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Varian Medical Systems, Inc. (VAR)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, we will now get started. Just a reminder that the replay of this call can be heard on the Varian Investor website at www.varian.com/investor, where it will be archived for one year. To hear a telephone replay, please dial 1-877-660-6853 from inside the U.S. or 201-612-7415 from outside the U.S., and enter the confirmation code 13669524. The telephone replay will be available through Friday, October 27.

At this time. I would like to turn the program over to Mr. Michael Bruff, Vice President of Investor Relations. Thank you. You may begin.

J. Michael Bruff
Vice President-Investor Relations, Varian Medical Systems, Inc.

Thank you, operator. Good afternoon and welcome to Varian's Fourth Quarter Fiscal 2017 Conference Call. Joining me today on the call are Varian's President and Chief Executive Officer, Dow Wilson, and Chief Financial Officer; Gary Bischoping. Dow will share his thoughts on our results and long-term strategy, and Gary will cover our operating and financial results in more detail.

On the Varian Investor Relations website, you can find our fiscal fourth quarter press release and web deck, which are intended to provide additional perspective and details. Included in these documents is the reconciliation of 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 year-on-year and any references to orders are gross orders.

Also, note that we may provide growth rates in constant currency, allowing assessment of the business excluding the effect of foreign currency fluctuations. As we noted in previous SEC filings, Varian, like other companies, is required to adopt Revenue Accounting Standard Codification 606. We intend to implement this new standard in our first quarter of fiscal 2018.

Our results for fiscal 2017 that we disclosed today and any forward-looking statements including guidance follow Accounting Standard Codification 605. Once we adopt the new standard, we will hold a conference call to provide additional clarity on how the change will impact our reporting and guidance. At that time, we will also provide restated numbers for 2017.

And finally, during this call, many statements made may be considered forward-looking statements. Our use of words and phrases such as outlook, believe, expect, anticipate, could, should, will, promising, and similar expressions are intended to identify those statements which represent our current judgment on future performance or other future matters. While we believe them to be reasonable based on information currently available to us, these statements are subject to risks and uncertainties that could cause actual results to differ materially. We assume no obligation to update or revise the forward-looking statements in this presentation and discussion because of new information, future events, or otherwise.

And with all that said, I'll turn it over to Dow.

Dow R. Wilson

President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Thanks, Mike, and good afternoon, everyone. Today I'll devote most of my prepared comments to the key milestones we achieved this past year. I also want to share with you our new strategic framework for driving sustainable long-term value creation.

First, let me touch on our fourth quarter results, which concludes a transformative year. Total company revenue declined 1%. Oncology revenue grew 1%, while the Proton business declined 23% in the quarter. GAAP earnings per share was $0.89, down 10%. Non-GAAP earnings per share grew 5% to $1.09. Gary will provide more details on the drivers of these results during his discussion.

Total orders for the company were $1 billion, growing 11%. Oncology orders were up 7%, supported by the healthy ramp up of new products. Halcyon, our new image guided IMRT treatment platform, had 23 orders in the quarter, 12 orders in EMEA, 10 orders in North Africa (sic) North America, and one in APAC. Additionally, orders growth was positively impacted by double-digit services growth and upgrades for hardware and software, including 40 orders for HyperArc, our high-definition radiotherapy technology.

BRICM markets grew 5% in the fourth quarter and 16% in the full year. Services revenue grew 9%, with strong growth across all geographies. Our linac installed base grew 4% over the year, exiting the year at 7,833 installs globally.

Orders of our software products and services grew double digit in the quarter and for the year. We continue to see accelerated uptake of Varian software solutions, building on the strength of our Eclipse treatment planning and ARIA oncology information systems. Newer applications such as RapidPlan and multi-criteria optimization are inside of analytics solution, our 360 oncology cloud based cancer operating platform, and the Velocity longitudinal cancer imaging solution are fueling the enthusiasm for Varian software solutions.

Since we acquired Velocity just three years ago, orders have nearly tripled and customer installations have more than doubled to 450 institutions worldwide, managing over 50 million cancer patient images. We are very pleased with the customer uptake and demand for our software solutions and expect to see global installations continue to grow.

In Proton therapy, we booked two orders in the quarter, including the Concord Medical Proton Center in Guangzhou, China for $52 million and HCG in India for $19 million. Orders growth was 94%.

And one final thought on the fourth quarter, while Varian did not experience any material financial impact due to the hurricanes in Texas, Florida, and Puerto Rico, or the wildfires in northern California, we're very concerned about and have the deepest sympathy for the people in those areas. We continue to work closely with our customers in these regions to minimize disruption in their operations. I want to say thank you to our Varian team members who went above and beyond in getting some of these facilities back to taking care of patients.

Looking more broadly at fiscal 2017, we took meaningful actions to transform our company. In January, we successfully completed the spinoff of Varex, which allows us to focus exclusively on cancer care solutions. In May, we introduced the Halcyon treatment platform, which is designed to extend the availability of high-quality cancer care globally. Since the introduction, we have received 50 orders across 15 countries. Installations are progressing well, and the first patient was treated at the University of Pennsylvania on September 13. In August, HyperArc treated its first patient in Negrar, Italy, after receiving the CE Mark that same month. FDA clearance followed in September. We finished the year with six new Proton therapy orders, bringing the total number of Proton customers to 21.

Finally, at ASTRO [American Society for Radiation Oncology] last month, we launched our new brand which defines the fresh focus for our company and is consistent with our long-term strategy. It expresses our Varian spirit, ambitions, and mission to combine the ingenuity of people with the power of data and technology to achieve new victories against cancer.

Our long-term growth and value creation strategy ensure that we have the right focus and capabilities to capitalize on industry trends. We intend to leverage our scale and financial strength to selectively broaden our capabilities as we transform our company to become the global leader in multi-disciplinary integrated cancer care solutions.

To achieve these long-term objectives, we are focused on three growth initiatives; first, strengthen our leadership and radiation therapy. We are committed to the development and deployment of high-quality industry-leading innovation in this space. As an example, the service track imaging 2017 report recently announced that radiation oncology professionals ranked Varian the leader in eight categories, including overall manufacturer performance, overall system performance, and overall service performance. The report also showed Varian with a Net Promoter Score of 75, which is over two times higher than our nearest competitor. These results along with our recent launches of Halcyon, HyperArc, and 360 Oncology, reflect our commitment to deliver world-class solutions in the fight against cancer.

Our second growth initiative is to extend our global footprint, delivering a world-class treatment platform such as Halcyon with a lower total cost of ownership, faster installation time, smaller footprint requirements and a greater ease of operation enables us to touch more patients globally. And Proton Therapy, too, continue to extend its footprint. Through the end of this year, we have 21 customers in 13 different countries of which 5 are operational and 16 in varying stages of construction

Third, expand into other addressable markets. This includes other modalities, software and services, as we continue to build the Comprehensive cancer care ecosystem across the patient journey. A proof point here is our 360 Oncology SaaS solution, which reflects our recent entry into the oncology care coordination and clinical decision support market. This broader oncology focused platform enables better, more informed decisions across the multidisciplinary teams engaged in that patient's journey.

We've also made select investments in companies such as Grail in the field of liquid biopsy and Fusion Pharmaceuticals in the field of radiotherapeutics. Investments such as these are important as we continue to innovate and look beyond our core market. We had the financial discipline and flexibility to continue investing in growth opportunities both organically and inorganically, enabling us to expand into other markets over time. Based on our company estimates and reported results, Varian has 54% share of the $5.3 billion global radiation oncology market, gaining 1 point of share for the trailing four quarters ending in our fiscal third quarter.

We expect this market to grow at about a 4% compounded annual growth rate to $6.3 billion over the next five years. Executing on our growth initiatives, we expect to grow share in addressable market such as in cancer care coordination on operating Information systems, which is an estimated $2 billion market today and is expected to grow at a double-digit growth rate to $6 billion over the next five years. Combining the core radiation oncology market with these addressable opportunities, Varian is operating in markets project it to be $12 billion in the next five years.

Achieving our long-term strategy is a multi-year journey as such our targets for fiscal year 2018 support sustainable long-term value creation, thus we expect fiscal year 2018 results within the following ranges. Revenue growth from 2% to 4%, net earnings per diluted share from $4.20 to $4.32.

I'll turn it over to Gary now who will provide more context on the fourth quarter financials as well as the fiscal year 2018 guidance.

Gary Bischoping, Jr.

Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.

Thanks, Dow, and hello, everyone. I'll frame my comments today 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. Company-wide revenue was $739 million in the fourth quarter, down 1% in dollars and down 2% in constant currency. For the full year, revenue of $2.7 billion was up 2% in both dollars and in constant currency. We ended the year with $3.5 billion in backlog up 10%. For the fourth quarter, Oncology revenue was $686 million, up 1% in both dollars and in constant currency. Orders were $964 million, up 7% in dollars and in constant currency.

Taking a closer look at our Oncology business results. In the Americas, fourth quarter revenue grew 2% in dollars and in constant currency. Orders were $489 million, up 1% in dollars and 2% in constant currency. North America orders grew 8% supported by key wins in the quarter, including Barnes-Jewish healthcare which ordered one Halcyon system for two beams and software packages for five sensors in their network.

We continue to see strong multi-system orders from a variety of healthcare customers such as Spectrum Health, multi-care, Trinity and Western Connecticut. A slight correction to Dow's opening comments, we had overall 10 Halcyon orders in North America during the quarter not in North Africa.

Dow R. Wilson

President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

Sorry about that.

Gary Bischoping, Jr.

Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.

In Latin America, orders were down 46% due to several tenders pushing out, mainly from public sector deals. However, Brazil had solid performance, highlighted by a $9 million order with Rede D'Or and a $6 million order with the clinic of oncology and radiotherapy of [ph] Bella Mennu (14:12). Asia-Pacific revenue declined 5% in dollars and 4% in constant currency.

Orders were $155 million, declining 10% in dollars and 9% in constant currency. Orders declined double-digits in the Japan market primarily due to continued market softness, which is offset by solid double-digit growth in other countries.

Our first Halcyon system in Korea was ordered by Anam Hospital. In Australia we received a Treatment Planning System order from Peter MacCallum Cancer Centre in Melbourne worth $16 million over 10 years. And lastly in the region, in China we maintained our market leadership position with robust double-digit growth.

In our Europe, Middle East, India and Africa geography, revenue grew 3% and was flat in constant currency. Orders grew 32% in dollars and 29% in constant currency to $321 million in the fourth quarter. Growth was balanced across mature and emerging markets in the region. In Western Europe, an $18 million order at a network of clinics in France supported its 49% growth in the quarter. In India, strong double-digit orders growth in the quarter was supported by a $15 million order from West Bengal for three TrueBeams and two VitalBeam systems. Across the geography we booked 12 Halcyon orders in the quarter.

Turning to full year results, oncology revenue of $2.5 billion was up 1% in dollars and in constant currency. Orders were $2.9 billion, up 7% in dollars and in constant currency, and backlog grew 9% over the year ending at $3.2 billion. By geography, Americas orders grew 3% for the full year driven by strong North America performance of 6%. APAC orders grew 7% and Europe orders grew 14% overall, increasing its geographical mix to 30%, up 2 points from last year. Overall, we are pleased with our full year performance and strength in our oncology business as evidenced by our linac installed base growing 4% for the full year with a strong distribution of new units installed across all three geographies.

Our Proton Therapy business posted revenues of $52 million in the fourth quarter, down 23% from a year ago but in line with company expectations. We booked two orders during the quarter, bringing the total number of orders for the year to six, half of which were in international markets. For the full year, revenue was $182 million, up 12%. We ended the year with $323 million in backlog, up 18% year on year.

Turning to profitability, total company fourth quarter gross margin rate decreased 50 basis points to 42.3%. This included a $2 million or 30 basis point unfavorable adjustment to estimated project costs in our Proton business. However, for the full year, gross margin rate increased 87 basis points to 43.5%.

Oncology fourth quarter gross margin increased $1.6 million, but the rate decreased 26 basis points to 45%. Strong services revenue mix within the quarter was offset by lower product gross margin rate in the quarter, primarily due to country and product mix. It's worth noting that at a country level, average selling prices held relatively steady. Also within the quarter, we recorded a $3 million customs duty-related charge in Brazil. Full-year oncology gross margin increased 161 basis points to 46%, primarily driven by increased service mix and realization of ongoing efforts to optimize the supply chain.

Looking at Proton therapy, fourth quarter gross margin dollars were down $9 million, including the impact of the $2 million adjustment to estimated project costs. Full-year gross margin dollars were down 36%.

Fourth quarter SG&A expenses were $131 million, up $11 million or 9%, and 18% of revenue. This included a $5 million bad debt expense. A quick reminder that the fourth quarter of 2016 included a favorable $4 million bad debt release. And since the first quarter of this year, we have consistently reduced SG&A costs as a percent of revenue, but there's more work to do.

On a GAAP basis, fourth quarter depreciation and amortization was $18 million, and full year was $77 million.

Investment will continue to be a driver of our long-term growth and value creation strategy. In the quarter, we invested $52 million in R&D or 7% of revenue. R&D expenses for the full year were $210 million, up 5% and representing 5% of revenue.

Turning to earnings, fourth quarter operating earnings results were $131 million or 18% of revenue, declining 11%. The decline was primarily driven by a bad debt expense of $5 million, Brazil customs duty-related charges of $3 million, the $2 million adjustment to estimated project costs in the Proton business, and lower Proton business gross margin. EPS in the quarter was $1.09, and our diluted share count in the quarter was 92.6 million shares.

For the full year, operating earnings of $437 million or 16.4% of revenue declined 8%. Our effective tax rate was 23.6% and EPS was $3.60. These results include the fourth quarter items I mentioned previously and the impact from the first quarter $38 million accounts receivable reserve related to the Proton Therapy business.

On a GAAP basis, Varian took a $13 million charge in the fourth quarter related to the California Proton Treatment Center, or CPTC, in San Diego because of a decrease in expected operating cash flows and an increase in incremental financing needs arising out of the transition of the center from scripts to a white-label regional center, which was an agreement executed in September.

During the quarter, we performed a review of this new agreement, including expected EBITDA amounts, timing of the expected municipal bond financing, and the amount of new senior debt required. In comparing that to the analysis performed in the first quarter of 2017, it was determined that the present value of cash flows expected to be collected by Varian was less than the carrying value of the CPTC loan balances. Thus, we recorded an impairment charge in the fourth quarter.

Turning to the balance sheet and liquidity, we ended the quarter with cash and cash equivalents of $716 million and debt of $350 million. Cash flow from operations was $130 million in the fourth quarter and $399 million for the full year. We are pleased to see continued improvement in DSO for our oncology business, which is down one day from the prior quarter and down six days from our second quarter. We will continue to focus on operational discipline and the cash conversion cycle.

In addition to R&D, other investments in the quarter included $18.7 million in CapEx and $25 million to repurchase 250,000 shares of our stock. As of the end of the fourth quarter, we had 5.25 million shares remaining on our existing repurchase authorization.

Now let's talk about FY 2018. As Dow mentioned, we have a long-term growth and value creation strategy supported by initiatives to strengthen our leadership in radiation therapy, extend our global footprint, and expand into new addressable markets. We continue to invest in high-quality innovation and building new capabilities and software services and big data, while driving operational efficiency and disciplined capital management. We will track key performance indicators to evaluate results, but always in the context of progress towards our long-term value creation objectives.

Therefore, we're deploying a framework across the business to drive a culture of ownership and evaluating operational tradeoffs, capital allocation and investment decisions. We will also incorporate this into our incentive design to achieve the desired outcomes over the long term. Given the duration of our sales, research and development and product cycles, we believe that a trailing four quarter view is a better indicator of our progress toward achieving our long-term strategy.

Thus, we are moving to annual guidance for fiscal 2018 and outlining our financial practices accordingly. As Dow said earlier, for fiscal 2018 we expect revenue growth from 2% to 4% and net earnings per diluted share from $4.20 to $4.32.

Going forward, we also provide full-year guidance on operating earnings, cash flow from operations, tax rate and share count. For fiscal year 2018, we see the following for these items. Operating earnings between 18% and 19% of revenue, cash flow from operations between $475 million and $550 million, and a 23% tax rate for the year and no change to share count year-over-year.

Thank you. And now let's go to the operator for Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, we will now be conducting our question-and-answer session. [Operator Instructions] Our first question comes from the line of Jeff Johnson from Baird. Please go ahead.

Jeffrey D. Johnson
Analyst, Robert W. Baird & Co., Inc.

Q

Thank you. Good evening, guys. Can you hear me okay?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Hi, Jeff. Loud and clear.

Jeffrey D. Johnson
Analyst, Robert W. Baird & Co., Inc.

Q

Great. Hey. So, Gary or Dow, I guess for you, just looking at the revenue guidance again, it was at 2% to 4%. You did have 7% oncology order growth this past year or 11%, I think, company-wide with a strong year in Proton. I typically think of service and software contributing a couple of points to fiscal 2018 revenue growth, so why our hardware revenues, I guess, essentially being guided flat or maybe up only slightly this coming year given how strong the order growth was in the past year?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Why don't I start and then Gary can clean up here a little bit. As we said on the call, we're guiding at 2% to 4%. When you look at 2016 and 2017, we had 1% growth in 2016 and 7% growth in 2017. We have had a good orders year, 2016 was a good orders year and you saw the results on the quarter. We're also positive with the increased mix in our EMEA backlog, and kind of 15 to 18 months cycle time on the backlog. We've taken a pretty pragmatic view on our growth guidance and so at the highest level, that's how we're kind of penciling it out. Gary, anything to add there?

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Look, Jeff, we're coming out of a transitional year as well. And the spend at Varex, the new product launches with Halcyon and HyperArc, our new brand. We're going to continue to watch our conversion metrics as we go through the year, but like Dow said this is a pragmatic approach to revenue guidance at 2% to 4% for the year.

Jeffrey D. Johnson
Analyst, Robert W. Baird & Co., Inc.
Q

Okay. And, Gary, I guess the two follow-ups on that. One, is there any currency embedded in that? By my model, it's maybe 1% to 2% tailwind. I just want to confirm that. And then two, again it does seem to me the trailing 12-month order growth has been stronger, and maybe I'm wondering if there's any chance with Halcyon out there, are any orders kind of sitting in backlog a little bit longer than usual, hospitals re-evaluating, do they want to convert from one system to Halcyon instead, or is there no extension going on in that kind of backlog exit timing?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Yeah. We're not seeing extension in the backlog timing. We are seeing a little mix. So as we said last quarter, we are seeing a little mix to more vaults outside of our developed markets and those – as people build new vaults, that takes a little bit longer. So we might have a little bit of a geographical mix that way.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Yeah. Jeff, just to build on that a little bit and I'll answer your currency question just thereafter. The market we just came out of for the trailing 12 months through the third quarter, market growth was 2.1%, okay? And so we just guided to 2% to 4%. And then our orders growth over that same period of time was 3.4%. So again, we feel like that guiding in 2% to 4% is a pragmatic approach to that number. And then your answer on the currency side, no, we assume no currency impact next year.

Jeffrey D. Johnson
Analyst, Robert W. Baird & Co., Inc.
Q

Okay, I'll let others jump in. Thanks, guys.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Thanks.

Operator: Thank you. Our next question comes from the line of Amit Hazan from Citigroup. Please go ahead.

Amit Hazan
Analyst, Citigroup Global Markets, Inc.
Q

Thanks. Hey, good afternoon, guys.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Hi, Amit.

Amit Hazan
Analyst, Citigroup Global Markets, Inc.
Q

Hey. Let me start with you, Gary, and I think just given that it's your first quarter out of the gate, people are going to want to know what surprised you causing the miss, given it's the first quarter. And people are going to want to know why they should be confident in 2018 guidance ranges given this miss for the first quarter.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Thanks for the question, Amit. From the overall revenue guidance perspective, we did make the revenue guidance in the quarter and felt good about the momentum exiting the quarter here in the second half from an orders growth perspective, and so again we think 2% to 4% of the revenue guidance is pragmatic.

From an earnings per share perspective, I think the way to think about it is if you look back on all of 2017 and you look back into the fourth quarter, there were things that impacted the business that was a result of good operational rigor that will continue. Those things in the fourth quarter would include the bad debt expense, would include the Brazil's customs duty related expense, and the adjustment of estimated Proton business project costs. That's about $10 million there in costs that, again, good operational rigor that drove us to incur those costs in that period. But as we work our way through the operational rigor, I'm sure we'll continue to improve from a results perspective as we move forward. So $4.20 to $4.34 (sic) $4:32 from an earnings per share guidance perspective feels about right given the operational excellence that I've seen in the business here in the last five or six months that I've been at Varian.

Amit Hazan
Analyst, Citigroup Global Markets, Inc.
Q

So let me just follow up on that, so it's another guidance question on operating margin in shares. So yeah, operating margin guidance actually doesn't show much of a benefit over kind of the periods in fiscal 2017 that would be apples-to-apples. So I'm just wondering if you can give us some of the puts and takes to think about property margin and why you're not able to show additional benefit in fiscal 2018? And then separately on the share count, just give us an idea if this would be the first time Varian hasn't bought back shares as long as I can remember. So just what your thoughts are behind that and the lack of share repurchase in fiscal 2018? Thanks.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Sure. So as it relates to the operating earnings margin rate, look, we're looking for targeting driving sustainable improvement in our supply chain and operating expenses. This range that we gave would infer 50 to maybe 70 or even 100 basis points to the top end of the range of operating margin improvement in FY 2018 over FY 2017 when you take a look at things on an apples-to-apples basis. We're still driving to achieve that 18% to 22% aspirational target that we've got out in front of us. And we also want to be cognizant of the fact that we want to ensure the ability to invest in growth options organically that we see in front of us. So that's the nature of the guidance from an 18% to 19% perspective on operating earnings.

And as it relates to share repurchase, there will be share repurchase just like there was in the fourth quarter, right? We did $25 million to retire 250,000 shares. What I said in my guidance is that share count would be flat year-over-year so there will be due to restricted shares and stock option exercises – there will be shares that come into the share count, and we'll endeavor to keep that flat year-over-year with our share repurchase activity in FY 2018. And again, the overall objective here from how we deploy capital is, one, organically like I just said. Two is look at inorganic options, we feel like we have good financial flexibility relative to our capitalizing on the inorganic activities that are in front of us. And then third, and only thereafter, we would execute on the share repurchase side.

Amit Hazan
Analyst, Citigroup Global Markets, Inc.
Q

All right, thanks. Thanks, guys.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Sure.

Operator: Thank you. Our next question comes from the line of Tycho Peterson from JPMorgan. Please go ahead.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

Hey, thanks. Dow, I've got one question on the software side. Given that that's driving a lot of the growth in order here, can you just get us comfortable what the trajectory here, that that's sustainable. And it seems like most of your installed base is RapidPlan at this point. I know obviously you've got HyperArc and 360 Oncology now. So help us think about the sustainability of the software growth you've got.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

We had a very good quarter and a very good year. both the fourth quarter and the fiscal year had strong double-digit growth rates in software. Maybe a little color, RapidPlan, we have 1,200 licenses ordered to date, about 500 customers. The treatment planning installed base is 5,000 to 6,000 systems. So we've still got a long way to go there. InSightive, we have 250 customers ordered with about 100 in clinical use, again our RE installed base is 4,500 to 5,000, so we've got a big opportunity to go there. Velocity, while it's tripled, it still is a pretty small business, but we very much like the trajectory of that business. So we've got I think 450 customers on Velocity now. Again, an installed base of 7,800 machines, we've got a long way to go there.

So our aspirational goal here is to see if we can't drive this double-digit growth for the next four or five years, and we think that this has moved off the historical lower growth and the trajectory is upward, so we like what we see on the software side.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

And then I know you guys haven't given guidance on orders for Halcyon, but can you tell us how kind of [indiscernible] (34:20) tracks relative to your expectations? And as we think about a lot of the emerging market customers and capital budgeting, so when you really think the product cycle could start to take off?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Sure. And apologies again for throwing in North Africa instead of North America in the call. The reception has been outstanding, it's the head of our internal plan. We have taken 50 orders, as I mentioned in the call, since the introduction. We very much like what we're seeing. About half of them are for greenfield sites, so these are new vaults going in. We like that. We've also had a handful of competitive takeouts, and we've also had a handful of units go in where vault fit has been a factor. As you know, this was a stealth launch that we did in May, so people are still lining their budgets up. Our funnel looks terrific. Of these 50 orders we've taken, we've only taken three in Asia Pacific. We don't have clearance yet in China or Japan and hope to have that end of Q2, early Q3 next year. So we very much like what we see. The first treatments have been very successful. Our customers are very happy with what they're seeing out of the machine.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

Okay. And then on the longer-term growth strategy you outlined, is the incremental spending starting to get baked in here in 2018, and what are your kind of competitive advantages that you see in the areas like diagnostic imaging and precision medicine? It seems a little bit far afield relative to what you've historically done.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

I think as Gary mentioned, it starts first with our core business. We have a terrific core business, and we believe we have very significant opportunities to keep driving organic investment in R&D in our core business. Second, there are some inorganic opportunities out there. We see those in the first phase maybe building off our software business, seeing how we can get more longitudinal with the patients through their cancer journey. And I'd say those are the those are the top two.

Tycho W. Peterson
Analyst, JPMorgan Securities LLC
Q

Okay, thank you.

Operator: Thank you. Our next question comes from the line of Anthony Petrone from Jefferies. Please go ahead.

Anthony Petrone
Analyst, Jefferies LLC
Q

Thanks. Maybe just back to Halcyon and HyperArc, maybe on Halcyon where pricing has settled out, I know you had a range there of $2 million to $4 million, so how's that settling out? And is there a delta between how U.S. pricing and OUS pricing is settled out? And then on the HyperArc, maybe what the margin contribution from a HyperArc upgrade is, and at what point do you see that benefiting the P&L? And then I've got a couple of follow-ups. Thanks.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

I'd say on Halcyon, pricing is meeting our expectations. So we like that, it is very configuration dependent. I would say that our U.S. customers in general are ordering a richer mix. But our average selling price is ahead of our expectations and the overall margin of the product will be accretive to company margins.

On HyperArc, Anthony, as I mentioned in the call, we've received 40 orders in Q4, so the uptake has been substantial. We just got regulatory approval, CE mark in August and 510(k) in September. We've done first treatments at three sites, and this version of the product is optimized for brain metastatic disease. We'll have future releases for SBRT. I think the reception of the product has been very good in terms of kind of how this flows to the P&L, I think of again margins here will be very good. I think Halcyon will move a little faster through the backlog and the customers because of its installation time and where people have built and evolved to be a little bit different, but where we've got a Halcyon is going in as a replacement, that should flow very quickly. I think HyperArc will take a little bit longer as it flows into the P&L.

Anthony Petrone
Analyst, Jefferies LLC

Q

That's helpful. And the follow-up would be just a little bit on if you expect any cannibalization of TrueBeam as it relates to Halcyon, or will that be offset by HyperArc? And then just to revisit on Japan, a little bit more color on the weakness there, what's going on behind the pressure and what's your outlook potentially for that to normalize out? Thanks.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

We have maybe a little bit of movement from TrueBeam to Halcyon, I think it's going to be very small. We've been very pleased with the reception that HyperArc has received, so I think that'll be very good.

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

Anthony Petrone
Analyst, Jefferies LLC

Q

On Japan, we...

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Oh, Japan. Yeah. Japan has been – has had a rough year. I think good news is we see that bottoming out. Our market share has remained. We haven't lost any share there, so we feel good about that, but that market has been down pretty substantially this past year. And you saw a little bit of that more in the fourth quarter. Looking forward, I do think we're seeing that kind of bottom out and the funnel looks pretty good.

Anthony Petrone
Analyst, Jefferies LLC

Q

Thanks.

Operator: Thank you. Our next question comes from the line of Isaac Ro from Goldman Sachs. Please go ahead.

Isaac Ro
Analyst, Goldman Sachs & Co. LLC
Q

Good afternoon, guys. Thank you. I just want to confirm on the guidance comment you guys made that that top line growth outlook you gave, 2% to 4%, that is assuming zero impact from currency?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Yeah. that's correct.

Isaac Ro
Analyst, Goldman Sachs & Co. LLC
Q

Okay. And so just if I look at sort of where you're coming from, from prior year, it does imply a bit of a deceleration even though you have a new product cycle in Halcyon, so just help us reconcile, is it the extent to which you've taken a lot of share and that part of the dynamic is falling off? Why would you see a deceleration in top line growth as a new product cycle ramps up? And then second to that, any commentary on emerging market approvals for Halcyon would be great. Thank you.

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.
A

Yeah. So just we're on the same page, we grew 2% in Oncology for the full year, right? And we see now and are guiding now – sorry 1% year-on-year in Oncology. And so we're guiding now 2% to 4% overall for 2018. So we don't see it as a deceleration in the growth rate. We kind of see it at or better than what we did here in 2017. Again, we'll continue to keep a close eye on conversion rates and the opportunities we see in front of us, but we feel that that's pragmatic growth given the orders growth rate we've seen historically over the last 12 to 18 months.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

And then for emerging market approvals, the biggest two, one is not an emerging market is Japan. We think both Japan and China, we should have approvals. End of Q2, beginning of Q3 next year, we should have China and Japan. Those are the two largest approvals that are remaining.

Isaac Ro
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Brandon Henry from RBC Capital Markets. Please go ahead.

Brandon Henry
Analyst, RBC Capital Markets LLC
Q

Yeah, thanks for taking my question.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.
A

Hi, Brandon.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Can you start out by talking about your expectations for free cash flow for fiscal year 2018 versus fiscal year 2017 and what's driving the expected improvement in the operating cash flow for next year?

Gary Bischoping, Jr.
Senior Vice President, Finance & Chief Finance Officer, Varian Medical Systems, Inc.

A

Yeah. So we'll talk to – I'll certainly talk to cash flow from operations. And the way of thinking about that guidance is that the revenue and EBIT targets that we gave, plus we're looking for our continued focus on the cash conversion cycle and our ability to operationally execute to improvements there, that those two combined, so working capital benefit along with the EBIT dollars kind of trends you right into that range for FY 2018. As far as free cash flow, I'm not going to comment on free cash flow today and get into kind of CapEx and other elements of the capital allocation process that we've got ahead of us, but from a cash flow from operations perspective, we feel good about that guidance that we have out there.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Okay. And then on the proton side, looks like Varian booked another two Proton Therapy orders during the quarter. First half of the year I think was kind of a slow start, but it picked up in the back half. So can you discuss your expectations for the Proton market for fiscal year 2018, and is the company bundling strategy with linacs and protons, helping the company to win orders there?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah. I mean, I'd say first of all, on the year we booked six proton orders. So a pretty good year for us. We did seven in 2015 and two in 2016. The funnel looks pretty good. So I'd say a pretty good funnel for what we're seeing. The strategy that we're going to market with is with an integrated commercial team, and that is working out very well for us.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Okay. And then...

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

And then from a – and maybe from a broader product strategy, we're certainly leveraging a treatment planning and the information systems with Proton Therapy as well.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

All right. Last question from me, you mentioned that the company has made some investments in I think liquid biopsy and radio therapeutics, can you spend some time helping us understand how you're thinking about the size of potential revenue timing considering the new opportunities?

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

A

Yeah. From now what we really want is a seat at the table. These are small investments that we've made. We are very interested in integrating our information systems, our treatment planning. There's something very exciting , emerging, who knows exactly when, but call it radiomics, and that the idea there is that patients would have a different radiation dose depending on their genetic profile. And as we look at these kind of opportunities, these would be things that we'd build into our information systems and treatment planning. And so having a seat at the table is very important to us, and as a growth engine for our existing core business, as well as some new business opportunities.

Brandon Henry
Analyst, RBC Capital Markets LLC

Q

Okay, thanks.

Operator: Thank you. Ladies and gentlemen, we have no further questions in queue at this time. I'd like to turn the floor back over to management for closing comments.

Dow R. Wilson
President, Chief Executive Officer & Director, Varian Medical Systems, Inc.

All right, thank you, operator. Let me leave you with a few key takeaways. First, I'm very excited about the opportunities for Varian. We're solely focused on Cancer Care Solutions and well-positioned to capitalize on our strength and leadership in radiation therapy, to grow market share and extend our global footprint in both mature and emerging markets. With that foundation and a long-term focus, we intend to invest in profitable growth, expand into other addressable markets, and build multi-disciplinary integrated Cancer Care Solutions.

We're focused on being operationally and financially disciplined, aligning our internal decision-making and incentive structure to our long-term strategy. And we have built financial flexibility to take advantage of appropriate investment opportunities. Finally and most importantly, Varian is well-positioned to positively influence the cancer care continuum for more and more patients globally every day. By bringing smarter and simpler solutions to healthcare providers, they can focus more time on what's important to all of us, their patients. And together, we can achieve a world without the fear of cancer.

Thank you very much for joining us today.

Operator: Thank you, ladies and gentlemen. This does conclude our teleconference for today. You may now disconnect your lines at this time. Thank you for your participation and have a wonderful day.