# Q3 FY20 Cardinal Health, Inc. Earnings Conference Call

**May 11th, 2019 8:30AM Eastern**

**Operator**: Good day, and welcome to the Cardinal Health, Inc. Third Quarter Fiscal Year 2020 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Kevin Moran. Please go ahead.

**Kevin Moran:**

Good morning. This is Kevin Moran, Vice President of Investor Relations. We hope that you and your loved ones are healthy and safe, and we thank you for joining us as we discuss Cardinal Health's third quarter fiscal 2020 results and expectations for the remainder of the fiscal year.

Joining me on the call today are Mike Kaufmann, Chief Executive Officer, Dave Evans, Interim Chief Financial Officer and Jason Hollar, our Incoming Chief Financial Officer. You can find today's press release and presentation on the IR section of our website at ir.cardinalhealth.com.

During the call, we will be making forward-looking statements. The matters addressed in the 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 description of these risks and uncertainties.

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

As far as the agenda for today, Mike will start off by sharing Cardinal Health's response to the COVID-19 pandemic before turning the call over to Dave, who will cover the financials. Jason will briefly introduce himself and then Mike will share some perspectives on our mid- and longer-term strategies as we navigate this time of tremendous change. The remaining time will be available for your questions. During the Q&A, we kindly ask that you try and limit yourself to one question, so that we can try and give everyone an opportunity.

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

**Michael C. Kaufmann:**

Thanks, Kevin. Good morning to everyone joining us. I hope you and your families are safe and well.

These past several weeks, we've had a heightened focus on both keeping our Cardinal Health family healthy and safe and on effectively serving our customers. As one of the largest suppliers of medical and pharmaceutical products, now, more than ever, we are committed to fulfilling our mission of supporting healthcare providers and the patients they serve.

Keeping our distribution and manufacturing facilities functioning smoothly remains a key priority. To do so, we have implemented measures to protect and retain our frontline employees and maintain the continuity of our operations. And early on, we proactively and successfully implemented remote work policies for office employees.

As the pandemic unfolds in different ways, and on different timetables around the world, our teams across the company are adapting to new working environments and responding to industry-wide challenges with tenacity, speed, and creativity. Our global manufacturing, procurement and logistics teams are finding innovative ways to consistently produce and ship medical products. Faced with significantly increased demand for masks, gowns, and other products, our R&D, manufacturing, engineering, quality and regulatory teams have been working together to increase supply in creative ways.

For example, we have invested in, retrofitted and redeployed equipment to manufacture additional surgical masks, procedure gowns and face shields in our North American facilities. We have also repurposed production lines to make items like hand sanitizer and wipes for use in our facilities. We're grateful for the opportunity to serve our communities and healthcare providers, and we are using the full scale and breadth of our distribution, sourcing and manufacturing capabilities to provide essential medical supplies and pharmaceuticals to customers each day.

Demand for masks and other facial protection, gowns and gloves have spiked 2 to 12 times normal levels in the last 90 days. Supporting the delivery of these critical products is a priority for us and we will continue to do all we can to address these increases in demand. I will share more about how we will continue to navigate this challenging environment to perform our essential role in healthcare.

Now, I'll turn to Dave to discuss the financials.

**David C. Evans:**

Thanks, Mike. I'd also like to recognize all of our teams for their incredible efforts serving our customers during these extraordinary times and I want to express appreciation for our suppliers and partners who've worked diligently with us to support healthcare providers. I've been proud to be associated with Cardinal Health and all its employees over these past nine months.

Before I dive into specific results, I will share the macro level financial impact of COVID-19 as I think this will help put appropriate context around my subsequent commentary on third quarter results in FY 2020 guidance. We saw a modest net positive impact related to COVID-19 in Q3. We expect a more significant, net negative impact to both earnings and margin rate in Q4. This fourth quarter impact will be primarily due to a full quarter of reduced revenues, related to declines in elective procedures in the United States and an expected reversal of accelerated Pharmaceutical sales, which I'll discuss in a moment.

Turning to our results, in Q3 we delivered earnings of $1.62 per share, an increase of 2% from the prior year. Total company revenue increased 11% versus last year to $39.2 billion, with consolidated gross margin up 7% to $1.9 billion. SG&A increased 6% to $1.2 billion. The net result was growth in consolidated operating earnings of 8% from the prior year to $719 million.

Moving below operating earnings, interest and other income and expense increased 28% to $79 million. This was primarily driven by the decline in the value of our deferred compensation plan investments, partially offset by lower interest expense as we continue to reduce our long-term debt. As a reminder, changes to deferred compensation reported in other income and expense are fully offset in corporate SG&A and have no bottom line impact.

We continue to place a high priority on reducing debt leverage. In Q3, we paid down approximately $90 million of long-term debt and have now paid down approximately $880 million through the first nine months of fiscal 2020.

Our effective tax rate for the quarter was 25.7%, approximately 4 percentage points higher than the prior year, which included some net favorable discrete tax items. Average diluted shares outstanding were 294 million, about 5 million fewer than the prior year quarter, reflecting the $350 million accelerated share repurchase program completed in our second fiscal quarter.

Moving on to cash flow, operating cash flow for the quarter was approximately $1.7 billion as we focused foremost on addressing our customer needs. Keep in mind that the timing of inventory purchases and the collections on those sales as well as the day of the week in which the quarter ends all have the potential to impact point-in-time cash flows. We ended the quarter with a cash balance of $2.3 billion and we continue to have access to an additional $3 billion of liquidity in the form of our commercial paper program and AR securitization facility.

Moving on to segment results, starting with Pharma. Segment revenue increased 12% to $35.1 billion due to sales growth from Pharmaceutical Distribution customers, and to a lesser extent, Specialty Solutions customers.

Segment profit was flat at $534 million, reflecting both the strong performance of our generics program and the adverse impact of customer contract renewals.

In the quarter and more specifically in March, we saw a surge in Pharmaceutical sales. We believe this was driven by accelerated purchases related to the COVID-19 pandemic and we are experiencing below-average sales early in the fourth quarter.

Though not a material driver in the third quarter, activity in our Nuclear and Specialty businesses started to slow in March, as elective procedures and physician office visits began to be impacted by the virus. While we expect these activities to gradually rebound over the calendar year, the reduced activity will be more impactful to our fourth quarter, particularly in our Nuclear business which has higher margin products and a more fixed cost structure.

Before closing out on Pharma, a quick note on generics. We were encouraged to see another quarter of consistent dynamics within the generics market. Recall, we first began to see this in the fourth of our fiscal 2019. If these dynamics remain consistent going forward, we don't expect a year-over-year comparison to be as beneficial. As always, factors like mix and new launches could influence quarter-to-quarter comparability.

Turning now to the Medical segment, revenue increased 5% to $4.1 billion, due to growth in products and distribution and Cardinal Health at-Home Solutions. Segment profit increased 15% to $178 million due to an increase in products and distribution, including benefits from global manufacturing and cost savings initiatives.

In the quarter, we saw the global pandemic affect the segment in various ways. We've seen an unprecedented increase in demand for PPE products that we both source and manufacture. Because the surge quickly outstripped inventories on-hand and available market capacity to supply new PPE, we implemented disciplined allocation procedures. This was done in collaboration with our customers to balance demand and available supply, taking into account geographic areas experiencing the greatest impacts.

Due to ongoing market-wide supply constraints, we do not expect to see a similar increase in PPE-related sales in the fourth quarter, despite elevated demand. We continue to maximize our internal manufacturing capacity and collaborate with our supplier partners to address this dramatic increase.

Inversely, given the broader declines in elective procedures, we have seen a decrease in demand for many of our higher margin offerings, like customer surgical kits, Cordis and legacy Patient Recovery products.

As we look to Q4, I will remind you that we'll be lapping the large charge we booked in the fourth quarter of fiscal 2019 in the Med segment. Recall that this related to an exclusive distribution agreement with the Cordis supplier.

Turning briefly to fiscal 2020 guidance, we're pleased with our performance to-date. Our underlying business fundamentals have been strong, as have the momentum and progress of strategic initiatives across the company.

With this performance and with only a few months of COVID-19 related impacts, at this time, we are reaffirming our fiscal 2020 EPS guidance range of $5.20 to $5.40.

We're also reaffirming assumptions provided last quarter for the Medical segment and corporate. We are, however, making one update to our Pharma segment assumptions. Given expected Q4 COVID-related impacts, Pharma segment profits could now decline as much as mid-single digits for the year.

Before handing this back to Mike, I just want to share what a privilege it's been to be a part of the Cardinal Health team over these past nine months. It's through those experiences I witnessed how extraordinary this company is and how talented and committed the people are. This is a special place with an honorable mission and an enviable culture.

I'd like to thank the finance team for their support and patience and the full Cardinal Health family for their dedication in navigating these past nine months. I'll treasure the relationships I've forged here for a long time to come.

Finally, and most importantly, I would like to extend a very warm welcome to Jason. It's been great to have him on board and I look forward to working closely with him over the next few weeks to help make this a seamless transition. With that, let me turn it back over to Mike.

**Michael C. Kaufmann:**

Thank you doesn't seem like nearly enough for all that Dave has accomplished over the last nine months. He has been a trusted advisor and a skilled CFO. And his leadership has contributed significantly to our executive team and the finance organization. We appreciate his ongoing work to ensure a seamless transition with Jason Hollar, who joined us on April 27. Dave will remain with us until May 26, at which time Jason will officially assume the CFO role. Jason has been getting up to speed for the last few weeks and I already appreciate his candor and contributions. With his strong leadership background, deep financial expertise and prior experiences managing dynamic environments, he will be a true asset to our team as we navigate this pivotal time.

Jason, I'll turn it to you to briefly share a few thoughts.

**Jason M. Hollar:**

Thanks, Mike, and thanks to Dave as well. I've appreciated the partnership from both of you as I get up to speed. I'm really excited to join the team. While Cardinal is and has been an industry leader that is essential to care, there are still tremendous opportunities in front of us. What really drew me to Cardinal Health was both the strength of the current team as well as the positive culture and values of the organization that I share. I look forward to meeting and interacting with many of you over the coming months.

**Michael C. Kaufmann:**

Thanks, Jason. In my opening comments, I discussed our immediate response to the global pandemic. It's clear that the current environment presents uncertainty. And although there are many variables to consider as we look ahead, I'd like to highlight three areas to watch that we believe could most meaningfully affect our business. I'll then share some strategic actions we're taking to best position Cardinal Health for the future. It is important to note that each of these three areas will be affected by the trajectory of the virus itself, including its potential resurgence and manageability and the timeline for developing and distributing ways to test and treat it. This, in turn, affects when and to what extent the global environment returns to some relative normal.

With that backdrop, I'd like to highlight elective procedures, generics availability and pricing and the potential for changes in our ecosystem. First, elective procedures. When and how patients re-enter non-emergency areas of the healthcare system, including elective medical procedures and physician office visits, affects multiple areas of our business. In Med, the decline in elective procedures is causing significantly lower demand for some of the higher margin offerings in our portfolio. And in Pharma, we are seeing challenges in our Nuclear business and, to a lesser extent, the physician office area of our Specialty business. Although we expect near-term headwinds in these areas, we do believe demand will eventually rebound to historical levels. It's also possible that we might see a surge in some areas related to pent-up demand. We are doing everything we can to remain prepared to meet this demand and we will continue to best position these businesses for the future.

Second, generics availability and pricing. Our sourcing teams and our partners at Red Oak are working directly with suppliers to understand any potential disruptions and resulting changes in pricing that could emerge. Things like potential export restrictions or the impact of the virus on manufacturing capabilities in key countries may affect the availability of finished goods or raw materials.

Although we've seen some temporary spikes in demand for certain products, the team has partnered well with both customers and suppliers to help mitigate these disruptions. Red Oak's strengths in data and analytics as well as its visibility in understanding of the supply chain are key capabilities that we will utilize during this time of rapid change.

Third, potential changes in our ecosystem. Clearly, the coronavirus has changed the way we and all companies are currently operating and will operate in the future. We are monitoring the economic conditions, changes, shifts and various timetables for recovery for the participants in the healthcare ecosystem, including, but not limited to, suppliers, customers and the patients they serve. I'll discuss how we are adjusting our strategies to best position ourselves in light of these potential changes in just a moment. These are just three of the many areas we are monitoring.

In response to these shifting dynamics, we have taken strategic actions across the company to partner, adapt and invest. Let me briefly touch on each of these and share how we are leveraging our scale and heritage to better serve the healthcare system now and into the future.

First, we're partnering to address unprecedented demand as much as possible. Surges in demand have challenged the underlying supply in the marketplace and we have worked with partners across the supply chain to help identify alternative sources of supply. We are even partnering with non-traditional healthcare companies to develop creative, safe solutions to increase production of critical products. We're also collaborating with innovative companies like Battelle, one of the largest private, nonprofit research and development organizations in the world. Their teams received FDA authorization for collecting, decontaminating, and returning N95 respirator masks to healthcare personnel in the US and we are working with them to provide an end-to-end solution. We will continue to partner and identify additional collaborative opportunities which will be critical as we collectively navigate this pandemic.

Second, we're remaining and flexible and adaptable. COVID-19 will have long-lasting and broad-reaching implications and we are thinking about how to modify our strategies accordingly. For example, we recognize that our sales team plays a critical role in supporting our customers and we recognize there could be changes to how these teams will interact with customers going forward. For that reason, across the company, we are evaluating how to use our capabilities, talent and technologies in new ways.

In Med, we will focus on furthering our commercial initiatives, optimizing our supply chain and identifying product development opportunities. In Pharma, we are committed to enhancing our customer engagement experience as well as supporting our customers with new offerings and helping them innovate through this time of change.

Finally, we're continuing to invest in our business for the long-term. These significant investments will be focused on our IT infrastructure, including our customer ordering platforms, key businesses such as at-Home and Specialty and our employees to name a few.

For these and other investments throughout the company, we are utilizing portions of the savings generated through our ongoing cost optimization efforts. We remain on track to deliver on our savings goals for fiscal 2020 and beyond.

Now, let me shift gears and discuss capital allocation. We remain committed to a disciplined and balanced capital allocation approach that prioritizes reinvesting in the business, maintaining a strong balance sheet and returning cash to shareholders in the form of a dividend.

Capital expenditures remain a critical priority going forward, so we expect to annually spend at least what we have in prior years. Further, we remain committed to improving our balance sheet through further deleveraging. As Dave mentioned, we're on track to reduce outstanding long-term debt by at least $1 billion in fiscal 2020. With respect to the dividend, our board of directors recently approved a 1% increase.

Finally, going forward, we will continue to evaluate M&A and share repurchases. But in the near-term, our other capital allocation priorities take precedence.

To close, we are focused on supporting the healthcare system now and into the future. We play a critical role in helping our customers combat many of the challenges this pandemic has presented. Simultaneously, we are maintaining a strategic focus on positioning ourselves for the future.

Finally, I'd like to reiterate my gratitude for our employees as well as for our customers and partners across the industry. It is a privilege, now more than ever, to be essential to care.

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

## QUESTION AND ANSWER SECTION

**Operator**: [Operator Instructions] We will take our first question from Michael Cherny with Bank of America.

**Michael Cherny:**

Good morning and thanks for all the color so far. I just want to dive a little bit more into some of the 4Q dynamics. Mike, in particular, the reduction in the Pharma outlook for the next quarter. Is there any way to characterize or frame how much of this is tied to expectations or what you saw relative to pull-through perspective?

And then as you think about 4Q, mid single-digits can be a wide range. Within mid single-digits, how do you think about what has to happen in the business qualitatively to get to the varying different degrees of where you fall out for mid single-digit performance for the year?

**David C. Evans:**

So Michael, this is Dave. Why don't I start and then Mike can add more of the kind of the qualitative color to your question.

With respect to the fourth quarter, I think the way you need to think of it on a year-over-year basis is that this slowdown in elective procedures is impacting our Pharma business in the form of our Nuclear business, which tends to be our higher margin product lines with higher fixed costs. So the Nuclear business itself is the biggest impact year-over-year.

Recall on a year-over-year basis, we have the ongoing headwind of the contract renewals as well. So those are a couple of the biggest drivers that you find year-over-year. Now, offsetting that is the continued stability in the generics market dynamic, though a much smaller number. But, yeah, I would say that's probably the biggest tailwind. So, year-over-year, it's elective procedures, the contract renewals, marginally offset by the generic program's dynamic. So, Mike, do you want to provide more color on that then?

**Michael C. Kaufmann:**

Yeah. I think the only thing I would add, Michael, is that our Nuclear business, we feel really good about over the mid-to-long-term. It's a business that we remain committed to and I know that probably is a surprise to a lot of folks that it's a headwind because we don't talk about it a lot. It's been a business that's been growing, but it has seen a significant reduction in it's – the procedures in its marketplace. So it's seen a significant reduction and we thought long and hard about it, but we feel really good about our positioning there. And so we're doing everything we can to maintain the cost or to manage the costs as effectively as we can. But these tend to be more technical jobs that are hard to replace and we don't want to put ourselves in a position that when it bounces back that we're not ready to go. And so that's why we have decided to invest in that business, take some short-term pain. As Dave said, we expect actually Nuclear to be the biggest negative driver in Q4, even bigger than customer contract renewals but we want to be prepared for that business to rebound, which we believe it will be.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Glen Santangelo with Guggenheim.

**Glen Santangelo:**

Oh, yeah. Thanks for taking the question. Hey, Mike, in your prepared remarks, you sort of called three areas that you were monitoring closely and I was just kind of curious to maybe follow-up on two other things that you all talked about. The first was on the generic pricing trends. And secondly, I think on the Medical side, you said that there's an expectation that the recent above-average demand may not be sustainable. So I was just curious if you can comment on those two areas? Thanks very much.

**Michael C. Kaufmann:**

Sure. Thanks for the question. Yeah, in the generics area of availability and pricing, we look at – Q3, there were some early challenges but our team at Red Oak did a fantastic job on the generics side, making sure, understanding where we thought those supply disruptions might be, adding some new vendors to the program, buying some inventory ahead of the surge. And we actually managed it really well. And so far we're seeing that in Q4, but it's always hard to know right now with this COVID, where it might be re-surge, where we might see some export restrictions in certain countries, where certain manufacturing or raw materials might have challenges that could create either availability issues that might cause price increases or raw material increases that might create some price increases.

So at this point in time, I'm not saying that we're calling out anything different than what we've seen generally, but it's something we want to keep an eye on because there's just this added situation with

COVID-19 that we think could have an impact either in Q4 or possibly going forward in Q1. So we're just going to keep our eye on it and we'll be ready to react accordingly. And if we do see price increases, obviously our goal would be able to at least keep our margin per unit similar going forward.

On the Medical side, when it comes to the PPE, the really biggest thing to think about is that we work through our safety stock. That's probably the one thing that people to probably connect is that in Q3 we saw significant surge, but we were able to essentially meet the demand of the surge because we had safety stock. By early in our Q4, we had blown through that safety stock, and so now we're really only able to supply what we're able to get in replenishment. And that's why we're seeing that our PPE sales, we do not expect to see them to be the same as we saw in the surge in Q3, that, again, we had a safety stock to work ourselves through.

**Kevin Moran:**

Thank you. Next question, please.

**Operator**: Next question comes from George Hill with Deutsche Bank.

**George Hill:**

Yeah. Good morning, guys, and thanks for taking the questions. I guess, Mike, given all the color that you've provided about the Med-Surg business, I'm surprised the guidance there isn't changing as much. I guess could you talk about the puts and takes when I think I guess about like the regular way medical supplies business versus like the AssuraMed business. And I guess, can you talk about I guess more what's going on inside the segment and kind of how it relates to the guidance not coming down? I kind of expected a significant guidance change to Q4.

**Michael C. Kaufmann:**

Yeah. Thanks for the question. A couple of things. Remember, we have two really big things that are the drivers for us when it comes to Medical from the positive side, and number one is going to be the year-over-year benefit of not having that charge that we had last year. So that would be number one.

And then, number two is going to be our cost initiatives. We've been really, really getting after it when it comes to looking at both our manufacturing, distribution and overall cost in the Medical segment. So those two are going to be the two really big positive drivers. We're also going to see strong performance in our at-Home business, our Services business. And, as you can imagine, our Lab Distribution business, which we don't talk about a lot generally, has had increased volumes, too.

And so we're seeing strong performances from the businesses. Clearly, the negative is we're getting hit very hard on elective procedures. And so our higher margin product businesses are the biggest negative driver. But I think the piece that is the key here is the excellent work that we're doing on the cost side and the performance of some of what might be considered our smaller business in the Medical segment.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Robert Jones with Goldman Sachs.

**Robert P. Jones:**

Great. Thanks for the question. I guess just, Mike, going back to the Pharma segment, I wanted to just understand the guidance there a little bit better. I know it's probably been several years since you've quantified the Nuclear business, but sounds like that's kind of a standout as far as the downdraft you expect to see next quarter. So I was wondering if you could give any context around the size of that business today versus probably several years ago when we probably had a clearer sign of the size of that business.

And then, I guess just the one other question is, the assumption on the core business, the kind of small molecule specialty channels, is the assumption that what you're seeing kind of late in the quarter, early this quarter, just kind of run rated through 4Q or is there a little bit more complexity around how you're thinking about forecasting the core business? Thanks.

**Michael C. Kaufmann:**

Yes. So from a core business standpoint, what we saw was a surge in our Q3. I think you can see that through a lot of the data out there. As Dave mentioned in his script, we saw a surge in Q3 which led to upside in our Pharma business in Q3. And we've seen the reversal of that already through April. So if you probably add the two quarters together, our assumption is that Pharma would be relatively consistent from an overall sales growth standpoint, again, unless we see some types of surges again in this quarter that we're not necessarily anticipating, but the surge in Q3 we see reversing in Q4 on Pharma. So that's the big – really biggest driver between Q3 and Q4 when it comes to overall Pharma. We did see some, and expect to see some, decline in Q4 on our Specialty business because doctors' visits are down. And when you look at both oncology, and rheumatology, nephrology, you are seeing more office visit decreases in some of the non-oncology areas where we're strong. So we expect to see a little bit of that.

Specifically, as it relates to Nuclear, it's about a $900 million top line business that's been growing each of the last couple years. Ever since we had the couple of year period where there was a significant reduction in the procedures done in that business, we've seen some consistent growth. And so what we're seeing, as Dave mentioned, this is a high fixed cost business. And so when you see the procedures decline as dramatically as we did and you have a high fixed cost, we're seeing a significant impact to the bottom line of the Nuclear business.

And to try to give it some size – because we're not going to get into specific details on it, but to give it some size, we expected in Q4 to be the number one negative year-over-year driver, even larger than customer contract renewals. Now, again, that's an estimate at this point in time. But right now we are expecting that business to have a larger negative year-over-year impact, but, again, feel good about it for the mid to long-term. So we remain committed to it. And as we start to see electives ramp up, we're going to be ready to go to take advantage of that.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Kevin Caliendo with UBS.

**Kevin Caliendo:**

Hi. Thanks for taking my call. I want to ask about generics a little bit. I think you said that the generics have been improving since Q4 of last year and thus the comps will get incrementally harder. Can you talk – can you give us a little more detail on what's happening in that marketplace? Is it that the deflation is moderating? Are the spreads tightening a little bit? What do you expect going forward with regards to the generics business?

**Michael C. Kaufmann:**

Yeah. Generics, as I said, is one of the three key areas we're keeping our eyes on because it's an area that, with COVID-19, could see impacts related to raw material changes in cost, export restrictions, manufacturing facilities may or may not be affected. So there's a lot of potential dynamics that we have to keep our eye on.

But as you know, our generics program really has four components, which is: the cost side, which is generally managed by Red Oak and we continue to see very strong performance by that team; the sell price side that we talk about and, again, we've invested a lot of capabilities into our pricing and analytics team, because our overall goal is to maintain that margin per unit, which is really the key, which, as we said before, is why we went away from talking about individual components.

So our goal is to maintain that margin per unit and then hopefully continue to see volume increases which we have seen and some new item launches, which we said from beginning of the year we expected those to be relatively small over these next couple of years. That's generally running about as expected. And so putting those four together, we're very pleased to say last quarter we now expect our generics program to be a net tailwind for the year versus at the beginning of the year. We thought it would be a net headwind and we still expect it to be a net tailwind for the year. Not quite as big potentially with some of the COVID impact, but we still expect it to be a net positive for the year.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Charles Rhyee with Cowen.

**Charles Rhyee:**

Yeah. Thanks for taking the question. Mike, maybe building on that can you give us a sense on how you're thinking about – if 4Q is sort of a net negative and obviously we have Nuclear and a few other of the headwinds that you discussed. Your thoughts on how you expect things to recover in terms of volumes as we get into the back half of the calendar year? Obviously, we had a number of companies that have reported kind of giving their estimates on sort of a recovery path and in particular, some have discussed seeing more than 100% of volumes kind of in the, let's say, the fourth calendar quarter. Is this something that you are expecting as well as you project internally?

And just to clarify – and just one other thing was you talked about the Cardinal at-Home. A lot of stuff is doing virtual now. Do you expect a change in overall patterns of how people see their providers in the future and does that create a great opportunity for the at-Home business? Thanks.

**Michael C. Kaufmann:**

Yeah. I'll start with that then I'll go back to the other. We do feel really good about how our at-Home business is positioned. This has been a trend we've been seeing for a while now, we've been calling out. We think that this COVID-19 will just accelerate that trend and we really like the way we're positioned in that business. It's a business we have been investing in significantly on our interactions with the patient, how to run that business more efficiently. So we have and are expecting to have significant internal investments into that business going forward because we do believe it's going to be a significant growth area going forward.

As far as the forecast goes, as you know it's our kind of way we work because we don't talk a lot about the following year until we get there and so we'll give you the color and obviously all the appropriate thoughts on fiscal year 2021 in August. But I will try to give you at least color in this elective procedures area; and on the rest of the stuff, we're going to continue to monitor. We're lucky in the sense that we have the benefit of being a June 30 year-end. We can take this next quarter, really evaluate the trends in generics, the economic health of the ecosystem with all of our customers and how are they doing and how will they hold up in the ongoing environment, and we feel really good about who we're partnered with. We tend to be partnered with the folks that are more likely to be consolidators than consolidatees, and we feel really good about that.

But in the terms of elective procedures, obviously we started to see a fall-off in March. We expect our Q4 to be significantly down, both sequentially and year-over-year in terms of elective procedures. We do expect to see it get a little bit better as the quarter progresses but we do not expect an exit rate of our Q4 that would put us back with elective procedures in – back to where they were.

Our point of view is that there's still a lot of work to be done. We think it's going to be definitely choppy and our current thoughts – but we're going to refine these as we go forward and get a chance to look at it as though we would not expect elective procedures to fully recover in the first half of our fiscal 2021. We would think that they would have more likely to fully recover in our second half but we'll give more color later on and we are going to continue to look at that pent-up demand component. We hope it will be there. We think it could be there but there's a lot of things that we need to look at to understand going forward. So I would tell you the biggest color is we do not expect to see a full recovery until the second half of our fiscal 2021 on elective procedures.

**Kevin Moran:**

Next question please.

**Operator**: Next question comes from Eric Percher with Nephron Research.

**Eric Percher:**

Thank you and thanks for the efforts alongside the commentary. A question on Medical and I'm thinking what you provided on Nuclear was very helpful. You mentioned some of the better performing elements. I know you've sized at-Home at around $2 billion in the past. You mentioned Services and Lab but can you help us with the remainder of the business? And I know that Cordis and Patient Recovery are portions that are international, maybe walk us through any commentary you can give in terms of sizing some of the other businesses and how they've been impacted or expected to be impacted in the coming quarter?

**Michael C. Kaufmann:**

Yeah. This is again something we're going to continue to look at. But as you summarized well, we would think that our Services business, our at-Home business and our – well, those two businesses would perform the best going forward and the Lab business would perform well in Q4 based on what we saw in Q3. And the other biggest driver though for us in Q4 is though we're going to continue to get after our overall global manufacturing and supply chain. We're seeing outstanding work by the team there at making our manufacturing facilities more efficient, our distribution facilities more efficient.

Now, of course, we're seeing a lot of added costs related to COVID here and there, expediting product and things like that but those guys are doing a lot of really good work. So the two biggest drivers in Medical for Q4 will be the year-over-year impact of not having the charge last year related to the Cordis exclusive distribution agreement; expenses will be number two, and then the other three smaller businesses, combined together, would be like the third largest positive driver. And then the biggest negative which is why we'll still have some challenges in Q4 is going to be related to overall elective procedures where our core businesses, with the biggest one being our products business, in our OR, our kitting, our Cordis business, those businesses are going to see significant declines and have seen significant declines related to COVID.

**David C. Evans:**

Yeah, Eric, the Med is, it is a bit of a complex story for Q4. The way I'd distill it down is you have this charge from last year. That's nearly equally offset by the loss in elective surgeries this year. Then we have ongoing cost benefits driven by global manufacturing supply chain and other initiatives. Those are being more or less offset in the fourth quarter by incremental cost of supply chain and cost to our labor force; the premiums to our frontline workers.

**Michael C. Kaufmann:**

Yeah. I will emphasize one thing: We have not used this pandemic and demand for products as an opportunity expand to Medical product margins. So it's important to know that, that increase is not due to expansion, of taking opportunity to raise price or anything like that. So know that it's really what Dave and I talk about.

**Kevin Moran:**

Next question, please.

**Operator**: Our next question comes from Jailendra Singh with Credit Suisse.

**Jailendra Singh:**

Hi. Good morning. Thanks everyone. I was wondering if you guys can provide any color around if there was any margin impact in the third quarter from the shift from retail to mail channel we have seen and, additionally, once we are out of COVID-19, do you see this mix returning to pre-COVID levels or do you think this is going to be a new norm, just curious on your thoughts on the trend moving forward?

**Michael C. Kaufmann:**

Yeah. It's a really interesting question. It's hard to decipher because we saw a lot of just pull-forward across all channels. There was a little bit of a shift to mail order. I wouldn't call it that we've seen anything significant. I still feel really good about how our retail independents are operating. They're competing very effectively. They've added more deliveries those that weren't – are delivering, those that are working to compete and do effective things there, they're continuing to serve their communities really well. So – and we did see some 90-day at retail shift too. So it's hard to know exactly right now. I think its going to take another couple of quarters to understand how that mix will be impacted.

As we've said in the past, mail order is a lower margin business for us. So if we do see a shift to there and we are obviously working with one of the largest mail order companies, we will see some margin erosion but we still feel really good about where our retail independents and chains are positioned. And at this point in time, we don't expect that to be a huge material driver for us in Q4 but we'll have to reevaluate that for next year after we get some more intel.

**Kevin Moran:**

Next questions, please.

**Operator**: Our next question comes from Elizabeth Anderson with Evercore.

**Elizabeth Anderson:**

Hi. Good morning, guys. Thanks for the question. I noticed this obviously this is complicated by the COVID impact, but my question was around can you talk about a little – about how you've seen the business performance in the early parts of prior economic downturns and how maybe qualitatively if you can talk about it over sort of the longer period of a recession? Thanks.

**Michael C. Kaufmann:**

Yeah. It's hard to compare this to anything else. There's really been nothing else like this. But you can go back to events like 9/11, you can go back to events like the 2008 and 2009, and you can even go back to regional events, and generally what we see on both of our businesses is they rebound well. They tend to weather challenges like that incredibly well over the mid- to long-term, so you may see some temporary disruptions or changes, but generally these businesses tend to perform really well over cycles. And so we still feel that will be the case here. I think this one is a little different in the sense of how much it has disrupted elective procedures. But again we do feel that those will recover and we still are evaluating whether or not we might see some surges related to pent-up demand, but we do feel good about the resilience of these businesses over the long-term.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Ricky Goldwasser with Morgan Stanley.

**Ricky R. Goldwasser:**

Yeah. Hi, good morning. I have one follow-up on Nuclear and then my question. So, just that we understand on Nuclear. If we think about it, this was I think a $222 million business in the fourth quarter of last year. And in the guidance, in EBIT guidance for the Pharma segment, you lowered EBIT guidance by about $18 million to $73 million. I think we knew already about the contracts before, so should we assume that at $18 million to $73 million change is all Nuclear or is there anything else new that was not included in prior guidance? So that's kind of like the follow-up question.

And my other question is really around just kind of like thinking about long-term fundamentals; Mike you talked about changes in the ecosystem, some other companies across the healthcare ecosystem are talking about potential changes to supply chain dynamics and bringing some manufacturing back to the US, whether it's on the Pharma side or on the Med segment side. So just curious as to your thoughts on that dynamic? And if that were to happen, who would carry that additional cost? Is it going to be the wholesale distributor or is this going to be a cost that the channel will have to assume? Thank you.

**Michael C. Kaufmann:**

Yeah. I'll let Dave start on the nuclear piece and then I'll come back and talk about the long-term fundamentals…

**David C. Evans:**

Yeah. So let me just do a little housekeeping on the first question. So with respect to the Pharma fourth quarter segment, yeah, I think you kind of characterized Nuclear in broad terms that would be consistent with our expectations. There are other impacts though resulting from COVID-19. As we mentioned in the script, in the fourth quarter we do expect to see the reversal of the acceleration in the PD volume into Q3, so that will happen in Q4 and we also expect there to be a modest negative impact related to Specialty. So Specialty was a growing business year-to-date. It was growing in a healthy way. This slowdown of elective procedures is really going to negate some of that growth. So, Ricky, those would be the major items characterizing our fourth quarter COVID impact.

**Michael C. Kaufmann:**

Yeah. So as far as the supply chain goes, as you can imagine with COVID-19, we are evaluating our overall supply chain. We were, as you know, working through that, but with these changes we are looking at our global footprint with a new lens. We do some of our manufacturing right now for masks and certain other products in North America.

We'll continue to look at that and we've not seen any supply disruptions in those businesses. But it wasn't all of it. So we were sourcing globally. I'm sure we will continue to be a global sourcer. We will absolutely take a look at China and how it plays in there. It's hard to believe that China won't be part of an overall global sourcing strategy going forward, but the percentage of the products that are made there and, more importantly, the type of products that we make in China or that we source in China, we don't have any actual manufacturing there. But where we source in China, we're going to take a look at that and make sure that we have the type of infrastructure that, as we go forward not only in this situation but in future situations, probably is more diversified and not as dependent as the US was on certain categories in China this time. So absolutely we'll be taking a look at that.

Your question around cost increases in the channel, it's hard to speak about how that will look going forward, but I will tell you, so far, we've been very transparent with our customers. They understand and have put patients first, just as we have. And for us to be able to do that, we've had to change where we source and how we get certain PPE products. And customers have been willing to work with us on those products and work with us on those higher costs. And we're going to continue to have those open and transparent conversations, continue to look at the supply chain going forward and determine what's the right and fair way to manage this situation as it goes to cost increases, either on raw materials and those types of things.

Overall, over the longer-term, I'm not too worried about new players in the marketplace, in terms of manufacturing. I believe many of those are temporary for people that are trying to help out and just do the – feel an obligation. And that's great. And we really admire and respect the people that are doing that. I don't think many of them will stay in the business.

And for those that will, that have the high-quality type of products that we're looking for, we think it could give us some opportunity to continue to look at our overall number of sourcing partners and the ability to drive cost. So that is going to be a key area for us in FY 2021, is going to be managing supply chain cost. And we'll come back with more color when it's appropriate.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Lisa Gill of JPMorgan.

**Lisa C. Gill:**

Thanks very much. Good morning and thanks, Mike, to everyone on the Cardinal team, helping with all this PP&E on the frontline. I just really want to understand two things, one, just kind of dovetailing to what you were talking about. Do you see near-term opportunities to take cost out of your system? So, as you look at the ecosystem, you look at where your costs are today, do you see any cost-cutting opportunities?

And then, secondly, I just want to understand the health of your customer. Have you had any issues with collections? You talked about the fact that you believe there will be consolidation and you're well-positioned because you're with the larger players, but how about some of the smaller, independent pharmacies or smaller hospitals, are you seeing anything on the collection side?

**Michael C. Kaufmann:**

Yeah, I'll have Dave talk a little bit about what we're seeing on the collection side and the balance sheet and then I'll talk about a few of the other things.

**David C. Evans:**

Yeah. So, on the balance sheet side, collections. Lisa, we've seen liquidity, as you saw in the third quarter, strong. And we continue to see fairly consistent trends in terms of cash flow early in the fourth quarter. We're not oblivious to the fact, as Mike mentioned, the economic health of our ecosystem will likely have some implications down the road. We're anticipating some. We expect those to be fairly modest in the grand scheme of things.

**Michael C. Kaufmann:**

Yeah. And then, as again, I mentioned that as one of the three key areas so we will continue to look at that. And from a cost-cutting standpoint, though, this is something that we're always doing. We're always taking a look at things. And I wouldn't call it cost-cutting, maybe in the sense that we're just cutting costs to cut costs. It's really been about prioritizing what's important and finding better ways to think about it.

So if I think about when we announced what we were doing in finance last quarter, that wasn't a cost-cutting initiative. That was an initiative that saved a lot of money and reduced our overall cost, but it was really about being more efficient, taking out – putting in the right locations, using AI, using robotic automations; all those types of things to really drive the right types of behaviors to have ongoing capabilities and use our skill sets at the highest levels of folks.

So those are the types of things we're really looking for; like how do we do things smarter and take advantage of technology and efficiencies to get after cost. I will say one thing about the COVID situation, when we all get forced to work-from-home, you do find ability to prioritize what is really, really important and what is not so important when you're dealing with all of these types of things. And you'll also find a way I think to be faster than you normally would.

And I've seen our teams work at speeds that are just outstanding because there's such a deep commitment to patients and healthcare to get after things. So the ability to which we have flipped manufacturing plants, added capacity, worked through different types of things, I do think we will find some additional cost-cutting opportunities through prioritization, technology and just being faster as a company.

**Kevin Moran:**

Next question, please.

**Operator**: Our next question comes from Steven Valiquette with Barclays.

**Steven Valiquette:**

Great, thanks. Good morning, everyone, hope you're staying safe. So just regarding the comment in your prepared remarks about the mask and gown demand spiking up, just curious if you can give us a sense for just what percent of your Medical segment profits roughly came from PPE just in the reported 3Q, just to give us some context around that because the profits were announced eventually. And actually just speaking to that quickly, following some of your acquisitions in recent years. Can you remind us about any seasonality in the profits of the Medical segment? Is there a factor that normally drives profits down sequentially in fiscal 3Q versus fiscal 2Q because that was kind of the trend the last three years or so? Thanks.

**Michael C. Kaufmann:**

I'll chat briefly about it. If I miss anything, Dave, feel free to jump in here. We don't really break out the PPE as a percentage, plus you get into a lot of definitional issues around exactly what's PPE and not, but what we can tell you is that it did – we did see a little bit of a surge in Q3 on that where we had significantly increased demand, as I've said, 2 to 12 times on some products. We did have some safety stock and so we blew through a lot of that, which drove some extra incremental. It's worth talking about. I wouldn't say it's a lot of our other higher margin. Kitting and surgical businesses are going to be more important type of product lines to us than the lower margin, lower value PPE type of items. But it was important enough to mention from that standpoint.

And so I would say that as far as seasonality, flu can be a seasonality item for Medical. We have seen in the past when flu ramps up in a Q, either, Q2 or Q3; we see some increases in our Med business and in some of our sales because there tends to be some hospitalization. And usually also in Q2, Med tends to be a little bit stronger as people kind of rush to get some of their year-end type of insurance procedures done and we tend to see some increase in electives in those types of procedures in Q2, which leads to a little bit stronger Q2 in general for us. So, hopefully, those are two pieces of helpful information.

**Kevin Moran:**

Next question, please.

**Operator**: Next question comes from Stephen Baxter with Wolfe Research.

**Stephen Baxter:**

Hey, thanks for the question. Hope you're all doing well. I was hoping you could talk a little bit about the Pharma margin rate in Q3? We had seen three quarters of relative stability on that line. And then this quarter, it was down a little bit more than maybe I had expected. I was hoping you could talk about the drivers impacting the comparison there? And also you might have touched on this but any insight into how the March pull-forward volumes may have impacted the margin comparison? Thanks.

**Michael C. Kaufmann:**

Yeah. That margin profile gets a little complicated because there was a significant uptick in the surge in products. I would say this: There's nothing going on that's unusual in there. You probably just have some mix of certain generics, certain branded products that were higher and some lower because there were some shortages, some mix within generics. I wouldn't call out – there's nothing as we dug through the margin change that I would tell you tell you is some type of unique change that I would call out. I think it's just a lot of noise in the quarter because of the pull-forward and some of the dynamics of what items had extra demand on them and other items that maybe didn't. So I wouldn't call out anything unusual there.

**Kevin Moran:**

Operator, I think we have time for one last question, please.

**Operator**: Our last question comes from Eric Coldwell with Baird.

**Eric White Coldwell:**

Thanks very much. Ricky's question and I think you started to hit on mine. It's about Medical. We've been hearing that mature suppliers like Cardinal, with their existing customers have generally committed to GPO and customer contractual prices, whereas off-contract spot prices have spiked anywhere from as much as 15% – 5% to 15% in some cases. I'm just curious what is the potential to revisit contracts and pricing moving forward? I mean I think we're going to have a sustained demand spike in certain Medical items, the PPE, the swabs, et cetera. Clearly, a lot of supply chain integrity, service and access demand going forward. So I'm just curious, any thoughts on ability to maybe revisit pricing and margin in certain Medical items going forward? Thanks very much.

**Michael C. Kaufmann:**

Yeah. Thanks for the question. A couple of things: First and foremost, we are absolutely committed to keeping cost as low as possible for our customers and doing everything we can to help to be part of reducing the overall cost of healthcare in this country. So we're always looking at our sourcing strategies and our own expense structures in order to get after those types of things, so we can aggressively help our customers lower their cost, either by how much they buy – the price of the product, how they utilize it and all those types of things. So that being said, there are a lot of disruptions at this point in time. And so it's really hard to comment on what we see of the overall long-term. We continue to want to work with our customers and will. They have been great, and we're going to continue to have very transparent conversations for us at Cardinal. That's the way we like to work with our customers. We're not afraid to tell them bad news or give them information or whatever to help them understand how things are going because we think having open and transparent conversations around the supply constraints and those types of things is important and they've been appreciative and working with us well.

So we're going to continue to have those and where we're seeing challenges in certain PPE items that have super high demand. And the only way you can get extra supply is to bring in alternative suppliers and those might be at higher cost. We're going to continue to work with them. On our own products that we manufacture ourselves, we can control the cost structure. Obviously, we're going to be able to work with them a way to maintain our contract pricing and do those types of things. But as you said, in the spot market buys to be able to take care of patients, which is what everybody wants to do more than anything else, it's going to be incredibly important.

**Kevin Moran:**

Operator?

**Operator**: And that concludes our question-and-answer session. I would now like to turn the call back to Mike Kaufmann for any additional or closing remarks.

**Michael C. Kaufmann:**

Yeah. I just want to thank everyone for joining us this morning. On behalf of the entire Cardinal Health family, we hope you and your families stay safe and well, and we look forward to speaking to you again sometime soon.

Take care, everybody.

**Operator**: That concludes today's presentation. Thank you for your participation. You may now disconnect.