



Biotech Daily

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Daily news on ASX-listed biotechnology companies

Dr Boreham's Crucible: Cochlear

By TIM BOREHAM

ASX Code: COH

Market cap: \$8.5 billion; **Share price:** \$147.56; **Shares on issue:** 57.4 million

Chief executive officer: Chris Smith

Board: Rick Holliday-Smith (chairman), Chris Smith, Prof Bruce Robinson, Yasmin Allen, Prof Edward Byrne, Andre Denver, Donal O'Dwyer, Glen Boreham*, Alison Deans

Financials (December 2016 half): revenue of \$604.4 million (up 4%), earnings before interest and taxation \$156.4 million (up 19%), net profit \$111.4 million (up 19%), earnings per share \$1.94 (up 18%), interim dividend \$1.30 (up 18%)

Major shareholders: Black Rock 6.1%, Baillie Gilford & Co 10%, Hyperion Asset Management 5%.

* No relation (as far as we know)

Two years into his stint as Cochlear top dog, Chris Smith is starting to reshape the hearing implant giant with a direct-to-consumer focus, which befits his sales and marketing background.

That's not to say Cochlear was in any way broken after the illustrious reign of erstwhile chief executive officer Dr Chris Roberts and chief financial officer Neville Mitchell.

It's just that the company believes awareness of its products could be better among its target audience, with plenty of scope to sell add-on services and parts to its 450,000 existing global users.

Cochlear's recent investor day highlighted the role of the services arm, which now accounts for 25 percent of the company's \$1 billion plus annual revenues. Only 15 years ago, this contribution was less than one percent.

Services includes anything from financing plans, travel insurance, shake-awake alarm clocks, remote controls, spare coils and cables and repairs.

Just to reinforce this directional tweak, Cochlear this month paid \$US78 million (\$A100 million) for Sycle LLC, the world's dominant provider of audiology practice management for practice management software. The business is profitable – broker Credit Suisse estimates sales of \$US10-15 million and a 20 percent earnings before interest and taxation margin, but in the context of Cochlear's size it won't move the earnings dial.

The real motivator is increasing practitioner engagement. For example, if its software can more accurately analyse the audiograms of patients suitable for cochlear implants, this should drive more sales.

Cochlear is thought to account for 70 percent of global cochlear implant (CI) sales – its main rival is Advanced Bionomics of the US -- yet awareness is surprisingly low.

The company estimates 360 million citizens of the world have disabling hearing loss and that 37 million could benefit from Cochlear. Yet, the company's market penetration is only five percent although it is higher in the developed countries where reimbursement exists.

On the consumer and public relations front, Cochlear has done wonders to develop a global network of 4,000 volunteers to support CI candidates.

There's even an International Cochlear Implant Day (Feb 16, seeing you asked). This is most impressive for a for-profit entity and one of our biggest ASX stocks.

After all, we don't have a World Westpac Day to look forward to, or a network of community helpers spruiking the virtues of the banks (and, boy they could do with some friends at the moment).

While the developed market continues to drive growth, the company recently opened a Dubai office and is not deaf to opportunities in Central and Eastern Europe, China, India and Latin America.

Come to think of it, that just about covers the world.

The Cochlear product – an implant that receives messages from a sound processor – has been around since the University of Melbourne's Prof Graeme Clark invented it in 1978 and implanted the first device at Melbourne's Royal Victorian Eye and Ear Hospital.

But the company spends a poulitice on research and development (\$140 million last year) and is constantly honing its offerings, rather like mobile phone manufacturers.

Speaking of which, the emphasis is on wireless delivery, smartphone based controls and smaller, more discrete sound processors. Its Baha5 iteration is Iphone compatible.

Another product, Kanso, is dubbed the “world’s first off-the-ear processor with dual microphones and Smart Soundiq”.

The Slim Modiolar Electrode C1532 has been fitted on the first 100 patients, while the Kanso has been “well received” by the market.

Financials:

The key message was full-year earnings forecast was reiterated at \$210 million to \$225 million, 10 to 20 percent higher than in 2015-'16.

This assumes an average Australian dollar exchange rate of 75 US cents and comes despite lower than expected Chinese government tendering activity.

Cochlear is well over a voluntary implant recall in September 2011, which wiped \$800 million off the stock in one day and resulted in a \$101 million after-tax bill.

After hitting a low of \$53 in October that year, the shares breached the magic \$100 a share mark in February last year and it’s been onwards and upwards ever since.

At \$146 a pop, Cochlear shares look expensive to Aussie investors unaccustomed to high-value share prices. Of course the real measure is earnings per share and the company trades on a heady EPS multiple of 35 times.

The Sycle purchase generally has been well received. But broker UBS scoffs that Sonova, parent of Advanced Bionomics has had an integrated CI retail and manufacturing business for some years, “With no apparent benefit to sales at this point.”

Dr Boreham’s diagnosis:

Given the shares have climbed 15 percent since the first half earnings result on unchanged earnings expectations, the learned opinion of the broker fraternity is that the company is high quality, but fully (or over) valued.

Dr Boreham (not Glen) reckons that with such high-quality stocks, there’s never a good or bad time to buy. Pop this one in the bottom drawer and the short-term ‘expensive’ aspect will be negated over time.

Better still, buy up on a market bad-hair day.

Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. Happily his hearing deficiencies are confined to tone deafness and a tin ear.