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McKesson Corp. (MCK)

Q4 2019 Earnings Call

CORPORATE PARTICIPANTS

Holly Weiss
Senior Vice President, Investor Relations, McKesson Corp.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

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

OTHER PARTICIPANTS

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Eric Percher
Analyst, Nephron Research LLC

Elizabeth Anderson
Analyst, Evercore Group LLC

Kevin Caliendo
Analyst, UBS Securities LLC

Michael Cherny
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Stephen Baxter
Analyst, Wolfe Research LLC

Charles Rhyee
Analyst, Cowen & Co. LLC

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

David Larsen
Analyst, SVB Leerink LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the McKesson Q4 Earnings Call. Today's call is being recorded.

At this time, I would like to turn the call over to Holly Weiss. Please go ahead, ma'am.

Holly Weiss

Senior Vice President, Investor Relations, McKesson Corp.

Thank you, Ebony. Good morning, and welcome everyone to McKesson's fourth quarter fiscal 2019 earnings call. Today, I'm joined by Brian Tyler, our Chief Executive Officer; and Britt Vitalone, our Chief Financial Officer. Brian will lead off, followed by Britt and then we will move to a question-and-answer session.

Today's discussion will include forward-looking statements such as forecasts about McKesson's operations and future results. Please refer to the cautionary statements in today's press release and our slide presentation and to the Risk Factors section of our periodic SEC filings for additional information concerning risk factors that could cause our actual results to materially differ from those in our forward-looking statements. During this call, we will discuss non-GAAP financial measures. Additional information about our non-GAAP financial measures including a reconciliation of those measures to GAAP results is included in today's press release and presentation slides, and is also available on our website at investor.mckesson.com.

With that, let me turn it over the Brian.

Brian Scott Tyler

Chief Executive Officer & Director, McKesson Corp.

Thank you, Holly, and thanks, everyone, for joining us on our call. Today, we're going to focus on our fiscal 2019 results and our outlook for fiscal 2020. Britt will cover our financial performance in greater detail, but first let me take a couple of minutes to discuss some of our important accomplishments, and why we are so confident in McKesson's future.

During our fiscal 2019, we saw increasing momentum in our strategic growth initiatives, including priority areas that focus on manufacturer value proposition, specialty pharmaceuticals or biopharma services, and the expanding role of retail pharmacy in community health services. All this supported by our ongoing investments in data and analytics. We also continue to optimize our operating model to improve our cost position and the overall speed and effectiveness of the organization. We recently renewed our CVS agreement. This follows a renewal of our Rite Aid agreement and a two-year extension of our Veterans Affairs agreement earlier in the year.

We believe our strong value proposition and superior service quality were critical to allow us to continue supporting the success of these customers and we are very pleased to continue these long-standing partnerships. We made several changes to strengthen our leadership team, including: the promotion of Kirk Kaminsky, as President of our U.S. Pharmaceutical and Specialty Solutions segment; the promotion of Kevin Kettler, as the President of our Europe segment; and the hiring of a new leader for our UK business. More recently, we appointed Tracy Faber, as our Chief Human Resources Officer to succeed Jorge Figueredo, upon his retirement later this year.

In our medical business, we acquired Medical Specialties Distributors or MSD, which has, among other things, expanded our value proposition with manufacturers and brought specialty infusion capabilities and services. It is progressing in line with its business case. And Change Healthcare filed its S-1 with an intention to complete an IPO, market conditions permitting.

In terms of overall performance for the quarter, I'm pleased with our adjusted EPS of $3.69, up 6% versus the prior year, driven by solid execution across multiple businesses. And for the year, we were able to deliver results that were in line with our expectations outlined at the beginning of the year. Our fiscal 2019 adjusted earnings of $13.57, represents 8% year-over-year growth. Despite the challenging industry environment we faced in fiscal 2019, as a company, I'm pleased with our results. We have scaled businesses in many good markets, and we are a critical resource to providers in the community care setting. Through our 80,000 associates acting together, we successfully delivered for our customers, executed and took decisive action to position McKesson for success over the long haul.

Looking forward now to fiscal 2020. Our fiscal 2020 outlook for adjusted earnings of $13.85 per diluted share to $14.45 per diluted share, represents low to mid-single digit percentage year-over-year growth. This outlook reflects solid growth across our operating segments, a continuation of disciplined efficient capital deployment, investments in the business, increased cost for opioid litigation, and modestly improved UK results. I will remind you that this guidance is inclusive of our organic growth and our strategic growth initiatives. Britt will cover this in more detail.

I'll now touch on developments in each of our businesses during the past year, which provides a platform to delivering on our expectations in fiscal 2020. First, despite the dynamic environment in which we operate, the revenue growth of our combined U.S. Pharmaceutical and Specialty Health segment was in line with our expectations, with higher growth being delivered in specialty health provider space led by our differentiated U.S. oncology value proposition, as well as continued growth in our Health Mart franchise, the franchise of independent pharmacy members which now numbers more than 5,000. We are pleased with the progress of our multi-year initiative to implement differential pricing for brand, generic, specialty, biosimilar and OTC drug classes, in line with the services we provide to both our customer and manufacturer partners in all of these categories.

We continue to address these important changes as we work through the tail of our remaining contract renewals. We expect low to mid single digit revenue growth in this segment for fiscal 2020, reflecting continued good organic growth. In our European Pharmaceutical segment, we experienced sizeable UK government reimbursement cuts, which we've previously discussed, and we took additional actions this quarter to further rationalize our footprint and back office operations in Europe. Overall for Europe, we anticipate revenues to be growing by low to mid-single digits, driven by market growth with no incremental UK cuts contemplated in our fiscal 2020 guide.

In Medical-Surgical, we delivered another year of solid growth across all of our customer channels and we are well positioned to support the growing alternate site markets. The acquisition of MSD and our investments in home delivery help us meet the needs of the patients wherever it suits them and further supports our growth in this segment. For the Medical segment, we expect to deliver revenue growth in the high single digit range for fiscal 2020.

Now turning to Other, which primarily comprises McKesson Prescription Technology Solutions, or MRxTS, Canada and our investment in Change Healthcare. MRxTS is a fundamental part of our strategy to improve healthcare one patient, one prescription, one partner at a time. We're excited by innovative solutions like RxBenefit Clarity, which provides transparency around prescription pricing at the point of prescribing for any medication and all payers. Physicians and patients are excited about this tool, and a fast-growing number of them, currently over 100,000, benefit from information they can really use to make timely decisions. We believe we can do much more to improve transparency for patients and to improve adherence by enhancing the ability of patients, pharmacists to collaborate with their prescribing physicians.

In Canada, we made significant progress to mitigate the impact of government actions as we move through fiscal 2019. Our Canadian retail presence combined with Well.ca, which by the way was recognized by Forrester as the number one digital retailer in Canada in 2018, provides patients with another channel to connect with us, and we've been piloting our future retail pharmacy concept that evolves the patient experience, which is currently being expanded to more sites. We also announced a collaboration with Google Cloud that will enable us to accelerate how we leverage our data to develop insights and predictive capabilities that will support better patient outcomes and reduce waste. In combination, we expect Other to deliver flat to low single digit revenue decline for fiscal 2020.

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 healthcare systems globally. In particular, we have a scaled presence across important community care settings, including community pharmacies, specialty providers, oncology, alternate sites, which are all critical to addressing the nation's cost, quality and access challenges.

Before I wrap up, I want to take a moment to share a perspective on the evolving drug pricing reform landscape and opioid litigation. Given our broad capabilities and the multitude of customers and channels that we serve, are sometimes referred to 360-degree view of the supply chain, we've been actively engaged with the administration, Congress and industry stakeholders to provide thought leadership on a range of proposed policy changes. The breadth and depth of our enterprise-wide access provides a platform for developing new solutions that can help the industry adapt. Our MRxTS or our pharmacy technology business, has been investing in real-time benefits tools and cost transparency solutions for patients, prescribers and pharmacies, so they can make informed choices about the cost of therapy.

As we move towards a world potentially without rebates, our manufacturer partners and pharmacy customers are interested in exploring new and innovative operating models. We're committed to being part of that solution. We have differentiated technology capabilities that can help move a solution forward, leveraging our retail health (sic) [RelayHealth] pharmacy switch and the assets and capabilities like our Chargeback platform in our wholesale business. Our unique experience and value-based programs such as the Oncology Care Model optimally position us to support the evolving needs of providers as they adapt to new care delivery models and value-based payment programs.

With respect to opioid litigation, you are all well aware of the scope and complexity of litigations facing McKesson and many members of the pharmaceutical supply chain. Last week, we announced the settlement with the State of West Virginia. The settlement resolves all the State's past claims regarding McKesson's operations in West Virginia. While we deny wrongdoing, it's important to us that the settlement provides funding towards initiatives intended to address the opioid epidemic itself. We remain committed to resolving other claims and, more importantly, to being part of the solution to this public health crisis.

For example, we have contributed $100 million to a foundation focused on combating the crisis. We've been educating our customers to comply with regulations and identify warning signs of prescription abuse and potential diversion. We've advocated for solutions identified in our White Paper, Call to Action: Execute Solutions Today to Combat the Opioid Epidemic (sic) [Crisis]. These solutions in our White Paper include the SUPPORT for Patients and Communities Act, which was signed into law last year and the ALERT Act, which if passed, would establish a prescription safety alert system to help identify patients at risk for opioid abuse.

Finally, I'd like to take this opportunity to thank our employees for their continuing dedication, leadership and consistent focus on a safe and secure supply chain as we strive to improve care in every setting, one product, one partner, one patient at a time. I am continually inspired by the letters I receive from patients who tell us about our associates consistently going the extra mile to ensure great health outcomes.

With that, I'll turn the call over to Britt.

Britt Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks, Brian, and good morning. Today, I'll provide an update on our fourth quarter and full year fiscal 2019 results. And then, I'll close by providing our fiscal 2020 guidance, before turning to your questions. My comments will focus primarily on our adjusted earnings results; however, I want to start by discussing two items that impacted our GAAP-only results.

As a result of the dynamic market environment, regulatory headwinds and business performance in our European segment, we reported an after-tax charge of $1.5 billion in our fiscal fourth quarter, reflecting noncash goodwill and long-lived asset impairment charges and restructuring charges that are largely in our European business. The impairment charges were mainly due to declines in estimated future cash flows, primarily attributable to the effects of UK government reimbursement reductions and competitive pressures in the UK. Following this charge, there is no remaining goodwill balance in our European business.

The restructuring charges in our European business are related to actions taken to address our performance in the segment. We're working to reinforce and accelerate our UK restructuring through further closures of retail pharmacy stores and cost management efforts throughout Europe. We anticipate recording additional restructuring charges in future periods as we execute on planned actions. We remain focused on our business performance in the UK and Europe more broadly, and we've taken these actions to better position the business for the future.

Now, let's discuss our fiscal 2019 results. As a reminder, our initial fiscal year 2019 guidance called for adjusted earnings per diluted share of $13 to $13.80. Despite significant regulatory and competitive headwinds, fiscal 2019 adjusted EPS was $13.57, 8% above fiscal 2018 and above the midpoint of our initial guidance. And fourth quarter adjusted earnings of $3.69 per diluted share were ahead of our expectations. We exit the year with another quarter of solid performance, and remain focused on building upon this positive momentum as we enter fiscal 2020.

Starting with the details of our full year fiscal 2019 consolidated results, which can be found on slide 5. Consolidated revenues for the year increased 3% versus fiscal 2018, primarily driven by market growth in our U.S. Pharmaceutical and Specialty Solutions segment, acquisitions and organic growth in our Medical-Surgical segment, partially offset by Q4 fiscal 2018 customer losses, which we've discussed previously. Adjusted gross profit was up 2% year-over-year, mainly driven by growth in U.S. Pharmaceutical and Specialty Solutions, McKesson Prescription Technology Solutions or MRxTS, Medical-Surgical and contribution from acquisitions. These positive developments were partially offset by Q4 fiscal 2018 customer losses, headwinds in our European segment and the fiscal 2018 sale of the Enterprise Information Solutions business.

Fiscal 2019 adjusted operating expenses increased 4% year-over-year, principally driven by acquisitions, increased opioid-related litigation costs, investments to support growth including incremental spend on data and analytics capabilities and information security and charges related to the Q3 fiscal 2019 bankruptcy of Shopko within our U.S. Pharmaceutical and Specialty Solutions segment. These increases were partially offset by the lapping of the $100 million contribution to create a nonprofit foundation for opioids in Q4 fiscal 2018, the $90 million reversal during Q2 fiscal 2019 of a contractual liability associated with our equity investment in Change Healthcare and the fiscal 2018 sale of the Enterprise Information Solutions business.

Adjusted income from operations was $3.8 billion for the year, a decrease of 2% from the prior year. Interest expense was $264 million for the year, a decrease of 7% compared to the prior year, reflecting fiscal 2018 fourth quarter refinancing of debt at lower interest rates. Adjusted tax rate was 17.8% for the year, mainly driven by our mix of business and discrete tax benefits. Income attributable to noncontrolling interest was $221 million for the year, a decrease of 4% compared to the prior year. Adjusted net income from continuing operations totaled $2.7 billion and our diluted weighted average shares outstanding were 197 million for the year, a decrease of 6% year-over-year.

Next, I'll discuss our full year segment results, which can be found on slides 6 through 9 and let me start with U.S. Pharmaceutical and Specialty Solutions. Revenues were $167.8 billion for the year, up 3% driven by market growth and acquisitions partially offset by previously-disclosed Q4 fiscal 2018 customer losses and branded-to-generic conversions. Segment adjusted operating profit for the year was down 2% to $2.5 billion due to fiscal 2018 customer losses and the Shopko bankruptcy, which offset higher growth in our specialty business and acquisitions. The segment adjusted operating margin rate was 150 basis points, a decrease of 8 basis points.

Next, European Pharmaceutical Solutions. Fiscal 2019 revenues were flat to fiscal 2018 at $27.2 billion for the year. On an FX adjusted basis, revenues were up 1% driven by solid performance outside of the UK, mostly offset by the fiscal 2018 reduction of approximately 200 retail pharmacies in challenging market environment in the UK and France. Segment adjusted operating profit was down 36% to $219 million and, on an FX adjusted basis, down 35% to $220 million. The segment adjusted operating margin rate was 80 basis points on both the reported and an FX adjusted basis, which was a decrease of 44 basis points. The decline in the segment was driven by headwinds in the UK, which included an inventory charge of approximately $20 million.

Moving now to Medical-Surgical Solutions. Revenues were $7.6 billion for the year, which were up 15% driven by the Medical Specialties Distributors, or MSD acquisition, and growth in our Primary Care business, most notably from growth in pharmaceutical products and Lab Solutions. Excluding the MSD acquisition, segment revenue grew 6%. Segment adjusted operating profit for the year increased 11% to $605 million, driven by solid operational performance, contributions from the MSD acquisition and ongoing cost management partially offset by additional investments to support business growth. The segment adjusted operating margin rate was 794 basis points, a decrease of 29 basis points, driven by growth in lower-margin pharmaceutical products and investments in our patient home delivery business.

Finishing our business review with Other. Revenues were $11.7 billion for the year, down 1%. On an FX adjusted basis, revenues grew 1%, driven primarily by market growth across the businesses within the segment, partially offset by the April 2018 government pricing actions in Canada and the sale of our Enterprise Information Solutions business in fiscal 2018.

Other adjusted operating profit increased 8% to $1 billion on an FX adjusted basis, driven mainly by growth in our MRxTS business and the $90 million reversal of a contractual liability associated with our equity investment in Change Healthcare in the second quarter. This is partially offset by the fiscal 2018 sale of the Enterprise Information Solutions business and the impact of the April 2018 government pricing actions in Canada. Included in Other, adjusted equity income from Change Healthcare was $242 million for the year.

Next, McKesson reported $555 million in adjusted corporate expenses, an increase of 7% compared to the prior year. There are a few discrete items impacting the expense growth led by the increase in opioid-related litigation costs and investments in technology infrastructure. These items were partially offset by the fiscal 2018 contribution to create a non-profit foundation for opioids, which is detailed in our press release. Excluding these items, we're executing on cost discipline, an important component to driving leverage and a key part of our financial model that we have confidence in driving and sustaining over the long term.

Turning now to cash, which can be found on slide 10. Our cash flow remains dependably strong as we remain focused on working capital efficiency and cash flow generation. For the fiscal year, we generated $3.5 billion in free cash flow, which includes $557 million spent on capital expenditures. With the scale of our distribution businesses, there can be variability in our cash flows through quarter to quarter, including the day of the week a quarter-ends on. A portion of the fiscal 2019 performance was due to favorable timing in our U.S. distribution and European businesses. We ended the quarter with a cash balance of $3 billion, and in fiscal 2019, we returned $1.9 billion to our shareholders via share repurchases and dividends. Additionally, we have a total of $3.5 billion remaining on our share repurchase authorization.

Before returning to our outlook for fiscal 2020, I'd like to make a few comments as it relates to the fourth quarter. Our detailed results are provided in our press release, so I'll just hit a few of the highlights. Consolidated revenue grew 3% on an FX adjusted basis. Revenue was led by market growth in our U.S. Pharmaceutical and Specialty Solutions segment and acquisitions, partially offset by the Q4 fiscal 2018 customer losses, which we've discussed previously. Adjusted earnings per share were $3.69, up 6% for the quarter. This result exceeded our expectation and was led by lower share count, strong performance in Medical-Surgical and MRxTS, offset by the weak Europe segment results, principally driven by the inventory charge in the UK and a higher tax rate.

Free cash flow for the quarter was $3.7 billion (sic) [$3.5 billion], led by strong working capital performance and some favorable timing. In summary, adjusted operating profit performance was ahead of our expectations in our segments with the exception of Europe. Earnings per share were in line with the most recent guidance range despite increased opioid litigation costs and investments in technology, and we generated strong free cash flow above our target. Overall, we demonstrated progress in many areas. But importantly, there's room to improve on all metrics.

Now, let me turn to our fiscal 2020 outlook. The dynamic macro environment in this past fiscal year, which was led by regulatory impacts, particularly in our international retail markets, uncertainty regarding the outcome of several U.S. drug pricing proposals, reimbursement headwinds and increased opioid-related litigation costs, will continue to confront us in fiscal 2020. We continue to invest in several strategic initiatives. We're making solid progress against our cost and operating model programs. We've attempted to construct guidance ranges that reflect these components. We expect adjusted earnings per share of $13.85 to $14.45 for fiscal 2020, which contemplates adjusted operating profit growth across each of our segments including our U.S. Pharmaceutical and Specialty Solutions segment, and we will continue to deploy capital in a disciplined manner.

Please refer to our press release and slides 11 to 14 in our supplemental slide presentation for our full list of fiscal 2020 assumptions. In lieu of outlining each assumption, I'll instead walk you through the key items and I'll start with the segments. In the U.S. Pharmaceutical and Specialty Solutions segment, we expect low to mid-single digit percent revenue growth, primarily driven by market growth, including strong performance in our specialty business. Adjusted operating profit is expected to grow in the low to mid-single digit percent, primarily driven by growth in our specialty business and ongoing cost management.

In the U.S. market, we anticipate mid-single digit percent branded pharmaceutical price increases, consistent with our experience in fiscal 2019. As a reminder, approximately 95% of our contracts with branded manufacturers are on a fixed fee rate per service basis. As Brian noted we're pleased to have renewed our agreement with CVS Health. Both the CVS Health renewal and the Rite Aid renewal during fiscal 2019 are included in our fiscal 2020 expectations for the segment.

Moving to the European Solutions segment, we expect low to mid-single digit percent revenue growth. Adjusted operating profit is also expected to grow in the low to mid-single digit percent driven by solid performance in countries outside of the UK and cost management programs, including the benefit from recent restructuring actions. This outlook assumes a modest improvement in our UK business with no incremental reimbursement cuts contemplated. We're focused on executing against key initiatives to strengthen the business in the UK and bolster the performance in other European countries.

Moving to Medical-Surgical solutions, we expect high single digit percent revenue growth primarily driven by the shift of care to lower-cost settings, increased demand in patient home delivery and growth in pharmaceutical products. We expect high single to low double-digit percent adjusted operating profit growth, reflecting organic growth, synergies from the MSD acquisition, benefits from fiscal 2019 investments in patient home delivery business and operating expense leverage.

For the remaining businesses included in Other, revenue is expected to be approximately flat to down by a low single-digit percent driven by the exit of an unprofitable customer in our Canadian business, partially offset by anticipated volume expansion and increasing sales in MRxTS. Adjusted operating profit is expected to be down by low to mid-single digit percent driven principally by the $90 million reversal of a contractual liability associated with our equity investment in Change Healthcare in our second quarter of fiscal 2019.

For Change Healthcare, we anticipate the adjusted equity income attributable to our interests to be in the range of $250 million to $270 million, which assumes that our ownership continues at 70% throughout fiscal 2020. As a reminder, Change Healthcare, Inc. which owns the remaining 30% of Change Healthcare filed its S-1 with the SEC on March 15 of 2019 and continues to make progress towards a potential IPO. We will not comment specifically on the anticipated performance of the business. I'd instead refer you to SEC filings by Change Healthcare Inc. for further information.

Moving on now to corporate expenses, as detailed in our press release, our fiscal 2021 (sic) [2020] guidance contemplates increased corporate expenses year-over-year. This assumption reflects an increase in opioid-related litigation costs to approximately $150 million, an increase over fiscal 2019 of approximately $70 million related to technology investments, most notably infrastructure and data and analytics investments, investments related to our strategic growth initiatives and a decline in other income. As a result of these items, we anticipate adjusted corporate expenses to be in the range of $725 million to $775 million for fiscal 2020. While we're not providing an outlook beyond fiscal 2020 today, we anticipate that investments related to technology, our growth investments and initiatives and operating model optimization efforts will be higher in fiscal 2020 than future fiscal years.

Now turning to the consolidated view, we expect low to mid-single digit percent revenue growth and adjusted income from operations is anticipated to be flat to down by a low single digit percent. While we expect adjusted operating profit growth in the majority of our businesses, this growth will be partially offset by the higher corporate expenses that I outlined earlier. We remain particularly focused on lowering operating expenses across the organization in addition to the important progress we're making on our operating model optimization. As a result of recent restructuring efforts, we've increased our annual pre-tax, gross cost savings target from approximately $300 million to $400 million, to a new range of $400 million to $500 million. We expect these savings will be substantially realized by the end of 2021, and we've made solid progress in fiscal 2019 and we're tracking in line with our expectations.

Moving now to below the line. We assume a full year adjusted tax rate of approximately 18% to 19%, which may vary from quarter to quarter and includes anticipated discrete tax item that we expect to realize during the course of the year. We expect weighted average diluted shares outstanding for fiscal 2020 to be approximately 185 million, which reflects share repurchases completed in fiscal 2019 and the benefit of share repurchases anticipated in fiscal 2020. We anticipate our revenues and results of operations to be currency-neutral.

And turning to cash flow, we expect free cash flow of approximately $2.8 billion to $3 billion, which is net of property acquisitions and capitalized software expenses of between $500 million and $700 million. The free cash flow expectation reflects the favorable timing realized in the fourth quarter of fiscal 2019.

In closing, we're pleased with the results of our fiscal fourth quarter performance and the execution against our strategic priorities. While the external environment presents many headwinds, we're making important progress. Our efforts to drive productivity, execute on initiatives to deliver savings to fund investments for growth, simplify our organization structure and increase accountability, are all aimed at delivering balanced top- and bottom-line growth that creates value for our shareholders. We know we have more work to do, yet we are pleased with the progress. We look to build on the momentum of our third and fourth quarter operating performance, and remain confident in our business as we enter fiscal 2020.

With that, Brian and I would be happy to take your questions, and I'll turn it back over to the operator.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We will take our first question from Robert Jones with Goldman Sachs. Please go ahead.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks for the questions. I guess just to start on the U.S. Pharma business around guidance and specifically around branded inflation. I was wondering if you guys would be willing to share what the assumption around inflation is that is assumed in guidance? And then more importantly, I was hoping you could provide us an update on how you feel generally around the branded portfolio and renegotiations with branded manufacturers, Britt, both on the fee-for-service side as you mentioned, but also on that 5% that's still contingent upon inflation.

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

A

Well, good morning, Bob, and thanks for that question. Let me see if I can answer those in order. In terms of our guidance for the U.S. Pharmaceutical segment, as I mentioned, our assumption around branded price inflation is mid-single digits, and that's really in line with what we've been experiencing here in our fourth quarter and it's really in line with fiscal 2019.

Our conversations with our manufacturing partners continue to be very productive. We have conversations with our manufacturing partners on a regular basis. We feel like we're very well positioned in those conversations, and there's nothing in our conversations today that would suggest anything different from the guidance that I provided you. As it relates to the contingent portion, again I wouldn't point to anything new here. We continue to have really constructive conversations with our manufacturing partners, and we're really feeling like that fiscal 2020 sets up pretty similar to fiscal 2019.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great. And I guess just a quick follow-up. You guys highlighted the corporate expense obviously taking a step up, it sounds like in large part, because of the ramping opioid litigation. Can you maybe just talk a little bit about the visibility you have into what those expenses will be specifically in 2020? And as we think about where we stand in the timelines of some of those larger cases, it seems like some of the bigger ones are poised to go to trial in 2020 and obviously could be an expense for some time beyond that. Any sense you can give us on how you're thinking about the run rate around these costs as we move not just in 2020, but beyond 2020?

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

A

Yeah. Well, thanks for that question. Let me start. And then, I'll have Brian add some commentary here. As we were going through last year, we provided you the best guidance that we had for fiscal 2019, and we talked about opioid-related costs being in excess of $100 million for FY 2019. As we set our guide, again what we're doing is giving you the best visibility that we have to those costs. I outlined that as $150 million for FY 2020. It's very difficult to forecast these out. These really are dependent on the speed of the trials, the decisions that the judges make along these cases and it's hard for us to predict that. And so, what we've done here is given you our FY

2020 view as we sit here today on how we think those trials might progress and what we think those costs might be to defend in those litigation proceedings.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

No, I think you covered it well, Britt. It is difficult to forecast exactly. It's a little bit of art and a little bit of science. Obviously, we're prepared to make the investment we need to make to prepare a proper defense and protect our shareholders' interests. As information unfolds and judges' decisions and schedules and proceedings occur, we'll be committed to keep this group updated.

I would say, in general, I think, if you look at the operating expense environment and discipline in the core operations, I'm very pleased with the trajectory and the progress that we're making. It is being offset by investments in opioid defense and some very specific targeted investments we're making into the business as part of our strategic growth initiatives.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks for that.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Thanks, Bob.

Operator: Our next question will come from Eric Percher with Nephron Research. Your line is open. Please go ahead.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. Last year, we were talking about a lot of unique headwinds, and it seems significant that CVS is not considered a unique headwind. Brian, I'd be interested in your perspective on what makes for unique or not and whether there is any change to the scope of that relationship. And, Britt, it would be helpful if you have any commentary on the cadence of earnings given some of the renewals and one-timers and acquisitions that are contributing.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Well, Eric, good morning and thank you for the question. Obviously, we're very pleased to be able to announce the renewal of our CVS agreement this morning. It's a long-time partnership that we've enjoyed with them. I would say that I don't characterize this renewal as really any different than many of the others I've been through with CVS in the years. These are big business relationships, complicated business relationships, and we worked through those discussions in a way that, obviously, we reached a feeling that was mutually beneficial for us to continue to go forward. And so, we're really excited about our partnership with CVS. And the economics of that renewal, as always, have been built into the numbers Britt shared with you this morning.

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

Hey, Eric. Maybe I'll just answer your second question here. As we think about the progression of earnings over the course of the year, we don't provide quarterly guidance. But what I would say to you is that as we look at the year, you should expect that our earnings will be roughly the same first half to second half as what we experienced in FY 2019.

Eric Percher
Analyst, Nephron Research LLC
Q

Thank you for the detail.

Operator: Our next question will come from Ross Muken with Evercore ISI. Your line is open. Please go ahead.

Elizabeth Anderson
Analyst, Evercore Group LLC
Q

Hi. This is Elizabeth Anderson on for Ross. Can you talk a little bit more about your expectations on Europe in the coming year? I know, obviously, there were a couple of one-time items or things that were unavoidable in FY 2019. But sort of what gives you confidence in the profit growth trajectory for fiscal 2020?

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

Thank you, Elizabeth. Well, we obviously did take a charge of approximately $20 million in the fourth quarter in the UK. But I would say if you step back and look at Europe overall, we were really in line with our growth expectations in most of the countries, and we're pleased with the performance. We feel like with the headwinds we've experienced over the past years in the UK and the management actions that we've taken, which includes really building a new leadership team there, rationalizing our store portfolio, restructuring the operations, is the work we've done that gives us confidence to feel that we can get Europe back to very modest growth next year.

Elizabeth Anderson
Analyst, Evercore Group LLC
Q

Okay. Perfect. That's really helpful. And I also wanted to ask a question in terms of the upside in your cost-cutting program. Are there any particular areas that you're seeing additional dollars coming from or any other color you can provide there would be very helpful.

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

Yeah, thanks for that question. I think as we've talked about before, there are several areas that we were really focused on as we think about not only cost cuts and spending behaviors and disciplines themselves, but also we're going through some operating model optimization efforts in our finance operations, in legal, HR and our technology and we've also talked about investments that we're making in technology, in data and analytics. We've also talked about some things in our finance operating models like the partnership with Genpact as we've expanded that. So I wouldn't think of it just as cost-cutting, spend discipline is important, it's an important component to that, but we're also going through some operating model optimization capabilities and we've made some really great progress, particularly in the areas of technology and in finance. In the area of technology, we're in a position now to reinvest back into that, invest in infrastructure and also invest in data and analytics capabilities.

Elizabeth Anderson
Analyst, Evercore Group LLC

Q

Perfect. Thank you very much.

Operator: Our next question will come from Kevin Caliendo with UBS. Your line is open. Please go ahead.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Hi. Good morning, everybody. Thanks. I want to get back to the U.S. Pharma business and your guidance there. It assumes, if I'm thinking about this right, I think it assumes margins to be pretty flattish year-over-year. And I understand there are some synergies from M&A and some other improvements in growth and specialty and the like. How much, if you can break down sort of what your expectations are for generic profitability and the spreads there. Like, what have you been seeing versus maybe margins in some of the other segments within U.S. Pharma?

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Thanks for that question, Kevin, I'll start. And what I would say to you as a starting point is, we're pleased to be able to provide an outlook for our U.S. Pharma and Specialty Solutions segment which returns to growth next year. And I think that's on multiple dimensions. We've certainly made some advances in our specialty business and continue to see good growth there. As we talked about, we're seeing relative stability in the manufacture price increase area of our business.

And as it relates to generics, we don't provide specific guidance on inflation or deflation rates. What I would tell you though is that we are very comfortable with the sourcing capabilities that we have through ClarusONE and continue to drive good value out of that. And on the sell-side, we have great compliance with our customers. We utilize our capability and scale from ClarusONE to provide really good value to our customers, and we believe that we're continuing to create an appropriate spread, which is in a market that is competitive yet stable. And so we're very comfortable operating in that environment. And overall, that leads us to be able to provide you an outlook for the segment that has low- to mid-single-digit growth in 2020.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Just one quick follow up speaking of outlook, it feels to me like this guidance is a little bit narrower than we've seen recently, especially given the higher number. What would cause guidance to come in at the high end of range versus lower end of range, given what you've provided us so far? What's $13.85 versus $14.25, like what needs to happen?

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Thank you, Kevin. First of all, it is narrower than the guidance that we provided last year. We have certainly put together plans and constructed these plans with a lot of really good information and visibility into our business units. I think as you think about the top-end of the range, certainly continued growth in our specialty business would propel us there. We've had very strong growth in our medical surgical business, continuing to grow patient home delivery and the investments we've made there, we called those out, we think that those are going to deliver some upside in 2020 and beyond. And our ongoing cost management efforts will take hold as we get further into the period to FY 2021.

On the downside, I think things that could happen could be the outcome of U.S. drug pricing reform or additional regulatory impacts in our international market, which again we called out, we're not contemplating those but those are things that could happen that drive us to the lower end of that range.

Kevin Caliendo
Analyst, UBS Securities LLC
Q

All right. Thanks, guys.

Operator: Our next question will come from Michael Cherny with Bank of America. Please go ahead.

Michael Cherny
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Q

Good morning, and thanks for taking the question. Brian, you talked before about the CVS renewal and how it wasn't that different from [ph] traditional (44:42). That being said, you've recently renewed three of your largest customers, CVS, Rite Aid, VA against the backdrop of some of these drug pricing dynamics. You've also talked about your engagement with brand inflation manufacturers. How do think about the conversations that you went into them, and thinking about the trade-off of services versus price versus volume commitments in this new drug pricing world? And was there anything that given the moving piece on drug pricing, you were able to essentially pivot the conversation on?

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.
A

Thanks for the question, Michael. Obviously as we entered these discussions, we're well aware and informed of the regulatory environment as frankly were our customers. And as we have been evolving our model over the past years to think about how we think of different product classes and the services we provide around those classes and the economics we get with those classes, that kind of all goes into the mix, and is the context and the backdrop for these conversations.

So, as we think about the gross to net environment and things of that nature, I would remind folks that there is a little bit of a natural hedge on the buy and the sell side for us, but these were all well considered and well contemplated frankly on both sides as we entered into these agreements. And we have baked the results of these renewals into the guide that we've reviewed to you this morning and we're very comfortable in the relationships and excited to extend our business partnership with both Rite Aid and CVS.

Michael Cherny
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Q

Okay. And then just one quick one relative to the share count guidance. It looks like, if my math is correct, you're assuming a higher degree of buyback versus previous years of guidance. Does that have anything to do with your outlook on potential M&A targets relative to where you sit on a portfolio basis? Or the viability of what you see across the market?

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

A

Well, again, I would just point to, as I mentioned, our share count assumption is $185 million at the end of FY 2020. As Brian talked about, and we've talked about in the past, we look at our capital deployment on a balanced perspective, and trying to drive the most value for our shareholders. And as we think about FY 2020, we think that capital deployment towards share repurchases is still an important component of that and we believe that our share price is undervalued at this point, so that certainly is going to be a component of how we think about capital deployment.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

I would just add, I don't think the message should be that we don't see good M&A opportunities or good growth opportunities for this company. We have had a good track record and some of our recent deals I think have been highly successful for us. But what we are doing is really being very focused on where that M&A might occur and making sure it's aligned with our strategic growth initiative and the three growth pillars that we have aligned. And we make those decisions obviously in the context of where our share price is today and what we think the relative attractiveness of share buybacks versus M&A are. So we do have good opportunities. We are, and will, continue to be active and looking for growth, or capabilities that might come to us through M&A, but doing that in a very disciplined way.

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

A

And I think MSD is a good example of that that we completed in FY 2019.

Michael Cherny
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

Great. Thanks for the color.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Thanks, Michael.

Operator: Our next question will come from Stephen Baxter with Wolfe Research. Please go ahead.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Hi. Thanks for the question. I was hoping to get some additional insight into the pacing of the efficiency program? And can you help us understand how much of the cost savings was achieved in 2019? How much incrementally you think happens in fiscal 2020? And then how much of that remains to benefit the numbers in 2021 and 2022? Thank you.

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

A

Yeah. Thanks for that question. What we have told you is that we expect to have $400 million to $500 million of cost savings by the end of FY 2021. So we are comfortable raising that target given the actions that we've taken here in the last quarter. We haven't provided a specific year-to-year guidance on that. What I have said is that in FY 2019 the savings that we generated are largely invested back in the business. We talked about our information technology, infrastructure and data and analytics capabilities. So you should view FY 2019 as largely reinvested back in the business.

As we progress through the time period over FY 2020 and now 2021, we would expect that those savings will increase over time, and that you should expect to see more and more of those hit the bottom line. But we haven't provided specific year-to-year or quarter-to-quarter guidance on the numbers.

Stephen Baxter
Analyst, Wolfe Research LLC
Q

Okay. Thanks. And as a quick follow-up, I think in the past you said, of the cumulative program, most of it will drop through. Is there any update to that? Or is that still kind of the right way to think about it?

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

That's the right way to think about it.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.
A

And I think about it, that we're in the early phases. Our efficiency initiatives are producing. We're making a calculated decision in some instances to invest that back into the business. As those efficiency efforts continue to grow, the investments will begin to wane off, you'll see a bigger impact.

Stephen Baxter
Analyst, Wolfe Research LLC
Q

Great. Thank you.

Operator: Our next question will come from Charles Rhyee with Cowen. Please go ahead.

Charles Rhyee
Analyst, Cowen & Co. LLC
Q

Yeah, hey. Thanks for taking the question. I wanted to ask a question regarding sort of the rebate rule and sort of the role you see the distributors play, and if I'm not mistaken in some of the comments that the wholesalers have provided to GC-MS here, it sort of applies with the Chargeback system that you were to have in place with manufacturers for pharmacies to apply this for the administration of [indiscernible] (50:46). Can you talk about sort of the capabilities that you currently have to do that today? How that works for pharmacies? And how quickly could that be applied for the use for consumers directly? Thanks.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.
A

Thanks for the question, Charles. So first off, I would remind everybody that the Part D safe harbor does not really impact our business model directly. We are not contemplating that. So what we're really talking about in the course of that reform is what are the implications for retailers and manufacturers, and then how might that ultimately impact us.

We do think that we have some scaled and significant capabilities to help address this dilution for this area. That would be not just the wholesaler Chargeback infrastructure and technology which really operates at big scale and highly efficient today, but also through our Relay switch business. We are transacting 18 billion, 19 billion transactions at the pharmacy desktop each and every day – well, not each and every day, each and every year as we speak.

And so while each one of those solutions by itself is probably not what's going to be required to administer whatever comes out, and we think it will actually come out pretty soon in terms of a final rule, we think the underlying capabilities will be there. And so what we're really looking for in the rule is what does HHS say relative to transparency? What are they going to stipulate in terms of the service providers that can support this, and frankly, what is the timeframe for the implementation? And contemplating all of those things, we'll look at how we bring our capabilities which are unique to us.

Not all of them. We all have the Chargeback capability, but the Relay switch business is a little bit unique to McKesson. Anyhow, if the opportunity is there for us to play a differentiated role or be part of the solution, that's something that we would certainly look to do. But we'll also approach it with the seriousness that these are massively scaled transactions with big financial implications for all party, and so anything that we would roll out would have to be robust, tested and reliable.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

And just to follow up, I think one of the concern is particularly as you think about the application of point-of-sale discounts, there's potential that particularly like pharmacies or independent pharmacies could be sort of caught on the wrong end carrying sort of a negative float here until sort of a true-up on payments. Is that something where you see distributors potentially playing a role, kind of supporting pharmacy customers using a balance sheet to sort of help them on the working capital side? Thanks.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Yeah, really that's a good question, and it's one that we're probably not prepared to answer right now until we see what the final rule looks like. I mean, I will say that we have long been an important part of supporting the independent customer base, with a really broad array of solutions from helping on the reimbursement side of the business, helping with the cost, the reporting, obviously generic procurement programs, and as this rolls out and we see what the impact and evolutions are, we'll assess our capabilities, whether they support in services or balance sheet to figure out how to best support the independent and retail community pharmacy space. But it would be premature to make any definitive statements.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Great. Thank you.

Operator: Our next question will come from Steven Valiquette with Barclays. Please go ahead.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning, Brian and Britt. Thanks for taking the question. Just to come back for a minute here on the cost savings and the segment reporting. Just kind of thinking out loud for the $400 million to $500 million in cost savings, we're assuming most of that does show up in the operating profit segment results for U.S. Pharma Solutions and European Pharma Solutions.

But just curious if any material amount of the savings would show up in the corporate expense line over the next couple years, even though corporate expenses are obviously going up a lot in fiscal 2020. So, it does seem like, as you described, some of the sources of savings, it does seem like some of that would fit into a corporate expense bucket. So just curious if there are some savings factored into that guidance and in corporate expense for fiscal 2020. Thanks.

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

A

Yeah. Thanks, Steve, for that question. It's a great question. Let me just clarify that. The cost savings programs that we put in place, which include the optimization of our operating models, are enterprise-wide. So as we think about cost savings, it's really discipline on an enterprise basis, which would include our corporate functions.

As we think about our operating model optimization efforts, whether that be in finance or technology or HR, clearly, those will be enterprise-wide as well. So as we think about these really holistic programs where we expect the benefits to have an impact not only within the segments but also within our corporate expense line as well.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Okay. And one other quick one here just on the guidance. Normally, you guys will give some comments on contribution from new generic launches. And I didn't hear much about that for FY 2020. And there's been some big ones launched recently, Generic Advair, a few others, but just big picture, any view on profits from new generic launches, FY 2020 versus FY 2019?

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

A

Yeah, thanks for that question. Clearly, there will be generic launches in every year. As we think about this, we don't expect a material profit difference in FY 2020 than FY 2019 from generic launches. So there will be what we would expect to be a modest impact from generic launches in FY 2020.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Got it. Okay. Thanks.

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

A

Thank you.

Holly Weiss
Senior Vice President, Investor Relations, McKesson Corp.

A

Operator, we have time for one more.

Operator: Thank you. Our final question will come from David Larsen with SVB Leerink. Please go ahead.

David Larsen
Analyst, SVB Leerink LLC

Q

Hi. It looks like you're guiding pretty good operating profit growth for fiscal 2020 across all segments, with the exception of Other. Can you just remind me what is going on in Other that is going to basically cause the entire enterprise's operating income, it looks like, to decline possibly low single-digits in fiscal 2020? Thanks.

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

A

Yeah, thanks for the question. As I talked about in my remarks, in fiscal 2019 in our Other segment, we had the benefit from the $90 million reversal of a contractual liability within our Change Healthcare business. And so that – obviously, we will be lapping that in fiscal 2020. That is the primary change, and that is really partially offsetting some good growth and some good expansion that we're seeing particularly in our MRxTS business.

David Larsen
Analyst, SVB Leerink LLC

Q

Okay. And then with the opioid litigation costs, I mean, some of the numbers we're hearing from these litigators are very, very high. Like would you expect to include those costs of litigation in your adjusted EPS going forward beyond fiscal 2020? Or would you view those as onetime items? Thanks.

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

A

Yeah, thanks for that question. What I would be prepared to say now is our guidance assumes the litigation costs and that number is $150 million. We don't have any visibility into anything beyond that. And so, it'd be inappropriate for us to really comment on it at this time. As things come up or there are decisions that are being made, we'll certainly provide that guidance and visibility to you. But as it relates to our guidance today, it's the $150 million in opioid-related litigation costs, which are in our Corporate segment.

David Larsen
Analyst, SVB Leerink LLC

Q

Okay. And then just maybe last one for me, yeah, you got $23 million of operating income in European Pharma Solutions this quarter. I mean, it looks like we're expecting a pretty big rebound in fiscal 2020. Just what's going to drive that? And I'll stop there. Thanks a lot.

Brian Scott Tyler
Chief Executive Officer & Director, McKesson Corp.

A

Well, I'll just remind you that we took a charge in the fourth quarter related to that business, and we've also been hard at work in terms of optimizing our store portfolio, rationalizing our back-office support functions, and we think all those will begin to yield benefit.

David Larsen
Analyst, SVB Leerink LLC

Q

Okay. Congrats on a good fiscal 2019, Britt.

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

A

Thank you.

Brian Scott Tyler

Chief Executive Officer & Director, McKesson Corp.

Thank you, David, and thank you, operator. Unfortunately, we're out of time. So I want to thank all of you for joining us on the call this morning, particularly those with questions, and we appreciate your support and interest in McKesson.

We have a clear strategy and a solid operating plan for fiscal 2020 and exciting growth opportunities across McKesson. I remain confident in our future. Thanks again for joining us this morning and I'll now hand the call to Holly for her review of upcoming events for the financial community.

Holly Weiss

Senior Vice President, Investor Relations, McKesson Corp.

Thank you, Brian. We will participate in the Bank of America Merrill Lynch Healthcare Conference in Las Vegas on May 14, and we will participate in the Goldman Sachs Global Healthcare Conference in Southern California on June 11. We look forward to seeing you in the new fiscal year. Thank you, and goodbye.

Operator: And, ladies and gentlemen, this does conclude today's conference. Thank you for joining today. You may now disconnect. Have a great day.