



# 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:** \$343.37

**Shares on issue:** 65,494,094

**Market cap:** \$22.5 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 2023):** revenue \$1,113.4 million (up 25%), earnings before interest and tax \$254.9 million (up 37%), net profit \$191.4 million (up 35%), earnings per share \$291.9 million (up 36%) dividend per share \$2 (up 29%), net cash \$485.22 (down 12.6%)

**Identifiable major shareholders:** Blackrock Inc 6.8%, State Street Corp (5.9%), ABP (Algemeen Burgerlijk PSF) 5.4%, Perennial Investment Management 5%.

With apologies to visiting diva Taylor Swift – of whom you might have heard - it's a case of Shake It Off for Cochlear, exemplified by its shares this month hitting a record high ahead of this week's sturdy half-year numbers.

On Monday, the company unveiled record half-year revenue, driven by sales of Cochlear's next-generation Nucleus 8 sound processor.

The company's interim profit was also the second highest on record.

We use the term 'unveiled', but the numbers in effect had been pre-announced on February 8. In other words, they were as predictable as a controversy over the price of Swifty merchandise.

"Implant growth has been strong across all segments - children, adults and seniors," says Cochlear chief Dig Howitt.

"We continue to see an improving trend in adult referral rates, in part driven by initiatives to improve awareness and access for older adult cochlear implant candidates."

### **Inspired by a day at the beach**

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'.

The term 'cochlear' - as in lower case - is generic.

On a beach in 1977, otolaryngologist (ear specialist) Graeme Clark (later to become Prof Clark) fiddled with a shell and a blade of grass and realized there was a safe way to insert electrodes into the inner ear.

His discovery was inspired by his profoundly deaf pharmacist father.

Prof Clark partnered with Australian entrepreneur Paul Trainor (Nucleus Group) to commercialize an implant, the Nucleus 22.

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 750,000 implants and has a circa 60 percent market share.

Headquartered at Sydney's Macquarie University, Cochlear employs more than 4,800 people and sells to more than 180 countries, with a direct presence in 50 of them.

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 and Mr Howitt - then chief operating officer - took over.

## **Cochlear's products**

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

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.

The key acoustics devices are Osia (as in 'osseo integrated steady state implant') and Baha (as in bone-anchored hearing aid).

In October 2022, Cochlear launched the latest product iteration, the Nucleus 8 sound processor, which has features such as Bluetooth connectivity and background noise suppression.

## **Opening the cheque book**

In 2017, the hitherto not-especially-acquisitive Cochlear paid \$US78 million (\$A115 million) for Sycle LLC, the world's dominant supplier of audiology practice management software.

In April 2022, Cochlear whipped out the cheque book again to buy Oticon Medical for around \$170 million.

Oticon consists of the implant business of the Danish-based Demantis Group, which wanted to focus on other activities.

Cochlear's rationale is that while it is clearly the leader in implants, it doesn't get much custom from the hearing loss segment because hearing aids are still the main treatment option.

The transaction was meant to have been sealed by the end of 2022, but was been delayed because of concerns from the 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.

In June 2023, the UK Competition and Markets Authority green-lighted the purchase, but demanded the divestment of Oticon's bone-conduction business.

The purchase still depends on consent from the Australian Competition and Consumer Commission and the European Commission. Cochlear expects the deal to be completed by June this year, with expected integration costs of \$30 million compared with the earlier envisaged \$60 million.

## **Finances and performance**

The overall gist of the results was higher-than-expected implant revenue, which offset some weakness in the acoustics and services division.

First half sales revenue was \$1,113 million (up 25 percent), with a net profit of \$191 million (up 35 percent).

Management reiterated its upgraded guidance of a net profit \$385 million to \$400 million for the full year to June 2024, a 26 percent to 31 percent improvement.

Half year implant revenue was up 26 percent to \$638.5 million, with 24,193 units installed. The company now expects full-year implant growth of 10 percent to 15 percent, compared with the high single digit growth envisaged last August.

Services revenue (from sound processors and upgrades) grew 35 percent, to \$349 million.

Acoustics revenue declined four percent to \$116 million, the main reason being reduced sales of the you-beaut Baha 6 sound processor, launched three years ago.

Mr Howitt cites strong growth in both the developed and emerging markets, with the former growing at a 15 percent clip and the latter at 10 percent.

Meanwhile, Cochlear spends about 12 percent of its revenue on research and development and over time has invested \$2.7 billion.

Over the last 12 months, Cochlear's share price has tiptoed between a record \$334.50 (February 16 this month) and a low of \$222 (July 10, 2023).

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

## **Not bye bye buyback, but au revoir**

With nil debt, Cochlear has been making liberal use of share buybacks to improve earnings per share - but management has paused the latest round.

The reason is that with interest rates so high, the company is earning a nice five percent or so by plonking its cash in a term deposit.

Having spent \$43 million soaking up shares in the half, the company won't pursue the targeted \$75 million of buybacks for the current year.

"We still believe [buy-backs] are the best way to return cash to shareholders," says chief financial officer Stuart Sayers.

Cochlear's coffers were boosted by a \$1,320 million capital raising in early 2020, at the onset of the pandemic, at a heavily discounted \$140 a share. That move in hindsight was unnecessary, but it was a case of 'you don't know what you don't know'.

## **What? A cure for deafness?**

As with Resmed and the new fat-busting drugs, Cochlear could suffer if new drugs reduce the incidence of childhood deafness.

Pharma house Moderna has been working on a vaccine drug for the cytomegalovirus (CMV), called mRNA-1647. A member of the herpes family, CMV accounts for about 20 percent of childhood deafness.

Moderna is due to release phase III trial results later this year.

UBS estimates that if the drug got to market, 5-6 percent of Cochlear's revenue could evaporate in the mid-term.

Mr Howitt says while accurate numbers are hard to find, CMV is the cause of deafness in fewer than 10 percent implant-eligible of kids.

"If there is a vaccine to control or stop CMV we would all want it to be successful," he says.

## **Say it again?**

Another potential threat lies with an early-stage gene therapy being developed by drug maker Eli Lilly.

The first trial patient, an 11-year-old Moroccan boy born with profound hearing loss, was able to hear some sounds within 30 days.

A second child is being treated at a Philadelphia clinic.

The therapy involves using a virus to insert the OTOF (otoferlin) gene into the child's inner ear, so the organ can sense sound and transmit it to the brain.

According to Science magazine, around 200,000 people are born with two flawed copies of the gene annually, leaving them deaf but with hair cells that could potentially work.

"The new deafness treatments add to a string of recent successes for the gene therapy field, but also raise questions," Science says.

The Eli Lilly trial is expected to be completed in 2028.

Mr Howitt says gene therapy would be relevant only for about one in 1,000 paediatric implants.

Cochlear cites a developed world market of 130,000 children (with severe or higher hearing loss) but the company already services 80 percent of this market.

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

As Ms Swift crooned, the haters are going to hate, hate, hate and it appears Cochlear's fan base isn't quite as ardent and unquestioning as her acolytes.

In spite of the upbeat results, most broking analysts ascribe a 'sell' call (or similar).

To be fair, most of them simply reckon the stock is overvalued, with ascribed 'target prices' as low as \$227. "[A] high quality result but difficult for us to see any additional outperformance in the stock," harrumphs investment bank Jarden.

An outlier, Wilsons' Dr Shane Storey ascribes a \$365 valuation: "Cochlear may even be doing better (tactically and strategically) than the immediate numbers suggest."

A key concern is how successfully Cochlear will broaden its adult market to achieve its target of high-single digit implant growth in the medium term.

The World Health Organisation estimates 60 million people have severe or higher hearing loss and only five percent of those suitable for an implant are serviced.

Cochlear says when it comes to the acoustic transplants the take-up is more like one percent.

To date, the growth come mainly from existing implantees upgrading their equipment.

Mr Howitt says there is a "huge clinical need" for older people who have given up on hearing aids, while there is also a growing awareness of the link between hearing loss and declining cognition.

Aside from raising awareness, the company needs to boost the low level of referrals from stretched audiology practices. Much depends on how the company uses Oticon and Sycle as a tool for sales referrals.

Unlike Ms Swift, Cochlear occasionally misses a beat and faces problems. But management's loud and clear message is that Cochlear knows how to solve 'em.

***Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort - not even Harvard's 'Taylor Swift and her World' or the University of Florida's 'Musical storytelling with Taylor Swift and other iconic female artists'.***