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ASX Announcement

19 February 2019

COCHLEAR FINANCIAL RESULTS FOR THE SIX MONTHS ENDED DECEMBER 2018

The business delivered an increase in in sales revenue of 11% and net profit of 16% for the half

- **Reported sales revenue up 11% (6% in constant currency[1]) to $711.9m**
- **Cochlear implant units up 5% to 16,740**
- **Reported net profit of $128.6m, up 16% (up 16% in CC), up 11% (11% in CC) adjusted for the impact of the deferred tax asset revaluation in HY18**
- **Strong cash flow generation supports the 11% increase in the interim dividend**
- **AMF patent dispute disclosed as a contingent liability**
- **Maintaining FY19 net profit guidance of $265-275 million, an 8-12% increase on FY18**

A$m	**HY19**	HY18	Change % (reported)	Change % (CC)
Cochlear implant units	**16,740**	15,972	⬆ 5%	
Sales revenue	**711.9**	639.6	⬆ 11%	⬆ 6%
Earnings before interest & tax (EBIT)	**177.0**	160.4	⬆ 10%	⬆ 11%
Net profit	**128.6**	110.8	⬆ 16%	⬆ 16%
Net profit margin %	***18%***	*17%*		
Basic earnings per share	**$2.23**	$1.93	⬆ 16%	
Interim dividend per share	**$1.55**	$1.40	⬆ 11%	
Franking %	**100%**	100%		
Payout ratio %	**70%**	73%		

[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

HY19 operational highlights

The business delivered sales revenue growth of 11% (6% in CC) for the half.

The highlight was the Services business which grew revenue by 28% (21% in CC), with sound processor upgrade revenue increasing by 26% in CC. Cochlear's CEO & President, Dig Howitt said, "The Services business continues to grow in importance as our recipient base grows, now representing almost 30% of sales revenue. Cochlear's recipients have enthusiastically embraced the Nucleus® 7 Sound Processor, the world's first Made for iPhone cochlear implant sound processor, launched in October 2017, with the addition of the Nucleus Smart App for Android™, released in June 2018."

The cochlear implant business grew revenue by 5% (0% in CC) with unit growth of 5%. Mr Howitt said, "After delivering eight halves of strong growth driven by a combination of market growth and share gains from new products, our developed markets delivered units in line with the first six months of last year.

"The US experienced a lower rate of growth with a loss of share following a competitor product launch. Western European growth was affected by a combination of factors including health budget constraints in a few markets and increased competitor activity, particularly in Germany. Japan was the highlight with strong demand following the expansion of indications and funding for cochlear implants in late 2017.

"The seniors segment continues to be the fastest growing segment across the developed markets as awareness increases. Surgeries for seniors, particularly in the US, are increasingly being driven by our successful direct-to-consumer marketing campaigns, with a small but growing number being referred from the hearing aid channel. The Cochlear Provider Network in the US is expanding rapidly, increasing education of the indications and benefits of cochlear implants to hearing aid audiologists and providing a referral pathway to cochlear implant surgeons.

"Our emerging markets business had a strong start to the year with units growing by over 15%. Emerging markets provide a long-term growth opportunity as awareness of and affordability for cochlear implants expands. The strong growth we have been experiencing in part reflects investments over many years to strengthen our presence across all regions."

The Acoustics business grew revenue by 7% (1% in CC) with demand continuing for the Baha 5 sound processor range.

Commitment to product innovation and technology leadership

Cochlear is committed to being the technology leader in the industry. Mr Howitt said, "At Cochlear, we are driven to develop hearing solutions that improve hearing outcomes and empower people to connect with others and live a full life. Our latest product releases, including the Nucleus® 7 Sound Processor, the Nucleus Smart App for Android™ smartphone users and the Baha® SoundArc, provide recipients with the combination of market-leading technology, connectivity and lifestyle solutions.

"Over the last six months we have expanded the Smart Hearing Alliance collaboration with GN Hearing which will ensure our bimodal recipients, which are growing rapidly, can access the latest in connectivity and wireless technology. We also continue to invest in long-term product innovation, recently announcing the next phase in the development of a totally implantable cochlear implant, with the start of a further clinical feasibility study."

Cochlear continues to advance its innovation agenda with a number of new products in the pipeline. "As we look ahead, we have an exciting portfolio of products to be launched over the next 18 months, supported by our continuing commitment to invest around 12% of revenue, or over $170 million per annum, in R&D," said Mr Howitt.

Multi-year investments in building awareness and market access

Cochlear's priorities are centred on the customer, with activities aimed at growing awareness and access to the industry for implant candidates. And with a growing recipient base, the Company is actively strengthening its servicing capability to provide products, programs and services to support the lifetime relationship with recipients.

Mr Howitt said, "Cochlear has an important role to play in supporting cochlear implants becoming the standard of care for adults and seniors with severe to profound hearing loss. We have been increasing our investment in health economics, our market access capability and the collaborative partnerships we have with the medical research community to build on the clinical evidence that demonstrates the effectiveness of our products, particularly for seniors.

"At the same time, we are increasing our focus on driving referrals from the hearing aid channel by building education and capability in the channel through our Cochlear Provider Network and Sycle software business in the US."

Expanding indications for cochlear implants

There is a growing recognition of the need to expand the clinical indications for cochlear implants as outcomes have improved. Mr Howitt said, "Over the past 18 months we have seen the expansion of clinical indications and/or reimbursement for cochlear implants in Japan and Taiwan, Greater China with greater demand experienced for implants following the changes. Health authorities in the UK, a Top 5 market for Cochlear, are currently reviewing cochlear implantation criteria and are expected to expand clinical indications and funding in the next few months."

Strong financial position

Cochlear delivered net profit of $128.6 million, an increase of 16% on HY18 (16% in CC). Adjusting for the impact of the deferred tax asset revaluation in HY18, net profit increased by 11% (11% in CC). Operating cash flow increased by $71.4 million to $164.1 million and the Board has declared an interim dividend of $1.55, an increase of 11% on the last year.

Mr Howitt said, "Cochlear continues to target the delivery of consistent revenue and earnings growth over time. We have a strong balance sheet and delivered operating cash flows in excess of net profit, enabling the business to fund market development activities and capital investment, while reducing net debt and increasing dividends to shareholders."

Patent dispute contingent liability

In November 2018, the US District Court awarded damages of US$268 million against Cochlear in the long-running patent dispute with Alfred E. Mann Foundation for Scientific Research (AMF) and Advanced Bionics LLC (AB). Cochlear has appealed the decision, including the damages award and the finding of "willfulness" and has arranged an insurance bond of US$335 million to stay the Judgment pending the appeal.

AMF and AB have subsequently asked the District Court to award US$123 million in prejudgment interest. Cochlear has opposed both the application and the calculation methodology. The Judge has reserved his decision until further notice. Any interest award is contingent upon the current damages being upheld in the Appeals Court.

The Board of directors has obtained independent legal advice on Cochlear's appeal prospects. The Board is of the opinion it is probable that Cochlear's appeal will result in the lawsuit being remanded to the District Court for a retrial on damages.

Given the inherent uncertainties in assessing the likely damages amount of this case following the appeal, the Board is unable to make a reliable estimate of the amount that will ultimately be paid to AMF and AB. As a result, the provision for damages held at 30 June 2018 of $21.3 million has been released and a contingent liability is disclosed.

Subsequent to the District Court's November 2018 decision, a provision for estimated future costs including legal fees, bond costs and other costs associated with defending this matter was made. As at 31 December 2018, $19.6 million of the provision remains.

Cochlear's current product portfolio is not affected by this litigation as the patent at issue has expired. The Company maintains a very strong balance sheet with conservative gearing levels. In the event the appeal is unsuccessful, the Board is confident that Cochlear will be able to access debt facilities to fund the existing decision and any award of interest and costs.

FY19 financial outlook

For FY19, Cochlear reaffirms its expectations of delivering reported net profit of $265-275 million, an 8-12% increase on FY18. Mr Howitt said, "We expect to continue to deliver growth in revenue and earnings in the coming years, underpinned by the significant investments made in product development and market growth initiatives.

"We will continue to invest operating cash flows in activities aimed at building awareness and market access, with the objective of delivering consistent revenue and earnings growth over the long-term. We are targeting to maintain the net profit margin, reinvesting any efficiency gains, currency or tax benefits into market growth activities, adapting the pace of investment to revenue growth.

"Over the next few years, we have a number of large long-term investment projects including the development of our China manufacturing facility, with the construction phase expected to be complete by the end of FY20, and investments in IT platforms to strengthen our connected health, digital and cyber security capabilities. As previously advised, these projects are expected to increase capital expenditure levels to $80-100 million per annum over the next few years.

"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 FY19:

- Revenue growth to be driven by the Services business, with strong uptake of the Nucleus 7 Sound Processor, particularly in the first half;
- Expect a lower rate of cochlear implant growth across the developed markets for FY19;
- Emerging market growth rates over time continue to be strong, however, annual growth rates can be variable driven by the timing of tender based activity and macro-economic conditions;
- Continued investment to retain market leadership and drive long-term market growth with the target of maintaining the net profit margin; and
- Forecasting a weighted average AUD/USD exchange rate of 72 cents for FY19 (77 cents in FY18) and AUD/EUR of 0.63 EUR (0.65 EUR in FY18).

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PRODUCT & SERVICE HIGHLIGHTS

	HY19 $m	HY18 $m	Change % (reported)	Change % (CC)
Cochlear implants (units)	16,740	15,972	⬆ 5%	
Sales revenue				
Cochlear implants	413.9	393.3	⬆ 5%	⬆ 0%
Services (sound processor upgrades and other)	207.2	161.6	⬆ 28%	⬆ 21%
Acoustics (bone conduction and acoustic implants)	90.8	84.7	⬆ 7%	⬆ 1%
Total sales revenue	**711.9**	**639.6**	**⬆ 11%**	**⬆ 6%**

Cochlear implants – 58% of sales revenue

Cochlear implant revenue grew 5% (0% in CC) with unit growth of 5%. Cochlear's developed markets business, which represents around 80% of revenue, delivered units and CC revenue in line with last year.

The US experienced a lower rate of growth with a loss of share following a competitor product launch. Western European growth was affected by a combination of factors including health budget constraints in a few markets and increased competitor activity. Japan was the highlight, growing strongly following the expansion of indications and funding for cochlear implants in late 2017.

The seniors segment continues to be the fastest growing segment across the developed markets as awareness increases. Surgeries for seniors, in the US in particular, are increasingly being driven by the company's successful direct-to-consumer marketing campaigns, with a small but growing number being referred from the hearing aid channel.

Emerging markets units grew by over 15%. Emerging markets provide a long-term growth opportunity with growing awareness and affordability for cochlear implants. Cochlear continues to increase its direct presence across all regions.

Services (sound processor upgrades and other) – 29% of sales revenue

Reported Services sales revenue increased by 28% (21% in CC). Sound processor upgrade revenue increased by 26% in CC driven by strong uptake of the Nucleus 7 Sound Processor. The growing recipient base, initiatives to strengthen connectivity with recipients as well as the product's market leading functional and lifestyle features, have all contributed to the strong Services growth.

Cochlear continues to invest to provide its growing customer base with a world-class customer experience with increased connectivity and engagement. Cochlear Family, the recipient membership program, provides Cochlear with the opportunity to connect directly with recipients to provide service and support. Membership continues to grow rapidly, increasing by 20% since June 2018, to now exceed 120,000 members with an acceleration in recruitment in recent years driven by a combination of direct outreach programs and improvements in customer onboarding.

Cochlear Family members upgrade to new technology at a greater rate than non-members and adopt new products more rapidly. They are also more likely to volunteer to provide implant candidates with support on their hearing loss journey, an important factor for many in deciding to proceed to surgery.

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

Reported Acoustics revenue increased by 7% (1% in CC) with solid demand continuing for the Baha 5 sound processor range.

REGIONAL REVIEW

Sales revenue	HY19 $m	HY18 $m	Change % (reported)	Change % (CC)
Americas	350.5	317.2	⬆ 10%	⬆ 3%
EMEA (Europe, Middle East and Africa)	248.4	221.7	⬆ 12%	⬆ 8%
Asia Pacific	113.0	100.7	⬆ 12%	⬆ 8%
Total sales revenue	**711.9**	**639.6**	**⬆ 11%**	**⬆ 6%**

Americas (US, Canada & Latin America) – 49% of sales revenue

Reported sales revenue increased by 10% (3% in CC). The US experienced a lower rate of growth with a loss of share following a competitor product launch. Services performed strongly driven by upgrades to the Nucleus 7 Sound Processor.

The business continues to invest in expanding field sales and direct-to-consumer marketing in the US with a growing emphasis on working with the hearing aid channel to grow referrals. The Cochlear Provider Network is expanding rapidly and is increasing education of the indications and benefits of cochlear implants to hearing aid audiologists and providing a referral pathway to cochlear implant surgeons.

EMEA (Europe, Middle East and Africa) – 35% of sales revenue

Reported sales revenue increased by 12% (8% in CC). Unit growth in Western Europe was affected by a combination of factors including health budget constraints in a few markets and increased competitor activity, particularly in Germany. Services however performed strongly driven by upgrade demand for the Nucleus 7 Sound Processor.

Western Europe continues to invest in expanding the field sales organisation, building its market access resources and direct-to-consumer marketing to build awareness of cochlear implants and drive demand at clinics.

Expansion of indications and funding for cochlear implantation in Western Europe is a key opportunity, with expectations of an expansion of indications and funding for the UK in the coming months.

Units and sales revenue across EMEA's emerging markets grew strongly as a result of the timing of a number of tenders and is underpinned by investments in the organisation in recent years.

Asia Pacific (Australasia & Asia) – 16% of sales revenue

Reported sales revenue increased by 12% (8% in CC). Japan experienced strong unit growth, with Australia delivering strong growth in sound processor upgrades. Solid unit growth was delivered across a number of smaller countries in the region driven by a combination of tender activity, expanded indications and Cochlear's growing presence.

There were only a small number of Chinese Central Government tender units delivered in both HY19 and HY18, with no impact on revenue growth for the region.

FINANCIAL REVIEW

Profit & loss

	HY19 $m	HY18 $m	Change % (reported)	Change % (CC)
Sales revenue	**711.9**	**639.6**	**11%**	**6%**
Cost of goods sold	179.5	176.4	2%	(2%)
% gross margin	*75%*	*72%*	*3 pts*	*2 pts*
Selling, marketing and general expenses	216.1	189.1	14%	10%
Administration expenses	47.5	44.2	7%	7%
Research and development expenses	88.2	80.6	9%	8%
% of sales revenue	*12%*	*13%*		
Total expenses	**531.3**	**490.3**	**8%**	**5%**
Other net income	4.5	1.1		
FX contract gains / (losses)	(8.1)	10.0		
Earnings before interest and tax (EBIT)	**177.0**	**160.4**	**10%**	**11%**
% of sales revenue	*25%*	*25%*		
Net finance expense	2.7	3.8	(29%)	
Income tax expense	45.7	45.8	0%	
% effective tax rate	*26%*	*29%*		
Net profit	**128.6**	**110.8**	**16%**	**16%**
Net profit margin %	*18%*	*17%*		

Reported sales revenue increased by 11% (6% in CC) to $711.9 million while total expenses increased by 8% (5% in CC) to $531.3 million. As a result, the business generated an EBIT increase of 10% (11% in CC) to $177.0 million, with the EBIT margin remaining stable at 25%.

Key points of note:

- Reported cost of goods sold increased by 2% (down 2% in CC) to $179.5 million, reflecting manufacturing efficiencies, lower warranty costs and lower repair expenses resulting from the centralisation of repairs. As a result, gross margin improved by three percentage points to 75%;
- Selling, marketing and general expenses increased by 14% (10% in CC) to $216.1 million. The increase reflects the continued investment in the sales force and direct-to-consumer marketing, with a growing investment in longer-term market growth activities including standard of care and market access initiatives;
- Investment in R&D increased 9% (8% in CC) to $88.2 million, representing 12% of sales revenue;
- Other net income of $4.5 million includes $5.3 million relating to a release in the contingent consideration value of Sycle and a $3.5 million write down in the investment in Earlens; and
- The effective tax rate reduced from 29% to 26% primarily reflecting the impact of the $5.5 million revaluation of the deferred tax asset in HY18, a result of the changes to the US federal corporate tax rate.

Cash flow

	HY19 $m	HY18 $m	Change $m
EBIT	177.0	160.4	16.6
Depreciation and amortisation	17.5	15.4	2.1
Changes in working capital and other	19.0	(24.2)	43.2
Net interest paid	(2.7)	(3.7)	1.0
Income taxes paid	(46.7)	(55.2)	8.5
Operating cash flow	**164.1**	**92.7**	**71.4**
Capital expenditure	(36.0)	(15.1)	(20.9)
Acquisition of other intangible assets	(8.7)	(1.4)	(7.3)
Other net investments	(20.9)	(3.4)	(17.5)
Free cash flow	**98.5**	**72.8**	**25.7**

Operating cash flow increased by $71.4 million to $164.1 million and free cash flow increased by $25.7 million to $98.5 million.

Key points of note:

- EBIT increased by $16.6 million driven by the 11% increase in sales revenue;
- Changes in working capital and other increased by $43.2 million, primarily reflecting a reduction in trade receivables;
- Capital expenditure (capex) increased by $20.9 million to $36.0 million, reflecting stay in business capex as well as the commencement of construction of the China manufacturing facility;
- Acquisition of intangible assets primarily relates to investments in IT software; and
- Other net investments of $20.9 million primarily relates to the investment in Nyxoah, a medical device company focused on the development and commercialisation of a best-in-class hypoglossal nerve stimulation therapy for the treatment of Obstructive Sleep Apnea.

Capital employed

	Dec18 $m	Jun18 $m	Change $m
Trade receivables	275.0	299.1	(24.1)
Inventories	176.5	167.4	9.1
Less: Trade and other payables	(144.1)	(140.5)	(3.6)
Working capital	307.4	326.0	(18.6)
*Working capital / sales revenue**	*22%*	*24%*	*(2%)*
Debtor days	*69*	*69*	-
Inventory days	*178*	*171*	*7*
Property, plant and equipment	140.9	128.4	12.5
Intangible assets	368.8	345.3	23.5
Other net liabilities	(90.9)	(102.7)	11.8
Capital employed	**726.2**	**697.0**	**29.2**

* Based on doubling HY19 sales revenue.

Capital employed increased by $29.2 million to $726.2 million since June 2018.

Key points of note:

- Working capital decreased by $18.6 million driven by a reduction in trade receivables. The improvement is a combination of a strong focus on collections and business mix, with a lower mix of tenders with long payment terms; and
- Intangible assets increased by $23.5 million to $368.8 million primarily reflecting investments in IT.

Net debt

	Dec18 $m	Jun18 $m	Change $m
Loans and borrowings:			
Current	3.5	3.7	(0.2)
Non-current	161.5	144.0	17.5
Total debt	165.0	147.7	17.3
Less: Cash and cash equivalents	(92.3)	(61.5)	(30.8)
Net debt	**72.7**	**86.2**	**(13.5)**

Net debt decreased by $13.5 million to $72.7 million since June 2018, driven by improved earnings.

Dividends

	HY19	HY18	Change %
Interim ordinary dividend (per share)	$1.55	$1.40	11%
Payout ratio %	70%	73%	
Franking %	100%	100%	

Strong free cash flow and the continued strength of the balance sheet have supported the declaration of an interim dividend of $1.55 per share, an increase of 11%, franked at 100% and representing a payout of 70% of net profit.

The record date for determining dividend entitlements is 26 March 2019 and the interim dividend will be paid on 16 April 2019.

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 foreign 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 the 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

	HY19 $m	HY18 $m	Change %
Net profit (reported)	**128.6**	**110.8**	**16%**
FX contract movement		(18.1)	
Spot exchange rate effect to sales and expenses*		18.9	
Balance sheet revaluation*		(1.1)	
Net profit (CC)	**128.6**	**110.5**	**16%**

* HY19 actual v HY18 at HY19 rates.