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Varian Medical Systems, Inc. (VAR)

Q1 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

J. Michael Bruff
Vice President of Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

- Included in these documents is the reconciliation of the differences between GAAP and non-GAAP financial measures
- We report non-GAAP earnings to provide comparisons of operational performance excluding unusual items
- Unless otherwise stated, all financial results discussed are non-GAAP, and from continuing operations, all growth rates are y-over-y and any references to orders are gross orders

Dow R. Wilson
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Revenue and GAAP EPS

- Today I'll share the key milestones we achieved this past quarter and how they contributed to our long-term strategy

- First, let me touch on our first quarter results
- Total company revenues of $679mm increased 13%
- Oncology revenues grew 14% and the Particle Therapy business declined 4% in the quarter
- Operating earnings of $126mm or 18.6% of revenue grew 84% in part due to the non-recurrence of an accounts receivable reserve taken in the prior year
- GAAP EPS was a loss of $1.22 and non-GAAP earning per share of $1.06 grew 110%
- Our earning per share results reflect the impact from the new Tax Cuts and Jobs Act as Gary will discuss in more detail later

Cash Flow

- Cash flow from operations was $179mm, up 118%
- Looking more long term, we continue to make meaningful progress towards our long-term growth and value creation strategy across three initiatives
- First, strengthening our leadership in radiation therapy
- Based on company estimates the radiation therapy market grew 4.5% on an orders basis over the trailing 12 months
- Varian grew orders 7% over that time, growing share and extending our market leadership

Oncology Business

- In our Oncology business, orders grew 7% in Q1 and our worldwide net installed base is now 7,876 units, up 3% over the trailing 12 months
- Regarding Halcyon, we continue to be pleased with the order ramp, with 62 total orders taken since the launch in May of last year, including 12 new orders in Q1
- What's meaningful here is that of the 62 orders to date, more than half have been incremental and greater than 40% are for greenfield sites
- Looking forward, we expect solid demand over the coming quarters
- The anticipated growth will be driven by new scaled configurations optimized for different customer segments, more advanced capabilities such as kilovoltage cone-beam CT imaging, and the continued ramp up of public tenders as budgets are finalized for the new CY

HyperArc

- HyperArc, our high-definition radiotherapy technology, also continues to ramp nicely
- With 19 new orders in Q1, we have now taken 57 orders since the launch in Q4 last year, and greater than 60% of those orders are upgrades
- We're excited about what HyperArc will mean for treating multiple metastases brain cancer cases as these sites are installed

Software Solutions

- We continue to see strong demand for our software solutions
- The number of unique Varian software customers grew 4% in the quarter and we're very pleased to see the installed bases of RapidPlan double and Velocity grow strong double digits
- And services had another strong quarter posting revenue growth of 8% in the Oncology business, which includes performance obligations for installation, training and warranty as per the new revenue standard, ASC 606

Particle Therapy Business

- In our Particle Therapy business, we booked two new proton orders in the quarter, one at the University of Alabama at Birmingham, and one at the Sylvester Comprehensive Cancer Center at the University of Miami
- Both orders are for ProBeam Compact single room systems
- Today, Varian has 23 customer sites with 70 rooms installed or under contract
- In Q1, there were clinical room handovers at the Holland Proton Therapy Center and the Proton Therapy Center in St. Petersburg, Russia
  - This brings the total of operational sites to seven globally with the remaining 16 in progress

Global Market Share Growth

- Our second growth initiative is to extend our global footprint
- Our global market share growth was driven by orders-based share gains in both our EMEA and Asia Pacific regions
- In the Americas, we held our market leading share position
- We're very pleased with Halcyon's continued adoption outside North America
- Two months after the hospital ordered the system, the University Hospital Leuven in Belgium became the first to treat a cancer patient on Halcyon in Europe
- In Australia, the radiation oncology center in Toowoomba became the first to treat a patient on Halcyon there
- And now with regulatory approvals obtained in Brazil, Japan and Taiwan during Q1, more clinicians around the world are learning about and have access to this new advanced cancer care technology

Emerging Markets

- Of the 62 Halcyon orders taken since launch, almost 40% were from emerging markets and approximately 90% of the emerging market orders are for incremental units
- Our software products are being met with increased demand globally as well
- In December, we announced that Peter MacCallum Cancer Center in Melbourne, Australia selected Varian's Eclipse treatment planning to replace its existing systems across all five of its sites
- The full solution includes Varian's Velocity software for adaptive radiotherapy

Latin America

- Demonstrating our commitment in the fight against cancer in Latin America, we announced the opening of our new facility in Jundiaí, Brazil, which extends Varian's global manufacturing and training footprint in the region
- Partnering with the Brazilian Ministry of Health, we are bringing greater access to advanced radiotherapy treatment in that country and to greater Latin America

Other Addressable Markets

- Our third growth initiative is to expand into other addressable markets
- We continue to build momentum in Oncology Care Coordination, which is part of a larger care coordination market that is expected to grow at greater than 20% CAGR over the next five years

- With ongoing feedback from customers who are using our 360 Oncology software to manage clinical workflow and digitize the multi-disciplinary tumor board, we are enthusiastic about the potential of the product

Oncology Applications

- We are expanding the platform's clinical decision support imaging and analytics capabilities, building enterprise and SaaS channel capabilities and beginning to provide real world evidence for 360 Oncology applications
- Overall, we are very pleased with the progress we've made through Q1 our FY2018 and we remain committed to long-term growth and value creation for the company and our employees, our customers and patients, and our shareholders

Gary Bischoping, Jr.

Senior Vice President of Finance & Chief Financial Officer

FINANCIAL HIGHLIGHTS

Revenue Growth

- As always, I will consistently frame my comments in the context of our long-term growth and value creation strategy, which includes balancing growth, profitability and liquidity
- So let me start with growth
- Companywide revenue was $679mm in Q1 up 13% in dollars and 11% in constant currency
- In Oncology, revenue was $649mm up 14% in dollars and 12% in constant currency driven by increased linac shipments in mature markets
- Orders were $620mm, up 7% in dollars and 6% in constant currency
    - We ended the quarter with $2.7B in backlog, up 7%

Oncology Business Results

- Taking a closer look at our Oncology business results, in the Americas revenue grew 16% in dollars and in constant currency
- Orders were $300mm, up 2% in dollars and in constant currency
- North America orders grew 2% supported by key wins in the quarter including Norton Healthcare, which purchased three TrueBeam systems along with our ARIA, InSightive and Eclipse software solutions to deploy in their two sites

Latin America

- In Latin America, orders were down 3% primarily due to Brazil
- We did have four Halcyon orders in the region, two in Brazil, one each in Aruba and the Dominican Republic
- Asia-Pacific revenue grew 15% in dollars and 17% in constant currency
- Orders were $130mm, increasing 6% in dollars and in constant currency
- Orders in Japan and Greater China had solid growth in the quarter
- In Greater China we extended our market leadership, with key wins in Qingdao Central Hospital, Fudan University, Zhuhai People's Hospital, all buying our Edge system

Europe, Middle East, India and Africa

- In Europe, Middle East, India and Africa geography, revenue grew 9% and 2% in constant currency
- Orders grew 19% in dollars and 13% in constant currency to $190mm in Q1
- We continue to see market penetration across the regions as illustrated by wins in Denmark for 15 total treatment machines, including both TrueBeam and Halcyon to be deployed in two hospitals in Copenhagen region
- And in Poland where Varian won a public tender with the Ministry of Health for one Halcyon, one TrueBeam and three VitalBeam machines
- Our Particle Therapy business posted revenues of $29mm in Q1, which is down 4%
- And as Dow mentioned earlier, we booked two new orders, both in the U.S.

Profitability

- Turning to profitability
- Total company gross margin was $304mm, up 13% and 44.8% of revenues
- Oncology gross margin of $302mm increased 15%, and the rate was 46.5%, up 36BPS.
- Looking at Particle Therapy, gross margin dollars were $2mm, down $3mm due to a mix of lower-margin deals in the current period

SG&A Expenses

- Company-wide SG&A expenses of $122mm or 18% of revenue were down $28mm or down 18%
- The decline is primarily driven by the non-recurrence of prior year's $38mm accounts receivable reserve related to the Proton business
- Excluding this, SG&A increased $10mm or 9%, driven by targeted investments in product management and sales head count
- On a GAAP basis, depreciation and amortization was $19mm

Investments

- Investment will continue to be a key driver of our long-term growth and value creation strategy
- In the quarter, R&D was up 12% to $56mm, investing 8% of revenue
- Company operating earnings were $126mm or 19% of revenue, increasing $57mm or 84%
- Excluding the $38mm impact on the prior year's results related to the non-recurrence of accounts receivable reserve, operating earnings increased $19mm, growing 18%

Tax Cuts and Jobs Act

- Turning to taxes
- A major event in the quarter was the enactment of the Tax Cuts and Jobs Act which was signed into U.S. law on December 22
- Two provisions of the new law had an immediate impact
- First, the U.S. corporate tax rate was reduced from 35% to 21%
- In the long run, this will be favorable to Varian
    - However, in the quarter, it requires us to re-measure our deferred tax assets, which were originally recorded assuming a future tax benefit at the 35% rate
- We estimate that the total impact of this re-measurement of deferred tax assets will be about $47mm

- The impact to our first quarter is a charge to income tax expense of $38mm
- The remainder or about $9mm will be charged over the balance of the FY

New Territorial System

- Second, as part of the transition to a new territorial system, the new law imposes tax on the unremitted foreign earnings of a U.S. company's foreign subsidiaries at reduced rates
- Specifically, 15.5% to the degree the earnings are held in the form of liquid assets, and 8% to the degree the earnings are held in the form of illiquid assets
- We estimate the tax effect of this mandatory deemed repatriation to be $169mm
- Companies may elect to pay this tax often called a toll charge over an eight year period
  - We intend to make that election

GAAP and Non-GAAP Effective Tax Rate

- The Securities and Exchange Commission has issued guidance allowing companies a one year measurement period to refine their estimates of the tax impact of the new law
- We fully expect that we, like many other companies, will true up our estimates of these tax impacts from the new tax legislation over the measurement period
- Other provisions of the law will take effect over the next few years
- Thus after impacts of the new legislations provisions, our resulting GAAP effective tax rate for Q1 was 191.5%
- Our non-GAAP effective tax rate was 22.5%, which excludes the tax expenses due to the repatriation of foreign earnings and lower corporate tax rates impact on our deferred tax assets
  - Similarly, our non-GAAP net earnings per diluted share also exclude these items
- GAAP net loss per diluted share was $1.22
- Our non-GAAP net earnings was $1.06, with related diluted share count of 92.7mm shares in the quarter

Balance Sheet and Liquidity

- Turning to the balance sheet and liquidity
- We ended the quarter with cash and cash equivalents of $823mm and debt of $340mm
- Cash flow from operations was $179mm
- Due to the adoption of ASC 606, we restated oncology DSO in Q1 FY2017 from 95 days to 108 days
- Oncology DSO in Q1 FY2018 was 103 days, improving five days y-over-y

R&D

- In addition to R&D, other investments in the quarter included $9mm in CapEx and $57mm to repurchase shares of our stock
- As of the end of the quarter, we had 4.7mm shares remaining under our existing repurchase authorization

Dow R. Wilson

President, Chief Executive Officer & Director

Q1 HIGHLIGHTS

Performance

- With respect to our annual guidance, we maintain a pragmatic approach
- There are three new factors we've taken into account regarding our FY2018 guidance
  - First, the global radiation therapy market growth increased from 2% growth over the trailing 12 months exiting our Q3 last FY, to 4.5% growth over the trailing 12 months exiting our Q4 the last FY
  - Second, our growth and share gain in the faster growing market and our operational execution in Q1; and third, the implementation of the Tax Cuts and Jobs Act

GUIDANCE

Revenue, Tax Rate and EPS

- After careful consideration of these factors, we believe it is prudent to update and raise our FY2018 annual guidance to the following:
  - Revenue growth range of 4% to 7%, non-GAAP operating earnings as a percentage of revenue range of 18% to 19%, non-GAAP effective tax rate of 21%, weighted average diluted shares of 93mm, non-GAAP earnings per diluted share of $4.24 to $4.36, and cash flow from operations range of $470mm to $550mm
- The updated non-GAAP EPS guidance reflects $0.11 related to tax rate reduction primarily related to the impact of the law change on FY2018 earnings
- We intend to reinvest about half in R&D to drive organic growth
- The remainder of the anticipated non-GAAP EPS increase is driven by our continued market share gains in a stronger market and through operating leverage

QUESTION AND ANSWER SECTION

Jeff D. Johnson
Baird

Q

All right. Great. Hey, Dow, just wanted to start on the Oncology order side. The biggest upside vs. my model anyway was in APAC, that 6% constant currency growth came against a strong 29% comp. So just wondering what was going on there, what's driving the strong growth in APAC on top of that tough comp. And if I look at the Halcyon orders of 2012, that's about half of what you booked in the prior quarter, in fiscal Q4, so I'm assuming it wasn't Halcyon that drove that but maybe you could touch on Halcyon and maybe thinking we weren't going to get a budget flush or maybe some upside on the Halcyon number that didn't seem to come through this quarter. So just what's going on there?

Dow R. Wilson
President, Chief Executive Officer & Director

A

Sure. Yeah. I mean, just going around the horn, geographically first, Jeff, we had a good quarter in Japan. As you know, we didn't get shown an approval in Japan until the quarter. So there's very good interest there so we think longer term that the funnel looks very good. But we had a very good quarter in Japan. It was up significant y-over-y. Southeast Asia was also up y-over-y. We had very good performance from a number of geographies in Southeast Asia. Australia was really the only one that was kind of going the other way, and then we had good double-digit growth in China. So even on a tough comp, we had very good performance in China. And again, in China we also don't have Halcyon approval there yet. There the – from a product point of view, it was all about our Edge product. We had very good uptake of Edge, Gary mentioned in his remarks, and as well as on VitalBeam.

The other things that we are starting to see in Asia, and especially in China, is some very good uptake in the software side of the business. So historically, that's been a very, very small business for us. And with both the introduction of our ARIA Qin product and longer-term development with Ping An and others like that, we think we've got a very good cycle.

As it relates to Halcyon, we're very comfortable with where we are. The orders are incremental, they are in new sockets, it's growing our install base. We did surprise the market with this product. Our funnel remains very, very strong. I think what we're excited about is we have cured the product and so we really think that we can get both more aggressive at kind of lower-end price points, and with the coming of kilovoltage cone-beam CT, higher price points in developed markets. So we're very excited about where this product goes. We are seeing some activity in the tender market as customers try to put themselves in line and develop budgets for the product. So I think it's very much in the budget development part of the market, and we like what we see, very good funnel for the product.

Jeff D. Johnson
Baird

Q

All right. That's helpful. Thank you. And Gary, maybe one follow-up just on guidance. It looks like your revenue guidance update tonight implies 1% to 5% reported growth over the balance of FY2018 over the next three quarters. I've got currency in my model adding probably 250BPS over the next three quarters. So just trying to figure out if kind of flattish organic revenue over each of the next three quarters is kind of – is that you guys being just uber-conservative at this point? Is there something where first quarter took some out of the next few quarters? Just how should we think about kind of your constant currency or your organic revenue expectations for the next few quarters?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. There's no real material change from our perspective, Jeff, in the currency market relative to our guidance. And so we'll see what the markets do. Maybe you know better than I do as to where things are going, but our view is that currency really isn't impacted by the guidance update that we just gave, so no new news on currency. We like our backlog. I think the teams are doing a nice job of working through conversion, and we saw some of that benefit certainly in Q1 as we moved more towards some mature markets that came through the revenue line from more recent orders, and so that certainly has helped. But overall not a big impact in guidance for us from what we had previously discussed from currency.

Jeff D. Johnson
Baird

Q

Okay. So just so I understand that then, with the weakness we've seen with the U.S. dollar across so many currencies here over just the past four weeks, six weeks or so, you're essentially not putting any of that in the updated guidance?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

That's correct.

Amit Hazan
Citi

Q

Let me stick with guidance for a second and just ask about the cash flow guidance, maybe that can help explain some of how the P&L changes are flowing through. You're actually not changing your cash flow guidance, so is the implication there that this would be – and the raise is kind of more of a noncash, accounting related, or is there some real pull through here that you've somehow kind of offset somewhere else?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. Amit, good question, and thanks for that. It's a pretty wide range, right, $475mm to $550mm? When you look at trailing 12 months cash flow, it's actually about $500mm right now on a trailing 12-month basis so it's a pretty wide range. But no, the update in guidance and Q1 results are strong operating margin dollars, right, driven by the top line of a little bit of margin rate expansion and some operating leverage.

And then from a cash flow perspective, as we talked about, we saw a good conversion from a DSO perspective in the oncology business, and the PT business had a good cash flow quarter as well. So kind of hitting on all cylinders to deliver that $179mm, but there's no impact from ASC or any accounting changes that you've got running around in the revenue number that we have just guided to, right? We had a separate call just for that conversation and this update is based on our performance in the market and a stronger market as Dow had outlined.

Amit Hazan
Citi

Q

Okay. That's very clear. And then I want to come back to Halcyon because I think that'll be one question people ask tomorrow. And so maybe a different way is asking the question, if we look at your orders, my guess is it's maybe about 5% of your oncology orders or something right now. And I hear what you're saying about it being more in budget development at the moment

27.56

And so forth, but can you just maybe give us a sense of over the next year or two years, however you want to characterize it, where it should be in the percent of oncology orders, what you feel about that product? If you can, just ballpark something for us so we get an idea of your confidence in it, I know it's early days, but where that might go.

Dow R. Wilson
President, Chief Executive Officer & Director

A

I mean, I think that the number one thing I'd point you to here is our total installed base growth. When you look at what we're trying to do, we want to grow sockets. We want to go after those 12,000 incremental sockets that The Lancet report came out with a couple years ago. Clearly, that's what Halcyon is focused on. Having said that, we introduced two new products last year, both are in the 60-unit range. We feel very good about that. Both are driving installed-base growth. We've been very pleased.

For us here early on, we're looking at where they're going. So when you look at the 62 orders, first of all it's almost 20 countries. 19 countries have placed orders, so we like the big, broad-based – we still have regulatory approvals to go in some key geographies but we're 60% of those in mature markets. Frankly, I think that'll come down. The kilovoltage cone-beam CT will probably have an impact and we'll see a little juice there, but I think long-term the big play here is going to be in emerging markets. So 40% here early on have gone into emerging markets. 40% of the 62 are in new sites. So these are folks who have not done radiation therapy before, so that's 25, 26, customers that are new in the business. That's huge for us. If we can keep that up with the product, that'll be very significant. Growth, coming back to where I started, grows our installed base, gives us new opportunities for upgrades, software and service.

We also like the competitive thrust here. About seven of them have been in competitive sockets and there's been a handful, four or five, that were in – where we wouldn't have been able to fit in the vault before. So I think we're very comfortable with where this is. As we've kind of said before, we're not guiding on kind of Halcyon units because it's part of the whole portfolio of the family. It is not replacing an existing product. It is a new product on the market, and so that kind of test of what's incremental, for us, is really the game here, and we like what we're seeing there and we think in the developed world, as we bring cone-beam CT into the market and then exercise these new price points in the value markets, we're going to get some more juice. Funnel remains very positive, and so that's the Halcyon story.

And then you've got the HyperArc story to go with it. And HyperArc, we've had 57 orders placed. That's very, very good on HyperArc. As I said in the text, 60% of those are upgrades. People are really liking this product. The upgrade price is around, depending on what they order, some ins and outs but it's about $1mm for the upgrade and north of $2.5mm for new systems. But the – we're really liking what we see here on HyperArc.

Amit Hazan
Citi

Q

Okay. Let me just sneak one quick one in for Gary on the next quarter. I know you guys don't guide to quarterly, but is there anything you want to tell us from a modeling perspective that just kind of help us keep numbers consistent given the volatility we saw and some of the accounting changes that happened with last week's changes?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. Nothing material, Amit, as we look through kind of the full year again, backlog is strong, the market is better than we thought but kind of in line with what we expect for the long term. We've been able to take share in that market and we saw good hardware execution in the quarter. So nothing really new news with regard to Q2 vs. where we landed Q1 and our ability to continue to convert that backlog into orders is a key focus area and the teams are out there winning business competitively in the field. So in the long term we think that turns into that 4% to 7% revenue range that we gave.

Anthony Petrone
Jefferies LLC

Q

Maybe to start on installation cycles and a backlog question. I think, Gary, you mentioned in your prepared comments just that I think installations on Edge accelerated. So how much are you seeing a faster installation cycle benefit or come through to that 4% to 7% top line outlook? And then maybe just reconciling the order backlog, gross orders are down to a little north of $3B I think with the accounting change you called out $3.1B. So how much of that was just installations coming out as opposed to maybe age-outs and cancellations? And then I have a follow-up.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. So thanks, Anthony, for the question. So first of all, just in the quarter, the way to think about what was a robust revenue growth rate of 13% is that in our Oncology business, from a hardware perspective, we mix to hardware, and then inside of that, we really saw an acceleration of units that we kind of booked in orders over the last six months as a higher percentage of our overall book than we had seen in the prior year, even all of last year. And so we attribute that to some good execution in the field, but also just kind of how the order book mixed out into revenue here early in the year.

So can we keep that up, that level of consistency? It's choppy. It's choppy out there, that's part of why we went to annual guidance, just trying to smooth out some of that choppiness that we see in any given quarter. So overall, we're happy with execution. We like the book of business that we took on from an orders perspective at 7% in Oncology. And again, we think that translates into 4% to 7% kind of revenue growth over the year.

As it relates to backlog, the backlog for Oncology, it's something that – it wasn't impacted by ASC 606, first and foremost, okay? So there's no impact from ASC 606 adoption to backlog at all. We made a change in methodology, right, that we had talked about on the call, and there were no abnormal amounts of dormancies that we saw in the quarter from what we'd see normally with regard to percent of the overall backlog total. So we're not seeing anything at all, to reiterate, from ASC 606 in backlog, and the overall Varian backlog increased 10% year-on-year, and Oncology grew 7% year-on-year to $2.7B of backlog. So good backlog growth should translate into that 4% to 7% revenue growth as we move through the year.

Anthony Petrone
Jefferies LLC

Q

Yeah. Maybe just to follow up on revenue rec, just I mean is there any – if we were under the prior model, I mean, would there have been a notable difference in the revenue guidance? Or again, is this just you're seeing whether it's better installations or just share gains, whatever the case may be, is that more reflective of the 4% to 7%? Just trying to...

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer — A

Yeah. To be really clear, right, we held the call earlier in the month, and that call was a pure translation of ASC 605 to ASC 606, right? So this current guidance going from 3% to 5% to 4% to 7% is purely the two things in our mind. One is the market's better than we had thought as we exited Q3, right? Exited Q3, the market was growing about 2%, and now we see the market growing 4.5%. And two is our execution in that market. So that's what's reflected in the increase in guidance – purely our market growth, the overall market growth and our ability to execute in that market. Nothing to do with ASC 606 adoption.

Anthony Petrone
Jefferies LLC — Q

Very clear. And the last two for me real quick would be just a quick update on Siemens, the install base there. Haven't heard about that in a while, just where that is and maybe where those bunkers are going. And then just on M&A, I think out of the spin from Varex there was some talk potentially of tuck-in acquisitions. The company's balance sheet continues to shrink and you're approaching $900mm. It looks like the debt is going to be paid off soon so there's room to lever back up, so just an update there. Thanks.

Dow R. Wilson
President, Chief Executive Officer & Director — A

Yeah. In terms of the Siemens install base, it remains a good opportunity for us. It does continue to ramp down. We like the Halcyon play in that market a lot, so it's – we're actually seeing in the Halcyon market with prospects a lot of these customers that have been hanging on to old stuff really interested in Halcyon. So these were smaller systems that were sold. Often we couldn't get a big TrueBeam in those vaults, with Halcyon we've got a real play. It is a value market and we see that opening up.

I don't have the exact count for you on the installed base. I would say that it's come down from where it was five, six years ago, but it is stickier than we thought. I think when we started this thing, it was like 2,200-, 2,500-unit installed base, and it's certainly less than that now. But when we kind of look at the whole thing, at least for Halcyon as an opportunity, the IEA counts about 2,100 cobalt units, there's a whole bunch of TomoTherapy units, and a whole bunch of Siemens units on top of that. We really kind of view that as the prime target market for Halcyon.

And then the second part of the question was...

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer — A

M&A.

Dow R. Wilson
President, Chief Executive Officer & Director — A

M&A. In terms of M&A, as we've kind of said before, we're looking at extending our footprint in software. So yeah, first and foremost is we want to continue to drive the organic investment in R&D. Second is really looking at what we can do to enhance kind of this ecosystem for cancer therapy on the software side. We continue to value things that use radiation and is there a play for synergies with our treatment planning or oncology information system software? And then with that, we can make some other kind of capital allocation decisions as we go. But at least here, as we've looked at the FY, we wanted to maintain our firepower and all the flexibility for those kind of plays as we move forward.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. The only thing, Anthony, I would add to that with regard to financial flexibility is that, over time, certainly the Tax and Jobs Act will give us some more financial flexibility as we work our way through getting that money to the U.S. And so with that, you can't kind of do that at a flip of a switch, that takes a few months to tax and get the money [ph] home (00:40:39)

Brandon Henry
RBC Capital Markets LLC

Q

Hey. So FY2018 guidance still assumes kind of a wide range in terms of operating margins, can you talk about what you view as the main drivers of operating margin expansion for this year and the various factor that get you to the top and the bottom end of that range?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. I think you saw some of that in the current quarter. With that stronger top line, we were able to still invest and grow our investment in R&D, but get a little bit of operating leverage out of that. I think it was 10BPS on a y-over-y basis in the quarter. And then SG&A leverage, right? We continue to invest on the sales side. We like how those investments are returning, for example, software folks in Asia, that makes a lot of sense and we're starting to see early returns from that. So you'll see us continue to look to invest, right, in R&D, our organic growth options as well as on the sales line, and then get a little more operating leverage out of G&A.

So some of what you saw on a y-over-y basis, Q1 of 2018 vs. Q1 of 2017 is what we think will define the high end of the range. On the lower end of the range, we're going to invest. And so we're looking – there's a whole host of organic options. Now we're a pure play cancer treatment company. We're focused on the software side. That will also require organic investment. Kind of throttling that as we go through the year would help define the low end of the range.

Brandon Henry
RBC Capital Markets LLC

Q

Okay. And then separately, the ramp of 360 Oncology has gone a bit more slowly than we expected. Can you give us an update there and kind of talk about what Varian is doing to accelerate the option of a solution?

Dow R. Wilson
President, Chief Executive Officer & Director

A

Yeah. No, I think we're pleased with the product. We're getting very good reaction from early customers. I think the market very much wants to see evidence. And so we're kind of very much in the evidence-building phase of that product. I think it's going to take this year to kind of be able to show people both the effectiveness impact as well as the efficiency productivity related impact. We've got very good relationships in the UK and with Cone Health where folks are working this. We have had other very good luminary orders on the quarter, but I think big impact is going to be after we really have got the evidence. In the meantime, we're working on increased functionality for – in broadening the capability of the product, bringing critical decision support, incremental tumor board functionality and I think we've got the right product. We've also retooled our sales force a little bit to make sure we're calling on the right people. And we're bullish about where that's going but I think in full disclosure, we do think it's going to – it is an enterprise sale, it is a little more complex sale, and I think our real impact is going to be after we kind of get the evidence accumulated and demonstrated to folks.

Brandon Henry
RBC Capital Markets LLC

Q

All right. And then just last question for me if I could sneak one more in, can you give us an update on the current balance sheet exposure, both on the receivables and loan front for Proton Therapy? I'm just asking because I remember the Munich, Germany facility, I think, went bankrupt last year and is in proceedings right now. And then also if you can provide kind of an update on how the Maryland Proton facility – how the uptake is going there. Thanks.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. Just from a balance sheet perspective, I think it's about $175mm on the balance sheet in terms of the investments that we have in the loans related to that. Look, we continue to monitor that. MPTC is showing pretty good results relative to the patient volume. They continue to work their way through driving those with multiple initiatives. Maybe Dow can help chime in there here in a second.

But that's the key to success and we have seen very good markets with regard to the Municipal Bond Market, right? The Georgia Proton Center kind of got that started. Delray kind of followed through. We had a successful refinancing of the CPT Center in San Diego. That's now clinically moved over to a new operator as well. So we do see strong capital markets for these assets and that, combined with kind of steady to slightly rising patient counts, should help us move our way through this.

Dow R. Wilson
President, Chief Executive Officer & Director

A

Yeah, because down in Maryland they're doing very well. Their patient count is around 100 patients a day so they're getting good volumes. They're doing very interesting work. I think the medical staff is very much on board with the program, have an outstanding team and are continuing to drive it forward.

Tycho W. Peterson
JPMorgan Securities LLC

Q

I hate to go back to guidance but I'm going to go back to guidance. You're guiding to 4% to 7% after doing 13% this quarter. Maybe, Gary, can you kind of address the question as to whether there was some pull forward this quarter or whether you're just being a little bit conservative on the rest of the year? And then can you clarify what the organic growth guidance is? There seems to be some confusion on that based on my amounts.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. So I would say again, we executed pretty well in the quarter. We did see more of a mix shift into mature markets on the hardware side. And as mature markets are shorter duration to get from orders to revenue, that certainly helped that revenue growth. Whether that continues or not over the rest of the quarter, probably not at that rate that we saw in Q1. As it relates to what's organic, what we gave as guidance, 4% to 7%, is organic growth rate, right? And so currency, there's some benefit here that we see in the short term. We'll see if that holds on. You saw a little bit here in Q1, but really what you're staring at there, 4% to 7%, is our organic growth guidance.

Tycho W. Peterson
JPMorgan Securities LLC
Q

Okay. And then I guess for Dow, did the new rules around CapEx expensing for tax deductions change anything from your view from a customer perspective in terms of willingness to purchase?

Dow R. Wilson
President, Chief Executive Officer & Director
A

I mean, I think we could intellectualize it a little bit but we certainly haven't seen any change in behavior yet.

Tycho W. Peterson
JPMorgan Securities LLC
Q

Okay.

Dow R. Wilson
President, Chief Executive Officer & Director
A

At least when we look at the funnels, I wouldn't say we've seen any change in behavior yet, Tycho.

Tycho W. Peterson
JPMorgan Securities LLC
Q

Okay. And one last one that's come up is GE this morning talked on their call, I guess the SEC is looking into the revenue recognition around 606. You're one of the other few companies that have changed your numbers. Is there any risk to you guys that SEC could be looking into this for you?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer
A

We've been transparent with the investors and with our disclosure approach. And look, we're not at the SEC but we are very comfortable with how we've gone through the implementation and in coordination with our accounting teams internally as well as PWC.

Isaac Ro
Goldman Sachs & Co. LLC
Q

Hey, Dow. First question is on Halcyon. No update on the prepared comments with regards to China. Just curious if you still expect June or July approval timeline, and if so, what's baked into your expectations there. I'm wondering if there's any pent up demand that you can point to.

Dow R. Wilson
President, Chief Executive Officer & Director
A

I mean we've kind of said summer all along, so I think we have had – we do have to go through a clinical trial, and we're going through that clinical trial. It's accumulating slowly. But there might be a little bit of risk around that but it's not more than a quarter-ish. But I'd say we're still on H2.

In terms of pent up demand, what we've seen, we've seen a very good China market, double digit again this quarter. So we haven't seen anybody stalling plans. We do know that people are looking at the product and maybe there'll be a few out there. So we're bullish about the market, and the play it's eventually going to have in the market, it's in part why we've elected to manufacture it there. And we're certainly excited about the long term prospects of Halcyon in China.

Isaac Ro
Goldman Sachs & Co. LLC

Q

Okay, thanks. And then maybe a second question on software. Could you give us any color as to the percentage of your software that comes from planning-related tools vs. other applications? And the reason I asked is I'm just trying to think through the path to doubling your software over the next few years for your-long term plan.

Dow R. Wilson
President, Chief Executive Officer & Director

A

Yeah, sure. Yeah. It's about 50/50. When you look at treatment planning vs. Oncology information systems, the business is split about 50/50, so the treatment planning part is a significant portion of the business. We have good products coming out there. We also have exciting new products in our Oncology information system with new analytics capabilities, new informatics capabilities, the software that we're selling as part of a service agreement is growing nicely and remains a big opportunity there.

One of the things that I mentioned briefly before in one of the Q&A is historically, we've done very little in the Oncology information system business in China. And you saw earlier this quarter we announced ARIA Qin, which is a new localized Chinese version of our Oncology information system product, and we announced this new memorandum of understanding with Ping An to kind of bring that product to those markets.

So we're very excited about where China can go. And at the same time, some of the SG&A investment that you saw this last half has been for incremental sales people in Europe and APAC to go sell these new software offerings, so we remain very bullish about the software opportunity.

Isaac Ro
Goldman Sachs & Co. LLC

Q

Thanks. Last question is for Gary on the guidance. I just want to reconcile one more time. You guys raised revenue and EPS guidance today but you didn't raise cash flow guidance, and I'm just not clear as to why that's the case. I'm wondering if there's something with working capital that factors into the guidance for cash flow.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Again, I appreciate the question but it's a pretty wide range like I had mentioned earlier in the call, $475mm to $550mm. We saw good progress again y-over-y on Oncology Systems' DSO. We'll continue to drive and work through that progress. And then on the inventory front we think we have opportunity as we go through the rest of the year. So I wouldn't read anything into that. It's just, again, a wide range and we felt it was comfortable given the changes we had in revenue.

Dow R. Wilson
President, Chief Executive Officer & Director

A

And it was a huge increase over 2017.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

The only other thing I'll point to that remember as we grow, we actually chew into working capital, right? So we raised the revenue growth, it was 3% to 5% to 4% to 7%. So as you grow you actually eat working capital. So that's the other thing to keep in mind here is to think about that $475mm to $550mm.

Vijay Kumar
Evercore ISI

Q

Congrats on the nice quarter. So I had a few questions. Maybe I'll start with Q1 revenue, really, really strong. I guess my question is would – that 13% growth we saw in Q1, would that have still been 13% if this is the old accounting methodology, because there seems to be some confusion on what happened, what drove the 13%?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Vijay, the answer is yes, all right? We restated Q1 per ASC 606 of last year and we used the same methodology in this year. So that growth rate is y-over-y, like-for-like with regard to accounting standard.

Vijay Kumar
Evercore ISI

Q

Okay. Okay. And then what was FX in the quarter, right? Was it a couple of percentage points on the revenue? So if organic is 11% in Q1 – and that 4% to 7% organic that you mentioned for the guidance, is that – so do we assume that there is no FX in that 4 to 7% guidance on the revenues?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. So in the quarter it was 1.5% impact on our growth rate. And again, to reiterate that growth that we had guided to for the full year, that's organic. And so if currency conduct stays where it is, we'll then trot that out as we get closer to realizing that.

Vijay Kumar
Evercore ISI

Q

Okay. That's helpful, Gary. And then on the product side, Oncology, it was up 20% in Q1. I can't remember the last time products were up by 20% rate, so maybe some color on what happened, what drove products plus 20% because that implies in the services, which has certainly been stronger, that came in more like mid-singles?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. I referenced it a little bit earlier on the call but it's this rolling into more mature markets that have shorter data going – time slot going from orders into revenue. And so just for example in Q1 of 2017, about 25% of our units came from units that were the prior six months, whereas in Q1 of 2018 that jumped up to about 35% of units. And so we saw an increase in the number of units that are rolling into revenue from the prior six months of orders than we had in the prior year. So that's in large part of that mix to mature markets that we had talked about, but also some good execution by the team.

Vijay Kumar
Evercore ISI

Q

That's helpful, Gary. And that segues me into my next question. So North America – when you say mature I'm sort of thinking it's North America. What was North America orders in Q1?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

North America orders in Q1 in Oncology, don't have it at my fingertips.

Dow R. Wilson
President, Chief Executive Officer & Director

A

It's up 2%.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah, 2%. Yeah, up 2%.

Vijay Kumar
Evercore ISI

Q

Thank you, Dow. And then one last one, just on the quarterly EPS cadence, right, historically if I look back so Q1 was the least, and then usually we have sequential step ups throughout the year. Is that – again, when we look at the guidance for this year, just given the revenue strength, some of this quarterly cadence changes, can you comment on the quarterly EPS progression?

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

Yeah. I'm not going to comment on the quarterly EPS progression. We gave our annual guidance. We think $4.24 to $4.36 made sense given how we're operating and given the market we're operating in. As quarters go on, we'll see trends kind of play out here so no comment at this point.

Jeff D. Johnson
Baird

Q

I'll be quick here and I don't want to belabor the point but, Gary, I just want to understand you're now guiding constant currency revenue. I've covered you guys I think 10, 11 years now and it's always been reported revenue is what the guidance is. So is this a formal change that we're now – any guidance in the future is organic and our currency assumptions go on top of that, or should we just assume that you're just being conservative in the 4% to 7% and there's currency upside to that? I just want to know if this is formal from here on out, any revenue guidance you give is organic growth guidance. Thank you.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

This is not formal, Jeff. So FX rates are basically the same as what we saw at our initial budget. So there's – we're not going to break out currency here specifically. This is not formal, though.

Jeff D. Johnson
Baird

Q

Okay. And again, not to belabor this, but I think the yen or the pound has moved like almost 10%, the euro's moved 5%, the yen 4% or 5% here in the last few weeks so I'm just trying to understand your comment that currency hasn't moved since you put the budget together.

Gary Bischoping, Jr.
Senior Vice President of Finance & Chief Financial Officer

A

It's – that is what it is, Jeff, at this point, from a currency perspective. And the guidance as it rolls out is, like I said, organic. It's not a formal change. You saw about a 150 basis point impact in Q1, and we'll see how that plays out over the year.

Dow R. Wilson
President, Chief Executive Officer & Director

CLOSING REMARKS

- Yes, I'm very pleased with our first quarter performance
- We're strengthening our leadership in radiation therapy, extending our global footprint and enthusiastic about entering faster growing markets beyond traditional radiation oncology
- Looking forward, we'll continue to focus on our growth initiatives
- We remain committed to innovating new technologies for treating cancer and building solutions that connect clinical teams to advanced patient outcomes
    - We're driving toward the ultimate victory, a world without the fear of cancer.