Conference Call Prepared Remarks

FINAL: 11/8/17

Note: May Change Slightly When Delivered

Mike Watts
VP Investor Relations and Corporate Communications

Thank you, ______. Good afternoon and thanks for joining us for Hologic's fourth quarter fiscal 2017 earnings call. With me today are Steve MacMillan, the Company's chairman, president and chief executive officer, and Bob McMahon, our chief financial officer. Steve and Bob both have some prepared remarks, then we'll have a question and answer session.

Our fourth quarter press release is available now on the investors section of our website. We also will post our prepared remarks to our website shortly after we deliver them. Finally, a replay of this call will be archived through November 24.

Before we begin, I would like to inform you that certain statements we make during this call will be forward-looking. These statements involve known and unknown risks and uncertainties that may cause actual results to differ materially from those expressed or implied. Such factors include those referenced in the Safe Harbor statement included in our earnings release, and in our filings with the SEC.

Also during this call, we will be discussing certain non-GAAP financial measures. A reconciliation to GAAP financial measures can be found in our earnings release.

Finally, any percentage changes we discuss will be on a year-over-year basis, and revenue growth rates will be expressed in constant currency, unless otherwise noted.

Now I'd like to turn the call over to Steve MacMillan, Hologic's CEO.

Steve MacMillan
Chairman, President & CEO

Thank you Mike, and good afternoon everyone.

We're pleased to discuss Hologic's financial results for the fourth quarter of fiscal 2017. We posted strong results overall, with revenue exceeding our guidance and earnings per share finishing at the high end of our expectations. And we redeployed more than $300 million of capital to buy back shares and retire convertible notes.

Our fourth-quarter results capped off a very productive fiscal 2017. Over the last 12 months we made excellent progress toward building a sustainable growth company, with emphasis on that word sustainable. In the short-term, we delivered solid, mid-single-digit revenue growth excluding acquisitions and divestitures, as we said we would at the beginning of the year. But at the same time, we took three important steps to solidify our growth profile for the long-term. First, we laid the foundations for sustainable growth internationally. Second, we shifted our business portfolio toward higher-growth segments with the divestiture of blood screening, and the acquisition of Cynosure. And third, we began to launch new products that reflect increasing innovation from our revitalized research and development pipeline.

In short, 2017 was a year in which we delivered on our near-term financial commitments, and did what we said we would to build sustainable, long-term growth.

With that introduction, let's review our fourth quarter results.

Revenue of $802.9 million grew 10.5% on a reported basis, or 9.9% in constant currency. Excluding the impact of the Cynosure acquisition and the blood screening divestiture, fourth-quarter revenue increased 5.0%, or 4.4% in constant currency, as all our legacy divisions grew on a global basis. We are pleased with this solid, mid-single-digit growth rate on the top line, which represents sequential acceleration compared to the 3.1% growth we posted in the third quarter.

One factor underpinning this acceleration is growing sales of new products, which totaled more than $50 million in the quarter, nearly five times the level of a year ago. Obviously this is not all incremental growth, but the rejuvenation of our product portfolio bodes well for the future.

In terms of geography, international sales drove most of the growth in the fourth quarter. OUS revenue of $189.9 million increased 24.7%, helped by the contribution of Cynosure. Even excluding Cynosure and blood, international sales increased a robust 17.5%, as a result of very focused and deliberate efforts that began with new leadership less than two years ago.

Reflecting back on early 2016, we described our international business as a start-up, and this was a major concern among investors and analysts, one that dominated our conversations with many of you. By the first quarter of 2017, the international business grew mid-single-digits. One quarter after that, it grew double-digits. And this quarter, it grew 17.5%. So while we thought that international would be a double-digit grower by 2018, we've actually delivered on that promise a year earlier than anticipated. Yes, we achieved double-digit international growth in fiscal 2017.

We hope you remember this success story – a complex one that occurred across divisions and geographies – as you think about the more straightforward efforts we have underway today to build a stronger, better Cynosure 2.0. We'll talk more about these in a moment.

In terms of divisional performance in the fourth quarter, we're pleased that growth accelerated in our two largest businesses, Breast Health and Diagnostics, compared to the third quarter. In addition, we believe that Cynosure sales bottomed out, and should start to grow on a sequential basis from here. Growth slowed in Surgical, but Skeletal reversed recent trends and posted very good results.

Now let us provide a little more detail on each of these divisions.

Diagnostics has clearly emerged as a sustainable growth driver for the Company. In the fourth quarter, excluding the divested blood screening franchise, we posted sales of $273.7 million, an increase of 6.6%. This compares favorably to the 5.4% growth we posted in the third quarter.

Fueling this growth again was molecular diagnostics, where sales of $153.5 million increased 13.8%. Molecular sales did benefit from $9.5 million of non-recurring royalty revenue in the quarter, compared to $5 million in the prior year period. But if you back out all these royalties, underlying molecular sales still increased 10.9% globally. The business was also very strong internationally, posting growth of 10.3% against a very tough prior year comparable of roughly 15%. This marks the sixth consecutive quarter of double-digit growth for molecular internationally.

Global growth was driven by the Panther system, our fully automated molecular diagnostics instrument. By the end of 2017, we had shipped about 1,300 Panthers to diagnostics customers, with about 800 of these in the United States. Importantly, we actually shipped slightly more Panther systems in 2017 – the seventh year after launch – than we did a year ago. This illustrates the strength of our competitive position and bodes well for future growth.

Based on increasing usage of our Aptima women's health assays and our growing menu of virology tests, the average Panther system generated more than $200,000 of assay revenue on a global basis in 2017, nearly a high-single-digit increase in utilization per system compared to the prior year. And we expect further improvement in utilization in the future, based in part on new assays that will emerge from an R&D pipeline that is healthier – and more global – than it's ever been. For example, in recent weeks we received FDA clearance for the first two respiratory assays that will run on our revolutionary new Panther Fusion system.

Before we leave Diagnostics, we want to mention that while sales of cytology and perinatal products declined slightly to $120.2 million in the fourth quarter, this was due mainly to lower perinatal sales. Sales of cytology products – mainly our ThinPrep liquid Pap tests – increased at a low-single-digit rate as strong international growth offset modest declines in the US.

We also want to mention that we've been encouraged to see various professional societies and patient groups speak out against the draft USPSTF cervical cancer screening guidelines, which represent bad science. Although primary HPV testing has been FDA-approved for three years, it is rarely used in the United States, as studies have shown it can miss nearly 20% of cervical cancers, reversing decades of progress we've made against the disease. As a result, we do not expect these draft USPSTF guidelines will have much effect on our business in the near-term. Instead, we believe that co-testing for cervical cancer will remain the gold standard.

Now let's turn to Breast Health. As foreshadowed in our August call, several encouraging signs had begun to emerge in this business last quarter, ranging from new products to new indications to increased insurance coverage. And in the fourth quarter, these positive factors continued to build, helping us regain market momentum and extend our leadership position.

Global Breast Health sales totaled $300.9 million in the quarter, an increase of 2.4% compared to the prior year period, and a sequential acceleration compared to the 0.9% growth we saw in the third quarter. The US business declined 1.2%, although this was due largely to a tough comp in the prior year period, when sales increased at a high-single-digit rate. International sales grew a strong 20.6%, reflecting the tremendous progress we have made in building a sustainable growth engine through both organic and inorganic means.

For all those who have been concerned about a potential "cliff" in domestic 3D placements, our results this quarter further prove that we have broken that boom and bust cycle, based on strategic plans we put in place years ago. In the United States, we had a record quarter of 3D shipments, again exceeding the 300 mark based on strong initial uptake of our recently launched 3Dimensions and 3D Performance systems. In addition, we continued to gain market share and our backlog increased, which bodes well for future growth.

Importantly, although we have now sold roughly 4,700 3D units in the United States, this still represents just over half of our own installed base. And MQSA statistics suggest that 3D still represents well less than half the overall market, so we still have many quarters of solid performance ahead of us.

At the same time, other growth drivers continue to emerge in Breast Health. In the fourth quarter, service revenue again exceeded $100 million, and grew at a mid-single-digit rate. Sales of our Affirm prone table increased nicely, and we also launched Brevera, our revolutionary new, real-time biopsy system, which should contribute to growth in 2018.

Now let's turn to Surgical, where sales of $104.7 million increased 2.7%, slower growth than we have seen in recent quarters. MyoSure continued to perform well, with sales increasing 17.0%. And we recently launched MyoSure Manual, which will help us penetrate the growing in-office market. Novasure sales declined 7.2% due to a number of factors, including the annualization of a competitive withdrawal, increasing competition, and some softness in overall surgical volumes.

Although our Skeletal business is small, we were pleased to see it reverse recent trends and return to growth in the fourth quarter, driven by better portfolio selling, strong performance from our Horizon bone densitometry system, and stabilization of our Fluoroscan franchise. Skeletal sales totaled $24.2 million, an increase of 12.9%.

Now let me discuss our new medical aesthetics division. Cynosure sales were $81.4 million in the quarter. As expected, this was down significantly from the prior year period, when Cynosure was a standalone company. We estimate that the two hurricanes in the Southern United States reduced Cynosure sales by $3 to $4 million in the quarter, as sales events were canceled and purchase decisions were delayed.

We want to make two big-picture points about Cynosure that are very different than today's prevailing discourse among investors and analysts. But they illustrate how we're building this business for the long-term, and why we are confident that we will succeed and grow in medical aesthetics.

First, we'd like to remind you why we bought Cynosure in the first place. Medical aesthetics is a great growth market, one of the best in medtech. By divesting blood screening, where volumes and price are declining, and purchasing Cynosure, we fundamentally shifted our portfolio toward higher-growth segments.

The many tailwinds boosting Cynosure's market include increasing social acceptance of aesthetic procedures, high levels of disposable income among patients, decreasing reimbursement for physicians that is prompting interest in cash-pay services, improving treatments that minimize patient downtime, and growing interest among younger women as well as men. These tailwinds have been driving market growth rates in the high-single to low-double digit range.

Our second point is that we are making good progress toward building what we call Cynosure 2.0, which we expect to include the greatest commercial organization that the laser industry has ever seen. This is a bullish comment, especially in contrast to recent results, but we want you to know that our goals are high, and we intend to achieve them.

This process starts with great leadership, just as it did with our international business in 2016. We have already put in place outstanding leaders as Cynosure's president, and the heads of sales and marketing. We have stopped the voluntary turnover in the field, and re-hired a handful of high-performing reps. We have instituted new screening and recruiting methods to ensure that new hires share our commitment and values – to winning as a team, to winning the right way, and to winning in partnership with our customers over the long-term. We have upgraded our structure and compensation programs to ensure that sales reps have the ability to prosper by selling our entire portfolio, which is the broadest in our industry. We have hired new leaders to revitalize the customer experience, and build the same kind of customer loyalty that we see in our other divisions. And we are implementing, across the division, a robust sales model that has been proven to work by Cynosure's best reps.

Based on all these factors, we are confident that Cynosure's sales bottomed in the fourth quarter, and are poised to grow from here. Not only will we execute better with our existing portfolio of products, we will effectively launch new products, such as the submental indication for Sculpsure, which is receiving positive early feedback from customers.

While we still have a ton of work to do, we are making good progress. As early indicators of this, our international performance remains solid, and some domestic sales regions are performing very well. And overall, sales so far this quarter are tracking ahead of their pace in the fourth quarter. We are confident that Cynosure will make steady progress in the coming quarters, like our international business did, and become an important growth driver for the Company in 2018 and beyond, like our international business is today.

Before I turn the call over to Bob, let me summarize by saying that we posted a very good fourth quarter that exceeded expectations and capped off a productive fiscal year. Not only did we execute against our short-term financial commitments, we made important progress in building a sustainable growth company for the long-term by growing international, strengthening our portfolio of businesses, and launching new products. I'm proud of our team and all that we have accomplished together, and am eager to drive even greater successes in 2018 and beyond.

Now I will hand the call over to Bob.

Bob McMahon
CFO

Thank you Steve, and good afternoon everyone.

I'm going to review the rest of our income statement, cover some balance sheet and cash flow items, and discuss our financial guidance for 2018. Unless otherwise noted, my commentary will focus on non-GAAP results.

As Steve mentioned, we closed out our fiscal 2017 with a strong fourth quarter. Revenue exceeded our guidance, and EPS came in at the high end of expectations. During the quarter we also strategically redeployed capital, and as we head into 2018, we see new growth drivers emerging.

With that introduction, let's move down our fourth quarter income statement.

Gross margins of 64.1% decreased 160 basis points compared to the prior year period, due primarily to the divestiture of our blood screening business and sales of Cynosure products, which carry a lower margin. However, it's important to note that gross margins improved by about 60 basis points on a sequential basis, even if you strip out the royalty income that Steve discussed.

Total operating expenses of $275.8 million increased 17.1% in the fourth quarter, primarily due to the inclusion of Cynosure expenses. But if you back these out, our efforts to drive strong operating leverage continue to bear fruit, with operating expenses declining 3.0%.

Our operating margin of 29.8% declined 360 basis points due to product and geographic mix, as well as the divestiture of our blood screening business. Yet we continue to maintain one of the best profit profiles in medical technology, with multiple levers to drive expansion going forward.
Finally, net margins of 17.8% decreased 220 basis points, as the negative mix factors just discussed were partially offset by improvements in our effective tax rate.

All this led to non-GAAP earnings per share of $0.50, hitting the high end of our guidance range.

Before we move on to our 2018 guidance, I'll quickly touch on a few other key financial metrics.

First, we've had a very productive few months as we continue to optimize our debt structure and allocate capital in accordance with our stated priorities.

During the fourth quarter, we took advantage of weakness in our share price to opportunistically reduce our convertible debt and repurchase our common stock. Specifically, we retired $86 million in principal of our convertible notes for a total purchase price of $106 million. In addition, we repurchased 5.3 million of our outstanding shares for a total of $200 million. So in total, $306 million in productive capital deployment.

In addition, in early October we announced two positive changes to our debt structure, beginning with an amended five-year secured credit agreement. Through this agreement, we extended the maturity by two years, increased our financial flexibility, and upsized our revolver. In addition, we also issued in early October $350 million of senior notes maturing in 2025, at a very attractive interest rate of 4.375%. Together, the larger revolver and the senior notes will provide the capacity to retire our remaining convertible notes when they become callable in December and March of fiscal 2018.

This quarter was certainly a very productive one for our financial organization, following on the heels of the blood divestiture and Cynosure acquisition earlier in the year, so I want to take this opportunity to publicly thank the finance teams for all the hard work that made these successes possible.

At the end of the fourth quarter, our leverage ratio, net debt over EBITDA, stood at 2.7 times, slightly below our year-ago level despite all the capital allocation activities that occurred in fiscal 2017. Finally, in the fourth quarter, adjusted EBITDA of $262.7 million declined slightly compared to the prior year, as improvements in our base business were offset by the divestiture of blood screening.

Now I'd like to cover our non-GAAP financial guidance for fiscal 2018.

First, as a housekeeping item, I will make references to organic revenue, which is defined as total revenue less blood screening and medical aesthetics for the first two quarters of fiscal 2018. Said differently, medical aesthetics is included in our organic numbers for the third and fourth quarters of fiscal 2018. Organic results also adjust for three fewer selling days in 2018 than 2017, which we estimate has a sales impact of roughly $20 million. Finally, organic revenue adjusts for $9.5 million of royalty revenue that we don't expect to recur in 2018, similar to how we excluded discontinued product lines in last year's guidance.

We anticipate fiscal 2018 to be a good year for Hologic overall. At the highest level, we are forecasting continued mid-single-digit organic revenue growth with faster organic EPS growth.

Specifically, we anticipate sales of $3.20 billion to $3.28 billion in 2018, with reported growth rates between 4.6% and 7.2%. Based on recent exchange rates, this translates to constant currency growth of 4.0% to 6.6%, with organic constant currency growth in the mid-single-digits. As you update your forecasts, we would encourage you to model at the middle of our guidance ranges at this early stage, as we've tried to set realistic ranges that incorporate both potential upsides and downsides.

In terms of divisional growth in 2018, our guidance contemplates low-single-digit growth in Breast and Skeletal Health, mid-single-digit growth in Diagnostics excluding blood screening, mid-single-digit growth in Surgical, and double-digit pro forma growth in Medical Aesthetics.

In Diagnostics, Molecular should continue to lead the charge behind Panther and an expanded menu including the full suite of virology assays, which we expect to have in the US with the approval of our HBV test around the middle of the fiscal year. We anticipate continued strong international growth in diagnostics, plus a $25 to $30 million revenue contribution related to blood screening transition services, which will have little to no benefit on earnings.

In Breast Health, growth will be driven by new products like the Affirm prone biopsy system and Brevera, our international business, and a growing service annuity.

In Surgical, we expect growth to be driven by continued market expansion efforts behind Myosure, new products like Myosure Manual, the stabilization of Novasure, and international.

In Medical Aesthetics, we expect strong growth from a stabilized and fully productive sales force, and new products including the submental indication for Sculpsure and our new RF platform.

In terms of profitability, I would remind you that our non-GAAP margin profile in the second half of fiscal 2017 represents a new baseline for the business post-blood screening and Cynosure. So from gross margin levels of roughly 63.5%, we forecast solid improvement from continued operational efficiencies, tempered somewhat by the rapid growth of our international business. In addition, we expect to continue showing strong leverage in operating expenses. So from a baseline of roughly 29.5%, operating margins should expand faster than gross margins.

Below the line, we expect net non-operating expenses to be materially higher in fiscal 2018 than the $122 million we posted in 2017. This will result from higher forecasted interest rates and the financing activities I mentioned earlier, which are tied to the anticipated retirement of the remaining convertible notes in December and March.

All this leads us to forecasted earnings per share between $2.10 and $2.15 in 2018. This represents reported growth of between 3.4% and 5.9%, with double-digit organic growth after adjusting for the blood screening divestiture.

This guidance assumes a full-year tax rate of approximately 31%, and diluted shares outstanding of about 284 million for the year. Our guidance does not assume any capital deployment beyond calling the convertible notes, and excludes the possible re-instatement of the medical device excise tax.

Now let’s cover guidance for the first quarter of fiscal 2018. As a reminder, we will have four fewer selling days this quarter than we did a year ago, which translates into more than $20 million of revenue. We expect revenues of $775 to $790 million, down on a sequential basis, as we see a normal seasonal decline due to our global sales meeting and the RSNA conference in Breast Health. In addition, we'll be missing the $9.5 million in diagnostics royalty revenue that Steve discussed. Compared to the prior year period, which included those extra selling days, this range reflects reported revenue growth of 5.5% to 7.6%, and constant currency growth of 4.7% to 6.7%.

We forecast non-GAAP diluted earnings per share of $0.48 to $0.50 in the first quarter. This anticipates a decline of (7.7%) to (3.8%) on a reported basis, but double-digit growth excluding the $0.10 in the first quarter of last year related to blood screening.

Before we open up the call for questions, let me conclude by saying that our fourth quarter capped off a successful and productive year for the company. Externally, we are encouraged by the productivity of our R&D investment and a building product pipeline, the impact that organizational changes have made on the international business, and the overall shift in our portfolio toward higher-growth markets. Internally, we continue to exercise tight expense controls, improve our debt structure, and strategically redeploy capital. Overall, we feel confident in our foundation heading into 2018, and have the levers to deliver healthy revenue and EPS growth.

With that, I will ask the operator to open up the call for questions. Please limit your questions to one plus a related follow-up, then return to the queue. Operator, we are ready for the first question.