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McKesson Corp. (MCK)

Q2 2020 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Eric Percher
Analyst, Nephron Research LLC

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Brian G. Tanquilut
Analyst, Jefferies LLC

Stephen Baxter
Analyst, Wolfe Research LLC

Michael Cherny
Analyst, Bank of America Merrill Lynch

Charles Rhyee
Analyst, Cowen & Co. LLC

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

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

Kevin Caliendo
Analyst, UBS Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to McKesson's Q2 earnings call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Holly Weiss. Please go ahead.

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

Thank you, Susanne. Good morning, and welcome, everyone, to McKesson's second quarter fiscal 2020 earnings call. Today I'm joined by Brian Tyler, our Chief Executive Officer; and Britt Vitalone, our Chief Financial Officer. Brian will lead off, followed by Britt, and then we will move to a question and answer session.

Today's discussion will include forward-looking statements such as forecasts about McKesson's operations and future results. Please refer to the cautionary statements in today's press release and our slide presentation and to the Risk Factors section of our periodic SEC filings for additional information concerning risk factors that could cause our actual results to materially differ from those in our forward-looking statements.

During this call, we will discuss non-GAAP financial measures. Additional information about our non-GAAP financial measures, including a reconciliation of those measures to GAAP results, is included in today's press release and presentation slides, which are available on our website at investor.mckesson.com.

With that, let me turn it over Brian.

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

Thank you, Holly. Good morning, everyone. Thanks for joining us on our call today. Today, we reported second quarter total company revenues of $57.6 billion. Our adjusted earnings per diluted share was $3.60, which was in line with our expectations. And, when excluding the $0.33 prior-year benefit from the reversal of a contractual liability associated with McKesson's investment in Change Healthcare, second quarter results per diluted share increased more than 10% year over year.

Our first-half fiscal 2020 results give us confidence in our reaffirmed fiscal 2020 full-year outlook of $14 to $14.60 of adjusted earnings per diluted share. This continues to reflect year-over-year adjusted operating profit growth in each of our segments.

Before I go deeper into our second quarter results, I want to take a few minutes to discuss one topic I know is top of mind for everyone, and that is opioid litigation. Last week McKesson, along with two other distributors, reached a collective $215 million settlement with two Ohio counties, Cuyahoga and Summit, in the first track of the multidistrict opioid litigation. McKesson's portion of the settlement was $82 million, which was recorded in our second quarter results. We strongly dispute the allegations made by these two counties. However, settling the bellwether trial was in our view an important stepping-stone to achieving a broad resolution to opioid litigation and to accelerating relief efforts for the people and communities impacted by this public health crisis.

Over the next few months, we'll be working hard with other parties on the settlement framework that includes states and their subdivisions. While we have made good progress, there are many details and variables that remain open and still need to be addressed. We're optimistic that a broad resolution can be achieved, and that remains our goal. All along we've said the goal is to ring-fence the risk. However, to the extent the broad resolution settlement framework is unsuccessful, McKesson is prepared and continues to be prepared to litigate and to vigorously defend the mischaracterization that our company drove demand for opioids in this country.

The litigation process, if necessary, will be costly and could take many years to conclude, causing a significant and substantial delay to crisis mitigation efforts. I've stated this before: McKesson remains firmly committed to being part of the broader solution to this crisis. And while I appreciate there are many, many questions on this topic, given that discussions are ongoing, we'll be somewhat limited in what we can say. And I'm sure you can appreciate this, and we thank you for your understanding.

I also want to provide a brief update on our Board of Directors. In mid-October, our Board of Directors welcomed Maria Martinez as a new Independent Director. Maria has served as Executive Vice President and Chief Customer Experience Officer for Cisco since April 2018. She brings deep experience in customer experience, technology, and innovation, which we look forward to benefiting from. Maria's appointment, in addition to Ken Washington joining our Board of Directors in July, demonstrates our continuing commitment to refresh our Board and add valuable expertise and new perspectives.

Now let's get to the business results and share why I'm so confident in McKesson's positioning and our outlook. If you step back from a macro perspective, trends continue to support growth in healthcare. We have an aging population, as well as increase in chronic conditions. We're also seeing growth in innovative specialty medicines. The pipeline is rich with such medicines, including biosimilars.

Our U.S. Pharmaceutical and Specialty Solutions segment reflected solid execution in the quarter against this macro backdrop. Branded pricing is tracking in line with our fiscal 2020 assumption of mid-single digit price increases. For generics, consistent with prior quarters, our ClarusONE Sourcing venture is performing in line with expectations, and the sell-side remains competitive but stable.

Independent pharmacies continued to demonstrate resiliency and remain an important customer of McKesson. Recently, our McKesson RxOwnership team partnered with the National Community Pharmacists Association to sponsor its 10th annual Ownership Workshop series. RxOwnership supports the future of pharmacy ownership by giving pharmacists the knowledge, the support, and the tools required to achieve their ownership goals.

In the past year, RxOwnership assisted more than 725 owners in launching a new pharmacy, and since 2008 our team aided in ownership or transfer process of roughly 6,000 community pharmacies. We are proud of the long-term investments we've made in helping independent pharmacies deliver exceptional care to their patients and communities.

I'm also pleased with the strength we continue to see from our specialty businesses, where we have a broad array of assets and capabilities. When I talk about our specialty businesses, I'm largely referring to our provider solutions and practice management businesses that serve the community setting, primarily in oncology but also in other "ologies" like ophthalmology, rheumatology, and neurology, and our life sciences business, that leverage our provider footprint and differentiated services to drive solutions upstream for our manufacturer partners.

These businesses are organized in three strategic areas. First, provider solutions, which is the largest of the three businesses, includes the distribution and GPO services that are core to McKesson and to the needs of our physician customers. Also in this business, we have technology and tools that enhance value-based care delivery and products and services to help expand practice revenue.

Next is the practice management business. We discuss the U.S. Oncology Network quite often. This organization supports more than 1,400 physicians across 450 sites of service. We provide a unique value proposition, which allows the physician to remain independent while utilizing McKesson's services and staff to ensure the practice is running efficiently and effectively. This allows the physician to focus his or her time on treating patients. McKesson has 15 practices in the U.S. Oncology Network that are participating in the Oncology Care Model, or OCM. The Centers for Medicaid and Medicaid Innovation recently released results for the fourth performance period related to the OCM. I'm pleased to report that all 15 practices earned high marks for quality performance. The practices improved care and provided an enhanced patient experience and also saved Medicare approximately $35 million during the performance period as compared to the established benchmark. We are committed to ensuring that community practices have access to all the resources necessary, including access to clinical trials, to successfully accomplish the challenging practice transformation required by the OCM and the other value-based alternative payment models.

The third business is our McKesson Life Sciences business. This business includes third-party logistics, specialty pharmacy solutions for oncology and other rare and orphan products, patient access, adherence and affordability solutions, clinical education services, and a suite of data services providing commercial insights and real-world evidence. These services help ensure biopharma manufacturers are successful in the post-launch commercialization of their products.

These three businesses are well-positioned as innovative specialty products, including biosimilars, are coming to the market. And McKesson is often the partner of choice throughout the lifecycle of a therapy. As you can see, two of our strategic imperatives, supporting specialty and the manufacturer services value proposition, are underpinned by the strong portfolio of our existing offerings. And we consistently look at ways to expand those offerings and create new value-added services for our customers. We are investing in these businesses, specifically in the areas of oncology and biopharma services. We're making these investments in order to further expand our capabilities and support our future growth.

Let me turn now to Europe. As a reminder, last quarter in our U.K. retail business we experienced industry-wide underfunding by the NHS. Consistent with our expectations in July, we did see a nominal tariff increase in the month of August. And we do expect a further upward tariff revision later this fiscal year, which should result in a partial recovery of the underfunding we've experienced year to date.

Outside of the U.K. in Europe, we continue to see in aggregate year-to-date performance in line with our expectations for that segment. Britt will discuss our full-year outlook for this segment in a few minutes.

A few words on our Medical-Surgical business. We continue to see above-market growth as we operate in strong markets and [ph] care (11:12) shifts out of the hospital to alternate sites of care. McKesson has a full range of products and services for our physician, health system, post-acute, and home care provider customers, so we can serve their needs comprehensively. And our customers benefit from our enterprise mind-set as our Med-Surg team partners closely with our U.S. Pharmaceutical and Specialty Solutions business to ensure physicians receive the pharmaceuticals they need to run their practices. This continues to be an area of growth for our business. And the MSD acquisition, which we fully lapped in the first quarter, is on track with its planned integration as we work to consolidate the business and position ourselves to effectively scale.

Turning to the Other segment, which primarily consists of Canada, McKesson Prescription Technology Solutions, or MRxTS, and our investment in Change Healthcare. As we evaluate ways to further leverage the scale and expertise of our businesses in Canada, we've recently streamlined our leadership team structure into a retail and wholesale operations focus. We've introduced two new Senior Vice President positions responsible for leading the core operating businesses of retail, which includes digital and loyalty programs and our distribution solutions and specialty health business in Canada. This strategic change will enable our Canadian operations to work even better together as we deepen relationships with manufacturers and retail partners and drive real value for patients. I believe we have the right talent to move the company forward and contribute to a better healthcare system for all Canadians.

Moving on to MRxTS, the business continues to show strong growth in both new and existing products. In addition, our CoverMyMeds business, which is focused on electronic prior authorization, continues to innovate across the organization. During the quarter, CoverMyMeds and RxCrossroads by McKesson announced the launch of AMP, which stands for Access for More Patients, a first-in-class, technology-driven patient-support solution that transforms how patients access, afford, and adhere to their medications. This collaboration brings together the robust technology platform and established provider network of CoverMyMeds with the deep specialty experience and commercialization expertise of RxCrossroads by McKesson and is designed to automate access to specialty medications for physicians and patients.

The traditional hub model has had complex requirements and many times relied on time-consuming manual processes, which typically delay treatment, sometimes significantly. In our pilot case study, McKesson's AMP solution enabled patients across the U.S. to access their specialty medications 27% faster than traditional hub programs, fundamentally improving the way patient support is provided. AMP also provides high-touch services for patient cases that need intervention support beyond the automated technology platform, such as proactive clinical support, behavioral coaching, and financial assistance, improving adherence and helping to support better outcomes for patients. We're very excited about this cross-collaboration, as it again exemplifies our mission to improve patient care by providing innovative service offerings and demonstrates the value of our McKesson team and our broad set of capabilities. This represents another example of how we're investing in our differentiated businesses.

Let's move on to Change Healthcare. Our value-creating transaction with Change Healthcare provided McKesson with a cash payment up-front that allowed us to retain 70% ownership of the new company. It created a scaled healthcare software and analytics and technology-enabled services company that will unlock the value of our legacy MTS businesses. We have begun activities to exit the investment in the next six to 12 months in a tax-efficient manner. This drove certain charges that impacted our results for the second quarter. Britt will walk you through these accounting details later in the call.

In the Change Healthcare transaction, we found a way to create value while exiting businesses that weren't core to our McKesson strategy. It's a great example of how McKesson regularly evaluates our portfolio to ensure we have the right set of assets for the present but also for the future. I'm very pleased by the execution across our businesses in the second quarter. That execution included the impact of our cost savings initiatives across the enterprise. Britt will get into more of the details, but I think from my remarks, you can see evidence of not only the savings efforts, but the partnership across the businesses and overall cultural change happening across the organization.

For example, we've centralized our IT organization, implementing a center-led hub model to increase efficiency. In Med-Surg, I talked about the partnership with the U.S. Pharmaceutical and Specialty Solutions segment to ensure physicians receive the pharmaceuticals they need to run their practice in an easy way. And in MRxTS, I talked about the partnership with RxCrossroads business to launch AMP. Overall, we're evolving behaviors as it relates to company collaboration and spending and are focused on moving with speed in an ever changing healthcare landscape. We're building upon our strong culture, leveraging our diverse perspectives to make decisions with an enterprise-first, Team McKesson mind-set. I feel confident in the execution I've seen across our businesses in the first half of fiscal 2020, and I feel great about the future of McKesson.

And with that, let me turn the call over to Britt to go over the financials and some of the details I alluded to. Britt?

Britt J. Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks, Brian, and good morning. I'll begin with a few comments on second quarter results, including changes to our guidance for you to consider as you update your models.

We are pleased with our adjusted earnings per diluted share results in the second quarter, which were in line with consensus and grew 10% over the prior year, when excluding a one-time $90 million benefit in FY 2019. Our performance through the first half of fiscal 2020 was solid, and we're pleased with the momentum across the business. And we're reiterating our fiscal 2020 adjusted earnings outlook of $14 to $14.60 per diluted share. Updated guidance assumptions can be found in our second quarter earnings slide posted to the Investors section of our website.

Before we get into the details of the results, I want to address two items that impacted our GAAP only results. First, we've concluded it's the appropriate time to exit our remaining stake in Change Healthcare, and we've begun activities expected to lead to an exit of the investment, which we anticipate will occur within six to 12 months. As we've previously communicated, we will execute this transaction in a tax-efficient manner, and we expect that this transaction will continue to deliver value to McKesson's shareholders. We believe that this transaction better positions McKesson to focus on its core set of businesses.

As part of this work, we completed a market value assessment and recorded a non-cash, pre-tax impairment charge of $1.2 billion in our fiscal 2020 second quarter. It's important to note this charge in no way reflects the future value of Change Healthcare. Rather, it's an adjustment of the book value to the current market value and one of the necessary accounting activities within the planned exit process. Overall, the Change Healthcare transaction has been and continues to be value-creating for McKesson's shareholders.

Second, as Brian mentioned earlier, we recorded a pre-tax charge of $82 million after settling all claims against McKesson in the suits filed by Cuyahoga and Summit counties of Ohio in the first track of the multidistrict opioid litigation.

Moving to the adjusted earnings results for the quarter. On slide 3 of the presentation, our second quarter adjusted earnings of $3.60 per diluted share was flat year over year. As a reminder, in the second quarter of fiscal 2019, McKesson recorded a $90 million or $0.33 per diluted share pre-tax benefit related to the reversal of a contractual liability associated with our investment in Change Healthcare. Excluding this one-time item, second quarter adjusted earnings per diluted share increased 10%, driven by a lower share count and growth in the Medical-Surgical and prescription technology or MRxTS businesses. Year to date, adjusted earnings per diluted share was $6.91, an increase of 6% year over year. Excluding the previously mentioned one-time benefit in FY 2019, year-to-date adjusted earnings per diluted share grew 12% year over year.

Moving to the details of our consolidated results on slide 4. Consolidated revenues for the quarter increased 9% year over year, due to higher-than-anticipated growth in the U.S. Pharmaceutical and Specialty Solutions segment, in part related to increased Caremark volumes associated with the onboarding of a new customer. Taking this into account, we are updating our consolidated revenues guidance from low to mid-single digit growth to mid to high single digit percentage growth year over year.

Adjusted gross profit increased 2% year over year, or 3% on an FX adjusted basis, mainly driven by a strong primary care pharmaceutical volumes within our Medical-Surgical segment, continued growth in our specialty provider solutions business within our U.S. Pharmaceutical and Specialty Solutions segment, and growth across our existing MRxTS offerings, principally within our electronic prior authorization products.

Second quarter adjusted operating expenses increased 5% year over year. Excluding the prior-year $90 million contractual liability reversal, operating expenses increased 2.5% year over year on an FX-adjusted basis. Adjusted income from operations before tax was $859 million for the quarter, 6% below the prior year. However, excluding the one-time prior-year $90 million benefit, adjusted income from operations before tax increased 4%.

Interest expense was $64 million for the quarter, a decrease of 3% compared to the prior year. Our adjusted tax rate was 17% for the quarter, which included discrete tax benefits of approximately $31 million. And we continue to assume a full-year adjusted tax rate of approximately 18% to 19%, which may vary from quarter to quarter and includes anticipated discrete tax items that we expect to realize in the back half of the fiscal year.

During the quarter, we completed $750 million of share repurchases, and our diluted weighted average shares outstanding were 184 million for the quarter, a decrease of 8% year over year. As a result of share repurchase activity this year, we're updating our guidance to diluted weighted average shares of approximately 184 million for the year.

Moving now to our segment results, which can be found on slides 6 through 9. And I'll start with U.S. Pharmaceutical and Specialty Solutions. Second quarter revenues were $46 billion, up 10% year over year, driven by branded pharmaceutical price increases and the previously mentioned increase in Caremark volumes, which were largely specialty products and were partially offset by branded to generic conversions. Based on the revenue development in the first half of the fiscal year, we are updating our guidance to revenue growth of high single digits.

Segment adjusted operating profit for the quarter increased 1% year over year to $641 million, due to continued growth in our specialty businesses, led by the provider solutions business, partially offset by customer and product mix, which includes the new customer volumes that are flowing through Caremark. Year to date, segment adjusted operating profit growth is 6%.

As Brian discussed, we have differentiated assets and capabilities in the areas of oncology and manufacturer services. As such, we will be investing an incremental $25 million in the second half of the year to extend these leading positions. Inclusive of these additional investments, we are reiterating our adjusted operating profit guidance of low to mid-single digit percent growth for the full year.

Next, European Pharmaceutical Solutions. Second quarter revenues were down 1% year over year to $6.6 billion. On an FX-adjusted basis, revenues grew 4%, in line with our original expectations, driven by market growth in the pharmaceutical distribution business. Segment adjusted operating profit was down 23% to $41 million. On an FX-adjusted basis, adjusted operating profit was $43 million, down 19%, due to continued weakness in the U.K. retail pharmacy environment. As Brian mentioned, we are expecting partial recovery of the underfunding we experienced year to date by the NHS. And while we continue to anticipate improvement in the second half of fiscal 2020, we are, however, updating our full-year guidance for Europe. Our updated revenue guidance is flat to low single digit percentage decline and adjusted operating profit growth in the low single digits.

Moving now to Medical-Surgical Solutions. Second quarter revenues were $2.1 billion, up 6% year over year, driven by growth in pharmaceutical volumes within our Primary Care business. Segment adjusted operating profit for the quarter increased 20% to $166 million, primarily reflecting the previously mentioned organic growth and the lapping of $8 million of bad debt expense in the prior year. The segment adjusted operating margin rate was 807 basis points, an increase of 99 basis points, driven by organic growth and lapping of prior-year bad debt expense.

And finishing our business review with Other. Revenues were $3 billion for the quarter, up 4% year over year due to organic growth in the Canadian wholesale business and higher volumes of our prior authorization products within the prescription technology or MRxTS business. Our original revenue guidance for Other reflected the anticipated exit of an unprofitable customer in our Canadian business at the onset of the fiscal year. This transition has been delayed, and as a result we are updating revenue guidance for Other to grow low single digits in fiscal 2020.

Other adjusted operating profit decreased 26% to $221 million, driven by the prior-year $90 million contractual liability reversal and lower contribution from our investment in Change Healthcare, partially offset by higher transaction volumes in our MRxTS business, principally from our electronic prior authorization products and growth in our Canadian wholesale business. Excluding the prior-year $90 million contractual liability reversal, Other adjusted operating profit grew 5% versus the prior year. And we continue to expect adjusted operating profit to be down low to mid-single digits. Year to date, our adjusted equity income from Change Healthcare was $147 million, and we continue to anticipate the adjusted equity earnings from our investment in Change Healthcare in fiscal 2020 to be in the range of $250 million to $270 million.

Moving now to corporate expenses. McKesson recorded $146 million in adjusted corporate expenses in the second quarter, an increase of 2% compared to the prior year, resulting from planned investments in technology. McKesson recorded $36 million in opioid-related litigation expenses in the second quarter and $72 million year to date. We continue to assume opioid-related litigation costs to be approximately $150 million in fiscal 2020. Based on the progress against our cost initiative program and the anticipated timing of planned technology investments, we are updating our corporate expense guidance to a range of $695 million to $745 million for the year.

Turning now to cash, which can be found on slide 10. We ended the quarter with a cash balance of $1.4 billion. For the first half of fiscal 2020, McKesson used $159 million in cash flow from operations. We used $184 million for internal capital investment, resulting in negative free cash flow of $343 million. For the first half of the fiscal year, McKesson also paid $95 million for acquisitions, and we returned a $1.6 billion to our shareholders through the repurchase of $1.4 billion in common stock and payment of $148 million in dividends.

Finally, I would remind you that our working capital metrics and resulting cash flow may be impacted by timing, including the day of the week that marks the close of a given quarter. I would also remind you we typically generate the majority of our annual operating cash flow in the second half of the fiscal year, with more than $3 billion generated in each of the past two years. In fiscal 2020, we continue to expect internal capital investments of between $500 million and $700 million and free cash flow of $2.8 billion to $3 billion. Our disciplined approach to capital deployment is committed to maintaining our investment-grade rating, which underpins our financial flexibility, and delivering value and returns to our shareholders.

Before I wrap up, we are updating our guidance around the impact of foreign currency exchange rate movements to a net unfavorable impact of up to $0.05 per diluted share year over year. And in terms of fiscal 2020 earnings progression, we continue to expect that the fourth quarter will be our largest in terms of EPS contribution, similar to prior years, and the first half earnings progression as compared to the second half will be similar to FY 2019.

Let me take a minute to update you on the optimization of our operating model and cost structure. Our cost program is called Spend Smart. This emphasizes that everyone in the organization must think like an owner and that we will leverage to scale the enterprise. We're seeing good progress in reducing costs to be a competitive and lean operator. As we have stated previously, we expect that a portion of these savings will flow through profit, as evidenced by our lower corporate expense guide and overall operating expense results, and a portion will be reinvested in growth, such as the investments I discussed earlier in oncology and manufacturer services.

Additionally, we are on track to successfully transition several business unit functional and back-office services to a more centralized hub model, allowing us to further increase standardization, gain efficiencies, and drive focus to our customers. We've already made great progress in transforming finance and IT. And we've seen tangible results from our investments in technology, more specifically data and analytics. And we're confident that our focus in this area will unlock additional benefits. The collective efforts and focus of our associates across the enterprise have resulted in meaningful savings for the organization.

In closing, we are encouraged by the continued positive momentum across our businesses through the first half of fiscal 2020, led by the focus and execution of our associates across the enterprise. As a result, we are reiterating our fiscal 2020 outlook of adjusted earnings per diluted share of $14 to $14.60.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Eric Percher of Nephron Research. Your line is open.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. Maybe to begin, it's hard to disaggregate the underlying gross margin trend for pharma in particular, given what has going on in the EU. Can you give us some perspective on what gross margin is doing and-maybe gross margin and absolute gross profit?

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

A

Yeah, hey, Eric. Thanks for that question. As we talked about, we had significant growth in revenues in the quarter. And as I mentioned, specifically in our U.S. Pharma and Specialty Solutions business, we had growth that caused us to raise our guidance for the full year. And I also pointed to the fact that a great portion of that came from specialty products and in particular from the growth of Caremark through growth in new customers there. And that had an impact on our gross profit rate in terms of in terms of comparing that to our revenue growth.

We did have a 1% impact from foreign exchange. So, when you looked at our gross profit, 3% when you exclude the impact of foreign exchange. But I would point you back to the fact that our revenue grew faster than we had anticipated at the beginning of the year. It's largely coming from the onboarding of some customer wins through Caremark, and there's a customer and product mix aspect to that where the products are largely coming through specialty products. And that's largely what's driving that delta between revenue growth and gross profit growth.

Eric Percher
Analyst, Nephron Research LLC

Q

And on an absolute basis, you're seeing growth from specialty. And is it also reasonable to expect, that given the stability you speak to in the generic marketplace and given sourcing, that we're seeing generic profitability grow on an absolute basis?

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

A

Yeah, Eric, we are seeing that. As Brian talked about, we continue to see great benefits coming from our ClarusONE Sourcing organization. We were able to generate good savings there this year. We're seeing stability on the sell side, and that's allowing us to continue to create a spread from a generics perspective. In our specialty businesses, Brian I think talked a lot about our provider business, our advances that we have in manufacturer services, and the lead that we have in from U.S. oncology as an asset. But we're seeing a lot of growth that is coming through our full-line wholesale distribution. And as I mentioned, that's particularly coming from the growth of large customers like Caremark.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you.

Operator: And our next question comes from the line of Lisa Gill of JPMorgan. Your line is open.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Great. Thank you. Good morning. Brian, I just wanted to go back to your comments around the opioid litigation and settlement. If I do the math, 38% of the settlement was McKesson. Should I think about that – that was the market share in those two counties? Or do you anticipate, just given your overall market share with the independents in the U.S., that if we think about any settlement, it would be somewhere in that type of range on a percentage basis?

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

A

Oh, good morning, Lisa. Thank you for the question. You did your math correct. We were 38% of that settlement. Obviously, there is data in the marketplace, the ARCOS data in particular, that many of you are aware of and familiar with. That data can be cut lots of ways, depending on how you look at time periods, and how you look at the customer segments and whether you consider doses, et cetera, et cetera. And so part of the discussions that we had to go through was a methodology, and we landed on a data-based methodology. And so you can roughly think of 38% as the McKesson representation of, quote-unquote, "our share."

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Okay. That's helpful. And then just as we think about the timeline of this, I know you said that you're prepared to defend and litigate if needed. My understanding is that the next court case isn't until sometime next summer. So does that mean that that kind of gives you this time between now and then for a settlement? And any update that you can give us on where you are on a potential global settlement. Because if I remember correctly, I think that's what you've talked about in the past, right? Ring-fencing those and having a global settlement, not doing these one-off – as each case comes.

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

A

Yeah. Yeah. Yes. That's right. Thank you, Lisa. I mean, our objective and priority continues to be – we'll call it sometimes global resolution or ring-fencing. And that remains our priority. Our view on these two counties and coming to the settlement agreement we did with them was that was an important stepping-stone or building block for momentum for more global discussions to progress. And so we're encouraged by the status of the discussions. There is a lot of activity and things that we need to continue to work through, and we are actively working through those. We're working through those with some urgency. But it will take a bit of time to get through those.

We're talking about 50 states, and we're talking about subdivisions within states. So we've got a framework that we're very optimistic about. The teams are working diligently to address the issues. We'll progress it as quickly as we can. But obviously as we contemplate the two paths we've always talked about – there's a path to litigate, which we can project an amount of time and amount of dollars to go down that path, and then there's a path that we think ring-fences the risk and can give us other resolution – that we'll take the path that we think is most beneficial for our shareholders. We certainly are anxious to find a resolution that gets care to patients and the communities they serve as quickly as they can. But, as we pursue these discussions, we continue to invest in our defense, and we think it's only prudent to do that.

Operator: And our next question comes from the line of Brian Tanquilut of Jefferies. Your line is open.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

Brian, just as I think about your comments about the strength that you saw with the medical side on the primary care physician offices resupply, how are you strategizing? Or how are you thinking about the emergence of retail-based care delivery on the primary care side, whether that's Walmart, who's your client obviously, or the competitors in the retail space?

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

A

Yeah. Great. Thank you for the question. Maybe to frame my answer a little bit, I'd go back in time. I think the medical business has been very successful at following the emergence of new channels in the alternate site settings. At one point in time, that was urgent care clinics. We have a large footprint in the retail-based clinics that are out there today. And so we think as these new models for community-based care emerge, the solutions that we have in the medical business are right on point for the needs that those businesses and services will have. So my view is it's just the continued evolution in a new segment. And our team has proven quite adept and quite effective at evolving our capabilities and really leading the way as these segments emerge, and I would expect that's what the team is focused on today.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

And then I guess just my follow-up for Britt. As I think about calendar 2020, what are your expectations in terms of brand pricing just for January 1?

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

A

Yeah, what I would say is that we're reiterating our view that brand price inflation's mid-single digit. We don't see anything that has occurred in the first half of the year or this quarter that would change that expectation. So we're continuing to view brand price in the mid-single digits. Obviously, January is usually an important month, historically, but at this point, we're not changing our view on branded price inflation.

Operator: And our next question comes from the line of Stephen Baxter of Wolfe Research. Your line is open.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Hi, thanks for the question. So I'm trying to understand the magnitude of the revenue revision in the U.S. pharma business. Now, I appreciate the color on Caremark, but it sounds like you're suggesting this is coming in a lot better than expected levels. So I guess, first, can you help us understand what why that is? And then I guess the follow-up would be you're raising revenue guidance here by what looks like roughly 3% to 5% but not changing your EBIT growth outlook. I get that we're talking about specialty and Caremark, but it's surprising there isn't there really any noticeable drop-through to earnings. So I guess how should we be thinking about that? And is there something about the rest of the business we should be keeping in mind? Thanks.

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

A

Yeah, thanks for that question. So let me just step back to the revenue guidance. Our prior revenue guidance was low single digit to mid-single digit. And so we've updated that to high single digit, and that's largely reflective of the growth that we're seeing that's coming from Caremark and particularly specialty products that are going through that customer. That's really what's driving this.

In terms of the drop-through to the bottom line, we're really pleased that we're able to make investments in the business. I talked about $25 million of investments in our oncology and manufacturer services capabilities. And despite those investments we're pleased to be able to hold and affirm our guidance for the segment on AOP at that low single to mid-single digit number.

So I would call this as growth from one of our customers that is primarily coming through specialty. We're making investments where we have leading positions and great capabilities. And I talked about that as being an additional $25 million, but we're still holding and affirming the AOP guide for the segment.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Got it. And I guess just coming back to what is better than was expected going into the year. Is there any clarity you can provide on that? I appreciate what the driver is in absolute terms, but understanding versus your prior expectation would be great. Thanks.

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

A

Sure. Well, I'd just reiterate a couple things. Branded pricing inflation is performing as we had anticipated. We're seeing really good progress out of ClarusONE, and so our – from a generics perspective, I think it's performing as we had anticipated, still stable, competitive marketplace. I think a couple things that I would point out that Brian really talked about is our specialty provider business is performing quite well. And certainly the investments that we've been making in our manufacturer service capabilities and that we are continuing to make there, that's also performing well.

So I think as you think about our specialty business, we're getting a lot of growth through customer wins. In our wholesale distribution business, we're making great advances in our provider business and our manufacturer services capabilities.

Operator: And our next question comes from the line of Michael Cherny of Bank of America Merrill Lynch. Your line is open.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

Thanks so much for taking the question. So I want to go back to the comment you made, Brian, about stability of what you're seeing on the sell side relative to generics. Now it's been about three years since we had a shift in the independent market. You also highlighted some of the value that you provide in terms of the independent customers. And so I guess as we go forward, how do you think about the activity and kind of the puts and takes that go on with the independent market and how they think about negotiating, especially as they all tend to get into their own specific buying groups?

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

Yeah, sure. Thank you for the question. I mean, I referenced in my comments RxOwnership program and the fact that 700-ish new pharmacy owners we helped in opening or establishing or transferring into the business. And that's not a unusual number. I mean, if you go back many, many years, we often see lots of exits in the independent pharmacy segment. Some of those are family-planning and transition exits. Some are script file sales. But we also see as many new openings or many new storefronts come into play, and so it's been remarkably stable over the years. And that trend we continue to see today. Now, we do – over the years we have and we continue to invest in these tools and these services that we think help independent pharmacists stay independent, stay healthy businesses, and stay vibrant in the communities and the patients that we serve. But we really haven't seen anything that I would say was a massive trend break in terms of the – there's always ins and there's always outs in the independent segment.

Michael Cherny
Analyst, Bank of America Merrill Lynch
Q

Thanks. And then just one quick question on capital deployment. As you think about the discussions and debates going on relative to the push for a global settlement, does that have any impact on your cash availability or capital deployment priorities? And I know not from a reserving perspective per se, but do you think about keeping some level of cash to present itself for any type of potential settlements?

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

I would say this. I think we've been pretty clear on what our capital deployment philosophy has been in the past, a very balanced approach to that. And what I would say is we have not made a change to that portfolio approach. We continue to make investments internally that we think will drive future growth. We continue to be open to M&A, where we can find the M&A that makes sense, balancing obviously valuation expectations, where our share price is, what alternate returns of that capital are. But that was a long answer to give you the short answer, that it really has not impacted our approach to capital deployment.

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

And I think if you look at how we've deployed capital in the first half of the year, it's pretty historical – amount of capital has been deployed. We've returned a lot of capital to our shareholders, particularly in the second quarter. And as Brian mentioned, we'll continue to evaluate really on a balanced perspective, but we haven't made any changes to the amount or how we're deploying capital at this point.

Operator: And our next question comes from the line of Charles Rhyee of Cowen. Your line is open.

Charles Rhyee
Analyst, Cowen & Co. LLC
Q

Yeah, hey. Thanks for taking the question. Just wanted to go back, Brian, about the framework here. You're optimistic about in terms of getting toward sort of more of a global kind of settlement here. Just to clarify, in these kinds of discussions, is it clear to you that [ph] you'll encompass all plaintiffs? (47:40) You might have mentioned that. I just couldn't catch that clearly.

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

You were breaking up a little bit. Let me – I think the question was coming back to the framework. Is it going to be all encompassing of all the litigation? And what I would say is that relative to the states and relative to the subdivisions in those states, our goal is to get as comprehensive of a settlement within that framework as we can, and that is a majority of the outstanding litigation, but it is not all of the cases.

Charles Rhyee
Analyst, Cowen & Co. LLC
Q

And is that something mechanically that you would kind of reach a framework and then wait for all the parties to then look at it and say we're okay with this? And is there some type of – from your standpoint as you kind of look at it and then think, all right, this is enough that we will move forward, or this is not enough and we will not agree to this because it's maybe – you might have thought some large percentage were okay with it, but in the end, lot of the subdivisions said we're not satisfied with this, and in this case you'd go [ph] up to a different track (48:59)?

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

Yeah. So I guess the easiest way to answer that is to say that this is a complex legal situation. We have established a framework and had good discussion around that framework. It is very much a process, though, and we are very much working through the details of how that process will unfold. And there's really not a lot more I can add to it at this time.

Charles Rhyee
Analyst, Cowen & Co. LLC
Q

Okay. Thank you. And, Britt, just to follow up one real quick question on the European segment, on the guidance. It looks like you're still looking for operating profit guidance in the low single digits, [indiscernible] (49:45). Can you give us a little bit more thoughts on what helps you get there in the back half? Thanks.

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

Yeah. Thanks for the question. I think, as we've talked about, we expected the business will continue to improve its performance in the back half. And then Brian also talked about some nominal increases in the tariffs in the U.K. And we would expect that there could be additional increases in the back half for the year. So that's really what is driving that second-half performance.

Operator: And our next question comes from the line of Steven Valiquette of Barclays. Your line is open.

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

Great, thanks. Good morning. Thanks for taking the question here. So I guess this has been touched on a little bit, but I guess I'm looking for any update on the ClarusONE progress. And tied into that, based on a little bit of the margin compression in the U.S. Pharmaceutical and Specialty business, should we assume that the relationship between the procurement price on generics versus your sell-side pricing may have fallen off a little bit during the quarter? Or in your mind was that relationship still relatively consistent during the quarter? Thanks.

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

A

Yeah. Thanks for that question. We're really pleased with the performance of ClarusONE, and it's performing in line with what our expectations were at the beginning of the year. We're continuing to see that organization drive great value, which is very helpful. As we think about the sell-side, which is, as we've talked about now for several quarters, still a competitive but a stable environment. We're pleased with ClarusONE. It's performing as we had anticipated. We think that there's still great value to be gained out of that organization. And we're pleased with the partnership that we have with our partner Walmart as we continue in that relationship as well.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Okay. What about the relationship, then, between the buy side versus sell-side pricing? Was that consistent during the quarter, or was there some slight erosion? Just curious, just a high-level comment on that.

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

A

Yeah, sure. No, it's consistent. We're seeing consistency over the last several quarters now. And, again, a good performance on ClarusONE and a stable competitive environment on the sell side, and that's in line with our expectations and what we've seen now for several quarters.

Operator: And our next question comes from the line of Bob Jones of Goldman Sachs. Your line is open.

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

Q

Great. Thanks for the questions. I guess just a couple to go back to specialty, Brian, if I could. You discussed the three main areas within specialty, and it sounds like generally very pleased with the performance across the board there. And I think most of us get the mix dynamic that you guys have discussed within specialty pharmacy and Caremark specifically. But I guess if we take a step back, the operating profit for the overall pharma and specialty segment was up 1% in the quarter. It just sounds like there's a lot of secular tailwinds there. So I guess just wondering if you could shed a little bit more light on how you think about overall EBIT growth as it relates specifically to what seems like some pretty strong tailwinds within specialty.

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

A

Yeah, great. Thank you. And we reflected on the questions we've had over the last few quarters, and that's why we included a little more description or color on the specialty businesses that we have in the Pharmaceutical Solutions segment. And if you think about the three segments we highlighted, they are all performing very well. And we think in all cases, we have assets that are not only competitive with the market, but probably one of the most robust set of solutions and services when taken in the aggregate.

And so those businesses are continuing to perform well. They're delivering good growth, and they're performing right in line with where we thought they would for the year. Obviously, there is another segment in specialty. It is the more retail, mail-order oriented specialty products, and Britt talked a lot about the impact we've seen of the growth in the Caremark book of business that has been – the mix has been slanted towards those specialty products, which tends to be the lower margin profile for us. So when you net all that all out, that's how you get to the results that you're seeing today.

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

Q

And then I guess just to follow up on that, maybe Britt. I mean, just to maybe understand that a little bit better. I mean, these kind of outsized growth within Caremark products, I mean these aren't margin or EBIT dilutive, I guess I would say. And then just on the $25 million investment that you mentioned in the back half, maybe just a little bit more specificity around what area within specialty those would be pointed, that would be helpful, too. Thanks.

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

A

Yeah. As we've talked about before, and as we think about specialty distribution in our line of wholesale business, they do have a dilutive impact on the rate. We still participate in the profit dollars. It's just grown a lot faster than we had anticipated, and that's had a much more dilutive impact on the rate of growth. As we think about the investments that we're making, as Brian talked about, we are very pleased with our positions in oncology, our positions that we're developing in manufacturer services. And as we think about this $25 million, it will be largely invested in oncology capabilities and assets. But, again, we're continuing to invest in our manufacturing services capabilities as well. But you should think about this investment as investing where we have leading-edge positions, and oncology is certainly one of those.

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

A

Just to build on that. I mean, these investments are tied to our strategy. Our strategy is anchored in where we believe we have differentiated capabilities and we have a good marketplace growth. And so we're very happy to be able to say we're continuing to make these investments and still delivering on the year as we committed.

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

A

Operator, we have time for one more.

Operator: Okay, great. Our last question for today is Kevin Caliendo of UBS. Your line is open.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Hi, thanks for getting me in, guys. I appreciate that. If we think about the CVS relationship and the fact that it was just sort of re-upped for June, is there some anticipation that over time the margin would then – could get better? Meaning are we in a situation right now where the first sort of 12 months of this relationship, the margins from that contract might be worse, and over time they could get better?

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

A

Well, first let me say we're always happy to renew our customers, and we're always happy when they grow. We are experiencing a shift in the mix of business that on a margin rate perspective you see in our results. I mean, great top-line growth, but there is a margin rate impact in there. We're never disappointed when our customers grow, and we think it's always additive to the business.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

One quick follow-up. Can you talk about the performance and impact Northstar would have had in the quarter?

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

A

We don't specifically talk about Northstar, but when we think about our generics portfolio, Northstar is obviously a critical part of that, and we're really pleased with the performance of Northstar, and we're pleased with the progress that we're making there.

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

A

I think the relationships with the manufacturers and Northstar have really evolved over the years and are quite productive, and I think that's what's supporting the success that we're seeing there.

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

Okay. Well, thank you, everyone, for your questions, and thanks again for your interest and giving us some of your time this morning. Thank you, Susanne, for facilitating this call.

Just maybe to conclude, I really think the fundamentals inside the business are strong. The macro healthcare environment is supporting a stable market. We executed well in the second quarter; I'm very proud of the teams and the execution. We're continuing to drive cost savings, we're continuing to speed up our decision-making, we're continuing to make investments where we think we have opportunities for growth, and I feel good about our fiscal 2020 full-year outlook.

My confidence is of course rooted in the 80,000 employees that come to work every day for McKesson, for our shareholders, really embodying our values, including integrity. They do the right thing, and our execution and success are a direct result of their contributions. So I want to say thank you to them. None of this is possible without you.

And now let me hand the call over to Holly for a review of our upcoming events. Holly?

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

Thank you, Brian. We will participate in the J.P. Morgan Healthcare Conference in San Francisco in mid-January, and we will release third quarter earnings results in late January. Thank you and goodbye.

Operator: And thank you for joining today's conference call. You may now disconnect, and have a great day.