FINAL TRANSCRIPT

Thomson StreetEvents℠

CAH - Q1 2010 Cardinal Health, Inc. Earnings Conference Call

Event Date/Time: Nov. 05. 2009 / 1:30PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Cardinal Health conference call. (Operator Instructions)

I would now like to turn the conference over to your host for today, Ms. Sally Curley, Senior Vice President of Investor Relations. Please proceed.

Sally Curley - *Cardinal Health, Inc. - SVP of IR*

Thank you, Stephanie, and welcome to Cardinal Health's first quarter fiscal 2010 conference call. Today we will be making forward-looking statements, the matters addressed in these statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected or implied. Please refer to our SEC filings and the forward-looking statements slide at the beginning of our presentation found on the investor page of our website for a description of those risks and uncertainties.

In addition, we will reference non-GAAP financial measures. Information about non-GAAP financial measures is included at the end of the slide, and a transcript of today's call is also posted on our investor web page. Before I turn the call over to our chairman and CEO George Barrett I'd would like to remind you of a few upcoming investor conferences in which we will be participating this month. Notably the Credit Suisse Healthcare Conference on November 12, and the Lazard Capital Market's Healthcare Conference on November 17.

Details of these events are or will be posted on the IR section of our website at Cardinalhealth.com so please make sure to visit that site often for updated information. Now I would like to turn the call over to Mr. George Barrett.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Thanks, Sally, and good morning, everyone. I'm very pleased with our progress in this first fiscal quarter as the new Cardinal Health. We posted a 6% increase in revenues and reported a non-GAAP EPS number of $0.54 for the quarter, up 15% over last year's quarter. Our overall operating performance was better than we originally anticipated with both of our segments performing well. Our medical segment showed strong earnings growth and our pharma segment performed somewhat better than expected. Our Q1 numbers were boosted by the positive impact of a few note worthy items. These included an accelerated revenue recognition item in our medical segment related to the spin-off and some earlier than expected price increases from a few brand manufacturers. The impact from restructuring, impairments, and other costs associated with spin-off of CareFusion did bring GAAP earning from continuing operations to a loss of $62 million net of tax for the quarter with the main driver being $172 million tax charge for the anticipated repatriation of cash. Jeff will cover in this more detail later.

I continue to be encouraged by our progress and the renewed energy I see among our employees. We remain focused on our priorities to sustain improved performance, and we're tracking well against the work we need to get done. We came into this transition year knowing what we needed to tackle and while I'm proud of what we've accomplished to date, we recognize there is still much to do. As I walk you through our performance, I will touch on many of the key initiatives we talked about in August. There are also three broad themes that you will hear throughout my comments this morning. First, building a customer-centric organization; second, driving performance management; and third, positioning the company for the future.

Our work to improve the customer experience in both our medical and pharmaceutical segments continues. We're making investments and adapting our organization to better serve the customers and to reinforce a mind-set that everything we do begins and ends with our customers. Having said this, we are taking a disciplined approach to customer profitability analysis, even though it resulted in a couple of lost customers in the quarter. The loss of these customers will dampen our revenue growth for the remainder of the year, although the impact on profitability is much less significant.

Our pharma segment continued its progress in the first quarter. Sales increased by 5% versus prior year with profits down 2%, better than we had expected. As you know we had anticipated a steeper year-over-year decline in the first quarter, based on a number of factors. The largest of which was a decline in generic launch value versus prior year. But our organization has done a good job for compensating for the head winds and we had the benefit of some earlier than expected brand price increases that cumulatively had a positive impact. Our pharma mix was again roughly 50/50 bulk to non-bulk. We did, however, see a more balanced growth with bulk and non-bulk both growing at approximately 5% to 6%. I would point out that the rate of growth in our non-bulk business as well as growth in our non-bulk margins are encouraging signs of progress in our underlying business, particularly given the decline in generic launch value and generic deflation relative to last year's first quarter.

We have devoted considerable organizational resources to improving our generics business. While the particularly robust generic launch activity in Q1 of last year did create a difficult year-over-year comparison, it does track with our expectations for the year and I'm pleased with the progress we are making here. Despite considerable generic deflation on certain key products launched last year, our Q1 generics sales were up nearly 2% and in our retail independent business we saw sequential quarter growth in dollars and in generic compliance to our source program. On the generic sourcing side, we also decreased our number of generic suppliers from 120 down to roughly 30, and we're confident that our enhanced relationships will generic drug manufacturers will provide incremental value to our customers, to Cardinal Health, and to our generic partners. These sourcing changes will roll out through the course of the year as we conclude existing agreements and work with our customers to avoid any disruption downstream.

The restructuring of our Medicine Shoppe business model is ongoing and while it waves on earnings in this fiscal year, we continue to see evidence that this model change is the right strategic move for us. Our nuclear business continued to deliver exceptional bottom-line growth, driven by an effective selling strategy, economies from our management of raw material costs and tight expense management. The team has done an outstanding job managing through the generator shortage resulting from the temporary shut down of the Chalk River Reactor in Canada. Although this had an impact on our overall volume we've worked hard to manage the supply constraints by adjusting schedules with our customers. According to the most recent report from the Atomic Energy of Canada, the Chalk River Reactor is projected to be up and running in the first calendar quarter of next year. Our forecast for production assumes resumption in January so any delay past that time could further impact this business in the second half of fiscal 2010.

Turning now to medical, this segment reported strong double-digit profit growth boosted by decreases in commodity prices, some up-side associated with the demand for flu-related products, and an immediate revenue recognition benefit from international sales to CareFusion that was triggered by the spin-off. Overall, hospital sales were in line with our expectations. Our pre source kitting business continues to improve, showing a second consecutive quarter of earnings growth. This business plays an important role for hospitals by improving the efficiency of the OR supply chain, minimizing waste and increasing compliance with the recommended safety standards, particularly critical given today's healthcare environment. In the quarter we saw double-digit revenue growth in both our lab and ambulatory businesses as well as in our private label medical portfolio. Additionally, our lab business signed an important five-year sole-source contract with Novation.

In ambulatory care, our investments to improve the customer experience and grow the business are progressing well. We've invested in technologies to support the sales force and enabled reps to provide critical information to customers in real-time at the point of care. And Canada performed extremely well, posting more than 20% profit growth as a result of new supplier agreements, new products, and the impact of the demand for flu-related production.

I would like to take a moment to comment more broadly about this flu season. Clearly, we're in the middle of an intense flu season and our people are working with incredible dedication to support our customers. Given some supply shortages in the market for certain medical and drug products, we've had to apply our fair-share allocation process to ensure that all of our customers have access to supplies of the flu related production. Increased demand has had an earnings impact of approximately $5 million in the quarter, mostly affecting our Lab, Medical Distribution and Canadian businesses.

Also of note, our work on our medical business transformation is moving forward. We've completed the blueprinting stage of the project and are shifting to the design and implementation phase. Our Q1 investment spending rate wasn't as high as we originally forecast but we expect that underspend to flow into Q2.

Expense and capital management remain a key area of focus. We continue to maintain disciplined cost management, making sure our cost management is lean and appropriately sized for our business going forward. In spite of the investments we are making in med transformation and our customer facing IT initiatives we were able to reduce SG&A year-over-year. We are also managing balance sheet carefully with a strong emphasis on returning days of inventory. We continue to optimize our portfolio across the company, with regular reviews to ensure that we're maximizing the potential of each business. We anticipate that a divestiture of our Martindale and Specialty Scripps pharmacy businesses will be occurring in the next few quarters. We've completed the acquisition of Biotech Pharmacy and Cyclotron which increases our cyclotron production facilities in the test phase. This is an area of strong growth potential within our nuclear business.

I would wrap up my comments about the quarter by saying that our year is off to a good start. Our core businesses are tracking well and we're make going progress on our key initiatives. Now I would like to make a few comments about the remainder of fiscal 2010. Back in August we outlined the head winds we expected to face in 2010, and at this stage there are no real changes to our perspective on the year. We're making important investments in the business, we're executing against our key initiatives and I'm encouraged by our progress. Based on where we are at this stage we expect that our full year performance will likely come in toward the higher end of our non-GAAP EPS guidance range of $1.90 to $2.00.

Before I turn the call over to Jeff, I'd like to mention a couple of things. We have two important additions to our senior leadership team. Patty Morrison joined us in August as our Chief Information Officer. Patty has served as CIO at Motorola and Office Depot, and has extensive experience with large scale supply chain processes. Mark Blake joined us just last month from MedCo Health Solutions as our Executive Vice President of Strategy and Corporate Development. Mark has extensive business development experience and also brings investment banking and consulting. We're thrilled to have them both on board completing our 10-member executive committee.

Our board of directors also recently added two directors with exceptionally strong backgrounds -- Bruce Downey and Glen Britt. Bruce brings valuable healthcare experience from his time as Chairman and CEO of Barr Pharmaceuticals, and Glen brings a wealth of leadership and financial expertise as the current Chairman and CEO and former CFO of Time Warner Cable. I look forward to working with Bruce, Glen, and the entire board as we move forward. Now let he me hand the call over to Jeff for more details on the quarter.

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Good morning, everyone. Thanks for joining us. As George mentioned we're very pleased to report that our first quarter consolidated results were above our expectations driven by solid operating performance and supplemented by a few noteworthy items. The steps we began take last fiscal year to drive performance improvement within the company can be seen in our first-quarter results. For my presentation this morning, I'm going to take you through the consolidated results for the quarter, update you on some key financial drivers, and then spend some time going through our outlook for the remainder of the year.

Let me start with a few comments on our financial results from continuing operations on a non-GAAP basis. My comments will relate to slides 4 and 5. Consolidated revenues were up 6% to $24.8 billion. Operating earnings were up 3.8% to $323 million reflecting excellent growth in our medical segment and performance better than we anticipated in our pharma business. We continue to exercise good discipline regarding operating expenses, and I have worked hard to mitigate the costs associated with the spin-off. For the quarter we reported total non-GAAP operating costs of almost 1% lower than last year's Q1. We're able to absorb the considerable investments to prepare for the future.

Please note that we have begun to break out other interest expense in our financial statement presentation. Other income improved by about $10 million versus last year. Primarily due to deferred compensation asset gains and credit adjustment related to FAS 157 marked to market accounting. Interest expense increased slightly year on year to about $34 million.

Our non-GAAP tax rate for the quarter was 35.4% versus 39.8% last year. The lower rate in the current quarter was attributable to a change in estimate for our deferred state tax accrual which is a discrete item for the quarter. In last year's Q1 we also had a change to our state deferred tax accrual that moved it in the opposite direction. Overall we're still on track with our guidance for a rate of 36% to 37%. Non-GAAP diluted EPS was $0.54 for the quarter up 14.9% from the prior year.

Now moving to our cash flow statement and the balance sheet. For the quarter, we reported total operating cash flow of $406 million. Because of the mid-quarter spin, the allocation of these flows between continuing and discontinued operations is a little complex but approximately $262 million of that is attributed to continuing operations versus the use of almost $500 million in the year-ago period. This cash flow was driven by strong operating performance combined with excellent working capital management, including a reduction of approximately three days of inventory versus the prior year's Q1. Our accounts receivable days are down slightly year on year, and bad debt expense is tracking consistently with our expectations.

Turning to slide number 6, let me take a moment to walk you through the items that impacted the difference between our GAAP versus non-GAAP EPS numbers. These figures are on an after-tax basis. Restructuring and employee severance was approximately $42 million, primarily driven by restructuring charges related to the spin-off. Impairments and loss of assets were $16 million primarily due to an impairment charge related to Specialty Scrips. Other spin-off costs totaled $198 million. The biggest items in this category included $172 million tax charge related to the portion of earnings and cash that will no longer be indefinitely invested offshore as well as approximately $26 million related to the tender and retirement of over $1.1 billion in debt as we reset our capital health structure post-spin.

Let me spend a moment on the tax charge. With the spin-off complete and our business mix outside the US smaller it is unlikely that all of our offshore cash earnings will be invested indefinitely overseas. On August 18, we advised you that we anticipated taking approximately a $150 million charge related to offshore funds that would need to be repatriated at some point. Initially the charge will primarily be noncash but could eventually translate into cash tax payments when we repatriate. We would anticipate any repatriation of cash to occur over the next several years. Our prior estimate of $152 million tax charge related to this APB-23 at tax stations came in as expected. In addition, we incurred $20 million of incrementally interest, resulting in $172 million total impact. Also please note these charges are not reflected in the anticipated non-GAAP tax rate of 36% to 37% for the full year fiscal 2010. The total negative impact to GAAP EPS in these items was $0.71, or $256 million for the quarter.

Turning to slide 7, I want to call out a few note worthy items in our non-GAAP numbers. The our first-quarter operating numbers were somewhat enhanced by some unusual or timing events. It was a spin-off related revenue recognition item in our medical segment which is worth about $14 million of profit or $0.02 to $0.03. This is due to acceleration of timing for recognition of revenue and profit on inventory being held by CareFusion's international business at the time of the spin. Although we anticipated this it was slightly higher than expectations.

In the pharmaceutical segment we saw some earlier than expected price increases from some brand manufacturers that were not significant on an individual basis but collectively had an impact on the quarter. This shifted what we believe is about $15 million or $0.03 of pretax earnings from future periods, namely Q2 and Q3. Impact of an early and strong flu season which increased demand for a number of medical product was worth about $5 million or $0.01 of EPS. As I mentioned earlier the difference in effective tax rates between this year and last was worth about $0.04. Finally, within other income and expense we had $0.01 to $0.02 of benefit compared to last years quarter driven by the items I mentioned earlier. However, I should point out that although the deferred compensation issue which is worth over a $0.01 does show up in other income and expense, it had no net effect on the income statement as there is an off setting adjustment through SG&A.

Turning to slide 8, I would like to call out a few items on the balance sheet that relate to the spin-off. The book value of our ownership stake in CareFusion calculated as assets minus liabilities as of September 1, totaled approximately $861 million. Marked-to-market on September 30, this equaled $902 million. This amount may be found on the line labeled Investment CareFusion. As mentioned in August any marked-to-market fluctuations do not flow through to the income statement until such time as we actually sell our shares in CareFusion.

Under other assets, approximately $212 million of the $735 million is listed as a receivable from CareFusion with an offsetting tax liability. This is recorded per our tax matters agreement with CareFusion. Within the liability section of our balance sheet, you will see a long-term debt balance of $2.1 billion, and another $350 million of debt in the current portion of long-term obligations. That $350 million represents some floating rate notes that came due in October and were paid off. In conjunction with the debt tender and some synthetic lease facilities that were paid off in Q4, we've now reached our target debt structure for new Cardinal Health of $2.1 billion. The $172 million repatriation related tax charge I discussed earlier flows through the deferred income taxes and other liabilities line. Finally, note the $3.7 billion dividend of CareFusion on September 1 was treated as a dividend to shareholders and therefore is deducted from retained earnings. Note that retained earnings are lower by approximately that amount from last quarter.

Before we get to the segment results, I want to answer a question we received regarding the accounting and tax treatment of any divestiture of our CareFusion stake, specifically we've been asked whether we are subject to capital gains and losses from the sale of any CareFusion shares. The answer yes, we are subject to capital gains and losses for tax purposes. Also from an accounting perspective, any equity sale of CareFusion would be recorded on the P&L as a gain or loss versus the book value at the time of spin.

Now let's turn to segment performance, and I will be referring to slide 9 and 10. Pharmaceutical segment had a stronger start than we expected to FY 2010. Revenue increased 5.4% to $22.6 billion for the quarter, driven by strong growth in Pharmaceutical Distribution. Revenue growth was balanced between bulk and non-bulk businesses at 5.6% and 5.3% respectively. Segment profits were $208.4 million, a decline of 2.3% compared to last year. This is primarily driven by the timing and reduction in new generic launches and price deflation as well as customer contract repricing and the impact of the Medicine Shoppe transition. However, we did have some significant positives of note in the quarter. Our nuclear pharmacy business had strong growth and margin expansion despite some of the supply issues they are facing. We continue to perform very well under our DSA agreements we have with our branded vendors. We made good progress in our generic sourcing and compliance initiatives as well as overall generic sales. As mentioned earlier, branded buy margin timing shifts also helped the quarter within pharma distribution. And finally, we continue to exhibit overall disciplined cost control across the segment.

One other item I wanted to cover relates to bulk/non-bulk margin that we'll be breaking out in our 10-Q which is being filed within the next couple days. Within our pharma business you will see nine basis points of segment profit margin improvement related to non-bulk customers, going from 1.73% in Q1 FY2009 to 1.82% in Q1 FY 2010. Our bulk business reported what I would describe as an abnormally low segment profit margin of three basis points for the quarter. Now I should mention that we have expected to see a full-year decline in bulk margin in FY 2010 versus full year FY '09, driven by major contract repricings, the mix of our expected brand price increases, and year-on-year generic launch comparisons.

That all said, there are also some unique items and seasonal impact in Q1 which together account for at least 15 basis points of the difference in bulk segment profit margin versus our expected full year rate. Final comment on our bulk and non-bulk margins I think is important. Although we did break out our margin by this classification in our 10-Q this is not really the way we price or view our business. We price and bid for business by customer, not by business type. In other words, when we price contracts we look at that time overall profitability and return on capital for that particular customer, ensuring that we receive fair value for the overall basket of products and services we provide.

Turning to our medical segment they had a very solid start to fiscal year '10. Revenue increased 9.8% to $2.24 billion for the quarter driven by robust organic growth, the accelerated revenue recognition benefit I mentioned earlier, and demand for flu related product. Ambulatory, lab, and Canada had particularly good quarters. Many of the actions we began to implement with regard to pricing structures and customer outreach have started to take hold. Segment profit was $114.9 million, an increase of 17.4% over last year, driven by organic growth, the spin-off revenue benefit, flu demand, and commodity price decreases, partially offset by medical transformation spend and loss earnings associated with the divestitures of TeCoMet and Med Systems. Overall, as George mentioned, we are encouraged by progress made over the quarter in both of our segments, although we realize we have more work to do to position us for long-term sustainable growth.

So turning to slides 12 to 15 let's review FY 10 outlook. Our pharmaceutical segment assumptions shown on slide 12 remain the same including many of the market factors, strategic moves and investments which impact the full year. There are two items I'd like to specifically call to your attention. First is our assumption around the raw material supply shortage in nuclear. For now our forecast maintains our assumptions that supply issue will be resolved in January. That is a potential risk for the second half of the year. Second, our projection for full year revenue within pharma remains at modest growth, despite the relatively strong start we saw in Q1. Revenue on full year sales reflects the impact of a couple of customer losses that George spoke about earlier which began to impact us in Q2. Our medical segment assumptions remain essentially the same as we outlined in August as shown on slide 13. Segment revenue growth may be slightly above the overall market driven by our mix and the accelerated revenue benefit that happened in Q1.

Regarding our overall EPS guidance range, as I mentioned a portion of our performance in Q1 was one timish in nature or a pull forward from future quarter, in particular Q2. Therefore we have readjusted our internal quarterly forecast for the remainder of the year to account for this. Taking into account these issues and given the good core performance we have seen so far we now expect non-GAAP earnings per share to be toward the higher end of our $1.90 to $2.00 guidance range. As shown on slide 15, our corporate assumption around tax rate, capital expenditures, and shares outstanding remain essentially the same. We now expect the combination of net interest expense and other to be approximately $120 million for fiscal '10.

And finally, there are a few upcoming events I would like to highlight. The first is that we'll be filing our 10-Q in the next few days that will detail our financial results. Second, as I mentioned in August, we will be filing recast fiscal '09 financials in a Form 8-K next week. This will include adjusted financials which reflect the impact of the CareFusion spin-off and will look similar to those included in our August 18 8-K filing. Finally I want to make you aware of the new format of our income statement. We have done some benchmarking and collected feedback from our investors. As a result have made some minor enhancements in an effort to improve clarity and transparency in certain disclosures on the income statement. We hope you will find this slight change helpful. With that, I'll turn it over to George for Q and A.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Thanks, Jeff, and Operator, we're ready to take Q & A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Lisa Gill of JP Morgan. Please proceed.

Lisa Gill - *JPMorgan - Analyst*

Hi, it's Atif in for Lisa. As we look at the earnings guidance you provided, the run rate for this quarter implies you should be over $2.00 for the year but we recognize there are some items that are going to be nonrecurring so could you perhaps quantify by EPS guidance that wouldn't be recurring in future quarters to give us a better picture of what the quarterly progression might look like going forward?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Sure. Thanks for the question. I went through a little bit of this during my script but let me try to review some of these again, I would be happy if there's any additional follow-up questions. First of all there was a unique acceleration of revenue and profit within medical and let me explain in that a little bit more detail. That was worth about $14 million of profit or $0.02 to $0.03 and the way it worked is basically as follows. When we owned both the domestic and international operations of our medical business, we did not recognize revenue or profit on sales until we sold to the end customer. So our domestic business would sell to our international business, our international business would hold those products in inventory, and then when they eventually sold to an end customer we recognized that revenue and profit on the consolidated books of the company. The moment we spun off CareFusion, and they took the international business with them, effectively they became a third party. So any inventory they were holding at that moment of the spin-off effectively got reclassified as a sale of product, and that revenue and income got accelerated into the quarter of the spin. As I said, that was worth about $14 million or $0.02 to $0.03 on EPS basis.

In the pharma segment, as both George and I mentioned, there were a number of price increases which individually weren't significant, but collectively represented a pull forward of about $15 million of income, which is about $0.03 of earnings from future periods. Versus our original expectations, most of that came from either Q2 or Q3. So again, way view that as a pull forward from future quarters, not necessarily an add-on for the year.

The other unique item in Q1 was the early and strong flu season. That impacted mostly within our medical segment and as we've said that was worth about $5 million or $0.01 of EPS. Now, I assume a follow-up question would be, well, wouldn't you expect that to continue through the whole year and the answer is we don't know. It's obviously very hard to predict the flu season although we do expect to see continued flu related demand in Q2. However, I would point out that that demand is dampened somewhat by the fact that we're on allocation for a number of products from our manufacturer. So the ability of that demand to necessarily flow through as incremental earnings in Q2 and beyond is somewhat dampened. So we may see a slight up-side to Q2 as a result. I would also mention that we planned for flu season in Q2 and Q3 as we typically do. It was really the Q1 piece that was unplanned because of the early and stronger issues we're facing.

Lisa Gill - *JPMorgan - Analyst*

Okay, that's great clarity. Just as a follow-up, the medical distribution and the revenue recognition, that's a one-time event, we're not expecting that to recur?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

That's correct.

Lisa Gill - *JPMorgan - Analyst*

Then a second question related to revenue that you lost from the customers. Any way you could give us an idea what that is around?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

They were fairly significant in terms of revenue. In total we're talk in excess of a billion dollars of lost revenue for those customers which begins to impact us in Q2 and beyond. Although as George said, the impact on profitability from those same customers is much less significant.

Lisa Gill - *JPMorgan - Analyst*

Got it. Thanks very much.

Jeff Henderson - *Cardinal Health, Inc. - CFO*

You're welcome.

Operator

Our next question comes from the line of Randall Stanicky of Goldman Sachs.

Randall Stanicky - *Goldman Sachs - Analyst*

Just a couple, Jeff, you talked about the medical segment growing slightly above market. Can you just remind us what your outlook for market growth there is?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Well, it depends on which market you're looking at, Randall. Typically our expectations for the hospital market looking forward is to grow in the 2% to 3% range, and that's generally what we're seeing this year as well. Ambulatory market growing more quickly. The lab market growing more quickly, driven in part by the flu-related demand which disproportionately impacts the lab market during times like this. But the biggest market is hospital, which is 2% to 3%.

Randall Stanicky - *Goldman Sachs - Analyst*

So are we thinking, just given the strength of growth this quarter, mid single-digit growth rate?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Yes, we haven't given a specific number, but I would say as a ballpark, not an unreasonable assumption.

Randall Stanicky - *Goldman Sachs - Analyst*

And then, George, given all efforts to on the generic sourcing side, I know you've got a lot of similar efforts on the sourcing set in the medical business. Can you talk about, as we think about the margins, the magnitude of opportunity, and then the timing of that opportunity in terms of how it should play to the P&L?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Randall, that's a little bit of a tough question, because, as you might imagine, the sourcing connects to the selling which connects to the flow of product into the system. So net-net we've said that certainly the earlier part of 2010, we have some trade-offs that are somewhat negative. Fundamentally though this is a driver of growth for us and of margin, and I would say we'll feel this more as the year goes on. But we have to flow these products into the system, as I mentioned in my comments earlier, there's a transition stage where we have to honor existing commitments. But I would say net-net this has gone extremely well. We're really excited about it. I think it's good for our customers and good for our suppliers and feeling very good about that program.

Randall Stanicky - *Goldman Sachs - Analyst*

Finally on the same topic on Medicine Shoppe, any change in terms of how you're think about the break-even timing for that business?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

No, I still think that we'll be working throughout 2010 to compensate for some of the lost fees by growing our business with each of those account and I think we're doing a good job and I still think that as we get into 2011 that starts to feel like more of a positive driver force.

Randall Stanicky - *Goldman Sachs - Analyst*

Great, thanks.

Operator

Next question comes from the line of John Kreger of William Blair.

John Kreger - *William Blair - Analyst*

Quick follow-up to Randall's question. I think you mentioned at the beginning of the call that your generic supplier number had gone down to about 30. Do you expect that to be stable or you will drive it down further?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

No, I think that's about where we belong, John. There are a relatively smaller number of manufacturers that have the broadest lines and the greatest flow of new production. Clearly those companies tend to be larger, I think, in the practice. But this is an enormous product line. You're talking about several thousands of products, so there's a need to have enough suppliers to make sure that we have not only the product but we have backup suppliers. As you know, there are things that happen now and again in the system, and we've tried to take care to make sure that we've got backup supplies or access to backup supplies when there's a disruption.

John Kreger - *William Blair - Analyst*

Okay, thank you. And your latest timing or thinking on when that will start to benefit the P&L? Is it sort of the early half of your fiscal '11?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

It's so hard to describe the benefit, because the generic program really is an integrated program. So you have the sourcing and procurement part of it, and then you have the selling part of it. And, in fact, one ties to the other. So certainly in the early part of the year we're feeling a little bit more of the brunt of it. But I would say it's been modeled into our year. We're feeling comfortable that it's been modeled appropriately, and I think we're on track to deliver as we expected.

John Kreger - *William Blair - Analyst*

Thanks. Then just finally, if you look out over the next year, for your pharma business, any key sell side customer renewals that we ought to be thinking about, or have the primary ones already been taken care of?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

This year is a relatively calm year as we get to the end of the year, into next year. We'll see K-Mart will come up for renewal and Kroger will probably be two of the larger companies that would come up for renewal.

John Kreger - *William Blair - Analyst*

Thanks very much.

Operator

Your next question comes from the line of Eric Coldwell with Robert W. Baird.

Eric Coldwell - *Robert W. Baird - Analyst*

Thanks very much. A lot of things going on this morning. Sorry if I missed this, but have you discussed or will you discuss at all what your intentions might be with the CareFusion shares? I know there were some prepared comments on what happens in the P&L and balance sheet when you decide to take some gains on that, but the stock's been very strong, they just announced up side this morning. I'm curious whether that might spike some interest to take some money off the table?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Good morning, Eric. This is Jeff. No, I haven't commented on that but let me tell our current expectations. First of all, let me reiterate that in order to maintain the tax-free nature of the spin we are committed to divest our remaining ownership in CareFusion no later than the fifth anniversary of the transaction. However, our current expectation is that we'll start our process of selling CareFusion shares over time within the next year or two, including through Rule 144 sales. Those sales could commence as early as this quarter depending on market conditions and other factors. As we indicated the onset of the spin we intend to do so in an orderly and responsible manner.

Eric Coldwell - *Robert W. Baird - Analyst*

Okay, thanks for that detail. Then a follow-up question. You've done a good job in nuclear, no doubt about it. Very strong profit growth. I'm hoping you can give a little more detail on what the primary driver of the profit expansion in a period where isotope supply obviously is challenged, and also what happens in January if, in fact, the supply does not come back fully on-line, how should we think about the model impact and how would you respond to that. That thanks so much.

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Great question, Eric. First of all, I want to send out some kudos to the nuclear team who is doing an outstanding job of managing through the these supply situations. I will point out we've been through these situations many times in the past and we have very specific procedures that we follow in order to maximize usage of the supply that we get and also manage the customer demand in such a way that we can allocate supply in a more orderly way when we have these supply shortages. Despite that, as I said, we experienced some very strong growth in margin expansion, and that's really due to the impact of the generic event that happened last year together with the fact that we are now able to offer three different options for customers in terms of the raw materials going into the imaging agents. And by offering that suite of products, by pricing them appropriately and bring in place an effective selling and sourcing strategy, we've really been able to gain margin over the past year and we expect to continue that trend going forward, assuming that we don't hit some additional snags from a supply standpoint. Now, I will point out that, as I said, the expectation is the Canadian Chalk River Reactor will come on board in January. If it doesn't, another wildcard will be what happens to the reactor in the Netherlands which is scheduled for maintenance in Q3. If they are both down, that obviously would put a very significant crimp in the supply for the entire industry, and if that's the case and if we suffer sort of the dual off of supply in the second half of the year that potentially is a $0.03 to $0.04 downside for second half of the year should.

Eric Coldwell - *Robert W. Baird - Analyst*

Thanks for the detail.

Operator

Your next question comes from the line of Larry Marsh of Barclays Capital. Please proceed.

Larry Marsh - *Barclays Capital - Analyst*

Thanks and good morning. Great start to the year. Couple quick things. First, Jeff and George on pricing, you talked about $0.03 or $0.04 pull forward for manufacturers this quarter, so think about that coming out of Q2, a little bit out of Q3. Could you reconcile the comments there to sort of the structure fee for service relationships under those you don't really have to think about when pricing occurs. Then net-net for fiscal '10, do you think pricing is a net positive relative to your earlier expectations, given what you're seeing so far?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Great question, Larry. First of all with the transition of Pfizer to a more typical fee for service arrangement, we now see about 80% of our business being on a fee for service arrangement, which obviously is a significant portion of our branded margin. That all said, there's still that remaining 20% that's subject to the variability of price increases. And in any given quarter, that 20% can have a significant influence on earnings and EPS, which is why we still get some of these somewhat unusual timing issues or one-time events in the quarter. There are still a number of larger manufacturers, but then a number of very small manufacturers that remain under the old model that can impact a particular quarter. Regarding our overall views on branded price increases for the year, I would say at this point we still expect it to be largely in line with original plans for the year. It was slightly higher in Q1, as we said, by $15 million than we expected, but at this point we have no reason to believe that's not just simply a pull-forward for the year. So no material change for the overall year.

Larry Marsh - *Barclays Capital - Analyst*

Okay. Second question on the generic sourcing, George, we've talked about strategy there narrowing the manufacturers, and you communicate that here today. Does the progress of your program, costs this year versus benefits next year, are you confident in that end result, and do we think of Cardinal as being a bit differentiated versus competitors here, or more like its competitors? Then a very quick one. Is there an opportunity on some of the generic injectables hitting the market? I know some of your competitors have talked about generic eloxatin, do you see that as an opportunity given your knowledge of the generic space?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Thanks, Larry. The generic program transition for us has gone extremely well. Our team executed well. Our generic partners have been really open to looking at new ways to doing business and we're really pleased with the way it's going so I would say I'm feeling very confident that the work that we've done has set us in a good place as it relates to creating value for our customers downstream and for our vendors upstream so I'm really feeling good about it. I think we're on track to do exactly what we intend to do with that program. At is a relates to Eloxatin, it certain is a product that we're always excited to have a generic launch. It may be bigger for one company versus another depending on mix of downstream customers. So, for example, if you have a large oncology business it may be more meaningful launch for you unless oncology is a smaller piece. So for us oncology is not an enormous part of our business we're glad to have the launch but I wouldn't describe it as a huge mover of the dial. I'm thinking you asked about the generic program and whether or not we're differentiated. We have taken great pains to think about every one of our products and every one of the suppliers and what their strategies are and what they're looking for in a distribution partner. And my hope is that we've done that very effectively. I think we have, and to that extent I think we're very well positioned to compete in generics.

Larry Marsh - *Barclays Capital - Analyst*

Okay, and then a quick clarification. Jeff, you mentioned CareFusion sales would be subject to capital gains. Do you have an idea what your cost basis is in CareFusion?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Yes, first of all, it's still something that's being finalized, Larry, because there's some somewhat complex valuations that have to be done before we can come up with a final number but our best estimate at this point is that our initial stake on a tax basis will be worth at least $820 million.

Larry Marsh - *Barclays Capital - Analyst*

So, roughly per share, just in terms of what you're thinking, is that like, what, $4.00 or $5.00?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

No, just one second. We'll get back to you on that. We'll look at the calculation.

Larry Marsh - *Barclays Capital - Analyst*

You can answer later in the call. Thanks.

Jeff Henderson - *Cardinal Health, Inc. - CFO*

But I do want to point out, as I said earlier, we would be subject to gains or losses from any sale of those shares, although whether we end up actually paying cash taxes or not will depend on any capital losses that are available at the time to offset that gain.

Larry Marsh - *Barclays Capital - Analyst*

Thanks for clarification.

Operator

Your next question comes from the line of Ross Muken of Deutsche Bank.

Ross Muken - *Deutsche Bank - Analyst*

So now that we've gone through the process and the workforce has been split and we've got the new Cardinal Health fully operating, what's been the sort of response from the workforce? Have you seen anything different in terms of productivity? Are there any specific things you're measuring to sort of see if you're getting some of the benefits of the split on sort of the new focus of the employee base? Just trying to get a sense for what's changed in terms of life at Cardinal.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Sure, Ross, I'll take that and thanks for the question. Yes, actually we feel great about the way our organization is responding to the spin-off. In some ways, an event like this is a catalytic event. It's really enabled us to recharge the organization, to reaffirm our focus on improving the cost effectiveness of healthcare and to help people understand how they play a part in that. So I would say the organization is excited. We do a very routine measurement of our organization. We call it the voice of employee. What we're looking at is engagement and we measure this in many ways. If you look at our numbers today versus where they were a year ago there's a dramatic improvement. It tells us our employees feel good about who we are, what our mission is, where we go, where we're going and what their role. And we're seeing in that in the daily performance of the organization. So I would say anecdotally I'm very excited about what I'm seeing in terms of the attitude of our employees. In terms of metrics, the data suggests pretty consistently that our organization is excited, focused, clear about priorities and performing at a high standard right now, and I'm very pleased about it.

Ross Muken - *Deutsche Bank - Analyst*

Great, thank you.

Operator

Your next question comes from the line of Tom Gallucci representing Lazard.

Colleen Lang - *Lazard - Analyst*

This is Colleen Lang representing Tom. Did you say the bulk margins were 3 basis points and that was negatively impacted by about 15 bips of unusual items?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

That's, in fact, exactly what I said.

Colleen Lang - *Lazard - Analyst*

Okay, just wanted to make sure I heard that right. And what's your expectation for bulk margins for the year then?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

We generally don't give a forecast for specific parts of the business, but I think the indication I gave regarding some of the abnormal events probably helps you get a little closer to what we'd expect the full year rate.

Colleen Lang - *Lazard - Analyst*

So closer to 20. Last quarter you talked about the opportunity for improved pricing through better governance and improving how you bundle services. Could you give us an update there?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Yes, this is obviously not a one-time event, Colleen. This is really a thoughtful rethinking about our portfolio and the way we price our portfolio. As we mentioned during the call we're trying to take a very disciplined approach to analyzing our business and our customers. And while I can't say it's something with a beginning point and ending point, it is really an ongoing process. I feel very good that the organization has built the tools to do this kind of work. We're doing things that we need to do, enforce our own standards about pricing and how we analyze pricing, and I'm feeling like we're moving the right direction.

Colleen Lang - *Lazard - Analyst*

Okay, great. And one last thing, we saw a news article that you guys have a new product for mail customers to help improve efficiency. I think it's called EZ cart. Any color on that product and any types of initiatives that you're doing to help your customers?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

this is an example of sort of listening to the customers what their unique needs are. Each of our customer segments has very distinct needs, and even within segments that we typically hear discussed in the public forum, there are distinct needs customer by customer. And part of what we need to do as an organization is focus our business on the unique needs of each customer. In this particular case it was about better efficiency and stocking, and particularly unique to the mail order segment. I think we're doing a good job of listening and translating the listening into inventive ways to help customers compete and create value for them.

Colleen Lang - *Lazard - Analyst*

Okay, great, thank you.

Operator

Your next question comes from the line of Steven Valiquette of UBS.

Steven Valiquette - *UBS - Analyst*

My question was also on the branded drug price inflation and fee for service you touched on. A couple of quick follow-ups to better understand this. Was this product where you were specifically loading up on inventory, ahead of the price increases, or was it just natural inflation on a normalized level of inventory that you were holding that it was material enough to move the needle? That's part one. Number two, I guess I'm still not sure mechanically how you know at this stage that this is a pull forward from future quarters. How do you know there won't be more price increases from these same manufacturers either around that's product or on a different bundle of products?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Great questions. This is Jeff. First of all, Larry, let me go back to your question. The $820 million or so of tax basis in CareFusion works out to a little under $19.50 per share. Regarding your questions on the price increases, it was the latter of the two scenarios you described. We did not take on additional inventory to achieve the benefits of these price increases. Just natural price increases that the vendors took that we were able to realize the benefit of our inventory levels. In fact, as I mentioned earlier, our days of inventory were actually down three days year on year, really reflecting some of the great efforts going on in the pharma distribution group to bring down our days of inventory and maximize cash flow. Regarding your second question, how we know for sure this is a pull ahead, I think the reality is we don't. We make certain assumptions regarding the timing amount of price increases from vendors based on the historical patterns. Once we see price increases, we have to make judgments whether those are pull-forwards or not. But your question is a fair one. It could very well be that we'll see price increases again later in the year, and obviously that would be an upside if that occurred.

Operator

Your next question comes from the line of Helene Wolk of Sanford Bernstein.

Chris Smith - *Sanford Bernstein - Analyst*

This is Chris Smith for Helene. Turning back to the generics program what percentage of customers are now buying generics from Cardinal?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

This is George, Chris. The overwhelming percentage of our customers are buying generics from us. Again, this is the pharmaceutical segment, the overwhelming percentage of our customers are buying generics from us in some form but that comes in different ways. Some of those customers are buying exclusively or some exclusively off our generic program. There are others for whom we essentially serve as prime vendor, based on their contracts, but in terms of numbers of customers, the overwhelming majority of our customers buy generics from us in some form.

Chris Smith - *Sanford Bernstein - Analyst*

Okay. Have you seen an increase in the amount of generics or the amount that they're relying on Cardinal?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

We are seeing, and this is something you've probably heard me talk about in recent months, and whether or not you use the penetration or compliance, what we're looking for customers to bay as much of their generics from us as possible. And we are seeing sequential growth in the percentage of the customers' generic business. We're very pleased about that and we've been working hard at that and it's an important driver for us.

Chris Smith - *Sanford Bernstein - Analyst*

Okay, and on the supply side, with consolidation and also supply constraints in generics, have you seen a stabilization of pricing, or perhaps even increases in generic pricing?

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

It's been episodic and certainly event-driven. So there have been some, as know, some disruptions in supply, really over the last year at various times. And so those disruptions can cause volatility in demand, but also a little bit in pricing. So some prices have gone up, or are quite stable. And others look like the traditional competitive market. So I would say the way to think of this is primarily event-driven. It's hard to give sort of a systemic trend as opposed to unique distinct items.

Chris Smith - *Sanford Bernstein - Analyst*

That's helpful. Last question, just curious if you have an update regarding the level of negative synergies expected from the CareFusion spin relative to what was provided in June?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

No real update other than what we said over the past couple months is that our intent has been and will continue to be to more than offset any negative synergies that result from the spin, and in fact we're doing just that. Our plans for the year were to more than offset those reductions in our infrastructure and particularly holding down headcount and infrastructure within our corporate functions. We've achieved that as you can see by the 1% reduction in SG&A in the first quarter, we've been quite successful at doing it. So I feel quite good about our ability to offset those going forward.

Operator

Your next question comes from the line of Blake Goodner of Bridger Capital.

Blake Goodner - *Bridger Capital - Analyst*

Good morning. Two quick questions. I know you tried to address this earlier. I want to make sure I understood it. On the non-bulk side it sounded like you had good performance, up nine basis points, sounds like if anything you're ahead of your plan, but on the bulk side, the three basis points, can you walk through the reasons why that was so far below the 20-bip target for the year?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

Sure. First of all Q1 is always our lowest of the year due to the somewhat seasonal nature of our business and when branded price increases happen, which tend to be in the late Q2, Q3, Q4 period. So historically Q1 is always our lowest margin period. Secondly, there were a few unique events, let me give you a couple examples. We were subject to an excise tax in the state of Delaware that relates to the shipments that we make into Delaware to one of our mail order customers. This relates to a longstanding dispute over the applicability of those excise taxes to our shipments into Delaware. As a result of a recent court ruling, we decided to accrue for what turned out to be about $10 million of potential historical expenses related to these excise taxes, because all mail order business as in bulk that $10 million very disproportionately impacted our bulk margin. Secondly, and this is a little bit more complicated to explain, but depending on the exact vendors that increase branded prices in any particular quarter, they can disproportionately hit non-bulk or bulk. Again, I won't go into all the nuances and complexities of why that may be, but it relates to the amount of inventory that we carry in those two businesses. But as a result of the particular price increases we saw in Q1, the year on year comparison for bulk tend to be a little bit distorted. So that's really what makes up the difference in Q1 versus what we'd expect the full year rate to be.

Blake Goodner - *Bridger Capital - Analyst*

Great, that's helpful. Then my second question just relates to free cash flow performance looked pretty good in the quarter. Any sense for sort of just more color on how you expect free cash flow to trend throughout the year? This quarter, it would seem you're tracking towards $850 million of free cash after CapEx. Any general color there? Is that coming in versus your target?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

We haven't given a specific guidance on our cash flow projections other than our last call I did say we would expect operating cash flow for the year to be under a billion dollars, and way say that's still very much our expectation. Whatever our cash flow does come in, a substantial amount of that is already committed, either to our capital expenditures which we expect to be $200 to $250 for the year, a bulk of that going into our IT systems improvements, and then we have our dividend program and as you know we increased our dividend last quarter. And then the share repo that we're doing related to the offset of any equity issuances over the year, so a substantial portion of that operating cash flow is already spoken for. I think that's pretty much the guidance we provided at this point.

Blake Goodner - *Bridger Capital - Analyst*

Thanks so much.

Jeff Henderson - *Cardinal Health, Inc. - CFO*

You're welcome.

Operator

Your next question comes from the line of Charles Boorady of Citi. Please proceed.

Garen Sarafian - *Citi - Analyst*

Hi, this is Garen I sitting in for Charles. At your last investor day you provided this slide with the major head winds and tail winds, and I know you went through many of them, but there were some that I didn't hear, and apologies if we missed it, but can you update us on the rest of the head winds and tail winds? I don't think I heard on some of the transformational investments, for example.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Let me give you a quick update. I think we've covered a good many, but perhaps we didn't provide enough clarity. Certainly we talked about the year-over-year, which the largest swing is sort of a systemic swing which is the year-over-year generic comps. Those are playing out pretty much as we expected. No particular change there. We've got relatively good visibility on that. That we talked a little bit about the Medicine Shoppe transition and I would say that transition continues to move forward, and we're feeling quite good that that's the right strategic direction for us. The Pfizer DSA switch is at this point something that comes in the future, and we fully expect it will play out as expected. We have continued to invest in our medical transformation. This is integral to our strategy for medical business and really so important in terms of our ability to take advantage of what we think is a unique business model in which we have this tremendous channel footprint as well as vertical capability. So the medical transformation a very important initiative. It's ongoing. I am trying to think of what other drivers we did not touch. Those really are the biggest ones, so hopefully that gives you some clarity.

Garen Sarafian - *Citi - Analyst*

Thank you very much.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

you are welcome.

Operator

Your next question comes from the line of Richard Close with Jefferies Company. Please proceed.

Dana Hambly - *Jefferies & Co. - Analyst*

Thank you. This is Dana Hambly in for Richard. The inventory days, Jeff, is 23 days the right way to think about it now? Is that a good run rate, or is there something, maybe something that would have impacted that positively this quarter?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

No, I wouldn't describe it as a timing issue. Our inventory days can fluctuate a little bit depending on the particular quarter that we're in, which is why I think always the year-on-year comparison is the best comparison versus sequential, but I think the three-day reduction from last year is a pretty firm number. Do I think there's additional opportunity over the coming years to bring that down some more? Yes. I think to make a day or two improvement over the next couple years is still very much within our objectives, and we have plans in place to go after that but I think the number you saw is indicative of some very solid work, there were no particular loops of timing in there.

Dana Hambly - *Jefferies & Co. - Analyst*

On the medical segment, a competitor called out a significant supplier price decrease as benefiting them in the quarter. Did you see anything similar?

Jeff Henderson - *Cardinal Health, Inc. - CFO*

No, just want to point out the difference between how our competitor accounts for their inventory versus us. It's my understanding they use the LIFO inventory method, which means they will potentially have LIFO credits or debits at the end of each quarter, depending on supplier price changes during that quarter. Although we use the LIFO accounting method within our pharma business, within our medical business we actually use FIFO so we are not subject to the same credit or debit adjustments at the end of each quarter depending on supplier price changes.

Operator

At this time we have no further questions. I will turn the call over to Mr. George Barrett for closing remarks. Please proceed, sir.

George Barrett - *Cardinal Health, Inc. - Chairman & CEO*

Thank you. I would just like to conclude the call by saying we're really pleased with our start to the year. We would like to thank you for your time today. Our IR team, Jeff and I will be available for questions and we look forward to speaking with you again soon. Thanks everyone.

Operator

Ladies and gentlemen, if you wish to access the replay for this call you may do so by dialing 617-801-6888, or 888-286-8010 with an ID number of 83452415. This concludes our conference for today. Thank you all for your participation, and have a nice day.
