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# Varian Medical Systems, Inc. (VAR)

Q2 2018 Earnings Call

## CORPORATE PARTICIPANTS

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**Dow R. Wilson**

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Greetings and welcome to the Varian Medical Systems' Fourth Quarter 2017 (sic) [Second Quarter 2018] (00:07) Earnings Results Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Mike Bruff, Vice President of Investor Relations for Varian Medical Systems. Thank you, Mr. Bruff. You may begin.

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**J. Michael Bruff**

*Vice President of Investor Relations, Varian Medical Systems, Inc.*

Thank you, operator. Good afternoon and welcome to Varian's second quarter fiscal year 2018 conference call and webcast. Joining me today on the call are Varian's President and Chief Executive Officer, Dow Wilson; and Chief Financial Officer, Gary Bischooping. 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 second quarter press release and web deck, which are intended to provide additional perspective and details. 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 year-over-year and any references

to orders are gross orders. All references to trailing 12 months refer to the trailing 12 months ending on the last day of our most recently completed fiscal quarter.

Also note that we may provide growth rates in constant currency allowing assessment of the business excluding the effect of foreign currency fluctuations. As a reminder, Varian adopted Revenue Accounting Standard Codification 606 at the beginning of fiscal year 2018. The results that we disclose today, including fiscal year 2017 results and any forward-looking statements, include guidance, reflect this new standard. During this call, we will be making forward-looking statements which are predictions, projections, and other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings release, this conference call, and our SEC filings. We do not undertake any duty to update any forward-looking statement.

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

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## Dow R. Wilson

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

Thanks, Mike, and good day, everyone. 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 results. Total company revenues of \$730 million increased 10%. Oncology revenues grew 10%, driven by our integrated platform with best-in-class hardware, software, and services. Our Particle Therapy business grew 2%.

We saw some currency tailwinds that helped us in the quarter and Gary will provide additional detail on constant currency growth rates in a minute. Operating earnings of \$129 million or 17.6% of revenues grew 22%. GAAP EPS of \$0.79 grew 6% and non-GAAP EPS of \$1.15 grew 28%. GAAP EPS was impacted by acquisition-related expenses and an impairment charge related to the expected refinancing of the Maryland Proton Treatment Center. Gary will discuss these in more detail as well.

Cash flow from operations was \$66 million, up 104%, driven by operating income performance and working capital efficiencies. In terms of our long-term growth and value creation strategy, we made progress across our three growth initiatives. First, strengthening our leadership in radiation therapy. Based on public filings, the radiation therapy market grew 3% on an orders basis over the trailing 12 months ending in December 2017. Varian grew gross orders 6% over that time, growing worldwide share and extending our market leadership.

In our Oncology business, orders grew 5% in the quarter and 6% through the first half of the year. Our worldwide net installed base is now 7,954 units, up 3% or 263 units. On the hardware side, we're pleased to announce that TrueBeam, our fully integrated system for image-guided radio therapy and radio surgery, was named category leader for radiation therapy by KLAS, an independent research firm, in its 2018 report.

Additionally, we made progress with our global roll out of Halcyon and have now taken 81 orders since our May 2017 launch, including 19 new orders in the second quarter. Most of the orders since launch have been incremental and greater than 40% are for greenfield sites. Additionally, Halcyon has succeeded in replacing a growing number of competitive machines with take-outs representing over 25% of orders this quarter. Included in these take-outs were replacements of tomotherapy and cobalt systems.

Over one-third of orders were in North America and the [ph] field day (05:22) is reporting growing interest and momentum as the product installed base grows along with papers and publications from leading institutions. Operationally, the team has executed well and about 20 sites worldwide are now using Halcyon clinically, with some sites treating 80 to 100 patients or more per day. For example, at Clinique Charcot in Lyon, France,

Halcyon achieved [ph] beam on (05:43) from start of installation to ready-to-treat in just eight days and is now treating approximately 80 patients per day.

We're also pleased to provide an update on kilovoltage cone-beam CT imaging, a valuable extension to the Halcyon platform. The first human kV cone-beam CT images on a Halcyon were acquired at Washington University with positive feedback on image quality, speed of image acquisition, and processing. In this study, imaging was done in 17 seconds, half of standard cone-beam CT image acquisition times, enabling an easy breath hold technique for a compromised patient and improved image quality. We launched Halcyon 2.0 with kilovoltage imaging last week at ESTRO in Barcelona.

On the software front, we continue to see strong demand and positive feedback for our software solutions. Software revenues grew 7%. The number of unique Varian software customers grew 5% and the installed base for RapidPlan grew approximately 80%. RapidPlan continues to make a positive impact on the market. For example, at Royal North Shore Hospital in Sydney, Australia, 80% of patients are now planned with RapidPlan and 87% of RapidPlan generated plans are approved by the attending radiation oncologist without any replanning. In terms of time savings for gynecological cancer, planning time was reduced from four days to just two hours.

Also in the quarter, our ARIA oncology information system and Eclipse treatment planning system were both selected as category leaders in the 2018 Best in KLAS Report. Eclipse has now been named the top oncology treatment planning system for five straight years. KLAS's recognition of TrueBeam, ARIA, and Eclipse validate that our commitment to provide clinicians and patients with the most advanced integrated solutions is resonating in the market.

The capability of the Eclipse treatment planning were further demonstrated when customers using this software placed the highest in the overall category in the first-ever World Championships of Treatment Planning hosted by ProKnow. In addition to the top four and six of the top 10 positions in the overall category, Eclipse customers also had the top three scoring VMAT plans. Additionally, ARIA received the most recent edition of Certification of Compliance with the requirements of the U.S. government's Quality Payment Program. This designation allows our customers to meet meaningful use requirements to qualify for an incentive bonus payment from CMS under the ongoing EHR adoption program.

Finally, in February, we acquired a small privately-held quality assurance software company, Mobius Medical Systems. We have long provided high-quality QA for our products and view Mobius as market leading software, including Mobius3D and DoseLab as key enhancements to our existing portfolio of patient treatment plan QA and machine QA technologies. We look forward to leveraging Mobius technology through our global channel to impact more patients with software solutions designed to assure the quality of treatment.

Our services revenues grew 10%, driven by our growing installed base and higher mix of newer machines which typically have a higher attach rate and contract value. Varian services were also recently recognized in China where we won the Best After-Sales Service Performance Award for Radiotherapy Products. This was awarded by one of the most influential medical industry performance evaluations conducted in China. We look forward to continuing to innovate to provide superior and efficient services worldwide.

In our Particle Therapy business, we did not take any new orders in the quarter. In the trailing 12 months, we've taken six proton orders and our sales pipeline remains solid. Our seven operational sites are executing well and have been operating at over 96% uptime. We recently announced that Varian and the University of Maryland

School of Medicine reached their first educational milestone at the Maryland Proton Treatment Center as more than 150 medical professionals have now completed training there.

Education and training remain a vital component in the continued growth of proton therapy around the world and partnerships like the ones we have with Maryland and the University of Pennsylvania allow Varian customers to learn from experienced proton clinicians how to best deliver treatments and build successful proton therapy practices. And in March, we announced the first patient treatment at the St. Petersburg Proton Therapy Center in Russia, an important step in expanding access to proton therapy around the world.

Our second growth initiative is to extend our global footprint. Our global market share growth was driven by orders-based share gains in EMEA. For example, Varian was awarded a contract for eight TrueBeam systems at the new Karolinska Hospital in Stockholm, Sweden, with installations expected to begin in the coming weeks. In addition to a multi-year service agreement, we will also provide our ARIA and Eclipse software solutions. Varian is committed to building on the strong legacy of partnership with its global luminary and we look forward to fulfilling our commitment to provide the most advanced technologies and best-in-class support services to Karolinska.

Elsewhere in Mexico, the Instituto Mexicano del Seguro Social selected Varian to equip seven treatment centers in the country with Varian systems. The deal includes six VitalBeam systems, Mexico's first Edge system for image-guided stereotactic radiosurgery, plus a full suite of Varian's treatment planning and oncology information software. All installations are expected to be completed by December of 2018.

On the Halcyon front, global momentum continues to grow. Of the Halcyon orders taken since launch, over 40% have been from emerging markets and over 80% of these have been for incremental units. Lastly, our third growth initiative is to expand into other addressable markets and we made meaningful progress on this front. First, in January, we signed an agreement to acquire Sirtex, an Australian-based company, focused on interventional oncology therapies for approximately AUD 1.6 billion. This transaction is expected to close by the end of May. The acquisition of Sirtex is consistent with our long-term value creation strategy as it enables us to enter the fast-growing interventional oncology market.

Second, to enhance the capabilities of Varian 360 Oncology care management platform, we announced the acquisition of Evinance Innovation, a small, privately-held Montreal-based company specializing in clinical decision support software. With this acquisition, we will use the 360 Oncology platform to more tightly integrate clinical workflow and decision support based on leading cancer care guidelines, a key challenge for physicians around the world.

Additionally, we received 360 Oncology orders, including one from UT Tyler, which is affiliated with the MD Anderson network. Installations will begin over the coming months. Overall, we are pleased with the progress we made in the second quarter of our fiscal year 2018. We made meaningful strides towards our long-term strategy to become a global leader in multi-disciplinary integrated cancer care solutions.

And with that, I'll turn it over to Gary who'll provide more context on the second quarter financial results.

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**Gary Bischooping, Jr.**

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

Thanks, Dow. As always, I'll consistently frame my comments in the context of our long-term growth value creation strategy, which includes balancing growth, profitability, and liquidity. So let me start with growth. Company-wide revenues were \$730 million in the second quarter, up 10% in dollars and 6% in constant currency.

In Oncology, revenues were \$698 million, up 10% in dollars and 6% in constant currency, driven by growth across hardware, software, and services. Year-to-date revenues grew 12% in dollars and 9% in constant currency. Orders were \$664 million, up 5% in dollars and 1% in constant currency. On a trailing 12-month basis, orders grew 5% in dollars and 4% in constant currency. We ended the quarter with \$2.6 billion in backlog, up 7%.

Taking a closer look at our Oncology business results, in the Americas, based on lumpiness in revenue timing, revenues declined 3% in the quarter in both dollars and constant currency. Year-to-date revenues in the Americas are up 6% in both dollars and constant currency. We expect revenue growth for the full year and growth from the back half of this year for the region. Orders were \$341 million, up 2% in dollars and in constant currency. On a trailing 12-month basis, orders for the Americas grew 1% in dollars and in constant currency. And in North America, orders grew 2% in dollars and in constant currency.

Asia-Pacific revenues grew 2% in dollars and was flat in constant currency. Year-to-date revenues grew 8% in dollars and in constant currency. Orders were \$123 million increasing 3% in dollars and 1% in constant currency. On a trailing 12-month basis, orders for Asia-Pacific region grew 2% in dollars and in constant currency. Greater China continued its growth and strong share performance as we continue to lead the market there. And in Japan, we saw growth for the second consecutive quarter. We hope to see this trend of a modest recovery in the Japanese market continue.

In our Europe, Middle East, India and Africa geography, revenues grew 44% and 29% in constant currency. Year-to-date revenues grew 26% in dollars and 16% in constant currency. Orders were \$199 million increasing 11% in dollars and flat in constant currency. On a trailing 12-month basis, orders grew 15% in dollars and 11% in constant currency. Our Particle Therapy business posted revenues of \$32 million in the quarter, which is up 2%.

Turning to profitability, total company gross margin was \$320 million, up 16% at a rate of 43.8% of revenues. This was driven largely by our Oncology business where we continue to see solid revenue growth across hardware, services and software as well as margin rate expansion. Oncology gross margin of \$319 million increased 15% and the rate was 45.7%, up 168 basis points. This is primarily driven by revenue growth across hardware, software and services and margin rate expansion in Europe from pricing discipline and ongoing operational excellence.

Looking at Particle Therapy, gross margins were \$1 million, up \$2 million. Companywide SG&A expenses were \$132 million or 18% of revenues were up \$15 million or 12%. The increase was primarily driven by additional sales team and infrastructure investments to support business growth. Investment will continue to be a key driver of our long-term growth and value creation. In the quarter, R&D was up 10% to \$59 million, investing 8% of revenues into organic innovation programs.

On a GAAP basis, depreciation and amortization was \$17 million. Company operating earnings were \$129 million or 17.6% of revenues increasing \$23 million or 22%. This quarter, we had two significant items that impacted GAAP earnings. First, acquisition-related expenses totaled \$20 million for the quarter, primarily driven by \$16 million relating to hedging the Australian dollar purchase price for the Sirtex acquisition.

Second, we took an impairment charge for \$11 million related to the upcoming refinancing of the Maryland Proton Treatment Center. The charge is due to the expected difference in value between the security currently held by us and the value of the new security that will be issued to us in exchange as part of the expected refinancing. The amount of the impairment is approximately the accrued interest on the security held by us. As the refinancing goes as planned, we may recognize some gains from our investments in the second half of the year. Overall the Maryland Proton facility continues to perform well, treating up to approximately 100 patients per day.



Turning to taxes, you may recall the Tax Cuts and Jobs Act, which was enacted in December of 2017, had a significant impact on our GAAP effective tax rate for the first quarter. It continues to have a significant impact on our year-to-date GAAP effective tax rate and as expected had some impact on our effective tax rate for the second quarter. After impacts of the new legislation, our resulting GAAP effective tax rate for the second quarter was 23.4%.

Our non-GAAP effective tax rate was 17.9%, which includes tax expenses due to the repatriation of foreign earnings and lower corporate tax rates impact on the deferred tax assets. Similarly, our non-GAAP net earnings per diluted share also exclude these items. GAAP net earnings per diluted share was \$0.79. Our non-GAAP net earnings per share was \$1.15 with related diluted share count of 92.6 million shares in the quarter.

Turning to the balance sheet and liquidity. We ended the quarter with cash and cash equivalents of \$740 million and debt of \$255 million. In April, we replaced our existing \$600 million credit facility with a new \$1.8 billion credit facility. We intend to use a portion of the credit facility along with cash on the balance sheet to fund the acquisition of Sirtex.

Cash flow from operations was \$66 million, up 104%, driven by operating income performance and working capital efficiencies. This brings our trailing 12 month cash flow from operations to \$529 million. Oncology DSO decreased by 15 days from 118 days to 103 days in the quarter. In addition to R&D, other investments in the quarter included \$9 million in CapEx and \$36 million to repurchase shares of our stock. As of the end of the quarter, we had 4.4 million shares remaining under existing repurchase authorization.

I will now turn it back over to Dow who will discuss our updated fiscal year 2018 annual guidance.

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## Dow R. Wilson

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

Thanks, Gary. With respect to our annual guidance, we continue to maintain a pragmatic approach and have considered the following factors regarding our fiscal year 2018 guidance: first, continued projected market growth; second, our products and solutions continue to resonate in the market driving our share gains; third, recent tailwinds in the currency markets; and fourth, the impact of the tax cuts and their implications to our tax rate. After careful consideration of these factors, we believe it is prudent to update our fiscal year 2018 annual guidance to the following.

Revenue growth range of 6% to 9%, which now includes the impact from currency for the remainder of the year. Non-GAAP operating earnings as a percentage of revenue range of 18% to 19%. Non-GAAP effective tax rate of 20%. Weighted average diluted shares of 93 million. Non-GAAP earnings per diluted share range of \$4.43 to \$4.53. Cash flow from operations range of \$475 million to \$550 million. This updated guidance does not reflect the impact of the Sirtex acquisition which is expected to close by the end of May.

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

## QUESTION AND ANSWER SECTION

**Operator:** At this time, we will conduct a question-and-answer session. [Operator Instructions] Our first question is with Anthony Petrone with Jefferies. Please proceed with your question.

Anthony Petrone  
*Analyst, Jefferies LLC*

Q

Thank you and good afternoon. Maybe, Dow, I'll start a little bit with guidance and a couple questions on orders and then just one on Sirtex. So just on guidance, 6% to 9% from 4% to 7%, maybe just to segregate out what actually is currency and where the constant currency range settles within the revised guidance you issued here today?

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

A

Yeah.

Gary Bischooping, Jr.  
*Senior Vice President of Finance & Chief Financial Officer, Varian Medical Systems, Inc.*

A

Yeah. Anthony, let me grab that one quick. So the 6% to 9% basically catches about 2 percentage points from currency, right. And so that's kind of what we saw in the first half and equivalently capturing the same here for the second half. And so that 6% to 9% would basically come back to 4% to 7% on a constant currency basis to answer your question.

Anthony Petrone  
*Analyst, Jefferies LLC*

Q

And I guess just going to backlog on the quarter, the 9% growth in just the rate of revenue recognition from backlog to revenue, the cadence of that. So that number was a little bit better than we were expecting. It seems like it's a cleaner number now, pure hardware. So, where is the installation cycle trending and how do we sort of look at that 9% backlog growth as it relates to say the back half of the year potential for revenue growth? And then I'll have one on Sirtex.

Gary Bischooping, Jr.  
*Senior Vice President of Finance & Chief Financial Officer, Varian Medical Systems, Inc.*

A

Sure. And just so we clean it, we're talking apples-to-apples here, right. Oncology backlog is up 7%. Overall company backlog is up that 9% you referred to. So as it relates to oncology, we really saw good progress out of Europe with the order to revenue cycle. We've seen some good quality orders there. We've seen an acceleration of revenue in the period from prior six months orders versus the prior year. And it's good discipline, good operational discipline and good sales discipline as we take those orders and then flow it through into revenue. So really the acceleration has been out of Europe and you saw that in the revenue growth rate in Europe reflected as well.

Anthony Petrone  
*Analyst, Jefferies LLC*

Q



That's helpful. And last one for me is just on Sirtex. I know we're approaching the close, but maybe, Dow, just a little bit on the strategy with the clinical pipeline. So there was a read out in HCC. The study design, I think, had high hurdles. But maybe what is the outlook for HCC and just the broader clinical pipeline going forward for Sirtex? Thanks again.

Dow R. Wilson

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

A

Yeah. Maybe just starting at the highest level, we really like this from a radiation medicine point of view. It strengthens our position in radiation medicine. And two, it enables us to build out an interventional oncology channel, which it'll be of growing importance in our market. Just as a reminder for everybody, Sirtex is – I think their guidance for their fiscal year is about 180 million-ish with about 50 million-ish of EBITDA, so a very good franchise and position. In terms of the news on their trial, there was really no new news there. That was all in their marketplace and kind of should have no impact. Certainly, we were aware of it as we conducted our due diligence. Product has great position for colorectal mets to the liver. We've got some work to do to provide evidence for primary liver cancer. We do like some of the things that we see there and we're going to have to work on ongoing evidence.

Anthony Petrone

*Analyst, Jefferies LLC*

Q

Thank you.

**Operator:** Our next question is with Amit Hazan with Citi. Please proceed with your question.

Amit Hazan

*Analyst, Citi Research*

Q

Thanks. Hey. Good afternoon, guys.

Dow R. Wilson

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

A

Hey, Amit.

Amit Hazan

*Analyst, Citi Research*

Q

Just on the order side – hey. I'll start on the order side maybe tackle the Americas and the APAC pieces. If you kind of take kind of last 12 months' trends, I think up 1% in Americas, now up 2% in APAC. So it's a slowdown and I'm wondering if you think that's the right market growth. And then, secondly, just a sense or some more color around what's going on with those two markets and why they look like they explode in the last 12 months?

Dow R. Wilson

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

A

I'd say, first of all, when you look at the overall, our overall trailing 12-month order rate is 5%. There is nothing that we see in the quarter that's changing that. We've got some lumpiness going on. Funnel remains very, very good. So I'd say we don't see much in terms of overall change. On the specific geographies, maybe the one piece of color is we might have a little bit of weighting for Halcyon in Asia but otherwise the market and the market funnel we continue to be pretty bullish about our funnel and what we see there.

Amit Hazan

*Analyst, Citi Research*

Q

Okay. All right. And so if I kind of move over back to guidance and maybe look at it from a cash flow perspective, I think, this is second quarter in a row now you've raised guidance but no change to cash flow guidance for the year. And I'm wondering whether that's an implication that [ph] the beat raises (28:00) more non-cash related in some way or where the offsets are that you're somehow not seeing that flow through to cash flows?

Gary Bischooping, Jr.

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

A

Yeah. Amit, as we grow faster in dollars or local currency, we use more working capital. Receivables and inventory are growing faster than payables. And so we'll see the list as you saw in our earnings per share guidance raise. It's just there's more usage of working capital as you grow faster. It's not any more complicated than that.

Amit Hazan

*Analyst, Citi Research*

Q

Okay. And then last quick one for me is on your SG&A comment, just a little bit more color as you talk about additional sales and infrastructure investments that you're making. What specifically are you doing there?

Gary Bischooping, Jr.

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

A

Yeah. I would say good investment in the sales activity both around software and around the India sales teams to take advantage of growth options that are there. And, look, we see that as greater returns for us and we'll continue to invest as we capitalize on the growth options we see both in software and across emerging markets, but specifically India this past quarter.

Dow R. Wilson

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

A

I mean we also have a small piece from the small acquisitions.

Gary Bischooping, Jr.

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

A

Yeah.

Amit Hazan

*Analyst, Citi Research*

Q

All right. Thanks, guys. I'll jump in queue.

Gary Bischooping, Jr.

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

A

Thanks.

**Operator:** Our next question is with Tycho Petersen with JPMorgan. Please proceed with your question.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

Hey. Thanks. Maybe on Halcyon, Dow, can you just talk on – you mentioned China, maybe there's still some pent-up demand. Any update on timing there and does this kind of trade war dynamic kind of hold things up further?

Dow R. Wilson

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

A

Yeah. No, I'd say plan is still on track. We've finished our clinical study. We're turning things over to the regulatory bodies. We've kind of said end of this year, if everything goes well. I think we're still end of this year. There's some uncertainty around that depending on how fast they move. But we're still on track with our plan to end of the year.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

All right. And then similarly in Japan post-approval there. I mean how do we think about the opportunity? I think you've talked in the past about the fact there's potentially big replacement cycle that could happen but it hasn't yet. [ph] So something about how quick (30:15)...

Dow R. Wilson

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

A

Yeah. We haven't seen it yet. I think one of the things about that market is there's a lot of single vault customers in that market and a lot of them have very old equipment. So especially with the really high turnover of the machine and the short installation cycle I was very hopeful. We did just have the ITEM trade show. That's the Japan radiation oncology trade show and we had very high interest in the product. So that was very good to see.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

All right. And then, two quick ones for Gary. On Sirtex, is there anything – well, could you comment on what's included in guidance, as we get near the close next month?

Gary Bischooping, Jr.

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

A

Yeah. As we stated, there's nothing in guidance for Sirtex.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

Nothing. Okay. And then, did you guys book anything on the Flatiron sale to Roche? You had an equity investment in them, right?

Dow R. Wilson

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

A

No.

Gary Bischooping, Jr.

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

A

No. I don't believe we did bookings.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

Okay. That was just the partnership. Okay.

Dow R. Wilson

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

A

Yeah. It was just the partnership. There was no equity.

Tycho W. Peterson

*Analyst, JPMorgan Securities LLC*

Q

Okay. Thank you.

**Operator:** Our next question is with Brandon Henry with RBC Capital Markets. Please proceed with your question.

Dow R. Wilson

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

A

Hey, Brandon. We can't hear you.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

Can you hear me now?

Dow R. Wilson

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

A

There we go. We got you.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

All right. Thanks for taking my question. The company raised fiscal year EPS guidance. Can you just discuss the factors that led you to raise that range and how much of that was from FX? And then I just have a couple follow-ups.

Gary Bischooping, Jr.

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

A

Yeah. There was a couple of things, which Dow outlined. We are seeing the market growth that we had talked about for the year. We are seeing our products continue to resonate and therefore taking share. I think there is – the factors here are clearly currency as we talked about with the opening comment. That's certainly part of it and then tax rate. So it's kind of the combination that we see, good strong revenue growth, 6% to 9%, as we outlined, driven by market and our solutions in the market.

We have seen some margin rate expansion, but we continue to invest, Brandon, investing in the sales capacity that we talked about, investing in the software capacity we need in order to move 360 Oncology forward. And then

we'll continue to invest at the right rates from an R&D perspective. So it's balancing the short-term and the long-term and making sure we're making the right structural investments in order to deliver the right level of long-term growth. And so you've seen us so far in the first half. I believe, our operating income as a percent of revenue was 18.1% and that reflects the investments that we've made here in the first half as we've outlined and that's kind of what's embedded in our guidance as well.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

Okay. And just on the operating margin side, just help me understand that the guidance was reiterated there. The range looks pretty wide for the full fiscal year and you guys are halfway through the fiscal year or so. Just kind of help me understand the factors that would get you to the kind of the lower or the upper end of that range for the back half of the year.

Gary Bischooping, Jr.

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

A

Yeah. I would tell you that the margin rate expansion has been nice to see. That usually happens in a currency-driven market like this and good pricing discipline to hold on to that favorability we see on the currency front. So that's definitely a tailwind for us. I think the headwinds are what we've talked about which are investing in the ongoing sales and growth options we see and ongoing innovation in R&D. And so like I said, we've performed at 18.1% in the first half here and we'll continue to invest in growth options over time.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

All right. And just a couple quick other questions. The President Trump have obviously come out with the 25% tariffs on certain medical devices and equipment and some other items for goods imported from China. Can you spend some time discussing Varian's potential exposure to those tariffs?

Dow R. Wilson

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

A

Sure. We're monitoring it very closely and are working with [ph] admin (34:24) and other industry organizations to address the issue and clearly preserve access to potentially lifesaving cancer treatment. It is important to note that the U.S. trade representative list is still in proposal form and has not been finalized. They are seeking comments on that. And, clearly, we're advocating for the removal of medical devices and component parts as part of that.

At this stage, the U.S. trade representative list is only a proposal. Remains to be seen what final products are that will be included. So it's a dynamic environment and we continue to watch it. I guess from kind of a really broad perspective, don't see it having a big impact on market, nor our market share. How it impacts tariff cost, et cetera, is in play and we're going to have to watch that as it moves through the process.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

All right. And then just last one for me on Sirtex. You guys have had a couple months post the announcement to kind of think about the financial impact from the deal. Can you help us understand how you're thinking about ROIC targets for the deal and then any thoughts in terms of the mix of cash versus debt to finance the deal? Thanks.

Gary Bischooping, Jr.

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

A

Yeah. Let me grab the last two financial points here real quick and turn it back to Dow here for some broader comments. But, look, we think over time this will be value accreting clearly and we think about our weighted average cost of capital in the 8% or so range. And so over time, we see our ability to beat that number. As it relates to how we're going to fund this, it'll be some combination of credit facility and the cash we have on the balance sheet and we'll know more about that clearly when we close. We'll communicate it then. Dow, anything else to add?

Dow R. Wilson

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

A

Maybe just the regulatory steps have been completed. So we like that. It's progressing. We're working through the Sirtex shareholder vote. Haven't seen any surprises there. And we expect the acquisition to close late May. And as we get to that point, we'll be in a position to talk a lot more about where we see it going.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

Okay. Thank you.

Gary Bischooping, Jr.

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

A

And, Brandon, just before you jump, I just want to come back to your guidance question and the basic assumption around currency for second half basic, we've looked at spot rates at the start of our third quarter and kind of use that to imply what we think the currency impact will be for the second half.

Brandon Henry

*Analyst, RBC Capital Markets LLC*

Q

Okay. Thank you.

**Operator:** Our next question is with Vijay Kumar with Evercore ISI. Please proceed with your question.

Vijay Kumar

*Analyst, Evercore ISI*

Q

Hey, guys. Thanks for taking my question. So, maybe, Dow, just one on revenues, really strong revenue quarter. But if I just look at the installed base growth versus how product revenues have been trending, right, I know last quarter you guys had this mix where a higher proportion of revenues came from developed regions. It feels like the backlog has been burning at a fast rate. Like does this have any implication on future revenues, right? I guess what I'm asking is if we end up in first half of next fiscal and if the same proportion of revenues are not being recognized from developed regions like is that sort of an issue because emerging market revenues are – maybe they get converted – those orders get converted at a slower clip?

Gary Bischooping, Jr.

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

A

Vijay, thanks for the question. I think what I stated earlier is kind of a synopsis. One is it's lumpy out there, right. And orders in Europe were really high quality and turned very fast here that we took in the last six months versus



the ability for us to turn those orders in the prior year. And that's good like I said operational execution, quality order and sales process and we turn that over pretty quick. I wouldn't read a trend into that one way or another because things are lumpy in any given quarter. So, we'll continue to stick to our booking process and governance around having to have an actual delivery date within the next 24 months and that ongoing governance will continue. So again nice execution across Europe, really like to see it. But I wouldn't read a trend and things are lumpy.

Vijay Kumar

*Analyst, Evercore ISI*

Q

No, that's helpful, Gary. And on Halcyon, I don't know if I caught the number. How many Halcyon orders do we have currently?

Dow R. Wilson

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

A

We had 19 on the quarter, 81 since launch.

Vijay Kumar

*Analyst, Evercore ISI*

Q

Thank you. And, Dow, like just given historical sort of if we look back in a TrueBeam adoption curve or how those orders trended, right, within year-one, is this now Halcyon like are you guys happy with how Halcyon is trending or is this just a function of maybe we need the China approval and then we see an inflection?

Dow R. Wilson

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

A

Hey. Where we are is it's on track to our plan. We were very confident about the product. We remain very confident about the product. The regulatory approvals have happened right on the plan that we said at the beginning. So it is achieving what we want. We love the fact that the sites are all incremental or not all, but a huge percentage of them are incremental. And so it's expanding our installed base, setting up physician for service. We're especially pleased to see the emerging market growth.

Again new sockets grow in the installed base of our business enhancing our position to leverage our service and software business and upgrade business down the road. As I mentioned on the call, we had Halcyon 2.0 introduced at ESTRO last week. The reception was outstanding. We now have kilovoltage cone-beam CT in that product. If anything, that will attract more developed market customers and give us an upgrade to sell as well to the 80 orders we've already taken. So we're very confident about the product. It's right on the plan that we had for it and we kind of love seeing the momentum that it's achieved in the marketplace and believe that that is growing.

Vijay Kumar

*Analyst, Evercore ISI*

Q

Understood. And then, Gary, one last housekeeping. The Mobius acquisition, does acquisition have any revenues and if so can you give us what the contribution is?

Gary Bischooping, Jr.

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

A

Yeah. It certainly does in the quarter. It's pretty small overall relative to the size of the company, so we're not going to disclose the actual number, right. But it's strategic. It's part of what we see as a nice space for us to

leverage across our channel and grow rapidly via that channel with the QA product. So we're excited about it, teams been great, really good integration, off to a nice start.

Vijay Kumar

*Analyst, Evercore ISI*

Q

Thank you, guys.

**Operator:** Our next question is with Jeff Johnson with Robert W. Baird. Please proceed with your question.

Jeff D. Johnson

*Analyst, Robert W. Baird & Co., Inc.*

Q

Thank you. Good evening, guys. A couple questions here, and I've been jumping between calls so hopefully I'm not repeating anything here. But I wanted to ask an MR Linac question. Saw a large number of abstracts at ESTRO here over the past week and I think we've got a multisystem order for elect out of the UK recently. ViewRay, I think, has over 50 orders at this point. I mean just any updated thoughts on MR Linac market. I know you've been watching it, but any change in the last few months at all on how you feel Varian needs or doesn't need to compete in that market over time?

Dow R. Wilson

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

A

We continue to watch it, Jeff. It's clear it's got an academic niche. What its long-term play is in a broader market that's stressed for value-based pricing and cost effectiveness as a big question mark. I would say that our position has not changed. Our market share is growing in spite of – those orders are included in our market share numbers. So we're seeing our share growth continue, even with that performance.

Jeff D. Johnson

*Analyst, Robert W. Baird & Co., Inc.*

Q

Yeah. That makes sense. Thanks, Dow. And then, Gary, just a question for you on interest rates. We've seen them start to rise here. Is there a rate of change? Is there an absolute level, anything we should be thinking about when you've historically seen hospitals get a little hedgy on capially purchases, anything like that or we're still near historical lows I know? So are we a long ways away from having to worry about any of those kind of issues?

Gary Bischooping, Jr.

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

A

Yeah. I would say the nature of the yield curve too, Jeff, kind of matters here and where hospitals are funding. And you hit the nail on the head, overall historically very low, and I don't see access to capital as a constraint here, for sure.

Jeff D. Johnson

*Analyst, Robert W. Baird & Co., Inc.*

Q

Yeah. That makes sense. Thanks, guys.

**Operator:** Our next question is with Isaac Ro with Goldman Sachs. Please proceed with your question.

Isaac Ro

*Analyst, Goldman Sachs & Co. LLC*

Q

Good afternoon, guys. Thank you. I wanted to spend a little more time on Halcyon, if we were to kind of spend some time on the order book that you have in North America. I think, Dow, you kind of mentioned earlier that there are most – or a large percentage of those orders are incremental customers. I just want to clarify that that was for the global order book or in the U.S. versus OUS, just trying to get a sense of in the U.S. who the incremental customers have been.

Dow R. Wilson

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

A

Well, the numbers I gave earlier were global. And I think the other point that I'd make is we're seeing it in both markets, U.S. and outside the U.S. And one of the places that we're seeing it in the U.S. market is with competitive take-outs. So we are seeing that impact in the U.S. market. Of the 19 orders we took in Q2, we believe 15 are incremental and 60% of them were taken from emerging markets.

Isaac Ro

*Analyst, Goldman Sachs & Co. LLC*

Q

Okay. That's helpful. And then maybe just an update on software. I know you guys have a lot of people working on that and maybe not something that's super impactful to this quarter, but would appreciate an update on the strategy there. Where you guys spent your resources this quarter on building up that part of the business? Thank you.

Dow R. Wilson

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

A

Yeah. We continue to invest aggressively in software. The growth rates are positive. We do have a little bit of a model change going on, as we go from a historically strong license business to more software-as-a-service business. But both are growing and in the meantime the software-as-a-service is growing faster. Our investments in treatment planning continue to pay off big for us with our multi-criteria optimization, RapidPlan and other features in that product. And we also have a big penetration opportunity. We got 80% of the installed base yet to sell to. So nice opportunities there. Our ARIA product continues to see very good momentum in the marketplace. Relative to Oncology 360, it's really the kind of vision story. It describes how and where we're going. It's resonating very well with customers. We're still installing those and getting the evidence to kind of drive the enterprise sale.

As I mentioned on the call, we did receive Best in KLAS, kind of the third-party Gartner of our industry, for both Eclipse and ARIA. So we've got a very good competitive position. We continue to invest strongly in those markets. We did announce acquisition. It's a pretty small acquisition of Evinance, but the capability there is very important. It has clinical decision support tools that keep people on track for guidelines. So this is going to help drive the variation out around the standard of care and help people more consistently and efficiently deliver the right kind of quality. We're excited about having that product on our Oncology 360 platform and working guidelines into the product.

Isaac Ro

*Analyst, Goldman Sachs & Co. LLC*

Q

Thanks for all the detail. I appreciate it.

**Operator:** Our next question is with Anthony Petrone from Jefferies. Please proceed with your question.

Anthony Petrone

*Analyst, Jefferies LLC*

Q

Maybe just a quick follow-up on overall margin progression, just in light of the increased SG&A investments and that, Gary, you announced here today. I mean I think the sort of multi-year target was to be get to 20% and over time I think it was almost three years, but maybe just to revisit on the multi-year outlook for adjusted operating margin in light of the increased spend that you announced here today. Thanks.

Gary Bischooping, Jr.

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

A

Yeah. You know what the overall gross margin profile is encouraging to see, right. And some of that's attributable to currency environment that we're in, but also it's good operational execution and pricing discipline to take advantage of that out there in the field. And we chose to take some of those dollars and invest it into future growth options, which I think is the right answer here. We've got to be able to sustain that growth rate that we've talked about over time in order to get to where we want to be. So here we've talked about investing in sales and R&D. We're going to continue to invest in sales and R&D to drive the sustainable top-line growth. Anthony, long-term we still would think we can get into that 20% range, but we want to make sure we can do that while growing at the right rate.

Dow R. Wilson

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

A

Yeah.

Gary Bischooping, Jr.

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

A

So, it's that ongoing balance of profitability and growth that I talked about that will work our way through here over time.

Dow R. Wilson

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

A

But no change in the long-term goals.

Gary Bischooping, Jr.

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

A

No.

Anthony Petrone

*Analyst, Jefferies LLC*

Q

Thank you.

**Operator:** Ladies and gentlemen, we have reached the end of our question-and-answer session and I would like to turn the call over back to management for closing remarks.

## Dow R. Wilson

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

Yeah. Thank you, operator. I'm very pleased with the strides we've made in the second quarter towards executing on our long-term value creation strategy. We continue to strengthen our leadership in radiation therapy, extend our global footprint, and are enthusiastic about entering faster-growing markets beyond traditional radiation oncology. Our recent signing of the agreement to acquire Sirtex will position us as a leader in broader radiation medicine outside of external beam radiation therapy and enables us to enter the fast-growing interventional oncology market.

Mobius expands our software portfolio and enhances our quality assurance capabilities. And, finally, Evinance enables us to improve on the development of our existing 360 Oncology care coordination product. Looking forward, we'll continue to focus on our growth initiatives and remain committed to innovating new technologies to drive towards the ultimate victory, a world without the fear of cancer. Thank you for joining us today.

**Operator:** This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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