

# FINAL TRANSCRIPT

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**CAH - Cardinal Health, Inc. at JPMorgan Healthcare Conference**

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## CORPORATE PARTICIPANTS

### **Lisa Gill**

*JPMorgan - Analyst*

### **Jeff Henderson**

*Cardinal Health, Inc. - CFO*

## PRESENTATION

**Lisa Gill** - *JPMorgan - Analyst*

My name is Lisa Gill, and I am the healthcare technology and distribution analyst with JPMorgan. This morning we have Cardinal Health. Cardinal is a leading healthcare services company and provider of distribution and other innovative products and services. This company has broken down into four segments, which is pharmaceutical supply chain, which is the main drug distribution business, medical supply, medical product manufacturing, and clinical technologies and services. Over the last year or so, Cardinal has really been the tale of two cities. When you look at drug distribution as well as medical product distribution not performing as well as the manufacturing side of the business, which have been really exciting -- both Pyxis, Alaris, as well as the recent acquisition of VIASYS, have all done really well. To talk more about the opportunities around Cardinal, we're very happy to have their CFO today presenting, Jeff Henderson. After the presentation, we will move to the breakout session where we'll take your Q&A across the hall, which is the [Georgia room]. Jeff?

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

Thank you, Lisa. Hello, everyone. Thanks for joining us this morning, and happy new year. If I seem a little depressed this morning it's not because of anything to do with the business, it's because I'm from Columbus, and the Buckeyes blew it again last night. When they went up 10 nothing, my daughters phoned me from Columbus, and they're all excited. I said, you know, it feels a lot like last year. And it was exactly like last year. So, very unfortunate. Anyway, it's great to be here, great to be in San Francisco, although it is 70 degrees in Columbus today. So, I actually think the weather is nicer there than it is here.

I'll let you read this for yourself, and it's in our materials if you want to read it in more detail. I'm sure you've seen before.

A number of things that I want to talk about this morning, many of which may not be new news to some of you. For a lot of you who may be relatively new to the Cardinal story, or rejoining the Cardinal story recently, there could be a fair amount of new information here.

Just a few themes that I'll be covering. First of all, I'm going to walk you through our primary businesses and how they fit in the overall portfolio of Cardinal Health, and then talk a little bit about how we focused our business and leveraged scale to really take advantage of the leading businesses that we have in a number of healthcare product and service areas. And finally, I'll talk a little bit about how this translates into value in terms of the progress we're making on improving our returns.

First of all, let me step back and talk a little bit about what Cardinal Health is. And again, for some of you this may be old news. But, the structure I'm going to show to you is something we've really sort of settled upon over the past six to 12 months. It begins with a leading portfolio of terrific businesses that we have, which we've organized into two sectors, all under the general banner of our mission, which is to make healthcare safer and more productive.

The HSCS sector, or Healthcare Supply Chain Services, which is the group you see on the left, is composed of our leading pharmaceutical and med-surg distribution platforms, which for many of you may be the business that you're most familiar with if you've been following Cardinal Health for some time.

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On the right side of this chart is our Clinical and Medical Products sector, or CMP, which primarily contributes to making healthcare safer through our manufactured medical products and technologies.

So, again, that's the basic structure of our business. That's how we're organized. We have a leader in charge of each of those sectors, all adding up to the overall Cardinal Health organization under the leadership of our Chairman and CEO, Kerry Clark.

So, let me dig down into that a little bit further. I think the thing that's somewhat unique about Cardinal in this space, and differentiates ourselves from some of our peers, really is the balance of our portfolio. Yes, we're a market-leading distribution company. But, I think, often people forget just how significant the non-distribution business is as a percentage of our overall profit.

And in fact, if you look at CMP in the most recent period, it contributed for only about 6% of revenue because of the unique nature of distribution within our other sector. But, it did account for a 30% and growing piece of overall profit. So, clearly has a very significant contribution to the overall Cardinal story, is the higher margin and more rapidly growing piece of the overall business, and I think importantly, provides overall balance to the portfolio, which doesn't exist in many other companies that you may cover in this space.

Looking at these two sectors in a little bit more detail, one thing I can say is at the end of the day, it's really our eight businesses that make up the core of the Cardinal Health business.

Within HSCS, there's four that I will touch on, starting with our largest business, which is pharmaceutical distribution. It is our largest business. It is responsible for distributing about one-third of all the pharmaceuticals that are prescribed in the US, and has what we believe is the best-in-class cost structure within this space, an advantage that we've had for some time now and intend to continue into the future.

Next in the pharmaceutical segment is our nuclear pharmacy services business. This is a leading network of nuclear pharmacies located throughout the US, which provide radiopharmaceuticals to hospitals. It's capable of delivering a prescription to virtually every hospital in the US within three hours, which is a significant advantage it provides to us. For those of you who don't understand this business that well, given the nature of this particular type of pharmaceutical, and the half-life of the radioactive substance that's in this medicine, that sort of turnaround time is absolutely critical to meeting our customers' needs. And in fact, we distribute about 75% of all Cardiolite that is prescribed in hospitals throughout the US.

Moving to our supply chain medical business, or HSCSM as we often will refer to it, on a North American basis, Cardinal is the largest provider of hospital supplies, if you incorporate both our US and leading Canadian business. We provide hospitals with more than 300,000 SKUs from 2000 suppliers. Our products are used in more than half of the surgeries in the United States.

Finally, the last business that I'll touch on within the HSCS sector portfolio is our Presource, or kitting, business. This is really our surgical procedure kitting business. And we are the market leader in this area, providing more than 40 million kits per year. These are largely customized products that have either been customized for the procedure at the hospital, or in some cases even customized for the particular surgeon doing the procedure. And our presence throughout the US and the overall scale of this business really allows us to be a market leader in this area.

If you move to the right-hand side of this chart and our CMP sector -- and again, CMP stands for clinical and medical products -- again, there are four primary businesses that make up the bulk of the revenue and profit within this sector.

I'll start with infusion, where we are a leader with our Alaris pumps. We accounted for more than 50% of all product installs in fiscal 2007, and really have a significant competitive advantage because of our technology and the clinical differentiation that the Alaris products provide to our providers, primarily in the hospital space.

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I think what's also very unique about this business and what people often overlook is this really is a razor/razor blade model, in that, obviously, there's a significant amount of revenue and profitability that goes with selling the actual pumps to the hospital. That is then followed on, really, by an annuity stream from the dedicated disposables that go along with those pumps. And each of those pieces form a substantial piece of the overall portfolio and level of profitability in the infusion business.

Moving on to the dispensing business, again, very much a market leader here. We are clearly the market leader in the US with our Pyxis brand of dispensing products, and we have an installed base nearly five times that of our nearest competitor.

Turning to our medical products and technologies segment, or MPT, again, we have a number of market-leading businesses within this particular segment. We are the leader in surgeon gloves, and non-latex gloves as well. We also provide a number of other infection prevention and other products within this space that are used in virtually every hospital in the US, and in many other countries around the world as well.

And finally, last but not least is our respiratory business, which was aided considerably by our purchase of VIASYS Healthcare, which was completed in June of this most recent year for a purchase price of about \$1.5 billion. This really allowed us to build upon our existing respiratory platform to acquire a company that was a market leader in respiratory, particularly in the acute space within hospitals. The other thing that's unique about this business, although very similar to our Alaris business, is this is also a razor/razor blade type model, where (inaudible) capital equipment sale, as well as the dedicated tubing that goes along with much of the respiratory equipment.

Overall, a very balanced portfolio, composed of eight major businesses divided into four segments, and then further consolidated in two segments that make up the overall Cardinal Health story.

One business I did want to touch on for a few more minutes is our CMP sector. I think very often, when people ask me what is missed in the Cardinal Health story, I think the piece that's often overlooked by many investors is the contribution of our non-distribution businesses to the overall portfolio.

As I mentioned, in our most recent period, CMP made up about 30% of our segment profit. And that is a number that is expected to grow to as high as 40% by our fiscal year 2010. By the way, when I talk about our fiscal years, I just want to remind people that our fiscal year actually ends in June of each year. So, we're currently halfway through our fiscal '08.

I think what's also particularly attractive about this business is it's high margin; it's rapid growth; we're market leaders in most of the spaces in which we compete. But, there also is a significant opportunity to go to market with our distribution businesses, particularly at the hospital level, and combine that with our CMP businesses, where we have very differentiated products and technologies that we can provide into the hospital space.

With that, I wanted to touch on something a little bit more near and dear to my CFO role, and that is our value-focused financial strategy. And really, this is a broad term for the financial strategy targeted at driving overall returns within the business. There really are three legs to this stool -- balance sheet management, capital structure, and capital deployment. Let me just touch on each of those in turn, and on the next slide I'll give you some recent examples of some of the results we've been able to achieve in each of these areas.

First of all, balance sheet management is something that I have been speaking about for some time now since I joined the Company. We do have and have had tremendous opportunities over the past couple of years to refine our balance sheet. We've particularly focused on that within our pharmaceutical distribution business, where we've taken a substantial amount of inventory out of the business. And we have lesser, but not insignificant, opportunities in our other business as well to continue to refine our overall balance sheet and become more efficient in the use of our capital.

This is also about ensuring that we're focused on the right businesses as well within our overall portfolio. As many of you may know, for many years Cardinal grew significantly through acquisition. And it's really been over the past couple of years where

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we've taken a much closer look at that portfolio of businesses that we've accumulated, and become much more disciplined about ensuring that we're in the right businesses. And in many cases, we've made the decision that the business no longer fit in the portfolio, for reasons either of return, growth potential, or strategic fit. And as a result, we've made the decision to divest the business. And probably the most recent and most visible example of that is our decision last year to divest our pharmaceutical and technology services segment from the business, which we completed the beginning of our FY '08.

I will mention that we'll continue this process of portfolio optimization for the indefinite future. As a matter of fact, it's something we look at on about a quarterly basis to determine whether the portfolio of businesses that we have is still providing optimal value for our shareholders. And I suspect there will be continued cases where that answer is not affirmative, and we'll take the appropriate action to streamline the overall portfolio as appropriate for our shareholders.

Another big driver for us is capital employment. For a company that can generate \$2 billion or so of operating cash flow a year, how in fact we deploy that capital is of great interest to me as CFO, and I'm sure of great interest to you as shareholders as well. And over the past couple years, we have been as transparent as possible about our intended uses of that operating cash flow, to make sure you had confidence in us that we're going to use it in a responsible manner. Our general policy over the past couple of years has been that we're going to return about 50% of that operating cash flow to shareholders, either through share repurchases or an increasing dividend payout. About 20% to 25% would be used for smallish tuck-in type acquisitions that would allow us to complement our existing portfolio, and another 25% or so would be used for capital expenditures to support our existing businesses, primarily in the information technology area, where the bulk of our capital expenditure has been over the past couple of years.

And thirdly, the area of capital structure. Again, we have been fairly deliberate and fairly transparent with respect to our targets in this regard. I've said publicly many times that our goal is really to have a debt to capital ratio in the 28 to 35% range, and we've made substantial progress towards moving into the top-end of that range over the past couple of years, as you'll see on the next slide.

So, what does that mean in terms of actual results over the most recent period? Let me talk about each of the strategies in turn.

First of all, in terms of balance sheet management, we've managed to reduce our days of inventory on hand from 30 to 28 days over the past year or so, with the bulk of that coming from our pharmaceutical distribution business, as well as some improvements that we've made in our med-surg distribution business as well.

Our portfolio optimization process has been ongoing and continues to be so, as I referenced earlier our decision to sell our pharmaceutical and technologies services segment last year for net proceeds of about 3.1 billion. Over the past couple of years, we've made a number of other smaller divestitures as we've determined or identified pieces of the business that no longer made economic or strategic sense to keep in the portfolio. And that process continues today.

Importantly, at the end of the day, this is about improving our returns. And through the process of becoming more efficient with our balance sheet, as well as some of the portfolio optimization steps that we've taken, we've been able to improve our return on invested capital 157 basis points versus Q1 of last year, which is not an insignificant amount for a company of our size.

Secondly, in the area of capital deployment, we had a very substantial repurchase program in our FY '07, to a large part driven by our decision to divest PTS. And we committed to return that full \$3.1 billion to shareholders, which in fact we did, and we completed that in our Q1 of FY '08. And in total we repurchased almost \$600 million of shares in our Q1, and that repurchase program has continued into Q2. Again, as a reminder, our Q2 ended on December 31st of last year.

Finally, we have made significant progress on the capital structure front as well. Our debt to total capital ratio has increased from 26% in FY '07 to about 35%, or the top-end of our target range, in Q1 of FY '08. And our net debt to capital increased from 11% to 26% over that same time period. So, net net, as I said, the focus of all of this is to generate improved returns, not only

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returns on invested capital, but also ultimately leading to improvements in return on equity. And we've seen a significant increase in that ratio over the past several years and quarters.

You can see that on this next chart. We've gone from a return on equity in FY '05 and FY '06 in the 12 to 13% range, to a return approaching 17% in FY '07. Clearly, as we look into FY '08 and beyond, a significant focus for us as we look at driving the business, as we look at portfolio optimization, and as we look at becoming more efficient with our capital structure, it really is to continue to drive significant improvements in our return on equity, and hopefully commensurate improvement in our overall shareholder return.

Obviously, as you look at both the significant initiatives we have going on related to the businesses and our income statement, as well as the focus on the balance sheet and our capital structure, and overall capital deployment, that should also manifest itself in our overall EPS trends. We think we have a very compelling story here. If you look at the low point in FY '07 of \$2.47 per share, that increased to \$3.42 per share in FY '07. And we expect significant growth in our EPS going forward, consistent with our stated goals of delivering EPS growth in the 12 to 16% range on an annual basis.

With that, I wanted to pause for a few seconds, because that really was sort of the overview of Cardinal Health. And for some of you, you've seen that several times before. I wanted to pause for a few moments and talk about some specific relatively recent events that have transpired at Cardinal Health, and just give you a little bit more detail behind that. And I will speak to this in two roles, both as my role as Chief Financial Officer for the Company, but also, as many of you may know, I have been serving as the interim CEO of our Healthcare Supply Chain Services business for the past two months or so as we're looking for a permanent replacement to take over that sector.

Three specific areas that I'll touch on. First of all, we have issued press releases recently regarding our controlled substance diversion issue. As most of you may know, the DEA has suspended our controlled substance license at three of our 22 distribution centers in the US. I will point out that that license suspension applies only to controlled substances, which make up about 5 to 10% of the overall portfolio in a distribution center. That action was taken because in the eyes of the DEA, we had not done a good enough job of controlling the flow of controlled substances to certain accounts that they determined to be suspicious accounts, or customers that may be diverting controlled substances to customers other than legitimate customers.

We have taken this action very, very seriously. We have worked very closely with the DEA on this matter. In fact, Kerry and I met with the DEA shortly before Christmas to reiterate our collective commitment to ensuring that Cardinal Health, as a major distributor of prescription drugs in the US, does everything it can to ensure that -- two things -- that drugs are going to the right people in the timeframe that they are needed to ensure appropriate patient care; and secondly, that we're doing everything that a distributor can do to avoid the diversion of drugs to illegitimate customers. Clearly, this is a major societal issue for the United States, and I suspect outside the United States as well, as the abuse of prescription drugs has become one of the major growth areas, unfortunately, of drug abuse in the US. And we'll continue to work closely with the DEA to ensure we're doing our part to put in place all the controls that we can to avoid the diversion of these controlled substances to illegitimate users.

Again, as a result of these suspensions, we have had to put in alternative sources of supplies for all of our customers impacted by these three distribution centers. We have done that, and in virtually all cases, we have restored supply to the legitimate customers in each of these regions.

The second recent issue I wanted to comment on is the Alaris pump recall. In Q1 of this fiscal year for us, we identified an issue related to what are known as occluder springs within our Medley pump, which is used in a great number of hospitals throughout the US. As a result of that identification, we changed a manufacturing and inspection process that we had related to that pump, and issued a recall notice to our customers, which effectively said that we are going to go and check the pumps in each of those hospitals to ensure there was not a defect in that particular pump in their hospital.

I will point out that there has been a relatively few number of potential incidents related to this occluder spring issue with our Medley pumps throughout the US. But, given the seriousness and what these pumps are used for, we have been very proactive

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in our communications with the customers and the FDA with respect to solving this issue. As a result of our most recent meetings with the FDA, in our Q2 we issued an 8-K indicating that our total reserve for this recall would be in the 12 to \$14 million range, including the 4 million that we took in Q1. And we continue to work very closely with the FDA and our customers to ensure that these inspections are carried out on a very timely basis, and to the extent necessary, that the pumps are repaired and returned to the customers without a service disruption.

The final issue I wanted to comment is on our Healthcare Supply Chain Services sector. And again, I'm going to do this in the context of my interim role as CEO of that sector, which I have been doing now for just slightly over two months. And if you asked me, so, what are my thoughts after having to do a deeper dive into HSCS now for the past 60 days or so? I would say a couple of things.

First of all, that this fundamentally is a very, very strong position. We have a wonderful franchise, where we're -- have a major market presence in retail independents, hospitals, regional chains, and national chains. And we have every intent of maintaining those strong relationships and building on those franchises going forward. We have a very strong nuclear pharmacy franchise, which has very promising economics for the next couple of years. We have a healthy and growing specialty distribution platform, and we continue to be a best-in-class provider of pharma distribution services and products in the US. So overall, from a strategic and market positioning standpoint, I feel very good about where we are.

What do I not feel so good about? I don't feel so good about some of the execution issues that we've had in HSCS over the past six to 12 months. Clearly, that is an area of focus as we move forward into the future that we need to address. The good news is that that's not a three-year fix, but it's also not a one-month fix. And we're going to put all necessary resources and management talent behind getting those execution issues fixed so we can go on to being the preeminent healthcare distribution company in the US.

With that, I'll bring my remarks to a close, and I will move on to the Q&A in the adjoining room.

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