THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

COO - Cooper Companies Inc at William Blair Growth Stock Conference

EVENT DATE/TIME: JUNE 14, 2017 / 4:20PM GMT

CORPORATE PARTICIPANTS

Albert G. White *The Cooper Companies, Inc. - CFO, Chief Strategic Officer and EVP*

CONFERENCE CALL PARTICIPANTS

Brian David Weinstein *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

PRESENTATION

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

Good afternoon, everybody, or I guess, good late morning, as the case is. My name is Brian Weinstein. I believe I know a lot of you out in the audience. But for those who don't know me, I am one of the research analysts here at William Blair. I cover medical devices and diagnostics for our company. And I'm the analyst that does cover Cooper. My compliance officer, Mike [Bezenchek], who is an unfortunate White Sox fan, he's told me that you guys should go to our website, williamblair.com for a list of all disclosures or potential conflicts. We're thrilled to have Cooper with us again at the Growth Stock Conference. The company has really been operating in a sweet spot of late with good performance driven by stable end markets, positive mix shift and strong cash generation. We see this as a unique asset as it's the only way to get exposure -- investment exposure to the attractive contact lens market. In addition, there's an interesting women's health business, which is expected to continue to see positive dynamics as well. With us to discuss the company, its markets and products, is the company's CFO, Al White. Also with us is Vice President of Investor Relations, Kim Duncan. And I will let you know that the breakout will take place in the Bellevue room downstairs on the seventh floor. With that, I will turn it over to Al. Thanks.

Albert G. White - *The Cooper Companies, Inc. - CFO, Chief Strategic Officer and EVP*

Great, thank you, Brian. I always have to make a comment about the Cubs or the White Sox as I'm a Yankee fan. So clearly, I'm happy this year. Let's jump in the presentation. The Cooper Company is, for those of you who do not know us, and this presentation, probably be a little bit more generic, but I'm happy if we have time, especially at the end, to answer any questions anyone has. But we have 2 business units: CooperVision and CooperSurgical. CooperVision is around 80% of our revenues. It's one of the largest contact lens manufacturers in the world, and I walked through kind of details behind that. And then CooperSurgical's changed a little bit over the years and a little bit more than half of the business is fertility now, and the other half being more focused on medical devices, all covering kind of the general family OB-GYN space. So see, I'm here, obviously, in New York Stock Exchange and we have revenues, I'll walk through the revenues and so forth, a little bit over 10,000 employees and operating around the world.

So let's walk through some of the numbers here. I mean, if you look at our sales, we've been growing on a consistent basis here for many years, sales growth at CAGR 7.5%, and about $2 billion in sales last year, up 9%, up 7% pro forma. We do look at our business and talk frequently on a pro forma or constant-currency basis. We do have a lot of currency, especially within CooperVision around the world, and then in CooperSurgical, we've done a number of acquisitions. So we try to look through it and present everything on an organic basis. If you look at our EPS last year, $8.44. We've had nice growth in earnings and free cash flow of $357 million. We are at an inflection point on free cash flow, which is nice to see, and you've seen that starting this year. Our fiscal year-end is October 31, so we've reported our first 2 quarters, and our free cash flow is swinging up. I'll talk a little bit about that more as we move forward. On the last quarter that we just reported, 8% growth, 6% growth on a pro forma basis, non-GAAP EPS at $2.50 and free cash flow of $103 million. Those numbers beat expectations here recently, and we're pretty proud with this performance we're having so far. Some of that's being driven by nonoperational items like currency and our tax rate, thanks to changes in the accounting standard with equity comp, and then there's also an operational component where our operations have been stronger than our initial guidance.

If we look at the company on an EPS basis, historical basis, a little bit over 10% CAGR in terms of earnings growth. That includes this year, the midpoint of this year's guidance. So pretty consistent, solid EPS growth. There was a little bit of noise here a couple of years ago. Most of that's driven by currency. As I mentioned, we have a decent operation offshore. So anytime we get currency swings, euro, yen, pound are the biggest drivers for us. You can see impacts to EPS from currency alone. But you are seeing revenue growth. We are seeing gross margin improvements. We are investing fairly heavily in the business right now from an OpEx perspective because we are getting gross margin improvements, so we're taking some of that gross margin and we're rolling that back into the OpEx side from sales force expansion and then also more just general infrastructure development.

If you look at guidance for this year, this was just recently updated a couple of weeks ago. So you can see the revenue guidance, the pieces for CooperVision and CooperSurgical. CooperVision, our initial guidance this year was 6% to 8% constant currency. We've taken that up. These numbers reflect 7% to 8% constant currency growth. If you look at CooperSurgical, these numbers, on a look-through basis, pro forma, represent 4.5% to 5.5% pro forma growth. Non-GAAP EPS at $950 million to $965 million, which is up from our last guidance range prior to this quarter, which was $910 million to $930 million. So a decent increase in EPS coming roughly half from currency that we've incorporated, positive currency moves and then roughly half from operations. I saw currency moved again in our favor just recently. I haven't seen a Fed announcement, so I don't know what that was about.

If you look at our long-term objectives, this is a slide I like, and we've had this slide for a number of years. So this doesn't really change. But I think it captures the business fairly well. And what we try to do as an executive team driving the business forward, we look at our business. We want to grow revenues faster than the marketplace. That's pretty simple, but we stayed pretty heavily focused on that. The contact lens industry is a relatively happy oligopoly, if you will. It's close to 90% of contact lenses right now are sold by J&J, Alcon and ourselves. So we stay focused on that as a company heavily, heavily targeting contact lenses. We look at that from a diversified standpoint geographically and also product offerings to ensure that we stay ahead. We have a slide in here where we'll show kind of how we've done a nice job over the years of maintaining growth faster than the market.

Grow EPS faster than revenue, that's as simple as leverage the business. We looked at leverage the business as we get larger. Generate over $2 billion in free cash flow in the next 5 years. That's a little low. We're actually going to be north of $400 million of free cash flow this year. So it certainly says over $2 billion once it's appropriate. Expand CooperVision and CooperSurgical geographically. There are a lot of people around the world, and there are a lot of people not wearing contact lenses or utilizing products within our women's healthcare and fertility side like they should. So we're taking advantage of that by growing and looking to grow in emerging markets. Now Emerging Markets are relatively small component of our business right now, be less than 5% of revenues, but we clearly see nice growth. There's a number of markets led by China, where we're seeing some very nice growth. So we view that as a pretty significant upside in the coming years.

Complete strategic acquisitions. We've been doing acquisitions for a number of years. I would highlight strategic in there. We do, do deals, we focus on deals that are part of our core space. So whether it's CooperVision or CooperSurgical, our acquisitions are within those spaces. We haven't moved out and done third legs or something and try to tie them in. We continue to do deals that we feel makes sense from a strategic standpoint, accretive deals where we're going to get a nice return on them. So we'll continue to look at doing those where we can.

Roll all that together and you talk about 21 operating margins at 28%-plus. We're looking at around 25.5% operating margins this year, so pretty consistent operating margin expansion. We had 28% on that, I think, 6 months ago, and added the plus on there recently. Business is going well.

If you look at operating income and operating margins, again we talk about kind of driving growth through the P&L and driving EPS expansion, right, and we're heavily focused on operating margins as obvious component of that. Growth of 11% up to 25.5%, as I've said, so pretty consistent operating margin expansion. We look 70 to 100 basis points of kind of an operating margin expansion in years as a general target.

Let's talk about the contact lens industry for a little bit. I'm not sure how familiar everyone is with that, but if you look on a global basis, the contact lens market is around $7.2 billion. 71% of that is standard spheres, which will be regular visual correction that everyone's aware of. You look at torics, 22%. Those are specialty lenses for people who have astigmatisms. And then you look at multifocals at 7%, that should be [indiscernible]. You move forward to 2021 and you look at growth coming from multifocals, which is an improvement in the technology around multifocal lenses themselves, growth in torics, again, both of those products are relatively small in relationship to the use within the U.S. So anytime we can get an expansion of specialty lenses, which makes all the sense in the world outside of the U.S., that's going to help grow the overall industry. And you look at spheres being the regular growth. But if you look at the overall total market growth, we talk about that. Looking at 6% over the next 5 years, and that's obviously taking share in that. That's driven by a number of different areas I'll talk about as we move forward.

If we break that -- those same numbers down but we look at it geographically around the world, this is a really interesting slide. Still 6% growth. But what's kind of interesting is the 3 regions that we look at, and there's not a specific individual region that you'd say, oh, that's driving it. And you might think that it should be that way, especially with the growth that we see in Asia Pac, but it's not necessarily that way. And if you look at the 3 components, we'll start with EMEA up on top. That's a good market. It's a developed market, but it's also expanding some in terms of wearers. Eastern Europe and so forth expanding the wearer base. We're seeing a conversion to dailies, to greater dailies and daily silicone hydrogels in that marketplace. So we're getting nice growth there. We're neck and neck with Alcon in that marketplace right now for #1 in that space. So that's a very nice market and a growth market, and we anticipate continuing to see decent growth in EMEA for quite a while.

If we look at Asia Pac, about 2/3 of Asia Pac is Japan. That's a large developed market. The growth coming in Asia Pac is really coming from non-Japan. So you look at China and the other countries, so there's a lot of growth there. That marketplace is already converted to dailies in a great way. So one of the things I'm going to talk about as we move into the Americas here is the shift to single-use lenses. The global contact lens market is about 50% single-use lenses and the other 50% is 2-week and monthly lenses. That shift is a great shift for the industry. So when you're moving somebody from a 2-week or monthly contact lens to a daily lens, that is a significant trade-up. So from a manufacturer perspective, we'll pick up 4, 5, even as much a 6x as much revenue from a daily patient as we'll pick up from a 2-week or a monthly patient. So that is a significant positive move that's underlying the entire contact lens industry right now. We see that mostly in the Americas here, where you're seeing the shift because the percentage of wearers that are wearing daily lenses are already fairly high in Japan, certainly in Asia Pac, in general, and then in Europe. So you have different growth drivers that are driving the different components, which is great. There's nothing like good diversified growth in different regions. For us, we have a diversified product portfolio within those regions, so it's one of the things that helps us produce consistent results. If we look at this chart again, break it one more way, and that's the daily way I was talking about. And you look at last year, you had 47% of the market being 1-day lenses. It's up to about 50% right now. And we're saying it's going to go up to 58% daily lenses in the next 5 years. So if you look at that, one of the fascinating things here is what's driving the growth. And you can see it that it's being driven by the daily portfolio out there. 10% of the growth in the marketplace is coming from dailies. Now I'll probably branch off here just a minute. I mean, if you look at our growth, if you look at CooperVision and you say, what is driving CooperVision to have such strong growth? And why are we going to continue to have growth where we're taking market share? A lot of that gets driven by our product mix. So right now, we're around 24% of the global market share but we have about 16% market share in the daily side. So if it's outside of dailies, we're a 30% market share-type company. It's that daily side that's going to drive us up. We spent a lot of money. We did an acquisition a few years ago to get on the forefront of technology within the daily space and specifically within the daily silicone hydrogel space. So that component of our business is the piece that's the fastest-growing daily. The fastest-growing subsegment of that is daily silicones, and we're a clear market leader in that space. So we're positioned very, very well from a product portfolio perspective within the fastest-growing space. So we're pretty excited about this trend. This trend right here, which we've been seeing for several years and looks to continue, is a very big positive for us.

Generally speaking, looking at the soft contact lens market, there's multiple drivers to it. So even when the economy slows and you go into a recession, I think you go back to 2008, it was probably the best example back when we were in a recessionary period, the contact lens industry was still growing 3% a year back then. The reason for that is you get children who are entering earlier, you're getting kids coming in, 12- and 13-year-olds, more frequently, you're getting people staying in contact lenses longer because the technology is better and it's addressing things like end-of-day dryness and so forth. You get better comfort because it's silicone hydrogel. A lot of that is tied to chemistry, better chemistry behind the lenses. You get increasing incidences, myopia, which is kind of a separate topic but a fascinating one where we're doing some R&D work and so forth, but we have some kind of early-stage or early-mover advantages within myopia control. This is a big issue especially in countries like China. You look at pricing and modality when I'm talking -- when I talk about the shift to dailies and the trade-up from a manufacturer perspective, another positive, the silicone hydrogels. And then you look at geographic expansion. And there's not an expansion of the wearer base, really, when it comes to the U.S. and a number of the really developed countries, but there are a lot of new wearers coming into the contact lens industry around the world.

This slide highlights a little bit of what I've been touching on in different pieces, but it's interesting when you look at this and you look at the global on the bottom left, then you can kind of see roughly 50% of the market being dailies, and you can see the drivers. That America is at 36% one day, was probably around 10% if we go back from 8, 9, 10 years, something like that. So there's a consistent improvement in terms of daily sales in the U.S. We would anticipate that 36% continuing to move higher every single year. And we're -- we'll be a recipient of that move with our product portfolio. You can kind of see as I was talking about Europe in the middle and Asia Pac already with a fairly high concentration of daily wearers.

If I move to a little bit more of CooperVision within the global dynamics, you can kind of see the market share, how we've trended on the market share and where we are today. J&J right now, we have a 39% market share. That's come back. They were probably as high as 44%, 45% at one point in time. They've come back a little bit. Bausch, if I go back 10 years, was probably around 16%, 17% market share. They're obviously part of Valiant right now. They are losing share right now. If you look at Alcon at about 25%, it's been relatively stable. With question mark, obviously, around Alcon right now is what [Phil Bardus] ends up doing with them, what does that disruption mean to the industry? How is that impacting us? And I think -- I would argue, certainly, that it's been a positive to us, and we'll see how that plays out. But you can see the consistent market share gains that we've had for a number of years here focused on all the items that I've been mentioning.

I'll talk about soft contact lens market growth versus CooperVision, again goes back to consistency of performance. You can see the market here at 5% and then down to 4% for several years and us growing consistently above that around 2x to the market. There's been a number of dynamics, and I won't take everyone through that, but if you look at pricing, we had UPP, which was a pricing policy that came out a few years ago. We had some consolidation in the industry from a distributor perspective. It took channel inventory out. So there's been a number of different factors that had held the market growth back a little bit. I think we're finally there now where we're seeing that market growth come back up. We had a 6% in calendar Q4, 5% market growth in the first calendar quarter. I think J&J's recent moves, as they move and shift towards daily silicone hydrogel lenses, it's a positive for them. It's a positive for the industry. So I think that in general, speaking, the industry trend is a little bit more positive, which should be great. We don't sit as a company and say, we want to grow 2x the market. That's not our objective. Our objective is to put up solid growth in conjunction with margin expansion and cash flow. So to have the market grow, especially if the market's growing from geographic expansion from places like China and India and Russia and so forth, a lot of that growth gets driven by our competitors who are out there branding, selling and marketing the product. So that's fantastic. I'd love to see that market get a little bit stronger for all of us.

If we look at our products at CooperVision and we talk about the marketplace, and you look at the single-use lenses, these are 2 single-use silicone lenses. And it's what differentiates us right now is that J&J and Alcon both have premium-priced daily silicone hydrogel lenses. They're very good lenses, and we have MyDay, which is a very nice lens. So the 3 of us compete in that premium daily space, which is a great space and a nice growth space. We do very well there with MyDay. The unique part is this mass market lens, which is a lower-priced silicone hydrogel lens. So to put a couple of numbers around this and hopefully not confuse anyone, if you look at the 2-week and the monthly space, that's about 80% silicone hydrogel lenses now. That material's 80% of the marketplace. If we look at daily lenses, only 25% of that market is silicone hydrogel. That market is going to continue to grow and grow. Now whether it goes to 80% or whether it goes to 50% or whether it goes to 60%, we can all debate that. But right now, I don't think anyone's going to argue that the daily market is continuing to grow and the daily silicone hydrogel component of that is growing faster. We grew 43% with these 2 products in our last quarter. And we've been growing north of 40% for many quarters with these products combined. So this is a big growth driver for us, going to continue to be. All the dynamics of the industry are shifting that way. We have the mass market daily silicone hydrogel lens, the only one in the marketplace with a toric and a multifocal. So that's a -- it's a great product offering and those 2 products combined are really driving a lot of our growth, and we anticipate that to occur for quite a while longer.

If we look at the FRP side, this is the 2-week and the monthly side. Two different stories here. We have Biofinity, which is our monthly lens, which is the largest monthly lens out there, fantastic lens, doing really well. These 2 products have been combining to grow in the low-teens. We grew about 12% this past quarter, so we're getting continued nice growth within these products, heavily driven by Biofinity. What's interesting about Avaira and Avaira Vitality here in the 2-week space is we've been selling this lens for a while. We came up with an upgraded lens here. So it's a better product for the customer. The manufacturing cost that we developed on this, though, are significantly lower than the replacement product. So as we shift wearers out of our Avaira 2-week into our 2-week Vitality, that's a significant margin enhancement for us. So one of the things that you'll know if you look at our numbers is improving gross margins. That's going to be a driver that's going to continue to drive gross margins higher as we work through this year. And certainly, as our product portfolio transition occurs in '18 and '19, that'll be an underlying positive shift for us. So when we talk about mix shift, the mix shift within Biofinity is it's a high-margin product that's doing very well, the mix shift within Avaira and Vitality is more of a cost basis.

So I look at CooperVision and we talked about that, we get out of market and talk about CooperVision and the actual numbers for CooperVision, you can see roughly 7% growth over the last 5 years, a good consistent growth. We're guiding to 7% to 8% right now for constant currency growth for this full year. If we look at sales here this last quarter, we were up 7%. We were -- grew 9% in constant currency in the first quarter. So we're getting pretty good, consistent growth. We do get the anomalies, if you will, that every company gets. We have an easier comp here in Q3 than we're in right now, and a harder comp in Q4. So we'll get a little seasonality and a little variability. But if you look at it on an annual basis, certainly very consistent performance. One of the interesting things about contact lenses is once a patient moves into contact lenses and gets a brand that they like, they stay in that contact lens roughly 7 years. So it's annuity product. When you can get out and you can get new wearers and they're wearing your product, they're going to wear it for a long time. Then they'll have a tendency to trade-up or change products, they'll stay in your products. So you can get a contact lens wearer and have them for a very, very long time. What that results in is kind of consistent annuity stream, if you will. And part of that ends up translating into the cash flow side. And we had cash flow. We were years and years ago kind of flat, and then we jumped to $200 million or low-$200 million of cash flow for a number of years, and now we've kind of gone through that next shift on cash flow where we're ahead on this cycle. We've invested in this daily cycle, and our free cash flow is moving up $400 million-plus. And because of the investments and so forth we've put in place over the last few years, we expect that to continue for a number of years in front of us and even accelerate to the point where, right now, we start looking at that from a cash flow perspective and saying, okay, what are we going to do? As I mentioned, we like the strategic acquisitions. Those have a tendency to be smaller. We did some share buybacks this past quarter. We have some debt to still pay down, but that's a nice problem, if you will, that's -- that we're looking at right now. There's a lot of cash generation.

Look at CooperVision again. We'll break that down a little bit differently and look at it geographically. This last quarter, the Americas grew 4%. We have about 42% of our sales in the Americas. Asia Pac, where we had a lot of growth for a long time, up 9% and around 21% of our sales and EMEA, 37% of our sales, up 10%. One of the interesting things that we run into is how diverse our business is geographically. And we have a lot of sell-side people who cover us and, obviously, investors who hold our stock. We've seen a pretty significant increase in interest, which is interesting since we moved into the S&P 500 from the European side. And people who look at this always get a little surprised. And we go over and we talk about it, the size of the business that we have in Europe and practically the size of business we have in Asia Pac. And it did catch people off-guard a little bit when we had the big swings in currency a few years ago, the impact to us on revenues and the bottom line from a currency perspective, but I still look at this as something that's great. Having a nice diversified business with growth in all 3 regions and then having a nice product portfolio in those regions, puts us in a position where we're going to get that consistent growth.

If we jump to materials, we're over-indexed, as I was saying. You look at the daily side where we're less, where you can see torics are 32% of our sales, multifocals, 10% of our sales. We have a lot of strength in the specialty lenses, we had another good quarter in torics, up 12%. I've kind of walked through this, I won't spend much time on this slide.

If we look at CooperSurgical, so that's the other part of our business and that's 20 -- I think it's 22% of revenue since last quarter. That business, as you can see, you go back a few years with -- it was $320 million and it kind of sat there at $325 million, $309 million. It wasn't growing. It was heavily focused in the OB-GYN space and medical device products. And we did a number of acquisitions recently in the fertility space, which excites us. If you look at global fertility, I'm talking about IVF, not pharma, but IVF products, genetic testing and so forth, that's a marketplace that's growing around the world. And it's a mid- to upper single-digit growing space and has a great future, long-term future of solid growth. So we did a number of acquisitions in that space. We've been -- that's reflected in the as-reported numbers here. We're consolidating those acquisitions right now, doing a lot of integration-related work on that. We actually took a step back here. The first couple of quarters of this year were a little bit softer than we've been running in order to get a lot of distributor consolidation activity and so forth done. I think we're at a point now where you see Q3 come back a little bit stronger and we'll get back to pretty good footing on this business, as a lot of the integration activity gets behind us. But the fertility piece is now greater than half this business. So a lot of people like to look at CooperSurgical for us because it's a small piece. It's an OB-GYN business. But it's really transitioned to more of a family-type business, if you will, which includes the OB-GYN medical device products, other medical device products that are used for things like laparoscopic surgery, and then our fertility piece, which includes your basic medical device, products and services within fertility, and then also genetic testing. We're a fairly large genetic testing company within fertility. So as you go through your IVF process, you would take an embryo and that embryo or series of embryos would be sent to our labs. We would do the genetic testing on those embryos, looking for any genetic abnormalities like cystic fibrosis and so forth. If we find those genetic abnormalities in the embryo, we would obviously exclude that embryo and we would send back, if you will, "the good embryos" back to the IVF plant clinic to be implanted. So some exciting stuff there, and we're excited about that. And we're excited about what can happen within the fertility space, relatively against small portion of our business from an overall perspective. But this business went from a little bit of a stodgy business to kind of a growth, exciting kind of platform. So we're pretty excited about this. And if we look at this last quarter, you can see that fertility was up 52% and at $61 million versus $53 million for office surgical, products portfolio has become quite a bit larger than that.

If we touch on acquisitions, you can see them within CooperSurgical here, a lot of these acquisitions seems fertility, fertility, fertility. We've done 40 acquisitions over the last 27 years, so we have a tendency to do a number of small acquisitions in this space on a consistent basis. We -- if we can do that, we'll continue to look at those kind of acquisitions and try to do them, but a number of these deals that you see on here are more recent fertility-based acquisitions where we try to become a true leader in that space, outside of pharma again, but a true leader in that space for the treatment of fertility, including the diagnostic genetic testing side.

If I flip to the last slide here, which is the 5 key takeaways, I think I talked through these, you can see we're 2 separate markets, 2 unique markets, but they're both solid markets, they're both nice growth markets. They both have high barriers to entry. You can see that in the contact lens space, where we're down to 3. You can see it in the fertility space, if you look at that certainly where there's a relatively small handful of players now. Revenue growth exceeding the market, we focused on that again heavily for CooperVision where we have a lot of market data. I believe we're also getting that from CooperSurgical. Investing in the infrastructure of the business. That's an important point. We are getting a lot of growth. We are getting margin expansion but we are continuing to invest in the business from hiring sales people and other more general infrastructure investments. We're positioned to achieve our long-term objectives, and I would argue we have a pretty good track record of success, and we look to continue that.

So with that, I think we've used up most of our time.

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

Yes, I think that the best thing to do from here is why don't we adjourn to the breakout for full Q&A. That will take place in the Bellevue room on the seventh floor. I want to thank you for a really good presentation. Thank you so much, Al.
