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McKesson Corp. (MCK)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

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

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

OTHER PARTICIPANTS

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Michael Cherny
Analyst, BofA Securities, Inc.

Charles Rhyee
Analyst, Cowen & Co. LLC

Kevin Caliendo
Analyst, UBS Securities LLC

Eric Percher
Analyst, Nephron Research LLC

Brian Tanquilut
Analyst, Jefferies & Company, Inc.

George Hill
Analyst, Deutsche Bank Securities, Inc.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

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

Jailendra Singh
Analyst, Credit Suisse Securities (USA) LLC

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the McKesson's Q2 Fiscal 2022 Earnings Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Rachel Rodriguez. Please go ahead.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

Thank you, Sarah. Good afternoon and welcome everyone to McKesson's second quarter fiscal 2022 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 to Brian.

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

Thank you, Rachel, and good afternoon, everyone. Thank you for joining us on our second quarter call today. We are happy to report another strong quarter for McKesson, driven by continued market improvements in underlying fundamentals of our businesses. We achieved double-digit adjusted operating profit growth in all four segments, based on a strong operating performance and alignment across the enterprise.

As a result of our second quarter performance, our confidence in the second half of the fiscal year and McKesson's continued role in the COVID-19 response efforts, we are raising our guidance range for fiscal 2022 adjusted earnings per diluted share from $19.80 to $20.40 to a new range of $21.95 to $22.55.

We continue to believe we will see a return to pre-COVID pharmaceutical prescription and patient engagement levels in the second half of our current fiscal year. We're encouraged by the trends we continue to see across primary care, specialty and oncology patient visits in addition to overall prescription volumes. We are pleased to see our markets are recovering in line with our original expectations.

Our enterprise-wide focus on our company priorities is driving operating performance and furthering the advancement of our long-term growth. I would like to take the time today to talk about each of our company's priorities.

First, we have a focus on our people and the culture, which is guided by our ICARE and ILEAD values. These values include a commitment to both our local and global communities, our customers and the healthcare industry to innovate and deliver opportunities that make our customers more successful, all for the better health of patients.

Along with these values, we're committed to fostering an inclusive workplace that celebrates our differences and respects the diverse world in which we live and work. As an organization, we continue to be committed to diversity, equity, and inclusion. Through a more diverse and inclusive workplace, we're a stronger, a more creative and a more productive team.

At McKesson, our priority has been the health and safety of our employees and we're deeply committed to supporting our team members across the organization, which why I am incredibly pleased to have announced McKesson's first-ever day of wellness, which we call Your Day, Your Way. This will take place this Friday, November 5. We understand that mental, physical and emotional wellbeing are of the utmost importance to our team. So we made the decision to set aside a special day to help ensure our employees can rest, recharge and take time for themselves. We're so grateful for all the contributions from the team over the last 19 months. McKesson employees continue to be in the center of the fight against COVID-19, and we want to make sure everyone gets a chance to take a well-deserved break.

Our second priority is to strengthen our core pharmaceutical and medical supply chain businesses. Across North America, we have a best-in-class pharmaceutical supply chain. As a reminder, in the US, we have a scale distribution presence that delivers roughly one-third of prescription medicines each day. Our operational excellence and our ability to leverage our scale with global suppliers is one of the many reasons why McKesson continues to be the partner of choice for hospitals, health systems, and pharmacies of all size.

We strengthen our business when we strengthen our customers and partners. This past quarter, we held our annual McKesson ideaShare educational event, which brought together independent pharmacy operators to help them learn new skills, how to grow strategically and how to operate efficiently. The virtual experience helped

2,000 independent pharmacies prioritize education and networking, which we believe will shape the future of community pharmacy and strengthen the independent business for the better.

In Canada, we've been the leader in healthcare related logistics and distribution for 100 years, and we support hospitals, community and retail pharmacies to ensure that medication is always available. We're a leader in medical distribution to alternate site markets, and our footprint in the US healthcare is underpinned by our strong sourcing and supply chain capabilities. We deliver medical and surgical supplies and services to over 250,000 customers.

Our pharmaceutical and medical distribution businesses continue to play an integral role in the pandemic response efforts, and our capabilities have been highlighted through our evolving partnership with the US government's COVID-19 vaccine distribution, kitting and storage programs.

I'm glad to say that the fundamentals in our core business remain solid, and our execution has continued to improve as we accelerate our growth and work to deliver high quality, resilient supply chains to our customers.

Our third company priority is to simplify and streamline the business. We're prioritizing the areas where we have deep expertise and are central to our long-term growth strategies, largely within the North American market. As a result, we made the decision to fully exit McKesson's businesses in the European region. In July, we announced that we have entered into an agreement to sell our European businesses in France, Italy, Ireland, Portugal, Belgium and Slovenia to the PHOENIX Group.

Today, we're announcing that McKesson has made the decision to sell our UK retail and distribution businesses as a whole. The transaction is expected to close in Q4 of fiscal 2022, subject to customary closing conditions, including receipt of required regulatory approvals. We believe this step toward a full exit of our European business is an important milestone in our strategy as a streamlined, efficient, focused organization.

Building upon the foundation of a strong company culture and a stable business, the last company priority encompasses our two strategic growth pillars. We are investing to advance our oncology and biopharma services, which includes building integrated ecosystems that leverage our differentiated assets and capabilities and our strategic focus on these two pillars is important as both of these areas have good inherent growth opportunities.

McKesson's oncology ecosystem supports over 14,000 specialty physicians through distribution and GPO services, and we are the leading distributor in the community oncology space. We have over 1,400 physicians in the US oncology network spread over approximately 600 sites of care in the US.

Within our oncology ecosystem, Ontada generates insights at the intersection of technology and data and supports community providers with precise cancer care by improving patient outcomes and delivering evidence and insights to help accelerate life sciences research.

The ecosystem helps the clinicians to provide better care in an increasingly complicated oncology care landscape by helping them grow their businesses, attract more patients and produce better health outcomes. We can then leverage interconnected technology and real-world insights to feed data back upstream to manufacturers, which can help them think about identifying new products, innovations and new markets.

Within the biopharma ecosystem, the Prescription Technology Solutions businesses leverage technology networks and access to provider workflows to serve biopharma and life sciences partners and patients. We have built this ecosystem over many years as it includes assets like RelayHealth Pharmacy, CoverMyMeds, and

RxCrossroads. It allows us to connect providers, payers and patients together to focus on access, adherence and affordability solutions.

Our two strategic pillars of oncology and biopharma services are not just businesses or products, but fundamentally a suite of solutions that solve long-standing problems in ways that bring more speed, impact, and efficiency. We will continue to invest and accelerate the execution against those strategies, which support the long-term growth for McKesson. I'm confident in the progress against our company's priorities that they will enable the advancement of our growth.

Before I turn to our second quarter results, just a brief update on our Board of Directors. In September, our Board of Directors welcomed Dr. Richard Carmona as a new independent director. Dr. Carmona has a strong focus on improving public healthcare and extensive experience in clinical sciences, healthcare management and emergency preparedness, which led to his nomination and unanimous Senate confirmation as the 17th Surgeon General of the United States from 2002 until 2006. Currently, Dr. Carmona is Chief of Health Innovations at Canyon Ranch and a Professor of Public Health at the University of Arizona. His hands-on healthcare experience will be invaluable for McKesson's Board of Directors.

Now I want to turn to the business performance within the second quarter. We are pleased with our strong second quarter performance, and we remain encouraged by the underlying fundamentals in our business. Let me start with US Pharmaceutical, where our solid results for the second quarter reflected continued improvement of prescription trends, which were in line with our expectations. Within specialty oncology visits we saw an exit rate of pre-COVID levels, which, again, was in line with our expectations.

The US Pharmaceutical segment saw a 12% adjusted operating profit growth, which was underpinned by the distribution of specialty products to providers and health systems and the contribution from our successful COVID-19 vaccine distribution operations. We are in a strong position to continue to support the government and private enterprise in the future for distributing COVID and flu vaccines, and our investments in the distribution business continue to be showcased through our successful vaccine response.

Through October 28, our US Pharmaceutical business has successfully distributed over 311 million Moderna and Johnson & Johnson COVID-19 vaccines to administration sites across the United States and to support the US government's international donation mission.

In Prescription Technology Solutions, the business continued to perform well this quarter as our technology and service offerings have accelerated the support and growth of our biopharma customers, and we've been successful in adding new brands to our platforms. The segment had excellent momentum and delivered a 38% increase to adjusted operating profit growth during the second quarter.

In addition to the operational strength, I'm proud to say that we are helping patients get access to the therapies through our market-leading technology offerings in this segment.

In Medical-Surgical, we saw an increase in COVID-19 tests, an improvement in patient care visits, and we announced we are expanding our work with the US government through a new kitting and storage contract. Our Medical-Surgical business remains well-positioned to continue to support the government as needed.

The growth in our Medical-Surgical segment is reflective of strong top line performance and underlying business improvement. As it relates to international, the segment had solid adjusted operating profit growth, benefiting from both local COVID programs and a new partnership with one of Canada's largest retailers. We are partnering with local governments to distribute and administer COVID-19 vaccines. And through September, we've distributed over 58 million vaccines to administration sites in select markets across our international geographies.

As a reminder, excluding our planned divestitures in Europe, we have businesses in Norway, Austria, Denmark and Canada in our International segment. For our remaining European businesses, we are exploring strategic alternatives as we align future investments to our growth strategies.

Before I close, I'd like to update you on the status of the proposed opioid settlement. Recently, we announced that enough states have agreed to settle to proceed to the next phase, which is the subdivision sign-on period.

During this phase, each participating state will offer its political subdivisions, including those that have not sued, the opportunity to participate in the settlement for an additional 120-day period, which ends January 2, 2022. We are pleased with this important step, and we believe the settlement framework will allow us to focus our attention and resources on the safe and secure delivery of medications and therapies, while expediting the delivery of meaningful relief to the affected communities.

In closing, I'm encouraged as we continue to make progress and accelerate growth as we advance our company priorities. Our underlying distribution business have stable fundamentals, great teams, and strong execution. We're investing in what we believe are two good growth markets where we have differentiated capabilities, and we look forward to sharing more of those successes and proof points with you at our upcoming Investor Day.

Thank you for your time. And with that, I'm going to turn it over to Britt for a few additional comments.

Britt Vitalone

Chief Financial Officer & Executive Vice President, McKesson Corp.

Thank you, Brian, and good afternoon, everyone. I'm pleased to be here today to discuss our fiscal second quarter results, which reflects strong performance and momentum across the business, driven by operational excellence and execution against our growth strategies. This momentum could be seen in each of our segments.

A summary of our second quarter results and updated guidance assumptions can be found in our earnings slide presentation, which is posted on the Investors section of our website.

Let me start with an update on Europe. This morning, we announced that we've entered into a definitive agreement to divest our retail and distribution businesses in the UK to Aurelius for approximately $438 million.

The ultimate proceeds from this transaction are subject to certain adjustments under the agreement. Therefore, the proceeds may differ from the announced purchase price. McKesson will continue to operate these businesses and record revenue and income until the transaction is closed, which is expected to occur in our fourth quarter of fiscal 2022, pursuant to the satisfaction of customary closing conditions, including receipt of regulatory approvals.

The assets involved in this transaction contributed approximately $7.8 billion in revenue and $64 million in adjusted operating profit in fiscal 2021. The net assets included in the transaction will be classified as held for sale. The held for sale accounting will be effective beginning with our fiscal 2022 third quarter. We will remeasure the net assets to the lower of carrying amount or fair value, less cost to sell. And we estimate that this will result in a GAAP-only charge of between $700 million to $900 million in our third quarter of fiscal 2022.

Due to held for sale accounting treatment, we will discontinue recording depreciation and amortization on the assets involved in the transaction. This impact is not included in the fiscal 2022 outlook provided today. This transaction provides us the focus to pursue the growth strategies of oncology and biopharmaceutical services in North America. And as Brian mentioned, we remain committed to a full exit of our European businesses, which includes announced transactions to the PHOENIX Group and Aurelius, as well as our remaining operations in Norway, Austria, and Denmark.

Let me now turn to our second quarter results. Before I provide more details on our second quarter adjusted results, I want to point out two additional items that impacted our GAAP-only results in the quarter. First, we recorded a GAAP-only after-tax charge of $472 million related to our agreement to sell certain European businesses to the Phoenix Group to account for the remeasurement of the net assets to lower of carrying amount of fair value less cost to sell. This transaction is expected to close within the next 12 months. Also during the quarter, we recorded an after-tax loss of $141 million on debt extinguishment related to the successful completion of a bond tender offer.

Moving now to our adjusted results for the second quarter, beginning with our consolidated results, which can be found on slide 7. Our second quarter results were highlighted by strong operating performance, which included record revenue and double-digit adjusted operating profit growth across all segments. We are encouraged by the ongoing market improvement in both prescription volumes and patient visits, which we observed in our second quarter. These improvements are supported by our strategic agenda, setting us on a path of disciplined growth.

In our work to support US government's COVID-19 domestic and international vaccine, kitting efforts continues to contribute to growth in addition to the momentum we have built across the business. Second quarter adjusted earnings per diluted share was $6.15, an increase of 28% compared to the prior year. This result was driven by the contribution from COVID-19 vaccine kitting, distribution, and growth in the Medical-Surgical Solutions segment, partially offset by higher tax rate.

Second quarter adjusted earnings per diluted share also includes net pre-tax gains of approximately $97 million or $0.46 per diluted share, associated with McKesson Ventures' equity investments as compared to $49 million in the second quarter of fiscal 2021.

Consolidated revenues of $66.6 billion increased 9% above the prior year, principally driven by growth in the US Pharmaceutical segment, largely due to increased pharmaceutical volumes including growth in specialty products and our largest retail national account customers, and partially offset by branded to generic conversions.

Adjusted gross profit was $3.3 billion for the quarter, up 12% compared to the prior year. Comparable adjusted gross margin for the quarter was up 10 basis points versus the prior year. Adjusted operating expenses in the quarter increased 4% year-over-year and adjusted operating profit of $1.3 billion for the quarter was an increase of 34% compared to the prior year and reflected double-digit growth in each segment.

Interest expense was $45 million in the quarter, a decline of 10% compared to the prior year, driven by the net reduction of debt in the quarter. Our adjusted tax rate was 18.8% for the quarter, which was in line with our expectations. In wrapping up our consolidated results, second quarter diluted weighted average shares were $155.8 million, a decrease of 5% year-over-year.

Moving now to our second quarter segment results, which can be found on slides 8 through 13, and I'll start with US Pharmaceutical. Revenues were $53.4 billion, an increase of 11% year-over-year as increased pharmaceutical volumes, including growth in specialty products and our largest retail national account customers, were partially offset by branded to generic conversions.

Adjusted operating profit increased 12% to $735 million, driven by growth in the distribution of specialty products to providers and health systems and the contribution from COVID-19 vaccine distribution. The contribution from our contract with the US government related to the distribution of COVID-19 provided a benefit of approximately $0.28 per share in the quarter, which was above our original expectations.

In the Prescription Technology Solutions segment, revenues were $932 million, an increase of 40%, driven by higher biopharma service offerings, including third-party logistics services and increased technology service revenue, partially resulting from the growth of prescription volumes. Adjusted operating profit increased 38% to $144 million, driven by organic growth from access and adherence solutions.

Moving now to Medical-Surgical Solutions. Revenues were $3.1 billion, an increase of 23%, driven by increased sales of COVID-19 tests and growth in the primary care business. Adjusted operating profit increased 52% to $319 million, driven by growth in the primary care business, increased sales of COVID-19 tests, and the contribution from kitting, storage and distribution of ancillary supplies for the US government's COVID-19 vaccine program. The contribution from our contract with the US government related to the kitting, distribution and storage of ancillary supplies for COVID-19 vaccines provided a benefit of approximately $0.14 per share in the quarter, which was above our original expectations.

Next, let me address our International results. Revenues in the quarter were $9.1 billion, a decrease of 5%, primarily driven by the contribution of McKesson's German wholesale business to a joint venture with Walgreens Boots Alliance, partially offset by volume increases in the pharmaceutical distribution and retail businesses. Excluding the impact of the contribution of our German wholesale business, which was completed in the third quarter of fiscal 2021, segment revenue increased 13% year-over-year and was up 9% on an FX adjusted basis.

Adjusted operating profit increased 41% year-over-year to $163 million. On an FX-adjusted basis, adjusted operating profit increased 34% to $155 million, driven by the discontinuation of depreciation and amortization on certain European assets classified as held-for-sale beginning in the second quarter of fiscal 2022. The held-for-sale accounting in our International business contributed $0.13 to adjusted earnings in our second quarter of fiscal 2022.

Moving on to corporate. Adjusted corporate expenses were $83 million, a decrease of 39% year-over-year, driven by gains of approximately $97 million, or $0.46, from equity investments within our McKesson Ventures portfolio. This quarter, we had fair value adjustments related to multiple portfolio companies within McKesson Ventures. Compared to fiscal 2021, gains from McKesson Ventures contributed $0.24 year-over-year.

As previously discussed, it's difficult to predict when gains or losses on our ventures portfolio of companies may occur. And therefore, our practice has been and will continue to be to not include Ventures portfolio impacts in our guidance.

We also reported opioid-related litigation expenses of $36 million for the second quarter, and anticipate that fiscal 2022 opioid-related litigation expenses will be approximately $155 million. Consistent with the proposed settlement announced in July, we also made the first annual payment into escrow of approximately $354 million during the quarter.

Let me now turn to our cash position, which can be found on slide 14. We ended the quarter with a cash balance of $2.2 billion. And for the first six months of the fiscal year, we had negative free cash flow of $109 million. In Q2, we completed several debt transactions. In July, we redeemed a 600 million euro-denominated note prior to maturity.

In August, we completed a cash-funded upsized tender offer, which resulted in the redemption of $922 million principal outstanding debt. And finally, we completed a public offering of a note in the principal amount of $500 million at 1.3%. These actions align with our previously stated intent to modestly delever and to further strengthen our balance sheet and financial position.

Year-to-date, we made $279 million of capital expenditures, which included investments to support our strategic pillars of oncology and biopharma services. For the first six months of the fiscal year, we returned $1.4 billion in cash to our shareholders through $1.3 billion of share repurchases and the payment of $134 million in dividends. We have $1.5 billion remaining on our share repurchase authorization, and continue to expect diluted weighted average shares outstanding to range from $154 million to $156 million for fiscal 2022.

Let me transition now and speak to our outlook for the remainder of fiscal 2022. For our full list of fiscal 2022 assumptions, please refer to slide 16 through 19 in our supplemental slide presentation. As a result of our strong first half performance and our outlook for the remainder of the year, we are raising our previous adjusted earnings per share guidance range for fiscal 2022 to $21.95 to $22.55, which is up from our previous range of $19.80 to $20.40.

Our updated outlook for adjusted earnings per diluted share reflects 27.5% to 31% growth from the prior year, and our guidance assumes growth across all of our segments. Additionally, fiscal 2022 adjusted earnings per diluted share guidance includes $2.30 to $3.05 of impacts attributable to the following items: $0.50 to $0.70 related to the US government's COVID-19 vaccine distribution, which is an increase from the previous range of $0.45 to $0.55; $0.80 to $1.10 related to the kitting, storage, and distribution of ancillary supplies, an increase from the previous range of $0.50 to $0.70 as discussed at a recent conference; $0.50 to $0.75 related to COVID-19 tests and impairments for PPE and related products; and approximately $0.49 from gains or losses associated with McKesson Ventures' equity investments within our Corporate segment year-to-date. Excluding the impacts of these items from both fiscal 2022 guidance and fiscal 2021 results, this indicates 20% to 29% forecasted growth.

Let me provide a few additional assumptions related to our guidance. We continue to expect prescription and patient engagement volumes will return to pre-COVID levels in the second half of our fiscal 2022, which is in line with our original guidance. In the US Pharmaceutical segment, we now expect revenue to increase 8% to 11% and adjusted operating profit to deliver 4.5% to 7.5% growth over the prior year.

We continue to see stable fundamentals. Specifically, our outlook for branded pharmaceutical pricing remains consistent with our original guidance and the prior year of mid-single-digits increases in fiscal 2022. And our view is that the generics market remains competitive yet stable, as our volumes have continued to improve in the September quarter.

Our guidance includes contribution related to our role as a centralized distributor for the US government's COVID-19 vaccine distribution. This includes work preparing vaccines for international missions. Our current outlook remains aligned to the volume distribution schedule provided by the CDC and the US government. The current guidance excludes booster shots due to the timing of the recent approvals, as well as vaccines for pediatrics, which have not been approved by the CDC. We will continue to update you on the progress and contribution from this program.

When excluding COVID-19 vaccine distribution in the segment, we expect approximately 3% to 6% adjusted operating profit growth. In addition, our investments in our leading and differentiated position in oncology will continue to represent an approximate $0.20 headwind in fiscal 2022.

In our Prescription Technology Solutions segment, we see revenue growth of 31% to 37%, and adjusted operating profit growth of 23% to 29%. This growth reflects the strong service and transaction momentum in the business.

Now transitioning to Medical-Surgical. Our revenue outlook assumes 8% to 14% growth and adjusted operating profit to deliver 35% to 45% growth over the prior year. As mentioned previously, our outlook includes $0.80 to $1.10 related to the contribution from the US government's distribution of ancillary supply kits and storage programs and $0.50 to $0.75 related to COVID-19 tests and PPE impairments-related products. Excluding the impacts from these items from both fiscal 2022 guidance and fiscal 2021 results, this indicates 13% to 19% forecasted growth.

One additional note related to our US distribution businesses. One of the pillars of our enterprise strategy is talent, the ability to attract and retain the best workforce in healthcare. The labor market remains competitive, and we have assumed a modest expense impact to ensure there is continued service continuity through the holiday season and the back half of our fiscal year. Therefore, the guidance that we're providing today includes approximately $0.10 to $0.20 of adjusted operating expense impact for labor investments in our US distribution businesses in the second half of the year.

Finally, in the International segment, our revenue guidance is 1% decline to 4% growth as compared to the prior year. As a reminder, this reflects the impact of the contribution of our German wholesale business to a joint venture with Walgreens Boots Alliance. For adjusted operating profit, our guidance reflects growth in the segment of 39% to 43%, which includes approximately $0.38 of expected adjusted earnings accretion in fiscal 2022 as a result of the held-for-sale accounting related to our agreement to sell certain European assets to the Phoenix Group. It also includes our strong performance in the second quarter and the contribution from COVID-19 vaccine distribution in the segment.

Turning now to the consolidated view. Our increased guidance assumes 8% to 11% revenue growth and 18% to 22% adjusted operating profit growth compared to fiscal 2021. Our full year adjusted effective tax rate guidance of 18% to 19% remains unchanged, and we anticipate corporate expenses in the range of $610 million to $660 million.

On our May 6 earnings call, we outlined an initiative to rationalize office space in North America, to increase efficiencies, and to support employee flexibility. We've made good progress against this initiative. And based on this progress, we now expect earlier benefits from these actions, resulting in the realization of annual operating expense savings of approximately $15 million to $25 million in the second half of fiscal 2022, with annual savings of $50 million to $70 million when fully implemented. These savings will be realized across all of our segments.

Let me now turn to cash flow and capital deployment. We expect free cash flow of approximately $3.5 billion to $3.9 billion in fiscal 2022, which is net of property acquisitions and capitalized software expenses.

As a reminder, historically, we generate the majority of our cash flows in the fourth quarter of our fiscal year. This strong cash flow generation provides the financial flexibility to execute a balanced capital allocation approach, investing in our strategies of oncology and biopharma services, positioning our business for long-term growth while remaining committed to returning capital to shareholders through our dividend and share repurchases. Our investment-grade credit rating remains a priority and underpins our financial flexibility.

In closing, we are encouraged by our strong performance in the first half of our fiscal year. The momentum across the business, including our partnership with the US government, positions us to deliver the updated fiscal 2022 outlook provided here today.

Finally, we're looking forward to providing additional details on our strategies and the strength of our businesses at our upcoming Investor Day on December 8. Thank you for your time.

And now, I'll turn the call over to the operator for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Lisa Gill with JPMorgan.

Lisa C. Gill
Analyst, JPMorgan Securities LLC
Q

Thanks very much and good – thanks very much. Good afternoon, and congratulations on a great quarter. Britt, I appreciated your comments around what you're seeing as far as wage inflation goes. But one of the other questions we've gotten around inflation is around freight costs. Can you remind us of how that works between the manufacturer and the drug distributor? And if you'll bear any of those costs from a distribution perspective? Or is it just the manufacturer that bears that costs? Are you able to pass it on to the customer? Just any color around that would be helpful.

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

Yes. Thanks for your question, Lisa. Certainly, we will bear some costs for freight. We've been able to pass that on to this point in time, both our Pharmaceutical and our Medical business. We are responsible for the freight from our distribution locations to our customers. And to this point, we've been able to manage through that without any material impact, and our guidance for the rest of the year assumes that that will continue. We did call out the incremental labor impact, the investment that we're making, to make sure that we have continuity through the rest of the year. But as it relates to freight, we are responsible from...

[Technical Difficulty] (36:14-38:27)

Operator: Please proceed.

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

We'll go ahead and take the next question.

Operator: Thank you. We'll take our next question from Michael Cherny with Bank of America.

Michael Cherny
Analyst, BofA Securities, Inc.
Q

Good afternoon. Thanks for taking the question. First of all, the call cut off, so I don't know if you've got the chance to finish Lisa's question on freight. I don't know if you want to highlight that again. And then I guess just from my perspective, I don't want to get too far ahead of things, especially with the Analyst Day coming up, but I appreciate all the breakout you have on the strong work tied to all of the COVID-related elements. I know one of the questions that I'm guessing will come up is what that means into next year, given that you outlined some of the benefits that you're seeing specifically this year that, for all our sakes, we all hope that don't [audio gap] (39:19) growth trajectory into next year. Is there any way to think about that $230 million to $305 million and how we have to think about that as a whole in terms of your overall growth versus what your core business will continue to do?

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

A

Hey, Mike, this is Britt. Thanks for hanging in there. Let me just get back to Lisa's question, just to finish that up. We are responsible for the freight from our distribution centers to our customers. To this point this year, we have not had an impact in our financial statements as a result of increased freight. And we don't expect any of that in our guidance as well. So, just to be clear on that, we did call out for you investments that we're making in labor in the back half of the year so that we can ensure the holiday season in the back half of the year for our customers has continuity.

As it relates to your question, Mike, what we've really tried to do here is to provide you some clarity on those items that are related to our distribution of COVID vaccines and ancillary kits, as well as the increase that we've seen in COVID test kits, which vary quite a bit from quarter to quarter over the last year. We've tried to isolate those for you so that you can have a good view into the operations of our core business. I would remind you that the first quarter of this year was lapping a very low quarter from the prior year, which is really the first quarter post the COVID pandemic. So, the growth that you're seeing this year, while strong, includes the first quarter which lapped a very low quarter due to COVID in FY 2021.

So, we'll provide more detail for you on sort of the core components of each of the segments at our Investor Day. We're very pleased with the performance that we've seen thus far. Our core business has performed well. But again, I just would remind you that in addition to that, we did have that low quarter lap in Q1 of last year.

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

A

[indiscernible] (41:22) question, Michael, was just about the vaccine and kitting operation. We continue to run that operation at the direction of the CDC in accordance with the schedules, production schedules, that they give us. It's obviously been quite dynamic over the past months. We are prepared and we'll continue to run that operation as long as the CDC sees value in it and asks us to do it.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

A

Next question, please.

Operator: We'll take our next question from Charles Rhyee with Cowen.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Yeah. Thanks for taking the question. Wanted to ask a little bit about Prescription Technology Solutions. Obviously, very strong growth here in the quarter. And you raised for the full year outlook. When we look at sort of the like slide 4 and you talk about the various services within in this for biopharma services, can you kind of highlight which of the ones are really driving the growth here? Obviously, some of it is tied to prescription utilization. And I know that we are still kind of coming out of the COVID period. But maybe any comments around growth among some of these various services? And I guess, just a sense on which ones will benefit as we continue to kind of recover from the COVID levels? Thanks

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

Thank you for the question. Look, we continue – this business is responsive to absolute levels of activity relative to prescription volumes in the market. We continue to see benefits from the prior investments we've made in these technology services offerings. We do see good underlying growth across the portfolio. Clearly, we've benefited from the recovery in COVID-19-related pandemic volumes. And honestly, some of the policy decisions payers would have made around the way they manage prior authorization, we're really seeing that market kind of return to pre-COVID level kinds of conditions and requirements coming out of the payers. So, we believe, as patients continue to start on new prescriptions, this business is well-positioned to support the access and adherence to those medications, and we will continue to invest from that. We are seeing returns on some of the investments we highlighted for you in previous calls in things like AMP. And there are components of this business that we haven't talked much about like 3PL, and we saw strong 3PL growth in the quarter.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.
A

Okay. Next question, please.

Operator: Thank you. We'll take our next question from Kevin Caliendo with UBS.

Kevin Caliendo
Analyst, UBS Securities LLC
Q

Hi. Thanks for taking my call. So, I was wondering, it looks like in the slide presentation, the non-COVID pharma growth estimate is slightly lower. It's now 3% to 6% versus 5% to 8% at the end of 1Q. Can you just walk us through what the delta – what's changed there? I know part of it is probably labor, but doesn't explain it all. And then maybe do the same for Med-Surg which is also now higher than what you saw or expected at the end of 1Q.

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

Yeah. Thanks for that question, Kevin. Let me just maybe point out a couple of things. First of all, we're pleased with the continued performance of our US Pharmaceutical segment. The momentum there is really good. There's a couple of things that we called out for you, or I called out for you in my opening comments. First of all, the investments that we're continuing to make in our oncology business, and Ontada called that out as a $0.20 headwind year-over-year.

And then as I also talked about and you referenced, the labor investments that we made into our business, our US distribution businesses. Those two things really had an impact on the growth of US Pharma.

And in our Medical business, we're really pleased with not only the performance against the US government program and the increase in COVID test kitting, which is really reflective of the strength of our lab solutions business, but we're pleased with the performance of our primary care business and the core business underneath our medical business in addition to labor investment that I called out. So, both businesses continue to have good momentum.

In the case of our US Pharmaceutical business, continuing to invest in oncology as well as the labor investment in our medical business, really continuing to leverage the strength of the lab business and the investments we made there, and we're seeing good performance in our primary care business.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

A

Next question, please.

Operator: Thank you. Eric Percher with Nephron Research.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. A question on the brand marketplace or maybe brand pricing in particular. I think you've made it pretty clear that the book is no longer tied in a material way to brand price increases. Given the reimbursement and policy debate going on, can you remind us what your view is of what could happen if we saw a change in list prices, particularly a downward change and how you may or may not be exposed to that?

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

A

Thanks for the question, Eric. Maybe I'll start and take the first part of that question and Brian can maybe respond to the policy piece. You're right. We've continued to evolve our business over really the last several years in terms of tying the services that we provide to our customers and for our manufacturers to the pricing and the agreements that we have. And it is less – the brand inflation is less impactful than it has been in the past. We've talked about that a lot over the last few years. As it relates to really the policy piece, Brian, I'll maybe let you talk about that.

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

A

Yeah. Just to build on that comment before we move on. I mean, I think one of the tenets we've always held through multiple changes in dynamics in the industry over my career here is that our services provide real value. And regardless of what sorts of mechanisms get changed in the marketplace, we will continue to be paid fair market value for those services.

As it relates to the public policy debate, and it's as dynamic now as ever, I suppose, I think the main issues that we're discussing are issues that, frankly, have been long discussed. I mean, we are active at the company with elected officials on both sides of the aisle on key policy priorities. We track these discussions very carefully.

We're always advocating for the role of care being provided in the community. We obviously have very strong presences in the community channels, but we believe that fundamentally, that's where you get the best access, the best care, and equally good quality.

We have been at the forefront in many of the experiments, I suppose you could call them, think about [ph] USAN (48:45) and our value-based care. We've had robust participation in the oncology care model that's delivered substantial benefit to CMS. So I think the mix is – it's really – it's not exactly clear where this will go. I think we have a lot of assets. We're engaged in the discussion. We'll find a way to navigate through them as they unfold. I mean, right now, I think these issues have been long discussed and well discussed.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

A

Okay. Next question, please.

Operator: Thank you. From Brian Tanquilut with Jefferies.

Brian Tanquilut
Analyst, Jefferies & Company, Inc.

Q

Hey, good afternoon, guys. Congratulations. I just have one question. Britt, as we think about the investments in labor that you called out, it sounds like it's a back half thing. Is it a bonus structure? Or is this a reset in the wage rates that we should be thinking about as we start thinking about our models for fiscal 2023?

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

A

Yeah. Thanks for the question, Brian. We're just going to guide today to fiscal 2022. We thought that this was an investment that was important for our frontline associates, for our delivery drivers and others to get us through 2022 with continuity. We're not guiding anything beyond that. So I think you'd take this as an important investment to make sure that our customers have the continued service that they would expect from McKesson to the holiday season in the back half of the year.

Operator: Thank you. We'll move on to our next question with George Hill, Deutsche Bank.

George Hill
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Good afternoon, guys and thanks for taking the call. I guess, Brian, I would ask you – or Britt, like I know that you guys have said – been on the record in the past just talking about not wanting to enter any big new businesses. But as you continue to retrench away from Europe with a focus towards the United States, I guess, is there any rethinking of the capital deployment priorities or an appetite for maybe bigger transactions?

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

A

Well, I would start by saying that I don't think our overall capital deployment strategy has changed. We take a balanced approach to capital deployment. We want to prioritize strategic growth. We think we've got a really clearly defined strategy. We've laid out what we consider our strategic growth areas. And assuming the alignment to those strategies and assuming they meet our disciplined financial review process and create value for our shareholders, we would love to be deploying capital against those strategies.

We obviously always balance that against returning capital to shareholders through stock buybacks and our modestly growing dividend, but we think we've really identified – we had a set of differentiated assets in good markets and focused in North America that when we execute against, we'll deliver at the long-term growth that we're looking for. So, a strategic alignment, financial discipline that's really what drives capital deployment.

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

A

And I think what you're seeing here by our actions is a focus on return on invested capital, really making sure that – where we allocate capital that finds the highest returns in the company. And our actions thus far that you've heard us talk about the last couple of quarters have been focused on divesting and moving capital away from lower-returning assets to higher returning assets and to Brian's point, are right on strategy.

Operator: Thank you.

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

A

Next question?

Operator: ...from Steven Valiquette with Barclays.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Thanks. Good afternoon, everybody. So within the Med-Surg segment, clearly, a lot of variables driving the strong profit growth there. On slide 10, you mentioned the increased primary care business as one of those drivers. Are you able to comment just on the current level of patient volumes in the quarter, either as a percent of the pre-COVID baseline, either for your customer base or just your assessment of the overall US marketplace for physician patient visits? Thanks.

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

A

Yeah. I mean, I'll start and Britt can add some comments, if he'd like. Obviously, we think about patient visits. We think about elective procedures. You think about then primary care versus specialty. I would say, generally, we have been pleased with the market recovery. It's recovering in line with how we expected it to at the outset of the year. It is – we think it's continuing to strengthen, but as we'll reach in the second half of our year, like what we call, I guess, people call pre-COVID levels. So we think we're more or less right in line with our expectations, and we're really pleased with the performance of the Medical-Surgical business.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

A

Next question, please.

Operator: Will come from Ricky Goldwasser with Morgan Stanley.

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

Q

Yeah. Hi. Yeah. Hi. Good evening.

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

A

Hi, Ricky.

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

Q

Hi, there. So a quick follow-up on your last comment. You said pre-COVID levels second half of your fiscal year for the Med-Surg business. How should we think about when do we get to pre-COVID levels for the drug distribution? It sounded like specialty is already there. But how should we think about the segment in its entirety and in core? So that was kind of like the follow-up question. And then you're hosting the Analyst Day in December. So maybe can you give us a sense of granularity around what should we expect from the day next month?

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

A

Do you want to start with Pharma, and I'll take the Investor...

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

A

Yeah. I think similar to Medical, we are pleased with the performance of – volumes. They are approaching pre-COVID levels in pharmaceutical prescription volumes as we expected. So I think as we look to the rest of the year, we expect that these prescription volumes will get back to what we guided originally in May, which is in line with those pre-COVID levels. So we're continuing to see improved performance and improved volumes across all – both brand specialty and as well as generics. We expect that that will continue in the second half of the year.

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

A

Great. And as it relates to Investor Day, we are really excited to be able to have an Investor Day. We're going to host it December 8 in New York City. Probably would have done it sooner, but it's been quite a crazy environment for the last 18 or 20 months. In terms of what we hope to see is we really want to bring some more members of the management team, the executive team that have been leading the results that we've had a great chance to review with you. The team that's been responsible for developing these strategies; we want to provide just a little bit more insight and granularity into each of our growth strategies and in some of our core distribution businesses. And we plan to begin to outline our long-term growth prospects. So we think it's going to be a great day. We hope you can all join us.

Rachel Rodriguez
Public Relations Contact-Investors, McKesson Corp.

A

Next, question please.

Operator: We have one final question from Jailendra Singh, Credit Suisse.

Jailendra Singh
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah, thank you. Thanks for taking my questions here. Just wanted to make sure I understand what is in and what is not in the guidance with respect to vaccine benefit? It seems you're not including the benefit from vaccines designated for kids or booster shot. Is that true on both vaccine distribution benefit and the benefit related to the kitting storage and ancillary supplies as well? Just trying to understand if you see a reasonable adoption of boosters and vaccine among kids, will that drive incremental revenue in both Pharma and Med-Surg?

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

A

So your first part of the question, I think, answered your question. We are not including – we have provided guidance based on what the CDC has provided to us. And at this point, that does not include boosters and pediatric vaccines.

Operator: Thank you. And there are no further questions.

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

Okay. Well, thank you, Sarah, and thank you, everyone, for the great questions and for joining our call. I want to conclude my remarks today by just underscoring that we're hosting an Investor Day on December 8, and we hope everyone will get a chance to join us and tune in. We're going to have our leadership team there. The team that's been responsible for building the momentum in the business and executing the strategies that have been put in place.

We will spend some quality time on our oncology and biopharma strategic growth pillars. I think it's going to be a great day. We are really excited to be with everyone and see you. I also don't want to let this call lapse without thanking the McKesson team for their incredible work and their dedication as we round out the first half of our fiscal year. That's where the real work gets done, and I'm so proud of them. So thanks, everyone. I hope you have a great evening.

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