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McKesson Corp. (MCK)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to McKesson's Q3 Earnings Call. Today's conference is being recorded.

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

Holly Weiss

Senior Vice President-Investor Relations, McKesson Corp.

Thank you, Jack. Good morning and welcome, everyone, to McKesson's third 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 forecast 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, and good morning and thank you everyone for joining us on our call this morning. Before I get into our third quarter results, I wanted to take a few minutes to provide a brief update on opioid litigation. As you know, we've been engaged in complex discussions with the state attorneys generals and others about a settlement framework with the goal of achieving a broad resolution of opioid-related claims.

Those discussions continue to narrow what's left to address to achieve resolution on all the items that remain. However, to the extent our efforts to reach a broad resolution settlement framework are unsuccessful, McKesson continues to be prepared to litigate and vigorously defend the mischaracterization that our company drove the demand for opioids in this country. McKesson remains firmly committed to being part of the broader solution to this crisis. Given, however, the discussions and litigation are ongoing, I'll be somewhat limited in what I can say. I do appreciate your understanding.

Now, let's get to our business results. Today, we reported third quarter total company revenues of $59.2 billion. Our adjusted earnings per diluted share was $3.81. And I'm pleased with our third quarter and year-to-date execution across the majority of our businesses in our fiscal 2020. Also today, we reaffirmed our fiscal 2020 full year outlook of $14.60 to $14.80 of adjusted earnings per diluted share, which we first provided on January 13.

This update reflects our outlook for growth in our US Pharmaceutical and Specialty Solutions segment, primarily driven by specialty; strength in our Medical-Surgical segment; lower-than-anticipated corporate expenses; and the benefit from share repurchase activity in the third quarter. Our US Pharmaceutical and Specialty Solutions segment performed well in the quarter, reflecting stable macro fundamentals and good execution and was aided by the continued strong growth across our specialty businesses.

Let me walk you through the recent trends from an industry fundamental standpoint. For the third quarter, we saw branded price increases tracking in line with our expectations and we continue to assume mid-single-digit branded price increases year-over-year for fiscal 2020.

For generics, we remain disciplined in our approach to the market. We are sourcing effectively through our scaled sourcing venture and the sell side remains competitive, but stable. I'd like to take a moment to acknowledge how pleased we are that the VA announced in December it had again selected McKesson to be the prime pharmaceutical vendor beginning in August 2020.

We have been the VA's prime pharmaceutical vendor for veterans' hospitals and the department's mail order pharmacies for more than 15 years. This is a great point of pride for McKesson and we're dedicated to hiring veterans and helping them build their careers after their service.

At McKesson, we have many employee resource groups celebrating and leveraging the diversity of our workforce. The McKesson Military Resource Group or MMRG, as we refer to it internally, provides opportunities for all employees to recognize and welcome veterans and their families to McKesson.

MMRG offers networking opportunities, facilitates personal and professional development, supports McKesson's recruitment, hiring and retention of veterans, and sponsors events within our communities for active-duty military and veterans. I want to thank McKesson's veterans, and every veteran really, for their service. We're very proud to serve the VA and we look forward to continuing our longstanding partnership.

Moving to specialty, as you've heard me discuss at several recent events, we have a differentiated portfolio of assets and capabilities that we've built over time with targeted internal and external investments. First, we distribute specialty pharmaceuticals via the traditional wholesale model to retail and hospital pharmacies. And although these products are margin rate-dilutive, we benefit from this growth at the top line and in our gross profit dollars. Next, we distribute specialty products that are primarily infused in the community-based setting and typically require special handling, including temperature control.

We also provide other services like group purchase organization activities, data and technology services in oncology and other multi-specialty practices. And then, we have our leading practice management business, specifically, The US Oncology Network, which now includes more than 1,200 oncology physicians providing 12% to 13% of all community-based oncology care. We handle all aspects of managing the practice, so that the physician can focus on treating the patient. In addition, we're active in clinical trials, research and formulary development.

The practice management business, combined with the wholesale distribution and specialty product distribution and services business, are the scaled channels we leverage to provide services and solutions to our many biopharma partners, including commercialization, hub and patient assistance services. We help manufacturers find patients that are appropriate and relevant for care, help them get started on that therapy sooner, and work to keep them adherent to that therapy for the course of their treatment. This results in a patient getting the best possible outcome from their treatment. These services not only support better outcomes for patients, but they also provide tremendous value to our manufacturer partners.

We're really pleased with the growth we're seeing across these businesses, and we remain focused on specialty as a key tenet of our strategic direction. We're also pleased that we're returning to growth in the US Pharmaceutical and Specialty Solutions segment in fiscal 2020, while continuing to invest in our future.

Now, let me turn to Europe. In mid-December, McKesson and Walgreens announced a joint venture agreement that we expect will bring together our respective wholesale operations in Germany. After review of our business in Germany, we believe this is the right course of action, as the combined business will have large reach and scale, driving increased efficiency and performance in a market where scale is vitally important.

The transaction is subject to merger clearance and approval, and that process is expected to take at least six months from the time of the announcement. As such, this transaction will not have any impact on adjusted earnings in our current fiscal year.

In the UK, we continue to monitor the retail pharmacy funding dynamics. As we detailed earlier in the fiscal year, the retail pharmacy industry experienced underfunding by the NHS in our first quarter. While there was a modest improvement in our fiscal second quarter, further upward revisions have not yet been implemented. We continue to monitor the situation in the UK closely and engage in active dialogue with the NHS related to industry funding and the role pharmacy can play in managing NHS's overall cost quality and access challenges. Outside of the UK, we're continuing to see performance in line with our expectations for the other countries in this segment.

Next, our Medical-Surgical business; again, this quarter, we had good growth across multiple markets, such as our home care delivery business and product categories, including pharmaceutical sales into the primary care space. Customers are repeatedly choosing McKesson because of our relentless focus on providing what they need to take care of their patients. We differentiate ourselves in the marketplace through innovation and a focus on operational excellence, breadth of product and service offerings, along with one of the largest and most tenured sales forces in the industry.

We also saw an early start to the influenza season in the third quarter, which we are continuing to monitor for severity and duration. In addition, our results continue to reflect the integration of the MSD acquisition, which we lapped during our first quarter, and our focus is now on driving synergies. This acquisition continues to perform in line with its business case.

Turning to Other, which primarily consists of Canada, McKesson Prescription Technology Solutions, sometimes referred to as MRxTS, and our investment in Change Healthcare. In Canada, we're now capturing the benefits of previous actions we've taken, including our investments in people and in reconfigured pharmacy formats as community pharmacy plays an important role in Canadian healthcare.

And market fundamentals are stable, which helped to drive growth in our wholesale operations year-over-year. In addition, McKesson Canada also has broad specialty assets, and capabilities and we are well positioned to participate in the growth of specialty in the Canadian market.

Moving on to MRxTS, which is a key area of investment, we're making investments to ensure we have the right product and personnel resources in place to support the growth trajectory of these businesses, and we're looking to launch new products that leverage our existing technologies and build upon them. As we look at how MRxTS is performing year-to-date, we're pleased with the growth in the business, which is net of several investments we are making to drive and support our future growth.

Let's move on to Change Healthcare. As we've discussed previously, we continue to take the customary steps toward an exit of our investment in Change Healthcare. As part of the exit process, registration statements were filed today with the SEC. The previously discussed timing expectations are unchanged and this is simply a necessary step as we move through the process of exiting our investment in Change Healthcare.

Recently, you've heard me talk about aligning McKesson under one vision to improve care in every setting; one product, one partner, one patient at a time. We've been transforming and energizing the culture at McKesson. We've got a great collaborative workspace at our new headquarters in the Dallas area. We've rolled out new enterprise behaviors building on the already strong foundation of our ICARE and ILEAD values, and getting everyone aligned around our strategy and how we want to work together to execute it.

We're looking to become a simpler, more focused and nimbler organization. We've centralized some of our functions and are looking at ways to work more efficiently and to utilize technology for day-to-day tasks that can be automated, freeing up time to focus on strategy, work that drives value for the organization and better leverages our teams.

We're seeing great execution across the enterprise, including cost savings, as we track towards our target of $400 million to $500 million in gross pre-tax savings by the end of our fiscal 2021. Our organization has rallied around these efforts and it's showing in the culture and the results. I could not be prouder of the McKesson team. And with one quarter to go in fiscal 2020, I'm confident in our reaffirmed adjusted earnings outlook of $14.60 to $14.80 per diluted share.

As we look forward, we're in the initial stages of planning for our fiscal 2021. Let me walk through some of the things we're thinking about. The timing and impact of the exit of our investment in Change Healthcare, as exit activities are currently underway. For customer renewals, the VA contract goes into effect in August 2020. As a reminder, we have stated that this new contract will not be a material headwind to our fiscal 2021 outlook.

We are continuing to progress against our cost savings target with a portion of those savings falling to the bottom line and a portion being reinvested for growth. And finally, from a capital allocation perspective, we would anticipate benefits from share repurchases completed in fiscal 2020.

As you think about the market and the macro perspective in the US, we're entering an election year and we'll make assumptions related to any potential impact we might expect based on our analysis, including related to drug pricing trends. McKesson will continue to engage with policy makers and industry partners to ensure that any reforms support solutions to improve cost, quality and access. The policy landscape remains a dynamic environment and we remain confident in McKesson's path forward.

As it relates to the UK, we're continuing to monitor the market environment and NHS funding, as well as Brexit activities. We will review our businesses and expectations, including the impact of external factors, and will provide our fiscal 2021 outlook in May when we report fourth quarter and full year fiscal 2020 earnings.

Before I turn the call over to Britt, I want to take just a moment to thank Kathy McElligott, who just retired from McKesson. In her role as Chief Information and Technology Officer, she helped McKesson increase its focus on data and analytics and accelerate our technology modernization. Kathy, thank you for your contributions to McKesson.

And on the flip side, I'd like to also welcome Nancy Flores, who is succeeding Kathy as CIO and CTO. Nancy has a long track record of success in healthcare IT and we look forward to utilizing her experience, as we remain focused on our mission to improve healthcare in every setting, by leveraging technology solutions for our company, our customers and our business partners.

And with that, let me turn the call over to Britt to go through the financials.

Britt J. Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Well, thank you, Brian, and good morning, everyone. I'm pleased to be here this morning to talk about a solid third quarter for McKesson. I'll focus on our third quarter results and full year fiscal 2020 guidance, including changes you need to consider as you update your models. Brian walked you through high-level puts and takes as we think about our fiscal 2021 guidance and we'll provide detailed assumptions for fiscal 2021 when we report fourth quarter and full year results in May.

We're pleased with our adjusted operating profit and adjusted earnings per diluted share results in the third quarter, which were ahead of our expectations and represent solid execution. We continue to see momentum across the business as we execute against our strategic initiatives. As a result of this momentum and based on the confidence in our fourth quarter outlook, on January 13 we raised and narrowed our fiscal 2020 adjusted earnings outlook to a range of $14.60 to $14.80 per diluted share from the previous range of $14 to $14.60 per diluted share and today we're reaffirming that adjusted earnings per diluted share guidance.

Updated guidance assumptions can be found in our third quarter earnings slide presentation, which is posted on our Investors section of our website. Before I provide more details on our third quarter adjusted results, I want to address one item that impacted our GAAP-only results in the quarter.

During the third quarter, we recorded a pre- and post-tax charge of $282 million for the remeasurement to fair value of the net assets from the majority of McKesson's German wholesale business, in relation to the expected formation of a new German wholesale joint venture with Walgreens Boots Alliance.

Moving now to the adjusted earnings results for the quarter. Our third quarter adjusted EPS was $3.81, an increase of 12% compared to the prior year, which was primarily driven by organic growth in the US Pharmaceutical and Specialty Solutions segment, the Medical-Surgical segment, and the European segment.

To better understand our third quarter results, let me remind you of two discrete events in our prior year third quarter, both within our US Pharmaceutical and Specialty Solutions segment. First, the $60 million pre-tax charge related to the bankruptcy of Shopko; and second a pre-tax benefit of approximately $17 million related to the reversal of accrued New York State Opioid Stewardship Act charges. If you normalize for these two items, Q3 fiscal 2020 adjusted earnings per diluted share increased 7%.

Moving to the details of our consolidated results on slide 4. Consolidated revenues for the third quarter increased 5% versus the prior period, primarily driven by growth in our US Pharmaceutical and Specialty Solutions segment, driven by branded pharmaceutical price increases and higher retail national account volumes. We continue to anticipate mid- to high-single-digit percent consolidated revenue growth for the full year.

Third quarter adjusted gross profit increased 4% year-over-year, principally due to organic growth in our Medical-Surgical and US Pharmaceutical and Specialty Solutions segments. Third quarter adjusted operating expenses increased 3% year-over-year, driven by higher corporate expenses, which include planned technology investments.

Adjusted income from operations was $958 million for the quarter, which was up 4% year-over-year or 5% on an FX-adjusted basis. As a result of this solid performance and our updated outlook, we are guiding full year adjusted income from operations to increase a low-single-digit percent.

Interest expense of $64 million in the quarter declined 4% compared to the prior year. And our adjusted tax rate was 17.1% for the quarter, which included discrete tax benefits of approximately $36 million. For the full year, our adjusted tax rate assumption remains approximately 18% to 19%.

Wrapping up our consolidated results, our third quarter diluted weighted average shares were 180 million, a decrease of 8% year-over-year. During the quarter, we completed approximately $500 million of share repurchases, bringing our year-to-date total share repurchases to $1.9 billion. As a result, we now expect diluted weighted average shares of approximately 183 million for the year.

Next, I'll review our segment results, which can be found on slides 5 through 8. Before I start with my review of the segments, including updated full year guidance, I want to reiterate that we provide full year guidance and do not provide quarterly guidance. As a reminder, there are a number of items, particularly in our largest segment US Pharmaceutical and Specialty Solutions, that can cause fluctuations on a quarter-to-quarter basis.

While this can make comparing year-over-year results on a quarterly basis difficult, these items do tend to balance out over the course of the year. These items include customer volumes, customer and product mix, brand price increases, and the timing of discrete tax items. We anticipate that there could be additional fluctuation in our fourth quarter results.

Let me now start with US Pharmaceutical and Specialty Solutions. Revenues were $46.9 billion for the quarter, up 6%, driven by branded pharmaceutical price increases and continued growth by our largest retail national customers, partially offset by branded to generic conversions. Third quarter adjusted operating profit increased 11% to $658 million, primarily driven by the execution and growth in our differentiated portfolio of specialty businesses.

As I mentioned earlier, there were two discrete items included in our prior year third quarter results: a $60 million pre-tax charge related to the bankruptcy of Shopko and a pre-tax benefit of approximately $17 million related to the reversal of accrued New York State Opioid Stewardship Act charges. If you adjust for these two prior year items, the segment adjusted operating profit was up 3.5% year-over-year in the quarter.

Also, as a reminder, this is the final quarter in which we are lapping the effects of the lost Shopko earnings, which was approximately $8 million per quarter in terms of operating profit. The segment adjusted operating margin rate was 140 basis points, an increase of 6 basis points.

On a year-to-date basis, the segment adjusted operating profit is up 7%. If you adjust for the prior year impact of the $60 million pre-tax charge related to the bankruptcy of Shopko and the prior year earnings contribution of approximately $24 million from three quarters of Shopko results, segment adjusted operating profit increased 5% year-to-date.

For the third quarter, brand price activity trended in line with our expectations. Additionally, based on manufacturer price actions taken in January, we are maintaining our full year fiscal 2020 assumption of brand price increases to be in the mid-single-digit percent range.

I would remind you that our branded pharmaceutical contracts are primarily fixed fee-for-service rate in nature and as a result, our compensation with branded manufacturers is less impacted by price increases when compared to several years ago. To wrap up this segment, given the underlying strength in the quarter and the year-to-date performance, we have confidence that segment adjusted operating profit growth will be on the high end of the previously provided range of 3% to 5% growth for fiscal 2020.

Next, European Pharmaceutical Solutions; revenues were $6.9 billion for the quarter, which was flat year-over-year. On an FX-adjusted basis, revenues increased 3%, driven primarily by market growth in the pharmaceutical distribution business. Segment adjusted operating profit was up 16% to $80 million, driven in part by lower operating expenses as a result of actions previously taken to rationalize store footprint and streamline back office functions. The segment adjusted operating margin rate was 116 basis points on a constant currency basis, an increase of 16 points.

Moving now to Medical-Surgical Solutions, revenues were $2.1 billion for the quarter, which was up 6%, driven by organic growth led by the primary care business, including higher pharmaceutical volumes and an earlier start to the influenza season. Segment adjusted operating profit for the quarter was up 8% to $184 million, driven by organic growth.

The segment adjusted operating margin rate was 859 basis points, an increase of 14 basis points. Year-to-date, the segment adjusted operating profit growth is 18%. As a result of the organic growth in the segment year-to-date, we now anticipate that the segment adjusted operating profit for fiscal 2020 will increase by a low-double-digit percent year-over-year.

I'm finishing our business review with Other, revenues were $3.2 billion for the quarter, which was up 6%, driven primarily by organic growth in the Canadian wholesale business. Other adjusted operating profit was down 4% to $214 million, in part driven by higher strategic product investments in our Prescription Technology Solutions Business, or MRxTS, partially offset by growth in our Canadian wholesale business.

Closing our segment review with Change Healthcare, adjusted equity income from Change Healthcare was $51 million for the quarter. As a reminder, our equity investment ownership in Change Healthcare was approximately 58.5% in our fiscal third quarter 2020 as compared to 70% in the prior year.

As Brian mentioned earlier, registration statements were filed this morning with the SEC, disclosing our intention to exit our investment in Change Healthcare via an exchange offer. This is the next step in the process to exit our investment in a tax-efficient manner. I direct you to today's filing for additional information.

Next, McKesson recorded $178 million in adjusted corporate expenses, which was an increase of 29% year-over-year, driven primarily by planned technology investments, which included investments in data and analytic capabilities. For the third quarter, we reported net opioid-related adjusted operating expenses of $36 million and, year-to-date, $108 million. For fiscal 2020, we continue to anticipate that opioid-related costs will approximately be $150 million.

We continue to make solid progress against our cost savings programs, which include a focus on our core operating expenses, by leveraging the scale of our enterprise and the continued transformation of back office functions. We remain on track with our previously announced annual pre-tax savings of $400 million to $500 million, which is anticipated to be substantially delivered by the end of fiscal 2021.

As we've discussed, a portion of these savings will be reinvested back into the business, in line with our growth initiatives, and the remaining will flow to the bottom line. As a result of our performance year-to-date, we now anticipate adjusted corporate expenses to be in the range of $660 million to $700 million.

Now that I've wrapped up our results, let me discuss our updated fiscal 2020 outlook. We feel really good about our steady execution throughout fiscal 2020. The recent narrowing and increase to our fiscal 2020 adjusted earnings per diluted share to a range of $14.60 to $14.80 reflects the following: solid core performance in our US Pharmaceutical and Specialty Solutions segment, driven by continued strength across our differentiated portfolio of specialty businesses; organic growth in our Medical-Surgical segment; improved second half performance in our European segment as compared to the prior year; lower corporate expenses than originally anticipated; and, a lower share count as a result of share repurchase activity year-to-date.

This solid performance was partially mitigated by continued planned investments in strategic initiatives, including incremental second half investment in our differentiated oncology and manufacturer services businesses; investment in our technology products; and, investment in technology infrastructure, including data and analytics. We remain confident that we are well positioned to execute in our fourth quarter.

Turning, now, to cash, which can be found on slide 10. We ended the quarter with a cash balance of $2.1 billion. In the quarter, McKesson used $121 million in cash flow from operations. After deducting $154 million in internal capital investments, McKesson had negative free cash flow of $275 million.

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 the given quarter. It is not uncommon to experience net use of cash during our fiscal third quarter, primarily driven by the build in inventory for the holiday season. In our fiscal fourth quarter, we typically generate more than two-thirds of our annual operating cash flow.

During the quarter, we repurchased approximately $500 million of common stock. We've now repurchased approximately $1.9 billion in common stock for the first nine months of the fiscal year. The repurchase of our common stock underpins our belief that McKesson shares are undervalued. Combined with the confidence in our execution and our outlook, we view this as a prudent use of capital.

For the first nine months of the fiscal year, McKesson paid $97 million for acquisition and $222 million in dividends. We now expect internal capital investment to be in the range of $500 million to $600 million, and we continue to anticipate free cash flow in the range of $2.8 billion to $3 billion.

In closing, we are pleased with the solid operational results of our fiscal third quarter and our performance year-to-date. We will build on our third quarter performance and we remain confident in our business as we focus on a strong finish to the year, which is reflected in our expected adjusted earnings per diluted share range of $14.60 to $14.80 for fiscal 2020.

As I look at our performance over the past several quarters and our outlook for the remainder of fiscal 2020, it clearly demonstrates focus and execution against our strategy as well as continued steady improvement in our financial results.

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] And our first question will come from Charles Rhyee with Cowen. Your line is open.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Yeah. Thanks for taking the question. Maybe, Brian, we could start with just on opioids, real quickly. What are the remaining points that are being negotiated? You kind of said that the negotiations are going well or it seems to be progressing and some of the points are being resolved. Maybe you can give us a sense of what are some of the remaining kind of sticking points perhaps. And if I understand correctly, the framework is being discussed among – or is being led by four state attorney generals (sic) [attorneys general] (31:55).

During these kind of discussions, are the other constituents, let's say, the other states or some of the bigger municipalities that are in this lawsuit or part of this multi-district litigation, are they able to sort of see the progress as well and understand what is being kind of negotiated so that when we get to maybe a final framework, the process for them to review and to accept is kind of in tandem? Or is this kind of being done in kind of a closed session and then opened up later?

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

A

Thank you for the question, Charles. And I think the way you framed the question naming the number of parties or counterparties or folks involved in this discussion helps to frame why it's moving at the cadence that it's moving. We do continue to be in constructive dialogue with the AGs. The AGs have broadened their group and they continue to talk amongst themselves. The good news from my perspective is the basic framework that we've laid out is still the framework that's being discussed and the details for the many component parts of that are progressing well.

There is still a long way to go with regard to ultimately getting as broad of AG support as we can and then AGs themselves going to their subdivisions and extending that broad support. So, there's a lot of work that is ongoing. The discussions are really continuous. It'd be too early for me to try to project a timeline or where the finish line might be. But I am pleased that the framework that we've been negotiating continues to be the framework. The details are progressing. And I think as we get through the coming months, we'll begin to assess what the various AG and sub-municipality positions are.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Great. And if I could have a follow-up just on the core business, obviously, you increased your outlook on the core pharmaceutical segment here. It seems like a lot of things are moving in the right direction. Is there anything you'd point to specifically that is kind of driving the improved outlook here? Thank you.

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

A

Maybe I'll start and then Britt might want to offer a few comments. I mean, I think if you think about the general kind of industry fundamentals, the brand price inflation has been in line with where we thought it would be. The generic market is continuing to behave in a way that we had forecast. And by that I mean our scaled sourcing entity continues to produce in line with our anticipation.

We are going in the market with a very disciplined approach reflective of the transition our industry has been in. And we think that the competitive – the sell side in the generics market remains stable. I mean it's competitive and there's pressures, but it's stable.

I think we're seeing the benefits of a lot of the work and planning that we've been – the last several quarters, we've been executing and implementing. And so combining that I think with the market fundamentals and our really good positions in specialty is driving the results that you see.

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

A

Maybe I might just add. I think, Brian, you hit on it here. The focus and our execution against our differentiated assets, particularly specialty and you talked a lot about that, I think is really driving a lot of this. And then, I would just reiterate that our cost programs are really driving not only in our corporate line, but also across our segment. And so, that focus is not only on our core set of differentiated assets, but just the discipline and focus around cost across not only our corporate segments, but our business segments.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Okay. Thank you.

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

A

Thank you, Charles.

Operator: And next will be Brian Tanquilut with Jefferies.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

Hi, good morning, and congrats on a good quarter. So, I guess the question for me as I think about it, Brian, you talked about the execution and how you guys seem really positive about it. So, how do you think about the runway remaining in specialty as we head into fiscal 2021 without going into guidance specifically? And just how you're looking at the volume outlook from the key accounts because it sounds like that's a volume driver that's been driving some upside as well? Thanks.

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

A

Yeah. I mean, we're really pleased with our specialty businesses. We talked a few weeks ago about the "core," the distribution of these products to hospitals and retail pharmacies as being our biggest segment. And clearly, we benefit there from the growth that these products have just in general. And the pipeline, if you look at the pipeline of the innovative products coming, they tend to look that way. And as you know, we've got established scaled channels across both of these segments. And then, if you think about the community setting, oncology we have a clear leading stake. We're a leader in many of the other multi-specialty settings. They're going to benefit from that same pipeline.

And I also think if you step up from a more macro view, if you think about the challenges that the cost of healthcare represent in this country, we have a fundamental belief that to get at access, cost and quality care needs to continue to shift into the community based settings. So, that's where our community provider business, I think, from a macro standpoint is well positioned.

And then, our US oncology business, we have particular depth and strength in oncology. And if you look at the pipeline there, that continues to be strong. So, I would say, all of those things are what are giving us our confidence. But at the bottom – at the end of the day, it's really the execution of the business to let you capitalize on those macro trends and opportunities.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

I guess my follow-up, Britt, you mentioned the cost cuts and the opportunities that you've found there. So, do you think there's a lot of runway left as we think about cost opportunities both on the corporate side and also on the operation side?

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

A

Yeah, our cost program, Brian, what we talked about we would capture these cost savings at the end of fiscal 2021. So, we're still making progress not only in leveraging the scale of our enterprise across all of our business units, but some of the things that we've talked about previously in terms of back office function transformation and there's still opportunities there as the size of our enterprise allows us to continue to work across and collaborate and drive additional cost synergies.

So, I would say that that program as we talked about is – we expect it to be substantially complete by the end of fiscal 2021. However, as the business grows and our focus and execution in specialty continues, there's still opportunities for us to leverage our scale and transform our back office functions.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

Got it. Thanks, guys.

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

A

I mean efficiency is a core part of the way you have to run a business like this at this scale. So, it is a program that we implemented a few years ago, but most importantly to me it's a mindset. It's a part of the way we think about how we manage and run the business.

Brian G. Tanquilut
Analyst, Jefferies LLC

Q

Got it. Thank you.

Operator: And next will be Robert Jones with Goldman Sachs.

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

Q

Great. Thanks for the questions. I guess just to go back to the segment guidance and specifically the US Pharma segment. It seems like if I look at what's implied with 4Q, at the high end it seems like you're kind of calling for year-over-year flat EBIT there in that segment. I know there's a number of moving pieces, Britt. But maybe could you just help us think about what the major swing factors are in 4Q because you guys highlighted the business there, in particular, specialty seems to be performing well and there's some momentum, but it seems like 4Q you're implying at least that things could potentially slow a bit. So, just want to make sure we had the moving pieces there correctly.

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

A

Yeah, sure, Bob. You're right about the implied. What I would just go back to and point out is that I've talked about in a business the size of ours with customers that are growing and you have mix that is changing in terms of customer and product mix, we are going to see fluctuations from quarter-to-quarter. We've seen that historically.

I think we're seeing that a little bit more this year as some of our larger retail national customers are growing a little bit faster. I think what we're pleased with though, as Brian talked about, there is some stability in the pricing environment, particularly with branded pricing, certainly continue to make good progress against generics. But what you should expect, as I talked about at the beginning, is that we are going to see some items that are going to fluctuate from quarter-to-quarter.

We don't manage our business that way. We manage our business for the long haul. We look at our business on an annual basis. And these items do tend to balance out over the course of the year. We were very pleased that we started the year with being able to guide back to growth in this segment and we're very pleased that given the momentum and the execution that Brian talked about, particularly in our specialty business, so we could raise that guidance today to the upper end. So, we're making good progress, but I think you should expect to continue to see some fluctuation in our quarterly results.

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

Q

No, that's fair. And then I guess, Brian, you opened the door to a little bit of preliminary 2021 thoughts. And so I know we'll get more detail in May. But if I heard you correctly, it sounds like core drivers playing out in line this year with your expectations. You guys have highlighted the VA is not a material headwind. It sounds like cost savings will continue, could be a benefit from capital allocation. All seem pretty neutral to tailwinds. Is there any major headwinds you would have us start to contemplate as we start to think about framing 2021 more specifically?

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

A

Well, look, as we come to May, we will try to be very thoughtful and share with you our view of the thinking. If I think about what could materialize as headwinds, I mean the policy arena has been dynamic, well, probably for most of my career. But certainly for my tenure as CEO and yet while the clouds always seem to be gathering, nothing has really materialized. I would suspect we'll hear some commentary tonight. I think as we come into the face of election year, we'll be evaluating not only the policy proposals, but the politics that's around that sort of set of framework for the likelihood of any of that really getting done. But to me that's a normal part of being in healthcare and a normal part of being in this business.

I think our European business is coming off of a good quarter, but our experience there particularly in NHS has been challenges around having good line of sight into how the reimbursement mechanisms really play out. And so while we're encouraged that we have a five-year macro agreement with NHS for the pharmacy community there, I think underneath the nuances of the timing and the different mechanisms that make up that framework, we'll have to continue to monitor and evaluate. So, I mean, those are the two things that first pop to mind. Anything you want to add, Britt?

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

A

No, I think you've captured them correctly, Brian.

Operator: And next will be Lisa Gill with JPMorgan.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Brian, I just want to follow up on that last point as you talk about the policy arena. Clearly, specialty has been a growth area, you've talked the whole call about specialty. What are your thoughts around IPI and what it could mean to your specialty business? And then, secondly, as we think about the European markets, what have you learned from the European markets where it is a fixed-cost environment versus here in the US?

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

A

Great. Thanks, Lisa. I'll take the IPI business first – the question first. So, IPI is, I guess there's been a lot of different constructs around getting to Part B. There's been discussions of caps or limiting ASP rates, future caps on allowable inflation. IPI would be a proposal to index what the US pays based on a basket of internationally referenced prices for various products, and I think there's even been some debate or discussion around MFN or most favored nation type clauses.

So, the proposals have really been very wide in the spectrum. And without commenting on any of them specifically, I would say first and foremost, we think any reform in Part B should be constructed and we work with industry, the government and our partners to advocate for this in a way that pushes care into the community. It's clearly the low-cost, high-access setting and we believe it has extremely high quality as well. So, it kind of hits all the three macro principles.

And so anything – any reform that were to happen in our view should move care into the community. Anything that – what move the opposite way would be counterproductive, really, for the US spend on healthcare, in general. Now, relative to IPI, if something were to occur, the way I think about this is in most instances in our core pharma distribution, in our community provider setting, this is an implication to our customer. And so, it will be a secondary effect, really, from a wholesaler perspective.

The one place we would have some exposure would be in The US Oncology Network, where I remind you through our partnership we share in the practice economics. So, we continue to watch this very closely. I'm not sure there's been a proposal that's had more commentary and more aligned commentary to kind of come out against it, because of the impact, potentially, to patients and patient access and cost of care, but I suppose we'll see what we hear tonight.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Great. And then, just my follow-up, I just – Britt, you talked about the Change exit as being one of the key components to 2021. And you said it's consistent with what you've said before. Can you just remind us what you've said before on the timeline of the exit?

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

A

Sure, Lisa. So, what we've said previously, dating back to our Q2 earnings call, from that point in time we'd expect to exit our transaction in 6 to 12 months, although that it could be before the end of our fiscal 2020. So, I would reiterate that language today.

Operator: And next will be Ricky Goldswater (sic) [Ricky Goldwasser] (47:15) with Morgan Stanley. Your line is open.

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, hi, good morning. I have a follow-up question on the cost cutting initiative. I think you reduced your corporate expense guidance by about $45 million. Part of it is flow-through of cost savings to the bottom line and some timing of investments. By our calculation, it's about $0.18 to the EPS. So, as we think about the ongoing benefit of cost cutting, can we just kind of like run rate that $45 million that you say in the fourth quarter?

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

A

Yeah, let me answer that, Ricky. Certainly, we are pleased with the progress that we're making against our cost initiatives, and I'd reiterate that we expect to generate $400 million to $500 million of savings by the end of 2021. So, the cost programs are ongoing.

As I called out at the beginning of the year, there were some additional investments that we were going to be making, particularly in the areas of information security management and data and analytics. We are continuing to make those investments, but we're seeing good efficiency across the organization.

So, I don't think you can necessarily take our performance this quarter and just run it out. We're continuing to make investments in the business, but we're also continuing along getting the efficiencies from scale in some of the back office functions. So, what we wanted to do today was to update our guidance based on some of the benefits that we've seen in performance and execution, but we're continuing to make investments along as we generate those savings.

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then, one follow-up on Change, I mean, obviously I understand that the exit is tax efficient. But can you just remind us directionally kind of like the mechanics? Should we expect Change – what should we expect in terms of impact? Would it be neutral to EPS, accretive or dilutive? And same, how should we think about just directionally the impact to cash?

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

A

Yeah. So, let me just remind you that today is a filing that is another step along our exit. We have nothing that is included in our FY 2020 guidance related to Change. So, there's no additional information that I can provide you on that. And in terms of when we exit, depending on – regardless of how we exit, there'll be no cash impact.

Operator: And next will be Elizabeth Anderson with Evercore.

Elizabeth Anderson
Analyst, Evercore Group LLC

Q

Hi, good morning, guys. Just maybe broader long-term picture on the specialty side. How do we think about like the ramp-up in sort of additional specialty services you're providing, particularly on the US oncology side, but maybe also in the core business? And sort of, are there sort of key moments that cause either providers or other customers to sort of take up that services? Is it something gradual? I'm just sort of looking for like a longer-term vision of that.

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

A

Yeah, it's a great question and it's obviously an area that we have some excitement about. And we have spent, really, a good part of the last 10 or 15 years building out some through internal development and some through acquisition, a set of capabilities that are really oriented around helping manufacturers identify which patients are appropriate and should be benefiting from their therapy, finding those patients and getting them started on that therapy, and then ensuring that they stay on that therapy through the full clinically appropriate course so that they can get the best possible outcome.

So, the first good news in that is that the patient gets the best outcome. We think it's good for the patient and it's good for the healthcare system. Obviously, for our biopharma partners, that can result in more patients benefiting from their products. That has obvious benefit to them and that's a service, therefore, they're quite interested in paying us for it. So, as we think about building off of really our 20-year experience in this marketplace, building off of the sets of assets that we've acquired for the commercialization of these products, there's opportunities to both refine and deepen and develop the tools we offer today.

A few weeks ago, I shared an example of a program like that we're calling Access for More Patients, which fundamentally is getting at the same issue, but it's doing it in a more automated, efficient way that lets us get more – find more patients and get them on those therapies faster. As we look at that as a core, we think there are opportunities to expand downstream and to get earlier-stage services to support pharmaceuticals. And as we think about some of our provider segments, there's opportunity to do some integration with providers downstream. So, this is an area that we think, as you look at the pipeline, as you look at the products, as you look at what's happening in terms of in the clinical trial space and the fragmentation of populations, that there's going to continue to be a good opportunity here for McKesson.

Elizabeth Anderson
Analyst, Evercore Group LLC
Q

Perfect. That's really helpful. Thank you.

Operator: And next will be Eric Coldwell with Baird.

Eric White Coldwell
Analyst, Robert W. Baird & Co., Inc.
Q

Thanks. Good morning. So, maybe I'd just focus on the Med-Surg segment for a second. You've mentioned the early flu season consistent with peers. I'm curious, if you could carve out for us what you think the incremental benefit of early flu was or heavy flu. And then, I know it's probably a bit early and maybe an evolving situation, but coronavirus, any issues with sourcing out of the Asia-Pac region or pricing changes, demand changes in the US as maybe some facilities pre-stock certain gloves, gowns, masks, et cetera. Just any answers on coronavirus impact so far would be interesting. Thanks so much.

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

Good morning, Eric. This is Britt. I'll take the first one and let Brian comment on the second. As I talked about in my remarks, we're really pleased with the performance of the medical business. We had good organic growth really across our business, but primarily in our primary care business. And I also called out higher pharmaceutical volumes as one of the drivers. We did see some modest impact from early flu season.

I would remind you though that typically the flu season has a larger impact on our fourth quarter than our third quarter. We did plan the year for a normal flu season. So, we saw a little earlier start than we had anticipated. But again, I would just remind you that the strong core organic growth across our primary care business, which was inclusive of higher pharmaceutical volumes, was really the driver for the performance.

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

A

I'll take the coronavirus. Maybe before that, we've been around this business for a long time. And we chart every year what the flu season, influenza season looked like in the US and every season has its own cycle or rhythm, if you will. And so, I think it's fair to say, we have seen an early start. Ultimately, how that plays out will depend on the duration and the severity. And it's probably hard to predict that right now. Relative to coronavirus, I guess let me start by first saying our thoughts and sympathies go out to those, particularly in China, but really Asia that are obviously dealing with this in a very real-time way.

We at McKesson have really been working across industry partners, peers, trade associations, government agencies for the better part of three or four weeks. So, we try to jump on these things early and get ahead of them. And so, we're monitoring this very, very closely. I would remind everybody that we don't manufacture these products. We procure them, we sell them and we distribute them. And we do have a domestic supplier base, although the majority of the products, the masks and the disinfectants and the gowns are sourced from Asia or China.

I guess fortunately or unfortunately, depending on your perspective, we've had some experience with SARS and H1N1. And so, what we're doing is implementing the protocols, the monitoring capabilities that we've built up through these prior experiences and working in close coordination with government agencies and industry partners to make sure we can keep good continuity of supply.

Now, what that ultimately looks like depends really on how does the virus continue to proliferate, does it stay contained in a region, and so those are things that we just have to watch. But we wake up every day thinking about the markets that we serve and how we make sure we have product available for our customers that operate in those markets.

Operator: And next will be Michael Cherny with BofA Securities.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Thanks so much for taking the question. I guess a lot of the key topics have been asked. The one thing that did stand out, you highlighted the recent success on the transaction side, medical really rocking it, pretty low so far from an acquisition perspective, at least, in terms of your historical spend year-to-date.

As you're heading into fiscal 2021, as you're getting rid of the Change position on the balance sheet and the ownership stake, as you think forward of the portfolio, are there any macro trends that you think would drive some areas for opportunities for you to go and drive inorganic growth? Or anything from a broader picture perspective where your customers are really asking you to pursue an area that you may not be in or in as strong as you would like to be right now?

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

A

Great question. I think we probably – if you look back over the past few years, we came through a cycle of pretty heavy M&A as we really bolstered some of the capabilities and assets that we thought surrounded our specialty biopharma manufacturer value prop and our oncology business or ecosystem, however, you want to think about that. And as we've done the work to integrate those and it's a lot of work to integrate these things and to integrate them properly, in parallel we've really been refining our strategies. And if you've heard me – you've probably heard me say this before, all good M&A follows a good strategy.

And so, as we put this strategy together, we've identified the areas that we think we have differentiated capabilities in markets that have good overall growth prospects. So, when I think about capital deployment, we've obviously got to deploy capital to be invested in efficiency and compliant and safe, secure always on environment. And then, the second area we'd look for is growth. But those growth investments, meaning M&A investments, have to be closely aligned to the strategy. And I think that that's what you should expect from us.

So, we like growth investments. We like growth capital, either extend our capabilities or add scale to the places that we have capabilities; although, we always have to balance – obviously, strategy can't be based on M&A, because it takes a buyer and a seller and it takes a price that you can agree on. So, as we've looked at the market and looked at those trade-offs obviously the past 12 months or so, we've been favoring to deploy our capital to buy back our shares, because we think those are great investments, but we continue to be very active in looking for areas we can inorganically help support the growth.

Operator: And next will be Stephen Baxter with Wolfe Research.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Hi. Thanks for the question. So, wanted to ask about the generics business. I mean, you guys have been very clear that gross profit is growing here. And that appears to be a pretty different result than the rest of the industry. So, from a macro point of view, it looks to us like the broader market is relatively flat.

So, I was hoping to better understand what's driving your growth here in bigger picture terms. Are you growing generic revenue against the backdrop of stable margins, stable revenue with improving margins? Really any color you can add on how you're achieving this result so we can better assess sustainability going forward would be appreciated. Thank you.

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

A

Good morning. I'll start and certainly Brian can add on. As we've talked about previously, we're really pleased with a couple of dimensions that lead to – that are around our generics business. First of all, we have a scaled and efficient sourcing operation. We think we source as well as anybody. And we continue to find opportunities from a sourcing perspective.

We continue to be disciplined in a stable, yet competitive environment. We think that that is – those dynamics are leading to our ability to generate gross profit growth. We are seeing some growth in units. And when you combine that with a scaled and stable sourcing operation and disciplined approach in a competitive, but stable market, we think that those are dynamics that are really helping us be very successful in the generics area.

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

A

Operator, we have time for one more question.

Operator: Certainly. That question will come from Eric Percher with Nephron Research. Your line is open.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. A quick one on Europe. Loud and clear on expense reduction and a little benefit from the UK helping the uptick this quarter on OP profit. Is it correct that the German business has not been moved to discontinued ops? So, is that still flowing through? And at some point, would we see that a benefit or maybe a loss might be removed from that segment when the JV is struck or approved?

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

A

Morning, Eric. It is true we have not moved it to discontinued operations and it doesn't qualify for discontinued operations. I did talk about a GAAP-only charge that we took in the quarter. And we have the assets as held for sale on our balance sheet.

Eric Percher
Analyst, Nephron Research LLC

Q

Okay. And can you state anything on whether that is in a loss position?

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

A

I'll just go back to my comments in terms of the loss that we recorded from a GAAP-only perspective in the quarter of $282 million.

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

Okay. Well, I think that runs us out of time. I want to thank everyone for your great questions and your continued interest in McKesson. I want to thank Jack for facilitating this call. To conclude, McKesson continued to execute well in the third quarter and we remain confident in our fiscal 2020 outlook. I am extremely proud of how our employees are embracing the Team McKesson culture and I want to thank them for everything they do day in and day out not only to deliver these results, but most importantly to improve care in every setting we serve. Thanks again for your interest in McKesson. We will release fourth quarter earnings results in early May. Look forward to talking to you then. Goodbye.

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