overall while we continue to work through a couple of challenges, the medical segment had success in many areas and we are confident in it's potential to continue to deliver a differentiated value proposition to customers and contribute as a long term driver of high-margin growth.

Turning now to our outlook, as you've seen from our press release we are forecasting a more modest fourth quarter and Jorge will walk you through the specifics of how we are thinking about the quarter and full year. As we look ahead, we are now anticipating FY19 will be more challenging than previously expected. Well we will still have the tailwinds of Patient Recovery and Red Oak and subsequent U.S. tax reform, we now see significant headwinds including Cordis performance, customer repricings, the loss of PharMerica and continued generic deflation.

Taking into account both the headwinds and the tailwinds, the company should see some modest growth in non-GAAP EPS in FY19 based on the updated FY18 guidance of $4.85 to $4.95. On our August earnings call, we will provide specific FY19 guidance and more detail as we usually do at year end.

Within this context, as we think about the future - FY19 but also longer term - our team is taking a hard and fresh look across the business to determine what the right steps are to drive long term growth for the benefit of our shareholders and other stakeholders. Over the past four months since Jorge and I took on our new roles, our management team has been carefully assessing both where we are and the potential opportunities that we have to best position Cardinal Health in what we know is a rapidly evolving industry landscape.

We know we have terrific opportunities to continue to capitalize on the strengths of our model, the complexity of the supply chain and the stickiness of our customer relationships. While we are in the earliest stages of our work, what I can say is that we are taking a comprehensive and objective look across the business with a view towards better leveraging our unique and broad portfolio of assets to drive profitable future growth.

Among our priorities, we are focused on three key things. Number one, our business mix. We know that we need to have the right composition and balance in our portfolio to fully capitalize on industry tailwinds and opportunities for growth. In addition, we are actively looking at select portions of our business that are poised for outsized growth and focused on scaling our performance in them. We are carefully considering the right investments to achieve both of these objectives.

Number two, our cost structure. Execution is essential to sustainable performance. We are taking a fundamental and in-depth look at the best opportunities to drive efficiency and lower our manufacturing and SG&A cost to improve our ability to compete. Finally, number three, our capital deployment strategy. We are examining how to best utilize our strong financial profile and capital to drive value for our shareholders and other constituents. We are carefully considering how we balance our various short and long term needs.

The entire team is highly energized to advance and implement the right strategy for the future of Cardinal Health. We have an exceptional portfolio of assets, a tremendously talented and dedicated organization and a critical position in the delivery of global healthcare. We look forward to building on this incredibly strong foundation to drive future performance and increase value for our shareholders. We look forward to updating you on our plans

as we update them and develop them further. With that, let me turn it over to Jorge to discuss more detail on the financials.

Jorge Gomez: Thank you Mike. Good morning. As Mike said, we are focused on execution. And we are actively working through our near-term challenges to deliver the results that we all expect. We will achieve this objective by enhancing efficiencies, reducing complexity and cost in a systematic way and ultimately generating sustained growth and delivering value. Today, I will cover three key topics. First, I will review our results for the quarter and give some additional detail by segment. Second, I'll share some thoughts on our outlook for the total year. Finally, I will provide some thoughts on our next steps to build a path for growth.

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 third quarter. Operating earnings was in-line with our expectations this quarter but fell short at the EPS line driven by a substantially higher tax rate. Beginning with total company results diluted EPS for Q3 was $1.39 -- a 9% decrease versus the prior year. This decline was driven by a substantially higher tax rate which I will explain shortly. Revenue increased 6% versus last year totaling $33.6 billion. Total company gross margin dollars were up 11% to $1.9 billion versus the same quarter in the prior year.

Consolidated SG&A increased 18% versus last year in-line with our expectations. This increase was primarily driven by recent acquisitions including Patient Recovery. Consolidated operating earnings was $781 million which represents 3% 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 primarily driven by the interest on the debt issued to finance the Patient Recovery acquisition.

Our Q3 effective tax rate was 37.5%, a five-percentage point increase versus the prior year and about seven percentage points more than what we expected for the quarter. Two primary factors account for this unfavorable variance. First, in the third quarter of fiscal 17, we had several favorable discrete tax items which drove last year's Q3 effective tax rate to an unusually low 32%. Second, in Q3 this year, Cordis performance drove an unexpected reduction to pre-tax income in certain geographies.

This required a year-to-date true up of approximately 13 cents per share relative to our Q2 expectations. Additionally, we booked provision-to-return adjustments of 6 cents that contributed to a higher than anticipated increase in the Q3 effective tax rate. These unfavorable tax adjustments reduced the benefits from U.S. tax reform this year and we now expect our fiscal 18 effective tax rate to be between 32% and 34%.

Third quarter diluted average shares outstanding were approximately 350 million about 2.7 million fewer shares than the third quarter of fiscal 17. During the quarter, we completed share repurchases for a total of $300 million bringing our total fiscal year-to-date repurchases to $450 million. We have about $1 billion remaining under our board approved share repurchase plan. Operating cash flow was very strong for the quarter. It came in ahead of our expectations at $754 million. During the first nine months of the fiscal year, we generated approximately $2.2 billion in operating cash flow. Our cash balance as of March 31, was $2.2 billion with about $600 million held outside the U.S.

I'll now transition to segment performance which you can find starting on slide 5. The pharmaceutical segment delivered strong revenue growth of nearly 5% in Q3. Revenues were $29.7 billion in the quarter. Sales growth was driven by both pharmaceutical and specialty distribution customers, and was partially offset by the previously announced expiration of the Prime Therapeutics contract and the divestiture of the China distribution business.

Segment profit for the quarter decreased 2.5% to $596 million. This reflects the most negative impact from our generics program performance even taking into account the strong flu season. This favorability from the flu season will not continue into Q4. Segment profit for Q3 also reflects a positive contribution from the Specialty Solutions business. As a reminder, the early completion of the China distribution business divestiture on February 1 is reflected in Q3 results and will more significantly impact Q4.

Now, I'll turn to the results of the medical segment on slide 6. Revenue for this segment grew 15% in the quarter to $3.9 billion primarily driven by the Patient Recovery acquisition. Medical segment profit increased 34% to $199 million during Q3. This increase was driven by contributions from Patient Recovery and was offset by lower than then anticipated performance primarily in Cordis, and to a lesser extent, other Cardinal Health Branded products.

Patient Recovery continues to perform in line with our expectations. As Mike said, our teams are making good progress in preparation for the TSA exits that begin this summer. Other areas of the medical segment performed

well in the quarter. We saw a nice growth in Cardinal Health at Home, Lab and services. Also, our strategic accounts were up for the quarter.

As we discussed on our last call, we continue to face challenges in the medical segment mostly with Cordis. We are working through the headwinds in the Cordis business. We've seen revenue growth year-to-date, primarily driven by our business outside the U.S. particularly in China where we saw double-digit revenue growth. On the operations front, we're actively working to position Cordis on a path toward growth. We have implemented several supply chain work streams to enhance our global demand planning capabilities and consignment processes.

As part of this initiative, we implemented new ERP functionality which allowed us in Q3 to identify inventory positions in certain geographies that require higher inventory reserves. This new functionality gives us greater market visibility and will help us continue to use complexity in our global supply chain. The weaker than expected Cordis performance and higher inventory reserves, are major contributors to a higher than anticipated tax rate for the current quarter and full year. Though we are actively deploying operational improvement efforts, it will take time to yield the results we expect.

Now, I will transition to GAAP to non-GAAP adjustments for the quarter which you can find on slide 7. The 58-cent variance to non-GAAP diluted EPS was primarily driven by amortization and our acquisition-related costs. Next, I'd like to discuss our guidance for this year found on slide 9. Based on Q3 results and expectations for the fourth quarter, we have revised our full year guidance to a range of $4.85 to $4.95 from a previous range of $5.25 to $5.50. This revision is primarily driven by Cordis operating performance and its corresponding impact to the tax rate that I mentioned earlier.

For our full year corporate assumptions found on slide 10, you will see that we have several changes. First, based on my earlier commentary on the tax rate we now expect the full year tax rate to be between 32% and 34%. We are reviewing options to address the Cordis-related tax rate increase that we are seeing in the second half and mitigate this negative impact in the future. We have revised our diluted shares outstanding to a range of 315 to 316 million shares. We expect our interest and our expense to be between $330 and $350 million. We also expect our capital expenditures to be between $400 and $430 million. Lastly, we are updating our acquisition related intangible amortization to $575 million.

Our pharma segment assumptions are on slide 11, where we have three changes. We now expect our full year segment profit to be down to a range of high-single to low-double digits. This is an improvement from our previous assumption of down low-double digits. Also, we now expect to see mid-to-high single digit deflation in generic drug prices and better than expected incremental contribution from Red Oak Sourcing. While generic deflation is slightly higher than our original expectations, we've seen moderation in deflation versus last year and sequentially. Keep in mind our generic deflation assumption is a point-to-point calculation from June to June.

Our medical segment assumptions are on slide 12 where we have two updates. First, we now expect medical segment profit to be down high teens for the year, excluding Patient Recovery. This reduction reflects business dynamics that I discussed earlier, specifically related to the challenges we continue to address in the Cordis business, and to a lesser extent, in other Cardinal Health Branded products including exam gloves. Second, we will not achieve the 6% margin rate in the second half of fiscal 18, again primarily due to Cordis performance. Now, let me share a few additional thoughts that I think can be useful to help you understand the remainder of the year.

As you know, we had about 8 cents in our second half for customer initiatives. As Mike mentioned, we extended and expanded our relationship with Optum which represents about half of our planned customer initiatives for fiscal 18. In addition, we discussed on our Q2 call that the China distribution business divestiture will be a loss of 5 cents for the full year, mostly in pharma. Also, we anticipate that the operational challenges with Cordis will continue through Q4 and fiscal 19.

In closing, we're focused on creating a path toward growth in fiscal 19 and we are committed to developing and implementing a strategy that will position Cardinal Health for long-term success. To that end, as Mike mentioned earlier, we are proceeding with a detailed operational review, which will include growth and efficiency initiatives as well as portfolio optimization and capital allocation. We will share more about this in August. With that I'd like to open the line and invite your questions.

Lisa Capodici: Operator?

Operator: Thank you. If you'd like to ask a question, at this time, please signal by pressing star 1 on your telephone keypad. Again, please press star 1 to ask a question and please limit your questions to one and one follow-up. We'll take our first question from Ross Muken in Evercore. Please go ahead.

Ross Muken: Hi. Good morning guys, obviously, a lot on the update. Can you just help us, you know, in terms of interpreting kind of what we should learn from 4Q in that 4Q guide about 2019? I know you probably don't want to go too much detail on '19 but, you know, Mike you sort of laid out some of the headwinds or incremental headwinds the business is facing, but obviously, some of those are occurring in the quarter and then some things may not continue in the future and obviously a huge swing factor is the tax rate. So, can you just help us understand sort of in that 4Q run rate kind of as we lift off relative to what you've talked about at least qualitatively kind of what's already captured, what's not captured, what are the other things we should be considering and then anything you can give us on the tax rate would be helpful.

Mike Kaufmann: Hey thanks for the question Ross, a lot of pieces there. And as you said at the beginning we're going to really be limited here because we really want to take some time and continue our analysis and update folks at the time of our year-end, you know, guidance and at that time. So right now, all I can say is, as you kind of talked about them as you can imagine we see some tailwinds from things like tax reform in Red Oak but the – some of the other items that you mentioned around repricings and other pieces are going to be some headwinds for us. So right now the, what we can provide you is and we just again want to be helpful at this time is that we would expect to see modest growth off of the $4.85 to $4.95 guidance that we gave you. And we plan to come back with a lot more detail and thoughts around that in August.

Ross Muken: And maybe just Mike just I realize just maybe on the tax rate because that is so sensitive, can you help us understand a bit better kind of what's, what are the key drivers we have to look for that's causing that to be above what one would expect an effective rate to be in kind of the new tax reform environment and then what the path is

back to a more normalized rate longer-term because I'm assuming a north of 30 rate is probably not where the business ends up, you know, on a very long-term basis?

Jorge Gomez: Ross, this is Jorge. I'll take that question. You know, with respect to the issue that we're facing, you know, in simple terms the downturn in the quarter's performance results created certain losses in certain jurisdictions where we cannot take the benefit of those operating losses from a tax perspective. Obviously, we are reviewing multiple options available to address the, to your question the going forward impact and we expect to be in a position to take action within the next few months. I think overall the impact from U.S. tax reform will continue to benefit us and we expect to see a decline or a tax break going forward. The exact impact from the dynamic that we have going on right now is something that we will be, we are evaluating and we address, we are finding options to address that long-term.

Mike Kaufmann: And if you remember last time on the call we also mentioned that with U.S. tax reform, the positives of it because we're June 30 year-end we had the six months' worth of that. But as we mentioned before we wouldn't be able to see those benefits double in our FY19 because some of the other components of the Tax Reform Act that have a negative impact on us don't actually kick in until our FY19 and that we said we would still be evaluating those and we're still at that point because there's still some clarity being given on those items and so we're still working through those. Again, we said that U.S. tax reform would still be a net positive for us in '19 but because some of those negative items don't kick in until July 1 we're still evaluating those too.

Lisa Capodici: Operator next question.

Operator: Next question is from Glen Santangelo with Deutsche Bank.

Glen Santangelo: Yes thanks and good morning. Mike I just wanted to follow-up on some of the comments that you made with respect to the new management and sort of working with the board to take a comprehensive look across the businesses of, and I know you probably don't want to go into too much detail there but I'm trying to get a better sense, are you assessing whether you think that you need to add more pieces to try to make what you have work a little bit better or are you trying to more signal that maybe you need to do a full-blown evaluation of all, everything you do have and maybe start considering shedding some pieces? So, any additional elaboration there would be helpful.

Mike Kaufmann: Yes thank you, actually don't see it is either one of those. First of all I think, you know, the change in management for us where we really feel lucky that we were able to take Jon Giacomin who has a tremendous track record as our leader on our pharmaceutical segment and someone I've worked with a long time and actually has a lot of knowledge of the medical business based on some of his prior history within Cardinal or outside of Cardinal and within Cardinal. So, Jon has been moved over to the CEO of the segment and he'll bring a very disciplined and focused approach to what all we're doing there. And then we changed out the leader of the Cordis business with someone who was actually running our Asia Pac business within Cordis which was doing incredibly well. And he's a very seasoned leader, knowledgeable to the business, has a good track record with the business and is a guy that we have a lot of faith in. So as far as leadership changes we've made those two initially and we'll continue to add some talent in the medical segment in some areas that we think could be beneficial.

We actually feel really good about our portfolio in medical. What we're disappointed on is really just our execution in a few areas, again particularly and primarily related to Cordis. So, I don't really see an absolute need to add pieces. I think in the future we still completely believe in the strategy of having a product business on top of a distribution business. And after we get a chance to absorb the Patient Recovery acquisition and the, get the Cordis business back on a growth trajectory we'll continue to look at more pieces but I don't think we need to have those. And at this point time we're always going to be evaluating our entire portfolio but there is nothing sticking out to me that there's something that we need to shed in order to be able to operate effectively going forward.

Glen Santangelo: Okay thanks for that. And maybe just one quick follow-up on generic pricing. I mean it felt like through the winter months maybe we were starting to see some of that generic price deflation abate somewhat. Now you're kind of signaling maybe it's getting a little bit worse. And so, could you maybe just give us a sense for maybe what we saw through the winter months and what we're seeing now and do you expect that this is going to translate into any additional sell side pricing pressure? And I guess I'm kind of curious also why do you guys disclose so much about generic pricing? Aren't you just signaling to your customers that they should be asking for greater discounts?

Mike Kaufmann: Yes I think, you know, look we always have to balance what we try to disclose to be helpful to you guys is well as what's a competitive situation. But what we're really saying is we're not at all saying that we think it's deteriorating. In fact, what we're seeing is that it is moderating from last year and sequentially from the last quarter. So, all we're saying is that originally when we looked at our point to point number we expect it to finish in the mid-single digits down from point to point. And as we look at it we think it might be slightly worse than that from that point to point but still better sequentially and versus the prior year. And so, we continue to see it moderate. So, we aren't seeing, and I wouldn't characterize it as seeing it more aggressive necessary pricing in the market. We just didn't, it's just not moderating as much as we originally thought it might. Next question please.

Operator: Next question from Michael Cherny with Bank of America Merrill Lynch.

Michael Cherny: Good morning team and thanks for all the color so far. I just wanted to follow-up on the customer repricing commentary you had relative to '19. You mentioned the Optum expansion, some of the customer initiatives. As you think about heading into '19 and the moving pieces of your business is Optum the only pressure you see relative to customer repricing or how do you think about the rest of the business in terms of what could pressure into '19, you know, broadly speaking? I don't know if you can give an exact number but just maybe have some qualitative comments about how you see that shaking out over the next year?

Mike Kaufmann: Yes obviously, we can't go into any customer details but I'll try to be helpful here. Optum is clearly one of them and Optum is one of our largest customers and we're excited to renew and expand our relationship with them. We also have repriced some of our other customers during this year, and so we actually as you can imagine from our budget process role in the impact year over year for that. And as we look out at our contract expirations over the next 12 to 18 months we also take a look at those to understand the timing of when some of those customers may reprice and build all of that in. So, that's what we take into account to do that and we do expect that to be something that we have a larger maybe portion than normal to do next year and that's why those customer repricings are significant for us.

Michael Cherny: Got it. I'll jump back into the queue. Thanks.

Mike Kaufmann: Thanks Michael.

Lisa Capodici: Operator?

Operator: Next question from Robert Jones with Goldman Sachs

Robert Jones: Great. Hey thanks for the question. Yes Mike just want to get a little bit of a better understanding of the size and scope of the Cordis issue., You know, obviously there's been several revisions along the way around the business. You guys have given a lot of commentary this morning on it but if I just look at the performance in medical in the quarter I'm curious if Cordis is actually profitable today as we look at 3Q? And then you talked about getting back to profitable growth by the end of fiscal 19. I'm just wondering if you could share some more specificity around what steps you need to take in order to get the business back to profitable growth by the end of next fiscal year?

Mike Kaufmann: Yes thanks, a couple things. First of all, I would say inventory reserves are one of the biggest issues were having. As we came off the TSAs and have been working through this our ability to be able to understand all of the demand signals, roll those demand signals up, turn those into manufacturing plans and then correspondingly having visibility to both the consigned inventory as well as our own inventory across our network on Cordis particularly outside the U.S. -- it's obviously much easier for us in the U.S. -- but outside the U.S. has been much more difficult than we expected it to be.

As we said in prior quarters we said we would be rolling out some IT projects and solutions. We rolled one of those out in this past quarter which started giving us more visibility to our inventory and as you might expect as we roll that out that visibility pointed out to us that we had some inventory that needed to be reserved against due to excess amounts in certain parts of the world.

So, that drove some inventory write-offs that we had and we're going to be rolling out some further detail IT systems to give us more clarity. And so, we believe that we're going to be working through some challenges in getting our inventory at the right levels in the right spots in order to – and that's probably going to create - has and probably will create some inventory reserve challenges. Second of all, when you don't have as good of demand signals it's hard to run your manufacturing plants as efficiently as you would like to. And so, that's been a challenge for us on our cost side. And so, as we get better visibility into that we'll be able to do the types of things we need to do in our manufacturing plants to reduce cost.

And lastly setting up the ex-U.S. or OUS cost structure related to the commercial organization and the other pieces has been more costly than we anticipated. And we so far have been erring to doing everything we need to do to support our sales team so we don't have any impact on our topline. And that has caused us to have more expenses than we expected to, again particularly outside the U.S. were 70% of Cordis' business are. So, those are the big things that are causing it. And as you can imagine we have work plans on each one of those to get after those in order to get us back on track for profitable growth at the end of '19.

Robert Jones: Now I appreciate all that Mike. And then just one quick follow-up on your repricing comments as a headwind to '19 I'm just wondering is that kind of normal course of business as you, you know, re-up important customers like Optum or is that something incremental to what you've been seeing in the market?

Mike Kaufmann: Yes, I would say it's more normal course of business. You know, we operate in a very competitive environment and while we have great relationships with our customers, you know, they're always looking for us to be able to provide some additional value to them but this is nothing where we're seeing necessarily different pricing in the market or competitive nature than we have in the past. We just have a large share of repricings ahead of us in '19 that we're going to need to work through. Next question please?

Operator: Next question from Charles Rhyee with Cowen.

Charles Rhyee: Yes, hey guys, thanks for taking the questions. Mike, you know, sorry to stay on the medical topic here but, you know, last quarter you guys actually posted a really good result in medical and, you know, if we backed up the inventory step up charge it would have been even better. You know, can you give a sort of a contrast and compare like, you know, what changed, you know, really in the last three months that – because it seemed like, you know, last quarter things were actually going in the right direction. Maybe you can give us a sense on, you know, what reversed so much from last quarter to this one?

Mike Kaufmann: Yes, it's really Cordis is by far the biggest component of it. It is again some - we rolled out that inventory system during late in the quarter. And as we rolled up and took a look at our inventory really for the first time to be able to see it a lot more clearly across the globe it created a large inventory write-off in the quarter that was a significant hit to our operating earnings in medical. Exam gloves also continues to be a challenge in the quarter.

But that was the biggest one with the Cordis write-off. Then as part of your work what you have to do is you then have to relook at your forecast for Cordis. And what happens is when you take a look at the inventory write-offs

we've had the performance of the business as I mentioned, the various components and you forecast where you're going to be for the year as Jorge gave some color on it changed where we believe our income was going to be in various jurisdictions and that caused us to have to go back and restate what we expect the tax impact would be on Cordis. I know that's below the line but that was what drove the tax component that also had the impact on EPS that we mentioned.

Charles Rhyee: I see so just to be clear here what you're saying is that, you know, if you had this inventory system in place a quarter earlier we might have seen some of this – these effects earlier than now?

Mike Kaufmann: Oh absolutely. Had we had it in place we probably would have seen some write-off at that time but it's again hard to know. You do the best you can with the visibility you had. It rolled off. But when the system rolled on we got better visibility, we were able to assess in a better way what our inventory situation needed to be from reserves.

Charles Rhyee: Okay great. Thank you.

Mike Kaufmann: Next question please.

Operator: Comes from Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yes hi, good morning. You know, I have a couple of questions on the drug distribution side. So, you talk about better results in distribution. And I know that you highlighted specialty in Red Oak. But it seems there are some conflicting remarks. So, if you think about Red Oak you talked about the fact that it was a headwind to operating income in the quarter. And then you also said that performance from Red Oak then is not enough to

offset deflation. So, can you give a little bit kind of a context? Is it that just price deflation from manufacturers is picking up and you are not able to garner the same pricing power over them through the purchasing consortium? And then secondly, what does that mean to sell side pricing? Does this mean that we are seeing more price concessions that you need to give to your independent customers?

Mike Kaufmann: So thanks for the question Ricky. I'm not sure how – as far as the comment around Red Oak being a headwind. Red Oak was absolutely not a headwind at all. Red Oak has been and continues to be a tailwind for us. And we feel actually absolutely great about Red Oak. We think they continue to perform better than anyone in the market.

We like our model. We like where we're going. We like our talent -- no issues at all with Red Oak, continues to be a tailwind. What I was trying to indicate was that the generic deflation within the quarter was more than the over performance of Red Oak. And so just to tie that piece out and so in total what we're saying that we're not seeing anything really different in the marketplace from pricing pressures from our customers or from competitors. So, we don't see the environment being different than we had been expecting it to be other then we just looked at where we actually thought we'd finish at June 30.

And when we were looking at that we thought that we might not be, you know, we said we'd be down mid-single digits and we think we might be somewhere between mid-single and high-single digits, but again still better sequentially and better than last year on where generic deflation is. So, my summary would be Red Oak's still a tailwind, generic deflation is moderating. It's just that Red Oak is not enough itself in order to offset what we saw for generic deflation in the quarter.

Ricky Goldwasser: Okay. And if we step back and we think about what do you think the sustainable growth rate is for the drug distribution business?

Mike Kaufmann: Yes at this point in time, you know, we'll take a look at that and give some more color when we, with our '18 guidance. We still have a lot of work that we're - or I'm sorry '19 guidance. We still have a lot of work to do to

understand all the various components of both of the pharma and medical segment. And we'll do that and give more color in August.

Lisa Capodici: Operator next question.

Operator: It comes from Lisa Gill with JP Morgan.

Lisa Gill: Thanks very much and good morning. Mike just I want to come back to Cordis just one last time strategically. So, when we think about Cordis and the asset that it is can you help me to understand why it's important to the portfolio when we think about cross sell? I know there's a lot of sales outside the U.S. Is this your anchor to build out your medical supply business outside the U.S.? I just really want to understand – I understand the commitment that you're making to, you know, try to rebuild this business and everything that it's going to take on your side but I just want to understand the strategic rationale for doing so.

Mike Kaufmann: No thanks, good question and I appreciate it Lisa. I think you hit it pretty well there in the fact that when we first bought Cordis again we think that it fits within our ability to bundle and work with our customers to bring a total package of products that our value proposition can help them have equal or better products at lower cost. So, we think it fits well within our overall product offering, the customers in the U.S. And then externally it really helped us got a, get a base of being able to grow and sell our products outside the United States. By being 70% of its volume outside the U.S., what that did is cost us to be able to and begin to build an ex-US infrastructure. Granted that building of that infrastructure has been more expensive than we thought. It hasn't gone as well as we thought so we're clearly disappointed and absolutely we'll own up to that.

But we learned a lot from doing that and, you know, we were able to set up third-party logistics companies, set up HR processes and all those things. And we've been using that in order to put on top of that the Patient Recovery business that is outside the United States. And so, we're able to leverage off of that as well as some other moves

that we've made to take back some of our other products outside the U.S. that we were going to others to be able to sell that so we can offer a lot more robust product offering outside of the United States. So, I think that's a good piece of our strategy and why we still feel that's a good fit for us.

Lisa Gill: And so as you evaluate that I mean so it's been a couple of years since you bought Cordis almost a year for Patient Recovery. What's your timeline where you say yes this is - obviously, I mean if we see the numbers turn around then it's a yes, it's working. But do you also have a timeline of you know what maybe this isn't this strategy that makes sense for us. Maybe we should stay, you know, more so in the U.S. and think about maybe divesting things rather than investing in them? I, you know, I think that's the big question for a lot of us is just to understand your process how you're thinking about this and what the timeline is for those types of evaluations.

Mike Kaufmann: Yes, fair question. You know, that's – it's hard to put a specific timeline on that. It's something that we are clearly doing. I think there's various degrees too. There's also being outside the U.S. in 60 countries. Are you outside the U.S. in 30 or 40 countries? So, I don't think it's necessarily all in of whether you want to be outside of the U.S. are not. It would be hard for me to imagine at this point in time not wanting to be outside the U.S. with our significant breadth of products many of which in our Patient Recovery business as well as Cordis we think can compete effectively outside the United States.

But whether or not we need to have the breadth of 60 or 70 countries or not that's something we are absolutely looking at at this point in time right now and whether each and every country is where we need to be. So, we're going to continue to evaluate that portfolio but feel that we have some really great products that we think can help people outside the United States as well as in the United States. Next question.

Lisa Capodici: Operator?

Operator: Erin Wright with Credit Suisse.

Erin Wright: Great thanks. I guess beyond Cordis, can you give us an update on the Medtronic kind of integration process here? And can you speak to maybe some of the other businesses as well within the segment and naviHealth for instance and the prospects there? And then I'm curious how core is the exam glove business to your Cordis business overall? Thanks.

Mike Kaufmann: Great. So, a couple things there, just the last piece, the exam glove business would not be tied at all to the Cordis piece. That is just a large volume commodity type of a product that I think every distributor has to have access to and have a private label offering on in order to have a low-cost alternative for it. So, I just think that's one of those staple products that everybody needs to have to be a product company and distribution company. And it's just that with the limits on availability for the product and some commodity challenges it's creating some headwind right now as I've mentioned in the past because we have a lot of downstream fixed contracts that we're working through.

As far as Patient Recovery the Medtronic acquisition of the Patient Recovery business that continues to go well. We continue to hit our milestones. One of the things that we've done and that Jon was able to do with his leadership is he was able to tap back into the pharma side and bring over some excellent talent from the pharma side to help join the team on medical. And so, Jon has done a nice job of taking a look at where we could use some various folks, bring some people over that are experts in areas like inventory management, data management -- things like that to help the team. And of course, we operate as one Cardinal Health and so the pharma team's happy to contribute whatever resources we can in order to get it right.

So far that acquisition is going well. We begin to roll off of some of the TSAs in our mid to late summer. And that will be a kind of a new big checkpoint for us to make sure that goes well. But so far, we still are feeling like we're on track and hitting the milestones that we have.

As far as the other businesses that you may have mentioned we're seeing really strong demand for naviHealth and our at Home business and particularly are two that we feel really good about. We continue to see the trend of care moving more towards the home. Both of those businesses compete in that space and both are we believe best in class in that space. And so, we're seeing a lot of demand not only for just core every day services that

they offer but for folks that want to partner with them in various unique ways in order to drive volume. So, we feel really good about both of those businesses as well as our portfolio of medical services businesses, freight management and others that we have that we're also seeing very nice performance from.

Lisa Capodici: Operator?

Erin Wright: Right and then could I just ask a quick one on the CAPEX? Does it step down and for the year I guess should we expect a meaningful step up capital expenditures in fiscal 19? Thanks.

Mike Kaufmann: You know, at this point in time that's something that as Jorge and I look at all of our cap, all of our, you know, spends of capital that CAPEX we're always going to want to make sure that we're investing appropriately in the business but at the same time being very careful because we know what that creates in the future. And so, this was more of just us over the last 60 days or so evaluating what was out there and also reprioritizing some of our focus and bandwidth on other projects that just then we didn't need to spend some of the capital that we had previously anticipated to spend. Next question.

Erin Wright: Okay great thank you.

Operator: Next question is from David Larsen with Leerink.

David Larsen: Hi. Can you talk a bit about the inventory management system that the Medtronic Patient Recovery business is on? Like what is your level of visibility into those products and, you know, are we at risk of seeing a similar situation with that business line similar to what we're seeing with Cordis now? Thanks.

Mike Kaufmann: Yes first of all the – a couple things. The Patient Recovery business remember is more 75% in the U.S., much smaller volumes outside the U.S. So, that's the first thing to know. And it's actually, you know, just coming into our warehouses as part of our everyday offering. And so, from an inventory visibility standpoint very little concern on Patient Recovery. Second thing related to Patient Recovery and our other medical products they're not consigned inventory type of items. And so, that creates a different level of inventory visibility challenges that we don't have in Patient Recovery.

As far as Cordis goes I would say that, you know, we still have additional levels of inventory visibility that we would like to see but we are going to – we feel a lot better where we are today as you could imagine by having the visibility that we got. The biggest area of challenge that we have is not so much in our own systems to seeing inventory visibility, it's in our consigned inventory. And so, that's really where we have to take it to the next level is around the consigned inventory to get better visibility there to make sure we don't have any additional write-off concerns in that part.

One other thing I would say too is that back to the Patient Recovery in general those don't – those products don't have expiration dates where the Cordis products do have expiration dates. And that's what's creating some of the inventory challenges. It's not just that you have over inventory potentially but if you have some that are expiring you're going to need to reserve those.

David Larsen: Okay and that's helpful thank you. And then for the 16 cents of client investments that you've been planning on and opioids for fiscal 18 have those occurred yet or not? Will they occur in 4Q or will they push into fiscal 19? And then are those recurring in nature, like will we see those continue indefinitely? Thanks.

Jorge Gomez: Dave I'll take that question. So, for – as we indicated before in the second half of fiscal 18 we accounted for about 8 cents related to customer investment. And with the Optum repricing, with the Optum extension we have utilized probably half of that, most of it in Q4. We continue to look at other opportunities to expand relationships in other – with other customers. And as it relates to how we should think about that going forward I

think Mike alluded to our expectations going forward especially in '19 as it relates to the normal cycle of renewals of certain customers in '19.

Mike Kaufmann: And as far as the rest of the 16 cents the other 8 cents, the tax component we talked about that part has basically been spent. And then the piece of Opioid as we said would be moved back into our second half, so we saw some spend in Q3 and would expect the rest of the spend to happen in Q4. So really the vast majority of the 16 cents did get spent – will get spent this year other than a portion of the customer initiatives.

Lisa Capodici: Operator?

Operator: Next question from John Kreger with William Blair.

Courtney Owens: Hi. This is Courtney Owens on for John Kerger. So I noticed, I know that you just called out kind of like some of the differences from like an inventory perspective between Patient Recovery and Cordis. But just kind of outside of that we're just trying to see like kind of what's significantly different about the Patient Recovery business in the sense that like what have you learned since your integration of Cordis to kind of avoid some of the issues that you're seeing with Cordis right now as it relates to the Patient Recovery business. Thanks.

Mike Kaufmann: Yes, a couple things. Again, back to the inventory, this nature of having inventory with expiration dates. The fact that it's consigned inventory in Cordis versus not consigned in Patient Recovery. I think the – we clearly underestimated the needs and requirements of being able to have inventory visibility at a deeper level than we anticipate or understood that we would have through that process. So, while that's a learning for us in Cordis it's not a big deal as we said for Patient Recovery because it's not as much U.S. and it doesn't have – or it's not as much outside the U.S. and it doesn't have expiration dates. So, after learning I would say that's not one that's a hugely valuable one to us for Patient Recovery.

I think the areas where we really had some learnings was around estimating what our cost structure would be. You know, when we came out with Cordis early in our quarters and recently have been saying that we underestimated what our cost would be to stand up the ex-U.S. infrastructure and to work through all of that. And we knew that going in the Patient Recovery which we've now had since, you know, end of July of this past year. And so, when we estimated our costs we were much more realistic about setting those up and understanding what it would be to do that. So, I think that's probably the biggest one is understanding what it would take to do it. The good news too is by already having established relationships with third-party logistics companies setting up some of the infrastructure again outside of the U.S. we were able to leverage that same infrastructure. And so, some of the learnings around how to contract and what we need from those service providers also was helpful.

Courtney Owens: Got it, thank you.

Lisa Capodici: Operator next question.

Operator: Next question from George Hill with RBC.

George Hill: Hey, good morning guys and thanks for taking the questions. First, it's kind of a housekeeping question for Jorge. With the Optum renewal is there a prior period adjustment kind of for like retroactive it impacts Q4 that artificially weighs on results?

Jorge Gomez: No. No there is no retroactive adjustment there. We just signed the agreement and it, you know, the accounting and the economic impact is all perspective.

George Hill: Okay. And then like I guess I'm going to hit Cordis one more time. If you kind of bucket the three challenges, one I'll call operational, two I'll call competitive, three I'll call kind of end market challenges as we looked out to '19, I guess can you kind of rank order the challenges? It sounds like most of them are operational which you guys should be able to fix. I guess I would just ask you to address the other two because we've talked a lot about the inventory systems. I guess talk about the market and talk about competitive as it relates to the outlook for that business?

Mike Kaufmann: Yes it's, you know, obviously is a competitive marketplace – but we feel good about our ability to compete in the marketplace. And then one of the things that we're doing that I think is helping our competitiveness in the marketplace besides some of the great work Jon and team are doing around the commercial structure, our ability to bundle with other products, our ability in training with our sales reps is also by adding to the portfolio. So, we have more in the bag.

And as I mentioned our addition of the drug-eluting stent has been an important component of our commercial competitive ability to compete going forward. And we feel really good about the quality and the acceptance of that stent and expect that to be something that we would see growing going forward. And we're actively working with other players out there to look at other products that we can add to our bag in a very capital efficient way by partnering with folks to bring them in. So, I like our competitive positioning and, you know, part of where that's indicative is that this is a business that historically had not grown in a long, long time. And so far, year-to-date we are seeing growth year over year in our topline.

So, where I get encouraged is we're seeing a top line that is while we still think there's opportunities to grow more and do some things we're seeing it actually grow year over year which is different than history. We're seeing a bag that's expanding. We just haven't been able to turn it through to a drop through to the bottom line because of the inventory reserves and the operational issues that we have. So, for me clearly it's the operational issues that are the biggest concern. And I think we have the right folks and the right plans in place. It's going to take some time because we don't want to do anything rash in order to – that would, you know, hurt our momentum on the top line but the team is very focused with detailed work plans, metrics and timelines to get after getting this business back on track.

George Hill: Okay. And if I could just maybe sneak in a third one real quick for Jorge? Jorge just kind of what volume levels do we need to see in generics given the – the depreciation that we're seeing in generics? What kind of volume growth do we need to see to grow EBIT in that segment? Thanks.

Jorge Gomez: Well, you know, that is a level of detail that we, you know, we normally don't get into. And as you – as we have discussed a number of times there is a lot of variables that come together to generate growth when you think about ASP units, Red Oak. So, we look at the totality of those variables when we try to estimate the growth. So, there is multiple combinations of all those variables that result in your growth or decline.

Mike Kaufmann: Next question please.

Operator: Comes from Brian Tanquilut with Jeffries.

Brian Tanquilut: Hey morning guys, just a quick question, as we think about generic pricing and your qualitative comments about FY19 EPS I mean what are your views on, you know, or thoughts and where that trends or what assumption are you making as you've made those comments on EPS growth? And also, how would you characterize generic inflation expectations today versus 2016 calendar?

Mike Kaufmann: Yes, I'll take a stab at that. I think a couple things. We're not ready to give any specifics around '19 at this time and where we would expect it to be. You know, right now we would assume it would be continue to see deflation but at what level it's still something we're evaluating. Again, what I can emphasize is that what we've seen versus last year and what we've seen sequentially we have seen generic deflation moderating. But as Jorge said not only within generics do you have to understand all the various components but when you're repricing and thinking through deals with customers you have all of the components to take into account which would be branded mix, generic mix, specialty mix and all of those as we reprice.

And so, I think one of the things that we need to do and we are continuing to do is assess the overall on all the buckets within our customer go to market strategies and pricing in order to manage our profitability appropriately going forward and drive growth.

Brian Tanquilut: Hey Mike just a follow-up to that, as we think about your repricing's are you seeing any ability to increase compliance, rate requirements or what kind of leverage do you have in these contract negotiations with your price?

Mike Kaufmann: Yes it really depends on the customer. As you know some customers are already buying 100% of their product from us and so it's obviously been hard to take that up above that. But we do have other customers that aren't buying all the generics from us. And as you can imagine anytime we go to work with a customer we look at all of the components that they could buy from us including consumer health, brand and generics and look to partner with them so that if they would like to see a price decrease what can they give us in terms of additional volume that might help offset some of the impact that we feel? So, we continue to see that as an opportunity for us to penetrate not only in generics but in other areas like consumer health. We'll continue to push on that. And I would say in typically in most contracts on renewals we do tend to see improved penetration of generics. And oftentimes private label and other products.

Lisa Capodici: Operator next question.

Operator: Comes from Eric Percher with Nephron Research.

Eric Percher: Thank you. I may stay on generics because I have a feeling the stocks will react to the commentary today. I want to make sure I understand. There was a comment that there is a negative impact from the generic program performance. I know later you said that your expectation was for substantial improvement. You didn't quite see

that but you did see improvement this year. I know you also said that Red Oak was strong. So, I just want to come back to that simple comment about negative impact from generic program performance and was that just relative to your expectation for the year?

Mike Kaufmann: Yes that was relative to our expectation for the year that when we put together what we are seeing in generic deflation which as you said was, you know, moderating but not moderating quite as much as we expected Red Oak's over performance then in all the combination of wins, losses, penetration, etc generic launches when we put that all together the net impact of that is that our generic programs was net negative but again still better than we expected it to be.

Lisa Capodici: Operator we have time for one more question.

Operator: Our last question comes from Steven Valiquette with Barclays.

Steven Valiquette: Hi, thanks. Good morning Mike and Jorge. My line dropped earlier so thanks for fitting me back in here. Just on the topic around the FY18 guidance around generic price deflation, obviously, your guidance is sell side based if we do focus on the buy side generic pricing for a moment. Is there any update on the whole discussion around the generic manufacturer portfolio rationalization and whether that's creating any changes in the pricing trend so far in calendar 2018? Thanks.

Mike Kaufmann: Yes, I wouldn't say that we've seen any material impact yet from that. We have as you can imagine the Red Oak team leads all of those discussions for us, and again, glad we have such a talented group up there to be able to do that for us. They constantly are working with manufacturers and we want to work with manufacturers. And we understand some may need or want to, you know, discontinue certain lines.

We work with them on the timing and at the same time knowing that we're focused on getting the best everyday cost possible we'll look for other folks to maybe put them back into those products if we need to in order to make sure we're maintaining the cost. So, at this point in time I would say we're not really seeing any material impact. And going forward I feel like with Red Oak both its talent and its game plan we feel like we're positioned well to compete in an environment and be – and still be effective at getting after cost even as manufacturers look at reducing their overall product lines.

Steven Valiquette: Okay. So, it sounds like if deflation is moderating. That's not really the driver of it. It's basically other factors within the overall generic portfolio?

Mike Kaufmann: I think from us it's the deflation component again goes back to the sell side so that's more based on the competitive environment. As far as Red Oak being able to get after cost and find better cost for us it's not seems so far impacting their ability to go continue to lower and drive lower cost for us. Thanks for the question.

All right so I just want to thank everybody for taking the time to get on the call today. I know we gave you a lot of information today to digest. We hope you found it helpful and Jorge and I and the IR team look forward to talking to many of you today and over the next coming days. Take care everybody.

Operator: Thank you. And this will conclude today's conference call. Thank you for your participation. Ladies and gentlemen, you may now disconnect.