



# Biotech Daily

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*Daily news on ASX-listed biotechnology companies*

## Dr Boreham's Crucible: Cochlear

**By Tim Boreham**

**ASX code:** COH

**Share price:** \$172.92

**Market cap:** \$9.98 billion

**Shares on issue:** 57,715,821

**Chief executive officer:** Diggory Howitt

**Board:** Rick Holliday-Smith (chair), Dig Howitt, Shah Abbas Hussain, Yasmin Allen, Glen Boreham\*, Alison Deans, Donal O'Dwyer, Andrew Denver, Prof Bruce Robinson.

**Identifiable major shareholders:** Baillie Gifford & Co 7.9%, Black Rock Group 6%, Vanguard 5%.

**Financials (December half):** revenue \$712m (up 11%), net profit \$128.6m (up 26%), earnings per share \$2.23 (up 16%), dividend \$1.55 per share (up 11%), cash of \$92.3m (up 11%).

\*No relation (as far as we know)

Even when you're an established global device outfit turning over \$1.45 billion annually, seemingly trivial product tweaks on the part of a competitor can upset the sales momentum.

In Cochlear's case, arch-rival Advanced Bionics launched a hearing implant called Hires Ultra 3D which is magnetic resonance imaging (MRI) compatible: wearers don't have to remove the batteries if they are undergoing a scan.

This small advantage over Cochlear's state-of-the-art Nucleus 7 implant and processor range cost Cochlear crucial sales, especially in Germany where more MRIs are carried out per capita than anywhere else.

"That has affected our market share in the US and Germany, our two biggest markets for Cochlear implants," rues CEO Dig Howitt.

A compote of other factors saw Cochlear generate only anaemic growth in its core developed country markets in the half year - notably the US, the country's most important market.

Deaf to Cochlear's longer term potential, irate investors marked Cochlear shares down eight percent after the company's February 19 results briefing.

### **The devil is in the detail**

Cochlear's reported net profit - a 16 percent increase to \$128.6 million - looked acceptable enough. Management also reaffirmed full-year earnings guidance of \$265 million to \$275 million, an increase of eight to 12 percent.

Services revenue - which encompasses sound processor upgrades, spare parts and sundry items such as shake-awake alarm clocks and travel insurance - surged 28 percent to \$207 million.

This segment - which management has targeted for growth in recent years - now accounts for 29 percent of Cochlear's revenue.

However, investors couldn't forgive the sub-par performance of implants, which remain Cochlear's core market, accounting for 58 percent of revenue (the acoustic and bone implant range, known as Baha, accounts for a further 13 percent of turnover).

Mr Howitt attributes the sales malaise in developed countries not just to Advanced Bionics' new product, but to reimbursement caps in some western European markets.

A nuance of that geography is that hospitals have a combined funding cap for implants and upgrades, which means that sales of the former could cannibalize the latter (and vice versa).

Mr Howitt notes that as Cochlear launched Nucleus 7 in the prior comparative half, it was 'cycling' tough comparative numbers this time around. He maintains that Cochlear continues to see a strong demand for Nucleus 7, the company's latest product iteration that is now compatible with both android phones and Apple iPhones.

Among the emerging countries, Mr Howitt calls out Argentina and Turkey as significant opportunities, despite currency devaluation and generally dodgy economies.

Back in the first world, Cochlear saw only three percent growth in the US market.

“We do expect developed world market growth over the medium to long run,” Mr Howitt says, adding that the uptake is difficult to predict.

### **Patent appeal pending**

In November last year, the US District Court awarded \$US268 million (\$A380 million) against Cochlear in a long-running patent breach dispute.

The company is appealing the decision, brought by Advanced Bionics (yes, that name again) and the Alfred E Mann Foundation for Scientific Research.

The plaintiffs are also demanding \$US123 million in pre-judgment interest, which Cochlear also opposes. Naturally.

Because it expects to win an appeal, the company is treating the amount as a contingent liability and has expunged a \$A21.3 million provision on the balance sheet, but a \$A19.6 million provision for legal and other costs remains.

Mr Howitt says the judgment relates to expired products and does not affect Cochlear's current range.

### **Innovation and opportunity**

Cochlear has a 60 percent share of the global children's market and is hell-bent on protecting that share.

But there are other segments where the company is not so prevalent, notably the over 65s market.

As anyone with elderly relatives would know, they either wear hearing aids or simply try to get by - often with less than optimal effect in terms of having a decent conversation.

(There's also a phenomenon called selective hearing but we won't go there ...)

The company also cites links between hearing loss, ageing and cognitive decline, depression and the risk of falls.

Cochlear also has only 10 percent penetration of the children's market in developing countries, which is not surprising as the products are without a reimbursement system in place.

Still, Cochlear can't be accused of complacency, with 12 percent of revenue (\$160 million) devoted to research and development.

In a collaboration with GN Hearing Solutions, called the Smart Hearing Alliance, Cochlear aims to develop the latest connectivity and wireless technology.

The alliance is relevant to "bimodal" patients, that is, those with a Nucleus 7 sound processor in one ear and a GN's Resound hearing aid in another. The devices are paired with an iPhone or iPod to control the functionality of both devices.

## **Harnessing the consumer**

With a sales and marketing background, newly-minted CEO Chris Smith introduced a 'direct to consumer' focus when he took over from long-running CEO Chris Roberts in September 2015.

This strategy involved sharpening the appeal of Cochlear's products to its target audience.

As it happened, the Denver based Chris The Second quit in July 2017 after he realized that an agreed plan to move to Sydney HQ would not work for family reasons.

Under Mr Howitt - Cochlear's chief operating officer who took over from Mr Smith - the strategy remains unchanged.

One successful innovation has been a "member recipient" program called Cochlear Family. The loyalty-style club has now signed up 120,000 users whom, it is hoped, will become advocates of the product on online forums and such.

## **Finances and performance**

Despite the headwinds, Cochlear's results showed sound cash generation which enabled investors to be awarded with an 11 percent dividend increase to \$1.55 a share, fully franked.

This is also despite \$80 million to \$100 million being earmarked for long-term projects including a new manufacturing facility in China.

With cash of \$92 million and net debt of only \$72 million, Cochlear is in a sound position to pursue further acquisitions into areas that expand its repertoire.

In May 2017, Cochlear paid \$US78 million for Sycle LLC, the world's dominant supplier of audiology practice management software.

Via its innovation fund, in November the company announced an EUR13 million (\$A20 million) investment in the Copenhagen Nasdaq-listed Nyxoah, to develop and commercialize a best-in-class nerve stimulation therapy for obstructive sleep apnoea.

While finding a cure for snoring may seem far removed from Cochlear's core technology, the therapy is based on an implant to modulate the hypoglossal nerve, which controls the functions of the tongue.

Then again, perhaps some spouses of locomotive-grade snorers would rather remain hard of hearing.

Performance wise, Cochlear shares over the last 12 months have traded in a range of \$155.22 and \$221.44

### **Dr Boreham's diagnosis:**

Since 1981, Cochlear has provided more than 500,000 implants in more than 100 countries. As a company, you know you have made it when your brand is synonymous with the broader product, a la Eskys or Hoovers.

Despite this, Cochlear has only scratched the surface of the addressable market. The company estimates 15 million people could benefit from a Cochlear bone conduction implant, which implies it has penetrated only 3.3 percent of the global market.

Globally, 460 million people suffer hearing loss, with one in three over 65 years having impaired hearing to a disabling degree.

Strategy wise, Cochlear is targeting the "hundreds and thousands" of people with profound hearing loss who use hearing aids and have not transitioned to implants.

Meanwhile, it's hard to know what to make of the court judgment and Cochlear's chances of ultimate victory.

Investors can only hope that Cochlear's legal eagles are right and that the balance sheet won't have to be deployed to fund the massive court judgment.

As fellow home-grown global hero CSL would attest, patent disputes are part and parcel of doing business in the litigation trigger-happy US.

***Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. He does not head a global biotech company but when it comes to career advancement is all-ears to the possibilities.***