



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: \$222.50; **Shares on issue:** 65,775,238; **Market cap:** \$14.6 billion

Chief executive officer: Diggory Howitt

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

Financials (first half to December 2021): revenue \$821 million (up 10%), earnings before interest and tax \$217 million (up 24%), underlying net profit \$157.5m (up 26%), net profit \$169.3m (down 28%), dividend \$1.55 (up 35%), net cash \$505.6 million (down 10%)

Identifiable major shareholders: Blackrock Inc 7.13%, ABP (Algemeen Burgerlijk PSF) 5.5%, Baillie Gifford & Co 5.2%, State Street Corp 5.1%.

While biotech valuations have been smashed globally, Australia's home-grown 'three pillars' have delighted investors with their narrative of post-pandemic revenue recovery and resilience against the cost pressures we are seeing everywhere.

Firstly, sleep disorders house Resmed on January 28 reported a 12 percent surge in December quarter earnings and revenues. The stock bounced eight percent over the ensuing two trading days.

On February 16, CSL reported a five percent profit decline but better than expected numbers from its 'flu vaccine division, which was enough to add 14 percent to the value of the third-biggest ASX-listed company.

Completing the trifecta, Cochlear shares gained 16 percent after the hearing device half-year revenue numbers definitively beat market expectations on February 22 (the auspicious 22/2/22).

The lesson? When investors turn risk averse, they will always favor the stalwarts over the pre-revenue plays reliant on the next capital injection.

A year ago, the speculative minnows could pretty much rely on an equity raising with the flimsiest rationale. Those days are over.

But we digress. Cochlear's half-year numbers were a story of a stronger division - or geography - making up for a weaker one.

For example, subdued implant sales were offset by sales of other products and services - processor upgrades and the like - while revenue from emerging countries made up for sluggish sales in developed countries.

A word in your shell-like ...

Cochlear owes a debt of gratitude to a young fellow called Graeme Clark - later Prof Graeme Clark - who declared he wanted to "fix ears" after seeing his pharmacist dad struggle with hearing loss.

Inspired on a beach by the shape of a shell and a blade of grass, Prof Clark partnered with local entrepreneur Paul Trainor (Nucleus Group) and the University of Melbourne to develop the first implant, the Nucleus 22.

Cochlear was founded in 1981 while part of the Nucleus Group and listed in 1985.

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

So far 650,000 devices have been implanted.

Cochlear's core business is not just the implants, but the sound processors and other add-ons, such as spare coils and cables, remote controls, repairs, shake-awake alarm clocks and travel insurance.

Long-running CEO Dr Chris Roberts stepped down in September 2015, to be replaced by the Denver-based Chris Smith. With a sales and marketing background, Mr Smith introduced a 'direct to consumer' focus. But he quit in July 2017 for family reasons and Mr Howitt - then chief operating officer - took over.

While not being overly acquisitive, in May 2017, Cochlear paid \$US78 million (\$A115 million) for Sycle LLC, the world's dominant supplier of audiology practice management software.

Hear about the results?

While Cochlear's overall implant volumes rose seven percent from pandemic lows to 18,598 units, this was less than originally forecast because of staff shortages (mainly of nurses in operating surgeries).

Implant sales crept up 0.7 per cent to \$458 million.

Volume declines were most evident in the US, where the Delta and Omicron Covid outbreaks resulted in operating theatres running below capacity.

European implants have rebounded nicely, albeit with country-by-country variations.

The soft implant performance was more than offset by the 'other stuff'. By that we're talking about the services division (sound processor upgrades and the like) and acoustics (bone conduction implants).

Services revenue gained 19 percent to \$256 million (32 percent of total revenue). Acoustics revenue surged 38 per cent to \$109 million and now accounts for 12 percent of total revenue.

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 is "driving strong demand for sound processor opportunities across all regions".

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.

Geographically, revenue from developed economies fell two percent, while emerging ones picked up the slack with a 30 percent increase. Revenue from the Americas (mainly the US of course) rose 3.4 percent to \$388.4 million. Europe, the Middle East and Africa sales rose 21 percent to \$287 million, with Asia-Pacific sales up 8.2 percent to \$140.1 million.

To tackle the ongoing semiconductor shortage, the company spent an extra \$20 million to build its inventory as a buffer.

Finances and performance

Cochlear's statutory profit of \$169.3 million fell 28 percent, but the underlying result was 26 percent better at \$157.5 million.

The difference stems from the underlying number excluding an \$11.8 million gain from the company's innovation fund in the current half, a similar \$35 million gain in the previous half and \$59 million of patent dispute costs and a \$17.2 million Jobkeeper repayment in the previous half.

(The company chose to repay the proceeds from Jobkeeper - the government's pandemic wages support scheme - after it became evident the company really didn't need the handout. Plenty of other companies didn't need it either, but kept the dough anyway).

A key reason for investor jolliness was that the board maintained full-year earnings guidance at \$265 million to \$285 million, which at the midpoint would be 14 percent higher than last year's number.

Given the number includes the \$18 million to \$20 million impost from a digital (cloud) program, the guidance in effect is five percent higher at the midpoint.

As a qualifier, the guidance does not factor in a "more material disruption from Covid that significantly impacts sales".

Encouragingly, management says the second (current) half-year is tracking in-line with the first half "with continuing intermittent Covid-related hospital or region-specific elective surgery restrictions".

Over the last 12 months, Cochlear shares have ranged in value between \$182 (late January 2021) and a record high of \$265 in mid-August of that year.

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

Keeping ahead of rivals

Cochlear earmarks 12 percent of its revenue to research and development and has expended \$2 billion since listing to stay ahead of its rivals.

When a provider slips up in the high stakes medical devices world, rivals don't hang around to salve the bruises.

In February 2020, Cochlear's nearest competitor Advanced Bionics announced a "voluntary field corrective action" for some of its unused Hi-res Ultra and Hi-res Ultra 3D implants.

Cochlear duly stole market share with its Nucleus Profile Plus, touted as the world's thinnest and most reliable implant.

"We think overall they have regained some of their [market] share, but we don't see them gaining the share from us," Mr Howitt says.

Still, there's no room for schadenfreude: in 2011, Cochlear was forced to recall its Nucleus CI500 implants because of a moisture related defect - at a cost of more than \$100 million.

Cochlear last upgraded its processor in 2017. Given it normally does so every four years it's thought the company is overdue for another one.

Dr Boreham's diagnosis:

According to Mr Howitt, the wearing of masks during the pandemic has highlighted that "our hearing is worse than we thought it was".

Indeed! Try being understood in a noisy shop or restaurant through the protective but sound muffling material.

For those still questioning Cochlear's growth credentials, the company has a 60 percent market share of implants, but has penetrated only five percent of the available market.

About 1.5 billion of the world's people suffer some hearing loss - masks or no masks - with 60 million in the severe or higher category. Of these folk, only one in 20 of them have benefited from an implant.

Cochlear accounts for 80 percent of the kids' market but only three percent of adults. This implies there's still a lot to be done in the six million-strong adult sector, with future annuity revenue coming from the children already implanted.

The company has a more modest share of the services and acoustics markets: 29 percent and 10 percent respectively.

In the short term, the company risks further disruption from the pandemic as it continues to carve its path through humanity. In the longer term, we can't see - or hear - too many impediments to further growth.

With a healthy net cash balance, it will be intriguing to see what the company does with its war chest.

"We are happy to have the cash," says chief finance officer Stuart Sayers. "We are thinking of the right things to do with it but we are in no rush."

Hear hear! It's better to have a lazy balance sheet than no balance sheet.

Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. We're hoping World leaders are hearing - and heeding - sage advice as no-one should be deaf to the repercussions of a wider conflict.