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ASX Announcement

13 February 2018

COCHLEAR FINANCIAL RESULTS FOR THE SIX MONTHS ENDED DECEMBER 2017

Strong momentum across developed markets continues. Key points include:

- **Reported sales revenue up 6% (7% in constant currency[1]) to $639.6m**
- **Cochlear implant units down 2% to 15,972 (units up 5% excluding Chinese Central Government tender units). Developed market unit growth of 12% was offset by a reduction in emerging market units, the result of the timing of a number of tenders**
- **Reported net profit of $110.8m, down 1% (up 1% in CC). Net profit includes a $5.5m one-off non-cash impact from the revaluation of deferred tax assets following the recently announced reduction in US corporate tax rates, reducing reported net profit growth by 5%**
- **Solid cash flow generation supports the 8% increase in the interim dividend**
- **Maintain FY18 net profit guidance of $240-250 million, a 7-12% increase on FY17**

A$m	HY18	HY17	Change % (reported)	Change % (CC)
Cochlear implant units	15,972	16,234	⬇ 2%	
Sales revenue	639.6	604.4	⬆ 6%	⬆ 7%
Earnings before interest & tax (EBIT)	160.4	156.4	⬆ 3%	⬆ 4%
Net profit	110.8	111.4	⬇ 1%	⬆ 1%
Basic earnings per share	$1.93	$1.94	⬇ 1%	
Interim dividend per share	$1.40	$1.30	⬆ 8%	
Franking %	100%	100%		
Payout ratio %	73%	67%		

[1] Constant currency (CC) removes the impact of foreign exchange (FX) rate movements and FX contract gains/(losses) to facilitate comparability. See end note for further detail.

OVERVIEW

HY18 operational highlights

Cochlear's CEO & President, Dig Howitt said, "The positive momentum we have experienced across the developed markets over the past few years has continued into FY18 with a 12% increase in cochlear implant units delivered across these markets.

"Cochlear's market leadership position has strengthened with new products broadening the portfolio and driving share gains. Over the past 18 months we have released the Nucleus® 7 Sound Processor, the world's first Made for iPhone cochlear implant sound processor, the Kanso® Sound Processor, our first off-the-ear sound processor, the Nucleus® Profile Slim Modiolar (CI532) electrode, the world's slimmest electrode, and the Baha® 5 SuperPower Sound Processor, with strong demand experienced for each product.

"The Nucleus 7 Sound Processor was launched during the second quarter across key markets including the US, Western Europe and Australia, performing well in its first three months. The technology allows users to stream sound from an iPhone®, iPad® and iPod touch® directly to their sound processor, offering greater accessibility, connectivity and wireless solutions.

"Emerging market implant units reduced during the half primarily as a result of the timing of a number of tenders. In particular, the HY17 result included 1,100 Chinese Central Government tender units. We expect to start shipping the 1,491 China tender units awarded in October 2017 during the second half.

"The Services business delivered CC revenue growth of 12% driven by the release of the Nucleus 7 Sound Processor and the first time inclusion of Sycle revenue. The Acoustics business delivered sales growth of 5% in CC with solid demand continuing for the Baha® 5 range of sound processors."

Good progress made against business priorities

Mr Howitt said, "Cochlear's priorities are focused on the customer with activities aimed at building consumer awareness of cochlear implants and the importance of hearing to healthy ageing. We will continue to invest around 12% of sales in research and development (R&D) to strengthen our technology leadership position while expanding our investment in research and trials to build the clinical evidence that further demonstrates the effectiveness of our products. At the same time we are strengthening our servicing capability to provide products, programs and digital services to support the lifetime relationship with our recipients, which now number over 475,000."

Strong financial position

Cochlear delivered net profit of $110.8 million for the half, down 1% on HY17 (up 1% in CC). Mr Howitt said, "Consistent with strategy, Cochlear has continued to invest in sales, marketing and R&D to drive long-term growth. The first half result includes the launch costs for the Nucleus 7 Sound Processor as well as a $5.5 million one-off increase in taxation expense from the revaluation of the US deferred tax assets. The business generated solid cash flows and this has funded an 8% increase in the interim dividend."

Impact of changes to US tax legislation

The US Government recently passed the *Tax Cuts and Jobs Act* which contains significant tax reform measures. The major change in legislation that will affect Cochlear is from the reduction in the US federal corporate tax rate from 35% to 21%, effective 1 January 2018. The reduction in the corporate tax rate is positive and is expected to provide Cochlear with a small annual cash tax benefit.

As a consequence of the reduction in corporate tax rates, Cochlear was required to revalue its US deferred tax assets as at 31 December 2017, resulting in a reduction in the value of the asset. The first half result includes a one-time non-cash expense of $5.5 million reflecting the revaluation of the deferred tax assets, which had the effect of reducing reported net profit growth by 5%.

Cochlear expects the full year net impact of the change in US tax legislation to reduce net profit by $3-4 million, or around 1.5%, with tax savings expected in the second half from the reduction in the US corporate tax rate to partly offset the impact of the revaluation of the deferred tax asset.

FY18 financial outlook

For FY18, Cochlear reaffirms its expectations of delivering reported net profit of $240-250 million, with currency headwinds expected to moderate strong underlying business growth.

Mr Howitt said, "Positive momentum continues across the developed markets with the significant investments made in product development and market growth initiatives over the previous few years expected to underpin growth in FY18. The balance sheet and free cash flow generation remain strong and we continue to target a dividend payout ratio of around 70% of net profit."

Key guidance considerations for the second half of FY18:

- expect solid momentum in developed market unit growth to continue, which will be supported by investment in market access and market growth activities;
- expect to start shipping the 1,491 China tender units awarded in October 2017;
- expect full year R&D expenditure to be $160-170 million;
- expect the full year net impact of the change in US tax legislation to reduce net profit by $3-4 million;
- forecasting a weighted average AUD/USD exchange rate of around 79 cents for FY18 versus 75 cents in FY17.

For further information, please contact:

Analysts
Kristina Devon
Head of Investor Relations
Email: kdevon@cochlear.com
Ph: + 61 2 9611 6691

Media
Jennifer Stevenson
Head of Corporate Communications
Email: jstevenson@cochlear.com
Ph: +61 2 9611 6959

PRODUCT & SERVICE HIGHLIGHTS

	HY18	HY17	Change % (reported)	Change % (CC)
Cochlear implants (units)	15,972	16,234	⬇ 2%	
Sales revenue *(A$m)*				
Cochlear implants	393.3	377.1	⬆ 4%	⬆ 6%
Services (sound processor upgrades & other)	161.6	144.8	⬆ 12%	⬆ 12%
Acoustics (bone conduction & acoustic implants)	84.7	82.5	⬆ 3%	⬆ 5%
Total sales revenue	**639.6**	**604.4**	⬆ **6%**	⬆ **7%**

Cochlear implants – 62% of sales revenue

Reported Cochlear implant revenue grew 4% (6% in CC) with unit growth down by 2% (up 5% excluding the impact of Chinese Central Government tender units).

Across the developed world, the cochlear implant market continues to experience robust growth, with improving awareness and growing uptake in the over 65 age demographic. Cochlear's developed markets business, which represents around 80% of revenue, grew units by 12% with highlights including continued strong performances from the US and Western Europe.

The Nucleus 7 Sound Processor, the world's first Made for iPhone cochlear implant sound processor, was launched across key markets during the second quarter and has performed strongly, driving market share gains for Cochlear.

The increase in sales revenue also reflects continued investments in market growth initiatives including direct-to-consumer activities and sales force expansion. These initiatives help build awareness of implantable hearing solutions and support further penetration into the adult segment.

The emerging markets have been growing strongly over the past five years, often experiencing inconsistent rates of growth over the shorter term. Emerging markets units reduced this half, primarily as a result of the timing of a number of tenders. In particular, the HY17 result included 1,100 Chinese Central Government tender units.

Services (sound processor upgrades and other) – 25% of sales revenue

Reported Services sales revenue increased by 12% (12% in CC) driven by the release of the Nucleus 7 Sound Processor during the second quarter and first time inclusion of revenue from Sycle, the audiology practice management software business acquired in May 2017.

Sound processor upgrade revenue increased by 9% in CC with the Nucleus 7 Sound Processor available as an upgrade in key markets from October. Cochlear continues to invest to provide customers with a world class customer experience with increased connectivity and engagement to its more than 475,000 recipients. Cochlear's recipient membership program, Cochlear Family, continues to grow rapidly, with membership growing by over 27%, to around 76,000 recipients since June.

Acoustics (bone conduction and acoustic implants) – 13% of sales revenue

Reported Acoustics revenue grew 3% (5% in CC), following 20% growth in CC in HY17, with solid demand continuing for the Baha® 5 range of sound processors.

REGIONAL REVIEW

Sales revenue *(A$m)*	**HY18**	**HY17**	**Change % (reported)**	**Change % (CC)**
Americas	317.2	285.2	⬆ 11%	⬆ 15%
EMEA (Europe, Middle East & Africa)	221.7	207.9	⬆ 7%	⬆ 5%
Asia Pacific	100.7	111.3	⬇ 10%	⬇ 7%
Total sales revenue	**639.6**	**604.4**	⬆ **6%**	⬆ **7%**

Americas (US, Canada & Latin America) – 50% of sales revenue
Reported sales revenue increased by 11% (15% in CC). The highlight was the growth in the US with cochlear implant unit growth of 15%, the result of market growth as well as market share gains. Growth has been driven by new product introductions and the success of awareness building initiatives which continue to drive overall market growth rates, particularly in the seniors segment. Services revenue also grew strongly, particularly in the second quarter, following the successful introduction of the Nucleus 7 Sound Processor as an upgrade option in October.

The expanded field sales organisation, direct-to-consumer marketing and improvements in sales force effectiveness have continued to contribute to market growth in the US.

EMEA (Europe, Middle East and Africa) – 35% of sales revenue
Reported sales revenue increased by 7% (5% in CC). Western Europe unit growth was 9% with market growth and market share gains delivered across many countries including the UK and Germany. Like the US, Western Europe is benefitting from the expanded field sales organisation and direct-to-consumer marketing which are building awareness of cochlear implants and driving demand at clinics.

Expansion of indications for cochlear implantation in Western Europe continues to be a key opportunity and focus area with much of the region restricting access and funding to candidates with a profound hearing loss. Germany leads the region with indications extending to severe hearing loss, an important factor for driving growth in adults, and is in line with indications in the US, Australia and Japan.

Units and sales revenue across EMEA's emerging markets, including Central & Eastern Europe and the Middle East & Africa, reduced primarily as a result of the timing of a number of tenders.

Asia Pacific (Australasia & Asia) – 15% of sales revenue
Reported sales revenue was down 10% (7% in CC). Australia experienced solid unit growth while private pay surgeries in China continue to grow strongly. During the half, Japan announced the expansion of indications for cochlear implantation to include candidates with severe hearing loss, a major milestone that is expected to support growth of the Japanese market over the coming years. The Kanso Sound Processor is being progressively launched across the region with a number of markets experiencing a strong preference for the off-the-ear processor.

Growth at the regional level was however materially impacted by the 1,100 Chinese Central Government tender units in the HY17 result. Cochlear expects to start shipping the 1,491 China tender units awarded in October 2017 during the second half.

FINANCIAL REVIEW

Profit & loss

A$m	HY18	HY17	Change % (reported)	Change % (CC)[1]
Sales revenue	**639.6**	**604.4**	**6%**	**7%**
Cost of goods sold	176.4	176.2	0%	1%
% of sales revenue	*28%*	*29%*		
Selling, marketing and general expenses	189.1	165.2	14%	16%
Administration expenses	44.2	44.3	0%	0%
Research and development expenses	80.6	72.2	12%	11%
% of sales revenue	*13%*	*12%*		
Total expenses	**490.3**	**457.9**	**7%**	**8%**
Other net income	1.1	5.1		
FX contract gains	10.0	4.8		
EBIT	**160.4**	**156.4**	**3%**	**4%**
% of sales revenue	*25%*	*26%*		
Net finance costs	3.8	3.4	12%	
Taxation expense	45.8	41.6	10%	
% effective tax rate	*29%*	*27%*		
Net profit	**110.8**	**111.4**	**(1%)**	**1%**

[1] Constant currency removes the impact of exchange rate movements and FX contract gains/(losses) to facilitate comparability. See end note for further detail.

Reported sales revenue increased by 6% (7% in CC) to $639.6 million while total expenses increased by 7% (8% in CC) to $490.3 million. As a result, the business generated an EBIT increase of 3% (4% in CC) to $160.4 million with the EBIT margin decreasing by one point to 25%.

Key points of note:

- Reported cost of goods sold (COGS) remained in line with HY17 (increasing by 1% in CC) to $176.4 million, reflecting relatively stable volumes. COGS as a percentage of sales revenue reduced by one point to 28%;
- Selling, marketing and general expenses increased by 14% (16% in CC) to $189.1 million. The increase reflects the continued investment in the sales force and expanded marketing activities, the launch of the Nucleus 7 Sound Processor which was launched in September, and the first time inclusion of expenses related to Sycle, which was acquired in May;
- Investment in R&D increased 12% (11% in CC) to $80.6 million, representing 13% of sales revenue;
- FX contract gains on hedged sales were $10.0 million, reflecting the impact of the AUD appreciation against many of the major currencies compared to HY17 rates;

- Net finance costs increased by 12% to $3.8 million, reflecting higher average net debt levels; and
- The effective tax rate increased from 27% to 29%, reflecting the $5.5 million one-off non-cash impact from the revaluation of deferred tax assets following the recently announced reduction in US corporate tax rates. The revaluation reduced reported net profit growth by 5%.

Cash flow

A$m	HY18	HY17	Change $
EBIT	160.4	156.4	4.0
Depreciation and amortisation	15.4	15.9	(0.5)
Change in working capital and other	(24.2)	(29.0)	4.8
Net interest paid	(3.7)	(3.3)	(0.4)
Income taxes paid	(55.2)	(37.7)	(17.5)
Operating cash flow	**92.7**	**102.3**	**(9.6)**
Capital expenditure	(16.5)	(17.2)	0.7
Other investments	(3.4)	-	(3.4)
Free cash flow	**72.8**	**85.1**	**(12.3)**

The business generated $92.7 million in operating cash flows and $72.8 million in free cash flow. Key points of note:

- Income taxes paid increased by $17.5 million to $55.2 million reflecting the impact of the timing of cash tax payments; and
- Capital expenditure reduced by $0.7 million to $16.5 million.

Capital employed

A$m	Dec17	Jun17	Change $
Trade receivables	275.2	275.4	(0.2)
Inventories	177.3	160.0	17.3
Less: Trade and other payables	(116.7)	(130.9)	14.2
Working capital	335.8	304.5	31.3
Debtor days	*71*	*74*	*(3)*
Inventory days	*182*	*164*	*18*
Property, plant and equipment	121.0	120.1	0.9
Intangible assets	343.9	340.0	3.9
Other net liabilities	(88.8)	(91.6)	2.8
Capital employed	**711.9**	**673.0**	**38.9**

Capital employed increased by $38.9 million to $711.9 million since June 2017, primarily as a result of an increase in working capital.

Key points of note:

- Inventories increased by $17.3 million to $177.3 million driven by additional raw materials to cater for growing volumes as well as inventory build ahead of delivery of Chinese Central Government tender units during the second half;
- Trade and other payables reduced by $14.2 million to $116.7 million, reflecting a return to normalised levels. There was an increase in current payables in June 2017 relating to the Sycle acquisition and the gearing up of the supply chain for production of the Nucleus 7 Sound Processor; and
- Other net liabilities includes a reduction of $5.5 million in the value of US deferred tax assets. The reduction was a consequence of the legislated reduction in US corporate tax rates, which required a revaluation of US deferred tax assets as at 31 December 2017.

Net debt

A$m	Dec17	Jun17	Change $
Loans and borrowings			
Current	59.6	84.7	(25.1)
Non-current	184.4	134.2	50.2
Total debt	244.0	218.9	25.1
Cash and cash equivalents	(106.9)	(89.5)	(17.4)
Net debt	**137.1**	**129.4**	**7.7**

Net debt increased by $7.7 million to $137.1 million.

Dividends

	HY18	HY17	Change %
Interim ordinary dividend ($/share)	$1.40	$1.30	8%
Payout ratio %	*73%*	*67%*	
Franking %	*100%*	*100%*	

Strong free cash flow and the continued strength of the balance sheet have supported the payment of an interim dividend of $1.40 per share, franked at 100%, representing a payout of 73% of net profit.

The record date for determining dividend entitlements is 20 March 2018 and the interim dividend will be paid on 12 April 2018.

NOTES

Forward looking statements
Cochlear advises that this document contains forward looking statements which may be subject to significant uncertainties outside of Cochlear's control. No representation is made as to the accuracy or reliability of forward looking statements or the assumptions on which they are based. Actual future events may vary from these forward looking statements and it is cautioned that undue reliance not be placed on any forward looking statement.

Non-IFRS financial measures
Given the significance of exchange rate movements, the directors believe the presentation of the non-IFRS financial measure, constant currency, is useful for the users of this document as it reflects the underlying financial performance of the business. This non-IFRS financial measure has not been subject to review or audit. However, KPMG has separately undertaken a set of procedures to agree the non-IFRS financial measures disclosed to the books and records of the group.

Constant currency
Constant currency removes the impact of exchange rate movements to facilitate comparability of operational performance for Cochlear. This is done by converting the prior comparable period net profit of entities in the group that use currencies other than Australian dollars at the rates that were applicable to the current period (translation currency effect) and by adjusting for current year foreign currency gains and losses (foreign currency effect). The sum of translation currency effect and foreign currency effect is the amount by which reported EBIT and net profit is adjusted to calculate the result at constant currency.

Reconciliation of constant currency net profit to reported net profit

	HY18	HY17	Change %
Net profit (reported)	**110.8**	**111.4**	**(1%)**
FX contract gains		5.2	
Spot exchange rate effect to sales and expenses[1]		(4.0)	
Balance sheet revaluation[1]		(2.7)	
Net profit (CC)	**110.8**	**109.9**	**1%**

[1] HY18 actual v HY17 at HY18 rates