Corrected Transcript

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Varian Medical Systems, Inc. (VAR)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

J. Michael Bruff
Senior Vice President-Investor Relations, Varian Medical Systems, Inc.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

OTHER PARTICIPANTS

Matthew Taylor
Analyst, UBS Securities LLC

Amit Hazan
Analyst, Citi

Anthony Petrone
Analyst, Jefferies LLC

Brandon Henry
Analyst, RBC Capital Markets LLC

Jason M. Bednar
Analyst, Baird

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

Vijay Kumar
Analyst, Evercore Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to Varian's Fiscal First Quarter 2019 Earnings Conference Call. As a reminder, this conference call is being recorded and a replay can be accessed on the Varian Investor Relations website at www.varian.com/investors.

Now, I will turn it over to J. Michael Bruff, Senior Vice President of Investor Relations.

J. Michael Bruff
Senior Vice President-Investor Relations, Varian Medical Systems, Inc.

Thank you, Matt. Good afternoon, everyone. Joining me today on the call are Varian's President and Chief Executive Officer, Dow Wilson; and Chief Financial Officer, Gary Bischoping. Dow will share his thoughts on our results and long-term strategy, and Gary will cover our operating and financial results in more detail.

On the Varian Investor Relations website, you can find our fiscal first quarter press release and earnings presentation, which are intended to provide additional perspective and details. A webcast of this call and any accompanying non-GAAP reconciliations are available on our website at www.varian.com/investors.

Unless otherwise stated, all financial results discussed are non-GAAP. All references to EPS are to net earnings per diluted share. All growth rates are year-over-year, and any references to orders are gross orders. All periods referred to are fiscal periods unless otherwise stated, and all references to trailing 12 months refer to the trailing 12 months ending on the last day of our most recently completed fiscal quarter.

During this call, we will be making forward-looking statements, which are predictions, projections, and other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings release, this conference call, and our SEC filings. We do not undertake any obligation to update any forward-looking statement.

With all that said, I'll turn it over to Dow.

Dow R. Wilson

President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Thanks, Mike, and good afternoon, everyone. Today I'll share the key milestones we achieved this past quarter and how they contributed to our long-term strategy. We're pleased to see continued momentum coming off a strong fiscal year 2018.

First, let me touch on our first quarter results. Total company revenues increased 9% to $741 million. Oncology revenues grew 8%, driven by our integrated platform with best-in-class hardware, software, and services. Revenues for our Proton Solutions business were $39 million, up 32%. Operating earnings declined 5% to $120 million, or 16.2% of revenues.

GAAP earnings per share was $1.12, and non-GAAP earnings per share was $1.06, flat year-over-year. Operating earnings and earnings per share results were negatively impacted by $11 million of tariffs. Gary will cover this in more detail during his discussion.

Cash flows from operations were $141 million, down 21%. In terms of our long-term growth and value creation strategy, we made progress across our three growth initiatives: first, strengthening our leadership in radiation therapy. Based on public filings, the radiation therapy market grew 9% on an orders basis over the trailing 12 months ending in September 2018. Varian grew its market leadership and worldwide share during that period.

In our Oncology business, orders grew 16% in the quarter, our highest growth rate in a decade, and 11% in the trailing 12 months. Our worldwide net installed base is now 8,198 units, an increase of 322 units or 4%. This continued growth in our installed base drives recurring revenue from software and services. On the hardware side, we made progress with our global rollout of Halcyon and have now taken 202 orders since our May 2017 launch, including 20 orders in the first quarter, up 8 units or 67%. Since launch, over 60% of orders worldwide have been incremental.

Additionally, Halcyon was selected by R&D Magazine as an R&D 100 winner as one of the most exceptional innovations in science and technology in 2018. We are pleased that Halcyon was recognized for empowering clinicians to care for more patients by making radiation therapy simpler and more efficient than ever.

On the software front, revenues grew 14%, as we continue to see strong demand and receive positive feedback. The number of unique Varian software customers grew 8%, driven by our integrated best-in-class portfolio and the acquisition of Mobius. Varian is the industry leader in machine learning and AI-driven software solutions. We launched RapidPlan, our machine learning planning software, four years ago, and have taken nearly 1,800 orders since launch, continuing to expand penetration within our Eclipse installed base.

Related to RapidPlan, Beijing Cancer Hospital won an IDC China Digital Transformation Award (sic) [Transformation Annual Award] (00:05:08) for their successful clinical use of the product. IDC, the world's leading digital research firm, recognizes outstanding organizations in China that have successfully implemented digital transformation. Beijing Cancer Hospital is one of the pioneers in China utilizing our RapidPlan in clinical practice, and was the only winner from the healthcare industry in its category.

Hao WU, Deputy Director of Radiotherapy and Chief Medical Physicist of Beijing Cancer Hospital, shared that RapidPlan has improved the quality and consistency of treatment plans and efficiency of clinical workflow. Since the technology reduces planning time from several hours to several minutes, he noted that it could greatly help with the shortage of medical physicists in China.

Orders for HyperArc, our high-definition radiotherapy solution for SRS, grew nearly 50%, and we have expanded our global reach by taking orders in over 30 countries since launch. And Eclipse MCO, our multi-criteria optimization planning software, delivered stellar performance, with 180 license orders in the quarter, bringing our total orders to nearly 800 since launch in Q4 of 2017.

Our services revenues grew 8% driven by our growing installed base and higher mix of newer machines, which typically have a higher attach rate and contract value. In our Proton Solutions business, we completed clinical handovers for one room each at the Emory Proton Therapy Center in Georgia, HollandPTC in the Netherlands, and The Christie Hospital in the UK. These handovers represent an important future recurring revenue stream for our Proton business.

We also announced the official opening of two proton centers, the 4-room HollandPTC and the 5-room Emory Proton Therapy Center. Equally exciting is the start of patient treatments at The Christie, HollandPTC, and Emory proton centers; each center is treating complex disease sites, including pediatric patients with sophisticated IMPT protocols. We continue to see strength in our Proton Services (sic) [Solutions] (00:07:08) business with 27 rooms handed over to date, and our customers continue to perform well, achieving an average 95% uptime across all clinical sites.

In October, we announced the formation of the FlashForward Consortium to study potentially groundbreaking ultra-high dose rate cancer treatments with protons, more commonly known as Flash. We are currently conducting preclinical research building on published studies suggesting that Flash significantly spares normal tissue while maintaining tumor control in animal models. If the results of our preclinical studies continue to be encouraging, we would move to human trials in the next 18 to 24 months.

Both Flash and ProBeam 360, our new smaller footprint proton system introduced at ASTRO in October, are building momentum for our Proton Solutions.

Our second growth initiative is to extend our global footprint. Our global market share growth was driven by continued orders-based share gains in our three geographies, each of which delivered double-digit orders growth in the quarter.

For EMEA, this was the sixth consecutive quarter of double-digit growth, driven by emerging markets and public tender wins. For example, in November, we announced that Varian was selected by South Africa's largest private radiation oncology provider, Medical Specialist Holdings or MSH, to equip seven of its centers with Varian LINACs and Eclipse treatment planning software. The seven LINACs included in the order are three Halcyon, two TrueBeam, and two VitalBeam systems. This deal also represents a major win for [ph] Acura health (00:08:38) with a competitive software conversion.

We are proud MSH selected Varian as its partner, and look forward to expanding access to advanced cancer care across South Africa.

We also made progress towards extending our global footprint in our Asia-Pacific and Latin America regions. In Asia, we saw very strong growth across the region. For example, we booked orders for eight systems from the Philippines' Department of Health in the quarter, as well as two Halcyon and two HyperArc orders in Korea.

In China, our second largest market, we continued to see momentum with strong double-digit orders growth in the quarter. Our portfolio is well-positioned to take advantage of the continued shift towards SBRT, and the increasing demand in China for world-class products and solutions is driving continued momentum.

In October, the Chinese government announced the quota of 188 category A licenses and 1,208 category B licenses. The increase in license quotas demonstrates China's commitment to increasing access to radiation therapy for the treatment of cancer, including protons. This is welcome news as it provides greater opportunities in the China market, a market in which we have been winning over 50% of public tenders.

One of our key ambitions for Halcyon was to expand access to high-quality radiation therapy to underserved regions around the world. This quarter, we announced that we secured approval for Halcyon from the China National Medical Product Administration. In China, approximately 4.5 million new cancer cases are diagnosed each year, compared with 1.7 million in the U.S. However, radiation therapy utilization in China is less than 25% as compared with 50% to 60% in mature markets.

We specifically designed Halcyon for resource-constrained markets like China, and this approval further expands the global availability of Halcyon and access to high-quality, cost-effective cancer treatments. Earlier this month, following approval, we launched Halcyon in China and showcased our broader cancer treatment portfolio at our China Users Meeting. This is the largest customer event in Varian's history, with nearly 1,300 Chinese radiation oncology professionals in attendance and over 8,000 additional clinicians watching via a live webcast.

We are committed to the Chinese market and are well-positioned to continue to grow there. Our integrated best-in-class portfolio, our commercial team, and our investments in channel localization and local manufacturing are proving to be the right strategy.

Finally, Latin America also performed well, with Halcyon orders in Guatemala, Colombia, Chile and Brazil. We also opened a Jundiai manufacturing facility and delivered our first locally manufactured TrueBeams to Oncoclínicas in Brazil.

On Halcyon front, global momentum continues to grow, with the Halcyon orders taken since launch over 40% have been from emerging markets, and approximately 90% of these have been for incremental units. Thus, we see Halcyon expanding the market and our market share, as well as increasing our patient impact.

And lastly, our third growth initiative is to expand into other addressable markets. We continue to believe that 360 Oncology will be a growth driver for the company as we enter the cancer care coordination market, an area of large unmet need.

In the first quarter, we won a competitive contract for our cancer care coordination platform including patient engagement at Northeast Georgia Health System. This $8 million five-year agreement will enable the Oncology program to optimize clinical, operational, and financial workflows, support growth, and improve patient care. This contract represents progress towards our strategy of targeting key opinion leaders for adoption of 360 Oncology, and look forward to demonstrating the impact the product can have on clinical effectiveness, as well as efficiency and productivity.

In October, we expanded our addressable markets in the broader cancer space by announcing the acquisition of Noona, a developer of cloud-based mobile patient engagement software, designed to capture cancer patient-reported outcomes, or PROs.

We signed two deals this quarter with pharmaceutical companies to conduct post-market, prospective clinical trials on patient outcomes using the Noona platform. Through Noona, we plan to continue building partnerships with life science companies, as the Noona software application is used to meaningfully engage patients, collect PRO data, and enable clinical studies and real-world evidence generation about the efficacy of cancer treatments.

Finally, an update on tariffs, we received notification in December that the United States Trade Representative granted our exclusion request for Halcyon systems manufactured in China and subject to tariffs, resulting in approximately $1 million anticipated positive impact on fiscal year 2019 earnings. We thank the U.S. Trade Representative and the U.S. government for recognizing the impact of Varian's cancer technologies on millions of patients by excluding Halcyon from the current trade dispute.

We are hopeful that China will reciprocate, but until further notice, tariffs on products imported into China from the U.S. effective as of August 23 remain in place. Additionally, Varian's exclusion applications for components sourced from China are still pending with the U.S. Trade Representative. We remain dedicated to ensuring that our customers and the patients they treat are able to achieve new victories against cancer without any global disruption in access to our leading edge technologies and solutions.

Overall, we're pleased with the progress we made in the first quarter towards our long-term strategy to become a global leader in multi-disciplinary integrated cancer care solutions.

And with that, I'll turn it over to Gary, who will provide more context on the first quarter financial results.

Gary E. Bischoping

Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

Thanks, Dow. As always, I will consistently frame my comments in the context of our long-term growth and value creation strategy, which includes balancing growth, profitability, and liquidity.

So let me start with growth. Company-wide revenues were $741 million in the first quarter, up 9% in dollars and 10% in constant currency. And Oncology revenues were $702 million, up 8% in dollars and 9% in constant currency, driven by growth across hardware, software, and services. Excluding the impact of tariffs, revenues were up 9%. On a trailing 12-month basis, revenues grew 12% in dollars and 11% in constant currency. Orders were $716 million, up 16% in dollars and 17% in constant currency. On a trailing 12-month basis, orders grew 11% in dollars and 10% in constant currency. We ended the quarter with $3 billion in backlog, up 11%.

Taking a closer look at our Oncology business results, in the Americas, revenues declined 2% in the quarter on a strong prior-year comparison. Orders were $336 million, up 12%, and in North America, orders grew 12% driven by strong execution across our integrated portfolio. We saw robust demand for Halcyon, TrueBeam, and Edge, as well as significant growth in software and services.

Asia-Pacific revenues grew 7% in the quarter. Excluding the impact of tariffs, revenues grew 13% in the quarter. Orders were $162 million, up 25%. As Dow discussed, we saw growth across the region, particularly in China, where we continue to lead the market and grew strong double digits.

Orders in Southeast Asia and Korea nearly doubled, and Australia, New Zealand grew strong double digits. In Japan, orders were also up over the prior year. In our Europe, Middle East, India and Africa geography, revenues grew 28% in the quarter. Orders were $218 million, up 15%, with outstanding performance across the region, particularly in emerging markets. This is EMEA's sixth consecutive quarter with double-digit growth in orders, driven by large tenders.

Our Proton Solutions business posted revenues of $39 million in the quarter, which is up 32%, driven by the progress made on centers under construction and the increase in centers transitioned to service contracts.

Turning to profitability, the total company gross margin increased 5%, driven by continued solid revenue growth in our Oncology business. The gross margin rate was 42.9% of revenues, down 189 basis points. This included an approximately 100 basis point impact from tariffs, with the remainder driven by geographic mix. On a trailing 12-month basis, gross margin increased 12%, consistent with revenue growth. Gross margin rate over this period was 43.4%, up 58 basis points, including approximately 19 basis points negative impact from tariffs.

Oncology gross margin rate was 44.4%, down 209 basis points. Approximately 100 basis points of decline were driven by tariffs, and the remainder was consistent with the drivers at the total company level. Despite a lower margin rate, Oncology margin dollars grew 3% due to a strong 8% revenue growth.

Looking at Proton Solutions, gross margin dollars were $7 million, up $4 million. We continue to make good progress on profitability. However, our aspiration to achieve operating breakeven in this fiscal year may be delayed due to the timing of orders.

Investment will continue to be a key driver of our long-term growth and value creation strategy. We invested a record $61 million in R&D, which was up 9% at 8.2% of revenues. Likewise, we are investing in sales and marketing while continuing to be responsive with G&A investments to ensure our infrastructure scales to support growth.

SG&A expenses were $137 million, or 18.5% of revenues, an increase of 47 basis points. The increase was driven in large part by investments in software solutions and the timing of the ASTRO trade show falling in October of 2018 versus in September of 2017. Company operating earnings were $120 million, or 16.2% of revenues, decreasing 5%. Excluding the impact of tariffs, operating earnings grew 4%, and were 17.6% of revenues.

On a trailing 12-month basis, operating earnings increased 13% at a rate of 17.1%. Excluding the impact of tariffs, operating earnings during this period grew 17% at a rate of 17.6% of revenues, an increase of 83 basis points.

This quarter, GAAP earnings per share included $22 million from the gain on the sale of our equity investment in Augmenix. We also incurred $2 million in acquisition-related expenses.

Turning to taxes, after impacts with the Tax Cuts and Jobs Act legislation, our resulting GAAP effective tax rate for the first quarter was 24.4%. Our non-GAAP effective tax rate was 20.3%, which excludes the impact of the transition to the new legislation. Similarly, our non-GAAP EPS also excludes this impact. GAAP earnings per share was $1.12; our non-GAAP earnings per share was $1.06, with related diluted share count of 92 million shares in the quarter. Tariffs result in a reduction of non-GAAP EPS by $0.10.

Turning to the balance sheet and liquidity, we ended the quarter with cash and cash equivalents of $616 million and no debt. Cash flow from operations were $141 million, down 21% driven by timing of certain accounts receivable collection efforts and an inventory build to support production, offset by moderate improvement in accounts payable. Oncology DSO increased from 107 days to 111 days in the quarter.

In addition to R&D, other investments in the quarter included $14 million in CapEx and $35 million to repurchase shares of our stock. As of the end of the quarter, we had 3.3 million shares remaining under our existing share repurchase authorization.

I will now turn it back over to Dow.

Dow R. Wilson

President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Thanks, Gary. With respect to our annual guidance, we carefully considered the projected market growth and the continued momentum of all of our products and solutions in the market. We also continued to monitor the situation on tariffs. As we discussed on our last earnings call, we expect roughly $60 million gross impact from tariffs in fiscal year 2019. As noted earlier in the quarter, we had an $11 million negative impact from tariffs, which was generally in line with company expectations. We anticipate the remainder to be spread evenly throughout the rest of the year.

Lastly, we remain on track to mitigate the impact of tariffs, which are expected to materially phase in during the second half of the year. Therefore, as we stated in our fourth quarter earnings call, we continue to expect our earnings performance to be weighted towards the back half of the year. As such, we are reaffirming the following guidance for fiscal year 2019: revenues of $3.06 billion to $3.15 billion, representing growth of 5% to 8%; non-GAAP operating earnings as a percentage of revenues of 17% to 18%; non-GAAP earnings per share of $4.60 to $4.75; cash flows from operations of $460 million to $510 million.

The guidance continues to assume a non-GAAP effective tax rate of 21% to 22%, a weighted average diluted share count of 92 million, and currency rates as of the beginning of fiscal year 2019, and excludes any future acquisitions.

Thank you. And now let's go to Q&A.

QUESTION AND ANSWER SECTION

Operator: Great, thank you. At this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question is from Matt Taylor from UBS. Please go ahead.

Matthew Taylor
Analyst, UBS Securities LLC

Q

Hi. Good afternoon. Thanks for taking the question.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Hi Matt.

Matthew Taylor
Analyst, UBS Securities LLC

Q

Hi there. So I was hoping that you could go into a little bit more detail around some of the dynamics that you're seeing on the ground in China. You mentioned you had a good Users Meeting. It seems like there's early signs of interest there. Can you talk about your confidence in being able to keep up the kind of 56% win rate that you've had there in the public tenders, and then how the timing of orders in place could shake out with this new quota that the [ph] government has placed (00:23:56)?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah. Sure, Matt. Thank you. I'd say, first of all, we really like what we see in China. We had a very strong quarter there. Having said that, we don't believe there's much impact at all from the announcement about the new China quota in our first quarter. So any impact to date so far is immaterial, and we think it's going to take some time for that to play out.

Second, we think the market is very good. As I mentioned in the text, there's almost three times as much cancer incidence in China as there is the U.S.; U.S. has about 1.7 million diagnoses a year, China has 4.5 million, and you're talking about a factor of at least two in terms of patients that get radiation therapy. So, clearly, the government is seeing the need and making the investment.

In terms of the win rate, I'd say we've been kind of above that 50% win rate for some time and feel very confident about our ability to execute that. Our team's obviously having lots of conversations in China, and we're excited about what we see there. Our portfolio is winning, and I think maybe a little piece of the new news is we've got Halcyon in that market, we've also got recent introductions of our software products that are starting to scale now in China.

Matthew Taylor
Analyst, UBS Securities LLC

Q

Great. Thanks for that. And I was wondering, maybe for Gary, you talked a little bit about the tariff, and it sounds like you're kind of cautiously optimistic that you'll get some relief on the other side. But what should we look for as guideposts as analysts or investors to think about maybe relief that you could get, and I guess if you did get upside, how would you think about reinvesting that or dropping that through?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah, no, thanks, Matt, for the question. And as we stated in the quarter, $11 million impact in Q1, just a little more color there, $8 million of that would have been through the revenue line, and $3 million through the COGS line, all dropping to the operating line of $11 million. We think that – we'll continue to talk about the gross impact on the call. It's clearly really easy for us to track that, and as we stated, we think the rest of that $60 million gross impact we talked about will be spread pretty evenly throughout the rest of the year. Mitigation efforts take a little bit longer, and so therefore the back half ended – the back half strengthened in profitability that we alluded to you earlier.

As far as if we get relief from the tariffs that we have currently in place, look, we're going to balance always that growth and profitability over time. And we see a great opportunity to continue to invest in that market. We've invested nicely in the China market and it's yielding some of those results. And so we'll put some of that money back to work. How much and what the breakout will be, we'll see as we get closer to that, as we're not certain about how the breakouts will be is, is it going to be retroactive or not, is it going forward. So we'll talk more about it as we get closer to that event.

Matthew Taylor
Analyst, UBS Securities LLC

Q

Okay. Great. Thank you very much, guys.

Operator: Our next question is from Amit Hazan from Citigroup. Please go ahead.

Amit Hazan
Analyst, Citi

Q

Thanks. Hey, good afternoon, guys. Let me ask the guidance question first. It's on the top line and your reiteration. I mean, obviously, if we think about the order growth in this first quarter being where it was, pretty high, and looking at your backlog health and high single-digit growth there kind of begs the question of why your top line guidance couldn't have been raised a little bit. So I'm wondering if you can just give us some color on that first.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah, sure. Thanks, Amit. And I think the way to think about it in terms of headwinds and tailwinds as we thought through that question is, there are still some unknowns in the macro environment, and I wouldn't say the geopolitical environment has cleared up any at all either. And so we're keeping a close eye on that and want to make sure we continue to be aware of that risk as we thought about the guidance.

The other thing is that no orders here in Q1 in the Proton business. And so I would say that that would be a headwind as we think about the full-year guidance. That being said, our Oncology business, just a fantastic continuation of the momentum of that business; China and India continue to be strong, our European business now six quarters in a row of growth. And so, I think we kind of balance it, too. Strength in the Oncology portfolio offset by some risk in the top line of that VPS business, our Proton business, and came to that guidance of 5% to 8%, and we'll hold there.

Amit Hazan
Analyst, Citi

Q

[ph] Okay (00:29:06). And then I want to come back to China, just given this is your first earnings call since that announcement. And I'm curious if you can, you've had a couple more months now since then to kind of get smarter on this, and out of the 1,400 or so, if we think about the total units in that tender, what percent do you think are going to ultimately get consummated? That's the question I often did get just given the context for the prior tender. And then maybe give us some kind of a timeframe that you can on when we might start to see those hit your official orders.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

I mean, the short answer is that kind of depends. In our experience, all of them eventually get relieved. I think in the kind of timeframe that they've announced, the reality is, it's probably going to be 70% to 80%. But I think it's fair to assume that eventually, all 100% of it, at least that's been their track record when they issue – when there's a license, it's going to happen.

So – and I think that's kind of what we're seeing early on. As I said in my remarks, we haven't seen a material impact so far, and yet we had a very strong quarter in China, very strong double-digit quarter in China, and that is also from an order booking point of view, we book them after the license are awarded to the sites, and they issue a tender, so it's got to go all the way through the process for us to book an order.

Amit Hazan
Analyst, Citi

Q

Great. Thanks, guys.

Operator: Our next question is from Anthony Petrone from Jefferies. Please go ahead.

Anthony Petrone
Analyst, Jefferies LLC

Q

Thanks, and congrats on a strong quarter here. Maybe I'll stick with China, and then I have one on Noona. On China, maybe just a recap of which systems fall under Class A, on our notes, we have Edge in and TrueBeam, and then which are currently under Class B, and actually it's a correction...

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah.

Anthony Petrone
Analyst, Jefferies LLC

Q

...I think TrueBeam is Class B.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah. TrueBeam was moved. Yeah, Edge is still in Class A, and everything else is Class B.

Anthony Petrone
Analyst, Jefferies LLC

Q

And then Halcyon is not in there yet?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Halcyon is in Class B.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Approved and in Class B, yeah.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah, yeah. I mean...

Anthony Petrone
Analyst, Jefferies LLC

Q

Okay. Okay. [indiscernible] (00:31:32)...

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

...that happened in December. We needed the regulatory approval, so that happened in December and that was part of the – that was the main focus of our Users Meeting that I've mentioned was the 1,300 customers showing up is to come see the Halcyon launch.

Anthony Petrone
Analyst, Jefferies LLC

Q

Okay. And then maybe just a quick one there would be on – can you share anything on pricing, like between Class A and Class B? How wide of a delta that is, and then I'll have a last one on Noona.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

I'd say, a short version is, we'll see, because we haven't done it yet, but we don't think that the China experience is going to be – our China pricing experience is going to be much materially different on these new quotas as has been historically. In general terms, Class A products are kind of north of $3.5 million, and Class B below. But I think, just to kind of reiterate the price point, we like our pricing, that good execution in the quarter. There's some geographic mix, but the actual price to price within a market looks pretty solid.

Anthony Petrone
Analyst, Jefferies LLC

Q

Okay. All right. And then last on Noona, just – maybe just a little bit of background here on [indiscernible] (00:32:53) announcement of pharmaceutical deals with Noona specifically, so how large of an opportunity, maybe not necessarily these two deals, but as you look out in terms of mining the pharmaceutical sector with the Noona platform?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah, no, I mean, we're very excited about it. I would say, the short version is, payers are looking to have not just physician reported outcome information, they also want patient-reported outcome information, and so that's been one of the big trends that's been happening in clinical trial. And so that's the market that we're selling into, and the two deals that we've signed up this past quarter is to help do that patient-reported outcome work in these clinical trials.

These tend to be very large deals, and they tend to be multiyear. We hope they can expand in the kind of relationship, where in Oncology, we're doing all of their patient-reported outcome, not quite there yet, but that's what we want to do. And clearly, it's not as fragmented as the provider market. We think that we'll be a provider market in this space, but the big fish here is going to be the pharmaceutical deals, and we're kind of thrilled with these first two, and look forward doing a whole bunch more.

Anthony Petrone
Analyst, Jefferies LLC

Q

All right. Great. Thanks again.

Operator: Our next question is from Brandon Henry from RBC Capital Markets. Please go ahead.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Hey, Brandon.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Hey. Thanks for taking my question. First question, I just wanted to touch on the gross order [ph] beat (00:34:44) in the quarter, which, to me, appeared pretty broad-based across geographies. So, can you just spend some time talking about the general environment you're seeing across the markets, and do you think the market is accelerating again, or are you just taking more share from Elekta?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Let me – I'd say share is a small positive trend, but the bigger one is just the underlying strength of the market. The market has been really strong, let me kind of wing through the geographies. In the Americas, we're seeing very robust demand for TrueBeam and Edge of course, but as well, Halcyon in the Americas has been very strong.

And we've also saw in the quarter very significant growth in software and services. In EMEA, as Gary mentioned, we've had our sixth quarter of double-digit growth. Last year that was mostly – last year that was kind of in every geography of Europe. [ph] I might say (00:35:41) on the first quarter, it was a little bit more emerging market growth, we think that that is going to continue. That's been Central Europe, Middle East, Saudi Arabia, Africa and India, those have all been strong, and we think that that's going to continue, we don't see that changing.

In APAC, we talked a lot about China here, we've seen pretty good activity in Southeast Asia. Australia has been little quiet, but strong growth across Asia.

The – maybe just one other comment on the Americas. The Americas, that was a huge quarter for the Americas, and the trailing 12 months now is 7% for the Americas. So, that's some renewed strength, and it's not just one quarter to celebrate, but it's kind of some sustained growth in the Americas. So that's very good.

And then maybe just a reminder, our share reporting is one quarter lagged, so our 16% [indiscernible] (00:36:52) included in the number. And then maybe from a market standpoint, you guys ask the question, maybe this is preempting the question a little bit, are we seeing a replacement cycle, acceleration, what's going on? I think we are seeing a little bit of that in the Americas. I think Halcyon, with the speed with which it goes in, its ease of use, it's replacing some of this kind of really old, freestanding market in the Americas. We might be seeing a little bit of an acceleration in the replacement cycle in the Americas.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Okay, very helpful. And just one other question on operating margins, it looks like that fell a little short of consensus in the first quarter. So, can you spend some time discussing the reasons there? Was it just [indiscernible] (00:37:41) the tariff impact in the first quarter? And then what gives you confidence that operating margins can reaccelerate to that kind of 17% to 18% range for the remainder of the year?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah, it's a little bit, I think, of we're trying to make sure we'll all have the tariffs falling through here. Tariffs was about 100 basis point impact from a year-over-year point of view. The other two big elements running around in there, Brandon, are, this year, we had ASTRO fall in our Q1. And you combine that with the acquisitions and investments we made starting kind of Q2, Q3 of last year, those are now fully flowing into Q1 of this year.

Those two, ASTRO, as well as acquisitions and investments we made, that are now flowing in Q1 of this year, that's about 40 basis points. And there's about another 60 basis points of gross margin largely driven by geographic mix, as we outlined, that geographic mix last year, our Q1 in the Americas was 20% year-on-year growth. And that's going to [ph] print to a (00:38:43) higher margin number in the overall portfolio [ph] and then rise to tides (00:38:47) last year. This year, Americas, not as strong, and Europe was stronger. So when you mix that way, you just get a little pressure on the margin rate, at the transaction level, we're fine.

When you think about how do we accrete from here to there, as we exit the full year and get to that guidance number, there's a couple of things. One is that Proton business will keep putting on service sites. And so we'll start to see some more improvements in profitability there. Two is we won't see that big spend you had in Q1 here, as we roll out to the rest of the year. Three is we'll start to see some of the OpEx scale and the R&D scales we talked about, and then some of the tariff mitigation actions explicitly will be in the second half of the year as we've outlined. So, as we've said, we're reiterating that guidance range, and we've operational actions in place to deliver that.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Okay. Thank you.

Operator: Our next question is from...

[Technical Difficulty] (00:39:51-00:40:37)

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Good day, everybody, on the call. We sure still is live here in Palo Alto. So we're going to stay on the line, we assume we've had – if you can hear us, we assume we've had a disconnect somehow at the operator level and getting back on. There we go. Operator, are we on?

Operator: Yes, I'm here. Apologize. Can you hear me?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah, we can.

Operator: Okay. Apologize for that technical difficulty. We do have Jason Bednar here from Robert W. Baird to ask a question.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Hi, Jason.

Jason M. Bednar
Analyst, Baird

Q

Hi, good afternoon, guys. I just wanted to start with...

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

I'm not sure what you did to the – not sure what you did to the line there, but I'm glad we're back on.

Jason M. Bednar
Analyst, Baird

Q

Yeah, I have that effect on a lot of people, I think. So I wanted to start with EMEA, the past several quarters, you've been pretty impressive [indiscernible] (00:41:22). So just wondering if there's any insight you can give us, maybe to the pacing of backlog or tenders that are underway in EMEA.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

You've seen from us that, I would say, EMEA is kind of the tale of two cities. On the one hand, Western Europe, core Europe is pretty much a replacement market, and that flows pretty fast. And that's clearly what we've seen [ph] not (00:41:50) from a velocity backlog point of view, as kind of the some of the calls we had last year as we talked through some of the faster pacing of the European market. The emerging market segment is not quite that fast. More of those vaults tend to be new or waiting on a new vault to be built. So it's kind of a function of what mix fits us and what timing, I'd say, especially in the last half of last year, we saw an acceleration of that kind of core Europe market, and thus pacing picked up.

I'd say over time, when you kind of look at the numbers, the quarter in Europe was very good, constant currency growth of 17%, in the trailing 12 months, constant currency growth's 14%. So it's been pretty solid for a while, I think we're still pretty bullish about what we see in our funnel, both segments of market have been growing, we've seen a lot of replacements in conventional Europe and in our emerging market piece of that geography, really, really good growth, and we certainly don't see that slowing down at all.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc. A

And just one point to add, the data point on we had given out before as a percent of revenue that comes from orders in the previous six months, in Europe, in Q1 of 2019, was still a strong 59%. And so...

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc. A

Yeah.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc. A

...that was versus Q1 of 2018 at 64%, so we're still seeing the nice execution in that flow-through in the book. The only thing I would add to Dow's comments is, this is the result of sustained investments we've made on the sales and marketing front in and across the region. We've put in several teams to our software, as well as competitive takeout teams, as well as replacement teams, and they're delivering across the board, and therefore the consistent results that we've seen now here for six quarters. So, nice team – nice job by the team executing across Europe.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc. A

Yeah. And maybe one of the small thing to add, and that is we've spent a lot of time talking about China and the new quota and all the activity going on. Well, the same thing's happening in India. The Indian government's really been outside of the market in India for a long time. They've had other health priorities, and gradually, they're turning their health priorities to cancer. The Modicare, that – the new proposal for healthcare investment there looks to be expanding, and we'll probably be targeting a lot more cancer as well. So I think we'll see some acceleration [ph] in that (00:44:33) very good market growth in India for a while now, but I think we're going to see that accelerate as well.

Jason M. Bednar
Analyst, Baird Q

Okay. That's very helpful, guys. Just one other follow-up on here, and just on the Proton Service (sic) [Solutions] (00:44:45) revenue and/or the segment profitability, Gary, I think you've referenced maybe a delay in Proton segment breakeven, maybe no longer falling into this year. I mean, is that getting pushed into fiscal 2020 or further beyond that, and then should we interpret this adjustment in your breakeven target as being part of your original guidance range, or it's now being absorbed by maybe a little bit stronger than expected Oncology performance?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc. A

Let me just comment on that order piece of that, and Gary can take the rest of it. In 2017, we had seven orders; in 2018, we had two. And for us to achieve our breakeven targets, we need some orders. So that's where we are, clearly, we didn't have an order in the quarter. We think the number of orders that we take this year is probably somewhere between the 2017 and the 2018 actuals, somewhere between the two and the seven. We feel pretty good about that, as well as probably second half loaded. And so the business is a little bit lumpy and that's going to affect a little bit the timing of our kind of breakeven target.

And with that, Gary, you can comment on the rest of the P&L.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Yeah. I would say the teams are executing across the rest of the P&L very well, from where we're spending R&D dollars to controlling expense, to the pursuits that are required to pull deals out of the pipe, which, by the way, we think is strong and probably second half weighted, but still strong. So, we'll kind of see how this plays out. I'm not going to guide you beyond what we talked about already. And like we've said, the teams are out there executing, and we still believe in that business, and we'll continue to put investment in Flash, and go down that path as an option on the back of getting the rest of these service rooms up and running and realizing the profitability from that. So, we'll continue to make this play and continue to invest in the business accordingly as we go through time.

Jason M. Bednar
Analyst, Baird
Q

Okay. Thanks, guys.

Operator: Our next question is from Tycho Peterson from JPMorgan. Please go ahead.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Hey, Tycho.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

Hey, thanks. Hey. Maybe I'll start with the Halcyon orders. You had 20 [indiscernible] (00:46:53) last quarter. Can you maybe just talk to was it pull-forward last quarter? And then as we think about the kV launch on Halcyon, how meaningful is that in terms of new adoption?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

The good news is we're seeing very nice uptake of the kV option on the quarter, more than half of our orders were kV, that gives us a little bit of price and margin. So we're excited about that. I think, as I mentioned in the script, the 20 units is up 60% over last year, so truly good trend overall. Yeah, we had a gigantic Q4. I don't think that there was any pent-up demand in there. I think that's just been kind of the track we're on is very much in keeping with what we were planning to and kind of on track with our internal plan.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

All right. And then just a couple others on China, appreciate all the color there. Are you able to say what is kind of embedded in guidance for fulfillment there? And can you talk at all on kind of conversion of orders into revenues for China market?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah, in terms of guidance, nothing there from a revenues perspective or an earnings line with regard to that, just going to take some time to translate into orders, then orders into revenue. Look, I think the teams are out there executing, we've got the field covered fantastic. I was actually in China for the Users Meeting, and it was quite an event, very, very well done and received, and we've got key opinion leaders there on stage talking about the quality and the technical capabilities of our fully integrated platform and how it's going to help them solve the cancer burden there. And so, it really is resonating clinically there in China. And we're excited to see this play out.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

Q

And then Gary, can you comment on cash flow conversion? Looks like cash flow is down about 21%. Are there levers you can kind of pull there to improve that going forward?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah. We're still on track to the guidance number that we had outlined, and, yes, a few things slip over the finish line here from Q1 into Q2, and we have line of sight to continuing to see improvement and get to that guidance number.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

And the other thing we said in the script as well is we did have some firm – we've got a pretty big revenue build, a great momentum in the market. So, a big chunk of that was inventory.

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Thanks, Dow.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

Q

All right. And then just lastly for Dow, on adaptive, any – I mean, how should we think about kind of timelines there and then? Once that gets added to Halcyon, how do we think about the trade-off with TrueBeam and risks, if there's a cannibalization?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

I mean, the short version is, we're still in active development on adaptive. We showed it as a works in progress. We had several hundred, [ph] I don't know (00:49:46) what the count was, 300 customers come through at ASTRO, 400 customers come through at ASTRO, and what they really like about our product was the workflow. To a person, they're saying, wow, you're a year ahead of everybody in terms of how you're thinking of implementing adaptive in the workflow, keeping it within or under a 15-minute timeslot, and really delivering both the clinical effectiveness and the productivity.

So people were able to see actual development software, not PowerPoint, and so short version is, I think we've still got a ways to go probably end of this fiscal year. I think it's a vision that's resonating with folks, and we'll probably have a big full FDA approved commercial launch in the next 12 plus-ish months.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

Q

All right. Thanks.

Operator: Our next question is from Vijay Kumar from Evercore ISI. Please go ahead.

Vijay Kumar
Analyst, Evercore Group LLC

Q

Hey, guys. Thanks for taking [indiscernible] (00:51:03).

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Hi, Vijay.

Vijay Kumar
Analyst, Evercore Group LLC

Q

Congrats on a really nice [indiscernible] (00:51:06). I had a couple of questions, so maybe a couple of housekeeping, one, I guess, what was the acquisition contribution in the Q? And for the guidance, can you give some color on what the FX assumption is?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Let me talk about the first part of this. First of all, we really like the acquisitions we did last year. I think strategically, they've really helped us out. Some of the channel acquisitions – two years ago, we made an acquisition in Poland, we think that's paying off for us big time. We made an acquisition last year in Taiwan, that's starting to have little impact. The short version is, these are all pretty small. They're on their business case, and they're probably immaterial in the overall results. The acquisition we made last year of humediQ looks to be very good, we've got some nice orders momentum on that, but any revenue and margin impact is kind of immaterial at this point. Gary, anything else you want to [indiscernible] (00:52:09)?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

No, that's right, Dow. Continue to attract the business case, as well as the spending required to make sure we deliver those platforms. So, a lot of them are product-driven and technology-driven. So we'll continue to invest in those solutions as we pull them through the product roadmap, so more to come, Vijay.

Vijay Kumar
Analyst, Evercore Group LLC

Q

I've got you. And then maybe couple of quick follow-ups, one, Dow, on interesting comment in the slide deck, right, the cash from operations down, but the drivers were really inventories up, and that seems to be signaling you guys are prepping to fulfill some big orders in the back half year. So I'm just curious, again, given Q1's strength and the guidance, right, I'm curious, with the cash from operations and inventory commentary, how we were sort of thinking about the back half trajectory?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

I mean, you see our revenue guidance. Revenue guidance is 5% to 8%, we've reaffirmed that today. When you look at that revenue guidance and think about the – both the tariff and the FX hit, it's really about 150 basis points higher than that. So you're really talking about something that's more in the, call it, 6% to 10% range, rather than a 5% to 8% range by the time you kind of take the revenue impact of the currency headwind and the tariff headwinds.

So the revenue number is pretty big. And we are building some inventory, want to make sure we deliver on the revenue guidance, and if we have a little extra inventory to take care of some upside, so be it. But we see momentum continuing into 2020, so we want to build ahead here and that's what we're doing.

Vijay Kumar
Analyst, Evercore Group LLC
Q

And just maybe one last one on the margins here, Gary, the Q1 start, am I correct in assuming there was no benefit from the cost offsets in Q1 and in the back half as we're looking at 18% or maybe even above the high end of the annual guidance?

Gary E. Bischoping
Senior Vice President-Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Yeah, Vijay, that's correct. In Q1, that was gross equals net from an overall tariffs impact of that $11 million. And as we said, the rest of the gross impact, we think, will be spread out throughout pretty evenly throughout the rest of the year, with the tariff mitigation actions to the back half of the year. Therefore, we'll see us ramp into that 17% to 18% overall guidance as we go through time.

Vijay Kumar
Analyst, Evercore Group LLC
Q

Okay. Thanks, guys.

Operator: Great. Thank you. This concludes the question-and-answer session. I'd like to turn the floor back to Mr. Wilson for any closing comments.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Yes, thank you. I'm very pleased with the progress we've made in the first quarter towards executing on our long-term value creation strategy. We maintain the momentum we built last year, delivered exceptional orders growth, and are on track to achieve our 2019 targets. Looking forward, we'll continue to invest in our growth initiatives and remain committed to innovating new technologies to drive towards the ultimate victory, a world without a fear of cancer. Thank you for joining us today.

Operator: This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.