Q3 FY19 Cardinal Health, Inc. Earnings Conference Call

May 9, 2019 8:30AM Eastern

Operator: Ladies and gentlemen, please stand by. We are about to begin. Good day and welcome to the Cardinal Health Inc. third quarter fiscal year 2019 earnings conference call. Today's conference is being recorded. Now at this time I would like to turn the conference over to Ms. Lisa Capodici. Please go ahead, ma'am.

Lisa Capodici: Thank you, Jake. Good morning and welcome to Cardinal Health third quarter fiscal 2019 earnings call. I'm joined today by our CEO, Mike Kaufmann, and Chief Financial Officer, Jorge Gomez.

During the call, we will provide details on our third quarter results and full year outlook. You can find today's press release and presentation on the IR section of our Web site 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 all relevant periods can be found in the schedule attached to our press release.

In addition during the call, we will provide an update to our FY '19 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 will 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.

Michael Kaufmann: Thanks, Lisa, and good morning, everyone. Today I'll begin with some comments on our third quarter of fiscal 2019 and then I'll discuss our progress on a number of fronts to drive future growth.

Overall for the third quarter, revenue was up 5% and operating results were in line with our expectations. Non-GAAP EPS for the quarter was $1.59, up 14% from the prior year.

Based on the year-to-date performance and our current expectations for Q4, we are raising the bottom end of our EPS guidance to a new range of $5.02 to $5.17.

As I reflect on the quarter, we made progress in several areas, including our strategic initiatives. And the team is focused on delivering full year expectations as we navigate the current health care environment.

As I have recently spent time with our upstream and downstream customers, I am hearing from both that what we do and how we do it are as important today as they have ever been. We have scaled businesses that are important to our customers' success as they look for the most efficient ways to deliver high-quality care to patients.

Our commitment to innovation and strong customer focus were keys to recent pharma renewals. Most notably, we've extended our distribution agreement with CVS Health for four years beginning July 1.

We look forward to working hand-in-hand with CVS Health to further enhance our relationship with them. In that regard, we continue to work with all of our customers across our portfolio of business as they balance their commitment to deliver high-quality care with the need for efficiency.

For example, retail independent pharmacy customers have navigated years of change in their pharmacies. And we've been right by their side helping them succeed in learning in the process.

We are advancing solutions that help them address reimbursement, manage their inventory and place the right focus on the front of store. In addition through our connected care platforms, we offer pharmacies medication therapy management services and the ability to communicate with patients to help them follow their prescribed course of care.

We continue to develop these types of strategic capabilities as they enable our customers to navigate the evolving pharmacy landscape where improving both patient care and the linkage among providers, payers, pharmacies and patients remains critical.

In our generics program, we are seeing market dynamics and program performance consistent with prior quarters. We continue to invest in data and analytics and allocate significant time to improving the overall performance of our generics program, which is key for long-term growth in the pharmaceutical segment.

Our commitment to innovation, our customers and their success is also bearing fruit across the balance of the pharmaceutical segment where we are seeing strong positive contributions to earnings from both specialty and nuclear.

Turning to medical, while we have made significant strides we are disappointed with the segment performance this quarter. We would like to see quicker progress on several initiatives including our global cost structure.

We continue to actively evaluate how we can accelerate our progress here while balancing our commitment to maintain service levels and deliver an outstanding customer experience.

We are moving with a sense of urgency to address the opportunities for improvement we've identified in the medical segment. Importantly, the Patient Recovery primary TSA exits are now complete, leaving just a few minor exits in action.

At Cordis, the stabilization program remains on track. We continue to see improving service levels and fill rates, lower back orders and increased cost discipline. Cardinal Health at Home and our services businesses continue to flourish.

Services continues to expand its niche, providing value-added technology and logistics support to our partners while the at-home business is capitalizing on a number of larger health care trends.

Let me briefly touch on our strategic priorities. As I have shared already this morning, we are making progress in our pharma segment, Cordis and Patient Recovery. The team has also made excellent strides on our overall cost structure. And we are already realizing the benefit in our results.

Regarding capital deployment, I would note that we continue to execute a very disciplined and thoughtful strategy to fund the future growth of the business, return cash to shareholders and maintain our healthy balance sheet. And Jorge will share the details.

Altogether we remain highly focused on how we can deliver the greatest value and be nimble in the ever-changing health care environment so that we can respond to our customers' challenges. We know that our success begins with an emphasis on the longer-term, a balanced thoughtful approach to how we prioritize and deploy capital and discipline in our cost structure.

The team is focused on executing across both our newer and existing businesses, investing in what makes us stronger and continuing our essential role in the health care system. The value we provide to customers and suppliers is as strong today as it has ever been.

I want to thank our entire team for the work they are doing. We look forward to continuing to deliver for our customers, shareholders, employees and the communities we serve.

With that, let me turn it over to Jorge.

Jorge Gomez: Thanks, Mike, and thanks, everyone, for joining us today. Let me start with a quick overview of the quarter. We made operational and commercial progress in both segments to strengthen our relationships with our strategic partners and benefited from a few tax items that drove our effective tax rate below typical levels.

This morning I will focus on our Q3 performance, our view of the current fiscal year and updates on a few of our strategic initiatives.

Our Q3 total operating results, which exclude tax, were in line with the expectations we had for this period when we updated guidance last quarter. Total company revenue was strong again, increasing 5% versus last year to $35.2 billion.

Total company gross margin was down 8% from last year to about $1.8 billion. Operating earnings were $667 million.

As Mike said, our EPS for the quarter was $1.59, a 14% increase versus last year. This increase was driven by a lower tax rate and by prudent balance sheet actions, which resulted in fewer shares outstanding and lower interest expense.

Our Q3 effective tax rate was lower than expected at 21.6%, driven by net favorable discrete tax items of 6 cents. The largest discrete item was a true-up related to a patient recovery acquisition.

In the quarter we saw a 3% improvement in SG&A due to divestitures and the ongoing benefit from our cost optimization efforts, which I'll discuss when I cover strategic initiatives.

Interest and other expenses improved 24% versus prior year to about $62 million. It was driven by the change in the value of our deferred compensation plan, which as I explained previously, is fully offset above the line in corporate expenses and has no impact on the net income or EPS line.

Average diluted shares outstanding were approximately 299 million, about 16 million fewer shares than last year.

We generated very strong operating cash flow of $1.5 billion in Q3, which includes a large benefit from the timing of inventory purchases. Our year-to-date operating cash flow is $2.2 billion. We ended the quarter with a cash balance of $3.4 billion, with about $800 million held outside the U.S.

Now I'll turn to segment results, starting with the pharma segment. Sales to pharmaceutical and specialty distribution customers were strong in the quarter, driving segment revenue growth of 6% to $31.4 billion.

Although segment profit of $536 million was lower than last year, it was ahead of our expectations from a quarter ago. The 10% decrease versus last year reflects the negative impact from generics program performance, prior customer renewals and opioid litigation expenses.

These headwinds were partially offset by specialty, which again delivered very strong top and bottom line growth. Of note, key customers continue to reward Cardinal Health with the trust of long-lasting partnerships. The renewal of CVS Health validates both our strong value proposition and our reputation as a trusted and effective long-term partner.

Turning to medical, segment revenue for Q3 was down slightly to $3.9 billion driven by previously discussed divestitures, offset by growth from existing customers. Excluding divestitures and FX, revenue was up low-single digits.

Segment profit decreased 22% to $155 million driven by the performance of Cardinal Health brand products. Market dynamics in our product businesses as well as incremental supply chain costs contributed to this lower-than-expected performance.

In response to the challenges, we are moving forward with the work that I mentioned last quarter to drive efficiencies across the Medical segment through refining our commercial, operational and data capabilities.

We currently have teams deployed to support each of these pillars of work through activities including global product and geography rationalization, supply chain optimization and selling strategies.

Now let me share a few updates on some specific business areas. What we refer to internally as our medical solution business, which includes patient recovery and our legacy Cardinal Health brand products, is experiencing challenges relative to market dynamics and supply chain integration activities.

However, the team is actively engaged in multiple initiatives to drive greater operational efficiency and to address the below-target service levels experienced over the last few months. As a result of this work, we are seeing improvement in service level trends, particularly in the U.S. where the levels are reaching six month highs.

At the same time all areas of our medical businesses are showing strong growth. We see a strength in our strategic accounts, which are growing above market rates.

Also, Cardinal Health at-home had another terrific quarter. The customer pipeline for this business is healthy and our cost management was extremely effective, producing another quarter of double-digit growth.

National brand distribution had a strong performance as did services, which delivered above-market growth in Q3.

At Cordis we are seeing top line growth in several geographies, most notably in the U.S., Latin America, Canada and Asia Pacific. As we move forward with our stabilization plan, we are seeing improvement in fill rates and backorders, with Q3 reflecting the lowest backorder levels we have seen in 18 months.

Also service levels are improving due to our work on SKU rationalization and additional technologies will help us better manage both inventory and sales productivity.

We also continue to evaluate product mix and partnership agreements. Our key challenge remains our cost structure, primarily outside the US, which we are actively working to address.

Turning to our full year outlook for fiscal '19, based on our most current expectations for our effective tax rate and operating performance in both segments, we are raising the lower end of our EPS guidance from $4.97 to $5.02. Our updated range for the year is $5.02 to $5.17.

We are making the following changes to our assumptions for the full year. For the segment assumptions, due to the dynamics that we continue to experience in medical, we now expect segment profit to be down low to mid-single digit.

For our corporate assumptions, we now expect our effective tax rate to be in the range of 23.5% to 25.5%. This update reflects a few favorable discrete tax items, including the impact of tax reforms, the legal entity restructuring work we completed earlier this year and the tax true-up related to patient recovery that I mentioned before.

Also we now anticipate our interests and other expenses as well as capital expenditures for the year to be lower. We expect interest and other expenses in the range of $330 million to $350 million. The new range for capital expenditures is $310 million to $340 million.

I'll now provide an update on some of our strategic initiatives. First, regarding our cost optimization efforts. We will exceed our initial commitments of $100 million in annualized savings by the end of fiscal '19 and the aggregate $200 million by the end of fiscal '20. We will provide more precise numbers when we finish the year.

To deliver the savings we have developed a compressive data-driven approach that extends beyond budgeting and is supported by an organized program structure. Leaders across the company are accountable for initiatives that we are rigorously identifying, operationalizing and tracking to support these commitments.

And all of this work is enabled by a more agile, forward-thinking mindset that we are embedding at every level of the enterprise. This broad approach standing across strategy, tactics and culture will enable value creation for our shareholders, customers and employees.

We shared previously that we will reinvest some of this savings we generate from this work back into the enterprise. For these investments, we are focused on opportunities to rapidly implement and enable new digital technologies with the goal of streamlining our processes, creating greater efficiencies and optimizing our data capabilities. We will share updates as specific initiatives are operationalized.

Second, with respect to capital, we are generating strong cash flow and remain very disciplined in our approach to capital deployment. Our financial flexibility allows us to efficiently fund both current operations and investment opportunities for long-term growth.

As part of this disciplined approach, we plan to use cash on hand to repay $1 billion of debt that matures next month. Additionally we maintain a significant level of scrutiny and selectivity regarding our allocations such as capital expenditures and acquisitions with a focus on high thresholds for strategic fit, ability to execute and return metrics.

Overall, as I look back on the quarter and year-to-date, while internal and external dynamics continue to evolve, we continue to be resilient and agile. We remain thoroughly focused on delivering our commitments as we finish the year.

With that, I'd like to open the line and invite your questions.

Operator: Ladies and gentlemen, if you would like to ask a question, please press star 1 on your telephone keypad. If you are using a speakerphone, please lift the handset before making your selection.

Please limit yourself to one question and one follow-up question. Once again, please press star 1 if you have a question. We will take our first question from Steve Valiquette with Barclays.

Jonathan Young: This is Jonathan Young on for Steve today. Just going to CVS renewal, were there any changes in the contract or anything that we should consider given that you guys got the renewal?

Michael Kaufmann: Thanks for the question, John. First of all we're really excited and pleased to extend our partnership with CVS. As you know, they've been a long-term customer of ours.

What I can tell you is that the contract is for a four year period. Actually the new pricing goes into effect July 1. And other than that, you know, same business and same typical structure that we've had in the past. Nothing that I would call out differently.

Jonathan Young: Okay, great. And then just turning to the medical business, I guess kind of what were the challenges that you're kind of seeing in the business specifically to the supply chain activities, et cetera?

Jorge Gomez: Let me take that question. Good morning. Yes. You know, we had a difficult quarter in medical in Q3. As I indicated in my prepared remarks, the largest driver in the quarter was the performance of our Cardinal brand products.

Within that I think there are two key buckets. The first one is just the normal market dynamics that we normally overcome through actions around mix and commercial efficiency and volume.

This time and in this quarter we were not able to offset those dynamics because there were additional challenges from a supply chain cost integration work that resulted in backorders and higher expenses as we were trying to meet our commitments to our customers. Those are kind of the two main things.

This is what we're doing about that. We clearly have deployed a number of teams to work on the short-term issues around operational efficiency, below-target service levels. And we are seeing improvements in that.

Our service levels and backorder trends towards the end of the quarter were improving. And in fact in the U.S. our service levels are reaching now a six month high. But from a long-term perspective, we have -- I mentioned this in my remarks as well -- we are working on global product and geography rationalization to simplify our business.

We are trying to optimize our supply chain, and we are making some good strides on that, and working on our selling strategies as well. Obviously all of these actions have different time lines and some of them are being executed very quickly. And as I said before, we're seeing improvements.

All of our initiatives will take a little bit longer. Overall, we're actually encouraged with the underlying demand of this business. And we have a very strong conviction about the value proposition we're bringing to our customers every single day.

Michael Kaufmann: Thanks. Next question.

Operator: I'm going to move to Lisa Gill with JPMorgan.

Lisa Gill: Thanks very much and good morning. I just want to follow back up as we think about the Cardinal Health brand products on two levels. Just one, when you talk, Jorge, about the supply chain cost, is that actually commodity cost or is it the actual process that you just described at the last question?

And then, Mike, can you talk about the current competitive landscape? You know, it appears that just in the peer U.S. distribution you have a competitor that's really struggling in the marketplace.

I would have anticipated that that would have created opportunities for someone with a strong balance sheet like Cardinal to continue to gain from market share. So just some thoughts around the competitive landscape would be helpful.

Michael Kaufmann: Great. I'll let Jorge start and then I'll answer your question.

Jorge Gomez: Yes. Thanks, Lisa, for the question. The cost challenges, I guess, expand over all of the areas of the P&L. So from a manufacturing perspective, we have, as you indicated -- commodities are actually one of the headwinds and there are other elements within cost that are creating some short-term challenges.

And then the overall supply chain as we finish integration work and as we continue to improve our network, especially outside the U.S., we have experienced a higher cost, which essentially stems from the fact that we want to make sure that we balance cost with servicing our customers at the best possible level. So all of those areas of the P&L from a cost perspective impacted the segment this quarter.

Michael Kaufmann: And as far as the competitive environment in the medical side, we continue to see a competitive environment no differently than we really have in the past. I obviously don't want to comment on any specific competitor. But I think the dynamics are similar, that they have been in the past.

We feel really good about our value proposition. And we really want to make sure that we're focused on winning and retaining the customers that appreciate our value proposition, which is being both a strong distribution medical business and a products company that people see as someone that can bring them equal to or better products at lower cost.

Lisa Gill: Just so I understand all the comments around this. As we think about this going into next year, Mike, I mean, do you feel like you can really get your arms around these costs and continue to win customers based on what you just talked about? Or do you think that this is kind of a multiyear challenge as we think about it? And I'll stop there.

Michael Kaufmann: Thanks, Lisa. You know, I think Jorge - from what he said, I'll emphasize just a few things. First of all I think there are some things that were very fixable in a short-term period. And we put the people on that and we've made very good solid progress.

Some of the other things, for instance, evaluating our global manufacturing footprint, looking at our U.S. distribution footprint, we believe there's areas for opportunity to streamline and maximize the efficiency in both our manufacturing and distribution footprints as well as the overall supply chain.

Those aren't going to happen overnight. Those are going to take time as we work through those because ultimately, as much as we'd like to go faster, for us, the most important thing is keeping our eye on our customers.

And we don't want to do anything that would disrupt the overall demand for the products, which we continue to see strong. And we still believe in our value proposition. So it's truly balancing what we know are opportunities in our footprint with making sure that we don't let any customers down.

Michael Kaufmann: Operator?

Operator: We'll now move to Robert Jones with Goldman Sachs for a question.

Robert Jones: Great. Thanks for the question. I guess just to stick there with medical, Mike, you know, I want to make sure I understand this because it does seem like a fairly dramatic shift from last quarter's update.

And so does this boil down to really just some fulfillment issues that created higher cost, which I would imagine, you know, obviously would be within your control to fix? Or is it that plus, you know, a bigger issue that you're seeing as far as the macro backdrop in that sector?

I know, Jorge, you mentioned demand still felt really good for the lines of business here. So just really want to make sure I understand, you know, what shifted from last quarter to this quarter and was it really more just around, you know, some fulfillment miscues and costs that obviously would be associated with fixing that?

Michael Kaufmann: Yes, and thanks for the follow-up. I totally get the question. And, you know, it obviously was a significant change on our assumption for this business so a very fair observation.

I would say, first of all, we've said several different times that when you exit TSAs they can sometimes be lumpy. I would say the exits that we've had recently have been a little bit more lumpier than we would have expected.

And some of those created some unexpected service level challenges Jorge mentioned in our Q3. And we're still working through those as quickly as possible, but there's still little bit of work to do on that.

And as Jorge has mentioned, we are seeing some challenges in our cost structure. Some of it is related to commodities and FX, some of it related to some cost initiatives that we hope to get to quicker that we've had to slow down on in order to make sure we don't have service level disruptions. Jorge, would you add anything?

Jorge Gomez: Just, Bob, to be clear, the change in expectations in the segment was mostly driven by volume issues related to our own internal challenges in terms of bill rates. And we had backorders throughout the quarter.

So as I indicated from a demand perspective, we are seeing - we haven't seen any major change, any changes since last time we talked about medical. So it's mostly related to volume issues within our business.

Robert Jones: That's really helpful. I guess just one follow-up if we could shift over to Pharma. You know, you guys mentioned obviously good performance in the quarter. But you did mention one of the negatives being the generic performance, the performance of the generic program.

You know, could you maybe just elaborate on what exactly you're seeing there? You know, I'm imagining that's more in the sell side but just the dynamics that led that to be a bit of a negative in the quarter would be helpful to better understand.

Michael Kaufmann: Yes. You know, in generics, we really look at all of the factors, which to us are, you know, the inflation, deflation rates, launches, penetration, the ability of Red Oak to take out cost.

And when we look at combining all of those together, we still continue to see our generics program to be a significant headwind for us both in Q3 and for the entire year. So I wouldn't necessarily say that we've seen any one of those components change dramatically, you know, within those various components of the program, just that it continues to be consistent with prior quarters versus seeing some of the improvement, you know, we would obviously like to see.

Next question, please?

Operator: Eric Percher with Nephron Research will have the next question.

Eric Percher: Thank you. Jorge, did you say that you had to scale back your ambitions for cost reduction in part because of what was occurring in the medical business this quarter?

Jorge Gomez: No. Actually our cost initiatives are tracking ahead of our internal plans. What happened this quarter is that some of those savings, we actually had to redirect and reinvest to try to fix up some of the short-term challenges that we're seeing in medical.

So that's why we are not seeing the entire benefit of cost savings dropping to the bottom line because we have been - we have used those to cover some of the short-term challenges. But the initiatives are very much on track.

And in fact, every quarter, we are gaining more confidence in those targets. And we will exceed the target for this year.

Eric Percher: Okay, got it. Now and then on CAPEX, I know you've reduced your expectation for the year and that had been running low in the first half but it seemed to normalize this quarter. Can you give a little bit of color on your expectations there?

Jorge Gomez: Yes. I think nothing really has changed fundamentally. But as we have indicated we have been extremely disciplined and strict about return metrics and thresholds for investment. And then when you add that to bandwidth and the thing that we're trying to take care of in the short term, we believe that the new amount that we are guiding to is a reasonable fluid amount for this year.

Lisa Capodici: Operator, next question.

Operator: The next question will come from Stephen Baxter with Wolfe Research.

Stephen Baxter: Hi. Thank you for the question. So I wanted to come back to medical again, more of a big picture question. So if we look at the revised EBIT outlook for the segment, it looks like it's somewhere around, you know, $640 million.

And based on your previous guidance for patient recovery, I would estimate that that's contributing somewhere around near $450 million of EBIT? So If you look at the legacy medical EBIT for Cardinal, it would be something less than $200 million.

It would be really helpful to us if you could rank the decline in terms of drivers over the past few years? It feels like the issue has shifted slightly from quarter-to-quarter, and I think it will be really helpful to have sort of the cumulative sense of what's happening in the business over the past couple of years.

Jorge Gomez: Yes. Let me take the question. I'd say we've been very transparent about the performance of the Cardinal brand products this quarter and the issues we are facing with respect to volume in that part of the business.

Overall, the biggest parts - the business unit within the segment, they are performing not too far from where we thought they would be, but certainly, we have some short-term challenges that we are facing.

We have some businesses within the core legacy businesses, if you will, that are performing very well. As I Indicated before we have at-home services doing really well.

And patient recovery although - patient recovery we are still on track to meet our accretion goal that we set for this year. It is probably the projections we have now or probably lower than what we thought due to the volume challenges, but we are on track to meet the accretion goal that we have for fiscal '19.

Stephen Baxter: Thanks. Just a quick follow-up. Is it possible to comment on what revenue trends look like, you know, sort of ex-Patient Recovery? Thanks.

Jorge Gomez: The underlying revenue trends in the segment, as I indicated, when you exclude dispositions and FX, the business is tracking pretty much in line with the market and with the expectation. So no major changes there.

Lisa Capodici: Operator, next question.

Operator: We'll hear from David Larsen with Leerink.

David Larsen: Hi. Can you talk a little more about the spread you're seeing on the generic side of the house. One of your peers is obviously talking about, you know, pharma operating income growth over the next year. But, you know, from your tone or from your comments it sounds like, you know, you're not necessarily seeing an improvement on the generic side. What's the difference in your view? What do you think the difference could be? Thanks.

Michael Kaufmann: Yes. It's hard to comment on other people's views of generics based on the fact that we all have different mixes and we may be defining and putting different things in various buckets.

But I would tell you that we do see it as more consistent with the prior quarters. And, again, would not say that we have noticed any one factor. As you know, we said at the beginning of the year that we expected that all those components to be a net headwind for us.

And it has been a net headwind for us for the year. It has been the most significant one. And other than so far what we're seeing through three quarters is consistent market dynamics, it's really hard for me to comment on ours compared to someone else.

David Larsen: Okay. And when you use the term consistent, like, is your spread expanding or is it, you know, contracting? Is it a consistent rate of, you know, contraction in the spread? Any more thoughts there would be very helpful, Mike.

Michael Kaufmann: Yes. You know, I guess when we're talking about consistent, what we're talking about is that when we take a look at deflation rates, we look at the value that we're going to get from launches, et cetera. Those are basically tracking where we expected.

The deflation rate is, you know, relatively consistent quarter-to-quarter. And so we -- you know, for us, again, it's a net headwind. And so we're continuing to see consistent net headwind quarter-to-quarter not necessarily at this point in time through three quarters seeing that headwind reducing.

Lisa Capodici: Operator, next question.

Operator: We'll now hear from Kevin Caliendo with UBS.

Kevin Caliendo: Good morning, guys. So not to keep going back to medical, but if we look and think about your guidance and how it plays through the fiscal fourth quarter, would you consider that a run rate as we move into 2020?

Is there anything in there that's sort of onetime-ish? Or should we think about this as the base of which X is any seasonality in that business that we should be thinking about growing off of moving forward?

Jorge Gomez: Good morning, Kevin. Thanks for the question. As Mike indicated before, at this point, you know, it's too early for us to start talking about trends going into next year. But obviously, we have taken down the guidance for the rest of the year.

It reflects what the challenges that I discussed before that we are seeing. And we had a good first half. The second half of the year is going to be relatively consistent in terms of the challenges.

And that's why we've taken the guidance for medical for Q4. I think it's too early to start talking about the things that we're seeing going into fiscal '20.

Kevin Caliendo: Okay. That's fair. And just on the CVS renewal, you said everything was the same in terms of the business, the structure. Pricing starts July 1. Just a couple of questions around the pricing.

There's obviously an incremental stepdown when you renew a contract. We understand that. Was the incremental stepdown typical with most renewals that you do?

And then secondly, does this contract through 2023 also incorporate your relationship with Red Oak? Or is it just simply on the distribution side?

Michael Kaufmann: Yes, this contract was strictly on the distribution side. Our Red Oak agreement still has five years left on that agreement. The first five years will expire here at the end of roughly June 30 and then we have another five years left on that so there's no current need to address that contract.

Although things continue to go really well with Red Oak. We love the team and love the partnership that we've had with CVS on that. As far as the deal goes, yes, it is - the new pricing does go in effect July 1 for us.

And I would say that, you know, there was nothing about it that I would say was different than what we would expect in the marketplace for customers of this size, and importance and how they're growing. And, you know, we feel that it's a fair and appropriate renewal and are excited to have the business for four more years.

Lisa Capodici: Operator, next question.

Operator: We'll hear from Michael Cherny with Bank of America.

Michael Cherny: Thanks for taking the question. Jorge, just to clarify, you just talked about - you know, it's a little early at this point to start giving color clarity on fiscal '20. A, is that for medical versus the whole business?

And then I guess B, you know, when you think about what's changed this year versus previous 3Qs when you've had some visibility and color into the next year, I guess what changed your view on how you expect - or why you decided to not give any color heading into next year?

Jorge Gomez: Good morning, Michael. Thanks for the question. We normally don't provide any guidance into next year at the end of Q3. Our typical cadence for providing color into the next fiscal year is during our August call.

So we are not changing that. This is just not consistent with our typical practices. And my comments in terms of not giving color about medical, it applies to the entire corporation and all the numbers across the enterprise.

Michael Cherny: Okay, yes, I know you don't give guidance. But you usually give some color on here are some headwinds that we expect to pursue, here are some tailwinds that people are thinking of. You know, I guess at this point, we'll just wait until August to hear on some of those. So thanks.

Michael Kaufmann: Yes. I think just some quick comment on that. Remember last year, there was - we had made an earlier comment around 560 in the marketplace. And then we had decided because of that, we gave a little bit around that last year. It was different.

But that is not our typical and it's not something that, you know, we would typically do. We want to stay disciplined to being around our August earnings time.

Lisa Capodici: Operator, next question, please.

Operator: We'll hear from Brian Tanquilut with Jefferies.

Bryan Ross: This is Bryan Ross on for Brian Tanquilut. When you look when you look at the generic landscape, you know, across the buy side and sell side in terms of what you're seeing now versus historical norms, I guess what inning do you think that - your inning getting back to that to normalized generic pricing environment? And are expecting to get back to that, you know, over the next year? Or do you think that's further off than that?

Michael Kaufmann: Thanks for the question. You know, it's really hard to say. And, again, that would be really more around giving guidance. And we just want to stay away from that.

For us it's just, you know, again, we just want to keep emphasizing that it continues to be a significant headwind, you know, in FY '19 for us. And the market dynamics across our various components have remained consistent.

But we'll give some more color to your question in August around not only, you know, our results for our Q4 but what our thoughts are obviously around that for our fiscal '20.

Bryan Ross: Got it. And then just a follow-up on the 4Q guidance. You know, relating last year, somewhat of an easier comp and factoring in cost optimization and some of the actions you're taking in medical, what are the puts and takes that give you the confidence in the year-over-year ramp implied by, you know, the fiscal year guidance?

Jorge Gomez: You're talking about the medical segment or the...

Bryan Ross: No. Overall just the, you know, 4Q in respect to the full fiscal year guidance?

Michael Kaufmann: I guess it's a couple different components. I know Jorge went through the detail here, but, you know, we've got, as he said, he's got the ETR benefit we've had so far this year.

Now we expect it to be higher in Q4. And we've changed our medical guidance for the year. So we would obviously have taken down what we expect our medical segment earnings to be.

And then we've mentioned some other opportunities like the pharma business doing, you know, obviously, it's going to offset some of that in are expense initiatives. So think it's just a total of all those. When we look at it, we feel like our new guidance is, you know, the best indication of where we think we will finish for the year.

Lisa Capodici: Operator, next question, please.

Operator: That will come from John Ransom with Raymond James.

John Ransom: Hi. You know, we can look at the generic marketplace just with a handful of public companies and we can look at pricing data, but the analysis sort of stops there.

I'm curious. If you were to compare today to say couple of years ago and think about your, you know, top 50 100 drugs, do you see a material decline in the number of suppliers for, say, a generic Lipitor or some of the larger products?

Because what we have seen with the big public companies is they appear to be abandoning me-too products. And of course, you know, the public drug store chains are complaining of lack of generic deflations. So, you

know, Occam's razor would be that we just have fewer suppliers. And I'm just kind of curious to your perspective on that.

Michael Kaufmann: Yes. You know, it's an interesting question. I would say that - I would not say that overall that we're seeing less generic suppliers. There's clearly been a lot of public discussion around some of the larger ones rationalizing their supply chain in their portfolio of products.

But at the same time, we're seeing the FDA approve generic drugs at a record pace. We're still seeing suppliers from outside the United States come in both on newer drugs as well as opportunities on some of the older drugs.

And most importantly, you know, whether there is, you know, 5 or 10 players, probably doesn't make as much of a difference for us because as long as there is a certain amount of competition, we're going to be able to go get the cost that we need to from a Red Oak perspective.

And when we've seen it start to get to maybe fewer suppliers on certain specific items than we wanted, Red Oak has done a nice job of working with companies to either get them back in supply or find ways to get agreements to continue to get the cost.

So I wouldn't say that I've seen a material difference in the net overall number of suppliers on items although you can always pick 1 or 2 items where you might see significant changes.

John Ransom: So if that's true, it's not entirely clear, at least to me, where the pressure will be coming from. And certainly you would say there's a lot of distress in the retail channel. So is it you're having to give a little more

price concessions downstream because your retail customers need every bip of margin they can find? Or is there something else that we're missing?

Michael Kaufmann: So I think that what we've said in the past is that when you look at all of the components, when you take a generic deflation, which we at Cardinal define as sell-side deflation, and you net it against launches, penetration and the ability for Red Oak to go reduce cost on existing items, the net of all that is a net headwind for us for this year and has been for the quarter and for the year so far.

So it's kind of exactly what you're saying is that we're seeing more pressure on the sell side and we are able to offset that with launches, penetration and cost decreases. And we're seeing margin shrink.

Next question.

Operator: And that will come from Charles - excuse me, Glen Santangelo from Guggenheim Securities.

Glen Santangelo: Oh, yes. Thanks for taking the question. Mike, just to maybe follow-up on the pharmaceutical segment, you know, for a moment.

It looks like the headwind that you experienced in 3Q was smaller than what you did in their first and second quarter. So the operating profit was probably better than most people on this call were looking for.

And so if we hear you clearly, it doesn't sound like it came from the generics program at all. So was there something else within the pharmaceutical segment that maybe performed a little bit better than what you or we all would have thought?

Michael Kaufmann: Well, remember Q3 is the quarter that is always going to be the quarter that has seasonality and the most seasonality and it related to brand price increases in the January time frame.

And so while those came in roughly about where we expected, I would say for us, the quarter came in about where we expected it to be in pharmaceutical. So I wouldn't call out any individual item being significantly better or worse than we actually anticipated for the quarter.

Glen Santangelo: And then maybe just a follow-up to that. I was kind of curious on how maybe the conversations are trending with the manufacturers given all the scrutiny around rebates and the HHS proposal and all of that. Are there any sort of initial what-if type conversations or is it just sort of business as usual? Thanks and I'll stop there.

Michael Kaufmann: Thanks. That's a good question. I would say - here's what we're hearing from manufacturers. I think we continue to have very open, transparent conversations with manufacturers.

We have been - as contracts expire, you know, we continue to work through the wording to make sure that we are protecting ourselves in the case of sudden changes in WAC prices that might potentially alter our dollar earnings from those manufacturers.

The conversations with manufacturers around the fact that if there were any changes around that, we would need to work together because we still need to earn the dollars that we deserve based on the value of the services we provide.

And so you take that with constantly talking to them about ways to help them reduce their cost, improve their service levels, provide other services. I would say conversations with manufacturers continue to be, you know, fruitful, positive and very transparent about all the various things that we're seeing out there that could impact both of us.

Lisa Capodici: Operator, next question, please.

Operator: We'll hear now hear from Charles Rhyee with Cowen.

Charles Rhyee: Yes, thanks. I just wanted to follow-up a little bit on medical. And I think there was a sterilization plant that was shut down in February and some articles around that. I think it affected some of the manufacturers and it sounds like maybe it affected you.

How much of that maybe is in this when you talk about sort of the internal challenges on fill rates? And then, Jorge, you talked about still on track in terms of the accretion for the deal in '19.

Does that mean when you guys gave sort of the accretion targets for patient recovery, you kind of gave numbers not only for '19 but also for fiscal '20. Are the fiscal 20 sort of numbers still intact here from your mind, you know, understanding that we've reinvested some of those in the near-term and then also sort of the $150 million synergy target that you initially laid out? Thanks.

Michael Kaufmann: Yes. I'll take the first part on the issue related to ethylene oxide is what I'm assuming you're talking about there and then I'll let Jorge talk about the accretion part.

As far as the ethylene oxide issue that really had an incredibly minor impact on us for the quarter. Now that being said, it's something we have our eye on. We think it's important.

It's used widely across the entire industry to sterilize products. So it's something that would impact everyone in the industry, including our competitors and manufacturers. So, you know, it's important to the industry on that. But for the quarter it was immaterial. And, like I said, at this point in time we continue to look at alternatives and make sure that we're prepared in case there are any other changes related to that.

Jorge Gomez: Charles, your question about patient recovery. So I said before that we are on target this year. For the disruptions that we experienced in the last quarter or so, we are below what we thought we were going to achieve this year in terms of the growth from patient recovery but again within the accretion target.

Similar to any other parts of the business, at this point we don't want to get into any trends going into '20. We will do that in August, but as of now this is how this quarter is trending. Within the fiscal '19, we are trending below what we thought we would achieve with patient recovery this year.

Charles Rhyee: But at that time you did give us fiscal '20 as well. I mean can we think that understanding that this year we're trending below what you initially expected, is it fair to think or are we still, you know, thinking from a sequential basis that you would expect things to continue to improve overall?

And then just Mike, just to clarify what you are talking about, when you talk about ethylene oxide, that's the stereogenic plant that we're talking about?

Michael Kaufmann: That's right. That's the sterilization method that that plant uses. There are several different types of sterilization methods but that is what that plant is using that I was referring to.

Jorge Gomez: And, Charles, going back to your question about patient recovery and going into the future, obviously the business case was designed and our expectations continue to be that we will, you know, improve the results and the performance of this business over time especially as synergies kick in. The synergies are expected to accrue over a few years. And when we think about those synergies at this point right now during this fiscal year we are on track with that trajectory.

Lisa Capodici: Operator, next question, please.

Operator: We'll hear from Ross Muken with Evercore.

Ross Muken: Guys, on the medical side, I mean, is there any incremental thought on sort of, you know, the portfolio mix? And maybe as you thought about sort of the longer-term strategy, you know, given some of the volatility you've seen in some of the units and maybe changes in the end market, whether or not, you know, sort of you are in all the right markets?

And then secondarily, you know, is there anything else you see on the outside that would be sort of synergistic with it in terms of pivoting in a, you know, direction where maybe you've had more success versus some of the areas where pricing and other elements have been more challenging?

Michael Kaufmann: Thanks, Ross. I think a couple of things. I do think that, you know, when we look at our overall strategy of medical of being - and really leveraging our historical distribution roots with having a broad and well-known product portfolio, it's really still the right strategy and important to us.

We think that leveraging those two, like I said, is the right thing and important. We still have work to do, as we've said, around how we continue to modify our comp structure and the way we go to market to drive that.

So as we said, we're making the progress we want, but that takes time to change that, and we're continuing to work through that. So from that standpoint, we still feel very good about that.

And so, you know, there's always opportunities to look at individual products to see if you - if we need to add or delete from the portfolio. But in general, we feel really good about our portfolio and the overall strategy. Jorge, would you add anything to that?

Jorge Gomez: Yes. Ross, just to one of your specific points about certain markets and being in the right place, as we indicated a couple of times in the past and even today, part of the work we're doing is looking at our entire global portfolio, looking at geography rationalization opportunities.

A couple of quarters ago, we talked about a few small geographies that we exited and that is an ongoing work. We will always look at opportunities to improve our footprint, in some cases, potentially add in many other cases, exit in geographies and certain product lines in certain places. So that is all part of the ongoing strategic work that John and team are doing.

Ross Muken: And maybe just on the corporate side. I mean, maybe I missed it, but I don't remember anything on opioid trial-related expenses. I know one of your peers yesterday called out, obviously, a big step up for them into next year.

I guess where are you in terms of that headwind and how you are thinking about that in the context maybe of some the cost takeouts that you're doing hopefully offsetting maybe some of that incremental pressure?

Jorge Gomez: Yes. So this year, as you may recall, the number that we have included in our pharmaceutical segment, which by the way we include all the opioid litigation expenses in pharmaceutical, those are tracking in line with the guidance we provided a couple of quarters ago.

So we are probably - at some point, we said it was like about $80 million including some factories in New York that we ended up unwinding. So we're probably in the $70 million area plus or take - you know plus or minus a few million dollars.

And so that is a major headwind for us this year. And obviously, we work really hard to make sure that we offset that with other cost-savings initiatives. But it's trending in line with what we were expecting for this year.

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

Operator: And that last question will come from Ricky Goldwasser with Morgan Stanley.

Ricky Goldwasser: Yes. Hi, good morning and thank you for fitting me in. So two questions here. First of all, if you think about the Pharma segment and we you think about how much guidance implies for fourth quarter, it seems that there is still a fairly wide range in your expectations from operating income.

And when we kind of just in fact look at the numbers, it seems they're at the high end. You expect operating income to potentially be up year-over-year versus a scenario where operating income is still down.

So can you just help us better understand what are the swing factors into fourth quarter? Are you expecting generic to do better? Is there anything that you see that would drive that variability?

Jorge Gomez: Yes, Ricky, this is Jorge. The drivers for the fourth quarter are the same drivers that we have experienced throughout the year. So obviously, what happens with our generics programs is an important factor.

The specialty business has been trending above expectations for us throughout the year, has done really, really well, and that is a swing factor as well. I think the type of savings we are able to achieve with our programs - internal programs, that is another important factor. So there is nothing new that I could point to that is driving the range that you're talking about for Q4.

Ricky Goldwasser: Okay. And then when we think about the specialty, because you highlight that -- and you highlight specialty, strong growth in specialty now helping you for a few quarters, can you just give us some context on what's driving specialty growth. Is it pricing? Is it market share gains, new products?

Michael Kaufmann: I think for the most part, I think the big driver in specialty is really - the overall market growth is a big component of it.

I mean, obviously, we feel very good about our offering and how we our competing in the marketplace. And our discipline around cost structure are - also our upstream services business continues to grow but I think the biggest factor in specialty really is strong market growth that we're able to take advantage of.

Operator: Ladies and gentlemen, this will conclude your question-and-answer session. I'll turn the call back over to your CEO, Mike Kaufmann, for any closing remarks.

Michael Kaufmann: Yes. Thanks, everyone, for joining us today. As you can see we continue to execute on our plans and position Cardinal for future growth. And we really look forward to reporting on our progress with you over the next several months and in particularly August when we talk about our FY '20. Thanks, and have a great day, everybody.

Operator: Ladies and gentlemen, this does conclude your conference for today. We do you thank you for your participation and you may now disconnect.