



Biotech Daily

Friday February 24, 2023

Daily news on ASX-listed biotechnology companies

Dr Boreham's Crucible: Cochlear

By TIM BOREHAM

ASX code: COH

Share price: \$226.19

Shares on issue: 65,781,532

Market cap: \$14.9 billion

Chief executive officer: Diggory 'Dig' Howitt

Board: Alison Deans (chair), Mr Howitt, Yasmin Allen, Glen Boreham, Andrew Denver, Prof Bruce Robinson, Michael Daniell, Christine McLoughlin, Michael del Prado, Karen Penrose

Financials (first half to December 2022): revenue \$885.2 (up 8%), earnings before interest and tax \$185.7 million (down 22%), net profit \$141.6 million (down 16%), dividend per share \$1.55 (steady), net cash \$505.4 million (down 14%)

Identifiable major shareholders: Blackrock Inc 6.4%, State Street Corp (5.7%), ABP (Algemeen Burgerlijk PSF) 5.5%.

Cochlear's ostensibly downbeat half-year numbers show that when it comes to corporate results, the raw figures usually need a decent explanation.

At face value, the hearing implant leader's results show that a healthy growth in implant and volumes is not being reflected in earnings - either the reported number or the underlying figures that management prefers.

One explanation is that the company is building inventories as hospitals re-open and surgeries recover to more normal levels. Another is that the previous comparative half simply was better than expected, so the bar was raised in the first place.

In any event, Cochlear chief Diggory Howitt didn't give the impression of a man under pressure as he fronted analysts, post results (ironically, the questions were hard to hear because of a technical glitch).

Another sign of Cochlear's corporate health is that it is launching a share buyback to soak up some of its \$500 million of excess cash. In contrast, at the onset of the pandemic the company raised \$1.32 billion in an upsized institutional issue and share purchase plan at a heavily discounted \$140.00 a share.

"We can see that uncertainty receding," Mr Howitt declares.

We'll defer to the investor reaction as the final arbiter: a six percent share boost in immediate response to the results.

Ear's a bit of history

The Cochlear name refers to the cochlea spiral tunnel of the inner ear that receives vibrations and sends them to the brain for interpretation, as well as the adjacent cochlear canal or duct and cochlear nerve. The Cochlear implant is implanted in the cochlea.

Cochlear, by the way, is Latin for 'snail shell'.

But how did the devices come about?

While idling his time on a beach in 1977, otolaryngologist Graeme Clark (later to become Prof Clark) fiddled with a shell and a blade of grass - as you do - and realized there was a safe way to insert electrodes into the inner ear.

His Eureka moment was inspired by his pharmacist father who profoundly deaf.

After wiping the sand off his thongs, Prof Clark partnered with a mob called Nucleus Group to commercialize an implant.

The first device was the Nucleus 22 "the first multi-channel cochlear implant". The device is said to have been the only real hearing advancement since the 17th century ear trumpet (hearing aids included).

Nucleus Group was acquired by the conglomerate Pacific Dunlop but morphed into Cochlear, which listed on the ASX in 1995.

To date, Cochlear has sold more than 700,000 implants and has a circa 60 percent market share.

The company has spent more than \$2 billion on research and development since listing. But in the case of one device, it should have spent a little more: in 2011 the company recalled its Nucleus CI500 implants because of a moisture-related defect - at a cost of more than \$100 million.

Headquartered at Sydney's Macquarie University, Cochlear employs about 4,500 people and sells to more than 180 countries, with a direct presence in 30 countries.

Long-running CEO Dr Chris Roberts stepped down in September 2015, to be replaced by the Denver-based Chris Smith. Mr Smith quit in July 2017 for family reasons and Mr Howitt - then chief operating officer - took over.

Staying a step ahead

Cochlear's products include the implants, the sound processors and other bits and pieces such as spare coils and cables, remote controls, repairs and shake-awake alarm clocks.

As with home-grown medical device giant Resmed, Cochlear needs to stay one step ahead of competitors with constant product tweaks and iterations.

The lion's share of the company's revenues derives from implants and services (such as sound processors and upgrades).

But acoustics (bone conduction implants) are becoming more important.

Bone conduction implants are more suited to patients with mixed, or single sided, hearing loss. Typically, they have functioning cochleae, but a middle ear problem prevents sound transmission from the outer ear to the cochlea.

The resounding fortunes of acoustics were driven by the western European rollout of the core Osia 2 device, following recent approval (Osia, by the way, stands for 'osseo integrated steady state implant').

The new Baha 6 Max Sound Processor - as in bone-anchored hearing aid - is "driving strong demand for sound processor opportunities across all regions".

In October 2022, the company launched the Nucleus 8 sound processor, which the company dubs "the smallest on the market by far". With features such as Bluetooth connectivity and background noise suppression, Nucleus 8 is expected to be a key short-term revenue driver for the company.

Hear's a good acquisition

As with CSL - another home-grown bio-giant - Cochlear has discovered its acquisitive juices after a long period of relying on organic growth.

In April 2022, Cochlear announced the purchase of Oticon Medical for around \$170 million.

Oticon consists of the implant business of the Danish-based, Nasdaq-listed Demantis Group, which wanted to shed its Oticon implant business in favor of other stuff (such as hearing aids).

Cochlear's rationale is that while it is clearly the leader in implants, it doesn't get much custom from the hearing loss segment "where hearing aids remain the primary treatment option".

With 75,000 clients, Oticon generates \$75 million to \$80 million of revenue a year, but is currently loss-making.

The transaction was meant to have been sealed by the end of 2022, but has been delayed because of preliminary concerns raised by Australian and British competition regulators.

In Australia, Cochlear and Oticon are two of only three providers of non-surgical bone conductors and bone anchored devices.

The UK Competition and Markets Authority is undertaking a further review, as is the Australian Competition and Consumer Commission. The latter has nominated a March 16 decision date which, come to think of it, is not far off.

While it's common for the takeover gatekeepers to raise competition concerns, it does not mean a deal is likely to be kyboshed. Cochlear is engaging with authorities, but maintains the deal will not diminish competition and will go ahead.

Oticon is Cochlear's biggest purchase since paying paid \$US78 million (\$A115 million) for Sycle LLC, the world's dominant supplier of audiology practice management software, in 2017.

Finances and performance

Cochlear posted a statutory net profit of \$141.6 million for the first (December) half, down 16 percent and ahead of consensus expectations of \$136 million.

Implant volumes increased by 14 percent to 21,249 million, but revenues rose only 9 percent to \$9 million.

Mr Howitt attributes the gap to flat pricing in developed markets. But deferred revenue rose sharply, the result of the company shipping Nucleus 8 units ready for users of the current Nucleus 7 units to upgrade.

Implant sales rose 12 percent and now account for 57 percent of revenue.

Services revenue (29 percent of sales) edged up one per cent. Driven by Osia 2 and Baha 6 upgrades, acoustics revenue rose 20 percent and accounted for 13 percent of sales.

Geographically, the Americas account for almost half of Cochlear's revenue, while Europe, the Middle East and Africa chips in one third. Asia Pacific (notably Australia) accounts for 18 percent.

An interesting quirk was that growth was best in the regions most affected by Covid-19, such as Latin America, India and China.

One reason for this is that government tendering for device programs was non-existent during the plague, but this sector has come back to life.

"The company delivered better than expected revenue across all product segments, with significantly higher Cochlear implant and acoustic revenues," RBC Capital Markets analyst Craig Wong-Pan said.

Over the last 12 months, Cochlear's share price has varied between \$186 (mid-October 2022) and \$236 (mid-April 2021). The shares hit an all-time high of \$265 in August 2021.

Two decades ago, the stock traded around \$40.

Hello buy back

Despite the Oticon acquisition, Cochlear will spend up to \$200 million over two years to buy back its own shares, thus modestly improving earnings per share and dividends per share.

The company intends to spend \$75 million in the first year - about 0.5 percent of shares on issue - but as per the norm, the quantum and timing depends on market conditions.

Broker Barrenjoey estimates that even after the Oticon purchase and the buyback, Cochlear will have \$60 million of excess cash (over and above management's targeted \$200 million buffer).

Outlook

Management has maintained its full-year earnings guidance at \$290 million to \$305 million on an underlying basis, an increase of five to 10 percent.

At last August's full year results, management referred to "variable" country-to-country performance, with pandemic hospital staffing shortages impacting operating theatre capacity.

Mr Howitt opines that the market continues to improve post lockdowns, but there are still "uncertainties" including surgical backlogs in most markets.

"While it is great to see the reopening, we are still a bit cautious on our outlook."

Dr Boreham's diagnosis:

A year ago, we opined that when investors turn risk averse, they will gravitate to the established big names rather than the pre-revenue wannabes. Cochlear's share price - up 12 percent for the calendar year to date - suggests this is indeed the case.

"Our long-term strategy is absolutely intact," Mr Howitt says. "The need for our products is very clear and if anything [the pandemic] has increased awareness."

(He contends that when people were forced to hear people wearing masks, they realized how deficient their hearing was).

In the long term, Cochlear's game is about accessing the 60 million people who have severe-to-high hearing loss. Of these, only five percent of those suitable for an implant actually have one.

The company also estimates an addressable market of 1.3 million people for acoustic implants, with less than one percent benefiting to date.

In the short term, Nucleus 8 upgrades will play a key role in boosting revenue given the delayed surgeries have constrained the supply of newly-implanted patients.

Another management priority is to boost the low level of referrals from hearing aid practices, with the Sycle and Oticon purchases expected to help the company to achieve this.

Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. But when it comes to finding subject matter, he does keep his ear to the ground and his nose to the grindstone.