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Cardinal Health, Inc. (CAH) CEO Mike Kaufmann on Fiscal Q1 2020 Results - Earnings Call Transcript

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FQ1: 11-07-19 Earnings Summary



Press Release



10-Q



Slides

EPS of \$1.27 beats by \$0.18 | Revenue of \$37.34B (6.04% Y/Y) beats by \$590.46M

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Cardinal Health, Inc. (NYSE:CAH) Q1 2020 Results Earnings Conference Call November 7, 2019 8:00 AM ET

Company Participants

Kevin Moran - Director, Investor Relations

Mike Kaufmann - Chief Executive Officer

David Evans - Interim Chief Financial Officer

Conference Call Participants

George Hill - Deutsche Bank

Glen Santangelo - Guggenheim Securities

Ricky Goldwasser - Morgan Stanley

Charles Rhyee - Cowen and Company

Steven Valiquette - Barclays Capital

Lisa Gill - JP Morgan

Robert Jones - Goldman Sachs

Dolph Warburton - Nephron Research

Stephen Baxter - Wolfe Research

John Ransom - Raymond James

Eric Coldwell - Robert W. Baird

Kevin Caliendo - UBS Equities

Operator

Good day, and welcome to the Cardinal Health, Inc. First Quarter Fiscal Year 2020 Earnings Conference. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Kevin Moran. Please go ahead, sir.

Kevin Moran

Good morning and welcome to Cardinal Health first quarter fiscal 2020 earnings call. Today, I'm joined today by Mike Kaufmann, our Chief Executive Officer, and Dave Evans, our interim Chief Financial Officer.

You can find today's press release and presentation on the IR section of our Web site at ir.cardinalhealth.com.

During the call, we will be making forward-looking statements. The matters addressed in these statements are subject to the risks and uncertainties that could cause actual results to differ materially from those projected or implied. Please refer to our SEC filings and the forward-looking statements slide at the beginning of our presentation for a full description of these risks and uncertainties.

Note that during the discussion today, our comments will be on a non-GAAP basis unless they are specifically called out as GAAP. Our GAAP to non-GAAP reconciliations for all relevant periods can be found in the schedules attached to our press release.

We will provide an update to our FY '20 outlook on a non-GAAP basis. We do not provide guidance on a GAAP basis due to the difficulty in predicting items that we exclude from our non-GAAP results.

During the Q&A portion of today's call, we kindly ask that you limit yourself to one question with one follow-up, so that we may give everyone in the queue a chance to ask a question.

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

Mike Kaufmann

Thanks, Kevin. And congratulations on your new role.

Good morning, everyone. Thanks for joining us today. I am here with Dave Evans and I'd like to welcome him to his first call as our interim CFO. Dave has done a great job getting up to speed over the past few months. I'm grateful for his leadership and experience as we conduct our search for a permanent CFO.

This morning, we'll cover our progress and our path forward. I'll start with a few high-level thoughts on the quarter and then Dave will cover the financials. I'll close with some thoughts on how we will build on the solid start to the year.

We remain confident in our strategic direction as we focus on driving both efficiency and growth. Our Q1 performance validates our short-term progress and longer-term path.

At the enterprise-level, our disciplined cost management is enabling strategic reinvestment across both segments as well as in critical, functional areas.

In the Pharma segment, we're seeing early signs of positive trends. And although we still have work to do, we are making progress in key areas.

In Medical, we're encouraged by early traction from our improvement efforts, as well as the initial returns from ongoing investments in our growth platforms. I'll share more about this work in both segments later in my remarks.

But, first, I'll turn to Dave to walk you through our results and specific milestones we achieved in Q1.

David Evans

Thanks, Mike. And thanks everyone for being with us today. I'm pleased to join you on my first call. I'll walk through the numbers and highlight a few actions taken in Q1 to demonstrate our commitment to long-term growth.

Overall, I'm happy to report that we delivered earnings of \$1.27 per share in the first quarter, which were ahead of our expectations. Total company revenue increased 6% versus last year to \$37.3 billion.

Consolidated gross margin increased 1% from last year to about \$1.7 billion. The decline gross margin rate principally reflects year-over-year Pharma distribution contract renewals and products and distribution mix.

SG&A, which includes variable distribution related expenses, improved 2% despite higher revenue. This improvement reflects sustained organization-wide efforts to streamline our cost structure.

Mike might elaborate more on some of these efforts in a few minutes, but I'd like to say that just in the few months that I've been here, I've already seen this effort evolve from a cost reduction initiative to a broader cultural mindset of efficiency and improvement.

Total operating earnings were \$577 million, a 6% increase from the prior year, driven by performance in the Medical segment.

Interest and other expenses were roughly flat versus prior year at \$80 million. This reflects a decline in interest expense.

Our effective tax rate for the quarter was 24%. This compares to last year's rate of 14%, which was impacted by changes to our international legal entity structure.

Average diluted shares outstanding were \$297 million, about \$9 million fewer than last year. During the quarter, we entered into an accelerated share repurchase program to opportunistically buy back \$359 million of stock. We tired 80% of these shares in Q1 and expect to complete the program in our second quarter.

Combining share repurchases, we returned well over \$400 million to shareholders in the first quarter, demonstrating our continued commitment to look to deploying capital on a balanced, disciplined and shareholder-friendly way.

Moving on to cash flow, operating cash for the quarter was a use of \$653 million. As a reminder, timing, in particular, the day of the week in which the quarter ends, affects point in time cash flows. This dynamic negatively impacted our year-over-year cash flow for Q1, but will reverse in Q2. We ended the quarter with a cash balance of \$1.2 billion, which includes about \$700 million held outside the US.

So, I'll now transition to segment results, starting with Pharma. Revenue increased 6% to \$33 billion, driven by sales growth in our Pharmaceutical Distribution and Specialty Solutions divisions.

Segment profit decreased 3% to \$398 million, which reflects the impact from Pharma distribution customer contract renewals. This was partially offset by the benefits of our ongoing cost savings initiatives and performance in our Specialty Solutions business.

As a reminder, we record opioid related litigation expenses in the Pharma segment.

Before I leave Pharma, I want to note that our generics program performed roughly as expected. While we continue to see improvements in the market dynamics for generics, I would remind you that several variables impact the net performance of our generics program, including sourcing, volume, new item launches and sell side pricing.

Overall, we're seeing positive trends and good progress in the Pharma segment. Mike will discuss our ongoing efforts to maintain this momentum.

Transitioning to Medical, segment revenue for Q1 increased 3% to about \$4 billion. This was due to organic growth across the segment led by products and distribution as well as in Cardinal Health at Home, one of our strategic growth areas.

This growth was partially offset by the divestiture of naviHealth in August 2018. Segment profit increased 26% to \$170 million. This reflects benefits from our cost savings initiatives, as well as growth in products and distribution services and Cardinal Health at Home. As with revenue, these benefits were partially offset by the divestiture of the naviHealth business.

To provide some additional clarity, products and distribution includes both Cardinal Health brand and national brand products, as well as costs from our global supply chain.

Our work across the Medical segment to integrate our infrastructure, streamline our footprint and improve the customer experience is progressing as planned. Mike will discuss how this work will transition into growth over the longer term.

Moving now to our full-year outlook, with one quarter's worth of results behind us, we've increased confidence in our full-year guidance. At the same time, we continue to monitor external factors and key assumptions that could impact our forecast. We also continue to track the timing and evolution of internal investment initiatives.

Examples of external factors could be headwinds, which include tariffs and medical device tax. Examples of key assumptions we closely monitor include brand inflation and our generics program.

Considering the potential fluctuation of these and other items, we are reaffirming our guidance along with our corporate and segment assumptions. While we generally don't provide quarterly guidance, I will say that, directionally, we expect operating earnings in Q2 to be modestly lower than Q1.

So, before I turn it back over to Mike, I'd like to mention a significant item included in our GAAP results. In connection with a recent opioid-related settlement with Cuyahoga and Summit counties and the agreement in principle amongst the parties involved to a global settlement framework, we accrued \$5.1 billion after-tax in the first quarter.

We believe this global settlement framework will serve as the basis for definitive settlement terms and documentation. And for this reason, from a legal and accounting perspective, this accrual is prudent.

For Cardinal Health, the cash component of the settlement framework is up to \$5.6 billion over 18 years. If factors change, we'll adjust the accrual appropriately.

Let me now turn it back over to Mike to provide further remarks.

Mike Kaufmann

Thanks, Dave. This settlement with the two Ohio counties enables the discussions around the global settlement framework to proceed. The global framework, which is supported by a bipartisan group of state attorneys general, is designed to resolve all pending and potential opioid lawsuits by states and political subdivisions.

Importantly, with the commitment of both funds and the distribution of treatment medications, this framework provides an immediate solution to the communities and families that need it most.

As you know, we have an important, but limited role, in the pharmaceutical supply chain. We take that role and the responsibility that comes with it seriously. We remain committed to being part of the solution to this epidemic and that is why we are committed to the global framework and continue to be actively involved in its progression. With that said, if this framework is not successful, we are prepared to vigorously defend ourselves.

Shifting now to our strategic direction in the focus areas I mentioned last quarter. I said on our last call that, in Pharma, we're focused on two things – further enhancing our core distribution business and fueling sustained growth in key areas.

Regarding our core distribution business, we are focused on continuously enhancing the customer experience, improving pricing and contract discipline, and reducing costs. We are making significant investments throughout the segment with a longer-term view of the business.

For example, we're implementing digital technologies that will improve visibility and enhance our pricing capabilities. In addition, we recently began a program to improve our e-commerce capabilities and enhance the experience for our customers.

Beyond investing in our core businesses, we are focused on investing to drive growth in rapidly-evolving spaces in healthcare and identifying ways to further differentiate ourselves and shape the future.

For example, in Specialty, we recently made a multi-million dollar investment to establish a new distribution center outside of Nashville, Tennessee with a state-of-the-art, cold chain complex including deep frozen technology.

This new facility will enable us to combine two existing distribution centers, streamline technologies to drive operational efficiencies and support continued growth in rapidly evolving areas of the Specialty industry.

We're also investing in our higher margin services businesses, which we call our connected care offering, to build greater connectivity between manufacturers, payers, pharmacies and patients.

We will continue to purposely redeploy capital in these and other areas that align to our strategy.

Moving on the Medical, we are building out our commercial and operational capabilities across the segment and continuing investment in key areas. Dave shared some of these activities, which include enhancing our commercial approach, streamlining our supply chain, and rationalizing our footprint, are showing early signs of success.

Commercially, we are more closely aligning ourselves with the needs of our customers and incentivizing our sales force to sell Cardinal brand products. We expect these enhancements to be complete by Q3 and their benefit will begin to materialize in FY 2021.

As part of our supply chain work, we are reconfiguring our North American network. For example, in California, we are consolidating two of our distribution centers into a modern flagship center, which will enhance customer experience at a lower cost to serve and position the segment for growth.

Additionally, with respect to our global supply chain, we more than doubled our manufacturing footprint with the patient recovery acquisition. We are already leveraging some synergies, but we see a path to capture significantly more.

To that end, within the next quarter, we will finalize plans to reduce cost and deliver industry-leading service across our global network. These plans will take some time to execute. So, we have a strong governance structure in place and are committed to diligently managing our costs to realize the greatest long-term benefit.

As in Pharma, we're making significant investments across the Medical segment to improve the customer experience and drive growth in both the products and services spaces.

For example, as Patient Care shifts more toward the home, we continue to capture growth opportunities through Cardinal Health at Home solutions. We are committed to further developing this business and are redeploying some of our cost savings benefits in this area to improve the customer, healthcare professional and patient experiences.

In Medical services, another business unit in the segment with sustained growth and strong results, we're building additional digital and data capabilities, modernizing our operating systems and streamlining clinical and operational workflows. This will reduce costs for both us and for our customers and, importantly, will improve patient safety.

We recognize the components of the work across our products and services spaces will take time to translate into sustained growth and results. We remain committed to fueling this momentum.

On the enterprise level, as Dave and I shared earlier, our cost savings initiatives are producing tangible benefits across the company. We expect to meet or exceed our \$130 million commitment for the year, primarily through SG&A-related activities.

Our initiatives to improve gross margin, like those in Medical to right-size our manufacturing and distribution footprint, will contribute more significantly to our five-year, \$500 million savings goal as they will ramp up over the next few years.

With these initiatives, leaders across the company are evaluating internal operating models and identifying opportunities to leverage automation, analytics and additional technologies that not only drive efficiencies and contribute to our savings goals, but to improve insights.

One example is our recent partnership with Genpact, a global professional services firm focused on digital business transformation, who will help us transform our finance operating model.

As part of this partnership, Genpact will create a data analytics and FP&A hub here in Central Ohio to drive industry-leading innovation. About 200 current Cardinal Health FP&A and data analytics employees are transitioning to the Genpact hub next week, alongside a team of Genpact's process, finance and data analytics experts.

This is just one of the many initiatives across the company to streamline our processes, leverage our scale and enhance our data capabilities. We will share additional updates on these initiatives as they develop.

As we drive these type of efficiencies across the company, we will fuel growth through balanced capital allocation. This includes reinvesting in the business, returning cash to shareholders and improving our financial flexibility, while maintaining our investment grade status.

We remain committed to paying down at least \$1 billion of long-term debt this fiscal year, which includes the \$450 million of debt maturing in Q2.

To close, in Q1, we generated positive momentum across the company. We are pleased with this start to the year and recognize that there is more work ahead.

We have a strong foundation of scale and industry knowledge. With our talented and dedicated employees, we're committed to building on this foundation to adapt, innovate and lead as our industry evolves.

With that, I'll now open it up for questions.

Question-and-Answer Session

Operator

Thank you, sir. [Operator Instructions]. We will take our first question from George Hill of Deutsche Bank. Please go ahead.

George Hill

Hey, good morning, guys. And thanks for taking the questions. Mike, I guess, can you help me square two things here. You talked about the early signs of positive trends that you're seeing in the Pharmaceutical business, but I kind of want to square that with the guide where it seems like operating earnings deceleration is going to continue through the balance of the year. So, I guess, could you put a little more color on the positive trends that you're seeing and kind of help me square that with the guide for operations growth or actually operating kind of deterioration in the segment?

Mike Kaufmann

Go ahead. I'll let Dave start.

David Evans

George. Thanks for the question. Look, I think the way we're thinking about this is, we're really pleased with the first quarter results. I'll start with that. It certainly gives us increased confidence in the full year. At the same time, I'd say we're very cautious and that we're only one quarter into the year. So, we've got some pretty significant assumptions out there that are still left open – for example, brand inflation – and there's also a lot of other key kind of environmental assumptions that we're making that could change. So, our view is, at this early stage in the year, there's just no reason to be changing our full year guidance. We'll certainly be in a much better position to do that after our next quarter earnings call.

George Hill

Okay, that's super helpful. And then, maybe just a quick follow-up is, did we see a full quarter of the CVS repricing this quarter? And is there any way to call out the impact of that?

David Evans

We did see the full quarter. And we have not provided any specificity in terms of the annual impact of that contract renewal.

Mike Kaufmann

Thanks.

George Hill

Okay. Helpful, thank you.

Kevin Moran

Operator, next question please.

Operator

Thank you, sir. We will now take the next question from Glen Santangelo of Guggenheim Partners. Please go ahead.

Glen Santangelo

Oh, yeah. Thanks and good morning. Mike, I just wanted to follow up on the strength in the Medical business. In the past few years, you talked about the challenging market conditions, some of the supply chain issues. It sounds like this quarter, the company did a great job on the cost side. But what else has changed to help drive that performance, so we can maybe think about the sustainability of the results, you posted this quarter?

Mike Kaufmann

Yeah, thanks for the question. I feel really good about the Med segment. They performed a little better than we expected in Q1 and really happy with the transition of Steve Mason in his role. He's done an excellent job of getting up to speed so far and really surrounded himself with a solid team.

SG&A clearly was a component of our performance in the quarter. But there are multiple areas where we are working through various performance improvement. For one example, service levels now are not only back to where they were at the acquisition of patient recovery products, but are actually better than at any time while we've held the business. So, we've made a lot of progress in service levels. We're making solid progress on both SG&A and items that will really drive COGS. And we're in different innings on each one of those, but really happy so far with what we saw in the first quarter of Medical.

Glen Santangelo

Thanks. Maybe I just have one follow-up for Dave. Dave, you maintained the guidance for the full year, but you called out specifically that the operating profit in 2Q would be lower than Q1. Could you maybe just help us think about some of the assumptions in that sequential second quarter or some of the seasonal items that are maybe driving that outlook in 2Q? Thanks.

David Evans

Yeah, absolutely. So, I'd say – first of all, we said modestly lower. And we think about that, we think about a variety of factors that could change from quarter to quarter. One, for example, would be our SG&A spend. We've got a large inventory of investment opportunities to drive long-term improvements, and those are ramping up. And so, the level of the spend, the pace of that spend, we expect to increase in our second quarter.

Further, we've talked about the CVS and the Kroger's contract renewal being effective July 1st, we do have other contract renewals in much smaller scale, but yet other contract renewals will be occurring in the second quarter and throughout the year.

And finally, I would also say that we have some customers that have experienced difficulty either through bankruptcy or other financial distress where we're expecting some modestly lower volume in the second quarter than the first quarter. And as that volume declines, we'll capture our fair share of that, but we'll only capture our fair share of that is our current assumption.

So, there's a lot more depth in that, but I'd say those are some of the headlines that give us some reason to believe that Q2 won't be just simply a mirror image of Q1.

Glen Santangelo

Okay, thank you.

Operator

Thank you. We'll take our next question from Ricky Goldwasser from Morgan Stanley. Please go ahead.

Ricky Goldwasser

Yeah. Hi, good morning. My question is related to the opioid comments. When we think about that \$5.6 billion that you're now reserving, if that ends up being the final number and within that 18-year timeframe, would that have any impact on the business, the core business? And if so, do you have – what degree of freedom do you have to offset that with additional streamlining initiatives?

Mike Kaufmann

Yeah, thanks for the question. It broke up a little bit, Ricky. So, if I don't quite get the answer right, feel free to follow-up on that, particularly. I can't provide a lot of details on it. But, first of all, the settlement is spread over 18 years. And so, that's important to know. We continue to believe that that settlement is something that will be a consideration as we look at capital deployment, but not a limitation as to when we look at capital employment or investments.

We do believe that the overall settlement framework is something that is supported by a bipartisan group of state attorneys general and it does provide a framework by which hopefully we can continue to not only get this behind us, but also get meaningful funds to the people that need it, begin looking at the distribution of the free goods that are out there and also look at other ways that the industry can work together to improve the overall monitoring of opioids. So, I'll stop right there and see if I was able to answer your question or not.

Ricky Goldwasser

No, you did. Thank you, Mike. Let me just have a quick follow-up, or maybe not so quick. But when we think about the long-term financial profile. Obviously, in the quarter, revenue up mid-single digits and profit were down because of the renewals that you talked about and we'll see throughout the year. But when we step back and we think about the industry on a steady state in your assets, and once you normalize for the renewals and taking into account all the streamlining and efficiencies that you talked about in your prepared comments, what type of operating profit growth do you think the business can support long-term with a mid-single-digit type top line growth?

Mike Kaufmann

Yeah. Thanks for the question. It's too early for us to give any real comments on 2021 and beyond. I would just say that we feel really good about the progress that we made this quarter, both in investing in the growth areas that we've talked about, Specialty at Home and our services businesses, but also getting after our cost structure.

I think Dave made a comment that's really important, is this isn't just a cost reduction, this is taking entire cost structures out in a way that they won't come back, that the culture and the way the leadership is working is really driving at prioritizing and focusing us on the right things, so we're spending dollars in the right space, taking advantage of digital technologies, robotic automation, AI, et cetera, in order to really drive our cost structure down.

So, we feel really good about achieving our overall \$500 million number, our \$130 million number for this year and really have this built into our overall culture. But, again, it's just too early for us to make comments on 2021 and beyond, but we feel that we are not only getting after our cost structure, but investing for growth, which is really important.

Kevin Moran

Next question.

Operator

Thank you, sir. Our next question comes from Charles Rhyee of Cowen. Please go ahead.

Charles Rhyee

With Cowen. Yeah. Hey, thanks for taking the questions, Mike. Just one going back to the opioids real quickly. Your comments – and one of your peers today sounds a lot more positive, I would say, maybe than the comments from many other companies the other week. Anything kind of change in the last week or two that kind of increased the sort of the optimism here in terms of getting towards a global settlement here?

Mike Kaufmann

Wouldn't say anything changed. Let me just step back and make sure that we're on the same page. As you know, a few weeks ago, we settled with two Ohio counties, which, by doing that, enabled us to move forward with this framework. That was an important component of being able to get that behind this, so all of the parties involved in the global framework could move forward and begin working on. So, that's an important thing to know.

We clearly have a global settlement framework and structure with the \$18 billion over 18 years with our component being \$5.56 billion. We've also agreed upon distributing the free treatment medications for 10 years and we've agreed that, when we get this behind us, we can all work together to look at the way state, federal government, distributors, everybody work together to monitor opioid shipments and uses, so that we can work together.

We think the desire and – if we can get this behind us, how we'll bring meaningful relief in both funds and distribution of treatment medication to the people that need it is important, and so we feel positive that folks will work hard on this to get this going. So, again, nothing specific, but our belief is that the way this is structured that this is the right accounting for us at this point in time.

Charles Rhyee

And if I could just follow-up, obviously, if you look at the number of plaintiffs – I forget the last count. It's upwards of 2,000 or so. Obviously, the states are a big component of it, but you have a lot of smaller plaintiffs. As I read some of the comments from AmeriSys as well as who speaks to it, it kind of suggests that not only state AGs, but also a lot of the other plaintiffs. Can you kind of discuss like the participation of the smaller entities in this? In other words, if you get this framework done, do we still have a long tail of small plaintiffs kind of coming after the players here? Or is it kind of – this is structured in a way, would you think, that this will achieve [indiscernible] looking forward?

Mike Kaufmann

Yeah, good question. I would say this. You could probably put them in many, many buckets. Well, let me put them in three broad buckets. There's state, there's the political subdivisions, the counties, the cities and then this will become more private plaintiffs,

which might be pension funds or individuals and those things. This global framework is put together to settle on the first two, all of the state claims as well as the cities and all the political subdivisions. And the accrual that we put on the books is to represent the global framework we did for those first two buckets. That third bucket, which there is also still suits out there, are very different and it's a mixture of different things and those are still out there and will be things that we will have to address going forward.

Kevin Moran

Next question.

Operator

Thank you. We will take our next question from Steven Valiquette of Barclays. Please go ahead.

Steven Valiquette

Great, thanks. Good morning, Mike and Dave. So, kind of following up a little bit on that last question. One of your peers had some very different language in their press release this morning about when they make accruals and when they don't. But without getting too much into that, I guess, the question is, is there any possibility that Cardinal's further along or closer to a settlement agreement than some of your distributor peers? Is there any scenario where Cardinal may reach a global settlement, but your peers may not? Or is it kind of all three year or none around the global settlement? Just curious to get your extra thoughts on that. Thanks.

Mike Kaufmann

Yeah, thanks for the question. No, I would say that Cardinal is not doing anything different. This is just our understanding and belief of the way the global framework is set up that we believe the accounting that we've done is appropriate for the circumstances in our – on that.

Steven Valiquette

And one of your peers talked about a settlement maybe still being months away and that seemed to be different than what some investors were thinking. To me, I think that's still a pretty short time horizon given the number of parties involved, but is there any extra color on when do you think the timing could be nailed down on a settlement?

Mike Kaufmann

Yeah, it's really hard to actually predict timing, but it's not something that we think is going to get done tomorrow. There is work to be done. And as I mentioned, we believe settling the two counties, getting that behind us and allowing the state AGs to begin the process of working with the political subdivisions, plaintiffs, attorneys, et cetera, that that process has begun and we're fully supportive and we'll do what we can to help in that process. And it will take some amount of time, but it's really hard to predict what that will be.

Kevin Moran

Next question.

Operator

We will take our next question from Lisa Gill from JP Morgan.

Lisa Gill

Thanks very much. Good morning, Mike. As we think about the global settlement, how do I think about it from a tax perspective? I'm just trying to figure out what the impact will be to cash flow. You talked about the fact that there'll be some impact, but really shouldn't change how you think about capital deployment? So, that would just be my first question, was how do we think about the tax implications.

David Evans

Yeah, Lisa. This is Dave. Thanks for the question. Look, the intent of this is consistent with the public policy and guidelines of the IRS and the state tax authorities to make this tax deductible. Having said that, the details and specifics of this agreement really just aren't there right now, to provide the level of precision that, ultimately, we'll have, nor is the complete clarity of the tax code there at this stage.

So, from an accounting perspective, we just followed accounting guidance and established what we believe is an appropriate reserve for what will be tax deductible. But that, I would say, will continue to become more clear as time marches on and the specifics of both the tax code and the settlement offer become more clear.

Mike Kaufmann

And as far as the cash flow impact goes, Lisa, as you said, while it's spread over 18 years specifically, how it will be paid and funded each year is still being worked out. So, it's hard for us to give you any real color on the exact timing and impact of cash flows. But as you can imagine, we spread it out over time in order to be able to still manage our business effectively going forward.

Lisa Gill

And then, Mike, if I could just sneak one in on policy. Thoughts around re-importation and the potential impact that that could have to Cardinal and drug distribution in general?

Mike Kaufmann

Yeah, it's an interesting question. It's one of those things that it's probably a little too early to get into a lot of detail. This is something that I can remember working on 15 years ago when we thought it was going to be imminent and working on setting up all of the capabilities internally to help make sure that, if it did happen, there would be a safe supply chain. And I think the focus on re-importation has to be on patient safety.

And I think that Cardinal was as well-positioned as anybody that, if this were to get some legs, that we would be able to work with folks to help make sure that any re-importation was done on a safe basis. It's hard to imagine that it could be material in any way to affect our businesses, but if it did happen, I think Cardinal was well-positioned to help any of the folks that would do that.

Kevin Moran

Next question.

Operator

Thank you. We will take our next question from Robert Jones from Goldman Sachs.

Robert Jones

Great, thanks for the questions. Mike, I just want to go back to some comments from the prepared remarks around the financial distress of certain customers. I guess, first, I'm assuming that's some retail independents, but wanted to confirm that. And then, could you talk a little bit about what you think is driving this? Was it kind of a one-off related to a certain pocket of customers or is there anything more systemic you're seeing in the marketplace around the health of some of your maybe perhaps smaller customers?

Mike Kaufmann

No, those comments were not meant – so I'm really glad you asked, were not meant to talk about the small customers. This was really about the bankruptcy of Fred's and the continuing restructuring of the Kmart account – two accounts that we've had that we've been managing over time that were both generic buyers of ours. And as those volumes declined due to their financial situation, that has had some impact on us. But that's really what we were referring to in those comments.

Robert Jones

Got it. Got it. No, thanks for the clarification. And, I guess, just one follow up on the Medical guidance, you guys mentioned that you're monitoring the med device tax and tariffs as it relates to guidance. And, clearly, the guidance would imply a deceleration over the course of the year. So, I just wanted to maybe get a better sense of what maybe the guidance looks like if in fact those items don't, in fact, come to fruition. And just one point related to Medical. I wanted to make sure I was thinking about this right. I believe you're lapping a fairly meaningful headwind from a supplier charge in 4Q. Wanted to confirm that that was right as we just think about the cadence around the Medical guide for the rest of the year.

David Evans

Yeah, Bob. That's absolutely correct in terms of the second half of your statement. We will be lapping in the fourth quarter a reasonable charge that should be non-recurring.

With respect to the balance of the year, we have not built in – as we said last quarter with the full-year guidance, we've built in nothing with respect to the med device tax. So, if it doesn't come to fruition, then that's consistent with the guidance we provided. And, clearly, if it does, then that's going to be a headwind we're going to have to manage through.

Tariffs are just such a dynamic topic that we've done our best to offset the tariffs that are in effect now. But that, again, is changing. So, I'd say if that would completely cease any further dialog around tariffs, then what's been announced today, we've more or less been able to manage through that.

What I would say is there are still a lot of other SG&A initiatives that Mike talked about that do have a longer runway and, therefore, they aren't necessarily all – the cadence isn't equally distributed amongst four quarters.

I'd really highlight some of the supply chain initiatives that have a long runway and won't necessarily bear fruit for – it could be two, three years, but we are incurring costs to begin to plan for those this year. And as well, the sales force restructuring that we've discussed as well is kind of in-flight through the course of the year. So, that's not something you can just kind of ratably divide it by four and say it's going to be equal in terms of the cost or the benefits.

So, look, you're right in that the fourth quarter does have a tailwind this year and the fact that this is non-recurrence of a charge, but we just – we feel, I guess, I'd say, cautiously optimistic for the year based on the first quarter, but feels too early at this stage, given all these variables that are out there to call anything up at this early stage.

Operator

Thank you. We'll take our next question from Eric Percher from Nephron Research.

Dolph Warburton

Hi, this is Dolph on for Eric. Question about the in kind portion of the potential settlement. If we take \$1 billion of value, is that \$1 billion of revenue? And if so, are you able to determine kind of the costs? Or, I guess, the better question is, what does an in-kind service really look like for Cardinal?

Mike Kaufmann

Yeah, it's a great question. That would be an area that is still looking to be defined yet, but, essentially, they're one of the folks that's settling in the case, is contributing free goods is the essential idea here. And the thought is that the three distributors would agree to distribute those free goods to the people that need it. None of the actual cost of distributing those free goods, because we don't have enough information on that, are included in our overall accrual.

That being said, we at this time don't think that would be material, but don't have enough information to know. But the concept is just being able to take those drugs and then using the efficiency of our overall supply chain of the distributors to get those to the folks that need them most.

Dolph Warburton

Great, thank you. And then, just a follow-up. The difference between the charge listed in the text of the release and what's listed as an add back pre-tax, it looks like about \$40 million. I assume that's legal services in the quarter? Or is there something else causing the difference?

Mike Kaufmann

No, the breakdown...

David Evans

We've got two components. The primary two components. Of course, our pro rata share of \$18 billion and then there's the pro rata share of the two Ohio county settlements. The remaining small difference relates to – I believe we may have spoken in the past about, which is in our med supply business, our Cordis business, the IVS product, which we continue to accrue for a loss, continue to see on that as well. It's a fairly small number, but that – if you get to the third decimal digit, that's where you're going to find, is the IVS...

Mike Kaufmann**Kevin Moran**

Next question please.

Operator

Thank you, sir. We will take our next question from Stephen Baxter from Wolfe Research.

Stephen Baxter

Thanks for the question. I wanted to follow-up on the opioid discussion. Really appreciate all the color and insight you've provided thus far. I wanted to come back to the outlook for share repurchase. So, if we were to treat the settlement like debt, this settlement would point to trailing leverage approaching 4.5 times. So, it sounds like you're saying that the settlement framework, as currently proposed, would not be a limitation on capital deployment. So, I'm hoping you can help us square your comfort level with this implied leverage. How you think the debt rating agencies are going to look at this issue and the importance of maintaining an investment grade rate to the company? Thanks.

Mike Kaufmann

Yeah. First of all, I would say that – I wouldn't say that – remember, this is a consideration. So, we don't see it necessarily as a limitation, but, clearly, once we understand the flows of the cash over the 18-year period, we're going to have to take that in consideration in all of our capital deployment pieces. But let me turn it over to Dave to give you a little color on our thoughts around the rating agencies and what we could talk about.

David Evans

Look, first of all, we've got good relationships with the rating agencies and we stay in close contact with them. So, it's continuous dialog.

Second, our investment grade credit rating is very important to us. So, it's something that we value and we'll continue to monitor and manage – to maintain that.

Let's say, when you look at the leverage, the numbers that you're citing, a couple of factors. One, recall, this year, we've committed externally to de-levering by at least \$1 billion. So, as we look forward on this, that number will be coming down.

And second of all, I'm not sure – I'm not going to speculate on the credit rating agencies or opine on where they're going to land, but I think there's multiple scenarios between saying this is zero liability or it's the book accounting accrual liability.

For example, you could look at – it's just a discount in future cash flow of all the future years' payments, which nets you a number that's quite a bit smaller than the headline \$5.6 billion.

So, we'll see how the credit rating agencies opine on this, where they land. But at this point, I'd say we'll be focused on this. We will make a substantial bite of the apple this year and we'll continue to monitor this in the broader scheme of our capital allocation policy in the years ahead.

Stephen Baxter

Great, thanks. One quick follow-up. Just given how you started out the year on cash flow, can you remind us what you're expecting for the full year for operating cash flow, or at least some directional context relative for the past couple of years? Thanks.

David Evans

Yeah. Look, we have not provided cash flow guidance in the past and we didn't provide it this year. So, I'm not going to speak to that. It's just – I'd say, if you look at the fundamentals, the fundamentals are not structurally different than last year. We continue to work on our working capital efficiency initiatives. We continue to drive strong cash flow. You will see anomalies based on a point in time, but I wouldn't say we expect anything materially different year-over-year without providing a finer point to it in terms of giving you any specific guidance.

Kevin Moran

Next question.

Operator

Thank you. We will take our next question from John Ransom from Raymond James.

John Ransom

Hey, good morning. Just going back to the stuff we used to talk about a lot, Mike. I know you've probably answered this question 18,000 times over your career. But it's interesting to us what's happening with the generic cycle, in that the pricing at a manufacturer level has certainly firmed. So, we calculate deflation having dropped from the high teens to something like the mid-single digits, whereas at the pharmacy level reimbursement pressure just continues. So, you're seeing an accelerated squeeze at the Pharmacy. So, I just wonder you guys being a student of the pharmacy and you're already talking about Fred's and Kmart, how long can this go on without just continued chaos in the independent pharmacy channel?

Mike Kaufmann

Well, that's a tough question to really talk about. So, I'll give you a little bit of color. A few things come to mind. I'll talk about it from both sides. First of all, I think our – all of our customers are – are there a few one-offs like a Fred's and a Kmart? Yeah. But as we look, our retail independents, in general, have stayed at roughly the same number over several years now. They continue to find not only ways to work through the reimbursement challenges, but to continue to find other ways to compete in the marketplace, whether it be through packaging, through additional services, through front end, through just the high quality service that they give every day. And I think the chains continue to do the same through automation and other programs themselves.

So, I think that the chains, including the independents, all of the retail pharmacies, continue to be an important component of getting pharmaceuticals to patients. And so, it's something we're always going to keep our eyes on, but I think they've learned how to compete in this marketplace.

As far as on our side, we have seen some improvement as we said in the market dynamics around the sell side pricing side. Remember, our generics program is made up of four components and we've always said it's sell side, buy side, launches and overall volumes with our customers. Because of some of the customers we've mentioned, we've seen a little bit of weakness on the volume side than we expected. And the new item

launches, as you know, are always highly fluctuating and can change. That's been a little less than we expected so far this year. And all that netting together, our generics program came in about as expected..

John Ransom

Okay. And just switching gears. A philosophical question. We're all kind of scratching our heads about how to treat this settlement. But if this is going to – if it's an 18-year settlement and it's just an annual cash outlay, why would that be added back to adjusted earnings? It's not something like amortization, it's non-cash or it's not a one-year one-time. Isn't this just best thought of as a reduction in adjusted earnings for almost 20 years? Why would we add this back?

David Evans

So, the way I'd answer that is, this isn't going to be a charge to the P&L over 18 years. It's a cash cost. But from a GAAP accounting P&L expense perspective, the charge is recognized initially once and that was what you saw recorded this quarter. And so, recognizing a 18-year charge, we did call out as a GAAP to non-GAAP adjustment, appropriately so. So, I think we might be mixing and matching cash and expense charges. Does that answer your question?

John Ransom

I mean, if I could just push back on that, it seems like we want to have it both ways in terms of – if it's helpful, we add it back. Yeah, I get, you can take the charge year one, but it's going to be a reduction of what I would call cash earnings. And so, yeah, add back amortization, that's not cash. I get that. Or a one-time. But this is an actual reduction. So, it just seems like we're having it both ways to take this big accounting charge, but then add it back to adjusted earnings. So, yeah, the mismatch, seems like we're a little bit having it both ways. That's all.

David Evans

Yeah, I understand your question. I think what I – look, when we make GAAP, non-GAAP adjustments, that's for when we have an expense or a credit in the current period P&L that we add back or subtract out to get to non-GAAP.

In the case of this opioid accrual, we won't have a P&L charge in future periods. So, there won't be anything to add back to get to non-GAAP earnings. Now, I suppose – I think you will look at this from a cash perspective and certainly everyone can model the cash flow impact for the next 18 years, but that's separate from – it just won't really be in the equation in terms of a GAAP versus non-GAAP adjustment because it won't be a charge in future P&Ls. So, it won't be anything to add back .

Kevin Moran

Next question.

Operator

Thank you. We will take our next question from Eric Coldwell of Baird. Please go ahead.

Eric Coldwell

Thanks. Good morning. All of my snazzy questions have been asked already, but I have a couple of technical ones. I think it was Bob that asked about the medical device tax. You admitted it's not in guidance. It could come back. What would be the actual impact or best estimate of the impact if it does come back in dollar terms?

Secondarily, commodity cost inputs and FX in the Medical segment. I'm curious if you can give us some sense of the impact those had on profit in Medical. Thank you so much.

David Evans

Yeah. So, first, with respect to the medical device tax, we don't have complete clarity on this. So, I don't have a precise answer for you. But I would say that, on an annualized basis, we believe it could be in the neighborhood of \$40 million to \$50 million on an annual basis. Okay? So, if we look at for – if it's effective in January, the second half of the year,

you'd pro rate that. Again, I'll just kind of caution that that's based on a lack of perfect clarity and information. And so, if that were to actually happen, we'd be prepared to provide a more precise answer to that at that stage.

The second question was related to FX. Look, we have FX that shows up in different areas of our P&L. We have some that's showing up in the segments. And then, you may have noticed in interest and other, we have other changed a bit, and that's principally driven by FX.

I would say that, on a net basis, FX in the first quarter was reasonably neutral, was not a material driver positive or negative. I think the team is doing an excellent job in managing this and navigating through this as appropriate.

Eric Coldwell

And the commodity costs?

David Evans

Oh, I'm sorry commodity costs.

Eric Coldwell

[indiscernible] pointed that out yesterday, yeah.

David Evans

Yeah, I know. I apologize. So, commodities, for us, in the first quarter, I'd describe them as a small headwind. They were a headwind, but not in a material way.

Eric Coldwell

Thanks very much.

Kevin Moran

Next question.

Operator

Thank you. We will take our final question from Kevin Caliendo from UBS.

Kevin Caliendo

Great. Thanks for getting me in, guys. So, my question on the opioids is just how much confidence do you have – that \$18 billion over 18 years – that this will be the final layout between the level 3 – or the tier 3 groupings that you mentioned earlier, that this is really going to be the final number for the MDL and for everybody else and that you can really put this to bed with this kind of settlement?

Mike Kaufmann

Yeah, thanks for the question, Kevin. Look, it's still too early to tell. As I said, this global framework does only impact the first two buckets. There is no accrual or ability to even estimate and understand the size of the last bucket that we talked about. But as far as the global framework, we have to separate both the accounting and the likelihood of this getting done in our mind and this framework is something that we support. We like that it's being supported by a bipartisan group of AGs and it's something that we're behind, but it's still too early to tell you whether or not it will be successful. But we do think not only is it something that we can support, and it has the support of them, but it's something that's important to the people that need it most because it will get dollars, free drugs and some potentially new processes out there that I think all benefit the country.

Kevin Caliendo

Sure. And just one quick follow-up, when are out visiting you guys, you talked about a restructuring of the Medical sales force compensation. Did that impact 3Q in any way? And how are you thinking about the impact of what the incentive program for sales force might have or have had on Medical going forward?

Mike Kaufmann

Yeah, that's something – it's one of the really key things going on in Medical that Steve and the team are leading. As I mentioned in the prepared remarks, this restructure is a component of not only compensation and sales incentives, but also around how we go to market to best address selling to the customers they want – to our customers, the way

they want to be sold to. So, we did a lot of work out talking to and understanding the way our customer base would like us to come to them and how they would like to be serviced. And so, this restructuring was highly defined by a lot of detailed work. We started to – we put it in place in our Q1. And as far as incentives go, changing the jobs, interviewing folks for roles, both internally and deciding that, in some roles, we needed to go externally for the right level of talent the way we want to work and we would expect that that entire restructuring will be done and behind us by the end of our Q3 and that we would start to see benefits from that next year in FY 2021. So, we're really excited about it and like the progress we're making.

Kevin Moran

So, next question.

Operator

There are no further questions. So, I'd like to hand back to your host for any additional or closing remarks.

Mike Kaufmann

Well, thank you all for joining us this morning. We're really pleased to be off to a solid start to our FY 2020 and we look forward to seeing many of you in the coming months. Take care, everyone.

Operator

Ladies and gentlemen, this concludes today's call. Thank you all for your participation. You may now disconnect.