

26-Jul-2018

McKesson Corp. (MCK)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the McKesson Q1 Earnings Call. Today's conference is being recorded.

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

Craig Mercer

Senior Vice President, Investor Relations, McKesson Corp.

Thank you. Thank you, Lynette. Good morning and welcome to the McKesson fiscal 2019 first quarter earnings call. I am joined today by John Hammergren, McKesson's Chairman and CEO, and Britt Vitalone, McKesson's Executive Vice President and Chief Financial Officer.

John will first provide a business update 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 9:00 a.m. 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 slides 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 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 first 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 when reviewing the fiscal 2019 versus fiscal 2018 results discussed today.

Thank you, and here is John Hammergren.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Thanks, Craig and thanks everyone for joining us on our call. Today, we reported a solid start to fiscal 2019. For the first quarter, we achieved total company revenues in excess of \$52 billion and adjusted earnings per diluted share of \$2.90, consistent with our expectations. Given our recent update provided at our Investor Day in late June, I will focus my attention on a few topics and will let Britt go through the quarter financial results in greater detail.

I'd like to take a moment to discuss the progress we've made against our multiyear strategic growth initiative. First, we continued to proactively execute against our priority growth areas namely the manufacturer value proposition, specialty pharmaceuticals and the role of retail pharmacy. In the past quarter, we closed the Medical Specialties Distributors or MSD acquisition. We accelerated the commercialization for a recently approved specialty prescription medicine with the reimbursement hub in specialty pharmacy support services representing one of the largest programs launched to-date. This is one example of a number of planned future commercializations with this partner and many others. We are executing against the business cases for other recent acquisitions such as CoverMyMeds, intraFUSION, Well.ca and RxCrossroads that also support our priority growth areas, which are beginning to contribute to our earnings growth.

Second, we launched a program designed to optimize and drive an efficient operating structure that supports our prioritized growth areas. Britt will discuss these initiatives in more detail shortly.

Next let me touch on our European Pharmaceutical Solutions segment. You'll recall in our year-end earnings call that I outlined a series of initiatives we took in Q2 of last year. These were in response to certain UK government actions. We have substantially achieved the results we outlined, generating savings and efficiencies from the plan we initiated in Q2 last year, rationalizing the store footprint and streamlining our back-office operations.

On June 29, the government announced additional cuts to retail pharmacy reimbursement. Although helpful, the restructuring program we put in place in fiscal 2018 will not fully mitigate these new cuts. We will continue to respond to event-driven government actions through company-specific mitigation efforts. We also remain committed to continued policy and education discussions with the health ministry to ensure patients have ongoing access to care in low-cost and convenient settings.

We have spoken previously about how retail pharmacy would help to ensure the sustainability of the health system in the UK and elsewhere as more services migrate from higher cost locations into the lower cost

pharmacy setting. And the pharmacist plays a critical role in providing a range of personalized healthcare services to the patient.

Now, I'd like to take a few moments to discuss our perspective on the recently-announced Health and Human Services blueprint request for information or RFI. The current administration is focused on fostering an affordable, accessible healthcare system that puts patients first, and we fully share this goal. We were also encouraged by the broad scope of the RFI, solving a myriad of healthcare issues is not a simple task and it requires a comprehensive evaluation of the challenges and opportunities.

While policy decisions are being evaluated, McKesson continues to engage as a key stakeholder in educating policy makers, addressing issues that may impact patients, our industry and our business partners, and helping to drive the necessary change to support access, quality and affordability for a sustainable healthcare system. We remain confident in McKesson's path forward, the critical role of the services we provide to the healthcare industry today, and our ability to identify and apply solutions to address the most pressing challenges to the healthcare system globally.

We can help drive the stated objectives of the administration. Today, we support patient access through affordable generic medication. We do this by leveraging our global scale and efficiency. We're proud to be a leader supporting clinical trials to help bring innovative specialty therapies to market through an increasingly optimized path and to partner with manufacturers and other stakeholders to help bring these new drugs to the patients who need them. We have extensive experience in supporting value-based care with tools, processes and expertise for both commercial and government payers and many of you will recall that through partnership with manufacturers almost 15 years ago, we were able to transform our business model by introducing inventory management agreements and distribution service agreements that significantly improved transparency across the supply chain.

Many of you know that distribution service agreements compensate distributors for the fair value of the services provided. These agreements appropriately consider the requirement to maintain an efficient, secure and safe supply chain, high service levels, as well as substantial working capital investment made when taking title to inventory or collecting customer receivables, which together represents tens of billions of dollars on our balance sheet.

To the extent changes are made to the current model, we are well-equipped to facilitate the change and to again partner with all stakeholders to ensure a smooth and effective transition. The value we deliver has been validated over the past 15 years through contract renewals, and expanded relationships both upstream and downstream in the supply chain. We remain confident we will continue to demonstrate the value of our highly-scaled and efficient distribution network, our services and capabilities, far into the future.

McKesson has the patient at the center of how we think and we want to continue to be a leader in bringing real solutions to the debate that helps to lower cost while improving access and quality.

Now to wrap up my comments, McKesson's fiscal first quarter results represent an in-line performance across our segments. We believe we are well-positioned to drive future growth with our scaled and efficient foundation, our clear focus on several priority growth areas and improving the efficiency of our operating structure, our leading Technology Solutions for our partners and of course our strong financial position.

We are extremely well-positioned to execute our portfolio approach to capital deployment and to deliver value for our shareholders through a mixture of internal capital investments, acquisitions, share repurchases and dividends.

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

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks, John. As John discussed earlier, our fiscal 2019 first quarter results were in-line with our expectations and we're reiterating our fiscal 2019 adjusted earnings outlook of \$13 to \$13.80 per diluted share. Please note that unless stated otherwise, the underlying assumptions that were detailed in our fourth quarter press release are being reiterated today. I'll start with the results for the first quarter.

Turning to slide 6 of the presentation, first quarter adjusted EPS of \$2.90 represents an increase of 18% year-over-year driven by a lower tax rate and share count, and growth in our U.S. Pharmaceutical and Specialty Solutions segment, partially offset by previously discussed headwinds in our European and Canadian businesses, and a negative \$0.05 foreign currency impact.

Our first quarter adjusted earnings results excludes the following GAAP-only items: amortization of acquisition-related intangibles of \$0.74 per diluted share; acquisition-related expenses and adjustments of \$0.22 per diluted share; LIFO inventory-related credit of \$0.07 per diluted share; gains from antitrust legal settlements of \$0.13 per diluted share; restructuring and asset impairment charges of \$0.42 per diluted share; and other adjustment net charges of \$2.41 per diluted share, largely comprising a non-cash goodwill impairment charge in our European Pharmaceutical Solutions segment, primarily triggered by the recently-announced UK government reimbursement reductions as well as a change to our segment reporting structure.

As detailed on slide 7, as a function of our segment reporting change in Q1 of FY 2019, our European business is no longer considered a single reporting unit. Following the change during the quarter, the segment was split into two distinct reporting units: Consumer Solutions and Pharmacy Solutions. We're conducting impairment testing of this new reporting unit level. We recorded a goodwill impairment charge during the quarter. Given that impairment testing is now being performed at a more discrete level for this segment, future negative events will trigger additional evaluation and we may be required to report impairment charges in the future.

As John discussed, on June 29, the UK government announced additional reimbursement cuts to retail pharmacy. The cuts reduced our estimation of future cash flows resulting in a goodwill impairment charge. We responded to prior government action through our previously announced divestiture of closure of approximately 200 retail stores and, as a result of these recent actions, we are evaluating the effects these measures will have on our business. We will engage in discussions with the UK government to articulate the critical value pharmacy plays.

We also recorded restructuring and other charges in the first quarter. These charges primarily relate to the ongoing execution of our multiyear strategic growth initiative. We're making solid progress to restructure and reshape our operating model and investment in strategic growth initiatives we have previously communicated. We're executing against the operating model framework we previously discussed. As one example, after a comprehensive review, we've expanded our strategic partnership with a business process outsource provider, which will allow us to continue our transformation of key supporting functions. This important step will allow us to swiftly move select functions out of our operations into our business process service provider, reducing costs and increasing productivity.

We're making progress against our enterprise spend program. We've identified several cost categories that will leverage the scale of McKesson. We're confident these initiatives will generate meaningful and sustained savings. We expect to provide the quantification of the operating model and cost-out targets next quarter. And we continue

to expect to incur GAAP-only after-tax restructuring and other charges of approximately \$150 million to \$210 million in fiscal 2019. I'll remind you that these GAAP charges are not included in our adjusted earnings outlook.

Now let's turn to the details of our consolidated first quarter adjusted earnings, which can be found on slide 8. Consolidated revenues for the first quarter increased 3% versus the prior period, primarily driven by market growth and acquisitions, partially offset by previously disclosed customer losses in our U.S. Pharmaceutical and Specialty Solutions segment. On a constant currency basis, revenues increased 2%. First quarter adjusted gross profit was up 5% year-over-year, primarily driven by market growth including the timing of branded pharmaceutical compensation in the prior-year and acquisitions, partially offset by customer losses.

First quarter adjusted operating expenses increased 9% year-over-year primarily driven by acquisitions. Adjusted income from operations was \$796 million for the year (sic) [quarter] (13:36), an increase of 1%. Interest expense of \$61 million decreased 10% for the quarter driven primarily by the refinancing of debt at lower interest rates, partially offset by short-term borrowings.

Now let's move to taxes. Our adjusted tax rate was 18.8% for the quarter, driven by our mix of business and a discrete tax benefit. We continue to assume an adjusted tax rate of approximately 21% to 23% for the year, which may vary from quarter-to-quarter. Additionally, income attributable to non-controlling interest was \$58 million for the quarter, an increase of 4%. For fiscal 2019, we continue to expect income attributable to non-controlling interests to decline year-over-year. Our adjusted net income from continuing operations totaled \$589 million with first quarter adjusted earnings of \$2.90 per diluted share, up 18% compared to \$2.46 in the prior-year.

Wrapping up our consolidated results, our first quarter diluted weighted average shares were 203 million, a decrease of 5% year-over-year. During the first quarter, we completed approximately \$300 million of share repurchases, and we continue to expect diluted weighted average shares of approximately 200 million for the year.

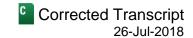
Next, I'll review our segment results which can be found on slides 9 to 12. As a reminder, effective in fiscal 2019, McKesson revised its segment reporting structure. We now report results in three main segments, which include U.S. Pharmaceutical and Specialty Solutions, European Pharmaceutical Solutions and Medical-Surgical Solutions.

All other businesses would primarily include McKesson Canada, McKesson Prescription Technology Solutions or MRxTS and our equity investment in Change Healthcare are included in Other. We believe that these segment reporting provides increased transparency and visibility of the underlying operating performance of the businesses within McKesson. In addition, in the first and second quarter of fiscal 2018, contribution from Enterprise Information Solutions or EIS is included in Other. EIS contributed \$17 million in adjusted operating profit for both the first and second quarters of fiscal 2018 for a total contribution of \$34 million.

We start first with U.S. Pharmaceutical and Specialty Solutions. Revenues were \$41 billion for the quarter, up 2% driven by market growth partially offset by previously disclosed customer losses in branded to generic conversion. Segment-adjusted operating profit for the quarter was up 2% to \$540 million, driven by market growth, the timing of branded pharmaceutical compensation in the prior-year and growth in our Plasma and Biologics distribution business, which is partially offset by customer losses.

The segment-adjusted operating margin rate was 132 basis points, an increase of 1 basis point as increased branded compensation was offset by our mix of business. We continue to see a growing mix of specialty

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pharmaceutical and we continue to benefit from the dollar contribution of these products, although it is dilutive to the margin rate.

Moving now to European Pharmaceutical Solutions, revenues were \$6.9 billion for the quarter, up 9%. Revenues benefited from \$487 million in favorable currency rate movement. On a constant currency basis, revenues were up 1% driven by market growth and acquisitions, largely offset by the previously disclosed increased competition in France, as well as a reduction in owned retail pharmacies in the UK following the closure of divestiture of approximately 200 stores.

Segment-adjusted operating profit was down 12% to \$74 million. On a constant currency basis, adjusted operating profit was down 18% to \$69 million driven by the impact of reduced reimbursement and the reclassification of certain prescriptions of over-the-counter products in our UK retail pharmacy business and increased competition in the French wholesale market. The segment-adjusted operating margin rate was 107 basis points on a constant currency basis, a decrease of 25 basis points. As a result of the first quarter segment performance, as well as the incremental government cuts I mentioned earlier, we now expect segment-adjusted operating profit to be at the low-end of the previously-provided range of flat to mid-single-digit growth.

Moving to Medical-Surgical Solutions, revenues were \$1.7 billion for the quarter, up 11% driven by market growth and one month of contribution from the MSD acquisition. Segment-adjusted operating profit for the quarter was flat at \$125 million driven by market growth offset by timing of certain events. The segment-adjusted operating margin rate was 734 basis points, a decrease of 81 basis points, reflecting our mix of business.

Finishing our business review with Other, revenues were \$3 billion for the quarter, up 5%. Revenues benefited from \$111 million in favorable currency rate movement. On a constant currency basis, revenues were up 1% driven primarily by market growth across the businesses in the segment and acquisitions, largely offset by the impact of government actions in our McKesson Canada business and the prior-year sale of the EIS business. Other adjusted operating profit was down 8% to \$213 million.

On a constant currency basis, adjusted operating profit was \$204 million driven by the impact of previously-disclosed government initiatives on our Canadian business, the prior year's sale of the EIS business and a lower equity contribution from Change Healthcare, partially offset by growth in MRxTS. Adjusted equity income from Change Healthcare was \$64 million for the quarter.

Next, McKesson reported \$95 million in adjusted corporate expense, a decrease of 16% in constant currency year-over-year primarily driven by timing and lower incentive compensation. We continue to anticipate that adjusted corporate expenses will decline in the low double-digit percentage in fiscal 2019.

I'll now review our working capital metrics and cash flow, which can be found on slide 13. Our receivables days sales outstanding was flat at 26 days, days sales in inventory increased 1 day to 30 days and days payables outstanding decreased 1 day from the prior-year to 58 days. I would 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 \$2.2 billion. For the quarter, McKesson paid \$826 million for acquisitions, repurchased approximately \$300 million in common stock and paid \$71 million in dividends.

In the first quarter, McKesson used \$1.1 billion of cash flow from operations, which was in line with expectations. As a reminder, our operating cash flow can vary significantly depending on timing. As we discussed on our Q4 conference call, in the fourth quarter, we received a customer payment that had been anticipated for the first quarter of fiscal 2019.

After deducting \$145 million for internal capital investments, McKesson had negative free cash flow of \$1.2 billion, again in line with our expectations. For fiscal 2019, we continue to expect internal capital investments of between \$600 million and \$800 million, and free cash flow of approximately \$3 billion.

And yesterday, our board of directors approved an increase of \$0.05 for our quarterly dividend or 15% to \$0.39, which will be payable to shareholders in October. The increase to our dividend reflects our commitment to returning cash to our shareholders as part of a balanced approach to capital deployment. We also have a total of \$4.8 billion remaining on our share repurchase authorization.

Before I wrap up, we continue to expect a positive foreign currency impact of up to \$0.10 in fiscal 2019 and, in terms of fiscal 2019 earnings progression, we continue to expect that the second half will have a stronger relative EPS contribution similar to our fiscal 2018 results.

In closing, I'm pleased with the progress being made on our operating model and cost-out initiatives, which will drive increased efficiency and productivity in our operations and allow us to capitalize on growth opportunities. We had a solid start to fiscal 2019 and we're reiterating our fiscal 2019 outlook with adjusted earnings per diluted share of \$13 to \$13.80.

With that, I'll turn the call over to the operator for your questions. In the interest of time, I ask you to 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. [Operator Instructions] Take your first caller, Glen Santangelo from Deutsche Bank. Please go ahead.

Glen Santangelo

Analyst, Deutsche Bank Securities, Inc.

Yeah. Thanks and good morning. Thanks for taking my question. John, I just wanted to discuss two pretty high-level issues that I think are on everyone's mind and just sort of get your take. There's been a lot of rhetoric in the market around branded price inflation. You've seen some activity by a number of the manufacturers and so I'm kind of curious, have you had conversations regarding that and how you think that could ultimately impact the balance of your fiscal year?

And then secondly, my follow-up would be around the administration's criticism around the current rebating system and the potential push to move from gross-to-net pricing and so both those issues in aggregate could have at least a meaningful near-term impact on your business and I'm sure there will be some type of mitigation efforts, but could you just give us your updated thinking on both those issues? Thanks.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Thanks for the questions, Glen. Clearly, both of these issues are not new to the discussion. I think obviously the concerns or the comments around it have increased in frequency in the last several months, but several years ago, people began to talk about the widening spread, the use of rebates, the transparency or lack thereof of those tools and clearly, we've dealt with the changes in branded inflation for many years.



I mentioned in my opening comments about the transition 15 years ago that the company I think helped lead to a more stabilized, more transparent relationship with the branded manufacturers in particular, focused on making sure that our model was not fully dependent on price inflation as one of the key drivers to our economics and over time, we've discussed with our shareholders that the view that we maintain some exposure to price increases in our P&Ls, but that exposure is significantly less than what it would have been going back in time and our relationship with manufacturers continues to be extremely productive.

We have not only renewed all of those relationships time and time again over 15 years, but the conversations with the manufacturers have broadened in their context to include not just Distribution Solutions, but also go-to-market solutions as I highlighted also in my opening comments, helping people with product launches, helping them handle specialty products that require a lot of additional attention, and clearly helping them get better take-up on their new launches as well as better adherence to the prescriptions being written by physicians and reducing the friction, things like CoverMyMeds, those tools, allow patients to get access to these drugs faster, better economics and clearly without having to wait sometimes weeks to get authorization to take the meds. So, we've been evolving the model with branded manufacturers and specialty manufacturers, and I'm quite pleased and positive about my future outlook of our evolution of services focused on those manufacturers.

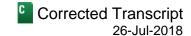
As it relates to the impact of the year, I think Britt and I continue to evaluate how much value we expect in our guidance relative to branded price inflation and obviously we provided a range at the beginning of the year with an expectation of where that branded inflation would likely come in. Clearly, the month of July we believe is running at a rate that's less than what we would have normally expected, but I think several of these manufacturers have talked about delaying their price actions until later in the year, as they see how this transition or this model change progresses or doesn't progress. So, I think we're committed to continue to work with manufacturers and to make sure that we mitigate whatever negative impacts might occur as a result of their change.

As it relates to the rebating that goes on, clearly, we are students of this industry and have some awareness of the [ph] chewing and throwing (27:21) of the manufacturing relationships with those that are negotiating formularies with them. We don't participate in the rebate structure that goes to the payers and the debate on gross-to-net is a very interesting discussion because as I've described I think in the past on conversations with you and others that although there obviously is a financially net price or average price that's realized by our manufacturing partners, that's not a single net. It's an aggregation of multiple nets and I don't see necessarily the ability or the desire of the industry to have a one-price for all type of a strategy.

Now, we don't control what the manufacturers do and we don't have any input on how they set their prices, how much inflation they have or how much rebate they provide to the people in the channel, but what I would say is that if there is a significant reduction in the list price of these products where most of the driver of our economics is derived from, then we will be in discussions with manufacturers to make sure that we get the appropriate reimbursement for the fair value of the services we provide and our rate of return on a lower sell price would have to reflect the recoupment of that value so that we [ph] come out in a similar place at (28:47) where we are today.

We clearly agree with many others in the channel that cash payers of these drugs are being forced to pay list price and other abnormalities as they have risen over decades of these types of business models need to be addressed and Americans should get a fair price for the pharmaceuticals, but at the same time, a system like this that has been developed over decades can't be completely reengineered in a matter of weeks and months, and so I think it will take some time as we evolve to whatever model the manufacturers and the payers believe is appropriate going forward.

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Glen Santangelo	0
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Analyst, Deutsche Bank Securities, Inc.

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Thanks for the thoughts.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Α

Yeah.

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

Michael Cherny

Analyst, Bank of America Merrill Lynch



Good morning, everyone and thank you for taking the question. So staying along those same lines, John, it's been about a year since you outlined the initial attempts and discussions to work with your manufacturer partners on the contract shifts on how you contract with them. Clearly, there's a lot going on as Glen had asked regarding the overall market. Can you talk about how those discussions have continued to go and maybe just give some hypothetical examples or some big picture examples of what some of the evolution has been in any of the contracts that may have changed structure or changed how they're contracted between the two sides just to give us a sense of as we think about the go-forward what we could expect to see with those changing negotiations?

John H. Hammergren

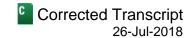
Chairman, President & Chief Executive Officer, McKesson Corp.



Well, thank you for the question, Michael. The manufacturers obviously all of them are in different places in terms of how they price their products, the level of innovation that they're delivering to their marketplace, the productivity of their R&D activities, et cetera. And so I think, I can't speak with any specifics with any of them related to our relationship. What I can say is sort of a reinforcement of what I said to Glen and that is that the relationship between McKesson and our manufacturer partners has never been stronger, and when we've had conversations with them about their strategies related to price inflation or their strategies related to their list price of their product, never in those conversations do they indicate a desire to reduce the economics to McKesson because they recognize the tremendous value of the services we provide. So albeit, it may be a time and a process change that goes on between us and our partners related to how we're reimbursed and how these mechanisms might evolve over time, nowhere has anyone said to me, gee, we need to change this model because we believe the economics that we're paying for the value you deliver isn't fair. In fact, it's quite the opposite.

They talk about not wanting to do what we do and the fact that we provide great utility value both to our buying customers as well as the manufacturers that we're both trying to serve. So, I think that I'm very confident that we will continue to make progress and as individual decisions are made by individual manufacturers related to their pricing strategy, we'll sit down and have individual discussions with them to make sure that we're properly reimbursed for the value of the service we provide and clearly, we always are trying to expand that discussion to include more than just our distribution services and go beyond into some of the other services that I described. And I'm probably the only remaining CEO in the distribution channel that actually went through the process 15 years ago and helped lead the process of providing better visibility to the manufacturers around the value of we do, providing better stability around our reimbursement, and in those leadership discussions, I think set a standard for how McKesson would move forward and I believe that standard still exists today.

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Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Mike, maybe what I would add – this is Britt, I would add that over the last couple of years, the conversations have really become around focusing on the value for the services and expanding the services that we provide, whether that's special handling for certain new products that are being launched and as you've seen us over the last couple of years, you've seen less of a reliance on the variable component of compensation with manufacturers and really focusing on what are the services that we're providing and what is the value for those services and what additional services can we provide to those manufacturers whether that's distribution services or those are other capabilities that we can help them with launching a product. So I think that's one of the ways that you've seen the conversations change over the last couple of years.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Thanks Michael for the question and I want to also congratulate you by the way on the birth of your new daughter [ph] Arice (33:54). I was just told that recently, so congratulations on starting a new era.

Michael Cherny

Analyst, Bank of America Merrill Lynch

Thank you very much, John.

Operator: And at this time, we'll move to the next caller in the queue, Lisa Gill from JPMorgan. Your line is open.

Lisa C. Gill

Analyst, JPMorgan Securities LLC

Thanks very much and good morning. John, last night, CMS proposed that we move to a new competitive acquisition program for Part B drugs. The way that it reads, it comments that they're looking to use private vendors to negotiate Part B drugs replacing ASP. Can you talk about it from two sides? One, the role that you think McKesson could play as a private vendor and two, any impact that any new pricing could have on your existing business? I'm thinking specifically U.S. oncology?

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Well, thanks for the question, Lisa. As you point out, U.S. oncology is the part of our business that has the greatest exposure to Part B reimbursement, and we are probably one of the largest purchasers of specialty drugs primarily focused on oncology and we certainly have experienced over time our ability to work closely with the manufacturers to make sure that we've got the right economics on sourcing those products and making sure that the patients are getting access to the best available treatment regimes, and we believe that role is extremely important.

In addition, I think that folks in the administration that I've chatted with when we've discussed this particular issue understand clearly that the best value for them as payers for cancer care continues to be in the community setting, and their view of our quality is as good or better than anyone else in the provider network. So I don't think there's a desire in specifics to focus on community-based physicians in any category let alone community-based oncologists in an attempt to destroy the economics of practicing in that venue. What they are focused on is making sure that the economics are maintained perhaps in a different way than just or just primarily on the drug's reimbursement characteristics.

So we've had an open dialogue for some time. Like I said, there may be a transition here in terms of how oncologists are paid for the services they provide and clearly as a very large buyer of these Part B drugs, we think we're in a good position to be a private vendor who negotiates the purchase price of the Part B drugs because we have the pull through characteristics [ph] of actually (36:42) great formularies that utilize those drugs and provide market share to the manufacturers as a result of them providing us the right economics and that's a role that we already play today with our buying activity. So albeit this could be another transition point for our business that may take some time to straighten out, but I think at least from my experience, having the best value from an economic perspective and the best quality aligned creates a position for you to be able to negotiate a model that makes sense for both the payers as well as for us and I might end my comment on the relative scale or meaningfulness of this as it relates to McKesson's overall financial characteristics.

Clearly this is important to our physician partners and their viability is a top priority for us, and the ability to continue to treat patients in that setting is a top priority; however the economics that actually flow through to McKesson's P&L as a result of our relationship with the U.S. Oncology doctors in particular is relatively insignificant.

Lisa C. Gill Analyst, JPMorgan Securities LLC	Q
Okay. That's helpful. Thank you.	
John H. Hammergren Chairman, President & Chief Executive Officer, McKesson Corp.	A
Yeah.	
Operator: We'll hear next from David Larsen from Leerink.	
David Larsen Analyst, Leerink Partners LLC	Q
Hi. Can you talk a little bit about the operating income growth rate in the Oth	

Hi. Can you talk a little bit about the operating income growth rate in the Other division? It looks to me like it's actually down year-over-year. Is that correct, Britt maybe, and then how is Change Healthcare progressing? Thanks.

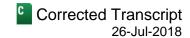
Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Yeah. Thanks for that question. As we pointed out during our Q4 earnings call, we did expect it to be impacted by the headwinds in our Canadian business. We outlined for you the changes in the generic reimbursement rate would have a gross headwind of \$100 million to \$125 million for the year, so that certainly is part of it. We are seeing really good growth in our MRxTS business as I mentioned in my remarks and then the third piece here is while we did see a decline year-over-year in Change Healthcare in the quarter, we still expect the Change Healthcare will meet the full year guide that we gave.

We're seeing good operating performance. We're seeing good performance and progression against synergy targets. We're pleased with our performance, so I think the overriding impact here in the first quarter is really two-fold. One, the Canadian headwinds that I mentioned and then secondly, last year, we did have about \$17 million of operating profit from EIS, which we have divested.

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David Larsen

Analyst, Leerink Partners LLC

Okay. That's very helpful. Thanks. And then just any comments on generic deflation trends both on the buy and sell-side? How are those relative to your expectations and how did ClarusONE perform relative to expectations? Thanks.

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks for that question. We haven't seen any change from what we guided at our Investor Day. On the sell-side we still see a competitive but relatively stable market so no change in our view on the sell-side component of that. ClarusONE continues to perform quite well ahead of very strong first quarter. We're very pleased with the progress there and the partnership and the opportunities that are in front of us.

From a buy perspective, the dynamics on the buy side, as we've talked about we've seen more of a stable environment from a deflation perspective, so this is running in-line with what our expectations were, really no supply disruptions that are of any material either and ClarusONE continues to drive great value from a buy side, so we're continuing to focus on building out ClarusONE and additional opportunities and taking the ability that we have on ClarusONE to create a spread for us that we can deliver great value to our customers on the sell-side.

David Larsen

Analyst, Leerink Partners LLC

Great. Thank you.

Operator: Steven Valiquette from Barclays your line is open.

Steven Valiquette

Analyst, Barclays Capital, Inc.

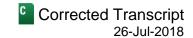
Hey. Thanks. Good morning, John and Britt. So just on staying on the topic of brand inflation, we keep getting asked by investors how to triangulate the collective commentary from drug distributors overall, then brand inflation doesn't matter that much anymore because of the fee-for-service agreements, but then the industry still has this large spike in profits in the March quarter each year that obviously seems pretty closely tied to the January annual brand price inflation cycle. I'm curious to hear your thoughts on that and maybe just the follow-up question tied to that would be, should we probably assume that McKesson is going to maintain a fairly wide EPS guidance range for most of fiscal 2019 because obviously your fiscal fourth quarter may be the most critical in relation to brand inflation. Thanks.

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks for that question. I would point to a couple things. First of all, you are right. Historically we have seen the manufacturers take the majority of their price increases in our fiscal fourth quarter. There is an impact from seasonality. We have our highest volumes in the fourth quarter, so the impact we would see from those would be higher just given that seasonality, and I would also point out that while we are more fixed than we have been historically, there is still a variable component to our compensation. So I would expect that that trend would continue. It is more of a seasonality component than anything else.

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Steven Valiquette

Analyst, Barclays Capital, Inc.

Got it. Okay. Thanks.

Okay. As far as the guidance range then for the year?

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

I think as we've talked about previously, we're not adjusting our guidance at this point. We have seen lower price inflation as John mentioned in the July month. If we see some changes to that that are significant, then certainly we will update you on that but we would expect to still be in the guidance range that we provided.

Steven Valiquette
Analyst, Barclays Capital, Inc.

Operator: Moving next to Ross Muken from Evercore ISI.

Ross Muken
Analyst, Evercore ISI

Good morning, guys. So, obviously, pretty disappointing developments in the UK business. I guess that business obviously has been trending lower and we felt we were getting to kind of the bottom of margins and then obviously the UK has a lot going on economically right now. I guess how are you thinking about sort of the pushes and pulls there in France and some of the other countries where there's sort of uncertainty around your ability to kind of adjust the cost structure as these kind of sea changes occur and the ability to kind of balance that versus kind of the long-term you see in those markets?

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

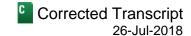
Well, thanks for the question, Ross. Clearly, we are disappointed with the continued actions that the UK government has been pursuing, primarily focused on the retail pharmacy business there to your point. At some point there's going to be diminishing returns for this to be a source of their budget gap solved, and our dialogue with them is continuing. We don't want to be in a position where we find that the government puts us in a place where the entire retail industry is at risk and clearly, the more cuts that come down the line, the more likely that is to be a possibility, and perhaps a reality.

So we are working to be more efficient in that market. We talked about the changes we made in our back-office in the fourth quarter. We continue to take cost-out, and the store closures have helped and if they push more stores into a lack of profitability, we may have to continue with that strategy.

As it relates to France, we're obviously a very large provider of services in France. We've got great customer relationships. We've got a great strategy there. It's one of the markets where we have really delivered an omnichannel capability with online, in-store pick up et cetera, experiences for our partners to take to their patients and I think our presence in the market is really second to none.

We have recently in the last 18 months or so experienced more significant price activity by our competitors probably in response to our superior value proposition and we've been forced to react to that in certain parts of the French market, but as we have in the UK and other markets in Europe, we'll continue to expand the value

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proposition and at the same time try to become more efficient and in particular in France, we did develop a national re-distribution center, similar to what we have in the U.S. that is performing at exceptional levels and allowing us to take out cost and capital in that market and deliver superior service and our scale frankly allows us to compete in a much superior way to others in that marketplace.

So we're not going to lose market share there. We're going to match the price that our competitors put into the marketplace and maintain the volumes through our business and we hope that the pricing environment will stabilize over time.

The larger backdrop of Europe is we're continuing to expand our services in many different areas, and begin to evolve our model so that we can provide services outside of retail pharmacy into specialty and hospital and home care like we've done in the UK, so we're still focused on expanding that business. Thanks, Ross.

Ross Muken

Analyst, Evercore ISI

Thanks, John. And maybe just quickly, a lot of debate on biosimilars. Obviously the government is very focused on it. There's some new developments with new labs and a few others, I guess what's sort of your updated thoughts on how that market is kind of changing and the like and kind of your opportunity set there?

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Well, we obviously are very encouraged as well not only in the government's focus on the biosim opportunities and getting these products into the marketplace but the manufacturer partners that have come to us in particular are looking for McKesson to help them build a channel into the marketplace, in particular in biosims focused on oncology.

As you know, Ross we have a world-leading clinical trial capability inside of our U.S. oncology network that provides value to all oncologists across the country. We help get products to the market faster and more efficiently and we have done that over and over again as it relates to branded product being launched.

We think the biosimilar market provides a similar opportunity because of some of the characteristics of these products and a requirement to prove clinical equivalency to the original products and our doctors are very keen on helping make that happen and making sure the patients get the best product at the most value and that helps produce market share for the biosim manufacturers and improved profitability for their practices and a lower-cost for the patient.

Ross Muken	
Analyst, Evercore ISI	C

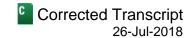
Excellent. Thanks, John.

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

Yeah.

Operator: Eric Percher from Nephron Research, please go ahead.

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Eric Percher

Analyst, Nephron Research LLC

Thank you. A question on U.S. Pharma and Specialty. Last year, when you spoke to brand pharma compensation and the fact there was a tailwind in the quarter, I think there was an evening out over the course of the year. So when we look at this quarter I understand it sounds like that was a bit of a benefit to Q1. How does that progress over the next couple guarters and any other commentary on the cadence within that segment?

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks for that question, Eric. My comments really relate to that timing event that happened last year between Q1 and Q2. Our compensation or the value that we've earned from brand compensation in the first quarter of this year is in-line with what our expectations are and we wouldn't expect that there'd be any variability as we saw last year between first quarter and second quarter.

Eric Percher

Analyst, Nephron Research LLC

And last year, was that a headwind in Q1 that's been evened out over the course of the year, and I guess my question is should we expect that things get a little bit tougher in that comparison? And I'll add-on to that, the follow-on question which is among the other headwinds you expect this year, how many of those are reflected now in Q1 versus building over the course of the year?

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

First of all, there was a headwind in Q1 of last year. It was really between the two quarters, so we wouldn't expect – and that was related to our continued evolvement of our agreements with manufacturers. As we think about the quarters this year, we wouldn't expect there to be any headwinds from types of evolvement of agreements like we had last year, so I think as you think about the first quarter of this year, we did have that timing event between Q1 and Q2 of last year. We also had customer losses that we talked about in our numbers in Q1 this year, but we still had some growth overall.

Eric Percher

Analyst, Nephron Research LLC

Okay. Thank you.

Operator: Moving next to Ricky Goldwasser from Morgan Stanley.

Ricky R. Goldwasser

Analyst, Morgan Stanley & Co. LLC

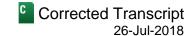
Yeah. Hi. Good morning. So just to clarify on Eric's question, Britt, when we think about the second half acceleration, in your prepared comment you said the second half acceleration is similar to last year. To give us some context, in 2018, what percent of second half acceleration can be attributed to the March quarter inflation?

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

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Well, first of all, thanks for the question. I don't believe I used the word acceleration. I used the word relative contribution, and as we think about our second half, we would expect the same types of contribution in the second half would be the same this year as it was last year. What Eric asked about was a very specific event in Q1 of last year that was timing between Q1 and Q2, and that was related to our continued evolvement around our branded contracts become more fixed, so we would expect the dynamics of our quarters in the second half of the year to be very similar this year as they were last year.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

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On a proportional basis.

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

А

Relative contribution basis.

Ricky R. Goldwasser

Analyst, Morgan Stanley & Co. LLC

Okay. And then the second question, John. Many, many factors are suggesting moving the payment model to a fixed price system, which is not really benchmarked to a metric that's impacted by price. You operate in Europe where the model is a fixed fee based. So can you maybe kind of give us some color or some observation about what you see in Europe? Is it where you could potentially draw some similarities to how the markets here in the

U.S. will evolve? Maybe what are the differences in terms of the economic value between the two regions?

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.



While I appreciate the question, Ricky, I think it has several nuances in it. In Europe, there's not really a single model or a single reimbursement mechanism. I would say though in certain markets, the reimbursement is more dictated by the government and can sometimes be different based on brand versus generic and who the payers are for generic and whether they've outsourced the payments for generics and contracted for generic to other parties et cetera, et cetera, including we talked about the Canadian environment where the price of generic is set by government but it's a percentage of the branded price for the non-generic. So there's all kinds of different ways people have set up pricing regimens.

We believe – it was my interpretation of the administration is that they're looking for the market to set prices and the conversation that Lisa had a few minutes ago where she talked about the government looking for private vendors to negotiate the price of drugs is another indication of the fact that the government does not want to play a role, in my view at least, the government doesn't want to play a role in price setting.

This idea that Part B drugs are set by the government and not through some type of a process is something that they appear to be wanting to change. So I think, frankly, there is not going to be a coming together of the way drug reimbursement happens in Europe and the way it's going to happen in the U.S. It's more likely that market forces will shape the way U.S. drug prices are set. There'll be more transparency to consumers who are increasingly paying more and more of a portion of their drug spend through the benefit plan designs that companies like ours and others have put in place for their employees. And so, I frankly am encouraged by that move and I believe it allows McKesson to continue to work with the manufacturers and to negotiate reimbursement based on the fair value of what we deliver every day for them and in my view it can't be disconnected from the dollar value of the product that we are putting through our channel.

Analyst, Jefferies LLC

Unlike a "shipper" of a product that would charge a fee for a box at a certain weight, McKesson's financial model is much more dynamic and much more significant and much more dependent on our ability to buy inventory, use our balance sheet, provide tremendous service levels to our customers, collect receivables, adjudicate prices, thousands of prices every day through our chargeback systems on behalf of the manufacturers and to manage contracts with GPOs and to do all kinds of things that go far beyond what a logistics provider is prepared to do. And because of our use of our balance sheet and the use of our financial systems and our knowledge of this industry built over 185 years, I think it's highly unlikely that we would go to some type of a fixed fee or per-unit fee model for McKesson. It would have to reflect the use of our financial tools and our role in the entire supply chain for pharmaceuticals in a fashion that's very similar today.

So what's more likely to happen is the rate that we receive on the price of the product, however that price gets set, would be reflective of the value in dollars that we need to receive to be properly reimbursed for those services. So that's the strategy that we think works best for us. It's a strategy we think reflects the value of what we deliver every day and it's a strategy that we think the manufacturers are already used to having with us and that we think can be replicated going forward albeit there may be some transition timeframes that we'll have to work our way through.

Ricky R. Goldwasser Analyst, Morgan Stanley & Co. LLC	C
Okay. Thank you.	
John H. Hammergren Chairman, President & Chief Executive Officer, McKesson Corp.	Α
Yes.	
Operator: We'll move next to Brian Tanquilut from Jefferies.	
Brian Gil Tanquilut	

Hey. Good morning, guys. John, as I think about the UK business and the series of price cuts that you've seen, does McKesson have the ability to go back to the manufacturer – the drug manufacturers for price concessions to pass on some of the cuts? And then I know it's a different business but as we think about your relationship with the manufacturers here, I mean, how does that translate in terms of – I heard you talk about the value proposition, but if we can pass price cuts in the UK, where is the confidence that we can pass on some of the price cuts or adjustments here in the U.S. in the future?

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

Thank you for the question. Clearly, the way the UK manages drug pricing both and service pricing for that matter is vastly different than the way it's managed here in the U.S. and the government's activities both on the manufacturer price as well as the retail service price is not established based on what we can at least determine as a market view. It's more of a policy view, and we continue to work with the payers to make sure the payer, or to make sure they understand the value we believe is being derived by using Retail Pharmacy. It's difficult for us to go back to the manufacturers when their economics are preset also by the same regulatory body with perhaps a different regime. So I think we're stuck in a little different place in the UK related to what might be actionable with the manufacturers.

Now, clearly, on the services front, we can do a series of different things as a wholesaler to make sure that we're properly paid for the service we provide in those markets. I think as a retailer though because the government is involved in the retail dispensing economics for drugs, it makes it more of a challenge.

I don't believe that anything that I'm hearing from the discussions with the administration here in the U.S. or my counterparts in the industry, I'm not hearing any discussion of people wanting to follow a model similar to what's being done in the UK as an example. And as I mentioned earlier, I think it's much more likely to take a market-based approach.

Brian Gil Tano	Ιui	lut
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Analyst, Jefferies LLC

All right. Guys, thank you.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Yeah.

Operator: Robert Jones from Goldman Sachs. Your line is open.

Robert Patrick Jones

Analyst, Goldman Sachs & Co. LLC

Hey, thanks for the questions. John, I know there's been a lot asked on this call and a lot of focus on branded price increases but I just want to make sure if I try to summarize this, is this the right way to think about it is this the right message. So if there are in fact less branded price increases over time, as a wholesaler, as a pharmaceutical wholesaler, you need to just adjust the rate at which manufacturers pay you for the fair value that you bring, and ultimately you guys are confident that that will happen over time. Is that a fair summation of kind of the message around the potential change in branded increases?

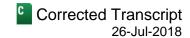
John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

I think it's a fair assessment of not only that dimension but also the question related to a massive reduction in the retail or list price of the product to a lesser price, whether that is defined as a gross-to-net discussion or a lower list price discussion, or better value for cash payers, however that's discussed, I believe that we are going to be focused on recovering the economics related to our relationship with these individual manufacturers that allow us to continue to have the same dollar yield as we do today from the same transaction activity because the value we deliver frankly doesn't change based on their activity related to brand inflation or related to gross-to-net-type of a discussion.

So you're absolutely right. Your summary is accurate and we did a very similar transition frankly that was more difficult 15 years ago because the manufacturers at that point were not even really aware of how wholesalers are paid or how we made money and our activity in the channel and we improved our relationships with them significantly. We helped them improve their manufacturing cadence. We gave them better visibility to service levels and inventory levels and that activity really sets the stage for us to more rapidly move our model around to accomplish a net neutral economic impact to McKesson and that will be our objective.

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Robert Patrick Jones

Analyst, Goldman Sachs & Co. LLC

John, I think that makes a lot of sense. Just one quick follow-up if I could for Britt just around that same topic. As it relates to this year, not to get too tactical but obviously there's some changes going on with branded companies and their desire to take inflation. I know inflation is a factor in the guidance for this year. Is the type of changes you're seeing, is that captured, Britt, within the ranges that you guys have out there for this year?

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks for the question. Our first quarter was roughly in-line in terms of the experience that we saw with the manufacturers. July obviously has been quite a bit lower than we had anticipated and lower than what we've seen in previous years. We do anticipate at this point at least that we'll see the same type of behavior or activity by the manufacturers in the fourth quarter. To the extent that that doesn't happen it will have some impact on our numbers, and we would expect to still be in the guidance for that. So I think what we've seen in July is indicative of something different than what we've seen in the past but as we look at the whole year, we still maintain our guidance that we provided for branded price increases. But to the extent that the fourth quarter, our fiscal fourth quarter is – we experienced less branded price inflation. We'll have an impact but we would expect it to still be in the guidance.

Robert Patrick Jones

Analyst, Goldman Sachs & Co. LLC

Thanks for that.

John H. Hammergren

Chairman, President & Chief Executive Officer, McKesson Corp.

Well, I want to thank everybody for your participation on the call this morning. Like always, the questions are sound, they're appropriate, and they're based on your knowledge and experience with our company and I appreciate your objective in trying to get even more information and insight.

We are off to a good start in fiscal 2019 and I'm excited about the opportunities that are ahead of us. I certainly want to recognize the outstanding performance of all of our employees and their contributions to help our customers improve lives and deliver opportunities to make better health possible.

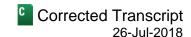
I'm now going to hand the call off to Craig for his review of upcoming events for the financial community. Craig?

Craig Mercer

Senior Vice President, Investor Relations, McKesson Corp.

Thank you, John. I have a preview of upcoming events for the financial community. We will participate in the Morgan Stanley Global Conference in New York in September and we will release second quarter earnings results in late October. Thank you for your participation and have a good day.

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



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