Q1 FY19 Cardinal Health, Inc. Earnings Conference Call

November 8, 2018 8:30AM Eastern

Operator: Good day everyone and welcome to the Cardinal Health Inc. First Quarter Fiscal Year 2019 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to your host, Lisa Capodici. Please go ahead.

Lisa Capodici: Thank you, Lynette. Good morning and welcome to Cardinal Health's First Quarter Fiscal 2019 Earnings Call. I am joined today by our CEO, Mike Kaufmann and Chief Financial Officer, Jorge Gomez.

During the call, we will provide details on our first quarter results, full year outlook and an update on our strategic initiatives. You can find today's press release and presentation on the IR section of our website at ir.cardinalhealth.com.

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 these risks and uncertainties.

During the discussion today, our comments will be on a non-GAAP basis unless they are specifically called out as GAAP. Our GAAP to non-GAAP reconciliations for the first quarter can be found in the schedules attached to our press release.

In addition, during the call we will provide an update to our FY19 outlook on a non-GAAP basis. We do not provide guidance on a GAAP basis due to the difficulty in predicting items that we exclude from our non-GAAP earnings per share and non-GAAP effective tax rate.

During the Q&A portion of today's call, we ask that you limit your questions to one, with one follow-up 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.

I will now turn the call over to Mike.

Mike Kaufmann: Thanks Lisa. And good morning everyone. I am glad you could join us.

As Lisa mentioned, I'll open up with some comments on our first quarter of fiscal 2019 and then provide a brief update on the six strategic initiatives we have underway to best position Cardinal Health for future growth. I am proud of the hard work our team is doing and we are on track as we execute on these initiatives.

The first quarter provided us with a solid start to the year. Non-GAAP EPS came in at $1.29 -- up from the $1.09 we reported in the first quarter last year. Revenue for the quarter grew 8% to $35 billion.

Non-GAAP operating earnings for the quarter were $542 million. And operating cash flow was $365 million. Overall, operating performance came in about as expected.

On the bottom line, we saw a large benefit from a lower tax rate. This was composed of the expected benefit from tax reform and roughly 18 cents of discrete benefits that Jorge will discuss in more detail. Based on our current assumptions, we are reaffirming our previous earnings guidance for the full year.

Turning to the pharma segment, let me share a few comments. On the top line, we are pleased with the revenue growth of nearly 9%. This increase was driven primarily by growth from existing customers. I believe that we are well aligned with customers who are growing, and this is being reflected in our increased volume.

As it relates to segment earnings, the primary reason for the year over year decline is the previously communicated performance of our generic programs. Of note, we continue to be very pleased with the performance of our specialty business, which once again delivered outstanding results.

Looking ahead, as we focus on driving the profitability and long-term growth of the pharma segment, we are pleased to welcome Victor Crawford, who will join us as CEO of the pharma segment beginning November 12.

Victor is a proven leader with a strong track record at world class companies, including Marriott, Pepsi and most recently Aramark. He brings a wealth of knowledge and strong strategic relationships with many of our partners in the acute care space and serves on the advisory board of a large acute care hospital.

Victor knows what it takes to successfully manage a high volume, low margin distribution and services business. And he inherits a very experienced team of leaders in a business that is well positioned with strong fundamentals. We look forward to benefitting from his experience and insight as he takes on his new role.

Turning now to the medical segment. Overall, medical delivered profit growth of 5% on revenue growth of 2%. Let me touch on a few highlights.

Patient recovery continues to perform well. And the integration of this business is on track. We are seeing solid progress on selling our expanded offering and leveraging the Patient Recovery teams category management skills across our portfolio.

At Cordis, we continue to generate sales growth during this quarter, particularly in Asia. And we are making good progress in addressing the cost and inventory challenges we have experienced. Both our national brand distribution business and our services business continue to do very well, driven by solid demand for both.

And finally, Cardinal Health at Home delivered a strong first quarter, continuing its success in a growing market. Headwinds for the quarter were the expected impact of the China divestiture, and reduced contribution from naviHealth following our divestiture as a result of our partnership with Clayton, Dubilier & Rice. In addition, we experienced product cost increases in a few areas in our Cardinal Health brand, which reduced margins.

So, all in all, while we still have work to do in the medical segment, I am pleased that we are moving in the right direction. Importantly, we are growing in key areas of the business while taking steps to address other areas where we have had some challenges.

No doubt our expanded product breadth has provided us with new opportunities to enhance our value to customers and patients. And we are focused on taking advantage of this potential to drive long-term, profitable growth.

On our last call, we shared with you six strategic priorities that our team is laser-focused on in fiscal 2019: cost structure, Cordis, Patient Recovery, the pharma model, our business portfolio, and capital deployment. We are making good progress in each of these areas. Let me touch on a few highlights, and Jorge will provide further detail in the course of his financial review.

In terms of cost, we are on track to deliver targeted annualized cost savings of $100 million in fiscal 2019 and in excess of $200 million by the end of fiscal year ’20. And we continue to take a hard look at how we can operate even more efficiently.

At Cordis, our stabilization program is on track. The team has made meaningful progress and we are seeing improvements in inventory management, demand planning and cost.

At the same time, the team is taking steps to optimize Cordis’ product offering and global footprint to drive higher profitability. We remain confident that Cordis will be on a path to profitable growth by the end of fiscal year ’19.

With respect to Patient Recovery, we exited our TSAs with Medtronic for North America, Latin America and the global supply chain in late July. In addition, we exited the TSAs for the Europe, Middle East and Africa regions in late October. So far, while still early, things are going according to plan.

We appreciate the hard work of our team in meeting these important milestones. We intend to exit the remaining TSAs in Asia-Pacific in early calendar 2019. At the same time, the team is keenly focused on continuing our momentum in the business of the business.

As it relates to our pharma model, we are continuing conversations with both our upstream manufacturer and downstream provider partners. We are discussing the industry dynamics that are impacting each of us and evaluating new models where appropriate.

For example, we continue to push for differentiated pricing models with providers and less contingent margins with manufacturers. With respect to our portfolio, we have made some progress, including the exit of our China business early in the calendar year in our naviHealth partnership. We continue to actively assess the scope and mix of our businesses consistent with our overall objective of focusing on where we can win and driving long-term profitable growth.

And finally, regarding capital deployment, we are reinvesting in our business to drive future growth as well as returning cash to our shareholders. Jorge will discuss our balanced and disciplined approach in more detail.

All in all, we are very pleased that we are making significant strides in all of our initiatives and we look forward to building on this progress over the balance of fiscal year 2019. In closing, I want to thank all of our employees for their hard work in getting fiscal year 2019 off to a good start.

And as I've said before, everything is on the table when it comes to delivering long-term growth, enhancing shareholder returns and serving our customers and their patients. Our team is moving with a sense of urgency and we are focused on achieving the goals we set in the months and the years ahead.

With that, let me turn it over to Jorge to discuss our financials, provide additional detail on our strategic initiatives and comment on our outlook for the balance of the year. Jorge?

Jorge Gomez: Thank you, Mike. And thank you all for joining us. This morning, I will cover our Q1 results, elaborate on our full-year outlook and share some detail on a few of the key initiatives that Mike mentioned.

Starting with our first quarter results on Slide 4, overall, these results were in line with our operating performance expectations apart from the tax rate, which was better than expected this quarter. I will discuss this shortly.

Total company revenue increased 8% versus prior year to $35 billion. This increase was driven by growth from pharmaceutical distribution and specialty solutions customers. Total company gross margin was essentially flat at about 1.7 billion.

GAAP operating earnings for the quarter were $816 million, which includes a pre-tax book gain on the sale of naviHealth of $508 million. Non-GAAP operating earnings were $542 million. Our Non-GAAP EPS for the quarter was $1.29 -- an 18% increase from the prior year.

Our Q1 effective tax rate of 14% was lower than expected due to favorable discrete items of approximately 18 cents. This is included in our Q1 EPS of $1.29. These discrete items include primarily the continued work to alleviate the tax rate pressure created by Cordis' financial performance in certain jurisdictions. We completed the majority of this work in Q1 as we anticipated and shared with you last quarter.

For Q1, SG&A increased 6%, primarily due to opioid-related expenses and a onetime stamp duty incurred in Switzerland related to international legal entity changes for Cordis. These changes were a key driver for the more favorable tax rate in Q1. I will discuss the opioid-related expenses when I cover the pharma segment results.

Shifting to our cost optimization initiatives that we introduced last quarter, we are making strong progress and seeing results. Our initial labor savings and positive changes took effect in late August and early September.

And we achieved the savings milestones we set for Q1. The benefits from this and additional actions will continue to ramp up throughout the year. I'd like to be clear. This is not a traditional cost reduction exercise.

We are looking at our enterprise with fresh eyes. We are taking a holistic approach to create a sustainable operating structure supported by meticulous cost management. As Mike has said, everything is on the table. I will cover more about this work to drive long-term growth when I revisit our full year assumptions.

Returning to our overall results for the quarter, interest and other expense were about $80 million. It's likely to increase versus the prior year, driven by a lower debt balance. Q1 average diluted shares outstanding were approximately 306 million -- about 12 million fewer shares than Q1 of last year. Recently, we completed a $600 million share repurchase program. We included both the amount and the timing of this program in our fiscal '19 assumptions.

Yesterday, our board approved a $1 billion increase to our share repurchase program. We now have $1.3 billion remaining under a share repurchase authorization. Separately, our board approved our quarterly dividend, which will be payable to shareholders on January 15, 2019.

As we mentioned last quarter, we remain committed to thoughtful capital deployment, which includes delivering a strong cash flow yield to our shareholders through share buybacks and dividends. Our continued focus on cash flow generation and diligent working capital management resulted in Q1 operating cash flow of $365 million.

We ended Q1 with a strong cash balance of $2 billion, even after funding a large share repurchase program, dividends and capital expenditures. This cash balance includes approximately $600 million held outside the US.

Now, I'll turn to segment results, starting on Slide 5. Pharmaceutical segment revenue increased 9%, to $31.4 billion -- driven by sales growth from pharmaceutical distribution and specialty customers. This increase was partially offset by the divesture of our China distribution business.

Segment profit for Q1 was $409 million versus $467 million in the prior year. As anticipated, this decrease was driven by the negative impact from our generic programs, contract renewals and the divestiture of the China distribution business.

Partially offsetting these headwinds were strong results from our specialty solutions business. As Mike said, we are very pleased with the performance of specialty. It continues to be a contributor to growth through higher volume and better mix. Let me elaborate on the opioid-related expenses I mentioned earlier that are included in our pharma SG&A for the first quarter and whole year.

First, as you may remember, last quarter, I mentioned the potential impact of the New York Opioid Stewardship Act, which created an aggregate annual assessment on all manufacturers and distributors who sell or distribute certain controlled substances in New York State.

This assessment is retroactive to calendar year '17. We recently received a preliminary invoice for calendar '17.

Based on this estimate, we accrued $34 million for the amount owed through Q1 of fiscal ’19. Of this number, $29 million is excluded from non-GAAP results because it relates to the catch-up accrual for sales in periods prior to fiscal ’19. And the remaining $5 million relates to our first quarter this year.

Our pharma segment profit outlook for the year now reflects our current view of this assessment’s impact going forward. This matter is complex and there are a few things to keep in mind.

First, the State of New York has indicated that the preliminary invoice amounts for calendar ’17 may change significantly.

Second, this newly adopted law is currently being challenged in court. As we monitor both of these factors, we are actively exploring a number of mitigation plans.

Also included in our opioid-related expenses are the cost associated with litigation and multiple legal cases where Cardinal Health is a party with our distributors, pharmaceutical manufacturers and retail pharmacy chains. This legal cost has exceeded our initial expectations and are included in our pharma segment results, as well as in our fiscal ’19 outlook.

Excluding the $29 million accrued for prior periods, we expect our total expenses in fiscal ’19 for both the New York assessment and the ongoing litigation to be about $80 million. We will continue to share more information as it becomes available.

Continuing with the medical segment, revenue grew 2% to $3.8 billion. This top line growth was driven primarily by contributions from new and existing customers. We saw strong growth in national brand distribution, Cardinal Health at Home and services.

First quarter segment profit increased 5%, to $135 million. As a reminder, in Q1 of fiscal ’18, our results included an inventory step-up charge of $42 million for patient recovery.

This quarter, the non-repeat of that charge was mostly offset by increased costs related to Cardinal Health brand products, including Cordis.

The net impact of acquisitions and divestitures -- excluding the effect of the step-up – did not fully impact segment profit in the quarter. As a reminder, after the close of our partnership, our share of naviHealth is reflected in other income and expense rather than in the medical segment.

Regarding Patient Recovery -- as Mike shared -- we are pleased with the performance of the business and the progress on the integration. In late July, we exited the TSA for North America, Latin America and global supply chain, which accounts for the majority of the overall business. We successfully worked through a few of the typical bumps seen in large integrations.

Additionally, while still early, we are pleased with the progress on the second wave of TSA exits completed in October, which include geographies in EMEA. Overall, the Patient Recovery business is performing as expected. We are on track to achieve the accretion goal we shared previously.

For Cordis, we saw topline growth in Q1, particularly in Asia-Pacific. And we continue to see the commercial health of this business improve.

We mentioned last quarter that our team is executing a multifaceted strategy to stabilize this business. This includes category optimization and geography rationalization. We successfully transitioned manufacturing lines and exited 14 countries based on profit profiles. This work will allow us to focus on the major and growing markets for this business.

We are seeing positive metric trends including improved fill rate, increased service levels and lower backorder rates. Overall, we have greatly increased our demand planning capabilities and inventory visibility, and this business continues to stabilize.

Next, I'd like to direct you to our full year assumptions on slides 8 and 9. We are on track to finish fiscal '19 as we indicated in August.

With only one quarter completed, at this time, we have no changes to our corporate or segment assumptions for the year. Current industry and business dynamics for the rest of the year will continue to evolve. We are weighing the potential impact of several factors, such as brand inflation as well as the generic deflation trends.

In addition, we are looking at other factors including the final true of of our provisional tax estimate under tax reform, the value capture of our cost and structural initiatives and the net impact of changes within the businesses of a few of our pharma customers.

We expect our second quarter to reflect many of these elements. We continue to see good topline growth for the pharma segment and a strong performance at the top and bottom line for our specialty solutions business. This has been offset by some headwinds I discussed earlier, as well as the renewal of options.

Our second quarter and full year results would also reflect the year over year impact of dispositions. Given all the considerations above, we expect Q2 operating earnings performance for the company to be somewhat in line with the performance in our first quarter.

We will meet and likely exceed both of the savings estimates we shared with you in August. We are realizing near-term improvements that will drive us toward and beyond the $100 million of annualized savings for fiscal ’19 and likely increase the aggregate $200 million in savings by fiscal ’20.

In parallel with this savings capture, we’re implementing strategies that will empower all of our employees to practice sustainable, diligent cost management well into the future. At the same time, we are actively evaluating strategies to leverage new ideas, tools and technologies to simplify our internal operations and drive efficiencies across the enterprise.

This includes opportunities to optimize resources, infrastructure and geographies. We are developing large scale roadmaps for this work. And we are rapidly entering the execution phase for certain workstreams. We will share more progress as this work continues.

These approaches will allow us to substantially improve our cost structure and efficiently modernize our internal operating model to fuel thoughful growth as we adapt to a rapidly changing industry. In light of all of these initiatives and factors I just discussed, we are not changing our full year guidance at this time.

In closing, we are pleased that the performance in Q1 aligned with our expectations. We are also pleased with the momentum we have gained regarding the numerous initiatives in flight that are squarely addressing the key opportunities and challenges on our horizon.

We are laser-focused on creating sustainable growth and delivering value for our shareholders, customers and partners. With that, I'd like to open the line and invite your questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing Star 1 on your telephone keypad.

We do ask that you please limit yourself to one question and one follow-up to allow everyone an opportunity to ask a question. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment.

Again, that is the Star key followed by the digit 1 to ask a question or if you have a comment. We'll pause for just a moment. We do have several callers in the queue. Again, that is the Star key followed by the digit 1.

We'll hear first from Robert Jones from Goldman Sachs. Please go ahead.

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

You know, Mike, I guess we don't spend a lot of time typically talking about revenue. But the top line, you know, in the pharma segment drew significantly and was obviously well above what we were anticipating in the quarter. And yet, as you guys mentioned, it didn't really have the same incremental or commensurate impact on the operating profit for the segment.

So, I was hoping maybe you could just go back and spend a little time helping us better understand the dynamic at play there. Just what, you know, is driving what seems to be well above average topline grown and maybe not seeing the flow through on the operating profit side within the pharma segment.

Mike Kaufmann: Yes, thanks for the question. Appreciate it.

It was strong revenue growth in the quarter. And as I mentioned, it was really because we're aligned with -- I think -- some very strong growing customers. So, it really wasn't materially new business. It was really coming from existing customers who had strong, you know, revenue growth in the first quarter.

And as Jorge said with several things, it's just a little bit too early for us to be looking at these as trends because we know there's some upcoming headwinds when some things were lapping as we, you know, build into our plan.

So, at this point in time, we're pleased with the first quarter, but again, a little bit too early for us to call it out as a trend. But we'll continue to evaluate that.

Robert Jones: And then I guess, Mike, just the follow-up there, you know, embedded in that was just, you know, why not the commensurate kind of impact on operating profit?

You know, obviously you're aligning yourselves with these customers that are driving significant or above average topline growth but yet, you know, not really necessarily seeing that carry through to the profit side. Any further explanation just on that dynamic?

Mike Kaufmann: Yes, I think it's -- we obviously did see some drop through from it. It's coming from larger customers that are going to be lower margin rate customers. So that's one thing to keep in mind.

A lot of it is going to be on lower margin branded business because it's, you know, the higher dollars. And so, that doesn't have as high a margin rate.

And as Jorge said, there's some other puts and takes in the quarter such as extra opioid spend and a few other things that are all kind of netting out. So, we did see some drop through but there's several different puts and takes in the quarter. Thanks for the question.

Operator: We'll move next to Charles Rhyee from Cowen.

Charles Rhyee: Yes, hey, thanks for taking the question. Hey, I just wanted to get a couple clarifications.

Jorge, you know, in regard to tax rate when you talked about legal entity changes, could you clarify, like, what does that mean? Are we kind of consolidating sort of the global footprint for Cordis and rationalizing that?

And then you also talked about the increased cost rate of Cardinal Health brands including Cordis. Is that related to commodities? If you could just give us some more details around that, that would be great. Thanks.

Jorge Gomez: Sure. On the first question about tax and Cordis, if you recall back in Q3 our tax rate was - Q3 of last year, our tax rate was very high as a result of some issues that we experienced with international legal entities reported and how the profitability was looking at that time.

We took pretty decisive action at that point and we began a process to restructure the legal entities that basically are the basis for the business of quotas outside the US. We began the first set of execution of steps in Q4. And as you may recall, we had actually a very favorable tax rate in Q4 of last year. And that was the result of the first steps that were executed.

At that point, I also indicated that we had not finalized that project, that we would finalize it in Q1, which in fact we did. And as we completed the final steps in that restructuring, we also experienced some further discrete items that benefited the rate in Q1.

So, that process related to restructuring those legal entities is now finalized and we basically went back to the place we wanted to be to structure the legal entities outside the US. So that's what happened there.

With respect to Cardinal costs, there is a few things going on. And as you probably have heard from others, there is some substantial increases in market cost of commodities and other supplies in that business. So that has created some cost pressure.

We also had in the quarter some elevated costs related to TSA-related expenses -- the exits from the TSAs with Medtronic. Some global supply chain costs and FX was a slight headwind in the quarter net-net for the medical segment as well.

And then finally, I'd say as it relates to cost within Cordis, we have talked about this a couple times but there is in manufacturing we have some headwinds.

Primarily manufacturing absorption costs. As we have indicated before, we have a very good plan to bring inventory balances for Cordis down to levels that we think are sustainable and reasonable for this business.

And as a result of that, production levels have come down, have slowed down. And that creates an accounting impact related to absorption that is reflected as a headwind from a cost perspective in that business.

Charles Rhyee: Okay, if I could follow-up, is that to continue through the rest of the year? So, when we think about modeling out Cordis, because you talked about greater than expected savings and obviously you had better tax this quarter but were reaffirming guidance.

Should we think about then the difference would be more just a flow through on the Cordis side here through the rest of the year?

Jorge Gomez: Yes, I think we're thinking about this cost pressure…Not only related to Cordis but commodities and other parts of our cost basis within medical. That will continue over the next few quarters.

There are issues around nitrile prices and other commodity prices. We are doing a lot of things to manage that exposure. We hedge where we can. We're managing inventory levels. We are trying to use pricing as possible to offset some of those pressures.

But we expect that it will continue over several quarters. But again, all of those cost pressures are captured within our assessment of our guidance for this year. So, all of that is contemplated and it will be a headwind but it's included in our guidance.

Operator: We'll move next to Ricky Goldwasser from Morgan Stanley.

Ricky Goldwasser: Yes, good morning. Thanks for taking my question.

Jorge, one question of clarification. When you talked about next quarter, were you referring to EPS enterprise operating profits or a specific segment?

Jorge Gomez: My comment about Q2 was enterprise level first. And I said that we expect the performance in this quarter -- in Q2 -- to be in line with Q1 from an operating earnings perspective. That was my comment.

From an EPS perspective, there is a - the tax rate is something that, as we have indicated before, it can fluctuate from quarter to quarter. But, you know, overall, for the year, we still think the tax rate is going to be very close to within the range that we talked about before.

So, operating performance in Q2, we believe sequentially is going to be very similar.

Ricky Goldwasser: So, and should we think about it in an absolute dollar value, I.E. the opearting earning number that you reported in the quarter?

Jorge Gomez: Correct.

Ricky Goldwasser: Oh, okay. Thank you. And then, Mike, you talked about a potential new payment model -- as did your peers on their calls.

How should we think about the potential transition to a model where rates are determined product by product or by product class? Should we think about this type of changes happen upon contract renewal or is this something that's going to happen all at once?

If you can give us some color there and your thoughts about the time it's going to take to make that transition?

Mike Kaufmann: Yes, so, since I'm not 100% sure whether you're referring to upstream or downstream I'll just address both to be helpful.

Downstream-wise, as we've said in the past, we continue to evaluate our pricing models to make sure that we are looking at the various product classes and pricing them appropriately.

So, basically, while we will always continue to bundle price to some degree on the pharma side, we're trying to break that bundle down as appropriate to drive the right behaviors and protect us from margin erosion and make sure that contracts going forward are both getting paid appropriately and the mix changes don't impact us as much going forward.

And so, we're working and continuing to do that. I know you've heard us and many others talk about things like specialty in those. We're continuing to just refine that pricing model downstream.

Second thing is if you go upstream, it would depend on the manufacturer. You know, I'm very comfortable with the current model priced on black, like it is with the DSAs, you know, as long as we're being paid appropriately and the dynamics work as they're supposed to.

The area where we're most likely to change our pricing models upstream is in the contingent margin agreements with manufacturers, is if the manufacturers are going to have lower price increases or different price increases than expected per what we calculated to be our fair payment, then we're going to have to adjust those models.

And we're constantly having conversations with those manufacturers to make sure not only this year we'll be paid appropriately but going forward that those deals reflect the proper value of what we provide to them.

Thank you. Next question.

Operator: We'll hear next from Steven Valiquette from Barclays.

Steven Valiquette: Well thanks, good morning Mike and Jorge. So, just another question on the commodity costs on the medical business.

You know, I guess in your 10K you guys help us out. You gave the math on the hypothetical 10% inflation on your 425 million direct exposure. And just back of the envelope calculations, seems like that would be about maybe a ten cent EPS impact.

But I guess I'm curious to hear, you know, more color on what you're seeing on the actual inflation trends in the real world right now, on this, you know, key basket of inputs so far in this fiscal year, whether that's trending, you know, below 10%, above 10%.

Just any color on that might help since it's hard for us to know all the inputs in that particular component. Thanks.

Jorge Gomez: Thanks, Steve. Thanks for the question.

Yes, it's hard to give, like, an overall inflation rate for the entire basket of commodities because of timing issues and all the actions that we take. And so, it's hard to give an overall number. But I would say that the inflation pressures on those items are high.

And we're working really, really hard to minimize the impact. But it's something that in the last several months has increased substantially. But as I said before based on our projections, when we look at each of the products and the projections for the rest of the year, we believe that based on the forward curves that we see of inflation for those products, we can certainly manage that within the guidance for this year.

Steve Valiquette: The only real quick follow-up is just if you have a one-liner on, you sort of changed talking about the direct and indirect impact. Now you started to just talk about the direct impact, you know, in that 10K discussion.

Is there any quick color on the thought pattern on the change there?

Jorge Gomez: Yes, so, clearly, we are exposed to both, you know, direct inflation on the products that we buy to make our products. But we also have the exposure related to finished products that we buy.

So, the best example is exam gloves which has experienced a lot of inflation in the last several quarters. First, due to supply disruptions and now it's more about the actual cost of the raw materials.

So, we track both. Obviously, the direct exposure is easier to hedge and to manage. The indirect exposure, we try to handle through contract negotiations, inventory levels and other operational actions.

Lisa Capodici: Operator, next question.

Operator: We'll move next to Ross Muken from Evercore ISI.

Ross Muken: Good morning guys. You know, could we talk a little bit about, sort of the underlying medical trend? Because if I adjust for the 42 million from the prior year, the implied on the base is obviously pretty negative.

And I know we've talked about Cordis and some of the input costs. But I'm just trying to understand more the magnitude of how we're going to get from, you know, what looks like down in sort of double digits underlying right now back to kind of growth and what are sort of the biggest buckets of that driver.

I know you've called a few things out but I'm just trying to understand magnitudally what the biggest pushes on that to get particularly to the back-half numbers given what you said already about Q2.

Mike Kaufmann: Yes, thanks for the question. I'll let Jorge go through the details.

I just want to say though we are very excited about the way Patient Recovery is going so far off of the TSAs. And we are seeing very good performance there and making some good progress. But there are some puts and takes that I think would be helpful that Jorge will give you a bit more color.

Jorge Gomez: Yes, Ross the first thing I would say is, so we have been very transparent about the performance of the medical segment. And excluding patient recovery, the step-up.

We are down in the quarter for the medical segment. Mechanically, if you remember first you need to deduct naviHealth and China. So, those are two elements that deduct from the growth in the quarter.

Then we have several businesses within medical that are actually performing really well. I mentioned at home, services, those businesses are growing. And so, as you think about the rest of the year and the ramp, we believe and we are forecasting those businesses to help the next several quarters from a growth perspective.

When we go down to Cordis, Cordis from its topline perspective has grown for the last few quarters. And we are expecting and we are seeing that all the actions that we are taking in that business will contribute over time -- over the next several quarters -- to ramp the earnings up of the medical business.

Patient Recovery, Mike mentioned this before, is performing as expected. Progressing well the integration. And as I said before, we feel very comfortable with respect to meeting the accretion goals that we talked about in the past.

We have the challenges from a cost perspective and I mentioned commodities. I mentioned supply chain cost. Net-net including all the puts and takes, we are comfortable with the trajectory of the medical segment this year.

And we think it will continue to ramp to get to deliver the numbers that we indicated in our guidance -- the growth rate that we presented for the medical segment. We feel good about that despite the cost challenges that we saw in Q1.

Ross Muken: And just sort of to follow-up, you know, relative to your comment on sort of Q2 being flat on an operating earnings basis, you know, if I look back historically at Cardinal that wouldn't be sort of an unusual outcome.

You know, in prior years flat, probably up modestly in Q2 was fairly typical. But last year, you know, partially given the full onboarding of Patient Recovery and maybe a little bit less of the inventory, you had a much bigger sequential step-up. And so, the street was sort of looking for that this year.

I guess if I think about that flat, you know, kind of guide for Q2 or color, you know, am I to think that most of that, you know, sort of comment or the delta is probably on the medical side or is it also contemplating the pricing reset from United, which seems to be happening next quarter. I'm just trying to get magnitude where the street in your mind was probably most off.

Jorge Gomez: Well, what I can tell you Ross, is sequentially, if I look at the magnitude of the earnings and the puts and takes from what is seasonal, what is not seasonal from Q4 to Q1 to Q2. We are not seeing anything that I would call out as special that could yield a result that was not based on our expectations.

So, we see the trend from Q1 to Q2. When I look at all the puts and takes from quarter to quarter, I don't see anything that is unusual from an operating earnings perspective.

It's kind of in line with our expectations, with the trends, with the progressions that we are seeing for each of the business. Including obviously the headwinds that we indicated we would have this year, including the headwinds related to generic deflation, customer contract renewals, those type of things.

So, all things considered, everything we've shared with you guys and what we see in terms of drivers of the business, there is nothing unusual there from Q1 to Q2 that we would highlight.

Lisa Capodici: Operator, next question.

Operator: We'll hear next from Michael Cherny from Bank of America Merrill Lynch. Please go ahead, sir.

Michael Cherny: Good morning and that's for the question. I apologize for this.

Maybe it's a fuzzy line, maybe whatever it is. I just want to make sure as clear as possible becase I know a bunch of questions have been coming in to me. Q1 to Q2, this is dollars that are similar, not growth rate on EBIT, enterprise EBIT?

Jorge Gomez: Correct.

Michael Cherny: Okay. If that's the case, when you think about the - into the back half of the year. I know you reiterated guidance. In terms of that delta, what is the biggest thing in your mind either across medical, across pharma or across corporate that really gets better?

Especially because I know there are some concerns as we start into fiscal '19, that there might be a lower branded price inflation than we've seen given all the political rhetoric that's going on.

Mike Kaufmann: So, I'll mention a few things. Then, Jorge, if I miss anything.

You know, first of all, remember, Q3 is always - our Q3 is always seasonally high. And at this point in time, we are still expecting the amount of branded inflation that we essentially originally forecasted or budgeted for the year in Q3.

And we have had a lot of conversations with the manufacturers that are contingent and still continue to believe that that is the right assumption. We've said that if we're off by a couple percentage points, that could be absorbed within our guidance range.

But at this point in time, we are still assuming that based on conversations that we're having and compared to what we plan to have. So, remember that Q3 tends to be bigger.

The second thing is we are ramping up our cost initiatives. And so, those grow and create benefits for us over the rest of the year. And then we have some other initiatives that we continue to work on.

And I don't know, Jorge, if you would add anything else to that?

Jorge Gomez: No, I think, Mike, you've covered all the key points there.

Mike Kaufmann: Good.

Michael Cherny: Thank you so much.

Operator: We'll hear next from Erin Wright from Credit Suisse.

Erin Wright: Great, thanks. Can you detail a little bit more on where you are at in the progress of your cost structure initiatives? What are those next steps?

Maybe that helps us reconcile with that quarterly progression a little bit more in terms of how that or when that will materialize more meaningfully here. And given you mentioned that could exceed your initial expectations, are those higher expectations embedded in your 2019 assumptions? Thanks.

Jorge Gomez: Yes, thanks Erin. So, we indicated that we are targeting to achieve this year annualized cost savings of about $100 million. Those savings actually began to accrue in Q1.

We implemented some labor initiatives as well as spending policy initiatives as a first step. And those are in flight. They were implemented and in Q1 we - whatever we had in the budget we actually exceeded in Q1.

Those initiatives will continue to ramp throughout the year. And there is other initiatives related to operating model and other zero-based that redesign operating model initiatives that are kicking in in Q2, Q3.

And, as I said in my prepared remarks, I feel very comfortable about achieving the target that we set for fiscal '19. I believe we will be actually overachieving that saving. And it will continue to ramp when we exit fiscal '19

we should be on or above $100 million in annualized cost reductions for the enterprise. As Mike indicated, everything is on the table. We're working on labor policy, zero-base redesign, all of those things and we feel good about them.

Erin Wright: Okay, great. And then on capital deployment, how should we be thinking about the timing and magnitude of the debt paydown as well as share buyback with the new authorization announced today? Are you active on the buyback quarter to date?

Jorge Gomez: Well, the first thing I would say is we just completed a $600 million share repurchase program. We pay out a dividend of close to $150 million.

So, our commitment to returning cash to shareholders, I think is very clear. We will continue to balance our capital deployment following the same principles that we have followed in the past. We want to reinvest in the business when it makes sense. We'll continue to pay our dividend. We'll continue to do share repurchases depending on valuation, depending on excess cash.

We are not going to sit on idle cash. And we want to keep all of those options available to us always with the intention of having a very prudent reasonable capital structure, financial flexibility and returning cash to our shareholders.

I don't think you should expect to see any changes - any significant changes from what we have been doing for the last several quarters and years.

Lisa Capodici: Operator, next question.

Operator: David Larsen from Leerink, your line is open.

David Larsen: Hi. Can you talk a little bit more about your expectations for costs related to opioids?

I think you mentioned maybe 100 million or so for the year is what's expected. How much of that is actually included in your adjusted operating results?

How much of that is related to the State of New York? And if this spreads to other states, what sort of exposure are you thinking about? Thanks.

Mike Kaufmann: Yes, thanks for the question. I'll start and turn it over to Jorge.

First of all, I just want to step back from this whole thing and tell you that Cardinal just cares deeply about this whole opioid abuse issue and the impact it's having on families and communities.

We understand it's a complex and multifaceted problem. Many parties are involved. And we're working with all of them to help find solutions. We want to be part of the solution for sure.

As complicated as it is, we're going to continue to focus on that. I do want to continue to always remind folks that we're not the ones that control the supply or demand for opioids. We don't promote, we don't manufacture and we don't prescribe. So, I think just stepping back for a minute, that's really important.

Specifically, the cost that we're incurring and expect to incur this year between the opioid and litigation spend. Let me have Jorge give you a little bit of detail on that.

Jorge Gomez: Yes, Mike, so, just to clarify, the number that I mentioned in my prepared remarks was about $80 million of expenses related to both opioid litigation or opioid legal fees, as well as the New York assessment that we are contemplating for the next few quarters. Within that number, I would tell you the majority of that number is related to legal fees.

David Larsen: Okay. And then if it expands to other states, I mean, is that included in this 80 million estimate?

And like, based on what you know now, with, you know, your discussions with your attorneys, is that a possibility or not?

Jorge Gomez: It is too early to make any comments on that.

Operator: We'll move next to John Kreger from William Blair. Please go ahead.

Courtney Owens: Hi, this is Courtney Owens on for John Kreger. But our question is answered so I'm just going to hop out of the queue. Thanks, guys.

Mike Kaufmann: Thank you. Next question.

Jorge Gomez: Thanks.

Lisa Capodici: Operator?

Operator: We'll move next to Lisa Gill from JPMorgan.

Lisa Gill: Thanks very much. Good morning. Mike, I just want to go back to your comment earlier in your prepared remarks where you said everything is on the table.

You clearly talked about what's happening on the medical supply component of your business and, you know, continued challenges there. You've talked about, you know, some of the other elements of your business.

What do you mean exactly by that comment, Number 1? And Number 2, what's the review process that you're going through today to look at what businesses make sense for Cardinal on an ongoing basis?

Mike Kaufmann: Yes, thanks for the question. I would say it comes from a couple different angles.

First of all, from an expense standpoint, we're saying everything is on the table and as it relates to there is just because we've been doing something this way in the past doesn't mean we're going to continue doing it.

We're looking very aggressively at things such as putting, you know, robotic automation in place to be more efficient, looking at, you know, blockchain. Other things like that.

So, we're looking at all types of automation and activity, streamlining, spans and layers to get aggressively after our cost structure. We're also looking aggressively at the way we contract both upstream and downstream.

And just because, again, we've been doing something one way in the past. We're looking hard at that. And that's not just what we typically talk about, which is the pharma segment. But very much also on the medical segment.

We are very much looking at the fact that we need to do category management in a much more disciplined and aggressive way than we ever have because we believe that it's actually not only just better for us but much better for our customers. Because when we carry fewer SKUs and can drive higher service levels and better costing, it allows us to operate more efficiently in our distribution centers.

It allows us to be a better partner with the manufactures that we partner with. And most importantly, we can provide better service levels and better costing to our downstream customers in medical.

And that is something that we need to be aggressive at and look at. It's not something you change overnight. But it is something that is clearly on the table. And then I would say, in the third bucket, is around the businesses. We are putting a lens on every business that we have.

We are being dispassionate about how long we've had it, why we had it, where it's at, can we win? Are we best positioned to be a winner with that business? And what are the growth prospects of that business?

And we are doing, as you can imagine, very detailed analysis on each one of our businesses. And we look at them and when appropriate we will work through the appropriate either exits, partnerships or growth.

If we think it's an area for us, then we want to double down. And so, we are being very fact-based and not emotional or stuck to anything that we do.

Lisa Gill: And just as my follow-up, you know, Jorge, I think that we continue to get the question -- I know you answered this several times as we think about first quarter to second quarter -- it is EBIT that you expect to be flat first quarter to second quarter? Is that the right way to think about it?

Jorge Gomez: That is correct, yes Lisa.

Lisa Gill: Okay, great. Thank you so much.

Mark Kaufmann: No problem.

Lisa Capodici: Operator?

Operator: George Hill from RBC. Please go ahead.

George Hill: Hey, Jorge. I'm going to get on the guidance kind of merry-go-round one more time.

And I guess, as I look at the guidance for the pharmaceutical segment, you're talking about low single digit revenue growth and high to low single digit EBIT growth decline for the year. Q1 put up -- as Bob kind of noted earlier -- very strong revenue growth.

I don't see a reason why that would shift in Q2. It looks like something flips in the mix significantly in the back half of the year, because the implication would be revenue growth slows down pretty dramatically, while margins would have to somehow improve given the guidance.

I guess, is there any more color that you can give us around the moving pieces in the drug segment as it relates to the EBIT in the guide. And I have a quick follow-up if we have time.

Jorge Gomez: Yes, I'm going to repeat something that Mike said with respect to revenue. So, let me start with revenue. Clearly, we had a very strong Q1 with a growth of 9%. At this point, we don't want to extrapolate from that number. Our largest customers are growing really fast. They had a good quarter that benefitted us - Mike talked about that.

When I look at the progression of the quarters, we expect the top line to have a healthy growth in line with what we indicated in our guidance. And within the businesses, we have - specialty had a great Q1 and we are seeing, you know, good performance for the rest of the year.

And the other piece is we talk about that. You have branded inflation. Q3 is the key quarter for us. At this point, we don't have any reason to believe that that number that we have in the budget for Q3 is going to be different. I think we feel good about that.

And then generic deflation will continue to be a headwind for the rest of the year as we indicated in our guidance. And that's what we're seeing today.

So, there is no - in totality for the pharma segment as well as - yes, for the pharma segment, in totality, what we are projecting now is in line with what we have initially contemplated for that segment.

Mike Kaufmann: One thing I'll add that just might be a little bit helpful is, remember, some of our larger customers are also still warehousing and buying the products from us. So, it's hard to over one quarter when they could be adjusting their inventory levels up or down to all of a sudden determine that's a trend for a whole year.

And so, as I said, we're comfortable that we're aligned with strong growing customers, remember that sometimes just on the days of the week or the timing of some of their decisions around inventory, it can cause revenue to fluctuate a little bit.

And we just want to be prudent to be let some more time pass and feel that it's a little bit early.

George Hill: Okay, that's helpful. And I guess if we look at the brand side of the business, we've seen the authorized launch of a generic drug in Hep C. And we've seen Amgen take a steep price cut on a cholesterol drug.

As you guys think about the changes to the branded side of the business, do you think your unit economics can stay the same or your unit profit can stay flat in this kind of - in an environment where manufactures are taking price of their own accord or at their own will?

Mike Kaufmann: Oh yes, absolutely. We are having very active conversations with manufacturers.

Whether it is launching an authorized generic but that acts actually more like a brand, that we are, you know, looking at the unit rates that we were making and adjusting the percentage fees appropriately with those so that we don't lose net dollars.

And we are having very positive and proactive conversations with manufacturers related to this, because the value of what we do does not change as they make these large price decreases. And that we still need to get paid for the services that we provide.

So, we're having very appropriate proactive and I think good conversations with manufacturers around those types of items.

Lisa Capodici: Operator, next question. Operator?

Operator: Eric Percher, please go ahead.

Eric Percher: Thank you. Maybe back to the conversation around everything being on the table. We learned this quarter that you're exiting the specialty pharmacy business. Could you speak to what was behind that and the commitment to specialty distribution?

Mike Kaufmann: Absolutely. Thanks for the question on that.

I guess first and foremost, you know, we're incredibly committed to specialty. We've said that we had another really great quarter with specialty. The business continues to perform very well. And it remains one of our key growth drivers.

We've done an exceptional job of growing the business. Consistently double digits both upstream and downstream to providers and manufacturers.

I do want to emphasize though, we still possess specialty pharmacy capabilities. We still have a full-service specialty pharmacy that complements our metro medical and dialysis products businesses and we also have a noncommercial specialty pharmacy that is part of our Sonexus Hub Services business.

This was just an individual specialty pharmacy that we got through an acquisition in the past that represented a very, very small portion of our specialty solutions business. And that we just didn't feel that we were in the best position to grow that particular piece of business.

It was incredibly small and to continue to grow it to reach a competitive scale just didn't make sense for us. So, it's very consistent with how we've talked about evaluating our portfolio around simplifying, playing where we can win and being dispassionate about those types of things.

But I want to stress that we are deeply committed to specialty, invested in several areas in specialty in this area and continue to have scale in all the tools we need where we need to be and want to be in specialty.

Eric Percher: So, I should take from that that in supporting your current customer base, you feel like you have those capabilities but you're no longer looking to create a significant specialty pharmacy presence for its own purpose?

Mike Kaufmann: I think if I understand that right, everything that our current customers need, whether it's provider or really manufacturer, we can service them. But having just a separate standalone specialty pharmacy and competing in that environment with its dynamics, it was again, incredibly small.

Very minor to our earnings. And it just didn't make sense to continue to hold onto that. And we believe that we sold it to someone else that can do very well with that. And you know, add to the scale they already had.

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

Operator: Your last question will come from Eric Coldwell from Baird.

Eric Coldwell: Oh great, I get the scraps today. Thanks guys, for letting me in. Just a couple of quick technical ones.

First off, on the New York stewardship, the opioid situation, have you changed how manufacturers ship to you or are you considering doing so such that they pay the fees and not you?

Mike Kaufmann: Yes, as you can imagine, we are looking at that. We have communicated to manufacturers that there will be some changes in the way we would expect to operate going forward.

We plan to work with them and with our provider customers, but we will and have - we will be making changes and have had discussions and communicated with the manufacturers around that. Specifically, what the details are.

I'm not comfortable with going into those exact details, but as you can imagine, we would expect to mitigate the cost of that assessment going forward.

Eric Coldwell: Sounds good. Now, the 80 million of opioid costs in non-GAAP guidance, how much of that is incremental from the original guidance this year?

Mike Kaufmann: Over half of that is incremental to our original guidance this year. All right, well, thank you for - go ahead.

Operator: That does conclude the question and answer portion of today's conference. I would like to turn the conference over to Mr. Kaufmann for any additional or closing comments.

Mike Kaufmann: Thank you very much. I just want to end with thanking all of you for your questions.

And most importantly I want to wish you all some enjoyable time with family and friends over the holidays. Take care, and I'm sure we'll seeing many of you.

Operator: That does conclude today's teleconference. We thank you all for your participation.