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McKesson Corp. (MCK)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to McKesson's Q4 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, Lashana. Good morning and welcome everyone to McKesson's Fourth 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'll 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 to Brian.

Brian S. Tyler

Chief Executive Officer & Director, McKesson Corp.

Thank you, Holly, and good morning, everybody. Appreciate you being with us on the call today. I sincerely hope that you and your families and your communities are staying healthy and safe as we navigate through these really extraordinary times.

Today, we reported a strong finish to our fiscal 2020, with the trends we saw in the fourth quarter prior to the COVID-19 pandemic reflecting a continuation of the momentum we experienced coming into and really throughout our fiscal year. Throughout McKesson's 187-year history, we've demonstrated time and time again our ability to adapt and swiftly respond to the evolving needs of our customers, particularly in trying times, and the resiliency and the long-term strength of our business model.

Today, my remarks will echo similar themes. I want to walk you through McKesson's response to the COVID-19 pandemic and the essential role we play in the healthcare supply chain, the progress we've made this year against our strategic priorities and our FY 2020 results, including the impact COVID-19 had on our fiscal fourth quarter. I also want to talk about why I'm confident that McKesson remains well positioned now and especially over the longer term.

Before I begin, I want to acknowledge and really sincerely thank all those who are working so tirelessly to keep us healthy and safe during this crisis, including our customers and all frontline healthcare professionals, nurses, physicians, first responders literally around the world. Thank you to each and every one of our 80,000 McKesson associates for their passion, their energy, in many cases, courage these past several months, working around the clock to maintain McKesson's operations and support our customers and frontline caregivers during these challenging times.

I want to particularly recognize our colleagues, who are on our front lines, like those in our distribution centers, in our pharmacies in Canada and Europe, supporting community practices and our transportation professionals, your commitment to making it happen, going the extra mile for our customers and rallying around one another in these times, it's – well, it's just what makes McKesson's culture so special that makes me incredibly proud to be part of team McKesson.

As one of the largest healthcare companies in the world, we have and we will continue to play an essential role in addressing the COVID-19 pandemic. Our response has been guided by the key principles of protecting health and safety for the healthcare supply chain, for our customers and for our employees and the communities in which we all live.

Early on, we enacted our business continuity and disaster recovery plans across the organization in order to maintain high-functioning operations around the globe. We assembled a Critical Care Drug Task Force comprised of our sourcing specialists and individuals with clinical backgrounds in health systems pharmacy to review guidelines and protocols, and to forecast changing pharmaceutical and medical product demand. This task force in conjunction with guidance from our government partners is working to predict, allocate and extend supply availability to serve the rapidly changing needs of our customers.

In addition, our ClarusONE and our global sourcing teams in London are working closely with manufacturers to understand their plans and to create new capacity or scale-up production, so that we can be prepared to swiftly react as a supply chain in the coming weeks, months and years ahead. McKesson is partnering with government agencies at the federal, state and local level, along with other industry leaders to creatively solve for the most complex and pressing issues this crisis presents.

As demand surges for personal protective equipment or PPE, McKesson is doing everything within our power to identify new sources, manufacturers and markets for these critically needed products. We are very proud of our partnership with Walmart to produce and deliver medical gowns to the US. Our two companies have collaborated in an entirely new way by bringing expert teams together and moving with remarkable speed, which has led to 2 million additional medical gowns in our country supply to date, and we expect roughly 10 million will be added by the end of June.

In Europe and Canada, our retail pharmacies have remained open, providing the essential community-based care that our customers rely on. We implemented several changes in our retail pharmacies to ensure our customers feel comfortable and safe, including limiting the number of customers in stores, installing protective shields at pharmacy counters, dedicating shopping times for seniors and for first responders, and regularly disinfecting all high-touch areas.

We're also expanding our pharmacy services to include virtual health offerings, home delivery in certain markets and increased online pharmacy capabilities. We've undertaken multiple measures to protect and promote the wellbeing of our employees. These include comprehensive sanitation protocols for our distribution centers and office facilities, work-from-home technology for our office-based employees, enhanced medical benefits, including telemedicine and wellness offerings and emergency paid sick leave.

Some of our very first actions were to recognize the stress that this situation would put on our frontline workers and our communities. So we made special payments to reward the hard work of our associates on the frontline and to bring some comfort and sense of calm to their families. We increased funding to our Take Care of Our Own Fund to help with expenses such as child care, groceries, housing and utilities. And we increased our Foundation funding to support our communities in their time of great need, including donations to support local food banks in communities where McKesson distribution centers are located around the US.

Our approach to address the pandemic underscores our value system and how we carry out our vision to improve care in every setting, one product, one partner, one patient at a time.

Turning now to our financial performance, we're going to review our fiscal 2020 results, our fiscal 2021 outlook and why we're so confident in McKesson's long-term future, despite the near-term uncertainties that are really facing everyone.

In fiscal 2020, McKesson delivered strong revenue and adjusted operating profit growth across the business. Our fiscal 2020 adjusted earnings per diluted share result of $14.95, which was up 10% versus the prior year, reflects continuing momentum and transformation within our business.

Coming into the CEO role a little over a year ago, I focused the organization around three strategic priorities, which I shared during our Analyst Meeting in December. I'd remind you, these priorities were growing our core US pharma business, investing in the areas where we have differentiated capability and growth prospects, and simplifying the business and better aligning the organization. I'm extremely pleased with the meaningful progress we made in executing against these strategic priorities in fiscal 2020.

In our U.S. Pharmaceutical Specialty and Solutions (sic) [U.S. Pharmaceutical and Specialty Solutions] (00:09:05) segment, we finished the year with the highest level of adjusted operating profit growth in our last four fiscal years. And we, again, this year successfully renewed large customers while being disciplined in our approach to the market, most recently, having been selected by the VA to continue to serve as their prime pharmaceutical vendor.

We believe our strong value proposition and superior customer service quality are foundational to this success. Our cost and working capital efficiencies underpin this growth and further fuel the strategic investments we're making in the business. We view our investments in data and analytics as investments in foundational capability, leveraging our scale to deliver greater value for our customers.

We're also making investments into areas where we believe we have differentiated capability and opportunity for growth. In alignment with our strategic growth initiatives, we're expanding our manufacturer value proposition to drive more innovation, better patient outcomes and additional uptake for our manufacturer partners.

We're harnessing our decades of experience in patient access and adherence programs and combining it with the connectivity and reach of CoverMyMeds within our MRxTS business to deliver new capabilities at accelerated speed. And we continue to prioritize specialty as a key area of future growth and investment. We have been building and investing in our portfolio of differentiated specialty assets for more than a decade, which gives us great expertise in areas like oncology.

Our third strategic priority is centered around simplifying the business and aligning the organization. We are becoming a more focused, more aligned and more agile company, a foundation that served us well during our COVID-19 pandemic response.

In fiscal 2020, we transformed our operating model through initiatives like our Spend Smart program and centralizing functional services across North America and in Europe. Evidence of our success in rationalizing costs and streamlining back office functions is also reflected in our positive European segment fiscal 2020 results.

Our Canadian business successfully streamlined its organization structure to better serve our retail and wholesale operations customers. This strategic change, combined with the continued execution of actions taken in the prior year, translated into good profit growth for the Canadian business this year.

We also invested a significant amount of time in our culture transformation and leveraged our corporate headquarters relocation to Texas to strengthen our management team. Five new members have joined my management team this year, and I could not be more pleased with how quickly the team has united together to execute our strategic and cultural priorities.

One of the most visible accomplishments we made in fiscal 2020 towards simplifying the business was the completion of our exit of Change Healthcare. This is a significant milestone in our company's history that was nearly four years in the making, and we're pleased to deliver on our commitment to create shareholder value through a tax-efficient exit.

Let me turn now to the trends that we're currently seeing on our business and how we're planning ahead for fiscal 2021 in light of these near-term macro uncertainties. I'll discuss these trends really in kind of more real-time granularity than we typically would and then Britt will further elaborate on my comments. We really want to help you understand how the rapidly evolving environment impacted not just our FY 2020 results, but also our FY 2021 outlook.

I'll start in the U.S. and Specialty Solutions (sic) [U.S. Pharmaceutical and Specialty Solutions] (00:13:01) segment. We saw increased demand in pharmaceutical sales during the month of March as consumers prepared for an extended stay-at-home. In turn, pharmaceutical sales declined below pre-pandemic levels in April, coinciding with the start of our fiscal year.

More pronounced was the decline in specialty provider volumes, primarily in the non-oncology markets. In oncology, as evidenced by US oncology practices, despite a decline in routine office visits such as consults and follow-ups, we are seeing relative signs of stability in oncology volumes as patients remain on their treatment regimens.

In our medical business, our alternate site customers are facing significant headwinds, with providers and surgery centers seeing sharp declines in office visits due to shelter-in-place guidelines that have taken effect. In our technology, our MRxTS business, we're seeing lower prior authorization volumes as a result of provider office closures and relaxed and sometimes extended requirements from payers. And in Canada and Europe, our retail pharmacy operations are navigating how to adapt to changing consumer needs as retail traffic is impacted by social distancing guidelines.

While it is still early in the quarter, we are currently seeing positive indicators and encouraging signs across all of our businesses that activities are beginning to pick up in the communities where shelter-in-place guidelines are being relaxed. With this as our environmental backdrop, we carefully and thoughtfully constructed our fiscal 2021 outlook based on what we know today.

Our fiscal 2021 outlook of $13.95 to $14.75 of adjusted earnings per diluted share factors in several macroeconomic and business-specific assumptions. Britt is going to take you through the detailed assumptions of our outlook, but let me comment on why I remain confident now more than ever in McKesson's future.

We have proven our resiliency and natural ability to lead during times of crisis such as H1N1, SARS, the recession of 2008-2009. I think the lessons we've learned and the expertise we've gained continue to serve us well. We operate from a position of financial strength. Our strong balance sheet, access to capital markets, strong credit ratings provide us great financial flexibility.

Our fiscal 2020 results reinforce the operational momentum we're generating in our business and we have repeatedly demonstrated our willingness and commitment to make the right, not always easy, but right decisions to best position the business for long-term growth. Despite the near-term challenges, we remain focused on executing against our priorities and investing in our strategic growth initiatives. The positive energy, dedication, commitment and togetherness of team McKesson is unmatched, and I do believe our future is bright.

I, again, thank you for your time, and let me now turn it over to Britt.

Britt J. Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thank you, Brian, and good morning, everyone. Our fiscal fourth quarter was certainly very different than we were expecting when we last spoke during our third quarter earnings call. The COVID-19 health crisis has impacted the way our employees, customers, partners and communities live and work.

We could not be prouder of how our teams across the world have responded. In this new environment, our team supported our employees, customers, patients and communities, and demonstrated the resiliency and strength of our business with solid financial performance during these challenging times.

Let me start by reaffirming that the fundamentals of McKesson's business are solid. Our strategy is clear, and the prospects for the business remain unchanged and promising. Despite the challenges and uncertainties of the current environment, our businesses continue to play a leading role in the healthcare supply chain. Our focus, execution and financial discipline remain intact.

Today, I'll provide you with more granularity than I typically do to help you understand our view on recent trends and how our business is performing in this uncertain and rapidly evolving environment. I have three primary goals for today's call: first, to provide an update on our fourth quarter and fiscal 2020 results, including the estimated impacts from COVID-19; second, to provide an overview of the recent trends we are seeing; and third, to provide a detailed fiscal 2021 outlook.

Many companies have withdrawn or not provided guidance. However, given the uncertainties in the environment and the wide disparity across analyst models, we felt it was important to provide our assumptions and views on the upcoming fiscal year. I will address our guidance in more detail later in my prepared remarks. However, I'd like to provide a bit of framing as it relates to fiscal 2021.

The guidance we are providing today assumes that the first half of fiscal 2021 will be challenging with the most severe impacts from COVID-19 occurring during our fiscal first quarter ending June 30. We anticipate that we begin to see gradual improvement in our fiscal second quarter ending September 30, with continued improvement in our results over the second half of our fiscal year.

Let me state at the beginning of this call, we expect the business will deliver growth in adjusted income from operations and adjusted earnings per diluted share in the second half of the fiscal year as compared to 2020 when setting aside the fiscal 2020 contribution from our prior equity stake in Change Healthcare.

Let's turn now to review of our fiscal 2020 results. McKesson posted a solid close to fiscal 2020 with full year adjusted earnings per diluted share of $14.95. This result was 10% above fiscal 2019 and included return to adjusted operating profit growth in all reportable segments.

Additionally, we're pleased to have completed the successful exit of our investment in Change Healthcare during the quarter through a tax-efficient split-off transaction. Our exit resulted in a pre and post-tax gain of $414 million, which impacted our GAAP-only results in the quarter.

With the split-off complete, we are well positioned to move forward with increased focus against our strategic growth initiatives. Our balance sheet remains solid, which underpins our investment grade credit rating. Our financial position provides us the flexibility necessary to navigate current market uncertainty and future growth opportunities.

On our February 4 third quarter earnings call, I discussed momentum building across the business. This momentum continued to build through mid-March. On March 11, the World Health Organization declared the COVID-19 outbreak a pandemic. Shortly after, our businesses experienced increased demand and consumer behavior patterns began to change as the virus continued to spread.

Pharmaceutical distribution volumes in the US, Europe and Canada increased, as people stocked up on medications and personal protective equipment. This incremental demand provided a net tailwind to our fourth quarter revenue results.

I want to take a moment and provide the estimated impact of COVID-19 on our fiscal fourth quarter consolidated results. There's approximately $2 billion of incremental revenue, resulting primarily from higher customer demand for pharmaceuticals. We expect this to reverse in the first quarter of fiscal 2021.

Adjusted gross profit in the quarter was favorably impacted by approximately $65 million, offset by approximately $15 million in variable operating expenses, as a result of these incremental volumes. We also had approximately $45 million of one-time adjusted operating expenses in the quarter, including investments in our frontline employees, higher expenses to support a remote workforce and charitable contributions to support our communities. In summary, the impact of COVID-19 had a nominal effect on our fourth quarter adjusted earnings results, as the previously mentioned impacts largely offset.

Let's transition now to a discussion of our adjusted earnings results for the fourth quarter. Fourth quarter adjusted earnings per diluted share was $4.27, up 16% in the quarter compared to the prior year, primarily driven by a lower share count and growth in the European Pharmaceutical and U.S. Pharmaceutical and Specialty Solutions businesses, offset by higher corporate expenses, which includes the one-time costs I referenced earlier.

Moving to the details of our consolidated results, which can be found on slide 4, consolidated revenues for the fourth quarter increased 12% versus the prior period, principally driven by growth in our U.S. Pharmaceutical and Specialty Solutions segment. As previously mentioned, the estimated impact of COVID-19 was approximately $2 billion of incremental revenue in the quarter. Excluding these incremental sales, consolidated revenues increased approximately 8% year-over-year.

Fourth quarter adjusted gross profit was up 7% year-over-year, led by growth in our Medical Surgical and U.S. Pharmaceutical and Specialty Solutions segments. Fourth quarter adjusted operating expenses increased 8% year-over-year, driven by increased investments to support future growth in our oncology and specialty businesses, technology infrastructure and the previously mentioned one-time expenses during the quarter. These incremental one-time and COVID-driven expenses accounted for approximately 3% of the year-over-year increase.

Adjusted income from operations was $1 billion for the quarter, an increase of 1% as compared to the prior year. Interest expense was $65 million in the quarter, a decline of 7% compared to the prior year, due to lower commercial paper balances. Our adjusted tax rate was 17.3% for the quarter, mainly driven by our mix of business and discrete tax benefits.

Wrapping up our consolidated results, our fourth quarter diluted weighted average shares were 174 million, a decrease of 9% year-over-year. Our adjusted earnings results includes a $0.07 benefit from our previously mentioned split-off of Change Healthcare, which lowered our shares outstanding by 15.4 million.

Next, I'll review our results, which can be slides 5 through 8, starting with the U.S. Pharmaceutical and Specialty Solutions segment. Revenues were $46.3 billion for the quarter, up 13%, driven by branded pharmaceutical price increases and growth from our large retail national account customers, including incremental volume resulting from COVID-19. These were partially offset by branded to generic conversions.

Fourth quarter adjusted operating profit increased 3% to $772 million, driven by continued growth in specialty businesses, partially offset by previously announced investments in the oncology and manufacturer services. Segment adjusted operating profit for the full year increased 6% to $2.7 billion and the segment adjusted operating margin for the full year was 146 basis points, a decrease of 4 basis points.

Next, European Pharmaceutical Solutions revenues were $7.2 billion for the quarter, an increase of 6% year-over-year. On an FX-adjusted basis, revenues increased 9%, driven by growth in the pharmaceutical distribution business, including incremental revenue as a result of COVID-19.

Fourth quarter adjusted operating profit increased 226% to $75 million. On an FX-adjusted basis, adjusted operating profit increased 239%, driven in part by lower operating expenses as a result of actions previously taken to rationalize our store footprint and streamline back office functions, and the lapping of a prior year inventory charge of approximately $20 million.

Segment adjusted operating profit for the full year increased 5% to $231 million, driven primarily by expense rationalization and the previously mentioned prior year item. Segment adjusted operating margin for the full year was 84 basis points, an increase of 4 basis points.

Moving now to Medical Surgical Solutions, revenues were $2.2 billion for the quarter, up 13%, driven by organic growth led by our primary care business, including higher pharmaceutical and flu test kit volumes. Segment adjusted operating profit for the quarter was down 1% to $170 million, driven primarily by higher expenses in the quarter, which included a provision for bad debt in our primary care business, partially offset by organic growth, principally in our primary care business.

Segment adjusted operating profit for the full year increased 12% to $679 million, driven by organic growth, and the segment adjusted operating margin for the full year was 818 basis points, an increase of 24 basis points.

Finishing our business review with Other, revenues were $2.9 billion for the quarter, up 3%. On an FX-adjusted basis, revenues were up 4%, driven primarily by growth in the Canadian and MRxTS businesses.

Adjusted operating profit was $242 million for the quarter, down 6% on both the reported and FX-adjusted basis, driven primarily by a lower equity contribution from the company's investment in Change Healthcare, partially offset by organic growth in the MRxTS business.

Other adjusted operating profit for the full year was down 4% to $953 million, driven by the lapping of a $90 million contractual liability reversal related to our investment in Change Healthcare in the prior year, partially offset by higher volumes in our MRxTS businesses.

Included in Other, adjusted equity income from Change Healthcare was $253 million for the full year. As a reminder, McKesson will no longer record adjusted equity income for Change Healthcare beginning in fiscal 2021 as a result of the split-off.

Moving to Corporate, McKesson reported $224 million in adjusted corporate expenses in the quarter, an increase of 25% year-over-year, driven primarily by the previously mentioned one-time expenses and higher opioid-related legal fees. These one-time expenses accounted for approximately 8% of the year-over-year increase.

For the full year, adjusted corporate expenses were $685 million, an increase of 23% compared to the prior year. The year-over-year increase was a result of planned increases in technology-related investments and an increase of $36 million in opioid-related litigation costs to $150 million for fiscal 2020.

Turning now to cash, which can be found on slide 10, for the fiscal year, we generated $3.9 billion in free cash flow, which includes $506 million spent on capital expenditures. Fiscal 2020 represented another solid year of cash flow generation, resulting from our continued focus on working capital efficiency, positive timing impacts and COVID-19. Similar to fiscal 2019, a portion of the fiscal 2020 result was due to favorable timing in our US distribution and European businesses.

We also benefited from the previously mentioned demand pull-forward in response to the COVID-19 pandemic, which coincided with the end of our fiscal year. We estimate a COVID-19-related benefit of approximately $550 million, which is expected to reverse in the first quarter of fiscal 2021. We ended the quarter with a cash balance of $4 billion, after paying down approximately $2.4 billion of debt in the fourth quarter, net of issuances, which include a repayment of $2.1 billion of outstanding commercial paper. And in fiscal 2020, we returned $2.2 billion to our shareholders via share repurchases and dividends.

Wrapping up fiscal 2020 results, our performance in the fourth quarter highlights the resiliency of our business model and the strength of our financial position. Fiscal 2020 marked a return to adjusted operating profit growth across every business, reflecting improved fundamentals and solid execution. Despite recent macroeconomic headwinds, the company is in a solid and stable financial position.

With that, let me turn to our fiscal 2021 outlook. As I mentioned in my opening remarks, we believe it is important to provide our views of the environment, insight into the trends we are seeing across our businesses and to provide an outlook for fiscal 2021. We believe it's constructive to provide you with our view of the business, including our perspective on the economic uncertainties surrounding the potential impact and duration of the COVID-19 pandemic.

We take a long-term approach to our businesses. And although the COVID-19 pandemic presents a near-term headwind, we believe this to be temporary. The underlying fundamentals of our business remains stable and on solid footing as evidenced by our Q4 and full year results for fiscal 2020.

I'll start by providing a brief overview of the environment we are operating within. After the initial volume spikes following the March 11 World Health Organization declaration, volumes began to trend lower across our businesses. In April, the landscape continued to evolve quickly and state, provincial and local governments issued shelter-in-place orders.

As a result, physician offices and surgery center sites began to close temporarily, meaning fewer patients going to see their doctors and delays in elective procedures. Throughout April, average weekly volumes in our medical and specialty provider business trailed off up to 50% of pre-COVID-19 levels. Oncology visits declined, while volumes in our pharmaceutical distribution and retail businesses experienced greater levels of volatility as customers adjusted to the environment and government orders and recommendations.

From the onset of the pandemic in the US, elective therapies showed a sharp decline through April, especially within ophthalmology, where declines were nearly 30% versus calendar 2019. In the first couple of weeks of May, we've seen volumes begin to stabilize and modestly improve in our pharmaceutical and retail businesses.

Volumes in our medical and specialty provider businesses have also begun to stabilize, although well below pre-COVID levels. To this point, the relative shape of the curve is in line with our expectations and confirms our view on the progression of recovery over the course of fiscal 2021.

I will note that the guidance we are providing today is based on what we know at this time, and I want to be clear that one certainty is that events will occur in the coming days, weeks and months that will cause these underlying assumptions to change from what we present to you today.

Next, I'll provide some framing on a couple of key macro level economic assumptions. We are not assuming that a second wave of the virus returns, leading to shelter-at-home scenarios precluding patient consumption of healthcare services, supplies and pharmaceutical products. We are not assuming any systemic customer insolvency events.

We do assume that unemployment peaks in our fiscal first quarter, and gradually begins to improve across the remaining quarters of our fiscal year. We do assume that physician and oncology office visits and pharmacy interactions will begin to gradually resume in our fiscal second quarter and continue to improve in the back half of our fiscal year.

Our view of the environment, in particular, our largest market, the US, assumes that the impact, in particular, to our medical, specialty provider and oncology businesses is more significant and severe in the first quarter and that the shape of the recovery gradually improves each quarter with a return to more normal volumes in our fiscal fourth quarter. With those underlying assumptions in mind, let me turn to our fiscal 2021 guidance.

We expect adjusted earnings per diluted share to be in the range of $13.95 to $14.75, which is notably wider than past guidance ranges, given the economic uncertainty inherent in our previously mentioned assumptions. As I discussed in my opening remarks, we anticipate a positive progression of earnings over the course fiscal 2021. We expect Q1 to be sharply down on a year-over-year and sequential basis.

We assume modest recovery begins in our fiscal second quarter and that this recovery progresses into the back half of the fiscal year, with the business returning to adjusted income from operations and adjusted earnings per diluted share growth in the second half of the fiscal year. For a full list of fiscal 2021 assumptions, please refer to slides 12 through 14 in our supplemental slide presentation.

Rather than outlining each assumption, I'll instead walk you through the key items, starting with the segments. In the U.S. Pharmaceutical and Specialty Solutions segment, we expect 3% to 6% revenue growth, which considers current headwinds in our practice management and provider solutions businesses as a result of office closures and delays in elective procedures.

Adjusted operating profit is expected to be flat to 4% down as compared to the prior year, as a result of the previously mentioned headwinds in our specialty businesses. We expect that the second half adjusted operating profit result will reflect flat to 3% growth, in line with our previously outlined recovery assumptions.

In the US market, we anticipate mid-single-digit branded pharmaceutical price increases, largely consistent with our experience in fiscal 2020. As a reminder, approximately 95% of our contracted branded manufacturers are on a fixed fee-for-service rate basis.

Moving to the European Solutions (sic) [European Pharmaceutical Solutions] (00:36:00) segment, we expect revenues to be flat to a 5% decline as compared to the prior year. Adjusted operating profit is also expected to decline between approximately 20% to 25%, driven by anticipated impacts of the COVID-19 pandemic on customer behavior patterns over the first half of the fiscal year. We expect that the second half adjusted operating profit results will be flat to 2% growth as compared to the prior year, with variability by country as each market opens and begins to return to normal.

Transitioning now to Medical Surgical, as we've discussed previously, we have a dynamic and broad portfolio in Medical Surgical. Approximately 60% of our Medical Surgical business supports primary care sites, physician offices, ambulatory surgery centers and reference lab locations. These sites of care have been impacted more significantly as office visits and elective procedures have been canceled or deferred.

In constructing our outlook for the Medical Surgical segment, we developed several potential outcomes to inform the range from the low end to the high end of our estimates. We projected it could take a few quarters for patients to get comfortable returning to physician office sites and with scheduling an elective procedure, but we do believe this demand will return.

Over the past few weeks, we've seen our Medical Surgical business begin to stabilize, and we see modest improvements in volumes. We expect the recovery in demand to continue through our fiscal second quarter, with further improvements in the second half of our fiscal year.

Therefore, we expect a 3% to 8% revenue decline, primarily driven by softened demand in the first half of the fiscal year. As a result of these macro level headwinds, we also expect a 10% to 20% adjusted operating profit decline for the full year. As demand continues to improve, we expect that the second half adjusted operating profit results will grow 5% to 15% as compared to the prior year.

For the remaining businesses included in Other, revenue is expected to decline approximately 7% to 12%, driven by expected lower foot traffic in retail stores across Canada in the short-term and lower prior authorization volumes.

As a reminder, fiscal 2020 results include our investment in Change Healthcare, which included $253 million in adjusted equity income in fiscal 2020. Excluding the Change Healthcare results in the prior year for comparison purposes, we expect that adjusted operating profit within Other will be flat to down 5% for the full year, but it is expected to increase greater than 10% in the second half of the fiscal year as the businesses within Other return to normal volumes.

Now, let me turn to the consolidated view. We expect 2% to 4% revenue growth and adjusted income from operations is anticipated to be a 10% to 15% decline as compared to the prior year. Excluding the results of Change Healthcare from fiscal 2020, we expect that adjusted income from operations will decline 5% to 8% for the full year, but will grow 6% to 10% in the second half of the fiscal year on a year-over-year basis, in line with our stated economic recovery assumptions.

We expect corporate expenses to be approximately flat compared to prior year, and this assumption reflects opioid-related litigation cost to also be roughly flat year-over-year. We remain focused on our cost savings programs. Our annual pre-tax gross cost savings target remains approximately $400 million to $500 million, which we are on track to substantially realize for the end of fiscal 2021.

Additionally, we've implemented mitigation efforts in light of the headwinds presented by the COVID-19 pandemic, including an effort to continue to reduce controllable spend across all categories.

Moving below the line, we expect interest expense in the range of $230 million to $250 million. We expect income attributable to non-controlling interest in the range of $200 million to $220 million. We assume a full year adjusted tax rate of approximately 18% to 20%, which may vary from quarter-to-quarter and includes anticipated discrete tax items that we expect to realize during the course of the year.

We anticipate the impact of foreign currency exchange rate movements be a net unfavorable impact of approximately $0.05. And we expect weighted average diluted shares outstanding for fiscal 2021 to be in the range of approximately 161 million to 163 million.

Let me wrap up our fiscal 2021 outlook with a few comments on cash flow and capital deployment. We expect free cash flow of approximately $2.3 billion to $2.7 billion, which is net of property acquisitions and capitalized software expenses and includes the pull-forward impacts of COVID-19 previously discussed.

We will use our cash flow to continue to invest internally in our strategic priorities of oncology and manufacturer services. We anticipate property acquisitions and capitalized software expenses to be in the range of $400 million to $550 million.

At McKesson, capital deployment starts with our continued ability to generate healthy operating cash flow. We will continue a disciplined and balanced approach to capital deployment. Our priorities remain clear and consistent. Our demonstrated history of solid cash flow generation provides us flexibility in our capital allocation program.

First, we prioritize growth investments in our strategic assets. As an example, in Q4, we continued to invest into our oncology and manufacturer services assets and capabilities to extend our differentiated and leading positions.

In fiscal 2021, we will continue to invest in our strategic initiatives to drive further differentiation and position our businesses for long-term growth. The current environment does not impact our desire to invest in M&A opportunities that are on strategy at multiples that offer superior returns on capital and accelerate future growth and cash flow generation.

We also remain committed to returning capital to our shareholders through a modest yet growing dividend and share buybacks. And I would remind you that we currently have $1.5 billion remaining on our share repurchase authorization.

We've maintained our investment grade credit rating, which underpins our financial flexibility and our ability to access the long-term debt and commercial paper markets. We also have access to $4 billion through our revolving credit facility, which has not been drawn upon. At this time, we have no immediate need to access the long-term debt market, nor draw upon our revolver to meet near-term liquidity needs.

In closing, we are pleased with the results of our fiscal fourth quarter and proud of how we responded to the extraordinary demands brought on by this pandemic. We remain focused on our employees, customers, partners, and communities. While the external environment presents many unknowns, our businesses continue to show resilient and stable fundamentals along with consistent execution.

We continue to have a solid balance sheet and healthy cash generation, which underpin our investment grade credit rating, and we'll continue to deploy capital to invest in growth areas aligned to our strategy, aimed at creating balanced returns for our shareholders. Despite the current macroeconomic headwinds, we remain confident in our business and in our ability to create stability in the supply chain through the strength of our sourcing and distribution operations.

And with that, I'll turn the call over to the operator for your questions. In the interest of time, I'd ask you to limit yourself to just one question to allow others an opportunity to participate.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And your first question comes from Michael Cherny with Bank of America Merrill Lynch.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

Good morning. Thank you for all the details. I want to just ask a bit of a follow-up clarification, additional question on the pharma EBIT guidance, in particular you talked about 0% to 3% growth in the second half of the year on an adjusted profit basis. So, as you think about the ramping, should we assume that you'll be exiting fiscal 2021 at a "normalized run rate?" And jumping into fiscal 2022, on what should be the normalized run rate or profit growth for the pharma segment in particular?

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

A

Hi, Mike, thanks for that question. I'll start and let Brian add on to that. We're very pleased with our performance in our U.S. Pharma and Specialty Solutions segment in fiscal 2020. We finished the year with full year adjusted operating profit of 6%. We had strong revenue growth throughout the year. And as we talked about, we expect that the first half of the year, we're going to have some more sharp impacts on our Specialty Solutions businesses, which will impact, obviously, the full year operating profit.

As we talked about, we expect that to continue to improve throughout the year. And as we get to the back half of the year, that gradual improvement throughout each quarter will lead us to get back to growth for the second half of the year. And so I think that as you think about this, there's going to be gradual improvement across each quarter. As we get to the end of the year, we're going to be exiting on a growth basis again, and feel good about the prospects from that point forward.

Operator: Your next question comes from the line of Robert Jones with Goldman Sachs.

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

Q

Great. Thanks for the questions. I guess, maybe, Britt, just a follow-up on that. I mean, coming into fiscal 2020, you guys had thought the U.S. Pharma and Specialty business could grow at 3% to 5%. I'm sure there was a little bit of pull-forward in the 4Q. But generally, business performed in line to slightly better than that.

I mean, just to follow-up on your previous answer, I mean, is the assumption that the business kind of gets back to those levels as we get through the year and, in particular, into 4Q? And then just one housekeeping. I know you mentioned the $45 million of one-time adjusted operating expenses in the fourth quarter. I was curious if that was included, excluded, and then what's the assumption for additional COVID-related costs in 2020 guide? Thanks.

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

A

Yeah. Thanks for the question. Let me just step back to your first question. Again, as we talked about, in our U.S. Pharma and Specialty Solutions business, it's a broad business, US pharma distribution, but also a broad-based specialty set of businesses, which includes our multi-specialty provider businesses, which as we talked about have been more severely impacted in April and early May, and we expect to have a greater impact through the first quarter with just gradual improvement throughout the balance of the year.

So as we think about that second half of the year, it's really going to be that continued improvement of not only volumes, but profitability across both of those businesses. And we feel comfortable that getting to a 0% to 3% growth in the balance of the second half, again, with that gradual improvement, sets us up well to returning to that 3% to 5% as we go forward.

We won't recover all of the volumes this year. We'll recover gradually throughout the year. But again, I just would point out that our broad-based specialty business, which includes our provider business and our practice management business are more impacted and are going to gradually improve over the balance of the year.

The $45 million that I referenced earlier on, that was across all of our businesses. It was, as Brian mentioned, to pay bonuses to frontline workers in each of our businesses as well as donations that we made across communities as well as cost to set up remote work environments, again, in our corporate environment, but also in our businesses. That's, obviously, part of the year-over-year comparison that is included in our FY 2020 Q4 results, and that will be included in for comparison purposes in FY 2021.

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

A

Yes. Those are actions taken really early part of March as we assessed the impact this would have on our teams, and frankly, anticipated the impact on our communities. And we thought it was just important part of who we are as a company to take those actions. Obviously, as we look to the year coming ahead, there will be some incremental expense to support social distancing, workplace reengineering, protection of customers and employees, and we'll be continued to be committed to make whatever investments we need to take care of them.

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

A

Next question?

Operator: Your next question will come from Eric Coldwell with Robert W. Baird.

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

Q

Thanks very much. Good morning. Thanks for all the details. A couple of just unrelated questions. First one, share repurchase. You expressed interest in continuing with that program, but weighted average shares outstanding guidance seems a little bit higher than we would have expected given the low share price right now. I'm just curious if you can give us any specificity on what you're thinking about share repos?

Second question, unrelated, US oncology, it would be great to get an update on what you're seeing real-time with your practice management business and what impacts you're getting from COVID? Thanks very much.

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

A

Thanks, Eric. Let me start and take the first one off the table and then turn it over to Brian. As I mentioned, in the fourth quarter through the exit of Change Healthcare, we retired 15.4 million shares. And we've given you a guide of 161 million to 163 million. Our capital deployment program will include broad-based balanced approaches we always have, and that will include M&A as it presents itself on strategy and with good returns, but it also include continue to return capital to our shareholders which could include share repurchases. And we do have $1.5 billion remaining on the authorization, and we'll continue to use that to return capital as it's appropriate.

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

A

Yes. Let me maybe take up the US oncology question. So we worked very closely with our partners in the practices to respond to this unprecedented time and it's impacted all care providers. The US oncology patient visits have certainly declined as social distancing guidelines were implemented, and that impact is really varied depending on what kind of oncology, what kind of cancer you're experiencing.

I mean, you see in the very fast-moving aggressive cancers, patient volume has not fallen off so much. In some of the solid tumor cancers where progression is slower, people are more hesitant to go in and get testing, get diagnosis, may feel they had some time to delay. So we have seen a bit of visit decline, but the revenue decline has been less than the visit decline, which is encouraging to us.

We've also taken actions to implement things like telepresence or virtual consultation services, and we've ramped up that pretty significantly in the last few months. So, overall, I think, I'd say, we feel good about our positioning, oncology of all the ologies or specialties has probably been a little more insulated as you think about diseases that's probably not unexpected. But we continue to work closely with our practices to think about all the ways we can help feel – make patients feel more comfortable to returning to their care.

Operator: Your next question will come from the line of Eric Percher with Nephron Research.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you for the details and for your efforts. A question on MedSurg, the metric on 60% of this being provider focused was helpful. I imagine there's some very different dynamics in the ASC versus the physician office. Could you help us with an understanding of what your distribution business here focuses on? I'm thinking less on PP&E and potential benefits there. Are there significant pharmaceutical elements? Is there a number that you can provide us relative to the pharmaceutical component of medical and any expectation for vaccines or experience with the Vaccines for Childrens Program (sic) [Vaccines for Children Program] (00:53:41)? How is that running? And how might you participate in vaccines in the future?

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

A

Great. Thanks, Eric. Appreciate that question. Our medical business does have a significant footprint in primary care, which we include the ambulatory surgery center in there. And within the kinds of practices, we serve basically all different kinds of practices from general practitioners, OB/GYN, even up to special – more specialty-oriented practices with medical products. And so there's been a pretty wide variation in the way specific specialties or focuses of those practice would have responded. And as you're well aware, we have a very broad offering to these practices.

It is PP&E, which it tends to be a pretty small, historically a very small part of these practices. Obviously, in the last months, with social distancing and all the changes we've all experienced, the PP&E demand is up significantly. But we're also in specialty Rx, Rx, lab, equipment, reagents. I mean, we've a very, very broad business.

And what I would say to you is that, we see patient volumes decline, and as Britt reviewed the metrics that we've seen there, I mean, really all of those various elements have been impacted. And as patients begin to return to the practices, we think we'll begin to see those volumes all rebuild over the course of the coming year. It's – obviously, from a vaccine perspective, it's a little early. Vaccines are not on market. But I would remind everybody, we have quite an extensive footprint in the distribution of vaccines today. We do distribute vaccines through the medical business to all of our practice areas.

We are – we work with CDC and their Vaccine for Childrens Program (sic) [Vaccines for Children Program] (00:55:40) program as a supplier of those vaccines. Many years ago, when H1N1 hit us, we worked with public partners to facilitate a program to manage that vaccine. So we're very engaged with all the various agencies that will have interest in this, with our manufacturer partners to make sure we're availing our insights and our knowledge and our capability. And I suspect that as vaccines come to market, acceptance ramps up, we'll have to look at what is the production, how does that production scale up and how fast? But we would expect to be very engaged in those discussions.

Operator: Your next question comes from the line of Lisa Gill with JPMorgan.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Thanks very much and good morning. Brian, can you give us an update on where you are as far as an opioid potential settlement? I know we talked about the framework, which was several months ago. Sitting here today, I would anticipate that states being in a difficult financial position may be more likely to want to move forward. So if you could just give us any update there, that'd be really helpful.

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

A

Sure, Lisa. I'd be happy to. I mean, probably goes without saying that our primary focus the last weeks and months has been on responding to COVID-19, supporting our communities and our customers in that response. And I'm sure the same has been true for a lot of the public officials that have been involved, I guess, on the other side of this opioid issue.

I really don't think there's a lot to add to the commentary we provided last time in terms of the specifics of the settlement discussions. I mean, we continue to be engaged. We continue to be hopeful that a broad resolution can be achieved. We do think that one of the drivers has always been for us the recognition that people and communities have needs, and it would be great to get the resolution for them and those needs are probably greater now than ever.

Operator: Your next question comes from the line of Brian Tanquilut with Jefferies.

Brian Gil Tanquilut
Analyst, Jefferies LLC

Q

Hey, good morning, guys. Brian or Britt, as I think about the guidance, and obviously, I appreciate all the color you've given in terms of your assumptions. But as we stare down a recession heading into 2021, I mean, based on your experience being with the company during the last recession, how are you thinking about just the likely decline in physician office visits and how your business will be resilient through that?

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

A

Great question. We've – our business has been through many economic cycles over its history. Fortunately, Britt and I weren't here for all of them, but we were here for the 2008, 2009 one. And what I would say in general is I think our business model is pretty resilient to an economic recession. And I think if you look back over history, you would see that to be the case.

I will say this situation is a little bit different, though, because it's an economic recession, but it's really driven by an underlying health pandemic. And so, in my mind, the way the business will respond is a little bit more about how we respond to the health pandemic than a "recession." The faster patients get comfortable being out of their homes, the faster they get comfortable going into healthcare settings, the faster social policy, testing, tracing, all these things we're talking about in the business and the public community, and as these comes to place and our confidence resumes, I think that's really what's going to tilt the trajectory.

And so for me, it's much more about how healthcare demand comes back than the general economic climate. I mean, there's always puts and takes with are you uninsured with no coverage? Do you go to Medicaid? But those are – we tend to be a little more insulated from that. So I think it's really all about how quickly confidence comes back in patients consuming healthcare services.

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

A

Yeah. I might just add that our guidance really assumes that healthcare demand will return. We've seen that in prior recessions like this. And our guidance really assumes that it's a gradual build over the course of the year. We're already seeing some – as I mentioned, we're seeing some evidence of modest increases in May, that's early obviously, but we do expect that healthcare demand will return, and we do expect that we'll be well positioned for that in really in all the different settings that we participate in.

Operator: Your next question comes from the line of Stephen Baxter with Wolfe Research.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Hey, thanks for the question. I hope you all are doing well. This is a bit of a follow-up on the prior question about the economy in a more normalized recession. I was hoping you could spend a little time talking about how we should think about the financial healthier customers and how you could see the business being impacted by that in the coming months and years. For example, there are headlines in the news today where even large and well-funded businesses are seeking relief from landlords. So, I guess, what, if anything, are your customers asking of you at this stage? Any insight into your conversations with your customers would be helpful? Thanks.

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

A

Thanks for that question, and it's a really good question. And we've been working with our customers since the pandemic really started, and particularly those customers who have had to shut their doors on a temporary basis. We did record a small incremental reserve in our medical business in the fourth quarter, and I called that out. It's really more a mechanical adjustment.

We've been working very closely to try to understand when these customers would reopen, what the demand is in each of their businesses. And to this point, our customers have either been able to go out and get loans or access public funds that are available, work very closely with us, and we've been able to help them and really understand what their situation is. So we've not really seen a degradation in credit quality to this point. We'll continue to work very closely with those relationships. At this point, I think our customers are very resilient as well, and we're very close in working with them to keep them as credit resilient as possible.

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

A

Yeah. And based on the way we've described our expectation for volume to come back gradually over the course of the year and based on what we see now, you did call out that we built into our assumptions is that there is no major insolvency event. Now, if our assumptions play out correct, we believe based on our conversations and what we are seeing, that will continue to be true. So, risk, we'll monitor very closely over the course of the year.

Operator: Your next question comes from the line of Steven Valiquette with Barclays.

Steven Valiquette
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning, Brian and Britt. I hope everyone is staying safe. So I just have two interrelated questions on the European business. First, I guess, I'm curious how the German JV transaction with Walgreens impacts the FY 2021 guidance for the European segment, Germany generally included or excluded from the European guidance.

And then second, I guess, whether Germany is in there or not, I guess, what really sticks out to me is that the magnitude of the expected decline in operating profit in Europe, minus 20% to minus 25% relative to the revenue guide, 0% to minus 5%, 6% out a little bit, suggesting some notable negative operating leverage in Europe versus some of the other segments. Any color on the dynamics there would help as well. Thanks.

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

A

Generally, so start with the German JV, I don't think this will be material to our fiscal 2021. It is in competition review right now. We think it's continuing to progress on the timelines we expected to, so not really a lot to add to that.

As it relates to the fiscal 2021 impact on Europe, I mean, obviously, we're dealing with 13 countries that are going to have – have had 13 different kind of degrees of challenge and reaction with associated social policy to that challenge. And so, when we look at an aggregate level, it's going to depend a little bit on how these countries reopen and what their response will be. I will say that in the UK, our largest country in Europe, I mean, they have been one of the more severely impacted and have had some of the more severe social restrictions implied, and that's what you're seeing really flow through our numbers.

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

A

Maybe if I would just add on, our German business, as we talked about previously, is relatively immaterial to the overall European results. It is included – we did include Germany in our FY 2021 plan. But again, it's relatively immaterial.

I would just point to the fact that our second half European results in FY 2020 were quite good and we exited the year with pretty strong performance. And as we think about FY 2021, really gets back to what we've talked about with many of our other businesses that there is a temporary shock that is more severe in the first half of the year. And as Brian mentioned, mix matters a lot. How do countries open, one by one, they'll open at different rates in different times, and that mix is really what you're seeing flow through our business and our 2021 outlook.

Operator: Your next question comes from the line of Ricky Goldwasser with Morgan Stanley.

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

Q

Yeah. Hi. Good morning. My question is focused on generic pricing. We're hearing that manufacturing in India is below historical levels and, obviously, freight costs are seeing some step up. So what are you seeing on the buy side environment? How are you thinking about return to generic inflation in your fiscal year 2021?

And then also along the line of manufacturing, yesterday, HHS gave some funding to manufacturing of drugs in the US. Any thoughts of whether we will see generic manufacturing coming back to the US and what role would you play in that type of a scenario?

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

A

Thanks, Ricky, for that question. Let me start with your first question and then let Brian take it from there. From a generic perspective, we continue to have a very strong sourcing organization, which has really benefited us well as we've gone through this period. The relationships that we have with manufacturers, our ability to continue to secure supply in a very stable and consistent manner has played well for us.

On the sell side, we continue to see a relatively stable environment. And so there's competition, but pricing has continued to be stable and competitive. And so that's allowed us to continue to earn a spread on our generic products. And I think it really – it starts with our ability to secure that supply in a consistent manner, and ClarusONE has been able to do that very well over the last several years, honestly, and we expect that to continue into FY 2021.

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

A

Yeah. I think from an overall perspective, I mean, it's been pretty good performance industry-wide in terms of supply availability. And, obviously, we began monitoring this very closely. I mentioned we set up our critical care task force in really the very end of our fiscal 2020 to continue to monitor this. Frankly, we get very detailed updates every week on that. So I think, generally, we still feel okay. I [ph] would say (01:08:12) we've seen anything I would describe as a material change in pricing or ability to supply and things of that nature.

I mean, to your last question about will generic supply come back to the US or will – I think the broader question is, how will diversification and how will the supply community think about being a little bit more buffered for future events that may look like this. And that – those are – it's very early. I think there will be a lot of good questions asked, a lot of good work done. We do think anything that diversifies availability of supplies creates kind of a insurance mechanism, if you will.

We are supportive of that. We also have to recognize there are trade-offs in that. I mean, there are cost trade-offs and figuring out how that cost gets funded and whether that's working capital or cost of the product, we'll have to navigate ourselves through. But we're involved in many of these conversations, but I'd characterize them all as very early stage right now.

Operator: Your next question comes from the line of Kevin Caliendo with UBS.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Hi. Thanks for taking my call. I really wanted to delve into the cost side a little bit, understanding that there's an ongoing larger cost savings plan. But going through the businesses, if you would, talk about how much variable spending you have in each and really what the plan is, just thinking in looking at the margins and backing into sort of what you're saying, the margins versus the revenues definitely look like, and I'm just trying to gauge how much variable spending you might be taking out of the business or not?

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

A

Yeah. Thanks for that questions. Certainly, each of our businesses is a little bit differently positioned in terms of fixed versus variable cost. And I think the challenge that we're having in our first half of the year, in particular, is that the revenue declines are quite sharp. And so that kind of revenue decline is really putting pressure on the overall cost position.

I did talk about the fact that we've implemented mitigation plans across all of our businesses and across all of our different cost categories, and this is an extension of what we're already working on with our cost savings program. So we're certainly making great progress on that. We do have some things in our structure that will remain the same year-over-year in our material, like the opioids litigation-related costs, which we expect to continue to be $150 million.

But generally speaking, our variable costs will adjust with the volumes that we're seeing. But because some of our businesses have more significant and severe declines in volumes over the first half of the year, there will be some deleveraging that occurs in our businesses over that period. And as the year goes on, cost savings initiatives that we put in place, not only our cost savings program, but these mitigation activities will generally start to benefit our businesses and lead to that growth that we're seeing over the second half of the year.

Operator: Your next question comes from the line of Glen Santangelo with Guggenheim.

Glen Santangelo
Analyst, Guggenheim Securities LLC

Q

Hi, yeah, thanks for taking my call. I just want to follow-up on this negative operating profit leverage question. I mean, I appreciate all the details. But maybe, Britt, could you unpack the guidance a little bit at the gross margin line, particularly as it relates to things like mix and drug pricing and contract renewals, because what I think all of us are probably trying to understand is maybe how much of the operating profit contraction may be the result of a weaker gross margin versus lower revenues or incremental expenses related to something like COVID and that will maybe help us better assess how much of the incremental expense is maybe one-time versus ongoing? Thanks.

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

A

Yeah. Thanks for that question. Again, what I would come back to here is and I tried to give you a little bit more detail into where we're seeing the impacts on our business, and in particular, if you just talk about our medical business for a moment, that medical business has an adjusted operating profit rate of over 800 basis points. That is one of the most severely impacted of our business.

And we try to give you a little bit more detail in the sense that our primary care business where we have lots of capabilities and services that we provide there, about 60% of that medical business is primary care sites, which have been the most severely impacted. So what I would say is it's not necessarily a cost issue and we do have additional cost for protecting our employees and sanitation and cleaning in our distribution facilities. This is more a first half mix issue, particularly in our specialty provider businesses and our medical business, which as you know has a higher adjusted operating profit rate.

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 George Hill with Deutsche Bank.

George Hill
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, good morning, guys, and thanks for taking my question. I thought Glen had just kind of stormed it, but I will dive in on the US margin guide one more time. You guys called out in Q4 that branded generic conversions, which we normally think of as a tailwind to margins or a positive impact. I guess, as we look at the 2021 margin guidance in the drug segment, could you kind of rank order what's driving the margin erosion when we think of either customer mix, product mix, VA renewal or COVID, just kind of rank ordering the negative margin mix drivers. Thanks.

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

A

Yeah. Thanks for that question. Again, I would come back to what we're seeing is within our business, our specialties provider businesses are most impacted, so that's certainly having a big impact in the first half of the year. We've called out very similar types of mid-single-digit branded price increase rates that we've seen over the past couple of years, that's really not an impact. Renewals are not an impact, we talked about we've been able to renew our – sort of three of our largest customers without an impact to our guide.

So I'll just get back to, as you think about where the recovery and the shape of the curve in our business is, most severely impacted is our physician sites, our specialty provider sites. Those tend to be higher growth and higher margin businesses for us, and that mix is really what's impacting the business. There's nothing fundamentally or structurally going on within our business. Our business continues to be very, very fundamentally sound. This is a matter of a temporary decline in revenue and really a mix issue of where that revenue is coming from, but there's nothing fundamentally changing within the business itself.

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

Great. Well, thank you. Thank you, everybody, for your participation today, for your interest in McKesson and, certainly, your great questions. I want to thank Lashana for facilitating this call for us. Obviously, this was a little longer call than we typically have, but we thought it was very appropriate given the environment to try to provide a little more detail insight into what's going on in the business.

McKesson has navigated challenges many times before. Our industry and our countries have navigated these kinds of challenges many times before. I think it's fair to say, I know I and we all probably take great inspiration from our frontline healthcare workers and our essential workers like those in McKesson. And I want to thank the 80,000 members of team McKesson for their dedication and the inspiration they provide me every day. I am confident that we're well positioned to emerge from this experience as a stronger business and in stronger communities.

On behalf of our team at McKesson, we wish you and your families good health and wellness. We very much look forward to seeing you soon.

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