Varian Earnings Conference Call
Second Quarter 2019
Wednesday, April 24, 2019
Palo Alto, California

Operator Introduction

Good day, ladies and gentlemen, and welcome to Varian's fiscal second quarter 2019 earnings call. As a reminder, this conference call is being recorded and a replay can be accessed on the Varian investor website at www.varian.com/investors.

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

Introduction - JMB

Thank you, Kevin.

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 second 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 twelve months refer to the trailing twelve 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 or 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.

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

DOW

Thanks, Mike, and good day everyone.

Today I'll share the key milestones we achieved this past quarter, and how they contributed to our long-term strategy. We are pleased to see continued momentum in the first half of 2019, and we are raising our revenue guidance for the fiscal year while continuing to invest in future growth opportunities.

First, let me touch on our second quarter results:

- Total company revenues increased 7 percent to $779 million. Oncology revenues grew 7 percent, driven by our integrated platform with best-in-class hardware, software, and services. Revenues for our Proton Solutions business were $33 million, up 2 percent.
- Operating earnings declined 6 percent to $119 million, or 15.3 percent of revenues, driven by the impact of tariffs as well as increased project costs and site delays in our Proton business in the quarter.
- GAAP EPS was $0.96 and Non-GAAP EPS of $1.05 was down 9 percent.

- Cash flows from operations were negative $13 million, down $79 million due to tax payments and net working capital impacts from revenue growth.

Based on the company's strong orders and revenue performance year-to-date and our outlook for the rest of the year, we are **raising our fiscal year revenue guidance** from 5 to 8 percent to 6 to 9 percent.

Now, to provide additional color on the quarter:

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 10 percent on an orders basis over the trailing twelve months ending in December 2018, and we grew our worldwide share during that period.

In our **Oncology business**, orders grew 15 percent in the quarter, and 13 percent in the trailing twelve months. This was our fourth quarter in a row of double-digit orders growth and was driven by strong growth in the quarter across all geographies with strength in hardware, software, and services.

Our worldwide net installed base is now 8,292 units, an increase of 338 units, or 4 percent. 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 238 orders since our May 2017 launch, including 36 orders in the second quarter, double the number of orders from last year. Since launch, nearly 70 percent of orders worldwide have been incremental, including greenfield orders, competitive take-outs, and orders for systems that require a smaller vault. And, our Halcyon systems have now treated over 15 thousand patients.

Also on the hardware side, we're pleased to announce that for the second year since the Radiation Therapy category was created, TrueBeam® was again selected as category leader by KLAS, an independent research firm, in its 2019 Best in KLAS Report.

This month, The Lancet published clinical results of the **SABR-COMET** randomized phase 2 trial for the treatment of oligometastatic cancers. We are happy to report that the study found that SBRT was associated with an improvement in overall survival, achieving median survival of 41 months as compared with 28 months for the control group that was treated using standard of care. Varian is the global leader in SBRT treatments, and our platforms are well equipped to care for patients in the protocols outlined in the study.

On the **software** front, revenues grew 14 percent, double our hardware growth, driven by customer uptake of our new software features. Additionally, we were honored that for the sixth year in a row, Eclipse™ was named **Best in KLAS** for Oncology Treatment Planning, receiving the highest average score for overall performance.

Orders for **HyperArc™**, our high-definition radiotherapy solution for SRS, nearly doubled, and orders for **Eclipse MCO**, our multi-criteria optimization planning software, more than doubled compared with last year. MCO is fast becoming a standard addition to all new treatment planning orders and a significant upgrade opportunity for our installed base. We have now received nearly a thousand MCO orders at approximately 350 sites and have significant runway remaining with less than 10 percent penetration among our Eclipse customers.

Given our strong orders performance, we are incurring incremental costs to accelerate our software deployment capabilities to meet demand, which we expect to drive revenue growth in future periods. We expect an incremental $2 million in these costs this year.

Our **Services** revenues grew 1 percent, including an estimated negative impact of 3 percentage points from FX. This growth was 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, The Christie Hospital in the UK, and the Danish Center for Particle Therapy in Aarhus, Denmark. We now have 30 operational rooms at 10 sites, representing an important future recurring revenue stream for our Proton business. In Denmark, we also announced the opening and first patient treatments at the Danish Center for Particle Therapy. And, we achieved an important construction milestone with installation of the gantry for the ProBeam Compact single-room proton therapy center in Singapore. When completed, this project, the first Compact proton system in Southeast Asia, will expand access to proton therapy in the region.

Our pipeline in the Proton business remains strong, with customer interest driven by our smaller footprint ProBeam® 360° and the preclinical research we are doing with the FlashForward™ Consortium. We have been chosen as the preferred vendor at Shandong Cancer Hospital and Institute in China and are working with the customer to close this deal, which is expected in Q3. And, we are optimistic about our prospects for additional deals to close in the second half of this year.

In October, we announced the formation of the **FlashForward Consortium** to study potentially groundbreaking ultra-high dose rate cancer treatments with protons. Earlier this month at the American Association for Cancer Research meeting, we presented publicly the first pre-clinical results of our research with the FlashForward Consortium, which showed reduced toxicity in healthy tissues and organs in mice. We are excited about the possible breakthrough in cancer treatment that this research could present for patients around the world and are encouraged by these initial pre-clinical results.

Based on this progress, we are investing an incremental $5 million this year on our preclinical research with the FlashForward Consortium, the majority of which will occur in the back half of the fiscal year. We incurred approximately $1 million of this spend in the second quarter.

Our Second growth initiative is to extend our global footprint.

Our **global market share growth** was driven by continued strong orders performance in our three geographies.

For **EMEA**, this was the seventh consecutive quarter of double-digit growth, driven by strong performance across the region. An important milestone in EMEA this quarter was the signing of a framework agreement with **Tata** Trusts to increase patient access to advanced radiation therapy treatments in **India**. It is estimated that by 2025, there will be 1.8 million new cancer cases diagnosed per year in India. This three-year agreement, in which Varian has been selected as the preferred supplier, provides for the installation of potentially up to 200 radiation therapy systems across the country. We expect to begin taking orders from this framework agreement beginning in the second half.

In Africa, we announced earlier this month the opening of a **new office in South Africa** for local sales and service managers to support growth throughout the continent. And, in **Nigeria**, we announced this quarter that we will replace the older systems at a cancer treatment center in Lagos with one Halcyon and two VitalBeam® radiotherapy systems, and will deploy a training center to support development of human resource capacity to expand access across West Africa.

In our **Asia-Pacific** region, we delivered very strong double-digit orders growth in China, Japan and Southeast Asia.

In **China**, our second largest market, we continue to see strong momentum driven by demand for SBRT. Our best-in-class product portfolio continues to resonate with the China market, resulting in a leading share position over the trailing twelve months. We also received our first Halcyon orders in China following the great reception we had after launching the product at our China Users Meeting earlier this year.

In China, over four thousand linacs – more than double the current estimated installed base – are required to meet the current cancer burden in the country. Today, approximately 95 percent of patients are treated in either Tier 3 hospitals or in Tier 2 centers located in cities. These facilities cannot meet the demand for cancer care in China and present a barrier to access for patients in rural areas. The Chinese government is driving an initiative to localize cancer treatment, increasing the number of county centers and migrating 70 percent of patients to these hospitals. This shift presents tremendous opportunity for continued growth in this important market, as demand for advanced cancer care in China continues to grow.

Additionally, the Chinese government's announcement of a quota increase of radiation therapy licenses demonstrates China's commitment to increasing access to advanced cancer care. We are starting to see some activity in the provinces related to this announcement but haven't booked an order yet related to the quota increase.

Lastly, **Our Third** growth initiative is to expand into other addressable markets. This month, Varian went live across the Tennessee Oncology network with an implementation of our Noona patient-reported outcomes and symptoms management platform.

We also continue to look at inorganic opportunities to leverage Varian's core strengths to reach more patients and drive long-term growth.

Overall, we are pleased with the progress we made in the second quarter. We remain dedicated to providing customers with a full spectrum of intelligent, advanced tools to help improve patient outcomes and achieve our long-term growth strategy.

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

GARY

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 $779 million in the second quarter, up 7 percent in dollars and 10 percent in constant currency.

In Oncology, revenues were $747 million, up 7 percent in dollars and 10 percent in constant currency, driven by growth across hardware, software and services. Tariffs had a 130 basis point negative impact on the growth rate. On a trailing twelve-month basis, revenues grew 11 percent in dollars and 12 percent in constant currency.

Orders were $766 million, up 15 percent in dollars and 18 percent in constant currency. On a trailing twelve-month basis, orders grew 13 percent in dollars and 14 percent in constant currency. We ended the quarter with $2.9 billion in backlog, up 13 percent.

Taking a closer look at our Oncology business results.

In the Americas, revenues grew 11 percent, with double-digit growth in both North America and Latin America.

Orders were $366 million, up 7 percent. And, in North America orders grew 12 percent, driven by strong execution across our integrated portfolio, as well as key wins with Alliance Oncology in Huntsville, Alabama to replace 7 competitor systems and software with Varian solutions, and an additional 5 system order from HCA, bringing their total Varian-ordered systems over the past 3 years to over 20 accelerators.

Asia Pacific revenues grew 7 percent. Tariffs had a negative impact on the growth rate of 7 percentage points.

Orders were $167 million, up 35 percent. As Dow discussed, we grew strong double-digits in China, Japan, and Southeast Asia.

In our Europe, Middle East, India and Africa geography, revenues grew 2 percent. Revenues grew 9 percent in constant currency, as FX had a significant impact this quarter.

Orders were $233 million, up 17 percent, with outstanding performance across the region. This is EMEA's seventh consecutive quarter of double-digit orders growth.

Our Proton Solutions business posted revenues of $33 million in the quarter, which is up 2 percent.

Turning to profitability,

Total company gross margin was relatively flat year-over-year. The gross margin rate was 41.2 percent of revenues, down 260 basis points. This included negative impacts of 120 basis points from tariffs, 80 basis points from project costs and site delays in our Proton business within the quarter, 30 basis points from FX, and 10 basis points from costs related to our software deployment ramp.

Our trailing twelve-month gross margin rate was 42.7 percent, down 60 basis points. This included negative impacts of 70 basis points from tariffs and 20 basis points from project costs and site delays in our Proton business within the quarter.

Oncology gross margin rate was 43.6 percent, down 210 basis points. This included negative impacts of 130 basis points from tariffs, 40 basis points from FX, 10 basis points from costs related to our software deployment ramp, and the remainder from product mix.

Looking at **Proton Solutions**, gross margin dollars were negative $4 million, down $5 million, driven by $7 million in increased project costs and site delays in the quarter. These items, as well as delays in the timing of orders, will result in not achieving our aspiration of reaching operating breakeven for the year.

Investments will continue to be a key driver of our long-term growth and value creation strategy. We invested $59 million in **R&D**, which was up 1 percent, at 7.6 percent of revenues.

Likewise, we are continuing to invest in Sales and Marketing, which grew 10 percent, driven by investments in headcount supporting sales for recent acquisitions and product management for treatment planning. We are seeing leverage in the P&L when it comes to General and Administrative spend, with modest growth of 4 percent compared with robust orders and revenue growth rates. **SG&A** expenses were $143 million, or 18.3 percent of revenues, a rate which is flat compared with last year.

Company operating earnings were $119 million, down 6 percent, at 15.3 percent of revenues, down 220 basis points. This included negative impacts of 150 basis points from tariffs, 80 basis points from project costs and site delays in our Proton business within the quarter, and 40 basis points from FX.

On a trailing twelve-month basis, operating earnings increased 6 percent, at a rate of 16.4 percent, down 60 basis points. This included negative impacts of 80 basis points from tariffs and 20 basis points from project costs and site delays in our Proton business within the quarter.

Turning to taxes: Our GAAP effective tax rate for the second quarter was 21.7 percent and our Non-GAAP effective tax rate was 21.5 percent.

GAAP EPS was $0.96. Our Non-GAAP EPS was $1.05 with diluted share count of 91.9 million shares in the quarter.

Turning to the balance sheet and liquidity, we ended the quarter with cash and cash equivalents of $546 million and no debt.

Cash Flows from operations were negative $13 million, down $79 million due to tax payments and net working capital impacts from revenue growth. Oncology DSO increased from 103 days to 110 days in the quarter, driven by strong revenue growth.

In addition to R&D, other investments in the quarter included $11 million in **capex** and $51 million to **repurchase shares** of our stock. As of the end of the quarter, we had 2.9 million shares remaining under our existing share repurchase authorization.

I will now turn it back over to Dow.

Dow

Thanks Gary.

With respect to our annual guidance…

We carefully considered the projected market growth, our recent orders momentum, and our mitigation efforts with respect to tariffs, which remain on track.

- As such, we are **raising** revenue guidance to $3.09 billion to $3.18 billion, representing growth of 6 to 9 percent. Previously, we guided to $3.06 billion to $3.15 billion, representing growth of 5 to 8 percent.

And, we are **reaffirming** the following guidance for fiscal year 2019:

- Non-GAAP operating earnings as a percentage of revenues of 17 to 18 percent
- Non-GAAP EPS of $4.60 to $4.75
- Cash flows from operations of $460 million to $510 million

This updated guidance considers the following impacts to operating earnings:

- An increase of $5 million from the raise in revenue guidance, and a benefit of $5 million from an estimated reduction in gross tariff impact;
- Based on strong recent momentum, an incremental investment of $5 million in our preclinical research with the FlashForward Consortium;

- Continued investment in software deployment capabilities, which will result in approximately $2 million in incremental costs;
- And, the second quarter $7 million increased project costs and site delays in our Proton business.

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

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

Dow

Thank you, Kevin.

Per my previous comments, given the momentum in the business, we raised our revenue guidance. In concert with that revenue raise, we've decided to reinvest in innovation, primarily related to the FlashForward Consortium, and we remain on track to achieve our 2019 targets.

Looking forward, we will continue to execute our growth initiatives and remain committed to investing in innovation and new technologies to drive toward the ultimate victory: a world without fear of cancer.

Thank you.