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CORPORATE PARTICIPANTS

Craig Mercer
Senior Vice President-Investor Relations, McKesson Corp.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.

Brian S. Tyler
President and Chief Operating Officer, McKesson Corporation

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

OTHER PARTICIPANTS

Michael Cherny
Analyst, Bank of America Merrill Lynch

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Eric Percher
Analyst, Nephron Research LLC

Brian Gil Tanquilut
Analyst, Jefferies LLC

Robert Patrick Jones
Analyst, Goldman Sachs & Co. LLC

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Ross Muken
Analyst, Evercore ISI

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone. Welcome to the McKesson Q2 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Craig Mercer. Please go ahead, sir.

Craig Mercer
Senior Vice President-Investor Relations, McKesson Corp.

Thank you, Alan. Good morning, and welcome to the McKesson fiscal 2019 second quarter earnings call. I'm joined today by John Hammergren, McKesson's Chairman and CEO; Brian Tyler, our recently-appointed President and Chief Operating Officer; and Britt Vitalone, McKesson's Executive Vice President and Chief Financial Officer. John will first provide a business update, with Brian making some introductory comments. And then Britt will review the financial results for the quarter. After Britt's comments, we will open the call for your questions. We plan to end the call promptly after one hour at 9 AM Eastern Time.

Before we begin, I remind listeners that during the course of this call, we will make forward-looking statements within the meaning of the federal securities laws. These forward-looking statements involve risks and uncertainties regarding the operations and future results of McKesson. In addition to the company's periodic, current and annual reports filed with the Securities and Exchange Commission, please refer to the text of our press release and forward-looking statement slide for a discussion of the risks associated with such forward-looking statements.

Please note that on today's call, we will refer to certain non-GAAP financial measures. In particular, John and Britt will reference adjusted earnings, adjusted operating profit and margin, free cash flow and items excluding foreign currency exchange effects. We believe these non-GAAP measures provide useful information for investors with regard to the company's operating performance and comparability of financial results period-over-period. Please refer to our press release announcing second quarter fiscal 2019 results and the supplemental slide presentation for further information and a reconciliation of the non-GAAP performance measures to the GAAP financial results. The supplemental presentation is useful in reviewing the fiscal 2019 versus fiscal 2018 results discussed today.

Thank you, and here's John Hammergren.

John H. Hammergren

Chairman & Chief Executive Officer, McKesson Corp.

Thanks, Craig, and thanks, everyone, for joining us on our call. For the second quarter, we achieved total company revenues of $53 billion and adjusted earnings per diluted share of $3.60. And we are narrowing and raising the low end of our fiscal 2019 adjusted earnings range to $13.20 to $13.80 per diluted share from the previous $13.00 to $13.80 per diluted share. I'd like to take a moment to provide an update on our board of directors and leadership team. Our board of directors welcomed Dominic Caruso as a new Independent Director in September.

As the former Chief Financial Officer of Johnson & Johnson, Dominic brings with him significant financial and healthcare experience, which further strengthens the diverse backgrounds and perspectives we have on our board. Also, I'd like to welcome Brian Tyler to this call, following his appointment as President and Chief Operating Officer reporting directly to me. Many of you are familiar with Brian, as he has regularly presented at previous Investor Day events in Boston and has led nearly all of our businesses during his 21-year tenure at McKesson.

I'll now ask Brian to talk about his vision around leading our global operations. Brian?

Brian S. Tyler

President and Chief Operating Officer, McKesson Corporation

Thank you, John, and good morning, everyone. Well, I'm very excited about the opportunities that lie ahead of us. Clearly, there's a lot of work ongoing and work to be done. We have an impressive range of capabilities to build upon, combined with a great track record of execution. Having led corporate strategy and business development in many of our business units, I'm very energized about leading our operations as well as our strategic growth initiatives. We have faced and overcome many challenges during my time at McKesson. I continue to be encouraged by this company's resilience, its ability to navigate evolving market conditions and our strategic focus to improve long-term performance.

Our enterprise-wide multi-year growth strategy, including priority areas that focus on manufacturer value proposition, specialty pharmaceuticals and the role of retail pharmacy, all supported by data analytics, are promising areas of innovation. And importantly, we already have strong foundational businesses from which to build upon. The anticipated growth in conjunction with streamlined and aligned operations is strategically and financially attractive.

This focus positions us well for the changing landscape of healthcare. It allows us to leverage the strengths we've built in our world-class distribution platforms and services businesses, and we see substantial savings opportunities through the improved spend management, centralization of support functions and expanded outsourcing arrangements. Britt will discuss these operating model initiatives in more detail shortly.

And with that, I'll turn the call back to you, John.

John H. Hammergren

Chairman & Chief Executive Officer, McKesson Corp.

Thank you, Brian, and welcome to your new role. I'm delighted to have you in this important expanded responsibility. Before I dive into the details of the quarter, let me briefly touch upon the evolving landscape across healthcare, primarily around drug pricing and our relationship within the supply chain.

When I think about potential new developments, I step back and look at how we've adapted to and driven change in the healthcare industry, how we've broadened our capabilities well beyond the core function of distributing pharmaceuticals, how our services drive affordability, access and quality, supporting the value we deliver and how I think about future drug price changes.

To take a deeper dive into these areas, first, all of McKesson's brand pharmaceutical purchases are done in partnership with biotechnology and pharmaceutical, or as we refer to them, biopharma companies; unlike the industry standard practice before we had these distribution service agreements. Our relationships between wholesalers and their biopharma partners are now governed and driven by these agreements and have been for several years.

The partnership with biopharma companies has led to increased transparency and a more stable and predictable supply chain with inventory levels that are appropriate to meet customer demands and service levels. We've continued to evolve our relationships, reducing the economic variability in our distribution agreements and reducing our reliance on pricing decisions made by biopharma companies to approximately 5% of our total branded compensation.

As many of you know, we have been revising our terms when we renew agreements with our supplier and customer partners to encompass the broad array of services and capabilities we offer. We've implemented differentiated pricing across each category of product we provide services for; specialty, brand, generic, biosimilar and OTC classes of medicine. Our approach is designed to provide our suppliers and customers with transparency into the unique dynamics of each product category as opposed to a blended approach.

For almost two decades, we have expanded our capabilities beyond distribution and related services to support our partners at nearly every step in the product lifecycle. Examples include RelayHealth Pharmacy and CoverMyMeds, both technology businesses that help reduce the price of drugs and improve patient adherence. And with our newly rebranded manufacturer solutions business now called McKesson Life Sciences, we are taking another step forward to become the partner of choice for life science industry, driving successful commercialization, launch, and in-market solutions to connect patients to life-changing therapies.

While we acknowledge there is more work to do, the nature of what we do every day is aligned with the objectives of the administration, which includes affordability, leveraging our global scale to provide patients with low-cost generics, access, delivering one-third of all prescriptions in North America and quality, ensuring safe and efficient access to prescribe therapies every day.

Finally, while there is much speculation around potentially dramatic reform changes, we believe there will be gradual major transitions should there be any changes to supply chain dynamics.

In summary, we are confident in our ability to navigate changes to the existing healthcare supply chain because changes to our financial model are not new. As was the case with the changes to the supply chain in the past, we expect our biopharma partners to work with us in collaboration with our customers to ensure a seamless transition to avoid disruption to patients. And we are proactively engaged in ongoing dialogue with our customers and biopharma partners in assessing the existing financial models. We also continue to have broader policy discussions with the administration, policy makers and various trade associations that are important to our business.

Turning now to our business results, our U.S. Pharmaceutical and Specialty Solutions segment had year-over-year revenue growth in the second quarter of 2%. I'd like to discuss a few highlights in this business.

We're pleased with the performance of our McKesson Life Sciences business, as all top 20 biopharma companies utilize a majority of our best-in-class services, and we continue to expand those relationships, providing evidence that our offerings are resonating.

The Department of Veterans Affairs exercised their option to extend our agreement for another two years, as expected in our guide. And ClarusONE continues to leverage our scale and our unique in-house sourcing capabilities.

Turning now to McKesson Europe; on our last earnings call we mentioned increased competition in France, and that recently announced reimbursement cuts in the UK were in excess of historical levels, and greater than we had planned for on our fiscal 2019 guide. Facing the challenging market in the UK due to reimbursement cuts and declining prescription volumes, we took action last year to rationalize our store footprint and streamline our back-office operations. As these trends evolved in the UK, we continue to evaluate our footprint and cost structure and our UK colleagues remained committed to stabilizing the business and repositioning it for long-term profitability, all led by a newly-appointed president with more than a decade of industry experience.

We see our global retail presence as a way to stem the tide of growing healthcare costs as we anticipate more services migrating from higher-cost locations into the lower-cost pharmacy setting, and we believe that pharmacist plays an important role in providing a range of healthcare services.

Turning to our Medical-Surgical business; the underlying business continues to deliver consistent results benefiting from the shift of care to lower-cost sites. And of course, our recent MSD acquisition, which will contribute more meaningfully to earnings as we move from the integration phase to realizing anticipated synergies over time.

As evidence of further enhancing our value proposition, we recently announced a technology solution that complements our existing connectivity capabilities, provides us with access to a broader customer base, and allows patients to get more control over their care and additional support with products delivered to their home. Allows home health and hospice providers to save time and money, and spend more time delivering patient care, and it allows payers to receive improved accuracy in billing, to facilitate more timely reimbursement.

While many have alluded to the threat of new entrance, McKesson has been actively investing in our Medical-Surgical business to better serve patients and ensure we remain the trusted partner in the alternate site markets. In particular, we've made increased investments in home healthcare, adding to our home delivery capabilities, which is driving top-line growth. While this investment is dilutive to our margin rate today, over time these investments will drive increased adjusted operating profit growth as we optimize operations and further leverage our scale. And we are pleased with the response we're seeing from our efforts to improve patient care in the home.

Finally, McKesson Canada, McKesson Prescription Technology Solutions and our equity investment in Change Healthcare all included in other. We saw upside in the quarter driven by a reversal of a contractual liability, partially offset by previously-discussed generic price actions in Canada and the sale of our Enterprise Information Solutions business in October last year. During the quarter, McKesson Canada made great progress on mitigating the impact of the generic pricing cuts that went into effect April 1. And together with strong organic growth in our Canadian and McKesson Prescription Technology Solutions businesses, we were able to offset a lower-adjusted equity contribution from Change Healthcare. Britt will go into more detail on the performance of these businesses.

Based on the McKesson fiscal second quarter results, we are narrowing and raising the low end of our adjusted earnings range to $13.20 to $13.80 per diluted share for our full-year fiscal 2019 outlook. Despite anticipated challenges coming into the year, we expect a stronger second half of fiscal 2019. And as I look beyond fiscal 2019, the actions we are taking in our UK businesses are focused on addressing the disappointing reimbursement dynamics we are facing with new leadership to drive improved performance. As we focus on putting patient care first, we're investing in our businesses like homecare delivery.

Similarly, McKesson Life Sciences enables biopharma companies to connect their innovative therapies to the patients that need them. And what ties these examples together is our focus on the patient, under our multi-year strategic growth initiative, with the goal of improving care delivery and driving long-term performance.

Before I hand the call over to Britt, let me touch upon the recent weather events that impacted the Southeastern United States. McKesson was fortunate to have avoided significant impacts to our associates, our operations, and our facilities from the devastation resulting from the recent storms and flooding. We are proud to have played a role in the emergency efforts providing pharmaceuticals and medical supplies to the affected areas, despite very challenging conditions. Our employees in the McKesson Foundation have been extremely generous with their support for displaced residents and coworkers. We continue to aid in the recovery of our affected customers, communities and employees.

With that, I'll turn the call over to Britt and I'll return to address your questions when he finishes. Britt?

Britt Vitalone

Chief Financial Officer & Executive Vice President, McKesson Corp.

Thank you, John. Let's jump right into our second quarter results, and please note that unless stated otherwise, the underlying assumptions that were detailed in our fourth quarter press release are being reiterated today. As John discussed earlier, our fiscal 2019 second quarter results were ahead of our expectations. Turning to slide six of the presentation, second quarter adjusted EPS of $3.60 was principally driven by a lower tax rate, including a discrete tax benefit, a reversal of a contractual liability associated with our equity investment in Change Healthcare and a lower share count. These benefits were partially offset by incremental challenges in our UK and French businesses, previously announced customer losses, and increased litigation expenses related to opioids.

Our second quarter adjusted earnings results excludes the following GAAP-only items; amortization of acquisition-related intangibles of $0.75 per diluted share, acquisitions-related expenses and adjustments of $0.27 per diluted share, LIFO inventory-related credits of $0.08 per diluted share, restructuring and asset impairment charges of $0.34 per diluted share, and other adjustment net credits of $0.19 per diluted share.

Before I continue with the review of our second quarter results, let me take a moment to discuss the increased opioid-related expenses, including anticipated costs for the remainder of fiscal 2019. Earlier this year, the State of New York adopted the Opioid Stewardship Act, which required the creation of an aggregate $100 million annual surcharge that's [ph] distributed (16:02) amongst all manufacturers and distributors licensed to sell or distribute opioids in New York. The first annual surcharge is assessed for calendar year 2018, payable in January of 2019, and measured based on opioids sold or distributed in calendar year 2017.

The New York Department of Health notified manufacturers and distributors of this new law in mid-May. Given the timing of this new law, we did not include an assumption for the potential impact in our fiscal 2019 plan. While this newly-adopted law is currently being challenged in court, we have recorded an accrual to account for McKesson's estimated portion of the calendar year-to-date assessment, should we be required to pay the stewardship assessment in January of 2019. This accrual is reflected in our U.S. Pharmaceutical and Specialty Solutions segment. It's recorded in both our GAAP and adjusted operating results.

In addition, McKesson's a defendant, often named with pharmaceutical manufacturers, retail pharmacy chains and other wholesalers, in numerous cases alleging claims related to the distribution of controlled substances to pharmacies. McKesson's recorded expenses associated with these cases, which have far exceeded our initial expectations and are significantly higher than the charges incurred in fiscal 2018. These expenses are reflected within our Corporate segment and are recorded in both our GAAP and adjusted operating results.

Total adjusted operating expenses from both the New York legislation and costs to support ongoing litigation were approximately $34 million in the second quarter and $61 million year-to -date. For fiscal 2019, we now anticipate these opioid-related costs will exceed $100 million. We'll continue to provide updates on these items as more information becomes available.

Now let's turn to details of our consolidated second quarter adjusted earnings, which can be found on slide nine. Consolidated revenues for the second quarter increased 2% versus the prior period on a reported and constant-currency basis, primarily driven by market growth and acquisitions, partially offset by previously-disclosed customer losses in our U.S. Pharmaceutical and Specialty Solutions segment. Second quarter adjusted gross profit was down 1% year-over-year, primarily driven by customer loses and our sale of the Enterprise Information Solutions business or EIS in the third quarter of fiscal 2018, partially offset by market growth and acquisitions.

Second quarter adjusted operating expenses were flat year-over-year, primarily driven by acquisitions, offset by a reversal of a contractual liability and the divestiture of our EIS business. During the quarter, McKesson negotiated a reversal to a contractual liability associated with our equity investment in Change Healthcare. As a result, McKesson realized a pre-tax benefit of $90 million in both our GAAP and adjusted operating expenses within our consolidated P&L. Adjusted income from operations was $983 million for the quarter, a decrease of 6% from the prior year.

We now expect adjusted income from operations to decline in the low-to-mid single digits year-over-year, versus our original expectation of flat-to-mid single digit growth. Interest expense of $66 million in the quarter decreased 4% compared to the prior year, driven primarily by the refinancing of debt at lower interest rates, partially offset by short-term borrowings. Our adjusted tax rate was16.2% for the quarter, primarily driven by a discrete tax benefit of approximately $42 million and our mix of business. We now assume an adjusted tax rate of approximately 17% to 19% for the full year, which may vary from quarter-to-quarter.

Additionally, income to attributable to non-controlling interests was $54 million for the quarter, a decrease of 2% compared to the prior year. Our adjusted net income from continuing operations totaled $714 million, with second quarter adjusted earnings at $3.60 per diluted share, which is up 10% compared to $3.28 in the prior year. Wrapping up our consolidated results, our second quarter diluted weighted average shares were 199 million, a decrease of 5% year-over-year. During the quarter, we completed $580 million of share repurchases, and we now expect diluted weighted average shares of approximately 197 million for the year.

Next, I'll review our segment results, which can be found on slides 11 through 15. As a reminder, effective in fiscal 2019, McKesson revised its segment reporting structure. We report results in three main segments; U.S. Pharmaceutical and Specialty Solutions, European Pharmaceutical Solutions and Medical-Surgical Solutions. All other businesses, which primarily include McKesson Canada, McKesson Prescription Technology Solutions, and our equity investment in Change Healthcare are included in Other.

As a reminder, in the first and second quarters of fiscal 2018, contribution from EIS is included in Other. EIS contributed approximately $120 million in revenues and $17 million in adjusted operating profit in the second quarter of fiscal 2018 and $240 million in revenues and $34 million in adjusted operating profit in the first half of fiscal 2018.

Let me start now with the U.S. Pharmaceutical and Specialty Solutions. Revenues were $41.6 billion for the quarter, up 2% driven by market growth and acquisitions, partially offset by previously-disclosed customer losses and branded-to-generic conversions. Segment adjusted operating profit for the quarter was down 5% to $635 million, driven by customer losses and lower branded pharmaceutical compensation than the prior year, partially offset by strong growth across our specialty businesses, including acquisitions. The segment adjusted operating margin rate was 153 basis points, a decrease of 12 basis points, driven by a growing mix of specialty pharmaceuticals. We continue to benefit from the dollar contribution of these products, although they're dilutive to the margin rate.

Specific to brand compensation, we have lowered our assumption for branded pharmaceutical price increases in the U.S. to mid-single digit percentage from our prior assumption of mid-to-high single digit percentage. I would remind you that our branded pharmaceutical contracts are primarily fixed in nature versus variable, with the fixed component representing approximately 95% of the compensation we receive. I would also reiterate my previous comments at a healthcare conference in September. If in the second half of fiscal 2019, manufacturers do not take any price increases, the impact to our adjusted operating profit would be a range of approximately $75 million to $90 million, or approximately 2% to 3% of our adjusted EPS. We'll provide an update on the brand pricing environment when we report our third quarter earnings in late January.

And as a result of our expectation for increased stewardship expenses in New York related to opioids that I discussed earlier and our updated expectations for brand pricing, we now expect to be at the low end of original fiscal 2019 guidance assumption of flat-to-down mid-single digit adjusted operating profit for the segment.

Next moving on to European Pharmaceutical Solutions; revenues were $6.6 billion for the quarter, down 2%, negatively impacted by $68 million from currency rate movements.

On a constant-currency basis, revenues were down 1%, driven by the previously-disclosed reduction in owned retail pharmacies following the closure or divestiture of approximately 200 stores and challenging operating environments in the UK and France. These items were partially offset by strong performance in the other countries that we operate in.

Segment adjusted operating profit was down 40% to $53 million. On a constant-currency basis, adjusted operating profit was down 39% to $54 million driven primarily by the impact of the previously-announced additional reimbursement cuts and market conditions in our UK business, and increased competition in the French wholesale market. The segment adjusted operating margin rate was 81 basis points on a constant-currency basis, a decrease of 50 basis points.

As a result of the weak second quarter segment performance as well as our updated view that mitigation efforts will not materialize as quickly as originally planned, we now expect segment adjusted operating profit to decline year-over-year with a more similar contribution in the second half of the year relative to the first half. While we continue to experience challenges in this segment, we're encouraged by the performance we're seeing in most all the other countries that we operate in; however that contribution is not material enough to offset the challenges in the UK and France.

Moving now into Medical-Surgical Solutions, revenues were $1.9 billion for the quarter, up 17%, driven by the MSD acquisition and market growth. Excluding the MSD acquisition, segment revenue was up 6%. Segment adjusted operating profit for the quarter was up 1% to $138 million, driven primarily by market growth, partially offset by $8 million of higher bad debt expense in the quarter.

Segment adjusted operating margin rate was 708 basis points, a decrease of 111 basis points, reflecting our mix of business, including the growth in lower-margin products such as Rx, previously-discussed bad debt in the quarter, and our continued investment in the homecare delivery business, as well as the lower relative margin contribution from MSD.

We are very pleased with the progress in integration activities of the newly-acquired MSD business. As we move through the integration phase and to executing on the synergies, MSD, like most acquisitions, will begin to deliver operating profit accretion. This is consistent with our previously-discuss assumption that the MSD acquisition will be modestly accretive for adjusted earnings in fiscal 2019.

Finishing our business review with Other; revenues were $2.9 billion for the quarter, down 5%. Revenues were negatively impacted by $113 million from currency rate movements. On a constant-currency basis, revenues were down 1%, driven primarily by the sale of the EIS business, partially offset by market growth across the businesses in the segment and acquisitions.

Other adjusted operating profit was up 24% to $300 million. On a constant-currency basis, adjusted operating profit was $310 million, driven by the previously-mentioned reversal through a contractual liability associated with our equity investment in Change Healthcare and growth in our Prescription Technology Solutions business, or MRxTS, partially offset by the impact of previously-disclosed government initiatives on our Canadian business, the lower equity contribution from Change Healthcare, and the sale of the EIS business.

In Canada, our Rexall business faced some challenges in the quarter. Actions taken earlier in the year are not materializing as fast as we anticipated, resulting in a lower performance than expected. We remain confident and committed to this business and will continue to focus on addressing these challenges with an eye on long-term sustainability.

Additionally, we previously identified the impact of government actions in minimum wage increases as a gross pre-tax fiscal 2019 headwind of between $100 million and $120 million and discussed our efforts to mitigate that impact. I'm pleased with the work of our Canadian team, who have identified and begun implementing action plans that we anticipate will offset more than half of the $100 million to $120 million gross headwind, the benefits of which are expected to be captured primarily in the second half of the year.

Posing our segment review with Change Healthcare, adjusted equity income from Change Healthcare was $56 million for the quarter. We're pleased with the operational performance of Change Healthcare. Adjusted EBITDA performance was in line with our expectations for the quarter. This solid operational performance was offset by increased investments in growth areas, higher tax expense, and higher interest expense.

Due to the second quarter results and our expectation that these below-the-line dynamics will continue, we now expect the adjusted equity contribution from Change Healthcare to decline year-over-year relative to our original guide of low-to mid-single digit growth, and we expect a more similar contribution in the second half of the year relative to the first half.

We now expect other adjusted operating profit to increase year-over-year, driven by the benefit from a reversal of a contractual liability associated with our equity investment in Change Healthcare and higher-than-anticipated growth in our MRxTS business, partially offset by the lower equity contribution from Change Healthcare.

Next, McKesson recorded $143 million in adjusted corporate expenses, an increase of 55% in constant currency year-over-year, primarily driven by opioid-related expenses and planned technology investments. As a result of the outlook for opioid-related expenses that I discussed earlier, we now expect adjusted corporate expenses will increase year-over-year.

I'll now review our working capital metrics and cash flows, which can be found on slide 16. For receivables, days sales outstanding decreased one day to 26 days. Days sales in inventory decreased one day to 30 days, and days payables outstanding decreased two days from the prior year to 59 days. I'd remind you that our working capital metrics and resulting cash flow may be impacted by timing, including the day of the week that marks the close of a given quarter.

We ended the quarter with a cash balance of $2.1 billion. For the first half of the fiscal year McKesson paid $840 million for acquisitions, repurchased $877 million in common stock, and paid $139 million in dividends. McKesson generated $318 million in cash flow from operations. After deducting the $248 million in internal capital investments, McKesson had free cash flow of $70 million, which was modestly ahead of our expectations.

In fiscal 2019, we continue to expect internal capital investments of between $600 million and $800 million and free cash flow of approximately $3 billion. We also have a total of $4.2 billion remaining on our share repurchase authorization. And finally, our board of directors approved a quarterly dividend of $0.39 yesterday, which will be payable to shareholders in January.

In terms of fiscal 2019 earnings progression, we expect that the fourth quarter will be our largest in terms of EPS contribution, which is similar to prior years. For fiscal 2019, we anticipate that our higher-than-expected second quarter adjusted earnings per share results and lower full-year adjusted tax rate will be partially offset by ongoing litigation and stewardship costs related to opioids and the lower profit contribution from our European business. As a result, we're narrowing and raising the low end of our fiscal 2019 adjusted earnings outlook. We now anticipate adjusted EPS of $13.20 to $13.80 per diluted share in fiscal 2019.

Let me take a minute to update you on the optimization of our operating model and cost structure. We're focused on the alignment of our operating structure to support the growth initiatives that we have previously outlined. Additionally, we continue to focus on controlling our operating expenses, which will provide the flexibility to make investments into the business and drive operating leverage.

Throughout the second quarter, we made progress furthering the priority to evolve our operating structure with particular emphasis in the areas of finance, technology, human resources and on indirect spend. We've made progress in several areas, but I'd like to highlight three.

First, we are evolving our operating structure and related spend management. As a result, we've launched more disciplined and rigorous internal spend guidelines across the enterprise to support sustainable spend reductions.

Second, we're transitioning several business unit functional and back-office services to a more centralized hub model, leveraging outsourcing and technology. This results in a realignment of functions to report in a more centralized manner, improving service delivery and increasing focus on our operations and on customers and patients.

And third, we are accelerating technology adoption, including increasing the use of robotics processing automation, AI and data and analytics to deliver more efficient and accurate service and output.

These efforts will generate meaningful savings for the organization, driving increased productivity and efficiency, allowing our teams to focus on higher-value activities for the company and for our customers. These are just a sample of the initiatives that are underway as McKesson transforms its operating model to drive cost savings. And we have line-of-sight to many more initiatives that will drive additional savings. McKesson expects that these initiatives will drive approximately $300 million to $400 million in annual pre-tax savings that will be substantially realized by the end of fiscal 2021. I'm extremely pleased with the progress we're making and the change that we're driving at McKesson. And most importantly, I'm energized by the commitment and engagement of our McKesson employees across the globe that are driving this effort.

In closing, we're narrowing and raising our fiscal 2019 outlook of adjusted earnings to $13.20 to $13.80 per diluted share. We are making solid progress against our multi-year strategic growth initiative. While we faced incremental challenges in fiscal 2019, particularly in our European business, we anticipate that the second half of the year will ramp due to seasonality, organic growth, the realization of synergies from acquisitions and the benefits from mitigation efforts. Our leadership position and ability to execute combined with increased focus on reducing costs across the organization and investing in our priority growth areas, gives me confidence in McKesson's future.

And with that, I'll turn the call over to the operator for your questions. In the interest of time, I'd ask that you limit yourself to just one question and a brief follow-up to allow others an opportunity to participate. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question comes from Michael Cherny with Bank of America. Caller, your line is open.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

Good morning and thank you for all the color so far. I want to tie a little bit into the broader picture of drug pricing. Britt, you reiterated your view on what happens at the beginning of the year, or at least for your guidance, if there's no increases in the typical January 1 timeframe. As you think about what that could imply for the changing dynamics of the market as a whole, especially with news this morning about apparent change to Part B coming, how do you think about positioning yourself and contracting with manufacturers, contracting with customers in a world where there continues to be a moving target on what that reference rate or what that pricing dynamic could be over time?

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

A

Well, Mike, thanks for that question. I think I would reiterate that, again, we have changed our assumption on branded price inflation to the mid-single digits. And I would reiterate my comments, if pricing inflation does go away then we expect that, that range could be $75 million to $90 million. I would also remind you that we have talked, over time, how we've continued to evolve our relationships and our agreements with manufacturers, as well as evolving our relationships and agreements with customers.

And we believe that it's important for us to put the economics on each individual product that we service to our customers so that it reflects the services that we provide on those products for manufacturers to our customers. And so we continue to have strong dialogue with both manufacturers and customers. We continue to work with them and partner with them and try to understand the evolving dynamics. And we'll continue to evolve our relationships and our agreements such that we're being paid a fair value for the services that we perform on each of the product categories that we provide to our customers and for our manufacturers.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks a lot. I'll let others ask questions.

Operator: Next we'll go to Lisa Gill with JPMorgan.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Great. Good morning. John and Brian – John, I appreciated your comments at the beginning, but I want to really try to understand how to think about McKesson going forward. So, we talk about drug pricing, we talk about changes that are happening in D.C. I heard you talk about your Life Science business and maybe make incremental acquisitions there. As you think about the different businesses that you have today, for example, international that hasn't worked quite the way you anticipated when you bought Celesio, how do we think about

McKesson over the next few years? Does it make sense to continue to invest in that business outside the U.S.? Are there larger incremental acquisition opportunities you see within Life Sciences?

And then, as we think about, for example, your oncology business and this changing dynamic around pricing, are there other acquisitions that you need to make? Are there business model changes that need to be made? I know this is a big question, but I think if we just think about how McKesson is going to be positioned over the next few years, I think it'd be really helpful to hear your thoughts.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.

A

Well, thanks, Lisa, for the question there. And clearly that was a big question covering lots of different subjects. I think that if you look at McKesson historically, we've done I think a really good job of managing our portfolio of businesses. So first, as you pointed out, we're not afraid to buy and sell businesses and to react where we see the market opportunities emerging. Clearly, Brian was a big part of that in his previous role in corporate strategy and business development and will play a very important role in his new capacity.

We think we are in the right businesses at the right time. You mentioned a couple of times our McKesson Life Sciences business and our continued increased exposure to the biopharma industry and these new product launches that are coming out. We believe there's not only an opportunity for us to make money in our core distribution businesses related to this innovation, but perhaps as important, or maybe more important, a lot of these biopharma companies are beginning to turn to McKesson and our Life Sciences business to provide them with incremental support that helps them get the product to market, improve the adherence and compliance to these products, help the patient get access to both the drug as well as expert advice and support, and also get the right payment structure set up so these patients can qualify with their payers and health plans to be covered for the use of these medications. So, we feel really good about where we are and we think we're positioned properly.

When you think about changes to the pricing dynamic, I think Britt did a nice job of outlining for you how much risk McKesson might have related to price inflation. We've tried to bound that risk for investors so you have a sense for how meaningful or how little meaning it has to us at this point in our evolution. Years ago, we began to move our model away from a dependence on price inflation on the brand side to create value, and we think our new relationships continue to evolve nicely in that area.

Clearly, there have been people talking about this whole idea of a list price reduction. We believe what we received from manufacturers represents a fair payment for the value that we deliver on an ongoing basis. So we believe very strongly we will continue to have a revenue-based relationship with biopharma, and that that relationship may be modified over time as necessary if we find that the prices change in a significant way.

And then you mentioned our oncology exposure. We're really pleased with the growth we're seeing in our oncology business particularly, which is part of part of our Specialty Solutions business. And not only is the U.S. oncology business growing rapidly with a significant increase in the number of physicians and practices that are involved in U.S. oncology, but we're finding that the market in general finds our value proposition compelling and that solutions we bring are very differentiated in the market, and we are gaining significant momentum in oncology particularly.

When you think about pricing risk in that market, clearly various reimbursement strategies have been used over decades in community oncology, and our community oncologists have very resiliently moved their business practice and model to reflect the value and the service they deliver to their patients.

We don't believe the administration or anyone that's a payer for healthcare would like to see oncology services move away from the community setting. First of all, it won't be as convenient and as accessible for the patients in America. We don't think it'll improve quality, and it clearly will increase costs if these patients and physicians migrate to a more acute setting.

So, albeit there may be changes in the way payment structures move, but we've had significant success even recently with the Oncology Care Model experiment that took place with Medicare to help us prove that we can deliver in a value-based way a more all-encompassing treatment process in a way that delivered the quality that was reflected and required in the Oncology Care Model. So it wasn't necessarily drug dependent.

So, I think if we see some changes in the way that it's done, it's not clear that it'll affect oncology particularly. If it does, we think our practices and our partnerships are prepared to make that transition and work with the payers to be paid for the service.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Right. Thank you for all the comments. I appreciate it.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.

A

Yeah, welcome, Lisa.

Operator: And next we'll go to Eric Percher with Nephron Research.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. Thanks for all the detail on how your expectations have changed during the course of the first two quarters. Maybe one specific question, which is, as you laid out guidance for the year, did you expect that you might see the change benefit occur in fiscal year 2019?

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

A

Eric, thanks for that question. As we laid out, this was in connection with our original Change Healthcare transaction. It was not part of our original guidance. It was a negotiated agreement that happened during the second quarter. So we did not have that visibility as we laid out our original guidance, and it was not included in it.

Eric Percher
Analyst, Nephron Research LLC

Q

Okay. And, Britt, could you rank order the items that have created headwinds as you entered the year? I want to make sure we have some sense of the magnitude for these moving items.

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

A

Yeah, thanks, Eric. I think, as we've called out here, certainly Europe has been a challenge for us. And I think we've laid out for you some of the dynamics that have created that challenge. We did lay out for you in our U.S.

Pharmaceutical and Specialty Solutions segment that, before the year, we did have some customer losses, and those customer losses were anticipated. They were part of our guide. And from a year-over-year basis, they have created a headwind for us.

Beyond that, we also laid out for you at the beginning of the year the Canadian reimbursement or Canadian generics price decline. We laid out for you what the gross headwind was there. We've made tremendous progress in mitigating that. And as I laid out, we believe we've mitigated over half of that and should start to see some of the benefits in the second half of the year.

But we obviously have felt the impact on that the first half of the year. And then we've continued to make investments in our business, and I talked about some of the planned technology investments that are running through our Corporate segment. We believe that these are going to help us optimize our cost structure and our model going forward. And while there are headwinds this year from a cost perspective, these are the investments that are going to really give us the type of flexibility that we need as we go forward.

And then the last thing that I would point out is I gave more description on it certainly this quarter are the costs related to opioids and the opioid-related expenses. And as I pointed out, we have experienced a significant amount of costs in our first half of the year and I also tried to provide you and what our estimate is going to be for the full year on these opioid-related expenses. So I don't know if that's a perfect rank order for you, but I wanted to really summarize for you the headwinds and how we've made progress against some of these headwinds, particularly in Canada.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you.

Operator: Your next question comes from the line of Brian Tanquilut with Jefferies.

Brian Gil Tanquilut
Analyst, Jefferies LLC

Q

Hey. Good morning, guys. As I think about the performance during the quarter, U.S. pharma still beat despite brand pricing coming in below expectations. So is that just generics driving that? And then, what are your expectations on generics going forward? And what are you seeing there in terms of pricing trend and contribution to the P&L?

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.

A

Thanks Brian for the question. I'll ask Britt to talk specifically about pricing trends as we see it both on, sort of, the buy side of generics as well as what we're seeing on the sell side. But speaking at a higher level related to our U.S. Pharmaceutical business, I would say that we are beginning to see a very nice stabilization of that business. We talked about customer churn coming into the year. We believe strongly in our value proposition, and we continue to create great relationships with our customers, and I think we see that business reaching a point of recovery with the potential outlying risks still associated with what happens from a pricing model perspective related to governmental changes or big pharma, biopharma policy changes. But maybe he could talk specifically about generics.

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

A

Sure, and what I would add to that, certainly we're seeing that stabilization in our U.S. Pharma business. We're also seeing really strong growth in our Specialty Solutions business, and John talked about that at the beginning of the call. So that's also embedded in there. In terms of how we think about pricing on the generic side, we've talked about this now for the last couple of quarters. On the sell side, we continue to see a very competitive yet stable environment.

And on the buy side, we have seen that the rate of deflation has stabilized over the last several quarters. And in some product categories, we are seeing certain molecules and product categories firming up from a price perspective on the buy side. So the environment overall is in a more stable state than it has been in the last – or that has been 18 months ago. And we're certainly in a great position with our ClarusONE sourcing operation to continue to create great buying opportunities that we can provide good cost savings for our customers, as well as to really create that spread between the buy side and the sell side. So we're very confident in our ability to continue to source well through ClarusONE with a more stabilized environment, it really sets us up quite nicely.

Brian Gil Tanquilut
Analyst, Jefferies LLC

Q

Thank you.

Operator: Your next question comes from the line of Robert Jones with Goldman Sachs.

Robert Patrick Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks for the questions. Hey, Britt, just to follow up on the back-half guidance specifically on the U.S. business, you're now expecting it to be down towards the bottom end of the range, down mid-single digits. It seems like obviously the declines in the back half would be worse obviously than the front half in order to get to that bottom of the range, and you did share some of the moving pieces and expectations. But could you maybe just break out for us again, of the expected decline in the back half, how much of it is from the anticipated opioid expense versus some of your changes and assumptions around things like branded pricing?

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.

A

Within the U.S. Pharmaceutical and Specialty segment, we do have certain costs related to the New York State Stewardship. So that will be in a part of our second half. And as we think about branded price inflation, we did give you an updated assumption around our guidance. So at the beginning of the year, we gave you mid-to high-single digit assumption for branded price inflation. We've now updated that to give more of a mid-single digit price inflation assumption. So those would be the two pieces that I would call out that have helped us to clarify for you our guidance assumption around closer to the lower end of our original range for U.S. Pharma.

Robert Patrick Jones
Analyst, Goldman Sachs & Co. LLC

Q

That's super helpful. And then, Britt, just one follow-up on the free cash flow. I think it's about, what, $70 million through the first two quarters? You're still sticking with the $3 billion for the year. Can you maybe just help us understand what bridges that gap? What are some of the timing issues at play as far as cash flow for the back half?

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.
A

Sure. As I mentioned, you're right. It's $70 million of free cash flow in the first half of the year. Typically, we do see, because of seasonality, also because of just the timing of how certain customer payments happen during the year that our fourth quarter is our strongest cash flow performance. And we expect that to continue again this year.

So our first half of the year, as I mentioned, is slightly ahead of our own internal expectation, and we would continue to expect to generate $3 billion with a stronger second half performance, which is typical to prior years.

Robert Patrick Jones
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thanks.

Operator: Your next question comes from the line of Steven Valiquette with Barclays.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.
Q

Great. Thanks. Good morning, John and Britt. So just in relation to the UK pharmacy operations, the other publicly-traded company with large retail pharmacy operations in the UK seemed to be performing maybe a little bit better relative to your operations. I know there are some differences in revenue and profit mix between pharmacy versus front end when comparing these operations, but the two quick questions I have tied to this is, one, is there any strategic consideration on your part to perhaps diminish your exposure to pharmacy and focus more on front end in the UK?

And then just quickly, number two on this, you mentioned in the press release you continue to have conversations with the UK government to discuss the value-added pharmacies, low-cost setting of care, et cetera. It's unclear just from the outside whether or not these types of lobby efforts have really helped to improve any reimbursements. So I was just curious to just, generally, have there been any historical examples you can recall where some overly aggressive UK reimbursement cuts were perhaps reversed and there was some relief for pharmacy providers? Thanks.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.
A

Well, I think those are very important questions, and it's terrific to have Brian on the call given that his most recent responsibility was to run our European operations. And he, in particular, has spent a lot of time in the UK both in terms of the operations of the UK, but also the political environment of the regulators. So Brian, why don't you take that question for us?

Brian S. Tyler
President and Chief Operating Officer, McKesson Corporation
A

Sure. Thanks, John. Thanks for the question. So I'd start with the first question of mix, and clearly the model of some of our competitors is quite different than the model we have in the UK. They tend to be much more front shop, health and beauty focused, might comprise as much as 60% to 65% of their overall mix where historically we've been a very healthcare, pharmacy-focused organization with roughly 85% to 90% of our mix from the Pharmaceutical segment itself.

As we think about the front shop of that business, we continue to think about how we migrate to an overall healthcare value proposition, which puts retail pharmacy more in the front and center of the provision of care in the community. That could impact the mix of types of products we put in the front shop, and we're actively working through our merchandising strategies in that regard.

The second thing you asked about, I believe, was just NHS policy overall, and we continue to be in very active dialogue with the regulators in the UK to champion our view. And we believe it's a view they actually share, that community pharmacy plays an important role in the overall population health of the communities that they serve. And so we continue to evolve our model in that direction. Clearly, the reimbursement landscape has been a challenging one for us, not just in the magnitude of the cuts we absorb, but in the difficulty of predicting when and how those cuts have hit us.

I would say we are encouraged by the dialogue we're having, and you would see earlier this week, in fact NHS announced that they are going to keep the reimbursement rates for pharmacy flat for the coming year, where the original intent had been to impose some more decline. So, we view that as certainly incrementally positive news for us. And I guess I'd just leave you with the thought that the team there is actively engaged on the policy arena or actively engaged with manufacturer partners as we reposition this business. And we continue to believe that it will play an important part in provision of health care in the UK.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.
Q

Okay. That's very helpful. Thanks.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.
A

Yeah, thanks, Brian. Next question, please.

Operator: Next we'll go to Ross Muken with Evercore ISI.

Ross Muken
Analyst, Evercore ISI
Q

Hi. Good morning, guys. Given sort of where the stock is trading today, both on a sort of EBIT/EBITDA or P/E basis and where the free cash flow yield is, I guess, how are you thinking about kind of internal versus external investments? And I guess that – I know you've always been balanced in how you've done it, but obviously this is really unique time in terms of valuation for your business.

And then secondarily, on the M&A side, you had done some things on the technology front. You've moved into a couple higher growth areas also in Med-Surg, as you talked about at Life Sciences. How would you, kind of, characterize the pipeline or some of those [ph] growthier (56:20) assets and whether you think you're getting paid for some of those businesses you're moving into, kind of getting back to the original question, and the multiple that the market's implying for you overall?

Britt Vitalone
Chief Financial Officer & Executive Vice President, McKesson Corp.
A

Ross, thanks for that question. I'll start and then John can certainly add to this. From a capital deployment perspective, I would just reiterate my comments that we did repurchase shares in the second quarter, $580 million. We believe that a balanced approach still is appropriate for us. You've seen us balance our capital deployment during the year. We've made investments such as MSD. We've also returned capital. So we've really been very balanced this year in terms of cash.

We like businesses like MSD because they provide good growth opportunities for us, doing businesses that we know and have operated for a long period of time. They also fit into our strategic growth initiatives, so where there's opportunities such as MSD, we're certainly going to take advantage of looking at those and evaluating those.

We also believe, though, that our shares are attractively priced. And we talked about the share authorization that is still outstanding. Our management and board both feel that the shares are attractively priced, and we've continued to execute share repurchases as a result of that. And John, if you want to add to the M&A pipeline?

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.
A

Well, clearly, we are in the market. We're always active in the market evaluating transactions, and I think we make long-term bets on where we think the growth is going to be. To your point, some of the – in fact all of the recent acquisitions are performing very well for us and are producing returns that are significantly above our long-term cost to capital. We look at cash flow generation out of these businesses, and that's an important characteristic. And we can see our path to growing that cash flow. So, we're going to continue to use that combination. We're going to be disciplined. Clearly, the value of our own stock at these rates is, on a relative basis, improving in its attractiveness to us. And we're not blind to that, and we'll continue to be disciplined.

Ross Muken
Analyst, Evercore ISI
Q

Thank you. I'll look forward to that.

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.
A

You're welcome.

Craig Mercer
Senior Vice President-Investor Relations, McKesson Corp.
A

I think we have time for one more, operator. Alan?

Operator: Yes, sir. We'll take our last question from Ricky Goldwasser with Morgan Stanley.

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC
Q

Yeah, hi. Good morning and thank you for all the details. John, both Gilead and Amgen announced their lower WAC for some existing product. Can you share with us your views on what are you seeing the implications are for the industry, and if you had conversations with the manufacturers on what that means to your existing contracts?

John H. Hammergren
Chairman & Chief Executive Officer, McKesson Corp.
A

Well, we have constant conversations with manufacturers, Ricky, as you know, and as we've said earlier on the call and on other calls, we are very focused on making sure we get a fair return for the value that we deliver to these manufacturers. We can't control what they do from a pricing perspective, but we certainly have a significant relationship that delivers tremendous value to the manufacturers and gives them access to our customers, most of which buy only from us, in a way that is really important.

We continue to evaluate the economics of these changes from a price perspective, and we plan to maintain the economics that we've realized in the past on these products, certainly regardless of where the price point gets set. So that's our position, and we believe the manufacturers respect that and will continue to provide us with the right payment for the service that we continue to provide.

John H. Hammergren

Chairman & Chief Executive Officer, McKesson Corp.

I want to thank everybody on the call today for your time. McKesson continues to execute against our fiscal 2019 plan, and I'm excited about the opportunities ahead of us. I want to recognize the outstanding performance of our employees and their contributions to help our customers improve lives and deliver opportunities to make better health possible, and especially their commitment to helping their communities and each other during times of need.

I'll now hand the call over to Craig for his review on upcoming events for the financial community. Craig?

Craig Mercer

Senior Vice President-Investor Relations, McKesson Corp.

Thank you, John. I have a preview of upcoming events for the financial community. On Tuesday, November 13, we will present at the Credit Suisse Healthcare Conference in Scottsdale, Arizona. On Tuesday, November 27, we will present at the Evercore ISI HealthCONx, the conference in Boston. And in early January 2019, we will present at the J.P. Morgan HealthCare Conference in San Francisco. We will release third quarter earnings results in late January. Thank you and goodbye.

Operator: That does conclude today's conference. We thank everyone again for their participation.