31-Jul-2019

McKesson Corp. (MCK)

Q1 2020 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Michael Cherny
Analyst, Bank of America Merrill Lynch

Kevin Caliendo
Analyst, UBS Securities LLC

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

Ross Muken
Analyst, Evercore ISI

Stephen Baxter
Analyst, Wolfe Research LLC

Eric Percher
Analyst, Nephron Research LLC

Brian Gil Tanquilut
Analyst, Jefferies LLC

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

Charles Rhyee
Analyst, Cowen & Co. LLC

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

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the McKesson Q1 Earnings Call. Today's conference is being recorded.

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

Holly Weiss

Senior Vice President, Investor Relations, McKesson Corp.

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

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

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

With that, let me turn it over the Brian.

Brian Scott Tyler

Chief Executive Officer & Director, McKesson Corp.

Thank you, Holly, and thanks to everyone for joining us on our call today. We're pleased today to be able to report a strong start to our fiscal year 2020. For the first quarter, we achieved total company revenues in excess of $55 billion and adjusted earnings per diluted share of $3.31, ahead of our original expectations. On our fourth quarter call in May, I discussed that we were entering the fiscal year with positive momentum and I feel really good about this underpinning our first quarter results.

We're seeing healthy growth across many parts of our business, which is a direct result of the actions we have been and are taking to execute on our strategic imperatives, which are enabling us to become a more focused and efficient company. And our balance sheet remained strong, giving us the flexibility to deploy capital that can differentiate McKesson and create shareholder value. As a result of our first quarter performance, combined with our confidence in the business as we look ahead, we're raising our fiscal 2020 adjusted EPS guidance range of $14.00 to $14.60. This is from our previous range of $13.85 to $14.45.

Now, turning to the business. I'll summarize our first quarter results and then turn the call over to Britt to elaborate. The U.S. Pharmaceutical and Specialty Solutions had a good start to the year, driven by our broad set of specialty biopharmaceutical capabilities focused on both providers and manufacturers. I'm particularly pleased as this demonstrates the progress we're making on one of our three key strategic imperatives. We continue to see biopharma dynamics that are trending in line with our annual guide of mid-single digit price increases on branded drugs. In addition, given our presence in the provider space and particularly oncology where we are well positioned as biosimilars continue to become prevalent.

Talking about generics for a moment. Similar to the last few quarters, our ClarusONE sourcing platform continues to deliver yield in line with our expectations. With its scale, we're able to buy at prices that are competitive with our peers. On the sell side, we continue to see a market that is competitive, but stable. A few comments on Europe. Our UK retail business performance was impacted primarily by temporary-wide NHS underfunding, which we believe should improve in the second half; and to a lesser extent, volume weakness. Performance in the other European countries was not enough to fully offset these challenges. Britt will speak to the expected full year impact.

Before I address the NHS more specifically, let me remind you of the actions we've previously taken in the UK and across Europe to reposition the business for long-term profitability. With new leadership at the helm, we're making solid progress towards further rationalizing our store footprint and streamlining our back-office functions, and we continue to evaluate our cost structure as we do in all our businesses.

Turning back to the NHS, we're pleased by recent announcements, first, to increase the retail tariff beginning in August, and we would expect to see further upward revisions in tariff later in the year which should make up partially for any underfunding. The NHS also announced a new five-year community pharmacy contractual framework. This framework brings greater clarity and long-term certainty by maintaining the current level of industry funding for community pharmacies for the next five years.

While certain elements of the funding allocation are yet to be fully defined and could evolve over the five-year time horizon, we view this as an incrementally positive development for our European business. McKesson remains active in its support of and direct discussions with the UK government on the future of community pharmacy and health care in the UK.

Turning to Med-Surg. Our Medical-Surgical business continues to generate above-market, strong organic growth with its focus on delivering care in low-cost patient settings, and we have now lapped the Medical Specialties Distributor, or MSD, acquisition which is delivering results in line with our expectations. We saw good growth across multiple markets and product categories including lab, pharmaceutical and McKesson private label. The non-acute space continues to be an encouraging area for us.

Like others in health care, we continue to see care shift to these non-acute settings where we currently operate. With investments such as MSD and our new technology in our distribution centers, we're continuing to expand our services to these providers and to their patients.

Turning to the Other segment which primarily consists of Canada, McKesson Prescription Technology Solutions, or MRxTS, and our investment in Change Healthcare. We see improving prescription trends in our owned Canadian retail business, which reflects our focus on the retail customer experience. We've made investments in people and in reconfigured pharmacy formats. With strengthening fundamentals, we believe this can reinforce the role that community pharmacy plays in Canadian health care.

Within MRxTS, we continue to see good growth in CoverMyMeds and the RelayHealth pharmacy, driven by unique technology offerings that resonate with both our retail and biopharma partners. We continue to make investments in this business to position us for future growth. Change Healthcare achieved an important milestone with the completion of its initial public offering in June. Britt will speak more about this and what we can expect going forward. We're also investing in platforms that enhance our data and analytics capabilities. We realized benefits across the enterprise in the first quarter and we expect to see expanding benefits in the future.

I now want to touch upon drug pricing reform and the policy landscape. I had the opportunity recently to spend a few days in Washington, D.C. McKesson continues to engage as a key stakeholder in educating policymakers to address issues that may impact patients, our industry, and community-based pharmacy and medical practices, and helping to drive the necessary change to support access, quality and affordability for a sustainable health care system. These objectives align with the administration's goals and we're committed to continuing the dialogue with policymakers and industry partners on sound, sustainable and pragmatic solutions.

It remains a dynamic environment, yet we remain confident in McKesson's path forward. The critical role of the services we provide to the health care industry today and our ability to identify and apply solutions to address the most pressing challenges to the health care system globally. Let me address two of the most recent developments.

The Senate Finance Committee published a package of measures last week. We anticipate there might be further modifications as the package makes its way through the legislative process. So at this point, we're not in a position to go into great detail on specific provisions. However, we will continue to engage with policymakers and industry partners to ensure that these reforms support the efficiency, sustainability and security of the supply chain as we seek to improve cost, quality and access.

Finally, earlier today the U.S. Department of Health and Human Services, or HHS, and the U.S. Food and Drug Administration, or FDA, announced a Safe Importation Action Plan. Given how recent this announcement is, we haven't yet had the full time we'd like to digest this or study this plan, but maybe a few just quick preliminary thoughts. Obviously, McKesson's presence in both U.S. and Canada gives us a unique perspective on supply chain considerations and the impacts to stakeholders and patients as we navigate this complex question of importation.

There are legitimate concerns that importation could potentially introduce counterfeit or fraudulent products into the U.S. Importantly, we have a primary responsibility to maintain a safe, secure and efficient supply chain and to ensure that we conform to FDA safety and efficacy standards in addition to the safeguards put in place by the 2013 passage of the Drug Supply Chain Security Act. These objectives are paramount as we evaluate the two pathways announced in today's plan.

Before I wrap up, I'd like to spend a couple of minutes on the opioid epidemic. We continue to believe distributors are being disproportionally targeted, given our important but limited role in the supply chain, filling orders from licensed pharmacies who are in turn filling prescriptions written by licensed health care providers. Any suggestion that McKesson drove demand for opioids in this country would reflect a fundamental misunderstanding and mischaracterization of our role as a distributor.

We will continue to fight that mischaracterization in the multiple venues both state and federal, where lawsuits have been filed by thousands of plaintiffs. These are clearly novel, complex and unprecedented claims that must be navigated. And we remain deeply concerned about the impact that this crisis is having on families and communities across the U.S. and are passionately committed to using McKesson's capabilities to be part of the solution. This includes partnering with government, industry, social institutions and other players to help bring this crisis to an end.

I've spoken about it before, but let me remind you of the investments we've made and continue to make in our programs, our processes, our technologies dedicated to preventing diversion and in our corporate initiatives announced last spring to help address the epidemic. Those include educating the pharmacies and hospitals to whom we deliver about the importance of compliance with DEA regulations, creating a nationwide clinical alert system that uses patient prescription history to identify patients at risk of opioid overuse, abuse, addiction or misuse; and actively advocating for public policies that will help address the opioid epidemic.

In addition, we contributed $100 million to establish the Foundation for Opioid Response Effort, a foundation dedicated solely to driving solutions for the epidemic. I'm proud of our teams and our team members who ensure the safety and security of our supply chain day in, day out.

With that, let me turn the call over to Britt.

Britt J. Vitalone

Executive Vice President & Chief Financial Officer, McKesson Corp.

Thanks, Brian, and good afternoon. McKesson posted another solid quarter and strong start to fiscal 2020. Slides I'm reviewing with you this afternoon are posted to the Investors section of our website and include our full year fiscal 2020 guidance assumptions. Today we reported first quarter adjusted earnings of $3.31 per diluted share, ahead of our original expectations, and we're raising the full year fiscal 2020 outlook by $0.15 to a range of $14.00 to $14.60 per diluted share from our previous outlook of $13.85 to $14.45 per diluted share.

Let's move right to our first quarter results. Our first quarter adjusted earnings of $3.31 per diluted share were up 14% year-over-year, driven by strong performance in the U.S. Pharmaceutical and Specialty Solutions business, Medical-Surgical Solutions and our MRxTS businesses; a lower share count; higher contribution from our equity investment in Change Healthcare; a one-time gain from investment activities; and expense timing. These items were partially offset by the anticipated year-over-year increase in opioid litigation and technology costs, which we outlined with our initial outlook in May. Also had a lower profit contribution from the Europe segment and a higher adjusted tax rate.

Let me start with the details of our consolidated results, which can be found on slide 4. Consolidated revenues for the quarter increased 6% year-over-year, primarily driven by growth in our U.S. Pharmaceutical and Specialty Solutions segment. Adjusted gross profit increased 2% year-over-year, mainly driven by a few key operational items: within our Medical-Surgical business, the contribution from the MSD acquisition which we have now lapped; and above-market growth from pharmaceutical products; volume growth across our MRxTS offerings; and growth in our Specialty Provider Solutions business within the U.S. Pharmaceutical and Specialty Solutions segment. These items were partially offset by foreign currency effect and lower retail pharmacy margins in the UK.

First quarter adjusted operating expenses increased 1% year-over-year, partially driven by the acquisition of MSD in the prior year. Adjusted income from operations was $933 million for the quarter, 9% above the prior year. Interest expense was $56 million for the quarter, a decrease of 8% compared to the prior year, primarily due to lower commercial paper balances. Our adjusted tax rate was 22.6% for the quarter, mainly driven by our mix of business. We continue to assume a full year adjusted tax rate of approximately 18% to 19%, which may vary from quarter-to-quarter and includes anticipated discrete tax items that we expect to realize during the course of the year.

Income attributable to non-controlling interests was $54 million for the quarter, a decrease of 7% compared to the prior year and in line with our expectations. Our adjusted net income from continuing operations totaled $625 million; and our diluted weighted average shares outstanding were 189 million for the quarter, a decrease of 7% year-over-year.

Next, I'll discuss our segment results which can be found on slides 5 through 8; and I'd like to start with U.S. Pharmaceutical and Specialty Solutions. First quarter revenues were $44.2 billion, up 8% year-over-year, driven by solid contributions from our largest retail national pharmacy customers, growth across our specialty businesses and continued solid performance within our health systems segment, partially offset by branded to generic conversions. Segment adjusted operating profit for the quarter increased 11% to $600 million, primarily due to strong growth in our specialty businesses, continued strong performance by our sourcing operations, and the lapping of prior-year opioid-related expenses.

As a reminder, the State of New York adopted the Opioid Stewardship Act in the first quarter of McKesson's fiscal 2019. Although the act was being challenged in court, we recorded an accrual in both our GAAP and adjusted results of $15 million in the first quarter of fiscal 2019 in our U.S. Pharmaceutical and Specialty Solutions segment, which accounted for the estimated portion of the annual assessment. This legislation was later ruled unconstitutional and the accrual was reversed in the third quarter fiscal 2019. The segment adjusted operating margin rate was 136 basis points, an increase of 4 basis points.

Next, European Pharmaceutical Solutions. First quarter revenues were down 3% year-over-year to $6.7 billion. On an FX adjusted basis, revenues were up 3% driven by market growth in the distribution wholesale business. Segment adjusted operating profit was down 50% to $37 million on an FX adjusted basis, mainly due to the weak retail pharmacy environment in the UK. The segment adjusted operating margin rate was 52 basis points on an FX adjusted basis, a decrease of 55 basis points. Our first quarter results were lower than expectations, resulting from weak retail pharmacy margins in the UK due to industry-wide underfunding by the NHS. We anticipate this underfunding will modestly improve in the second half of fiscal 2020.

As Brian discussed earlier, in fiscal 2019 we took actions in the UK and across Europe to reposition the business for long-term profitability. These actions included further store rationalization and cost actions, and we continue to execute against these restructuring actions as we further evaluate our cost position. As a result of the UK outlook, we now expect European segment adjusted operating profit growth to be on the low end of our original assumption of low- to mid-single digit percent growth.

Moving now to Medical-Surgical Solutions. First quarter revenues were $1.9 billion, up 12% year-over-year. Excluding the MSD acquisition which closed on June 1 of 2018, segment revenue increased 4% driven by growth in our Primary Care and Extended Care businesses, including strength in pharmaceutical products and our home delivery business. Segment adjusted operating profit for the quarter increased 27% to $159 million, driven by organic growth and contribution from the MSD acquisition. The segment adjusted operating margin rate was 836 basis points, an increase of 102 basis points due to market growth and cost management.

Finishing our business review with Other, revenues were $3 billion for the quarter, down 1% year-over-year. On an FX adjusted basis, revenues grew 2% driven primarily by growth in our MRxTS business. Other adjusted operating profit increased 31% to $279 million on an FX adjusted basis, mainly driven by increased equity income from our investment in Change Healthcare and continued strength in our MRxTS business. Included in Other, adjusted equity income from Change Healthcare was $108 million for the quarter as compared to $64 million in the prior period.

Let me take a minute and update you on our equity investment in Change Healthcare. On June 27 of 2019, Change Healthcare began trading on the Nasdaq. This was an important milestone for Change Healthcare. While Change Healthcare is now a publicly-traded company, McKesson will continue to report the equity income from our interest in Change Healthcare based on our equity ownership percentage and we'll continue to report Change Healthcare results on a one-month lag.

As a result of the IPO, McKesson's equity ownership in Change Healthcare is approximately 58.5%, effective beginning with McKesson's second quarter. When taking into account McKesson's new equity ownership percentage as well as Change Healthcare's repayment of long-term debt following the completion of its IPO, we anticipate the adjusted equity income attributable to our interest in Change Healthcare in fiscal 2020 to be unchanged from the prior range of $250 million to $270 million, which it assumes 70% ownership throughout fiscal 2020.

I would point out that our adjusted equity interest assumption for Change Healthcare as well as our future results and commentary on Change Healthcare will be specific to McKesson's ownership interest based on the McKesson definition of adjusted earnings, our equity ownership percentage in Change Healthcare, and the period for which we are reporting which again will be on a one-month lag. Any questions related to the operating performance or the outlook for Change Healthcare will be addressed by the Change management team.

The IPO was an important next step in McKesson's efforts to unlock value for our shareholders, as we progress towards exiting our investment in Change Healthcare in a tax-efficient manner. As we've detailed in the past, there are lock-up periods and other milestones which must be met prior to our exit which include: first, the customary six-month lock-up period following the IPO; then Blackstone, our equity partner in Change Healthcare has the opportunity to do a secondary offering covering up to a three-month period; following that there'd be a three-month lock-up period.

Given all of these factors, our exit could extend to a period of 12 to 18 months. However, depending on the necessity of certain milestones, we may have the opportunity to exit by the end of our fiscal 2020. We will provide updates as we progress through the respective lock-up periods and milestones, as we move closer to our eventual exit.

Moving now to corporate expenses. McKesson recorded $137 million in adjusted corporate expenses in the first quarter, an increase of 44% compared to the prior year. The year-over-year growth was primarily driven by the increase in opioid-related litigation costs and the overall timing of technology investments in the fiscal year, partially offset by a one-time benefit recorded in the first quarter of approximately $0.10.

As it relates to opioid-related litigation costs, McKesson recorded $36 million in expenses in the first quarter. We continue to assume opioid-related litigation costs will be approximately $150 million in fiscal 2020. Based on the one-time benefit recorded in the first quarter, we now anticipate corporate expenses to be on the low end of the original assumption of $725 million to $775 million.

Turning now to cash, which can be found on slide 9. We ended the quarter with a cash balance of $1.9 billion. During the quarter, we had negative free cash flow of $162 million. This performance was ahead of our expectations. I would remind you that cash flow will vary from quarter-to-quarter, impacted by timing, including the day of the week that marks the close of a quarter. We continue to expect free cash flow of approximately $2.8 billion to $3 billion for fiscal 2020.

Investment in growth opportunities remains a key priority for McKesson. During the quarter, we made $111 million of capital expenditures and spent $46 million on acquisitions, and we continue to focus on internal investments in areas such as data and analytics and information security. We used cash in the quarter to continue returning value to our shareholders. We repurchased $684 million in common stock and have $2.8 billion remaining on our share repurchase authorization. We also paid $75 million in dividends in the quarter, and yesterday the board approved an increase to our quarterly dividend of $0.02 to $0.41, an increase of 5% which will be payable to shareholders in October.

In closing, we are pleased with the strong start to the year. In the first quarter, we had growth across the majority of our businesses which more than offset the weakness in the retail pharmacy market in the UK. Our results for the first quarter, which include an unplanned one-time benefit of $0.10, have given us confidence in our full year fiscal 2020 outlook. As a result, we're increasing our adjusted earnings guidance by $0.15 to a range of $14.00 to $14.60 per diluted share, which represents solid growth of approximately 5% at the midpoint versus fiscal 2019.

I would remind you that we do not provide quarterly guidance. However, to better inform your modeling, we continue to expect the percentage of adjusted earnings per diluted share in the first half of the year as compared to the second half, to be similar to fiscal 2019. Overall, we're pleased with the focus, the execution, and the performance across the company, and we're off to a great start in fiscal 2020.

And with that, Brian and I are happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from Lisa Gill with JPMorgan.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Thanks very much, and good afternoon. Congratulations on a nice start to the year. Brian, I know that it just came out, this new Safe Importation Action Plan. But just being in Canada, how realistic is this that the manufacturers are going to allow product to go to Canada and then come back to the U.S. and just given the size of the Canadian market? And what role do you think that McKesson can play as the largest distributor in Canada to make sure that, one, product that is meant for Canada stays in Canada; and two, anything that does potentially come back to the States is safe?

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

A

Thank you, Lisa, for the question. We do think McKesson is in a uniquely informed position, given our business in Canada and our presence here in the U.S. obviously. There were two tracks discussed in the plan that came out today. I will say, I was encouraged by the fact that it was a invitation for industry and industry participants to bring their perspectives and knowledge into the discussion, and we will plan to be actively engaged in that. Our first and foremost responsibility and priority will be the safety and security of the supply chain both in the U.S. and in Canada.

Now, you rightly point out the Canadian market from a population standpoint is less than a tenth of the U.S., and I suppose that various manufacturers will adopt various perspectives on what they may or may not do. We will carefully evaluate with various industry partners what the opportunity may be, but the overarching goal will be safety and security for citizens both north and south of the Canadian-U.S. border.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

And then just as a follow-up. Clearly, what they're trying to solve for here is overall drug pricing. You or Britt, can you talk about what we saw on the quarter around drug price inflation on the branded side as well as the generics? Clearly, quarterly results coming better and better, especially on the drug distribution U.S. component of the business. So just wondering some of the key drivers there as well as what you're seeing on both inflation/deflation in generics and branded.

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

Thanks for that question, Lisa. I'll start, and Brian can add. As we talked about in Brian's remarks, on the branded side what we saw from an inflation perspective was right along in line with our expectations. As you know, the first quarter is generally a softer quarter for brand inflation historically, and what we saw this quarter was really in line with our expectations. And as we think about the full year, we are reaffirming our guidance of mid-single digit inflation on the branded side.

On the generic side, we continue to be very pleased with the performance of our sourcing operation, ClarusONE. What we've seen thus far in terms of our sourcing performance is right in line with our expectations. And on the sell side, as Brian mentioned, we continue to see a competitive market, but we continue to see a stable market. And so, we're pleased with our ability to continue to source very competitively which is certainly benefiting our customers. And we're certainly pleased with the ability to bring that to the sell side and our customers.

Lisa C. Gill
Analyst, JPMorgan Securities LLC
Q

Great. Thanks for the comments.

Operator: And next will be Michael Cherny with Bank of America.

Michael Cherny
Analyst, Bank of America Merrill Lynch
Q

Good evening. Thanks for all the comments so far. Britt, I want to dive in a little bit more into the U.S. Pharma performance, maybe as a microcosm for the rest of the business. It seems like, just given the sheer magnitude of the performance and the outperformance on revenue relative at least to your guidance that a lot of it had to be driven by pharma. That being said, we didn't see a ton of gross margin pull-through. That might be splitting hairs a little bit here, but can you just talk a little bit about the dynamics in terms of what was the rationale for the slower gross profit growth relative to the revenue growth?

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

Sure. Thanks for the question. As I mentioned in my comments, some of the revenue growth that we saw came from some of our largest national retail customers; and as you might expect, they don't generate as great a contribution to gross profit. We did see broad-based strong performance across the segment and not only with our largest national retail customers, but we saw good performance in our health systems segment and we continue to see very strong performance in our specialty business. And so, we're quite pleased with that.

Overall, in the segment, while our gross profit was lower on a consolidated basis, within our U.S. Pharma and Specialty Solutions segment we saw very good performance at the adjusted operating profit line. So we're very pleased with the performance. We saw a very broad-based performance across that segment, and we think that we're well positioned to continue and achieve our guidance for the rest of the year.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

And just on the contribution from Change, is the way to think about it the fact that the numbers didn't change despite the fact that you had lower ownership stake versus guidance, simply driven by the outperformance contribution for 1Q? Or is there anything else that changed in terms of just the methodology aside from just a pure less ownership stake?

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

A

I would say that it's a combination of the lower ownership stake being offset by the deleveraging that changed it as a result of raising the funds from the IPO.

Michael Cherny
Analyst, Bank of America Merrill Lynch

Q

Okay. Great. Thanks so much.

Operator: And next will be Kevin Caliendo with UBS.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Great. Thanks for taking my call. Question around the guidance. You beat by $0.30; you only guided up by $0.15. I know you mentioned the EU business is now expected to be at the lower end of the range; you also mentioned corporate expenses are going to be lower. Is there any other delta there? Is this conservatism? How should we think about the guidance relative to the beat in the quarter?

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

A

Sure. I think there's a couple of things here, Kevin. First of all, we had good performance. We also called out a one-time gain from investment activities that is within our corporate expenses; that was about $0.10. So while we had strong performance across really a broad base of our businesses, we did see weaker performance in our European business and we did lower the range for the full year as a result of that. We had the one-time unplanned benefit.

We had some favorable timing in our corporate expense line. Again, as we called out at the beginning of the year, we intend to continue make investments in our business both on a data and the analytics side and in a technology side. So, we had strong broad-based performance across the business. We had a one-time gain within our corporate expense line. And I think it's early in the year, but we feel very confident and confident enough to raise by $0.15.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Okay. And just a quick follow-up on the Medical segment. You give us revenues ex MSD they'd have been a 4%. What would the EBIT growth have been ex MSD in Medical, as we're now lapping it? Just to give us a little bit of a better view of sort of what that business might look like going forward.

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

A

Yeah. We don't break that down specifically, Kevin. But what I would tell you is, we had strong organic performance within that business. And as I mentioned, we had strong pharmaceutical sales performance as well as continued strong performance in our home delivery business. So, we're pleased with the overall performance of the segment. We're pleased with the execution against the MSD acquisition.

And as I mentioned, across the broad base of that business, we had growth in pharmaceuticals, we had growth in our primary care business as well as our home delivery business. So, good organic growth as well as the MSD contribution.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Great. Thanks so much.

Operator: Next will be Ricky Goldwasser with Morgan Stanley.

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

Q

Yeah. Hi. Good evening. So, some follow-up questions here on the guidance. So obviously you had a very good performance on the top line, but when we look at your U.S. Pharmaceutical and Specialty Solutions' guidance for the remainder of the year, it would suggest that revenues are going to normalize, while we're getting to around plus 4% to negative 1% on the revenue; and on the operating profit as well kind of like negative 2% to about 3.3% growth.

So, was there any kind of like pull-forward of revenues this quarter that's going to normalize for the remainder of the year? Or what kind of like drove that strength? I understand it is your largest customers, but if you can give us some more color behind that?

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

A

Sure. Thanks, Ricky. There's nothing unusual about the revenue development in the quarter. There's nothing that I would call out as a pull-forward, to use your terminology. We had very strong performance. It was primarily in our largest retail national accounts. But again, as I mentioned, we had broad base of revenue growth across the business.

But one thing I would point out about our adjusted operating profit for the quarter, as I talked about in my opening remarks, last year we did have the opioid litigation costs that were included in that segment's results. And as I mentioned, we recorded $15 million last year for the New York state assessment. So I think you should factor that in. We're very pleased with the performance. We continue to expect to see growth in this segment for the remainder of the year, and we're very pleased with the revenue development.

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

Q

Okay. So, let me ask a follow-up on specialty. This is kind of like the third quarter both you and your peers are highlighting the strength in specialty is benefiting results. So, can you just share with us a little bit more color on specialty? And whether you've seen any contractual changes in the last year that would explain the improvement in benefit? Because I'm assuming that it's not coming from branded inflation. So how should we think about that benefit and how should we think about the sustainability of that benefit? And I think that historically you talked about specialty margin as being below traditional branded drugs. Is that still the case or should we assume that margins have re-rated higher?

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

A

I'll take this one, and Britt can jump in if he'd like. So when you think about the specialty as a segment, obviously the pipeline of innovation continues to be heavily slanted towards these types of products. In the old legacy core U.S. Pharma business, the margin profiles and structures you'd be accustomed to, I would characterize as still being in place. And so while we do benefit from that specialty growth through good volumes and it is beneficial for us on the gross profit line, it does continue to be modestly dilutive to the rate.

I would remind you though, we also have a very good business in the community setting related to specialty products, and that's both our U.S. oncology network and our unaffiliated community provider business. And those are the businesses where we continue to see really good momentum, really good growth and benefit from the pipeline of both innovative products and frankly biosimilars, as they emerge and come to market.

And we have a very robust value proposition, obviously a complete value proposition in the case of U.S. oncology and then a wide assortment of tools and services we offer to the unaffiliated community providers. And we think that that value proposition continues to earn us the right and the ability to grow and to benefit from the specialty pharmaceutical pipeline in general.

Operator: And next will be Ross Muken with Evercore ISI.

Ross Muken
Analyst, Evercore ISI

Q

Good afternoon, guys. So I just wanted to go back to kind of the Change in Other math again, because I don't think I have it straight. So in terms of the $108 million versus the prior year and then – and that's for Change, and then sort of the full year guide, I'm not sure I understand sort of what caused the up-step in cadence and then sort of the notable down-step. I know the ownership percentage is changing, but it still seemed like a big delta. And I'm guessing that's essentially what caused the spike in the Other segment profit. So I'm just trying to figure out sort of why that cadence was kind of funkier than what I think one would have expected.

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

A

Sure. Thanks for the question, Ross. So let me start with just the Other segment just generally. Within that segment, we have our Canadian business, we have our MRxTS businesses which are very strong businesses and growing very well for us, and we have our equity investment in Change. Now at first, I'd point out that our Canadian business continued to perform well. We certainly talked about the impact from the generic legislation at the beginning of the year. And that team really did a great job in mitigating that and we're pleased with the performance of Canada.

Our MRxTS businesses continued to grow very well and we're continuing to make investments in those businesses. Within our Change asset, we did have the ownership change from 70% to 58.5% effective in our second quarter, and in that second quarter you'll also see the impact from the de-levering. Within the first quarter though, there are a couple of things that I would point out. First of all, Change had – as most companies, had the implementation of the revenue recognition standard, and that created a timing element for the year. For the full year, that's not going to have an impact on McKesson, but it does have an impact earlier – favorable impact earlier in the year and [then it'll reverse out as the year goes on.

And then, of course, as you think about that business, there is a mix of income between taxable and non-taxable depending on the legal entity. So what I would say is, primarily for the first quarter you see some timing impact from the revenue recognition standard and you see a mix of income between the entities of taxable and non-taxable.

Ross Muken
Analyst, Evercore ISI

Q

Got it. And then maybe just thinking about sort of maybe business development activity or the M&A side of things. Lot of things in services including your own asset obviously had challenging multiples. There is a lot of political wings going on. I guess, how do you sort of frame what's the right time to be more active again on sort of tuck-in M&A? And how the risk reward sort of is there versus just continuing to buy your own equity which given its cash flow yield, seems like a reasonable investment?

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

A

Yeah. Thanks. Thanks for the question. And I think we would characterize our M&A activity in recent quarters as being relatively light. That doesn't mean that we're out of that space. I think when we think about capital allocation, we're always very focused on where are the opportunities to deploy capital, to build platforms and businesses and services for sustainable growth over the long term.

We are being very diligent to make sure that as we look at this process, that is guided by our strategy, that's guided by our focal areas, it's guided by the markets and segments where we think we have good businesses, strong teams, the right to win. And anywhere in those segments, we can find assets that are complementary and an accelerant to our business, we're quite interested in those.

We obviously consider alternative uses of capital and returns to capital in making those calculations and final determinations of what's the best way to deploy that capital on behalf of our shareholders. So, we continue to be active, we continue to be in deal flow. We continue to look carefully at the landscape with an eye to make sure it's aligned strategically, that it's an investment, an accelerant, and that it is the smartest way to deploy capital across the various uses of capital that we have.

Ross Muken
Analyst, Evercore ISI

Q

Thanks, guys.

Operator: And moving on to Stephen Baxter with Wolfe Research.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Hi. Thanks for the question. I wanted to ask about the sell side environment. You've said in the past that in general your contracts last about three years, so it appears you'd be coming up against some of the independent pharmacy contracts that renewed during 2016. It'd be helpful if you could give us a sense of what proportion of those contracts have been addressed at this point, and also any color you can provide on what the discussions look like in terms of helping your pharmacy partners deal with the pressure they're under would be very helpful. Thanks.

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

A

Yeah. So typically, as we've talked about, we would renew roughly a third of our contracts in any one given year. We've recently got through two big retail national account renewals successfully, which was great news. And I'd say, I'd characterize this year as having a fairly normal portfolio of renewals and renewal activity. So I wouldn't point to anything particularly unusual in that regard.

We work with our partners over the life of these contracts. We're typically engaging in day-to-day discussions. We begin conversations well in advance of any sort of sudden renewal activity. So we really view it as kind of an ongoing dialogue and an ongoing partnership over the course of these contracts. And you'll be well familiar with our track record of renewing these particularly larger deals.

As it relates to independents in general and what are we doing to help independents, I would say, independents have probably long been at the core of McKesson as a company. It's key part of our commitment to community practice, as we think being central to addressing the access costs and quality issues this country faces. Independents continue to benefit from the programs and services that we invest in. They continue to consume that in a sort of all-encompassing way through a relationship with Health Mart and our access reimbursement services that come along with that. But we are constantly looking at how we innovate for them both in how they interact with their patients, how they attract patients and draw footfall to their stores, how they monetize that footfall both in front and behind the counter. And we work with them day in, day out on the just efficiency of the operation of their business.

Community pharmacy today feels reimbursement pressure. It's felt that pressure every year I've been in the business, and that's almost 23 years now. So we partner with them very closely to help mature their position to survive and adapt and innovate. And independent community pharmacies do tend to be creative individual business folks who find ways to meet unmet needs in the communities they serve.

Stephen Baxter
Analyst, Wolfe Research LLC

Q

Okay. Thanks. I appreciate the color. And then just one quickly on capital deployment and the pacing of share repurchase. So, it looks like if you carried this magnitude of share repurchase through the balance of the year, you'd end up with something a few million shares below where your guidance is, which looks like 185 million shares, unchanged versus previous. So I was wondering if you could help us understand the progression of share repurchase and how you guys approach the balance between opportunism and planned activity throughout the year. Thanks.

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

A

Yeah. Thanks for the question. I would just reaffirm that we've not changed our assumption on our diluted shares for the end of the year. We don't have a set amount that you should think about for modeling to take it from quarter-to-quarter. We think about capital deployment – as Brian mentioned, we think about it, opportunities on strategy. And where we have opportunities to invest on strategy or invest internally, we do that. And certainly we've had an opportunity this quarter to return more to our shareholders. So, we make those decisions on a regular basis. But in terms of our guide on shares for the end of the year, we've not changed that.

Operator: And our next question will come from Eric Percher with Nephron Research.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. Like to go back to the gross margin question. And maybe given the comments around independents, I know that was one segment that hasn't been driving the same contribution that some of the other areas, the retail nationals and other less-profitable accounts may be. As you think about the growth in revenue and what that translates into at a gross profit growth level at a period of time where independents aren't driving it and a period of time where generic contributions aren't as high, what do you see as the natural growth rate?

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

A

Well, Eric, what I would point to is, if you look at our consolidated gross margin, there's multiple factors to consider in here. And one of the things that impacted our gross margin in the quarter was the weak retail results in our UK business within Europe. Now clearly, we had a large proportion of revenue being driven by our largest retail national account and we had a very broad base of revenue growth across our business.

And overall, I would just say that one of the things that impacted to the negative side was not only the mix of revenue, but the impact from a weak retail environment in the UK. When you think about our independent customers within U.S. Pharma, we haven't seen anything different this quarter from the previous couple of quarters. So I don't know that there's anything really to call out specific about that.

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

A

Yeah. When we look at the kind of reimbursement environment that retail independents are facing, think we talked last quarter about the fact that if we look at our data, and we really see in aggregate a very normal headwind that's been established, something that's kind of been consistent with prior years. And on average, that's a true statement now. Within that average, there are, based on patient mix and contracts, the government, private, commercial, product mix and really the patient population [ph] in your catchment area (00:49:56) you can see some winners and some losers. But in the blended way, it really feels like the same steady reimbursement headwind we've been accustomed to.

Eric Percher
Analyst, Nephron Research LLC

Q

So I think we see that and certainly the headwind in international and gross margin is evident. But my question is really where we don't see at a distribution and specialty segment level, what are your thoughts on the ability to drive gross profit growth relative to revenue growth? That's really the question I was getting at.

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

A

Well, as we've talked about previously, Eric, the growth of specialty products is going to have a dilutive impact on the rate. It's certainly very good for us from a margin dollars perspective. As I think about that, the U.S. Pharma and Specialty Solutions business, again, it's a business that is broad-based from a distribution perspective both in the nature of the products and the customers.

But also the specialty businesses that Brian talked about, our U.S. oncology asset, our provider base that we have and also the manufacturer life capabilities, the services that we provide to the manufacturer, those also add to our gross margin profile. So when I think about it, our distribution business is very scaled, it certainly is impacted by the product mix. But the fact that it's broad-based in terms of our U.S. oncology asset, our other specialty assets and then our manufacturer services asset, I think that really does give us the opportunity to develop that gross profit over time.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you.

Operator: And our next question will come from Brian Tanquilut with Jefferies.

Brian Gil Tanquilut
Analyst, Jefferies LLC

Q

Hey. Good afternoon, guys. Congratulations. Britt, just wanted to follow-up on Ricky's question from earlier, clarify that question again. So you put up an 8% growth number in the U.S. for Q1 and yet you're maintaining the guidance kind of like low- to mid-single digits. So is there anything we should be thinking about that could drive a deceleration in growth? I mean, you've talked about specialty being strong. Or is there anything to call out there?

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

A

Yeah. The thing that I would point out is, I think we saw a larger proportion of revenue from our largest retail national accounts in the quarter. We still expect to see very strong revenue growth in the mid-single digit range for the year. I think as you just think about a quarterization of that, we saw a larger proportion of that coming from our largest accounts and that had obviously a very favorable impact in the quarter.

Brian Gil Tanquilut
Analyst, Jefferies LLC

Q

All right. Got it. All right. Thanks, guys.

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

A

Thanks, Brian.

Operator: Our next question will come from Robert Jones with Goldman Sachs.

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

Q

Great. Thanks for the questions. I guess similar one, Britt, on the corporate expense side. You're pointing towards the lower end. But just looking at where you ended up in the quarter, it still seems like quite a big ramp through the year to get there. Anything you know of or that you anticipate on the corporate expense side that it would be terribly different than what we saw in the quarter?

And then I guess, Brian, just I'll throw my follow up out there. I'm sorry if I missed this in the prepared remarks, but large proposed generic merger out there. Curious if – or how impactful that would be on not only ClarusONE, but on McKesson in general? If you had a view, that'd be great. Thanks.

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

A

Thanks for the question. I'll start and then I'll turn it over to Brian. As we think about our corporate expenses, at the beginning of the year we talked about the things that are driving the higher corporate expense year-over-year. We talked about the increase in opioid litigation costs. We talked about the increased investments that we were making in technology, particularly infrastructure and data and analytics. We still intend to make those investments throughout the year. We had a favorable timing-related impact in the first quarter, but our intention is to continue to invest in those capabilities as we go throughout the rest of the year.

We also – in my remarks, I talked about our opioid litigation cost projection for the full year still remaining at $150 million. And then the thing that I did talk about that is, included in our corporate expenses was the one-time benefit we had from investing activities which reduced our corporate expenses in the quarter, and that allowed us to take our guide for corporate expenses down to the low end of the range that we provided at the beginning of the year.

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

A

Robert, to your second question – and we actually did not comment on it I think in our opening remarks. So, thank you for the question on the Pfizer-Mylan merger. So I would start by saying that we have strong relationships with both of these organizations and they've been important partners for us at McKesson and in ClarusONE. The rationale for the merger, as I understand it, is broadening of the portfolio. There is some cost synergy, some efficiency.

And frankly, at the scale that we operate and buy being partnered with large-scaled healthy organizations that are capable of continuity of supply and competitive pricing, it can be a good thing. So we'll evaluate how this merger comes together, we'll continue to be in dialogue with them, but I wouldn't say that poses any imminent concerns from our perspective.

Operator: And our next question will come from Charles Rhyee with Cowen & Company.

Charles Rhyee
Analyst, Cowen & Co. LLC

Q

Yeah. Hey, thanks for taking the questions. I think you touched on biosimilars being a benefit particularly in the oncology network. Can you talk about sort of your outlook here? I think there's some talks about I think insulin moving over to jurisdiction by, I guess, [ph] the biologics group in FDA, SBIR (00:56:07) and that could pave the way for interchangeability at least with biosimilar insulin. Maybe your thoughts on where you're seeing sort of that regulatory landscape right now? And how you think about that opportunity and what it means further down the road for you?

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

A

Well, I mean, the biosimilar landscape in general, we feel pretty positive about. More choices, more substitutability or interchangeability. That gives clinicians more choices, hopefully it gives. It helps address the cost challenges that we see in the marketplace. And we think with the footprint of providers that we have in the community, we're particularly well-positioned to take advantage of those trends. So, we also continue to work with innovators.

First and foremost, as we think about these, it's a patient outcome. It's a clinical-oriented decision. It's what product is best on the formulary to meet the clinical need. To the extent there are a variety of choices and interchangeability, that tends to be good for a company like us with the markets and channels that we serve. That choice tends to be a positive thing for us.

Charles Rhyee Q
Analyst, Cowen & Co. LLC

Is that something that you think is coming close and that you're trying to plan ahead of that, or is that you feel is still a ways off?

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

That's really hard to comment on the – what the regulatory pathways will be and timing. And our recent experience in the policy arena tells us anything, it gets very difficult to forecast. What may come out, there's lots of discussion what may come out ultimately and what it may look like in its final form. It would probably not be my best judgment to try to predict that for you.

Charles Rhyee Q
Analyst, Cowen & Co. LLC

Okay. Fair enough. And just one last question. You talked about the FX impact being sort of net neutral. But if I look, it seems like – particularly the pound and the euro have been getting weaker relative to the dollar. How are you guys thinking about that? Or sort of what's your expectations around that? Thanks.

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

Yeah. I don't want to predict the direction of the pound. On a consolidated basis, it doesn't have a material impact. But as I called out, it did have an impact on revenues within the Europe segment for the quarter. So, obviously we'll watch that very carefully. But as we think about it on a consolidated basis, we don't see an impact.

Charles Rhyee Q
Analyst, Cowen & Co. LLC

Great. Thank you.

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

Yeah.

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

Operator, we have time for one more question.

Operator: Certainly. That question will come from Eric Coldwell with Robert W. Baird.

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

Q

Okay. Thanks very much, and good evening. Most of my main ones were covered, but I'll shift gears a bit. I'd like your thoughts on generic introductions for the rest of the year. If possible, expected to be a good guy or a bad guy to profitability on a year-over-year basis?

And then specifically, if I dare ask, Lyrica comes out with roughly 10 manufacturers of very low initial price. How did that impact – pretty big product. How did that impact your thinking on generic profitability and trends in that market seeing so many manufacturers launch such a deep discount to the brand?

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

A

Yeah. Thanks for that question. Generic launches, as we've talked about, do not have the size of impact that they used to have. They have a modest impact on our profitability. So we don't see that having any change from our previous views on that. In terms of Lyrica, we're very fortunate to have a strong sourcing organization like ClarusONE, where we can partner with multiple manufacturers. We don't see that Lyrica is going to change the direction of our generics profitability; it'll certainly be a benefit for us and it'll certainly be a benefit from our customers. But it'll have a modest impact at most.

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

Q

Great.

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

Well, thank you, everyone, for your questions. And thank you, Justine, for facilitating this call. I want to thank everyone on the call today for your time. McKesson's off to a strong start for our fiscal 2020, and I'm real excited about the opportunities ahead of us.

I do want to take a minute to recognize the outstanding performance of really all of the McKesson employees and team members and their contributions to help our customers improve lives and deliver opportunities to make better health possible. So thank you, Team McKesson. Have a good evening, everyone.

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