

25-Jul-2018

Varian Medical Systems, Inc. (VAR)

Q3 2018 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/investors. To hear a telephone replay, please dial 1-877-660-6853 from inside the U.S. or 1-201-612-7415 from outside the U.S. and enter confirmation code 13680748. The telephone replay will be available through Friday July, 27.

Now, I will turn it over to J. Michael Bruff, Senior Vice President of Investor Relations.

J. Michael Bruff

Senior Vice President, Investor Relations, Varian Medical Systems, Inc.

Thank you, operator. Good afternoon, and welcome to Varian's Third 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 our 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 third 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.

During this call, we will be making forward-looking statements which are predictions, projections, or 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 statements.

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

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 \$709 million increased 12%. Oncology revenues grew 18%, driven by our integrated platform with best-in-class hardware, software, and services. Revenues for our Particle Therapy business were \$42 million.

Operating earnings of \$119 million or 16.9% of revenues grew 26%. GAAP diluted earnings per share of \$0.79 grew 4% and non-GAAP diluted earnings per share of \$1.04 grew 28%. GAAP earnings per share 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.

Cash flows from operations were \$102 million, down 34%, due to a large cash receipt from the Georgia Proton Treatment Center in the prior-year period. Year-to-date cash flows from operations were \$347 million, up 29%.

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 7% on an orders basis over the trailing 12 months ending in March 2018. Varian maintained its market leadership and worldwide share during that period.

In our Oncology business, orders grew 11% in the quarter and 8% year-to-date, our worldwide net installed base is now 8,046 units growing 4% or 280 units. On the hardware side, we made progress with our global rollout of Halcyon, and have now taken 98 orders since our May 2017 launch including 17 new orders in the third quarter. Since launch, nearly 60% of orders worldwide have been incremental.

We've also seen strong interest in the kilovoltage cone-beam CT option that we launched as part of Halcyon 2.0 at ASTRO in April. All of our – half of our orders in the quarter were for these new systems and approximately one-third of our previous orders are scheduled to be upgraded.

On the software front, we continue to see strong demand and positive feedback for our software solutions. Software revenues grew 13% and the number of unique Varian software customers grew 6%. Customers continue to adopt Varian's new software solutions. For RapidPlan, the installed base grew over 80% and we took more orders for licenses this quarter than in any prior quarter since we launched the product several years ago.

And for Eclipse, we have now taken orders for nearly 320 licenses for Eclipse MCO, our multi-criteria optimization treatment planning tool. This feature enables clinicians to quickly compare treatment plans and choose the optimal one, enhancing both efficiency and plan quality. 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.

In our Particle Therapy business, we did not take any new orders in the quarter. However, we've taken four proton orders over the trailing 12 months and our sales pipeline remained solid. We continue to make progress toward completing sites that are under construction announced last month, the installation of a Varian ProBeam cyclotron at University College Hospitals in London.

The center will feature four treatment rooms and is scheduled to begin treating patients in 2020. We continue to see strength in our proton services business as our installations at operating centers continue to perform well. For example, the Georgia Proton Treatment Center Project is currently ahead of schedule.

Our second growth initiative is to extend our global footprint. Our global market share growth was driven by continued orders-based share gains in EMEA. For example, in Spain, the Ortega Foundation in Catalonia ordered nine TrueBeam and three Halcyon systems. In Great Britain, the National Health Service in Leeds ordered 20 TrueBeam systems. And in Poland, we continue to maintain market share leadership across public and private segments.

In Africa, we received an order for three linacs, including a Halcyon system, from Nairobi West in Kenya and an order for two linacs, including a Halcyon system, from Lagos University Teaching Hospital in Nigeria. We're proud of our EMEA team's strong execution, achieving four straight quarters of double-digit orders growth and the strongest sequential four quarters in the company's history.

We also made progress towards extending our global footprint in our Latin America and Asia-Pacific regions. In Latin America, we signed a training and cooperation agreement with the Brazil Ministry of Health and Science and Technology Institutions. This agreement is part of Varian's commitment to partner with the Brazil Ministry of Health to increase access to and quality of radiotherapy treatment in Brazil and Latin America.

In Asia, we acquired Cooperative CL Enterprises or COOP, a leading radiotherapy equipment distributor in Taiwan. We believe that by leveraging Varian's global network and COOP's strong local team, we can provide state-of-the-art cancer care for patients in Taiwan.

Finally, we announced that the first cancer patients in Korea were treated with Varian's HyperArc, high-definition radiotherapy, which is designed to automate and simplify sophisticated treatments like stereotactic radiosurgery. Two patients with brain cancer were treated using the company's HyperArc at the Ajou University Hospital and we're pleased to partner with leading institutions like Ajou to deliver advanced cancer treatments to more patients.

On the Halcyon front, global momentum continues to grow. Of the Halcyon orders taken since launch, approximately 45% have been from emerging markets and nearly 90% of these have been for incremental units, thus we see Halcyon expanding the market and our market share in this segment.

One of our key ambitions for Halcyon was to expand access to high-quality radiation therapy to underserved regions around the world. This quarter, we announced that Halcyon is now being used in three centers in Africa: Clinique le Littoral Casablanca and Centre d'Oncologie Nakhil Rabat in Morocco, and Busamed Oncology Center, Hillcrest in South Africa.

In fact, at the Centre d'Oncologie Nakhil Rabat, Halcyon was installed, commissioned, staff trained and began treating patients in just two weeks. Within several months, the center is already treating 70 patients per day on Halcyon and offers other state-of-the-art techniques, including image-guided radiation therapy, RapidArc and stereotactic body radiation therapy using Varian equipment exclusively. We are proud of our collaboration with

these centers and look forward to working with more centers across Africa and around the world to provide access to high-quality cancer treatments.

Lastly, our third growth initiative is to expand into other addressable markets. We continue to believe that 360 Oncology will be a driver of future growth for the company as we enter the cancer care coordination market, an area of large unmet need. For example, this quarter, we won a competitive contract for a patient engagement platform at The New York Proton Center, which is an alliance between Memorial Sloan Kettering, Montefiore and Mount Sinai.

This five-year contract represents progress towards our strategy of pursuing key opinion leader cancer center adoption of 360 Oncology. And we look forward to demonstrating the impact that product can have on a clinical effectiveness as well as efficiency and productivity.

Additionally, we launched Velocity 4.0, a new version of our cancer imaging software that now includes RapidSphere, a module for Y90 Selective Internal Radiation Therapy or SIRT dosimetry analysis.

RapidSphere allows clinicians to better understand tumor response and normal tissue toxicity for individual patients receiving SIRT. The new software module extends Varian's Velocity platform to radioembolization in the interventional oncology market. Velocity 4.0 and RapidSphere module have received FDA 510(k) clearance.

Overall, we're pleased with the progress we made in the third 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 third quarter financial results.

Gary Bischooping, Jr.

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

Thanks, Dow. As always, I will consistently frame my comments in the context of our long-term growth and value creation strategy which includes balancing growth, profitability and liquidity.

So, let me start with growth. Company-wide revenues were \$709 million in the third quarter, up 12% in dollars and 10% in constant currency. In Oncology, revenues were \$667 million, up 18% in dollars and 16% in constant currency, driven by growth across hardware, software and services. Year-to-date revenues grew 14% in dollars and 11% in constant currency.

Orders were \$763 million or up 11% in dollars and 9% in constant currency. On a trailing 12-month basis, orders grew 6% in dollars and 5% in constant currency. We ended the quarter with \$2.7 billion in backlog, up 6%.

Taking a closer look at our Oncology business results, in the Americas, revenues grew 13% in the quarter and 8% year-to-date; orders were \$363 million, up 9%, driven by North America growth of 9%. On trailing 12-month basis, orders in the Americas grew 2% and orders in North America grew 4%.

We saw strong demand in North America for TrueBeam and Halcyon systems as well as orders for HyperArc across MCO and our GPU which enhances speed of dose calculations for treatment planning. Over 60% of our Halcyon orders in the quarter were from the Americas.

Asia-Pacific revenues grew 13% in the quarter and 10% year-to-date, orders were \$141 million decreasing 7%. On a trailing 12-month basis, orders for the Asia-Pacific region decreased 3%. We saw moderate growth in Greater China in the quarter, and continue to lead the market there. In Japan, orders were up slightly and year-to-date orders have been up mid-single digits.

In Europe, Middle East, India and Africa geography, revenues grew 32% in the quarter and 28% year-to-date. Orders were \$259 million, increasing 27%. On a trailing 12-month basis, orders grew 20%. We saw outstanding results across the region with growth driven by large product tenders and strong performance in both hardware and software orders.

Our Particle Therapy business posted revenues of \$42 million in the quarter, which is down 39% compared to last year, when we recognized significant revenues from the Georgia Proton Treatment Center. However, this quarter, we recognized \$3 million in earnings previously expected for the fourth quarter, primarily driven by the Georgia Project, which, as Dow said, is ahead of schedule.

Turning to profitability, total company gross margin was \$316 million, up 18% at a rate of 44.5% of revenues. This was driven largely by our Oncology business where we continue to see solid revenue growth across hardware, software and services, as well as margin rate expansion from higher TrueBeam mix. Oncology gross margin of \$307 million increased 19%, largely driven by revenue growth and the rate was 46.1%, up 35 basis points.

Looking at Particle Therapy, gross margin dollars were \$8 million, down \$0.5 million. Investment will continue to be a key driver of our long-term growth and value creation strategy. In the quarter, R&D was up 8% to \$60 million, investing 8.4% of revenues into organic innovation programs.

Likewise, we're investing in sales and marketing while continuing to be responsible of G&A investments to ensure our infrastructure scales to support company growth. Company-wide SG&A expenses of \$136 million or 19.1% of revenues were up \$20 million or 17%. The increase was primarily driven by investments in sales head count and in marketing.

Company earnings were \$119 million – company operating earnings were \$119 million or 16.9% of revenues increasing 26%. Year-to-date, our operating margin is 17.7% of revenues. Year-to-date and for each quarter of our fiscal 2018, we have driven leverage in the P&L by growing operating earnings faster than revenue growth.

This quarter, we had two significant items that impacted GAAP earnings. First, acquisition-related expenses totaled \$13 million for the quarter, primarily driven by acquisition costs and the hedging loss related to the Australian dollar purchase price for Sirtex, partially offset by the breakup fee. Second, as a result of updated information on expected key terms of the refinancing of the Maryland Proton Treatment Center, we took an additional impairment charge of \$11 million. The charge reflects a difference in value between the security held by us and the estimated value of the new security to be issued in exchange as part of the refinancing. We anticipate the refinancing will close in the fourth quarter. Overall, Maryland Proton facility continues to perform well, treating over 100 patients per day.

Turning to taxes. After impacts of the Tax Cuts and Jobs Act legislation, our resulting GAAP effective tax rate for the third quarter was 21.2%, our non-GAAP effective tax rate was 19.6% which excludes the impact of the transition to the new legislation. Similarly, our non-GAAP net earnings per diluted share also excludes this impact. GAAP net earnings per diluted share was \$0.79. Our non-GAAP net earnings per diluted share was \$1.04 with related diluted share count of 92.5 million shares in the quarter.

Turning to the balance sheet and liquidity, we ended the quarter with cash and cash equivalents of \$536 million and debt of \$18 million, \$237 million since last quarter. With the changes related to the Tax Cuts and Jobs Act, we are able to repatriate cash to significantly reduce our debt. Cash flow from operations were \$102 million, down 34% due to a large cash received from the Georgia Proton Center in the prior-year period. This brings our year-to-date cash flows from operations to \$347 million, up 29% in trailing 12-month cash flows from operations to \$476 million, up 13%.

Oncology DSO decreased by 15 days from 121 days to 106 days in the quarter. In addition to R&D investments – in addition to R&D, other investments in the quarter included \$13 million in CapEx and \$39 million to repurchase shares of our stock. As of the end of the quarter, we had 4.1 million shares remaining under our existing share repurchase authorization.

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

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 are resonating, driving our market leadership; third, recent fluctuations in the currency markets; and fourth, the impact of the tax cuts and their implications to our tax rate.

Additionally, while it continues to be a fluid and dynamic environment, we have reflected in our updated annual guidance the projected impact of tariffs imposed on July 6th by the United States Trade Representative.

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 9% to 11%, non-GAAP operating earnings as a percentage of revenues range of 17.5% to 18%, non-GAAP effective tax rate of 20%, weighted average diluted shares of 93 million, non-GAAP net earnings per diluted share range of \$4.43 to \$4.48, cash flows from operations range of \$475 million to \$550 million.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Amit Hazan from Citi. Please proceed with your question.

Q

Hi, guys. This is [ph] Phil (20:27) on for Amit. Can you hear me okay?

Dow R. Wilson

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

A

Hey, [ph] Phil (20:29) yeah. Loud and clear.

Q

Great. Two questions on the guidance, if I could. The first one probably for, Gary, as I was wondering if you could clarify what's the ex-FX guidance for revenue this quarter versus what it was last quarter?

Gary Bischooping, Jr.

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

A

The FX guidance is consistent with what – where kind of rates are running today to when we had the original guidance – sorry – the FX guidance reflected today is similar to where we stand today. So, that's kind of where we are and it's kind of the framework we use going forward.

Q

So, sorry, maybe I didn't phrase it well. Could you characterize what the ex-FX guidance was at last quarter call and what it's being updated to today?

Gary Bischooping, Jr.

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

A

Ex-FX guidance, sorry, I did not hear that, yeah.

Q

Well, that's okay.

Gary Bischooping, Jr.

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

A

So the impact that was embedded in the guidance from last quarter was 2 percentage points of growth from currency. So, 7% and 9% would have been 5% and 7%, ex-currency.

Q

7% and 9% today would have been 4% to 7% last quarter.

Gary Bischooping, Jr.

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

A

No, the guidance we gave last quarter was revenue growth of 7% to 9%, okay, embed – 6% to 9% – sorry 6% to 9%, embedded in that was 2 points of currency growth.

Q

Sure. Okay. So, still embedded in the FX in your guidance today is 2 points of currency headwinds?

Gary Bischooping, Jr.

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

A

That's correct.

Q

Okay. Got it. And the second one was on the operating margin side. Just wondering if you can parse out some of the components that Dow touched on and how those are impacting a reduction in the operating margin guidance for the year.

Gary Bischooping, Jr.

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

A

Yeah. Let me go to that. So as we thought about the guidance and the results you see in the third quarter, there's a few things going on. So one is, in our results, we're investing in R&D as well as SG&A to support the growth trajectory, right. You see the topline moving where it's moving. You see the gross margin dollars moving where it's moving.

I just want to reiterate that year-to-date, our operating earnings dollar growth is 39%. If you exclude the PT charge from the first quarter of fiscal year 2017, then the year-on-year operating earnings dollar growth year-to-date will be 22%. And that's growing faster than our revenue growth, right. So, we're getting good scaling into the P&L.

That said, we're setting up the G&A infrastructure for what this business needs support for the next two to three years, so there's some G&A investment, but G&A is scaling with revenue. And where you see the investments would be in software from a sales perspective in key markets, emerging markets. Investments on the sell side, there's Mobius and Evinance now running in those numbers, right, they weren't in there a year ago, and we're setting up acquisition reps for new territories we see out there from an expansion perspective. So those are the key elements of the sales and marketing lines from a growth perspective that you're seeing running in that SG&A number.

Dow R. Wilson

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

A

And maybe I'll just add a little follow-on to that. I mean, we're starting to see the impact of this in our software business line. So, as Gary said, some of the sales and marketing investments we've been making in software has been to support the new acquisitions and to support especially distribution of our software products outside the U.S. And in many ways, it's the best software quarter that we've ever had at very strong double-digit growth.

You heard in the call, I underscored HyperArc and RapidPlan, both had their biggest quarters. We also had very strong quarters for MCO, our multi-criteria optimization product that I mentioned in the call, as well as our Velocity 4.0 product. And then, Oncology 360 continues to kind of be at the spear point of the strategy driving our vision with our customers. We're very pleased to win this big order in New York that I mentioned in the call. So anyway, I mean, a lot of that infrastructure, just as Gary said, is going to support a software strategy as we roll forward.

Q

All right. Thanks for the color. Appreciate it.

Operator: Our next question comes from the line of Anthony Petrone from Jefferies. Please proceed with your question.

Anthony Petrone

Analyst, Jefferies LLC

Hi, and good afternoon, everyone.

Q

Dow R. Wilson

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

Good afternoon.

A

Anthony Petrone

Analyst, Jefferies LLC

Maybe you can start in a little bit just on TrueBeam, here two consecutive quarters of strength, so a little bit of renaissance for this technology, the 20-unit order in Great Britain is notable, but you're also seeing traction in other regions of the world. So, can you talk a little bit about TrueBeam, where the demand specifically is coming from, is it because of HyperArc on top of that, has the pricing for TrueBeam shifted, and maybe just a little bit more color on how sustainable you think the growth in TrueBeam is from here? And then, I have a couple of follow-ups.

Q

Dow R. Wilson

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

Yeah. I know, that's a really good question. We've seen multiple quarters strengthened TrueBeam. So, this is not a trend by any stretch. Yes, we did have a very good quarter on TrueBeam. But it continues to be the most flexible, most versatile market-leading machine out there. So, that's not news.

A

For us, the strategy is socket growth and we love socket growth of any flavor we can get. And I mean I'm really thrilled about these 280 units, our installed base is over 8,000 units right now. You heard us talk about that on the call. That drives, as you know, service contracts, software upgrades et cetera.

With the Halcyon, I think it's supporting TrueBeam very much. So, I think that strategy is working out very well. You heard me say on the call, we're at the pause – we're at the one-year mark now. We introduced the product just over a year ago. We've taken 98 orders since we introduced it. A vast majority of them are incremental. Almost half of them are in emerging markets.

And I think to your point, Anthony, we're seeing it support the TrueBeam strategy. And so that's part of that socket growth play. HyperArc, at the high end, is also working very well, it's driving the TrueBeam product line and we're getting a share of imagination and we had 30 new orders in the quarter, a 100 since launch. It's a very good product in tenders. So, a very strong position with TrueBeam. But I think we do have to see it in the context of the total portfolio and the total portfolio right now is, it's rocking.

Gary Bischooping, Jr.

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

A

Yeah. [indiscernible] (27:53) that installed base is up 4%, right.

Anthony Petrone

Analyst, Jefferies LLC

Q

Yeah.

Gary Bischooping, Jr.

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

A

And backlog grew in the period as well. So, good strong execution across the portfolio.

Anthony Petrone

Analyst, Jefferies LLC

Q

It just leads into the follow-up question which would be, just still getting some questions on the delta of that product revenue growth which has been certainly maintained here in fiscal 2018 in the low-teens. And then to your point, Gary, the backlog growth, the installed base growth I should say of single-digits. So maybe just a reconciliation between those two numbers would be helpful. And then last for me would be just any update on the strategy post-Sirtex, obviously certainly freeze a balance sheet capacity, so anything you could add there would be helpful? Thanks.

Dow R. Wilson

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

A

So, I'll take a try here. Anthony, if I'm not answering this right, correct me. Our service revenue is doing very well, it's double-digit revenue. Yes, when we – these new machines, when they go into installed base, they are in warranty for a year. So, we don't see the service impact for one year.

But, yes, the product revenue was higher than the service revenue this quarter. But both were double-digit, we'll take it, so that's kind of where we are. In time, that service revenue number will catch up as we come out of warranty. And then, I said it, briefly, but the software numbers were also double-digit and we're very pleased with what we saw there. So, it was really strength across the whole portfolio.

Operator: Our next question comes from the line of Tycho Peterson from JPMorgan. Please proceed with your question.

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Q

Hey, thanks. Dow, I'm going to start with couple on Asia. APAC orders were down 9%, can you maybe talk on that and did the Taiwanese distributor do anything to you guys in the quarter in terms of numbers?

Dow R. Wilson

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

A

Short version is kind of starting at the top. China and Japan were both up mid-to-high single-digit and we had a really tough comp in the region that was especially driven by Southeast Asia and Australia. So, we didn't see anything in the quarter that shocked us, I mean, yes, we have been executing double-digit growth pretty much every quarter in Asia. We did back off that this quarter. It was really driven by tough comp in ANZ and Southeast Asia.

China was mid-single digit and Japan about the same, so we had good execution in those two markets. Taiwan, we're excited about this acquisition. It's going to bring some capability in that market that we're excited about. In terms of impact on the quarter, nothing really notable. And then maybe just to close it out by saying pipeline in Asia looks very good.

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Q

And then can you just – on China, you mentioned tariffs, I didn't hear you quantify, so can you talk to that? Obviously, in linacs, we're on one of the list, so can you maybe talk to risk going forward and then latest thinking on approval for outcome?

Dow R. Wilson

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

A

Yeah, sure. I mean, we have included tariffs in our guidance for Q4, so that is built into our Q4 guidance and a piece of what you see there. I'll just say maybe from the top, I'm really proud of the team. Varian is an American innovator, created thousands of jobs, tens of thousands of jobs for our suppliers. We support efforts to expand American manufacturing and job creation. At the patient level, our innovation impacts more than 3 million patients each year, vast majority of those in the U.S.

In fact, one in seven Americans will be treated with a Varian system in their lifetime. We have really long-term relationships that are built with years of trust, and our strategy is to provide the most advanced cutting-edge cancer treatment around the globe to fulfil our mission to provide a world without fear of cancer.

While we support U.S. efforts to ensure a more level playing field for American businesses through bilateral trade, we also believe that trade dispute should not have an adverse impact on access to the highest quality of cancer treatment for each and every American and person around the globe.

So we continue to have very productive conversations with the administration on the disproportionate impact of tariffs to Americans who face cancer and to American jobs manufacturing and investments in next-generation technologies, those conversations are ongoing. And as we get more detail, we'll disclose those to you as that happens. But that's kind of what we know today.

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Q

Okay. And just two quick ones. Gary, can talk on cash flow? It looks like it did decline a bit there, and then did all of the 20 TrueBeams to the UK ship this quarter, could you recognize all that? Thanks.

Gary Bischooping, Jr.

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

A

Yeah. So on cash flow, trailing 12-month cash flow from operations, \$476 million, so in that \$475 million to \$550 million range that we've held here, that's a nice increase, that's up 13% year-on-year. So I think the teams were out there executing well, good operational execution, DSO in Oncology business down again on year-over-year basis, 15 days.

And so the engagement, the ability to get, like I've said before, an invoice is collectible out the door and get it collected, the first time the teams are executing well, and we're starting to see that show up in cash flow. Also, as I mentioned earlier, the operating earnings growth is driving through that number as well. The follow-up question was?

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Q

Did you recognize all 20 TrueBeams...

Gary Bischooping, Jr.

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

A

No, no, no. I think a couple over two years that'll take us time to get those installed.

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Q

Perfect. Thanks.

Operator: Our next question comes from the line of Vijay Kumar from Evercore. Please proceed with your question.

Vijay Kumar

Analyst, Evercore Group LLC

Q

Hey, guys. Congrats on a nice quarter. I had a few questions. So maybe I'll start with the – on the revenue front, really impressive on the product revenues. I guess my question is, when you look at 2019, right, orders and backlog, they've sort of been growing – you look at the last year [ph] or so (34:44), the 5% to 6% or maybe even 7% dip. And then this 16%, 17% year-to-date product revenues that we've seen, is this now a comp issue, because just when I look at the order backlog growth versus the product revenue growth, it feels like this is going to be a comp issue and there is a catch up, can you explain that please?

Dow R. Wilson

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

A

Yeah. I mean, short version is, we'll talk to you about 2019 next quarter. I will say trailing 12 months we've seen market growth of about 6% in Oncology, backlog growth of about same. So, that sort of market performance level trailing 12 months, our performance.

Gary Bischooping, Jr.

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

A

Yeah. So, yeah, we're growing a solid 6%, 5% on a constant currency basis. And like Dow said, we'll talk to you guys about 2019 in about 90 days.

Vijay Kumar

Analyst, Evercore Group LLC

Q

And that's the product revenue growth. I think if I understand correctly, this is mostly a mix issue, right, because I think the way you explained it was a higher proportion of revenues coming from Europe and those tend to be recognized faster. Is that what's going on here?

Gary Bischooping, Jr.

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

A

Yeah. Like I said, Vijay, we're not going to get into the 2019 implications and how this plays out. We'll talk to everybody about 2019 in 90 days.

Vijay Kumar

Analyst, Evercore Group LLC

Q

Got you, Gary. And then just one on gross margins I think, you know you mentioned tariffs was being baked into the Q4. Is that we're – just looking at the margin guidance, it looks like GM for Q4 should be somewhere in the 43% to 43.5% range. Is that – assuming obviously that's different on mix, but this is just based on tariffs, is that the right ballpark for us – for you to be modeling?

Gary Bischooping, Jr.

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

A

Yeah. So we don't guide on gross margin rate. What we did see in the quarter though is good solid execution in TrueBeam, right, and we saw software and services grow as well. So, that's what you're seeing flowing through into the margin line here from the actuals perspective in the third quarter. So, we're happy with that. And again, we don't guide to the margin rate for external purposes.

Vijay Kumar

Analyst, Evercore Group LLC

Q

Or if I have to ask the question in another way, Gary, the op margins was lowered, right, and that was based on tariffs and year-to-date impact, and that the tariff impact, that's a gross margin line, right. So for modeling for Q4 and if we're saying the guidance is baking in tariffs, that's a gross margin impact?

Gary Bischooping, Jr.

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

A

That is correct. The tariff impact will flow through the gross margin line. No, but, again, Vijay, we're very happy with that ex-PT charge, operating margin dollars are growing 22% year-on-year. Cash flow is growing 13% year-on-year. Both of those numbers are growing faster than revenue. That's good execution. And we're proud of those numbers and we'll continue to execute and try and perpetuate as we go forward.

Vijay Kumar

Analyst, Evercore Group LLC

Q

Absolutely, Gary. I'm sure people will be happy to see that the cash flow turnaround. Just maybe one last one on Halcyon. I know when the Halcyon was launched, right, this was supposed to be incremental to corporate margins. Given that Halcyon is going to be assembled in China, should the Street still be expecting Halcyon to be incremental to corporate given the tariff impact?

Dow R. Wilson

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

A

As I said on the call, we're really pleased with what we've seen so far. High percentage of these are incremental, they're going into cobalt vaults, going into tomotherapy replacement vaults, going into other small vaults till – people are now building small vaults around them, 40% of the volume is in emerging markets, that doesn't include Europe, and we can probably get that number for you. But we're doing very, very well.

Yes, a few of them are coming back here in the U.S., they might have some tariff exposure on the – as part of that, but we're very comfortable with where we are. And again, as a reminder, we continue to have – it's pretty opaque and we continue to have really productive discussions with the administration. We're trying to remove cancer fighting technologies from the list as these trade disputes go forward not to have an adverse impact on really high-quality cancer treatment around the world. So, that's still an ongoing conversation.

Vijay Kumar

Analyst, Evercore Group LLC

Q

That's helpful commentary to have. So last one for me is, any contribution from M&A, I think I heard you guys say the distributor acquisition, was there anything material at all in the Q or...

Dow R. Wilson

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

A

We've got a couple that we're very excited about that we've closed I'd say at least for Q4 marginal impact.

Gary Bischooping, Jr.

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

A

But on plan and track to...

Dow R. Wilson

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

A

On plan, tracking, a little small positive impact, maybe let me fix that, but on track with what we saw. We really like this Mobius in particular, taking these QA software tools and getting them through our global distribution network that gives us access to a nice growth story there.

Vijay Kumar

Analyst, Evercore Group LLC

Q

Thank you, guys.

Operator: Our next question comes from the line of Isaac Ro from Goldman Sachs. Please proceed with your question.

Isaac Ro

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good afternoon. Thanks. Just another one on the tariff topic, could you maybe just give us a little bit of color as to the customer conversations you had this quarter [indiscernible] (40:21) this might be causing maybe delays in decision making or different decisions, I'd be interested in sort of what you're hearing now and basically as a result what's embedded in your outlook for the rest of this fiscal year?

Dow R. Wilson

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

A

I mean, so far, we are having deep conversations with our customers. Those relationships are obviously important and critical to us. None of these are short-term relationships, they're all very long-term relationships that enable us to have the terrific position and franchise that we have. As I mentioned in the call earlier, we treat about 3 million patients a year. We're investing significantly in our R&D. Our customers buy us because we're best and we want to keep that – we want to keep that going. We've reflected the tariff impact into our fourth quarter guidance as to what the impact is going to be beyond that.

As I said, we continue to have productive conversations with Washington and are trying to address the disproportionate impact that tariffs have to not just Americans because of the R&D impact, but to American jobs manufacturing and investment. But I think at this time – at this point, it's had real no impact from kind of a market point of view. You saw our China orders were still mid-single digit on a really tough comp, so we haven't seen the impact on the market side.

Isaac Ro

Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. And then just last question would be on just the velocity of this conversation. Obviously, this wasn't a topic for us for the most part of last quarter and now it is. [indiscernible] (42:17) with your customers has really picked up in the last few weeks or has it been sort of a slow trickle for several months, be interested in sort of the velocity of discourse with customers on this issue? Thank you.

Dow R. Wilson

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

A

I'd say it's very opaque. There's conversations happening every day. I wouldn't say we've seen a pickup in that velocity at least in the sense that you're kind of getting that. These partnerships that we have with them are strong and more often than not often decades long and we continue to work with our customers to advance our joint mission to create a world without fear of cancer.

Isaac Ro

Analyst, Goldman Sachs & Co. LLC

Q

Got it. Thank you, guys.

Operator: Our next question comes from the line of Jeff Johnson from Robert W. Baird. Please proceed with your question.

Q

Hey, guys. This is [ph] Jason (43:13) on for Jeff. I just wanted to start with the tariff, again. Just is there anything you can discuss on maybe mitigation efforts here, you're putting in place or anything from like a supply sourcing or manufacturing perspective in order to potentially offset the headwinds, or is it really just trying to lobby the government for removal of the tariff?

Dow R. Wilson

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

A

I mean, the short answer is, yes, to everything. I mean, we're looking very hard at mitigation efforts and we're looking very hard at continuing to work with the administration. We are having productive conversations there, as I mentioned. Our focus is on our growth initiative. As you've seen, that the business is enjoying a nice uptick in growth, that's because we're spending on R&D on the right stuff and we're supporting it with the right sales and marketing activities to drive our growth.

Clearly, we want to keep maintaining that, and so having a business that doesn't have an impact from a disproportionate share of tariffs, not only to Americans who face cancer, but to American jobs and investment in R&D, in next-technologies, that's the game for us. So we will always evaluate our supply chain. I think team's done a great job of that, as I mentioned. I'm very proud of what we've done. We've generated thousands of jobs here in the U.S. and then our supply chain probably tens of thousands of more jobs. We'd obviously love to keep that going, but we'll always evaluate our supply chain and optimize it given the environment.

Q

Yeah. Thanks, Dow. Would you consider that's more of the supply chain and manufacturing shift, would that be more of a plan B, plan C for you, is that a fair way to think about it?

Dow R. Wilson

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

A

I mean, I think the short version is, we've got some global capability. We're a very large U.S. exporter. And clearly, we've got to look at cost as we go forward, that'll be a really important piece. But we're a very major U.S. exporter. Our supply chain is global. We do have some regulatory requirements. So shifting manufacturing isn't a snap your fingers, because we do have to go through FDA approval cycles. And I think for today, that's probably a specific as I'm going to get.

Q

Okay. That's helpful. And then, Gary, just wanted to come back to a question on the EPS guide. I just wanted to confirm from one question earlier that there's no change in the FX tailwinds that you're assuming in guidance for the year, still assuming 200 basis points. So then the follow-on to that is that there is no change reflect in your EPS guidance from FX, that's part one of the question? But then part two is then the entirety of the takedown of the top end of the EPS guide can be traced to tariffs, is that all accurate?

Gary Bischooping, Jr.

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

A

Yeah. So the guidance that you saw on the revenue line 9% to 11% still reflects that 2 percentage points, right. And so that's kind of what's in today.

Q

Okay. So the full takedown for the guide is tied to the tariff, there's no FX reduction in the EPS guide from or so there's – yeah, there's no reduction in the EPS guide from FX?

Gary Bischooping, Jr.

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

A

Yeah. I'm not going to talk to the tariff point of this. We will – I'd say that there's about maybe \$0.01 or so of currency, but it's pretty de minimis in the big picture of thing so, but the range reflects what we think we're going to operate at here for the rest of the year.

Q

Okay. Very helpful. Thank you very much.

Operator: [Operator Instructions] Our next question comes from the line of Anthony Petrone from Jefferies. Please proceed with your question.

Anthony Petrone

Analyst, Jefferies LLC

Q

Hey, just thanks for the follow-up. Just the math question on tariffs again, is the assumption that that would be on revenues or on the actual cost of goods sold in order to make an estimate on potentially what that impact is?

Dow R. Wilson

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

A

Again, let me come back to, it is very opaque and we have given you guidance for Q4, call us in 90 days and we'll clear it all up for what we learn and know in the next 90 days. So as it relates to kind of 2019, I think it's very important for us to get through the next part of the process. I've talked a lot about that here today. We're continuing to have very productive conversations with the administration. And until we kind of get some clarity on that, I think it's conjecture in our – we're kind of proud of the business we've built. And as a strong American exporter, I think, we've got a very, very strong case, we want to make sure that we've got the capability to deliver the best cancer treatment here in the U.S. and worldwide and continue the terrific job story that we have.

Anthony Petrone

Analyst, Jefferies LLC

Q

Thanks, again.

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

Dow R. Wilson

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

Yeah. Thanks. Thanks, operator. I'm very pleased with the progress we've made in the third quarter towards executing on our long-term valuation – value creation strategy. We continue to strengthen our leadership in

radiation therapy, extend our global footprint and grow our addressable markets. Looking forward, we'll continue to invest in our growth initiatives and remain committed to innovating new technologies to drive towards the ultimate victory, a world without fear of cancer. Thanks all for joining us this afternoon.

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

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